This article focuses on the danger company managements create with managed ("smoothed") earnings. There are lessons here for investors to understand the danger of high growth rates and unrealistic expectations.

The 15% Delusion

Brash predictions about earnings growth often lead to missed targets, battered stock, and creative accounting--and that's when times are good. Why can't CEOs kick the habit?

FORTUNE, February 5, 2001 By Carol J. Loomis

No turtles were harmed in the production of this magazine. The turtle on this page, you can plainly see, retains its dignity, even in the face of an impossibly tall obstacle. That's because it is mute and cannot make rash boasts about what it's going to do.

But executives can, and it keeps getting them into trouble. Again and again, they loudly tell the world about revenue and earnings goals they've set up--practically always the kind that consultant Ram Charan (see Managing for the Slowdown) calls "big, hairy, audacious goals." What follows, so much of the time, are big, hairy, ignominious failures. It's as if Babe Ruth had walked to the plate during that legendary World Series game in 1932, pointed his bat at the center-field wall to predict a home run--and struck out.

Actually, it's worse: It's as if the Babe, having embarrassed himself that way once, had gone on to do the same thing in game after game. The Babe may have been crude, but he wasn't that stupid. And yet serial grandstanding about goals and targets has somehow become accepted executive behavior.

Of all the goals articulated, the most common one among good-sized companies is **annual growth in earnings per share of 15%**--the equivalent, you might say, of making the all-star team. With 15% growth, a company will roughly double its earnings in five years. It will almost inevitably star in the stock market, and its CEO will be given, so to speak, ticker-tape parades.

And, hey, why settle for a measly 15%? Home Depot, for example, has long aimed for EPS growth of 23% to 25%. It was sailing along at that excellent speed until October, when it announced that earnings for its third and fourth fiscal quarters would be--dreaded words--below expectations. Its stock fell by nearly 29% in one day, taking more than $32 billion of market value with it.

Stomach-turning drops like that are a reason to ask why corporations let themselves in for this punishment. Every executive breathing knows that the course of business is not smooth, not even in the best of times, much less in a rough economy like the one settling in. Why, then, do CEOs presume to state a goal? Out of hubris, of course. Out of a yen to run with the gang. Out of naiveté about what's possible. And, certainly, out of some sort of feeling that it's good for their stocks. But that last point just won't stand up under examination. Talk may matter briefly, but over the long run, nothing succeeds but walking the walk. In the end, the only thing that counts is earnings.

So why don't executives just run their businesses as well as they can, report periodically on how they're doing, and return promptly to pulling the very best from their operations? Yes, even then surprises would pop. But they would not be framed in the harsh, hurtful spotlight of some overreaching expectation. And they would not as automatically damage the credibility of the players--as extravagantly set and then unmet targets are now ripping the reputation of Hewlett-Packard's new boss, Carly Fiorina.

Beyond that, the record shows that ambitious goals, often combined with incentive compensation plans that encourage unwise behavior, have time and again led corporations to "manage" earnings in unfortunate ways. Sometimes their behavior is simply uneconomical, as when they aggressively peddle cut-price merchandise at the end of a quarter, thereby stealing from full-price business down the road. Or they may use capital poorly, buying themselves earnings in the short run but creaming their returns on capital.

Worse, they may cook the books, letting their zeal for making their numbers push them over the legal line. The U.S. has had a run of high-visibility cases like that in recent years, with two big ones--Cendant and Bankers Trust--pinioning executives who pleaded guilty to false recordkeeping and reporting. (See in appendix: "Lies, Damned Lies, and Managed Earnings," FORTUNE, September 6, 1999.) And today we have **Lucent** on the grill: a case of lofty goals, thudding disappointments, a fired CEO, and a December admission by new management that revenues for the fourth quarter of 2000 had been overstated by nearly $700 million. Next came a lawsuit filed by a former Lucent executive who charges that unreachable goals induced the company to mislead the public. Lucent has said it is confident it can defend itself against the charges in court. But it has not escaped the attention of regulators. One, turning talkative recently, marveled at the scale of Lucent's overstatement. "Wow, $700 million. I think you could see some people ending up in striped suits in this one." (See Lessons From the Lucent Debacle.)

The ultimate, pragmatic reason for not aiming at targets like 15% is the sheer difficulty--indubitable for companies of size--of growing that fast over an extended period. Take the macro environment in the U.S. as one piece of strong evidence. **During a 40-year period, from 1960 to 2000, after-tax corporate profits grew at an annual rate of just over 8%.** That means, obviously, that any company galloping at 15% had to do almost twice as well as the general population of companies. (Remember the law of regression to the mean and the law of large numbers).

There is a counterargument, though, and that has to do with the great surge in profits over the past few years. Between 1995 and 2000 (with the last year estimated) profits of the FORTUNE 500 grew at a stunning rate of about 14%. In that kind of a world, you might argue that 15%

growth in profits is perfectly reasonable for the kind of superior, competition-throttling company that almost every big time CEO thinks of himself or herself as running. But where is that argument left when a rough year like 2001 appears and threatens to prove that economic cycles have not been wiped from the face of the earth?

How Companies Really Grow

To see how fast big companies have grown in earnings per share over the past 40 years, we started with a list of 150 for each of three periods; eliminated those having a loss for the base year (and also a handful for which consistent data proved unobtainable); and went on to calculate each contender's compounded annual growth rate for the 20-year--or 19-year--period we were analyzing. Only a handful of the companies managed a rate of 15% or better, and many flunked at growth entirely. But sometimes the flunking was because of the base year. For example, the oil companies had colossal earnings in 1980, and some have never again made as much. Meanwhile, Philip Morris--like it or not--just keeps growing and growing, as the lists below show:

Companies whose earnings-per-share growth rate was ...

