Tone at the Top:
Why Investors Should Care

A poor tone at the top is a strong predictor of aggressive or questionable financial reporting.

By Alfred M. King, CMA, CFM
Financial experts and media pundits often attempt to explain the stock market’s gyrations; some even try to predict what will happen in the future. Unfortunately, most stock market predictions seem to have, at best, no more than a 50/50 chance of being right. In certain situations, though, there’s a potential way to exceed these odds. You need to determine a company’s “tone at the top,” which is a shorthand way of looking at and evaluating the ethical standards of the board of directors and top management. If the tone at the top is at all suspect, a prudent investor will sell first and ask questions later or not even buy. While a good tone at the top isn’t a guarantee of future stock market performance, history suggests that well-managed companies have superior financial performance over the long run.

Three Examples

Let’s look at three examples of poor tone at the top: Groupon, Inc.; Chesapeake Energy; and Enron. Two are recent and may not have fully played out, but Enron has been analyzed in great detail. The summaries here aren’t meant to be exhaustive; they cover only what struck me as significant. My analysis is a reflection of my take on what has appeared in the business press and is based only on public information.

More than 50 years of experience as a management accountant and valuation expert have taught this investor that when a company first reports negative news of any sort, there usually is more to come. Negative news hardly ever is a one-time affair. Yet few managements want to be seen as so out of touch with their own business that one day they report bad news and then turn around a few days later and report good news. Since few people like to admit bad things, you can be certain that if negative news is released, the only reason for such disclosure is a legal or ethical requirement that it had to be divulged. It’s unlikely that there are any “favorable” surprises waiting to be disclosed.

In my experience, negative news is often a sign of poor tone at the top. The converse, however, may not be true. Good news from a company isn’t necessarily a sign of good tone at the top.

Groupon is a company that sells special deals, like half-off coupons, to consumers, pays the merchant half of that, and keeps the remaining fee income to cover expenses and generate a profit. The company experienced fast growth and was an innovator in consumer marketing. In fact, it grew so quickly that management decided to have an initial public offering (IPO) when the company was still, by most standards, very young and untested and had less than three years of operating experience.

The essence of an IPO in a technology company is to show high sales growth and at least the promise of future profit. For whatever reason, Groupon’s management apparently didn’t believe that its actual sales growth, as reported under Generally Accepted Accounting Principles (GAAP), was fast enough to justify the IPO and its anticipated initial price per share. Rather than complain about GAAP’s current income recognition rules, Groupon developed its own version of GAAP, which I like to think of as “GUP” (Generally Unacceptable Principles). The initial financial statements Groupon filed with the Securities & Exchange Commission (SEC) were rejected on the grounds that the company was overstating revenue by using unacceptable accounting practices.

This was warning sign number one that Groupon’s management was more interested in a successful IPO than in following GAAP. Developing your own accounting principles, no matter how they’re explained in the footnotes and narrative, is evidence that the tone at the top is suspect. Warning sign number two was a restatement of the 2012 first quarter’s already filed financial statements because “there were some problems with internal control.” Since then, there have been more missteps and slow growth.

To many analysts, Groupon management was focused on putting up good numbers, irrespective of actual results under more conservative accounting. The accounting issues at Groupon showed that the tone at the top was poor.

Chesapeake Energy is a petroleum company focused largely on natural gas as compared with liquid hydrocarbons. A couple of years ago, the CEO borrowed a huge amount of money to buy stock in his own company, Chesapeake. Unfortunately, the stock went down, the margin loans were called, and the financial posture of the CEO was in dire straits.

Not to worry. The board generously bought a private collection of vintage maps from the CEO at what might have been an inflated price and then, equally generously, gave him something like a $75 million “bonus” to assuage the pain caused by the drop in the company’s stock price. That was strike one.

Strike two was reported in the press last spring. Apparently this same board granted Chesapeake’s CEO a unique “perk,” allowing him as an individual to invest his own money alongside that of the company in the drilling
of new wells. But many observers thought this was a total conflict of interest, and the board later renegotiated the CEO’s investment and drilling rights. It’s obvious that, for a while, Chesapeake’s tone at the top was focused on the CEO’s personal financial gain, not on shareholders. Now there’s a new board, and the CEO announced in January that he’ll step down next month.

