One in 50 billion

General Electric Co. earned in the second quarter exactly what analysts had somehow known it would earn: $2.45 billion, or 74 cents a share.

In the house of John F. Welch Jr., total quality management extends even to the quarterly earnings report. As in jet engines, light bulbs and financial services, zero defects and absolute reliability are the orders of the day (you know how Jack hates surprises!). So advanced is quality control within the finance department that GE was able to report year-over-year growth in net income of 11%, plus or minus a few tenths of a percentage point, for eight consecutive quarters. (In the June 1997 period, which ended the string, net rose by 13.1%. Evidently, somebody slipped up.)

Green Tree Financial, Laser Mortgage Management, Oxford, Boston Chicken, Sunbeam and Cendant all stand as testament to the risk of poor and/or questionable corporate financial disclosure. The perfectly predictable earnings stream does not occur in nature. Yet when GE delivers the goods—the customary Six Sigma predictable rise in after-tax profits—an analyst can be counted on to marvel, in effect (as one recently did in fact): “It’s the certainty at GE.”

In his new book, “Contrarian Investment Strategies: The Next Generation,” David Dreman demonstrates that securities analysts usually fail to forecast earnings to within 5% of the actual number. In fact, he calculates, the odds of their getting to within a 5% tolerance for 10 consecutive quarters are 1 in 200,000.

The inverse of this analysis ought to be true, as well, we have been thinking: The odds of a company disclosing a number that comes within 5% of the analytical consensus for 10 consecutive quarters also ought to be 1 in 200,000. (The probability calculations are derived from a study conducted by Dreman and his collaborator, Michael Berry, of approximately 500,000 analysts’ forecasts committed to paper between 1973 and 1996.)

Yet, as Koby Oppenheim of this staff has determined, GE uncannily beats the odds. The analytical consensus was easily within the implausibly difficult 5% range for the past 10 quarters in a row. It was, in fact, within 2%. For the past 20 quarters, the consensus was within 2.37% of the mark. The odds of such a display of clairvoyance on Wall Street, according to Dreman, are 1 in 50 billion. Who says that bull markets make you stupid?

Which, however, begs the question: How does a company that sells everything under the sun almost everywhere under the sun generate a perfectly predictable earnings stream? It’s the very size and diversity of the enterprise, a spokesman responds, that “equals stability and consistency.”

Be that as it may, the July 13 issue of Business Week contains a bombshell on the quality of blue-chip corporate earnings in general (it does not mention GE in particular). Tucked away in an advertising supplement are the results of a poll of 160 delegates to the magazine’s seventh annual forum for chief financial officers last April. Employing “audience response electronic keypads,” the attendees, drawn from what
BW probably did not call the Fortune 500, were asked to respond to the following proposition: “As CFO, I have fought off other executives’ requests that I misrepresent corporate results.”

The responses were:

55%  Yes; I fought them off.
12%  I yielded to the requests.
33%  Have never received such a request.

In other words, observes James S. Chanos, paid-up subscriber and gimlet-eyed reader (it was he who picked up on the BW revelations), two-thirds of the magazine’s sample set have been asked to lie about the numbers. On the other hand, he notes, lending balance, fully one-third have not been asked to lie. Preceding this revelation into print by a few days was an “Abreast of the Market” column in The Wall Street Journal in which the argument was advanced that corporate accounting has become more conservative, not less. Companies are writing down more assets not to bury future expenses but to acknowledge mistakes in a forthright way, the thesis went. “With accounting questions playing a big part in some spectacular recent stock blowups,” the article said, “investors might wonder just how believable are the earnings now fueling record stock prices. Rest easy: They are more believable than in previous decades.”

If the Journal’s argument is right, it seems to us, Business Week’s poll results must be wrong, and vice versa. For reasons ably laid out by Albert Meyer, of Martin Capital Management, Elkhart Ind., we are inclined to trust in BW.

What’s right with accounting, says Meyer, our principal source on the Coca-Cola story in the June 19 issue of Grant’s, are the standards promulgated by the Financial Accounting Standards Board. They are absolutely rigorous. However, Meyer goes on, human nature at Dow 9,300 is working strongly against rigors. “[T]he salaries and wealth of senior executives are linked to options like never before, and there is a massive temptation there to do everything possible to increase the stock price. . . .” he says. “[H]uman nature being what it is, the wealth of executives tied to the stock price, I would imagine there is heavy pressure on the accountants to push the envelope.”

“There is a lot of fudging going on,” says Chanos, who sells stocks short for a living. “While maybe it isn’t company-killing, like at Oxford, you are still corrupting the marketplace. Companies will do anything they can to not miss somewhat aggressive earnings estimates when the penalty for missing by a penny or two is, in some cases, to see a high P/E multiple cut in half. That is the corruption. The incidents of the Sunbeams, Oxfords and Boston Chickens are still in the great minority. But everyone has gotten used to the nudge and the wink about the abilities of companies to massage the bottom line through a variety of subterfuges and artifacts, so there is not even a slight disappointment.

“What I have a problem with,” Chanos goes on when asked to name his pet peeves, “is when, in addition to the goodwill write-downs [which, he says, are not objectionable], you see these kitchen-sink restructuring charges that write down all sorts of things or set up reserves that aren’t needed. For example, a company will write down accounts receivable as uncollectible at acquisition and then collect them, with no cost associated. Writing down perfectly good plant and equipment to zero, and then having no depreciation expense against it. And then my favorite, setting up accrued liabilities, sort of nebulous future charges, and reversing them as no such costs are incurred. We noticed that in Sunbeam. And mergers give you all sorts of opportunities for accounting chicanery.”

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