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COVER STORY

## The Numbers Game

**Companies use every trick to pump earnings and fool investors. The latest abuse: "Pro forma" reporting**

"It is simply a matter of creative accounting," says Matthew Broderick, playing bean counter Leopold Bloom in the hit musical *The Producers*. "Under the right circumstances, a producer could make more money with a flop than he could with a hit." Max Bialystock, Bloom's client, immediately sees the potential for solving his money woes. He raises as much as he can from rich widows to finance a new Broadway musical, *Springtime for Hitler*. He blows the money on himself, intending for the show to bomb so that nobody will ask awkward questions.

For all the hoopla on the Great White Way, Bloom is a primitive in the numbers game. He's operating without pro forma accounting, which allows all kinds of fictions in the way companies present their earnings. In the great bull market of the 1990s, companies and their CEOs used aggressive tricks to deliver the continually rising sales and earnings that Wall Street wanted to see. It's gotten far worse in the market slump. The pricking of the Wall Street bubble has stepped up pressure on desperate CEOs to shore up earnings ravaged by the sudden economic slowdown. Whether it's boom time or bust, companies have cast aside constraints on how they report sales and earnings to the public. They are dodging accounting rules built up over decades, choosing instead a slew of unconventional and often questionable practices that would turn Bloom green with envy.

Sure, companies have always tried to present themselves in the best possible light. But some of today's practices, though perfectly legal, sail close to the wind: They seem designed to mislead unwary investors about the real financial state of companies that use them. Fading dot-coms, new tech giants, and venerable blue chips all hype their earnings. Cisco Systems Inc. subtracts payroll taxes on employee stock options in its

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earnings-per-share numbers. IBM lifts its earnings by assuming it would pay less into its pension fund, and Motorola Inc. boosts sales by lending huge sums to customers. "CEOs were obsessed with growth," says Christopher M. Davis, portfolio manager at the family firm of Davis Selected Advisers. "They, as in the past, tortured accounting to produce income statements that would be applauded by Wall Street."

The full extent of bad stuff that happened during the boom is only now becoming clear--and it is worse than anyone thought. Ordinary investors and Wall Street pros alike are beginning to cry foul.

What's alarming them is that the games affect the stock market and its integrity every day. It's getting harder to answer the basic questions that underlie rational investment decisions. What is a company's bottom line? Is it making money or not? What is the price-earnings ratio on its stock? The answers are all over the place.

Variations in how companies report their results make it harder to know if their valuation is cheap or rich compared with their peers and the rest of the market. Chipmaker Intel Corp. includes gains from stock investments in its preferred earnings measure; Cisco does not. And with inconsistent numbers seeping into calculations of p-e's for the major indexes, it's harder to gauge whether the market is valued high or low compared with the past. Companies "are destroying the credibility of the profits they are producing," says Robert Olstein, manager of Olstein Financial Alert, a mutual fund. "There is no way some of these companies were growing at the rates they were representing."

**CREDIBILITY GAAP.** The emergence of pro forma accounting is what enables companies to play the numbers game to the hilt. Tech companies in particular discovered a powerful new way to obscure what was really happening in their often shaky businesses. Traditionally, pro forma accounts were a way of giving an idea of what earnings would look like in completely new businesses or in those that would result from a merger. But real New Economy companies now conjure up a second set of figures--created outside generally accepted accounting principles, or GAAP, which still must be used in reports to the Securities & Exchange Commission--and call them pro forma. "It is open season [for companies] to say what they want in press releases," says Chuck Hill, research director at Thomson Financial/First Call, an earnings tracking service.

GAAP is a set of accounting rules hammered out by regulators, companies, and their auditors over decades. It aims to give a fair and true picture of a company's financial position and make it harder for executives to hype their results. GAAP rules are applied to every company, no matter what its business or stage of development. A small biotech startup with little more than patentable ideas is treated the same way as a fast-food empire or a giant auto maker with billions invested in plants. Some companies argue that GAAP isn't always the best way of measuring how they're doing. And on some points, even skeptical investors agree with them. But the virtue of GAAP is that it is the most

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consistent and objective way to compare results across companies and industries.

