Securities and Exchange Commission Historical Society
Interview with Howard Hodges
Conducted on October 28, 2004, by Mickey Beach and Bill Morley

MB: We are interviewing Howard Hodges, who was with the Division of Corporation Finance from 1960 until 1989 and chief accountant of that division from 1973 to 1989. Doing the interviewing is Bill Morley and Mickey Beach. Do you want to start, Howard, and tell us what it was like when you came to the Commission in 1960?

HH: I came to the Commission the end of October in 1960. At that time, I recall there were twelve branches within the Division of Corporation Finance and each had one accountant assigned to it. I was the first accountant assigned to a branch that had two accountants. At that particular time the branch that I was assigned to was doing most of the real estate filings that were coming into the Commission. And this was something fairly new at that time, and it took a lot of one person's time. So they felt they needed a second accountant in that particular branch. In the branch each had one accountant. And then there were four people in the Division Office of Chief Accountant who reviewed the work of all of the branch accountants before any letters of comment went out to registrants.

MB: What was the name of the chief accountant at the time?

HH: Well, Sydney Orbach was the chief accountant of the division at the time I first came. I came in the Commission at a time when there'd been a lot of new issues. And the reason I got to the Commission was I was in Washington on vacation visiting relatives and read a story in a newspaper of the tremendous backlog at the SEC, and the pressure of Wall

Street to get filings cleared and stories of how long it took. And since I, in previous prior practice, had been involved in the preparation of Form 10Ks for registrants that I audited, I thought it would be interesting to be on the other side. And I came in and talked to Andrew Barr, who was the chief accountant for the Commission. He encouraged me that he probably could get me on. And I guess I talked to him in the summer of 1960, and the end of October I joined the Division of Corporation Finance.

BM: Howard, were you with one of the—were they the Big 8 at the time, or with one of the major accounting firms?

HH: Well, I had worked with one of the major accounting firms. I spent ten years working for a major accounting firm in New York City. At the time I came to the Commission I had been working in Florida as the assistant comptroller of a new pipeline company that was bringing natural gas to Florida. And I'd been there just about two years when I came into the Commission to talk to Andy Barr. I could see that the completion of the pipeline meant that the work would be quite different thereafter, not very interesting. And I was interested in moving back further north where I could start looking for something else that would appeal to me.

BM: Were most of the division's accountants at that point people who would have had that kind of private practice experience before they came to the Commission?

HH: There were a few that had had some experience. Some of them were—at least were CPAs; I'm not sure that all of them were. But I think most of the accounting staff at that time were people who had been there for quite awhile. And most of them really retired within a few years after I came to the Commission. I think probably most of them—service dated back into the '30s.

MB: Did you say that at that time the accounting comments were reviewed by the Chief Accountants Office and not by the branch chief?

HH: Well, at that time a branch accountant reviewed a filing, wrote his comments. Anything that he wrote went to the Division Office of the Chief Accountant. Someone up there reviewed the filing and the comments before anything was sent to a registrant. Now, the branch chief didn't actually take responsibility for reviewing the accounting comments, but he incorporated the comments into an overall letter from the several professions who did look at a registration statement. But every filing was being looked at at the time I came there. That is, every registration statement was looked at and comments were sent to a registrant. And there was one man in the office of the Division of the Chief Accountant who looked at comments that branch accounts had written with respect to the annual reports on Form 10K and Form 9K before they went to the registrant. But he had an enormous backlog. There was one man doing that and I think there were three trying to keep up with '33 Act type registration work.

MB: Did the 10K form look a lot different then than it does now?

HH: Well, the 10K form was much more abbreviated then than it is now. The accountants had to look at financial statements. There was less ancillary data that related to the accounting examination in the earlier days. In later days, things like the management discussion and analysis were things that the accountant looked at that just didn't exist in the days when I came.

MB: Going back to the registration statements, how did they become a factor?

HH: Well, registration statements, after all of the comments had been complied with to the satisfaction of the branch chief, were then—I guess at that point the branch chief sent a copy of the registration statement to the Commissioners. And at least some of them apparently looked at it and the branch chief went before the Commissioners and effectively defended the adequacy of the registration statement. And the Commissioners asked questions and, I guess, not absolutely unheard of, and at times they were sent back and told to get more. More in the way of disclosure of some matters that were of concern.

