PART One

Reading between the Lines
CHAPTER 1

The Adversarial Nature of Financial Reporting

Financial statement analysis is an essential skill in a variety of occupations, including investment management, corporate finance, commercial lending, and the extension of credit. For individuals engaged in such activities, or who analyze financial data in connection with their personal investment decisions, there are two distinct approaches to the task.

The first is to follow a prescribed routine, filling in boxes with standard financial ratios, calculated according to precise and inflexible definitions. It may take little more effort or mental exertion than this to satisfy the formal requirements of many positions in the field of financial analysis. Operating in a purely mechanical manner, though, will not provide much of a professional challenge. Neither will a rote completion of all of the proper standard analytical steps ensure a useful, or even a nonharmful, result. Some individuals, however, will view such problems as only minor drawbacks.

This book is aimed at the analyst who will adopt the second and more rewarding alternative, the relentless pursuit of accurate financial profiles of the entities being analyzed. Tenacity is essential because financial statements often conceal more than they reveal. To the analyst who embraces this proactive approach, producing a standard spreadsheet on a company is a means rather than an end. Investors derive but little satisfaction from the knowledge that an untimely stock purchase recommendation was supported by the longest row of figures available in the software package. Genuinely valuable analysis begins after all the usual questions have been answered. Indeed, a superior analyst adds value by raising questions that are not even on the checklist.

Some readers may not immediately concede the necessity of going beyond an analytical structure that puts all companies on a uniform, objective scale. They may recoil at the notion of discarding the structure altogether when a sound assessment depends on factors other than comparisons of
standard financial ratios. **Comparability**, after all, is a cornerstone of generally accepted accounting principles (GAAP). It might therefore seem to follow that financial statements prepared in accordance with GAAP necessarily produce fair and useful indications of relative value.

The corporations that issue financial statements, moreover, would appear to have a natural interest in facilitating convenient, cookie-cutter analysis. These companies spend heavily to disseminate information about their financial performance. They employ investor-relations managers, they communicate with existing and potential shareholders via interim financial reports and press releases, and they dispatch senior management to periodic meetings with securities analysts. Given that companies are so eager to make their financial results known to investors, they should also want it to be easy for analysts to monitor their progress. It follows that they can be expected to report their results in a transparent and straightforward fashion... or so it would seem.

**THE PURPOSE OF FINANCIAL REPORTING**

Analysts who believe in the inherent reliability of GAAP numbers and the good faith of corporate managers misunderstand the essential nature of financial reporting. Their conceptual error connotes no lack of intelligence, however. Rather, it mirrors the standard accounting textbook’s idealistic but irrelevant notion of the purpose of financial reporting. Even Howard Schilit (see the MicroStrategy discussion, later in this chapter), an acerbic critic of financial reporting as it is actually practiced, presents a high-minded view of the matter:

*The primary goal in financial reporting is the dissemination of financial statements that accurately measure the profitability and financial condition of a company.*

Missing from this formulation is an indication of whose primary goal is accurate measurement. Schilit’s words are music to the ears of the financial statements users listed in this chapter’s first paragraph, but they are not the ones doing the financial reporting. Rather, the issuers are for-profit companies, generally organized as corporations.

A corporation exists for the benefit of its shareholders. Its objective is not to educate the public about its financial condition, but to maximize its shareholders’ wealth. If it so happens that management can advance that objective through “dissemination of financial statements that accurately measure the profitability and financial condition of the company,” then in
principle, management should do so. At most, however, reporting financial results in a transparent and straightforward fashion is a means unto an end.

Management may determine that a more direct method of maximizing shareholder wealth is to reduce the corporation’s cost of capital. Simply stated, the lower the interest rate at which a corporation can borrow or the higher the price at which it can sell stock to new investors, the greater the wealth of its shareholders. From this standpoint, the best kind of financial statement is not one that represents the corporation’s condition most fully and most fairly, but rather one that produces the highest possible credit rating (see Chapter 13) and price-earnings multiple (see Chapter 14). If the highest ratings and multiples result from statements that measure profitability and financial condition inaccurately, the logic of fiduciary duty to shareholders obliges management to publish that sort, rather than the type held up as a model in accounting textbooks. The best possible outcome is a cost of capital lower than the corporation deserves on its merits. This admittedly perverse argument can be summarized in the following maxim, presented from the perspective of issuers of financial statements:

*The purpose of financial reporting is to obtain cheap capital.*

Attentive readers will raise two immediate objections. First, they will say, it is fraudulent to obtain capital at less than a fair rate by presenting an unrealistically bright financial picture. Second, some readers will argue that misleading the users of financial statements is not a sustainable strategy over the long run. Stock market investors who rely on overstated historical profits to project a corporation’s future earnings will find that results fail to meet their expectations. Thereafter, they will adjust for the upward bias in the financial statements by projecting lower earnings than the historical results would otherwise justify. The outcome will be a stock valuation no higher than accurate reporting would have produced. Recognizing that the practice would be self-defeating, corporations will logically refrain from overstating their financial performance. By this reasoning, the users of financial statements can take the numbers at face value, because corporations that act in their self-interest will report their results honestly.

The inconvenient fact that confounds these arguments is that financial statements do not invariably reflect their issuers’ performance faithfully. In lieu of easily understandable and accurate data, users of financial statements often find numbers that conform to GAAP yet convey a misleading impression of profits. Worse yet, outright violations of the accounting rules come to light with distressing frequency. Not even the analyst’s second line of defense, an affirmation by independent auditors that the statements have been prepared in accordance with GAAP, assures that the numbers are reliable.
A few examples from recent years indicate how severely an overly trusting user of financial statements can be misled.

