

Ignoring the fundamentals: **How alternative accounting leads to market self-delusion**



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Agenda

- Intentional manipulation and willful self-delusion
- Three stories
- If you focus on fake accounting, what do you miss?
- Who to watch

Intentional manipulation and willful self-delusion



Warren Buffett, chairman of Berkshire Hathaway Inc., eats a Dairy Queen ice cream bar while walking on the exhibitor floor during Berkshire's annual shareholder meeting in 2009. Andrew Harrer/Bloomberg News

Intentional manipulation and willful self-delusion



Intentional manipulation and willful self-delusion

Do you know which company prompted the SEC to bring its first ever enforcement action for “abuse of pro forma earnings figures” now known as non-GAAP metrics?

Intentional manipulation and willful self-delusion

It's October 25, 1999, and the company's chief executive officer publicly announces its results for the third quarter of 1999:

- Our focus in 1999 was three-fold: first, to increase our operating margins at each operating entity; second, to decrease our marketing costs; and third, to increase our cash sales from our non-casino operations.
- We have succeeded in achieving positive results in each of the three categories. The third quarter and nine month results for the company indicate that we have successfully instituted the programs that we focused on during 1999.

Intentional manipulation and willful self-delusion

- Jan 2002 the SEC alleged the company had violated the law for highlighting “purportedly” positive results but failing to disclose that those results were because of an unusual one-time gain rather than ongoing activities.
- Oct 25, 1999, the day the company issued the misleading earnings release, its stock rose 7.8 % on volume approximately five times the previous day's volume.
- Oct 28th, an analyst explained effect of the one-time gain: roughly \$0.47 of the \$0.63 third-quarter *pro forma* EPS previously reported was “not operating EPS but were actually the result of an accounting gain.” After backing out the one-time \$17 million gain, net revenues would have fallen 2.7 %, rather than rising 1.5 %.
- DB Analyst: Without the one-time gain, the company experienced negative cash flow and margin trends, as well as revenues from operations, rather than the positive trends earnings release touted.
- Adjusting for impact of one-time gain, analysts lowered 1999 EPS estimate from -\$1.17, in initial report of 3Q results, to -\$1.64.
- Oct 28 the stock price fell ~ 6%, on volume approximately four times the previous day's volume.

Intentional manipulation and willful self-delusion

- Trump Hotels & Casino Resorts, Inc, through the THCR officers involved in the drafting and issuance of the Earnings Release, knew that the estimated fair market value of the All Star Café lease termination was recorded as part of operating income for third-quarter 1999 and that the estimated fair market value of the transaction was \$17.2 million.
- THCR knew that the Earnings Release used a *pro forma* net income figure that expressly excluded the one-time charge but did not disclose the existence or impact of the one-time gain.
- Accordingly, THCR knew or recklessly disregarded that the Earnings Release was materially misleading.
- Based on the foregoing, THCR violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by knowingly or recklessly issuing the Earnings Release.

[In the Matter of TRUMP HOTELS & CASINO RESORTS, INC., Respondent. ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND ISSUING CEASE-AND-DESIST ORDER ORDER](#)

Intentional manipulation and willful self-delusion

The Sarbanes-Oxley Act of 2002 mandated the SEC to adopt rules to address public companies' disclosure or release of certain financial information calculated and presented on the basis of methodologies other than in accordance with generally accepted accounting principles or GAAP.

Regulation G was effective for all disclosures as of March 28, 2003.

Intentional manipulation and willful self-delusion

The application of Generally Accepted Accounting Principles is intended to produce financial information that is:

- Relevant, representationally faithful, and reflective of the economics of the business
- Comparable across companies, industries and geographies with other organizations
- Standard and consistently applied so that they are verifiable and auditable by a third party
- Understood by regulators, investors, creditors, taxpayers, and other stakeholders.

