CHAPTER 3: WEAKNESSES AND LIMITATIONS IN ACCOUNTING MEASUREMENT

3.1 Earnings Per Share

First of all, the myth that increasing earnings, earnings per share, or return on equity is the way to attract investors must be abandoned. Many senior executives believe that the market wants earnings, and wants them now; despite the fact that not one shred of convincing evidence to substantiate that outlandish claim has ever been produced. To satisfy investors alleged craving for reported profits, many top managers feel compelled to conjure up earnings through time-consuming and ethics-corroding accounting legerdemain. Expenses that should be deducted to save taxes are deferred. Valuable acquisitions are avoided if a large amount of goodwill must be amortized. Research and Development and market-building outlays get short shrift. The execution of dying businesses is postponed. And perhaps worst of all, lusty earnings, growth is sustained by over investing in mature businesses.

Arrayed against the earnings myth and these harmful practices is an overwhelming body of established academic research. It shows that accounting measures of performance are only coincidently related to stock prices and are not the primary movers and shakers.

Traditionally, equity prices have largely been understood in terms of earnings growth. The greater a company's earnings growth year-on-year, the more investors are prepared to pay i.e. price/earnings ratios expands. Analysis of companies, therefore, has tended to focus on determining the relative or absolute trend in earnings. Analysts recommend those high growth stocks and wait for the market to catch up.

In practice, of course, another trend arises. In a bull market, analysts chase rising share prices with ever increasing growth forecasts in their earnings models. This only reverses after prices change direction. In the current environment in Asia, some analysts have got themselves in muddle. Prices roar down, reverse, move sideways, come to an abrupt halt and then go whistling up again. Ex-post rationalisation identifies external factors (the yen/dollar rate, hedge funds, political risk, sovereign spreads, government intervention, impeachment proceedings etc.) as the causative factor. Earnings forecasts have proved less than useful.

Traditional value models have broken down. Price/earnings ratios have seemingly lost their explanatory power – not least because great swathes of companies, and even market, are loss - making. This realization begs the question – did those ratios ever explain (as opposed to reflect) the way in which prices moved?

The theoretical answer is well- known. Share prices are a function of the changing expectations as to the present value of future perpetual dividend streams. An earnings forecast, therefore, achieves a theoretical validity only if discount rates are constant and if short-term earnings are good proxy for future dividend streams. These conditions do not apply in the current market and it is arguable that they never did.

3.2 Cash Flow

However important cash flow may be a measure of value, it is virtually useless as a measure of performance. So long as management invests rewarding projects - those with returns above the capital –the more investment that is made, and therefore the more negative the immediate net cash flow from operations, the more valuable the company will be. It is only when it is considered over the life of the business, and not in any given year, that the cash flow becomes significant.

3.3 Limitation in accounting measurement

There are many limitations associated with accounting measures, which limit their value in strategic financial analysis. Some of the major ones are:

- Risk is excluded.
- Investment requirements are excluded.
- Time value of money is ignored.

(a) Risk is excluded

Risk is of central importance in establishing the economic value of any asset. A firm's level of risk is determined both by the nature of its operations and by the relative proportions of debt equity used to finance investments. These two types of risk are respectively referred to as 'business risk' and `financial risk'. Earnings figures do not incorporate consideration of either type of risk.

(b) Investment requirements are excluded

The relationship between changes in economic value and changes in earnings is further obscured by the fact that the investments in working capital and fixed capital needed to sustain the firm and to support future growth are excluded from the earnings calculation.

(c) Time value of money is ignored

Earnings fail to measure changes in economic value because earnings calculation ignore the time value of money. Economic value calculations, by comparison, explicitly incorporate the idea that a sum of money received today is worth more than a sum money received a year from now because it can be invested to earn a return over the next year. What is more, the discount rate used to estimate economic value can be adjusted to include not only compensation for risk-bearing, but also compensation for the expected levels of inflation.