The New York Times
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MARKET WATCH

GRETCHEN MORGENSON

Hands Out, Even in a Time Of Crisis

WHERE'S Frank Capra when you need him? Surely, he would know how to make entertainment out of the greed and rank opportunism that has characterized behind-the-scenes Washington since Sept. 11. The moment it became clear that lawmakers would be bailing out troubled industries, passing a stimulus package to restart the economy and putting some teeth into money-laundering laws, the lobbyists moved in.

Alas, with Mr. Capra gone and his kind of movie a thing of the past, Americans may never enjoy the spectacle of wealthy corporate lobbyists swarming the Capitol steps, lunging for handouts at the whiff of crisis. Instead, they'll suffer through it.

Whatever happened to the idea of everybody pulling together, setting aside self-interest for the sake of a wounded country? Is grabbing for all you can now so imbued in corporate culture that executives don't remember what it is to act with honor?

Richard Sylla, professor of business history at New York University's Stern School of Business, said corporate lobbying for tax breaks during a crisis is a relatively new behavior. ''Taxes went up in World War II and nobody seemed to object,'' he said. ''There was more of a spirit of cooperation. It was more 'What's in the national interest?' than 'Can you do something for us?' ''

One egregious me-first move now gaining traction is repeal of the corporate alternative minimum tax, created in 1986 to keep profitable companies from using loopholes to eliminate taxes. Even worse, the House plan would return all the A.M.T. ever paid by these corporations. That would send billions in rebates to **I.B.M.** and **Ford Motor** and hundreds of millions to **General Motors, General Electric, Texas Utilities** and **DaimlerChrysler.**

If corporate America were groaning under the weight of onerous tax rates, repealing the alternative minimum tax might be acceptable. But while the presumed corporate tax rate is 35 percent, loopholes bring the effective average tax rate for big companies way down. Robert McIntyre, director of Citizens for Tax Justice, a liberal advocacy group in Washington, calculated the effective corporate tax rate at 20.1 percent in 1998, on average, down from 26.5 percent in 1988.

Culver Service

James Stewart played an honest man who resisted political graft in Frank Capra's film ''Mr. Smith Goes to Washington.''

While I.B.M. reported $5.7 billion in pretax profits last year, Mr. McIntyre said its federal income tax bill amounted to just 10.8 percent of that figure. Without the alternative minimum tax, I.B.M. would have paid 7.6 percent. G.M. earned $2.9 billion, pretax, in 2000, he said. Even with the A.M.T., its federal tax bill totaled only 1.5 percent of that.

''Take the repeal of A.M.T. and park it next to the big goose in depreciation write-offs in the bill and we're back to the early 1980's, when half the biggest companies in the country were regularly not paying any taxes at all,'' Mr. McIntyre said.

Big banks and financial industry groups mounted perhaps the most sinister post-Sept. 11 lobbying effort, trying to thwart some money-laundering provisions of the antiterrorism bill. Publicly, the corporations claimed support for the bill, which became law on Oct. 26. But several people who witnessed the furious lobbying efforts said some banks and industry groups tried to water down the bill into October.

''The bill gives important weapons to the administration to fight money laundering,'' said Robert M. Morgenthau, the Manhattan district attorney, who has pursued money launderers aggressively. ''The only reason this bill was passed was because of the leadership of Carl Levin, Paul Sarbanes and Joseph Biden. They dug in their heels,'' he said of the three senators.

Even hardened Hill staff members were surprised at the opposition to two relatively basic provisions in the bill. The first required financial institutions to conduct due diligence about who their customers are and where their money comes from. The second, which the staff members say **Citigroup** worked especially hard to defang, prohibited American banks from opening accounts for foreign shell banks, those with no physical presence and no affiliation with another bank. Shell banks are post office box operations tailor-made for money laundering and are found in places like Egypt and Ukraine.

IMAGINE requiring banks and brokerage firms to know who their customers are. Don't lawmakers realize how much due diligence can eat into profits? So what if asking such questions might have stopped a handful of terrorists from killing thousands of innocents in the World Trade Center?

Richard Howe, a Citigroup spokesman said, ''We strongly supported the anti-money-laundering legislation.'' The modifications were designed not to soften it, he said, but to make it more effective.

