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NAVY SHIPBUILDING PROBLEMS AT GENERAL DYNAMICS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC RESOURCES, COMPETITIVENESS,
AND SECURITY ECONOMICS

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

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NAVY SHIPBUILDING PROBLEMS AT GENERAL DYNAMICS

FRIDAY, JUNE 28, 1985

CONGRESS OF THE UNITED STATES, SUBCOMMITTEE ON ECONOMIC RESOURCES, COMPETITIVENESS, AND SECURITY ECONOMICS OF THE JOINT ECONOMIC COMMITTEE,

Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room SD-628, Dirksen Senate Office Building, Hon. William Proxmire (vice chairman of the subcommittee) presiding.

Present: Senator Proxmire.

Also present: Richard F. Kaufman, general counsel.

OPENING STATEMENT OF SENATOR PROXMIRE, VICE CHAIRMAN

Senator PROXMIRE. The subcommittee will come to order.

This morning, we are continuing our hearings into defense contract abuses. Our focus has been on General Dynamics' Navy shipbuilding contracts.

The Joint Economic Committee's interests in economy in Government and in the defense sector of the economy are long standing.

We have inquired into and disclosed several kinds of defense contract abuses. All of them have one thing in common: They unjustifiably increase the costs of defense and the burden on the taxpayer.

The present series of hearings have demonstrated a critical weakness in the defense contract system that contributes greatly to the problem. That is, the weakness in law enforcement.

The law enforcement agencies provide our last protection against defense contract abuses. It should be obvious by now that there is no more serious area of white collar crime. Yet, it is fair to say that, until now, there has been a breakdown of criminal law enforcement concerning the large defense contractors.

In recent decades, not a single high official of a major defense contractor has been indicted, and very few large firms have received even mild reproaches for their criminal behavior.

In view of the numerous criminal investigations currently underway, there is some possibility that this situation might change. There seems to be a new sense of seriousness at the Justice Department and in some quarters of the Pentagon. But we must wait and see if there are any results.

Part of the problem of law enforcement concerns the Securities and Exchange Commission. It has investigated two major defense contractors in the last 10 years or so, to my knowledge, Litton and General Dynamics.

In the Litton case, which involved Navy shipbuilding claims, a consent decree was obtained in a civil action. In the General Dynamics case, an investigation was begun in 1978 and dropped without any action taken in 1982.

There is an apparent reluctance in the SEC to go after large defense contractors who may be in violation of the securities laws. We will probe that reluctance today.

Our first witness is Abraham J. Briloff, Emanuel Saxe Distinguished Professor of Accountancy at the Bernard M. Baruch College, City University of New York. Professor Briloff is an author of many books and articles and a recognized authority on corporate accounting.

Mr. Briloff will be followed by John Shad, Chairman of the Securities and Exchange Commission.

Professor Briloff, I have read your excellent statement which, in the interest of time and so that we can get to the questions, I would like you to summarize or give the highlights of your conclusions in 15 minutes or so.

By the way, I should mention the fact that General Dynamics' outside audit firm, Arthur Andersen & Co., will receive some criticism during this hearing. I invited Arthur Andersen to testify this morning, but they chose not to do so.

Mr. Briloff, go right ahead, sir.

STATEMENT OF ABRAHAM J. BRILOFF, EMANUEL SAXE DISTINGUISHED PROFESSOR OF ACCOUNTANCY, THE BERNARD M. BARUCH COLLEGE, CITY UNIVERSITY OF NEW YORK

Mr. BRILOFF. Thank you, Mr. Vice Chairman.

I will omit my prefatory remarks in order to save time for the presentation and questions as you put it. However, I do want to express appreciation once again for the privilege of having been invited as a citizen to share whatever wisdom or experiences I may have in connection with this very significant and vital issue.

For purposes of my brief presentation, I have endeavored to summarize my thoughts around four related themes.

THE ACCOUNTING ISSUE

The first has to do with the accounting issue here involved, the conceptual issue that's involved; namely, the precepts and generally accepted accounting principles which might apply, which should apply, and possibly those that may have been abused.

Clearly, we are dealing here with a very special kind of accounting process; namely, percentage of completion accounting, which very briefly, permits the entity, General Dynamics, each year to pick up a proportionate slice of the potential profit with respect to the entire program as envisaged by the company and its independent auditors.

Now this, of course, is a very difficult phenomenon because in order to pursue this accounting alternative, management and the auditors are constrained to try to anticipate all of the costs and the revenues with respect to the program and then take proportionate slices of the potential profit year by year by year.

Now in addition, however, the precepts provide that if at any time, at any critical measuring period, the contract that's here subject to the percentage of completion demonstrates that a loss is probable, then the entire amount of the loss thus perceived or anticipated has to be factored into the operations for the particular period of measurement.

So what we have here very specifially and succintly is the question as to whether the company, and therefore the auditors, should have been permitted in the year 1976 to factor in as a plus in this complex calculus more than one-half of a billion dollars of claims which it had been filing with the Navy with respect to these contracts, and then for the year 1977, this amount which they factored in as a plus assumed to be $840 million.

The record, to the extent that it has been discerned by me and referred to in the auditor's footnotes, indicates that unless almost all of that one-half of a billion dollars was in fact recoverable by General Dynamics in 1976 and unless all of that $840 million of pluses for 1977 were in fact impacted into this cost-revenue relationship, then General Dynamics would have been constrained to show a loss on the 688 submarine contracts for the respective years. Instead of showing such a loss, the auditors—management and the auditors showed a break-even or a zero gain or loss instead of biting the bullet as it might have, all facts considered, which I will refer to briefly in a few moments, they determined to escape that critical determination and they showed no gain or loss.

Now there's no question but that with respect to the one-half of a billion dollars and the $840 million the management and the auditors were confronted with a serious problem of uncertainty. They did not know for sure as to what it is that the Navy would in fact be allowing on the amount that would be bargained out, but Senator, this is precisely the area in which accounting is constrained to operate; namely, the realm of uncertainty.

We have an uncertainty in many different contexts and I would note the fact that inasmuch as General Dynamics, through their accounting presentation and understandably, used these income injection numbers to increase their so-called current assets, namely, assets which are presumed to be available during the current operating cycle to meet General Dynamics' current liabilities, the problem of valuation and putting a value judgment on these uncertainties becomes particularly vexing, particularly urgent.

Now the problem is not brand new in percentage-of-completion accounting. We have the matters of uncertainty with respect to inventories. At what value should the inventories be reflected where there is uncertainty as to what the products will be sold for? We have that problem of uncertainty with respect to receivables. How much might fall out? And if we refer to insurance companies, by definition, they are dealing with uncertainty, and certainly banks with respect to their loan-loss reserves are dealing with uncertainty.

This is the vexing problem. This is the nettle that auditors must grasp.

So it is that we are not dealing with a brandnew problem but, nonetheless, it does become intense when we are dealing with percentage-of-completion accounting.

I want to move now to the second theme; namely, the responsibility of the independent auditors with respect to this critical judgment call.

THE INDEPENDENT AUDITORS

Certainly recognizing, as they did, that they were dealing with a situation of uncertainty, they should have manifested that independence, that healthy skepticism, that professional skepticism, that the Securities and Exchange Commission emphasizes so regularly, to try to determine just what are the probable determinations for this one-half of a billion dollars for 1976 and the $800 million for 1977.

Now it is my present sincere belief, based upon the documents that have been made available and the critical ones which are exhibits in my prepared statement, that had the auditors manifested that independence which is so essential, that unbiased critical mind which is so vital for the independent auditor to fulfill the objectives of the independent audit function, they should have, they were constrained to, they were required to determine the appropriateness and the verifiability of the one-half of a billion dollars.

Now there are items in the exhibits which indicate the fact that the engagement partner of Electric Boat, which was where the submarines were being constructed in Connecticut, wanted to inquire of the Navy as to whether and the extent to which these claims would be recoverable and he was told, based upon a memorandum in the files of Arthur Andersen, well, it will serve no purpose. Well, I cannot conceive of anyone with that healthy skepticism accepting that it would serve no purpose, particularly since as the Securities and Exchange Commission just 2 months after the issuance of the 1977 report, in documenting the reasons why a formal investigation should be undertaken—mind you, just 2 months after the preparation of the audit report—had a detailed listing of the extent to which the claims which were presumed to aggregate $800 million and more, were specious and inappropriate in terms of what the Navy's responsibility might have been. And only shortly after that were the claims settled out with General Dynamics really having to swallow a loss of about $350 million or $360 million pretax.

The point I'm making here is that the auditors preferred not to manifest that independence and healthy skepticism, and I particularly singled out for inclusion amongst the exhibits as exhibit G a memorandum in the files of General Dynamics whereby Mr. Lengfelder—and I have not sought to determine what his position was, although he appears to be principally involved in the overall relationship with General Dynamics because he's in the St. Louis office—saying that it's only if the auditors were certain, and he underlined the word "certain," that there would be a loss should there be any loss reflected on the financial statements.

I maintain emphatically that such an approach is nonsensical when we are dealing by definition with uncertainty. So it is that the critical value judgment should have been made by the auditors and the critical judgments here are peculiary material when we realize that for 1976 the pretax income of the General Dynamics Corp. was only about $130 million, including, mind you, the propor-

tionate income of unconsolidated subsidiaries, and for the year 1977 it was about $160 million.

The point I am making is that I have no doubt but had the auditors really determined to probe what was underneath this layer and into this potential can of worms and had they actually looked at the various documents which could have been made available to them, including internally created reports in the General Dynamics organization, that they most certainly would have been able to find enough questions and challenges to the one-half of a billion dollars or the $800 million to convert those $130 and $160 million pluses into negative numbers.

And as I noted earlier, when a few months after the 1977 report was promulgated in the spring of 1978, General Dynamics did swallow a writeoff of about $350 million pretax. Clearly, these loss numbers would have eliminated entirely the profits of the years 1976 and 1977.

Apparently there was an important compulsion somehow or other to get over 1976 first and then, trapped with what they did in 1976, to get over 1977 and then, even though there were then settlement discussions moving forward intensively and aggressively with the Navy to determine somehow or other to put that off beyond the audit date.

Moving very briefly to the third layer; namely, the process of corporate governance and accountability that prevailed within the General Dynamics Corp.

CORPORATE GOVERNANCE AND ACCOUNTABILITY

There, the files—and I must admit that here my mind is undoubtedly very much affected by my recall of the transcripts of the tapes of the Veliotis recordings—tend to emphasize the point that I made when questioned by Mr. Tyler of the Washington Post when a year ago he was writing his story regarding General Dynamics, based upon all that I had seen, this was most certainly a Byzantine environment, and Mr. Tyler quoted me correctly on that score.

It seems as though everyone wanted to protect everyone else from disagreeable news and, sadly, to go back, Arthur Andersen similarly was unable to bring itself to actually present the bad news in the 1976-77 reports at least.

Furthermore, as my prepared statement makes clear, it appears that even as recently as a few weeks ago, when Mr. Lester Crown was interviewed by the New York Times, there was still no mea culpa. The best that he could say was that there were mistakes, they didn't know what things would look like on the front pages of the newspapers when things came to light, that maybe the system ought to be changed.

Mr. Chairman and others, it's not the system. It's the individuals who operate within the system who must understand far more fully and forthrightly the roles and responsibilities that those of us who are possessed of power, various kinds of power, whether it be within the professions or the corporate entity or within journalism, must realize where we stand, why it is that society has endowed us with these important responsibilities, and to recognize that with

this responsibility that's been passed to us, delegated to us, there must be a full and equal measure of accountability.

Now I move to the last of the themes that I have prepared in my mind for deliberation; namely, the Securities and Exchange Commission when it determined in early 1982 to drop the then pending investigation of the General Dynamics Corp. with respect to this particular issue here involved that I have been discussing.

THE SECURITIES AND EXCHANGE COMMISSION

And as my text makes clear, there's that sense of deja vu because 3 years ago in 1982 I was testifying critically before a House committee regarding the Securities and Exchange Commission's almost corresponding determination to drop an investigation that was then pending with respect to the Citicorp situation.

And the aspects of consistency—and I will turn to the details in a moment with my concluding observations—is that in neither case, neither in the Citicorp nor General Dynamics case, did the Securities and Exchange Commission recognize that it wasn't just dealing with narrow accounting issues, whether the debits are here or the credits are there. They should have recognized the fact that here were entities possessed of enormous power who somehow within their operational complexes failed to fulfill their accountability and appropriate governance responsibilities.

Turning now to the critical issues where the SEC interfaces with the underlying accounting issues, why did the SEC say they were dropping these proceedings?

First of all, they said that it's because of the fact that it's so old and it's so complex and there would be a great deal of resources that would have to be delegated to it.

Well, the first question I would ask is, I don't know why the proceedings were so attenuated, as to why the examination wasn't going forward more aggressively, but that I do not know and cannot respond to.

The second basis for their determination was that they didn't have enough resources that might be allocated to this rather complex situation, but then my response to the SEC is if you don't have enough resources to do that which the law has delegated to you to fulfill, then what you ought to do is to either ask for these additional allocations or resources or else determine that you are not capable of fulfilling that which the securities laws compel you to fulfill.

You see, what happens by not allocating resources to these complex issues, it means that the SEC builds up an extraordinarily beautiful enforcement record where they will pick up some accountants somewhere in the boondocks who somehow or other may have fouled the nest in connection with an audit or the failure to audit the accounts of a $1 million or a $2 million stock offering.

In short, they build up their record on these tiny piddling items and to quote St. Matthew once again, "They are very effective at straining at a gnat while swallowing camels."

Now in terms of the way they responded technically on this, they said, well, there is this matter where maybe the 1976 footnote ex-

plaining this was defective but in 1977 that was better. That was better.

I submit that after studying that 1977 far more extensive footnote in the General Dynamics' financial statement, yes, there was a great deal more rhetoric, but to quote the chief accountant of the enforcement division, in an unrelated context but in a general context in a talk just a week ago Thursday in Michigan, "I see this as being just a lot of smoke and not the underlying substance." The underlying substance, I submit, was essentially that which in May 1978 the SEC enforcement division staff when they requested the investigation to be initiated, there was the substance, namely describing all of the inappropriate assumptions that were used by General Dynamics in making the claims of the Navy.

I would not use the smoke metaphor. This kind of disclosure I have referred to at various times as the "bikini" phenomenon; namely that which it disclosed was interesting; that which it concealed was vital.

But now the SEC then said, well, there is this Financial Accounting Standards Board Statement No. 5 dealing with contingencies and, here, low and behold, this $500 million and the $800 million was uncertain—was uncertain. Therefore, how could we criticize their somehow or other walking away from this phenomenon?

I go back to square one. This was precisely the kind of an area where value judgments on the part of the auditors were essential and even Arthur Andersen, in an extraordinarily attractive monograph which they prepared early this year on the objectives of financial statements, makes it clear that this contingency safety net that accountants might have should be very much restricted like, for example, they refer to the fact that some litigation—Union Carbide, for example, can take advantage of that contingency phenomenon with respect to the Bophal disaster last December because there was utter confusion as to what it is would prevail and there was no way they could anticipate that or factor that in. And then they say also with respect to the taxes which may be in litigation where the issues are complex. But here I come back to square one. The statement of the Financial Accounting Standards Board No. 5 relating to contingencies would, I submit, by its terms—and this I discuss in my presentation—by its terms would have precluded the inclusion of this half a billion or $800 million of revenues on the plus side, and instead, would have demanded a realistic evaluation of what the numbers should have been.

And I can't help but feel that all involved sensed and knew, but they were afraid or reluctant to be the messengers of unhappy news.

So it is, Mr. Vice Chairman and others, I have tried to summarize a long, long period of reflection—hard reflection with respect to these issues. I know I have been sometimes somewhat preemptory in these remarks, but to the extent that you have any questions for me to flesh out or go beyond what I have said, I would be privileged to answer to the best of my knowledge and belief.

[The prepared statement of Mr. Briloff follows:]

PREPARED STATEMENT OF ABRAHAM J. BRILOFF

Submerging and Camouflaging General Dynamics' Submarine Losses

Introduction:

Chairman Obey, Vice Chairman Proxmire, Members of the subcommittee on economic resources, competitiveness, and security economics of the Joint Economic Committee of the Congress of the United States:

My name is Abraham J. Briloff, I am a certified public accountant and am presently the Emanuel Saxe Distinguished Professor of Accountancy at the Bernard M. Baruch College of the City University of New York. I am indeed privileged to have been invited to testify before your Committee regarding certain aspects of the General Dynamics Corporation's accounting practices, particularly those relating to its contracts for the building of the 688 submarines for the United States Navy.

For the record, over the past fifteen years I have testified on four occasions before the Subcommittee on Oversight and Investigations of the House of Representatives' Committee on Energy and Commerce (formerly the Committee on Interstate and Foreign Commerce), and on four other occasions before the Senate's committees on Antitrust, Banking and Government Affairs.

On each such occasion my testimony was offered at the invitation of the respective committee, and related to particular accounting issues, or to the challenges confronting my profession generally.

I shall first direct my testimony this morning to the issues suggested by Vice Chairman Proxmire in his letter of June 14 inviting my testimony, to wit:

> . . .In your testimony, I would like you to discuss the SEC investigation of General Dynamics initiated in 1978 and terminated in 1982. I would be interested in your views on the

appropriateness and final action taken in that case, what you believe should have been done, and the basis for your conclusions.

I would also like you to discuss the SEC's policies regarding (1) defense contractors' booking of claims, requests for equitable adjustment, or other contingent sources of revenue, and (2) the withholding of information in order to prevent stock prices from going down. In addition, please give us your views on the role of the outside auditors in the General Dynamics case and more generally with regard to the issues I have raised.

In preparing your written statement, you might consider the following specific questions:

- Should the company have reported losses on one or both 688 contracts prior to 1978?
- Does it appear that the company failed in its financial reports to make full disclosure of its problems on the ship contracts?
- Did the company follow or fail to follow generally accepted accounting principles in the performance of the ship contracts?
- Did Arthur Anderson & Co. follow or fail to follow generally accepted accounting principles in the performance of its responsibilities?

Included herewith, as Exhibits A and B, are the auditor's reports (and relevant footnotes) for the 1976 and 1977 years respectively. In addition, for the purposes of this presentation, I am including the following documents forwarded to me by the Vice Chairman with his letter of April 19:

Exhibit:

C. SEC Division of Enforcement
Memorandum dated May 22, 1978

D. SEC Form 19A dated February, 1982 terminating investigation

E. SEC letter to GD dated April 28, 1978

F. Letter from GD to SEC dated May 11, 1978

G. Arthur Andersen & Co. Interoffice communication January 22, 1977, from Terry L. Lengfelder to Robert C. Palmer, both of the firm's St. Louis office

Background Facts

The essential background facts are reflected by Exhibit C, i.e., the SEC's Enforcement Division's 1978 request for the Commission to initiate a formal investigation.

Especially critical to the understanding of the accounting issue are the following facts:

- The General Dynamics Corporation ("GD") accounted for its 688 submarine contracts on the so-called "percentage-of-completion" basis -- thereby entitling it to reflect profits pari passu with its successful performance on the contracts.
- For its fiscal years 1976 and 1977, the corporation had been accounting for these contract operations on a "break-even basis" -- i.e., no gain or loss was recognized on its respective forms 10-K.
- The auditor's reports contained "subject to" provisions, relating to the uncertainty surrounding certain claims presented by General Dynamics to the Navy for cost overruns, etc.
- Such claims pending as of year-end 1976 and 1977 amounted to $544 million and at least $840 million respectively ($296 million incrementally). Such amounts are presumed to have been acccounted for as revenues in the respective years.
- The exclusion of even a minor portion of the 1976 claims or any portion of

the 1977 claims would have resulted in an overplus of costs anticipated to be incurred over anticipated revenues on the contracts.

- The materiality of the amounts here in issue is demonstrated by the fact that the corporation reported pretax incomes of $132 million and $166 million for the years 1976 and 1977, respectively.

The Relevant Accounting Precepts

My response to the critical queries regarding the General Dynamics 1976 and 1977 accountings is rooted essentially in the following provisions among the generally accepted accounting principles.

From Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies," March, 1975. ("SFAS 5") (Included in its entirety herein as Exhibit H.)

> ¶8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both the following conditions are met:
>
> a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of loss can be reasonably estimated.
>
> ¶17. The Board has not reconsidered ARB No. 50 with respect to gain contingencies. Accordingly, the following provisions of paragraphs 3 and 5 of that Bulletin shall continue in effect:
>
> a. Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

b. Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

¶37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

From Accounting Research Bulletin 45, and presently codified in Professional Standards -- Accounting, as ¶Co4.105 (under Percentage-of-Completion Method):

> If the current estimate of total contract costs indicates a loss, in most circumstances provision shall be made for the loss on the entire contract. If there is a close relationship between profitable and unprofitable contracts, such as in the case of contracts that are parts of the same project, the group may be treated as a unit in determining the necessity for a provision for loss [ARB45, 6]

My Analysis of These Issues

My analysis of the foregoing facts and relevant accounting precepts leads me to conclude that the General Dynamics 1976 and 1977 financial statements were flawed in that the corporation failed to recognize a loss which had accrued as of December 31, 1976 and 1977 on the 688 contracts, accounted for, as noted, under the percentage-of-completion method. The misapplication of GAAP was, in my view, the consequence of the entity's looking at the impact of SFAS 5 on the cost determinant of the cost/revenue relationships leading to income or loss, rather than on the revenue vector. To the extent Arthur

Andersen and the Securities and Exchange Commission indulged GD in this inverted logic, they were in pari delicto. By way of exemplification:

Assume that as of the focal date (e.g., December 31, 1976 or 1977) the corporation projected costs on the 688 contract over its entire life, exclusive of adverse "contingencies," at $1000X, and the corresponding contract revenues, without favorable contingencies, also at $1000X, we have a break-even situation.

If we were now to assume that a supplier of steel to GD for the 688 contract were to assert a claim for $100X, for reasons which are properly being resisted by GD (the dispute might, in fact, be in litigation) then, it would appear that paragraph 8 of SFAS 5 could be operative so as to obviate the need for the accrual of a loss on the contract.

But that is patently not the condition which prevailed at GD as of the aforementioned critical focal dates. Instead, the costs were projected at $1000X while the revenues (determined without reference to the claims) were projected at $900X; it required the accrual of $100X of revenues to bring the cost/revenues factors into an equilibrium.

That being the case the focus must shift to paragraph 17 of SFAS 5 (and clear and compelling logic consistent with traditional wisdom of accountancy) which would unequivocally proscribe the accrual of the claims as revenue.

Had the corporation and/or its independent auditor and/or the SEC studied the facts with an appropriate objectivity they would have recognized that Paragraph 37 of Statement 5 should also have served to proscribe the accrual of the claims against the Navy as additional revenue. Thus, if they were considering a claim against GD having the same tenuous qualities as the claims

here in issue they would not have been constrained to accrue a loss by reference thereto; correspondingly, I cannot see how they rationalized their respective determinations in this cause célèbre.

Arthur Andersen's Quest for Certitude:

Going beyond the particular issue here involved I maintain, based on my study of the Arthur Andersen memorandum dated January 22, 1977 (Exhibit G), that the firm failed to act in accordance with generally accepted auditing standards, in that it failed to manifest the "healthy skepticism" so essential for the effective fulfillment of the independent audit responsibility. Herewith the two paragraphs in the memorandum from Mr. Lengfelder to Mr. Palmer (both in the firm's St. Louis office) on which my impeachment of the accounting firm is predicated (emphasis in original):

> It is my belief that to sustain an "except for" opinion on the statements of the Division, the engagement partner must be absolutely convinced (with certainty) that a material loss has occurred in the SSN 688 program as of December 31, 1976. Since an opinion taking exception to fairness of financial statements in accordance with generally accepted accounting principles is unacceptable to the Securities and Exchange Commission, the company would then be forced (presumably in consultation with our EB [Electric Boat] engagement people) to make a material adjustment to their financial statements.
>
> Focusing on the amount or range of the potential material misstatement is of course the responsibility of the engagement partner, Bill Weldon, and his engagement team at Electric Boat. While obviously neither you, I, or anyone else without the detailed perspective that Bill has with respect to this complex audit matter can presume to make this judgment for him, I question that such a certainty exists.

The attention of your Committee is respectfully directed to the directives from Mr. Lengfelder that the Electric Boat engagement partner "must be

absolutely convinced (with certainty)" that a loss had occurred,". . . I question that such a certainty exists." (Underscoring his).

In 1789 Benjamin Franklin wrote that "in this world nothing is certain but death and taxes." Two hundred years later, as we learned from General Dynamics, taxes are no longer "certain"; and our physicians, ministers and ethicists are not presently certain as to the definition of death. Most assuredly, Mr. Lengfelder must allow that in accountancy certainty (even without underscoring) is a chimera.

A more appropriate response to the problem, in my view, should have been "based on the preponderance of evidence" or "beyond a reasonable doubt."

In sum, I verily believe that the 1976 and 1977 financial statements of General Dynamics Corporation were not in conformity with generally accepted accounting principles, inasmuch as the loss on the 688 contracts, absent the accruals of revenues from the claims and potential claims was material. Specifically, the company's and independent auditor's reliance on SFAS 5 to justify their conclusion was unwarranted. Correspondingly, the Securities and Exchange Commission, in my view, acted irresponsibly when, in 1982, it determined to terminate its inquiry into the corporation's accounting practices, citing SFAS 5 as the technical basis for its determination.

The SEC's Call for Skepticism:

Arthur Andersen's failure to comprehend its responsibilities as General Dynamics' independent auditor becomes patently self evident when we juxtapose the firm's views reflected above and those articulated by the Securities and Exchange Commission in its Accounting and Auditing Enforcement Release No. 16

(November, 1983) involving Touche Ross & Co., especially regarding the firm's Litton Audits. In that promulgation, the Commission reiterated its position, thus:

> Auditing standards require that: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." Statement of Auditing Standards No. 1, paragraph 220 states that independence implies acting with "judicial impartiality" or "without bias" in conducting an examination of financial statements of a client.
>
> In the Commission's view based on its investigation, Touche did not maintain a healthy skepticism, a failure which affected Touche's ability to evaluate in a fair and impartial manner accounting positions taken by Litton. . . .

Nor is this call for an appropriate skepticism a newly-coined phrase; to the contrary, more than a decade ago, the Commission's Accounting Series Releases alluded to the "healthy," "professional," "heightened degree" of skepticism as essential to the fulfillment of the objective unbiased independent audit function. (See, e.g., ASR 153, "In the Matter of Touche Ross.)

Most certainly "certainty" is not the standard for a proper judicial objectivity and/or professional skepticism. At best, such a standard can be met by "a preponderance of evidence" or "beyond reasonable doubt."

AA Ignores Its History:

What I find especially remarkable and correspondingly regretable about this Arthur Andersen approach to the percentage-of-completion reporting is that it reflects an abysmal ignorance of the Santayanan dictum: "Those who do

not read history are destined to repeat its mistakes."

Thus, if any firm should have been aware of the potential quagmires in this accounting method during the 1970s, it was Arthur Andersen & Co. It was that firm which experienced the trauma of having several of its partners criminally indicted for its alleged failures in the auditing of percentage-of-completion accounting in the Four Seasons Nursing Homes fiasco. While most of the AA defendants were acquitted (and the charges dropped against one following a "hung jury") the firm did marshal some of the most renowned experts to opine regarding the accounting auditing complexities pertaining to that exotic accounting method.

In my More Debits Than Credits (Harper & Row, 1976) I concluded my analysis of that cause célèbre on the following note:

> The Four Seasons matter is now, of course, history insofar as the traumatic criminal proceedings are concerned. Nevertheless, I do hope the message is not lost on you, good reader: Percentage-of-completion accounting, however calculated, involves conjecture and projection -- with all of its flexibility and potential for mischief. This demands of corporate managements and their auditors an even greater degree of discipline than might otherwise be called for. This is especially in point where we are confronted with a "concept" corporation or industry which is determined to maintain its glamour on Wall Street. Such a combination of accounting flexibility and the compelling necessity to keep the emperor clothed is, at best, a most contingent environment. Experience informs me this is the stuff quagmires are made of (where accountants and investors are undone). [p. 107]

GD Ignores Its History:

An article in The Washington Post for September 26, 1984 ("Submarines were Exceeding Budget by $100 million: Contractor Sought to Withhold Cost Overrun Data") would indicate that the corporation, too, is oblivious of the

Santayanan caveat. According to the article, based in good measure on tape recordings maintained clandestinely by an erstwhile GD executive, the corporate hierarchy was endeavoring to suppress losses which were burgeoning in 1981 on submarine contracts; this, mind you, three years after GD was compelled to face up to the losses which were festering during 1976-1977. According to the article:

> The tape-recorded statements of the General Dynamics' chairman, together with statements made in interviews with former senior officials in the company, raise questions about whether General Dynamics complied with Securities and Exchange Commission rules requiring disclosure of adverse financial information to the public.
>
> "It seems to me an untenable situation to have a chief executive officer holding back information," said John C. Burton, dean of the graduate business school at Columbia University. "An auditor has a hard time when senior management colusively concludes that it should not make information available to him." Burton was asked to evaluate key portions of the Lewis-Veliotis conversation.
>
> A former chief accountant at the SEC, Burton said that in his opinion General Dynamics had an obligation to inform its shareholders that the company caluclated, as early as April 1981, a cost overrun of $100 million or more.
>
> "When you publish a quarterly report, it cannot be misleading in any material way . . . . If a report did not include this uncertainty, then it was misleading," Burton said.
>
> A similar assessment was made by Abraham J. Briloff, a professor of accounting at the Baruch business school of the City University of New York. Briloff said the atmosphere in General Dynamics as reflected by the tape was "Byzantine" and that Lewis' statements in particular reflect a corporate attitude that "borders on a determination to deceive."
>
> "It's all part of a total failure to fulfill the responsibility of accountability vested in the chief executive officer," Briloff said.

> Briloff, a consultant to law firms on accounting, said that in his opinion General Dynamics' senior management had an obligation to promptly inform the corporation's audit committee, the outside auditors and the public, after a large cost overrun was confirmed by corporate accountants in April 1981.
>
> Elliot H. Stein, head of the audit committee drawn from General Dynamics' board of directors, said last week that he would not comment.

Déja Vu:

The corporate entity is different; the specific accounting issues and aberrations are different; the independent auditors are different. Nonetheless, as I am preparing this statement in anticipation of my appearance before your Committee there is the sense of déja vu. Thus, it is very much like my mood as I was preparing for my September, 1982, testimony before the House Oversight and Investigations Committee probing the actions of Citicorp, the roles of management, independent auditors and especially of the Securities and Exchange Commission. I will not burden the record of these hearings with a copy of my statement captioned "Quis Custodiet Ipsos Custodes?"; the entire proceedings of that Subcommittee are included in a volume entitled SEC and Citicorp (Hearings, September 15 and 17, 1982).

The differences notwithstanding, I discern in the record manifestations of critical flaws in the systems of corporate governance and accountability which are intended to obviate the abuse of the enormous power vested in the managements of giant enterprises -- of a giant financial institution on the one hand, and a giant exponent of the military-industrial establishment on the other. In each instance the flaws extended to the failure on the part of the entity's independent auditor to comprehend fully its role and responsibility

to society. And then, to cap it all, we see the most prestigious Securities and Exchange Commission, during a most brief time frame, December, 1981, for Citicorp, and February, 1982, for General Dynamics, quashing extensive investigations which were then in progress. Especially serious, was the SEC's predicating its determination on narrow technical grounds, ignoring entirely the governance and accountability ramifications of the entities' conduct. In short, during that time period, the SEC was determined to be oblivious of the moral, social, ethical ramifications of our Securities Laws.

In this regard it is noteworthy that in its February, 1982, order terminating the GD investigation (Exhibit D) the SEC assigned a passing grade to the corporation's disclosures in its 1977 filings regarding the 688 contracts. (See Exhibit B.) To the extent the assertions contained in the Enforcement Division's May, 1978, Staff memorandum requesting a formal investigation (Exhibit C), as well as those set forth in the April 2, 1985, report prepared for your Committee by Richard F. Kaufman, Esq., are fair, those disclosures were unfair. They may have reflected management's "hopefulies," rather than real facts. In short, once again, the Commission determined to make the matter of corporate integrity a "non-issue."

Lester Crown's Lament:

And lo! On the very Sunday morning that I am composing this statement the New York Times (June 16, Section 3, p.1) carries a feature story, "Lester Crown Blames the System."

According to that article, reporting on an interview with "General Dynamics' biggest shareholder," Mr. Crown stepped forward "to defend his company and its departing chief." How did he do this? Some extracts:

> During a daylong conversation last week in the company's suburban Washington office -- the first extensive interview granted by anyone in the Crown family since the storm over General Dynamics business misconduct began a year ago -- Lester Crown proffered an interpretation of the company's woes, seeking to absolve the company of any fault except perhaps lack of sufficient foresight.
>
> Despite the damage suffered by General Dynamics over the past year and the Navy's order that the company establish "a rigorous code of ethics for all officers and employees with mandatory sanctions for violation.". . .
>
> Discussing what he called the company's foolishness and stupidity" in not confronting problems with improper overhead billings, he said: "We didn't do anything wrong, but it wasn't right either."
>
> What emerged from the interview with Mr. Crown was a portrait of a deeply troubled company: He portrayed senior management as either unaware or unconcerned about improper billings and top officers who were blindsided by recent attacks from the former manager of its Electric Boat shipyard, P. Takis Veliotis. . . .
>
> "I have to say there was some foolishness and stupidity on our part not to look ahead and say 'What could this look like on the front pages?'" said Mr. Crown, reflecting on the millions of dollars of improper overhead expenses, including country club memberships and dog kennel fees, that a House committee discovered were charged against Pentagon contracts.
>
> At another hearing before the committee on March 25, Mr. Lewis [General Dynamics's incumbent chief executive] announced that he would voluntarily withdraw $23 million out of $63 million in overhead expenses submitted by the company but questioned by Defense Department auditors for 1979 through 1982. The Pentagon, however, found his offer to be insufficient.
>
> "The $23 million would have fallen out anyway" in the course of negotiations with Federal auditors, Mr. Crown

said . . .

> Yet while regretting with hindsight that General Dynamics never pressed for improvements in the Pentagon's auditing methods, he strongly defended the company's ethics.
>
> "You aren't just talking about ethics," he said. "I don't think anyone in the corporate office knew how these things were being charged. It was done on a local basis. The thing got sloppy, but not with any thought at the top."
>
> Mr. Crown refused, however, to acknowledge any willful wrongdoing on the part of company personnel. "The system should change," he maintained. . . .

Alas, Dear Lester, the troubles are not in the system but in those who are presumed to be responsible for implementing it. What pressures are put on corporate executives, personnel, professional consultants, et al., to forsake their ethical compass (assuming they once had such a compass)? To what extent are they all informed, by word of mouth, body language or by some form of ESP, that if they want to "get along, they had better go along?"

To what extent are the whitewashings by some judges, government agencies, e.g., the SEC in Citicorp and G.D., the Justice Department in the Hutton case, government auditors, schools of business, et al., in pari delicto? I recall vividly the days when a gift of a vicuna coat or a refrigrator become something of a pejorative compelling obolquy and resignation under less-than-honorable circumstances, contrasted with the way in which we tend to pass off with a quip clear and compelling evidence of sleaziness in high places in government as well as in the private sector.

A Conceptual Epilogue:

In my February, 1985, testimony before the Dingell Committee I stated the following regarding the Financial Accounting Standards Board's Statement No. 56, "Designation of AICPA Guide and Statement of Position (SOP) 81-1 on Contractor Accounting . . .," February 1982: (effective for fiscal years beginning after December 31, 1981):

> Here the FASB can be seen to be playing the role of the Alchemist. Thus, with its abracadabra it transmuted the base metal of a couple of AICPA SOPs into the Gold of a FASB SFAS. In case you are unfamiliar with the mystical numerology and acronyms implicit in this extraordinary transmutation, SOP 81-1 related to Contractor Accounting, while 81-2 dealt with Hospital-Related Organizations. And all that the distinguished Stamford Seven did was to designate them as a Statement of a Financial Accounting Standard.
>
> So let us examine the newly-designated yellow metal -- especially the one relating to contractor accounting. Here, I maintain, the Distinguished Seven could not have read SOP 81-1, or if they did, did not comprehend the stuff it was made of. Or what may be worse, just did not recognize the way the Board was being booby-trapped. You see, SOP 81-1 opened wide the Pandora's Box of percentage-of-completion accounting. Traditionally, that modifying precept was deemed appropriate only for long-term contracts; that long-term requirement was deleted in the AICPA pronouncement thereby making it available even for service arrangements, say, which might extend over but a couple of years.
>
> Most certainly, anyone presuming even a modicum of accounting scholarship would have recognized the serious pitfalls implicit in this accounting procedure. Most assuredly he (or she) would have recognized the ways in which Arthur Andersen wrung its hands in contrition regarding the Four Seasons Nursing Homes, and more recently in the Frigitemp disasters.
>
> Most certainly such a putative scholar would have proceeded with all deliberate speed to limit that exotic accounting procedure. Surely, anyone who read the critical objective of the Board's initial Concept Statement regarding the uncertainty of future cash flows would have done everything possible to put his finger into the dike -- instead, by this imperious SFAS 56

the floodgates were opened wide.

That the members of the Board may not have read SOP 81-1 may also be evidenced by the fact that the AICPA committee had indicated that there was a matter of unfinished business to which it would be directing its attention, i.e., to the matter of the "program method of revenue recognition and cost deferral." Presumably, by subscribing to the SOP the FASB undertook to complete that project. Most assuredly the Lockheed L-1011, General Dynamics submarine and Tally Industries accounting fiascos demonstrate the potential for extraordinary gamesmanship. But apparently even this intrepid, independent, richly-endowed Board finds itself rather unwilling or incompetent to play this hard-ball game in the face of such powerful opponents.

Now, as it turns out, that FASB promulgation has some special interest for us here today calling for exegetic analysis. Thus, the SOP, now enshrined as an SFAS, includes the following paragraph numbered 65:

Claims

Claims are amounts in excess of the agreed contract price (or amounts not included in the original contract price) that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs. Recognition of amounts of additional contract revenue relating to claims is appropriate only if it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated. Those two requirements are satisfied by the existence of all the following conditions:

a. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.

b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.

c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.

d. The evidence supporting the claim is objective and verifiable, not based on management's "feel" for the situation or on unsupported representations.

If the foregoing requirements are met, revenue from a claim should be recorded only to the extent that contract costs relating to the claim have been incurred. The amounts recorded, if material, should be disclosed in the notes to the financial statements. Costs attributable to claims should be treated as costs of contract performance as incurred.

By way of hypothetical rumination: Had that paragraph prevailed during the time periods here in issue, would it have permitted the accrual of the claims as revenues in an amount sufficient to produce the break-even objectives? At the outset the amount of the claim sought to be accrued as revenues is permissible only if "it is probable that the claim will result in additional contract revenue and if the amount can be reliably estimated." (Emphasis mine.)

