The Declining Quality of Corporate Earnings

April 01, 2023

Corporate accounting and the earnings reports issued by publicly-traded companies (that is, those that trade on the stock market) would seem to be a matter of simple mathematics. The company took in X amount of money, and its expenses in aggregate came to Y, and one might imagine that this tells us the earnings trajectory of the company (X today vs. X yesterday) and how profitable the company is (X-Y).

As it happens, accountants spend four years taking very challenging coursework that explores the many nuances of X-Y, and the surprising amount of subjective decision-making that goes into how companies can report their revenues and expenses. This matters because all of us read headlines saying that ‘corporate earnings are up,’ or that “ABC Company beat its estimates.” When you read that, or its opposite, you can be forgiven for imagining that the value of stocks is trending up or down.

The headlines today are talking about 'solid earnings,' which means growth above what was expected or above historical numbers. But corporate managers are under pressure to deliver good news about their companies in order to satisfy their shareholders and maintain their reputation in the marketplace, and they have lately been using their accounting creativity to dress up their balance sheets. Without getting into all the technical details of amortization and depreciation, carefully timed write-offs, and revenues booked before the payments are actually received, it appears that the managers have been working overtime to provide those positive headlines. A recent report by Bloomberg noted that companies, overall, reported 14% more income than cash flows in 2022 through September. For every dollar in reported profits, only 88 cents were matched by cash inflows—which the report says is the largest discrepancy since at least 1990.

The euphemistic term that analysts use is 'poor quality of earnings,' but you don't see that phrase in the headlines because explaining it would require some depth of reporting and an understanding of all those things that accountants learn in college. Bloomberg cites 'accruals' (where companies have the leeway to book sales they haven't been paid for yet) and counting inventory that is sitting unsold in warehouses as assets on the balance sheet. In one concrete example, homebuilder PulteGroup reported $2.6 billion in profits last year, but only took in $670 million of cash flows. The company had $2.3 billion worth of houses on its balance sheet that it had built but not sold.

Accounting tricks can only last so long before reality catches up to the balance sheet—and for some, it already has. Bloomberg reports that over the 12 months through January, 32% of the firms in the Russell 3000 Index fessed up to actually losing money, and such a widespread decline has happened only twice since 1978.

There is surely more to come. What all this means is that we should prepare for some bad news on corporate earnings at some undetermined point in the future, and not be surprised by it. Like all of us, companies go through rough patches and generally come out strong on the other side.

Source:

https://www.advisorperspectives.com/articles/2023/03/01/corporate-americas-earnings-quality-is-the-worst-in-three-decades

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