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NOVEMBER 26, 2001

COVER STORY

Confused about Earnings?

You're not alone. Here's what companies should do--and what investors need to know

In an age when giant earnings write-offs have become commonplace, it's hard to shock Wall Street. But on Nov. 8, Enron Corp. ([ENE](#)) managed to do it. After years of high-octane growth that had seen earnings surge by up to 24% a year, the Houston-based energy company acknowledged that results for the past three years were actually overstated by more than a half-billion dollars. It was confirmation of investors' worst fears. Three weeks earlier, Enron had announced a big drop in shareholders' equity, sparking fears that its hideously complex financial statements were distorting its true performance. Management pointed to a number of factors, including a dubious decision to exclude the results of three partnerships from its financial statements and a billion-dollar error several years earlier that had inflated the company's net worth.

Enron may be an extreme example of a company whose performance fell far short of the glowing picture painted by management in its earnings releases, but it is hardly alone. This year, Corporate America is expected to charge off a record \$125 billion, much of it for assets, investments, and inventory that aren't worth as much as management thought (chart). Even if companies don't go back and restate earnings, as Enron is doing, those charges cast doubt on the record-breaking earnings growth of the late '90s.

Not since the 1930s has the quality of corporate earnings been such an issue--and so difficult for investors to determine. There's more at stake than the fortunes of those who bought shares based on misleading numbers. If even the most sophisticated financial minds can't figure out what a company actually earns, that has implications far beyond Enron. U.S. financial markets have a reputation for integrity that took decades to build. It has made the U.S. the gold standard for financial reporting and the preeminent place to invest. It has also ensured ready access to capital for U.S. corporations. That a company such as Enron, a member of the Standard & Poor's 500-stock index and one of the largest companies on the New York Stock Exchange, could fall so far so fast shows how badly that gold standard has been tarnished. "The profession of auditing and accounting is, in fact, in crisis," says Paul A. Volcker, former chairman of the Federal Reserve and now one of the leaders of the International Accounting Standards Board.

Sometimes, as in the case of Enron, fuzzy numbers result from questionable decisions in figuring net earnings. More often, though, the earnings chaos results

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Nasdaq	1923.02	-12.95
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from a disturbing trend among companies to calculate profits in their own idiosyncratic ways--and an increasing willingness among investors and analysts to accept those nonstandard tallies, which appear under a variety of names, from "pro forma" to "core." (Enron offers its own such version. Before investors untangled the importance of Enron's first announcement, its stock rose briefly because it told investors that its "recurring net income" had met expectations.) The resulting murk makes it difficult to answer the most basic question in investing: What did my company earn?

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Why calculate a second set of earnings in the first place? Because the numbers reached by applying generally accepted accounting principles (GAAP) are woefully inadequate when it comes to giving investors a good sense of a company's prospects. Many institutional investors, most Wall Street analysts, and even many accountants say GAAP is irrelevant. "I don't know anyone who uses GAAP net income anymore for anything," says Lehman Brothers Inc. accounting expert Robert Willens. The problem is that GAAP includes a lot of noncash charges and one-time expenses. While investors need to be aware of those charges, they also need a number that pertains solely to the performance of ongoing operations.

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That's what operating earnings are supposed to do. But because they're calculated in an ad hoc manner, with each company free to use its own rules, comparisons between companies have become meaningless. "No investor--certainly not any ordinary investor--can read these in a way that's useful," says Harvey L. Pitt, chairman of the Securities & Exchange Commission. The SEC is examining whether new rules are needed to clarify financial reports and perhaps restrict use of pro formas.

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What's badly needed is a set of rules for calculating operating earnings and a requirement to make clear how they relate to net income. In the end, investors need two numbers--a standardized operating number and an audited net-income number--and a clear explanation of how to get from one to the other.

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"OUT OF HAND." A widespread consensus is building to do just that. In early November, S&P proposed a set of rules for companies to follow when tallying operating earnings. Only the week before, the Financial Accounting Standards Board, the rulemakers for GAAP, had announced that they, too, would be taking up this issue. Volcker says the International Accounting Standards Board is also seeking a uniform definition of operating earnings.

"Over the past two or three years, the use of creative earnings measures has grown and grown and grown to the point where it has really gotten out of hand," says David M. Blitzer, S&P's chief investment strategist. "Earnings are one of the key measures that anybody looks at when they're trying to evaluate a company. If people want to use an operating-earnings measure, we better all know what we're looking at."

