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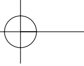

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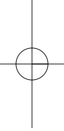

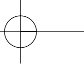
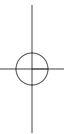

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CORE EARNINGS CALCULATIONS
A Revised Approach

Imagine going to your bank to apply for a loan and filling out an application on which you include a full year's estimated income as an account receivable. At the same time, you leave out several important liabilities. Even more unthinkable, imagine showing interest, dividend, and capital gains income based on what you *think* you are going to earn through investments over the next few years.

No self-respecting banker or underwriter would allow you, as an individual, to inflate your income and net worth with such moves. However, corporations inflate their numbers all the time. They include accounts receivable, offset by current income, often based not on the timing of delivery but on orders placed; they leave employee stock option expenses off their income statements; and they report

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estimated investment income for pension assets (the infamous *pro forma* income number that has caused such controversy).

Why do corporations get away with such liberal accounting interpretations when the same rules would be preposterous for individuals? One reason is that the rules (more precisely, the guidelines) under the GAAP system allow aggressive interpretations of the numbers on the part of our publicly listed corporations. Many of the traditional rules are under review, and the long, slow process of reform has begun. But it will take years. The GAAP system—as a decentralized collection of opinions, research papers, and general guidelines—does not reside in any one place. Rather, it is the combined body of knowledge of the accounting industry, led by the AICPA and FASB, but lacking any real authority to enact change.

The process of cleaning up the problems of GAAP will be slow. The consequences of the flaws in GAAP are glaring. These flaws have enabled many companies to overstate sales and net earnings and even to deceive stockholders through questionable and aggressive accounting decisions—with the blessing of the "independent" auditing process—to bolster stock prices and maximize incentive compensation to the CEO and CFO. Conflict of interest among executives *and* auditing firms led to most of the problems of Enron, WorldCom, and dozens of other publicly listed companies, and even to the sudden and rapid demise of Arthur Andersen.

The solution to the problems of how financial results are reported cannot be simple or quick. We need to depend on the SEC and state securities agencies to enforce the laws on the books, on the exchanges to police listing standards, and on corporate executives themselves to restore ethical practices to the boardroom and in dealings with auditing firms as well as with the public. In other words, fixing this problem is going to involve changes on many levels. Meanwhile, what are analysts, financial planners, and investors supposed to do to (a) protect their interests, (b) ensure reliability in the

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analyses they perform, and (c) offer advice and recommendations on an informed basis? If the very numbers are inaccurate, how can any form of fundamental analysis have validity?

Key Point: The inaccuracies found in financial reporting require long-term reform. In the meantime, investors and analysts need reliable ways to value companies whose stock they buy and hold. This is where core earnings adjustments become so important.

The solution is found in *core earnings adjustments*. By definition, core earnings are those earnings derived from the primary, or core, activity of a company. Looking at it from another angle, we can also conclude that core earnings are those earnings that can be expected to contribute to long-term growth. This distinction is at the heart of our discussion. Clearly, we cannot include income from discontinued operations, capital gains, or pro forma investment return in a long-term forecast of an earnings trend. At the same time, we cannot exclude substantial expenses like employee stock options if we are expected to identify the likely permanent long-term growth trend.

Standard & Poor's has begun using a calculation of core earnings to modify its corporate bond rating system. This is a significant change from previous methodology and, for some of our largest corporations, a chilling one. Many companies have included in their reported earnings a number of noncore items that, if excluded from the S&P bond rating analysis, may reduce ratings from investment grade down to questionable or even high-risk levels. This could affect long-term capitalization as well as immediate working capital; so the decision to make such adjustments is a serious one, and it demonstrates how serious the problem has become. The aggressive accounting policies employed by many companies have greatly inflated growth projections and, as a direct consequence, stock prices

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as well. Actual reform to GAAP may take many years, but analysts and financial planners need to be able to apply those adjustments to today's numbers in order to compare corporate value in real terms.

Applying the Core Earnings Idea

When you begin to critically review a company as a potential investment, one of the first things you check is the results of operations—revenues and earnings. Of course, you assume that the numbers themselves are accurate. But what if those numbers are inflated because they include nonoperational or one-time items? What if those numbers exclude significant expenses that, if disclosed, would drastically change your view about that company?

The very way that companies report earnings is flawed. Published income statements *should* provide you with a dependable roadmap to estimate likely growth and *should* be limited to only those items that are derived from operations. Under the current rules of GAAP, many nonoperational items are treated improperly; the rules allow these distortions, and you are expected to perform your detailed analysis based on what you are provided in an audited statement.

What does this problem mean to you? Many of the nonoperational items included as income or excluded from operational costs and expenses are material enough that the true profit picture often is far different than what you see. Later in this chapter, we provide some examples. This distortion of the true picture has led to the beginnings of a new but logical idea: companies would better serve their stockholders by reporting their results of operations on the basis of core earnings. Under this ideal, all core earnings items would be included in the report, and all noncore items would be left out. This does not mean that the excluded or noncore items are not valid

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forms of income or expense, but only that they should not be included in an analysis of long-term growth.

