

REMARKS

BY

CHAIRMAN ARTHUR LEVITT

SECURITIES AND EXCHANGE COMMISSION

"A PARTNERSHIP FOR THE PUBLIC TRUST"

BEFORE THE AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS

DECEMBER 8, 1998

Check Against Delivery

It is a pleasure to be with you all this morning. I want to thank Bob Herz for his kind introduction. I also want to express my appreciation to Olivia Kirtley and Barry Melancon. They personify the professionalism and integrity of the AICPA.

More than 65 years ago, James Landis, who was to become the third SEC Chairman, sought to enlist the help of the accounting profession in enacting the federal securities laws. It wasn't easy. With its severe penalties against misrepresentations of "material facts," lawyers, corporate managers and accountants did not take kindly to the legislation.

The accounting profession, having long battled corporate management, now felt itself threatened from the other side as well -- an overreaching government. A 1933 Journal of Accountancy editorial called the government's actions motivated by quote "the ambitions of pious theory."

Undeterred, Landis went directly to the accounting profession. He wanted to cut through the skepticism and explain his efforts to build effective regulation through existing mechanisms. So, beginning in 1933 and continuing throughout his tenure in Washington, he sought out opportunities to meet with and speak before every accounting group.

Landis told accountants, "We need you as you need us." Accountants had labored for years under the tight grip of corporate management. And, Landis knew that accountants desperately wanted to exercise the independence they needed for high quality financial reporting.

His exhortations helped convince the profession that a unique opportunity to gain respect and independence lay at hand. The Journal of Accountancy, soon after, called this time of new regulation "The most important epoch in the history of accountancy."

The AICPA was the first organization to take the lead in supporting the resulting legislation that is the foundation of the SEC's approach to regulation. The AICPA formed a Special Committee on Cooperation with the SEC -- which still exists today. In fact, it's the committee that organizes this outstanding conference each year.

Today, I come before you as an SEC Chairman to enlist, once again, your support. The issues may not be as widespread in scope, but the principles behind them are no less important to the health of our capital markets and to the integrity of our financial reporting system.

We need the support of both public accountants and financial managers in three critical areas: (1) to avoid the temptation to sacrifice sound financial reporting practices for the expectations of Wall Street; (2) to continually strive to maintain the highest quality accounting and auditing standards in an increasingly global and technologically driven marketplace; and (3) to uphold the independence, objectivity and professionalism of this most noble of professions.

EARNINGS MANAGEMENT

Today, America's capital markets are the envy of the world. Our efficiency, liquidity and resiliency stand second to none. That hasn't happened by accident. For a good part of this century, our system of financial reporting has come to be characterized by its high quality and transparency. This has instilled an unparalleled degree of confidence and trust.

But that confidence and trust can become all too fleeting if integrity falls victim to illusion. 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.

As you may know, I recently expressed concern that the motivation to satisfy Wall Street earnings expectations may be overriding common sense business practices. In the process, I fear we are witnessing a gradual, but noticeable erosion in the quality of financial reporting.

While the problem of inappropriate earnings management is not new, it has risen in a market unforgiving of companies that miss Wall Street's consensus estimates. For many, this pressure has become all too hard to resist.

Sales and income are overstated by recognizing revenue for partially shipped, unshipped or even back ordered equipment.

Fiscal years are extended beyond 365 days to record extra sales -- and even sales that the company knows don't conform to what a customer ordered.

"Big Bath" charges are perpetrated under the guise of corporate restructurings or mergers to avoid future charges related to normal operating costs. Companies claim "in-process" research and development instead of showing goodwill, when, in fact, purchased companies previously reported little or no R&D expenditures. Companies stash accruals in "cookie jar" reserves during the good economic times and reach into them when needed in the bad times.

These problems didn't develop over night. And they won't be remedied over night. I really believe that all of us -- working together -- need to affect nothing less than a cultural change in the financial community.

I know it's difficult to hold the line on good practices when others operate in the gray area between legitimacy and outright fraud. I believe this gray area jeopardizes the public trust. And without trust, innovation is stifled; our ability to raise capital is impaired; and market efficiency suffers.

I'm not an accountant, but there are few subjects on which I care more deeply about than the independence of auditors. As auditors, you are entrusted with a special responsibility. I can't say it any more succinctly than the Supreme Court when it declared, "The independent auditor assumes a public responsibility transcending any employment relationship with the client."