Given the corporation's history regarding prior claim settlements, and the long history of deficiencies in the contractor's performance, and the apparent deficiencies in the corporation's internal control procedures reflecting invidiously on the verifiability of the claims, I maintain that the probability and reliability preconditions could not be met by the auditors. Then, too, to the extent the presumptive revenue enhancements were attributable to claims still to be developed and/or contemplated productivity improvement, the essential objectivity and verifiability preconditions could not be met. What then is left, beyond management's "feel" and "representations"?

Even assuming arguendo that the 1977 $840 million in claims were sufficiently palpable so that something might have been deemed to be probable

and verifiable, I question whether the corporation's management and auditors made a good faith effort to verify the sums which might be realizable.

The record discloses the intensive dialogue and controversy which prevailed at about the time of the 1977 statement date; I have seen no evidence of any inquiry by the auditors of the Navy regarding the probability aspects of the amounts in dispute.

It is noteworthy that within three months subsequent to the rendering of the 1977 statements GD settled its $843 million in outstanding claims for less than $500 million -- and was thereby compelled to absorb a loss of $359 million, more than 40 percent of the amounts thus claimed.

That this was a staggering write-off is evident from the fact that it was an amount far in excess of the entire combined pretax income of the corporation for the years 1976 and 1977.

Further, in my view, the corporation, its auditors and the SEC are estopped from rationalizing their determinations regarding the 1976-77 accountings by applying SFAS 56 ex post facto. Note that their determination to avoid any loss recognition was rooted in SFAS 5, presumably paragraph 8 thereof. As noted, a contingent loss would not be accrued unless the loss was probable and the amount reasonably estimated. Presumably, their break-even determination resulted from the fact that while the costs were adequately determinable, the revenues could not be correspondingly anticipated with an adequate degree of probability and reliability. So it is, I maintain, the corporation, et al., are "hoist on their own petards." They cannot now assert that SOP 81-1, if applied nunc pro tunc, could prove their salvation.

If the corporation and their advocates (including the SEC) were now to be

heard saying that the added phraseology in paragraph 65 (i.e., setting forth the four conditions which would satisfy the principal rule for revenue recognition) somehow softened the revenue-recognition rule, vis-a-vis the cost side, then I would respond by noting that this would be a clear and patent violation of the "conservatism" precept enshrined as a "Pervasive Principle" in Accounting Principles Board Statement No. 4, October, 1970, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," paragraph 171, thus: "Conservatism. Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors and accountants have greatly preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the conservatism . . ."

Further, Statement 4, paragraph 35, sets forth as one of the characteristics of financial statements: "The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income."

While FASB Concepts Statement No. 2 (May, 1980) puts lesser emphasis on the Conservatism precept, it nonetheless demands of the auditor prudence and a "healthy skepticism" (paragraph 97).

From the foregoing discourse I maintain that even if General Dynamics, Arthur Andersen & Co. and the Securities and Exchange Commission could pretend that SFAS 56 and the underlying SOP could be presumed to have guided their judgments years previously, their response would be specious.

Conservatism and GD aside, the Accounting Standards Executive Committee of the American Institute of CPAs (which promulgated the SOP) and the Financial Accounting Standards Board (which anointed the SOP and elevated it to an SFAS) failed to manifest an appropriate neutrality, symmetry or reciprocity in the crafting of the critical paragraph 65. Note that for the booking of claims as revenues on the contractor's books the SOP-SFAS provides some "safe harbor" rules for presuming the probability and reliability of the sums to be accrued. There were no corresponding "safe harbors" included in the SOP ergo SFAS on the cost side (to require the booking of a liability on the contractor's books). Consequently, the rule in paragraph 37 of SFAS 5 remains unattenuated. It is, therefore, conceivable that a subcontractor might be permitted to accrue additional revenue and assets on its books for claims asserted against a contractor, whereas the latter would not be constrained to reflect, as a cost and liability the flip side of the claim.

Because I could not comprehend the theoretical rationalization for this paragraph 65, I telephoned a person in the AICPA's Accounting Standards Division who was importantly involved in the development of the SOP to inquire as to the substantial authoritative support in our theoretical infrastructure. I was told there was no such support; that the members of the technical committee deemed it appropriate. To quote Alexander Pope, "Whatever is, is right."

Coda!

The foregoing conceptual epilogue serves further to confirm my impeachment of the Financial Accounting Standards Board for its predilection for granting

absolution and dispensation to the Accounting Establishment. This impeachment extends to my assertion that the Board is, in fact, inimical (rather than salutary or merely neutral) to the effective fulfillment of the independent, objective audit responsibility vested in the accounting profession by the Securities Laws, and society generally.

Thus, the existence of the Board permits the Securities and Exchange Commission to abdicate its essential role and responsibility for the advancement of accounting standards appropriate for full and fair reporting regarding publicly-owned corporations. Further, the Board's existence essentially preempts the field for the advancement of the profession's theoretical infrastructure, thereby depriving the academic community of the prerogatives regularly vested in it.

Exhibits:

A. Independent auditor's Report for the year 1976, together with footnote re 688 contracts

B. Independent auditor's Report for the year 1977, together with footnote re 688 contracts

C. SEC Division of Enforcement
Memorandum dated May 22, 1978

D. SEC Form 19A dated February, 1982 terminating investigation

E. SEC letter to GD dated April 28, 1978

F. Letter from GD to SEC dated May 11, 1978

G. Arthur Andersen & Co. Interoffice communication January 22, 1977, from Terry L. Lengfelder to Robert C. Palmer, both of the firm's St. Louis office

H. Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, March, 1975, "Accounting for Contingencies"

Exhibit A

ARTHUR ANDERSEN & CO.

ONE MEMORIAL DRIVE
ST. LOUIS, MISSOURI 63102
(314) 621-0767

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To General Dynamics Corporation:

We have examined the balance sheets of GENERAL DYNAMICS CORPORATION (a Delaware corporation) and the consolidated balance sheets of General Dynamics Corporation and subsidiaries as of 31 December 1976, and 31 December 1975, and the related statements of earnings, shareholders' equity and changes in financial position for the years then ended, and the supporting schedules listed in the accompanying index. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements and supporting schedules of Asbestos Corporation Limited, a 54.6% owned consolidated subsidiary, which statements reflect approximately 1% and 1% of the total consolidated assets as of 31 December 1976, and 1975, respectively. These statements and supporting schedules were examined by other auditors whose reports thereon have been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for Asbestos Corporation Limited, is based solely upon the reports of the other auditors.

As discussed in Note A to the financial statements, the financial results of the Corporation's SSN 688 Program are dependent upon recovery of a substantial portion of the $546 million of claims filed with the U.S. Navy and achievement of the productivity improvements included in the program cost estimates.

In our opinion, based upon our examination and the reports of other auditors referred to above, and subject to the final resolution of the matter referred to in the preceding paragraph, the accompanying financial statements present fairly the financial position of General Dynamics Corporation and General Dynamics Corporation and subsidiaries as of 31 December 1976, and 31 December 1975, and the results of their operations and the changes in their financial position for the years then ended, and the supporting schedules present fairly the information required to be set forth therein, all in conformity with generally accepted accounting principles consistently applied during the periods.

ARTHUR ANDERSEN & CO.

11 February 1977

In accordance with industry practice, amounts relating to long-term contracts and programs are classified as current asset. Although an indeterminable portion of these amounts is not expected to be realized within one year. Title to inventories under certain contracts and programs is vested in the customer in accordance with contract provisions.

Inventory -

Inventory of commercial products, materials and spare parts is stated at the lower of cost, principally LIFO (last-in, first-out) and average, or market. The excess of current cost over inventories stated at LIFO cost was $24.2 million at 31 December 1976 and $14.4 million at 31 December 1975.

SSN 688 Program -

The Corporation has two contracts with a current total value of approximately $1.6 billion covering production of 12 SSN 688-class submarines. Delivery of these submarines will begin in 1977 and continue through 1981. Costs incurred on the program to 31 December 1976 and 31 December 1975, which are included in government contracts in process, amounted to $.78 million and $630 million, respectively, less related progress payments of $[illegible] million and $3[illegible] million, respectively.

For more than two years, the Corporation has been engaged in negotiations with the U.S. Navy for price increases to cover the impact of Navy-directed changes, in accordance with the contracts' changes clause. On 7 April 1976, the first claims submitted, covering the cost of changes directed by the Navy prior to 20 May 1975 on the first contract for seven submarines, were settled at a contract price increase of $.6 million. On 1 December 1976, the Corporation filed additional claims for ceiling price increases of $.94 billion to cover directed changes on both contracts through October 1976.

The Corporation estimates that cost at completion of these contracts, after giving consideration to projected productivity improvements, will significantly exceed presently negotiated contract ceilings. A substant portion of the $.94 billion of new claims must be recovered to offset the indicated cost overruns, even with the projected productivity improvements. The Corporation believes that actions of the U.S. Navy now required for this overrun are such that there should be sufficient recovery from the claims to insure that this long-term program does not incur a loss. Therefore, the Corporation continues to account for this program on a break even basis.

LNG Program -

The Corporation has contracts totaling $1.4 billion for the production of twelve liquefied natural gas (LNG) tankers. Two of these tankers have cancellation provisions and two are subject to regulatory approvals. The tankers are scheduled to be delivered through 1980 (see Note 8 regarding the acquisition and leasing of five of these tankers). Costs incurred on the program to 31 December 1976 and 31 December 1975, which are included in commercial programs in process, amounted to $425 million and $260 million, respectively, less progress payments of $[illegible] million and $239 million, respectively.

Based on current estimates of cost to complete, management expects a profit on this program. Since the LNG program is in its early stages, no profit is being recorded and overhead costs in excess of the overhead originally projected on this program have been charged to expense ($[illegible] million in 1976, $9.2 million in 1975 and $[illegible] million since program inception).

Exhibit B

ARTHUR ANDERSEN & Co.
ST. LOUIS, MISSOURI

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To General Dynamics Corporation:

We have examined the balance sheets of GENERAL DYNAMICS CORPORATION (a Delaware corporation) and the consolidated balance sheets of General Dynamics Corporation and subsidiaries as of 31 December 1977, and 31 December 1976, and the related statements of earnings, shareholders' equity and changes in financial position for the years then ended, and the supporting schedules listed in the accompanying index. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements and supporting schedules of Asbestos Corporation Limited, a 54.6% owned consolidated subsidiary, which statements reflect approximately 14% and 15% of the total consolidated assets as of 31 December 1977, and 1976, respectively. These statements and supporting schedules were examined by other auditors whose reports thereon have been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for Asbestos Corporation Limited, is based solely upon the reports of the other auditors.

As discussed in Note A to the consolidated financial statements, the financial results of the Corporation's SSN 688 program are dependent upon the recovery through present and future claims or other settlements from the U.S. Navy of the costs at completion in excess of anticipated revenues from the current contracts (the excess is presently estimated at $840 million assuming an annual inflation rate of about 7% over the projected six years to complete the contracts). It is not possible to determine at this time the final resolution of this matter or the effect, if any, on the accompanying financial statements.

In our opinion, based upon our examination and the reports of other auditors referred to above, and subject to the final resolution of the matter referred to in the preceding paragraph, the accompanying financial statements present fairly the financial position of General Dynamics Corporation and General Dynamics Corporation and subsidiaries as of 31 December 1977, and 31 December 1976, and the results of their operations and the changes in their financial position for the years then ended, and the supporting schedules present fairly the information required to be set forth therein, all in conformity with generally accepted accounting principles consistently applied during the periods.

ARTHUR ANDERSEN & CO.

24 March 1978

Year	General Dynamics Corporation	Consolidated
	(Dollars in Thousands)	
1977	$207,937	$275,116
1976	183,026	245,029

In accordance with industry practice, amounts relating to long-term contracts and programs are classified as current assets although an indeterminable portion of these amounts is not expected to be realized within one year. Title to inventories under certain contracts and programs is vested in the customer in accordance with contract provisions.

Inventories -

Inventories of commercial products, materials and spare parts are stated at the lower of cost, principally LIFO (last-in, first-out) and average, or market. The excess of current cost over inventories stated at LIFO cost is $13.6 million at 31 December 1977 and $14.2 million at 31 December 1976.

SSN 688 Program -

The Corporation has two contracts covering the construction of 18 SSN 688-class submarines, the first of which was received in 1971. Due to deficient engineering plans and specifications furnished to Electric Boat Division by the U.S. Navy and its design agent plus the serious delay in furnishing the plans, the costs of building these submarines have greatly exceeded the initial contract prices. More than 35,000 drawing revisions have been made to the plans and specifications which have adversely affected the production operations. Accordingly, the Corporation has filed claims with the Navy for price increases to cover the impact of the changes, in accordance with the contracts' changes clause. On 7 April 1976, the first claims submitted, covering the cost of changes directed by the Navy prior to 20 May 1975 on the first contract for seven submarines, were settled at a contract ceiling price increase of $97 million. On 1 December 1976, the Corporation filed additional claims for ceiling price increases of $544 million to cover directed changes on both contracts through October 1976. Since drawing revisions and changes which form the basis for these claims have continued at a high rate, the Corporation now has in preparation claims for price increases, which are expected to be very large, to cover the cost of subsequent Navy actions and to increase the earlier claim amounts as the true effect of those changes on the SSN 688 and Trident submarine programs has become evident.

Costs incurred through 31 December 1977 and 31 December 1976 on submarines to be delivered, which are included in government contracts in process, amounted to $1,162 million and $676 million, respectively. The related progress payments associated with these government contracts in process were $815 million in 1977 and $634 million in 1976. Under normal practice, the contractual retentions would be approximately $80 million compared to the $347 million of unreimbursed expenditures at 31 December 1977.

In February 1978, the Corporation completed a new study of costs and schedules to complete the SSN 688 program. It is now estimated that the last of the 18 ships will be delivered in approximately 6 years. Assuming an inflation rate of about 7% per year, cost to complete the program is estimated to be approximately $540 million in excess of the anticipated revenues from current contracts, assuming no return from present or future claims. This includes $475 million due to inflation. The estimated cost to complete is based upon the assumption that the rate of drawing revisions will be reduced

significantly and that historical manufacturing improvements will be realized as they have been on every previous class of submarines built by the Electric Boat Division as well as on the products of other manufacturing divisions of the Corporation.

Negotiations with the Navy over the past three years have failed to resolve this matter in a manner which would be fair and equitable to the Corporation and its shareholders. On 13 March 1978, the Corporation formally notified the Navy that it intended to stop all work on 12 April 1978 on the remaining 16 SSN 688-class submarines because the contracts for these ships have been materially breached by the Navy. In a subsequent meeting with the Navy on 21 March, it was suggested that General Dynamics extend the stop work deadline for two months to allow additional time for the Navy and the Corporation to negotiate an equitable solution. The Corporation agreed to this extension after the Navy offered to make an immediate provisional cash payment that would, together with normal progress payments, essentially eliminate the negative cash flow of the program for that two-month period. Negotiations are expected to be resumed in the near future. Since the resolution of this matter involves many uncertainties, including future actions by the Navy, the Corporation cannot forecast the final outcome at this time. Pending its resolution, the Corporation continues to account for this program on a breakeven basis.

Income Taxes -

Investment tax credits are recognized as a reduction in income taxes in the year the related property is placed in service.

No provision has been made for U.S. income taxes and foreign withholding taxes (estimated at $13 million after utilization of foreign tax credits) which would be payable upon distribution of earnings of foreign subsidiaries and domestic international sales corporations since the Corporation intends to continue investing those earnings in export activities and operations outside the United States. The undistributed earnings for which taxes have not been provided amount to $65.8 million, of which $47.8 million are included in consolidated retained earnings.

Property, Plant and Equipment -

Accelerated methods are used in the determination of depreciation for the majority of depreciable assets.

The estimated useful lives of the various property classes used in determining depreciation rates are as follows:

	Years
Land improvements	3 to 20
Buildings and improvements	2 to 50
Machinery and equipment	3 to 20

Substantial portions of plant facilities used in the operation of certain government contracting divisions have been provided by the U.S. Government.

Exhibit C

REQUEST FOR EXPEDITED COMMISSION DECISION

SUBJECT: General Dynamics Corporation
REQUEST: The Division recommends that the Commission enter a formal order of private investigation naming General Dynamics Corporation to determine whether there have been violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), and 14(a) of the Exchange Act and Rules 10b-5, 13a-1, 13a-11, 13a-13, 14a-13 and 14a-9 thereunder.

SERIATIM CONSIDERATION

( ) Pursuant to the provisions of 17 CFR 200.41(a), the Chairman or the undersigned member of the Securities and Exchange Commission, acting as Duty Officer of the Commission, is of the opinion that joint deliberation among the members of the Commission upon the above matter is unnecessary in light of the nature of the matter, impracticable, or contrary to the requirements of agency business but is of the view that such matter should be the subject of a vote of the Commission.

DUTY OFFICER CONSIDERATION*

( ) Pursuant to the provisons of 17 CFR 200.42(b) HO-1102

EMERGENCY CALENDAR CONSIDERATION

(X)

REASON EXPEDITED DECISION IS REQUIRED:

Action may be imminent between the Navy and General Dynamics concerning possible settlement of General Dynamics claim pursuant to an act of Congress. In addition, the staff's inquiry is being impeded by the delay of General Dynamics and its creditors & Arthur Andersen, in providing the staff with certain requested documents.

W. Timmeny
Requesting Division Director

Secretary

Chairman

Duty Officer/Commissioner (DATE)

COMMISSION ACTION

	Approved*	Deferred for Regular Calendar
Chairman Williams	_____	_____
Commissioner Loomis	_____	_____
Commissioner Evans	_____	_____
Commissioner Pollack	_____	_____
Commissioner Karmel	_____	_____

* Staff memorandum requesting affirmation by the full Commission is due in the Secretary's Office within three business days if item is approved by Duty Officer only.

MEMORANDUM

FILE NO:
DATE: May 22, 1978

TO : The Commission

FROM : The Division of Enforcement

RE : General Dynamics Corporation

DATE FILED :

AMENDED :

SUBJECT : Formal Order of Investigation

RECOMMENDATION : That the Commission issue a Formal Order of Private Investigation naming the above subject to determine whether there have been violations of Section 17(a) of the Securities Act of 1933, Sections 10(b), 13(a) and 14(a) of the Securities Exchange Act of 1934 and Rules 10b-5, 13a-1, 13a-11, 13a-13, 14a-3 and 14a-9 thereunder.

ACTION REQUESTED BY : Immediately

NOVEL, UNIQUE OR COMPLEX ISSUES : None

Recommendation approved by Commission.
JUN 6 1978
Barbara M. Jewell
Senior Recording Secretary

I. SUMMARY

General Dynamics Corporation ("General Dynamics") is a Delaware corporation with its principal executive offices in St. Louis, Missouri. Through its several divisions and subsidiaries, it is engaged in the following principal industry segments: government aerospace, in which it is involved in the engineering, development and production of military aircrafts, tactical missiles and space systems; submarines, in which it's Electric Boat Division ("Electric Boat") is the nation's leader in the design, construction, overhaul and conversion of United States Navy nuclear powered submarines including the Trident class and SSN 688-class attack submarines; and commercial ships, in which it's Quincy Shipbuilding Division is involved in a billion dollar program producing ocean-going tankers.

The common stock of General Dynamics is registered with the Commission pursuant to Section 12(b) of the Securities Exchange Act of 1934 ("Exchange Act"). As of December 31, 1977, the Company had 10,637,060 shares of common stock outstanding and listed for trading on the New York, Midwest, Pacific Coast, and Montreal stock exchanges.

General Dynamics has two major government contracts for the construction of the SSN 688-class attack submarines. In attempting to comply with these contracts, General Dynamics is experiencing substantial cost over-runs. The Company, in December 1976, filed a claim for $544 million against the United States Navy, alleging that these cost over-runs were primarily the responsibility of the United States Navy. 1/

The staff recently learned of these facts when it became aware of remarks made by certain Navy officials before the Senate Joint Economic Committee in December 1977. In an attempt to verify the validity of these allegations and in order to determine if General Dynamics may have made false filings with the Commission, the staff has been conducting an informal inquiry into this matter. The staff has recently obtained from the Department of Justice access to the Navy information referred for its consideration. Further, the staff has conferred with and obtained information from Admiral H.G. Rickover, his staff, and the Navy Claim Settlement Board, which analyzed and reviewed the $544 million claim in question. Finally, the staff has requested from General Dynamics' auditor, Arthur Andersen, its workpapers relating to all claims involving the

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1/ Admiral H.G. Rickover has submitted to the General Counsel of the Navy, after a review of certain elements of the $544 million claim, a report on 18 SSN 688-class submarine claim elements which he believes should be investigated for possible violation of fraud or false claim statutes. The matter has recently been referred to the Department of Justice for its consideration.

SSN 688-class attack submarines and the treatment of such claims in the financial records of General Dynamics. Due to the persistent delays in production by General Dynamics and Arthur Andersen for the past three weeks, the staff has not yet been able to review these workpapers.

II. DISCUSSION

A. SSN 688 Program

As indicated above, General Dynamics Corporation has two contracts covering the construction of 18 SSN 688-class submarines, the first of which was awarded in 1971. The cost of building these submarines has greatly exceeded the initial contract prices. General Dynamics alleges that the cost over-runs are due to deficient engineering plans and specifications furnished to Electric Boat by the United States Navy and its design agent in addition to the delay in furnishing the plans. The Navy has made more than 35,000 drawing revisions (a change made to an existing engineering design plan) to the plans and specifications which General Dynamics alleges may have adversely affected the production operations. Accordingly, General Dynamics has filed claims with the Navy for price increases to cover the cost of the changes. This was done in accordance with the contracts' changes clause.

On April 7, 1976, the first claims submitted by General Dynamics, (totalling $244 million) to cover the alleged cost of revisions directed by the Navy prior to May 20, 1975 on the first contract for seven submarines, were settled at a contract ceiling price increase of $97 million. On December 1, 1977, General Dynamics filed additional claims for ceiling price increases of $544 million to cover directed changes on both contracts through October 1976. Since drawing revisions and changes which form the basis for these claims allegedly have continued at a high rate, General Dynamics has in preparation additional claims for price increases. These claims, which are expected to be very large, are intended to cover the cost of subsequent Navy actions and to increase the earlier claim amounts as the effect of those changes on the SSN 688 and Trident submarine programs has become evident.

General Dynamics has incurred costs through December 31, 1977 and December 31, 1976 on submarines to be delivered, which are included in government contracts in process, amounting to $1,162 million and $876 million, respectively. The related progress payments (payments received by the contractor as work is performed; procurement regulations and contract provisions govern the form and timing of such payments) associated with these government contracts in process were $815 million in 1977 and $684 million in 1976.

In February 1978, General Dynamics completed a new study of costs and schedules to complete the SSN 688 program. It now estimates that it will be able to deliver the last of the 18 ships in approximately 6 years. It further estimates that the cost to complete the program is $840 million in excess of the anticipated revenues from current contracts, assuming no return from present or future claims. This estimated cost to complete is based upon the assumption that the rate of drawing revisions will be reduced significantly and that historical manufacturing improvements will be realized by the Electric Boat Division and other manufacturing divisions of General Dynamics.

General Dynamics and the Navy have engaged over the past three years in unsuccessful negotiations to resolve the Company's claims. On March 13, 1978, General Dynamics formally notified the Navy that it intended to stop all work on April 12, 1978, on the remaining 16 SSN 688-class submarines alleging that the contracts for these ships have been breached by the Navy. In a subsequent meeting on March 21, the Navy suggested that General Dynamics extend the stop work deadline for two months to allow additional time for the Navy and General Dynamics to negotiate an equitable solution. On April 6, General Dynamics agreed to this extension after the Navy announced an award of $66.5 million to the Company as provisional payments (payments received by the contractor that have no relationship to the work progress on a contract but rather relate to a portion of an outstanding claim that the Navy feels has been substantiated) on their outstanding $544 million claim. Navy officials indicate that these payments do not constitute an agreement between the Company and the Navy with respect to the total value of General Dynamics' claim.

B. General Background of Shipbuilding Claims

General Dynamics' shipbuilding claims involve fixed-price, incentive fee type contracts. Contracts of this type set a target cost, a target profit, and a ceiling price. The United States government and the shipbuilder share in cost overruns beyond target costs up to the ceiling price; costs exceeding the ceiling price are to be borne entirely by the shipbuilder, unless it can demonstrate that the cost overruns were caused by the government.

In the past, claims on Navy shipbuilding contracts have been settled for 30% - 50% of the face value of the claim. For example, in February 1977 the Navy Claims Settlement Board settled a $151 million nuclear cruiser claim by Litton Industries, Inc. for $44.3 million, or only 29% of the total amount claimed.

C. Electric Boat SSN 688-Class Claims

In its claims for cost over-runs, Electric Boat cites numerous government acts which it alleges increased the cost of production of the 688-class submarine. In addition, it alleges that the government is responsible for all delays experienced on this major construction program.

The staff has recently learned from officials of the Department of the Navy certain facts which tend to indicate that Electric Boat rather than the government may be primarily responsible for the disputed cost overruns as a result of a shortage of skilled manpower; low productivity; a five month labor strike; late ordering and late receipt of shipbuilder responsible material; frequent changes in management and supervisory personnel; and failure to provide adequate control of material in stores and work in process. In addition, having completed their analysis of the $544 million claim, the members of the Navy Claims Settlement Board have indicated to the staff that they have only been able to substantiate less than 20% of the claim.

The staff has also learned that Electric Boat's allegation that some 35,000 drawing revisions have caused a tremendous delay in the completion of these contracts may be misleading. The Electric Boat Division in response to Navy inquiries has stated that only 2,384 of the 35,000 drawing revisions have a direct cost impact. Further, information provided by the Navy to our staff with regard to their analysis of this portion of the claim indicates that of these 2,384 changes, 55 already had been settled; 25 actually reduced the cost of performance; 2,227 in total averaged a cost less than $1200; and only 77 were above $20,000.

Further, the staff has been informed that officials at General Dynamics headquarters in St. Louis may have ignored the advice of their ship cost estimators and management at Electric Boat and substantially cut their estimates prior to submitting the bids on the first and/or second contracts in order to win the contract awards. A major thrust of the Electric Boat claim, however, is that the company had no way of knowing how difficult the ships would be to build and that the government should pay for costs not reasonably anticipated by Electric Boat.

Electric Boat also alleges that drawings furnished by the government because of the delay in their presentation caused them to be unsuitable. The staff has learned that, in fact, in some cases drawings were furnished by the Navy to General Dynamics as early as 22 months before bid solicitation and 30 months prior to contract award. In almost every instance where delay is alleged, the staff has learned that the drawings were submitted to General Dynamics well in advance of bid solicitations allowing for contractor consideration.

III. ACCOUNTING IMPACT

The 1977 audit opinion of Arthur Andersen & Co. was qualified subject to the final resolution of its $544 million claim. The staff believes that for financial reporting purposes, General Dynamics may have treated its $544 million claim as fully recoverable from the Navy. All revenues from the SSN 688 program have been accounted for on a break even basis. There has been no recognition of loss on the construction of the SSN 688- class attack submarines.

Assuming that the conclusions of the Navy Claims Settlement Board (that less than 20% of the $544 million claim could be substantiated and of that figure everything above $25 million was awarded for litigative risks) as to the substantiation and validity of the claims were known or should have been known by General Dynamics, the Company may have filed false and misleading periodic financial statements as well as false and misleading proxy materials with the Commission by not recognizing and disclosing any losses on the SSN 688 program. In addition, since all losses must be recognized immediately, the cost overruns incurred above the contract ceiling price (assuming no adjustment is made) should have been reflected on the financial statements as losses in the period in which they occurred.

IV. NEED FOR A FORMAL ORDER

The foregoing information raises very serious questions regarding the integrity of General Dynamics' financial reporting. A formal order is necessary in order to properly pursue these issues through the subpoenaing of documents and the taking of testimony. The staff believes that due to the magnitude and breadth of the issues raised and the delays already noted, it is necessary to conduct the investigation on a formal basis.

V. RECOMMENDATION

The Division recommends that the Commission enter a formal order of private investigation naming General Dynamics to determine whether there have been violations of Section 17(a) of the Securities Act of 1933 and Sections 10(b), 13(a), and 14(a) of the

Exchange Act and Rules 10b-5, 13a-1, 13a-11, 13a-13, 14a-3 and 14a-9 thereunder. *

MGPickholz	755-1674
RTSharp	755-1146
RTD'Elia	755-1146
PWSmolen	755-5015

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* The Commission should be aware that various Congressional Committees are presently conducting hearings into these matters. Further, it should be noted, that to enable the above referenced staff to properly perform its investigation, we have requested tha the Secretary secure for them and Mr. Pickholz's secretary a temporary "secret" security clearance.

Exhibit D

Form 19A

U.S. Securities and Exchange Commission
CATS—Investigation

☒ Revision

1. Enf. File No.	2. Case Name
HO-1102	General Dynamics

3. Case Status (circle one)

- PE Open
- PJ Pending-Justice
- PL Pending-State/Local
- PS Pending-SRO
- PI Pending-Inactive
- PF Under Review/Closing-Field
- (PH) Recommended Closing-Hdqrs.
- PM Recommended Closing by Merger-Hdqrs.

4. Org. Code 40031

5. Date Opened 6-6-78

6. Primary Trading Markets (Circle no more than two)

- AME American
- BOS Boston
- CIN Cincinnati
- CBO Chicago Bd. Options
- IMT Inter-Mountain
- MID Midwest
- (NYS) New York
- PAC Pacific Coast
- PHL Philadelphia
- SPK Spokane
- FRN Foreign
- OTC Over-the-Counter
- NAS NASDAQ
- NAP Not Applicable

7. Case Origin (Circle no more than two)

- CB Cause Examination (BD)
- CI Cause Examination (IA)
- CC Cause Examination (IC)
- CA Change in Accountants
- CP Complaint from Public
- CG Congressional Inquiry
- FA Federal Agency
- IN Informant
- IF Issuer Filing
- IP Issuer Publicity
- IR Issuer/Reg. Stmt.
- MS Market Surveillance
- NM News Media
- OD Other SEC Division
- OI Other SEC Investigation
- PL Private Litigation
- RB Routine Examination (BD)
- RI Routine Examination (IA)
- RC Routine Examination (IC)
- SI Securities Industry Contact
- SR Self-Regulatory Organization
- SL State/Local Agency
- OT Other _____

8. Nature of Security (Circle up to five; if more than 5 apply, see instructions.)

- CP Commercial Paper
- CO Commodity
- CS Common Stock
- CD Corporate Debt
- FS Foreign Securities
- GO General Obligation Bond
- ID IDR Bond
- LD Limited Partnership
- IC Investment Company
- IT Investment Contract
- MB Municipal Bond
- OP Options
- PS Preferred Stock
- PM Promissory Note (non-corporate)
- RB Revenue Bond (other than IDR)
- SF Security Futures and/or Forwards
- UI Undivided Interests
- US U.S. Government Issue
- UG U.S. Government Guaranteed Issue
- WT Warrants
- NA Not Applicable
- OT Other _____
- XX (See Instructions)

9. Staff Assigned	10. Related SEC No.	11. MUI No.
1) V. Smolen	1)	
2)	2)	

SEC 1752 (5-80)

Form 19A Page 2

Enf. File No.	Case Name

12. Case Classification (Circle up to 10; if more than 10 apply, see instructions.)

AC	Accountants	IA	Investment Adviser
AP	Accounting Problem	IC	Investment Company
AT	Attorney (s)	MF	Management Fraud
BH	Bank/Bank Holding Co.	MA	Manipulation
BO	Beneficial Ownership	MI	Mining
BI	Books & Records (Issuer)	NC	Net Capital
BB	Books & Records (BD/IC/IA)	NP	Nonpublic/Inside Information
BF	Breach Fiduciary Relationship	OG	Oil/Gas
BD	Broker-Dealer	OP	Operational Problem
CH	Churning	PK	Perks
DL	Delinquent Filing	PO	Possible Organized Crime
EM	Excessive Markup/Markdown	PR	Proxy
EC	Extension of Credit	PU	Public Utility
FD	Failure to Disclose	RE	Real Estate
FI	Failure to File (Issuer Filing)	SU	Suitability
FO	Failure to File (Other Than Issuer)	TS	Tax Shelter
FR	Failure to Register (BD, IA, IC, etc.)	TO	Tender Offer
FS	Failure to Supervise	UT	Unauthorized Transaction
FF	False Filing	UO	Unregistered Offering
FP	Financial Problem	OT	Other _____
FC	Foreign Corrupt Practices		
FU	Fraud in Offer/Sale/Purchase	XX	(See instructions)
GP	Going Private		

13. Violations (Act/Section/Rule)

_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____

14. Comments (not to exceed 150 characters)

_____

_____

_____

Form 19A Page 3

Enf. File No.	Case Name

15. Summary of Facts - Opening or Closing Recommendation is to include a complete summary of the facts. Continue on additional pages, if necessary.

See Attached

16. Signatures

Attorney	Date 2/4/92	Branch Chief / Special Counsel	Date 02/11/92
Asst. Director / Asst. Reg. Adm.	Date 2/3/92	Regional Adm. / Assoc. Reg. Adm.	Date
Associate Director	Date 2/4/92	Case Management Review	Date

17. Management Code

18. Date Closed 7/23/92

Form 19A Page 4

Enf. File No.	Case Name

19. Related Names

Name (If individual, enter last, first, middle)	Relationship Code

This investigation was commenced in the spring of 1978 to determine whether General Dynamics ("GD") misstated its financial position by overvaluing its claims and potential claims against the United States Navy arising from contracts to construct the class 688 submarines. On June 6, 1978, the Commission entered a formal order of private investigation to determine whether violations of Sections 10(b), 13(a), and 14(a) of the Exchange Act had occured or were about to occur in connection with the financial treatment of these contracts. Shortly after the entry of the formal order, the Commission issued a subpoena duces tecum requiring the production of extensive documents relating to GD's claims and potential claims. The staff's analysis of the documents did not discover evidence that the GD claims were fraudulent, 1/ but did indicate possible disclosure violations in 1976.

As reflected in GD's public filings, the Company carried the 688 contracts on a "break-even" basis i.e., no earnings were recorded on the contracts. In 1976, the estimated cost of completion of the 688 contracts exceeded for the first time the amount of contracts. GD also submitted its first two claims during that year, alleging that the United States was responsible for approximately $220 million and $544 million of unanticipated costs. Prior to the close of FY 1976, the first claim was settled for $97 million. For that year, GD continued to carry the contracts on a break-even basis, stating in its Form 10-K that it believed that the amount likely to be recovered on the claim would at least allow it to break-even. GD's auditors, stating that they were unable to determine whether the claims would be collected, issued a "subject to" opinion.

Internal documents indicate that, in fact, GD was expecting that only part of the funds necessary to break-even on the contracts would be received due its claims and that it was relying on the Navy's substituting a revised escalation clause in the 688 contracts in order to recover the remainder. Although the Navey had indicated a willingness to make this substitution, it had no legal obligation to do so. Since there was a risk that the Navy would not ultimately agree to the substitution — particularly in light of the burgeoning GD claims — it may have been misleading for GD to state in its form 10-K that it expected to recover sufficiently from its claims to at least break-even.

In its 1977 form 10-K and annual report to shareholders, GD made much fuller disclosure, noting that it was expecting and relying upon a revision of the contracts'escalation clause. It continued to book the contract on break-even basis and its auditors again rendered a "subject to" opinion.

1/ A grand jury was convened to investigate whether GD filed fraudulent claims. The Company was recently advised that the grand jury has determined not to return any indictments.

While we believe that there may have been inadequate disclosure in 1976, the 1977 disclosure was much more complete. The accounting treatment in both years failed to record a loss but under GAAP as set for the in FAS-5 it would be difficult to prove that the break-even treatment was improper. Under FAS-5 a loss does not have to be recorded unless it is both "probable" and "reasonably estimable." Although a reasonable case can be made that a loss was "possible," it would be difficult to show that management thought a loss was "probable," as it apparently believed that the Navy would revise the contracts. Additionally, we found no documents indicating that GD made any estimate of loss and it would be difficult to establish that any minimum loss should have been foreseen. Thus, based on the present record, we would not recommend enforcement action based on the failure to report a loss in 1976 or 1977 -- even though in 1978 GD resolved its dispute with the Navy and absorbed a loss of $359,000,000.

We recommend that this investigation be closed, as the possible violations relate to a period of six years ago and as further investigation and any possible litigation will require the allocation of manpower that is currently unavailable and that could be better spent on other, more current cases.

Exhibit E

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
CORPORATION FINANCE

April 28, 1978

Mr. John P. Maguire, Secretary
General Dynamics Corporation
Pierre Laclede Center
St. Louis, Missouri 63105

Re: General Dynamics Corporation
Form 10-K for the period ended December 31, 1977
File No. 1-3671

Dear Mr. Maguire:

The following are the staff's comments on the financial statements in the annual report on the Form 10-K for the period ended December 31, 1977:

We may have further comments regarding other parts of the Form 10-K annual report in the near future.

Financial Statements

It appears to the staff that a minimum amount of loss should have been accrued on the SSN 688 Program at December 31, 1977 pursuant to FASB Interpretation No. 14 of FASB Statement No. 5 based upon the fact that recent newspaper accounts concerning negotiations with the Navy appear to indicate that the Company will not be able to achieve sufficient claims settlements to cover costs expected to be incurred. Please advise, supplying details of the consideration of this matter at December 31, 1977. We may have further comments.

In note (A) on page 32, the disclosures in regard to sales and earnings should indicate the accounting policy for recording claims as sales.

The amount of claims recognized as sales each year should be indicated in note (A), SSN 688 Program, on page 33.

In the carryover paragraph on page 34, the Company's exposure to loss if the historical manufacturing improvements are not realized should be quantified considering

the unusual problems encountered on the SSN 688 Program. We assume that no costs have been deferred in anticipation of improved manufacturing efficiency factors. Please advise. In addition, it appears the Company is no longer considering additional productivity improvements ($60 million) as was assumed at December 31, 1976 which appears to further support the possibility that a minimum amount of expected loss should have been accrued at December 31, 1977.

The total provision for income taxes should be reconciled to the federal tax rate for U.S. taxes in note (G) on page 42.

The tax effect of timing differences should be disclosed from the standpoint of the effect on amounts included in the financial statements rather than aggregate effects of different accounting methods used to report income or loss for income tax purposes. Net operating loss carryforwards should not enter into the disclosure of such timing differences. In addition, the effect of timing differences arising from the use of the completed-contract method of accounting for tax purposes should be disclosed separately from the effect of the practice of deducting currently on tax returns certain costs which are inventoried for financial reporting.

All amendments should contain a new manually-signed accountants' report.

It appears that the disclosures contemplated by paragraph 36 of SFAS No. 14 should be added to note L of the notes to financial statements.

The disclosures in note O should include amounts of gross profit as required by Rule 3-16(t) of Regulation S-X.

Note A to the financial statements of the Patriot subsidiaries should describe the ultimate disposition of earned investment credits.

General Dynamics Corporation
Page Three

If you have any questions concerning the above, please contact Mr. Richard J. Reinhard at (202) 376-2365.