Still, Citibank has had dealings with shell banks. The Senate's Permanent Subcommittee on Investigations last February named it as holding accounts for two shell banks, one associated with criminal behavior. Billions of dollars moved through the accounts, it said, until they were closed.

Perhaps self-interested corporate machinations are de rigueur now, war or peace. Maybe putting profits before patriotism is the way that the world works today. If so, I want to get off. **Ø**

MARKET WATCH

GRETCHEN MORGENSON

A Benefit For the Few Weighs On Many

SHAREHOLDERS of technology stocks have been battered by earnings shortfalls at their favorite companies and by day-late downgrades from brokerage analysts. But a third element is at work in the current devastation of tech stocks, one that's less obvious but every bit as powerful. It is the ill effect on shareholders of enormous stock-option grants.

Ira Kay, national director of compensation consulting at Watson Wyatt Worldwide, thinks corporate America's stock-option binge of recent years is a big contributor to the Nasdaq plunge. ''There are many factors going into the dramatic declines in the stock market,'' he said, ''but it can't have helped the tech sector that so many companies had 40 percent or more of their shares reserved for stock options.''

Mr. Kay bases his view on the results of a recent study by Watson Wyatt. It found that, even before the Nasdaq fall, companies making the biggest option grants produced lower total returns to shareholders and higher levels of stock price volatility. The study, which examined option grants and stock price moves at 850 of the nation's largest companies, concluded that the heavy use of stock options had motivated executives to pursue riskier business strategies, like adding debt and making high-priced stock buybacks. These moves produced bigger swings in the share prices, which are not in the best interests of stockholders.

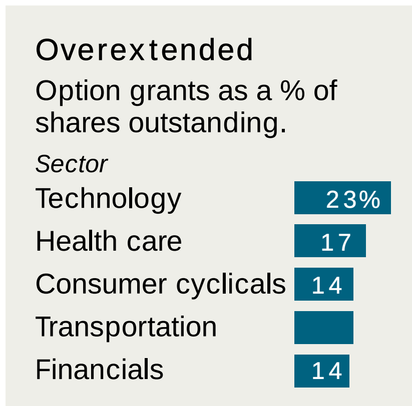
Stock options became an addiction in the 1990's. Companies liked them because they did not have to be counted as an employee expense and they made earnings look better than they really were. Employees liked them because they seemed to be the path to riches.

But options have a hidden cost: The more there are, the less valuable the underlying stock becomes, because options increase the number of shares that must compete for a company's earnings. This lowers earnings per share.

The Watson Wyatt study examined the number of option grants made and future ones planned at each company. Then it compared these figures with the number of shares outstanding. Companies with a high percentage of unexercised options have option overhang.

The overhang has surged in recent years, Mr. Kay said. The average overhang for the 850 companies surveyed stood at 13 percent of outstanding shares, according to the latest figures, up from 9.2 percent in 1995. Volatility among these companies' stocks averaged 17.2 percent, up from 12.7 percent.

Technology companies have the greatest overhang, devoting an average of 23 percent of shares outstanding to option grants. That is double the percentage found in sectors like financial institutions and makers of consumer goods. The only sector that approached technology in overhang was health care, with a 17 percent average.



In 1998 and 1999, companies with the highest growth in option overhang produced much lower total returns to shareholders than those with slower option growth. The biggest grantors returned 7.4 percent, while the smallest returned 14.3 percent. Companies with medium overhang showed 17.8 percent gains over the two years.

Now, the bill for all those options is coming due. As it becomes clearer to shareholders that options exacerbated their stocks' declines, perhaps executives at companies with option excesses will be forced to rethink their strategy.

Mr. Kay said companies should encourage outright stock ownership instead of options. Companies that do so show higher returns to shareholders, have less volatile shares and pursue more balanced stock repurchases.

''When the Nasdaq rout ends, companies with the largest overhang will have corrected more than middle- and lower-overhang companies,'' Mr. Kay said. ''It will be one of the explanatory factors.''

Executives thought that stock options meant having their cake and eating it too. Now comes the indigestion, for them and their shareholders. Ø

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MARKET WATCH

GRETCHEN MORGENSON

Employers Dodge a Bullet That Their Workers Can't

EXCRUCIATING. That's the best way for many Americans to describe this tax season. Enduring the most pain are many midlevel employees who exercised stock options in 2000.

