

Accountants, regulators or markets?

In the wake of Enron

The anxiety and disputes about the proper measurement of earnings may be bad news for accountants but very good news for market analysts. It is the task of analysts to add meaning to accounting reports and complexity is welcome grist to the analyst's mill. But we also argue that the importance of earnings, however consistently defined, and especially price/earnings ratios for estimating the value of companies and markets should not be exaggerated. Nor should management and analysts be expected to interpret results in the same way. Give us the raw truth – and let us debate what truth means – especially from the auditors we can believe in; this is what makes the markets in both shares and market analysts.

The accountants are feeling the heat

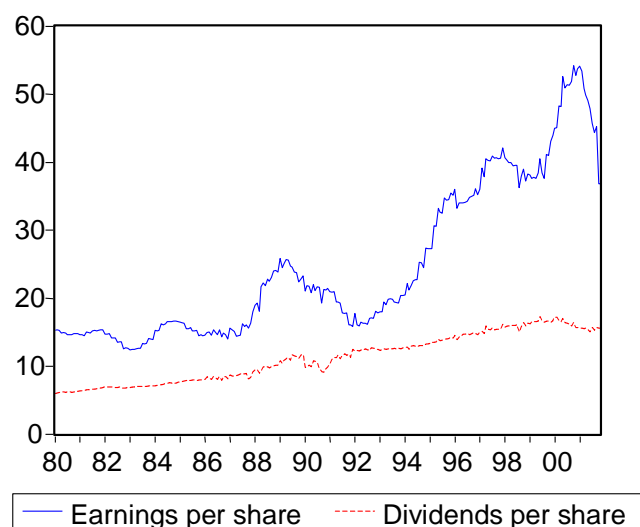
No less a personage than Paul A. Volker – he is very tall man after all, also the Chairman of the Fed before Alan Greenspan, and now, among other duties, “one of the leaders of the International Accounting Board” – stated, “the profession of auditing and accounting is, in fact, in crisis”. This quotation was included in an article by *Business Week*, 26 November 2001 entitled “*CONFUSED ABOUT EARNINGS?* – you're not alone. Here's what companies should do – and what investors need to know”.

The immediate reason for concern is the especially wide differences in earnings reported by the S&P rating agency, the accounting figures the firms themselves report to the Securities and Exchange Commission (SEC), and those of investment analysts as reported, for example by Thompson Financial / First Call. In quarter three of 2001 the analysts reported earnings per average S&P 500 share of \$10.78. The S&P calculated these earnings as \$9.17 while the companies themselves reported \$6.37.

What's going on?

The S&P 500 measure is a market cap weighted measure of after-tax, very bottom line index earnings, where it is also compared to S&P dividends, also market cap weighted, similarly calculated. Clearly, dividends are much less variable than earnings and indeed may be regarded as a proxy for smoothed earnings (see chart).

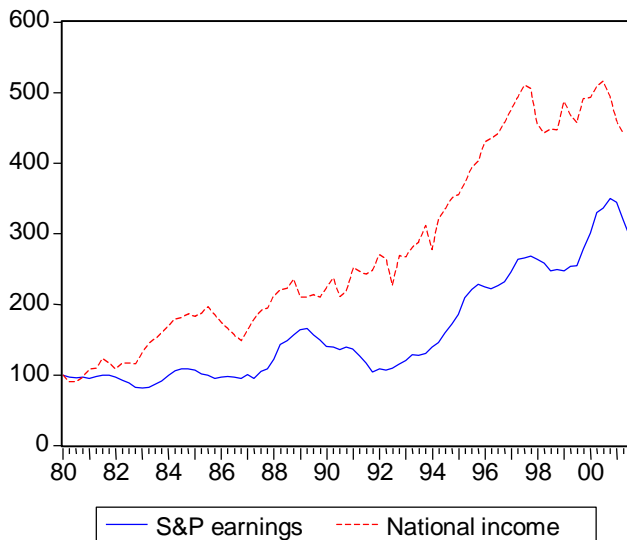
S&P 500 earnings and dividends \$ per average share



Source: I-Net Bridge

In the figure below we also compare S&P index earnings to the measure of the after-tax profits of all US corporations provided by the US government National Income Accountants. This measure is one that adds back estimates of corporate capital consumption and adjustments made for the value of inventories and may be regarded as closer to after-tax cashflow than earnings. The national-income accountants generate a larger estimate of earnings and also a somewhat less variable one, especially in recent years.