Enron and its demise have been the subject of at least 10 books and innumerable articles. All I want to say here is that, at the time, the tone at the top was clearly more focused on making the numbers than on providing clear financial reporting. When security analysts were bold enough to ask Enron’s management truly penetrating questions, they were laughed at for “not understanding” the company’s business model. A second red flag was the ever-increasing reported earnings growth, quarter by quarter. No company can, for long, string together an unbroken record of ever-increasing sales and profits without engaging in some sort of accounting gamesmanship.

In effect, Enron’s results were too good to be true. By going into many diverse businesses, it was apparently more interested in growth for the sake of growth; reported earnings were more important than cash flow. Though the specific problems at Enron might not have been easily located or identified, it was certainly clearly visible, at least in hindsight, that the company’s management was focused on financial results, not operating results. What came out after the demise of Enron, including jail sentences for many of the top executives, was overwhelming proof that Enron’s tone at the top was fatally flawed.

I could expand these three examples, but they represent a good cross-section of what investors should look for.

**COSO and Tone at the Top**

Decades before Enron, numerous financial scandals occurred in the 1970s and 1980s. As a result, in 1985 a group of professional associations created the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to sponsor the National Commission on Fraudulent Financial Reporting (the Treadway Commission). They are IMA® (Institute of Management Accountants), the American Accounting Association (AAA), the American Institute of Certified Public Accountants (AICPA), Financial Executives International (FEI), and the Institute of Internal Auditors (IIA). Led by James C. Treadway, Jr., the Commission of independent experts studied the causal factors that can lead to fraudulent financial reporting. It also developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions. The prime recommendation of the 1987 Report of the National Commission on Fraudulent Financial Reporting was that companies should adopt a strong system of internal controls. In 1992, COSO released *Internal Control—Integrated Framework* to provide guidance on how to design and implement effective internal controls. (For more about COSO and its work, visit [www.coso.org](http://www.coso.org).)

Tied in with this recommendation was a significant finding that tone at the top was a critical element of how companies handled the entire subject of financial reporting. Put simply, companies whose top management
insisted on strong discipline to enforce sound financial reporting didn’t get into trouble. Sound financial reporting can be seen as wanting to report to shareholders and creditors what really happened, “warts and all.” In contrast, companies with a poor tone at the top issued financial reports that tried to put the best face on things, even if it meant covering up bad news.

The Treadway Report also determined that few companies set out to lie, cheat, or issue knowingly false financial reports. Instead, the history of most problems could be traced back quite a period of time. One quarter wasn’t quite as good as expected or as had been promised to security analysts. To maintain credibility with analysts in such situations, companies often tended to get a little more aggressive in their accounting in the next quarter. Maybe bad debt reserves were reduced, or sales from the first day of the following quarter were counted in the prior period, or depreciation schedules were reviewed and found to be overly conservative.

Every reader knows that any financial report contains individual judgments, and there’s nothing wrong in applying professional judgment to individual accounting issues. Companies started to go wrong when management deliberately made most or all such choices in one direction with the direct effect of reporting higher income. For example, in the first quarter that a company feared missing its external commitments, individual choices were made so that the firm “met the numbers.” Further, every single choice in that early period could be defended, and, in all probability, each was in full compliance with GAAP.

Unfortunately, the passage of time is inexorable. Three months later the company had to issue another quarterly statement, and it had already used the “easy” changes to accounting assumptions. To report continued gains in income the next quarter, the company had to absorb the previous adjustments in current results plus provide for steadily increasing growth—also from the current quarter’s reported results. If actual operations hadn’t improved or had gotten worse, what could they do?

This is where tone at the top becomes critical. If management were committed to ethical financial reporting, they would admit publicly that operations had been disappointing and that earnings were below expectations. Then they would disclose what they were going to do to correct the problems. In essence, such an action is fully commensurate with a good tone at the top.

With a good tone at the top, companies will disclose all news, both good and bad, that’s likely to influence shareholder actions and behavior. If a competitor’s new product is adversely affecting sales, shareholders will be told, and sales projections will probably be adjusted downward. With a poor tone at the top and the same business situation, there are several courses open. One would be to institute a cut-price sales program to cover up the potential reduction in sales. Another would be to declare optimistically, “Our new competitive product is on the verge of going to market.” A favorite trick is to undertake a reorganization and front-load the costs of the process. In this way, recurring costs are characterized as “one-time nonrecurring reorganization costs.” Finally, sales could be borrowed from the next month, temporarily masking the problem. When things go bad, creative managements can
come up with a seemingly endless array of “cures” or “excuses” that work—for a period of time.