Without those standards in place, the gap between earnings according to generally accepted accounting principles and earnings according to Wall Street is only going to grow wider and more confusing. Look at the variance in earnings per share calculated for the S&P 500 for the third quarter: It's \$10.78 according to Wall Street analysts as tallied by Thomson Financial/First Call, \$9.17 according to S&P, and \$6.37 according to numbers reported to the SEC under GAAP. (S&P, like *BusinessWeek*, is owned by The McGraw-Hill Companies.)

The lack of a standard measure can be costly to those who choose wrong. Use First Call's earnings for the past four quarters and you get a relatively modest price-earnings ratio of 23 for the S&P 500. But run the numbers using GAAP earnings,

and suddenly the market has a far steeper p-e of 38.

How did we get into this mess? Investors and analysts have been calculating operating earnings for years, and for years, reasonable people could more or less agree on how to do it. Then came the dot-com bubble, along with increased pressure from Wall Street for companies to meet their quarterly earnings forecasts. Suddenly, companies that hadn't turned a profit by any conventional measure started offering ever more inventive earnings variants. These customized pro forma calculations excluded a grab bag of expenses and allowed upstart companies to show a profit.

"TOWER OF BABEL." Pro forma formulas vary wildly from company to company and even from quarter to quarter within the same company, casting doubt on their validity. And these days, the gulf between net earnings and pro forma earnings is wider than ever. S&P's tallies fall between the two: S&P's numbers are more systematic than pro forma, but they aren't followed widely enough to be a standard. "Investors are facing a Tower of Babel," says Robert K. Elliott, former chief of the American Institute of Certified Public Accountants (AICPA) and a retired KPMG partner. "It's not standardized, and the numbers are not audited."

That makes it tough to evaluate a company's performance. In the quarter ended on Sept. 30, Nortel Networks Corp. (NT) offered shareholders at least three earnings numbers to choose from. By conservative GAAP accounting, the telecommunications giant lost \$1.08 a share. The company also provided two possible pro forma options: a 68 cents loss that excluded "special charges," including some acquisition costs and restructuring charges, and a still better 27 cents loss that further excluded \$1.9 billion of "incremental charges," such as writing down inventories and increasing provisions for receivables. Wall Street chose the rosier one.

Confusing? You bet. Companies defend their pro forma calculations by pointing out that they're merely filling a void: Investors are clamoring for a measure that gives them better insight into their company's future. The goal is to get to the core of the business and try to measure the outlook for those operations. "There are good reasons why there is an emphasis on operating earnings," says Volcker. "It is an effort to provide some continuity and some reflection of the underlying progress of the company." Besides, as companies like to point out, they still have to report GAAP earnings, and investors are free to ignore everything else.

There's no starker lesson in the shortcomings of GAAP than the \$50 billion asset write-downs by JDS Uniphase Corp. (JDSU), the biggest charge of the year. Near the height of the telecom bull market in July, 2000, the San Jose (Calif.) maker of fiber optics topped off a buying spree by acquiring competitor SDL Inc. for \$41 billion in stock. When the deal closed in February, its assets ballooned from \$25 billion to \$65 billion. But by then, shares of JDS and other fiber-optics makers were collapsing. To bring its acquisitions into line with their new value, the company took charges of \$50 billion. Despite the fact that the bulk of its losses stemmed from stock transactions and involved no cash paid, GAAP required that the charges be taken out of net income. So according to GAAP, JDS lost \$56 billion in the fiscal year ending in June--a staggering figure for a company whose revenues over the past five years added up to only \$5 billion.

Analysts and the company argue that besides not involving cash, the charge-off was all about the past, a right-sizing of values that had gotten out of hand. To analyze the company's prospects, they excluded the \$50 billion charge. "The accounting is not designed to make things look better but to describe what happened," says JDS Uniphase Chief Financial Officer Anthony R. Muller, "and we'll live with the

consequences, whatever they are." Analysts make a similar defense. "My goal is to figure out what the business is going to produce so that we can value the company," says Lehman Brothers analyst Arnab Chanda.

GLACIAL PACE. Are JDS's pro forma numbers realistic--a fair gauge of JDS's ongoing operations? Right now, it's hard for investors to judge. And that's the kind of ambiguity S&P and others would like to eliminate. In November, S&P circulated a memo on how to standardize operating earnings. Under the proposal, operating earnings would include the costs of purchases, research and development, restructuring costs (including severance), write-downs from ongoing operations, and the cost to the company of stock options. It would exclude merger-and-acquisition expenses, impairment of goodwill, litigation settlements, and the gain or loss on the sale of an asset.

