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“THE NUMBERS GAME”

Remarks by Chairman Arthur Levitt
Securities and Exchange Commission

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Thank you very much. Dean Daly, Dean Sexton and to everyone gathered this evening, thank you for welcoming me tonight. I am honored to be here on such an auspicious evening for both NYU and Bill Allen.

The creation of the Center for Law and Business recognizes an important truth: we cannot continue to view the worlds of business and law as parallel but separate universes. And NYU could not have selected a more qualified or thoughtful individual than Bill as its first director. His leadership of the Delaware Court of Chancery—acknowledged as the nation’s most influential arbiter of corporate law—confirmed his reputation as a great thinker who effortlessly bridges the worlds of law and business. I’ve heard from friends on Wall Street that it’s a far less stressful experience to hear Bill lecture in front of a classroom than from his former seat on the bench.

Seven months ago, I expressed concerns about selective disclosure. Through conference calls or embargoed press releases, analysts and institutional investors often hear about material news before it is made public. In the interval, there is a great deal of unusual trading. The practice had been going on for a long time. And, while everyone was aware of it, and most were extremely uncomfortable with it, few spoke out. As the investor’s advocate, the SEC did and we will continue to do so.

Well, today, I’d like to talk to you about another widespread, but too little-challenged custom: earnings management. This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America’s financial reporting system. A game that runs counter to the very principles behind our market’s strength and success.

Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Managing may be giving way to manipulation; Integrity may be losing out to illusion.

Many in corporate America are just as frustrated and concerned about this trend as we, at the SEC, are. They know how difficult it is to hold the line on good practices when their competitors operate in the gray area between legitimacy and outright fraud.

A gray area where the accounting is being perverted; where managers are cutting corners; and, where earnings reports reflect the desires of management rather than the underlying financial performance of the company.

Tonight, I want to talk about why integrity in financial reporting is under stress and explore five of the more common accounting gimmicks we’ve been seeing. Finally, I will outline a framework for a financial community response to this situation.

This necessary response involves improving both our accounting and disclosure rules, as well as the oversight and function of outside auditors and board audit committees. I am also calling upon a broad spectrum of capital market participants, from corporate management to Wall Street analysts to investors, to stand together and re-energize the touchstone of our financial reporting system: transparency and comparability.

This is a financial community problem. It can't be solved by a government mandate: it demands a financial community response.

The Role of Financial Reporting in Our Economy

Today, America's capital markets are the envy of the world. Our efficiency, liquidity and resiliency stand second to none. Our position, no doubt, has benefited from the opportunity and potential of the global economy. At the same time, however, this increasing interconnectedness has made us more susceptible to economic and financial weakness half a world away.

The significance of transparent, timely and reliable financial statements and its importance to investor protection has never been more apparent. The current financial situations in Asia and Russia are stark examples of this new reality. These markets are learning a painful lesson taught many times before: investors panic as a result of unexpected or unquantifiable bad news.

If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested.

The Pressure to "Make Your Numbers"

While the problem of earnings management is not new, it has swelled in a market that is unforgiving of companies that miss their estimates. I recently read of one major U.S. company, that failed to meet its so-called "numbers" by one penny, and lost more than six percent of its stock value in one day.

I believe that almost everyone in the financial community shares responsibility for fostering a climate in which earnings management is on the rise and the quality of financial reporting is on the decline. Corporate management isn't operating in a vacuum. In fact, the different pressures and expectations placed by, and on, various participants in the financial community appear to be almost self-perpetuating.

This is the pattern earnings management creates: companies try to meet or beat Wall Street earnings

projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. And analysts seek constant guidance from companies to frame those expectations. Auditors, who want to retain their clients, are under pressure not to stand in the way.

Accounting Hocus-Pocus

Our accounting principles weren't meant to be a straitjacket. Accountants are wise enough to know they cannot anticipate every business structure, or every new and innovative transaction, so they develop principles that allow for flexibility to adapt to changing circumstances. That's why the highest standards of objectivity, integrity and judgment can't be the exception. They must be the rule.

Flexibility in accounting allows it to keep pace with business innovations. Abuses such as earnings management occur when people exploit this pliancy. Trickery is employed to obscure actual financial volatility. This, in turn, masks the true consequences of management's decisions. These practices aren't limited to smaller companies struggling to gain investor interest. It's also happening in companies whose products we know and admire.

So what are these illusions? Five of the more popular ones I want to discuss today are "big bath" restructuring charges, creative acquisition accounting, "cookie jar reserves," "immaterial" misapplications of accounting principles, and the premature recognition of revenue.