**Interpublic Tries Again... and Again**

Interpublic Group of Companies announced on August 13, 2002, that it had improperly accounted for $68.5 million of expenses and would restate its financial results all the way back to 1997. The operator of advertising agencies said the restatement was related to transactions between European offices of the McCann-Erickson Worldwide Advertising unit. Sources indicated that when different offices collaborated on international projects, they effectively booked the same revenue more than once. In the week before the restatement announcement, when the company delayed the filing of its quarterly results to give its audit committee time to review the accounting, its stock sank by nearly 25 percent.

Perhaps not coincidentally, Interpublic’s massive revision coincided with the effective date of new **Securities and Exchange Commission (SEC)** certification requirements. Under the new rules, a company’s chief executive officer and chief financial officer could be subject to fines or prison sentences if they certified false financial statements. It was an opportune time for any company that had been playing games with its financial reporting to get straight.

The August 2002 restatement did not clear things up once and for all at Interpublic. In October, the company nearly doubled the amount of the planned restatement to $120 million, and in November, it emerged that the number might go even higher. By that time, Interpublic’s stock was down 55 percent from the start of the year, Standard & Poor’s had downgraded its credit rating from BBB+ to BBB, and several top executives had been dismissed.

Like many other companies that have issued financial statements that subsequently needed revision, Interpublic was under earnings pressure. Advertising spending had fallen drastically, producing the worst industry results in decades. Additionally, the company was having difficulty assimilating a huge number of acquisitions. Chairman John J. Dooner was understandably eager to shift the focus from all that. “The finger-pointing is about the past,” he said. “I’m focusing on the present and future.”

Unfortunately, the future brought more accounting problems. A few days after Dooner’s statement, the company upped its estimated restatement to $181.3 million, nearly triple the original figure. Another blow arrived a week later as the SEC requested information related to the errors that gave rise to the restatement. It also turned out that the misreporting was not limited to double-counting of revenue by McCann-Erickson’s European offices. Other items included an estimate of not-yet-realized insurance proceeds,
write-offs of accounts receivable and work in progress, and understated liabilities at other Interpublic subsidiaries dating back as far as 1996. Dooner commented, “The restatement that we have been living through is finally filed.” He also stated that he was resolved that the turmoil created by the accounting problems would never happen again.

Fast-forward to September 2005. Dooner’s successor and the third CEO since the accounting problems first surfaced, Michael I. Roth, declared that his top priority was to put Interpublic’s financial reporting problems behind it. For the first time, the company acknowledged that honest mistakes might not have accounted for all of the erroneous accounting. Furthermore, said Interpublic, investors should not rely on previous estimates of the restatements, which also involved procedures for tracking the company’s hundreds of agency acquisitions. That proved to be something of an understatement. Interpublic ultimately announced a restatement of $550 million, three times the previous estimate, for the period 2000 through September 30, 2004. In May 2008, the company paid $12 million to settle the SEC’s accusation that it fraudulently misstated its results by booking intercompany charges as receivables instead of expenses.

**MicroStrategy Changes Its Mind**

On March 20, 2000, MicroStrategy announced that it would restate its 1999 revenue, originally reported as $205.3 million, to around $150 million. The company’s shares promptly plummeted by $140 to $86.75 a share, slashing Chief Executive Officer Michael Saylor’s paper wealth by over $6 billion. The company explained that the revision had to do with recognizing revenue on the software company’s large, complex projects. MicroStrategy and its auditors initially suggested that the company had been obliged to restate its results in response to a recent (December 1999) SEC advisory on rules for booking software revenues. After the SEC objected to that explanation, the company conceded that its original accounting was inconsistent with accounting principles published way back in 1997 by the American Institute of Certified Public Accountants.

Until MicroStrategy dropped its bombshell, the company’s auditors had put their seal of approval on the company’s revenue recognition policies. That was despite questions raised about MicroStrategy’s financials by accounting expert Howard Schilit six months earlier and by reporter David Raymond in an issue of *Forbes ASAP* distributed on February 21. It was reportedly only after reading Raymond’s article that an accountant in the auditor’s national office contacted the local office that had handled the audit, ultimately causing the firm to retract its previous certification of the 1998 and 1999 financials.
No Straight Talk from Lernout & Hauspie

On November 16, 2000, the auditor for Lernout & Hauspie Speech Products (L&H) withdrew its clean opinion of the company’s 1998 and 1999 financials. The action followed a November 9 announcement by the Belgian producer of speech-recognition and translation software that an internal investigation had uncovered accounting errors and irregularities that would require restatement of results for those two years and the first half of 2000. Two weeks later, the company filed for bankruptcy.

Prior to November 16, 2000, while investors were relying on the auditor’s opinion that Lernout & Hauspie’s financial statements were consistent with generally accepted accounting principles, several events cast doubt on that opinion. In July 1999, short seller David Rocker criticized transactions such as L&H’s arrangement with Brussels Translation Group (BTG). Over a two-year period, BTG paid L&H $35 million to develop translation software. Then L&H bought BTG and the translation product along with it. The net effect was that instead of booking a $35 million research and development expense, L&H recognized $35 million of revenue. In August 2000, certain Korean companies that L&H claimed as customers said that they in fact did no business with the corporation. In September, the Securities and Exchange Commission and Europe’s EASDAQ stock market began to investigate L&H’s accounting practices. Along the way, Lernout & Hauspie’s stock fell from a high of $72.50 in March 2000 to $7 before being suspended from trading in November. In retrospect, uncritical reliance on the company’s financials, based on the auditor’s opinion and a presumption that management wanted to help analysts get the true picture, was a bad policy.

THE FLAWS IN THE REASONING

As the preceding deviations from GAAP demonstrate, neither fear of antifraud statutes nor enlightened self-interest invariably deters corporations from cooking the books. The reasoning by which these two forces ensure honest accounting rests on hidden assumptions. None of the assumptions can stand up to an examination of the organizational context in which financial reporting occurs.