That can't be said of pro forma. Each company uses it any way it wishes. Yahoo! Inc., one of the first to emphasize pro forma, in January, 1999, presented results 35% better than GAAP by excluding a variety of costs of buying Internet companies. In its latest set of results, issued on Apr. 11, Yahoo excluded yet more items, such as payroll taxes on stock options. Data center operator Exodus Communications Inc., in its version of pro forma, also excludes some acquisition costs, but apparently not options taxes. Network Associates Inc. (table, page 106), meanwhile, conveniently drops a loss-making 80%-owned subsidiary, McAfee.com Corp., in working out its pro forma results, which show only half the loss reached under GAAP. In a Mar. 27 press release, software company Xcare.net Inc. reported revenues before subtracting the cost of warrants to buy Xcare shares that it gave to a customer. The value of the warrants was given lower down in the release, but the headline numbers boosted the company's apparent sales by 69% and cut its losses by 40%. Xcare Chief Financial Officer Gary T. Scherping says he wasn't trying to fool anybody. "I could probably have come up with another three things that I could have excluded had I wanted to play those games...that other people regularly do," he says.

Amazon.com Inc. can't even settle on a single definition of pro forma. In its Apr. 24 results announcement, it reported a "pro forma operating" loss of \$49 million in the first quarter of this year. Confusingly, it also reported a "pro forma net" loss of 21 cents a share, equivalent to \$76 million. Investors had to pick carefully among a slew of numbers to see that Amazon actually had a net loss of \$234 million, or 66 cents a share, using GAAP. Among the items excluded from pro forma operating losses were a net interest expense of \$24 million and a \$114 million charge for restructuring costs, such as closing a warehouse. "The pro forma numbers are how we think about our business" and how Wall Street analysts follow it, says Amazon spokesman Bill Curry, emphasizing that the GAAP numbers are included.

The magic of pro forma can turn losses into profits. That's just what happened at Computer Associates International Inc., whose accounting was challenged in an Apr. 29 story in *The New York Times*. By changing the terms of its software sales and how it accounts for them, CA reported 42 cents of pro forma earnings per share in the final quarter of last year, vs. a 59 cents loss under GAAP. Company officials say the new presentation is actually more conservative and not done to enhance growth. Similarly, giant telecom carrier Qwest Communications International Inc. reported \$2 billion in quarterly earnings before interest, taxes, depreciation, and amortization, or EBITDA, an early version of pro forma, in a Jan. 24 release. Shareholders had to wait weeks to find out, in a footnote to the annual results, that Qwest actually lost \$116 million, according to GAAP rules. Qwest says the variation is extreme because of adjustments for its takeover of US West Inc.

Some companies with profits can really give themselves a lift. Take Quintiles Transnational Corp., a number cruncher that sells statistical services to the drug industry. In press releases, it excludes the costs of Internet operations when it reports earnings from "core operations." The result: a 77% higher net income. Quintiles' investor relations officer, Greg Connors, says there's nothing wrong since GAAP results are attached: "We thought this was the best way to describe ourselves to the market." Including the cost would make it hard for investors to compare Quintiles with rivals that don't invest so much in the Net, he says, calling the cost "unusual." But the expenses aren't a one-time event: They have been going on for a year, and they are continuing.

The spread of pro forma earnings has plunged investors into an Alice-in-Wonderland world. SEC Chief Accountant Lynn E. Turner calls pro forma results "EBS earnings"--for Everything but Bad Stuff. "Way too often, they seem to be used to distract investors from the actual results," Turner says. Wall Street, of course, is happy to play along: First Call's Hill says more than 260 companies have persuaded a majority of top financial analysts to abandon GAAP when making earnings estimates.

Pro forma is the most egregious of the numbers games. But new variants of old accounting tricks are also flourishing throughout the corporate world. Here are the gambits for which investors should be on the lookout:

-- **VENDOR FINANCING.** Pressure from Wall Street for ever increasing sales generated lots of bad numbers as high-tech companies took to overstating their revenues by lending big to customers. In moderation, vendor financing is a sound selling technique; abused, it's a dangerous way to do business. Just ask some telecom-equipment suppliers: By the end of 2000, they were collectively owed as much as \$15 billion by customers, a 25% increase in a single year. Effectively, they were buying their own products with their own money, exaggerating the size and sustainability of their sales and earnings growth. "It is only now, in hindsight, that it is turning out that it wasn't real revenue growth at all, just bad receivables," says Hank Herrmann, chief investment officer at Waddell & Reed Financial Inc., a fund manager.

Investors were spooked to discover, deep in a company filing to the SEC on Mar. 30, that Motorola is owed \$1.7 billion by Turkey's No. 2 wireless carrier, Telsim. In a Feb. 3, 2000, press release announcing a \$1.5 billion order from Telsim, Motorola made no mention of any loans. "That is a risk I would have liked to have known about years ago," complains portfolio manager Davis. The risk is not just that the customer won't pay, but that the customer won't buy more products unless Motorola lends it more. Since the original announcement of the Telsim order, Motorola stock has fallen 69%, losing about \$75 billion of its market value. Motorola says it properly disclosed its financing practices in filings to the SEC. The loan is backed by a claim on "significantly" more than half of Telsim's stock, says spokesman Scott Wyman.

