Accrual, Defensive and Enterprising Earnings

New Ways To Follow the Money

by Angele McQuade

It's Earnings That Count: Finding Stocks With Earnings Power for Long-Term Profits **by Hewitt Heiserman, Jr., McGraw-Hill, November 2003, $27.95, 208 pages.**

Financial analyst Hewitt Heiserman is on a quest. Writing a column about earnings power at TheStreet.com's investment Web site RealMoney.com isn't enough for him — he wants to bring his strategy for analyzing corporate earnings to a larger audience.

And now he has, with his book *It's Earnings That Count: Finding Stocks With Earnings Power for Long-Term Profits*. Heiserman hopes this book will help teach investors how to look beyond a corporation's reported earnings for true, not "artificially enhanced," earnings.

At the core of Heiserman's message is a warning not to take a company's reported earnings at face value when considering the company as a potential investment. The traditional accrual income statements generated using generally accepted accounting principles (GAAP) and presented in annual reports, public filings and other documents may appear comprehensive, he says, but they actually have four major limitations. These limitations can disguise a company's true financial status, allowing it to appear profitable even with poor earnings quality.

He suggests you instead study financial results using two alternative income statements that he developed. The defensive statement indicates how much a company relies on outside sources of capital, while the enterprising version shows a company's return relative to its total capital base.

If you're not sure how to construct these kinds of statements or why the information in them is important in your analysis of a particular company, don't worry. Heiserman leads readers through collecting the necessary data from readily available sources, then he explains exactly how to create both types of earnings statements and interpret what they show. But these earnings statements are only stepping stones to his Quality of Profits Chart and his ultimate analysis tool, the Earnings Power Chart, which is used to help identify quality long-term growth stocks.

Charting Earnings

Heiserman relies heavily on previously published financial literature and gives generous credit to the foundation he builds on. His alternative income statements are based heavily on Kenneth Hackel and Joshua Livnat's ideas on free cash flow and Bennett Stewart's theories on economic value-added. Heiserman synthesizes these ideas and others and creates a model that's easily accessible for investors at any level and visually represented by the Earnings Power Chart.

Heiserman calls the Earnings Power Chart a "kind of investment compass that points you toward companies with the highest-quality earnings growth and away from those unable to self-fund and create value." He leads readers through the preparation of an Earnings Power Chart, beginning with a table of the accrual, defensive and enterprising income statements. The next step is to develop a Quality of Profits Chart, which plots the earnings figures from each statement so that you can see whether they correlate closely.

The final step is constructing the four-quadrant Earnings Power Chart. If a company being studied lands in the upper right quadrant, this indicates the quality of its earnings is excellent and the stock should be considered a potential investment opportunity. Though the process may sound complicated, Heiserman describes the steps so thoroughly and with enough illustrations that he makes it seem quite simple (made even more so if readers follow his instructions for using spreadsheet software).

Though all this talk of charting seems a little reminiscent of technical analysis, Heiserman's techniques are definitely aligned with the aims of fundamental analysis. Investors who use NAIC's Stock Selection Guide and related forms will find Heiserman's charts and graphs a familiar way to look at earnings growth over time, even if the variables being charted are different.

Putting Earnings to the Test

There's much more to *It's the Earnings That Count* than just the Earnings Power Chart and alternative income statements. Heiserman carefully explains the basics of accounting and reading a financial statement for investing novices.

He doesn't send readers out to navigate the vast world of potential investments empty-handed, either. He devotes a chapter to his Five-Minute Test, a stock screening method meant to eliminate earnings losers from consideration based on nine potential warning signs in the financial statements. These include problematic footnotes, earnings restatements and unusual losses.

It's Earnings That Count is filled with examples from actual companies, making the theories spring to life with data from corporations readers will recognize. Heiserman's main example is Wm. Wrigley Jr. Company; its earnings and other financial data are used to teach readers how to use his tools and ask important questions such as "Can this company finance its growth?" and "Is it successful at creating value for investors?"

It's Earnings That Count is a valuable map for navigating a world of "managed" earnings in which corporations may take liberties in financial reporting. Readers will learn the differences between the many types of earnings, whether they be reported, operating, pro forma or even fraudulent. They'll also pick up tips for detecting fraudulent earnings.

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His retelling of recent earnings scandals bolsters these lessons. They also underscore the idea that readers should take control of their investments by scrutinizing earnings more closely to determine whether a company that appears profitable in a traditional GAAP income statement remains that way when evaluated using the methods Heiserman advocates.

All This Work for Nothing?

The one major criticism I have concerns a sidebar in the last chapter. After writing a book filled with logical techniques for evaluating earnings to find the very best quality companies, Heiserman appears to backpedal with some last-minute guidance. First he states how difficult it is to beat the market averages, then he advises that "most investors should probably have most of their assets in professionally managed funds, perhaps even in index funds."

This statement shocked me, and I imagine it would dampen the enthusiasm of — or at least confuse — any reader who had pored over the previous 13 chapters devoted to the author's strategies for analyzing individual stocks. I couldn't help wondering why investors should bother analyzing stocks on their own at all if Heiserman believes they have so little chance of doing well; he suggests they shouldn't expose more than 10 percent of their portfolios to the "risk" of individual stocks they select, even using his methods.

While the book is well worth reading, this statement — coming as it does near the very end — seems to undermine the author's earlier confidence that with the right research and a little effort, individual investors can find worthy candidates for long-term investments.

"Choosing the right investment is really a process of elimination," Heiserman says in his introduction, and he follows through by presenting what he feels readers need to do. Investors can gain as much from learning to spot not-truly-profitable companies as they can from identifying those with authentic earnings.

For Beginning and Advanced Investors

It's Earnings That Count is an ideal book for investors who enjoy digging around in corporate financial statements. It will give them plenty of ideas for new ways to evaluate prospective investments as well as those they already hold.

But it's also quite helpful for beginners without much experience with financial statements. The book guides them through the basics, pointing out red flags as well as potential traps they might have fallen into otherwise. Investors at any level of expertise can find something here to help them understand their stock holdings better while improving their analysis techniques.

E-mail me at angemcquade@better-investing.org if you have any questions about these books or would like to share your favorites.

Angele McQuade of New York state is the author of Investment Clubs for Dummies *(Hungry Minds, 2001) and the revised version of NAIC's* Official Guide.