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## Pennies That Aren't From Heaven

**A**SK any chief executive officer if he or she practices the art of earnings management and you will undoubtedly hear an emphatic "Of course not!" But ask those same executives about their company's recent results, and you may very well hear a proud "we beat the analysts' estimate by a penny."

While almost no one wants to admit to managing company earnings, the fact is, almost everybody does it. How else to explain the miraculous manner in which so many companies meet or beat, by the preposterous penny, the consensus earnings estimates of Wall Street analysts?

After years of such miracles, investors finally seem to be wising up to the fact that an extra penny of profit is not only meaningless but may also be evidence of earnings management and, therefore, bad news. After all, the practice can hide what's genuinely going on in a company's books.

A study by Thomson Financial examined how many of the 30 companies in the Dow Jones industrial average missed, met or beat analysts' consensus earnings estimates during each quarter over the last five years. It also looked at how the companies' shares responded to the results.

Over the period, on average, almost half of the companies - 46.1 percent - met consensus estimates or beat them by a penny.

Pulling off such a feat in an uncertain world smacks of earnings management. "It is not possible for this percentage of reporting companies to hit the bull's-eye," said Bill Fleckenstein, principal at Fleckenstein Capital in Seattle. "Business is too complicated; there are too many moving parts."

The precision has a purpose, of course: to keep stock prices aloft. According to Thomson's five-year analysis, companies whose results came in below analysts' estimates lost 1.08 percent of their value, on average, the day of the announcement. The loss averaged 1.59 percent over five days.

Executives have lots of levers to pull to make their numbers. Lowering the company's tax rate is a favorite, as is recognizing revenues before they actually come in or monkeying with reserves set aside to

cover future liabilities.

If all else fails and a company faces the nightmare of an earnings miss, its spinmeisters can always begin a whispering campaign to persuade Wall Street analysts to trim their estimates, making them more attainable. Their stock might drift downward as a result, but the damage is not usually as horrific as it is when earnings miss the target unexpectedly.

So it is not surprising that the strategy has become so widespread and that fewer companies in the Thomson study are coming in below their target these days. For the first three quarters of 2004, 10.9 percent missed their expected results, down from 11.7 percent in 2003 and 25 percent in 2002.

At the heart of earnings management is - what else? - executive compensation. The greater the percentage of pay an executive receives in stock, the bigger the incentive to produce results that propel share prices.

A study published last year by Qiang Cheng, assistant professor of accounting at the University of British Columbia's Sauder School of Business, and Terry Warfield, assistant professor of accounting at the University of Wisconsin in Madison, found that managers with high equity incentives are more likely to report earnings that meet or just beat analysts' forecasts than are managers who have low equity incentives.

The study also found that managers with high equity incentives are less likely to report large positive earnings surprises, perhaps choosing instead to set aside the extra money for a rainy day. This practice is known as earnings smoothing.

Unfortunately for executives on the beat-the-number treadmill, an extra penny isn't what it used to be. In 1998, Dow components that beat their numbers by a cent saw their stocks rise 0.78 percent the day of the announcement, according to Thomson. This year, the increase has averaged 0.15 percent. Returns over five days were flat in 1998, while stocks of companies beating estimates by a cent have lost an average 1.42 percent this year.

This may be why the percentage of companies meeting or beating the estimate by a penny has also declined recently. This year, 35 percent of companies in the Dow average are in this category, down from 60 percent in 1998.

Genuine gains now go only to companies that exceed estimates by more than a cent. This year, shares of these companies have risen 0.64 percent on average on the day of the announcement. Over five days, there was an average 1.91 percent gain.

Meanwhile, the number of Dow component companies reporting results that are more than a penny above expectations has climbed significantly in the last few years, rising to 54.3 percent today from 27.2 percent in 2002.

This means one of two things: executives have figured out that a penny doesn't jump-start a stock anymore and are speeding up the treadmill, or they are playing the earnings smoothing game less and less.

Let's hope it's the latter. Companies should refuse to participate in the earnings management charade and investors should stop demanding it. "The marketplace wants quarterly measurement, but it has to be put into perspective," said Michael Thompson, director of research at Thomson. "What's more important is long-term viability of a company, and investors should be more respectful of that."

Yes, investors who reward companies for the myth of making their numbers are a big part of the problem. But so are those in the media who report breathlessly when companies beat estimates by a penny or two.

One company that successfully shuns the earnings game is the [Progressive Corporation](#), an insurer in Mayfield, Ohio. Rather than whisper to analysts what they can expect from upcoming results, Progressive publishes monthly, in-depth reports on its Web site. The reports, which it began in May 2001, include an income statement, a balance sheet and segment information. Also included are changes in loss reserve estimates, a number that is closely watched by investors and which contributes to wide swings in earnings.

"We never make promises to hit an earnings number," said Tom King, Progressive's treasurer. "We don't have predictable earnings, but it doesn't matter. We have been very clear on our financial reporting policies, and as a consequence we have not attracted those investors for whom meeting earnings numbers is important."

How have Progressive's shareholders fared? Interestingly, the stock has been less volatile than the Standard & Poor's 500-stock index since the monthly updates began.

It's not clear who got the earnings game going: executives or investors. But it's past time for it to stop. As the Progressive example shows, those companies that continue the charade do it by choice.