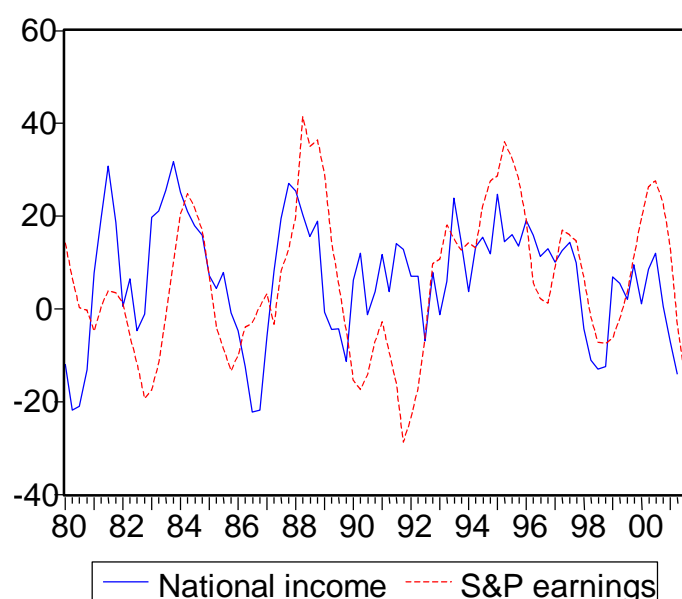
S&P earnings compared to all US corporate profits after taxes 1980 = 100



Source: Federal Reserve Bank of St. Louis, I-Net Bridge

The two earnings cycles (see chart) had a highly similar amplitude or variability until approximately 1990, but since then the standard deviation of the national-income profit cycle was 9.27% p.a. on average compared to 16.02% p.a. for S&P earnings. Clearly the accountants have begun to do something rather different with bottom-line earnings in recent years, most notably in the way they have changed their treatment of write-offs – especially of goodwill and other so-defined “extraordinary” items. Now further new rules with respect to the much more gradual write-off of goodwill are expected to add as much as five percentage points to next year’s S&P earnings-growth numbers, which of course raises the big issue. Why should any difference between the price paid for an acquisition and the book value of that acquisition have anything to do with the future value of the acquisition? Are all the people who run the new service-business going to leave in the next elevator?

Annual growth in earnings and profits: National income measure and S&P 500 measure



Source: Federal Reserve Bank of St. Louis, I-Net Bridge

How can we do price-earnings multiples if we can't measure earnings?

The charge made in the BW article is that financial officers and their accountants and auditors should be much more informative and much more consistent in their reporting practice. Clearly if “earnings” matter for the valuation of companies then it is an issue of what earnings to believe. And so the complaint is that these differences in the measured and reported performance of companies make it so much harder to undertake any consistent valuation exercise, particularly the calculation of comparable price-earnings ratios. Why anybody should believe in the power of some kind of normalised price-earnings multiple to predict value defies understanding and all of modern financial economics. Even the most consistent measure of earnings will not provide price-earnings multiples that could predictably be expected to gravitate to a stable equilibrium ratio. To make the point in another way, price-earnings ratios, however you wish to define the denominator, will never provide a reliable trading rule. Life is not going to be that simple.

From prices to “earnings” – not the other way round

The right way to approach the issue of what earnings to worry about is to find out the particular combination of accounting numbers that is most consistently aligned with the share price of a particular company. In other words, let the market itself tell you what numbers to take most seriously. That is, go from prices to “earnings” rather than the other way around. It might be bottom-line earnings with every possible write-off taken that do the trick, as if nothing the firm has ever invested in has any residual value. Alternatively, smoothed headline earnings with a bespoke smoothing technique might do the trick, as might dividends or cash flow or, better still, cash-flow net of investment spending, so-called free cash-flow and so on.

Will differences of definition matter for the market?

The differences that matter for individual companies are, however, likely to mostly wash out when it comes to valuing a whole market or a sector of it. When these different measures are aggregated across all companies there is bound to be a very high degree of correlation between the levels and the rates of change of earnings - bottom or headline - and cash flows defined one way or another. The problems with earnings are problems for the analysts of companies, not of whole markets, and it

should be remembered that much of the change in the value of any well-established company is explained by changes in the value of the market itself.

