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 a 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 their senior executives participate in lengthy conference calls 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 the renowned consultant to investment managers and author Howard Schilit, 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.[1]

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 statement 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.[2]

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, companies frequently bend and sometimes break the rules for financial reporting. 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. Reported numbers can be invalidated by subsequent revisions, typically, if not always credibly, attributed to honest mistakes.

Alternatively, issuers may emphasize supplementary, non-GAAP numbers to steer analysts toward a more favorable view of their performance. In fairness, some of the alternative metrics disseminated by issuers increase the clarity of disclosure by addressing genuine shortcomings in the financial reporting rules. The rule makers, after all, have found it challenging to keep accounting standards up to date with changes in the way corporations create wealth. Those changes are a consequence of the shift in the economy from traditional manufacturing to knowledge-based industries. At the same time, the lack of standardization in non-GAAP reporting enables issuers that are so inclined to exaggerate their financial performance.

The following case study demonstrates how an overly trusting user of financial statements can be misled.

### Mattel's Accounting Games

On August 2, 2019, PricewaterhouseCoopers (PwC), Mattel's outside auditor, received a whistleblower letter suggesting that accounting errors had occurred in earlier periods and questioning whether PwC was truly independent. The toymaker disclosed the letter's receipt on August 8, 2019, and the following day its stock plunged by 15.8 percent while the Standard & Poor's 500 Index registered a minor decline of 0.7 percent. Mattel's board directed the audit committee to investigate the matter.

The investigation found that income tax expense was understated by $109 million in 2017's third quarter and overstated by the same amount in the fourth quarter, resulting in no impact for the full year. Disclosing these findings on October 29, 2019, Mattel pointed out that the errors were noncash and did not affect operating income or **EBITDA** for 2017. The company acknowledged material weaknesses in its internal control over financial reporting but said that the audit committee concluded that PwC's objectivity and impartiality were unimpaired. Mattel further announced plans to restate its 2018 Form 10-K to restate 2017's final two quarters and strengthen its internal financial reporting controls.

Details of the findings included the disturbing fact that after the errors came to light they were not disclosed to Mattel's chief executive officer and the audit committee. The internal investigation did not find that management engaged in fraud, instead blaming mishandling of the discovery of the accounting error on "a confluence of one-time events, management's reliance on the accounting advice sought and received on the error from the lead audit engagement partner of Mattel's outside auditor, and lapses in judgment by management."[3]

Mattel's audit committee determined that many of the whistleblower's allegations about PwC's independence were unfounded. In conjunction with a separate investigation by PwC, however, the audit committee concluded that the lead audit partner for Mattel violated Securities and Exchange Commission rules on auditor independence by recommending candidates for the company's senior finance positions and providing feedback on senior finance employees. PwC replaced some members of the audit team assigned to Mattel, including the lead partner, who was placed on administrative leave. (One commentator on accounting issues characterized him as the fall guy in the affair.)[4]

The bland tone of Mattel's disclosure likely reassured investors whose confidence in the company's financial reporting had been shaken by the August 8 revelations. In the following month, however, the *Wall Street Journal* presented details[5] of what happened when Mattel's tax team discovered the accounting error in early 2018, several months before the news reached the audit committee.

Brett Whitaker, who was director of tax reporting at the time, said the company's finance team discussed correcting the error and restating earnings, expecting that Mattel would have to come clean about flaws in its accounting procedures. According to Whitaker and documents that the *Wall Street Journal* reviewed, senior company finance executives and PwC decided instead to change the accounting treatment of the *Thomas & Friends* cartoon series, starring a talking locomotive. That action effectively buried the problem.

Whitaker, who stated that he was not the whistleblower, characterized the senior executives' response as a coverup and said it dumbfounded his team. He reported that one of PWC's tax partners was high-fiving people in the hallway after the decision was made to change the accounting, relieving the auditing firm of the need to admit its error. Whitaker resigned from Mattel in March 2018. Mattel, for its part, replaced its chief financial officer but said the change in accounting treatment was appropriate.