Sincerely,

Jeffrey R. Moreland
Branch Chief

R. Reinhard/Accountant
Branch 3-J. Moreland:
crl

Exhibit F

1-3671-3

GENERAL DYNAMICS CORPORATION
Pierre Laclede Center
St. Louis, Missouri 63105

Wayne Wells
Vice President & Treasurer

314-862-3440

11 May 1978

Securities and Exchange Commission
Washington, D. C. 20549

Attention: Mr. Jeffrey R. Moreland
Branch Chief

Re: General Dynamics Corporation
Form 10-K for the period ended December 31, 1977
File No. 1-3671

Dear Sirs:

Enclosed you will find one (1) manually signed copy and seven (7) conformed copies of Amendment No. 1 to the Form 10-K referred to above. Three (3) copies have been red-lined to indicate the changes from the Form 10-K as filed. The changes made by this Amendment are in response to the comments in the Securities and Exchange Commission's letter of April 28, 1978. In addition to the changes incorporated in the Amendment, we are making the following comments:

1. At the time the 1977 financial statements were released on 23 March 1978, there was no basis under applicable accounting standards for the Company to accrue a loss on the SSN 688 Program. Apparently, the newspaper accounts of the negotiations with the Navy have caused a misunderstanding by your Staff of the Company's position in seeking a resolution of the SSN 688 problems.

The history and the present status of the SSN 688 submarine contracts have been carefully and fully set forth in the Company's 1977 Annual Report on pages 4 and 5. A copy of the Report is attached for your ready reference.

General Dynamics has consistently maintained over the course of several years that it is legally and equitably entitled to recover, as a minimum, all costs incurred under its SSN 688 contracts. It is prepared to pursue its various legal remedies to secure payment of costs incurred and to terminate future costs by discontinuance of performance of the contracts because of material breaches by the Navy.

Recognizing the probability that complicated contract litigation could continue over many years in the future, the Company, as an alternative, undertook extensive negotiations with the Navy to determine whether or not a prompt settlement of all the issues between the parties might be reached. Negotiated settlement with the Navy which could

result in a recovery of less than the total costs incurred on the Program might prove to be in the best long-run interest of the Company's shareholders for a number of reasons, including elimination of the uncertainties of protracted and expensive litigation.

When those negotiations reached an impasse and were discontinued on 12 March 1978, the Company notified the Navy on 13 March 1978 that it intended to discontinue work on the SSN 688 contracts on 12 April 1978. Subsequently, following a meeting with the Navy on 21 March, an interim agreement was made to defer the discontinuance of work until 11 June 1978 to permit further negotiations. Therefore, as of 23 March 1978 when the Company issued its financial statements, there was no indication of a final settlement whose terms would require an accrual of a loss on the Program by the Company under the Provisions of FASB Statement No. 5. This situation exists today.

Although the Company, as well as its Auditors and Legal Counsel, were unable, as of 23 March 1978, to predict the course of future events affecting the outcome of these complex issues, it did make a full and complete disclosure of its estimated cost to complete the Program in excess of anticipated revenues from current contracts, assuming no return from present and future claims. We refer the Staff to the notes to the 1977 financials relating to the SSN 688 Program set forth on pages 25-26 of the Annual Report and the same note appears on pages 33-34 of the Company's Form 10-K for 1977.

In summary, the uncertainties of the ultimate outcome of both the negotiations with the Navy and the other remedies available to General Dynamics led the Company to conclude that it should continue to account for the Program for 1977 as it had in prior years - on a break-even basis.

2. Footnote A to the financial statements provides full and proper disclosure with respect to the SSN 688 Program. The discussion in the third paragraph of the SSN 688 section of Note A regarding the studies of costs and schedules to complete and the various assumptions that are inherent in the costs to complete which result in the estimated $840 million of costs in excess of anticipated revenues from the current contracts, assuming no return from present and future claims, present a full and complete disclosure indicating the extent of the SSN 688 Program risks. As indicated in this paragraph, the estimated costs to complete are "based upon the assumption that the rate of drawing revisions will be reduced significantly and historical manufacturing improvements will be realized ...." These two items must be considered together since the manufacturing improvements are directly affected by the level of drawing revisions and separate disclosure would not be meaningful. Further, the discussion in the Note points out that the historical manufacturing improvements have been realized "on every previous class of submarines built by the Electric Boat Division as well as on the products of other manufacturing division of the Corporation". Therefore, we see no need or desirability to make an exception to quantify these amounts for the SSN 688 Program which quantification would be inconsistent with the treatment followed on other major programs of the Corporation. Any additional productivity improvements, as referred to in the footnote to the 1976 financial statements,

are included as a part of the historical improvements and we are unable to separate the two amounts.

Your assumption that no SSN 688 Program costs have been deferred in the anticipation of manufacturing efficiency factors is correct.

3. We are not sure that we understand the thrust of your comments regarding the tax effect of timing differences discussed in the second paragraph on Page 2 of your letter. We assume that the comment relates to the table in Footnote G - Income Taxes on Page 43. We believe that the presentation set forth in this table is proper and is comparable to the presentations used in prior years. When there is a loss for tax purposes that is carried forward, a problem arises regarding the assigning of priorities to the elements making up the difference between book and taxable income. We, therefore, believe the preferable disclosure is to show the gross amounts and then deduct the amount of the loss carryforward in total. An assumption could be made that all of the loss carryforward is attributable to the deferral of earnings and the deduction of certain costs on long-term contracts reported on the completed contract basis. The total amount attributable to these items could then be reduced on a pro rata basis for the amount of the loss carryforward. If you think that this is a better disclosure with a further indication in a paragraph below the table that there is a loss carryforward, we would have no objection. However, in our opinion, this is not improved disclosure.

4. Per FASB Statement No. 14, the amount of export sales from an enterprise's home country to unaffiliated customers in foreign countries need only be disclosed if the amount is 10% or more of total revenue from sales to unaffiliated customers. General Dynamics Corporation export sales (excluding foreign military sales made through the U. S. Government and sales of the Corporation's Canadian Asbestos operations) are less than 10%.

5. All costs incurred, including general and administrative expenses, are allocable to contracts and are inventoried in contracts in process insofar as the costs apply to the Government, shipbuilding and DC-10 products, which comprise the majority of General Dynamics' business. Therefore, operating profits is the proper level for reporting profits.

We trust that the above comments, together with the changes set forth in the attached Amendment, are responsive to your comments and will permit early clearance of the effectiveness of the Registration Statements for our various benefit plans.

Very truly yours,

Wayne Wells
Vice President & Treasurer

Enclosures

ARTHUR ANDERSEN & CO.

Exhibit G

INTEROFFICE COMMUNICATION

TO ST. LOUIS OFFICE FROM ST. LOUIS OFFICE

FOR ROBERT O. PALMER FROM TERRY L. LENGFELDER

DATE JANUARY 22, 1977

SUBJECT: GENERAL DYNAMICS CORPORATION -- REPORT CONSIDERATIONS

STRICTLY CONFIDENTIAL

After our recent discussions I have given some additional thought to the question of "except for" vs. "subject to," should a qualification be required on the interoffice opinion on the Electric Boat Division and the consolidated financial statements of General Dynamics Corporation.

It is my belief that to sustain an "except for" opinion on the statements of the Division, the engagement partner must be absolutely convinced (with certainty) that a material loss has occurred in the SSN 688 program as of December 31, 1976. Since an opinion taking exception to fairness of financial statements in accordance with generally accepted accounting principles is unacceptable to the Securities and Exchange Commission, the company would then be forced (presumably in consultation with our EB engagement people) to make a material adjustment to their financial statements.

Focusing on the amount or range of the potential material misstatement is of course the responsibility of the engagement partner, Bill Weldon, and his engagement team at Electric Boat. While obviously neither you, I, or anyone else without the detailed perspective that Bill has with respect to this complex audit matter can presume to make this judgement for him, I question that such a certainty exists.

Based on the many hours I have spent reviewing this program in 1976 and over the past several years and in view of the numerous developments in the last half of 1976, the situation seems almost one of a classic uncertainty. Unless our audit work identifies clear errors in the company's estimate to complete, the claim preparation, or absence of legal support and entitlement, and if we continue to be convinced in our work that the company reasonably believes estimates to complete and estimated claim values are attainable, I would have a great problem in considering the situation anything but an uncertainty.

INTEROFFICE COMMUNICATION

After writing these comments, which represent my views, I further reviewed Auditors' Reports and the AICPA Statement on Auditing Standards No. 1, both of which seem to support my foregoing comments.

TERRY L. LENGFELDER

SB

Exhibit H

Statement of Financial Accounting Standards No. 5
Accounting for Contingencies

STATUS

Issued: March 1975

Effective Date: For fiscal years beginning on or after July 1, 1975

Affects: Supersedes ARB 43, Chapter 6
Supersedes ARB 50

Affected by: Paragraph 13 superseded by FAS 71
Paragraph 20 amended by FAS 11
Paragraphs 41 and 102 amended by FAS 60
Footnote 3 superseded by FAS 16•

Exhibit H

Statement of Financial Accounting Standards No. 5
Accounting for Contingencies

CONTENTS

INTRODUCTION

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss[1] (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

2. Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

a. *Probable.* The future event or events are likely to occur.
b. *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
c. *Remote.* The chance of the future event or events occurring is slight.

4. Examples of loss contingencies include:

a. Collectibility of receivables.
b. Obligations related to product warranties and product defects.
c. Risk of loss or damage of enterprise property by fire, explosion, or other hazards.
d. Threat of expropriation of assets.
e. Pending or threatened litigation.
f. Actual or possible claims and assessments.
g. Risk of loss from catastrophes assumed by property and casualty insurance companies including reinsurance companies.
h. Guarantees of indebtedness of others.
i. Obligations of commercial banks under "standby letters of credit."[2]
j. Agreements to repurchase receivables (or to repurchase the related property that have been sold.

5. Some enterprises now accrue estimated losses from some types of contingencies by a charge to income prior to the occurrence of the event or events that are expected to resolve the uncertainties while, under similar circumstances, other enterprises account for those losses only when the confirming event or events have occurred.

6. This Statement establishes standards of financial accounting and reporting for loss contingencies (see paragraphs 8-16) and carries forward without reconsideration the conclusions of *Accounting Research Bulletin (ARB) No. 50*, "Contingencies," with respect to gain contingencies (see paragraph 17) and other disclosures (see paragraphs 18-19). The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in Appendix C. Examples of application of this Statement are presented in Appendix A, and background information is presented in Appendix B.

7. This Statement supersedes both *ARB No. 50* and Chapter 6, "Contingency Reserves," of *ARB No. 43*. The conditions for accrual of loss contingencies in paragraph 8 of this Statement do not amend any other present requirement in an Accounting Research Bulletin or Opinion of the Accounting Principles Board to accrue a particular type of loss or expense. Thus, for example, accounting for pension cost, deferred compensation contracts, and stock issued to employees are excluded from the scope of this Statement. Those matters are covered, respectively, in *APB Opinion No. 8*, "Accounting for the Cost of Pension Plans," *APB Opinion No. 12*, "Omnibus Opinion—1967," paragraphs 6-8, and *APB Opinion No. 25*, "Accounting for Stock Issued to Employees." Accounting for other employment-related costs, such as group insurance, vacation pay, workmen's compensation, and disability benefits, is also excluded from the scope of this Statement. Accounting practices for those types of costs and pension accounting practices tend to involve similar considerations.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accrual of Loss Contingencies

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income[3] if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.[4] It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
b. The amount of loss can be reasonably estimated.

Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual[5] made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have

[1] The term *loss* is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

[2] As defined by the Federal Reserve Board, "standby letters of credit" include "every letter of credit (or similar arrangement however named or designated) which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account party or (3) to make payment on account of any default by the account party in the performance of an obligation." A note to that definition states that "as defined, 'standby letter of credit' would not include (1) commercial letters of credit and similar instruments where the issuing bank expects the beneficiary to draw upon the issuer and which do not 'guaranty' payment of a money obligation or (2) a guaranty or similar obligation issued by a foreign branch in accordance with and subject to the limitations of Regulation M [of the Federal Reserve Board]." Regulations of the Comptroller of the Currency and the Federal Deposit Insurance Corporation contain similar definitions.

[redacted]

[4] *Date of the financial statements* means the end of the most recent accounting period for which financial statements are being presented.

[5] Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of *Accounting Terminology Bulletin No. 1*, "Review and Resume").

been incurred.* The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

11. After the date of an enterprise's financial statements but before those financial statements are issued, information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, e.g., an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, e.g., threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an enterprise whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 8(a) is, therefore, not met. Disclosure of those kinds of losses or loss contingencies may be necessary, however, to keep the financial statements from being misleading. If disclosure is deemed necessary, the financial statements shall indicate the nature of the loss or loss contingency and give an estimate of the amount or range of loss or possible loss or state that such an estimate cannot be made. Occasionally, in the case of a loss arising after the date of the financial statements where the amount of asset impairment or liability incurrence can be reasonably estimated, disclosure may best be made by supplementing the historical financial statements with pro forma financial data giving effect to the loss as if it had occurred at the date of the financial statements. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical financial statements.

12. Certain loss contingencies are presently being disclosed in financial statements even though the possibility of loss may be remote. The common characteristic of those contingencies is a guarantee, normally with a right to proceed against an outside party in the event that the guarantor is called upon to satisfy the guarantee. Examples include (a) guarantees of indebtedness of others, (b) obligations of commercial banks under "standby letters of credit," and (c) guarantees to repurchase receivables (or, in some cases, to repurchase the related property) that have been sold or otherwise assigned. The Board concludes that disclosure of those loss contingencies, and others that in substance have the same characteristic, shall be continued. The disclosure shall include the nature and amount of the guarantee. Consideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor's right to proceed against an outside party.

General or Unspecified Business Risks

14. Some enterprises have in the past accrued so-called "reserves for general contingencies." General or unspecified business risks do not meet the conditions for accrual in paragraph 8, and no accrual for loss shall be made. No disclosure about them is required by this Statement.

Appropriation of Retained Earnings

15. Some enterprises have classified a portion of retained earnings as "appropriated" for loss contingencies. In some cases, the appropriation has been shown outside the stockholders' equity section of the balance sheet. Appropriation of retained earnings is not prohibited by this Statement provided that it is shown within the stockholders' equity section of the balance sheet and is clearly identified as an appropriation of retained earnings. Costs or losses shall not be charged to an appropriation of retained earnings, and no part of the appropriation shall be transferred to income.

*For example, disclosure shall be made of any loss contingency that meets the conditions in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated [paragraph 8(b)]. Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a)—namely, those contingencies for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at

Examples of Application of This Statement

16. Examples of application of the conditions for accrual of loss contingencies in paragraph 8 and the disclosure requirements in paragraphs 9-11 are presented in Appendix A.

Gain Contingencies

17. The Board has not reconsidered *ARB No. 50* with respect to gain contingencies. Accordingly, the following provisions of paragraphs 3 and 5 of that Bulletin shall continue in effect:

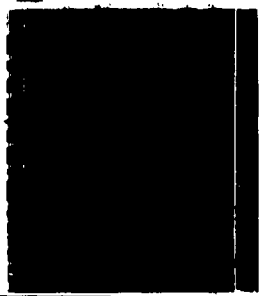
a. Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

b. Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

Other Disclosures

18. Paragraph 6 of *ARB No. 50* required disclosure of a number of situations including "unusual situations or of credit, long-term leases, assets pledged as security for loans, pension plans, the existence of cumulative preferred stock dividends in arrears, and commitments such as those for plant acquisition or the retirement of bonds to reduce debts, maintain working capital, or restrict dividends." Subsequent Opinions issued by the Accounting Principles Board established more explicit disclosure requirements for a number of these items, i.e., leases (see *APB Opinions No. 5* and *31*), pension plans (see *APB Opinion No. 8*), and preferred stock dividend arrearages (see *APB Opinion No. 10*, paragraph 11(b)).

19. Elsewhere of the type described in the preceding paragraph shall continue to be disclosed in financial statements, and this Statement does not alter the present disclosure requirements with respect to these items.



The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Marshall S. Armstrong, *Chairman*
Oscar S. Gellein
Donald J. Kirk
Arthur L. Litke
Robert E. Mays
Walter Schuetze
Robert T. Sprouse

Appendix A

EXAMPLES OF APPLICATION OF THIS STATEMENT

21. This Appendix contains examples of application of the conditions for accrual of loss contingencies in paragraph 8 and of the disclosure requirements in paragraphs 9-11. Some examples have been included in response to questions raised in letters of comment on the Exposure Draft. It should be recognized that no set of examples can encompass all possible contingencies or circumstances. Accordingly, accrual and disclosure of loss contingencies should be based on an evaluation of the facts in each particular case.

Collectibility of Receivables

22. The assets of an enterprise may include receivables that arose from credit sales, loans, or other transactions. The conditions under which receivables exist usually involve some degree of uncertainty about their collectibility, in which case a

contingency exists as defined in paragraph 1. Losses from uncollectible receivables shall be accrued when both conditions in paragraph 8 are met. Those conditions may be considered in relation to individual receivables or in relation to groups of similar types of receivables. If the conditions are met, accrual shall be made even though the particular receivables that are uncollectible may not be identifiable.

23. If, based on available information, it is probable that the enterprise will be unable to collect all amounts due and, therefore, that at the date of its financial statements the net realizable value of the receivables through collection in the ordinary course of business is less than the total amount receivable, the condition in paragraph 8(a) is met because it is probable that an asset has been impaired. Whether the amount of loss can be reasonably estimated (the condition in paragraph 8(b)) will normally depend on, among other things, the experience of the enterprise, information about the ability of individual debtors to pay, and appraisal of the receivables in light of the current economic environment. In the case of an enterprise that has no experience of its own, reference to the experience of other enterprises in the same business may be appropriate. Inability to make a reasonable estimate of the amount of loss from uncollectible receivables (i.e., failure to satisfy the condition in paragraph 8(b)) precludes accrual and may, if there is significant uncertainty as to collection, suggest that the installment method, the cost recovery method, or some other method of revenue recognition be used (see paragraph 12 of *APB Opinion No. 10*, "Omnibus Opinion—1966"); in addition, the disclosures called for by paragraph 10 of this Statement should be made.

Obligations Related to Product Warranties and Product Defects

24. A warranty is an obligation incurred in connection with the sale of goods or services that may require further performance by the seller after the sale has taken place. Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency in paragraph 1. Losses from warranty obligations shall be accrued when the conditions in paragraph 8 are met. Those conditions may be considered in relation to individual sales made with warranties or in relation to groups of similar types of sales made with warranties. If the conditions are met, accrual shall be made even though the particular parties that will make claims under warranties may not be identifiable.

25. If, based on available information, it is probable that customers will make claims under warranties relating to goods or services that have been sold, the condition in paragraph 8(a) is met at the date of an enterprise's financial statements because it is probable that a liability has been incurred. Satisfaction of the condition in paragraph 8(b) will normally depend on the experience of an enterprise or other information. In the case of an enterprise that has no experience of its own, reference to the experience of other enterprises in the same business may be appropriate. Inability to make a reasonable estimate of the amount of a warranty obligation at the time of sale because of significant uncertainty about possible claims (i.e., failure to satisfy the condition in paragraph 8(b)) precludes accrual and, if the range of possible loss is wide, may raise a question about whether a sale should be recorded prior to expiration of the warranty period or until sufficient experience has been gained to permit a reasonable estimate of the obligation; in addition, the disclosures called for by paragraph 10 of this Statement should be made.

26. Obligations other than warranties may arise with respect to products or services that have been sold, for example, claims resulting from injury or damage caused by product defects. If it is probable that claims will arise with respect to products or services that have been sold, accrual for losses may be appropriate. The condition in paragraph 8(a) would be met, for instance, with respect to a drug product or toys that have been sold if a health or safety hazard related to those products is discovered and as a result it is considered probable that liabilities have been incurred. The condition in paragraph 8(b) would be met if experience or other information enables the enterprise to make a reasonable estimate of the loss with respect to the drug product or the toys.

Risk of Loss or Damage of Enterprise Property

27. At the date of an enterprise's financial statements, it may not be insured against risk of future loss or damage to its property by fire, explosion, or other hazards. The absence of insurance against losses from risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a contingency exists as defined in paragraph 1. Uninsured risks may arise in a number of ways, including (a) noninsurance of certain risks or co-insurance or deductible clauses in an insurance contract or (b) insurance through a subsidiary or investee[7] to the extent not reinsured with an independent insurer. Some risks, for all practical purposes, may be noninsurable, and the self-assumption of those risks is mandatory.

[7] The effects of transactions between a parent or other investor and a subsidiary or investee must not eliminate from an enterprise's financial statements (see paragraph 6 of *ARB No. 51*, "Consolidated Financial Statements," and paragraph 19(a) of *APB Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock").

28. The absence of insurance does not mean that an asset has been impaired or a liability has been incurred at the date of an enterprise's financial statements. Fires, explosions, and other similar events that may cause loss or damage of an enterprise's property are random in their occurrence.[8] With respect to events of that type, the condition for accrual in paragraph 8(a) is not satisfied prior to the occurrence of the event because until that time there is no diminution in the value of the property. There is no relationship of those events to the activities of the enterprise prior to their occurrence, and no asset is impaired prior to their occurrence. Further, unlike an insurance company, which has a contractual obligation under policies in force to reimburse insureds for losses, an enterprise can have no such obligation to itself and, hence, no liability.

Risk of Loss from Future Injury to Others, Damage to the Property of Others, and Business Interruption

29. An enterprise may choose not to purchase insurance against risk of loss that may result from injury to others, damage to the property of others, or interruption of its business operations.[9] Exposure to risks of those types constitutes an existing condition involving uncertainty about the amount and timing of any losses that may occur, in which case a contingency exists as defined in paragraph 1.

30. Mere exposure to risks of those types, however, does not mean that an asset has been impaired or a liability has been incurred. The condition for accrual in paragraph 8(a) is not met with respect to loss that may result from injury to others, damage to the property of others, or business interruption that may occur after the date of an enterprise's financial statements. Losses of those types do not relate to the current or a prior period but rather to the *future* period in which they occur. Thus, for example, an enterprise with a fleet of vehicles should not accrue for injury to others or damage to the property of others that may be caused by those vehicles in the future even if the amount of those losses may be reasonably estimable. On the other hand, the conditions in paragraph 8 would be met with respect to uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements, even though the enterprise may not become aware of those matters until after that date, if the experience of the enterprise or other information enables it to make a reasonable estimate of the loss that was incurred prior to the date of its financial statements.

Write-Down of Operating Assets

31. In some cases, the carrying amount of an operating asset not intended for disposal may exceed the amount expected to be recoverable through future use of that asset even though there has been no physical loss or damage of the asset or threat of such loss or damage. For example, changed economic conditions may have made recovery of the carrying amount of a productive facility doubtful. The question of whether, in those cases, it is appropriate to write down the carrying amount of the asset to an amount expected to be recoverable through future operations is not covered by this Statement.

Threat of Expropriation

32. The threat of expropriation of assets is a contingency within the definition of paragraph 1 because of the uncertainty about its outcome and effect. If information indicates that expropriation is imminent and compensation will be less than the carrying amount of the assets, the condition for accrual in paragraph 8(a) is met. Imminence may be indicated, for example, by public or private declarations of intent by a government to expropriate assets of the enterprise or actual expropriation of assets of other enterprises. Paragraph 8(b) requires that accrual be made only if the amount of loss can be reasonably estimated. If the conditions for accrual are not met, the disclosures specified in paragraph 10 would be made when there is at least a reasonable possibility that an asset has been impaired.

Litigation, Claims, and Assessments

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.
b. The degree of probability of an unfavorable outcome.

[8] The Board recognizes that, in practice, experience regarding loss or damage to depreciable assets is in some cases one of the factors considered in estimating the depreciable lives of a group of depreciable assets, along with such other factors as wear and tear, obsolescence, and maintenance and replacement policies. This Statement is not intended to alter present depreciation practices (see paragraph 2).

[9] As to injury or damage resulting from products that have been sold, see paragraph 26.

- The ability to make a reasonable estimate of the amount of loss

34. As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred as the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the probability of loss is such that the condition in paragraph 8(a) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgment must first be made as to whether the assertion of a claim is probable. If the judgment is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgment is that assertion is probable, then a second judgment must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(a)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is probable that it will have to pay additional taxes of $2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of $8 million over and above the $2 million. In that case, paragraph 8 requires

accrual of the $2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonably possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the $2 million that was accrued.

Catastrophe Losses of Property and Casualty Insurance Companies

40. At the time that a property and casualty insurance company or reinsurance company issues an insurance policy covering risk of loss from catastrophes, a contingency arises. The contingency is the risk of loss assumed by the insurance company, that is, the risk of loss from catastrophes that may occur *during the term of the policy*. The insurance company has not assumed risk of loss for catastrophes that may occur *beyond* the term of the policy. Clearly, therefore, no asset has been impaired or liability incurred with respect to catastrophes that may occur beyond the terms of policies in force.

42. Although some property and casualty insurance companies have accrued an estimated amount for catastrophe losses, other insurance companies have accomplished the same objective by deferring a portion of the premium income. Deferral of any portion of premium income *beyond the terms of policies in force* is, in substance, similar to premature accrual of catastrophe losses and, therefore, also does not meet the conditions of paragraph 8.

43. The conditions for accrual in paragraph 8 do not prohibit a property and casualty insurance company from accruing probable catastrophe losses that have been incurred on or before the date of its financial statements but that have not been reported by its policyholders as of that date. If the amount of loss can be reasonably estimated, paragraph 8 requires accrual of these incurred-but-not-reported losses.

Payments to Insurance Companies That May Not Involve Transfer of Risk

44. To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding company. These contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such.

45. Conditions in certain industries may be subject to such high risks that insurance is unavailable or is available only at what is considered to be a prohibitively high cost. Some enterprises in these industries have "pooled" their risks by forming a mutual insurance company in which they retain an equity interest and to which they pay insurance premiums. For example, some electric utility companies have finished cost a mutual insurance company to insure risks related to nuclear power plants, and some oil companies have formed a company to insure against risks associated with petroleum exploration and production. Whether the premium paid represents a payment for the transfer of risk or whether it represents merely a deposit will depend on the circumstances surrounding each enterprise's interest in and business arrangement with the mutual insurance company. An analysis of the contract is required to determine whether risk has been transferred and to what extent.

Appendix B

BACKGROUND INFORMATION

46. In April 1973, the FASB placed on its technical

agenda a project then entitled "Accounting for Future Losses." The project addressed accrual and disclosure of loss contingencies. The Board believes that "Accounting for Contingencies" is a more descriptive title for this Statement than "Accounting for Future Losses."

47. A task force of 16 persons from industry, public accounting, the financial community, and academe was appointed in the summer of 1973 to provide counsel to the Board in preparing a Discussion Memorandum analyzing issues related to the project.

48. The Discussion Memorandum gave examples of various types of contingencies and considered several of those at length to assist in the development of standards of financial accounting and reporting. These included (a) uninsured risks ("self-insurance"), (b) risk of losses from catastrophes assumed by property and casualty insurance companies, and (c) risk of losses from expropriations by foreign governments.

49. Research undertaken in connection with this project included (a) a search of relevant literature, (b) an examination of published financial statements in annual reports to shareholders and in filings with the SEC on Form 10-K, (c) a questionnaire survey conducted by the Financial Executives Institute to which 64 companies responded, and (d) a study of catastrophe reserve accounting methods employed by property and casualty insurance companies. Summaries of research findings are included in appendixes to the Discussion Memorandum.

50. On January 3, 1973 (prior to the date the Board placed this subject on its agenda), the Securities and Exchange Commission issued its *Accounting Series Release No. 134*, which pointed out that a number of property and casualty insurance companies had adopted the accounting policy of making a provision from each period's income to cover a portion of major losses expected to occur in future periods. The SEC Release indicated that the Committee on Insurance Accounting and Auditing of the AICPA was working actively on the subject in cooperation with industry groups. The Release set forth certain disclosure requirements pending resolution of the question of accrual.

51. The AICPA committee's report (dated July 17, 1973) was in the form of a memorandum setting forth the views of those committee members favoring and those opposing accrual of losses from future catastrophes. In the course of its study, the AICPA committee had gathered considerable data on the subject, in part from a survey of member companies of the American Insurance Association, and this information was made available to the Board.

52. On August 2, 1973, the SEC announced in *Accounting Series Release No. 145* that property and casualty insurance companies should not change their method of accounting for catastrophe losses "until a single method has been adopted by the Financial Accounting Standards Board."

53. The Board issued the Discussion Memorandum on March 13, 1974, and held a public hearing on the subject on May 13, 1974. The Board received 87 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum. Eighteen presentations were made at the public hearing.

54. An Exposure Draft of a proposed Statement on "Accounting for Contingencies" was issued on October 21, 1974. The Board received 212 letters of comment on the Exposure Draft.

Appendix C

BASIS FOR CONCLUSIONS

55. This Appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others.

SCOPE OF THIS STATEMENT

56. Some respondents to the Exposure Draft proposed that the Statement not deal with accrual and disclosure of loss contingencies in general but, rather, only with the following three specific matters: "self-insurance," risks of losses from catastrophes assumed by property and casualty insurance companies including reinsurance companies, and threat of expropriation. As the basis for that position, they noted that the Discussion Memorandum considered those three matters at length. Other respondents suggested that catastrophe losses be dealt with in a separate Statement.

57. The Board has concluded, however, that the broad issue of accrual and disclosure of loss contingencies should be dealt with in a single Statement, just as the Discussion Memorandum encompassed "the broad issue of accounting for future losses."[10] As the Discussion Memorandum stated, "future losses of all types presently known to affect enterprises and new types of future losses that may arise are conceptually included in the scope of this project." The three matters dealt with at length in the Discussion Memorandum were used "as examples to assist in the evaluation and development of criteria for accounting for future losses," and other examples were discussed. The Board has concluded that loss contingencies such as those given as examples in paragraph 4 of this Statement have common characteristics and that questions about accounting for and reporting of those contingencies should be resolved comprehensively. It is for that reason, also, that the Board believes it inappropriate to deal with catastrophe losses in a separate Statement.

[10] The Board believes that contingencies is a more descriptive term than *future losses*, and the Discussion Memorandum indicated that the project would necessarily involve reconsideration of both *ARB No. 50* and Chapter 6 of *ARB No. 43*.

58. A question has been raised whether uncollectibility of receivables and product warranties constitute contingencies within the scope of this Statement. The Board recognizes that uncertainties associated with uncollectibility of some receivables and some product warranties are likely to be, in part, inherent in making accounting estimates (described in paragraph 2) as well as, in part, the type of uncertainties that give rise to a contingency (described in paragraph 1). The Board believes that no useful purpose would be served by attempting to distinguish between those two types of uncertainties for purposes of establishing conditions for accrual of uncollectible receivables and product warranties. Consequently, those matters are deemed to be contingencies within the definition of paragraph 1 and should be accounted for pursuant to the provisions of this Statement.

ACCRUAL OF LOSS CONTINGENCIES

59. Paragraph 8 requires that a loss contingency be accrued if the two specified conditions are met. The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. The requirement that the loss be reasonably estimable is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements. The Board has concluded that disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable should not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an enterprise's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.

60. In establishing the conditions in paragraph 8, Board members considered the factors discussed in paragraphs 61-101. Individual Board members gave greater weight to some factors than to others.

Accounting Accruals Do Not Provide Protection against Losses

61. Accrual of a loss related to a contingency does not create or set aside funds to lessen the possible financial impact of a loss, although some respondents to the Discussion Memorandum and the Exposure Draft argued to the contrary. The Board believes that confusion exists between accounting accruals (sometimes referred to as "accounting reserves") and the reserving or setting aside of specific assets to be used for, a particular purpose or contingency. Accounting accruals are simply a method of allocating costs among accounting periods and have no effect on an enterprise's cash flow. An enterprise may choose to maintain or have access to sufficient liquid assets to replace or repair lost or damaged property or to pay claims in case a loss occurs. Alternatively, it may transfer the risk to others by purchasing insurance. Those are financial decisions, and if enterprise management decides to do neither, the presence or absence of an accrued credit balance on the balance sheet will have no effect on the consequences of that decision. The accounting standards set forth in this Statement do not affect the fundamental business economics of that decision.

62. In that regard, some respondents to the Discussion Memorandum and the Exposure Draft contended that an accounting standard that does not permit periodic accrual of so-called "self-insurance reserves" and, in the case of insurance companies, so-called "catastrophe reserves" will force enterprises to purchase insurance or reinsurance because the "protection" afforded by the accrual would no longer exist. Those accruals, however, in no way protect the assets available to replace or repair uninsured property that may be lost or damaged, or to satisfy claims that are not covered by insurance, or, in the case of insurance companies, to satisfy the claims of insured parties. Accrual, in and of itself, provides no financial protection that is not available in the absence of accrual.

63. The sole result of accrual, for financial accounting and reporting purposes, is allocation of costs among accounting periods. Some respondents to the Discussion Memorandum and the Exposure Draft took the position that estimated losses from loss contingencies should be accrued even before available information indicates that it is probable that an asset has been impaired or a liability has been incurred to avoid reporting net income that fluctuates widely from period to period. In their view, financial statement users may be misled by those fluctuations. They believe that estimated losses should be accrued without regard to whether the loss relates to the current period if, based on experience, it is reasonable to expect losses sometime in the future.

64 Financial statement users have indicated, however, that information about earnings variability is important to them. Two elements often cited as basic to the decision models of many financial statement users are (a) expected return—the predicted amount and timing of the return on an investment—and (b) risk—the variability of that expected return. If the nature of an enterprise's operations is such that irregularities in the incurrence of losses cause variations in periodic net income, that fact should not be obscured by accruing for anticipated losses that do not relate to the current period.

65. The Board recognizes that some investors may have a preference for investments in enterprises having a stable pattern of earnings, because that indicates lesser uncertainty or risk than fluctuating earnings. That preference, in turn, is perceived by many as having a favorable effect on the market prices of those enterprises' securities. If accruals for such matters as future uninsured losses and catastrophes were prohibited, some respondents contended, enterprises would be forced to purchase insurance or reinsurance to achieve the more stable pattern of reported earnings that tends to accompany the use of an "accounting reserve." Insurance or reinsurance reduces or eliminates risks and the inherent earnings fluctuations that accompany risks. Unlike insurance and reinsurance, however, the use of "accounting reserves" does not reduce or eliminate risk. The Board rejects the contention, therefore, that the use of "accounting reserves" is an alternative to insurance and reinsurance in protecting against risk. Earnings fluctuations are inherent in risk retention, and they should be reported as they occur. The Board cannot sanction the use of an accounting procedure to create the illusion of protection from risk when, in fact, protection does not exist.

66. The Board has also considered the argument that periodic accrual of losses without regard to whether an asset has been impaired or liability incurred is justified on grounds of comparability of financial statements among enterprises. Some respondents contended, for example, that accrual is necessary to make the financial statements of enterprises that do not purchase insurance comparable to those of enterprises that do purchase insurance (and report the premiums as expenses) and to make the financial statements of property and casualty insurance companies comparable regardless of the extent to which reinsurance has been purchased. In the Board's view, however, to report activity when there has been none would obscure a fundamental difference in circumstance between enterprises that transfer risks to others and those that do not.

Financial Accounting and Reporting Reflects Primarily the Effects of Past Transactions and Existing Conditions

67. Financial accounting and reporting reflects primarily the effects of past transactions and existing conditions, not future transactions or conditions. For example, paragraph 35 of *APB Statement No. 4*, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," states:

> Financial accounting and financial statements are primarily historical in that information about events that have taken place provides the basic data of financial accounting and financial statements.

68. The first condition in paragraph 8—that a loss contingency not be accrued until it is probable that an asset has been impaired or a liability has been incurred—is consistent with this concept of financial accounting and financial statements. That condition is not so past-oriented that accrual of a loss must await the occurrence of the confirming future event, for example, final adjudication or settlement of a lawsuit. The condition requires only that it be probable that the confirming future event will occur. The condition is intended to prohibit the recognition of a liability when it is not probable that one has been incurred and to prohibit the accrual of an asset impairment when it is not probable that an asset of an enterprise has been impaired.

The Concept of a Liability

69. In many cases, the accrual of a loss contingency results in the recording of a liability, for example, accruals for a probable tax assessment, a warranty obligation, or a probable loss resulting from the guarantee of indebtedness of others. In the course of its deliberations, therefore, the Board found it relevant to consider the concept of a liability as expressed in accounting literature.

70. The economic obligations of an enterprise are defined in paragraph 58 of *APB Statement No. 4* as "its present responsibilities to transfer economic resources or provide services to other entities in the future." Two aspects of that definition are especially relevant to accounting for contingencies: first, that liabilities are *present* responsibilities and, second, that they are obligations to *other entities*. Those notions are supported by other definitions of liabilities in published accounting literature, for example:

> Liabilities are claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources.[11]
>
> A liability is the result of a transaction of the past, not of the future.[12]

71. The condition in paragraph 8(a)—that a loss contingency shall be accrued if it is probable that a liability has been incurred—is intended to prescribe recognition of losses that relate to future periods but to require accrual of losses that relate to the current or a prior period (assuming the amount of loss can be reasonably estimated—see paragraph 8(b)).

72. Liability definitions also generally require that the amount of an economic obligation be known or susceptible of reasonable estimation before it is recorded as a liability. For example:

> [Liabilities] are measured by cash received, by the established price of noncash assets or services received, or by estimates of a definitive character when the amount owing cannot be measured more precisely.[13]
>
> The amount of the liability must be the subject of calculation or of close estimation.[14]

73. The condition in paragraph 8(b)—that an estimated loss from a loss contingency not be accrued until the amount of loss can be reasonably estimated—is consistent with this feature of the liability concept.

Accounting for Impairment of Value of Assets

74. The accrual of some loss contingencies may result in recording the impairment of the value of an asset rather than in recording a liability, for example, accruals for expropriation of assets or uncollectible receivables. Accounting presently recognizes impairments of the value of assets such as the following:

a. Paragraph 9 of Chapter 3A, "Current Assets and Current Liabilities," of *ARB No. 43* provides that "in the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to be included as a current asset should not exceed the market value."

b. Statement 5 of Chapter 4, "Inventory Pricing," of *ARB No. 43* states that "a departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer in good as its cost. . . . A loss of utility is to be reflected as a charge against the revenues of the period in which it occurs."

c. Paragraph 19(b) of *APB Opinion No. 18*, "The Equity Method of Accounting for Investments in Common Stock," states that "a loss in value of an investment which is other than a temporary decline should be recognized the same as a loss in value of other long-term assets."

d. Paragraph 13 of *APB Opinion No. 30*, "Reporting the Results of Operations," states that "if a loss is expected from the proposed sale or abandonment of a segment, the estimated loss should be provided for at the measurement date. . . ." Paragraph 14 states that the measurement date is the date on which management commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment.

e. Paragraph 183 of *APB Statement No. 4* states that "when enterprise assets are damaged by others, asset amounts are written down to recoverable costs and a loss is recorded."