We all recognize that committed, effective, and objective auditors and financial managers represent a rampart against those practices which assault the public's trust. And, I fear that when short-term estimates rather than long-term results drive a company's stock, the public trust is jeopardized. When a company's earnings miss Wall Street's projection by one penny, and the stock price falls 15 percent, the public trust is jeopardized. When accounting practices are defined more by their gimmickry instead of their representation of underlying business conditions, the public trust is jeopardized.

Byron Woodside, an SEC Commissioner during the 1960's, once stated that, "History, common sense and experience tell us that at the heart [of our markets]...are faith and trust in the honesty of corporate financial records....One who weakens that trust without good cause does no one a service."

It won't be easy to change attitudes and behavior. But does anyone here think we have a choice? Can we ever afford to accept practices that defy the very principles behind our markets' success: transparency, disclosure and comparability? We can not.

Two months ago, I announced a coordinated plan to address the practice of earnings management. Since then, the response from CEOs, CFOs, investors, leaders of the public accounting profession and academics has been remarkable.

I specifically want to commend the AICPA's Public Oversight Board. They have formed a committee -- chaired by Shaun O'Malley, formerly head of Price Waterhouse -- to review the way

audits are performed and assess the impact of recent trends on the public interest. I know there is a strong desire to keep costs down in the audit process. But, we cannot permit thorough audits to be sacrificed for re-engineered approaches that are efficient, but less effective.

This isn't the only area in which the AICPA has demonstrated leadership. You have recently released a practice alert on revenue recognition and are beginning a newsletter for audit committees.

I'm also encouraged by the formation of a task force made up of auditors, industry accountants, appraisers and standard setters to deal with the issue of "In-Process" R&D. They met for the first time in November and are expected to meet next month. This, I believe, is a wonderful example of a partnership from all sectors of the financial community coming together to protect the interest of our investors. I know that all of us look forward to seeing the results of the group's efforts.

As many of you know, the New York Stock Exchange and National Association of Securities Dealers are sponsoring a blue ribbon committee to develop recommendations to strengthen the role of audit committees. Included in the panel are three members of the public accounting profession: Chuck Bowsher, the former Comptroller General of the United States, Jim Schiro of PriceWaterhouseCoopers and Phil Laskaway of Ernst & Young. The group has already met and I look forward to reading their recommendations early next year.

Working together, I know we can help create an environment where almost every company in America has an audit committee made up of the right people, doing the right things and asking the right, tough questions.

We're seeing progress on other important fronts as well. In August of this year, the profession prepared a white paper on the concept of "materiality." The recommendations of the Big Five Audit Materiality Task Force reflect many of the same ideas we have to strengthen financial reporting and audit effectiveness. I hope that their findings will be incorporated into the profession's standards.

HONORING THE PUBLIC TRUST IN AN INCREASINGLY COMPLEX BUSINESS ENVIRONMENT

This is, indeed, a dynamic time. Rapid advancements in technology and an increasingly connected global economy have helped create new sources of capital, greater cross-border flows, increased cooperation and consolidation and a significant influx of new investors.

The opportunities are limitless. The potential is great. But our responsibilities have become even greater.

Consider the Internet. Today, almost every Fortune 500 company has a web site replete with information from customer service to product awareness to distribution. Many of these sites also include financial information that was previously available only by mail to those who requested it.

But, through a click of a button you can view a company's financials in dollar, yen, Deutschemark or other currencies. You

can obtain statements prepared using generally accepted accounting principles from a number of different jurisdictions. You can even download data directly into spreadsheets.

Quarter by quarter financial statements are giving way to increasingly more frequent reporting of key information -- financial and otherwise. Financial reporting has not only become more accessible to the public, but the transmission of the reporting has become nearly continuous.

The way business is conducted is clearly changing. The way markets function is changing. The way information is transmitted is changing. Who here would deny that the auditing profession doesn't need to keep pace with these changes?

But, every time I talk about public accounting, I return to a theme that is the hallmark of the profession -- independence. Given the changing dynamics of business, the independence of the profession is constantly being challenged.

In recent years, the amount of revenue generated by accounting firms in areas of business other than traditional auditing services has increased exponentially. Some firms, perhaps preferring to distance themselves from the roots that have given them such opportunities -- like to refer to themselves as multi-disciplinary professional firms.

Public accounting firms and business competitors outside the traditional public accounting firm structure have taken different approaches to handling this market driven growth in non-audit services. For example, some new arrivals -- which offer other financial services -- are acquiring accounting and auditing firms. As we all know, some accounting firms even are considering floating IPOs for their consulting practices.

Some have even gone so far as to question whether the traditional public accounting firm structure is still relevant in an environment where the revenue streams are so diverse.