To begin with, corporations can push the numbers fairly far out of joint before they run afoul of GAAP, much less open themselves to prosecution for fraud. When major financial reporting violations come to light, as in most other kinds of white-collar crime, the real scandal involves what is not forbidden. In practice, generally accepted accounting principles countenance a lot of measurement that is decidedly inaccurate, at least over the short run.
For example, corporations routinely and unabashedly smooth their earnings. That is, they create the illusion that their profits rise at a consistent rate from year to year. Corporations engage in this behavior, with the blessing of their auditors, because the appearance of smooth growth receives a higher price-earnings multiple from stock market investors than the jagged reality underlying the numbers.

Suppose that, in the last few weeks of a quarter, earnings threaten to fall short of the programmed year-over-year increase. The corporation simply borrows sales (and associated profits) from the next quarter by offering customers special discounts to place orders earlier than they had planned. Higher-than-trendline growth, too, is a problem for the earnings-smoother. A sudden jump in profits, followed by a return to a more ordinary rate of growth, produces volatility, which is regarded as an evil to be avoided at all costs. Management’s solution is to run up expenses in the current period by scheduling training programs and plant maintenance that, while necessary, would ordinarily be undertaken in a later quarter.

These are not tactics employed exclusively by fly-by-night companies. Blue chip corporations openly acknowledge that they have little choice but to smooth their earnings, given Wall Street’s allergy to surprises. Officials of General Electric have indicated that when a division is in danger of failing to meet its annual earnings goal, it is accepted procedure to make an acquisition in the waning days of the reporting period. According to an executive in the company’s financial services business, he and his colleagues hunt for acquisitions at such times, saying, “Gee, does somebody else have some income? Is there some other deal we can make?” The freshly acquired unit’s profits for the full quarter can be incorporated into GE’s, helping to ensure the steady growth so prized by investors.

Why do auditors not forbid such gimmicks? They hardly seem consistent with the ostensible purpose of financial reporting, namely, the accurate portrayal of a corporation’s earnings. The explanation is that sound principles of accounting theory represent only one ingredient in the stew from which financial reporting standards emerge.

Along with accounting professionals, the issuers and users of financial statements also have representation on the Financial Accounting Standards Board (FASB), the rule-making body that operates under authority delegated by the Securities and Exchange Commission. When FASB identifies an area in need of a new standard, its professional staff typically defines the theoretical issues in a matter of a few months. Issuance of the new standard may take several years, however, as the corporate issuers of financial statements pursue their objectives on a decidedly less abstract plane.

From time to time, highly charged issues, such as executive stock options and mergers, lead to fairly testy confrontations between FASB and the
corporate world. The compromises that emerge from these dustups fail to satisfy theoretical purists. On the other hand, rule making by negotiation heads off all-out assaults by the corporations’ allies in Congress. If the lawmakers were ever to get sufficiently riled up, they might drastically curtail FASB’s authority. Under extreme circumstances, they might even replace FASB with a new rule-making body that the corporations could more easily bend to their will.

There is another reason that enlightened self-interest does not invariably drive corporations toward candid financial reporting. The corporate executives who lead the battles against FASB have their own agenda. Just like the investors who buy their corporations’ stock, managers seek to maximize their wealth. If producing bona fide economic profits advances that objective, it is rational for a chief executive officer (CEO) to try to do so. In some cases, though, the CEO can achieve greater personal gain by taking advantage of the compensation system through financial reporting gimmicks.

Suppose, for example, the CEO’s year-end bonus is based on growth in earnings per share. Assume also that for financial reporting purposes, the corporation’s depreciation schedules assume an average life of eight years for fixed assets. By arbitrarily amending that assumption to nine years (and obtaining the auditors’ consent to the change), the corporation can lower its annual depreciation expense. This is strictly an accounting change; the actual cost of replacing equipment worn down through use does not decline. Neither does the corporation’s tax deduction for depreciation expense rise nor, as a consequence, does cash flow (see Chapter 4). Investors recognize that bona fide profits (see Chapter 5) have not increased, so the corporation’s stock price does not change in response to the new accounting policy. What does increase is the CEO’s bonus, as a function of the artificially contrived boost in earnings per share.

This example explains why a corporation may alter its accounting practices, making it harder for investors to track its performance, even though the shareholders’ enlightened self-interest favors straightforward, transparent financial reporting. The underlying problem is that corporate executives sometimes put their own interests ahead of their shareholders’ welfare. They beef up their bonuses by overstating profits, while shareholders bear the cost of reductions in price–earnings ratios to reflect deterioration in the quality of reported earnings.

The logical solution for corporations, it would seem, is to align the interests of management and shareholders. Instead of calculating executive bonuses on the basis of earnings per share, the board should reward senior management for increasing shareholders’ wealth by causing the stock price to rise. Such an arrangement gives the CEO no incentive to inflate reported
earnings through gimmicks that transparently produce no increase in bona fide profits and therefore no rise in the share price.

Following the logic through, financial reporting ought to have moved closer to the ideal of accurate representation of corporate performance as companies have increasingly linked executive compensation to stock price appreciation. In reality, though, no such trend is discernible. If anything, the preceding examples of Interpublic, MicroStrategy, and Lernout & Hauspie suggest that corporations have become more creative and more aggressive over time in their financial reporting.

Aligning management and shareholder interests, it turns out, has a dark side. Corporate executives can no longer increase their bonuses through financial reporting tricks that are readily detectable by investors. Instead, they must devise better-hidden gambits that fool the market and artificially elevate the stock price. Financial statement analysts must work harder than ever to spot corporations’ subterfuges.

SMALL PROFITS AND BIG BATHS

Certainly, financial statement analysts do not have to fight the battle single-handedly. The Securities and Exchange Commission and the Financial Accounting Standards Board prohibit corporations from going too far in prettifying their profits to pump up their share prices. These regulators refrain from indicating exactly how far is too far, however. Inevitably, corporations hold diverse opinions on matters such as the extent to which they must divulge bad news that might harm their stock market valuations. For some, the standard of disclosure appears to be that if nobody happens to ask about a specific event, then declining to volunteer the information does not constitute a lie.