75. A recurring principle underlying all of these references to asset impairments in the accounting literature is that a loss should not be accrued until it is probable that an asset has been impaired and the amount of the loss can be reasonably estimated. As influenced by these references, impairment is recognized, for instance, when a non-temporary decline in the market price of marketable securities below cost has taken place, when the utility of inventory is no longer as great as its cost, when a commitment, in terms of a formal plan, has been made to abandon a segment of a business or to sell a segment at less than its carrying amount, when enterprise assets are damaged, and so forth. The condition in paragraph 8(a) is intended to prescribe accrual of losses that relate to future periods, and the condition in paragraph 8(b) further requires that the amount of loss be reasonably estimable before it is accrued.

The Matching Concept

76. A number of respondents to the Discussion Memorandum and the Exposure Draft noted that losses from certain types of contingencies are likely to occur irregularly over an extended period of time corresponding a number of successive periods. In their view, the matching process in accounting

[11] American Accounting Association, *Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements* (Sarasota, Fla.: AAA, 1957), p. 16.

[12] Maurice Moonitz, "The Changing Concept of Liabilities," *The Journal of Accountancy*, May 1960, p. 44.

[13] American Accounting Association, *Accounting and Reporting Standards for Corporate Financial Statements*, p. 16.

[14] Maurice Moonitz, "The Changing Concept of Liabilities," p. 44.

requires that estimated losses from those types of contingencies be accrued in each accounting period even if not directly related to events or activities of the period.

77. *APB Statement No. 4* explicitly avoids using the term "matching" because it has a variety of meanings in the accounting literature. In its broadest sense, matching refers to the entire process of income determination—described in paragraph 147 of *APB Statement No. 4* as "identifying, measuring, and relating revenue and expenses of an enterprise for an accounting period." Matching may also be used in a more limited sense to refer only to the process of expense recognition or in an even more limited sense to refer to the recognition of expenses by associating costs with revenue on a cause and effect basis.

78. Three pervasive principles for recognizing costs as expenses are set forth in paragraphs 156-160 of *APB Statement No. 4* as follows:

> *Associating Cause and Effect.* . . . Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue recognizing them as expenses accompanies recognition of the revenue.
>
> *Systematic and Rational Allocation.* . . . If an asset provides benefits for several periods its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect.
>
> *Immediate Recognition.* Some costs are associated with the current accounting period as expenses because (1) costs incurred during the period provide no discernible future benefits, (2) costs recorded as assets in prior periods no longer provide discernible benefits or (3) allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.

79. Some who believe that matching requires accrual of losses that are likely to occur irregularly over an extended period of time encompassing a number of accounting periods cite the systematic and rational allocation principle of expense recognition as justification for their position. That principle, however, involves the systematic and rational allocation of the cost of an asset (an asset that *has been* acquired) throughout the estimated periods that the asset provides benefits or the systematic and rational accrual of the amount of some obligations (obligations that *have been* incurred) throughout the estimated periods that the obligations are incurred. The customary depreciation of plant and equipment is an example of the former, when reasonably estimable, the accrual of vacation pay is an example of the latter. The systematic and rational allocation principle has no application to assets that are expected to be acquired in the future or to obligations that are expected to be incurred in the future.

80. Matching, in the sense of recognizing expenses by associating costs with specific revenue on a cause and effect basis, is a consideration in relation to accrual for such matters as uncollectible receivables and warranty obligations. For example, most enterprises that make credit sales or warrant their products or services regularly incur losses from uncollectible receivables and warranty obligations. Frequently, those losses can be associated with revenue on a cause and effect basis. If the amount of those losses can be reasonably estimated, paragraph 8 of this Statement requires accrual if it is probable that an asset has been impaired (estimated uncollectible receivables) or that a liability has been incurred (estimated warranty claims).

Spreading the Burden of Irregularly Occurring Costs to Successive Generations of Customers and Shareholders

81. Some respondents to the Discussion Memorandum and the Exposure Draft contended that all costs of doing business should be accrued in each accounting period so that successive generations of customers and shareholders would bear their share of all costs including those that occur irregularly. It would seem, however, that those irregularly occurring costs are usually borne by customers through pricing policy and that pricing is not necessarily dependent upon financial accounting and reporting practices. With regard to accrual on grounds that it enables successive generations of shareholders to bear their share of irregularly occurring costs, see paragraphs 63-65.

Conservatism

82. On the grounds of conservatism, some respondents supported accrual of estimated losses from loss contingencies before available information indicates that it is probable that an asset has been impaired or a liability has been incurred. Conservatism is indicated as one of the "characteristics and limitations" of financial accounting in paragraph 33 of *APB Statement No. 4* as follows:

> *Conservatism.* The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

83. Conservatism is further discussed in paragraph 171 of *APB Statement No. 4:*

> *Conservatism.* Frequently, assets and liabilities are measured in a context of significant uncertainties. Historically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism. . . .

84. The conditions for accrual in paragraph 8 are not inconsistent with the accounting concept of conservatism. Those conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued. They require only that it be *probable* that an asset has been impaired or a liability has been incurred and that the amount of loss be *reasonably* estimable. In the absence of that probability or estimability, however, the Board has concluded that disclosure is preferable to accruing in the financial statements amounts so uncertain as to impair the integrity of the financial statements.

Risk of Future Loss or Damage of Enterprise Property, Injury to Others, Damage to the Property of Others, and Business Interruption

85. Some persons contend that the decision not to purchase insurance against losses that can be reasonably expected some time in the future (such as risk of loss or damage of enterprise property, injury to others, damage to the property of others, and business interruption) justifies periodic accrual for those losses without regard to whether it is probable that an asset has been impaired or a liability incurred at the date of the financial statements. As a basis for their position, they frequently cite the following factors: matching of revenue and expense, spreading the burden of irregularly occurring costs to successive generations of customers, and conservatism. They also believe that accrual of estimated losses from those types of risks improves the comparability of the financial statements of enterprises that do not insure with those of enterprises that purchase insurance. Some contend that a prohibition against periodic accrual for uninsured losses will force enterprises to purchase insurance coverage that would not otherwise be purchased.

86. In the Board's judgment, however, the mere existence of risk, at the date of an enterprise's financial statements, does not mean that a loss should be accrued. Anticipation of asset impairments or liabilities or losses from business interruption that do not relate to the current or a prior period is not justified by the matching concept.

87. The Board's views regarding the contention that periodic accrual for uninsured losses is a way of providing protection against loss and improving comparability among enterprises that do and do not purchase insurance, and the contention that prohibition of accrual will force enterprises to purchase insurance, are discussed in paragraphs 61-66. The Board's position regarding periodic accrual for uninsured risks and other loss contingencies on the grounds of spreading the burden of irregularly occurring costs to successive generations of customers or on the grounds of conservatism is discussed in paragraphs 81-84.

88. Some respondents to the Exposure Draft said that prohibition against periodic accrual for uninsured losses would be detrimental to government contractors because requirements of Federal government agencies in auditing costs subject to procurement regulations currently allow reimbursement for periodic accruals for uninsured losses only if they are included in the contractor's financial statements. Contract reimbursement and financial accounting and reporting may well have different objectives. Accordingly, the provisions of this Statement may not be appropriate for contract reimbursement purposes.

Catastrophe Losses of Property and Casualty Insurance Companies

89. At the time that a property and casualty insurance company or reinsurance company issues an insurance policy covering risk of loss from catastrophes, a contingency arises. The contingency is the risk of loss assessed by the insurance company, that is, the risk of loss from catastrophes that may occur *during the term of the policy.*

90. Some respondents to the Discussion Memorandum and the Exposure Draft proposed that insurance companies accrue estimated losses from catastrophes including both those that may occur during the terms of insurance policies in force and those that may occur beyond the terms of policies in force. Other respondents proposed that some portion of the premium revenue of a property and casualty insurance company be deferred beyond the terms of insurance policies in force to provide what, in substance, is an estimated liability for future catastrophe losses. Some respondents proposed that accrual of estimated losses or deferral of premiums be permitted but not required. On the other hand, some respondents to the Discussion Memorandum and the Exposure Draft were opposed to any accrual for future catastrophe losses by means of an estimated liability or deferral of premium revenue. Because those estimated liabilities and revenue deferrals have come to be referred to as "catastrophe reserves," that term will be used in paragraphs 91-101 for convenience.

91. In response to the Exposure Draft, it was recommended that the FASB appoint a special commit-

tee to study further the matter of catastrophe reserve accounting and to make recommendations thereon. The Board has concluded, however, that its own research and that of others (mentioned in Appendix B to this Statement and summarized in the Discussion Memorandum), the written responses received to the Discussion Memorandum, the presentations made at the public hearing, and the letters of comment on the Exposure Draft provide the Board with sufficient information with which to reach a conclusion.

92. Proponents of catastrophe reserve accounting generally cite the following reasons for their position:

a *Catastrophes certain to occur.* Over the long term, catastrophes are certain to occur; therefore, they are not contingencies.

b *Predictability of catastrophe losses.* On the basis of experience and by application of appropriate statistical techniques, catastrophe losses can be predicted over the long term with reasonable accuracy.

c *Matching.* Some portion of property and casualty insurance premiums is intended to cover losses that usually occur infrequently and at intervals longer than both the terms of the policies in force and the financial accounting and reporting period. Catastrophe losses should, therefore, be accrued when the revenue is recognized (or premiums should be deferred beyond the terms of policies in force to periods in which the catastrophes occur) to match catastrophe losses with the related revenue.

d *Stabilization of reported income.* Catastrophe reserve accounting stabilizes reported income and avoids erratic variations caused by irregularly occurring catastrophes.

e *Comparability.* Reinsurance premiums paid by a prime insurer are said to be similar to accrual of catastrophe losses prior to their occurrence because the reinsurance premiums paid reduce income before a catastrophe loss occurs. Accrual of catastrophe losses as an expense prior to occurrence of a catastrophe makes the financial statements of property and casualty insurance companies comparable regardless of the extent to which reinsurance has been purchased.

f *Non-accrual would force purchase of reinsurance.* Non-accrual of catastrophe losses will force property and casualty insurance companies to purchase reinsurance.

g *Generations of policyholders.* Periodic accrual of estimated catastrophe losses charges each generation of policyholders with its share of the loss through the premium structure.

93. The Board does not find these arguments persuasive. The fact that over the long term catastrophes are certain to occur does not justify accrual before the catastrophes occur. As stated in paragraph 59, the purpose of the conditions for accrual in paragraph 8 is to require accrual of losses if they are *reasonably estimable and relate to the current or a prior period.* An enterprise may know with certainty, for example, next year's administrative salaries, but that does not justify accrual in the current accounting period because those salaries do not relate to that period. As indicated in paragraphs 67-68, financial accounting and reporting reflects primarily the effects of past transactions and existing conditions, not future transactions or conditions; accrual for losses from catastrophes that are expected to occur *beyond the terms of insurance policies in force* would amount to accrual of a liability before one has been incurred. Existing policyholders are insured only during the period covered by their insurance contracts; an insurance company is not presently obligated to policyholders for catastrophes that may occur after expiration of their policies. Accrual for those catastrophe losses would record a liability that is inconsistent with the concept of a liability discussed in paragraphs 69-73.

94. The Board recognizes that the costs of catastrophes to insurance companies are large and are incurred irregularly and that insurance companies recoup those costs in the long run through periodic adjustments in the premiums charged to policyholders. It is the view of the Board, however, that the long-run nature of pricing of premiums should not be a determinant of the time when a liability is recorded.

95. The AICPA Industry Audit Guide, "Audits of Fire and Casualty Insurance Companies," describes accounting for premiums as follows (pp. 24-25):

> As soon as a policy is issued promising to indemnify for loss, the insurance company incurs a potential liability. The company may be called upon to pay the full amount of the policy, a portion of the policy, or nothing. It would be impossible to try to measure the liability under a single policy. However, since insurance is based on the law of averages, one may estimate from experience the loss on a large number of policies.
>
> As state supervision of insurance developed, the insurance departments set about providing a legal basis for determining the potential liability under outstanding policies in order to establish an ample reserve for the protection of policyholders and provide a uniform method of calculation. It was recognized that, since the premium is expected to pay losses and expenses, and provide a margin of profit over the term of the policy, the portion measured by the unexpired term should be adequate to pay policy liabilities (principally losses and loss expenses) and return premiums during the unexpired term on a uniform basis for all companies. Therefore the unearned premium was adopted as the basis for computing the unknown liability on unexpired policies.

96. Because unearned premiums represents the "unknown liability," the Board is of the view that it is inappropriate to accrue an additional amount as an estimate for that same unknown liability. Further, in the Board's view, deferral of premiums beyond the terms of policies in force is inconsistent with the concept of revenue recognition set forth in the Audit Guide and is without any conceptual basis. Moreover, the Board believes that its conclusion regarding the time at which accruals shall be made for catastrophic losses is consistent with the Audit Guide. It should be noted that this Statement does not prohibit (and, in fact, requires) accrual of a *net* loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated, just as accrual of net losses on long-term construction-type contracts is required (see *ARB No. 45,* "Long-Term Construction-Type Contracts").

97. With respect to catastrophes that may occur within the terms of policies in force, to satisfy the conditions for accrual in paragraph 8, the occurrence of catastrophes would have to be probable during the terms of those policies, and the amounts of losses therefrom would have to be reasonably estimable. The letters of comments and position papers received in response to the Discussion Memorandum and the Exposure Draft and persons appearing at the public hearing lead the Board to conclude that neither the timing of catastrophes nor the ultimate cost of losses therefrom are reasonably predictable within the terms of policies in force.

98. The Board is of the view that accrual of costs from catastrophes is not justified by the accounting concept of matching. Systematic and rational allocation does not apply to costs that have not been incurred. The Board recognizes that large and irregularly occurring costs must of necessity be considered in systematically and rationally determining premiums to be charged to customers but does not believe that pricing considerations should dictate the accrual of losses for financial accounting purposes. The Board also does not believe that matching in the sense of recognizing expenses by associating losses with specific revenue on a cause and effect basis is, in and of itself, a basis for accrual of catastrophe losses prior to the event causing the loss. The Board believes that, for the reasons stated in paragraphs 94-96, there can be no presumed direct association with specific revenue prior to the event causing the catastrophe loss.

99. The Board's views regarding justification of periodic accrual of catastrophe reserves on grounds of (a) stabilizing reported income, (b) improving comparability among financial statements of insurance companies, and (c) preventing the "forced" purchase of reinsurance are discussed in paragraphs 61-66.

100. The argument that accrual of catastrophe reserves enables each generation of policyholders to bear its share of the losses through the premiums that it is charged is also questionable because amounts established for premiums are not necessarily dependent on financial accounting and reporting practices.

101. The Board considered the proposal that catastrophe reserve accounting be permitted but not made mandatory. Whether it is probable that an asset has been impaired or a liability incurred is determined by the circumstances, not by choice. Accordingly, the conditions for accrual in paragraph 8 apply to all loss contingencies, including risk of loss from catastrophes assumed by property and casualty insurance companies and reinsurance companies. In the Board's view, the use of different methods to report catastrophe losses in similar circumstances cannot be justified.

DISCLOSURE OF NONINSURANCE

103. A number of respondents to the Exposure Draft inquired as to whether it is the Board's intent to require disclosure of noninsurance or underinsurance. Some recommended that the Board require disclosure with respect to uninsured risks that enterprises ordinarily insure against. Others said that they were unable to define risks that would ordinarily be insured against because the insurance practices of enterprises are so varied. Because of the problems involved in developing operational criteria for disclosure of noninsured or underinsured risks, this Statement does not require disclosure of uninsured risks. However, the Board does not discourage those disclosures in appropriate circumstances.

EFFECTIVE DATE AND TRANSITION

104. The Board considered three alternative approaches to a change in the method of accounting for contingencies: (1) prior period adjustment, (2) the "cumulative effect" method described in *APB Opinion No. 20*, "Accounting Changes," and (3) retention of amounts accrued for contingencies that do not meet the conditions for accrual in paragraph 8 until those amounts are exhausted by actual losses charged thereto. The Exposure Draft had proposed the change be effected by the prior period adjustment method. A large number of respondents to the Exposure Draft, however, opposed the prior period adjustment method for a number of reasons, including significant difficulties involved in determining the degree of probability and estimability that had existed in prior periods as would have been required if the conditions in paragraph 8 were applied retroactively. On further consideration of all the circumstances, the Board has concluded that use of the "cumulative effect" method described in *APB Opinion No. 20* represents a satisfactory solution and has concluded that the effective date in paragraph 20 is advisable.

Senator PROXMIRE. Professor Briloff, thank you very, very much for a superlative presentation. I have rarely been more impressed by a witness. What you presented to us here today has been extraordinarily useful.

You say—and I'm deligthed to hear you say this—that it's not the system. It's the individuals within the system, whether we're talking about a corporation, General Dynamics, or whether we're talking about a fine accounting firm, like Arthur Andersen, or whether we're talking about what I think has been over the years probably the best agency in Washington, the SEC.

Mr. BRILOFF. Yes.

Senator PROXMIRE. And I especially like your reference to the "bikini" phenomenon. I hadn't heard that before, that which is disclosed is interesting, but that which is concealed is vital.

Let me ask you first, in your opinion, did General Dynamics fail to make adequate disclosure and thereby violate securities laws in its financial reports during 1976 and 1977?

Mr. BRILOFF. The answer is yes, as far as 1976 is concerned. Even the Securities and Exchange Commission, when it determined to terminate the investigation in early 1982 would confirm that. With respect to 1977, most certainly consistent with what it is that I said of when we have within just a few months thereafter the SEC able to document the extent to which those claims were not sufficiently palpable to warrant the inclusion within the financial statements per se, and where the footnote as it was presented, presented the situation in the best light as seen by management; namely, the tens of thousands of changes that were made and similar observations instead of including some of those factors which I can't help but feel were available to the corporation and the auditors as to the fact that so much of the cost overrun included within the claims was attributable to inefficiencies and possibly even increasing inefficiencies on the part of the corporation and other factors which were not the fault of the Navy but had to be swallowed by the corporation.

Senator PROXMIRE. In your judgment, Professor Briloff, should the SEC have taken action against General Dynamics? And if so, what action would have been appropriate?

Mr. BRILOFF. There is no question but that the 1982 determination to conclude the investigation was, at best, premature. It should have done that which it said it cannot do; namely, to allocate sufficient resources.

As I recall it, no testimony was taken under oath with respect to these determinations and they should have been. In short, the investigation should have been permitted—in fact, required to go forward with expedition and with an effective conclusion.

Senator PROXMIRE. Did the company's outside auditors, Arthur Andersen & Co., violate accounting standards of any of the laws administered by the SEC in connection with General Dynamics' 1976 and 1977 financial reports?

Mr. BRILOFF. Well, just as I have said during my presentation and stated definitively in my prepared statement, by my assertion that they violated generally accepted accounting principles by including as revenue an amount in excess of that which was probable and verifiable, they violated generally accepted accounting prinici-

ples; and when I said that the auditors failed to manifest the independence of attitude and responsibility, when they failed to show that professional skepticism which the Securities and Exchange Commission points up so very, very frequently in connection with its allegations in various situations, by their failing that independence they violated generally accepted auditing standards.

Hence, I maintain that by the violation of both of those essential pillars of our audit responsibility, Arthur Andersen is severely to be faulted, and the Securities and Exchange Commission should be faulted because I cannot help but feel that my friends, fellow accountants, and the staffs of the chief accountant and the enforcement division should have sensed that.

Senator PROXMIRE. Well, should the Securities and Exchange Commission have taken any action against Arthur Andersen & Co. and, if so, what action?

Mr. BRILOFF. Well, they most certainly—assuming for the moment that the continuance of the investigation would have gone forward and confirmed the views that I have, then what they should have done was to do that which they did in the Litton situation; namely, to censor Arthur Andersen certainly, and General Dynamics, and, Senator, to go back to your opening remarks, the Commission and the Justice Department should move far more diligently very early during these periods to make sure that the statutes of limitations for possible criminal actions are not permitted to pass without full and effective remedies on behalf of our society.

So it is that the SEC—I fault it in terms of what I said in terms of the context of looking from 1982 backward, but the fault lay even earlier, I believe.

Senator PROXMIRE. Now according to an April 12, 1976, memo by General Dynamics auditors of the submarine contract, it was learned, "The internal reporting on this contract continues to be inadequate since there is no measurement of actual return hours versus the hours expected to be incurred for the actual progress achieved."

Now how significant is this deficiency and is it possible that it would prevent an auditor from finding out about overprogressing on Navy ship contracts?

Mr. BRILOFF. Senator, the document that you read from is but one of those that were made available indicating a great deal of confusion within the internal organization of General Dynamics regarding just what it is that was happening with respect to the building of these submarines.

Now, then to the extent that an independent auditor confronts an important situation where there is an inadequacy of internal controls with respect to critical matters, then our book of rules requires the independent auditor to develop the data independently in order to permit him or her to reach an opinion with respect to the financial statements as a whole.

In short, what I am saying, without referring to this memorandum only, that to the extent that they found the accounting procedures carried on internally with respect to the submarines or the 688 contract to be so confusing and uncertain as to what were the costs, then the independent external auditors should have either

made their own independent determinations or then denied an opinion by saying we are not in a position to express an opinion.

And let us again remember that which I said several times this morning, we are dealing here with an enormous sum in absolute terms but probably even more importantly, relatively speaking, we are talking in terms of should the 1976 income statement show $130 million pretax income or show a loss; should the 1977 income statement show $160 million plus or show a loss. So it is that those numbers cannot be verified through the reliance on the internal control system and the auditors cannot move to implement their own investigation, then the answer is that they have to deny an opinion.

Senator PROXMIRE. Now in addition to being General Dynamics' outside auditors, Arthur Andersen & Co. serves as management consultant to the firm and Arthur Andersen receives much, if not most, of its income from the company through consulting contracts.

In your view, is there an inherent conflict of interest when an outside auditor also serves as a consultant to a firm, and might that explain why Arthur Andersen did not act as independently as it should have on the submarine contracts? Also, should the SEC do anything about such conflicts of interest?

Mr. BRILOFF. Senator Proxmire, this has been the subject of my testimony twice before the subcommittees of the House of Representatives and once before Senator Eagleton's subcommittee of the Committee on Government Affairs, to emphasize and reemphasize and to underscore the very phenomenon of the conflict. Whether it be a conflict in fact, which it may very well have been in this case, or merely a conflict in appearance is for me of secondary import. And here, Senator, Chief Justice Burger in his 1984 opinion in the Arthur Young situation said precisely what it is that I have just concluded, that the independent auditor must not only be independent but he must be perceived as being independent.

And certainly now, knowing the facts that you have just described, which I was not privy to before I heard it from you, Senator, it certainly says to me that most certainly in appearance the auditors were not independent.

Now with respect to what should the SEC do, back in 1978 and 1979, the SEC did try to do something and in fact did something. They promulgated two accounting series releases, 250 and 264, but then—and I've testified with respect to this once or twice before other committees—came 1981 when the incumbent Chairman of the Securities and Exchange Commission, according to the Wall Street Journal article in August 1982 as I recall, asked the then chairman of the American Institute of CPA's what does the accounting profession want most and he was told, according to the article by William Kanega, then the chairman, "Get rid of 250 and 264," and that was gotten rid of; 250 and 264, I should mention, required a modicum of disclosure regarding potential contamination of independence through the rendering of peripheral services. So now—and these are the phrases I used when testifying 3 months ago—this is a manifestation of the arrogance of power where only my profession, the accounting profession, says:

We're going to do whatever it is that we darn please, providing the clients are prepared to pay for it, of course; and it may involve some questions of the appear-

ance of independence and we are not even going to tell you what it is that we are doing.

And I keep saying, would we permit such a standard from anyone in the judiciary, from anyone in the legislative branch, from anyone in the journalistic profession, or the historian profession? Of course not.

Only we, because of the arrogance of power, to use the phrase that I alluded to—it's not original, as you know—feel that we can do just that.

The Securities and Exchange Commission ought to reinstate an even stricter standard than that which prevailed under accounting series release 250.

Senator PROXMIRE. Professor Briloff, do you view the SEC deficiencies in this case as part of a more widespread problem concerning the enforcement of securities laws against larger corporations or large defense contractors? If so, how would you define the problem?

Mr. BRILOFF. I define this as the double standard that prevails with respect to the SEC's enforcement actions, Senator, where when they confront the actions by our smaller, less affluent, less powerful colleagues, the Commission moves preemptorily and denies them the right to practice for periods of months, years, and sometimes to eternity.

However, when it comes to our major brethern—and I must admit, though, that they are manifesting some alertness recently—somehow or other, they perfer to act with benign neglect. And I have noted in my testimony case after case where the SEC has in fact compelled the corporations—again recently—to recast their financial statements as not being in accordance with generally accepted accounting principles, and they did in fact recast, and these releases don't even mention the name of the independent accounting firm, and I keep asking the question, how come? Were the independent auditors involved there? And then, when it comes to the major firms, somehow, even when they have under rare occasions determined to mete out some censor, even in those rare occasions, it's a consent decree and quite frequently they will say, "Well, the partner has retired," or "He's no longer involved in this industry," as they did in connection with the Coopers and Lybrand matter, as I recall, last year, when this person agrees for the last 5 months—last 5 months, not the next 5 months—he won't audit another such situation again, and other similar soft responses to these critical issues, even though, mind you, as I indicated earlier, the smaller brethern are involved in a $100,000 or $1 million—I'm not condoning what they have done—as contrasted with hundreds and hundreds of millions of dollars involved in the larger issues.

And how does the Commission respond? Again now I am quoting the chief accountant of the enforcement division, "When it comes to the major firms, their involvements are in a gray area, therefore, there's always some question and some doubt."

Of course, they're in a gray area. Of course, it is, but the question is, How dark a gray before it becomes black and to what extent should these major firms be responsible for being particularly sensitive to the shadings of the gray?

Remember, they sit in the seats of power. They are critically involved in the creation of our standards of accounting principles and auditing standards. If they don't clean up the act, who will?

Senator PROXMIRE. I have one more question, Professor Briloff. Are there any congressional actions you would recommend to encourage the SEC to more vigorously enforce the securities laws against defense contractors.

Mr. BRILOFF. Interestingly, Senator, I am not certain that it requires legislative action. I believe that we have enough legislation on the books now to fulfill that which I know you want very much to see fulfilled; namely, meaningful and effective corporate governance and accountability at all levels, because it requires not only management, not only the auditors, but also the Securities and Exchange Commission.

The legislative responsibility that I see importantly invested in it is to keep inquiring and probing as to whether the system is functioning optimally.

Now there are serious shortfalls in the way in which the system is functioning, Senator. I have alluded to some of them in passing today.

I believe, as I have noted in some contexts, that the independent audit committees that are now required of most publicly owned entities, certainly all those admitted to trading on the New York Stock Exchange—those committees should see their responsibilities fully and forthrightly and to see them followed aggressively.

The committees should be comprised of persons who are prepared to give enough time to their responsibilities to understand fully what it is that is happening or going on. They should be surrounded by a group of professionals, not on a full-time basis and not on a staffing basis, but to have the consultative relationships whereby at least the independent audit committee could ask the right questions and not be snowjobbed by the added wisdom that presumably comes to them either from their chief financial officer of the corporation or from their independent auditors. The auditors, probably before meeting with the independent audit committee of the board of directors, have already cleared their comments and remarks with the chief financial officer of the corporation.

So that ought to be strengthened and then, too, the SEC ought to move far more aggressively to make certain that the peer review system that might be made to prevail within the profession operates more effectively than that which prevails presently, both with respect to the administration of the Ethics Division of the American Institute of CPA's or with respect to the peer review system that prevails otherwise.

Senator PROXMIRE. Professor Briloff, thank you very, very much. We are in your debt. You have been an extraordinarily useful witness and we deeply appreciate your appearance.

Mr. BRILOFF. Thank you again for the privilege of being able to share my views as a citizen, Senator.

Senator PROXMIRE. Chairman Shad, you may step forward to the witness table. We are happy to have you here, sir.

Chairman Shad, I have read the statement that you have submitted. It is, of course, signed by two of the Commission staff and not by yourself. It will be placed in the record and I have some ques-

tions based on it, but you're the witness invited and you were confirmed by the Senate and we will look to you for guidance and for clarification of the policies of the SEC.

I understand you have an oral statement which I hope you can limit to 15 minutes so we can leave the maximum amount of time for questions and answers and we are happy to have you here, sir. Go right ahead.

STATEMENT OF HON. JOHN S.R. SHAD, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY CLARENCE SAMPSON, CHIEF ACCOUNTANT; AND GARY LYNCH, DIRECTOR, DIVISION OF ENFORCEMENT

Mr. SHAD. Thank you very much, Senator Proxmire and also members of the subcommittee. I have a very brief opening statement, and then I've asked Gary Lynch, who's the Director of the Enforcement Division, and Clarence Sampson, the Chief Accountant of the SEC, who are here with me to amplify and give their own opening statements. I hope that among the three of us we will be through within less than 15 minutes.

Thank you for the opportunity to testify concerning the accounting practices of defense contractors and the SEC's 1978–82 investigation of General Dynamics.

Present today are the Chief Accountant, Clarence Sampson; and Director of Enforcement, Gary Lynch; and other members of the staff. They are the most knowledgeable Commission officials on these matters. Neither I nor any Commissioner participated in the decision to conclude the General Dynamics investigation.

The following is a brief chronology of the actions of the Commissioners.

On June 6, 1978, by a 4-to-1 vote, the Commissioners approved a formal order of investigation which authorized the staff to issue subpoenas and take testimony to determine if there had been false filings with the Commission concerning General Dymanics' claims against the U.S. Navy.

In August 1978, the Commissioners unanimously authorized the staff to brief the House Appropriations Subcommittee representatives concerning the case, and SEC Chairman Williams sent a letter to you, Senator Proxmire, reporting on the status of the case.

On December 6, 1978, the Commissioners unanimously granted the FBI access to the case files and several months later the Justice Department.

In early February 1981, the members of the Enforcement Division responsible for the case determined that it should be concluded. In 1984 and 1985, the Commission unanimously authorized the release of the case files to various congressional committees on four occasions. Two were to this subcommittee.

To the best of my knowledge and belief, the foregoing is the extent of the Commissioners' involvement in this matter. Messrs. Sampson and Lynch have brief opening statements, as I mentioned. They will be pleased to describe the relevant accounting practices and principles and to provide the facts concerning the SEC's 1978–82 investigation of General Dynamics.

Thank you.

Senator PROXMIRE. Thank you, Mr. Shad. Before Mr. Sampson and Mr. Lynch testify, I appreciate very much your having these experts appear and, as you say, as I understand it, the staff makes the decision, in this case, as to whether to proceed or not. But after all, the staff is not appointed by the President or confirmed by the Senate and we hold you responsible and I'm sure you accept that responsibility. Is that right?

Mr. SHAD. Not for closing cases, no. It's been a longstanding practice of the Commission for many years that the staff has the authority to close investigations.

Senator PROXMIRE. I'm sure they do. But if the Commission—the duly appointed Commission, the people we rely on and are accountable to us would disagree with a decision to close a case, wouldn't you feel you have a responsibility to let them know how you feel about it and challenge them on it?

Mr. SHAD. If we had knowledge of it, but we do not have knowledge of cases that are closed. In the course of a year, 300 or more cases will be closed. We hold the staff accountable and review their performance on a regular basis in terms of the cases that are being brought, the productivity, if you will, of the division, in the cases that come before us. We set policy standards in the course of making a variety of decisions that do require the full Commission's reaction, but, no, we do not function on individual matters under inquiry when they are first commenced by the staff before they come to us for a formal order of investigation.

Senator PROXMIRE. Chairman Shad, this isn't just one of 300 cases. This is the biggest defense contract case you've ever had. This is something that involved far more money than any other. It seems to me that in this case you would have a responsibility for determining whether or not, in view of the significance and all the other elements connected with it, whether it ought to be closed or not.

It's something you would let the staff go ahead and do? I certainly wouldn't let my staff make a decision like that and I don't think any other Senator would.

I recognize you have an enormous responsibility and a very, very heavy workload and so forth, but it would seem to this Senator that when you have a case that's as big and significant as this one is that the Commission itself should take responsibility. The buck stops there.

Go ahead, Mr. Sampson.

Mr. SAMPSON. Thank you, Senator. I will describe the Commission's policies in three areas of interest to the subcommittee regarding financial accounting disclosure by defense contractors.

These are: First, defense contractors' booking of claims, requests for equitable adjustment or other estimated revenue; second, any withholding of information by defense contractors about cost overruns and other problems in order to prevent stock prices from going down; and, third, reluctance of outside auditors to take exception to such practices.

DEFENSE CONTRACTORS' BOOKING OF CLAIMS, REQUESTS FOR EQUITABLE ADJUSTMENT OR OTHER ESTIMATED REVENUE

Following the difficulties experienced by Lockheed Aircraft Corp. and other defense contractors in the 1960's, the Commission issued an order on June 4, 1970, directing its staff to conduct a public proceeding to determine the adequacy of disclosures with respect to costs incurred on major defense contracts. That inquiry revealed a wide variety of patterns of disclosure in financial reporting by defense contractors and indicated that disclosures should be upgraded to inform investors about the risks involved in defense contracting.

In the years following that proceeding, the Commission has made substantial changes in its registration and periodic reporting forms for all registrants. Generally accepted accounting principles and generally accepted auditing standards have also been expanded and enhanced during the intervening period.

Particularly relevant to the areas of the subcommittee's inquiry are:

(1) An industry audit guide, "Audits of Government Contractors," issued by the FASB in 1975, and reissued in 1983;

(2) A Statement of Financial Accounting Standards [SFAS] No. 5, "Accounting for Contingencies," issued by the Financial Accounting Standards Board in 1975; and

(3) Modifications to the Commission's regulation S-X.

With that very brief historical note, I will now describe the SEC's policies regarding defense contractors' booking of claims, requests for equitable adjustment or other contingent sources of revenues.

SEC rules require financial statements which are included in filings made by registrants to be in conformity with generally accepted accounting principles. These principles permit defense and other long-term contractors to recognize claims as assets and therefore revenues only when realization is probable and the amounts can be the extent of costs incurred.

Requests for equitable adjustment are subject to the same revenue recognition requirements. Because claims and equitable adjustments are necessarily based on reasonable expectations, there is usually a degree of uncertainty about the ultimate realization of such items, and SEC rules require disclosure of the amounts of claims and other such amounts which are included in inventories and receivables.

There are generally three accepted methods of accounting for Government contracts—percentage-of-completion, completed contract and unit-of-delivery. The percentage-of-completion method is the most widely used.

The principal difference between those methods is the timing of earnings recognition. Loss recognition is the same under all three methods because each involves the estimation of total costs and revenues in order to determine whether a loss is indicated on the contract. Failure to estimate revenues expected to be realized because of contract changes would result in understatement of earnings, that would lead to a complete mismatching of revenues and expenses.

The second item concerns the SEC's policies regarding the withholding of information by defense contractors about cost overruns and other problems.

WITHHOLDING OF INFORMATION BY DEFENSE CONTRACTORS

The failure to disclose information about material events violates the full and fair disclosure provisions of the Securities Acts. Therefore, if defense contractors withhold material information about cost overruns or other problems, they would be in violation of the acts administered by the Commission.

The last item of concern to the subcommittee is the SEC's policies regarding the reluctance of outside auditors to take exception to the withholding of information by defense contractors.

THE ROLE OF OUTSIDE AUDITORS

An auditor whose report on financial statements is included in a Commission filing would be in violation of generally accepted auditing standards if he had knowledge of omitted information having a material impact on the financial statements. Such auditor would be subject to sanctions by the Commission, and the financial statements would not be acceptable to the Commission because they would not be acceptable to the Commission because they would not be in conformity with generally accepted accounting principles.

That's the end of my statement, Senator.

Senator PROXIMIRE. Thank you, Mr. Sampson.

Mr. Lynch.

Mr. LYNCH. Thank you, Senator. I'm going to give a brief chronology of the investigation of General Dynamics conducted by the Division of Enforcement during the period 1978 through 1982, and I am going to explain why the investigation was concluded without an enforcement recommendation being made to the Commission.

FORMAL INVESTIGATION ORDERED

On June 6, 1978, after the staff of the Division of Enforcement had conducted an informal inquiry, the Commission, on the Division of Enforcement's recommendation, entered a formal order of investigation entitled "In the Matter of General Dynamics Corp."

The purpose of the investigation was to determine whether General Dynamics and persons associated with General Dynamics had committed violations of certain provisions of the Federal securities laws.

The investigation was intended to determine whether or not the company filed false and misleading periodic financial statements and proxy materials with the Commission by not recognizing and disclosing losses on the SSN 688-class attack submarine program.

SEC STAFF SUBPOENAS GENERAL DYNAMICS

After the issuance of the Commission's formal order of investigation, the staff subpoenaed General Dynamics, its auditors, and other persons to obtain relevant documents.

Between July 1978 and mid-1980, the staff engaged in the process of extensive document selection and review. The staff met in 1981

after the documents were received and analyzed to consider the evidence that had been obtained to date, and in light of the evidence, to decide if any further investigation was appropriate.

In particular, at that point in time, the staff considered whether testimony of corporate officials and employees was appropriate.

STAFF FORMALLY CLOSES THE CASE

After a lot of consideration, the staff finally concluded that further investigation was not warranted and that the matter should be closed.

The basis for this conclusion was that the evidence obtained by the staff indicated that with respect to 1976 and 1977, which were the primary years that were focused on the investigation, an absence of material violations of the Federal securities laws existed.

STAFF FINDINGS

The case was formally closed by the staff in February 1982. With respect to 1976, the staff's review of the evidence indicated that General Dynamics estimated its costs to complete the contracts at $380 million in excess of contract ceilings.

General Dynamics intended to recover these cost overruns from several sources. One source was through a portion of a $544 million claim filed against the Navy on December 1, 1976, that related to changes allegedly requested by the Navy on the 688 contract.

The management of General Dynamics estimated that the expected recovery from this aspect of the $544 million claim for financial reporting purposes was about $130 million. Actually, as it turned out, they did recover $125 million on that claim.

Management estimated that the remainder of the overruns, $250 million, would be recovered from changes in the escalation provisions of the 688 contracts.

As a result of these internal estimates, General Dynamics concluded that it was not required under generally accepted accounting principles to recognize a loss.

The staff did not discover evidence to disprove the propriety of this conclusion. The documents reviewed by the staff did not indicate that General Dynamics thought that the loss was probable, which was the prerequisite of a recognition of a loss in these circumstances.

With respect to the disclosure of 1976, moving from accounting to disclosure, in their periodic reports, General Dynamics did not disclose that it was in part relying on the Navy substituting a revised escalation clause in the 688 contracts in order to break even on the contracts.

Although the Navy had indicated a willingness to make the substitution, the Navy had no legal obligation to do so. And although you could argue that the 1976 disclosure was misleading for failure to note the reliance on substitution of a revised escalation clause as opposed to just recovering on claims, the staff concluded that the difference in disclosures simply wasn't material.

The primary question the staff faced with respect to 1977 was, like 1976, whether or not General Dynamics should have recorded a loss on the 688 contracts.

Based upon a review of the documents, the staff concluded that the uncertainties were such that a reasonable estimate of the loss on the contract could not be determined by the company at that time.

