Learn to Play the Earnings Game (and Wall Street Will Love You)

The pressure to report smooth, ever higher earnings has never been fiercer. You don't want to miss the consensus estimate by a penny--and you don't have to.

By Justin Fox

In January, for the 41st time in the 42 quarters since it went public, Microsoft reported earnings that met or beat Wall Street estimates The 36 brokerage analysts who make the estimates were, as a group, quite happy about this - the 57 cents per share announced by the software giant was above their consensus of 51 cents, but not so far above as to make them look stupid. Investors were happy too, bidding the already high-priced shares of the company up 4% the first trading day after the announcement.

In short, for yet another quarter, Microsoft had kept its comfortable spot in the innermost sphere of corporate paradise. This is what chief executives and chief financial officers dream of: quarter after - quarter after blessed quarter of not disappointing Wall Street. Sure, they dream about other things too-- mega-mergers, blockbuster new products, global domination. But the simplest, most visible, most merciless measure of corporate success in the 1990s has become this one: did you make your earnings last quarter?

This is new. Executives of public companies have always strived to live up to investors' expectations, and keeping earnings rising smoothly and predictably has long been seen as the surest way to do that. But it's only in the past decade, with the rise to prominence of the consensus earnings estimates compiled first in the early 1970s by I/B/E/S (it stands for Institutional Brokers Estimate System) and now also by competitors Zacks, First Call and Nelson's, that those expectations have become so explicit. Possibly as a result, companies are doing a better job of hitting their targets: for an unprecedented 16 consecutive quarters, more S&P 500 companies have beat the consensus earnings estimates than missed them.

Microsoft's prodigious record of beating expectations is due in large part to the company's prodigious growth, from annual revenues of $198 million at the time of its IPO in 1986 to more than $9 billion now. It also helps that it dominates its industry. But even the Microsofts of the business world have a few tricks up their sleeve. The most obvious is to manage earnings. "Managing earnings" has a pejorative, slightly sleazy ring to it, but even at the most respected of companies accounting and business decisions are regularly made with smoothing or temporarily boosting earnings in mind. Not all are as up front about it as General Electric, where executives say openly that they don't think their company would be as popular with investors if its profits weren't so consistent and predictable. But neither can it be a complete coincidence that of the top ten companies on Fortune's 1997 Most Admired list, seven--Coca-Cola, Merck, Microsoft, Johnson & Johnson, Intel, Pfizer, and Procter and Gamble--have missed fewer than five quarters in the past five years, according to I/B/E/S (and two of the other three don't have any earnings estimates to meet.

Meeting the estimates is made easier by the fact that they're not set in a vacuum-analysts rely heavily on guidance from companies to form their forecasts, and companies have in recent years figured out that it pays to guide the analysts to a lower rather than a higher number. At least partly as a result of this expectational interplay, the price of missing a quarter has risen sharply, particularly among high priced growth stocks. In the growth stock fraternity, "missing by a penny" now implies the height of corporate boneheadedness - that is, if you couldn't find that extra penny to keep Wall Street happy, then your company must really be in trouble, and since missing by a

penny is already going to send your stock plummeting, you're better off missing by a dime or two and saving those earnings for the next quarter.

Microsoft missed by a penny once -- back in 1988, when such behavior was not yet considered unbearable gauche. Nowadays its executives treat analysts to a constant patter of cautionary and even downbeat words about the future that the analysts say is a combination of genuine paranoia and astute expectations management. After a typically grim presentation by CEO Bill Gates and sales chief Steve Ballmer at an analysts' meeting two years ago, Goldman Sacks analyst Rick Sherlund ran into the pair outside and said, "Congratulations. You guys scared the hell out of people." Their response? "They gave each other a high-five," Sherlund recalls. But Microsoft, unlike some companies less attuned to the rules of this game, also lets analysts know when they're too pessimistic. That's what CFO Mike brown did, along with the usual warnings about slower growth ahead, during his regular quarterly conference call after the January 17 earnings release. He told the hundreds of analysts, money managers, and journalists listening in that earnings would be "more than a nickel, less than a dime" higher than predicted for the current quarter, and another penny higher in the next.