A reasonable premise is that any analysis you perform for the purpose of identifying stocks is more accurate if based on realistic numbers. Returning for the moment to the analogy of a personal loan application, your banker would expect you to provide a realistic summary of your income. If you had recently sold a boat and included the proceeds as "annual income," the loan officer would remove it, knowing that the proceeds are not part of your recurring annual salary. By the same reasoning, adjusting reported results of operations is intended to state corporate results on a realistic basis. Only with this adjustment can you calculate potential growth and compare one company to another. Without making an adjustment to arrive at core earnings, any comparison you make between companies, or from one year to the next for a single company, are likely to be distorted. If two or more companies have had differing noncore experiences during the year, a company-to-company comparison is also flawed. With core earnings adjustments, it becomes possible to make operational comparisons between those companies.

> **Key Point:** There is nothing mysterious about the premise underlying core earnings adjustments. It is the process of restating annual income on a *realistic* and accurate basis.

The Emergence of the Core Earnings Idea

The suggestion that nonoperational items should be excluded from results of operations is no small idea. In many cases, these adjustments will run into the billions of dollars in earnings. For example, among publicly listed companies reporting earnings in fiscal 2002,

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one dozen of the largest companies reported earnings that, when adjusted to actual core earnings, would have made downward adjustments exceeding $1 billion. Table 1.1 summarizes these.

These substantial adjustments are graphically illustrated in Figure 1.1. This figure shows in billions of dollars the amount of adjustment required to reported results to arrive at core earnings.

The S&P calculation has been used for these adjustments. As summarized in Table 1.1, the earnings numbers using traditional methods are drastically cut when adjusted to core earnings. Several companies' earnings are reduced by over 100% using the calculation.

The adjustment is not always downward. Some companies' earnings would rise under the S&P core earnings method. Big, positive changes applied for fiscal 2002 to AT&T (adjustment of $6.7 billion); JDS Uniphase ($3.2 billion); and Verizon Communications ($3.4 billion).[1]

Table 1.1 Core Earnings Negative Adjustments above $500 Million

Company Name	2002 Earnings (a)	2002 Core Earnings (b)	Difference
	(in $ mil)		
Boeing	2,107.0	–315.5	–2,422.5
Citicorp	15,930.0	13,708.8	–2,221.2
Du Pont De Nemours	5,069.0	–346.6	–5,415.6
ExxonMobil	10,590.0	9,527.0	–1,063.0
Ford Motor	–5,297.0	–8,412.7	–3,115.7
General Electric	15,158.0	11,225.4	–3,932.6
General Motors	1,829.0	–2,363.5	–4,192.5
IBM	5,657.0	287.3	–5,369.7
Lockheed Martin	378.0	–682.8	–1,060.8
Proctor & Gamble	4,228.0	2,870.2	–1,357.8
SBC Communications	6,872.0	4,107.6	–2,764.4

(a) Earnings for fiscal years ending in 2002, using traditional reporting methods, for corporations whose core earnings adjustments exceed negative $1 billion for the year
(b) Core earnings for the same period, as defined by S&P Corporation

Source: *BusinessWeek* online, 2002 index

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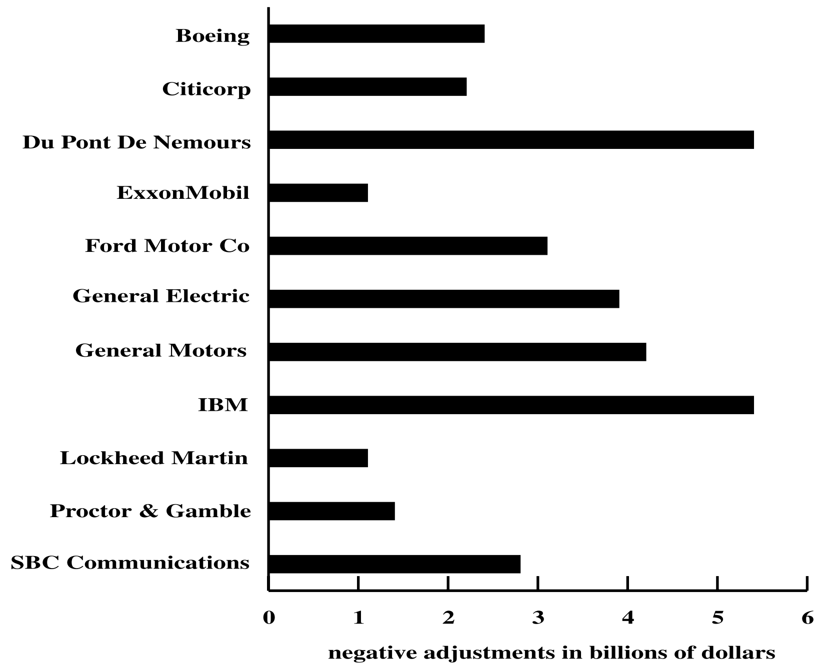

Figure 1.1 Core earnings negative adjustments above $500 million. (Source: original graph derived from information on *BusinessWeek* online, 2002 index.)