The staff did conclude that for 1977 a loss was indicated, and that's in contradistinction of 1976, but that the amount of the loss was not subject to estimation. Thus, under SFAS 5, recognition of the loss was not required under generally accepted accounting principles.

The staff concluded that the 1977 disclosure made by General Dynamics of the 688 problems was adequate. In particular, it was noted by the staff that General Dynamics disclosed the escalation clause problem and that it was expecting and relying upon a revision of the escalation clause.

Thus, at the time that the staff evaluated the investigation in 1981 and in early 1982, it focused on whether or not the disclosures to General Dynamics' shareholders for 1976 and 1977 and the accompanying financial statements were materially false or misleading in setting forth expectations as to the resolution with the Navy Department as to the 688 program cost overrun problems and in their accounting for that program.

The extensive documentary record developed from General Dynamics, from the Navy Department, from General Dynamics' auditors, and from General Dynamics' banks indicated that the 1976 and 1977 disclosures were not materially false or misleading. Accordingly, the investigation was concluded.

[The joint prepared statement of Mr. Sampson and Mr. Lynch follows:]

JOINT PREPARED STATEMENT OF CLARENCE SAMPSON AND GARY LYNCH

Chairman Obey, Vice Chairman Proxmire and
Members of the Subcommittee:

We appreciate this opportunity to discuss the reporting requirements generally applicable to defense contractors, and to discuss an investigation that the Commission staff concluded in 1982 concerning the accuracy of General Dynamics Corporation's disclosures and financial statements with respect to certain of its submarine building contracts with the United States government. It is requested that this submission be included in the record.

GENERAL POLICIES

The first portion of this statement describes the Commission's policies in the three areas raised by the Subcommittee, which are:

1. Defense contractors' booking of claims, requests for equitable adjustment or other estimated revenue,
2. Any withholding of information by defense contractors about cost overruns and other problems in order to prevent stock prices from going down, and
3. Any reluctance of outside auditors to take exception to such practices.

Following the difficulties experienced by Lockheed Aircraft Corporation and other defense contractors in the 1960's, the Commission issued an order on June 4, 1970 directing its staff to conduct a public proceeding to determine the facts, conditions, practices and matters concerning the adequacy of disclosures with respect to costs incurred on major defense contracts. 1/ That inquiry revealed a wide variety of patterns of disclosure in financial reporting by defense contractors and indicated that disclosures should be upgraded to inform investors about the risks involved in defense contracting.

In the years following that proceeding, the Commission has made substantial changes in its registration and periodic reporting forms for all registrants. Generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) have also been expanded and enhanced during the intervening period. An industry audit guide, Audits of Government Contractors, issued by the American Institute of Certified Public Accountants in 1975 and reissued in 1983, Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, issued by the Financial Accounting Standards Board in 1975, and the modifications to the Commission's Regulation S-X, described on page 3, are particularly relevant to the areas of the Subcommittee's inquiry.

1/ The contractors' difficulties at that time arose out of the "total package procurement" concept (rescinded in August 1970) under which contracts called for the design, testing, and production of equipment under a fixed-price arrangement.

ITEM 1. SEC POLICIES REGARDING DEFENSE CONTRACTORS' BOOKING OF CLAIMS, REQUESTS FOR EQUITABLE ADJUSTMENT OR OTHER CONTINGENT SOURCES OF REVENUES.

The Commission requires financial statements filed with it to be in conformity with GAAP. Generally accepted accounting principles permit defense and other long-term contractors to recognize claims as revenues and assets to the extent that such amounts are susceptible to reasonable estimation and realization is probable. Requests for equitable adjustment are subject to the same revenue recognition requirements. Because claims and equitable adjustments are necessarily based on reasonable expectations, there is usually a degree of uncertainty about the ultimate realization of such items, and Regulation S-X requires disclosure of the amounts of claims and other such amounts in inventories and receivables. 2/

There are three generally accepted methods of accounting for government contracts--percentage of completion, completed contract and unit-of-delivery--with percentage of completion being the most common. The principal difference among the methods is the timing of earnings recognition. Loss recognition is the same under all three methods. Each of the methods involves the estimation of costs and usually also requires contract revenues to be estimated. Even under the completed contract method, estimates must be made of the costs to complete the contract and of contract revenues. Such estimates are

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2/ 17 CFR 210.5-02

necessary in order to determine whether there will be a loss on the contract since any such loss is required to be recognized at the time a loss becomes probable and can be reasonably estimated. These estimates of costs and revenues (particularly the latter) result in the recognition of assets and revenues which may be uncertain. The alternative to such an approach would be to ignore the effects of unanticipated costs on revenues and recognize income or loss only after completion and final resolution of all matters related to the contract. Such a method would cause a complete mismatching of revenues and expense and create erratic earnings reports.

ITEM 2. SEC POLICIES REGARDING THE WITHHOLDING OF INFORMATION BY DEFENSE CONTRACTORS ABOUT COST OVERRUNS AND OTHER PROBLEMS IN ORDER TO PREVENT STOCK PRICES FROM GOING DOWN.

The failure to disclose information about material events violates the full and fair disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. Therefore, if defense contractors, or other registrants, withhold material information about cost overruns or other problems, they would be in violation of the Acts administered by the Commission. On numerous occasions, the Commission has specifically addressed disclosure obligations of defense contractors.

For example, in its report of investigation, In the Matter of Disclosures by Registrants Engaged in Defense Contracting 3/, the Commission stated:

> ...the inquiry revealed...substantial grounds to believe that disclosures should be upgraded to inform investors with regard to the substantial risks involved [in regard to defense contract operations].

That administrative proceeding was followed by Release No. 33-5263, issued in June 1972, which called for clear and meaningful disclosure in order to apprise the public of the investment merits and risks associated with the securities of registrants significantly engaged in defense contracting. The Commission urged corporate managers to review their policies regarding disclosures on defense and other long-term contracting activities and to ensure that adequate disclosure was made. The Commission, at the same time, acknowledged that government contracts pose difficult problems in the areas of cost prediction and revenue estimation, and noted the obligation of registrants to make every effort to reflect properly in their financial statements the progress made on significant contracts.

The Commission codified its views on the appropriate disclosure in Accounting Series Release No. 164. The release announced the adoption of rules which require long-term contractors to disclose, inter alia, the amounts included in

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3/ Administrative Proceeding File No. 3-2485 (June 1972).

receivables and inventories represented by claims, deferred (learning curve) production costs, and other elements peculiar to long-term contracts. 4/

ITEM 3. SEC POLICIES REGARDING THE RELUCTANCE OF OUTSIDE AUDITORS TO TAKE EXCEPTION TO THE WITHHOLDING OF INFORMATION BY DEFENSE CONTRACTORS.

An auditor whose report on financial statements is included in a Commission filing would be in violation of GAAS if he had knowledge of omitted information having a material impact on the financial statements. Such auditor would be subject to sanctions by the Commission, and the financial statements would not be acceptable to the Commission because they would not be in conformity with GAAP and the auditor's examination would not have been conducted in conformity with GAAS. 5/

4/ Securities Act Release No. 5542 (November 21, 1974).

5/ Audits of Government Contractors, Id. at 27, states:

> The government contractor can be faced with significant problems in the performance of long-term contracts and in the estimating of contract costs and profits (or losses). Such problems are often more severe for the contractor performing contracts which call for complex systems or involve significant technological advances. . . . In broad terms, the obligation exists to make adequate disclosure, either in the body of the financial statements or in related notes, of information that might affect the conclusions formed by reasonably informed readers.

THE 1978-82 GENERAL DYNAMICS INVESTIGATION

The Commission began an investigation in 1978, which was concluded in 1982, concerning the accuracy of General Dynamics Corporation's disclosures and financial statements with respect to certain of its submarine building contracts with the United States government. The following provides a chronology of the investigation and explains why it was concluded by the staff without an enforcement recommendation.

INFORMAL INQUIRY

In early 1978, the staff of the Division of Enforcement of the Commission initiated an informal inquiry concerning General Dynamics Corporation. This inquiry was based upon statements made by Department of the Navy officials before the Joint Economic Committee in December 1977, that General Dynamics was experiencing substantial cost overruns in connection with the construction of the SSN 688-class attack submarines pursuant to two government contracts. The staff was concerned, in particular, whether General Dynamics had adequately disclosed to its shareholders and the investing public the nature and extent of the problems it was facing in performing under the SSN 688 contracts. Additionally, the staff sought to review whether General Dynamics had misstated its financial statements filed with the Commission by failing to include a provision for anticipated losses resulting from performance under the SSN 688 contracts.

The Enforcement staff conducted the informal inquiry through the spring of 1978. During that period, the staff obtained information from the Department of the Navy, conferred with and obtained information from Admiral H.G. Rickover, his staff, and the Navy Claim Settlement Board and sought, unsuccessfully, workpapers from General Dynamics' independent public accountants.

During the course of its informal inquiry, the staff learned that General Dynamics Corporation had two contracts covering the construction of 18 SSN 688-class submarines. The cost of building these submarines had greatly exceeded the initial contract prices. General Dynamics alleged that the cost overruns were due to deficient engineering plans and specifications furnished to the Electric Boat Division of General Dynamics by the United States Navy and its design agent in addition to the delay in furnishing the plans. Accordingly, General Dynamics had filed claims with the Navy for price increases to cover the cost of the changes.

On April 7, 1976, the Navy settled with General Dynamics a previously submitted claim by General Dynamics, totalling $244 million, to cover the alleged cost of revisions directed by the Navy prior to May 20, 1975 on the first contract for seven submarines. The settlement provided for a contract ceiling price increase of $97 million. On December 1, 1976, General Dynamics filed additional claims for ceiling price

increases of $544 million to cover changes allegedly requested by the Navy on both contracts through October 1976, as well as the impact of inflation on both contracts. In early 1978, General Dynamics had in preparation additional claims for price increases.

General Dynamics had incurred costs through December 31, 1976 and December 31, 1977 on submarines to be delivered, which were included in government contracts in process, amounting to $876 million and $1,162 million, respectively. The related progress payments (payments received by the contractor as work is performed; procurement regulations and contract provisions govern the form and timing of such payments) associated with these government contracts in process were $684 million in 1976 and $815 million in 1977.

In February 1978, General Dynamics completed a new study of costs and schedules to complete the SSN program. It then estimated that its costs to complete the program, including inflation, were $840 million more than anticipated revenues from current contracts, assuming no recovery from previously asserted claims or from future claims. This estimated cost to complete was based upon the assumption that the rate of revisions to the design of the submarines by the Navy would be reduced significantly and that manufacturing improvements would be realized by the Electric Boat Division and other manufacturing divisions of General Dynamics.

In April 1978, the Navy announced an award of $66.5 million to the company as provisional payments (payments received by the contractor that have no relationship to the work progress on a contract but rather relate to a portion of an outstanding claim that the Navy believes has been substantiated) on their outstanding $544 million claim. Navy officials indicated informally to the Commission staff that these payments did not constitute an agreement between the company and the Navy with respect to the total value of General Dynamics' claim.

At that time, the staff learned from officials of the Department of the Navy certain facts which tended to indicate that General Dynamics rather than the government may have been primarily responsible for the disputed cost overruns. In addition, having completed their analysis of the $544 million claim, members of the Navy Claims Settlement Board indicated to the staff that the Board had been able to substantiate less than 20% of the claim. The staff also learned that General Dynamics' allegation that some 35,000 drawing revisions (revisions to the design of the submarines) had caused a substantial delay in the completion of these contracts may have been misleading. The Electric Boat Division in response to Navy inquiries had stated that only 2,384 of the 35,000 drawing revisions had a direct cost impact, and the Navy indicated that of these 2,384 changes, only 77 were likely to result in costs above $20,000.

Further, the staff learned that officials at General Dynamics headquarters in St. Louis may have ignored the advice of their ship cost estimators and management at Electric Boat and substantially cut their estimates prior to submitting the bids on the first and/or second contracts in order to win the contract awards. A major thrust of the Electric Boat claim, however, was that the company had no way of knowing how difficult the ships would be to build and that the government should pay for costs not reasonably anticipated by Electric Boat.

The SSN 688 program had been accounted for on a break-even basis and therefore no recognition of profit or loss on the construction of the SSN 688-class attack submarines had been recorded. The 1976 and 1977 opinions of General Dynamics' auditor were qualified, subject to the final resolution of its $544 million claim.

FORMAL INVESTIGATION

On May 22, 1978, based upon the above described facts learned during the course of the staff's informal inquiry, the Division of Enforcement recommended to the Commission the issuance of a formal order of investigation. The Division recommended further investigation to determine whether the company filed false and misleading periodic financial statements as well as false and misleading proxy materials with the Commission by not recognizing and disclosing any losses on the SSN 688 program.

On June 6, 1978, the Commission approved the Division of Enforcement's recommendation and entered a formal order of investigation In the Matter of General Dynamics Corporation (HO-1102) to determine whether General Dynamics and others associated with the company had committed violations of Sections 10(b), 13(a) and 14(a) of the Securities Exchange Act of 1934 and various rules promulgated thereunder.

On June 9, 1978, three days after the issuance of the formal order, General Dynamics and the Navy reached a settlement of their outstanding disputes concerning the responsibility for overruns on the SSN 688 contracts. Their settlement, as disclosed in General Dynamics Form 8-K for June 1978, called for, among other things, "the estimated $843 million overrun to be covered by a $125 million contract price increase . . . with the remaining $718 million of costs to be shared equally by the company and the Navy, with the company accepting a fixed loss of pre-tax $359 million." As part of the agreement, the Navy was to make a cash payment of $300 million. As a result of this settlement, General Dynamics, as of July 2, 1978, recorded a loss of $359 million on the SSN 688 submarine construction program.

Immediately upon issuance of the Commission's order, the staff began to conduct the formal investigation. On June 12, 1978, the staff issued a subpoena duces tecum to General Dynamics' auditor calling for the production of all documents,

including workpapers, relating to the firm's audit of the financial statements of the Electric Boat Division of General Dynamics for each period between January 1, 1974 to June 12, 1978. On June 15, 1978, the staff issued a subpoena duces tecum to General Dynamics requiring the production of all documents, from January 1, 1970, "which were prepared, used or received, directly or indirectly, in connection with the SSN 688 and Trident submarine contracts."

Document production under the General Dynamics and auditor subpoenas ensued. In addition, in August 1978, the staff issued subpoenas duces tecum to approximately 18 creditor banks of General Dynamics calling for the production of relevant documentation. The staff sought to learn what General Dynamics advised its creditors as to its performance on the SSN 688 contracts, and to compare that information with General Dynamics' public disclosures.

Between July 1978 and mid-1980, the staff obtained and reviewed voluminous documents of General Dynamics, the auditor and the banks. During this period of time, the staff remained in close contact with and obtained relevant information from personnel at the Department of the Navy.

In the beginning of 1981, the staff had substantially completed its review of the relevant documents. The staff met in 1981 to consider the evidence obtained and to determine, in light of the evidence, what, if any, further investigation was

appropriate. In particular, the staff considered whether testimony of corporate officials and employees was appropriate. The staff concluded that no further investigation was warranted because the evidence obtained indicated, with respect to 1976 and 1977, the years of primary focus of the investigation, an absence of material violations of the federal securities laws. The case was formally closed in February 1982.

STAFF'S CONCLUSIONS

Specifically, the staff concluded, based on the evidence it had reviewed:

(1) that the financial statements of General Dynamics for 1976 and 1977 were not misstated by failure to recognize a loss in those periods attributable to cost overruns on the SSN 688 contracts, and

(2) that disclosure was adequate for 1977 but may have been misleading for 1976 as a result of the failure of General Dynamics to identify that its belief that it would "break-even" on the SSN 688 contracts was based not only its estimate of recovery on the $544 million claim, but also upon its belief that the Navy would agree to substitute a revised escalation clause in the SSN 688 class submarines contracts.

In accordance with past practices and delegation of authority to the staff, 17 CFR § 200.30-4(a)(3), the decision of the staff to close the investigation was not reviewed or discussed with the Chairman or Commissioners, individually or collectively.

1976 DISCLOSURES AND FINANCIAL STATEMENTS

In its Annual Report on Form 10-K for 1976, General Dynamics disclosed that its cost at completion of the SSN 688 contracts would significantly exceed the contract price. General Dynamics stated that it "estimates that cost at completion of these contracts, after giving consideration to projected productivity improvements, will significantly exceed presently negotiated contract ceilings." General Dynamics, therefore, continued to account for the contract on a break-even basis.

General Dynamics' auditor qualified its accountant's report by stating that "the financial results of the Corporation's SSN 688 Program are dependent upon recovery of a substantial portion of the $544 million of claims filed with the U.S. Navy and achievement of the productivity improvements included in the program cost estimates."

In analyzing the accuracy and adequacy of the financial statements and disclosure of General Dynamics for 1976, the staff's review of the evidence indicated that for 1976, General Dynamics had estimated its cost to complete the contracts at $380 million in excess of contract ceilings. General Dynamics intended to recover these cost overruns from several sources. One source was through that portion of its $544 million claim against the Navy which related to change orders. Management

estimated the expected recovery from this aspect of the $544 million claim for financial reporting purposes to be $130 million. (In the June 1978 settlement, the Navy agreed to pay $125 million on the claim). Management estimated that the remainder of the overruns, $250 million, would be recovered from changes in the escalation provisions of the SSN 688 contracts. The Navy had indicated a willingness to make a substitution in the escalation provisions. As a result of these internal estimates, General Dynamics concluded that no loss was "probable." The staff did not discover evidence to disprove the propriety of the conclusion made at that time. Under Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, an estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met: (1) it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements; and (2) the amount of loss can be reasonably estimated. As the evidence indicated that no loss was probable at the time of preparation of the 1976 financial statements, under FAS 5, General Dynamics was not required under generally accepted accounting principles to recognize a loss.

With respect to disclosure for 1976, the company stated in its Annual Report on Form 10-K that:

> (a) substantial portion of the $544 million of new claims must be recovered to offset the indicated cost overrun, even with the projected productivity improvements. The Corporation believes that actions of the U.S. Navy are responsible for this overrun and that there should be sufficient recovery from the claims to ensure that this long-term program does not incur a loss. Therefore, the Corporation continues to account for this program on a break-even basis.

General Dynamics did not disclose that it was, in part, relying on the Navy's substituting a revised escalation clause in the SSN 688 contracts in order to break even. Although the Navy had indicated a willingness to make this substitution, it had no legal obligation to do so.

Although it could be argued that the 1976 disclosure was misleading for failure to note the reliance on substitution of a revised escalation clause, the staff concluded that the difference was not material. In this connection, the staff relied upon the position taken by representatives of the Department of Defense and U.S. Navy before Congress and others, including the testimony of William P. Clements, Jr., Deputy Secretary of Defense, before the Senate Committee on Armed Services on April 29, 1976, as to the inequity of existing escalation clauses, and the willingness to reform such clauses.

Accordingly, it was decided that further inquiry was not likely to lead to a different conclusion, and, taking into consideration the lapse of time since the filing of the 1976 disclosure, no further action was taken.

1977 DISCLOSURES AND FINANCIAL STATEMENTS

By the end of fiscal year 1977, the situation at Electric Boat had worsened. General Dynamics disclosed in its 1977 Annual Report on Form 10-K that in February 1978 it completed a new study of costs and schedules to complete the SSN 688 program. It disclosed that the last ships would be delivered in approximately six years, and, assuming an inflation factor of 7%, the "cost to complete the program is estimated to be approximately $840 million in excess of the anticipated revenues from current contracts, assuming no return from present or future claims." Included in the $840 million overrun was a $475 million inflation factor. Further, General Dynamics disclosed, in its Form 10-K, as supplemented in its Annual Report to Shareholders, the negotiations with the Navy and the lack of a resolution. General Dynamics stated:

> (s)ince the resolution of this matter involves many uncertainties, including future actions by the Navy, the Corporation cannot forecast the final outcome at this time. Pending its resolution, the Corporation continues to account for this program on a break-even basis.

General Dynamics' auditor qualified its opinion of the 1977 financial statements of General Dynamics as stated in the General Dynamics annual report: "the financial results of the Corporation's SSN 688 program are dependent upon the recovery through present and future claims or other settlements from the U.S. Navy of the costs at completion in excess of anticipated revenues from the current contracts (the excess is presently estimated at $840 million assuming an annual inflation rate of about 7% over the projected six years to complete the contracts). It is not possible to determine at this time the final resolution of this matter or the effect, if any, on the accompanying financial statements."

The major factor confronting the staff with respect to 1977 was, as in 1976, whether or not General Dynamics should have recorded a loss on the SSN 688 contracts. Based upon a review of the documents, the staff concluded that the uncertainties were such that a reasonable estimate of the loss on the contract could not be determined by the company at that time. The staff concluded that although a loss was indicated, the amount of the loss was not subject to estimation. Thus, under FAS 5, recognition of a loss was not required.

The staff concluded that the 1977 disclosure made by General Dynamics of the SSN 688 problems was adequate. In particular, it was noted that General Dynamics disclosed the escalation clause problem and that it was expecting and relying upon a revision of the escalation clause.

CONCLUSION

Thus, at the time that the staff evaluated the investigation in 1981 and early 1982, it focused on whether or not disclosures to General Dynamics' shareholders for 1976 and 1977 and accompanying financial statements were materially false and misleading in setting forth expectations as to a resolution with the Navy Department as to the SSN 688 program cost overrun problems, and in their accounting for that program. The extensive documentary record developed from General Dynamics, from the Navy Department, from General Dynamics' auditor, and from General Dynamics' banks, indicated that the 1976 and 1977 disclosures were not materially false or misleading.

After completing the analysis set forth above, the staff concluded that the possible violations uncovered, the limited 1976 disclosure deficiences, did not warrant an enforcement recommendation or further inquiry. Accordingly, the investigation was concluded.

Mr. LYNCH. That's a summary of my prepared remarks, but I would like to turn to something which was raised by Mr. Briloff before concluding because I understand the primary focus of this hearing is General Dynamics, and I fear that we might not get to the point where I can respond to an allegation that he made.

He suggested that the SEC only brings cases against small companies or small accounting firms. That simply isn't true. Our record doesn't show that.

In recent years, we've brought a case against Fox & Co. which at the time I think was the 11th largest auditing firm in the country. We brought a case against Touche in the Litton matter, a case we've already discussed this morning; and just last week, last Thursday, we filed an injunctive action against Price Waterhouse.

In recent months we have brought actions against Burroughs Corp., against Oak Industries, against Charter Co., against Stauffer Chemical, and against AM International. I would submit that those are not small companies, that the accounting firms we have proceeded against are not small firms and that we don't discriminate against small firms.

Mr. SHAD. Senator, may I add also, I have reflected on the question you posed to me a few moments ago and I agree with you that the Commission does have the responsibility, whether it's closing cases or anything else.

I think that, in fact, the procedures followed are very responsible and capable procedures. For instance, the Enforcement Division was created through a reorganization of the Commission in 1972, and in 1974 certain authority was delegated to the staff, including the authority to close cases. And yet, at any time, I or other Commissioners could inquire into any case that we had knowledge of or even set up additional procedures to review this area in greater detail.

I would hasten to add that I felt when I first came to the Commission that only the big cases were really important, that they were the ones that had an inhibitory effect on adverse conduct or questionable conduct, and that insignificant cases didn't. But I soon learned that law is established, precedent is established, regardless of the size of the case.

It's a very intensive effort of the staff to pursue possible violations, and there's a whole series of checks and balances that we do go through in the Commission in terms of the actions taken at each stage where we have to authorize or permit the staff to go forward. The delegation I have mentioned does away with the necessity of the Commission, as a Commission, to review hundreds of closings individually in the course of a year.

But on reflection, I want to clearly say, yes, we do have the responsibility when cases are closed, but I really question whether the procedures are wrong. I think on the facts, as they will develop in the course of today's testimony, the Commission would not have come out any differently than the staff did on their decision to conclude this matter.

Senator PROXMIRE. Well, I appreciate that statement very much, Chairman Shad. What you're telling me, as I understand it, is that you are assuming responsibility here and that in the event that you had decided that General Dynamics because it was an enor-

mously big case, because it was bigger than any other defense contract case, because it involved such an enormous amount of money and so much investor investment, you could have, if you wished, kept the case open; isn't that right?

Mr. SHAD. Yes.

Senator PROXMIRE. Now, Mr. Shad, a central concern about the SEC's response to the General Dynamics-Navy shipbuilding controversy is that for several years the company reported there would be no losses on the submarine contracts. In 1978, it finally reported a $350 million loss.

We now know that the company gave false information to the Navy about its cost overruns in the contracts. Navy Secretary Lehman concludes the company's costs and schedule information were grossly inaccurate.

Now it's a fact that the general public and investors were misled by General Dynamics' financial reports.

How do you respond to Mr. Briloff's conclusions that the company failed to make adequate disclosures and that the SEC should have taken action against General Dynamics and its auditors, Arthur Andersen & Co.?

Mr. SHAD. Senator, in the case of that and similar questions, I have to say that my own direct knowledge and involvement is extremely limited and, if I might, I'd like to refer to Mr. Lynch.

Senator PROXMIRE. Well, before Mr. Lynch answers—and I respect that—don't you see the contradictions involved here?

Mr. SHAD. I see the contention, but I do think that the rationale for closing the case as it related to this specific issue you have raised was appropriate conduct by the Commission. But I really feel that Gary Lynch or Mr. Sampson could give you a better considered answer than I can.

Senator PROXMIRE. Well, Mr. Chairman, the fact is, though, that for years they reported no losses and then they reported a $350 million loss, a colossal loss, and we are told by the Navy that their information was grossly inaccurate. Those are the terms of the Secretary of the Navy.

Mr. LYNCH. They didn't recognize any losses, but the disclosures in the 1976 and 1977 periodic reports clearly indicated that there was a problem on the contracts. I think that's beyond dispute.

And in fact, when they reached a settlement with the Navy—and I think it was June 9, 1978—when they did take the $359 million loss and took it on their financial statements, the market actually went up at that time. The stock went up four points the first day that announcement came out and then it went up eight points the next day. So within 2 days of the announcement, the market price had risen by 12 points.

So I'm not saying that that's determinative as to whether or not they withheld information, but based on that market reaction I think it's not unreasonable to conclude that the market thought that the situation was even worse than it actually was, based on General Dynamics' previous disclosures.

Senator PROXMIRE. I'm going to ask Mr. Kaufman to follow up on this.

Mr. KAUFMAN. Well, Mr. Lynch, maybe intelligent, informed people in the market understood that the financial reports weren't

telling all that was to be said about the difficulties in this corporation. You seem to be equating the reporting of problems of a corporation with the reporting of a loss.

In fact, aren't those two very different situations? Isn't it significantly different for a corporation to report it's experiencing problems on its defense contracts from a corporation reporting it's experiencing losses on defense contracts? And shouldn't the general public know that distinction and understand that there are losses and not just problems when those losses are being experienced?

Mr. LYNCH. Yes; except as I understand generally accepted accounting principles, the company was only required to actually recognize a loss in its financial statements if it was probable that a loss was going to be incurred—not that it was certain, but rather that it was probable that a loss was going to be incurred—and that the amount of the loss could be reasonably estimated. And in 1976, based on our review of the documents, we did not think we could make a case that a loss was probable. The documents seemed to indicate to us that General Dynamics held the belief—and we had no reason to doubt the good faith of that belief at the time—that they would break even in 1976.

Now 1977 is a different story. By the time you get to 1977, I think it's clear from a review of the documents that there was an anticipation of a loss. And the question is, What is the loss going to be? By the time 1977 rolls around, the loss could be as great as $840 million, but depending on what happens with the Navy and the renegotiation, it might be substantially less than that, as we found out. The amount turned out to be a $359 million loss.

So if the company had booked a loss for 1977 of $840 million, that would have been misleading as well, because in fact the company only lost $359 million.

And another point that I want to make is that the auditors did qualify their opinion. People were informed that there was perhaps a problem on the General Dynamics contracts on the 688 submarines. The auditors specifically said that because of the uncertainties associated with the 688 program we cannot give an unqualified opinion.

But to respond directly to your question, under SFAS 5, which I think is the principle we really have to turn to here, you only have to recognize loss, take it on your financial statement, if the loss is probable and then, in addition to that, if you can quantify the loss with reasonable certainty.

Clarence, have I stated that as it is?

Mr. SAMPSON. That is a fair statement. It must be determinable before it can be booked.

Mr. KAUFMAN. Mr. Lynch, are you saying that the SEC enforcement staff understood in its investigation that there would be a loss, there probably would be a loss in 1977, and that the corporation officials and its auditors knew that there would be a loss in 1977 but, because of the difficulty in quantifying that loss, they were entitled under accounting principles to report a break-even situation rather than a loss?

Mr. SAMPSON. Together with the disclosure that there was a potential loss and there was full disclosure as to the potential magnitude of the loss and a qualification by the auditors which was a red

flag to investors that they should look at the disclosure and footnotes about the contract.

Mr. KAUFMAN. It may be a red flag, but it wasn't a loss. You're saying that all they have to do is disclose problems but not losses, even though they know there are losses but there's some uncertainty about the magnitude of the losses?

Mr. SAMPSON. I'm not familiar with all the details of the case, and I will let Gary talk about those. If there was a clear indication of the loss, you could argue that there should have been a statement to that effect, that they expected the loss, but they weren't sure of the amount. If the amount is not determinable, SFAS 5 says that you should not book them in that case but that you simply make disclosures.

Senator PROXMIRE. Let me proceed.

Mr. Shad, a memo from SEC Chairman Williams to Stanley Sporkin is a pretty crucial memo, as a matter of fact. As you know, Stanley Sporkin was the former head of the Enforcement Division. It's dated April 14, 1980, and expresses doubts about whether the SEC ought to be investigating defense contractors engaged in negotiations with the Pentagon over cost overruns.

Will you comment on that memo and whether it represents your own views and concerns about this type of case?

Mr. SHAD. I have not carefully read this memo. I have skimmed it, but I haven't carefully studied it from the point of view of whether or not I would concur or take any exception to Chairman Williams' comments, but I would be glad to respond for the record later, if that would be acceptable.

Senator PROXMIRE. Well, we did make that available to you before the hearing. I would appreciate whatever response you could make.

Mr. SHAD. It was within the materials that we were provided by the staff and have been reviewed, but in terms of responding to your request for a specific qualification of it, an expression of my views, I am not now prepared to do that.

Senator PROXMIRE. I have some other questions on it. Perhaps we can get into it. I am informed that this memo from Chairman Williams was viewed as devastating and shocking by the staff of the Enforcement Division, that it had a depressing effect on morale because it, together with oral statements Mr. Williams had made, indicated the Commission did not support the General Dynamics and Litton investigations and that the Commission might not back up the staff if it requested that action be taken.

Do you have any reason to disagree with that assessment?

Mr. SHAD. I wasn't present at the time. You are characterizing the reaction of the staff. Not even Mr. Lynch, I believe, was directly involved at that time and there may be other people here who could amplify your statement. I don't know whether they were demoralized or how they reacted to it.

Senator PROXMIRE. Weren't you familiar with the Williams memo?

Mr. SHAD. Yes; I'm familiar with its existence.

Senator PROXMIRE. Well, you can see again, the SEC Commission, the bosses, the people who really have charge, who hire and fire the staff and have control of the staff and should have—if they

have a feeling, a concern, that the Commission should not investigate or should not take action in cases involving defense contractors who are negotiating with the Defense Department, you can see what a clear and devastating effect that would have on the staff.

Then the Commission turns around and says, well, it's a staff decision not to investigate.

Mr. SHAD. The Litton case was brought, and the auditors were sanctioned.

Mr. LYNCH. The Litton case was brought subsequent to the time this memo was written. The Litton case was brought in March 1981.

Senator PROXMIRE. Well, the Litton case was much further along, as I understand it. The General Dynamics case was dropped.

Mr. SHAD. There were very important distinctions between the two.

Senator PROXMIRE. Let me ask you this. The memo implies that when defense contractors negotiate with the Pentagon over contract cost overruns it understandably take extreme positions for bargaining purposes—that is, the Pentagon does—and, of course, the defense contractors also. And that a general disclosure about the defense contractor's problems is sufficient rather than detailed disclosure of losses which might harm its negotiating position.

Do you share that view?

Mr. SHAD. Which part of the view? The last sentence you just read or the entire statement?

Senator PROXMIRE. Well, I'll read it again.

Mr. SHAD. Good.

Senator PROXMIRE. The memo implies that when defense contractors negotiate with the Pentagon over contract overruns, they—that is, the defense contractor—understandably take extreme positions for bargaining purposes and that a general disclosure about the defense contractor's problems is sufficient rather than detailed disclosures of losses which might harm defense contractors' negotiating position.

Mr. SHAD. I have no basis for a personal knowledge of the statement that you've made as to extreme positions that may have been taken. I can appreciate that in negotiations both parties must present the best case they can and if extreme positions means that they claim that due to multiple specification changes and other actions, in this case by the Navy, they incurred enormous cost overruns, as well as the inadequacy of the escalation provision——

Senator PROXMIRE. The question is whether or not defense contractors should or should not have to report detailed losses. They are in a different position perhaps than some other corporations because reporting those losses could affect their negotiating position.

Mr. SHAD. Well, I think it's clear that under SFAS 5, if the loss is probable and reasonably determinable, they do have to book it and they do have to provide adequate disclosures within the 10-K to put investors on notice, yes.

Senator PROXMIRE. Now Mr. Williams suggests in his memo that in the Litton case it may have been sufficient that a general disclosure of overruns and claims was made together with a statement to a national magazine that a loss reserve was not set up because that

would make negotiations with the Navy more difficult. Is that your view?

Mr. SHAD. I think that's an accurate statement of what occurred at that time.

Senator PROXMIRE. Was that adequate or should they have had a disclosure? Any other corporation, I presume, you would have required a full disclosure of what the losses were. You see, all they had there was the general disclosure of overruns and claims made and then they said they had a loss reserve set up and that was about all they did.

Mr. SHAD. And we did bring an action as a consequence.

Senator PROXMIRE. OK. Answer that, if you can, a little further for the record.

Mr. Shad, I'm informed that members of the present Commission, including yourself, have expressed concerns similar to those in the Williams memo in discussions with the Enforcement Division staff. Is that correct or incorrect?

Mr. SHAD. You would have to refresh my memory. I don't recall any.

Mr. LYNCH. I'm not aware of any.

Senator PROXMIRE. You have not expressed views similar to the Williams view?

Mr. SHAD. No.

Senator PROXMIRE. Have you expressed any reservations at all in this connection?

Mr. SHAD. In connection with defense contracts?

Senator PROXMIRE. Yes, sir.

Mr. SHAD. I don't recall having a defense contractor case before the Commission in the past 4 years for a formal order of investigation or decision on whether to bring an injunctive or administrative proceeding.

Mr. LYNCH. I'm not aware of any such discussion either.

Senator PROXMIRE. How about the *Litton* case?

Mr. SHAD. No; it was the *Touche* case.

Mr. LYNCH. The *Touche* case came out of the Litton matter where we brought a 2(e) administrative proceeding against Touche, but I don't recall any statements being made to the effect that we shouldn't bring actions against defense companies. In fact, the Commission did authorize the Touche matter. We brought a 2(e).

Senator PROXMIRE. All right. Now let me ask questions of Mr. Lynch and Mr. Sampson, just this one.

Mr. Lynch and Mr. Sampson, I will read the first two sentences of the Williams memo:

> Following on our Thursday conversation, as you know, I have for some time now been struggling with the questions of what function disclosure should serve in the area of government contracts and of whether the Commission should inject itself into that process, especially after the issuer and the government have begun negotiations of some sort. I expressed some concern over these issues during the course of the Commission's discussion of the General Dynamics/Electric Boat Division matter, and they surface again in the Litton case.

My question is, Were you aware that Mr. Williams had expressed these concerns and have you heard any of the present Commissioners express these or similar concerns with respect to investigations of defense contractors or other corporations? Mr. Lynch.

Mr. LYNCH. Well, I didn't work directly on the *Litton* case. I was aware at the time that Chairman Williams was uncomfortable with that case, at least at some point in time, and I am aware now that he also voted against the recommendation for a formal order on General Dynamics.

But the formal order was issued. The *Litton* case was brought, and I certainly haven't had any discussions or even heard about any discussions with any current Commissioners where they expressed reservations about investigations aimed at defense contractors or their auditors or anybody else associated with them.

Senator PROXMIRE. Mr. Sampson.

Mr. SAMPSON. I received a copy of the memo, as you'll see in the prepared statement, so I'm obviously aware of it.

The only thing I can remember in my view is that SFAS 5 sets the standards for this. If the corporation believes a loss will be incurred, it is probably, and if they can estimate the amount, it must not only be disclosed but booked in their financial statements.

So I don't necessarily agree with the statements made here. I think discussions about the Touche-Ross matter when it came before the Commission probably included some discussion about the uncertainty inherent in defense contracting. It's very difficult to make estimates beforehand as to whether or not you would have profits or losses on a particular contract when you run into a lot of change orders and that sort of thing. So I think there was probably some discussion about that. But the *Litton* case was brought by the Commission at that time, and I think that shows that they also agreed that losses which are both probable and estimable must be reported.

Senator PROXMIRE. Chairman Shad, would you say that the Enforcement Division staff has the full support of the Commission in investigations of large defense contractors who may be failing to fully disclose cost overrun problems or losses on defense contracts or who may be in violation of the laws administered by the SEC?

Mr. SHAD. Yes.

Senator PROXMIRE. Without reservation?

Mr. SHAD. Without reservation.

Senator PROXMIRE. Mr. Shad, tell me how many investigations of major defense contractors have been started at the SEC since you took office.

Mr. SHAD. I wouldn't know that in the normal course of things. I think Mr. Lynch can give us a fair count.

Mr. LYNCH. At least one. Certainly one, and I can't tell you if there were more than that. One that I'm aware of.

Mr. SHAD. Matters under inquiry, of course, we neither confirm or deny.

Senator PROXMIRE. How many of the top defense contractors are under investigation by the SEC?

Mr. SHAD. Probably one, if that's Mr. Lynch's guess.

Senator PROXMIRE. As you know, nine are under criminal investigation by the Defense Department.

Mr. SHAD. Yes.

Senator PROXMIRE. How many of the top 40 or 100 are under investigation? One?

Mr. SHAD. We have matters under inquiry at several levels in the Commission, at the branch and the regional office level and at the home office level, and they have the authority to pursue these cases if they have a reason to believe that there may be a violation. But for me to——

Senator PROXMIRE. What does under inquiry mean, sir? Is this an investigation or not or is it preliminary?

Mr. SHAD. It's a preliminary investigation. Before coming to the Commission for a formal order, the staff has the authority and is encouraged to pursue all matters where they believe there may be a sustainable cause of action for violation of the securities laws. So that's a very aggressive area of pursuit by the staff; and when they get to the point where they believe they have adequate facts to justify, and in fact need, a formal order, in order to be able to subpoena information and draw testimony, then they come to the Commission with a full review of the staff's investigation at that point; and it moves from a matter under inquiry to a formal investigation.

Senator PROXMIRE. Can you tell me if there are any formal investigations of any defense contractors?

Mr. LYNCH. There is at least one, and there may be others.

