AER

Atlantic Equity Research
Independent Research

U.S. corporate earnings growth 2003 – 2006 / S&P 500 miraculously experiences 10 plus quarter's of double - digit earnings growth – Helping to solve the mystery

By Joe Gagan

Atlantic Equity Research, LLC / March 22, 2006

Wall Street investment strategists have been aglow over the 10 plus quarters of double -digit earnings growth for S&P 500 companies. Corporate America's cash to debt ratio is the best it has been since the sixties. But things just don't feel that great for many people. Job growth coming off the recent recession in '01 has been abysmal, with the largest payroll company ADP experiencing negative to less than 1 % same store check growth from '01 through the first quarter of '04, three years after the recession supposedly ended in '01. A recovery has always meant job growth and organic sales growth, and that just hasn't been the case this time. In almost every industry except for consumer finance companies, the brokers, the banks, homebuilders, defense contractors, construction equipment companies and the energy and health insurance industries, there really hasn't been a lot of organic sales growth. And much of the revenue growth for health insurance and energy companies has come from skyrocketing price inflation.

How can there be such phenomenal earnings growth when so many industries aren't selling more products, and many American's don't have more disposable income to spend on products and services? Well, we all know about the incredible debt, and the usage of homes as ATM machines, but there is more to the earnings growth story than just massive consumer and government debt.

This mystery of the earnings growth story can be solved by understanding the financial engineering maneuvers put in place by companies between '02 and '06. The financial engineering I have identified comes in two forms. The first part of the equation is from a new accounting interpretation put in place by the accounting standards bureau, FASB, in '02, and the second part of the equation is the numerous various accounting or financial engineering strategies put in place by companies over the last three years to increase earnings without any real improvements to the economics of their underlying business.

History has proven eventually when financial engineering maneuvers are put in place, instead of real economic growth drivers, eventually everything just stops. I believe we are close right now to the end of the latest growth run, and I will explain why in this paper.

One of the most important aspects to consider when trying to understand and analyze earnings growth in the modern day American economy is that you have to understand the psychology of the players doesn't allow for "soft landings", as all the "bulls" demand there will be in the housing market. The system is set up so that there is an unquenchable, almost animalistic, barbaric drive to have growth at any cost. And if a CEO goes against this mantra he probably will be removed. You must understand the psychology of the players involved. They have been taught to win at all cost and to keep the game going and this why there are booms and busts, and scandals.

They never say, this is just not right, we better slow it down. It is all about growth, growth, growth, growth, growth.

Earnings numbers are a moving target – The key is to buy time for the next scam

According to a New York times story on March 1st in recent testimony, David Delainey, who headed Enron's energy division, said that at a meeting on October 16, 2000, John Skillings, was overwhelmed with emotion when Mr. Delainey told him that Enron's whole sale unit had $200 million to $300 million in "reserves" that would give Enron "flexibility for a few quarters" He gave me a hug Mr. Delainey recalled. These reserves of course would be later dropped into earnings, and probably sprinkled amongst divisions to make it look like every division was operating on all cylinders. In a stunning article in Barron's on December 26th just last year, Jack Welch, the former GE CEO was on the cover under the title "Jack Magic ". According to the article, Welch had under -reserved insurance reserves by $9.4 billion, which now had to be made up because GE was selling off its insurance re- insurance unit. Profits would have been flat over the last few years of the late nineties if Welch didn't under -reserve the reserves.

The Welch story has received almost zero traction in the financial press since the story went to print in December. Maybe this under- reserve issue is why GE's stock has gone no where over the last few years. And though the Skilling's and Ebber's accounting shenanigans happened before supposed reforms were put in place in '02, my research is telling me if anything accounting maneuvers around acquisitions is accelerating, and reserve reversals haven't slowed down at all. And there is a simple reason for this. In the nineties there was actual organic sales growth, and there was employment growth. Today, because there is very little organic sales growth, mergers and acquisitions are growing exponentially, and the strategy is to make money from cost cutting and accounting maneuvers.

Profit growth numbers issued by companies, like the economic numbers given out by the government are moving targets. When you think that there is no room fundamentally for growth, somehow they make it happen. The sell - side analysts issue their nice and neat 15 % growth estimates, and management is then expected to according to the new popular mantra in America "get it done". Mark Mcquire and Raphael Palmeiro are two baseball players who "got it done" via steroids. Colin Powell at the U.N. in '03 "got it done" via charts and lies. The CEO's "get it done" by using aggressive accounting maneuvers. What the goal becomes if business slows is to buy time until management can somehow figure out away to meet up and coming earnings targets. And that way is almost inevitably an acquisition. There are literally hundreds of accounting gimmicks that can allow a company to squeeze through a quarter to buy time until the next quarter. And this is why Skillings was so excited about being told about the reserves he now had to play with. He could buy time until he could concoct another scam. This game is played throughout corporate America on a daily basis. People who study earnings and cash flow numbers know that Sarbanes Oxley has done nothing to stop the financial engineering, and accounting gimmicks. Restatements of financial statements set all - time records last year.