Employee stock options have proved useful throughout the economy in

recruiting and holding staff. But companies don't have to deduct the cost of options from their income, as they must for wages paid in cash. So they have a powerful tool to pump up profits in the short run--at the cost of diluting ordinary shareholders' equity as employees exercise their options. A handful of companies, such as Boeing Co. and Winn-Dixie Stores Inc., decline to play that game, and charge the estimated value of options immediately. But most don't expense the costs--some to terrific effect. At coffee chain Starbucks Corp., for example, expensing the value of options would have reduced reported net income by \$28 million, or 30%, in the year through October. At Cisco, it would have reduced reported income by \$1.1 billion, or 42%, in the year through July. Furthermore, the compounded annual growth of Cisco's reported net income for the three previous years would have sunk to 33% from 41%, according to Bear, Stearns & Co. accounting analyst Pat McConnell. Veteran short-seller James Chanos of Kynikos Associates Ltd. calls the treatment of options "a national outrage... an ongoing shame."

Aggressive options accounting makes overall corporate profits look much higher than they really are. McConnell of Bear Stearns figures the average earnings growth rate for companies in the Standard & Poor's 500-stock index with options fully expensed would have been cut from 11% to 9% for the three years to mid-2000. But the information is hard to come by. Companies are required only to disclose their option costs in a footnote to their annual reports.

-- **SQUEEZE AND STRETCH.** Companies that need to show earnings growth can help themselves by booking sales early or costs late. For instance, software company MicroStrategy Inc. reported revenue in three quarters in 1998 and 1999 based on contracts it did not complete until after the quarters had ended, the SEC found. The company restated three years' worth of profits to losses and settled the matter with the SEC, neither admitting nor denying the allegations. Three corporate officers agreed to pay penalties totaling \$1 million.

More companies than ever are boosting earnings by changing assumptions that will lower their reported expenses, says the SEC's Turner. Typically, executives use stratagems such as extending the expected life of assets to reduce depreciation charges or betting that they'll have fewer bad debts. Reader's Digest Association Inc. became more optimistic about the number of customers who would pay their bills on time and gained about 16 cents a share in last year's December quarter, says fund manager Olstein. Reader's Digest spokesman William Adler says the company's collection estimate "is not put in to affect income in any way." He says the estimate was raised properly, because its mix of business had shifted from books toward subscriptions, which are more likely to be paid.

In some cases, there has been no change in assumptions at all, but a questionable judgment from the start. The SEC recently took issue with Verizon Wireless Inc.'s decision to amortize the cost of its wireless licenses over 40 years instead of 20 years or less. The longer

amortization, which Verizon says is appropriate because the licenses are renewable, helps earnings, but assumes the licenses will never lose value because of another technology.

Company pension plans can become a fruitful source of extra earnings. Companies can't generally take money out of their pension funds, but by juggling several factors, including the actuarial present value of benefits, interest rates, and expected returns on assets, they can reduce or even eliminate what they have to pay into their plans in any given year, according to Gabrielle Napolitano, accounting maven at Goldman, Sachs & Co. For example, IBM picked up \$195 million--1.7% of pretax income--in 2000, when it raised the expected rate of investment return from 9.5% to 10%.

Companies, of course, would rather have investors imagine that all their earnings are coming from their businesses. So some try to disguise the pension lift by lumping it with other retirement benefits costs, says Jack T. Ciesielski, publisher of the *Analyst's Accounting Observer* newsletter. General Electric Co.'s annual report says 6.5% of its \$12.7 billion net earnings in 2000 were from "post-employment benefit plans," which cover everything from pensions to retiree health plans. Take out the cost of retiree health- and life-insurance benefits, which are found in footnotes, and the boost from the pension plan leaps to 9%. With the stock market in a funk, companies may not be able to count on the same gains in the future. Indeed, they may have to cough up to keep their plans whole.

-- **BIG BATH.** The slowing economy is giving a maneuver known as the big bath a whole new lease on life. A company takes a huge restructuring charge one year, often when it's making losses or much lower profits than before. It may sound crazy to make losses look worse, but the ploy gives the company big help in reducing expenses and enhancing earnings in the future. On Apr. 16, Cisco announced two whoppers. One charge, of up to \$1.2 billion, is for the cost of laying off workers, closing buildings, and erasing goodwill from its balance sheet. The other is to write off \$2.5 billion of excess inventory, primarily raw materials that Cisco says have zero value. Will Cisco sell the inventory, or use it in products later? A Cisco spokesman said the inventory is worthless and "we have no plans to use it, period."