The bottom line: Shareholders may not be able to identify, in advance, a company with a poor tone at the top. But when business problems become too great to hide and public explanations are required, many shareholders suddenly realize that tone at the top does matter.

How Can Shareholders Protect Themselves?

First, whenever corporate problems are disclosed, the immediate impact is a drop in the stock price. Shareholders know that bad news implies lower earnings, higher costs, or both. When a company’s stock drops 10%, 15%, or even 20% in one day, it’s apparent that unexpected bad news has been disclosed—news the market wasn’t anticipating. And the bad news usually relates to the company’s internal operations or to external events that didn’t, or at least shouldn’t, surprise management.

Would the audit partner of the company that had recently disclosed bad news be surprised by the bad news? Probably not. His or her comments likely would be that this was a management strictly obeying the letter of all the rules, so there was little the auditor could have done other than communicate with the audit committee. But what if the committee members didn’t take tone at the top all that seriously? By law, auditors have to report to the audit committee about the internal control framework and if management is adhering to good internal control. But independent auditors’ own evaluation of a company’s tone at the top is never disclosed to public shareholders. Nor is the situation where there’s a perception of satisfactory internal controls but a poor tone at the top. Can such a situation exist? I submit that it’s relatively easy to follow the letter of GAAP and internal control requirements and still have a poor tone at the top. The external financial statements won’t disclose the existence of underlying problems that management is reluctant to disclose and that neither it nor auditors is required to disclose.

From the perspective of an institutional or individual investor, is it reasonable to expect an independent auditor, hired and paid for by management, to publicly blow the whistle on a poor tone at the top? Even if they wanted to, what would be the medium of disclosure? Filing a form with the SEC? Notifying the NYSE or NASDAQ?
Calling the underwriter of the last public security offering? In terms of an intangible such as evaluating the tone at the top, auditors may be in the best position to know but the worst position to communicate their beliefs—particularly if they faced even the potential of a lawsuit from an aggrieved management or an equally aggrieved shareholder who might have sold on the auditor’s comments and then seen the stock rise, not fall. In today’s litigious society, I don’t see how investors can look to auditors to communicate the real tone at the top.

Then what potential sources are available for investors?

Rating Agencies

Some people might think that looking to the rating agencies for opinions about management might be a good source of information. But the rating agencies are hesitant after the fiascos of recent years. Often they appear negative about everything “just in case” something does go wrong. Right now it’s unrealistic to think that Moody’s, Standard & Poor’s, or Fitch will come out with their own evaluation about tone at the top.

One more reason not to rely on the rating agencies is that they’re paid by the company they’re rating. Consequently, they’ll want to justify any negatives in quantifiable terms and not be required to express a judgment on such an intangible as their perception of tone at the top. This is a key issue in the calls to overhaul the way complex financial products are rated for riskiness.

Security Analysts

This leaves security analysts. While I’m not a security analyst in the usual sense of the term, I’ve evaluated and analyzed hundreds of companies in the course of a lifetime career in valuation. It’s a cardinal principle that valuation specialists should, whenever possible, meet with management to obtain an understanding of the business climate, customers, suppliers, R&D, and so forth. In the course of those interviews, you can’t help but draw some conclusions about management’s competence, experience, and attitude toward the business.

Though not frequently, there have been a number of situations where it was obvious to me that the tone at the top of a particular company was such that management was more interested in the reported financial results than they were in the actual underlying business. The most obvious manifestation of this priority is companies where managements are focused solely on reported earnings per share (EPS) at the expense of real net cash flow. A few firms will sacrifice cash flow to increase reported earnings, and such an attitude tells me that the tone at the top leaves a lot to be desired.

Unfortunately, our valuation reports are hardly ever made public. They are between us and our client, and we usually have a condition in our report that the client has to obtain our permission if they want to make our work public. The only time our reports are made available (and it’s rare) is for one of them to be used in an SEC filing. Other than that, our conclusions are considered confidential and aren’t published.