Thanks for the (confusing) memory

While the accountants responsible for these differences of opinion may be confusing investors with a variety of definitions of earnings, they are providing ever more scope for investment analysts. This is something for which the community of analysts should be truly grateful. The more difficult it becomes to interpret the numbers put out by the firms and their accountants, the more significance will have to be placed on the forensic skills of the analysts, the greater the demand for their services and, I scarcely need to add, the greater their scarcity value. Analysts and their employers should be doing all they can to encourage complicated and difficult-to-interpret financial reporting. If it were made so easy then presumably anybody could do it. If it were made that easy there would be very little scope for differences of opinion about the value of a company or a market, and so very little reason to trade in shares. It is not only the market in analysts that would shrink if valuation were made easy – but also the market in shares.

Stop complaining – start living (better)

Of course one often notices analysts doing the opposite – that is, complaining about the quality of the financial disclosure and the obfuscations, evasions or worse of the managers who report to them. But, when they do so, aren't they typically making excuses for themselves and their failure to read or interpret the numbers or the spin-doctors accurately enough? Or, more directly, their failure to anticipate the direction of the share prices of the companies they follow.

It is not only shareholders but also analysts who like to blame managers for their own lack of predictive power. We can rely on managers to put their spin on their most recent financial statement. It is the task of analysts to predict well in advance what will be in the next report.

Don't ask the impossible

But while interpreting the actions and reports of companies should not be too easy for the sake of the market in analysts it should not be made impossible either. It would become impossible if no credence could be placed on any of the accounting numbers reported. Clearly, companies can not hope to attract more money from the public unless they can be trusted to tell at least a large part of the truth about what has been going on inside the business. And so once-trusted companies – if they were never trusted they would not have got to the market – that are caught defrauding and lying to their shareholders in any significant way do not escape the severest judgement by the market.

Yet trust is sometimes misplaced and only discovered after the event. But mostly the frauds that are perpetrated by dishonest managers are as much against their auditors as against their shareholders. However sometimes these outside accountants and auditors are negligent in the exercise of their functions, or too trusting by far, and if so they deservedly must take punishment too.

Oscars for auditors – or is box office enough of a reward?

I often think what a pity it is that there is no market in the shares of the very few leading firms of accountants and auditors, which investors could use as a form of quality control. Or better still a service that would rate the individual auditing partners of accounting practices. This would be a service even more valuable than the accountants' ranking of test cricketers. We need our celebrity auditors as much or more than our celebrity analysts.

Yet I generally prefer market rankings to those of rating agencies – the market is a leading indicator – the rating agents almost always play catch-up with the market. They are most useful before the

market has been established. The recent most important case of the collapse of Enron provides another very good case of corporate failure, where neither the analysts nor the auditors nor the rating agencies had much of an advance idea about what the company was doing on and off the balance sheet. And, as is not unusual, the market reacted before the debt-rating agencies

Shareholders would surely add value to the shares of firms confident enough to employ the most highly-ranked auditors. And the star (chamber) auditors would vigorously protect the status and rewards that would come with a high ranking. The general problem is that we have not market failure but perhaps too little of a market in accounting partners as individuals, rather than as members of very large and largely indistinguishable and undifferentiated accounting practices.

Recognising the war zone

Clearly the raw accounting facts about a business should not be a matter of dispute; the broken-down numbers should be able to be taken at least on face value and believed for what they are. Yet the difference between what is a matter of fact and what is a matter of interpretation can be a very fine line. And it is mostly along this front line that the firms with their accountants and auditors do battle with the analysts. This is both inevitable and healthy. Surely firms are free to make the best possible case for themselves, and analysts should be as free to knock them down. And ideally they and the firms that employ them should be rewarded well enough for their value-adding contributions not to be compromised by having to seek corporate-finance business. If the analysts were indeed providing value-adding analysis, even if it is mainly about “earnings” and what is going on inside the firms rather than their correct value, then surely the firms that hire analysts would not allow their brands to be so compromised.

Not history, not DCF, but a matter of judgement and second-guessing

Valuing a firm is a forward-looking exercise. With even the best of historical information, present value calculations can only take you so far. Skills in accounting and financial economics are necessary but not nearly sufficient. Interpreting the earnings announcements is a starting point, not the end point of the valuation process. What is required is a view not only of the ability of management to execute its plans and functions, but also of the character of managers and their controlling boards. Value will always be a matter of judgement, not only about the company and its story – believable or otherwise – but also about how well the market has priced the story. It is not just analysis but market-beating analysis that is required. As I said, it shouldn't be easy and, fortunately for well-paid analysts, it isn't.

Further reading

Myddleton, DR (1995) *Accountants without standards*, Hobart Paper No.128, Institute of Economic Affairs, London.

This Briefing Paper was written by Professor Brian Kantor of the University of Cape Town.