On most options, workers must pay ordinary income tax on the difference between the price they paid for the options and the price of the stock on the day they exercised the options. At the same time, their company takes a tax deduction equal to this amount, known as the spread. In recent years, this has significantly reduced or even eliminated tax bills at immensely profitable companies like **Microsoft** and **Cisco Systems.**

While stocks were roaring higher, individuals viewed these tax bills as a relatively low price for potential wealth. As stocks have plunged, many employees have found themselves in the ninth circle of tax hell. Those who kept their shares instead of selling when they exercised are paying huge taxes on stock gains they never realized and that have turned into losses. Many have been forced to file for bankruptcy.

Adding to these tax woes is the alternative minimum tax, a cancer placed in the code in 1986 to ensure that wealthy people and profitable corporations did not use deductions to evade taxes. Because the tax has not been changed in 15 years — it does not take into account tax credits put in effect in recent years — it hits more Americans all the time, even those with modest incomes. Many who exercised incentive stock options are now unable to pay their alternative minimum taxes.

But even as middle-income Americans are impaled on the tax, the likelihood that a company will incur the tax has been greatly reduced. A little-noticed ruling from the Internal Revenue Service on Jan. 18 ensures that many companies will escape what could have been the reach of the tax.

The ruling, notable for its two-sentence length, seemed to come out of nowhere. It stated that companies with employees who exercised stock options would not be liable for alternative minimum tax related to the tax deductions the companies received on those option exercises. It said a company's earnings and profits — which are its taxable income for alternative minimum tax purposes — were diminished by the deduction, reducing vulnerability to the tax.

Such rulings are issued for a reason. Asked about this one, an I.R.S. spokeswoman said it was issued ''for clarification.'' Clarification is usually needed only when there are alternative points of view on an issue. So what were the different opinions and who held them? The I.R.S. would not say, but the Treasury Department said the difference of opinion originated at the I.R.S.

One tax expert in the private sector said that a case could be made that the alternative minimum tax ought to kick in as a result of option exercises. After all, the company's earnings were not actually reduced because option grants represent no economic outlay.

The recent ruling essentially precludes any agent from making that argument. And it makes options even more appealing to companies than they were. That is not good news for shareholders.

Corporations had already been incurring alternative minimum tax bills much less often than individuals. Robert Willens, a tax analyst at Lehman Brothers, said that the tax was generally limited to companies in capital intensive industries that reduce their tax bills by taking heavy depreciation expenses.

Today, companies are cutting or erasing their tax bills by deducting the spread on their employees' stock option exercises. Happily, for them anyway, the alternative minimum tax will not undo these tax breaks.

Memo to Congress: For the Treasury Department to reduce the vulnerability of corporations to the alternative minimum tax while individuals continue to be eviscerated by it does not pass the smell test. Why not just rid all Americans of this cancer? ø

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MARKET WATCH

GRETCHEN MORGENSON

A Company Tested And Found Wanting

THE money pit that was once the telecommunications industry became a yawning crater last week. On Friday, **Nortel Networks,** a company that only a year ago epitomized stock market glamour, said a significant reduction in purchases of its equipment would result in a $19.2 billion loss in the second quarter.

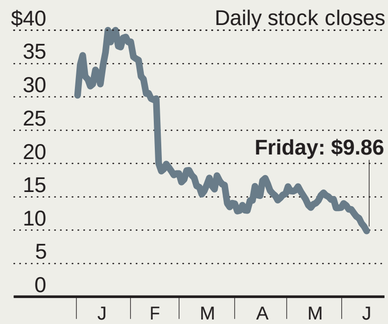
John Roth, Nortel's chief executive, blamed the now-miserly capital markets for shutting off the spigots to companies that used free-flowing funds to buy telecom gear, which everyone now realizes was superfluous. He allowed that the global telecom industry ''is undergoing a significant adjustment.''

The market shrugged off Nortel's loss, with the Nasdaq down less than 1 percent on Friday. But make no mistake: it is a milestone in the history of mismanagement of shareholder assets.