Intentional manipulation and willful self-delusion

Global audit firm PwC writes that companies use alternative accounting such as non-GAAP metrics to supplement GAAP financial reporting with *“information that is intended to provide additional insight into the business.”*

<https://www.pwc.com/us/en/cfodirect/assets/pdf/point-of-view-non-gaap-financial-measures.pdf>

Intentional manipulation and willful self-delusion

- The stock market isn't rewarding small earnings beats the way it used to. , For the last 17 years, companies have been using alternative accounting, **non-GAAP metrics**, to produce quarterly earnings per share that exceed analysts' forecasts by 5 to 15 cents not a penny or two, [according to new research](#).
- About 90% of S&P 500 companies use at least one non-GAAP measure in earnings releases instead. The trend toward bigger earnings surprises appears across the entire sample, but most pronounced among S&P 500.
- In the last twenty years Generally Accepted Accounting Principles or GAAP—the standards all public companies must use to report their results to the Securities and Exchange Commission—have been increasingly ignored by companies and research firms that provide data on predicted and actual earnings.
 - Auditors and regulators are traditionally focused on ferreting out small-time earnings manipulation. Driving bigger earnings surprises through non-GAAP metrics works because of the growing acceptance of non-GAAP numbers.
 - Analysts enable this behavior, since they may “increasingly bias their Street expectations downwards to generate a more positive response [from earnings surprises] for their clients – that is, they engage in strategic pessimism.”
 - Why use non-GAAP metrics to manipulate results?

Intentional manipulation and willful self-delusion

James Schnurr, former SEC chief accountant, in a [speech March 22, 2016](#):

- *Non-GAAP measures are intended to supplement the information in the financial statements and not supplant the information in the financial statements.*
- *However, when the financial news networks report quarterly earnings, they very frequently report the non-GAAP measure of earnings with no reference to the actual GAAP earnings, often not even identifying it as having been adjusted.*
- Particularly troubling to Schnurr:
 - The extent and nature of the adjustments to arrive at alternative financial measures of profitability, as compared to net income, and alternative measures of cash generation, as compared to the measures of liquidity or cash generation.

[SEC tells companies to be careful how they talk about free cash flow](#)

- Significant adjustments to profitability outside of customary measures such as EBITDA

Three stories: Herbalife

- In March 2016 Herbalife admitted it had misstated the number of active new members 28 times over three earnings calls since the prior year.
- Herbalife overstated the metric's growth 14 times and understated it 12 times.
- When overstating, Herbalife overstated by an average of 20.5 percentage points; and when understating, it understated by an average of 3.2 percentage points.
- Herbalife's stock price declined by 7% when it disclosed the error "It appears that investors in this case, were relying on this metric," said SEC Commissioner Stein in a speech.

Three Stories: Symantec's Ghost Revenue

- Symantec's shares dove 33.1% May 11, 2018. A former employee's accusations related to "the company's public disclosures including commentary on historical financial results, its reporting of certain non-GAAP measures including those that could impact executive compensation programs, certain forward-looking statements, stock trading plans and retaliation."
- [Companies including Symantec are using 'ghost revenue' to calculate bonuses](#)
 - Symantec was adding back millions in "ghost revenue" — deferred revenue that accounting standards force them to write off after an acquisition — when calculating executive bonuses.
 - Acquiring companies often assign a fair value to the deferred revenue added to their books when purchasing another company that are less than the amount reported on the acquired companies' balance. GAAP requires writedowns called "deferred revenue purchase accounting adjustments."
 - The write-downs become "ghost revenues" for the acquiring company. Symantec and others are adding back into GAAP revenue numbers to create adjusted revenue metrics that are reported to investors.
 - Creates a perverse incentive to write down more to create cookie jar.
- Attorneys have succeeded in getting [a class action complaint](#) approved suing Symantec, its CEO and CFO based on my article.

Three Stories: Valeant

- The Securities and Exchange Commission told Valeant Pharmaceuticals International Inc. to clean up its use of nonstandard earnings numbers, but I reported in November 2017 that the company sent reporters , its version of non-GAAP adjusted net income which the regulator told it to stop putting in its filings.
- Valeant referred to the adjusted net income non-GAAP measure as “cash earnings.”
- The SEC told Valeant in October 2017 to stop the metric because it was too similar to cash flow and was, therefore, not supposed to be used to calculate per-share earnings. Valeant said it would stop providing the per-share non-GAAP number “as it is currently calculated.”
- But then Valeant’s VP of Corp Comm called and emailed reporters in anticipation of the company’s third-quarter earnings report.
 - “We don’t report on adjusted EPS,” she wrote. “However, it can be calculated with the understanding that we have ~350 million shares outstanding at this time. That calculation comes to \$1.04, which is also above analyst estimates.”
- MarketWatch refused to report the \$1.04 number as it is not included in any of the company’s earnings presentations or disclosures.

If you focus on fake accounting, what do you miss?

