CFOs Agree: 20% Of Companies Have Misleading Earnings

We've made it our mission to build better financial models by adjusting for earnings manipulation conducted by companies taking advantage of loopholes. For those few analysts and investors that believe our earnings adjustments unnecessary, we provide proof that they are.

If anyone would know about earnings manipulation, it would be CFOs. They know how the sausage gets made, and they have an insider's understanding of the ways accounting loopholes can be exploited. Sure enough, a recent survey of 375 CFOs at public and private companies found that the practice of earnings manipulation is widespread:

> *"CFOs believe that in any given year a remarkable **one in five firms intentionally misrepresent** their earnings using discretion within generally accepted accounting principles (GAAP). The magnitude of the typical **misrepresentation is quite material: about 10 cents on every dollar**."*[1]

That settles it. The executives in charge of earnings statements state that 20% of companies have misleading earnings, and that those earnings are off by 10% on average.

In addition, the CFOs supplied a list of "Red Flags" for earnings manipulation, and they mirror issues we've been calling out for years. Their red flags include:

1. *Consistently meet or beat earnings targets*. We warned investors to look out for this red flag when we put Tangoe (TNGO) in the Danger Zone two years ago. The stock is now down almost 70%.
2. *Large/frequent one-time or special items.* The CFOs surveyed said that 1/3 of companies that mislead investors intentionally lowball their earnings in order to set themselves up for future outperformance. We identified an example earlier this year with insurance company Aetna (AET), which had significant one-time write-downs that decreased reported earnings. The stock is up 24% in the past few months since our call.
3. *Jump in accruals/sudden changes in reserves.* Just three months ago we pointed out that decreasing reserves helped Intersil Corp (ISIL) overstate earnings. The stock is down 18% since our report.
4. *Changes in (significant) accounting policies.* Just two months ago we warned investors in Barron's that M/A-Com's (MTSI) shift from a sell-through to a sell-in method of revenue recognition was a sign of potential manipulation. The stock has since dropped 20%.
5. *Using non-GAAP metrics.* Last year we put companies with non-GAAP earnings in the Danger Zone and specifically called out Trimble Navigation (TRMB). The stock is down 40% since our article.
6. *Misalignment of management compensation incentives.* Last month we put Speedway Motorsports (TRK) in the Danger Zone and argued that its executive compensation plan incentivized management to focus on accounting earnings and not shareholder value. In just over a month the stock has dropped 13%.

As our research shows and CFOs confirm, making adjustments to reverse earnings manipulation is both necessary and profitable. See the Most Dangerous list for a list of stocks with misleading earnings and dangerous valuations.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

[1] Bold and underline formatting was added by the authors.

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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