Core earnings adjustments serve not only as a means for reflecting operating results on a purely operational basis: the degree of adjustment tells us far more for the purpose of analyzing a corporation as a potential investment. The more liberal the accounting interpretations of a corporation, the larger the likely core earnings adjustments. So, in comparing one corporation to another, you can often draw a conclusion about the quality of accounting by the degree of core earnings adjustments required. This means that the adjustment itself can be used as a comparative fundamental indicator. When used in conjunction with other indicators, it is one of the many pieces of the puzzle. (We present much more on the topics of discovering, interpreting, and confirming trends in Chapters 2, 3, and 4.) The point to be made here is an important one: *corporations whose operating*

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results are inflated with nonoperational items are serving investors poorly; in comparison, those corporations requiring little or no adjustment are acting in a far more conservative manner. Investors may view the degree of change required as a sign of the corporation's reporting policies. If they want to provide investors with an honest look at their results, they will have fewer core earnings adjustments. If they wish to inflate their earnings, then their core earnings adjustments are likely be higher as a consequence. S&P referred to its decision to apply core earnings adjustments as an "effort to return the transparency and consistency to corporate reporting."[2]

Corporate executives and auditors have traditionally been able to make adjustments such as deferral of costs and expenses, early booking of revenues, inclusion of favorable extraordinary items, earnings captured as part of mergers and acquisitions, optimistic estimates calculated under pro forma investment income within profit-sharing plans, and more. The purpose of such adjustments—all done within the rules—often has been to meet earnings predictions, continue favorable sales and earnings trends, and in general to keep the market price of stock at or above current levels. Augmenting these liberal accounting practices, the rules have also allowed corporations to include capital gains from sale of assets, profits from discontinued operations, and more in their operating profits. Even though these items distort the profit picture, the accounting culture, always slow to change, has not taken a serious look at the reforms needed to make financial statements accurate. GAAP is going to react to trends made within the industry rather than take the lead and require change.

> **Key Point:** GAAP is slow to change. Accounting conventions allow great latitude in interpretation, so we need to be able to identify core earnings so that our comparisons and forecasts are realistic.

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While corporations may continue to operate under liberal GAAP guidelines, we need to look to S&P and other services for the like-kind adjustments that enable analysis on a realistic basis. Many of the larger U.S.-based corporations, recognizing the change in the whole culture, have already taken steps to adjust their practices. The trend—whether followed voluntarily or not—is moving toward the use of core earnings as the basis for public reporting on the part of several listed companies.

For example, in July 2002, General Electric—whose core earnings adjustment under the S&P calculation was a reduction of $3.9 billion in fiscal 2002—announced that it would start expensing the fair value of employee stock options. The company also enacted a holding period on option exercises by senior management of at least one year and further required officers to accumulate and hold stock on a formula "equal to a specified multiple of their base salary."[3]

Another high-profile company, Microsoft, announced in July 2003 that it would end stock options altogether. Replacing the options program is the granting of shares of stock directly, which will be shown as an expense in the year granted. Some market experts predict that this change may be a trend among other companies in the future.[4]

Those corporations taking the lead in making change voluntarily—whether GAAP eventually catches up with such reform quickly or slowly—demonstrate one of two things: a commitment to strong corporate governance or the acceptance of an inevitable trend. The decision is not always an easy one. Corporations that voluntarily make core earnings adjustments could also see a decline in stock prices and perhaps an additional reduction in credit rating by S&P and other services. However, whether corporations actually book these adjustments or the adjustments are used simply to reevaluate the method of fundamental analysis, the outcome is the same: Planners and analysts will be able to review corporate reports in a

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new light, one based on a realistic valuation of earnings, rather than using the past method of merely accepting what was listed on the audited statements.

Key Point: Some companies will voluntarily change their reporting, while others will only do what is required and demanded of them. One criterion for identifying quality of management may be its policies regarding the new reporting environment.

A Premise for Stock Selection: Accuracy in the Financials

If you are to evaluate stocks based on fundamental analysis of the company, core earnings adjustments are critical to this process. You need to determine that your study is both accurate and complete and that any significant adjustments are made. Because the whole premise underlying fundamental analysis is an evaluation of capital strength and growth potential, core earnings have to be made as a first step.

In this and remaining chapters of the book, we isolate our examples to the major core earnings adjustments. These include stock option expense, pro forma gains from investing pension assets, revenues from discontinued operations, and gains from the sale of capital assets. The purpose in limiting our analysis is to show the material changes without the need for a highly detailed breakdown.