The picture is not quite that bleak in every case, but the bleakness extends pretty far. A research team led by Harvard economist Richard Zeckhauser has compiled evidence that lack of perfect candor is widespread.13 The researchers focus on instances in which a corporation reports quarterly earnings that are only slightly higher or slightly lower than its earnings in the corresponding quarter of the preceding year.

Suppose that corporate financial reporting followed the accountants’ idealized objective of depicting performance accurately. By the laws of probability, corporations’ quarterly reports would include about as many cases of earnings that barely exceed year-earlier results as cases of earnings that fall just shy of year-earlier profits. Instead, Zeckhauser and colleagues find that corporations post small increases far more frequently than they post small declines. The strong implication is that when companies are in
danger of showing slightly negative earnings comparisons, they locate enough discretionary items to squeeze out marginally improved results.

On the other hand, suppose a corporation suffers a quarterly profit decline too large to erase through discretionary items. Such circumstances create an incentive to take a big bath by maximizing the reported setback. The reasoning is that investors will not be much more disturbed by a 30 percent drop in earnings than by a 20 percent drop. Therefore, management may find it expedient to accelerate certain future expenses into the current quarter, thereby ensuring positive reported earnings in the following period. It may also be a convenient time to recognize long-run losses in the value of assets such as outmoded production facilities and goodwill created in unsuccessful acquisitions of the past. In fact, the corporation may take a larger write-off on those assets than the principle of accurate representation would dictate. Reversals of the excess write-offs offer an artificial means of stabilizing reported earnings in subsequent periods.

Zeckhauser and his associates corroborate the big bath hypothesis by showing that large earnings declines are more common than large increases. By implication, managers do not passively record the combined results of their own skill and business factors beyond their control, but intervene in the calculation of earnings by exploiting the latitude in accounting rules. The researchers’ overall impression is that corporations regard financial reporting as a technique for propping up stock prices, rather than a means of disseminating objective information. If corporations’ gambits escape detection by investors and lenders, the rewards can be vast. For example, an interest-cost savings of half a percentage point on $1 billion of borrowings equates to $5 million (pretax) per year. If the corporation is in a 34 percent tax bracket and its stock trades at 15 times earnings, the payoff for risk-concealing financial statements is $49.5 million in the cumulative value of its shares.

Among the popular methods for pursuing such opportunities for wealth enhancement, aside from the big bath technique studied by Zeckhauser, are:

- Maximizing growth expectations.
- Downplaying contingencies.

MAXIMIZING GROWTH EXPECTATIONS

Imagine a corporation that is currently reporting annual net earnings of $20 million. Assume that five years from now, when its growth has leveled off somewhat, the corporation will be valued at 15 times earnings. Further assume that the company will pay no dividends over the next five years and
that investors in growth stocks currently seek returns of 25 percent (before considering capital gains taxes).

Based on these assumptions, plus one additional number, the analyst can place an aggregate value on the corporation’s outstanding shares. The final required input is the expected growth rate of earnings. Suppose the corporation’s earnings have been growing at a 30 percent annual rate and appear likely to continue increasing at the same rate over the next five years. At the end of that period, earnings (rounded) will be $74 million annually. Applying a multiple of 15 times to that figure produces a valuation at the end of the fifth year of $1.114 billion. Investors seeking a 25 percent rate of return will pay $365 million today for that future value.

These figures are likely to be pleasing to a founder or chief executive officer who owns, for the sake of illustration, 20 percent of the outstanding shares. The successful entrepreneur is worth $73 million on paper, quite possibly up from zero just a few years ago. At the same time, the newly minted multimillionaire is a captive of the market’s expectations.

Suppose investors conclude for some reason that the corporation’s potential for increasing its earnings has declined from 30 to 25 percent per annum. That is still well above average for corporate America. Nevertheless, the value of the corporation’s shares will decline from $365 million to $300 million, keeping previous assumptions intact.

Overnight, the long-struggling founder will see the value of his personal stake plummet by $13 million. Financial analysts may shed few tears for him. After all, he is still worth $60 million on paper. If they were in his shoes, however, how many would accept a $13 million loss with perfect equanimity? Most would be sorely tempted, at the least, to avoid incurring a financial reverse of comparable magnitude via every means available to them under GAAP.

That all-too-human response is the one typically exhibited by owner-managers confronted with falling growth expectations. Many, perhaps most, have no intention to deceive. It is simply that the entrepreneur is by nature a self-assured optimist. A successful entrepreneur, moreover, has had this optimism vindicated. Having taken his company from nothing to $20 million of earnings against overwhelming odds, he believes he can lick whatever short-term problems have arisen. He is confident that he can get the business back onto a 30 percent growth curve, and perhaps he is right. One thing is certain: If he were not the sort who believed he could beat the odds one more time, he would never have built a company worth $300 million.

Financial analysts need to assess the facts more objectively. They must recognize that the corporation’s predicament is not unique, but on the contrary, quite common. Almost invariably, senior managers try to dispel the impression of decelerating growth, since that perception can be so costly
EXHIBIT 1.1 The Inevitability of Deceleration

Note: Shifting investors’ perceptions upward through the Corporate Credibility Gap between actual and management-projected growth is a potentially valuable but inherently difficult undertaking for a company. Liberal financial reporting practices can make the task somewhat easier. In this light, analysts should read financial statements with a skeptical eye.

to them. Simple mathematics, however, tends to make false prophets of corporations that extrapolate high growth rates indefinitely into the future. Moreover, once growth begins to level off (see Exhibit 1.1), restoring it to the historical rate requires overcoming several powerful limitations.

Limits to Continued Growth

Saturation  Sales of a hot new consumer product can grow at astronomical rates for a time. Eventually, however, everybody who cares to will own one (or two, or some other finite number that the consumer believes is enough). At that point, potential sales will be limited to replacement sales plus growth in population, that is, the increase in the number of potential purchasers.

