This is a Fake Paper About Something

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On September 28, 1998, Chairman of the U.S. Securities and Exchange Commission Arthur Levitt sounded the call to arms in the financial community. Levitt asked for, immediate and coordinated action to assure credibility and transparency of financial reporting. Levitt’s speech emphasized the importance of clear financial reporting to those gathered at New York University. Reporting which has bowed to the pressures and tricks of earnings management. Levitt specifically addresses five of the most popular tricks used by firms to smooth earnings. Secondly, Levitt outlines an eight part action plan to recover the integrity of financial reporting in the U.S. market place.

What are the basic objectives of financial reporting? Generally accepted accounting principles provide information that identifies, measures, and communicates financial information about economic entities to reasonably knowledgeable users. Information that is a source of decision making for a wide array of users, most importantly, by investors and creditors. Investors and creditors who are responsible for effective allocation of capital in our economy. If financial reporting becomes obscure and indecipherable, society loses the benefits of effective capital allocation. Nothing illustrates the importance of transparent information better than the pre-1930’s era of anything goes accounting. An era that left a chasm of misinformation in the market. A chasm that was a contributing factor to the market collapse of 1929 and the years of economic depression. An entire society suffered the repercussions of misinformation. Families, and retirees depend on the credibility of financial reporting for their futures and livelihoods. Levitt describes financial reporting as, a bond between the company and the investor which if damaged can have disastrous, long-lasting consequences.

The pressure to achieve consensus estimates has never been so intense. The market demands consistency and punishes those who come up short. Eric Benhamou, former CEO of 3COM Corporation, learned this hard lesson over a few short weeks in 1996. Benhamou and shareholders lost $7 billion in market value when 3COM failed to achieve expectations. The pressures are a tangled web of expectations, and conflicts of interest which Levitt describes as almost self-perpetuating. With pressures mounting, the answer from U.S. managers has been earnings management with a mix of managed expectations. March of 1997 Fortune magazine reported that for an unprecedented sixteen consecutive quarters, more S&P 500 companies have beat the consensus earnings estimate than missed them. The sign of a quickly growing economy and a measure of the importance the market has placed on consensus earnings estimates. The singular emphasis on earnings growth by investors has opened the door to earnings management solutions. Solutions that are further being reinforced to managers by market forces and compensation plans. Primarily, managers jobs depend on their ability to build stockholder equity, and ever more importantly their own compensation.

A growing number of CEO’s are receiving greater percentages of their compensation as stock options. A very personal incentive for executive achievement of consensus earnings estimates. Companies are not the only ones to feel the squeeze. Analysts are being pressured by large institutional investors and companies seeking to manage expectations. Everyone is seeking the win. Auditors are being accused of being out to lunch, with the clients. Many accounting firms are coming under scrutiny as some of their clients are being investigated by the SEC for irregularities in their practice of accounting. Cendant and Sunbeam both left accounting giant Arthur Anderson holding a big ol’ bag full of unreported accounting irregularities. Auditors from BDO Seidman addressed issues of GAAP with Thing New Ideas.
The dollar amounts are staggering and the future implications far reaching. Since this approach was introduced by IBM in 1995 these charges have become commonplace for acquisition accounting. A popularity, largely due to the level of room allowed in research and development estimations.

The Third earnings manipulation tool discussed by Levitt is what he calls Miscellaneous Cookie Jar Reserves. The technique involves liability and other accrual accounts specifically sensitive to accounting assumptions and estimates. These accounts can include sales returns, loan losses, warranty costs, allowance for doubtful accounts, expectations of goods to be returned and a host of others. Under the auspices of conservatism, these accounts can be used to store accruals of future income. Restructuring liabilities created by Big Bath’ charges also provides these Cookie jar reserve effect. Jack Ciesielski, who manages money and writes the Analyst’s Accounting Observer, calls these accounts the accounting equivalent of turning lead into gold… a virtual honeypot for making rainy-day adjustments. Various adjustments and entries that can produce almost any desired results in the pursuit of consistency.
The statement of financial accounting concepts No. 2 (FASB, May 1980), defines materiality as:

*The magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgement of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.*

Finally, Levitt briefly touches on the complex issue of the manipulation occurring in revenue recognition. Modern contracts, refunding, delaying of sales, up front and initiation fees all add to the complications in some industries to follow specific rules of revenue recognition. With plenty of holes in revenue recognition the door is open for tweaking. Microsoft is a good example of the problems facing today’s companies. Concerned with proper revenue recognition, Microsoft started a practice in the software industry that allows companies to recognize revenue over a period of time. This recognition allows for better matching of revenues to future expenses generated by the sale of the software. Expenses such as upgrades and technical support are related to the revenue generated by the sale of the software but are incurred at a later date. The complexities of modern business transactions have left modern standards of accountancy years behind. Gimmicks, that all must be addressed by the financial community.

The task of returning integrity to U.S. financial reporting is of paramount importance. The interests of our financial system are at stake. Arthur Levitt and the SEC stand ready to take appropriate action if that interest is not protected. But, a private sector response that… obviates the need for public sector dictates seems the wisest choice. A nine part plan that involves the entire financial community is proposed by Levitt.
Bibliography


Johnson, Norman S. Recent Developments at the SEC. Speech. 20 August 1999.