SEC Staff Developing "Accounting Quality Model"

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In a recent speech, Craig M. Lewis, the Chief Economist of the Securities and Exchange Commission and director of its Division of Risk, Strategy and Financial Innovation, described an initiative to develop an "Accounting Quality Model." According to Mr. Lewis, the model will seek "to provide a set of quantitative analytics that could be used across the SEC to assess the degree to which registrants' financial statements appear anomalous." The model will be designed to identify possible instances of "earnings management," though Mr. Lewis is quick to say that earnings management (as he defines it) is not necessarily indicative of fraud but may reflect permissible applications of GAAP. Without delving too much into the technicalities, the model will identify "total accruals" (difference between cash flow and income before extraordinary items), and then seek to determine, based on a large set of factors, which of those accruals are discretionary and which are non-discretionary. If the discretionary accruals are out of line compared to peer companies, then the company may be flagged for further analysis. Mr. Lewis indicates that the model's analytics can be used for various purposes, including informing the Division of Corporation Finance's filing review process, use by the Enforcement Division to focus its investigative process, and evaluating claims by tipsters. For most companies, this new model is unlikely to have much impact. But the fact that the Commission staff is developing this model illustrates the SEC's continuing efforts to enhance its ability to carry out its regulatory objectives by "integrat[ing] rigorous data analytics into the core mission of the SEC."