

### Ahead Of the Tape

—Today's Market Forecast—

By JUSTIN LAHART

#### Black Boxes

■ Sure, hindsight is 20/20. But if investors in American International Group had doffed their rose-colored glasses a little earlier, they might have seen things for what they were.

On Monday, California Treasurer Phil Angelides said he was pushing for the state's two big pension funds to recover the money they'd lost on AIG stock since

#### Uninsured Losses

AIG's daily closing share price on the NYSE

Yesterday's close: \$53.20 up \$1.10



Source: Thomson Datastream

possible accounting irregularities surfaced at the company in February. The move against AIG follows a similar action from Ohio's attorney general after the scandal broke. One can guess that similar actions from other states, along with shareholder lawsuits, will follow.

For years, naysayers have said AIG's steady, double-digit earnings growth didn't match what they saw as a choppy set of businesses. The company is a leading seller of property-casualty insurance (think hurricanes and toxic-waste cleanups) and also is a large trader of volatile commodities and currencies. But as a whole, investors focused on AIG's numbers, and liked what they saw, giving its stock a richer valuation than its peers'.

Investors don't like choppy earnings. Not only are they harder to forecast, they increase the risk that a company will have a major shortfall. Even within the confines of accounting rules, companies have plenty of opportunities to smooth out their earnings. As Lehman Brothers accounting specialist Robert Willens puts it, "Financial statements are fraught with assumptions, estimates and contingencies."

That is especially true of financial companies. Banks and insurers can push up the amount of money they put into reserves for losses—from bad loans or policy claims—during fat times and then push it down during the lean times. Tweaking the numbers isn't the only way to smooth earnings. Companies can spend more or less on advertising and research and development and even defer maintenance, says Duke University finance professor Campbell Harvey. In many cases, it may not matter that such decisions can have obvious long-term consequences: In a late 2003 survey of 401 financial executives conducted by Mr. Harvey with his colleague John Graham and the University of Washington's Shiva Rajgopal, 78% of the respondents said they would give up economic value for smooth earnings.

The upshot may be that there are very few major companies in the U.S., if there are any at all, whose underlying businesses are as smooth as their earnings make them appear.