



Al Rosen
Between the Lines

For what it's worth

The third in an occasional series of Street-smart tips for vulnerable Canadian investors

Unfortunately, many investors have thrown the baby out with the bathwater when it comes to using reported earnings as a basis for investing. Without a doubt, income figures are easily pliable in the hands of deceptive corporate executives. But they also hold valuable information, and are the best valuation approach to use in some cases—after necessary adjustments have been made, of course.

The previous instalment in this series dealt with the pitfalls of investing based on reported cash flows. Many people think that cash flows are somehow reliable, or at least more so than reported income figures. In fact, cash flows are derived from income-based numbers and are just as easily manipulated.

Nevertheless, some investors cite hackneyed tales of such-and-such company continually beating quarterly earnings estimates by a penny a share, and then proceed to denounce all earnings figures in their entirety, with the presumed fallback being cash flows. Clearly, those cash flow figures come from the same cheating executives who are supposedly goosing earnings, but that doesn't seem to bother the cash flow zealots.

Another common beef with income-based valuations is that a multiple (or capitalization rate) is placed on earnings estimates to value an entity. Aside from the sometimes arbitrary nature of the multiple, critics claim that any manipulation in the earnings is magnified by the factoring.

Yet nobody in their right mind simply takes historical income figures and places a multiple on them to derive a value. Instead, investors generally dissect the historical figures, eliminate any distortions that don't reflect the economic operations of the company, consider a host of external factors that will impact the future, and then derive income projections from there.

In other words, estimating income is the same as estimating future cash flows. Thus, the errors and manipulations that influence earnings-based assumptions also creep into cash flow estimates,

and are just as easily magnified through the valuation process. In addition, cash flow valuations are just as sensitive to assumptions surrounding the discount rate as earnings-based values are to the multiple that is applied to income.

Indeed, placing emphasis on short-term earnings (or cash flows for that matter) has more to do with flawed investing principles than anything else. Therefore, ignoring earnings in favour of cash flows won't solve the problem. Swapping a long-term outlook for a short-term investment horizon does more to solve the problems inherent in both income- and cash-flow-based forecasts.

Complacency, though, should never set in. Investors still need to make material adjustments to the reported figures. It is easy to eliminate one-time gains and losses when they are separately broken out from operating earnings. It is harder to eliminate gains that may be buried higher up on the income statement.

For instance, reversals in arbitrary valuation allowances on income tax assets are sometimes buried in the cost of goods sold. This can positively skew the company's reported gross profit margin—a key performance metric that can influence income projections.

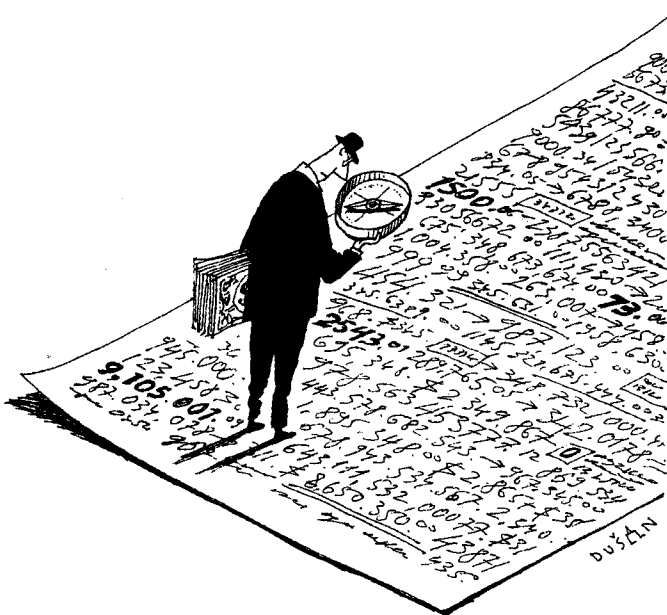
The only way to identify this problem (and several others that have been detailed in previous columns) is to sift through the notes to the financial statements, actively looking for analytical pitfalls.

In the end, however, the best valuation approach is a hybrid technique that focuses on the strengths of both earnings and cash flows. Examining cash flows can help to eliminate strange non-cash gains such as changes in valuation allowances, or pension credits that might be buried in the income statement figures. Likewise, looking at income statement figures can ensure that investors don't ignore the economic cost of the company's capital base, as recognized through depreciation expenses.

From an investment perspective, it is always best to use multiple valuation approaches whenever possible. The worst mistake is to simply ignore one possibility out of arrogance in favour of another equally flawed approach.

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