The $19.2 billion loss exceeds the annual gross domestic product of El Salvador and approaches that of Bolivia. Closer to home, Chuck Hill, head of research at Thomson Financial/First Call, said Nortel's loss contributed more than one percentage point to the 16.6 percent decline in earnings that he expects from Standard & Poor's 500 companies in the second quarter, compared with the same period last year.

Nortel's stock has collapsed. Last

Nortel Networks



Source: Bloomberg Financial Markets

July, it traded at $89, giving the company a value of roughly $275 billion. Now, with the stock at $9.86, Nortel has a value of $31 billion. Almost one-quarter trillion dollars in shareholder wealth is gone. And Nortel will discontinue its quarterly dividend, which it has paid since 1965.

Perhaps the most staggering figure in the Nortel news is the $12.3 billion write-down it is taking this quarter in good will on recent acquisitions. Good will is an intangible asset — the difference between the price a company pays to buy another and the value of the target's assets at the time of the purchase.

Nortel's write-down is the best proof yet of how entirely bankrupt the new-economy theory was that fueled the mania of the late 1990's. Because earnings didn't matter in the new era — only revenue growth did — Nortel was willing to pay exorbitant prices for acquisitions to juice its revenues. Never mind doing a cost/benefit analysis.

In 2000, Nortel acquired 11 technology concerns that management said would fulfill its ''vision of building the new, high-performance Internet.'' They included Sonoma Systems, a developer of high-speed data delivery systems, Alteon WebSystems, an Internet infrastructure company, and Xros Inc., a company in the business of photonic switching.

To buy these companies, which had net tangible assets totaling just $167 million, Nortel paid an astonishing $19.7 billion, mostly in shares. In other words, Nortel shareholders, at the behest of management, paid on average 118 times the value of these companies' tangible assets to acquire them.

On June 2, 2000, for instance, Nortel bought Xros for $3.2 billion in stock. Xros's net tangible assets at the time amounted to $3 million. No wonder all that good will is being written off.

The only wonder is that a manager and a board would make such blundering buys. Yes, Wall Street firms were feverishly pitching the deals, and yes, others in the industry were making equally awful acquisitions. But a seasoned executive or board attuned to stewardship of shareholder assets should have just said no.

Nortel explained the write-down as something it must do ''in light of the adjustment of technology valuations and the current business outlook.'' It added that it had derived ''enormous value'' from most of its acquisitions.

Everybody knows about bull-market geniuses — stock pickers who do well only in a market uptrend. Now, as Nortel shows, shareholders must be on the alert for bull-market managers, executives who have no clue how to manage a business when the economy stops roaring. How many more are out there? Ø

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MARKET WATCH

GRETCHEN MORGENSON

Warning Signs Fail to Shake True Believers' Faith

THIS is the story of Larry, Curly and Moe, three analysts whose writings on **Polymedica** illustrate why investors are right to mistrust Wall Street research.

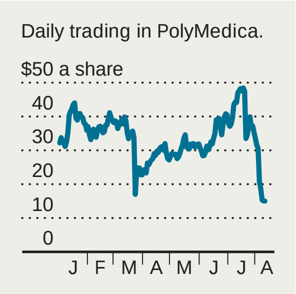
Polymedica sells medical supplies directly to consumers, many covered by Medicare. Few big brokerage firms follow it.

The big sticks on Polymedica belong to John Calcagnini of CIBC World Markets, Joel Ray of First Union Securities and Ryan Rauch of Adams, Harkness & Hill. CIBC and First Union underwrote three million Polymedica shares on Oct. 7, 1999, generating $3.4 million in fees. The next day, Mr. Ray began coverage with a ''strong buy.''

When 2000 dawned, Polymedica shares began an impressive ascent. On March 21, Mr. Rauch, who had been an analyst at CIBC at the time of the offering, began covering the company with a ''strong buy.'' The stock was $45; 10 days later it was $58.75.

But Polymedica is a volatile stock and by late May its shares had fallen to $27, perhaps because in April the company said it would sell $100 million in new shares.

To the stock's rescue rode Mr. Calcagnini, who began coverage on it with, what else, a ''strong buy.'' During June, the shares rallied to $52. As they rose, Steven J. Lee, Polymedica's chairman, sold shares worth about $1.3 million. During the summer and fall, as the analysts sang Polymedica's praises, Mr. Lee sold stock worth $1.4 million. CIBC and Adams, Harkness handled the trades.