As we demonstrate throughout this book, finding the information you need to make core earnings adjustments is not difficult. By going online to the Web site of each company you wish to study, you can find all of the information you need under "investor relations" or a link with a similar name, and from there you can bring up the latest

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annual report. You can find the major core earnings adjustments on the income statement, statement of cash flows, and in the footnotes (where details are listed for pension income and expenses and for stock options). While making these adjustments takes some time and effort, it is not difficult to locate the information you need. By isolating your investigation to the major core earnings adjustments, you limit the need for a lot of details; and since you are likely to investigate only a handful of corporations at any one time, the effort is not a large burden.

Market Resource: As an alternative to doing your own research, you may want to subscribe to Standard & Poor's Stock Reports. This is worthwhile if you will need to make core earnings adjustments for more than just a handful of companies throughout the year. Annual subscription cost is $995. For more information, check the S&P Web site at *http://www2.standardandpoors.com* or contact the client support department at 1-800-523-4534 or 1-800-221-5277. The department can also be contacted by e-mail at *clientsupport@standardandpoors.com.*

Under the S&P definition of core earnings, the following adjustments are required:

Employee stock options. The dollar value of current-year stock options granted to employees is recognized as an expense under the core earnings adjustment. This may be a major charge to earnings in many instances where annual stock option value is a significant portion of the overall earnings for the same period.

Impairment of goodwill charges. This is the difference between the computed fair value of goodwill and its book value. Traditionally, *impairment* would be amortized as an expense over a period of years. However, in 2001, the FASB issued a ruling

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doing away with amortization of goodwill and creating a new annual test for impairment.[5]

> Goodwill, as an intangible asset, normally is established when ownership changes and is the value of brand names, product recognition, or reputation. Under the S&P definition of core earnings, no write-off is allowed for the computed difference between the value listed on the balance sheet and the impaired value.

Capital gains or losses. While these gains affect cash flow and corporate tax liabilities, under the definition of core earnings, capital gains or losses are removed from the net income calculation. This is appropriate, since they are nonrecurring as well as nonoperational.

Pension gains. One area that has been especially troubling for financial analysts is quantifying reported gains from pension asset investments. Companies base their income on expected rates of return—pro forma profits—which often have no basis in reality. The actual returns on plan assets are not used exclusively to report such income. Thus, there is a large gap between reality and what is reported. As a consequence, large numbers of corporate pension funds are underfunded. Aggregate pension plans for the S&P 500 companies were underfunded by as much as $243 billion at the end of 2002.[6]

> Underfunded amounts are staggering for many companies. Estimates of underfunded dollars amounts include General Motors, $29.4 billion; Ford Motor Company, $14.3 billion; and Boeing, $6.8 billion. These large gaps in funding are at least partially due to poor market performance; however, the potential consequences on valuation cannot be ignored. About 30 companies are

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estimated to be underfunded by 25% or more of current equity market capitalization. In other words, pension plans in those situations have claims on over one-fourth of the shareholders' interest in stock value.[7]

With these potentially significant impacts in mind, reported pension gains are excluded from core earnings. To make financial statements even more accurate, corporations may eventually be required to adjust their reported equity by removing pension assets and liabilities from the balance sheet. In cases of underfunded plans, the effect would be a reduction in capitalization value, which would provide investors with a realistic view of the company's true valuation. We may refer to this adjusted value as *core net worth*.

Under the S&P calculation, service cost expense is allowed, but *expected* return on plan assets is excluded in the core earnings calculation. Interest cost is allowed, but only to the extent that it exceeds *actual* return on plan assets.

Reversal of prior year charges. Under GAAP, companies may adjust current earnings for reversals of prior year restructuring charges. Those credits are not recognized by S&P in the core earnings calculations. S&P recommends that as an alternative, those reversals are more properly used to restate earnings from prior periods, where those charges properly apply.

The effect of this decision is to limit current-period earnings to current-period activity. When companies reverse prior years' charges, it distorts today's core earnings, often making it difficult, if not impossible, for analysts to develop reliable trend analysis studies.

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Merger and acquisition fees. Under the S&P model, no adjustment is needed for fees associated with mergers and acquisitions, assuming that these activities are related to a company's primary business. While the question is not addressed specifically in the core earnings calculation, it would follow that if companies begin acquiring smaller companies whose business activity is *not* related to that primary activity, then associated fees should be excluded from core earnings. For example, between 1993 and 1995, Waste Management acquired 444 companies, most unrelated to core earnings.[8] Enron formed more than 800 off-shore subsidiaries and affiliates, a similar technique also aimed at distorting earnings. By excluding noncore merger and acquisition activities, the picture becomes far clearer.[9]

Litigation and insurance settlements. These are excluded because they are not part of core earnings. However, payments to settle lawsuits and related matters can be substantial. Companies are allowed to write off their litigation losses; these distort the year-to-year analysis of earnings and do not properly belong in the study of a company's principal business.