When S&P applied roughly that formula to JDS Uniphase, it split the difference between Wall Street and GAAP. Because of differences in what each group included in their earnings calculations, the results were chaotic. Using GAAP, the company lost \$9.39 a share. S&P figures it lost \$3.19, while the company put the loss at 36 cents. Meanwhile, Wall Street says it made 2 cents.

The S&P standard may make sense, but it raises the question: Where is the Financial Accounting Standards Board, the group in charge of GAAP? Chairman Edmund L. Jenkins says FASB will be addressing the problems. Still, investors shouldn't expect any improvement soon. The pace of change at FASB tends to be glacial. It typically takes four years to complete a new standard. In 1996, for example, the board realized that standards on restructuring charges had some big loopholes and it resolved to put the issue on its agenda. In June, 2000, the board finally issued a draft of a new standard, asked for comments, and held a public hearing. In October, 2001, the board said it still wasn't ready to put a fix in place. Now, the recession has set off another wave of restructuring charges, and the FASB still doesn't have new rules.

The slow pace means the standard-setters sometimes fail to react to sudden changes in the market. The most recent failure followed the terrorist attacks on September 11. An FASB task force, unable to come up with a set of rules for separating September 11 costs from general expenses, instead told companies that the disaster could not be treated as an extraordinary item. So GAAP earnings include costs stemming from the disaster as part of a company's general performance. Many companies have nevertheless broken those costs out in their unaudited press releases.

Many more are likely to do so in the fourth quarter. Indeed, 2001 is shaping up to be one for the record books. A poor economy and the devastating aftereffects of September 11 have resulted in a slew of unusual charges that are unlikely to recur and that no one could have foreseen. But there's a growing concern that the earnings fog is providing managers with cover to hide missteps of the past within that vast category of supposedly one-time charges. The temptation will be to take as big a charge as possible now, while investors are braced for bad news. Not only can managers sweep away yesterday's errors, but tomorrow's earnings will look even better.

The basic question comes down to what constitutes a special expense--a charge so unusual that to include it in the earnings calculation would be to distort the truth about a company's performance. Usually, big charges fall into a few categories, including charges for laying off workers and restructuring a company, charges for assets that have lost value since they were purchased, charges for investments that have lost value, and charges for inventory that has become obsolete. In a recent study, Harvard Business School professor Mark T. Bradshaw found that companies

are increasingly calling these charges unusual. That gives them a rationale for excluding them from their pro forma calculations.

Lots of critics disagree, saying such charges are often an inevitable part of the business cycle and should be reflected in a company's earnings history. They certainly should not be ignored by investors. "Charges are real shareholder wealth that's been lost," argues David W. Tice, manager of the Prudent Bear Fund, a mutual fund with a pessimistic bent that's up 17% so far this year. "It's money they spent on something no longer worth what it was, a correction of past earnings, or a reserve for costs moving forward. Whatever the reason, it's a real cost to the company, and that hurts shareholders."

Without standards, excessive write-offs from operating earnings can obscure actual performance. Without any rules, companies calculate operating earnings inconsistently in order to put their companies in the best possible light. Dell Computer Corp. ([DELL](#)) is a good example of this "heads I win, tails you lose" school of accounting. For years, Dell benefited from gains in its venture-capital investments and was happy to include those gains in its reported earnings, where they appeared as a separate line on the income statement. But this year, when those gains turned to losses, the computer maker issued pro forma numbers that excluded that \$260 million drag. Dell spokesman Michael Maher says the company's press releases and SEC filings break out investment income and give GAAP numbers as well as pro forma. "In our view, the numbers are reported clearly," says Maher. "It's all out there for the consuming public."

PAST PUFFERY. Many experts believe special charges are a sign that past performance was exaggerated. What should investors make of a company such as Gateway Inc. ([GTW](#))? Two restructuring charges in the first and third quarters, minus a small extraordinary gain, totaled \$1.12 billion, or about \$100 million more than the company made in 1998, 1999, and 2000 combined. Which is the truer picture of its performance and potential? The write-offs or the earnings? Write-offs for customer financing are another example. When Nortel increased its reserves for credit extended to customers by \$767 million in September, it effectively admitted it had booked sales in the past to companies that couldn't pay--in effect overstating its performance in those earlier periods. In addition, Nortel says booking sales and accounting for credit are unrelated issues. Tech companies blame the sharp downturn in their industry for the big write-offs. And these aren't isolated examples. Peter L. Bernstein, publisher of newsletter *Economics & Portfolio Strategy*, found that from 1989 to 1993, 20% of earnings vanished into write-offs.

