4 Reasons Executives Manipulate Earnings

At this point, it’s nearly impossible to argue with the notion that earnings manipulation is prevalent throughout the ranks of publicly-traded companies. We know that CFOs have admitted to manipulating earnings and the ongoing Valeant Pharmaceuticals (VRX) scandal continues to expose the creative ways companies can artificially boost results.

While most earnings manipulation is not as blatant as Valeant, the fact remains that investors have to be on the lookout for earnings management at all times. To be properly vigilant, it’s important to understand why executives misstate earnings. When you understand the why, you’ll have a better sense of what you need to look for.

1. Their Bonuses (And Jobs) Depend On It

Ever since “performance-based” bonuses were made tax-deductible in 1993, an increasingly large portion of executive compensation has been tied to hitting certain performance targets. In many cases, these are *adjusted* non-GAAP metrics that are designed for CEOs to always hit those incentive targets. In other cases, the targets are simply so low that it would be almost impossible to miss them.

Still, occasionally executives will see their bonuses get cut if they miss targets for metrics like revenue and EPS growth, so there’s an incentive in place for them to do whatever it takes to meet that target. That could mean things like channel stuffing to boost revenue at the end of a quarter, lowering reserves to artificially boost EPS, or even lumping regular expenses into one-time items such as “restructuring” so that they’ll be excluded from the earnings calculation.

There are almost too many options to count. In 2014, Caleres (CAL) hit an adjusted EPS of $1.72, 11% above the target threshold to receive their full bonuses. However, this number was inflated by:

- A $2 million decrease in the company’s inventory reserve
- Unrealistic pension plan assumptions, which included an expected return on plan assets of 8.25% and a discount rate of 5%, which allowed the company to earn $10.7 million in net periodic benefit income.

Together, these two non-operating items boosted CAL’s income by $0.29/share. Removing that impact, the company would have had an adjusted EPS of $1.43, which would have fallen short of the performance target. Boosting earnings to hit those targets helped the five highest paid executives earn record compensation of $18 million last year, or 15% of after-tax profit (NOPAT).

Of course, the risk for executives who miss earnings targets can be even greater than just losing money from their bonuses. Studies have shown that simply missing targets can increase a CFO’s chance of getting fired, even if they just barely miss and the stock still does well!

With the extreme focus on these quarterly and annual targets, it’s no wonder that executives give in to the pressure because those that don’t earn less in compensation and are at a higher risk of getting fired.

2. They Want To Lower The Bar

One of the most interesting details from the CFO survey linked above is the fact that roughly 1/3 of the cases of earnings misrepresentation actually involve companies *decreasing* their earnings. Decreasing earnings seems counterintuitive at first, but it makes more sense when you remember that it’s more important to the executives whether or not they hit their targets rather than by how much.

Therefore, if an executive is on track to beat their target by a wide margin, they might actually want to decrease their earnings, thereby setting up an easy comp the following year. One of the most common tactics for accomplishing this goal is to increase reserves. Executives can decrease earnings by inflating reserves. Then, if the company is struggling to hit their target in a later period, the executive can always decrease those reserves back down and book the decrease as positive income.
Figure 1 shows the results of the work we did on reserves in 2013. In 2012, the companies that increased their reserves the most—thereby decreasing reported income—were Capital One Financial (COF), Caterpillar (CAT), Walgreen's (WBA), Chevron (CVX), and Kroger (KR). The next year, three of those five companies significantly decreased their reserves, while the other two increased them by a much smaller amount.

If you just looked at reported income, it would have seemed like Capital One grew steadily in 2012 and 2013. In reality, by reversing the impact of change in reserves, we see that it grew NOPAT by over 100% in 2012 and then declined in 2013. By changing reserves, executives managed to show two years of growth rather than one great year and one struggling year where their bonuses would get cut.

3. Everyone Else Is Doing It

Since measures of executive performance are so often based on comparisons to a company’s peer group, it creates a sort of arms race of financial manipulation. As soon as one company in an industry starts manipulating their numbers, everyone else has to follow suit or get left behind.

A recent study looking at restatements from over 2,000 companies found that there was a strong tie between whether one company manipulated earnings and the percentage of firms in its region or industry that had announced restatements in the past year. Simply put, when executives see their competitors engaging in accounting trickery, they tend to follow suit.

The good news? The study found that when there was significant enforcement action, shareholder litigation, or negative press, the copycat effect didn’t occur. When executives are held accountable for manipulating earnings, their peers don’t tend to follow them. The bad news is that…

4. Executives Face Very Little Accountability

Executives rarely face much blowback when they misstate earnings, either from regulators or the investing public. On the regulatory side, enforcement is so weak that they rarely even have to give back the bonuses they earned from false earnings.

How crazy is that? Executives get paid massive bonuses for hitting growth targets, and then when it’s revealed they didn’t actually hit those targets, they get to keep the bonuses anyway! So much for being aligned with shareholder interests.

Investors and analysts don’t do much better. Sell-side analysts, who have a vested interest in maintaining a good relationship with the companies they cover, don’t tend to probe too deeply into reported earnings.
“The sell side has no incentive to detect earnings quality,” said one anonymous CFO who was interviewed for the survey on earnings misrepresentation.

Buy-side analysts and short-sellers tend to be better at detecting these red flags, but too often they get shouted down when trying to raise the alarm. Take the blowback of Andrew Left of Citron Research has faced for calling out Valeant. As the stock has fallen, the executives and large investors with a vested interest in supporting those misleading earnings have accused him of “playing on the fears of investors”.

This has led to a bizarre culture where executives manipulate earnings to reward themselves with bigger bonuses, and everyone knows this is happening, but when anyone tries to call them out on it they get accused of being greedy and self-serving.

The activist investors who might be best positioned to curb executive bonuses rarely do anything about them. Pershing Square founder Bill Ackman actively encouraged the aggressive acquisition accounting at Valeant that helped executives nearly triple their compensation in 2014, and he has been a staunch supporter of the executive team at Jarden (JAH) that uses an exec friendly form of adjusted earnings to help executives boost their own pay at the expense of shareholders.

Ideally, this situation will change at some point, and the correct enforcement mechanisms will be in place to prevent earnings manipulation. Until that time, investors need to be aware that the reported results they’re looking at are not necessarily an accurate indication of the underlying economics of the business. It takes a lot of work to reverse all the loopholes that executives exploit to serve their own purposes.

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

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don’t judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.
DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, “New Constructs”) is an independent organization with no management ties to the companies it covers. None of the members of New Constructs’ management team or the management team of any New Constructs’ affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs’ Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs’ research recommendations may not coincide with the hedge fund’s holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs’ reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.