These developments raise significant public policy concerns. Should a client company be able to invest in their auditors? What about an investor in an auditing firm who uses that firm to audit other businesses in which that investor has an ownership interest. The Independence Standards Board has begun addressing these issues at the request of the SEC.

It is vital that these issues get a public and timely airing. I expect the SEC staff will closely monitor this ISB project. We are also aware that the AICPA's Professional Ethics Executive Committee is in the process of issuing guidance on alternative firm structures that is applicable to auditors of non-public companies. I would urge the AICPA to work closely with the ISB in helping to create a set of similar rules for public companies and for private companies. As we all know, today's private company is tomorrow's hot IPO.

Technology, globalization and their by-products of new ways of doing business don't diminish the role of the auditor. In fact, they demonstrate how essential the auditing function is to strong, transparent capital markets.

The challenge is reconciling the fundamental obligation of the auditor in a more complex and varied business environment; an environment where demands for frequency and timeliness in reporting continually grow; and where accounting firms are increasingly exploring business opportunities outside traditional practice areas.

But, there is one area that can't be reconciled, that shouldn't change one iota: that's the absolutely critical responsibility of ensuring the integrity of the numbers and the transparency and disclosure of practices. Without independent auditors to assure the veracity of the numbers, confidence in our markets would be severely undermined.

It doesn't matter how much technology progresses. It doesn't matter how flexible or accessible reporting is. If investors don't have faith in the reporting, confidence will lose out to uncertainty.

TRANSPARENT CAPITAL MARKETS DEMAND STRONG ACCOUNTING STANDARDS

Look across the Pacific. These countries are paying a price for a system defined more by relationship-driven finance than market evaluation of risk and return. Everyone here knows what investors expect. They expect clear, comparable, dependable and honest reporting of events as they occur. And, if those expectations are not met, not only will a company's future be jeopardized, but so will the fundamental trust that allows our system to operate.

We can never forget that lesson. As technology and the forces of more globally integrated markets redefine the operation of capital markets, new demands for capital are increasing that must be satisfied at a global level. There has been an international effort, as many of you know, on several projects to reduce disparities in reporting and disclosure requirements.

We are very sensitive to the costs associated with non-uniform standards -- particularly those relating to accounting. But as we attempt to answer the call for more harmony, we must focus, first and foremost, on the needs of capital markets and capital market participants.

Participation in U.S. capital markets delivers great benefits -- but membership has a price. While we are looking for ways to reduce costs, we will not do so by diminishing the benefits our markets provide.

I don't presume to demand that the world's capital markets adopt our standards. But, any set of global accounting standards must satisfy a fundamental test -- does it provide the necessary transparency, comparability and full disclosure?

Our standards for financial reporting are recognized around the world for their high-quality. Recently, the World Bank questioned the quality of audits performed by the some of the firms represented in this room with affiliated operations in emerging markets. The Bank voiced its concern about these firms who lend their credibility through their name to an audit performed by an affiliate that fails to measure up to the usual high quality standards.

I share the World Bank's concerns. Some of these companies in emerging markets who wish to raise capital on international markets are practicing accounting techniques that simply don't measure up. If we want investors to have confidence in the numbers on a global basis, then auditors need to ensure that the highest quality independent audits are being conducted everywhere and anywhere.

Our major firms like to talk about their "reputational" capital. I couldn't agree more that reputation is an important asset. But it is a fragile asset that can be dissipated if the public trust is lost. Let us never forget that. Confidence is too precious a value to sacrifice for short-term market focus.

CONCLUSION

Oscar Gellein, who as many of you know, was an active member in the AICPA for three decades, once said that "Credibility of financial reporting is ever so precious, but ever so fragile." Our markets enjoy a level of confidence that is based, in large part, on the sanctity of the numbers.

That sanctity has been cultivated and strengthened through decades of partnership in effort. And, those efforts were born out of the foresight of James Landis and the public accounting industry. Together, they knew we had to work together to create a financial reporting system that would bring back confidence and stability to a country that sorely needed it in the midst of the Great Depression.

So, naturally, I see you as the Commission's natural allies -- indeed, each of you has responsibilities that are closely aligned with those of the SEC. While others rightfully serve the bottom line, you and I bring other priorities to the table.

I ask you today to remember and savor the special franchise our society has granted to auditors. And I remind you that this franchise rests on your ability to preserve the confidence of our markets.

This role has been fulfilled admirably by generations of accounting professionals, both in industry and in public practice. Let us build on that remarkable history -- let us guard the integrity of the process -- and, above all, let us work together to ensure that the confidence of investors is not compromised, but rather strengthened.

Thank you very much.

#