How did he know this? That involves something that looks a lot like earnings management-although not of the sort that provokes penalties from the Securities and Exchange Commission or nasty newspaper articles about inflated profits. Starting around the unveiling of Windows 95 in August 1995, Microsoft has followed a uniquely conservative method of accounting for the software it ships--deferring recognition of large chunks of revenue from a product until long after the product is sold. The reasoning is that when somebody buys software in 1996, they're also buying the right to upgrades and customer support in 1997 and 1998. If it hadn't been for the new accounting technique, the company would have had to report a sharp rise in profits in the latter half of 1995, then a sharp drop in the first half of 1996 - a turn of events that might have sent its stock price reeling - instead of the smoothly rising earnings that it did post. By the end of 1996, Microsoft had taken in $1.1 billion in "unearned revenue" that it had yet to recognize on its income statements. "Because of this, they know what they've got in the bag from one quarter to the next," says Marshall Senk, a Robertson Stephens analyst who follows the company. Which led him to conclude that "Microsoft does a better job of leveraging accounting -- I would almost say it's a competitive weapon -- than anybody else in the industry."

How the pros do it:

Plan ahead: Time store openings or asset sales to keep earnings rising smoothly. In most cases, this is earnings management at its least controversial. The master of this is General Electric.

Call it a sale: Madly ship products during the final days of a weak quarter, or hold off if the quarter's in the bag. There's leeway in revenue recognition too! Tech companies often book sales aggressively to boost profits, but Microsoft is now demonstrating the virtues of belated recognition.

Capitalize it: Usually it's pretty clear what costs you capitalize and which you expense. But there are gray areas--software R&D is one--and you can get creative about the length of time an asset should be depreciated. America Online was, until it stopped in October, a noted aggressive capitalizer.

Write it off: Take a "big bath" and charge a few hundred million in restructuring costs, and meeting future earnings targets will be easier.

Use your reserves: Build them up for product returns, bad loans, and insurance losses; drain them down to bolster earnings when business sags. Outsiders say this is one of the secrets of GE's success, but the company says that's just not true.

Microsoft treasurer Greg Maffei doesn't like this interpretation. "I'm a financial officer of this company, and I would be in deep doo-doo with the SEC if that was what was driving our revenue recognition policies," he says. "Our revenue recognition policies are driven by GAAP." That isn't quite true. In fact, GAAP-the Generally Accepted Accounting Principles companies follow in preparing financial statements--may in this area be driven by Microsoft, Virtually no other software company does its accounting the way Microsoft does, but standards setters, egged on by the industry leader, are starting to push in that direction.

That's how GAAP works. It's constantly changing and evolving, particularly in businesses that haven't been around for long. This is only natural, but it can be maddening for people trying to understand what a company's reported earnings really mean. "With industries that haven't been in the market before, you tend to see a lot of monkey business because accountants, even if well intentioned don't know what the standards are," says Martin Fridson, high-yield debt strategist at Merrill Lynch and a financial statement analysis guru. Underwriters of small companies and people who make a living doing IPOs are very conscious of the market's inability to see what the correct measures are." Add that confusion to the general cacophony of accounting quirks and judgment calls in financial statements, and you begin to realize that earnings are nothing but a vague, approximate measure anyway.

One of modern accounting's guiding principles is that of matching revenues and expenses over time. That's why the cost of building a factory that will be churning out cars for 20 years gets expensed over those 20 years, not when the money is actually spent. But such matching requires making all sorts of guesses and estimates about the future. These judgments - how much to set aside for potential loan losses, what rate of return to expect on a pension fund, over how many years to spread out the cost of a factory - make earnings a better reflection of the long-term economic health of a company. They also provide ample room for managers to fudge. This is why financial analysts and money managers are supposed to know how to look beyond a company's bottom line to find the true economic value in its balance sheet or cash flow statement or, best of all the footnotes to its financial statements. In the bull market of the past 15 years, however, analytic rigor hasn't always been required to make good stock picks. "Nobody's paying attention" says Robert Olstein, who in 1970 co-authored an influential newsletter called the *Quality of Earnings Report* and now runs the $140 million Olstein Financial Alert fund.