- Moviepass
 - There was an article July 31 in the New Yorker in July about Helios & Matheson Analytics Inc. MoviePass maybe running out of money.
 - The one party investors should have listened to is the auditor. It said Moviepass was not a "going concern", also known as officially being unable to pay its bills over next twelve months, in its 10K in April.
- Facebook shares slid 20% July 26, after its CFO shocked investors by saying revenue growth would start to decelerate, from a 42% growth rate in the current quarter to about 20% by the end of the fourth quarter.
 - But even with new, lower revenue growth expectations, FB is still one of only 11 companies in the S&P 500 that have notched year-over-year revenue growth of 20% or more in the last eight quarters.
 - Facebook's results are still relatively strong, whether looking at them on the reported basis required by the Securities and Exchange Commission, GAAP (Generally Accepted Accounting Principles), or on a non-GAAP adjusted basis.

If you focus on fake accounting, what do you miss?

- Berkshire Hathaway
 - *Buffett, a longtime critic of nonstandard accounting metrics, called out by SEC for using them himself*
 - *Buffett says new accounting rule will ‘severely distort’ future earnings figures*
 - *In his recent letter to shareholders, Buffett complained about a new accounting requirement that he believes will “severely distort” Berkshire’s results and potentially “mislead commentators and investors.”*
 - *The rule, according to generally accepted accounting principles, the standards all public companies must follow, requires net unrealized investment gains and losses in Berkshire Hathaway’s portfolio to be included, along with actual gains and losses, in reported earnings each quarter.*
 - *Buffett says that will produce “truly wild and capricious swings” in Berkshire’s bottom line.*
 - *Why Buffett will keep Berkshire Hathaway reporting earnings during the weekend*

If you focus on fake accounting, what do you miss?

- Alibaba
 - On Aug 28, 2018 \$BABA reported earnings and revenue that missed Wall Street's expectations, and the stock turned lower despite the China-based e-commerce giant's attempts to influence how its results were reported.
 - The company contacted MarketWatch to “explain” why stories should compare EPS to analyst estimates in renminbi terms, rather than in dollar terms.
 - Some news sources also reported that Alibaba beat earnings expectations — and it did, if you compare the net EPS numbers to analysts' GAAP estimates.
 - However, earnings reports rarely compare net EPS with analysts' GAAP estimates when non-GAAP numbers are available—the majority of companies that provide guidance give non-GAAP guidance, so that's all analysts have to work with.
 - MarketWatch also [exclusively reported](#) that Alibaba turned its investment in money-losing local services platform business Koubei, into earnings gold by combining it with recently acquired online food-delivery company Ele.me using obscure GAAP acquisition accounting.

If you focus on fake accounting, what do you miss?

- GE
 - The company's \$6.2 billion hit to income in January to **catch up on losses in long-term care insurance contracts** [was repeatedly signaled by the company](#).
 - GE started warned analysts beginning in the second quarter of 2017 that a review of its claims experience and reserves was under way, and any charge would happen in the fourth quarter.
 - The review of long-term care insurance contracts was prompted by a [new accounting rule](#) many years in the making that will require annual reviews of assumptions starting in 2021.
 - In 3Q 2017 company disclosed, "We have recently experienced elevated claim experience for a portion of our long-term-care insurance contracts and are conducting a comprehensive review of premium deficiency assumptions across all insurance contracts..."
 - GE dropped 3.5% on Friday Feb 23 closing at 14.49 after it disclosed that adoption of **new revenue-recognition** accounting standards would a non-cash charge of about \$4.2 billion to Jan. 1, 2016 retained earnings balance.
 - Instead of being impressed with full disclosure approach to providing recast prior year info for comparison purposes the news was mistakenly reported as a "restatement," a negative. [An astute trader could have caught the bounce](#) on Monday 2/26 when the misimpression was recognized and the stock traded as high as 14.68, closing at 14.65.
 - On the other hand... [Investors who paid attention to GE's accounting saw trouble coming](#)
 - **And now Flannery is out.** [Ousted CEO John Flannery pays the price for taking out GE's trash](#)

If you focus on fake accounting, what do you miss?

- Tesla
 - The revenue-growth rate that helped fuel Tesla's rally relied on an apples-to-oranges comparison
 - Tesla says it did not ask suppliers for cash back
 - New accounting rules trim Tesla deficit and promise faster future revenues
 - SEC takes Tesla to task over accounting practices
 - Even with its losses, Tesla won't take a big hit from lower tax rate

Who to watch

- BRK – Marmon roach motel, messy exposure, then breakup
- GE – Clean up is over, back to “Welchina” ways, maybe break up
- TSLA - No more shenanigans, legal overhang reduced, then acquisition

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