

# U.S. Securities and Exchange Commission

# **Financial Reporting Challenges**

## Remarks by

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U.S. Securities & Exchange Commission

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Good afternoon, it is a pleasure and an honor to address the Financial Executives International Conference.

At the present time, our financial reporting system is under pressure to improve and evolve. You, the financial and accounting profession, and we, the SEC, are challenged to meet the demands placed on our system by the constant advancements in communications and information systems. Today I want to speak about how we can work together to face these challenges.

But, before I begin speaking about what the SEC views as the importance of accurate financial reporting and auditing, I am obligated to state that the views that I express here today are my own and do not necessarily reflect the views of the Commission, other Commissioners, or the Commission's staff.

Let me start by reminding everyone about the philosophy that shapes the SEC's approach to regulatory issues. As most of you know, the SEC was established in the wake of the 1929 market crash and ensuing Depression. The SEC is a market regulator. That is, the SEC does not regulate by passing on the merits of securities offerings. Rather, SEC regulation aims to maintain fair and orderly markets and to protect investors by requiring securities issuers to make full and fair disclosure of all material information, so that investors have a basis for making informed decisions. Therefore, the quality and credibility of disclosure documents filed with the SEC by public companies is at the heart of this approach.

As we enter this new century, many of the worlds' capital markets, particularly in advanced economies, are probably more liquid and efficient

than at any other time in history. But, as we saw in the 1997-1998 Asian market crises, investors flee when markets are viewed as risky. And markets are only viewed as safe and stable if investors trust and understand the underlying financial reporting structure. Based on this and other instances of investor wariness, evidence suggests that the stability of markets is based, in large part, on the veracity of the information underlying the market. Therefore, the two issues that I wish to focus attention on today are first, the importance of the quality of the financial reporting process and second, the Commission's continued focus on financial fraud cases.

# **The Financial Reporting Process**

First, the financial statements and supporting disclosure documents are management's responsibility. Accountants within the company, that is management accountants, should do all that they can to make sure those statements and supporting documents are accurate, complete, and provide a reliable picture of the company.

The capital formation process hinges on the willingness of investors to make investments in the securities of public companies. Investors commit their personal funds to companies relying, in part, on management's representations and the auditor's opinion that a particular company's financial statements fairly reflect the financial position, results of operations, and cash flows of the company.

The federal securities laws, to a significant extent, make accountants the "gatekeepers" to the public securities markets. These laws require, or permit the Commission to require, that independent public accountants certify financial information filed with the SEC. As we all know, without an opinion from an independent auditor, a company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities in the U.S. markets.

In the fiscal year ending September 30, 2000, over 14,000 registrants filed annual reports with the Commission. While the Commission staff reviews filings, the staff is not able to review in detail all the financial statements filed with the Commission. Therefore, the Commission **must** rely heavily on the accounting profession to be primarily responsible for the large volume of financial information that forms the cornerstone of the Commission's full disclosure system.

Moreover, Congress, in creating a system in which investors and the Commission must rely on the accounting profession, granted the accounting profession an important public trust. The system Congress envisioned is predicated upon accountants working within corporations, as well as the independent auditors, adhering to strong ethical standards to ensure that the financial statements conform with US GAAP. Congress did not make this grant without considering the alternatives. As part of its deliberations, Congress considered creating a corps of government auditors to review and audit companies' financial statements, and even considered federal licensing

of accountants. Instead, Congress chose to entrust the accounting profession with the responsibility for auditing the financial statements of companies registered with the Commission.

This trust in management accountants and independent auditors forms the foundation of the financial reporting process. The resulting disclosure forms the bedrock of our financial markets.

#### **Current Trends**

Unfortunately, the Commission has recently noticed certain worrisome trends relating to the integrity of financial information. Current market conditions have increased the pressure on companies to meet past or projected earnings levels. As a result, some managers have engaged in manipulation or "smoke and mirrors" to prop up their companies' earnings and thereby their share prices. When such chicanery is discovered, the resulting and inevitable restatements of earnings have caused investors to lose billions of dollars, and perhaps, confidence in the market.

The second troubling trend on which we're keeping an eye is the increasing use of what has been called "pro forma" information. This is a tool that some companies use to disseminate an idealized version of their performance. It may exclude any cost or expense the company wants, yet it is presented in a format that suggests reliability and soundness. There's only one problem, pro forma statements are not audited and may not even be reconcilable with financial statements filed with the Commission.