1960-80	# companies	Percentage
15% or higher Growth Rate	3	2.1%
10% to 15%	38	26.6%
5% to 10%	64	64.0%
0 to 5%	22	22%
Negative	16	16%
1970-90		
15% or higher	4	2.8%
10% to 15%	37	26.2%
5% to 10%	46	32.6%
0 to 5%	30	21.3%
Negative	24	17.0%
1980-99		
15% or higher	5	3.5%
10% to 15%	26	18.3%
5% to 10%	40	28.2%
0 to 5%	38	26.8%
Negative	33	23.2%

1960-80

Standard Oil (Ohio)	17.1%
Philip Morris	16.3%
Boeing	15.6%

1970-90

Boeing	22.4%
Philip Morris	19.7%
Merck	15.4%
PPG Industries	15.4%

1980-99

Fannie Mae	32.0%
UAL	20.3%
Philip Morris	15.9%
Merck	15.7%
Abbott Laboratories	15.5%

Source: Value Line and FORTUNE

Furthermore, we have been talking up to now about the difficulty of increasing earnings, not earnings per share, which is a stricter measurement by far because it wraps in the dilution that springs from the issuance of new shares. Take a growth exemplar like Cisco Systems. In the past five years its dollar profits (after all special charges and credits) have multiplied more than six times. But because it has issued a huge number of shares for options and acquisitions, its per-share earnings have grown by only four times.

That's still a five-year growth rate for per-share earnings of 34%, which is sensational. But Cisco is just now getting to be a really big company--its $19 billion in 2000 revenues will probably edge it into the top 100 in this year's soon-to-be-published FORTUNE 500 list--and its EPS growth rate is inexorably slowing. In Cisco's fiscal 2000 (ended last July), the rate was down to 16%.

That's the problem for big companies: The growing gets hard, and we have two studies to prove it. The first was done a few years ago by Wharton School professor Jeremy Siegel for his book Stocks for the Long Run. Siegel's primary purpose was to examine how the Nifty Fifty of 1972 would have treated investors who paid the sky-high prices then being asked for them and held on for 25 years--and the answer was "not badly." But a secondary part of the study looked at the group's annual growth rates in earnings per share. And only three companies out of the 50 beat 15%. They were Philip Morris, at 17.9%; McDonald's, at 17.5%; and Merck, at 15.1%.

The second study is one FORTUNE, working with Value Line, did for this article. For three different periods--1960-80, 1970-90, and 1980-99--we examined earnings-per-share growth for 150 large companies. In our sample were the 150 publicly owned companies that (a) at the start of each period were the biggest in the FORTUNE 500 or were in the very top of the "Fifties" lists that we used to do for certain industries, such as commercial banks; and (b) were still independent beings at the end of the period being studied. The fact that we threw out any company that did not last the period (because it was acquired, perhaps, or subjected to a leveraged buyout) gives the results an upward, **"survivorship" bias**. Beyond that, we know retrospectively that there was no shortage of business opportunity in the years we studied: Though the companies looked big to the world as each period began, they still had plenty of room to grow.

And yet the number that managed to increase their earnings per share over the periods by 15% annually was very small, even when you include the companies that hit the mark because of an oddball situation. For example, Boeing beat 15% in two periods (1960-80 and 1970-90) because it moved from hard times in the base years to prosperity in the later years. Similarly, Fannie Mae had an extraordinary 32% growth rate for the 1980-99 years because it began the period in a near-bankrupt condition, brought on by sky-high interest rates, and later got rich.

You'll see the aberrations in the chart on the facing page--and you'll also see the really strong, can't-keep-them-down earners, most especially Philip Morris, but also Merck and Abbott Labs. If you next wonder why some well-known grower like Wal-Mart isn't in the 15% group, it's because the company was too small, even in 1980, to make our list of big companies.

The uncontested leader in all this, Philip Morris, does not publicly state goals for earnings. That seems understandable: Given that the company's main product is tobacco, it is doubtful that the world would react well to its saying that it plans in the future to sell loads more of the stuff at ever higher prices and therefore crank its earnings up by more than 15% a year. But that's what it does, without articulating the goal.

Though history shows how difficult it is for large companies to hit a 15% target in earnings over any extended period, there remains no scarcity of executives willing to assume they can do it. Sometimes, of course, they tailor the standards by which they wish to be judged. Among these are two close to home: Steve Case and Gerald Levin, chairman and CEO, respectively, of the new kid on the block, AOL Time Warner, which owns FORTUNE. The company has publicized three goals: annual growth of 12% to 15% for revenues; 25% for Ebitda (earnings before interest, taxes, depreciation, and amortization); and 50% for free cash flow. But it has announced no goals for net profit or cash earnings (net profit plus amortization of certain items, such as goodwill). At the least, that omission nicely diverts attention from the small size of these bottom-line items compared with the company's market value, which was recently about $250 billion. For the first three quarters of 2000, AOL and Time Warner together had net income of only $723 million. Change the standard to cash earnings, and the figure becomes about $1.8 billion--still hardly a blockbuster amount compared with the market value, but up the ladder in respectability.

In the tailoring of goals and records, no practice is more prevalent among corporations than the ignoring of special items, most especially restructuring charges. These, a company implicitly says, are not relevant to what we've done, to the glories we've accomplished. Look at ConAgra's annual report for fiscal 2000. The first chart you will see is 20 years of what's described as "diluted earnings per share." The figures march steadily and handsomely upward, forging a 14.6% growth record that elegantly satisfies the company's goal of "double digit" growth.

