Research Comments

Glenn E. Atkins, CFA
Executive Vice President & Director of Research

Earnings Management (Manipulation?) and Operating Income

Much has been written lately about the surging trend of corporate management to, well, "manage" earnings. The logic goes something like this: If we are going to have a bad quarter anyway, lets take a restructuring charge. This does two things. First, it serves to mask the bad quarter to a degree. Second, it provides an easy way by which to manipulate earnings. For a primer on this, see Warren Buffet's Letter to Shareholders for 1998 at www.berkshirehathaway.com.

To quote Mr. Buffet, "The distortion du jour is the "restructuring charge," an accounting entry that can, of course, be legitimate but that too often is a device for manipulating earnings. In this bit of legerdemain, a large chunk of costs that should properly be attributed to a number of years is dumped into a single quarter, typically one already fated to disappoint investors. In some cases, the purpose of the charge is to clean up earnings misrepresentations of the past, and in others it is to prepare the ground for future misrepresentations. In either case, the size and timing of these charges is dictated by the cynical proposition that Wall Street will not mind if earnings fall short by $5 per share in a given quarter, just as long as this deficiency ensures that quarterly earnings in the future will consistently exceed expectations by five cents per share."

According to R. G. Associates of Baltimore, "special charges…during 1998…totaled $72.1 billion." This represents greater that 22% of the earnings reported by the Fortune 500 during fiscal 1997. Was the market down 22% during 1998? No, the S&P 500 was up 28.57% (dividends reinvested) and the P/E multiple expanded by 31% to 32.15x versus 24.53x. The total return was driven entirely by multiple expansion as actual earnings per share were down by 3.36% to $38.23 versus $39.56.

Don't worry, the SEC is on the case. According to its Chairman Arthur Levitt, "managing may be giving way to manipulating; integrity may be losing out to illusion." Not surprisingly, the SEC has called for an end to "earnings management."

What do you do about "earnings management" from an analytical point of view? If you're a fixed income analyst just keep on doing what you have always done: focus on operating income, or notch it up a level and focus on EBITDA. Mr. Buffet would not approve of an acute focus on EBITDA. His belief about depreciation is pretty clear: "With rare exceptions, depreciation is an economic cost every bit as real as wages, materials, or taxes." He is, of course, correct. To the extent companies are not replacing the economic wear on plant and equipment, their underlying ability to produce goods and services is being gradually eroded. Many times this occurs even faster than the traditional accounting measure of depreciation. It usually manifests itself in the accounting terminology and attendant write-down called an "impairment of a long lived asset."

Nevertheless, EBITDA is the world in which we live. As long as companies are making an investment in their future (among some other assumptions including that working capital is largely self-funding over time), EBITDA is an effective measure of economic cash flow which is independent of the firm's capital structure and which removes the effects of earnings management to a large degree. According to a Forbes magazine article (March 8, 1999, p. 168), EBITDA "gives a fairer measure of how successful a

company is at its basic business."

Would looking at EBITDA have helped explain the significant increase in stock prices during 1998? Hardly. Operating income (a proxy for EBITDA that is net of depreciation) for the S&P 500 was down 1.6% to $44.33 per share versus $45.06 in 1997. Again, a multiple expansion phenomenon. Another interesting observation regarding the S&P 500 is that although the index itself was up over 28% last year, the average stock was up just under 11%. Behold the beauty of cap-weighting! The simple truth is that if you didn't own large stocks last year, you lagged the market.