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REFILE-SAFT ON WEALTH-CFOs see earnings shenanigans in 20 pct of U.S. public firms: James Saft

(Refiles to remove superfluous apostrophe from headline)

By James Saft

(Reuters) - If you think the fact that a U.S. company's earnings conform to accepted standards means they are to be trusted, then allow me to introduce you to the 20 percent of chief financial officers who disagree.

A survey of nearly 400 chief financial officers and top finance executives found the belief that earnings misrepresentation is widespread.

"CFOs believe that in any given period a remarkable 20 percent of firms intentionally distort earnings, even though they are adhering to generally accepted accounting principles (GAAP)," Ilia Dichev of Emory University, John Graham and Campbell Harvey of Duke University and Shiva Rajgopol of Emory and Columbia University write.

"The economic magnitude of the misrepresentation is large, averaging about 10 percent of reported earnings." (here)

Think about that for a moment: a portfolio of 50 companies might include 10 which, though they are abiding by the letter of the regulations, are still giving a misleading view of their earnings and position.

Of the firms that do misrepresent earnings, two out of three overstate, with the remainder understating.

The survey polled 375 CFOs and others in equivalent positions, of whom a little less than half were at public companies. The authors also supplemented the data gathering with 12 anonymous, in-depth interviews with CFOs at large firms.

The CFO's themselves didn't give much credit to the existence or strength of an audit committee as a safeguard, giving them a low ranking in a listing of factors that influence earnings quality.

"I think you can fool them, but what the audit committee is essentially going to ask is whether the CEO and controller are basically honest people who are going to report faithfully," the report quoted one CFO as saying.

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"That's about all they can do at the end of the day."

If audit committees don't strike fear in CFOs, neither do regulators. Even lower on the list, second last, was the enforcement process of the Securities and Exchange Commission.

CFO's gave even lower marks to privately held companies, estimating that earnings are misrepresented among them 30 percent of the time. That's a statistic that ought to alarm both private equity buyers of private companies and private equity investors.

In some ways that gap makes sense. Private companies face less scrutiny from public analysts and regulators, making the chances of being caught lower. Interestingly, CFOs, while not rating the ability of sell-side equity analysts to sniff out trouble, were more complimentary about debt investors and analysts, who usually pay closer attention to cash flows and less to flashy "growth" stories.

WHO STOLE THE COOKIE FROM THE COOKIE JAR?

We have a pretty clear view of why companies misreport earnings. They do so to impress Wall Street and drive their stock price. There is also internal pressure, either as a means of rigging executive compensation or because they feel they face sanction if they report poor performance.

Similar motivations may be behind understating earnings. Companies may wish to stash away what one CFO termed "cookie-jar reserves," funds that can be tapped later to flatter earnings if they fall short. It is also possible, but not supported by this data, that executives sometimes wish to create downward volatility in share prices as a means of maximizing the value of the share options they hold.

That company insiders benefit from and work to game incentives that are against the best interests of shareholders is not news. The sheer extent of this, though, if this survey is reliable, is shocking.

A practical question for investors is how to sift high-quality earnings from lower-quality ones.

There is an old expression "cash flows never lie" and CFOs appear to agree. When asked to name red flags for misrepresentation more than a third emphasized the importance of seeing earnings that don't correlate with cash flow from operations, or firms which show strong earnings despite falling cash flow.

As Enron and others have proved, another thing to look out for is a firm that never puts a foot wrong at earnings season, always meeting or beating analyst expectations. Large or frequent one-time or special items, like restructuring charges, can also flash red.

The upshot of all of this is more caution and due diligence by investors. Theoretically, this information will lead, or already has led, to investors demanding a higher risk premium in exchange for bearing accounting risk. Since we don't have a benchmark for this particular survey from before Sarbanes Oxley regulatory changes more than a decade ago, it is hard to know if the trend is for more fibbing or less.

Good or bad, earnings are read with a gimlet eye and taken with a large dose of salt. (At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund. You can email him at jamessaft@jamessaft.com and find more columns at blogs.reuters.com/james-saft) (Editing by James Dalgleish)

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