If Microsoft is the archetype of a hugely successful company trying to tone its earnings down so people don't get their expectations too high, Boston Chicken bespeaks an altogether different and more common phenomenon. It is a business that isn't successful yet, but has used accounting to help convince investors that it already is, or at least will be soon. This has enabled it to raise more than $800 million in stock and convertible debt offerings, money which has been essential not only to the company's rapid growth - from 175 Boston Chicken restaurants when it went public in one of the decade's hottest IPOs in November 1993 to 1,100 restaurants (rechristened Boston Markets) and 325 Einstein Brothers and Noah's bagel stores today - but to its very survival. That's because, economically speaking, Boston Chicken is still a big money loser, as probably can be expected of a startup restaurant chain. All the losses, however, have been incurred by "financed area developers," or FADs, which is Boston Chicken lingo for large-scale franchisees that act a lot like subsidiaries but aren't. If they were, their losses would have to lie reported on Boston Chicken's income statement (they are instead disclosed, on an annual basis only, deep in the text of the company's SEC filings). The FADs get 75% of their startup capital in loans from Boston Chicken, and with that money they pay the company the royalties, franchise fees, and interest that allow it to report ever-rising profits. Once the restaurants start making money, Boston Chicken exercises its right to convert the loans into equity, officially dubbing the FADs subsidiaries and allowing their profits to flow to its bottom line.

That's the plan, at least, as outlined with somewhat more delicacy in the company's 1993 annual report. And so far it has worked. Sure, business publications have printed nasty articles about the company, accounting professors have warned their students about it, and short sellers have lined up in droves to place bets that its stock price will crash. But Boston Chicken's stock price has more than held its own. Part of investors' sanguinity has to do with the track record of the two former Blockbuster Entertainment bigwigs who run it, CEO Scott Beck and President Saad Nadhir, and the belief that America really is hungry for takeout chicken, ham, and meat loaf. But it sure doesn't hurt, analysts and money managers say, that not only is Boston Chicken able to report earnings every quarter, but those earnings have so far never failed to meet or surpass analysts' expectations--even though those analysts all know that the earnings in no significant way reflect how the company is doing. "It's a very smart strategy," says Michael Moe, a growth stock strategist at Montgomery Securities. "It has made enormous amounts of capital available to them at an attractive price that most companies can only dream of."

Boston Chicken CFO Mark Stephens says his company was structured not to please Wall Street but to provide flexibility and motivate its franchisees. But he acknowledges that "a byproduct of where we are with the structure is that we have a public entity with an earnings complexion that is attractive." He adds: "It's like sausage. I love the product; just don't show me how it's made."

Another company that has used aggressive accounting to raise money is America Online. AOL's practice of capitalizing and writing off over two years the cost of those ubiquitous free disks and ads it used to lure members was highly controversial and was abandoned in October. But for years it allowed the company to post earnings most of the time instead of losses, which helped it to raise more than $350 million on the stock market. Says Wharton School accounting professor Richard Sloan, referring to both Boston Chicken and AOL: "They just view accounting as another marketing tool that they should use to try and promote their ideas." Boston Chicken and America Online are extreme cases. So is Microsoft. The mass of companies lead lives somewhere in between. When they manage earnings, they do it simply to smooth the ups and downs of business life, and of course to meet those Wall Street earnings estimates. Is there evidence of widespread earnings management? You bet. Looking at 17 years of I/B/E/S data on more than 1,000 companies, Jeff Payne of the University of Mississippi and Sean Robb of Canada's Wilfrid Laurier University found an unmistakable pattern of using accruals (i.e., judgment calls) to manage earnings upward if they were below the analysts' consensus and a somewhat less pronounced trend of managing them downward if they were above the consensus.

General Electric, a company whose name invariably comes up when you ask Wall Streeters about earnings management, says it does what it does because the stock market demands it. "We think consistency of' earnings and no surprises is very important for us," says Dennis Dammerman, the company's CFO. "We're a very complex, diverse company that no one from the outside looking in can reasonably be expected to understand in complete detail; so our story to the investing world is, we have a lot of diverse businesses, and when you put them all together they produce consistent, reliable earnings growth. And if something inconsistent comes along - say a one-time gain from selling off a factory - we have a pretty consistent record of saying, 'Okay, we're going to take these large gains and offset them with discretionary decisions, with restructurings.'"