BM: Yes, and of course the numbers at that point were significantly different than what came along at a different—as time went on, although part of that was the hot issue period in the

'33 Act registration statements. Things increased exponentially as more and more companies went public.

HH: Yes, I think that's true. The number of filings increased exponentially with the passage of time. While there was a big backlog at the Commission and in the branches at the time I joined the staff, you were talking about twelve and me, the thirteenth, accountant examining filings. And later on, we had as many as three accountants in some branches so that they could handle more.

BM: I was going to say that by 1969, I know when I started, we had two accountants. I think there were probably at least two accountants in each branch. And by that time—I don't remember whether you were the chief accountant by '69, how long before you moved into the Division's Chief Accountant's Office out of the branches?

HH: I was in the branch probably five to seven years before moving into the Division Office of Chief Accountant, and then worked there for probably another six or seven years before becoming chief accountant of the Division. And throughout all that time we were gradually building up an accounting staff to cope with the increasing number of filings.

BM: But still during all that time, the branch accountants, who were responsible—after their review, their review was reviewed by the Chief Accountant's Office rather than by either the branch chief or someone in the branch.

HH: Yes, the Division Chief Accountant's Office always took responsibility for reviewing the accounting work of the accountants. Their day-to-day work wasn't supervised.

BM: Right.

HH: But the accounting output comments were reviewed by the Division's Chief Accountant Office. There came a point in there at which, in order to keep up with the rush of filings, fewer things were reviewed by the accountants in the Division Chief Accountant's Office. I guess at some earlier stage I can remember that Orbach brought some of his accountants in on Saturdays. And his four—three people who were doing review work couldn't keep up, so he had branch accountants review the work of other branch accountants to get the stuff out.

MB: What was the relationship during those years between the Chief Accountant's Office in the Division and the Commission's Chief Accountant's Office? What was the breakdown of responsibility?

HH: Well, the Division Chief Accountant's Office really worked with the direct filings, sent comments to registrants, and attempted to resolve questions satisfactorily. But sometimes registrants just didn't feel like they could accept the opinion of the staff of the Division of Corporation Finance, and they appealed the accounting issues to the Chief Accountant. He listened to the accounting issues. He didn't get involved in anything to

do with the day-to-day clearance and timing of clearance of a filing. But he would listen to their questions on purely accounting matters, accounting principles and sometimes make decisions that would change the position of the Division, or work out what he thought was an acceptable solution for disclosure of an accounting issue.

It occurred to me too that in the earlier days when I first went to the Commission, whenever there was a question with a registrant and it got to be a question where you might really feel like there was something potentially fraudulent involved, the branch accountant was the guy who went out and looked at whatever books, records—whatever he felt was necessary to look at to try to determine whether there was some sort of enforcement action that was required. We didn't have an enforcement division when I first came there. We had someone in the Division. I remember Ben Levy, who I worked with once or twice on some accounting issues, and actually went out to several companies where we had some problems with fraud.

BM: That's a big change. All the time during my career we never went and looked at anything. Everything was based on the documents that we saw.

HH: Well, I think probably for the first five to six years that I was there branch accountants got involved in fraud investigations. After that—I don't know exactly when—there was a Division of Enforcement and we just referred things to that division and they took over.

BM: And they had their own Chief Accountant's Office in enforcement as well.

MB: Did they in the beginning?

BM: Yes. Well, I don't know about the beginning but . . .

HH: They had—I can't tell you who was their chief accountant at first but they did have accounting personnel at the beginning.

BM: Right.

MB: Yes, at one time, before the Division of Enforcement became a separate division, the Division of Corporation Finance had an actual branch, which was at one time headed up by Alan Levenson that did—but they did mostly . . .

BM: Administrative . . .

MB: . . . Section Five.

BM: Yes.

MB: Yes, administrative proceedings and Section Five cases.

BM: Right.

MB: And then the other enforcement cases went somewhere else. But that all changed and I can't tell you when the Division—it was all—it used to be called Division of Trading and Markets.