Big charge-offs can also distort future performance. Critics contend that excess reserves are often used as a sort of "cookie jar" from which earnings can be taken in future quarters to meet Wall Street's expectations. Or charges taken this year, for example, which is apt to be a lousy one for most companies anyway, might include costs that would otherwise have been taken in future periods. Prepaying those costs gives a big boost to later earnings. Rules for figuring operating earnings would help, but this is an area that will always involve a certain amount of judgment--and therefore invite a certain amount of abuse. "People are going to write off everything they can in the next two quarters because they're having a bad year anyway," says Robert G. Atkins, a Mercer Management consultant.

Part of the lure of big special charges is that investors tend to shrug them off, believing that with the bad news out in the open, the company is poised for a brighter future. Since Gateway detailed its third-quarter charge of \$571 million on Oct. 18, Wall Street has bid the stock up 48%, compared with a 6% runup for the S&P 500.

Often, though, investors should take exactly the opposite message. If, for example, part of a restructuring involves slashing employee training, information-technology spending, or research and development, the cuts could depress future performance, says Baruch Lev, a professor of accounting at the Stern School of Business at New York University. "Are these really one-time events?" he asks. "Or is this the beginning of an avalanche?" Indeed, Morgan Stanley Dean Witter & Co. strategist Steve Galbraith has found that in the year following a big charge-off to earnings companies have underperformed the stock market by 20 percentage points.

"LA LA LAND." Investors are apt to be faced with more huge write-offs next year, even if the economy doesn't continue to worsen. Why? The transition to a new GAAP rule that changes the way companies account for goodwill--a balance-sheet asset that reflects the amount paid for an acquisition over the net value of the tangible assets. Under the new rule, companies will have to assess their properties periodically and decrease their worth on the balance sheet if their value falls. An informal survey by Financial Executives International of its member controllers and financial officers found that at least a third expect to take more charges.

But figuring out the proper value of those assets is no easy task. Unless there is a comparable company or factory with an established market price, valuing them involves a lot of guesswork for which there are no firm rules. "What this is really coming down to is corporations and their auditors coming up with their own tests for impairment," says the Stern School's Professor Paul R. Brown. "It's La La Land."

While the tidal wave of special charges is providing cover for earnings games, it could also be an impetus for change--especially in the wake of the dot-com fiasco. Indeed, there are some signs of a backlash. The real estate investment trust industry was a pioneer of engineered earnings, with its "funds from operations," or FFO. But now some REITs have begun to revert to plain old GAAP earnings. Hamid R. Moghadam, CEO of San Francisco-based AMB Property Corp., shifted back to GAAP in 1999. "The reason I don't like FFO is very simple," says Moghadam. "One company's numbers look better than another one's even if they had identical fundamental results."

There are other steps FASB could take to improve financial reporting and restore GAAP's status. Trevor S. Harris, an accounting expert at Morgan Stanley, says it could force companies to make clear distinctions between income from operations and income from financial transactions. Lehman's Willens says companies should provide more information on cash expenses and how they bear on earnings. An easy step would be to require companies to file their press releases with the SEC.

At the least, says Lev, companies must clearly explain how their pro forma numbers relate to the GAAP numbers. Otherwise, he says, investors "see numbers floating there, and where did they come from?" In today's environment of unregulated pro forma calculations and supersize write-offs, no question is more important to investors.