These tactics have helped GE meet or beat expectations every quarter but one in the past five years, and they certainly haven't hurt it among investors, even skeptical ones. "They are using all sorts of techniques to smooth earnings," says Howard Schilit, whose Center for Financial Research and Analysis keeps institutional investors posted on companies earnings numbers may be hiding business troubles. "If I wrote that to my clients, there would be a big yawn."

Another investor favorite that produces awfully smooth earnings is Coca-Cola, which in the third quarter of last year took advantage of $520 million in one-time gains from a settlement with the IRS and the sale of some bottling operations to recognize $500 million in supposedly one-time hits.

One of those hits, $200 million used to reduce the inventories of soft drink concentrate at bottling companies, was explained as a move to free up bottlers' capital but was seen as an admission by Coke that it had been shipping concentrate early to artificially boost earnings. That hurt the company's stock price for a few months, but by taking the charge Coke gave itself the option of using inventory buildup at its bottlers to pad profits later. "When they pull it out in 1998 or 1999 to keep up their 19% or 20% earnings growth, everyone will have forgotten," says Boy Burry, who follows Coke for Oppenheimer & Co.

Will everyone really forget? If financial markets are in fact efficient, economic reality will in the long run win out over accounting games. But the long run can seem awfully far away when you've got a posse of analysts breathing down your neck every three months. Many corporate executives also seem to think investors take earnings numbers at face value; they write outraged letters to the Financial Accounting Standards Board, accounting's top rule-making body, whenever it proposes a change that might reduce reported earnings. "They obviously don't believe in efficient markets," says Neel Foster, a FASB member and former treasurer of Compaq Computer. "Academic evidence shows that generally, accounting changes don't result in changes in stock prices. But it also shows that people that make greater disclosures generally have a lower cost of capital. They don't believe that either."

Even this doesn't explain why some companies seem to persist in managing earnings in the face of Wall Street disbelief. Food maker H.J. Heinz grew rapidly during the 1980s but has since needed repeated asset sales and other special items to keep earnings steady--and its stock has lagged. Last June the company announced quarterly earnings of 45 cents a share but failed to mention that four of those cents came from the sale of a magazine and two pet food brands. It was "immaterial," a company spokesman says now, but it nevertheless infuriated some analysts, who found out only when they received the annual report a month later It didn't help the stock price either, although the stock later bounced back on rumors of a major restructuring.

What might motivate such corporate behavior? One answer is money. High-level executives like to get paid a lot, and it so happens that many bonus plans - including the one at Heinz--are built around meeting earnings targets. The rise of performance related bonuses has taken earnings tweaking to new heights, say some market watchers. There's no reliable measure of such activity, but one rough gauge, comparing profits reported to the Internal Revenue Service by U.S. corporations with profits reported to shareholders (the measure that counts for bonuses) by companies on the S&P 500, gives a clue. It shows some wild relative swings in S&P earnings in the late 1980s and early 1990s, probably a result of big corporations using one - time charges to pay for restructuring costs like plant closures. This write-off binge ended in 1994. Which could mean either that earnings quality is getting better or that companies are coasting to ever-higher earnings now because they hid ongoing costs back then.

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While there's no conclusive proof that managing earnings is on the rise, it is undeniable that the game is being played more aggressively than ever. This isn't necessarily bad. The good side of what a lot of people call the game of managing expectations is that companies realize that they have to give better guidance to the market as to what their prospects are," says Ed Keon, senior vice president for marketing at I/B/E/S.

The downside of giving better guidance-apart from the hours of valuable top management time that it eats up is that the investors most interested in the estimates are not exactly the well-run corporation's best friend. They are the momentum guys - mutual fund managers and hedge fund jockeys and individual investors - who jump on the bandwagon when a company's earnings growth is accelerating and beating the analysts' estimates, and jump off the second it misses a quarter.

"When it stops, they sell - you cannot break this algorithm," says a resigned Eric Benhamou, chief executive of 3Com Corp., which lost $7 billion in market value in a matter of weeks this year as it became known that its earnings for the quarter ended February 25 would nor not meet analysts' expectations.

The moral of the story: Unless you're a trader, ignore the short-term kabuki that the companies and the analysts perform for each other, but educate yourself about the accounting games that companies play. If enough investors did, it could mean that the smartest earnings and expectations management strategy of the 2000s will be -- don't bother.

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