BM: Yes, right.

MB: And it split up into the Market Reg and Division of Enforcement but I can't remember when.

BM: That was late '60s as well because I think the Administrative Proceedings was gone by the time I arrived in '69.

MB: Did you actually go out to visit companies and look at their books and records?

HH: I can remember looking at stuff in Los Angeles. I think Freddy Moss was the attorney on one out there. I went out to do something else there. I went to a company in Long Island and looked at their books and records. And those are the two that I specifically remember. I went to North Carolina some—to a place down there. But that was in connection with the Long Island company.

MB: Do you think that the relationship between the Division's Chief Accountant's Office and the Chief Accountant of the Commission's Office has always been the same or has changed over the years, or changes with the people involved?

HH: Well, I don't know that I recognize any real difference in what the relationship was supposed to be. There were different people in there and, because of that, there were different relationships. But professionally, I think the duties and interchange of information was theoretically about the same.

MB: You don't feel that the Chief Accountant's Office was sometimes more involved in decision making for the Division than it is of other times? Have they always been the final word?

HH: Oh, I think they pretty much were always the final word if a registrant went to them. And nobody in the Division of Corporation Finance would normally tell the guy to go to them. If he asked, "Well I don't agree with you. What's the next step?" you would tell him, "Well, he's my boss." But I think that was sort of a registrant matter to decide whether they were so unhappy with what the Division told them that they'd see if they could appeal it to somebody else.

BM: Did—and this may be a difficult question for you to answer—but did this sort of dual situation, which of course at times had registrants pounding on your door, because, well,

saying, "Well, we've got the non-financial stuff done. We're all ready to go and the branch is all set to go. Why can't you finish this up?" And so I know that that caused problems with registrants. Did you ever feel there was pressure within the Division from the non-accounting side to say, "Look, Howard. Get this—get this done and let's get this thing out of here."

HH: Well, at one point there were so few accountants in the branches that, yes, there was a lot of pressure to hurry up and get it done. Everybody else was done; why can't you? But I guess our feeling was that the proportion of the work and the number of people, it takes time to do and we'll do it when we can. So I don't think anybody really succumbed to that pressure to the point of not performing their duties properly. They may have rearranged things to suit somebody's time schedule. But they never intimidated anybody into ignoring what they were supposed to do.

MB: What was the relationship between the FASB and the Commission and, specifically, the Division of Corporation Finance? When did the FASB actually get established?

HH: Well, the Commission had always been very reluctant to write accounting rules. And so there was something called the Accounting Principles Board, which was made up of accounting practitioners who were doing this sort of as a moonlighting on their regular work. And sometime during Frank Wheat's tenure at the Commission I guess there also was some Congressional pressure on a couple of accounting issues. I think Frank Wheat

was sort of instrumental in ultimately setting up the Financial Accounting Standards Board. But there were a lot of discussions. And there were questions about whether practicing accountants should be doing this work, and whether they were devoting enough time to it, and whether there should be some representation of corporations on this to balance the opinions that were given as to how the accounting should be done.

And so the FASB was set up, as much as anything, to sort of alleviate the pressure on the Commission. And they did have some representatives or members of that board, which represented different factions. And there was a Board of Trustees responsible for appointing them. It was really formed to try to get a little more professionalism into the setting of accounting principles and a little less of the day to day—take a little pressure off the day to day practitioner who was sort of doing this as a sideline.

MB: Do you ever remember any situations where there were conflicts between the Commission and the FASB over what the accounting principles should be? And how much influence did the Commission have on what the FASB came out with?

HH: Well, the Commission staff worked to some degree in giving input to the FASB. Let's say, at my level I could say all I wanted to. But that wasn't a Commission's opinion, and I guess the Chief Accountant for the Commission would be the one to convey the Commission's opinion to the FASB. I personally didn't agree with a few things that they

did, but I wasn't speaking for the Commission and I don't know whether the Chief Accountant for the Commission agreed with them or not.

MB: Did the Commission ever refuse to accept a rule adopted by the FASB, or say, after the rule was adopted, "We just can't agree with you on this and we're not going to permit or require it" . . .