If valuation specialists can’t communicate the tone at the top to shareholders, in my opinion that leaves only one source for investors: sell-side security analysts, those hired by investment firms to provide opinions to the firm’s cus-
customers. There also are buy-side analysts, who work for private equity and hedge funds. There are many skilled financial analysts at these firms, but they work for their employer, and their ideas are hardly ever made public.

A sell-side security analyst’s stock in trade is personal relationships with the managers of the companies in the industries he or she covers. “Making waves” has cost many analysts their job, which is also why “buy” recommendations are so much more common than “sell” recommendations. When a sell recommendation is considered unavoidable, analysts rarely say how bad things are or even what’s bad. Rather, they cover themselves with the stock phrase, “At this price the stock of XYZ is fully valued and may not go up much in the near term. We therefore recommend a switch to ABC, which currently appears somewhat undervalued.” As an investor, you may choose to follow the sell advice, but you usually don’t know the analyst’s true feelings about the quality of management.

Analysts currently don’t report how aggressive a particular company is in terms of reported earnings. Sometimes there’s information in an analyst’s report that the company’s accounting differs slightly from its peers, and this should be a red flag for investors. But security analysts usually hedge when they are negative about a stock and the company’s management. In such situations, it’s actually easier for the analyst and his or her investment firm to simply drop coverage of the company and move on.

A Modest Suggestion

I repeat: There’s a high correlation between aggressive accounting, however you want to describe it, and a relatively poor tone at the top. Companies that report actual results as they occur, taking the good with the bad, reflect economic reality. Nothing goes straight up without any hesitations, jogs, false turns, and so forth. Actual sales and cost of sales vary because of overall economic conditions, the company’s ability to meet ever-changing consumer or customer requirements, and the impact of competitors and competitive conditions. Good companies usually have more good news than bad news and more good results than bad results, but they, too, suffer. IBM has been one of the most highly regarded companies for the past 60 to 75 years. Yet there have been periods where IBM has missed forecasts, lost market position, and experienced management turmoil. Still, even at the height of its problems, it was quite open about where it stood and what it was doing.

But what about problems that truly are under the radar—problems that most shareholders don’t know about? In short, shareholders and investors are usually unaware of the real business situation in most companies. If accounting is the language of business, shareholders have to rely on published financial reports, and if those reports are optimistic, even in full compliance with the current GAAP rules, how can we protect ourselves?

Most security analysts who write published reports on prospective investment opportunities have a strong background in accounting. In the process of interviewing management, competitors, and customers, they have to develop a sense of the strength of management and a feeling, imperfect as it might be, for the tone at the top. They have a strong idea as to how aggressive or conservative the firm’s financial reporting is.

Right now, most security analysts use one of three recommendation categories: buy, hold, or sell. Because many firms and analysts don’t want to go on record, they often use hold as a code word for sell. Analysts are usually judged by how well their buy recommendations do and how well their relatively few sell recommendations do. I doubt if anyone was fired for suggesting hold.

My suggestion is simple: Security analysts should also be required to make a call on the company’s accounting. They could use the terms conservative, neutral, and aggressive. As an investor, I would look very favorably on a conservative accounting rating, would look unfavorably on a neutral one, and would immediately sell a stock that received an aggressive rating on the firm’s accounting.

It also would be interesting to see how different analysts rated the accounting of the same company. Usually analysts concur on a buy, hold, or sell rating. It’s the outliers that get the attention. Similarly, I would expect a lot of consensus on ratings about accounting, and any outliers would immediately bring close scrutiny.

If my assumption about accounting policy as a proxy for tone at the top is realistic, and if most security analysts could be impartial in their rating of accounting, we as investors would be well served. Independent security analysts have the knowledge, judgment, and motivation to publish their own opinion about how they view a company’s accounting policy. Such disclosures would be helpful to investors and in many ways would reduce the number of unpleasant surprises we constantly fear.

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In this week's episode of Industry Focus: Tech, Sean O'Reilly and Dylan Lewis explain what investors need to know about capital allocation, dividends, and share buyback programs. Also, they give two examples on either ends of the buyback spectrum -- one company that executed their program beautifully, and one that couldn't have chosen a worse time.