Earnings growth strategy of corporate America '02 to '06 - how to "get it done"

FASB, the accounting standards board issued a new ruling for interpreting how intangible assets and goodwill are accounted for after an acquisition, which went into effect in January of '02. This new ruling, called statement 142, changed how goodwill and intangible assets will be amortized going forward. Instead of automatically amortizing goodwill over a 40 year period, and hence adding to expenses every quarter lowering earnings, companies are now supposed to conduct their own asset impairment test by doing a discounted cash flow analysis of the underlying assets. Surprise, surprise in most cases, in financial statement after financial statement, I keep on reading, "after conducting the appropriate tests we have concluded that assets aren't impaired", and an adjustment to goodwill, and hence an increase to expenses will not be required. And, I have run into numerous cases in which the company made acquisitions which turned out badly, but they still didn't take charges against goodwill. As most are aware, the number of mergers and acquisitions has been massive over the last two years, so not having to automatically amortize goodwill every quarter represents an automatic increase to earnings, giving an artificial growth stimulant.

According to data provided by Standard and Poor's, S&P 500 companies bought back a record $325 billion worth of their own shares in '05, up 64 % from '04, and up from approximately $110 billion in '03. This represents money that is not being invested in new capital equipment and new projects. This has the effect of lowering depreciation expenses, which of course increases earnings. It is not good for sales or job growth of course, but for the short term, it increases earnings per share by spreading earnings over fewer shares. Increasing EPS by buying back shares gets a lot of press, but adding to earnings by reducing deprecation costs because of lack of capital investment is rarely ever mentioned as an earnings booster.

Exhibit I

Income Statement Champion Enterprises –'99 –'04

	2004	2003	2002	2001	2000	1999
Sales	1,150,242	1,140,714	1,370,566	1,548,225	1,921,734	2,564,638
Cost of Sales	953,854	974,295	1,117,661	1,283,216	1,619,902	2,164,868
Gross Margin	196,388	166,419	192,905	265,009	301,831	399,770
SG & A	159,414	180,398	232,809	274,773	293,986	292,188
Mark to Market	5,500	3,300				
Charges	7,676	44,644	129,615	8,900	201,000	
Operating Income	23,798	-61,927	-169,519	-18,664	-193,155	107,582
Interest Expense	-17,984	-26,847	-26,353	-22,621	-27,177	-25,540
Income Before Taxes	5,814	-88,770	-195,872	-41,288	-220,332	82,042
Income Taxes	10,000	-5,500	53,500	-13,400	-73,000	32,000
Income from Cont. Operations	15,814	-83,270	-249,372	-27,888	-147,332	50,042
Discontinued Loss	1,197	19,814	-6,183	-27,888		
Net Income	17,011	-103,084	-255,555	-27,888	-147,332	50,042
EPS	0.19	-1.52	-5.09	-0.59	-3.12	1.02
Disc. EPS	0.02	-0.34	-0.13			
Diluted EPS	0.21	-1.86	-5.22	-0.59	-3.12	1.02

In the Exhibit above, the income statement for a company called Champion Enterprises provides a wonderful example of how the earnings game has been played over the last three years by many companies. The maneuvers used by Champion to increase earnings have been used by hundreds, if not thousand of companies across corporate America over the last three years. Notice the write -offs between '00 and '03. Many companies took the same type of the so called "big bath' restructuring charges between '00 and '03, and hence lowered the value of their assets, and reduced depreciation expenses moving forward which increased earnings. And while it was taking the big charges, Champion probably directed investors to look at the charge -offs as a one -time event, and to separate these numbers from their analysis of its earnings. Champion's depreciation expenses were significantly lower in '05 than what they were in previous years. Another, not widely known trick, which I am not sure if Champion used, is that after a company writes off its inventory, it can later resell that inventory, with the associated cost of good sold expense not against going revenues, so that the complete revenues drop right to the bottom line. Champion, when it started making money again in '04, reduced its tax rate to about 5 % from the standard 35 %, by using what is called tax loss carry forwards, which it was able to use because it experienced the big losses between '00 and '03. Many companies are paying at a lower tax rate because of losses they experienced during the downturn.

Many of the accounting maneuvers used by companies like Champion over the last few years have been used up, as obviously once you use accounting gimmicks like paying lower taxes, or lower deprecation expenses in one year, there is not the cost comparison advantage the next year. Also, because of the mergers and acquisitions, job cuts, and lack of capital investment there is just less employees and less businesses, which obviously means that there is less people to sell to, which is why there has been limited organic sales growth excluding the industries I outlined before. And once you sell written -off inventory once, you can't sell it again. So, once all the short term tricks are used, they can't be used again to propel growth, and they have come at the expense of true long term growth drivers such as investing in capital equipment or research and development. I think we are almost ready to come to a screeching halt for earnings growth as almost every trick in the book has been used over the last three years. But, as I have cited, the powers to be will not let this die without a fight. Right now in some building in New York someone is thinking of a ploy like the "American Job Creation act" or Y2K to keep the game going.