HH: I don't recall anything like that ever happening. I think in the early days—maybe it was actually before the FASB was set up—Congress adopted some accelerated depreciation rules, as I recall. And the Commission maybe had a tendency to go one way as to how they should be accounted for. And somehow or other, it became apparent to everybody that the Commission couldn't enforce such rules. If they tried to, Congress would adopt a position telling them that it should not be done in that way. I'm not sure how to explain the issue briefly and tersely, but there was a difference of opinion over accounting for accelerated depreciation.

MB: There was no discussion about oil and gas accounting?

HH: Well, that's true. I forgot that one. There was—at one point, the FASB—there was considerable discussion as to whether the company should use full cost accounting or successful efforts accounting for oil and gas exploration. So, I think the FASB was first prepared to require successful efforts accounting only. But there was a lot of side

discussion as to which was appropriate, and it ended up that we took both. I'm not too clear in my mind now exactly who was on what—what side in that issue, except to know that I think we ended up accepting both methods of accounting with disclosure.

MB: Do you remember any really major accounting issues during the 15 years that you were chief accountant? Major controversial issues, either—you've mentioned a couple of them with the Hill and the Commission. Are there any others?

HH: Well, of course, the Incentive Stock Options has been a problem in recent years. But accounting for stock options was a problem in the early 1950s, at least, when I was working for Price Waterhouse in New York, because the Commission issued some rules at that time which I understood to be, "If we can't get a solution, we'll require three different disclosures for an investor to consider, three different choices as to how to view these things. And you decide for yourself which you think is the most appropriate." And sometime about the 1970s we went through a major revision of Regulation SX. And at that time there were a lot of people taking a position that this was not relevant, and many other things in SX were no longer deemed relevant and the disclosures were reduced.

MB: You were chief accountant during the time when the Commission changed its policy about forward-looking information or projections. How much was the chief accountant—was your office or other accountants under you involved in all of that rule making, some of which never got adopted, or that whole issue . . .

HH: Well, we weren't really directly involved in that, simply because it's not accounting information as such. It's derived from accounting information but it's not the sort of thing that an independent CPA would ever have certified. And we were basically looking at the financial statements prepared in accordance with generally accepted accounting principles.

MB: But wasn't there some move at one time for the accountants to somehow review projections and make some kind of statement about them, not the kind of statement you made in the audit, but some kind of—you looked at them and they're internally consistent, something like that? Wasn't there some involvement of the accountants with projections?

HH: There was some consideration of this and I think you can say the accountants were interested in doing anything that they felt they could safely do. But I don't think it ever came to any final . . .

BM: The outside accountants were not in favor of that, were they, at the time?

MB: Some of them were.

BM: They were actually willing to go on the line and write their name down.

MB: It was a very minimum kind of thing. I mean, I think all that they "certified" to was that they were internally consistent. I don't know that they really passed on the assumptions or whether they commented upon the assumptions. So I think it was some kind of limited review. And I'm sure the accountants, as every other profession, would be swept between the more conservative and more liberal. And, you know, where we do anything for money. I had recollection that there were some cases actually filed where there was some kind of report. But it was very limited and, for the most part, it was not done by most accountants. Is that your recollection?

HH: I remember there was some discussion of whether they could issue some sort of report. But I don't remember that anybody ever did.

MB: Was there ever any controversy involving filings at the Commission while you were there about the different levels of review? And I remember for small business issues there was some talk about, instead of having a full certification, you would have something called a review or, there was another level that was even lower than a review. Do you remember that controversy?

HH: Well, accountants did give some sort of reports on reviews. And this is a subject that I guess the Commission never accepted them, so I never followed very carefully all of these alternative reviews. But accountants considered preparing statements from a company's books and records, putting it on his letterhead, things of this sort without—

and disclaim an opinion and so forth, and whether it should be on his letterhead. There have been discussions of this sort but it's not something that the Commission ever seriously considered accepting. So it's not something that I'm really well versed in.