Following this blow to its credibility with investors, one might have expected a chastened Mattel to be on its best behavior with respect to financial reporting. Only a year-and-a-half after the public learned of the accounting error in the 2017 statements, however, the Securities and Exchange Commission ordered the company to stop using a non-GAAP measure it employed in the discussion and analysis section of its 2019 financial statement. "Gross sales" excluded adjustments such as trade discounts. Mattel applied it to overall revenue as well as its "power brands," namely, Barbie, Hot Wheels, Fisher Price – and Thomas the Tank Engine and his pals. Mattel agreed to switch to "gross billings," the amounts invoiced to customers.

The context of these events is instructive for users of financial statements. Mattel's share price fell by 50.2 percent between year-ends 2014 and 2017. In 2018 Mattel lost $531 million on sales of $4.5 million. The company was plagued by declining sales, particularly in the Fisher-Price and American Girl Lines. In addition, Mattel recalled all 4.7 million Rock 'n' Play Sleeper products after the U.S. Consumer Products Safety Commission reported that they were associated with more than 30 infant deaths since their 2009 introduction. (The company said it was not at fault and that the fatalities resulted from customers disregarding safety warnings and instructions.) Seasoned observers of financial reporting notice that errors frequently occur in conjunction with depressed share prices. On January 4, 2021, when the Securities and Exchange Commission ordered Mattel to stop highlighting the non-GAAP gross sales number, its share price was still 44.3 percent below its year-end 2014 level.

Mattel's story is just one of many in this book that should dispel any illusions that financial statements are always completely reliable. The outside auditor's stamp of approval is no guarantee that reported earnings accurately reflect actual results. Auditing firms, no less than corporate issuers of financial statements, are for-profit businesses with incentives to sweep their failings under the rug. Users of the statements must employ the best analytical techniques available to identify signs that the reported numbers are out of line with the company's true performance or financial condition.

## THE FLAWS IN THE REASONING

As many examples that follow 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 pretty far out of joint before they run afoul of the accounting standards, much less open themselves to prosecution for fraud. When deliberate 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. In past years officials of General Electric indicated that when a division was in danger of failing to meet its annual earnings goal, it was 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?"[6] The freshly acquired unit's profits for the full quarter could 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 plan.

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[7] (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, if it is tied to the highly manipulable earnings per share figure.

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**.[8]

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 increasingly linked executive compensation to stock price appreciation in the closing decades of the twentieth century. In reality, though, no such trend was discernible. If anything, corporations became more creative and more aggressive over time in their financial reporting.

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

The Sarbanes-Oxley Act of 2002 raised hopes that analysts' lives would be made easier by enabling them to rely more heavily on the veracity of published financial statements. Enacted in the wake of a series of spectacular financial reporting scandals, the legislation required publicly traded companies' chief executive officers and chief financial officers to issue statements certifying that in all material respects their financial statements and disclosures present their companies' operations and financial condition fairly.

Spectacular financial reporting frauds did become less frequent as chief executive officers began to face the prospect of prison time if they signed off on fraudulent financial states. Fraud did not completely disappear, however. To an extent, CEOs were able to push responsibility for it down the chain of command by structuring their sign-offs on the statements as approvals of calculations by subordinates, making it difficult for prosecutors to secure convictions at the top level.

Although spectacular cases of outright fraud became less frequent after Sarbanes-Oxley went into effect, analysts needed to remain vigilant. As GAAP numbers became riskier, companies stepped up their efforts to redirect analysts' attention to non-GAAP, adjusted metrics that portrayed them in a better light. Not incidentally, many companies used the adjusted – that is, higher – earnings numbers in calculating CEOs' bonuses.

Some of the adjusted revenue and earnings figures served constructive purposes. By 2015, however, 90 percent of S&P 500 companies were reporting non-GAAP, up from about 70 percent in 2009. At that point, the Securities and Exchange Commission felt obliged to curb the trend.

The SEC cracked down on excessive use of nonstandard accounting metrics in 2016. Under the new guidelines, companies could supplement their reporting with on-GAAP numbers but had to give GAAP numbers equal or greater prominence and explain how the two different sets of figures were reconciled. The SEC crackdown had some initial impact, but financial statement issuers resumed their eager embrace of non-GAAP numbers when the COVID-19 pandemic hit.