We propose that your investigation can be limited to adjustments for stock option expense, pension pro forma income, income or loss from discontinued operations, restructuring charges, and capital gains or losses from the sale of assets—as well as any other significant extraordinary and nonrecurring items. The handful of suggested adjustments usually constitute the major core earnings adjustments and are easily found on the financial statements and in the footnotes of listed companies. If you are already performing fundamental tests on corporate financial statements, the information is already available

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to you. The relatively small adjustments for goodwill impairment or relatively minor adjustments can be ignored, remembering that the purpose of these changes is to estimate the likely recurring levels, thus trends, in sales and earnings.

Examples of Core Earnings Adjustments

How difficult is it to calculate your own core earnings adjustments? If you restrict your analysis to the major adjustments, you can get the information you need from the Web sites of listed companies. Following are three examples of core earnings adjustments, all of which came from information found on online annual reports (normally located under the "investor relations" link on each site).

Proctor & Gamble

All of the information needed to make the major adjustments were found on the corporate Web site, *http://www.pg.com*—including footnotes.

As of the period ending June 30, 2002, the following information was reported on the company's 2002 Annual Report:

Outstanding shares (mil)	1,408
Price per share at year-end	$91
PE ratio	29
Net earnings per share	$3.09
Net earnings (mil)	$4,352
Benefit plan expected return less interest expense (mil)	$184
Stock options granted during the year (mil)	$529

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From this information, we calculate the following core earnings adjustments for current-year expenses as well as changes in earnings per share and PE ratio:

	YE 6/30/02 (in $ mil)	
Net earnings as reported		$4,352
Adjustments:		
Benefit plan adjustment	–184	
Stock option expense	–529	
Net adjustments to earnings		–713
Core earnings		$3,639

As reported, the EPS was $3.09 ($4,352 ÷ 1,408 mil). The new EPS is $2.58 ($3,639 ÷ 1,408). This also increases the PE for year-end from 29 to 35.

JPMorgan Chase

All of the information needed to make the major adjustments were found on the corporate Web site, *http://www.jpmorgan-chase.com*—including footnotes.

As of the period ending December 31, 2002, the following information was reported on the company's 2002 Annual Report:

Outstanding shares (mil)	2,053
Price per share at year-end	$25
PE ratio	31
Net earnings per share	$0.81
Net earnings (mil)	$1,663
Benefit plan expected return less interest expense (mil)	$(126)
Stock options granted during the year, key employees (mil)	$1,938
Stock options granted during the year, other employees (mil)	$1,199
Stock options granted during the year, total (mil)	$3,137

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From this information, we calculate the following core earnings adjustments for current-year expenses as well as changes in earnings per share and PE ratio:

	YE 12/31/02 (in $ mil)	
Net earnings as reported		$1,663
Adjustments:		
Benefit plan adjustment	–126	
Stock option expense	–3,137	
Net adjustments to earnings		–3,263
Core earnings		$–1,600

As reported, the EPS was $0.81 ($1,663 ÷ 2,053 mil). The new EPS is $–.78 ($–1,600 ÷ 2,053). Because this is a loss, the core-earnings-based calculation has no PE.

Bristol-Myers Squibb

All of the information needed to make the major adjustments was found on the corporate Web site, *http://www.bristolmyers.com* —including footnotes.

As of the period ending December 31, 2002, the following information was reported on the company's 2002 Annual Report:

Outstanding shares (mil)	1,936
Price per share at year-end	$27
PE ratio	25
Net earnings per share	$1.07
Net earnings (mil)	$2,066
Benefit plan expected return less interest expense (mil)	$130
Stock options granted during the year (mil)	$446

From this information, we calculate the following core earnings adjustments for current-year expenses as well as changes in earnings per share and PE ratio:

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	YE 12/31/02 (in $ mil)	
Net earnings as reported		$2,066
Adjustments:		
Benefit plan adjustment	–130	
Stock option expense	–446	
Net adjustments to earnings		–576
Core earnings		$1,490

As reported, the EPS was $1.07 ($2,066 ÷ 1,936 mil). The new EPS is $0.77 ($1,490 ÷ 1,936). This also increases the PE for year-end from 25 to 35.

The three examples with core earnings adjustments are summarized in Table 1.2.

With these adjustments made, the companies can be compared to one another on the same post-core-earnings basis. Corporate results for each company can also be compared from year to year on the same adjusted basis. One of the chronic problems in fundamental analysis has always been year-to-year comparisons. With one-time charges, profits from discontinued operations, and other

Table 1.2 Core Earnings Summary, Three Examples

Company name	Net earnings	Pension income	Stock options	Core earnings
	(in $ mil)			
Proctor & Gamble	4,352	–184	–529	3,639
EPS	*3.09*			*2.58*
PE	*29*			*35*
JPMorgan Chase	1,663	–83	–1,938	–358
EPS	*.81*			*–.17*
PE	*31*			---
Bristol-Myers Squibb	2,066	–130	–446	1,490
EPS	*1.07*			*.77*
PE	*25*			*35*

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nonoperational changes between reporting periods, it may be difficult to develop a reasonable estimation of future growth trends. With core earnings adjustments, the values being studied are isolated to only those items we can expect to recur.