BM: Howard, going back to the nuts and bolts a little bit, at some point down the line, and I don't know whether it was when you were the chief accountant or not. But the level of review by the Chief Accountant's Office as opposed to what was going on in the branch changed. And the Chief Accountant's Office became once—as more—there were more and more accountants in the groups with a senior accountant of some kind who was doing the first-line review. And the Chief Accountant's Office was only sort of doing final reviews and sort—more policy stuff than they had been at one point. Was that while you were administering the office?

HH: There was an evolution and certain types of filings were not reviewed by the Division Office of the Chief Accountant. By the time I left, we were looking at basically significant accounting problems and working with branch accountants more, who looked at something and weren't sure. And they came and talked to us and we looked at it with them. And they may have had a number of other comments that they were so certain about, that we never looked at them with the branch accountants. So they may have sent out a letter and the only thing we looked at—maybe one comment that they wrote that was included in that letter. But we were not looking at everything by any means.

BM: But that was another function of just having too much to do and not enough people to do it?

HH: Well, it was a matter of—the way the staffing was changed, we had—I think it was probably only four accountants in that office when I left. Four—maybe five. And the branches got to the point that there was one senior review accountant for each of three branches. He worked with them and looked at most of their comments. Then some things came up into the Division Chief Accountant's Office. Usually, we spent an awful lot of our time either working with branch accountants or holding conferences or telephone calls with people who had problems resolving issues with the branches.

MB: How many accountants in your office when you left in the Chief Accountant's Office?

HH: I think there were only five in there.

MB: Do you remember approximately how many accountants there were in the whole Division?

HH: Well, I think they were attempting to have three in each branch but we never did have three in every branch when I left. I don't know the total number.

BM: Did we have twelve branches at that point or fifteen?

HH: I think we went to fifteen at one point . . .

BM: Fifteen and then dropped back.

HH: . . . came back down to twelve.

BM: Right.

HH: And we were trying to have three in each branch but I don't—I don't remember any time that we ever had three in every branch.

MB: So if my math is right, we're talking about fifty, give or take?

HH: Yes, about fifty.

MB: Fifty, fifty-five—something like that—accountants . . .

HH: That's right.

BM: And I was telling both Mickey and Howard when I came in that I had recently talked to an analyst, not an accountant, but a person who's still on the staff. And after Sarbanes-Oxley, that his group, one of the AD groups—I forget now whether there were five or six

AD groups. But they had twenty-one accountants in the group, eighteen staff accounts, three review accountants. And if you multiply that by either six or five, you come up to very different number than what there were when—how would you have liked to had that kind of staff to—one, to administer it, and also, to get work from?

HH: I'm not sure I can envision that. But when I was there there were only about ten to twelve people in a branch. And they worked as a team on any particular filing. If you tell me you've got twenty accountants in a group, it doesn't really seem practical to me that more than two people get involved in the same filing. So you're just telling me that it's an organizational matter, I guess.

BM: It's a definite management organizational problem. It stems from the fact that, of course, after everything that happened with Sarbanes-Oxley, that there's a mandate that the Fortune top thousand companies or what have you—their 10Ks be reviewed every year. And I think probably a lot more emphasis is now being placed on the '34 Act reporting, to go in addition to the review of new registration statements. And so in order to keep track of that many companies, you just need more manpower. There's no way to do it with less.

HH: But in reviewing an individual filing, you probably—for—at least, for the financial statements, maybe two people could get involved in it and talk with each other as to accounting issues, and maybe talk to a third if they've got something particular that they

want to look at. But it would seem pointless to me to have more than one or two that really go over any one filing thoroughly.

MB: This may not be a fair question and you don't have to answer it. But do you think that it was reasonable, or would have been reasonable to expect the Division to—its review processes—assuming that it reviewed the filing, that they would pick up on some of the problems that an Enron and some of the other big failures have been? Is that the kind of thing that could have or should have been picked up by review?

HH: Well, throughout my whole accounting career, starting from the days when I first went to work in public accounting, there's been an increasing pressure on companies to improve earnings per share. I can remember in about 1951 talking to a treasurer of a company in New York and telling him, "You've got too much reserve. You ought to put it back in the income now." And he said, "I don't want to show income. If I do, the shareholders will just want a dividend—want me to increase the dividend." There wasn't the interest in earnings per share in the 1950s that there is today, and that increased all through the time I was involved in accounting.

