DOW JONES CORPORATE FILINGS ALERT

Surveys Show Earnings Missives Still Lack Candor

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By Tiffany Kary

Two recent surveys have skewered the ornate governance practices springing from Sarbanes-Oxley legislation, pointing out that companies still fail the most obvious mark of good governance: candor.

As companies spend millions to comply with legislation designed to restore trust in the capital markets, many still appear intent on hiding their true financial health. According to two separate studies – RateFinancials' survey of Securities and Exchange Commission filings and Rittenhouse Rankings' analysis of annual proxy letters - many companies still aren't being up front in key communications with stockholders.

"Should companies improve their candor and specificity? Yes, they need to give that information," said Carol Bowie, director of governance services at Investor Responsibility Research Center, a Washington-based proxy research firm. Bowie added that while savvy investors recognize that shareholder letters are "a PR exercise" for most companies, executives should devote more care to what goes into all communications with shareholders.

Far too many publicly traded companies don't accurately portray their financial condition, according to New York-based research firm RateFinancials. The study classified 47% of financial statements it reviewed as acceptable, while 14% were "below average" and 1% were "poor." Only 3% were "outstanding," and 35% were "superior." The study covered filings from the past year issued by 120 companies in the S&P 500, which together account for close to 42% of the index's market cap.

"We don't see it as a good sign for the market that we've found such a large number of poor and below-average companies," said Victor Germack, founder and president of RateFinancials.

Factors that went into the rankings included the directness with which a company reported its earnings, clarity of footnotes, aggressiveness of accounting, and good governance policies such as heavily independent boards and responsible related party transactions. Directness with which earnings were reported was weighted most heavily in the study, accounting for 50% of a company's overall rating.

RateFinancials named names: outstanding companies included BMC Software, Family Dollar Stores and Microsoft. Those ranked below average included Archer Daniels Midland, Halliburton, Best Buy, Bristol Myers Squibb, Corning, Eastman Kodak, EDS, Gap, Janus Capital, Motorola and Walt Disney Co.

The only company rated "poor" was Computer Associates. While RateFinancials has yet to correlate its rankings to share price or governance imbroglios, Computer Associates has been plagued by high-profile problems this year, including an accounting probe and management departures.

The study uncovered other unsettling trends: 75% of companies used complex financing to shift long-term financial obligations off their balance sheet; 64% made unreasonable assumptions about future pension liabilities and 28% used aggressive revenue recognition techniques.

Rittenhouse Rankings, a service that measures candor by analyzing how earnings are presented in annual proxy letters, has found a similar trend: 87% of chief executives failed its candor test, as measured by how they report bottom-line performance in their letters. Some of the

worst offenses were failure to reconcile GAAP and non-GAAP earnings, and liberal use of aggressive pension forecasts and tricky off-balance sheet accounting. The survey covered letters contained in annual reports for companies' fiscal 2002, ranking a representative same of 100 companies from the Fortune 500. A study of 2003's letters is currently underway.

While both studies came up with similar revelations about corporate candor based on very different methods, there was little overlap in their lists of best and worst performers. JetBlue Airways, Knight Ridder, Wells Fargo, Continental Airlines and Estee Lauder were the top five companies according to Rittenhouse's survey. Boeing, Reebok, Time Warner, Trump Hotels and Franklin Resources were the bottom five, with Boeing at the bottom of the list.

L.J. Rittenhouse, president of AndBeyond Communications, which authors the study, said that while many institutional investors overlook the annual proxy letter, it is a better litmus test for financial well-being than actual earnings results.

“Most investors focus on financial numbers, but they forget that those number are being filtered through management judgments,” Rittenhouse said. “What our study has shown is that companies which choose to disclose information in a shareholder letter with great candor probably make those other decisions with great candor.” Famed investor Warren Buffett has also called the shareholder letter the primary document of a corporation, and he serves as a star example by producing an honest, readable letter for Berkshire Hathaway shareholders every year, Rittenhouse added.

“This is where a chief executive exposes him or herself to the world – shows if he or she understand the business, and can articulate to shareholders what's going on,” she added.

Rittenhouse looks for four main things other than lucid writing and sound judgment: whether a company includes diluted earnings per share for the current as well as prior years, whether that number matches the earnings per share number in the company's income statement, whether the company reconciles GAAP and non-GAAP earnings, and whether they clearly explain year-over-year variations in earnings.

Companies have shown themselves to be surprisingly devious – Rittenhouse cites a Enron Corp.'s financial report for 2000, before any of the company's more serious problems surfaced. “Enron's 2000 report was classic. It claimed in the first paragraph that net income was over a billion dollars for the first time. But if you looked at the income statement, it was $978 million – more than a rounding error – and there were no footnotes to explain the difference,” Rittenhouse said.

Unlike RateFinancials, Rittenhouse Rankings did analyze share price performance's link with candor. Unsurprisingly, the study found that over the past two years, top-ranked companies in the survey have seen share prices increase 21.5%, while bottom-ranked companies increased just 7.3%.