

## QUALITY OF EARNINGS

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**G**enerally accepted accounting principles (GAAP) is the broad term used to describe the body of principles that govern the accounting for financial transactions underlying the preparation of a set of financial statements. GAAP is derived from a variety of sources, including the Financial Accounting Standards Board, its predecessor, the Accounting Principles Board, and the American Institute of Certified Public Accountants. Other sources include the general body of accounting literature consisting of textbooks, articles, papers, etc. The purpose of GAAP is to make accounting information that is prepared by different companies more comparable. Unfortunately, when analyzing financial statements, the GAAP method of reporting comes up short. Many institutional investors, Wall Street analysts and even some accountants feel that GAAP is inadequate.

**I**nvestors are interested in a company's future prospects. The problem is that GAAP includes various non-cash charges and one-time expenses. While investors need to be informed of these charges, they also need a number that pertains solely to the performance of ongoing operations. Another problem with GAAP is the discretion that management is given in calculating the company's earnings. Management has discretion when calculating depreciation, inventory costs, revenue recognition, capitalizing vs. expensing, operating vs. capitalized leases, and intrinsic value vs. the fair value for stock options. Although the purpose of GAAP is to make financial statements more comparable, it often leaves investors confused.

**I**n order to facilitate investors' needs for an earnings number that reflects companies' future prospects, many companies will report operating earnings. Operating earnings can be categorized as "core," "pro forma," "recurring net income," etc. There is no uniform standard for companies to report operating earnings. Consequently, they are reporting earnings in an ad hoc manner. As you can imagine, since there are no standards, companies generally try to present themselves in the best light. Dell Computer is a good example of a company taking advantage of the lack of standards. For years, Dell benefited from gains in its capital investments. It had no problem including these gains in reported earnings where it appeared as a separate line item on the income statement. When these gains turned to losses, Dell conveniently excluded the \$260 million loss from its operating earnings.

**T**he flexibility that Corporate America is afforded in reporting earnings can lead to large gaps between GAAP and Wall Street. In the third quarter of 2001, the earnings per share for the S&P 500 was \$10.78 according to Wall Street analysts as calculated by Thomson Financial/First Call, \$9.17 according to Standard & Poor's, and \$6.37 according to numbers reported to the SEC under GAAP. The lack of standards can be costly for those who do not analyze companies carefully. Companies may employ accounting methods that are too creative and lead to overaggressiveness or overconservativeness. In 1998, former SEC chairman Arthur Levitt stated, "Increasingly, I have become concerned that the motivation to meet Wall Street expectations may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in the game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation. As a result, I fear that we are witnessing an erosion in the

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quality of earnings and, therefore, the quality of financial reporting. Managing may be giving way to manipulation. Integrity may be losing out to illusion.” His words proved prophetic.

**A**fter reporting earnings that had grown by as much as 24% a year, Houston-based energy giant Enron Corporation acknowledged that their results for the past three years were overstated by more than half a billion dollars. This came three weeks after Enron had announced a big drop in shareholders’ equity, sparking fears that its complex financial statements were distorting its true performance. Management pointed to a decision to exclude the results of three partnerships from its financial statement in addition to a billion-dollar error that inflated the company’s net worth. Enron filed for Chapter 11 bankruptcy in early December. Enron is not alone in falling short of the rosy picture painted by its earnings releases. This year Corporate America is expected to charge off a record \$125 billion, much of it for assets, investments and inventories that are not worth as much as management anticipated.

**T**he flexibility given to Corporate America makes it very important to determine the quality of earnings for a company. Without uniform standards, reported earnings should not be taken at face value. Careful examination is required. Managers on the Lockwood recommended list use different methods to evaluate the quality of earnings. Of the managers polled, the consensus is that GAAP-reported earnings alone are insufficient to determine the quality of earnings of a company. The managers’ reasons are similar to those previously mentioned —acquisition accounting, reduction in the effective tax rate, jump in accounts receivables, inventory buildup, consolidation of a subsidiary, writedown of goodwill, impaired assets, etc. It is also a consensus among the managers that a uniform set of standards regarding pro forma earnings would be helpful. However, until there are such standards, it is even more important to examine each company closely.