Long-Term Direction in Corporate Valuation

In our post-Enron investing environment, we may expect to see new trends both in how investing works and in how corporations report their results. Even the structure of the market itself is under review in the spirit of reform and reevaluation.

The New York Stock Exchange, for example, has traditionally been viewed uncritically as the most important trading center in the United States. The lower costs and less formal rules associated with the NASDAQ have put the NYSE under scrutiny. Today, the role of the exchange—and of all exchanges, for that matter—has merged from the relatively simple exchange functions into a combined exchange-and-regulatory function. The exchanges have a duty to regulate member companies, and through listing standards and enforcement of federal and state laws, the exchanges are beginning to take a more active and aggressive role in enacting and enforcing rules.

In this changed market environment, not only are the exchanges undergoing change, but planners and analysts are also taking a new look at the very assumptions used in making important financial decisions. The use of core earnings is perhaps the most significant step in this new trend; but at the same time, older methods are coming under question as well. For example, it was assumed for many years that the calculation of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) was a valid method for identifying cash-based results for companies. This assumption is questionable, and we now realize that it is very inaccurate.

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The most vigorous attempts at placing a fair valuation on a stock investment may be elusive and difficult for even the most skilled analyst. In the past, EBITDA was recognized by many analysts, accountants, and investors as a necessary adjustment to arrive at a reasonable definition of cash-based profit (cash flow versus earnings). The intention under EBITDA was a good one: remove the nonoperational expenses (interest and taxes) and add back the noncash expenses (depreciation and amortization), and the result will be a realistic cash-based, true operating net income number.

The problem, of course, is that EBITDA begins with some flawed assumptions. First of all, there is far more to what is included in "earnings from operations" than as calculated under the EBITDA system. The pro forma income from profit-sharing investments, unexpensed employee stock options, capital gains or losses, reversal or reserves for acquisitions, and other possible core earnings adjustments all have a significant effect on earnings and still pass through the EBITDA formula untouched. Secondly, the adjustments made for amortization and depreciation do not place revenues on a truly cash basis. In any review of working capital, it becomes evident that a massive shift in inventory, accounts receivable, accounts payable, and other current assets or liabilities also have a significant impact on earnings. For example, a change in assumption concerning bad debt reserve or inventory loss reserves may easily alter reported earnings.

Key Point: EBITDA served a useful purpose in the past in some respects. Under the current environment, though, it is of no real value.

Originally developed to enable analysts to review corporate earnings on a like-kind basis, EBITDA is now recognized as a deeply flawed system. The accounting adjustments that are allowed under GAAP make EBITDA less than adequate to create a fair reporting system. For example, in 2002, WorldCom disclosed that it had

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inflated earnings by $3.8 billion when it capitalized operating expenses rather than writing them off. Under EBITDA, not only would current earnings be inflated, but future amortization would be added back to earnings as well. Thus, the whole adjustment would have disappeared forever.[10]

We can see how an EBITDA adjustment would change the numbers for the three corporations used previously as examples to demonstrate how drastically the whole picture would change. All of the data in Table 1.3 are from the previously cited Web sites for the companies.

Under the calculation of core earnings, EPS fell in all examples. This is a reliable premise, since net earnings as reported included noncore transactions. Under EBITDA, the earnings picture is inflated. Considering the degree of change for these noncash and nonoperational adjustments, the level of change from reported earnings is enormous. However, it is not realistic to assess a company's earnings pretending that interest, taxes, and depreciation/amortization are not part of the overall equation. The original intent of the EBITDA adjustment, which can be traced back to the 1980s when leveraged

Table 1.3 EBITDA Adjustments, Three Examples

Description	Procter & Gamble	JPMorgan Chase	Bristol-Myers Squibb
	(in $ mil)		
Reported net earnings	$4,352	$1,663	$2,066
EPS	*3.09*	*.81*	*1.07*
PE	*29*	*31*	*25*
Interest	603	13,758	410
Taxes	2,031	856	435
Depreciation and amortization	1,693	3,426	735
EBITDA-based earnings	$8,679	$19,703	$3,646
EPS	*6.16*	*9.60*	*1.76*
PE	*15*	*3*	*15*

buyouts complicated the evaluation of profitability, no longer seems applicable to the fair evaluation of long-term investments. In the 1970s, EBITDA appeared to offer the solution to buyout potential valuation, adjusting all reviewed companies to the same cash-income assumed basis. As long as amortization of big-ticket reserves was included in the buyout, profitability was obscured and distorted. However, EBITDA does not stand up well under today's accounting environment, especially when compared to a more in-depth analysis of core earnings. In today's market, according to Moody's Investors Service in a 2000 report:

> ...the use of EBITDA has evolved from its position as a valid tool at the extreme bottom of the business cycle—where it was used to assess low-rated credits—to a new position as an analytical tool for companies still in their halcyon days.[11]

Closely related to EBITDA is the calculation of pro forma earnings. Pro forma has been defined as "a figure excluding some revenue, expense, gain, or loss that is required to be included in net income under GAAP, or includes some items not permitted or required to be included by GAAP."[12]

If this definition sounds like a rationale for tinkering with the books, there is good reason. The whole pro forma approach to reporting earnings came under fire shortly after the corporate scandals came to light; like EBITDA, pro forma was abused in many cases. Because there is no precise formula or definition to pro forma, it has served in the past to justify any adjustments corporations wished to make—as long as they explained those adjustments away as pro forma. The report "Pro Forma Earnings: A Critical Perspective" issued by Bear, Stearns supports the use of pro forma, citing the well-known book *Security Analysis* (Graham & Dodd), the

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FASB, and even the SEC.[13] However, none of their citations specifically endorse pro forma as a method worthy of use. Analysts have been criticized in the past for misusing pro forma results to inflate their buy recommendations.

Accounting Problems and Stock Selection

We constantly struggle with the question, What is a dependable method for consistently selecting stocks? We have come to depend on audited financial statements as the basis for finding fundamental trends. The Enron age has reminded us that this basic assumption may not be dependable after all and that making decisions based on audited financial statements could place us at risk.

It has always been the unspoken rule that pointing out the inaccuracies in accounting practice was off limits. Everyone knew, or at least suspected, that a lot of manipulation was done as a matter of course; and those familiar with GAAP further understood that the rules allowed flexibility in interpretation and reporting. But we have also assumed for many years that to the extent the numbers were manipulated, at least the auditors were ensuring that the financial reports were accurate within an acceptable range. It has become clear that as part of the fundamental approach, we have to look at ratios not only to spot future trends but also to uncover questionable current and past financial relationships—if only to raise questions about the reliability of the numbers. Investors must police the accounting industry, because it is clear that even the audited financial statement is not above suspicion.

That is where core earnings adjustments are valuable; these adjustments eliminate many of the areas where past abuses have distorted financial statements, such as in pro forma earnings from

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invested pension assets, for example. So, while core earnings adjustments do not address all of the problems associated with the accounting industry, they do address many of the areas where subjective interpretations have become a problem in the past.

Key Point: It is the very flexibility of GAAP that has led to so many accounting problems in the past. Abuse occurs, though, when isolated cases of questionable interpretation become recurring annual policy, and distortion in accurate reporting results.

Investors want and deserve realistic reports, and defining core earnings is the most reliable and consistent way to achieve that reality. In order to judge the likely earnings and, by association, future investment value, investors must be able to judge how core earnings growth will occur in the future.

The first problem in stock selection has been reliability in the very numbers we depend on for fundamental analysis. As we move through a period of reform, we need to rely not only on better policies and stricter enforcement, but also on our own sense of how trends are changing (see Chapter 2). We must use fundamental analysis to verify, rather than merely accept, the numbers presented by corporations and auditors.

Core earnings adjustments are, in effect, a return to simplicity. Corporations will continue to take tax write-offs for noncore expenses and will continue to enact changes in accounting methods. In part, much of the creative accounting practice that invaded the corporate culture grew from the complexities of federal taxation. However, to the extent that it crossed over into what was reported to shareholders, it got out of hand, to say the least. Deception and liberal interpretation became the rule in an environment in which the expectation had been disclosure and conservative reporting.

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By applying core earnings adjustments, corporate reports will be simplified and noncore transactions discarded for the purpose of analysis. Once this idea is clarified and applied universally, investors will be better able to use fundamental analysis to identify growth potential with a clear field in view. The development of core earnings may create a *third* form of accounting convention. We currently have statutory-basis reporting (the form allowed under the tax rules) and GAAP reporting (the loosely organized but broadly applied series of conventions and standards aimed at improving overall accuracy and consistency), which also includes possible adjustments under EBITDA and the use of pro forma methods to set income valuation. The third form of accounting may be called CEA, or Core Earnings Accounting. As S&P continues to revise its proposed standards, *and* as the company uses its core earnings adjustments to rate those corporations it tracks, it is likely that other organizations (such as Value-Line, for example) are likely to follow suit. A trend has already begun in which some corporations are making core earnings adjustments voluntarily, recognizing the validity of reflecting core-earnings-based reports to shareholders, even when accounting rules do not require such adjustments.

Fundamental versus Technical Approaches

The question of how to apply core earnings adjustments has to also take into account likely effects of such changes on market price of stock. Even if that effect is only short term, it may also radically change the way that we view stocks and their growth potential.