Senator PROXMIRE. There is one that you know of?

Mr. LYNCH. There is one that I'm certain of.

Senator PROXMIRE. As you know, there are 36 that are being investigated by the Defense Department for criminal investigation.

Mr. LYNCH. I should also mention that I have had discussions with the fraud unit of the Department of Justice about their investigations going back some period of time now where we have talked about how they might best go about approaching some of those cases, and we are following the investigations. There may come a time, based on a case they bring or information that we learn of, that we will subsequently follow up and see whether or not there are securities violations. But it's something that we have been aware of for some time. We meet regularly with the Department of Justice to discuss a number of issues regarding public corporations, and they have a very active investigation program right now that we have been given some detail about.

Senator PROXMIRE. Let me ask you this, Mr. Shad. On May 15 of this year, a staff report was submitted to the House Armed Services Committee concluding six of the largest defense contractors, in addition to General Dynamics, made millions of dollars of questionable overhead billings to the Pentagon. Representative Bill Nichols, chairman of the Investigations Subcommittee, said that the investigation showed billing abuses on defense contracts were widespread and not limited to General Dynamics. These findings were well publicized by the news media.

How many of the six corporations are you investigating?

Mr. SHAD. I do not know how many.

Senator PROXMIRE. You don't know how many?

Mr. SHAD. No.

Senator PROXMIRE. Do you know if you are investigating any? Mr. Lynch.

Mr. LYNCH. I don't know if one of the six referred to is under investigation. I don't know the identity of the six major defense contractors.

Senator PROXMIRE. Well, the six would not include General Dynamics. I'm talking about the six other corporations. And you don't know?

Mr. LYNCH. I can't say whether they are under investigation or not. They may be.

Senator PROXMIRE. Mr. Shad, last week, on June 20, it was reported in the Washington Post that 9 of the largest 10 defense contractors were under criminal investigation by the Pentagon's inspector general. In fact, 36 of the 100 largest contractors are under criminal investigation for alleged offenses, including costs mischarging, false claims, gratuities, subcontractor kickbacks, false statements and bribery.

How many of these firms is the SEC investigating?

Mr. SHAD. I do not know.

Senator PROXMIRE. Don't these violations potentially involve violations of the securities laws and shouldn't the SEC be concerned that these firms are doing such things?

Mr. SHAD. Well, I think Mr. Lynch has pointed out that we do have ongoing and continuing conversations with other law enforcement agencies, and where we can appropriately do so we give them access to our files and they give us access to their information.

Senator PROXMIRE. Where you have a big defense contractor—obviously in virtually all cases there are very substantial investments, investors are heavily affected. Shouldn't it just be a matter of course that if there's a criminal investigation of this kind that you would conduct an investigation, too?

Mr. SHAD. Not necessarily.

Senator PROXMIRE. Why not?

Mr. SHAD. Our business is disclosure. We are not in the business of bringing criminal sanctions against people.

Senator PROXMIRE. I recognize that and I am not suggesting you should be. What I'm saying is if there is this kind of a situation, it seems to me it should warrant at least an investigation to determine whether or not the SEC laws and regulations were being abided by, whether there is disclosure. It would suggest certainly to this Senator a matter of common sense that in many of these cases there probably wasn't adequate disclosure.

Mr. LYNCH. That may very well be, but I would submit that it would be duplicative for us to begin an investigation every time that the Justice Department or some other investigative agency opens up their own investigation. I think if you asked the officials of the Justice Department they would say that in most instances they would probably prefer that we weren't monkeying around as well at the same time that they had begun a grand jury investigation.

Senator PROXMIRE. But what I'm calling for is an effective enforcement of the securities laws. The Defense Department has nothing to do with the securities laws. The Justice Department doesn't enforce them. You do. It's your responsibility. So it seems to me that under these circumstances that you ought to take a very, very hard look and in many cases investigate.

You have told us this morning that you have some preliminary inquiries here and there. You can't tell us how many. You don't know whether there are any investigations at all and you're the head of the Enforcement Division.

Mr. LYNCH. There may very well be cases where we should begin investigations simultaneously with the Department of Justice, but that's not to say in every instance that we should open up an investigation as well. The premise that they use in bringing these investigations in some of these cases, I suppose, is that false claims have been filed with the Government. That's a very complex issue. I'm not certain that in every instance the SEC has the expertise to determine what's a false claim and what isn't a false claim.

Senator PROXMIRE. But you don't know of any, except maybe one, and you don't know—in all these cases—I could understand if you found on the basis of preliminary inquiry that the disclosure of securities laws and so forth were not being compromised that you might not investigate, but you would think that in some of these cases—5, 6, 8, 10, 15, whatever—that you would have become involved. And you say maybe one and you don't know of any others. If you don't know, who does? You're the head of the Enforcement Division.

Mr. LYNCH. I wasn't aware that his was going to be a subject of inquiry here. We could provide you with the supplemental information as to whether or not we are focusing on other defense contractors. I am familiar with the names of the very large defense contractors. I am not familiar with the names of the top 45 or top 50 defense contractors.

Senator PROXMIRE. Mr. Shad, the facts in the Litton shipbuilding claim case were very similar to the General Dynamics case and there the SEC took action against the company and its outside auditors, Touche, Ross, for violating the disclosure requirements.

Wasn't one of the key facts in the case that a Litton official had told its bank that it would lose money on its Navy contract?

Mr. SHAD. I think that there were similarities between the two, but they really stopped at the point of involving contracts with the Navy. Beyond that, they were entirely different. The facts were different. The material difference, in my opinion, was the acknowledgment of the loss by Litton, which we didn't have in the General Dynamics case. But Mr. Sampson, I believe, could amplify that.

Mr. SAMPSON. Senator, in addition to the loss on the Navy contracts, there was another matter involving some $130 million in costs incurred by Litton on commercial contracts in its new shipyard, which was not properly accounted for; and it was on the basis of that, plus the other loss, that the Commission brought its action.

Senator PROXMIRE. Mr. Shad, if the SEC had known during the General Dynamics investigation that a high-company official had notified the company's leading banker as early as 1975 that there would be large losses on the submarine contracts, would that have led to the conclusion that General Dynamics was violating the disclosure requirements in its financial reports?

Mr. SHAD. You said "would be," and if they hadn't been realized or they weren't reasonably ascertainable, then I'm not sure there would have been a change.

Senator PROXMIRE. All right. Now in its closing memo of February 23, 1982, the SEC Enforcement staff stated, "They found no documents indicating General Dynamics made any estimate of loss and it would be difficult to establish any minimum loss should have been foreseen."

But the staff of this committee found a number of documents in which high-company officials estimated large losses, including suggestions from the company's comptroller, Arthur Barton, and the memo of H.E. Caldwell, the company's banker.

How do you explain that discrepancy?

Mr. SHAD. Well, I happened to read that section of Mr. Kaufman's report. This was an enormous investigation. The staff went to both St. Louis and the shipyards themselves and were exposed to hundreds of files. They went through those files and tried to identify and in fact received access to tons of materials.

Now to suggest that they in that effort looked at every piece of paper that may have provided a clue, I'm sure they didn't, but I would ask Mr. Lynch to amplify that.

Mr. LYNCH. If I could, there's a document that's referred to in the Senate staff report. It's a Chase document, a September 8, 1975, memorandum which was used to support the proposition that they knew that they were going to recognize a loss and that the amount of the loss in 1975 was $100 million. And the report quotes a sentence which says, "The request for equitable adjustment they estimated to be somewhere in the area of $120 million on the first flight and $40 million on the second or a total of $160 million which would leave a net loss of approximately $100 million."

Now if you look at that sentence alone, I think it's reasonable to conclude that in fact General Dynamics did know that there was going to be a loss and they put a $100 million figure on it. But the report that I have seen, the Senate report, doesn't refer to the next page of that document.

On the next page of the document, the same person is saying to Chase, "As a result, all of the steps being taken and a really thorough reassessment of the whole situation, Gorden,"—and that's Gorden MacDonald from General Dynamics—"now feels that the company can break even on the total program of flights one and two assuming that they are able to get approximately $160 million on the request for an equitable adjustment, not an unreasonable assumption since the Navy has already offered on flight one $70 million as an initial start."

So the document that's cited does have the one sentence in it which would suggest that General Dynamics did know that they were going to recognize a loss of $100 million, but in the same document, on the next page, there's a quote attributed to someone from General Dynamics that in fact, based on changes that they have made, they think now there's a possibility of breaking even.

You can't just pick one or two sentences out of a document and say that it stands for the propositions reflected in that sentence. You have to read it in the context of that entire document.

Senator PROXMIRE. Did the SEC investigators contact Mr. Caldwell to discuss the September 8, 1975, meeting with Mr. MacDonald?

Mr. LYNCH. No, we did not.

Senator PROXMIRE. Did you question Mr. MacDonald about his statements in that regard?

Mr. LYNCH. No, we did not. No testimony at all was taken in the General Dynamics matter.

Senator PROXMIRE. Shouldn't that have been done?

Mr. LYNCH. The staff determined that it wasn't appropriate in the General Dynamics case, in this particular General Dynamics case, to take testimony. The feeling was that, based on the documents that we had reviewed, the case was as good as it was going to get, that you wouldn't get testimony from General Dynamics officials that added significantly to the statements that they were already locked into as a result of the documents, and that conclusion was reached by experienced people who have done a lot of investigations and it was based on the experience that in fact the investigation would not——

Senator PROXMIRE. Mr. Lynch, based on that memorandum from the company's banker, Mr. Caldwell, it seems to me that you had a clear reason for certainly discussing this with Mr. Caldwell and with Mr. MacDonald—investigating it. You say you did not.

Mr. LYNCH. The document itself, though——

Senator PROXMIRE. The document was ambiguous.

Mr. LYNCH. It's not ambiguous. It says that at one time they were concerned that there would be a $100 million loss, but as a result of changes that they had made it's not unreasonable to assume that they would break even.

Senator PROXMIRE. Well, but they did lose.

Mr. LYNCH. I understand that, but one has to assume, if you rely on the first page of the document, that the entire document is a legitimate document, that it's not a doctored document. And if that's the case, I think there's an explanation with in the face of the document itself which supports General Dynamics' assertion that in fact they thought they would break even, at least as late as 1976.

Senator PROXMIRE. I understand your reasoning on that. If all you have is a document, that would be understandable. I still can't understand why you don't follow up with a direct inquiry and get on record the banker and Mr. MacDonald both so you know what the situation is. That seems to be the logical thing to do, isn't it?

Mr. LYNCH. It is, and we do that in 90 percent of our cases, if not a greater percentage of our cases.

Senator PROXMIRE. You did not do it in this case.

Mr. LYNCH. We did not do it in this case. Although there was a lot of discussion given to the documents, and there was much discussion as to whether or not testimony should be taken. It was the view of everyone involved, many of whom had much experience in investigatory matters at the SEC, that taking testimony would not have added substantially to the facts in the record that had been developed through the documents.

Senator PROXMIRE. Let me just read from the Caldwell memo. It says:

The new figures that were shown to the board at the June session indicated there was a loss of roughly $200 million on the first flight and $60 million on the second flight, or a total loss of $260 million, before any request for equitable adjustment. The request for equitable adjustment they estimated to be somewhere in the area of

$120 million in the first flight and $40 million in the second, for a total of $160 million, which would leave a net loss of approximately $100 million. Needless to say, this shook up Colonel Crown and other members of the board of directors and there was much recrimination and discussion.

Colonel Crown, of course, is a very astute, able, as well as powerful and affluent person. It seems to me if he was shook up it is the basis for a more vigorous inquiry than apparently was pursued.

Mr. LYNCH. Well, on the first page of the document it does state that in June the report was made to the General Dynamics Board and there were fireworks. People were very upset and as a result of the fireworks that were set off as a result of the report that was made to the board, key executives in General Dynamics focused on the problem and by the time of the writing of this memo in September 1975, if one assumes that the matters in here are truthful, they had reevaluated the situation and they believed, based on changes that they had made, that they would be in a position to break even on the contract.

So things had evolved from June, where I think you're quite right in saying that there appears to be a real shakeup going on, to September, where because of changes that they had initiated as a result of the board's pushing them, I'm sure, that they were in a break-even situation or so they thought.

Senator PROXMIRE. Mr. Shad, in the prepared statement it says, "If defense contractors withhold material information about cost overruns or other problems, it would be in violation of the acts administered by the Commission."

If General Dynamics had systematically over several years withheld from the Navy information about cost overruns on the submarine contracts, if they had provided false information about costs and schedule slippages, or intentionally minimized the seriousness of the problems, would that be a violation of the acts administered by the Commission?

Mr. SHAD. I believe so.

Senator PROXMIRE. Now the committee staff study released on April 2 demonstrates that General Dynamics, in effect, had two sets of records on man-hour costs and schedules and that it systematically understated its cost overruns and schedule problems in its reports to the Navy.

If the SEC had known these facts, would it have changed the outcome of the investigation?

Mr. SHAD. I can't predict that. It would have been an area of inquiry, and we would then have to draw the conclusion as to whether or not they were reasonable in their estimates of expenses and probable realization.

Senator PROXMIRE. How about it, Mr. Lynch?

Mr. LYNCH. I think it might have. I can't say for certain that it would have, but to the extent that a company is maintaining two sets of records, certainly that's——

Senator PROXMIRE. Then the records that they provide to the Navy and presumably the records that they provide to the investor—they're the same—are false.

Mr. SHAD. That's not a fair assumption.

Senator PROXMIRE. It's not a fair assumption?

Mr. SHAD. No.

Senator PROXMIRE. Did they lie to the Navy and then tell the investors in the public statements?

Mr. SHAD. Companies have multiple accounts and books, including an entirely different set of books along with their tax returns as compared to those that are distributed to the investors. They can follow different, equally generally accepted accounting principles, in doing the two different sets of books.

Senator PROXMIRE. But what they told the Navy was false and what they told the Navy was exactly what they reflected in their reports to their investors in their financial statements. They understated their costs.

Mr. Shad, how do you explain the fact that these facts were missed or overlooked during SEC's investigation?

Mr. SHAD. I'm not sure that what you just read was overlooked.

Mr. LYNCH. If in fact that's——

Senator PROXMIRE. Do you know as a matter of fact that General Dynamics had two sets of records?

Mr. LYNCH. No, I don't think that we did, and I stated earlier that, had we known that and if its's true—I don't know if it's true—but if they did have two sets of books and one set of books is false, then certainly that would be a very serious violation of the accounting provisions of the Foreign Corrupt Practices Act.

Senator PROXMIRE. Well, I don't expect you to necessarily rely on what I say, but Secretary Lehman admitted that the information they had was false and that they did have two sets of records. We had an extensive hearing on that earlier.

Mr. Shad, your testimony says that the SEC staff learned in April 1978 that General Dynamics may have been primarily responsible for the cost overruns that were the basis of the claims and that the assertion that they were caused by Navy change orders may have been misleading.

Are you aware that numerous internal studies conducted by the company showed that the company was aware that the cost overruns were caused primarily by inefficiency and poor management in the shipyard?

Mr. SHAD. You referred to my testimony, but you're actually reading from the prepared statement of Mr. Sampson and Mr. Lynch. I think it would be better directed to them.

Senator PROXMIRE. Are you aware of that?

Mr. LYNCH. I think that is true, that there are documents which reflect a concern that the operation was very inefficient.

Senator PROXMIRE. Now if the company and the Navy were both aware that the cost overruns were primarily or even substantially caused by the shipyard inefficiency, would it have been reasonable for General Dynamics to believe that the Navy would provide 100 percent reimbursement for the cost overruns and isn't it correct that unless the Navy paid for all the overruns the company would lose money on the contracts?

Mr. LYNCH. Not necessarily. In fact, General Dynamics in 1976 had claims for $544 million, but their own projections were that they would only recover $130 million of the $544 million. They weren't projecting that they would get all $544 million. In fact, out of the $544 million, they did get $125 million.

What they were relying on in 1976 was the revision of the escalation provisions. They had a belief that the Navy might be willing to enter into discussions which would result in the escalation provisions being revised.

As I understand it, in April 1976, Deputy Secretary of Defense Clements appeared before the Senate Armed Services Committee and requested authority to renegotiate the escalation provisions and following that, there were renegotiations with General Dynamics and two other defense contractors, and in those preliminary discussions they talked about a revision—a renegotiation which would result in General Dynamics receiving $250 million more on the contracts.

If you put the $250 million together with $130 million from their claims on the cost overruns, they were projecting a loss of about $380 million; they would have been covered.

So it's not true that they were relying entirely on their claims. They were relying on a renegotiation of the escalation provisions.

Senator PROXMIRE. We're not saying they were just relying on their claims. In fact, given the extensive evidence of massive shipyard inefficiency and poor productivity, wasn't it unrealistic and misleading for General Dynamics to say there would be no losses on the contract because the Navy would provide 100 percent cost overrun reimbursement through a combination of claims settlements and a new escalation clause?

Mr. LYNCH. If that were the case. But I think even in the settlement that was reached in June 1978 between General Dynamics and the Navy, it didn't say that the problem was the result entirely of General Dynamics. In fact——

Senator PROXMIRE. But you admitted, Mr. Lynch, that you knew that they were inefficient.

Mr. LYNCH. Yes.

Senator PROXMIRE. And that was recognized and that, therefore, that part of the claim would not be honored.

Mr. LYNCH. But just because they were inefficient doesn't mean that they were wholly responsible for the problems.

Senator PROXMIRE. But they're going to be partially responsible and that means they were going to suffer substantial losses when they said they would not.

Let me ask you this. There were two issues concerning the escalation clause. One was whether it would be recalculated at a higher rate for future inflation. The other was whether it would be recalculated for a higher rate for past inflation and made retroactive to the date the contract was signed. Only if the new escalation clause was made retroactive could General Dynamics hope to get full reimbursement for the cost overruns.

What evidence is there that the Navy had indicated a willingness to make such a drastic overhaul of the contract?

Mr. LYNCH. As I understand it, they had negotiated a proposed settlement with General Dynamics where they would receive $250 million under the renegotiated escalation clause which would, at least for 1976, put General Dynamics on a break-even basis.

The problem that occurs is that the other two defense contractors that were involved in negotiations decided that the settlements that they were talking about on the escalation provisions with

DOD weren't sufficient and they backed out, and the whole discussion was based on the premise that all three defense contractors would reach an agreement. Those are the facts as we understand them. In fact, they did have a tentative arrangement with the Navy where they would receive $250 million under a revised escalation clause.

Senator PROXMIRE. I'm going to ask General Counsel Kaufman to follow up.

Mr. KAUFMAN. Mr. Lynch, with regard to that negotiation, even had they received the $250 million, that would not have been enough to bring them into a break-even or profit position with regard to the two contracts, would it?

Mr. LYNCH. As I understand what they were projecting as cost overruns in 1976, it would. They were projecting a cost overrun in 1976 of $380 million. They had a claim filed for $544 million. They realized that they weren't going to get $544 million. In fact, they had budgeted that they would get $130 million. As it turned out, they only got $125 million. But the $250 million that they would have gotten under a revised escalation clause, added to the $130 million that they thought they would get from the claim, would cover it. It would add up to $380 million projected shortfall that they had.

Mr. KAUFMAN. As you may know, in the company's records were numerous estimates of projected losses, including losses much greater than the ones you are citing.

In any event, the claims negotiations fell through in 1976. They did not get the $250 million recovery and in the final analysis, they got a recovery that amounted to over $600 million and they still suffered a loss. Isn't that correct?

Mr. LYNCH. Yes, it is.

Senator PROXMIRE. Mr. Shad, the committee staff went through SEC's voluminous files of the General Dynamics investigation. They found no evidence that the Navy intended to give the company a new retroactive escalation clause.

Can you point to any document in the files which shows otherwise, any of you three gentlemen?

Mr. LYNCH. Nothing other than our awareness of the negotiations between the Navy and General Dynamics.

Mr. SHAD. And a statement by the Secretary that the escalation clauses were inadequate.

Mr. KAUFMAN. Can you point to any statement by a Navy official that they were willing to provide a new retroactive escalation clause going back to the original date of the contract?

Mr. LYNCH. I am not certain that we have that document in front of us. I do know that at the April 1976 hearings before the Senate Armed Services Committee the Deputy Secretary of Defense said that the new escalation provision—said in effect—I don't purport to be quoting him—that the escalation provisions as they currently were written were inequitable and——

Mr. SHAD. He said, "The largest part of the inequities which is recognized in ongoing contracts signed in the period 1968 to 1973 can be overcome by a reformation of the provisions for escalation." That directly covered this area.

Mr. LYNCH. At the same hearings, Admiral Michaelis also indicated that the escalation provisions seemed to be inequitable.

Now certainly that doesn't suggest—I don't mean to suggest that that indicates that they definitely were going to give General Dynamics another $250 million, but by virtue of making those public statements, they certainly put themselves in a bad position in the matter of a litigation, and I think it is fair to say that by admitting that the escalation provisions in the contracts were inequitable it suggests that there was a willingness on their part to renegotiate to some degree.

Mr. KAUFMAN. In any event, following the collapse of the attempt to settle the claims, I think you will agree that there is no statement on the record of any Navy official or any other evidence that the Navy was willing to provide the company with a new escalation clause retroactive to the date of signing the original contract. Is that correct?

Mr. LYNCH. I can't point to a document. I don't know whether a document exists or not.

Senator PROXMIRE. Mr. Lynch and Mr. Sampson, were either of you aware that Arthur Andersen met with Gorden MacDonald and Arthur Barton on July 30, 1976, where it was agreed that unless productivity improved in the shipyard in the next 2 months a loss on the submarine contracts would have to be recognized and that in September and October of that year an Arthur Andersen partner noted in a memo that the projected productivity improvements had not occurred?

Don't these documents show that the company should have reported a loss in 1976?

Mr. SAMPSON. I'm not familiar with the details of the investigation, Senator.

Senator PROXMIRE. Mr. Lynch.

Mr. LYNCH. I think you're right, those documents do exist, but the situation was in flux. In fact, if there is anything I have learned over the years of doing investigations, the fact that you have one or two documents which suggest a conclusion doesn't necessarily mean that that conclusion can't be rebutted if you get to a point where the case actually has to be tried in a court of law.

And the fact that a document exists in September or July or any other time which would suggest that a loss might be recognized does not definitely indicate that the loss had to be recognized at the end of the year. Things could change. And the fact that one person reaches a conclusion doesn't mean that everyone else in the corporation or everyone else in the accounting firm is in agreement with that conclusion.

Senator PROXMIRE. Mr. Shad, in the 4 years it took to complete your first investigation of General Dynamics, no testimony was taken under oath. David Lewis was not questioned under oath. Gorden MacDonald was not questioned under oath. Takis Veliotis was not questioned under oath. No sworn testimony was taken.

How do you explain this oversight and are you taking testimony under oath in the current investigation of General Dynamics?

Mr. SHAD. We have not acknowledged or denied a current investigation.

In the investigation we are discussing today, the staff concluded that it did not have adequate documentary evidence to challenge or contradict expected exculpatory testimony by witnesses. That's the reason they decided not to go forward in taking testimony. They just didn't have enough proof up front, and they certainly could anticipate that most of the testimony they would get was going to be defensive and try to be explanatory or justify the actions taken.

Senator PROXMIRE. You say they didn't have proof up front. That's what sworn testimony is supposed to elicit. That's the purpose of it, isn't it?

Mr. SHAD. They didn't have adequate documentary evidence.

Senator PROXMIRE. Again, that seems to me makes it even more imperative that in order to determine whether or not you can develop adequate proof you take sworn testimony.

Mr. SHAD. I'm no expert in terms of investigation, but I think in each stage of an investigation you've got to make a decision as to whether further effort is justified because every moment that you put into an investigation that does not lead to a sustainable cause of action is a diversion of our resources that should be more effectively employed.

Senator PROXMIRE. Have you subpoenaed documents from General Dynamics in the present investigation and how long do you expect this investigation to take?

Mr. SHAD. I have no comment concerning whether or not there is a present investigation.

Senator PROXMIRE. Why can't you acknowledge whether or not there is a current investigation?

Mr. SHAD. Because if we just did it blithely, we could go around embarrassing and impugning an awful lot of innocent people and jeopardizing the result of bringing a successful court action.

Senator PROXMIRE. Well, here you have a corporation, General Dynamics, which I don't know how they could be embarrassed. It's a corporation that's under criminal investigation by the Defense Department. It seems to me if the SEC is conducting a—and by the Justice Department, too, I might add—and it seems to me if the SEC is investigating them I don't see how it could embarrass them any further. These are fine gentlemen, but they don't embarrass easily.

Mr. SHAD. Senator Proxmire, if we were investigating you and had no real basis to know whether or not you had violated the securities laws, would you want us to publicize it?

Senator PROXMIRE. Well, if I were being investigated for criminal activity by the Justice Department and by the Defense Department, I would certainly take it right in stride if the SEC came along and investigated me.

Mr. SHAD. I think, more importantly, we could jeopardize our own case by these kind of premature statements.

Senator PROXMIRE. All right. My final question, Mr. Shad, the SEC's critics would argue that you intend to conduct a protracted investigation in the hope that in a year or two or more the attention will shift away from General Dynamics and it will then be safe to close down the investigation without taking any action, as occurred in the first instance. How do you answer that criticism?

Mr. SHAD. I think I would say, of course not.

Mr. LYNCH. I would like to answer that. I would like to know who the critics are who suggest that. Has anyone suggested that the staff didn't act in good faith in the General Dynamics matter? I mean, to suggest that the staff has reached a conclusion now that we don't want to bring an action in a particular investigation is an insult to the staff, and there is absolutely no basis for making that sort of suggestion.

To suggest that we have reached a conclusion in any investigation before we assembled all the facts is an insult to the staff, and I don't know what critic made that sort of allegation against the staff, but I take offense, and I can tell you that the entire Division of Enforcement would take offense to that kind of remark.

Mr. SHAD. I would associate my attitude as well and the full Commission with that.

Senator PROXMIRE. Well, I appreciate that, but that's healthy, righteous indignation by an investigator and I think he has every right to feel that way.

Let me say in conclusion, it should be perfectly clear, as I say, that in the General Dynamics case the system or perhaps the individuals that are supposed to protect the taxpayer from defense contract abuses failed. There was a collective failure, not just a few parts, but every part. All the barriers erected by Congress over the years collapsed and I might add Congress was not much of a help either.

The Navy's contract negotiators and administrators failed in the first instance to detect a buy-in by General Dynamics or the systematic false reporting of costs and schedules that occurred.

The defense contract auditing agency failed to identify the abuses, as did Navy Inspectors General and Navy investigators.

The Department of Justice failed to enforce the criminal laws, at least in my judgment.

The company's outside audit firm, Arthur Andersen & Co., and the company's internal auditors failed their professional responsibilities to require full disclosure in the company's financial reports.

And the Securities and Exchange Commission failed in this instance to enforce the securities laws.

I am vexed by the weakness exhibited by the SEC. I have been one of its strongest supporters in the past and I still am. But I must wonder now on whose side is the Commission? Is it a regulator or a protector of a securities firm, particularly of the defense industry? Is it neglecting its mandate to protect the public from unscrupulous and unethical business practices?

In my judgment, the SEC is in danger of becoming perceived as and becoming in fact a business oriented, prodefense contractor organization. If that happens, it will be a disaster for the public and for the Commission. I have great respect and admiration for you, Mr. Shad. I think you have worked very conscientiously and I regret that I have to make that statement, but I make it sincerely.

Thank you very much.

[Whereupon, at 11:40 a.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following supplemental statement of Mr. Briloff was subsequently supplied for the record:]

Submerging and Camouflaging General Dynamics' Submarine Losses

Supplemental Statement
By Abraham J. Briloff
Emanuel Saxe Distinguished Professor of Accountancy
The Bernard M. Baruch College, City University of New York

Submitted to
The Subcommittee on Economic Resources,
Competitiveness, and Security Economics
Joint Economic Committee
Congress of the United States
Washington, D.C.

Submitted July 31, 1985

Introduction:

At page 89 of the Transcript of the June 28, 1985 Hearings of the Subcommittee on Economic Resources, Competitiveness and Security Economics of the Joint Economic Committee, Chairman Proxmire stated that the record would be kept open to permit additional questions to be directed to the witnesses. Because the Statement from the Securities and Exchange Commission, and testimony given by the witnesses appearing in behalf of the Commission, raise some important questions relating to the General Dynamics accountings, and to corporate governance and accountability generally, I deem it desirable to submit this supplementary statement for the record.

Before turning to the principal matter involved in the deliberations of your Subcommittee on June 28, I would like to pursue two peripheral issues, to wit:

1. A response to Gary Lynch's criticism of my commentary on the SEC's "double standard," and of critics of the SEC generally; and

2. The SEC's response to allegations regarding improper acts by defense contractors.

Mr. Lynch Takes Umbrage:

1. At page 43 of the Transcript Mr. Lynch asserted that:

> . . . I would like to turn to something which was raised by Mr. Briloff . . . where I can respond to an allegation that he made.
>
> He suggested that the SEC only brings cases against small companies or small accounting firms. That simply isn't true. Our record doesn't show that.
>
> In recent years, we've brought a case against Fox and Company which at the time I think was the 11th largest auditing firm in the country. We brought a case against Touche and Litton, a case we've already discussed this morning; and just last week, last Thursday, we filed an injunctive action against Price Waterhouse.

> In recent months we have brought actions against Burroughs Corporation, against Oak Industries, against Charter Company, against Stauffer Chemical, and against AM International. I would submit that those are not small companies and that the firms we have proceeded against are not small firms and we don't discriminate against small firms. [Emphasis supplied.]

I have scrutinized the transcript of my testimony most carefully and do not find the word "only" used anywhere -- certainly not in the context of my criticism of the SEC's "double standard."

I am confident that Mr. Lynch was intimately familiar with the point I was making; he was undoubtedly aware that I had developed a full and complete roster of the Commission's Accounting and Auditing Enforcement Releases from 1981 through 1984 for the purposes of my February 20, 1985, testimony before the Subcommittee on Oversight and Investigations of the House of Representatives Committee on Energy and Commerce (the "Dingell Committee"). He may not have been aware of the fact that I had updated that analysis for the purposes of a June 20 address delivered before the Michigan CPAs. (A copy of that address was, as I recall, provided to the Enforcement Division's Chief Accountant at the time of the meeting in Grand Rapids.)

In any event, for the record of these proceedings, as Attachments 1A and 1B, copies of relevant portions of my two presentations are provided.

2. Subsequently, at page 87, Mr. Lynch inveighed against critics of the Commission, asserting:

> I would like to answer that. I would like to know who the critics are who suggest that. Has anyone suggested that staff didn't act in good faith in the General Dynamics matter? I mean, to suggest that the staff has reached a conclusion now that we don't want to bring an action in a particular investigation I think is an insult to the staff, and there is absolutely no basis for making that sort of suggestion.

> To suggest that we have reached a conclusion in any investigation before we assembled all the facts I think is an insult to the staff and I don't know what critic made that sort of allegation against the staff, but I take offense and I can tell you that the entire Division of Enforcement would take offense to that kind of remark.

(Chairman Shad concurred in this view, saying, "I would associate my attitude as well as the full Commission with that.")

I presume that Mr. Lynch included me among the critics at whom he took umbrage. In any event, I am such a critic. Nonetheless, just as I believe myself to be a loving critic of my profession, so do I fancy myself to be a loving critic of the SEC. In each case I believe the enterprise to have an enormously important role in the fulfillment of the objectives of our American Democracy; to the extent that I sense the profession or the agency to fail seriously in the fulfillment of that responsibility, criticism is not merely justified, it is essential.

Probing Defense Contractor Aberrations:

Pages 59-65 of the Hearings transcript report the coloquy between Chairman Proxmire and the witnesses from the SEC regarding the Commission's investigations of alleged violations by defense contractors involving "costs mischarging, false claims, gratuities, subcontractor kickbacks, false statements and bribery." The SEC witnesses appear to have responded to the conditions described by Chairman Proxmire with what might be best described as essentially benign neglect -- thus, only one contractor was under investigation for the possible violation of the reporting provisions of the Securities Acts of 1933 and 1934.

This attitude is not comprehensible to me. A decade ago, when the "Corporate Watergate" phenomenon was discerned, the SEC's Enforcement

Division, then headed by Stanley Sporkin, initiated a program of "voluntary disclosure" by corporations which may have deliberately or inadvertently violated the reporting requirements of the Commission. It would appear that a corresponding "invitation for voluntary disclosure," with or without a promise of amnesty, should be instituted presently -- directed, say, to the top 100 defense contractors, or those who may have enjoyed a billion dollars, or more, of contracts during the past five years. If such a practice was appropriate a decade ago, it would appear to be inexorable presently in view of the enactment of the Foreign Corrupt Practices Act of 1977, particularly the enactment of Section 13(b) of the Securities Exchange Act of 1934.

By way of a footnote to history, I have included herewith, as Attachment 2, pages 170-172 from my Truth About Corporate Accounting (Harper & Row, 1981). Who Will Guard the Guardians?

As prologue to this phase of my analysis of the SEC position regarding the General Dynamics Accountings, the observation of OMB Director David Stockman, as quoted in The New York Times (June 29, 1985), is most apt:

> As the fiscal crisis has worsened and the political conflict intensified, we have increasingly resorted to squaring the circle with accounting gimmicks, evasions, half-truths and downright dishonesty in our budget numbers, debate and advocacy. Indeed, if the S.E.C. had jurisdiction over the executive and legislative branches, many of us would be in jail. So it is incumbent on both sides to come clean with the numbers, and thereby the true choices.

But then, in this very context, we hear the question from Juvenal calling across the millennia, "Quis custodiet ipsos custodes?" And here, I presume, the response should be that it is the Congress of the United States who must guard the SEC.

Analysis of the SEC Position:

My analysis of the SEC Statement submitted to your Subcommittee for the June 28 Hearings informs me that it is a most intriguing document. It appears to have been developed by a troika, none of whose members was necessarily aware nor responsible for what the others were writing.

Passing over the title page and the initial introductory page we find that pages 2 through 6 present a general statement regarding the accounting problems of defense contractors; and as will be noted presently, sets forth (at p. 3) the rule, as the SEC sees it, for revenue recognition on long-term contracts. While I will be commenting on certain aspects of those five pages, they are essentially descriptive -- and not especially controversial.

From page 7 through the last complete paragraph on page 13 the Statement provides a chronology of the investigation of General Dynamics by the SEC's Enforcement Division during the period 1978 through 1980. This section summarizes the facts which led to the Commission's authorizing a formal investigation.

And then, from the bottom of page 13 through the end of the document at page 20 there is presented the "Third Act," i.e., the Division's proceeding from 1981 to February, 1982, to terminate the investigation.

As will be noted presently, it is my view that this third segment is essentially oblivious of the facts included in the middle segment, and ignores entirely the SEC rule at page 3 regarding revenue recognition. Instead, this conclusionary segment appears to be determined inexorably to quash the investigation, that it brushes facts and rules aside and becomes obsessed with but one guiding precept, namely, to subsume the entire accounting issue under Financial Accounting Standards Board Statement No. 5, relating to Contingencies.

That there was less than full coordination among the several sectors of the Commission responsible for this project is clearly evidenced by two statements by the Chief Accountant at the Hearings, to wit: At Tr. 51, "I'm not familiar with all the details of the case . . .; at Tr. 83, "I'm not familiar with the details of the investigation . . . .

I turn to a more detailed critical analysis of the SEC's position in this controversy, as disclosed in the Statement and the testimony at the Hearings.

Regarding the 1976 Disclosures:

The SEC's 1982 determination to terminate the GD investigation did note the staff's misgivings regarding the 1976 footnote disclosures regarding the 688 contracts. I have some further misgivings which I believe should have given pause to the staff prior to its granting its 1982 absolution, including:

1. The footnote states that: "On 7 April 1976, the first claims submitted [to the Navy] covering charges directed by the Navy prior to 20 May 1975 as the first contract for seven submarines were settled at a contract price increase of $97 million." I dub this as a "40%-true disclosure" -- hence, something less than a half-truth. This is because, as now disclosed by the SEC Statement (p. 8) this $97 million settled the previously submitted claim aggregating $244 million.

By my standard of "full and fair disclosure" the information not contained in the footnote, per se, was material and relevant. The reader could then infer that GD's allegations of the Navy's responsibility for the cost overruns were being rejected by about 60 percent. This fact could impact on the reader's evaluation of the $544 million figure which was given currency in the footnote.

2. The footnote indicated that the 688 revenue/cost calculus received a credit for "projected productivity improvement." That this may well have been a canard might be evidenced from the following included in an Arthur Andersen memorandum of January 6, 1977:

> Bob Palmer opened the meeting by pointing out our concern over the growing uncertainties at the Electric Boat Division involving mainly around the extremely large magnitude of the claim and the continual decline in productivity in recent months since our last meeting with Gorden at the end of the third quarter. [Emphasis supplied.]

Just how the corporation and its auditors could subscribe to "productivity improvements" at the very "point in time" when they have been noting "continued decline in productivity" is beyond me. Just how and why this added favorable injection into the 688 calculus escaped the notice of the SEC staff is also beyond my ken.

3. Not disclosed in the 1976 financial statements but, to my knowledge, first revealed by the Commission at page 15 of its Statement was the fact that the SSN 688 cost overrun as of the close of 1976 was $380 million. Of that sum $130 million was intended to be recouped from the Navy on the portion of the claim relating to change orders; the remainder was based on management's hopes for change in the escalation provisions. These disclosures are, of course, far more informative than those included in the relevant footnote which noted that the required recoupment would be "a substantial portion" of the $544 million in claims.

The SEC position presumes that the $380 million vanishes into insignificance, first by asserting that GD did recover fully $125 million on the $130 million expectation; and then evaporated the remaining $250 million by referring to some testimony at some hearings.

By way of a commentary on the SEC's alchemy, I believe that its relating the $125 million portion of the June, 1978, settlement to the $130 million portion of the expectation is specious. There is nothing in the record discerned by me to demonstrate an even tenuous linkage between the two figures.

To the extent the Commission's accountants now believe that the $250 million was entitled to be reckoned as revenues on the basis of the flimsy evidence reported at page 17 of the statement, the awesome SEC is showing a willingness to grab at straws to rationalize a misbegotten position.

4. Even after giving full faith and credit to the June, 1978, settlement, the staff of the Enforcement Division should have noted the deep hole that remained in GD's 1976 operating results. Accepting the $125 million portion to be first credited to the 1976 year, the corporation was then reimbursed to the extent of another $128 million (i.e., one-half of the excess of the $380 million over the $125 million). Consequently, GD had to absorb a loss of $127 million for 1976, even after giving effect to the settlement; this amount just about equated the pretax income reported for that year. Most assuredly, a loss of that magnitude was material.

It does appear that the "healthy, professional skepticism" which the Commission properly expects from the independent auditor was not a quality manifested by the SEC staff in 1982 when they determined to give a passing grade to GD on the 1976 footnote disclosures.

Regarding the 1977 Disclosures:

1. My criticism of the "40%-true disclosure" in the 1976 footnote is equally applicable for 1977 since the footnote for that year repeats the reference to the $97 million contract price increase.

