News: Analysis & Commentary

EARNINGS: A CLEANER LOOK Standard & Poor's gets back to basics with a new measure of profits

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Shareholders have had it up to here. In the last two years, the U.S. stock market has fallen 27%, as calamity followed calamity in a stream of bad news that only seemed to get worse. First the tech collapse, then the crash in corporate profits and the avalanche of earnings restatements, all topped off by the Enron scandal, a wave of accounting questions at even the bluest-chip companies, and the collapse of a panoply of once high-flying telecoms. If 2002 proves to be a down year, a distinct possibility, it will be the worst three years since 1941.

It hasn't been fun. But what's most worrisome about this bear market is the creeping suspicion that the earnings that investors have long relied on to make informed decisions are widely inflated. Indeed, as companies have thrown up an ever more confusing array of self-defined ``pro forma'' earnings, everyone from government overseers like Securities & Exchange Commission Chairman Harvey L. Pitt to market giants like Vanguard Group founder John C. Bogel have publicly fretted about the way earnings figures are prepared, presented, and analyzed.

Amid this backdrop of fallen corporate icons and deeply betrayed investors, a debate is raging: Is it possible to define more clearly what earnings really are? If so, what is the best, fairest, and most lucid way to do so?

Fueling that debate are the sharply different numbers being counted as corporate earnings. Last year, according to generally accepted accounting principles, the companies in the Standard & Poor's 500 earned net income of $28 a share. But Wall Street came up with another figure. At the end of each year, analysts divine their own pro forma figures on operating earnings for the companies they cover. Then Thomson Financial/First Call, which tracks earnings, takes the consensus of those analysts' views to calculate its operating earnings for the year. For 2001, First Call's figure totaled $45 a share.

The problem, of course, is that there is no consistency in how the companies, or the analysts, actually tabulate operating earnings. On May 14, in a bid to come up with some rules to unify earnings and find a better measure for operating performance, Standard and Poor's introduced its new ``core earnings.'' S&P's new measure is aimed at providing a standard, comparable number that most closely reflects the ongoing earnings that a company produces from its operations.

It will surely be a sharp contrast to both pro forma figures and the earnings number calculated according to GAAP. That's largely because S&P will include in the core earnings many costs that companies and Wall Street analysts would rather exclude, including expenses from stock option grants and the restructuring of ongoing businesses, as well as the writing down of the value of certain assets, pension costs, and research and development purchased from another party. At the same time, S&P will exclude income that it doesn't consider as coming from a company's operating business, such as gains on its pension plan, asset sales, or hedging operations, or such things as income from litigation or insurance.

Will this third way prove to be better? When all is said and done, earnings will come in sharply lower, and the market will likely look more expensive. Still, that's a small price to pay for a more complete and consistent earnings measure, many insist. As the marketer of indexes like the S&P 500, the company, which, like BusinessWeek, is a unit of The McGraw-Hill Companies, is particularly interested in trying to restore what it sees as a growing concern among investors that the earnings being presented are

unreliable. ``Confidence in earnings underpins the value accorded to our markets,'' says Leo O'Neill, president of S&P. ``I hope this will enhance confidence in the equity markets.''

Eating away at that confidence is the rising prominence of pro forma earnings numbers calculated by companies and analysts at will, using no rules and with plenty of discretion. When CNBC broadcasters blare out that a company beat or didn't beat its earnings estimate, they're not talking about GAAP net income. They're talking about the First Call estimate of earnings from ongoing operations. And in recent years companies have increasingly moved beyond Wall Street's adaptations of GAAP to issue their own pro forma earnings. Research from the University of Utah and Brigham Young University found that the number of companies doing so jumped from 181 in 1998 to 695 in 2000.

The shift to pro forma started out as an attempt to get to a number closer to ``true'' operating earnings. But it has led instead to market pandemonium as companies attempt to redefine their own bottom line in ways that lead to the most favorable presentation and interpretation of their performance. Comparing one company to another has become next to impossible. And a growing number of people are questioning the legitimacy of the figures being produced. In his 2002 letter to Berkshire Hathaway shareholders, investing sage Warren Buffett warned that companies issuing such numbers ``want you to unthinkingly accept concepts that are dangerously flawed.''

That's why plenty of Wall Street types and corporate leaders appear willing to give S&P's approach a shot. ``A group with some authority and stature and a reputation for probity is stepping into the breach,'' says Lehman Brothers Inc. accounting expert Robert Willens. ``I think it's a necessary thing that they're doing.'' S&P has support even among companies that will probably see their earnings drop under the new measure. ``It's a step in the right direction,'' says John Connors, chief financial officer of Microsoft Corp., a major issuer of stock options, the cost of which will now be deducted. ``Obviously, credibility needs to be restored.''

Clearly, investors are clamoring for a better way. Traditional net income calculated according to GAAP is no longer the gold standard. The problem, critics say, is that it doesn't adequately reflect performance largely because it includes many costs which are not related to the company's future growth prospects. The result: ``a GAAP number that is technically correct but entirely inaccurate,'' says Vanguard's Bogel.