Well, Terry Smith, CEO of British brokerage firm Collins Stewart and no fan of fudged data, recently reminded the readers of his newsletters that digits are fingers and that "raising two fingers," in Britain at least, has a very special meaning. ConAgra's record seems to deserve that kind of salute: If you get to the very small print beneath the chart, you find that the figures simply reflect operating earnings and do not include restructuring charges in 1996, 1999, and 2000. These totaled $1.3 billion, a huge figure in ConAgra's financial picture--and yet the amount is ignored in the company's double-digit chart. And what does ConAgra say in defense of the presentation? A spokeswoman says its approach "is reflective of the way financial analysts track and report on our company."

That is unfortunately quite accurate: Most Wall Street analysts love anything that puts a sheen on earnings. Many companies also pander generally to analysts' wishes, spending an oppressive amount of time worrying about "what the Street wants." Gillette has done that. During the 1990s, to make its goals of 15% to 20%, it also periodically engaged in "trade loading"--that is, it stuffed its distribution channels with goods at the ends of quarters to push up sales. But that game eventually stopped working, and the company began missing its targets. It threw restructuring charges into the mix, trying to clear the decks for new assaults on 15%. It also went through an episode of killing the messenger. Upon badly missing quarterly expectations on one occasion a couple of years ago, it fired its director of investor relations.

Even one of the big honchos of corporate growth, Sanford Weill, chairman and CEO of Citigroup, ignores special charges (which in his history have occurred mainly when he has acquired companies) when talking about his long-term goal of doubling earnings every five years. That kind of doubling equates to an average growth rate of just under 15%, and by Weill's reckoning the companies he has headed have substantially exceeded that mark since 1990. At Citi itself, Weill is close to pulling off another doubling act. When Citi was formed in 1998, he and his former co-chairman, John Reed, committed the company to doubling its earnings per share in its first five years, and Citi ended 2000 way ahead of schedule in meeting the goal. That's even true when all special charges are taken into account.

Weill's problem now, if it can be described as such, is that Citi's profits in 2000 came to a colossal $13.5 billion (which tops the $12.7 billion reported by the usual profit leader, General Electric). What to state now about goals? Keep talking, is Weill's first answer: "I think you have to articulate something," he said in January. "Analysts want to know what you are going to do with the company, and investors want to have a feel." Besides, he said, goals are "self-imposed pressure."

But from here--from this size--do you really want the pressure of promising to double per-share earnings in five years? Weill is indicating no. What may be "realistic" for the future, he says, is double-digit gains, delivered consistently. Realistic that may be. But to dwell on total profits, even 10% gains over the next few years would put Citi at $21.7 billion in 2005, and that's a whale of a figure.

So Citi is one camp cutting back in goals--and there are others, though less for reasons of hugeness than humility. Under Durk Jager, Procter & Gamble had earnings growth goals of 13% to 15%; with Jager ejected, new CEO Alan Lafley is down to goals for this year of 7% to 10%. Newell used to state in every annual report that it aimed for earnings-per-share growth averaging 15% a year; then the company choked on its acquisition of Rubbermaid, and the line disappeared from print. Tiffany once claimed to be recession-proof and said it could increase profits by 15% to 25% "for the foreseeable future"; it is now hoping for 10% to 15% in 2001, and even then adds a qualifier about needing a decent economy to meet the goal.

An oddity in this environment of pulling back is that some CEOs who might logically have seized the opportunity to renounce goals have chosen not to do so. A classic example is Coca-Cola. The late Roberto Goizueta adored goals of 18% to 20% and kept on liking them even when, to make them, he had to add in capital gains from selling bottlers. The next CEO, Doug Ivester, settled on goals of 15% to 20% and didn't make them. Then came Douglas Daft, who you might think would ditch goals altogether and indeed bury any still around in that vault where they keep the Coke formula. Instead, amazingly, he announced that he would aim for 15%. With unit sales of Coke growing only by midrange single digits, that mark looks very hard to hit. In fact, the FORTUNE/Value Line study of earnings growth rates over the past 40 years produced an interesting statistic about Coke: In all three periods examined, its earnings grew at an annual rate of 12%. Mr. Daft, if you must have a goal and really want to reach it, may we suggest...

There is indeed a sense in the land that many executives just feel compelled to state goals. Carly Fiorina, CEO of Hewlett-Packard since mid-1999, gives every indication of being a charter member of that club. She, of course, came from Lucent, which came out of the womb spouting goals. She could, though, have kicked the habit at Hewlett-Packard ("legendary in its humility," she says), but didn't. Instead, only months into her job, she began announcing targets.

First, for 2000, they were revenue growth of 12% to 15% and, as she quantified it, "earnings faster than that." Then, as things went spectacularly well for HP in the early months of 2000, she went to a straight-out 15% for revenues, again with earnings "faster." Soon she added "guidance" for 2001, and it was still higher: 15% to 17% for revenues, with no target for earnings stated, though certainly "faster" was implied. Moreover, in her conversations with Wall Streeters, Fiorina was highly confident. To at least one who questioned the necessity of publicly advertising 15%, she said, "I wouldn't be promising that if I wasn't sure that it was in the bag."

And then came Nov. 13, when Fiorina was obliged to tell a shocked world that even HP's earnings for its fiscal fourth quarter (ended just two weeks before) weren't in the bag. Instead, she said, they would fall short of expectations by a few cents. The company lost $23 billion in market value in three days. The drop was almost certainly not the result of the pennies missed: Despite the fourth-quarter shortfall, HP's earnings per share for the year exceeded 1999's by 16%. No, the drop had to do with Fiorina's credibility, which in one terrible moment took a body blow. "If you go back ten or 15 years," says Samuel B. Jones Jr., chief investment officer of Trillium Asset Management in Boston, "investors might have excused a CEO for being that out of touch with the numbers. But not in today's world, when everybody knows that the technology exists for managements to keep totally posted. Carly Fiorina really looked bad on that one."