"Big Bath" Charges

Let me first deal with "Big Bath" restructuring charges.

Companies remain competitive by regularly assessing the efficiency and profitability of their operations. Problems arise, however, when we see large charges associated with companies restructuring. These charges help companies "clean up" their balance sheet—giving them a so-called "big bath."

Why are companies tempted to overstate these charges? When earnings take a major hit, the theory goes Wall Street will look beyond a one-time loss and focus only on future earnings.

And if these charges are conservatively estimated with a little extra cushioning, that so-called conservative estimate is miraculously reborn as income when estimates change or future earnings fall short.

When a company decides to restructure, management and employees, investors and creditors, customers and suppliers all want to understand the expected effects. We need, of course, to ensure that financial reporting provides this information. But this should not lead to flushing all the associated costs—and maybe a little extra—through the financial statements.

Creative Acquisition Accounting

Let me turn now to the second gimmick.

In recent years, whole industries have been remade through consolidations, acquisitions and spin-offs. Some acquirers, particularly those using stock as an acquisition currency, have used this environment as an opportunity to engage in another form of “creative” accounting. I call it “merger magic.”

I am not talking tonight about the pooling versus purchase problem. Some companies have no choice but to use purchase accounting—which can result in lower future earnings. But that’s a result some companies are unwilling to tolerate.

So what do they do? They classify an ever-growing portion of the acquisition price as “in-process” Research and Development, so—you guessed it—the amount can be written off in a “one-time” charge—removing any future earnings drag. Equally troubling is the creation of large liabilities for future operating expenses to protect future earnings—all under the mask of an acquisition.

Miscellaneous “Cookie Jar Reserves”

A third illusion played by some companies is using unrealistic assumptions to estimate liabilities for such items as sales returns, loan losses or warranty costs. In doing so, they stash accruals in cookie jars during the good times and reach into them when needed in the bad times.

I’m reminded of one U.S. company who took a large one-time loss to earnings to reimburse franchisees for equipment. That equipment, however, which included literally the kitchen sink, had yet to be bought. And, at the same time, they announced that future

earnings would grow an impressive 15 percent per year.

“Materiality”

Let me turn now to the fourth gimmick—the abuse of materiality—a word that captures the attention of both attorneys and accountants. Materiality is another way we build flexibility into financial reporting. Using the logic of diminishing returns, some items may be so insignificant that they are not worth measuring and reporting with exact precision.

But some companies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that’s the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly, “It doesn’t matter. It’s immaterial.”

In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of these so-called non-events simply don’t matter.

Revenue Recognition

Lastly, companies try to boost earnings by manipulating the recognition of revenue. Think about a bottle of fine wine. You wouldn’t pop the cork on that bottle before it was ready. But some companies are doing this with their revenue—recognizing it before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale.

Action Plan

Since U.S. capital market supremacy is based on the reliability and transparency of financial statements, this is a financial community problem that calls for timely financial community action.

Therefore, I am calling for immediate and coordinated action: technical rule changes by the regulators and standard setters to improve the transparency of financial statements; enhanced oversight of the finan-

cial reporting process by those entrusted as the shareholders' guardians; and nothing less than a fundamental cultural change on the part of corporate management as well as the whole financial community.

This action plan represents a cooperative public-private sector effort. It is essential that we work together to assure credibility and transparency. Our nine-point program calls for both regulators and the regulated to not only maintain, but increase public confidence which has made our markets the envy of the world. I believe this problem calls for immediate action that includes the following specific steps:

Improving the Accounting Framework

First, I have instructed the SEC staff to require well-detailed disclosures about the impact of changes in accounting assumptions. This should include a supplement to the financial statements showing beginning and ending balances as well as activity in between, including any adjustments. This will, I believe, enable the market to better understand the nature and effects of the restructuring liabilities and other loss accruals.

Second, we are challenging the profession, through the AICPA, to clarify the ground rules for auditing of purchased R&D. We also are requesting that they augment existing guidance on restructurings, large acquisition write-offs, and revenue recognition practices. It's time for the accounting profession to better qualify for auditors what's acceptable and what's not.

Third, I reject the notion that the concept of materiality can be used to excuse deliberate misstatements of performance. I know of one Fortune 500 company who had recorded a significant accounting error, and whose auditors told them so. But they still used a materiality ceiling of six percent earnings to justify the error. I have asked the SEC staff to focus on this problem and publish guidance that emphasizes the need to consider qualitative, not just quantitative factors of earnings. Materiality is not a bright line cutoff of three or five percent. It requires consideration of all relevant factors that could impact an investor's decision.