Yet it is far from certain whether the new S&P measure will prove the answer to the earnings mish-mash. To have real impact, the new measure will have to be widely adopted among Wall Street firms and investors. Yet the proposal is hardly being embraced by all. Morgan Stanley Dean Witter accounting guru Trevor Harris immediately fired out a report calling the measure ``noble but flawed'' by inconsistencies and the exclusion of items like pension gains. Ed Jenkins, chairman of the Financial Accounting Standards Board, which sets accounting standards in the U.S., said that he didn't expect S&P's move to have any impact on that body's work. And First Call won't be incorporating S&P's definitions into its service, either.

Many opposed to the new definition simply disagree with the philosophy behind it. They argue that it is a mistake to apply a ``one-size-fits-all'' rule to operating earnings. ``Standards are good. But unidimensional investing isn't the best way,'' warns Amazon.com CEO Jeffrey P. Bezos, himself a champion of pro forma numbers. He believes if people studied the GAAP statement more closely, they'd find all they need.

But critics also argue with the specifics of S&P's definition. One big concern stems from the decision to uniformly include such things as restructuring charges in ongoing operations when they are sometimes pertinent and sometimes not. The move stems from a growing dissatisfaction with companies that report ``one time'' restructuring charges over and over. Case in point: Toothpaste and diapers giant Procter & Gamble Co., which has reported a restructuring charge each of the past 12 quarters. But what about a company that only takes a restructuring charge once in five years? Many argue that should not be included in core earnings.

What can't be denied is the dampening effect this new calculation will have on the numbers. According to S&P, General Electric Co.'s core earnings per share last year would have been $1.11, or 28 times today's stock price. That's far below the $1.42 reported by GE and much more expensive than its implied price-earnings ratio of 22.

For GE, the biggest impact came from subtracting income earned on its pension investments. The industrial giant adds that to its earnings--in accordance with GAAP--but S&P argues that pension income shouldn't be included since it doesn't reflect basic performance. GE spokesman David Frail argues that S&P's treatment is inconsistent. Although it excludes pension income, S&P includes the service costs associated with pension benefits. For companies with overfunded pensions like GE, those costs would not be paid from core operations.

Free-market advocates also note that the troubles at Enron and Arthur Andersen, plus the spate of accounting problems elsewhere, have already put Corporate America on the straight and narrow. A helpful nudge came from the SEC in January, when it sanctioned Trump Hotels & Casino Resorts Inc. for pro forma reporting abuses. A month earlier it also warned companies that they must explain how pro forma numbers relate to GAAP earnings.

Still, S&P is hoping that its move will influence regulators like FASB and the SEC and help push them into creating an official and well-defined operating earnings measure. But so far the SEC appears cool. ``A one-size-fits-all approach for purposes of public disclosure doesn't seem to work,'' says Robert K. Herdman, chief accountant of the SEC. That means that for now, it's up to Wall Street and investors to embrace the new S&P definition--or not.

At the very least, S&P's move will stoke important debate about the true nature of earnings and how best to measure them. What S&P's O'Neill does not want to see is a return to ``that era of exuberance where investors did not look closely at the numbers.'' That, at least, should be one thing everyone can agree on.

A Haircut For GE

How S&P's core earnings measure would trim GE's operating earnings per share

GE'S 2001 EPS	$1.42
CHANGES FROM ASSET SALES.	- .06
STOCK OPTIONS	1.36
EXPENSE.	- .04
LESS	1.32
PENSION GAINS.	- .19
OTHER	1.13
ADJUSTMENTS.	- .02
GE'S CORE EARNINGS	$1.11

Data: Standard & Poor's

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Creating A Core Earnings Measure	The proliferation of operating and pro forma calculations is confusing and undermines investors' ability to understand the ongoing earnings power of a company's operations. By developing a standard definition of earnings that come from operations, S&P is striving to create consistency and restore investors' faith in the numbers.	The new S&P number will add one more entrant to the hodgepodge of earnings numbers now in use. Moreover, since different industries face different operating and financial conditions, a ``one-size-fits-all'' number isn't much use anyway. Better for investors to make their own calculations tailored to specific companies.
Treating Employee Stock Options As An Expense	The S&P measure would treat stock options the same as other compensation, such as salary and bonuses. That recognizes a real cost and may help trim excessive options grants.	Many companies, especially in the tech sector, will be penalized. Expensing options might lessen their use, limiting a tool intended to spur innovation and align management's interest with shareholders.
Deducting Pension Gains From Income	These gains reflect the abilities of investment advisers, not the performance of operations, so they should not be considered part of core earnings.	Companies must account for the costs of running pension plans, so it is only fair to count income from pension plans as well. Another problem: Pension data would be available only annually, not quarterly.
Including Restructuring Charges	With the rise of ``recurring nonrecurring'' charges-- one-time charges taken quarter after quarter--it makes sense to include them in any analysis of ongoing business.	Not all restructuring write-offs are the same, and this cookie-cutter approach would cause charges that truly are one-time events to impact operating earnings.

Data: Standard & Poor's, BusinessWeek