And, unbelievably, worse was still to come--though not before a dose of cheer. That was administered on Dec. 6, when Fiorina, apologizing once again for the miss on fourth-quarter data, nevertheless reaffirmed that she was still expecting 2001 revenues to grow by 15% to 17%, assuming that the economy made no worse than a "soft landing." That was the last of the optimism. Just over a month later, on Jan. 11, Fiorina lowered her guidance for the first quarter of 2001 to single digits--"low to mid"--and said uncertainties would prevent HP from updating its guidance for the full year.

In the midst of these zigs and zags--transpiring in just over two months--Fiorina came to FORTUNE, on Nov. 28, to talk to the editorial staff. To a skeptical question about why she needed to articulate goals, she said, "Well, I think there are very few companies in this day and age that get away with not providing guidance." She thought the SEC's new Regulation FD (for "fair disclosure"), which bars companies from providing important information to some investors and not to others, put a special obligation on companies to be "open and public" with whatever information they choose to provide. She didn't think they could clam up about a quarter, just saying, "Trust us."

But what if you trot out those marvelous goals, saying "Trust us," and you don't make them? What's the trust equation there? Nasty, right? Besides that, Fiorina's comments about Reg FD suggest it is something it is not. Nothing in the rule requires companies to publicly declare goals, issue "guidance," or for that matter talk to analysts at all. The rule simply says that if you're going to be wising up analysts and major shareholders, you'd better be wising up the general run of investors as well.

It may be time for a Martha Stewart lesson. Around 30 years ago she was a Wall Street broker (can you imagine being a client of Martha's? I can't), and when she took her company public in 1999 and did road shows to sell her stock, she called on her broker experience whenever she could. In one road show, an attendee reports, a questioner from the audience wanted to know whether she was going to be one of those CEOs who set big goals and then miss them. "I know where you're coming from with that question," answered Martha sympathetically. "I've been where you are. And what you want, I'm sure, is for companies to underpromise and overdeliver." Now, that would be refreshing. "A good thing," as Martha would say.

Lies, Damned Lies, and Managed Earnings The crackdown is here. The nation's top earnings cop has put corporate America on notice: Quit cooking the books. Cross the line, you may do time.

By Carol J. Loomis Reporter Asssociates Jane Folpe, Wilton Woods, and Patricia Neering

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(FORTUNE Magazine) – Someplace right now, in the layers of a FORTUNE 500 company, An employee--probably high up and probably helped by people who work for him--is perpetrating an accounting fraud. Down the road that crime will come to light and cost the company's shareholders hundreds of millions of dollars.

Typically, the employee will not have set out to be dishonest, only to dodge a few rules. His fraud, small at first, will build, because the exit he thought just around the corner never appears. In time, some subordinate may say, "Whoa!" But he won't muster the courage to blow the whistle, and the fraud will go on.

Until it's uncovered. The company's stock will drop then, by a big percent. Class-action lawyers will leap. The Securities and Exchange Commission will file unpleasant enforcement actions, levy fines, and leave the bad guys looking for another line of work.

Eventually someone may go to jail.

And the fundamental reason, very often, will be that the company or one of its divisions was "managing earnings"--trying to meet Wall Street expectations or those of the boss, trying also to pretend that the course of business is smooth and predictable when in reality it is not.

Jail? This is not a spot that CEOs and other high-placed executives see themselves checking into, for any reason. **Jail for managing earnings?** Many corporate chiefs would find that preposterous, having come to believe that "making their numbers" is just what executives do. Okay, so the pressure might lead some of them to do dumb (but legal) things--like making off-price deals at the end of a quarter that simply steal from full-priced business down the road. Who cares? Others might even be driven to make hash of the rules that publicly owned companies are required to abide by, Generally Accepted Accounting Principles, known as GAAP. Sure, that might mean crossing a legal line, but so what?

Well, the "so what" is Arthur Levitt, chairman of the SEC and the grand enforcer when it comes to GAAP. Last year, with his attorneys and accountants digging into Bankers Trust and Cendant and W.R. Grace and Livent and Oxford Health Plans and Sunbeam and Waste Management--and who knows what other big companies the SEC isn't talking about--Levitt finally reached the gag point. He simply declared war on bad financial reporting.

The opening shots came in a New York speech, "The Numbers Game," that Levitt gave last September to CPAs, lawyers, and academics. Lynn Turner, chief accountant of the SEC (and formerly a partner of Coopers & Lybrand), recalls that as Levitt started to speak, waiters whipped around serving salads, and people began to eat. "Then," says Turner, "two amazing things happened. First, people put down their forks and started listening very hard. Then--and this just never happens--they pulled out notepads."

What they heard was the SEC chairman committing his agency in no uncertain terms to a serious, high-priority attack on earnings management. Since then several SEC officials have gone out of their way to state that there are many managements doing their accounting honestly, but that night the chairman spared no one. He roundly criticized a business community that greeted "accounting hocus-pocus" with nothing more than "nods and winks." Among the accounting tactics he blasted were improper revenue recognition, unjustified restructuring charges, and the artifices called "cookie-jar reserves." Accountants know all of these (and more) as "accounting irregularities"--intentional misstatements in financial reports, which Levitt and his team regard as very often the equivalent of fraud.

In a recent conversation with FORTUNE, Levitt left no doubt that he intends to keep the heat on. What's at stake, he says, is nothing less than the credibility of the U.S. financial-reporting system, traditionally thought to be the best in the world. It will not now, he vowed, be undermined by managements obsessed with making their numbers. "It's a basic cultural change we're asking for," he said, "nothing short of that."

For those who can't get with the program, the punishment increasingly could be criminal prosecution. The SEC does not itself have the ability to bring criminal actions, so the chairman has been out jawboning people who do, like Attorney General Janet Reno and various U.S. Attorneys. Levitt would particularly like to see these folk nail brokers who cheat investors, but there are accounting-fraud cases in which he wants indictments as well.