Entry of Competition  Rare is the company with a product or service that cannot either be copied or encroached on by a knockoff sufficiently similar
to tap the same demand, yet different enough to fall outside the bounds of patent and trademark protection.

**Increasing Base**  A corporation that sells 10 million units in Year 1 can register a 40 percent increase by selling just 4 million additional units in Year 2. If growth continues at the same rate, however, the corporation will have to generate 59 million new unit sales to achieve a 40 percent gain in Year 10.

In absolute terms, it is arithmetically possible for volume to increase indefinitely. On the other hand, a growth rate far in excess of the gross domestic product's annual increase is nearly impossible to sustain over any extended period. By definition, a product that experiences higher-than-GDP growth captures a larger percentage of GDP each year. As the numbers get larger, it becomes increasingly difficult to switch consumers' spending patterns to accommodate continued high growth of a particular product.

**Market Share Constraints**  For a time, a corporation may overcome the limits of growth in its market and the economy as a whole by expanding its sales at the expense of competitors. Even when growth is achieved by market share gains rather than by expanding the overall demand for a product, however, the firm must eventually bump up against a ceiling on further growth at a constant rate. For example, suppose a producer with a 10 percent share of market is currently growing at 25 percent a year while total demand for the product is expanding at only 5 percent annually. By Year 14, this supergrowth company will require a 115 percent market share to maintain its rate of increase. (Long before confronting this mathematical impossibility, the corporation’s growth will probably be curtailed by the antitrust authorities.)

Basic economics and compound-interest tables, then, assure the analyst that all growth stories come to an end, a cruel fate that must eventually be reflected in stock prices. Financial reports, however, frequently tell a different tale. It defies common sense yet almost has to be told, given the stakes. Users of financial statements should acquaint themselves with the most frequently heard corporate versions of “Jack and the Beanstalk,” in which earnings—in contradiction to a popular saw—do grow to the sky.

**Commonly Heard Rationalizations for Declining Growth**

“**Our Year-over-Year Comparisons Were Distorted**”  Recognizing the sensitivity of investors to any slowdown in growth, companies faced with earnings deceleration commonly resort to certain standard arguments to persuade investors that the true, underlying profit trend is still rising at its
EXHIBIT 1.2 “Our Year-over-Year Comparisons Were Distorted”

Note: Is the latest earnings figure an outlier or does it signal the start of a slowdown in growth? Nobody will know for certain until more time has elapsed, but the company will probably propound the former hypothesis as forcefully as it can.

historical rate (see Exhibit 1.2). Freak weather conditions may be blamed for supposedly anomalous, below-trendline earnings. Alternatively, the company may allege that shipments were delayed (never canceled, merely delayed) because of temporary production problems caused, ironically, by the company’s explosive growth. (What appeared to be a negative for the stock price, in other words, was actually a positive. Orders were coming in faster than the company could fill them—a high-class problem indeed.) Widely publicized macroeconomic events such as the Y2K problem receive more than their fair share of blame for earnings shortfalls. However plausible these explanations may sound, analysts should remember that in many past instances, short-term supposed aberrations have turned out to be advance signals of earnings slowdowns.

“New Products Will Get Growth Back on Track” Sometimes, a corporation’s claim that its obviously mature product lines will resume their former growth path becomes untenable. In such instances, it is a good idea for
management to have a new product or two to show off. Even if the products are still in development, some investors who strongly wish to believe in the corporation will remain steadfast in their faith that earnings will continue growing at the historical rate. (Such hopes probably rise as a function of owning stock on margin at a cost well above the current market.) A hard-headed analyst, though, will wait to be convinced, bearing in mind that new products have a high failure rate.

"We’re Diversifying Away from Mature Markets” If a growth-minded company’s entire industry has reached a point of slowdown, it may have little choice but to redeploy its earnings into faster-growing businesses. Hunger for growth, along with the quest for cyclical balance, is a prime motivation for the corporate strategy of diversification.

Diversification reached its zenith of popularity during the conglomerate movement of the 1960s. Up until that time, relatively little evidence had accumulated regarding the actual feasibility of achieving high earnings growth through acquisitions of companies in a wide variety of growth industries. Many corporations subsequently found that their diversification strategies worked better on paper than in practice. One problem was that they had to pay extremely high price-earnings multiples for growth companies that other conglomerates also coveted. Unless earnings growth accelerated dramatically under the new corporate ownership, the acquirer’s return on investment was fated to be mediocre. This constraint was particularly problematic for managers who had no particular expertise in the businesses they were acquiring. Still worse was the predicament of a corporation that paid a big premium for an also-ran in a hot industry. Regrettably, the number of industry leaders available for acquisition was by definition limited.

By the 1980s, the stock market had rendered its verdict. The price-earnings multiples of widely diversified corporations carried a conglomerate discount. One practical problem was the difficulty security analysts encountered in trying to keep tabs on companies straddling many different industries. Instead of making 2 plus 2 equal 5, as they had promised, the conglomerates’ managers presided over corporate empires that traded at cheaper prices than their constituent companies would have sold for in aggregate had they been listed separately.

Despite this experience, there are periodic attempts to revive the notion of diversification as a means of maintaining high earnings growth indefinitely into the future. In one variant, management makes lofty claims about the potential for cross-selling one division’s services to the customers of another. It is not clear, though, why paying premium acquisition prices to assemble the two businesses under the same corporate roof should prove more profitable than having one independent company pay a fee to use
the other’s mailing list. Battle-hardened analysts wonder whether such corporate strategies rely as much on the vagaries of mergers-and-acquisitions accounting (see Chapter 10) as they do on bona fide synergy.

All in all, users of financial statements should adopt a show-me attitude toward a story of renewed growth through diversification. It is often nothing more than a variant of the myth of above-average growth forever. Multi-industry corporations bump up against the same arithmetic that limits earnings growth for focused companies.