On Oct. 23, Safeco Asset Management, Polymedica's largest shareholder, filed its intent to sell 300,000 shares through Adams, Harkness. The next day, Mr. Calcagnini and Mr. Ray restated their ''strong buy'' recommendations.

The bottom fell out of the stock on Nov. 20 when Barron's quoted a Federal Bureau of Investigation official saying the agency was looking into possible health care fraud at Polymedica. In the article, Mr. Lee denied knowledge of an investigation; the stock lost half its value that day.

Back in the Amen corner, the analysts worked to reassure investors. Mr. Calcagnini reiterated his upbeat view on Nov. 21, putting a $70 target on the stock, then trading at $30.25. He cheered again on Jan. 11 and Jan. 16; the stock rose to $44 two days later on news of record earnings.

Mr. Ray took over in March, recommending the stock just after it fell by half on news of customer complaints being sent to the F.B.I. An overreaction, Mr. Ray said, adding that Polymedica did not appear to be under investigation. Management had told him so.

In late June, Mr. Ray advised clients that the company expected a letter from federal authorities resolving the rumors shortly, according to Mr. Lee. The stock was at $40.

Last weekend, Barron's reported a federal grand jury investigation of Polymedica. In an interview Friday, Mr. Lee said the company would be exonerated.

After the news, Mr. Ray said of his coverage: ''I was basing my analysis on my discussions with the company. I felt that was the most accurate information.''

Polymedica's stock stands at $15.02. All three scribes have dropped their ratings, telling investors to ''wait for further clarity.'' Mr. Rauch threw in the towel last, saying, ''Other companies guilty of Medicare violations have survived and prospered.''

Neither Mr. Calcagnini nor Mr. Rauch returned phone calls. John Adams, chairman of Adams, Harkness & Hill, said he believed in Mr. Rauch's analysis. Asked if his firm's support of the stock was related to commissions generated by Polymedica insiders' trades, Mr. Adams said getting such orders is customary. ''It's a way of saying thank you for the research coverage,'' he said. Ø

MARKET WATCH

GRETCHEN MORGENSON

Price Targets Are Hazardous to Investors' Wealth

LAST Dec. 5, Andrew J. Neff, a computer analyst at **Bear, Stearns,** issued a report extolling the virtues of **Palm** Inc., the maker of hand-held computers. After meeting with Palm's management, Mr. Neff had come away a believer in the company's future and its battered shares. With the stock near $44, Palm was well below its March 2000 peak of $165, reached on its first day of trading. He put a 12-month price target of $80 on the shares, reflecting his belief that they would trade at 19 times his 2001 sales estimate for the company.

By the next week, Palm shares had climbed to $56.625. But then they began to sink, until, on Jan. 3, they had reached $27.88. That day, Mr. Neff cut his target to a range of $37 to $48. Two months later, with Palm in the mid-teens, Mr. Neff lowered his target again. Finally, on May 17, the shares stood at $7.05 when he slashed his target to around $5. It closed on Friday at $5.36.

Mr. Neff was by no means alone on Wall Street in his misplaced optimism regarding Palm. But his remarkable and almost certainly unreachable target of $80 for Palm shares does exemplify one of the most deplorable practices found among analysts during the stock market mania: the assignment of target prices that were based more on fantasy than reality.

''Those price targets were the equivalent of snake oil being sold off the back of covered wagons in the Wild West,'' said Stefan D. Abrams, chief investment officer for asset allocation at the Trust Company of the West in New York. ''The mere fact that you could not defend them by any rational means is evidence that these were nothing more than sales hype.''

Yet while money managers like Mr. Abrams recognized price targets for what they were — and laughed them off — many individuals bought stocks at least in part on their promise. Now they are sorry.

Early in the mania, of course, investors who bought stocks based on wild targets did well. **Amazon.com** blew through Henry Blodget's famous $400 target about a month after he assigned it in December 1998. And for every seemingly crazy target that was subsequently met, the next one became more credible.

Because analysts kept raising their price targets as the stocks neared them, investors were emboldened to stay at the party even after the band had gone home. Rather than advising investors to sell overpriced stocks, analysts, with their escalating price targets, kept investors in the shares long after they had begun to fall.

