Why Investors Ought to Heed This Recent Warning From Warren Buffett

Description

Warren Buffett is a magnificent teacher, and if you're a do-it-yourself retail investor, it often pays enormous dividends over the long-term to pay attention to his commentary. He's the world's greatest investor, but he also goes out of his way to look after the little guy (beginner investors) in an arena that can be daunting, to say the least.

Every once in a while, Buffett issues a warning, and if you can heed his warning, you can navigate many pitfalls set forth by a corrupt few. In many instances, these pitfalls are easily avoidable, but in other circumstances, it's notoriously difficult for a new investor with a limited (but growing) knowledge of accounting and the stock market to incorporate into their investment decision-making process.

Consider Buffett's most recent annual letter to **Berkshire Hathaway Inc.** shareholders. The biggest takeaway, I believe, was his warning of the trend of management "adjusted earnings," which may mislead many retail investors who aren't already knowledgeable in interpreting a company's financial statements.

"…a management that regularly attempts to wave away very real costs by highlighting 'adjusted per-share earnings' makes us nervous. That's because bad behaviour is contagious: CEOs who overtly look for ways to report high numbers tend to foster a culture in which subordinates strive to be 'helpful' as well," said Buffett. "Charlie and I cringe when he hear analysts talk admiringly about managements who always 'make the numbers.' In truth, business is too unpredictable for the numbers always to bet net. Inevitably, surprises occur. When they do, a CEO whose focus is centred on Wall Street will be tempted to make up the numbers."

That's a lot to chew off for a beginner investor, especially one who's not well versed in the accounting process. New investors should not shrug off this warning, however, as there are dire consequences for treating "adjusted earnings" as gospel.

Adjusted short-term earnings numbers and their potential effect on ratios may mislead many investors, as well as analysts who don't ensure full due diligence by "counter-adjusting" the numbers to form a more accurate and fair representation of a company's progress for a given period.

That's alarming indeed. And while a third-party auditor is required to thoroughly analyze a company's financial results (and accounting process), the fact of the matter is that it's one auditor versus a knowledgeable team of folks producing a company' financial statements. It's these folks who may be incentivized to adjust results in their favour to raise a company's stock price over the near-term, even if that means a potentially less accurate representation to the general public.

Although there are accounting standards in place, management teams can get pretty crafty by testing the boundaries of reporting methods, which require a high degree of discretion.

Not all companies have a dark secret to hide like Valeant (now known as **Bausch Health Companies Inc.** (TSX:BHC)(NYSE:BHC) did a few years ago. Given a range of reporting options, management may simply opt to go with the one that will mean better results for a given quarter, even if it misrepresents the actual performance and leads to seemingly poorer results in future quarters.

How can new investors protect themselves?

Accounting procedures can be ridiculously complicated. And in some instances, analysts may not be making the proper "counter-adjustments" to financial statements to obtain a more accurate picture of a company's performance for a given quarter. That means that some analysts may also be misled by management, which will in turn, mislead even more retail investors.

For a new investor, accounting can be intimidating, even dull. We want to discover stocks of wonderful businesses, not audit complexities within financial results!

Thus, in addition to considering analyst commentaries or reports, investors should also look at insider trading activities and stay up to date on news regarding a company's reputation for accounting mishaps.

Look for auditor's notes within financial statements to get a better grasp of accounting methods a company implements. The more conservative the methods, the better.

Moreover, spotting exorbitant insider selling activities may be an indication that results that were "artificially boosted" in the past may be brought back down to Earth.

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