Financial data provider Calcbench ran a calculation on the 60 companies with the greatest divergences between GAAP and non-GAAP net profits in 2020. The aggregate difference came to $132.2 billion, meaning that the companies collectively steered analysts toward adjusted earnings that were twice as great as their $130.7 billion of GAAP net income. In total, the 60 sample companies made more than 240 adjustments GAAP net income. Amortization of intangibles was the most popular device, accounting for 30 percent of all adjustments. "Companies will use whichever accounting practices make them look best and benefit their CEOs the most," commented Rosanna Landis Weaver of As You Sow, a nonprofit organization focused on corporate social responsibility.[9]

## 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 compiled evidence that lack of perfect candor is widespread.[10] The researchers focused on instances in which a corporation reported quarterly earnings that were 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 have included about as many cases of earnings that barely exceeded year-earlier results as cases of earnings that fell just shy of year-earlier profits. Instead, Zeckhauser and colleagues found that corporations posted small increases far more frequently than they posted small declines. The strong implication was that when companies were in danger of showing slightly negative earnings comparisons, they found 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 corroborated the big bath hypothesis by showing that large earnings declines were more common than large increases. By implication, managers did not passively record the combined results of their own skill and business factors beyond their control, but intervened in the calculation of earnings by exploiting the latitude in accounting rules. The researchers' overall impression was that corporations regard financial reporting as a technique for propping up stock prices, rather than a means of disseminating objective information.[11]

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 $10 billion of borrowings equates to $50 million (pretax) per year. If the corporation is in a 21 percent tax bracket and its stock trades at 20 times earnings, the payoff for risk-concealing financial statements is $790 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 $200 million. Assume that five years from now, when its growth has leveled off somewhat, the corporation will be valued at 20 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, annual earnings will be $743 million. Applying a multiple of 20 times to that figure produces a valuation at the end of the fifth year of $14.9 billion. Investors seeking a 25 percent rate of return will pay $4.9 billion 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, 25 percent of the outstanding shares. The successful entrepreneur is worth $1.2 billion on paper, quite possibly up from zero just a few years ago. At the same time, the newly minted billionaire 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 far above average for corporate America. Nevertheless, the aggregate value of the corporation's shares will decline from $4.9 billion to $4.8 billion, keeping previous assumptions intact.

Overnight, the long-struggling founder will see the value of his personal stake plummet by $25 million. Financial analysts may shed few tears for him. After all, he is still a billionaire on paper. If they were in his shoes, however, how many would accept a $25 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 $200 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 almost $5 billion.

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 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.

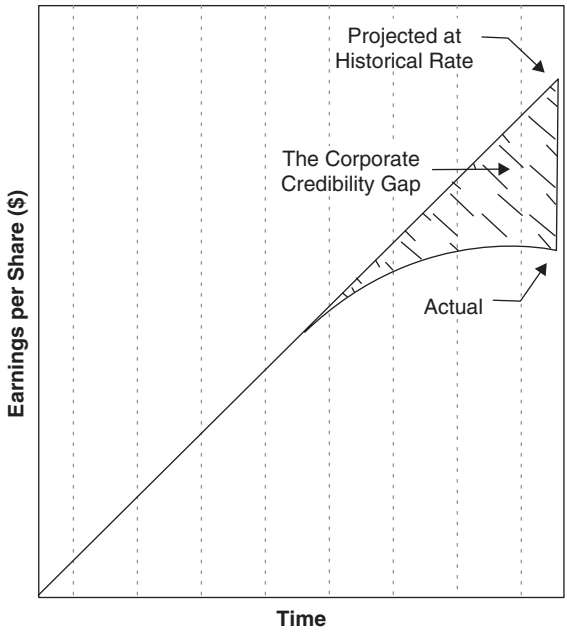


**EXHIBIT 1.1** The Inevitability of Deceleration.
*Note:* Shifting investors' perceptions upward through the Corporate Credibility Gap between actual and management-projected growth is a potentially valuable but inherently difficult undertaking for a company. Liberal financial reporting practices can make the task somewhat easier. In this light, analysts should read financial statements with a skeptical eye.