**DOWNPLAYING CONTINGENCIES**

A second way to mold disclosure to suit the issuer’s interests is by downplaying extremely significant contingent liabilities. Thanks to the advent of class action suits, the entire net worth of even a multibillion-dollar corporation may be at risk in litigation involving environmental hazards or product liability. Understandably, an issuer of financial statements would prefer that securities analysts focus their attention elsewhere.

At one time, analysts tended to shunt aside claims that ostensibly threatened major corporations with bankruptcy. They observed that massive lawsuits were often settled for small fractions of the original claims. Furthermore, the outcome of a lawsuit often hinged on facts that emerged only when the case finally came to trial (which by definition never happened if the suit was settled out of court). Considering also the susceptibility of juries to emotional appeals, securities analysts of bygone days found it extremely difficult to incorporate legal risks into earnings forecasts that relied primarily on microeconomic and macroeconomic variables. At most, a contingency that had the potential of wiping out a corporation’s equity became a qualitative factor in determining the multiple assigned to a company’s earnings.

Manville Corporation’s 1982 bankruptcy marked a watershed in the way analysts have viewed legal contingencies. To their credit, specialists in the building products sector had been asking detailed questions about Manville’s exposure to asbestos-related personal injury suits for a long time before the company filed. Many investors nevertheless seemed to regard the corporation’s August 26, 1982, filing under Chapter 11 of the Bankruptcy Code as a sudden calamity. Manville’s stock plunged by 35 percent on the day following its filing.

In part, the surprise element was a function of disclosure. The corporation’s last quarterly report to the Securities and Exchange Commission prior to its bankruptcy had implied a total cost of settling asbestos-related claims of about $350 million. That was less than half of Manville’s $830 million
of shareholders’ equity. On August 26, by contrast, Manville estimated the potential damages at no less than $2 billion.

For analysts of financial statements, the Manville episode demonstrated the plausibility of a scenario previously thought inconceivable. A bankruptcy at an otherwise financially sound company, brought on solely by legal claims, had become a nightmarish reality. Intensifying the shock was that the problem had lain dormant for many years. Manville’s bankruptcy resulted from claims for diseases contracted decades earlier through contact with the company’s products. The long-tailed nature of asbestos liabilities was underscored by a series of bankruptcy filings over succeeding years. Prominent examples, each involving a billion dollars or more of assets, included Walter Industries (1989), National Gypsum (1990), USG Corporation (1993 and again in 2001), Owens Corning (2000), and Armstrong World Industries (2000).

Bankruptcies connected with asbestos exposure, silicone gel breast implants, and assorted environmental hazards (see Chapter 13) have heightened analysts’ awareness of legal risks. Even so, analysts still miss the forest for the trees in some instances, concentrating on the minutiae of financial ratios of corporations facing similarly large contingent liabilities. They can still be lulled by companies’ matter-of-fact responses to questions about the gigantic claims asserted against them.

Thinking about it from the issuer’s standpoint, one can imagine several reasons that the investor-relations officer’s account of a major legal contingency is likely to be considerably less dire than the economic reality. To begin with, the corporation’s managers have a clear interest in downplaying risks that threaten the value of their stock and options. Furthermore, as parties to a highly contentious lawsuit, the executives find themselves in a conflict. It would be difficult for them to testify persuasively in their company’s defense while simultaneously acknowledging to investors that the plaintiffs’ claims have merit and might, in fact, prevail. (Indeed, any such public admission could compromise the corporation’s case. Candid disclosure may therefore not be a viable option.) Finally, it would hardly represent aberrant behavior if, on a subconscious level, management were to deny the real possibility of a company-wrecking judgment. It must be psychologically very difficult for managers to acknowledge that their company may go bust for reasons seemingly outside their control. Filing for bankruptcy may prove to be the only course available to the corporation, notwithstanding an excellent record of earnings growth and a conservative balance sheet.

For all these reasons, analysts must take particular care to rely on their independent judgment when a potentially devastating contingent liability looms larger than their conscientiously calculated financial ratios. It is not a matter of sitting in judgment on management’s honor and forthrightness.
If corporate executives remain in denial about the magnitude of the problem, they are not deliberately misleading analysts by presenting an overly optimistic picture. Moreover, the managers may not provide a reliable assessment even if they soberly face the facts. In all likelihood, they have never worked for a company with a comparable problem. They consequently have little basis for estimating the likelihood that the worst-case scenario will be fulfilled. Analysts who have seen other corporations in similar predicaments have more perspective on the matter, as well as greater objectivity. Instead of relying entirely on the company’s periodic updates on a huge class action suit, analysts should also speak to representatives of the plaintiffs’ side. Their views, while by no means unbiased, will expose logical weaknesses in management’s assertions that the liability claims will never stand up in court.

THE IMPORTANCE OF BEING SKEPTICAL

By now, the reader presumably understands why this chapter is titled “The Adversarial Nature of Financial Reporting.” The issuer of financial statements has been portrayed in an unflattering light, invariably choosing the accounting option that will tend to prop up its stock price, rather than generously assisting the analyst in deriving an accurate picture of its financial condition. Analysts have been warned not to partake of the optimism that drives all great business enterprises, but instead to maintain an attitude of skepticism bordering on distrust. Some readers may feel they are not cut out to be financial analysts if the job consists of constant nay-saying, of posing embarrassing questions, and of being a perennial thorn in the side of companies that want to win friends among investors, customers, and suppliers.

Although pursuing relentless antagonism can indeed be an unpleasant way to go through life, the stance that this book recommends toward issuers of financial statements implies no such acrimony. Rather, analysts should view the issuers as adversaries in the same manner that they temporarily demonize their opponents in a friendly pickup basketball game. On the court, the competition can be intense, which only adds to the fun. Afterward, everyone can have a fine time going out together for pizza and beer. In short, financial analysts and investor-relations officers can view their work with the detachment of litigators who engage in every legal form of shin-kicking out of sheer desire to win the case, not because the litigants’ claims necessarily have intrinsic merit.

