WHAT ARE THE EARNINGS?

A talk by Bosworth M. Todd, Jr., President of Todd-Boston Company, Inc., to the Louisville Chapter of the National Association of Accountants on September 17, 1968.

When Carl Weigel invited me to speak to your Chapter of the N.A.A., we agreed that the title, "What are the Earnings?" might be a particularly appropriate subject at this time in view of the rash of conglomerates, the increasing number of mergers, and the large number of suggested changes in accounting procedures for earnings in recent years. In addition to discussing this subject, I would like to comment briefly on our investment philosophy and the likely shift in the dominant forces in our economy over the next five to ten years. Then too, corporate management is becoming increasingly interested in taking whatever steps are necessary, within the rules of the game, to show a steady and uninterrupted growth trend in earnings per share of common stock. And look at what Wall Street has done in appraising those earnings in the market place. New issues of small, little known companies have commanded substantial premiums in the market in the past year or two because the prospectus shows a sharp five year earnings per share growth trend.

While I'm not an accountant, I am a user of the information which you record and I depend upon it in my investment decisions. My plea is for consistency and comparability or at least adequate footnotes for the exceptions.

ACCOUNTING PRINCIPALS

In the late '20's, according to Jack Carey, Administrative Vice President of the American Institute of CPA's, leaders in the accounting profession began to worry about some of the accounting practices being followed during that period of frenzied finance. The Institute approached the New York Stock Exchange with the idea of setting standards for financial reporting of listed companies. The President of the Stock Exchange, however, showed no interest until after the 1929 market crash. Subsequently, negotiations undertaken by the Institute and the Exchange resulted in an historic document published in 1934, "Audits of Corporate Accounts". It established concepts which were available to Administrators of the Securities Act of '33 and '34. Briefly, this correspondence emphasized the importance of consistency in accounting practices of an individual company from year to year. While assuming that there would be variation in methods, the institute advocated disclosure of the accounting principals followed by each corporation. This key recommendation, however, was never adopted. The Institute stated, according to Mr. Carey, that "within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year". Shortly thereafter, the SEC required independent audits by public accountants of companies under its jurisdiction, and decided not to prescribe the accounting principles to be followed as the statutes gave it power to do, and as it might well have done. Ever since that time, the SEC has relied on the accounting profession to promulgate accounting principles underlying corporate financial reporting.

With the growth in numbers of stockholders and numbers of financial analysts in the postwar period, there has been increasing criticism of the diversity of accounting principles which still prevailed, especially the continuing use of different accounting procedures by different companies in similar circumstances, which increase the difficulty of comparisons.

You are all aware of the effect various methods of accounting can have on earnings per share. Until recently, for example, extraordinary non-recurring gains could be taken into income and losses and could be charged against surplus, deferred taxes resulting from accelerated depreciation did not have to be shown as a charge against current income, potential dilution of earnings through conversion of convertible securities did not have to be disclosed. In recent years there has been increasing pressure from the financial community for all companies to follow the same procedures in the same circumstances, so that unnecessary obstacles to comparison of earnings of different companies would be removed. As a result a few years ago, the Institute issued a statement that, "Variations in treatment of accounting items generally should be confined to those justified by substantial differences in factual circumstances".

Mr. Carey recently commented that within the past year pressures have been put on the Account Principles Board by industry, investment bankers, and even spokesmen for the Treasury, to prevent the Board from saying what it thought ought to be said in the interest of the investing public -- these complaints rarely include any reference to the interests of investors. Meanwhile, members of the Accounting Principles Board are growing increasingly unpopular with some of their own clients. Some corporations have threatened to accept qualified certificates from auditors if necessary. It's not that management is not honest, it's just that in this present environment they are less than enthusiastic about accepting accounting changes which will temporarily reduce their earnings per share. Yet every change in the direction of comparability is likely to result in the reduction of earnings of some companies in the immediate future.

Mr. Carey has indicated that he feels the majority of CPA's realize that as professional people you must accept an independent responsibility to the public. You know that the capital markets are largely dependent on reliable and intelligible financial data, that attention is increasingly focused on earnings per share, and that the difficulty of comparing earnings of different companies is increased by differences in accounting methods, not justified by differences in circumstances. In pursuing a policy of comparability, you are actually protecting management against loss of confidence in corporate financial reports and against possible government intervention in this area with the consequent erosion of the private enterprise system.

