AUTUMN 2004 SEMINAR PROGRAM

La Quinta Resort and Club, La Quinta, California
Sunday, October 17, 2004 to Wednesday, October 20, 2004

DANGER

INVESTMENT
CHALLENGES
AHEAD!

ASSET - LIABILITY MANAGEMENT
and
THE TWILIGHT OF TRADITIONAL ANALYSIS

THE INSTITUTE FOR QUANTITATIVE RESEARCH IN FINANCE®

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statement would:

- Separate cash flows and accruals
- Classify accruals by level of uncertainty
- Provide a range as well as the most likely estimate for each accrual
- Exclude arbitrary, value-irrelevant accruals
- Detail assumptions and risks for each line item

For example, medium uncertainty accruals would include uncollectible receivables, warranty obligations, and restructuring charges, while high uncertainty accruals would include defined benefit pension expense and employee stock options. Such a statement would not only help investors make valuation decisions but would also make it easier for boards of directors to champion executive compensation plans that reward long-term value creation. Rappaport pointed out benefits for managers of closed-end funds and, to a lesser extent, for open-end managers.

In terms of incentives for corporate executives, he described indexed-options plans where the executive's performance is compared with peer group indexes, something that has been proposed for some time but adopted by almost no companies, and a somewhat more complex incentive that takes the form of discounted equity-risk options (DEROs) for companies unable to construct a peer index.

In closing, he made no claim that he has a clear and precise prescription for correcting what he identified as the unsatisfactory obsession with short-term performance, but believed that the direction in which his proposals pointed was correct.

7. The Economic Implications of Corporate Financial Reporting

Campbell R. Harvey, J. Paul Sticht Professor of International Business, Fuqua School of Business, Duke University, had made available a paper by himself, John R. Graham and Shiva Rajgopal entitled: "The Economic Implications of Corporate Financial Reporting."

His presentation was based on the results of a survey of chief financial officers leading to 401 usable responses, and interviews with 21 CFOs. This was the third major survey conducted by the authors. The first, on capital structure and project evaluation, was published in 2001 and the second, on dividend and repurchase policy, in 2004. He described in some detail the methodology of the project. The specific goals were:

Gain Insight on the following issues:

- Importance of reported earnings and earnings benchmarks
- Are earnings managed? How? Why?
  - Real versus accounting earnings management
  - Does missing consensus indicate deeper problems?
- Consequence of missing earnings targets
- Importance of earnings paths
- Why make voluntary disclosures?

In a broader sense, the objective of the survey was to examine assumptions, to learn what people say they believe, and to provide a complement to the usual research methods: archival empirical work and theory. Harvey believed it was important to distinguish these objectives from the predictive goals of "positive economics." He also described the extensive efforts that had gone into designing and testing the survey instrument.

Discussing specific findings, he began with earnings benchmarks. The four most important benchmarks (in order of importance) against which quarterly EPS would be judged in the opinion of the CFOs, were same quarter last year, analyst consensus forecast, reporting a profit (against a benchmark of 0) and previous quarter EPS. The analysts consensus was relatively more important for firms with more analysts, firms that give analysts some guidance with respect to future EPS, large firms, and more levered firms. The reasons given why meeting earnings benchmarks was important were (in order of importance) to build credibility with the capital market, to maintain or increase stock price, for the external reputation of management, to convey future growth prospects to investors, to reduce stock price volatility, to assure stakeholders the business is stable, to achieve bonuses for employees, to achieve a desired credit rating, and to avoid violating debt-covenants. Eighty-six percent of CFOS said that meeting benchmarks "builds credibility" and 80% said it maintains or increases the stock price.

Describing the consequences of missing benchmarks, respondants said (listed in order of number of respondants) this creates uncertainty about our future prospects, outsiders think there are previously unknown problems, we have to spend time explaining why we missed, it increases scrutiny of all aspects of earnings releases, outsiders might think the firm lacks flexibility, and it increases the possibility of lawsuits. Harvey continued with the consequences of missing benchmarks with some quotations from CFOs.