By Nanette Byrnes and David Henry
With Mike McNamee in Washington

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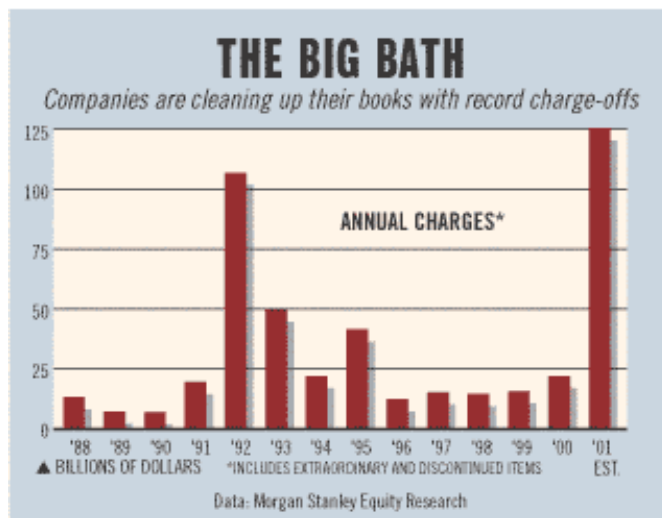
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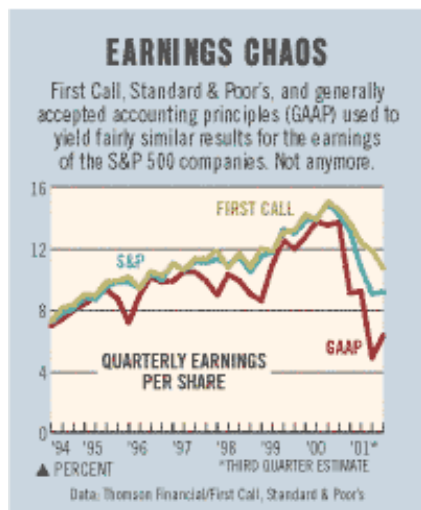
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Navigating the Numbers

There's plenty of information in a company's financial statements that can help determine the company's prospects. Here are the things accountants, analysts, and other financial sleuths focus on in their reviews.

THE EARNINGS PRESS RELEASE

1. This is a document to be read with great caution. If an earnings number is flagged in the headline, it may or may not be calculated according to conservative rules. Because these statements are not reviewed by regulators, they are largely public relations efforts. If management has included a pro forma number, be sure to read carefully for information about the charges a company is choosing to ignore. "We never use pro forma numbers," warns investor Cliff Asnes of AQR Capital. "I believe `pro forma' is usually just a fancy word for lying." But announcements of other news may be very useful. A change in auditor, outside legal counsel, or the CFO makes analyst Howard Schilit's list of "10 excellent clues to detect shenanigans."

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THE STATEMENT OF OPERATIONS

2. Here's where you will find earnings as calculated by CPAs--net income. Also, there are useful line items such as "investment income," which highlight how much money a company earned on its investment portfolio. Depending on the company, this may or may not be central to their success. Although investors tend to focus on the bottom line, the first item on the income statement--revenue--can sometimes be the most important. If it's hard to get a handle on the quality of a company's earnings, it may be easier to ascertain whether its revenue growth is slowing or increasing.

THE STATEMENT OF CASH FLOWS

3. This is rarely tacked on to the press release and usually can be found only in the quarterly report filed with the SEC about a month later. It's the most conservative measure of a company's health--how much cash its operations are creating every quarter. "Short of fraud, cash flow is much less vulnerable to manipulation" than earnings, says RL Renck's Robert Renck. It's broken into operating cash flow (money in the door), cash invested in the business, and cash from financing activities, such as issuing stock or debt.

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THE BALANCE SHEET

4. "People need to be looking at something they haven't been looking at for the past few years--the balance sheet," says former SEC chief accountant Lynn Turner. The balance sheet is prepared according to GAAP and highlights a company's cash on hand as well as what it has borrowed (liabilities), what it has yet to be paid for (receivables), and how much inventory it has on hand. If receivables or inventory are growing much faster than revenue, it's a warning sign that demand may be weakening. A company with plenty of ready cash can invest in its future growth, perhaps by making an acquisition or funding research and development.

THE FOOTNOTES

5. These can be found in SEC filings, some only in the annual report. Look for the footnote on the pension fund to see how much of net income may have come from its gains. In the bull market of the late '90s, that was an inflator at companies such as GE ([GE](#)) and IBM ([IBM](#)). Now, the issue may be shortfall. There's also a special note devoted to restructurings and how much money has been spent on layoffs and facility closings. Look for the word "reversals." This indicates that the company overestimated how much it would have to spend and has fed that excess back into earnings.

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Q&A: Words of Warning from the SEC

Says Chairman Harvey Pitt: "Anyone who uses pro forma disclosure as a vehicle for misleading or obfuscating results will have to answer to us"

Securities & Exchange Commission Chairman Harvey L. Pitt, in office since August, has focused on companies' financial reporting as one of his top priorities for overhaul. He spoke to *BusinessWeek* Senior Correspondent Mike McNamee about the pitfalls investors face with "pro forma" earnings -- and the perils for companies that use shaky numbers to mislead. Here are edited excerpts of their conversation.