There are still some interesting subjects on the agenda of the Accounting Principles Board: One is the treatment of good will in a pooling of interests merger -- should it be amortized or not?, some unresolved questions about the investment credit, and accounting changes for the conglomerates. The Financial Analysts Federation, as the only organized spokesman for investors outside the SEC and the Stock Exchange, has been asked to support the Accounting Board in their efforts to achieve these changes.

"THE MONEY GAME"

You know there's a very funny book out that's on the best seller list that I'm sure you'll enjoy reading. It's "The Money Game" by Adam Smith. Adam Smith in reality is Jerry Goodman, Editor of "The Institutional Investor", and a former mutual fund manager. I'll give you some excerpts from Chapter 13 entitled, "But what do the numbers mean?":

"But what are the earnings?

It really ought to be easy. You pick up the paper, and Zilch Consolidated says its net profit for the year just ended was $1 million, or $1.00 a share. When Zilch puts out its annual report the company will say the company earned $1 million, or $1.00 a share. The report will be signed by an accounting firm which says that it has examined the records of Zilch and in our opinion the accompanying balance sheet and statement of income and retained earnings present fairly the financial position of Zilch. Our examination of these statements was made in accordance with generally accepted accounting principles.

The last four words are key. Translation of 'generally accepted accounting principles' is 'Zilch could have earned anywhere from 50¢ a share to $1.25 a share. If you will look at our Notes 1 through 16 in the back, you will see that Zilch's earnings can be played like a guitar, depending upon what we could or don't count. We picked $1. That is consistent with what other accountants are doing this year. We'll let next year take care of itself.'"

"Numbers imply precision", Adam Smith goes on to say, "so it's a bit hard to get used to the idea that a company's net profit could vary by 100%, depending on which bunch of accountants you call in, especially when the market is going to take that earnings number and create trends, growth rates, and little flashing lights in computers from it. And all this without any kind of skulduggery you could get sent to jail for. How can this be?"

Well, he goes on to give examples of how Delta Airlines depreciates its planes in ten years and United in sixteen and look at what this does to earnings. He asks if the investment credit should be flowed through to earnings in the first year or spread over the life of the equipment, whether or not to amortize good will on a pooling of interest acquisition, whether or not companies should amortize their unfunded pension costs, etc.

He concludes that most accountants are honorable men, trying to do a job, but they are hired by corporations, not by investors (where have we heard this before?). He then makes reference to the now well publicized case of Yale Express, the corporation which reported profits for the years it was sliding into bankruptcy. The angry stockholders took to the courts, suing not only Yale Express, but Peat, Marwick who had put their accountants certification on Yale Express's report.

Jerry Goodman expresses his lingering skepticism for reported numbers because he got burnt once in Certainteed Products in spite of having received assurances from their accountants that the earnings were respectable. Later, when people started abandoning their shell homes where they had made but a modest down payment, Certainteed, which had reported as income the sale price of the whole house, managed to go from 62 to 11 (I have similar worries about some of the computer leasing stocks which sound to me like the shell home business all over again).

THE ANALYST'S NIGHTMARE

Now, I'd like to say a word or two about earnings per share, or the analyst's nightmare. I think we have to conclude that the purpose of earnings per share data is to attribute the earnings of a corporation for a specified period to the capitalization which existed during that period. Relatively simple in most cases, but what about when you've had a merger, on a pooling of interest basis, which included the issuance of a convertible preferred? Generally, in a pooling of interest combination income statements for the prior periods are combined as if the constituent businesses had been combined during the entire period. This seems like logical treatment when only common shares are issued in a pooling of interest transaction. There may be a problem when a convertible preferred is the medium for exchange. There have been cases when the preferred dividend requirements on the shares currently issued in the exchange, when applied retroactively on a pro forma basis in the combined statement of income, exceed the earnings of the company whose stockholders are receiving the preferred -- thus playing up one of the unsatisfactory results of restating prior earnings.

On the subject of potential dilution arising from convertible securities outstanding, I understand that it is now generally agreed that earnings will be shown both ways, i.e. on shares currently outstanding and proforma on a fully diluted basis. For example, the earnings on current shares might be $2.20, and fully diluted, $1.85.