Mr. Neff said his early optimism about Palm was based on a less rigorous methodology than he applied to the stock later. But he said that ''it doesn't make intellectual sense to have an investment rating unless you have some sort of price target in mind.''

Big and bold price targets are a relatively new phenomenon in Wall Street research reports. In the 1980's, an analyst might estimate a range within which a stock could trade, based on what the analyst expected the company to earn. But such targets were low profile and typically surrounded by caveats.

Robert A. Olstein, manager of the **Olstein Financial Alert** fund, said today's use of dubious targets was an extension of a trend among analysts toward predicting next week's earnings instead of valuing companies. ''Today's analysts are soothsayers, because they're trying to predict where the crowd frenzy is going to take a stock,'' he said. ''No one has ever been able to do that with any degree of certainty.''

Other investment veterans say that howlingly high price targets became the rage in the late 1990's because analysts, in the midst of the huge bull market, found it difficult to differentiate themselves from the herd. ''It

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Continued From Page 1

was a way for an analyst to establish himself as the most bullish person on a particular issue,'' said Mitch Zacks, vice president of Zacks Investment Research in Chicago. ''That was very useful for the investment banking business of the firm.''

Surprisingly, while share prices of many former darlings are now in the cellar, and while Wall Street analysts, with their myriad conflicts of interest, are sweating under an increasingly unpleasant spotlight, wildly optimistic price targets can still be found on stocks. Instead of owning up to their too-rosy predictions, two of the largest brokerage firms acknowledge that in some cases, their analysts simply eliminate the price targets altogether without comment.

According to research conducted by Zacks, price targets on the nation's largest technology stocks are currently so high that their stocks would have to rise 80 percent, on average, to meet them.

Lucent Technologies, as of last Wednesday's close, would have to vault 204 percent to meet analysts' average target price, **EMC** would have to almost double and **Hewlett-Packard** would have rise 40 percent.

''The price target is the piece of data produced by Wall Street that is least tied to reality,'' Mr. Zacks said. ''They tend to be overly optimistic. They tend to be very, very slow to change because lowering a target is a signal to the investment community that things have gone permanently sour.''

RiskMetrics, a software analytics company based in New York that specializes in risk assessment for the financial community, recently conducted a study for Money & Business that examined 550 price targets assigned to some 300 technology stocks as of June 22. It looked at five major Wall Street firms' targets for companies in computer software, hardware and semiconductors, and calculated the probabilities that these targets would be met within the next 12 months. The firms are **Goldman, Sachs**; **Merrill Lynch**; **Morgan Stanley Dean Witter**; **Prudential Securities**; and the Salomon Smith Barney unit of **Citigroup**.

Fewer than 1 percent of the price targets in the study were below the stocks' levels as of July 24. While many of the targets had a better than 50-50 probability of being met based on past price action, 46 companies carried targets that had less than a 20 percent chance of being hit.

Consider a $50 price target on **Inet Technologies,** a communications software provider that closed at $9 on Friday. According to RiskMetrics, this stock has an 11 percent chance of reaching that price. An $80 target on **Orbotech**, a maker of optical inspection systems that closed on Friday at $26.35, has

Great Expectations

Investment banks have assigned seemingly unreachable target prices to many stocks — including these four — that they also helped sell to the public.

INVESTMENT BANK	COMPANY	FRIDAY'S STOCK PRICE	12-MONTH TARGET PRICE*	YEAR-TO-DATE RETURN
Salomon Smith Barney	Airnet Communications	$0.24	$15.00	–96%
Goldman, Sachs	Corio	0.73	24.00	–65
Merrill Lynch	USInternetworking	0.74	17.00	–85
Morgan Stanley	Via Net.Works	1.15	15.00	–70

Sources: RiskMetrics; brokerages

*Most recent

a 17 percent likelihood of being met.

''There's no consistency even within a brokerage house in the creation of a price target,'' said Michael Thompson, RiskMetrics' global market commentator. ''Too many times, these things come out of the air.''