## 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.

**Real-Life Illustrations** Financial statement users who learn the above-described fables of unending earnings growth at unusually high rates will soon see that they are not merely hypothetical. The financial news frequently contains reports of companies bumping up against these limits. Here are a few examples involving well-known corporations:

Between 2010 and 2015 Under Armour's stock rose at an astounding **compound annual growth rate** of 42.5 percent. The manufacturer of sports and fitness apparel, shoes, and accessories was in the midst of a 26-quarter streak of 20 percent or greater year-over-year sales increases. Over the next year-and-a-half, however, Under Armour's shares plunged by nearly 50 percent even as the Standard & Poor's 500 stock index advanced by almost 20 percent.

The plummeting share price reflected a blow to high expectations for sales and earnings growth that investors had built into Under Armour's valuation. Even after management reported a deceleration in sales growth to 12 percent in 2016's fourth quarter, its stock remained at a lofty price-earnings **multiple** of 44 times. Among other setbacks, the company's sales were hit by a succession of bankruptcies at sporting goods retailing chains.

Concurrent with the slowdown in sales growth, Under Armour's gross margin was slipping. Management delivered the disheartening news that sustaining the high growth that investors were counting on would require heavy investment. Part of the problem was that Under Armour, which had cut its teeth in the apparel sector, was now counting on footwear to maintain the corporate-wide pace of sales gains. To compete with footwear heavyweights Adidas and Nike, Under Armour would have to spend aggressively on sponsorship and marketing.

The stock of another high-flier, Boston Beer, rose at a 26 percent compound annual rate in the 15 years through 2014. Over the next two years shareholders suffered a 41 percent decline. The S&P 500 rose by 9 percent during that span. Once again, the culprit was slowing revenue. In 2016 the brewer of Samuel Adams Lager posted its first year-over-year sales decline in 13 years, as well as a 6 percent drop in earnings per share.

"The problem for Boston Beer," wrote Avi Salzman in *Barron's*, is that craft beer appears to have reached the saturation point. Everybody and his brother now has a special brew with a cool label and a hint of cocoa."[12] In 1984, when Boston Beer was founded, the U.S. had just 97 breweries. By 2016 the number was 5,000, which included a doubling just since 2012, according to Brewers Association chief economist Bart Watson.

All that proliferation of brands may have been overwhelming beer drinkers with choices. Boston Beer's founder and chairman Jim Koch reported that some retailers were confused. Consumers were giving up on trying to choose a craft beer and just saying, "I'll have a Corona."[13] Compounding the problem, industry giants Anheuser-Busch InBev and MillersCoors were acquiring many craft brewers, making craft beer seem less special.

As with Under Armour, maintaining sales growth was expected to come at a cost that would likely put pressure on profit margins. Journalist Salzman suggested that Boston Beer's promotions budget would rise by 10 percent in the coming year.

Finally, Whole Foods Market far outpaced the S&P 500 with an 18 percent compound annual rise in its share price from 2003 to 2013. The stock index rose at just 5 percent a year during the period. Between 2013 and 2016, however, the organic food retailer's stock dropped by 47 percent versus a 21 percent gain for the S&P 500.

As with the previous examples, competition put a crimp in investors' dreams of continued high, steady sales growth. Co-founder and chief executive officer John Mackey acknowledged a similar complacency within the company, saying, "When you average 8 percent same-store sales [growth] for 35 years, it can breed a sense of 'Why do we need to change? Things are working.'"[14] Then reality stepped in.

For years, Whole Foods had a lock on the natural and organic sector, enabling it to charge high prices while spending little on promotion. Then other supermarket chains got into the game, offering similar products at lower prices. "More conventional supermarkets are copying us," Mackey lamented. "Every place we went bred the Midas touch. But it also bred envy."[15] By 2016, Kroger's natural and organic sales exceeded Whole Foods's total revenue. The warehouse-club retailer Costco Wholesale claimed honors as the top organic food retailer.