Q: Companies have created a raft of new ways to present their financial results -- pro forma statements, operating earnings, and the like -- that don't conform to the standards of generally accepted accounting principles (GAAP). Is this a problem?

A: Pro formas are an area of enormous concern to me. First, they're not prepared according to GAAP. Second, there is no comparability. Even if all other things were equal -- and they're not -- since different companies apply pro forma disclosures in whatever way moves them, pro formas raise significant problems.

Without appropriate disclosure, no investor -- certainly not any ordinary investor -- can read these in a way that's useful. An investor can't know what's been left out, why it's left out, or how it compares [with other companies' earnings].

Q: Are there legitimate reasons for companies and investors to turn to pro formas and other alternate measures of earnings?

A: Companies are concerned that they can't communicate effectively what happened, and is happening [using GAAP financial statements]. Shareholders confronting these cumbersome materials are looking for a clearer way to understand what's happening within companies. GAAP, even if it's done perfectly -- perhaps especially if it's done perfectly -- is not going to give the ordinary investor the kind of insight that's desired into company performance. GAAP itself raises, in my view, serious comprehension issues for ordinary investors.

Q: So you're not happy with standard financial statements, either.

A: The quality of financial reporting leaves a great deal to be desired. Even if there were no issuer problems, the information is not timely -- it's stale when investors get it. Worse, it's impenetrable.

We need to keep the system we have, which is the best in the world, but find ways

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to communicate that are clear and comprehensible. Improving this is clearly going to require a considered effort, a partnership between investors, companies, and accountants. The commission has a lead role to play. [SEC Chief Accountant] Bob Herdman is starting that work in consultation with investor and accounting groups. We need a system that is understandable, but not so simplistic that it distorts what the real information is.

Q: Your predecessor [former SEC Chairman Arthur Levitt Jr.] made policing companies' accounting irregularities a top priority. Where is accounting enforcement in your regime?

A: Notwithstanding anything else -- notwithstanding our desire to come up with something better -- the rules of the game as they presently exist still apply. Anyone who uses pro forma disclosure as a vehicle for misleading or obfuscating results will have to answer to us.

In my experience, in any economic downturn, there are always people who try to use [the economy as an excuse] to present a different picture of their actual results. They are tempted -- but those people would make an enormous mistake. We won't think twice. We will be able to move in, and move in quickly, if anyone tries to take advantage of this situation. Our Enforcement Div. is very much on the lookout.

Q: But your speeches stress that the SEC wants a more cooperative relationship with accountants and companies. How does that fit?

A: Bob Herdman and his staff are willing to be of assistance to companies when they face hard decisions about accounting. We're saying, "Come in before the problem arises." If issuers come in to talk to us beforehand, we, in good faith, will try to assist them. But if they go ahead and do it, they'd better get it right. If you're offered a helping hand, you either have to take it or accept the consequences of not taking it.

Q: The SEC issued a report saying that companies that uncover financial irregularities, but cooperate with the SEC's investigations, may get credit, in terms of lighter penalties. Is this an amnesty?

A: There's nothing in here about amnesty.

We believe that the most effective enforcement tool is self-policing and self-restraint. But that only works if companies have a sense that, if they have made a mistake, they can come in and discuss it, and not immediately be thrown to the wolves. If you come in and talk to us, and take steps to remedy the mistake, we will give you credit. We haven't said there will be credit in every case, or what credit we'll give.

No one should assume they can act with impunity toward the public, and damage investors, and then make it all better by confessing. Confession is good for the soul, and it is a necessary element, but it's not sufficient. We'll be looking for a real effort to repair any harm, to make sure it doesn't happen again. If senior management is behind the problem, that is a very serious impediment to receiving any credit.

This is not going to be a good program for anyone who has deliberately violated the law. They are not going to find us a kinder and gentler SEC.

Q: So enforcement against accounting problems is still a top priority?

A: We have not changed any priority, but we have changed the way we proceed. I've talked about "real-time enforcement." If it takes us five or six years to ferret through what happened [in a company's books] and eventually address the potential wrongdoing, in my view, we have helped virtually no one. We want to move with alacrity, warn investors, and put a stop to improper conduct while it's still going on.

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