2. Having now been informed that the cost overrun as of the end of 1976 was $380 million, it means that the incremental overrun for 1977 amounted to $460 million. (In my statement I alluded to a $296 million increment, p. 3, taking the differential between the $840 million and $544 million figures.) So it is that during the year 1977 General Dynamics was "hemorrhaging" in its performance on the 688 contracts. This condition notwithstanding, the corporation and its auditors were still staking their hopes for a break-even in part on the realization of "historical manfacturing improvements."

Just how GD's management and its auditors could have embarked on this psychedelic trip in the face of the realities is beyond me; that the SEC now blithely passes over this process is even more incomprehensible. In view of the $460 million incremental cost overrun for 1977, and given that the Navy agreed to absorb half of that amount, it means that the corporation was left with a staggering $230 million loss for the year, even after giving effect to the June 1978 settlement.

3. I have already alluded to my lack of comprehension of a number of the SEC's 1982 determinations regarding the General Dynamics accounting disclosures, and the determination to somehow wish away the failings discerned by the staff. What I find absolutely incredible is the staff's (i.e., those involved in the quashing) failure to juxtapose the 1977 disclosures regarding the claims with the facts discerned by the staff (i.e., those involved in initiating the 1978 investigation).

From the 1977 footnote:

> . . . Due to deficient engineering plans and specifications furnished to Electric Boat Division by the U.S. Navy and its design agent plus the serious delay in furnishing the plans, the costs of building these submarines have greatly exceeded the initial contract prices. More than 35,000 drawing revisions have been made to the plans and specifications which have adversely affected the production operations. Accordingly, the Corporation has filed claims with the Navy for price increases to cover the impact of the changes, in accordance with the contract's changes clause. . .

Now let us turn to the statement of facts included in the SEC Statement to your Committee, p. 10:

> At that time [April, 1978], the staff learned from officials of the Department of the Navy certain facts which tended to indicate that General Dynamics rather than the government may have been primarily responsible for the disputed cost overruns. In addition, having completed their analysis of the $544 million claim, members of the Navy Claims Settlement Board indicated to the staff that the Board had been able to substantiate less than 20% of the claim. The staff also learned that General Dynamics' allegation that some 35,000 drawing revisions (revisions to the design of the submarines) had caused a substantial delay in the completion of these contracts may have been misleading. The Electric Boat Division in response to Navy inquiries had stated that only 2,384 of the 35,000 drawing revisions had a direct cost impact, and the Navy indicated that of these 2,384 changes, only 77 were likely to result in costs above $20,000.

Did not someone at the Commission responsible for the 1982 quashing, and even now as the Commission was developing its Statement for presentation to your Committee recognize the invidious distinction between the footnote disclosures and the full facts? If, then, the Commission were to respond to me by asserting that the auditors completed their rounds in March, 1978, whereas the facts were developed a month later, I would reject that argument out-of-hand, as a banal absurdity.

"Teaching Grandma How to Suck Eggs":

I have no doubt but that emblazoned over the entrance to the offices of the Enforcement Division of the Securities and Exchange Commission is a copy of the Commission's anti-fraud rule, its Rule 10b-5. That pronouncement reads in part as follows:

> Employment of Manipulative and Deceptive Devices: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) . . .

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) . . .

I maintain that the errors of omission and commission noted by the 1978 staff of the Enforcement Division and those noted by me present a prima facie case of Rule 10b-5 violations by General Dynamics and its independent auditors; to the extent that the 1982 staff of the Enforcement Division and others ignore or gloss over these aberrations, I would judge them to be in pari delicto.

The Nuclear Conceptual Issue:

Throughout the SEC's defense of the quashing of its General Dynamics investigation, the Commission has manifested an obsession with FASB Statement 5, and especially paragraph 8 thereof, which reads:

> An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both the following conditions are met:
>
> a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implcit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of loss can be reasonably estimated.

The SEC's opting for the foregoing accounting precept is remindful of the drunk who lost his keys in the middle of the block, but went looking for them at the corner where the light was better. The "nuclear conceptual precept" is not in the foregoing but lies instead in that stated by the Commission in its

Statement at page 3, to wit: "The Commission requires financial statements filed with it to be in conformity with GAAP. Generally accepted accounting principles permit defense and other long-term contractors to recognize claims as revenues and assets to the extent that such amounts are susceptible to reasonable estimation and realization is probable . . . ." [emphasis supplied]

So it is that contrary to the presumption implicit in the SEC's 1982 determination, the burden of proof is not on the Commission, the Congress nor myself to demonstrate that a loss was probable for 1976 and/or 1977; instead, the burden of proof was and is with the company and its auditors to demonstrate that the claims, etc., had become sufficiently substantive so as to be capable of being recognized as revenues and assets. So it is that the company and its auditors should have been constrained to demonstrate that:

a. The claims as of the close of 1976 and 1977 were realizable to the extent of at least $380 million and $840 million for the two years respectively, and

b. The amounts were sufficiently palpable so as to be capable of being recognized as revenues and assets.

c. And only then, could these amounts be properly included in the revenues when reckoning the revenue/cost calculus on the 688 contracts.

There is no evidence discerned by me to demonstrate that they had ever been asked to meet that burden. This takes us to Arthur Anderson to demonstrate that it had completed its 1976 and 1977 audits in accordance with generally accepted auditing standards.

The Auditing Standard Issue:

The SEC Statement (p. 2) alludes to the Industry Audit Guides, Audits of Government Contractors to point up the developments in the accountings by such

enterprises. My review of the publication (both, the 1975 and 1983 issues) discloses but a single segment as being especially relevant to the issue at hand, thus, from Chapter 5, "Government Contracting Audit Consideration," regarding Claims Receivable:

> Claims receivable, other than those arising from contract terminations, usually arise from unilateral contract changes by the government (see Change Orders in this chapter) or disputes. An evaluation of the likelihood of settlement under terms which will result in collection of the recorded amount can sometimes be accomplished by review of the contract terms and documentation of the claim and by discussion of the basis for the claim with knowledgeable contractor personnel and legal counsel.
>
> Often claims are settled only after prosecuting through the Armed Services Board of Contract Appeals or the Court of Claims. Many of these claims are not recognized in the contractor's accounting record until settled. Disclosure of the existence of any material claims should be made in the financial statements (including the notes thereto). If collectibility of material claims is uncertain, the independent auditor may decide to modify his opinion.

In my view, this segment is so equivocal as to stand for anything or nothing at all. What was, however, especially relevent is the introductory paragraph to the chapter: "Generally accepted auditing standards are applicable in the examination of financial statements of companies which are government contractors. This chapter deals primarily with auditing procedures peculiar to government contracts."

So it is that the segment regarding the audit of claims must be subsumed in the pervasive auditing standards, hence:

General Standards:

1. Technical training and proficiency
2. Independence
3. Due professional care

Standards of Field Work:

4. Adequate planning and supervision
5. Study of system of Internal Control
6. "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion . . ."

Standards of Reporting:

7. Statement re conformity with GAAP
8. Consistency
9. Informative disclosures
10. Expression of opinion or denial of opinion

In my statement submitted in response to the Committee's invitation, as well as during the course of my testimony at the Hearings, I questioned the auditor's lack of objectivity and inadequate professional skepticism in their 1976 and 1977 audits; I thereby questioned their independence. I now turn to my questioning the firm's fulfillment of the Third Standard of Reporting, i.e., item number 6, in the foregoing roster.

Section 330* of the Statement of Auditing Standards "Evidential Matter," is of central import here; accordingly, I have included it in this presentation as Attachment 3.

I have not seen any evidence demonstrating that Arthur Anderson manifested due diligence to obtain the "evidential matter" required to permit the claims, etc. to be recognized as revenues and assets. Instead, a clear and compelling indication that Arthur Andersen preferred to remain blissfully ignorant of what a meaningful probing for independent evidential matter might disclose, is contained in the following section of a January 6, 1977, memorandum from the firm's files:

---

* Section 330 was redesignated Section 326 in 1980, at which time additional material was inserted. Inasmuch as we are here dealing with the years of 1976 and 1977 and the 1980 changes appear to be neutral for present purposes, the pre-1980 version is included herein as the attachment.

> Gorden briefly outlined the current status of progress on the boat, the estimate of completion, the history of this claim, including the prior settlement, Congressional testimony of Deputy Defense Secretary Clements, the escalation issue, etc. Gorden pointed out additional work we could do such as testing the estimate of completion, familiarizing ourselves with the testimony and reviewing and testing the claim by our personnel and by discussion with Sellers, Conner & Cuneo. We indicated that we were pursuing all of these matters and were pretty well up-to-date on all of those and would complete that work next week sometime. Bill Weldon offered to meet with Navy officials at an appropriate level so that we could have some outside verification of the validity of the claim. The concensus of the meeting including that of Gorden's was that nothing would be gained by direct meetings with the Navy.

How did the 1981-1982 Enforcement Division staff respond to these responsibilities vested in the independent auditors? For example, at page 16 of the Sampson/Lynch Statement, "The staff did not discover evidence to disprove the propriety of the conclusion made at that time." This view was repeated at the Hearings (Tr. p. 41, p. 70 ff.).

In short -- managements and auditors should not be judged by the extent to which they are capable of "Hearing no evil, Seeing no evil, and Speaking no evil"; they are paid most handsomely for ferreting out and disclosing all that is relevant for critical judgment calls by the users of the financial statements -- all, of course, consistent with the highest standards of the prevailing state of the art.

A Foreboding for the SEC:

Let the Commission be forewarned: To the extent to which it persists in the position it has taken regarding the 1976/1977 General Dynamics accountings it will find that it has opened a Pandora's Box.

The SEC Enforcement Division will regularly find that it will be confronted with an SFAS 5 rejoinder whenever a registrant has failed to provide for loan-loss, bad-debt, and/or insurance reserves. Corresponding rebuttals will come when the Division alleges a failure to take appropriate

write-downs on inventories, investments, intangibles, plant and equipment (even when abandoned). In each and every such case an effective response can be: "Granted that a loss was probable, possibly even inexorable, nonetheless, because we could not reasonably quantify the potential loss, no such loss was booked."

So it is that disclosure footnotes will proliferate and become even more expansive. Such a development would, in my view, be inimical to the reporting process; it would shift an important aspect of responsibility for critical judgment calls from the preparers of financial statements to the users thereof. This development would seriously detract from the understandability of the statements.

I sincerely and respectfully urge the Chief Accountant of the Commission to reconsider what has been done and said in this General Dynamics matter and to make clear that while all contingencies are fraught with uncertainty, all uncertainties are not contingencies to be subsumed in FASB Statement 5. As I noted in my testimony (p. 17) the 1985 Arthur Andersen & Co. monograph, Objectives of Financial Statements makes this point most concisely; accordingly I have included, as Attachment 4, the relevant page 71 from that publication.

ATTACHMENT 1A

Plus ça change, plus c'est la même chose

Statement by
Abraham J. Briloff, Ph.D., CPA
Emanuel Saxe Distinguished Professor of Accountancy
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Before
The Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
United States House of Representatives
Washington, D.C.
February 20, 1985

Gathering and Reporting System ("EDGAR"). Aside from patent conflicts of interest inherent in this undertaking, the signal which the Commission is sending forth is that it is entirely oblivious of AA's systems failures, or in any event exculpates the firm.

11. The SEC -- Is Big Brother Watching?

An August 10, 1982, Wall Street Journal article noted, "After years of badgering accountants to tighten audit procedures, the SEC is backing off and increasingly letting the profession police itself."

That this criticism was patently fair can be demonstrated by the fact that from February, 1981 through December, 1982, the incumbent Administration promulgated but two releases identifiable as disciplining members of the accounting profession -- and one of them, dated February 26, 1981, was probably so far advanced in the enforcement pipeline that it was still of the ancien régime.

But the SEC was not entirely idle during this extended period. Instead, we saw it quashing pending investigations of Citicorp and General Dynamics and, especially felicitous for the profession, as noted previously, it aborted ASRs 250 and 264 -- promulgations which called for some constraints on the auditors' compromising love affair with management advisory and other services.

The Citicorp affair was probed in depth by your Committee during the Fall of 1982. The matter of the 250/264 rescissions was described in the aforementioned Wall Street Journal article, and discussed previously in this statement.

The Commission's disciplinary pace did accelerate somewhat during 1983 when we find so-called Accounting and Auditing Enforcement Releases; it then intensified during 1984 -- with much fanfare devoted to the Commission's new

vigor. In fact, during 1984, there were no fewer than 27 such releases.

I have catalogued the 1983/84 releases into two categories, i.e., those which involved exclusively the so-called registrants or their officers, and those where the ostensibly independent auditors were cited as respondents, with the following results:

1983 Promulgations:

A. Involving the Registrant Corporations and Officers:

Release No.	Registrant(s)	Identity of Auditor	Auditor Identified in Release?
4	Clabir Corp.	Arthur Young	Yes
10	Aetna Life & Casualty Insurance Co.	Peat, Marwick, Mitchell & Co.	No
11	Hamilton Bancshares	Richard A. Chepul (C.P.A., VP/Secretary-Treasurer)	N/A
14	Southeastern S&L Co., Scottish S&L Co.	A.M. Pullen & Co.	Yes

B. Involving the Independent Auditors:

Release No.	Respondent(s)	Firm	Registrant
5	Joseph S. Amundsen	N/A	Olympic Gas & Oil Inc.
7, 8	Victor L. Verett, John A. Fulena, Jr.	Smith, Verett & Parker; Carbis Walker & Assoc.	Int'l Royalty, Black Giant, Golden Triangle
9	Fox & Co.	Fox & Co.	Saxon, Alpex Computer, Flight Transportation
12	George L. Simmon, Jerome R. Horwitz	Coopers & Lybrand	Security America Corp.
13	Stanley I. Goldberg	Touche Ross	J.B. Hanauer & Co.
15	Bruce R. Ashton	N/A	Consolidated Publishing, Inc.
16	Touche Ross	Touche Ross	Litton Industries, Gelco Corp.
17	Herman L. Fried	H.L. Fried & Co., P.C.	Channel Industries, Ltd.
18	Murphy, Hauser, O'Connor & Quinn	Murphy, Hauser, O'Connor & Quinn	Mr. Discount Stockbrokers
19	Robert E. Schulman	N/A	Quality Care

1984 Promulgations:

A. Involving the Registrant Corporations and Officers:

Release No.	Registrant	Identity of Auditor	Auditor Identified in Release?
22,33	U.S. Surgical	Ernst & Whinney	No
23	IntraWest Financial	Deloitte Haskins & Sells	No
24	Utica Bankshares	Coopers & Lybrand	No
26	PRO-MATION Inc.		No
28	Seaboard Assoc.	Main, LaFrentz & Co.	No
31	Datapoint	Peat, Marwick, Mitchell & Co.	No
34	Digilog	Coopers & Lybrand	(See Release 45)
35	Stauffer Chemical	Deloitte Haskins & Sells	No
37	First Nat. Bank of Midland		N/A
40	Chronar Corp.	Seidman & Seidman	No
41	Tandem Computers, Inc.	Arthur Anderson	No
43	Terence E. Dreiling	(See Release 42)	
44	Florafax, et al.	Arthur Anderson	No
47	Peter P. Dhawan (Re BTK Industries)		
48	(1.10.85)	Peat, Marwick	No

B. Involving the Independent Auditors:

Release No.	Respondent(s)	Firm	Registrant
20, 21	James E. Etue, Stuart C. Wardlaw	Etue, Wardlaw & Co.	A.T. Bliss
27	James H. Feldhake, et al.	Fox & Co.	Alpex Computer
29	Willie L. Mayo	Mayo & Assoc.,P.C.	Organized Producing Energy Corp.
30	Thomas H. Wilson, et al.	Goodman & Goodman	Doughtie's Foods Inc.
32	Stephen O. Wade, et al.	A.M. Pullen & Co.	(re Release 14)
36	Frederick S. Todman & Co.	Frederick S. Todman & Co.	Bell & Beckwith
38, 39	Smith & Stephens Accountancy Corp.	Smith & Stephens Accountancy Corp.	Corda Diversified Technologies
42	William M. Hoben & Robert A. Savage		Oil Tech Inc.
45	Coopers & Lybrand & M. Bruce Cohen	Coopers & Lybrand	Digilog
46	Hans V. Anderson, Jr. et al		Great American Financial Inc.

N.B. Releases No. 6 and 25 were essentially administrative and non-substantive.

A. The SEC's Double Standard:

A number of inferences may be drawn from a study of the foregoing rosters, and the underlying Releases, including:

1. There are some glaring omissions. For example, where are Baldwin United, Penn Square, Continental Illinois, Frigitemp, General Dynamics, Lockheed -- some matters of but recent vintage?

2. More serious even is the double standard in the punishments meted out against the various respondents.

Thus, individuals identified as sole, or local, practitioners are regularly penalized by being barred from practice before the Commission for extended periods, whereas the few major firms which are brought to book are generally merely enjoined from committing the same act, in the same place, in the same time, and in the same way. And my subsequent discourse on Release No. 16 will demonstrate, even this most limited punishment might not prove operative.

3. Given these demonstrated failures in auditing competence and judgment calls by accounting firms which are members of the SEC Practice Section of the AICPA Division for Firms, and which, as a consequence received A-OK reports from the Peer Review teams, how can the Commission continue to have confidence in the profession's self-regulatory apparatus? Has the SEC ever deemed it appropriate to inquire into the competence of the PR team which gave "clean opinions" to a reviewed firm which was then found grievously deficient? It might turn out that incompetent peers were being reviewed by peers, in the literal sense of the word.

4. And this to me is the most disturbing inference. I have taken careful note of the facts and conclusions set down in Release Nos. 10 and 48 (involving Aetna Life and Charter Corp., respectively). There is no question

but that GAAP precluded the accounting practices complained of by the SEC, thereby requiring the companies to restate their previously promulgated financial statements.

However, in neither instance did the SEC deem it appropriate to proceed against Peat, Marwick -- the independent auditor for each of these registrants -- in fact, the Accounting and Auditing Enforcement Releases do not even refer to the firm.

Mind you, neither of these cases involved exaggerated inventories, overstated receivables or revenues -- situations where the auditors may have been cuckolded. Instead, each involved a judgment call by someone undoubtedly high in the firm hierarchy to permit an accounting precept which he knew, or should have known, was wrong.

As noted in my commentary at point 3, should not Arthur Young & Co., as Peat, Marwick's review, be asked regarding the appropriateness of its PR? Should not the POB's SIC be asked as to what it has done, and/or proposes to do, regarding this (and corresponding) situation?

Given this record should the Enforcement Division's Chief Accountant have considered it appropriate recently to return to Peat Marwick -- the very firm whence he came? There is nothing illegal nor unethical in his "revolving door" action -- it is just that I consider it inappropriate with the high, sensitive office which he occupied.

B. Some Specific Misgivings:

Re Release No. 16: On November 14, 1983, the Commission promulgated a most remarkable Accounting and Auditing Enforcement Release No. 16. No, the substance of that release was not what made it remarkable; it was because the SEC again roused itself to censure an accounting firm identified with the

Accounting Establishment. This promulgation was directed against Touche Ross for its alleged failure to comply with GAAP and GAAS in its audits of Litton Industries, Inc. over a span of years from 1972 to 1978, and of Gelco Corporation for its 1978 fiscal year. Before proceeding, it must be noted that the Administrative Proceeding against the firm was terminated concurrently with the promulgation by Touche Ross's entering its consent "without admitting or denying" the allegations. In fact the firm submitted a statement seriously downplaying the Commission's assertions of fact in the Litton matter.

Insofar as the Litton brouhaha is concerned, the complaint was that the company was permitted to defer some $200 million in cost overruns on shipbuilding contracts long after a "healthy skepticism" should have compelled the auditors to strip them from the balance sheets.

Regarding Gelco, I am confident that the Commission would agree that Chapter 7 ("Fiddlers on the Road") of my The Truth About Corporate Accounting described the company's (and auditor's) gamesmanship in more intimate and intriguing detail than did this SEC release. The audit failure in that context was that the firm knowingly permitted its client to "front-end load" substantial amounts of income by improperly classifying substantial amounts of discounts on truck purchases as allowances on the disposition of used trucks.

What is there in this Accounting and Auditing Enforcement Release No. 16 with which I take umbrage?

First, and this is for me an old lament, it ends with the Scotch verdict, an amorphous "without admitting or denying."

Second: However carefully you might scrutinize this document you will not find any reference whatsoever to Accounting Series Releases NOs. 153 and 153A, both directed against Touche Ross; both also terminated by the amorphous

consents. The former related to the alleged audit failures at US Financial; the latter to the firm's aberrations in its Ampex and Giant Stores audits.

Given this background should Touche Ross, as a "three-time loser," have been permitted to slide through without anything more than the November 14, 1983, release? If it were Sam Smith or John Jones who was similarly involved would he have had the pull to get off so lightly?

Third, and this too is not especially unique to this release: Note that the respondent in this Administrative Proceeding is Touche Ross & Co.; I submit that it was not the disembodied firm which perpetrated the sins of commission and omission alleged by the SEC. If a Mr. Touche or a Mr. Ross was involved it would have been nought but a coincidence. Particular persons perpetrated these acts; I see no reason why individual guilt should somehow be shrouded by the firm's cloak. After all, in our fluid society persons move from the major accounting firms to important positions in government, industry and academe. To the extent such persons may have the Litton or Gelco skeletons in their closets we ought to know about them, so that we can judge the character and the quality of those who aspire to positions in the public realm.

Further, who knows which of the closeted miscreants sit on the major committees, trial boards, and the like of the professions' organizations?

Significantly, a footnote in the SEC release alludes to this condition, thus:

> As used in this document, Touche refers to the firm as a whole, including the engagement partner, other partners in the practice office, and partners from Touche's national staff, all of whom were involved in many of the matters described herein.

If the respondent in a particular proceeding were Arthur Allen or Barney Blake would he be permitted to enjoy a corresponding anonymity? Why should

our Big League Brethren be afforded that dispensation?

Re Release 45:

I now turn to the Commission's November 21, 1984 Accounting and Auditing Enforcement Release Number 45, in the Matter of Coopers & Lybrand and M. Bruce Cohen, CPA. According to the Release, the SEC terminated a so-called 2(e) investigative proceeding initiated against the respondents on July 5, 1984, growing out of their responsibility for the 1981 and 1982 financial statements of Digilog, Inc. ("Digilog").

The background facts are relatively simple. Thus, the corporation is a manufacturer of electronic equipment, especially microcomputers. Because of a change in marketing strategy Digilog found it desirable to embark on a major, costly sales endeavor in the U.S. and abroad.

In order to avoid having these substantially increased marketing costs impact adversely on Digilog's income statements, the company's management conceived of a scheme of funneling these costs through a newly-created entity, DBS, International ("DBS"). This new entity was essentially a "shell" owned entirely by a "marketing man." The resources required by DBS were to be provided entirely by Digilog and/or by bank loans extended on the basis of Digilog's guarantees. In return, Digilog was given notes entitling it to convert its stake into a 90 percent stock interest in DBS. In addition the two entities entered into a "marketing agreement" which so tightly controlled the activities of DBS that it is hardly likely that this newly-spawned enterprise could make a local telephone call without Digilog's anticipatory approval.

There was a condition precedent to the implementation of the scheme; it required Coopers & Lybrand's declaratory judgment that the activities of DBS

would not be consolidated with, or otherwise integrated into, those of Digilog. In short, for the scheme to work Coopers & Lybrand was called upon to assure Digilog that the inexorable losses of DBS in the near term would not impact inimically on Digilog's financial statements.

M. Bruce Cohen, CPA, the engagement partner, duly anointed the deal -- and thereafter his firm gave Digilog "clean certificates" oblivious of the DBS losses amounting to $460,000 and $1.2 million for the fiscal years 1981 and 1982 respectively.

Any accountant with even a modicum of commitment to the profession's "substance over form" doctrine would have rejected this best laid plan out of hand. Any accountant whose memory goes back to 1970 would have recognized this ploy as nothing more than an instant replay of the Memorex - ILS scheme which was shot down by the SEC.

But not so with M. Bruce Cohen, CPA, of C & L. Instead, as the July 5 release initiating the 2(e) proceeding informed us:

> Coopers Approves the Digilog - DBS Agreements: Coopers' Philadelphia office has a committee known as the "technical committee." The function of the technical committee is to, among other things, review certain accounting or auditing issues which may arise during an engagement. The technical committee in Coopers' Philadelphia office resolves such issues for the Philadelphia region.
>
> Mr. Cohen consulted with members of the technical committee on an individual basis prior to the execution of the transaction. Generally Mr. Cohen discussed the question of whether the "convertible notes" would require Digilog to consolidate the results of DBS' operations on its financial statements with each Coopers' partner consulted. Each Coopers' partner consulted noted that the "convertible notes" would not require consolidation. No Coopers' partner consulted by Mr. Cohen demanded an accounting treatment different for that transaction other than that ultimately employed in Digilog's fiscal 1981 and 1982 financial statements. Nor did any partner consulted demand additional disclosures. Mr. Cohen placed a memorandum in the work papers outlining the Digilog - DBS relation and the proposed accounting treatment.

A meeting of the technical committee may generally be convened as necessary. In advance of the meeting the engagement partner typically provides each member of the committee with a written memorandum reviewing the pertinent facts and noting the issue under consideration. This memorandum provides the committee members with an opportunity to conduct necessary research and consider the issue. If the technical committee is unable to resolve the issue, a consulting partner in Coopers' national office in New York City is contacted.

No meeting of the technical committee was convened to determine accounting issues raised by the Digilog -- DBS transaction prior to the issuance of Digilog's 1981 or 1982 financial statements. No pre-meeting memorandum was prepared. Coopers' national office was not consulted.

Coopers advised Digilog that consolidation of the results of DBS' operations would not be required on Digilog's financial statements.

And now I assert that the SEC violated its own 10(b)-5 standard when it promulgated its November "Opinion and Order"; it there omitted certain facts required to make the statements true and complete. This is the way Coopers went about dispensing dispensation, according to the November document:

Coopers reviews the transaction: Respondents met with Digilog and DBS' chief executive officer, reviewed accounting literature, discussed the proposed transaction, consulted with partners who were not otherwise involved in the audit engagement, including members of the Technical Committee -- a committee at Coopers' Philadelphia regional office which often resolves difficult auditing and accounting issues -- and concluded and orally informed Digilog and DBS, both prior to and after the consummation of the transaction, that their financial statements need not be consolidated. With each Coopers' partner consulted Mr. Cohen discussed at least the question of whether the convertible notes would require Digilog to consolidate the results of DBS' operations with Digilog's. Each Coopers' partner consulted opined that consolidation was not required. No partner consulted demanded an accounting treatment different from that ultimately employed in Digilog's fiscal 1981 and 1982 financial statements. Nor did any partner demand additional disclosures. Respondents also considered the possibility of equity accounting and concluded that equity accounting would be inappropriate.

> No meeting of the Technical Committee was convened to determine accounting issues raised by the Digilog-DBS transaction prior to the consummation of the transaction or the issuance of Coopers' unqualified report on Digilog's 1981 and 1982 financial statements. Coopers' national office was not consulted.

Note the invidious distinction between the two recitals. Where are the restatements of facts demonstrating unequivocally that Cohen had violated the procedures for quality control ordained by his firm? And who are the unnamed colleagues of M. Bruce Cohen, CPA, who correspondingly took leave of their firm's precepts and possibly also of those presumed for critical judgment calls by responsible professionals?

But now, how did that cause célèbre end? As noted, the 2(e) proceeding was aborted just prior to the convening of hearings by the Administrative Judge. And to what did Coopers agree? From the Commission's Opinion and Order:

> Respondents have submitted a "Consent and Settlement" solely for the purpose of this proceeding and any other proceeding brought by the Commission acknowledging that this "Opinion and Order" will be entered. That "Consent and Settlement" has been entered into with the understanding that this "Opinion and Order" is issued to settle this proceeding, is not a report of the Commission pursuant to its statutory authority and is not a record, report, statement, or data compilation within the meaning of Rule 803(8) of the Federal Rules of Evidence, with the exception of the findings in Part III (a) and (b) of this "Opinion and Order."

Now for the III a and b:

ORDER

Based on the foregoing the Commission finds:

a. That Digilog's financial statements for its fiscal years ended September 30, 1981 and 1982 were not consolidated with those of DBS, nor did they set out the results of DBS' operations; and

b. That Digilog's financial statements for its fiscal years ended September 30, 1981 and 1982 did not

provide for loss contingencies for the DBS loans and guarantees.

Little wonder that, as reported by the Wall Street Journal for November 30, Coopers & Lybrand's lawyer referred to this as a "walk-away" deal. He is right, the awesome Securities and Exchange Commission was given nothing more than the privilege of hyperventilating, of going into an elaborate catharsis on the substance vs. form theme -- as though there was a need for another such discourse.

But then we have the bold statement from SEC's Special Counsel, Thomas Gorman, to wit (as reported by the Wall Street Journal): "The Commission is making it clear it won't tolerate the use of this kind of loss-shifting device." My response to Mr. Gorman is, most respectfully, "humbug."

There is another facet to this Digilog - C & L - Cohen saga which demands some attention -- it relates to the pervasive question of auditor independence. Note that Digilog's management made the implementation of the DBS scheme contingent on Mr. Cohen's prior concurrence in the accounting treatment. Given such anticipatory dispensation it is hardly conceivable that C & L could challenge the accounting when they return for the audit ritual.

Once again, my colleagues in practice are not adequately sensitized to the various ways and circumstances by which they are drawn beyond the "point of no return" in their critical judgment calls. To the extent to which we consider ourselves relatively free to wheel and deal in the areas of taxation and managerial decision-making we jeopardize the objectivity and integrity of the independent audit responsibility.

ATTACHMENT 1B

The Accounting Profession Under Siege
Again or Still?

An Address
By Abraham J. Briloff, Ph.D., CPA
Emanuel Saxe Distinguished Professor of Accountancy
The Bernard M. Baruch College, City University of New York

June 12, 1985 Draft
Subject to Editorial and Substantive Changes

Before
The Michigan Association of CPAs
Grand Rapids, June 20, 1985

The Accounting Profession Under Siege
Again or Still?

Introduction

I am indeed pleased to have another opportunity to address an accounting symposium in Grand Rapids; this time to address you under the title theme: The Accounting Profession Under Siege: Again or Still? The substantive earlier for prior occasion was on Halloween, 1975, when, as it happened, the title theme might well have been The City of New York Under Siege. It was a time when the occupant of the White House was engaged in the denigration of the City; and as it happens the present occupant is putting that city, among a number of other cities and states under siege.

I remember that earlier occasion well. It was a Friday evening; I recall prefacing my remarks by a reading from Genesis. The reading told of Abraham's colloquy with God in the hope of saving Sodom. The city would be saved, we were told, if even a handful of good residents could be found. I noted that New York then, and now, had untold numbers of such good persons, and should not be told to "drop dead."

By the same token our profession has untold numbers of good persons, performing good deeds in behalf of their clients and society generally -- and accordingly should be saved, for its own sake, and that of society. And if you will forgive a presumptuous observation, just as the Old Testament Prophets discerned, and inveighed against the evils in the temples of the high priests, so do I, all too frequently discern perversity among the hierarchy in the Accounting Establishment.

So it is that the accounting profession is under siege. Whether it be again or still does not really matter; what does matter, in my view, is that it is rightly being challenged -- and unless we develop an effective and

meaningful response our professional stature and status are seriously vulnerable. In the "fleshing out" of this polemic I will use as my frame of reference my February 20 presentation to the Subcommittee on Oversight and Investigations of the House of Representatives' Committee on Energy and Commerce, i.e., the Dingell Committee.

You have been provided with the Table of Contents of the statement which I submitted in connection with my testimony; I shall identify the particular area to which my remarks this morning may relate.

The Auditor Responsibilities and His Certificate:

First, topics numbered 2 and 3, "The Independent Audit -- Sacred or Profane?" and "The Auditor's Certificate -- Hallmark or Nostrum?" respectively, are especially relevant to the title theme regarding our profession under siege. Thus, we ourselves do not really know for what we are responsible, and to whom. And possibly of transcendent import, neither does society.

Thus, under "topic 2" I juxtaposed the inspired encomium for our profession from Chief Justice Burger in his U.S. v. Arthur Young & Co. (____ U.S. _____, March 21, 1984) opinion, with the far more pragmatic views of John C. "Sandy" Burton (City Business, November 1, 1984). Note the invidious distinction:

From the Chief Justice:

> Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public. In an effort to control the accuracy of the financial data available to investors in the securities markets the Securities and Exchange Commission regulations stipulate that financial reports must be audited by an independent certified public accountant.

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

The SEC requires the filing of audited financial statements thereby encouraging public investment in the nation's industries. It is not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. [The auditor is not] an advocate for the client. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.

From the Dean Burton Interview:

Burton sees such mergers as inevitably arising from the changed economics of the accounting profession over the past 10 years. Traditionally, Burton says, accounting firms got their leverage by sending hordes of junior accountants into a company for the audit function, then charging more for these people's services than it paid them in salaries. The difference was rationalized by the financial advice the client could presumably ask for at any time from the accounting firm's senior partners.

Technology has changed all that, Burton says. Today, a large company's computers have all the audit information stored inside them. All an auditor has to do is walk over to the client's office and push some buttons. No more need for the swarms of juniors. No more need to rationalize high audit profit as payment for financial advice, which a big company can get elsewhere or procure internally. All many clients want today, in fact, is simply an accounting firm's stamp of approval. More low-bidding competition. So, no more leverage, and smaller auditing profits. "In short," Burton says, "the audit function has become a commodity."

As a result, the accounting firms have pushed hard on the more profitable business of providing tax advice and management consulting. "Every time the tax law is 'simplified,' it gets more complex and you need more professionals," Burton says . . .

As for management consulting, the accounting firms can be particularly valuable in providing information technology. Here, and in tax advice, too, the clients can more clearly see

what the accountants do for them, and are more willing to pay high fees.

So this is where the growth in accounting profit is, not in auditing.

So it is that while society generally, as exemplified by the Chief Justice, holds the audit to be the diadem in our profession's tiara, who we know to be a Sandy Burton, a devoted friend and colleague identifies that function as a commodity -- as something of a loss leader to the more lucrative pursuits of management and tax consultative and advisory services.

So it is with the auditor's certificate. While we indulge the public into fantasizing that it reflects our having "fought the figures and found the facts" (to use the phraseology of the late Colonel Robert Montgomery, a founder of Coopers & Lybrand) we know it means a great deal less. And then we lament the fact that those who may have relied on the prevailing myth sue us when they find that we did not really mean what we know they presumed. In short, we resent the fact that we were found out perpetrating a hoax.

The MAS/Independence Controversy:

Proceeding to item 5 in the Table of Contents, as Dean Burton observed, the major thrust from our colleagues is in the area of Management Advisory and Consultative Services. As we here are fully aware, this dimension of our professional pursuit can embrace anything for which the client is willing to pay. For present purposes I will not pursue the question as to whether, and under what circumstances, and to what extent these services compromise the auditor's independence where they are being rendered concurrently with the presumptively independent audit. Instead, I want to point to our arrogance in asserting that we can feel free to indulge in any and all areas of

consultation and advising and not be constrained to make known to the outside world fully and overtly all that we are doing -- so that the world of users of the financial statements might judge. This is the inference to be drawn from the fact that we exerted all the pressures vested in the profession's Establishment to abort the SEC's Accounting Series Releases 250 and 264.

I defy you to identify any other professional pursuit charged with a third party responsibility which has manifested a corresponding arrogance of power. Would we afford a corresponding clandestine situation for our legislators, judges, journalists, scientists, umpires, referrees, et al.? Why should we arrograte such a privilege for ourselves?

The Chief Justice has made clear that the independent auditor must not only be independent -- he must also be perceived as being independent.

The profession's heirarchy, in their testimony before the Dingell Committee and elsewhere, ignore the Chief Justice's dictum, and challenge the critics to point to the cases of "in fact" contamination of independence. Despite my catalogue of cases, they proceed with the litany regarding the absence of such cases. So let us try once more; to wit:

The Drysdale Debacle:

In my view such a case of actual contamination is presented by the circumstances set forth in Manufacturers Hanover Trust Company v. Arthur Andersen & Co., 82 Civ. 6622, USDC, SDNY.

By way of background, until 1978 Arthur Andersen & Co. ("AA") had been the auditors for Drysdale Securities, a securities dealer subject to regulation and audit by the New York Stock Exchange ("NYSE"). After receiving qualified reports from AA, Drysdale turned to Richard A. Eisner & Co. for the periodic audits; nonetheless, Warren Essner, the AA partner, maintained an ongoing

friendship with the Drysdale principals.

In late 1981 the latter turned to the AA partner for special consulting services; they wanted to get their principal business, the trading in government securities, out from under the NYSE's scrutiny. Whereupon Mr. Essner undertook discussions with the Exchange leading to a plan for a spin off of the government securities business to a newly-created Drysdale Government Securities entity ("DGS"), thereby "liberating" those operations from the NYSE. This divestiture was to be implemented as of February 1, 1982.

At the outset no invidious inference should be drawn from this deregulatory endeavor -- after all, there is a cost implicit in any regulatory process (including, for example, the accounting profession's peer review). So it is that I am not here questioning Mr. Essner's important services to Drysdale as of that "point in time." But he went beyond that critical point -- and this is where the "in fact contamination," and the lawsuit begin.

Thus, DGS required some statement with which to launch its activities -- a statement which was to go forth to the banks involved in DGS's "repos" and "reverse repos" activities. Mr. Essner realized AA could not opine regarding DGS nor Drysdale Securities from which the former was "cloned" -- after all, the firm had not audited the enterprise for a number of years, and the latest certified statements were as of the preceding May 31. Whereupon a most remarkable tour de force was conceived by Mr. Essner -- he would develop a statement setting forth a single DGS element, i.e., its Equity (consisting principally of subordinated debt, and some preferred stock, aggregating $20 million). The AA opinion was then presumed to be governed by Statement of Auditing Standards No. 14 "Special Reports," December 1976 ("SAS 14"), especially the section beginning with paragraph 9, captioned "Reports on Specified Elements, Accounts, or Items of a Financial Statement." Just how a

responsible certified public accountant could conceive of a certification of the Equity element of the fundamental accounting equation essentially oblivious of the Assets and Liabilities which equate to that Equity is boggling to my mind. It is noteworthy that AA's accounting expert, an erstwhile AICPA Vice President - Auditing, a principal architect of the "Report of the Commission on Auditors' Responsibilities," and now a distinguished academic, fully concurred in the AA procedure.

Be that as it may, the concentration on the Equity element permitted AA to avoid an audit of the government securities position stepped down to DGS as of the moment it was created. According to testimony at the trial instead of a net positive position of $5 million for that securities position (for which the preferred stock was issued) there was an actual deficiency amounting to almost $200 million. On that basis the jury found against Arthur Andersen & Co. on March 22.

There are numerous indications leading to an impeachment of the auditor's independence in this case -- producing personal and professional tragedy for Mr. Essner, and an enormous cost for his firm.

First, what could have caused AA to assume any responsibility for the DGS accounting as of the moment of its creation without first at least consulting with, and working in tandem with, Drysdale's regular auditors?