**O**ne method that Ashfield & Co. uses to evaluate the quality of earnings is forensic accounting. Forensic accounting converts both income and balance sheet items into sources and uses of cash to determine trends, particularly non-operational trends. Non-operational items can often boost earnings and potentially mask deterioration in the core business. Reported corporate earnings are based on accrual accounting methods, which allow future receivables to be recorded at the time of reporting. Corporate earnings can also include other sources of income and expenses not directly related to the core business. Similarly, earnings can be boosted by obtaining extended credit terms from suppliers, thus reducing current expenses. The basic source of cash is derived from customer sales. Hence, forensic accounting uses cash flow from operations (CFFO) to measure the true health of the business. It looks at the differential between reported earnings and CFFO and the quarterly rate of change in the differential. After several data points have been established, Ashfield will examine the differential. If deterioration in CFFO relative to reported earnings is present, it may be an attempt by management to mask a slowdown in the core business. Ashfield has detected this type of reporting over the last several years, especially in the technology area, which accounts for its lower-than-market weight in the sector.

**T**om Johnson Investment Management’s team views the quality of earnings issue as an important part of the analysis of current holdings or new stocks for purchase. The quality of earnings is the first thing that the firm’s analysts review when a company reports earnings. They view an unusual or extraordinary expense as an expense that is out of the ordinary, a one-time occurrence, or nonrecurring. GAAP versus

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operating earnings? GAAP looks at what has happened in the past, whereas Tom Johnson is more interested in what is going to happen in the future. Thus, the firm's main goal is to get to the core operations of the business. Next, it gets a detailed forecast of how those operations will perform and determines the true level of profitability of the company (on a continuing basis). The firm is also interested in whether write-offs are cash or non-cash items. This task is not always easy. It involves a great deal of analysis and careful examination of all financial documents released by the company (especially footnotes), as well as numerous questions to management during conference calls. Management's credibility and the company's record of accomplishment (history) regarding write-offs are additional factors for consideration. The firm believes that the subject of rules, standards and regulations will be widely discussed within the industry with a beneficial conclusion. However, analyzing "unusual and extraordinary" expenses will always be an area that requires the firm's attention.

**C**ampbell, Cowperthwait is challenged to assess a company's "normalized" earnings since stock prices reflect a discounted stream of future earnings/cash flows. The firm pays close attention to what a company includes/excludes from pro forma earnings. It takes a middle-ground view between pure GAAP and prettied-up pro forma earnings. Campbell is willing to recognize the writedown of goodwill or impaired assets as a one-time phenomenon. At the same time, the firm feels it is unacceptable for a company to jump through hoops to exclude expenses that are clearly normal and recurring in nature. An attempt by a company to push the envelope by redefining recurring earnings raises a red flag and places the company's results under higher scrutiny.

**R**ittenhouse looks at each company every quarter. It focuses on the growth of earnings. The firm tests the quality by looking at how cash flow growth tracks earnings growth. It looks at the sources of earnings growth and asks if it is primarily top-line revenue driven, from expense reductions, from share repurchases, etc. Unusual and extraordinary expenses tend to be excluded, but not before Rittenhouse evaluates them on a case-by-case basis and determines, among other things, whether they are cash or non-cash charges. Rittenhouse's analysts provide a case-by-case examination of a company's numbers and share their conclusions with the investment team. As a group, they decide if the company's quality meets their standards.

**R**oxbury Capital believes the quality of earnings generally relates to how well the cash earnings reflect the GAAP earnings. An increase in receivables or inventory buildups can be early signals of upcoming earnings disappointments. Making earnings estimates by lowering reserves is also considered poor quality. Changes in accounting practices are reviewed for reasonableness. Unusual items are examined to determine whether they are truly non-recurring and to assess the operating impact they may have. Many times, companies take a "one-time" write-off for past years' excesses. That may be an indication that the company did a poor job of managing its resources in the past.

**T**he overriding theme is that cash flow from operations plays a critical role in determining the quality of reported earnings. The manager's job is to see through the noise created by GAAP earnings and a company's pro forma earnings to determine the true earnings power of the company. As you can see, this is not an easy task. Until there is some standard (and even after a standard is established), managers can add value through the analysis of individual stocks.

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As far as new standards are concerned, changes are not expected soon. Although Standard & Poor's has been proactive in trying to establish some sort of standards, the Financial Accounting Standards Board (FASB) is in charge of GAAP. FASB chairman Edmund L. Jenkins has indicated that the problem will be addressed soon. The fact is that change at the FASB is very slow. It typically takes four years to complete a new standard. The most recent example occurred in 1996. The FASB realized that the standards on restructuring had sizable loopholes and put the issue on its agenda. In June of 2000, the board issued a draft on a new standard, requested comments and held a public hearing. In October of 2001, the FASB indicated that it was not ready to put a new standard in place. Now that we are in a recession, the FASB still has nothing in place. This lack of action on the part of the FASB makes a manager's role even more important in this time of turmoil.