To analysts who had absorbed the lessons of countess precedents, the results should not have been surprising. Whole Foods racked up six quarters of same-store sales declines, its longest such streak since going public in 1992. Over that span, customer visits fell by as much as 14 million, according to Barclays PLC. In June 2017, with activist investors pressuring management to rebuild shareholder value, Whole Foods agreed to be acquired by online retailing giant Amazon.

### 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 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[16] 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

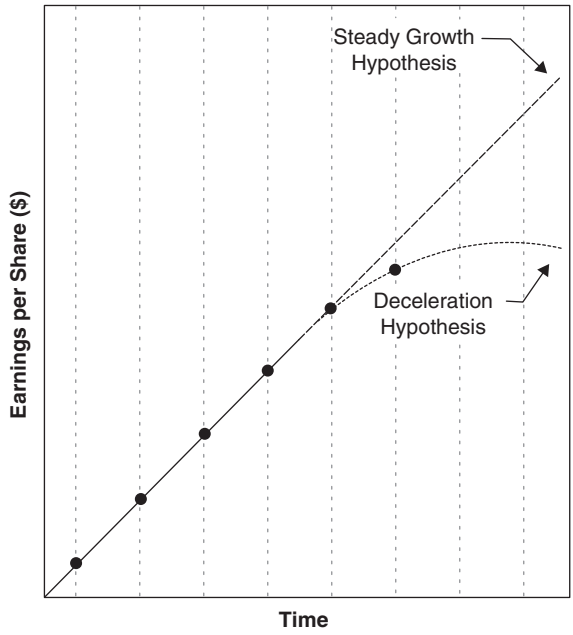


**EXHIBIT 1.2** "Our Year-over-Year Comparisons Were Distorted."
*Note:* Is the latest earnings figure an outlier or does it signal the start of a slowdown in growth? Nobody will know for certain until more time has elapsed, but the company will probably propound the former hypothesis as forcefully as it can.

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 hardheaded 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 especially 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).

Massive awards to litigants do not invariably trigger corporate bankruptcies. In 2016 a federal judge approved a $20 billion settlement of civil claims against U.K.-based integrate oil giant BP arising from the largest marine oil spill in history. Also in that year, a federal judge approved a $14.7 billion settlement in litigation concerning Volkswagen's scheme to cheat on emission test of diesel cars. Neither company went bust as a result, but the events underscore the magnitude of potential losses that could blindside analysts who ordinarily focus on the potential impact of much more minor earnings surprises.

Bankruptcies connected with asbestos exposure, silicone gel breast implants, and assorted environmental hazards have heightened 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 rosier 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 difficult for managers to acknowledge that their company could 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, at the time of the COVID-19 pandemic, a reopening of the economy. 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, dubious 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, regrettably, 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 crimped. 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, 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.

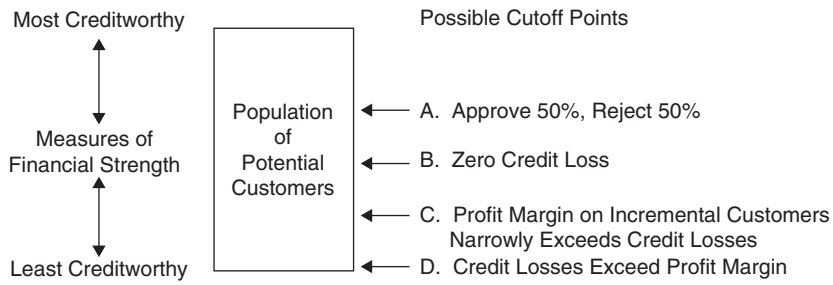


**EXHIBIT 1.3** The Bias toward Favorable Credit Evaluations.

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. Credit analysis gone awry was at the core of the Great Recession of 2008–2009. An unsustainable boom in housing prices was fueled by mortgages lending that abandoned all established standards for qualifying borrowers.

To be sure, defaults also occur among individuals and companies that satisfy established quantitative standards. When it comes to quantitative standards, though, 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.[17] 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.