So over the years there have been all sorts of pressures building up to—to do something to increase the earnings per share. And some of the things in Enron, these off balance sheet financings, we at the Division level, while I was there, blocked some of them from being accounted for as Enron did. And I think I can recall one where we made a

particular company restate its financial statements because we discovered they had done something on off balance sheet companies. But it's been a pressure and whether you catch these things or not depends upon how well they're concealed, how much time you've got to ask questions and how honestly you get answers.

BM: Isn't it complicated by, what we were talking about earlier, in the fact that, basically, what we get or what the staff gets are whatever we're given.

HH: That's right.

BM: And the ability that you talked about in the early 1960s for a staff accountant to go out and actually look at what some of the underlying—just isn't there. And I think with the numbers, it's awfully hard to look through. As diligent as you can be, it's always going to be hard. If somebody is trying very hard to hide something, they're going to have success hiding it.

HH: I'm seeing a little more than that. Over the years, companies have recognized that earnings per share is very, very important. So they're working to develop accounting practices or transactions where they can show as little real information as possible. And there's nothing out there to flag a problem for you. In earlier days when I was there, some of these transactions, like off balance sheet financing, had never been perfected, hadn't been worked on as hard as they have. And so, while I was there, there were a few

of them that we caught because there were a couple extra words in a footnote and we said, "What do they mean?" We got more information and we put an end to a couple of them. I don't think you could expect a guy to sit in an office, read something and catch everything.

MB: No matter how much time you spend.

HH: No matter how much time.

MB: Over the years, when you were there too, there was a lot of discussion about the independence of accountants and whether accountants should be involved in consulting work for the same firm. And I think that's been settled now. As I understand it, accounting firms don't do consulting work. Do you think that has made them more independent? Do you think it's better that they don't do this, or do you think it makes no difference one way or the other?

HH: Well, I thought the Commission had a pretty good handle on independence issues and a certain amount of consulting work. In the earlier days when I was there it wasn't too bad, but in the last, say, five years I was there, with the advent of computers and more sophisticated management information systems, the pressure grew. The accountants wanted to do more of this work. And there were actually a couple of accountants that petitioned the Commission before I left because they didn't like the staff positions. And I

think it got to be too much, obviously, but the independence problem got to be bigger with the passage of time. And probably the worst of it came after I left.

BM: The accounting firms now making more money on their outside activities than they were making on the accounting, and so the accounting was not driving things anymore. They were management-consulting firms.

HH: That seemed true about the time I retired.

BM: Yes.

HH: And I think it got to be that sort of a problem when people started using computers and we started getting sophisticated management information systems. But an accountant helping a company to do something relatively simple was not a problem.

MB: Okay. A few minutes ago, Bill mentioned that there are now twenty-three accountants in every branch and the number of accountants in the division are, you know, numbered by the hundreds. Do you think that with all those additional accountants that the likelihood of financial fraud is lessened any? Do you think by looking at every file in all the top thousand companies every year, and having a goal of looking every other year at other companies would help, or would significant decrease the chance of fraud?

HH: Well, I think there are more companies filing now than there were in the days when I was at the Commission. Certainly, they need more accountants to look at the filings. I think that the filings should—at least, '33 Act filings probably should be looked at a hundred percent, 34 Act filings probably at least every other year, every third year at the most. I know they can't do it without having more accountants available than they had when I was with the Commission. But I don't think the Commission can ever stop all frauds, because all the material that's sent in and included in financial statements is so filtered before the staff gets it, there may not be enough information there for them to smell a fraud, or to ask the right question to find out if there's a fraud. There are capable accountants and lawyers both who read the words of what the staff sees before the staff gets it. And I'm sure they can clean it up in many cases so that the staff doesn't recognize some of the problems that are being concealed.

MB: Okay. I don't have any more questions. Do you?

BM: On that final word, I thank you, Howard.

MB: We're closing. Thank you very much.

HH: I appreciate the interest and glad to talk to you.

[End of Interview]