One U.S. Attorney in tune with the SEC's tough new line is Mary Jo White, of New York's Southern District. White has brought a string of accounting-fraud actions and says she still has "a lot" in the pipeline. Her district has two big-time criminal cases even now--Livent and Bankers Trust, both stemming from managed earnings. However, as White points out, "On the criminal side, we don't use that polite a term; we call it accounting fraud or 'cooking the books.'" White has also prosecuted smaller cases that she prizes for their deterrence value. Object lessons don't work in most areas of the law, she says, but "significant jail time" for a white-collar executive is apt to give others of his ilk severe shakes.

What qualifies as significant? In March, Donald Ferrarini, the 71-year-old former CEO of a New York insurance brokerage, Underwriters Financial Group (UFG), got 12 years. (He is appealing.) Ferrarini had cooked the most basic recipes in the book: He overstated revenues and understated expenses, a combo that magically converted UFG from a loser into a moneymaker. The scam, uncovered in 1995, cost shareholders, policyholders, and premium finance companies close to $30 million.

One reason Ferrarini faces such a long stretch in jail is that sentencing guidelines treat $30 million as a lot of money. And so they should, considering that there really isn't much difference between $30 million lost in an accounting fraud and the same amount lifted in a bank robbery. But that sum is peanuts compared with the vast sums lost over the past couple of years as one big accounting scandal after another reeled out. The toll doesn't suggest that the next execs to be sentenced for accounting crimes should expect much in the way of leniency.

Whether all this is enough to change the culture at the top of U.S. business remains to be seen. In taking on earnings management, Levitt is threatening a practice many CEOs regard as part of their bill of rights. The former communications director of a prominent FORTUNE 500 company remembers the blast his CEO once let loose at the financial managers and lawyers trying to tell him that the quarterly earnings he proposed to announce weren't accurate. Roared the CEO: "Stop fooling around with my numbers! The No. 1 job of management is to smooth out earnings."

Or take this anecdote out of General Electric's recent history. In 1994 the Wall Street Journal ran a long, front-page story detailing the many ways that Jack Welch and his team smoothed earnings at GE. Among them were the careful timing of capital gains (which is a permissible way of managing earnings, says the SEC) and the creative use of restructuring charges and reserves (which sometimes is not). Immediately, so a GE staff member told a FORTUNE writer, GE people got calls from other corporations--specifically, according to the account, AIG, Champion International, and Cigna--saying, "Well, this is what companies do. Why is this a front-page story?"

One would have hoped the answer was obvious. The fundamental problem with the earnings-management culture--especially when it leads companies to cross the line in accounting--is that it obscures facts investors ought to know, leaving them in the dark about the true value of a business. That's bad enough when times are good, like now. Let business go south, and abusive financial reporting can veil huge amounts of deterioration.

The cult of consistent earnings imposes opportunity costs as well. To start with, even the least offensive kinds of earnings management take time, mainly because executives have to decide which of several maneuvers to go for. Then there are the related tasks, especially the need to talk extensively to analysts and massage their earnings-per-share expectations. Custom says those expectations must not be disappointed by even a penny, since a management's inability to come up with a measly cent, when so many opportunities to manipulate earnings exist, will often be interpreted as a stark sign of failure and a reason to bomb the stock.

One well-regarded FORTUNE 500 CEO said recently that he probably spends 35% of his time talking to analysts and big shareholders, and otherwise worrying about the concerns of the Street. Would his company's bottom line be better off if he devoted that time to the business? "Of course," he answered. But there is always the stock price to think about--and naturally the CEO's compensation is structured to make sure he thinks about it a lot. The television show Fantasy Island had a line, "The plane! The plane!" In the world of fantasy earnings, the rationale is always "The stock! The stock!"

What has sparked Chairman Levitt's war on falsified earnings reports, however, isn't the occasional distracted CEO. It's the continual eruption of accounting frauds. The accumulation of cases, in fact, keeps suggesting that beneath corporate America's uncannily disciplined march of profits during this decade lie great expanses of accounting rot, just waiting to be revealed.

Right now, among big cookers of books, the grand prize for rot is shared by the two caught up in criminal proceedings, Livent and Bankers Trust. Livent, for its part, vaporized close to $150 million in market value last August when new controlling shareholders (among them Hollywood bigwig Michael Ovitz) asserted that Livent's books had been cooked for years. Prosecutors went on to charge the company's former CEO, Ragtime and Fosse producer Garth Drabinsky, with creating another showpiece, in which Livent starred as a thriving operation when in reality it was crumbling. Indeed, Livent kept looking presentable only because financial facts were being whisked around like props in a stage set. Drabinsky was indicted in January and even earlier had exited from the U.S., stage north: He is holed up in his homeland, Canada, where he has denied wrongdoing and has said he will fight extradition proceedings. He has also sued both Livent and its auditors, KPMG.

At Bankers Trust, prosecutors say that employees working in the securities-processing business in the mid-1990s met top management's call for good results by misappropriating money that belonged to security holders but hadn't been claimed (and that was required to be escheated to the state). The funds were used to cover the department's general expenses, a procedure that increased profits. The evidence has already caused Bankers Trust to plead guilty and agree to a $63 million fine. In addition, at least three former BT managers, including B.J. Kingdon, the boss of the division that included securities processing, are reported to have been issued "target letters" that signal they may be indicted.

Kingdon, through his lawyer, neither confirms nor denies the existence of a target letter. The lawyer says Kingdon has reacted to reports about this matter with "astonishment" and "outrage." Kingdon, says the lawyer, was not aware that anything unlawful was being done. The lawyer also says that "whatever took place, took place in daylight, with the appropriate levels of the bank monitoring the activity."

