EDITOR'S CORNER

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Editor

Who's Minding the Store?

A host of transgressions, outbreaks of corporate malfeasance, accounting chicanery, and scandals in the mutual fund business—plus several timely articles in this issue of the *Financial Analysts Journal*—have prompted me to summarize some of my own musings on ethics in business and society.

Attorneys, investment managers, corporate boards, and officers—all serve as fiduciaries. The role of a fiduciary is to watch out for the interests of others, to earn recompense, often lofty, by serving this mission honorably. This involves placing the interests of others ahead of one's own interests. For example, board members view, and should view, an invitation to join a board as an honor, as a possible source of personal profit, and as a fiduciary obligation to the shareholders or unrepresented stakeholders. It is all of these. But honor and profit should take a backseat to fiduciary obligation.

A healthy capital market system hinges on trust. Trust hinges on ethical dealing and strong governance. Recent scandals in business ethics have far-reaching implications that go beyond the companies directly involved. The scandals gnaw at the very roots of a capitalist system. And these failures of governance invite the question: Who is minding the store?

Business and Societal Ethics

Business and politics are mirrors of society. Just as we elect "leaders" who reflect our own values (or pander to them), the business world tends to reflect current values. Thus, we need to improve the ethics of society at large before we can expect to improve the ethics of the business world.

Which leads to the broader question: How pervasive is corruption in society at large? The answers are worrisome.

- In a KPMG study, 76 percent of employees reported that they had observed a high level of illegal or unethical conduct at work in the past 12 months, 45 percent of employees admitted that they had lied to their supervisors within the prior year, and 36 percent said they had lied on or falsified a written report. Of course, only 1 percent of employees believed that their own ethical standards were lower than their peers' standards.
- In a Rutgers University study, 70 percent of university students admitted that they had cheated on an exam in the past year and 87 percent admitted to cheating on written assignments.
- This same study showed that among graduate students, more than 60 percent admitted to cheating to improve their chances of gaining admission to graduate school; this figure rose to 75 percent for MBA students.
- Many business schools no longer require ethics in their MBA programs. At least one has introduced the concept of "situational ethics," an oxymoron if I ever heard one.
- For the past century, among the Ivy League schools, if a student accepted early admission to one school, committing in writing that he or she would attend in the fall, other schools would drop the student from consideration. In a reversal that I found shocking, Harvard University recently announced that it would no longer follow this practice. In effect, the university is saying that it is fine for an entering student to abrogate a binding written agreement—as long as it hurts only a competing school.

Editor's note: This piece draws heavily from "Ethics, Earnings, and Equity Valuation" by Robert D. Arnott, which appeared in the Spring 2003 issue of the *Journal of Portfolio Management*, published by Institutional Investor. To view the original article, please visit www.aimr.org/memservices/plus/arnottarticle.html.

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What are our universities teaching us about ethics? In this issue, John Dobson (see "Why Ethics Codes Don't Work") sees the problem of unethical behavior as lying in the acculturation of individuals into an ethic grounded in narrow economic rationality: "Stock price maximization is proffered as not only an ethic but *the* ethic: It is the correct justification for decisions made by individuals within the company."

As the preceding list shows, the problem is not a problem specifically of business ethics. It is a problem of social ethics that pervades the shop floor as well as the executive suite. The problem for investor trust, however, is largely at the top: If even 10 percent of business leaders are not ethical, then 100 percent of the business world will be "on alert" in their business dealings. This situation adds immense costs to the business world, consuming resources that could be invested in the future or could be distributed to the shareholders. The costs are very real.

Ethics and Earnings

We see the degradation of business ethics and the relaxation of governance standards in many ways. For instance, we see methods for "adjusting" reported earnings upward to justify higher valuation levels and distortions in the reported earnings themselves.

Operating Earnings. In a Perspectives piece in this issue, Bradford Cornell and Wayne R. Landsman ask, "Accounting Valuation: Is Earnings Quality an Issue?" They note and I echo that "operating earnings" have merit in evaluating a company with recent extraordinary gains or losses. After all, how does an analyst or investor evaluate AOL Time Warner given its write-off of roughly $50 billion in 2002?

Operating earnings have essentially no meaning, however, when we are looking at marketwide aggregates. In a broad market index, some companies will *always* have written off some disappointing operations. What does it mean to look at the earnings for a broad market index after taking out whatever write-offs some companies in that index may have taken because of disappointing operations? So, for the market as a whole, the concept of operating earnings is virtually meaningless. An "extraordinary item" for an individual company is entirely "ordinary" in the context of the market as a whole.

The absurdity of this metric of "earnings" is evident when one considers that (1) this measure will *always* exceed reported earnings and (2) the shareholders *owned* the disasters as well as the successful parts of the companies. (For an analysis of the long-term impact of write-offs on valuations, see the article "Investor Underreaction to Goodwill Write-Offs" by Mark Hirschey and Vernon J. Richardson in this issue.)

EBITDA. Some observers have advanced EBITDA (earnings before interest, taxes, depreciation, and amortization) as an even more aggressive way of valuing stocks than using operating earnings. Most of the merger and acquisition industry of the 1980s and 1990s operated in the thrall of EBITDA accounting. But what exactly is it?

EBITDA is a simple measure of how much money would be available for debt service if all noncore expenses were diverted to service debt—(1) if it did not have to pay interest expenses or taxes and (2) if it chose to spend its depreciation and amortization rather than reinvest them for the future. Why does EBITDA matter? Because a company *can* spend its depreciation and amortization. If a company uses the depreciation and amortization of past investments for current debt service, however, it cannot make new investments.