Turning to actions taken to meet benchmarks, (in order of popularity) these were: decrease discretionary spending (e.g. R&D, advertising, maintenance, etc.), delay starting a new project even if this entails a small sacrifice in value, book revenues now rather than next quarter (if justified in either quarter), provide incentives for customers to buy more product this quarter, draw down on reserves previously set aside, postpone taking an accounting charge, sell investments or assets to recognize gains this quarter, repurchase common shares, and alter accounting assumptions (e.g. allowances, pensions, etc.). There was much more support for actions entailing a sacrifice in the value of the corporation than for accounting actions. Explaining this choice, CFOs indicated that any hint of accounting questions could have a devastating effect on stock prices. They were more willing to admit to real actions, and auditors could not second guess real actions.

The responses to a hypothetical scenario were particularly interesting. The hypothetical was a company with a cost of capital of 12%, a new opportunity near the end of the quarter offering a 16% rate of return and the same risk as the firm, and analyst consensus EPS estimate of $1.90. Five scenarios assuming the actual EPS if the project were (1) pursued and (2) not pursued called for an estimate of the probability that the project would be pursued. A surprising number of participants would reject the project just to beat, rather than simply meet, the consensus estimate. The explanation seemed to be a wish to preserve some "cushion" in case of an adverse development before the quarter end. In general, there was a very strong inclination to protect at least the consensus estimate.

Harvey turned next to the smoothing of earnings. Almost all of those interviewed preferred smooth described the extensive efforts that had gone into designing and testing the survey instrument.

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Harvey turned next to the smoothing of earnings. Almost all of those interviewed preferred smooth earnings to more volatile earnings if cash flows remained constant. In order of popularity, the reasons for smoothing were: The company is perceived as less risky by investors, it is easier for analysts/investors to predict future earnings, it assures customers/suppliers that business is stable, reduces the return that investors demand (i.e. smaller risk premium), promotes a reputation for transparent and accurate reporting, conveys higher future growth prospects, achieves or preserves a desired credit rating, it clarifies true economic performance, and increases bonus payments. It seemed that the sacrifices that would be made to achieve smoothing were somewhat less than those that would be made to achieve meeting a benchmark.

In identifying those who had the greatest impact on the stock price, the CFOs said institutional investors first, and analysts second.

8. Accounting and Stock Selection: A Survey

Brett Trueman, Professor of Accounting, UCLA Anderson Graduate School of Management, began his presentation with the observation that there appear to be accounting anomalies that can be exploited for excess returns. Many investors do not fully appreciate these anomalies and/or do not act on them quickly enough to profit. The returns occur mostly around future earnings announcement dates, and they are not explainable by risk. If the market is inefficient with respect to reported earnings, it might well be inefficient with respect to other accounting information, and Trueman proceeded to review a variety of published research.

In general the studies were characterized by a sample period extending from the 1960s into the 1990s. The abnormal returns were measured by market-adjusted returns, size-adjusted returns, and intercepts from the Fama-French 3-factor model. The returns were robust to risk adjustments and were often clustered around future earnings announcements.

Previous speakers at the seminar had referred to the different significance of cash flow and accruals that make up earnings. Trueman observed that investors appear not to fully understand the differences. It turns out that firms with high (low) accruals earn negative (positive) abnormal returns.

In Sloan's research, accruals were defined as: (change in current assets – change in cash) – (change in current liabilities – change in short-term debt – change in taxes payable) – depreciation and amortization expense. Firms were partitioned each year into deciles according to the magnitude of accruals, and the measured return period began four months after the fiscal year end. The hedge portfolio (lowest accrual portfolio minus highest accrual) returned 10.4% in the first year and 4.8% in the second.

The next variable of interest was growth in net operating assets (NOA). Accruals measure growth in short-term NOA. The question now was whether the accrual anomaly extended to growth in long-term NOA. Fairfield and others found that there was no significant difference between accrual and long-term NOA asset portfolio returns.

Hirshleifer and others tested the earnings implications of current NOA to find that high (low) current NOA is associated with high (low) past earnings growth but slower (faster) future earnings growth.

Daniel and others over a sample period 1964-2002 found that the hedge portfolio (lowest NOA portfolio minus highest NOA) produced abnormal