That comment raises a question already begging for an answer: whether executives up the line at Bankers Trust, like former CEO Charles Sanford, will be pulled into this affair. The SEC's attempts to curb accounting fraud have always emphasized "tone at the top," and Bankers Trust's management has given a great impression of being tone-deaf. A few years ago the company got into deep trouble for unprincipled selling of derivatives, and even now, in the midst of its securities-processing mess, it has the SEC on its neck because of possible problems with its loan-loss reserves.

A case alleging still another horrific fraud could soon come out of Newark. There, in what one knowledgeable person describes as "conference rooms jammed with lawyers," the office of the U.S. Attorney for New Jersey is boring in on the celebrated case of Cendant. Or, put more precisely, what's under the microscope are the flagrant accounting violations (of which more later) at CUC International, which merged with HFS Inc. in 1997 to form Cendant. The subsequent news of chicanery at CUC clobbered Cendant's stock by more than $14 billion in a single day.

For its part, the SEC has a "formal investigation" in progress on Cendant--that's its term for "you're in trouble"--and the same thing going on at Sunbeam and Waste Management and, down the line in size, Mercury Finance and telecommunications company Telxon. These all are companies that in recent times made major restatements of earnings, usually the first sign of serious accounting problems. Another restater is Oxford Health Plans, which is the subject of a lesser SEC investigation called an "informal inquiry." The big question about Oxford is whether its books got out of control simply because of the well-publicized chaos in its computer systems or because of irregularities as well.

Never fear that the SEC will run out of accounting cases to examine and perhaps move in on, because seldom does a month pass that those ugly words "restatement of earnings" do not fasten themselves to a new company. Joining the crowd recently from the FORTUNE 1,000 were drugstore chain Rite Aid, holding company MCN Energy Group, and drug wholesaler McKesson HBOC. Ironically, this is McKesson's second brush with accounting infamy this century (see box, "McKesson Again").

Like any good general, Arthur Levitt has a strategy for going after this enemy called managed earnings. In his September speech, in fact, he unveiled a list of five accounting problems that would get the unremitting attention of the SEC. They were "big bath" restructuring charges, acquisition accounting, "cookie-jar reserves," the abuse of "materiality," and revenue recognition.

Of these, that last item--the wrongful booking of sales--seems the closest to outright fraud. GAAP includes some firm rules for recognizing revenue, and most don't leave a lot of room for playing around. That hasn't stopped the bad guys. A recent study done for the Committee of Sponsoring Organizations of the Treadway Commission (called COSO), which is supported by various accounting and financial bodies, studied 200 alleged frauds carried out by publicly owned companies in the 11 years ended in 1997. Roughly 50% had a revenue-recognition component. Many of the cases involved small companies, which for that matter pack the list when it comes to fraud of any kind.

Even so, some of the biggest accounting scandals of the past few years (and now McKesson's to boot) have also featured revenue-recognition schemes. Executives at Sensormatic held the books open at the end of quarters so that they could get enough sales in the door to meet their earnings targets. Richard Rubin, former CEO of apparel company Donnkenny, is awaiting sentence for creating false invoices that he used to book sales. And Al Dunlap, who was fired as CEO of Sunbeam by its board, is alleged to have carried out (among other things) a "bill and hold" scam. In other words, Sunbeam recorded the sale of goods but simply held them in its own warehouse, a forbidden combo unless a customer has taken bona fide ownership of the goods and requested they be stored. (Dunlap, says his lawyer, relied on Arthur Andersen's assurances that Sunbeam was conforming to GAAP.) Walter Schuetze, chief accountant of the SEC's Division of Enforcement, sees in these scandals a simple theme: "When it comes to cooking the books, revenue recognition is the recipe of choice."

Lately, though, the other earnings-management techniques on Levitt's list have been coming on like a new cuisine, suddenly and sweepingly popular. Take, first, the charges that hit earnings when a company restructures on its own or as the result of an acquisition. Say that a company commits itself at these junctures to exit a business or close a factory in the near future. Under GAAP, it must today, in what we'll call year one, estimate the costs it will eventually incur in the restructuring--for severance payments, plant closings, and the like--and charge them off, even though many of the expenses won't actually be paid until, say, year two or three. These charges, which end up in a liability called a reserve, tend to put craters in year one's profits. But analysts generally ignore the bottom-line damage these write-offs do, focusing instead on operating earnings. In fact, all too often analysts cheer these charges, figuring that they clear the decks for good results in the future.

Earnings often do shine in the wake of a restructuring--but not necessarily because business has improved. Maybe all that happened was that the restructuring charge was a "big bath," deliberately made larger than the monies to be paid out, which allows the excess to be channeled back into earnings in year two or year three. Abracadabra!--higher profits than would otherwise have materialized.

Or maybe the company made the restructuring charge a kitchen disposal, using it to gobble up all kinds of costs that by rights should be hitting this year's operating earnings or next. Schuetze recently ticked off some of the impermissible costs the SEC has found in restructuring charges: services to be provided in some future period by lawyers, accountants, and investment bankers; special bonuses for officers; expenses for retraining people. "Even," he said sorrowfully, as if not quite believing this level of deceit, "expenses for training people not yet hired."

Since Levitt's speech, the SEC has sent a letter to about 150 companies that took large restructuring charges last year. The letter warned that their annual reports might be selected for review. It also reminded the companies that they are required to make disclosures about the status of their restructuring reserves--how many dollars paid out so far, how many employees terminated vs. the original plan, and so forth. The implication was that the SEC would be looking to see that the companies were adhering to their restructuring plans and not emerging with reserves that could be popped into earnings at a propitious moment. The disclosure requirements had been there for years but were often ignored. Not anymore.