Second, how could any responsible auditor proceed to account for the stepping down of the principal operating segment of an ongoing business without presenting the historical and pro-forma statements? This would, of course, have required an examination of Drysdale Securities balance sheet as of January 31, 1982 -- a procedure which would presumably have disclosed the state of disarray in the entity's accounting records, even if it may not have disclosed the ongoing monstrous fraud then being perpetrated by the Drysdale

principals.

But what is of central import in this MAS - Independence context is that DGS needed some statement to make AA's special consulting proposals operative -- whereupon AA agreed to "go along."

In sum, while the negotiations with the New York Stock Exchange and the development of the spin-off scheme may have been entirely proper, as a service to help management accomplish a particular objective, AA "fouled its nest" when it proceeded to provide the requisite independent opinion to legitimitize the newly-spawned DGS. What appears to have been overlooked by AA and its expert witness was that the critical SAS 14 section begins, "An independent auditor may be requested to report on one or more specified elements . . ." (emphasis supplied). So it is that while Mr. Essner may have been "requested" to provide the report, he was under no compulsion to do so; given his role in the creation of DGS it was a "request" he should have refused.

The DBS and C&L Saga:

And then we have the saga set forth by the SEC in its Accounting and Auditing Enforcement Release No. 45 (November 1984) describing the important role played by M. Bruce Cohen and Coopers & Lybrand in the shaping of a critical transaction contemplated by its Digilog Inc. client. The objective of the scheme was to permit certain material prospective losses to bypass the corporation's income statement; then, came time for the audit C&L (and M. Bruce Cohen, the engagement partner) went along with the ploy -- producing accountings, as the SEC and I see it, which did violence to GAAP.

The "Forces of Destiny" -- Briloff vs. the SEC:

As is evident from your program the "forces of destiny" have conspired to

join me with my friend Robert J. Sack for presentations before this symposium. He appears before us today as the Chief Accountant of the Enforcement Division of the Securities and Exchange Commission. Accordingly, it behooves me to move to item marked 11 in the Table of Contents, i.e., "Is Big Brother Watching?" And especially, to the SEC's Double Standard.

My statement submitted to the Committee included the following:

> An August 10, 1982, Wall Street Journal article noted, "After years of badgering accountants to tighten audit procedures, the SEC is backing off and increasingly letting the profession police itself."
>
> That this criticism was patently fair can be demonstrated by the fact that from February, 1981 through December, 1982, the incumbent Administration promulgated but two releases identifiable as disciplining members of the accounting profession -- and one of them, dated February 26, 1981, was probably so far advanced in the enforcement pipeline that it was still of the ancien régime.
>
> But the SEC was not entirely idle during this extended period. Instead, we saw it quashing pending investigations of Citicorp and General Dynamics and, especially felicitous for the profession, as noted previously, it aborted ASRs 250 and 264 -- promulgations which called for some constraints on the auditors' compromising love affair with management advisory and other services.
>
> The Citicorp affair was probed in depth by your Committee during the Fall of 1982. The matter of the 250/264 rescissions was described in the aforementioned Wall Street Journal article, and discussed previously in this statement.
>
> The Commission's disciplinary pace did accelerate somewhat during 1983 when we find so-called Accounting and Auditing Enforcement Releases; it then intensified during 1984 -- with much fanfare devoted to the Commission's new vigor. In fact, during 1984, there were no fewer than 27 such releases.
>
> I have catalogued the 1983/84 releases into two categories, i.e., those which involved exclusively the so-called registrants or their officers, and those where the ostensibly independent auditors were cited as respondents, with the following results:
>
> [This tabulation is omitted for present purposes]

The 1985 box score of Accounting and Auditing Enforcement Releases

parallels those for 1983 and 1984. Thus, we see the Commission pointing up aberrations in the reporting practices of a number of registrants, mostly entities which are so insignificant they are not even reported on by Moody's. From a study of these Releases one might infer that the aberrations resulted parthenogenetically, i.e., without the involvement of the entity's independent auditors. Thus, no matter how carefully one might study the Releases, the identity of the independent auditor is not disclosed.

Insofar as actions against independent auditors are concerned, with the notable exception of the ESM auditor who is alleged to have received important gratuities from the entity, the actions involved little-known registrants, and relatively tiny sums.

Be that as it may, the box score follows:

Those Involving Registrants

Release No	Registrant	Independent Auditor	Was Auditor Identified?
48	Charter Corp.	Peat, Marwick	No
49	Zondervan	?	No
50	Burroughs	Price Waterhouse	No
52	Rynco Scientific	?	No
54	Broadview Financial	?	No
55	Diversified Tech	?	No
56	Pan American Int'l	?	No
57	Comserv Corp.	Peat, Marwick	No
59	Midwestern Corp.	?	No

Those Involving Independent Auditors:

Release No.	Respondent	Registrant
51	Hans V. Andersen	Great American Financial
53	Russell Davy	SNG and Oil
57	Russel Gomez	ESM

The SEC's Double Standard:

A number of inferences may be drawn from a study of the 1983-1985 rosters, and the underlying Releases, including:

1. There are some glaring omissions. For example, where are Baldwin United, Penn Square, Continental Illinois, Frigitemp, General Dynamics, Lockheed -- some matters of but recent vintage?

2. More serious even is the double standard in the punishments meted out against the various respondents.

Thus, individuals identified as sole, or local, practitioners are regularly penalized by being barred from practice before the Commission for extended periods, whereas the few major firms which are brought to book are generally merely enjoined from committing the same act, in the same place, in the same time, and in the same way.

3. Given these demonstrated failures in auditing competence and judgment calls by accounting firms which are members of the SEC Practice Section of the AICPA Division for Firms, and which, as a consequence received A-OK reports from the Peer Review teams, how can the Commission continue to have confidence in the profession's self-regulatory apparatus? Has the SEC ever deemed it appropriate to inquire into the competence of the PR team which gave "clean opinions" to a reviewed firm which was then found grievously deficient? It might turn out that incompetent peers were being

reviewed by peers, in the literal sense of the word.

My oral presentation zeroed in on the double standard most deliberately. Thus, from the transcript of the hearings:

The Double Standard Exemplified:

> The Securities and Exchange Commission, which (was, as) -- I testified in 1976, in my view, is one of the very best of the regulatory agencies that could have been evolved to fulfill the responsibilities vested in it. I am sad to say that the intervening years, particularly the most recent past, have caused me to revoke that vote of approbation.
>
> I want to, at the moment, because of the limitation of time, concentrate on the ineffectiveness of the Commission in connection with its oversight of the accounting profession and the fulfillment of its responsibilities to discipline those who have failed in the fulfillment of the responsibilities vested in them by society. And at this particular juncture, my prepared text makes clear that there is a dual system of justice that prevails at the Securities and Exchange Commission in connection with its meting out of judgments against those who have gone astray.
>
> Those of the smaller regional firms who were found wanting are subjected to severe censure, suspended from practice before the commission for periods of time, and made to undergo various periods of penance. But when they turn to the major accounting firms, even those who are three-time losers -- and even more frequent than three-time losers -- somehow this awesome commission loses its capability and its effectiveness in the fulfillment of its burdens.
>
> In this particular context, I believe I can dramatize particularly what I have in mind by reference to two sets -- two sets of so-called Accounting and Auditing Enforcement Releases promulgated by the Commission over the past two or three years. Set Number One are Accounting/Auditing Enforcement Release Numbers 10 and 48 -- 48 being the most recent one promulgated in January of this year involving the Charter Corporation, which was made to restate its previous financial statements because it was found out as front-end loading income from its so-called Single-Premium Deferred Annuity contracts. I won't go into the details, but the corporation agreed that they had to restate, and they did restate.

Number 10, of Aetna Life and Casualty Insurance back in 1981, also had to be restated because of the fact that the SEC said they were improperly accounting with respect to their so-called operating loss carryforwards. Well and good. Made to restate, made to recant.

Mr. Chairman, members of the committee, I ask that you look at both of those promulgations. The firm of Peat Marwick Mitchell, the auditor in both of those cases, is not mentioned.

Now, these are not cases where the auditors were cuckolded, where, say somehow or other, inventories were disappearing. These were overt determinations by the auditor to go along with a wrong accounting precept, a wrong accounting precept which the auditor should have known was wrong.

The next pair, 12 and 45: Interestingly, both of those do apply directly to Coopers and Lybrand or personnel thereof. Number 12 had to do with the case where three of the Coopers and Lybrand persons in the Chicago office failed seriously, severely, to carry out their audit responsibility. The insurance reserves were wrong. They accepted managerial determinations when they should not have. It involves 22 pages printed in the Commerce Clearinghouse fine looseleaf; whereas, it probably represented at least 50 typewritten pages. Error after error after error; wrong after wrong after wrong.

What was the penance meted out? In August of 1983, the partner in charge was let off on the ground that he had agreed that in the last five months -- and this was in August -- he had not audited an insurance company. And therefore they said, in view of that, there isn't really that much more that we ought to do; maybe just vote a censure.

Second, with respect to the audit manager, he agreed, mind you, as an employee of Coopers and Lybrand, that henceforth until the end of that year his work was going to be reviewed by someone who was not involved in the audit.

I asked the question: Is this an appropriate judgment of this awesome commission under those circumstances? If it were John Jones or Abe Briloff that was caught in that particular circumstance, he would find himself expelled from practice before the commission in perpetuity, as he should be, as I should be, for having taken leave of GAAP and GAAS.

Number 45 is a case where, quite frankly, if I were an employee of the Chief Accountant's Office of the commission, I would be much embarrassed. 45 had to do with a company called Digilog where Bruce Cohen, the managing partner of Coopers and Lybrand, permitted losses, deliberately -- deliberately permitted losses -- to escape being reflected in the income

statements and balance sheets, overtly and deliberately, and this again is not a case which just escaped them. And, mind you, any accountant with a modicum of commitment to our precepts of accounting, we don't need a conceptual framework to tell us that about substance over form. Or who remembered the way in which the Memorex Corp., which involved almost the same thing, was shot down in 1970 by the Commission. Anyone having even a slight awareness of it would have said, "This kind of nonsense won't go, Mr. Digilog."

And what did the commission there do? As the attorney for Coopers and Lybrand appropriately pointed out, it wasn't even a consent decree saying that we, without denying or admitting or whatever that kind of verbiage is -- he said it is a walk-away deal. The commission just walked away.

Excepting, granted, they got the right -- as I put in my paper -- to hyperventilate for all of this document on the meaning of substance over form. Again, I am embarrassed for the Commission to subject their personnel to this kind of denigration.

The Revolving Door At the SEC:

There is a tangential theme in my testimony which, under the present circumstances requires my presentation.

Thus, under the rubic "Vote the Rascals In" I criticized the revolving door at the SEC involving the Enforcement Division's Chief Accountant during the period 1983-85. We then had a Peat, Marwick alumnus who, upon completing his SEC watch went right back to his Alma Mater. Even if we did not have Aetna Life and Charter during his incumbency I would have questioned the wisdom of his appointment; I would have done so recognizing the number of instances when his firm was the subject of regulatory and judicial obloquy.

By the same token I questioned and question the wisdom of the Commission in its determination to tap a person who was highly placed in the Touche Ross hierarchy at the very "points in time" when U.S. Financial, Giant Stores, Ampex, Litton, Gelco, Chrysler, et al., were festering. My inordinately high regard for Bob Sack notwithstanding, I question whether he could be viewed as

the intrepid chief investigative accountant determined to pursue the truth no matter where it leads -- and to use his initiative and integrity to insist upon equal justice for the affluent and resourceful as for those who are less felicitously endowed. It is, of course, early in his term of office; I sincerely hope that Bob has disavowed any desire to return to his former haven. At least for him, then, the door would not be revolving.

Clearly, I could not cover the entire range of subjects substantive included by my February testimony, especially since there has been a prolifiation of developments subsequent to that time, e.g., ESM, Hutton, General Dynamics, all of which have serious accounting implications. To the extent I may have omitted some subject of special significance for you, I would be pleased to respond during the time that may remain for questions.

Quo Vadis?

But now I must proceed to sketching out for you my considered responses to the siege. At the outset, we should disavow the manner of response of our profession's presumptive leadership -- in the AICPA, POB, FASB, etc. As I consider their presentations to the Dingell Committee they, and the Chairman of the SEC as well, manifest a siege mentality. They appear to have drawn their wagons in a circle around them, determined to protect their vested interests in their respective turfs.

I concluded my presentation before the Dingell Committee with the following:

> Where do I come out? Where do I come out in terms of proposals to your important committee and your important deliberations? To a series of proposals. None of them is being stated flippantly.

First -- and this is entirely consistent with Chief Justice Burger's observations and statements -- reverse the prevailing assumptions regarding the financial statements. Make them the auditor's responsibility based upon his credentials. Not "I have examined," but instead "I have prepared." Not merely that indecipherable phrase "Fairness in accordance with GAAP," but instead "It is the fairest that I can prepare and develop based upon all the circumstances that here prevail, with full awareness and knowledge regarding the state of the art, my profession and generally accepted accounting principles." And I believe that I have adopted those precepts which, my view, or in our view, most appropriately reflect economic reality as I see it. And I want to put my full faith and confidence in my colleagues' professional credentials. I have faith in them.

Ironically, my colleagues lack faith in our own competence and professional expertise. Instead, they are looking for someone to give them a dictionary and a book of rules, or a computer program.

I then urge, it is called, draconian -- but, as I will indicate, Mr. Chairman and members of the committee, I don't intend it to be draconian -- divest the major audit firms from peripheral services, management advisory and tax consultative, because I want the audit responsibility for publicly-owned corporations to be the most vital jewel in our diadem, in our crown.

This should be the ultimate objective. And I want all the personnel who are in that audit section to feel important rather than to feel, as is frequently said, "We are doing time and we are paying our dues and waiting our turn to get out of the audit responsibility."

Now that it is not draconian will follow from what it is that I am now going to say. Remember the audit function, as I see it, embraces a great many responsibilities -- lost reserves for banks and insurance companies, the intense development and review of the internal control system, looking at the compensation programs and trying to determine the liabilities and the like, and a whole array of responsibilities which are now presumed to be subsumed under management advisory services. By all means, all of those are important. But they all have to be subsumed to the audit responsibility -- the independent audit responsibility, as I see it. That should be.

What counsel do I have for the Financial Accounting Standards Board? And I mean it reasonably seriously. I believe that they ought to take a sabbatical, as far as rule-making is concerned. They have been around for a dozen years. They deserve a rest.

But I believe they can perform an extraordinarily important and vital function. With the seven persons at the head and their staffs, let them go into the marketplace and look at the financial statements that are being promulgated that are coming forth. Let them, with their higher judgment, determine which of them are not consistent with the best of practices as the state of the art has evolved. And then let them, with their professional responsibilities on the line, advise the Securities and Exchange Commission and the disciplinary apparatus of the profession as to those statements which they have found wanting. They can do it far better than the Securities and Exchange Commission staff, I believe, and they would be doing it in a nonadversary role. Instead, they would be doing it as an arm of the accounting profession.

Remember, the Financial Accounting Standards Board should not merely mean the setting of standards, but also the implementation of them. And if that were to be their goal and objective, I can't help but feel that this would be a most important contribution.

Now finally, Mr. Chairman, this is consistent with something that I said in 1982 in connection with the Citicorp matter. If the public cannot get that which the public believes it needs -- again, Chief Justice Burger enunciated that -- if the public cannot get that which it needs from the auditing profession and the accounting profession, then I urge that with the power vested in the Congress that you do that which is appropriate to bring forth or bring down the sunset standard. Say to the public there is no longer a need for the so-called independent audit of the financial statements. Put the onus and the responsibility and the burden where it is now anyway -- in management -- and then insist that management do that which is appropriate and essential, and the independent audit committees to do that which is appropriate and essential, and then let the public know that caveat emptor is back in the saddle again.

Enough. There is no longer -- the public should be told that somehow the benign hand of the auditors are there, and Big Brother is watching.

Now, that which I have just said is not entirely new as it comes to me. Eighteen years ago, in 1967, the late Justice William O. Douglas honored me by providing a forward to my first published book, "The Effectiveness of Accounting Communication." My ideas and ideals were then in a somewhat more formative stage than they are now, obviously. I have learned from 18 years and observed much in 18 years -- where he said, "If the accounting profession does not move to fulfill the objectives which Briloff has set down, then" -- as the Justice said -- "then some other profession, possibly a new profession, might have to come in to fill the void, or fill the breach."

And so it is , Mr. Chairman and members of the committee. Thank you again for the privilege of being able to share these long-considered, deeply-felt views, in the hope that the profession and the commission will yet move towards its positive course.

This is my objective. We are an important profession. The Commission is an important commission.

A Postscript:

Whether the prevailing state of siege is a continuum or a recurrent phenomenon does not really matter; there is no question but that we are being challenged, most critically, in the immediate present. The Dingell Oversight and Investigations Committee is proceeding diligently with its probe of the accounting oversight role of the SEC, and thereby of the profession itself. Yesterday's hearings of a House Judiciary Committee into the E.F. Hutton denouement raised some very serious accounting questions. Next week's hearings by the Congress's Joint Economic Committee should raise serious questions regarding the roles of the General Dynamics' internal and independent accountants. If the past be prologue there will be new crises confronting the profession and, correspondingly, calls from the Congress and the media demanding better answers from our profession's hierarchy. We can only hope that hierarchy could unshackle itself of a "seige mentality," to stop encircling itself with wagons, to recognize the critical causes of our prevailing difficulties, and to proceed with really meaningful and effective responses. In short, the self exculpatory responses emanating from the Accounting Establishment will not prove adequate to the challenges.

ATTACHMENT 2

ABRAHAM J. BRILOFF

The Truth About Corporate Accounting

HARPER & ROW, PUBLISHERS, New York
Cambridge, Hagerstown, Philadelphia, San Francisco
London, Mexico City, São Paulo, Sydney

Portions of this work originally appeared in *Forbes*.

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10

Grease

In 1975, Senator William Proxmire, speaking before the U.S. Senate Committee on Banking, Housing and Urban Affairs, said that close to a hundred publicly held corporations had made disclosures to the SEC of literally hundreds of millions of dollars paid over the years as bribes to foreign officials and political parties.

By 1978 the one hundred number cited by Senator Proxmire swelled to more than four hundred "voluntary" disclosures to the SEC by corporations which had made contaminated payments.

A Catalog of Accounting Perversion

The Charles E. Simon Company, a Washington-based consulting firm, had undertaken the responsibility of analyzing these disclosure filings in great detail. Mr. Simon, in association with Tom Kennedy, published the results of the analysis insofar as the cases related to corporations based in the tri-state area of New York, New Jersey, and Connecticut. That compendium, *An Examination of Questionable Payments and Practices,* included as Part VI the following configuration:

Questionable Accounting Practices

A. Questionable Accounting Practices Which Appear Not to Have Involved Third Parties
   1. Improper Bookkeeping (General)
   2. Improper Expense Account Vouchers
   3. Funds or Assets Questionably Transferred

4. Separate Set of Official Books
5. Non-Deductible (or Questionable) Expense Treated as a Deductible Expense
6. Improper Reporting of Revenues

B. Questionable Accounting Practices Which Appear to Have Involved the Collusion of Customers, Suppliers or Others
1. Overbilling and Underbilling Transactions
2. Questionable Rebates or Discounts, Granted or Received
3. Payments Disbursed for Goods or Services not Received or Received Only in Part
4. Payments Received for Goods or Services not Provided or Provided Only in Part
5. Improper Invoicing

C. Questionable Accounting Practices Which Appear to Have Involved Employees' Salaries
1. Unrecorded Supplemental Salaries
2. Taxed Employee Compensation to be Used for Questionable Purposes as Directed by the Company

D. Other Questionable Practices
1. Off-Book Cash Funds
2. Off-Book Accounts (Either Bank Accounts or Not Specified as Cash or Bank Accounts)
3. Creative Bookkeeping
4. Companies Improving Audit Procedure
5. Detailed Review of Investigative Procedures

These patterns of creative accounting were not contrived by accountants operating in the penumbra of our business sector; all of this related to publicly owned corporations required to file reports with the SEC. Nor were the companies audited by accountants who function in the interstices of the profession; instead, we find that the books of the reporting corporations were audited by those who are presumed to be the best and the most skilled among us—principally by firms comprising the accounting establishment.

A number of the disclosing entities were constrained by the Securities and Exchange Commission to create special investigative committees of their boards of directors, who were then required to file reports of their investigations with the Commission. The matter was the subject of a number of consent decrees as well.

Four such reports deserve special comment, namely, those relating to Gulf Oil, Lockheed Aircraft, Northrop, and International Telephone and Telegraph Corporations. I will not be especially concerned with

to whom or for what the payments were made. I will consider the critical manifestations of disintegration in the control and audit process in the entities.

Gulf Oil Exploits

First as to the Gulf Oil Corporation: Under John J. McCloy (later the chairman of the Public Oversight Board—see the preceding chapter), the Special Review Committee of Gulf's board rendered its report on December 30, 1976. This committee was mandated by the settlement of the legal proceeding instituted by the Securities and Exchange Commission in the United States District Court for the District of Columbia.

The broad outlines of Gulf Oil's machinations had been exposed previously before various congressional committees and in other proceedings which were reported by the press. These earlier disclosures had attracted the interest of the Justice Department and the Internal Revenue Service—in addition to the SEC. So it came as no surprise that the Special Review Committee (sometimes referred to as the McCloy Committee) determined that the domestic and foreign skullduggery was perpetrated through an offshore subsidiary, Bahamas Exploration, Limited (referred to as Bahamas Ex).

The idea was conceived in 1959 by William K. Whiteford, the dynamic and colorful chairman of Gulf's board and its chief executive officer. He wanted an available source of funds to grease the company's expansionist objectives at home and abroad. Following a strategy meeting between Whiteford and Gulf's counsel, it was determined to utilize a Gulf subsidiary which had no direct U.S. involvement so that the contemplated mischief would not run afoul of the Internal Revenue Service. Bahamas Ex, the chosen instrument, was organized in 1944 to undertake oil exploration in the Bahamas; however, from 1944 to 1960 it did little more than hold some exploration licenses and operated on an annual budget of about $10,000 to $12,000. During this period this subsidiary reported to Gulf's Exploration Division based in New York, but in 1960 there were two dramatic developments: Bahamas Ex was henceforth to report directly to home base in Pittsburgh, and William C. Viglia, an assistant controller in the Tulsa operations, was moved to Nassau to take charge of Bahamas Ex's finances.

Thereafter a trail of checks was issued by Gulf-Pittsburgh to the Bank of Nova Scotia in the Bahamas, and the money disappeared from Good Gulf's books. Pittsburgh appears to have debited the millions of dollars to some deferred exploration cost on its books, while Bahamas Ex wrote them off as operating expenses.

Viglia is described in the McCloy report as the trusted courier deliver-

ATTACHMENT 3

Codification of Auditing Standards and Procedures 1

Statement on Auditing Standards

Issued by the Committee on Auditing Procedure
American Institute of Certified Public Accountants

330 Evidential Matter

.01 The third standard of field work is:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

.02 Most of the independent auditor's work in formulating his opinion on financial statements consists of obtaining and examining evidential matter. The measure of the validity of such evidence for audit purposes lies in the judgment of the auditor; in this respect audit evidence differs from legal evidence, which is circumscribed by rigid rules. Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under examination. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence.

Nature of Evidential Matter

.03 Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor.

.04 The books of original entry, the general and subsidiary ledgers, related accounting manuals, and such informal and memorandum records as work sheets supporting cost allocations, computations, and reconciliations all constitute evidence in support of the financial statements. By itself, accounting data cannot be considered sufficient support for financial statements; on the other hand, without adequate attention to the propriety and accuracy of the underlying accounting data, an opinion on financial statements would not be warranted.

.05 Corroborating evidential matter includes documentary material such as checks, invoices, contracts, and minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him to reach conclusions through valid reasoning.

.06 The auditor tests underlying accounting data by analysis and review, by retracing the procedural steps followed in the accounting process and in developing the work sheets and allocations involved, by recalculation, and by reconciling related types and applications of the same information. In a soundly conceived and carefully maintained system of accounting records, there is an internal integrity and interrelationship discoverable through such procedures that constitutes persuasive evidence that the financial statements do present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles.

.07 The pertinent documentary material to support entries in the accounts and representations in the financial statements ordinarily is on hand in the company's files and available to the auditor for examination. Both within the company's organization and outside it are knowledgeable people to whom the auditor can direct inquiries. Assets having physical existence are available to the auditor for his inspection. Activities of company personnel can be observed. Based on certain conditions as he observes them, conditions of internal control for example, he can reason to conclusions with respect to the validity of various representations in the financial statements.

Competence of Evidential Matter

.08 To be competent, evidence must be both valid and relevant. The validity of evidential matter is so dependent on the circumstances under which it is obtained that generalizations about the reliability of various types of evidence are subject to important exceptions. If the possibility of important exceptions is recognized, however, the following presumptions, which are not mutually exclusive, about the validity of evidential matter in auditing have some usefulness:

a. When evidential matter can be obtained from independent sources outside an enterprise, it provides greater assurance of reliability for the purposes of an independent audit than that secured solely within the enterprise.

b. When accounting data and financial statements are developed under satisfactory conditions of internal control, there is more assurance as to their reliability than when they are developed under unsatisfactory conditions of internal control.

c. Direct personal knowledge of the independent auditor obtained through physical examination, observation, computation, and inspection is more persuasive than information obtained indirectly.

Sufficiency of Evidential Matter

.09 The amount and kinds of evidential matter required to support an informed opinion are matters for the auditor to determine in the exercise of his professional judgment after a careful study of the circumstances in the particular case. In making such decisions, he should consider the nature of the item under examination; the materiality of possible errors and irregularities; the degree of risk involved, which is dependent on the adequacy of the internal control and susceptibility of the given item to conversion, manipulation, or misstatement; and the kinds and competence of evidential matter available.

.10 The independent auditor's objective is to obtain sufficient competent evidential matter to provide him with a reasonable basis for forming an opinion under the circumstances. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present fairly, in conformity with generally accepted accounting principles, the financial position, results of operations, and changes in financial position are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being examined.

.11 To the extent the auditor remains in substantial doubt as to any assertion of material significance, he must refrain from formulating an opinion until he has obtained sufficient competent evidential matter to remove such substantial doubt, or he must express a qualified opinion or a disclaimer of opinion.

.12 An auditor typically works within economic limits; his opinion, to be economically useful, must be formulated within a reasonable length of time and at reasonable cost. The auditor must decide, again exercising professional judgment, whether the evidential matter available to him within the limits of time and cost is sufficient to justify formulation and expression of an opinion.

.13 As a guiding rule, there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. In determining the usefulness of evidence, relative risk may properly be given consideration. The matter of difficulty and expense involved in testing a particular item is not in itself a valid basis for omitting the test.

.14 In determining the extent of a particular audit test and the method of selecting items to be examined, the auditor might consider using statistical sampling techniques which have been found to be advantageous in certain instances. The use of statistical sampling does not reduce the use of judgment by the auditor but provides certain statistical measurements as to the results of audit tests, which measurements may not otherwise be available.

.15 The independent auditor should be thorough in his search for evidential matter and objective in its evaluation. In selecting procedures to obtain competent evidential matter, he should recognize the possibility that the financial statements may not be presented fairly in conformity with generally accepted accounting principles. In developing his opinion, the auditor must give consideration to relevant evidential matter regardless of whether it appears to support or to contradict the representations made in the financial statements.

331 Evidential Matter for Receivables And Inventories

.01 Confirmation of receivables and observation of inventories are generally accepted auditing procedures. The independent auditor who issues an opinion when he has not employed them must bear in mind that he has the burden of justifying the opinion expressed.

.02 The purpose of this section is to provide guidelines for the independent auditor in confirming receivables and observing inventories. This section relates only to confirmation of receivables and observation of inventories and does not deal with other important auditing procedures which generally are required for the independent auditor to satisfy himself as to these assets.

ATTACHMENT 4

ARTHUR ANDERSEN & CO.

Objectives of Financial Statements for Business Enterprises

1984

Although we do not believe that immeasurable intangibles should be recognized as assets, we acknowledge that they often have value, even great value. The identifiable expenditures that management makes to maintain or increase their value are relevant to financial-statement users in evaluating an enterprise's health and prospects. For that reason, we believe that identifiable expenditures for goodwill, research and development and other identifiable but immeasurable intangibles should be disclosed for each period covered by the statement of comprehensive income.

Undoubtedly many expenditures that enterprises make as part of their continuing operations create or enhance immeasurable intangible values that are sometimes referred to as internally generated goodwill. These are not identifiable apart from what is required for continuing operations, and we would not favor allocations, which would necessarily be highly subjective or arbitrary, to include these expenses in the disclosure of expenditures for identifiable intangibles. Only direct expenditures, such as for purchased goodwill, or the costs of identifiable activities specifically directed toward creating future values, such as the costs of research and development departments, should be included in this disclosure.

Contingencies

Disclosures are often most important with respect to contingencies. These are matters that, by their very nature, are not susceptible to measurement and reflection on the face of an enterprise's financial statements.* They can be disclosed only in notes.

Because of the pervasive uncertainty discussed in Chapters 1 and 2, these contingencies may be extensive, even for small companies with relatively simple operations. They need not all be disclosed; in fact, even to try would not be feasible. The notes would become so voluminous as to overwhelm the financial statements — and their users. Also, no listing could be complete.

Disclosure of contingencies should include, and generally be limited to, matters that are:

- ☐ Inherent at the date the financial statements are issued;
- ☐ Specific to the enterprise rather than applicable to the economy in general;
- ☐ Reasonably possible; and
- ☐ Material.

Our view that the contingency should normally be inherent when the financial statements are issued is to preserve the distinction between financial statements and financial forecasts and projections, as discussed in Chapter 1. Any attempt to reflect estimates of future transactions and events, even by disclosure, would soon lead the preparer of financial statements into quicksand.

Disclosures should not address those contingencies that impact the economy generally, such as wars, recessions and inflation. Rather, the contingencies should be ones peculiar to the enterprise — for example, pending litigation or a major tax uncertainty. A contingency should be disclosed if its fruition is reasonably possible and material. This requires a difficult exercise in judgment, but there is no place for a laundry list of remote contingencies that duck hard decisions and are merely self-protective without helping users.

---

*Many economic resources and obligations cannot be measured with precision. The judgmental margin of error present in these measurements is not what we have in mind as contingencies. Contingencies, rather, are items concerning which uncertainties as to existence or amount are so great as to preclude recognition in the financial statements.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

August 5, 1985

The Honorable William Proxmire
Vice Chairman
Subcommittee on Economic Resources,
Competitiveness, and Security Economics
of the Joint Economic Committee
United States Senate
SD-531 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Proxmire:

On June 28, 1985, at the Subcommittee's hearing concerning General Dynamics, you requested supplemental information for the record concerning three matters:

(1) Chairman Shad's views on a memorandum, dated April 14, 1980, from then Chairman Harold Williams to Stanley Sporkin, then Director of the Commission's Division of Enforcement, concerning Commission investigations of defense contractors;

(2) a further description of the Commission's action challenging the disclosures of Litton Industries, Inc., in connection with commercial and ship-building contracts in 1971-1978; and

(3) a further response to questions concerning whether the Commission is currently investigating defense contractors.

Enclosed are a memorandum from the Office of the General Counsel responding to item (2) and a memorandum from the Division of Enforcement responding to item (3). Chairman Shad is out of the country, and a response to item (1) will be provided when he returns to Washington.

Please let me know if we can be of further assistance in this matter.

Sincerely,

Charles C. Cox

Charles C. Cox
Commissioner

Enclosures

MEMORANDUM

July 31, 1985

TO: Commissioner Cox

FROM: Office of the General Counsel DGoelzer

RE: Hearing of June 28, 1985 before the Subcommittee on Economic Resources, Competitiveness, and Security Economics of the Joint Economic Committee -- Supplementary Information

At the hearing on June 28, 1985, before the Subcommittee on Economic Resources, Competitiveness, and Security Economics of the Joint Economic Committee, Senator Proxmire asked for additional details concerning the Commission's action challenging the disclosures of Litton Industries, Inc., in connection with commercial and shipbuilding contracts in 1971-1978. This memorandum describes that action, SEC v. Litton Industries, Inc., U.S.D.C. D.C., Civil Action No. 81-0589. In addition, a copy of the Commission's litigation release concerning this action, Litigation Release No. 9321, March 12, 1981, is attached.

On March 12, 1981, the Commission announced the filing and settlement of a civil action in the U.S. District Court for the District of Columbia against Litton Industries, Inc. The Commission's complaint had two facets.

First, the complaint addressed Litton's accounting for costs in excess of contract values on commercial and military shipbuilding contracts between 1971 and 1978, and the company's disclosure relating thereto. Specifically, with respect to two commercial shipbuilding contracts, Litton incurred costs in excess of the contract values amounting to $128 million by the end of its fiscal year 1972. Between 1972 and 1978, (at which time the entire amount was written off), Litton deferred recognition of such costs on the theory that they would benefit later military contracts to be performed in its new shipbuilding facility. The Commission's complaint, however, alleged that Litton did not have adequate grounds for deferring the $128 million of excess costs in light of the nature of the excess costs; the lack of accounting records sufficient to support a segregation of start-up costs from contract operating costs; and the lack of assured revenues against which to absorb the costs.

Second, with respect to a major shipbuilding contract with the U.S. Navy (the LHA contract) awarded in 1969, Litton incurred costs in excess of the contract value which grew to approximately $500 million by fiscal 1978. The Commission's complaint alleged that the costs in excess of the LHA contract value were largely caused by factors for which the Navy was not responsible under the express terms of the contract. Moreover, in the Commission's view, the uncertainties relating to Litton's recovery of its excess costs were such that the company did not have adequate grounds for not providing for a loss on that contract prior to 1978 (at which time it provided for a pre-tax loss of $200 million as a result of a settlement with the Navy). A factor of overriding significance in this connection was that the company's management, its accountants, and Navy officials all knew what the loss was going to be. Each knew that the loss would approximate $200 million and, indeed, the June 1978 settlement resulted in a loss of that amount. In the Commission's view, Litton ignored both its own experience and historical experience within the industry and asserted that it would recover all its revenues from proceeds of a claim settlement when it knew it would suffer a $200 million loss. Indeed, the investigative record indicated that outside counsel to Litton had stated that, notwithstanding recoveries from claims, Litton could expect a significant loss from the performance of the Navy contract. Furthermore, in years prior to the June 1978 settlement, Litton officials had made offers to the Navy to settle their disputes at a fixed loss.

Without admitting or denying the allegations of the Commission's complaint, Litton stipulated to the entry of a final order requiring that Litton would comply with Section 13(a) of the Securities Exchange Act of 1934, and the rules promulgated thereunder; Section 13(a) and its implementing rules prescribe filing and reporting requirements for publicly-held companies. The court's order also directed Litton to comply with undertakings (1) to submit cost deferral and revenue recognition determinations relating to certain military procurement contracts to a review by its audit committee; and (2) to implement any recommendations made by an Independent Consultant who would examine the procedures in place by which Litton estimated and accounted for costs in excess of contract values with respect to military procurement contracts of its shipbuilding division.

Attachment

Litigation Release No. 9321/March 12, 1981

SECURITIES AND EXCHANGE COMMISSION v. LITTON INDUSTRIES, INC. (United States District Court for the District of Columbia, Civil Action No. 81-0589).

The Securities and Exchange Commission today announced the filing and settlement of a civil action in the United States District Court for the District of Columbia against Litton Industries, Inc. ("Litton"), a Delaware corporation with its principal offices located in Beverly Hills, California.

The Commission's Complaint concerns Litton's accounting for costs in excess of contract values on commercial and military shipbuilding contracts between 1971 and 1978, and the company's disclosure relating thereto.

With respect to two commercial shipbuilding contracts awarded in 1968, Litton incurred costs in excess of the contract values amounting to $128 million by the end of its fiscal year 1972. Between 1972 and 1978, at which time the entire amount was written off, Litton deferred recognition of such costs on the basis that they would benefit later military contracts to be performed in its new shipbuilding facility. The Commission's Complaint alleges that Litton did not have adequate grounds for deferring the $128 million of excess costs for financial reporting purposes in light of the nature of the excess costs, the lack of accounting records sufficient to support a segregation of start-up costs from contract operating costs, and the lack of assured revenues against which to absorb the costs.

With respect to a major shipbuilding contract with the U.S. Navy (the "LHA contract") awarded in 1969, Litton incurred costs in excess of the contract value which grew from approximately $75 million in fiscal 1973 to approximately $500 million by fiscal 1978. Litton contended that such excess costs were caused by Navy delay and disruption in the construction process, and the financial statements contained in the annual and periodic reports which Litton filed with the Commission between 1973 and 1978 were presented on the assumption that the company would recover all of its costs under the LHA contract. The Commission's Complaint alleges that the costs in excess of the LHA contract value were largely caused by factors for which the Navy was not responsible under the express terms of the contract, and that the uncertainties relating to Litton's recovery of its excess costs were such that the company did not have adequate grounds for not providing for a loss on that contract prior to 1978, at which time it provided for a pre-tax loss of $200 million as a result of a settlement with the Navy. According to the Company, this loss has been significantly reduced as a result of incentive provisions in the 1978 settlement.

The Commission's Complaint alleges that the information with regard to the above commercial and military shipbuilding contracts contained in Litton's annual and periodic reports during the period did not comply with applicable disclosure requirements under Section 13(a) of the Securities Exchange Act of 1934 ("Exchange Act") and rules promulgated thereunder.

The Final Order also directed Litton to comply with certain additional undertakings made by the company. The first undertaking provides that Litton shall, for a period of three years, submit cost deferral and revenue recognition determinations relating to certain military procurement contracts where substantial overruns and disputes are involved to a review by its audit committee. With respect to such determinations, Litton shall either implement the recommendations of the audit committee or disclose the relevant facts in a filing with the Commission.

The second undertaking provides that Litton shall retain an Independent Consultant to examine the procedures in place by which the company estimates and accounts for costs in excess of contract values with respect to military procurement con-

tracts of its shipbuilding division. The Independent Consultant shall prepare and submit to Litton's Board of Directors a report setting forth the results of its examination and its recommendations, which shall be implemented by Litton, with respect to the procedures under review.

Schedule 13D. Finally, Smith is also ordered to report to the Commission every six months for five years (a) his ownership of, (b) his membership in any group for the purpose of acquiring, holding or disposing of and (c) any contracts, arrangements or understandings Smith may have with respect to 5,000 or more shares of any securities subject to the reporting requirements of the Williams Act.

Smith consented to the entry of the Judgment without admitting or denying the allegations of the Complaint.

TO : Commissioner Cox

FROM : Gary Lynch, Director
Division of Enforcement

RE : Request of Senator Proxmire on June 28, 1985 Concerning SEC Investigations of Defense Contractors

DATE : August 1, 1985

The Commission has one active investigation concerning possible securities violations by one of the top 50 defense contractors involving defense contract issues. The Commission recently conducted an inquiry into one other similar matter. The Commission is conducting five other investigations concerning the top 50 defense contractors, but such investigations do not involve defense contract issues.

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