Too often, financial writers describe the give-and-take of financial reporting and analysis in a highly moralistic tone. Typically, the author
exposes a tricky presentation of the numbers and reproaches the company for greed and chicanery. Viewing the production of financial statements as an epic struggle between good and evil may suit a crusading journalist, but financial analysts need not join the ethics police to do their job well.

An alternative is to learn to understand the gamesmanship of financial reporting, perhaps even to appreciate on some level the cleverness of issuers who constantly devise new stratagems for leading investors off the track. Outright fraud cannot be countenanced, but disclosure that shades economic realities without violating the law requires truly impressive ingenuity. By regarding the interaction between issuers and users of financial statements as a game, rather than a morality play, analysts will find it easier to view the action from the opposite side. Just as a chess master anticipates an opponent’s future moves, analysts should consider which gambits they themselves would use if they were in the issuer’s seat.

“Oh no!” some readers must be thinking at this point. “First the authors tell me that I must not simply plug numbers into a standardized spreadsheet. Now I have to engage in role-playing exercises to guess what tricks will be embedded in the statements before they even come out. I thought this book was supposed to make my job easier, not more complicated.”

In reality, this book’s goal is to make the reader a better analyst. If that goal could be achieved by providing shortcuts, the authors would not hesitate to do so. Financial reporting occurs in an institutional context that obliges conscientious analysts to go many steps beyond conventional calculation of financial ratios. Without the extra vigilance advocated in these pages, the user of financial statements will become mired in a system that provides excessively simple answers to complex questions, squelches individuals who insolently refuse to accept reported financial data at face value, and inadvisably gives issuers the benefit of the doubt.

These systematic biases are inherent in selling stocks. Within the universe of investors are many large, sophisticated financial institutions that utilize the best available techniques of analysis to select securities for their portfolios. Also among the buyers of stocks are individuals who, not being trained in financial statement analysis, are poorly equipped to evaluate annual and quarterly earnings reports. Both types of investors are important sources of financing for industry, and both benefit over the long term from the returns that accrue to capital in a market economy. The two groups cannot be sold stocks in the same way, however.

What generally sells best to individual investors is a story. Sometimes the story involves a new product with seemingly unlimited sales potential. Another kind of story portrays the recommended stock as a play on some current economic trend, such as declining interest rates or a step-up in defense spending. Some stories lie in the realm of rumor, particularly those
that relate to possible corporate takeovers. The chief characteristics of most stories are the promise of spectacular gains, superficially sound logic, and a paucity of quantitative verification.

No great harm is done when an analyst’s stock purchase recommendation, backed up by a thorough study of the issuer’s financial statements, is translated into soft, qualitative terms for laypersons’ benefit. Not infrequently, though, a story originates among stockbrokers or even in the executive offices of the issuer itself. In such an instance, the zeal with which the story is disseminated may depend more on its narrative appeal than on the solidity of the supporting analysis.

Individual investors’ fondness for stories undercuts the impetus for serious financial analysis, but the environment created by institutional investors is not ideal, either. Although the best investment organizations conduct rigorous and imaginative research, many others operate in the mechanical fashion derided earlier in this chapter. They reduce financial statement analysis to the bare bones of forecasting earnings per share, from which they derive a price-earnings multiple. In effect, the less conscientious investment managers assume that as long as a stock stacks up well by this single measure, it represents an attractive investment. Much Wall Street research, regretfully, caters to these institutions’ tunnel vision, sacrificing analytical comprehensiveness to the operational objective of maintaining up-to-the-minute earnings estimates on vast numbers of companies.

Investment firms, moreover, are not the only workplaces in which serious analysts of financial statements may find their style cramped. The credit departments of manufacturers and wholesalers have their own set of institutional hazards.

Consider, to begin with, the very term credit approval process. As the name implies, the vendor’s bias is toward extending rather than refusing credit. Up to a point, this is as it should be. In Exhibit 1.3, neutral Cutoff Point A, where half of all applicants are approved and half are refused,

<table>
<thead>
<tr>
<th>Most Creditworthy</th>
<th>Population of Potential Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measures of Financial Strength</td>
<td>A. Approve 50%, Reject 50%</td>
</tr>
<tr>
<td>Least Creditworthy</td>
<td>B. Zero Credit Loss</td>
</tr>
<tr>
<td></td>
<td>C. Profit Margin on Incremental Customers Narrowly Exceeds Credit Losses</td>
</tr>
<tr>
<td></td>
<td>D. Credit Losses Exceed Profit Margin</td>
</tr>
</tbody>
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**EXHIBIT 1.3** The Bias toward Favorable Credit Evaluations
represents an unnecessarily high credit standard. Any company employing it would turn away many potential customers who posed almost no threat of delinquency. Even Cutoff Point B, which allows more business to be written but produces no credit losses, is less than optimal. Credit managers who seek to maximize profits aim for Cutoff Point C. It represents a level of credit extension at which losses on receivables occur but are slightly more than offset by the profits derived from incremental customers.

To achieve this optimal result, a credit analyst must approve a certain number of accounts that will eventually fail to pay. In effect, the analyst is required to make mistakes that could be avoided by rigorously obeying the conclusions derived from the study of applicants’ financial statements. The company makes up the cost of such mistakes by avoiding mistakes of the opposite type (rejecting potential customers who will not fail to pay).

Trading off one type of error for another is thoroughly rational and consistent with sound analysis, so long as the objective is truly to maximize profits. There is always a danger, however, that the company will instead maximize sales at the expense of profits. That is, the credit manager may bias the system even further, to Cutoff Point D in Exhibit 1.3. Such a problem is bound to arise if the company’s salespeople are paid on commission and their compensation is not tightly linked to the collection experience of their customers. The rational response to that sort of incentive system is to pressure credit analysts to approve applicants whose financial statements cry out for rejection.