That's especially true because the SEC has followed through with tough reviews, both of annual reports and registration statements. One SEC target was Rite Aid, which took a large restructuring charge in fiscal 1999 (a year that ended in February) in anticipation of closing 379 stores. The SEC later compelled the company to reduce the size of its restructuring charge (from $290 million to $233 million), add major expenses to its operating costs, and restate its profits from the unaudited figure of $158 million it had reported in March--a figure even then far below "analysts' expectations"--to $144 million. This year, to date, Rite Aid has lost close to $7 billion in market cap, and class-action lawyers are all over its case.

In a second assault on acquisition accounting, the SEC attacked a dearly loved perquisite of tech companies: the write-offs that purchasers in a merger make for an asset called in-process research and development (IPR&D). As merger accounting works, a purchaser must assign values to all the assets it has bought and then, for the most part, capitalize them and write them off in future years. But IPR&D assets--ah, there's a beauty. The value assigned to these must be written off immediately, which means their cost doesn't hang around to clip earnings in future years.

And what are these things anyway? GAAP's definition of IPR&D assets are those "to be used" in R&D--this might be a gleam-in-the-eye technology, for example--as opposed to those "resulting from" R&D, like a proven technology. You can see that these definitions cry out for judgments, and there's the problem. It is the SEC's view that acquirers have done their utmost to assign maximum amounts of their purchase price to IPR&D so that they can ditch these costs immediately. The commission therefore got militant on this issue last year, forcing restatements of earnings when it concluded too much value had been assigned to IPR&D. A publication called the Analyst's Accounting Observer counts at least 60 tech companies that have been forced to restate. Among them was Motorola. Its accounting penalty was $99 million, which was the amount of IPR&D "costs" it tried to write off all at once in 1998 and which it will now instead be writing off gradually as the years go by.

Let us dip now, if you will pardon the expression, into another item on Levitt's list, cookie-jar reserves. GAAP, of course, is too stiffly worded to include a term like that. But not even the accounting-challenged have trouble visualizing that these are earnings held back from the period in which they should have been recognized and kept instead for a rainy day. Maybe the husbander is truly worried about bad weather hitting its business (as many banks, for example, claim to be), or maybe it just wants to manage earnings. It doesn't matter: GAAP says companies cannot establish reserves for "contingencies," because such costs can't be estimated. They should hit income statements when they actually arrive.

Beyond that, cookie jars are innately a problem because investors usually can't detect that they exist. Even outside directors, said one recently, typically wouldn't be told that managers had hidden cookies away. That makes it difficult for anyone to fairly value a company, says Harvey Goldschmidt, general counsel of the SEC. A second problem, he says, is that managements will often use reserves to "dim the signals" going to both the public and their boards when business turns down.

The SEC says it is looking at a number of companies suspected of harboring improper reserves. In fact, in late June mighty Microsoft admitted that it was getting the eye. The SEC's most elaborate reserve case, however, is the one it launched last December against W.R. Grace, not just attacking cookie jars but also roping in another item on Levitt's list, "materiality." This term acknowledges that the preparation of financial statements is a complex job and that neither managements nor their outside auditors, however well intentioned, can testify that the figures are accurate down to the penny. Auditors deal with this uncertainty by attesting that a company's statements are accurate "in all material respects." Unfortunately, auditors also lean on materiality when they are trying to convince themselves it's okay for managers to slip intentional misstatements into their financial reports.

The SEC is right now busy drawing a line in the sand about materiality. In the past it has sometimes permitted managements to get by with irregularities in their financial reports just as long as the deliberate misstatements could be classed, often by some ad hoc mathematical logic, as immaterial. But it is now preparing to say--in a staff bulletin soon to appear--that intentional errors made for the purpose of managing earnings just won't be tolerated.

In the W.R. Grace case, moreover, it went after intentional errors made several years back. It seems that in the early 1990s a division of that company, National Medical Care (NMC), made more in profits than it had expected. So NMC, according to the SEC, deliberately underreported its earnings (thereby creating an "irregularity"), stuffing the excess into a cookie-jar reserve that in time got to be $60 million in size. Then in 1993, when profits needed a sugar fix, NMC started feeding the reserve into earnings (thereby compounding the irregularities). Meanwhile, Grace's auditors, Price Waterhouse, went along with these contortions on the grounds that they weren't material.

The SEC, launching its case, objected to the entire goings-on. By June it had exacted cease-and-desist consents from two PricewaterhouseCoopers partners and from Grace itself, which agreed as well to set up a $1 million educational fund to further awareness of GAAP. The commission has also filed cease-and-desist proceedings against seven former Grace officers (among them CEO J.P. Bolduc), of whom three get special attention. These three, who include Grace's former chief financial officer, Brian Smith, are licensed CPAs whom the SEC views as having engaged in "inappropriate professional conduct." So the commission wants an administrative judge to bar them from practicing before the SEC. That means they could not play any part in preparing the financial statements of publicly owned companies or any other SEC registrant.

Smith's lawyer, Wallace Timmeny, once an SEC staffer himself and now at Dechert Price & Rhoads, plans to lean on the materiality argument in defending his client. But he also argues in essence that it would be bitterly unfair for Smith and a couple of other unlucky parishioners to get excommunicated for sins rampant in the rest of the congregation. "If you think what my client did constitutes fraud," he protested to the SEC before the charges came, "then every company in the FORTUNE 500 is engaged in fraud."

The Grace case is important to Levitt's initiative because it sends such a strong message to other companies, some of which should be thinking, "There but for the god of Grace go I." In an entirely different way, the Cendant case demands attention because it displays such gross behavior. The misdeeds are fully documented as well, in a remarkable and unsparing 146-page report done for the audit committee of Cendant's board by the law firm of Willkie Farr & Gallagher and auditors imported for the project, Arthur Andersen. Here are some of the report's findings:

--In the three years 1995-97, CUC's operating income before taxes was improperly inflated by $500 million, which was more than one-third of its reported pretax income for those years.