Another practice that the staff has noted with increasing frequency is "channel stuffing." Some companies have announced that they will not meet their year-end earnings targets, apparently because they have been, in effect, reaching ahead into next quarter's sales to meet their quarterly targets. Using these techniques or offering deep discounts, companies motivate their customers to buy sooner rather than later. Unfortunately, while that may create the appearance of another successful quarter, it virtually guarantees that the company is starting in a hole the next quarter. At the end of the year, when the auditors discover what had been going on, the result is a shortfall for the fourth quarter and/or the year, as well as a shock to misled investors.

#### Recent Enforcement Actions - Financial Fraud

The Commission takes financial fraud very seriously. About 100 of the SEC's enforcement cases brought last year involved accounting fraud. Charges were filed against 29 public companies, 19 CEOs, 19 CFOs, 16 Inside Directors and 1 Outside Director. As you know, SEC civil fraud charges can result in fines against companies and individuals and prohibitions against officials working again for public companies. Additionally, the Commission is making more criminal referrals, many of which have led to convictions and jail time.

As I stated earlier, we view these types of cases very seriously. That's why we have recently formed a 15-person task force of lawyers and accountants devoted to investigating financial fraud.

Now, I'd like to summarize a number of points that are evident in recent enforcement cases. As you listen to this summary, remember that many of these frauds could have been avoided if companies had established effective internal controls, the oversight of the auditing committees had been more critical, or the auditors had been more demanding.

**Revenue Recognition** — Over half the cases brought by the Commission involved improper income recognition, including conditional and other non-GAAP sales; outright fictitious sales; improper "bill and hold" sales; failure to record expenses; and improper adjustments to revenue. Revenue timing was also a significant problem; indeed in one case [Sirena Apparel out of LA] senior managers reset a computer clock in order to hold a quarter open to meet a target. Employees of that company even placed bets with each other over how many additional days it would take to make the numbers!

**Asset & Liability Valuation** – On the balance sheet side, about a quarter of the Commission's cases involved overvaluation of assets. Misuse of reserves, failure to record liabilities, and improper capitalization of expenses were also significant problems.

Moving on, let's review the **outcome** of some of these recent cases.

Individuals Charged – The Commission is increasing its sanctions against individuals who commit fraud on behalf of corporations. Last year, 78 individuals were charged with committing fraud, and 12 more were charged with aiding and abetting fraud. There are no sacred cows; as I stated earlier, the Commission charged 16 corporate directors with committing fraud. The problem for these individuals, however, does not stop there. The Commission is referring more and more of its cases to the U.S. Attorneys' offices for criminal prosecution as well. The number of criminal referrals is up in general and certainly with regard to financial fraud.

Additionally, many of our financial fraud cases are being brought more swiftly and efficiently than ever before. For example, the Commission's case against Microstrategy, involving premature recognition of revenue leading to incorrect financial statements, was brought in a matter of months. That investigation led to settled fraud charges against the company's CEO, COO, and CFO, and a record disgorgement by those individuals of \$10 million.

### **Accountants Charged**

Let's not forget the accountants, both those inside the company as well as the outside auditors. In every financial fraud or reporting failure, the Commission always asks the question, "Where were the accountants?" All too often we find accountants and even outside auditors who, at best, closed their eyes to the problem, and in some cases were even complicit. As you

know, we take the professional standards of practicing before the Commission very seriously. Last year alone, under Rule 102(e), we barred 26 corporate CPAs, holding positions from Accounting Officer up to CFO and CEO. We also barred 11 outside audit professionals.

To sum up, it is critical that management accountants, independent auditors and audit committees of boards of directors retain their objective and vigilant oversight of public disclosure filings made with the Commission. That way, investors have the reliable information necessary to make informed investment decisions. This continuing accurate reporting is, in turn, essential to maintaining the sanctity of today's markets.

#### Conclusion

In conclusion, I wish to stress that the tremendous challenge facing both the SEC and the people in this room. It's the challenge to maintain high-quality financial reporting and, therefore, a strong capital market. I have faith that together we can meet that challenge.

I **thank you** for your time and attention today and I look forward to working with all of you in keeping our markets safe for investors.

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