Meeting Expectations Used to Draw Favor, Now It Invites Scrutiny

By CASSELL BRYAN-LOW

MEETING STOCK ANALYSTS’ earnings estimates used to be a badge of honor for a company. Now, it is something that raises questions.

WorldCom Inc. consistently met Wall Street’s targets for earnings during 2000 and the first three quarters of 2001. But the company now says it improperly capitalized $3.8 billion dollars of expenses to inflate profits, in what could be the largest accounting fraud ever.

In matching or just beating estimates, at least, WorldCom is by no means alone. Indeed, 43 of the companies, or 9%, in the Standard & Poor’s 500-stock index consistently have met or beat estimates by a penny or two for the nine quarters through the first quarter 2002, according to a Wall Street Journal study based on earnings data from Multex.com Inc. The list includes such household names as Fannie Mae, Freddie Mac, Hershey Foods Corp., Pfizer Inc., Starbucks Corp. and Wal-Mart Stores Inc.

“Now making the numbers is suspect because too many tricks were used in order to do that,” says Stanley Levine, director of quantitative research at Multex.com, which compiles financial data for investors.

Of course, there could be various reasons why a company consistently makes its numbers, including good management and the fact that some industries are relatively predictable.

But a pattern of narrowly meeting or exceeding analysts’ estimates is among the characteristics that the Securities and Exchange Commission uses in identifying possible accounting irregularities, says Charles Niemeier, the SEC enforcement division’s chief accountant. For example, he added, a company reporting consistent revenue increases while cash flow is falling sharply would be of special interest if that company also consis...
Continued From Page C1

tently met earnings estimates.

Among the 43 companies that have been narrowly making their numbers, several companies showed patterns of rising revenues and falling cash flow from operations, says Charles Mulford, director of the financial analysis program at Georgia Institute of Technology in Atlanta, who compared revenues and operating cash flow for the same 43 companies. This could be a red flag for potential problems, some investors say.

Among them: Minneapolis retailer Target Corp., and H.J. Heinz Co., the Pittsburgh food company, both of which showed rising revenue and falling operating cash flow for both of their fiscal years 2000 and 2001.

Electronic Data Systems Corp., a Plano, Texas, computer-services provider, reported rising revenues for those years, paired with cash flow that declined in 2000 and rebounded part-way in 2001.

Some companies attribute their matching or just beating estimates partly to good communication channels with analysts, who then adjust their estimates accordingly. But skeptics say that if companies were merely communicating clearly with analysts, an even distribution should be present for those that beat estimates than those that missed.

However, the scales are tipped overwhelmingly in favor of positive, rather than negative, surprises. Multex.com's Mr. Levine attributes the tendency of companies to beat the analysts' consensus to a cozy relationship between analysts and the companies they follow.

"Look how much likelier it is for companies to beat "the number." In the first quarter of 2001, at the market's peak, 21.4% of S&P 500 companies reported earnings as expected, 16.6% beat those expectations by a penny and 11.8% beat by two pennies, according to Multex.com. By contrast, only 5.9% missed by a penny and 3.7% missed by two.

Arthur Winkleblack, chief financial officer at Heinz, notes that estimates the company has met or exceeded have in some cases been revised downward. (The 43-company screen is based on the last consensus before a company reports.) Heinz says its past declines in cash flow from operations—which totaled $1.07 billion in fiscal 1998, $910 million in 1999, $543 million in 2000 and $506 million in 2001—was mainly due to restructuring activity including plant closings. In the fiscal year ended May 1, 2002, Heinz said, cash flow from operations increased to $891 million.

At retailer Target, spokeswoman Cathy Wright explains, "we maintain an ongoing dialogue with the investment community and have a policy of full disclosure." She adds that the decline in the company's cash flow from operations in 2000 and 2001 stemmed primarily from increased investments in accounts receivable relating to the launch of a Target branded credit card in September 2001.

Jeffrey Baum, a spokesman for EDS, says the company's "accounting is conservative and complete, and follows both the letter and the spirit" of U.S. accounting rules. Fannie Mae and Freddie Mac say they issue regular data that helps analysts adjust their estimates, and that their mortgage securities businesses have shown a consistent pattern of growth. "There is not a lot of magic to it," says Fannie Mae spokeswoman Jayne Shontell.

Drug giant Pfizer and discount retailer Wal-Mart stressed the transparency of their financial disclosures and good communications with analysts. A Starbucks executive wasn't available to comment, and Hershey declined to comment. There also can be a quirk in the estimates. For example, a company may say it plans to earn three to five cents and analysts therefore estimate four cents, which means when the company reports five cents it looks like it beat estimates.

Some specialists argue that most companies manage their earnings to some extent. For example, a company could legitimately sell an asset, such as a plant, at the end of a period and report a gain on that sale. However, the practice may go too far when gimmickry is used "materially misrepresent true financial performance," says Mr. Mulford, the professor.

Earnings management is "like dirt, it is everywhere," says Walter P. Schuetze, the SEC's chief accountant from 1992 through 1995 and the chief accountant for its enforcement division from 1997 until early 2000. "I saw companies regularly making their earnings estimates by all kinds by earnings management," he says. By far the most common misuse of the practice in recent SEC cases, he says, is recognition of premature or fictitious revenue.

The practice has become increasingly widespread and "more blatant" during the past decade, adds Mr. Schuetze, pointing to the surge in earnings restatements as an indicator. Indeed, the number of earnings restatements rose 16% to 276 in 2001 from 233 in 2000. In 1997, by comparison, there were just 116 restatements, according to Chicago-based Huron Consulting Group. "Most of the problems we see begin in the subtleties," says the SEC's Mr. Niemeier, starting with small adjustments that may snowball into more serious situations.

For years, the stock market rewarded smooth earnings growth and responded well to positive surprises; but that climate has changed. Investors were unperturbed when insurance company American International Group Inc. announced in February that fourth-quarter net income fell slightly shy of what analysts had been expecting; the next day, the stock rose by 4.1%.

After December's bankruptcy-court filing by Enron raised concerns about companies with a lack of accounting transparency, AIG has worked hard to diminish the perception that it achieved earnings in hard-to-discern ways. The February surprise was "seen as being very honest" of AIG, says Itzhak Sharav, accounting professor at Columbia University in New York. "People are aware now of some change," he adds. If companies consistently meet estimates or beat them by a penny or two, "there is good reason to suspect there is some kind of earnings management."