--Though many of the improprieties occurred in CUC's biggest subsidiary, Comp-U-Card, they reached to 16 others as well. No fewer than 20 employees participated in the wrongdoing.

--Several CUC employees who were interviewed said they understood that the purpose of inflating earnings was to meet "analysts' expectations."

--In the first three quarters of each of the infected years, CUC put out unaudited financial statements that headquarters deliberately falsified, mostly by "adjusting" Comp-U-Card's revenues upward and its expenses downward. These favorable "adjustments" grew: They were $31 million in 1995, $87 million in 1976, and $176 million in 1997.

--At the end of each year, before its outside auditors, Ernst & Young, came in to make their annual review, CUC undid those improprieties (which would almost certainly have been discovered in the audit process) and instead created the earnings it needed mainly by plucking them from cookie-jar reserves.

--In most cases, the explanations that CUC gave Ernst & Young for these reserve infusions satisfied the accounting firm, which in general did not display impressive detective skills. On one occasion, however, E&Y could not find justification for $25 million transferred helpfully from a reserve--and this it let pass as "immaterial." (Cendant has sued E&Y, which has responded that it was the victim of deception and is "outraged" to be blamed for Cendant's own fraud.)

--In one particularly colorful incident, CUC used a merger reserve it had established in 1997 to swallow up $597,000 of private airplane expenses that its CEO, Walter Forbes, had paid in 1995 and 1996, and for which he had requested reimbursement. Had these expenses not been allocated to the reserve, they would have turned up where they should have: in operating costs.

Naturally, Willkie Farr questioned Forbes about his knowledge of CUC's wrongdoing. He denied knowing anything about it. After the lawyers' report was completed, Forbes also issued a statement saying, in part, "Any suggestion that I 'should have known' about the fraud is completely unfounded."

At a minimum, his obliviousness is odd, since one businessman who spent several hours with Forbes a couple of years ago remembers him as "a walking encyclopedia about his company, given to unusual specificity about numbers and details." But if Forbes truly did not know, at least one reader of the report--this writer--thinks Forbes was a pathetically uninformed CEO and probably one of the worst ever to head a major company. Forbes left Cendant in July 1998 and today, says a spokeswoman, is pursuing startup investments internationally, especially in Europe.

Michael Young, a Willkie Farr litigator and a student of accounting frauds, says they tend to follow a predictable trajectory. The Cendant case was no exception. It started small and grew out of control. It also dragged in employees who were troubled by what they were asked to do but did it anyway. Young remembers one case in which he was about to interview a woman implicated in a fraud. She suddenly burst into tears and said the totally unexpected: "I'm so glad to have someone to talk to about this."

Levitt understands well that the SEC is facing an enormous challenge in trying to get the cultural change it wants. Wall Street itself is an obstacle: It wants consistent earnings, however attained. Speaking at a recent investor-relations conference, one stock analyst, Gary Balter of DLJ, baldly urged that companies consider "hiding earnings" for future use. "If you don't play the game," he said, "you're going to get hurt."

On a second front, the SEC has already run into roadblocks on certain new rules it would like to impose on audit committees (see box). Levitt himself has grown used to visits from business leaders not happy at all with accounting changes disturbing their lives. Even some feds are up in arms. The SEC, brandishing GAAP, is arguing that certain banks have overstated their reserves; banking regulators, perfectly happy with a little conservatism, have risen in protest.

Another issue is whether really egregious cases can be made criminal actions. For a U.S. Attorney, whose alternatives include going after drug dealing, espionage, and bank robbery, it is no easy decision to take on a white-collar case stuffed with the arcana of accounting. According to Levitt's chief policeman, director of enforcement Richard Walker, the cases that ought to wind up in criminal court are those in which a company or executive has exhibited a high level of what lawyers call scienter--that is, knowing and willful conduct--and acted "to violate the law, misapply accounting standards, and affect financial reporting." Prosecutors may also weigh aggravating factors such as lies told to auditors or profitable trades made by an executive as he paints a false picture of his company's financial health. Walker, who has been at the SEC for eight years, thinks Levitt's message is in any event getting through. "I'm seeing more acceptance of these cases by U.S. Attorneys today than in all the time I've been here."

Some skeptics point out that Levitt is hardly the first SEC chairman to bear down on cooked books. Abraham Briloff, the crusty accounting professor from Baruch College, has reminded SEC chief accountant Lynn Turner that many another cleanup effort has been tried and has opined that this one, too, will probably fail. Other businessmen think political reality will force Levitt himself to limit his goals. Says one East Coast CEO deeply experienced in finance: "When he goes after GE, I'll know he's serious."

Meanwhile, some corporations continue to behave in ways that make you question whether they've even heard of Levitt. Companies are not in the least required to make forecasts about earnings. Yet this spring, as McKesson was conceding that it had no real handle on the profits of its accounting-troubled unit, HBOC, it was still saying it was comfortable with projections that it could make $2.50 a share for its fiscal year ending next February. McKesson's nervy statement supports the opinion of class-action lawyer William Lerach that it is always good to allow time for the actors in frauds, especially CEOs, to make the self-destructive public statements they almost always do.

If tales like McKesson's confirm the challenge that Levitt faces, there is another that puts a slightly different complexion on things. The SEC's Turner says he knows a largish FORTUNE 500 company that in a recent reporting period ended up with earnings well beyond Street expectations. The boss said to the CFO: "Let's hold some of those back." "Wait a minute," objected the CFO, "don't even go there. Don't you know what the SEC is doing to people?" And the boss looked at the CFO, told him he was in "career limiting" territory, and once again ordered the earnings hid.

And what happened then? Turner's answer: "The CFO, the auditors, and the audit committee got together and managed to convince the boss he was wrong."

That's just one time, at one company. But at least it's a start.

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