How many of the big EBITDA-based transactions have subsequently retained leadership in innovation in their industries? After an EBITDA-based transaction, managers have a huge incentive to maintain profits large enough to service the debt. They have an incentive to expand the business but not at the cost of debt service. For corporate managers, the benefit of continued growth is dwarfed by the consequence of failing to meet the new expense obligation.

The inevitable outcome is peculiar behavior: The managers measure the rewards for success in any new investment against the consequences if a business downturn depresses immediate profits. Any investment that fails to quickly achieve substantial profitability will be rejected out of hand. Product quality may be sacrificed in favor of short-term EBITDA profit margins. The consequence is a trade-off of future EBITDA for current EBITDA. This trade-off is fine if reinvestment ideas would be unprofitable; it is a mistake if the rejected reinvestment ideas would have led to future growth.

Moreover, EBITDA is a bad measure of profitability and a bad basis for valuation or for any purpose other than extracting maximum immediate value in the sale of a company. And as with operating earnings, EBITDA is worse than useless for evaluating the market as a whole. Write-offs of past management errors and failed investments are a natural part of the evolution of the broad economy and should not be stripped out of the earnings of broad market indexes.

Biases in Reported Earnings. Reported earnings have problems even before upward revision through EBITDA or operating earnings adjustments, notably in pension accounting and accounting for management stock options.

Companies maintain two profit statements—(1) profits from the perspective of the tax authorities and (2) profits from the perspective of the shareholder. The first forms the basis for the corporate earnings in the National Income and Products Accounts (NIPA) portion of GDP; the second is the public statement of generally accepted accounting principles (GAAP) earnings. The gap between the two was exceptional in 1999–2000 and again in 2003, with aggregate GAAP earnings far exceeding NIPA earnings. But eventually, one report must prove to be too low or the other too high.

- *Accounting for pensions*. Pension accounting is a mess. Lawrence N. Bader recently focused in the *FAJ* on this problem ("Treatment of Pension Plans in a Corporate Valuation," May/June 2003, pp. 19–24). GAAP earnings reports allow companies, in estimating their earnings, to estimate what they will earn on pension investments. Problems: In 1982, at a time when stocks were offering a *dividend* yield of more than 5 percent and both bond yields and stock earnings yields were in the low teens, the average return assumption was roughly 6.5 percent. Eighteen years later, after the largest bull market in U.S. history, when the dividend yield for the average stock was barely above 1 percent, and when the U.S. government bond yield curve topped out at 6 percent, the average return assumption was 9.5 percent. How on earth can a balanced portfolio with a blended yield of 3 percent deliver a 9.5 percent long-term rate of return?

What assumptions on economic growth would permit such a lofty expectation? If companies used the top yield of the government bond yield curve as a return assumption, aggregate U.S. earnings would have been roughly 15 percent lower in 2000 and 25 percent lower in 2002.[1] And the picture is not much better today. The government yield curve tops out at less than 5.5 percent; stocks have an earnings yield of *at most* 5.5 percent (probably closer to 3.5 percent); dividend yields are around 1.7 percent. Yet even now, the average company assumes it will earn around 8.7 percent on pension assets—net of all fees, trading costs, and operating expenses.

- *Stock options*. Management stock options are a wonderful thing. They align the interests of managers and shareholders in a direct way and allow managers who behave like entrepreneurs to earn entrepreneurial rewards. Without that opportunity, how can a company attract entrepreneurs to guide established enterprises? But to pretend that stock options cost nothing is folly. Whether a CEO receives a bonus of $100 million or stock options that deliver a $100 million gain, the cost to the external shareholder is the same. A dilution cost is the same as a cash cost from the perspective of the external shareholder. If the Financial Accounting Standards Board will not require expensing options, investment managers owe it to their clients to state the net-of-options earnings of a company.

Investment and Ethical Lapses

Characterizing aggressive accounting in ethical terms is harsh. The intent of earnings reports, however, is to let us know the true economic health of a company as a long-term going concern. Therefore, our industry should reward careful, correct accounting, not aggressive accounting. The scant good news in the recent flurry of scandals involving aggressive accounting, outright fraud, and puffed-up earnings is that the many investment implications are straightforward.

If earnings cannot be trusted, they will be discounted. If they are discounted, then the risk premium has an added component. It should compensate an investor not only for equity risk but also for the risk that the foundations of equity value (earnings and book values) are inflated. A higher risk premium is bad news. If public investors lack confidence in managers' ethics, they will demand more return for their investment. Investors may require a "credibility premium" on top of the old established risk premium.

What To Do

Our society is probably overly tolerant of dishonesty and corrupt behavior. It is too easy to get away with unethical behavior. It is too easy to resume one's career even after getting caught in the act.

If we reach a point where an individual is shunned by his or her peers for taking a pencil or stamp from the office, we can safely assume that the ethical standards of senior managers will cease to be an issue. Unfortunately, this will not likely happen during the careers of today's newly minted graduate students. In other words, we should brace for the possibility that ethical scandals will continue to be commonplace for the balance of our careers. In the meantime, we should start teaching our own kids that a promise is a promise, a lie is a lie, and honesty is not a matter of subjective interpretation.

Note

1. The return on the U.S. T-bond is, after all, the highest return that the companies could assuredly earn on a long-term basis to defease their pension obligations. All returns above this level represent the combined skill of the pension management team, the consultants, and the investment managers and are arguably the incremental "profit" earned by the pension department of the company.