A similar tension between the desire to book revenues and the need to make sound credit decisions exists in commercial lending. At a bank or a finance company, an analyst of financial statements may be confronted by special pleading on behalf of a loyal, long-established client that is under allegedly temporary strain. Alternatively, the lending officer may argue that a loan request ought to be approved, despite substandard financial ratios, on the grounds that the applicant is a young, struggling company with potential to grow into a major client. Requests for exceptions to established credit policies are likely to increase in both number and fervor during periods of slack demand for loans.

When considering pleas of mitigating circumstances, the credit analyst should certainly take into account pertinent qualitative factors that the financial statements fail to capture. At the same time, the analyst must bear in mind that qualitative credit considerations come in two flavors, favorable and unfavorable. It is also imperative to remember that the cold, hard statistics show that companies in the temporarily impaired and start-up categories have a higher-than-average propensity to default on their debt.

Every high-risk company seeking a loan can make a plausible soft case for overriding the financial ratios. In aggregate, though, a large percentage
of such borrowers will fail, proving that many of their seemingly valid qualitative arguments were specious. This unsentimental truth was driven home by a massive 1989–1991 wave of defaults on high-yield bonds that had been marketed on the strength of supposedly valuable assets not reflected on the issuers’ balance sheets. Bond investors had been told that the bold dreams and ambitions of management would suffice to keep the companies solvent. Another large default wave in 2001 involved early-stage telecommunications ventures for which there was scarcely any financial data from which to calculate ratios. The rationale advanced for lending to these nascent companies was the supposedly limitless demand for services made possible by miraculous new technology.

To be sure, defaults also occur among companies that satisfy established quantitative standards. The difference is that analysts can test financial ratios against a historical record to determine their reliability as predictors of bankruptcy (see Chapter 13). No comparable testing is feasible for the highly idiosyncratic, qualitative factors that weakly capitalized companies cite when applying for loans. Analysts are therefore on more solid ground when they rely primarily on the numbers than when they try to discriminate among companies’ soft arguments.

CONCLUSION

A primary objective of this chapter has been to supply an essential ingredient that is missing from many discussions of financial statement analysis. Aside from accounting rules, cash flows, and definitions of standard ratios, analysts must consider the motivations of corporate managers, as well as the dynamics of the organizations in which they work. Neglecting these factors will lead to false assumptions about the underlying intent of issuers’ communications with users of financial statements.

Moreover, analysts may make incorrect inferences about the quality of their own work if they fail to understand the workings of their own organizations. If a conclusion derived from thorough financial analysis is deemed wrong, it is important to know whether that judgment reflects a flawed analysis or a higher-level decision to override analysts’ recommendations. Senior managers sometimes subordinate financial statement analysis to a determination that idle funds must be put to work or that loan volume must be increased. At such times, organizations rationalize their behavior by persuading themselves that the principles of interpreting financial statements have fundamentally changed. Analysts need not go to the extreme of resigning in protest, but they will benefit if they can avoid getting caught up in the prevailing delusion.
To be sure, organizational behavior has not been entirely overlooked up until now in the literature of financial statement analysis. Typically, academic studies depict issuers as profit-maximizing firms, inclined to overstate their earnings if they can do so legally and if they believe it will boost their equity market valuation. This model lags behind the portrait of the firm now prevalent in other branches of finance. Instead of a monolithic organization that consistently pursues the clear-cut objective of share price maximization, the corporation is now viewed more realistically as an aggregation of individuals with diverse motivations.

Using this more sophisticated model, an analyst can unravel an otherwise vexing riddle concerning corporate reporting. Overstating earnings would appear to be a self-defeating strategy in the long term, since it has a tendency to catch up with the perpetrator. Suppose, for example, a corporation depreciates assets over a longer period than can be justified by physical wear and tear and the rate of technological change in manufacturing methods. When the time comes to replace the existing equipment, the corporation will face two unattractive options. The first is to penalize reported earnings by writing off the remaining undepreciated balance on equipment that is obsolete and hence of little value in the resale market. Alternatively, the company can delay the necessary purchase of more up-to-date equipment, thereby losing ground competitively and reducing future earnings. Would the corporation not have been better off if it had refrained from overstating its earnings in the first place, an act that probably cost it some measure of credibility among investors?

If the analyst considers the matter from the standpoint of management, a possible solution to the riddle emerges. The day of reckoning, when the firm must pay back the reported earnings borrowed via underdepreciation, may be beyond the planning horizon of senior management. A chief executive officer who intends to retire in five years, and who will be compensated in the interim according to a formula based on reported earnings growth, may have no qualms about exaggerating current results at the expense of future years’ operations. The long-term interests of the firm’s owners, in other words, may not be consistent with the short-term interests of their agents, the salaried managers.

Plainly, analysts cannot be expected to read minds or to divine the true motives of management in every case. There is a benefit, however, in simply being cognizant of objectives other than the ones presupposed by introductory accounting texts. If nothing else, the awareness that management may have something up its sleeve will encourage readers to trust their instincts when some aspect of a company’s disclosure simply does not ring true. In a given instance, management may judge that its best chance of minimizing analysts’ criticism of an obviously disastrous corporate decision lies in
stubbornly defending the decision and refusing to change course. Even though the chief executive officer may be able to pull it off with a straight face, however, the blunder remains a blunder. Analysts who remember that managers may be pursuing their own agendas will be ahead of the game. They will be properly skeptical that management is genuinely making tough choices designed to yield long-run benefits to shareholders, but which individuals outside the corporation cannot envision.

Armed with the attitude that the burden of proof lies with those making the disclosures, the analyst is now prepared to tackle the basic financial statements. Methods for uncovering the information they conceal, as well as that which they reveal, constitute the heart of the next three chapters. From that elementary level right on up to making investment decisions with the techniques presented in the final two chapters, it will pay to maintain an adversarial stance at all times.