The RiskMetric study showed that the Prudential analysts had the highest percentage of price targets that were most likely to be reached — 67 percent. Salomon Smith Barney took second place with 64 percent, followed by Merrill Lynch at 58 percent and Morgan Stanley at 57 percent. Goldman was last, at 49 percent.

A word of caution on these figures: this study was focused on one sector of the economy and based on data collected without the firms' help. The results could be quite different for research in other sectors.

Ed Canaday, a spokesman for Goldman, said target prices are based on a moment in time and are not intended to be continuous, because so much about a stock can change.

So why do firms keep outlandish targets on stocks? The answer may be akin to the reason Wall Street issue so few sell ratings: the fear of losing investment banking business.

The firms deny that price targets are used to draw in banking business or to keep clients happy. But in the RiskMetrics study, in more than one-fourth of the cases when stocks carried an outlandish price target from a brokerage firm, that broker underwrote shares or provided other investment banking services for the company.

Individual investors should do as their institutional brethren do and pay no heed to price targets. As RiskMetrics' Mr. Thompson said, ''We've got to stop the mumbo jumbo that's really not based on anything terribly meaningful.'' Ø

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MARKET WATCH

GRETCHEN MORGENSON

Take Away the Window Dressing, and Who Will Buy?

WITH the global economy in a stall, corporate spending at a standstill and layoffs threatening to subvert consumer spending, it is no surprise that the United States stock market is feeling overwhelmed.

But something else is weighing on stocks. That is the creeping realization among investors that the momentous earnings reported by many companies in recent years may have been digitally remastered to include a lot of hype, embroidery and fluff.

This is significant. Investors coming around to this view will be less inclined to trust forecasts that company executives make. Having lost faith in a company's numbers, investors will be unable to place a fair value on its stock. In the dark on valuations, many investors will shun the shares.

An extreme reaction? Not at all. It is precisely the payback that companies deserve for embellishing their earnings.

The quality of corporate earnings seemed a quaint concern when stocks were racing. Now, reality in company earnings is crucial.

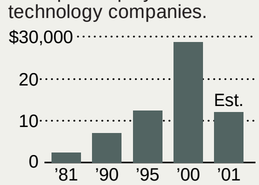
But separating reality from fantasy in corporate earnings is harder than ever. Consider the gulf between estimates of second-quarter earnings from First Call and Standard & Poor's. While First Call said operating earnings among companies in the S.& P. 500 had fallen by 17 percent from the same period last year, S. & P. reckoned that the decline at those companies was 33 percent in the quarter.

Because companies have much leeway in what they report as operating earnings, perhaps the best way to assess the true state of earnings is to consult government figures.

While the average annual earnings growth reported by companies in the S.& P. 500 came in at around 9 percent from 1995 to 2000, the Commerce Department's Bureau of Economic Analysis says corporate after-tax profits grew only 5 percent annually.

More Is Less Again

Profit per employee at technology companies.



Source: Morgan Stanley

A report from Sanford C. Bernstein & Company, a brokerage firm, supports the government's figures. The report says the 9 percent average annual earnings growth at S.& P. companies in the late 1990's was really only 5 percent if one cancels out favorable accounting for stock options and earnings boosts that companies took from stock gains in pension plans.

Had companies deducted the cost of options from revenue, which they need not do, annual S.& P. profit growth from 1995 to 2000 would drop to 6 percent from 9 percent, the report said. Subtract fat gains from shares held in pensions, and earnings growth falls by another percentage point.

Another stellar aspect of the technology marvel dims under the gaze of Steve Galbraith, United States equity strategist at Morgan Stanley. He says that at many tech companies, profitability per employee grew at astounding rates in the late 1990's but is now crashing. Per-worker profits at semiconductor companies, for example, are expected to fall 77 percent this year.

This proves not only that technology is cyclical, but also that profit gains were largely a result of easy money, not of intellectual capital. ''If this was somehow an intellectual-capital-driven business, there is no way you would have had this kind of degradation in profit per employee,'' Mr. Galbraith said. ''Capital was free and they all spent it into this area.''

Advances in technology were thought to have wrought a profitability miracle in the late 1990's. Now it seems the miracle was a result of a roaring stock market and accommodating capital markets.

Experienced investors know not to confuse brilliance with a bull market. The new era version of that rule: Don't confuse profits with a bull market, either. Ø