For example, if a corporation reports net earnings year after year, we may develop a sense of confidence in that stock, at least to the extent that earnings are a primary fundamental indicator that is

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followed each year. Of course, earnings serve as one of the primary indicators, and the Wall Street obsession on earnings is well known. The predictions made by analysts about quarterly earnings per share are followed carefully by "the street" as a most important measurement of corporate performance. In fact, the analyst's prediction (and how close actual EPS comes through) often is viewed as more important than longer term growth prospects—at least to the extent that the accuracy of those predictions is factored into stock prices.

At the point that the analyst's prediction becomes a primary indicator of "good" or "bad" results, the fundamental significance of *earnings* has already been lost. This crossover from fundamental to technical is dangerous. Even the most serious fundamental analyst can easily be distracted by short-term reaction to earnings predictions and may easily lose sight of more important trends.

Without making core earnings adjustments, the apparently strong EPS of a company could be far weaker than it first appears. In many instances, core earnings adjustments drastically reduce EPS and may even change a reported profit to a net loss. Of course, core earnings are the isolated earnings from operations, so one argument could be made that the corporation in question did, in fact, earn the reported profits. However, with the long term in mind, it is equally valid to recognize that nonoperational profits are not going to recur year after year and that the exclusion of items such as employee stock options makes reported profits inaccurate. So, core earnings adjustments are not merely theoretical for the fundamental investor. These adjustments can serve as the basis for realistic analysis and not merely as an alternative way to look at the numbers.

Is there a conflict between fundamental and technical? Of course. If you decide to watch price trends without also identifying what is going on in the fundamentals, then this limits your information. If a corporation is not making core earnings adjustments voluntarily,

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both fundamental and technical indicators are unreliable. The technician will be just as interested as the fundamental investor in seeing how core earnings adjustment affects stock prices. To the extent that reported results are less than accurate under traditional methods, the market price is going to be distorted as well. The technical analyst who tracks only price information is dealing in short-term trends only. How much faith would that investor take in the trends upon realizing that reported EPS was far off?

The reality is the same for both fundamental and technical sides: Core earnings are the most reliable and accurate format for tracking earnings and for identifying likely long-term growth. Even the technician, interested only in price trends, has to realize that price is also affected—in positive or negative ways—by inaccurate fundamental reports. Fundamental investors cannot completely ignore technical trends, and the opposite is true as well. Technical analysts who recognize the potential inflationary effects of overstated earnings will be interested in calculating the possible effects that core earnings adjustments would have on price. In fact, when price is inflated as the result of overstated earnings, the technical investor may be able to take advantage of the aberration through short selling, covered call writing, or put option speculation—as examples of how technicians and speculators may make profitable use of the situation.

Fundamental analysts who are aware of the importance of core earnings adjustments may also track technical indicators to identify the effect between earnings and market price. For example, monitoring price volatility is a smart way to monitor how EPS interacts with technical market trends. A stock with historically narrow trading range trends may enter a period in which support and resistance levels begin to expand or in which a price breakout occurs. With an awareness of core earnings in comparison to reported earnings, even the fundamental investor will be able to make short-term decisions based on growing price volatility. As one of many methods for confirmation

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(see Chapter 4), technical indicators may help you to verify or even contradict an apparent fundamental trend.

For example, if you are tracking a series of fundamental indicators and you see a departure from the established trend, seek confirmation of the apparent change by checking related ratios. If sales increase without explanation, you may see a corresponding increase in accounts receivable balances. Does this mean the company is booking earnings too early or too aggressively? The change requires further investigation. However, at the same time, if you also see increases in price volatility, that technical indicator could confirm your suspicion that something is not right with the reported fundamental trends. When fundamental and technical indicators are used to verify (or contradict) one another, both gain in value. The debate as to which type of indicator leads the other becomes less important; both sides may ultimately recognize that fundamental and technical trends are intertwined and directly connected.

On a practical level, it is difficult to confirm fundamentals using technical information on a day-to-day basis. The fundamentals are often months old by the time they are available to you, whereas technical information changes on a day-to-day basis. The comparison is valid, though, in evaluating a stock with historical perspective. For example, you may be trying to quantify the investment value of a stock with a review of the fundamentals for the past three years—perhaps the appropriate starting point. By including historical reviews of price trends along with the fundamental trends, you improve the scope of your review. When you recognize changes in price volatility, tests of support or resistance, and other important price trend alterations, you might also find a correlation to ongoing fundamental changes during the same period.

The problem in connecting fundamental and technical is one of timing. You cannot use fundamental trends to track stocks day to day

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any more than you can use technical trends to identify long-term growth. The fundamental trends are more applicable for long-term analysis. Your fundamental approach will be more accurate when it is based on post-core earnings adjustment numbers rather than on the unmodified GAAP numbers. To the extent that technical information helps to explain recent trends, it can be useful as well—not for current short-term market timing but as confirmation of what you see in the adjusted fundamentals.

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