Fourth, SEC staff will immediately consider interpretive accounting guidance on the do's and don'ts of revenue recognition. The staff will also determine

whether recently published standards for the software industry can be applied to other service companies.

Fifth, I am asking private sector standard setters to take action where current standards and guidance are inadequate. I encourage a prompt resolution of the FASB's projects, currently underway, that should bring greater clarity to the definition of a liability.

Sixth, the SEC's review and enforcement teams will reinforce these regulatory initiatives. We will formally target reviews of public companies that announce restructuring liability reserves, major write-offs or other practices that appear to manage earnings. Likewise, our enforcement team will continue to root out and aggressively act on abuses of the financial reporting process.

Improved Outside Auditing in the Financial Reporting Process

Seventh, I don't think it should surprise anyone here that recent headlines of accounting failures have led some people to question the thoroughness of audits. I need not remind auditors they are the public's watchdog in the financial reporting process. We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive. The integrity of that information must take priority over a desire for cost efficiencies or competitive advantage in the audit process. High quality auditing requires well-trained, well-focused and well-supervised auditors.

As I look at some of the failures today, I can't help but wonder if the staff in the trenches of the profession have the training and supervision they need to ensure that audits are being done right. We cannot permit thorough audits to be sacrificed for re-engineered approaches that are efficient, but less effective. I have just proposed that the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest.

Strengthening the Audit Committee Process

And, finally, qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting

as well as the mandate to ask probing questions. In fact, I've heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to a perfunctory presentation.

Compare that situation with the audit committee which meets twelve times a year before each board meeting; where every member has a financial background; where there are no personal ties to the chairman or the company; where they have their own advisers; where they ask tough questions of management and outside auditors; and where, ultimately, the investor interest is being served.

The SEC stands ready to take appropriate action if that interest is not protected. But, a private sector response that empowers audit committees and obviates the need for public sector dictates seems the wisest choice. I am pleased to announce that the financial community has agreed to accept this challenge.

As part eight of this comprehensive effort to address earnings management, the New York Stock Exchange and the National Association of Securities Dealers have agreed to sponsor a "blue-ribbon" panel to be headed by John Whitehead, former Deputy Secretary of State and retired senior partner of Goldman, Sachs, and Ira Millstein, a lawyer and noted corporate governance expert. Within the next 90 days, this distinguished group will develop a series of far-ranging recommendations intended to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability. They are going to examine how we can get the right people to do the right things and ask the right questions.

Need for a Cultural Change

Finally, I'm challenging corporate management and Wall Street to re-examine our current environment. I believe we need to embrace nothing less than a cultural change. For corporate managers, remember, the integrity of the numbers in the financial reporting system is directly related to the long-term interests of a corporation. While the temptations are great, and the pressures strong, illusions in numbers are only that -- ephemeral, and ultimately self-destructive.

To Wall Street, I say, look beyond the latest quarter. Punish those who rely on deception, rather than the practice of openness and transparency.

Conclusion

Some may conclude that this debate is nothing more than an argument over numbers and legalistic terms. I couldn't disagree more.

Numbers in the abstract are just that—numbers. But relying on the numbers in a financial report are livelihoods, interests and ultimately, stories: a single mother who works two jobs so she can save enough to give her kids a good education; a father who labored at the same company for his entire adult life and now just wants to enjoy time with his grandchildren; a young couple who dreams of starting their own business. These are the stories of American investors.

Our mandate and our obligations are clear. We must rededicate ourselves to a fundamental principle: markets exist through the grace of investors.

Today, American markets enjoy the confidence of the world. How many half-truths, and how much accounting sleight-of-hand, will it take to tarnish that faith?

As a former businessman, I experienced all kinds of markets, dealt with a variety of trends, fads, fears, and irrational exuberances. I learned that some habits die hard. But, more than anything else, I learned that progress doesn't happen overnight and it's not sustained through short cuts or obfuscation. It's induced, rather, by asking hard questions and accepting difficult answers.

For the sake of our markets; for the sake of a globalized economy which depends so much on the reliability of America's financial system; for the sake of investors; and for the sake of a larger commitment not only to each other, but to ourselves, I ask that we join together to reinforce the values that have guided our capital markets to unparalleled supremacy. Together, through vigilance and trust, I know we can succeed.

Thank you