Now we've got another problem -- what do we do about adjusting earnings when the capitalization includes a security, which Litton Industries first discovered, convertible into common at a rate which increases by a fixed percentage each year? What is the contingent dilution then? It has been suggested that only the common shares issuable for such securities during a relatively short period, say five years, from the date of the statement be used in computing potential dilution, instead of the aggregate shares issuable over longer periods, even up to twenty-five years. The question is -- which period will provide the most useful information to the investor? We expect to hear from the Accounting Board on this one fairly soon.

A CLASSIC EXAMPLE ABOUT EARNINGS

Arizona Public Service's earnings per share history represents a classic example of another segment of accounting problems -- capitalizing interest costs during a construction period rather than deducting them against current earnings. Arizona Public Service in 1957 earned 90¢ a share. In that year they purchased all electricity from outside sources. Around 1960 Arizona embarked on a major construction program to such an extent that today they are net sellers of power to other utilities. This construction program had a very favorable impact on reported earnings per share because of credits for interest charged to construction. Reported earnings per share grew at an above average rate until 1964 when earnings peaked at $1.52 per share. In that year, interest charged to construction credits were equal to 36¢ per share out of $1.52, representing almost 60% of the total increment earnings since 1957. The following year reported earnings per share declined 18% a share to $1.34. This was also the decline in interest charged to construction credits as the construction program was completed. In 1966 earnings were $1.42 a share with no interest charged to construction credits. In 1967, they rose slightly to $1.50 and this year probably will not exceed that figure. Therefore, the company's earnings for the past five years have been on a plateau. The price of the stock peaked in early 1965 at 42 when earnings were essentially overstated. The stock is now 45% lower, currently selling at 22 on the New York Stock Exchange. This decline is twice that of the utility average.

THE INVESTMENT OUTLOOK

To conclude my remarks, I'd like to comment briefly on the investment outlook or at least the investment philosophy which influences our actions.

Every investor is worried from time to time about inflation, war, and anxiety over possible devaluation of the dollar. Therefore, it is interesting to look at the experience of the British investor where these problems have been prominent for the past fifty years. During this period, Britain has had three labor governments, which devalued the pound three times, and was in a major war (which seems to have been lost, because of its great expense, although everybody thought it was won at the time). During this period, Britain lost her empire and her industrial trade supremacy. A study by a London Stock Exchange firm indicates that in the period from the beginning of 1919 to the beginning of 1968, an index of representative common stocks advanced from 100 to 980 or 5% a year. Dividend income rose 4% a year during this period. The cost of living rose an average of 2% a year, thus throughout the 50 years, the holder of stocks came out well, and certainly beat inflation. By contrast, the holder of British Perpetual 2 1/2% high grade bonds saw their price decline from 100 to 60, and their purchasing value decline from 100 to 24, so you see why we emphasize stocks instead of bonds in portfolios even though their current yeild is only half as great.

We agree with Paul Miller of Drexel, Harriman, Ripley that the economy and the stock market over the next five to ten years will probably be dominated by a completely different set of circumstances than what we have thus far seen in the post war period.

Since 1948, the dominant force in both the economy and the stock market has been the cold war and its direct and indirect effects. The launching of Sputnik, for example, coming as it did ahead of a successful U.S. launching, made us seriously question our educational process and technological superiority. If we've had any dominant national purpose since then, it has been the establishment of a technological and educational superiority, a scientifically oriented nation. This has had great effect on hundreds of small companies which have thereby been able to carve out a small niche based on technical competence, and many of them are currently speculative favorites.

Now there are very few who would question our technological superiority. Meanwhile, the U.S. and Russia have become noticeably less antagonistic toward each other. While any trends toward closer relations with Russia will have to await some conclusion to the Vietnam War and while such thoughts may have had a severe set-back by the Russian invasion of Czechoslovakia, certainly the possibility of a change for the better in our relationship has increased significantly over the last three years.

The United States has been awakened to its sociological problems in large cities. Is it not, therefore, likely that the dominant national purpose over the next ten years will be the sociological progress rather than technological? I agree with Paul Miller who feels that technological momentum will not necessarily lose its force or that technology has no place in solving our urban problems, but only that it will not be receiving the crash government programs, and fewer resources are likely to be devoted to research that is not economically based; that is, research that the private economy, when left to itself, would not perform. Technology will have to adapt rather quickly to these new goals, but such areas as construction and transportation have not typically been dominated by technologically oriented companies. We plan to do more work on the investment implications of these expected changes in the economic forces of our society.