Worried about the possible abuse of the big bath technique, the SEC in late 1999 directed companies to disclose sizable charges in more detail. But the facts are still sometimes hard to find. Even before Computer Associates' issues with revenue recognition surfaced, analysts were suspicious of its earnings numbers. Last year, Sterling Software Inc. apparently took a charge right before being acquired by CA, a move that may have accelerated operating expenses to the benefit of CA's later earnings, according to Howard Schilit, head of the Center for Financial Research & Analysis, an earnings watch service. CA says the charges were described in its filings to the SEC and notes that it reported lower-than-projected earnings following the merger.

How did earnings reports slide into such chaos? It's tempting to finger the auditors, who after all are supposed to be the first line of defense against financial chicanery. But that would be too simple. "Auditors are really not responsible for doing analysis on financial reports," says Schilit. A more serious problem is that strict accounting is losing its champions within companies. Fewer and fewer chief financial officers are certified public accountants, notes the SEC's Turner.

"Everybody is to blame here," says a veteran hedge-fund manager, who admits that he, too, was buying rising stocks with little regard to how companies were spinning their numbers. Mutual-fund portfolio managers learned in the bull market that if they took time to check details in financial reports before buying a stock, competitors would have already bid up prices. Analysts at Wall Street investment banks started spending more time soliciting underwriting business and less time verifying what managements were telling them, complains Philip T. Orlando, chief investment officer at Value Line Asset Management Services, a money manager.

**AOL'S PAYOFF.** Today's abundance of ways of calculating earnings has its roots in the 1980s heyday of the junk-bond market and, ironically, in deliberations by the Financial Accounting Standards Board, the major accounting rulemaker. Purveyors of junk made EBITDA part of Wall Street's daily vocabulary because it measured how much debt a company could carry in a leveraged buyout. LBO firms then used it to promote sales of stock back to the public in the mid-1990s. FASB responded to the interest by considering a rule under which companies would also report something to be called "cash earnings" that would have been similar to EBITDA. FASB ultimately dropped the idea but by then had opened a Pandora's box, encouraging companies to ignore GAAP as the prime measure of earnings.

But now, with the renewed skepticism that comes amid big stock market losses, investors and regulators are much less inclined to tolerate aggressive accounting. "We're going to force better disclosure," promises money manager Herrmann.

Trouble is, it takes the regulators ages to clamp down on questionable practices, allowing companies to hoodwink investors in the meantime. For years, America Online Inc. aggressively deferred the marketing expenses of sending out millions of computer disks to potential customers. That enabled AOL to look more profitable than it really was, helping it issue securities for cash and acquisitions that fed its growth. By the time AOL submitted to an SEC settlement on May 15, 2000 (without admitting or denying any wrongdoing), paid a \$3.5 million fine, and restated its former income to losses, the company was home free. It was an Internet giant. Now, AOL owns communications giant Time Warner and is called AOL Time Warner Inc. "If AOL were by itself today, its stock price would be a lot lower... [so] the accounting aggressiveness paid off," says David W. Tice, a money manager who publishes the earnings

watch bulletin *Behind the Numbers*.

Under former Chairman Arthur Levitt, the SEC started a campaign against numbers games in September, 1998 (table). Among the results: a financial fraud task force, which SEC enforcement chief Richard Walker says has been "working on some very, very substantial matters, which the public will learn about shortly." They involve some of the largest companies in the country and the biggest accounting firms, he says.

Private groups are getting involved, too. At the behest of the SEC's Turner, Financial Executives International, an organization of financial officers, on Apr. 26 issued guidelines aimed at reining in the excesses of pro forma reporting. At the New York Society of Security Analysts Inc., a discussion group has focused attention on the way Amazon reports its results. Gary Lutin, an investment banker and co-sponsor of the group, says: "I hope we are helping to accelerate the natural process of the cycle" back to reality-based financial reporting. Apparently, he has made some progress. Amazon included a table reconciling pro forma and GAAP data in its latest results.

Still, cleaning up financial reporting won't be easy, given that the stakes for companies are so high. But so are those for ordinary investors whose wealth and retirement prospects are ultimately on the line in the numbers game.

Unless they and their advisers want to end up as thoroughly fleeced as Max Bialystock's rich widows, they need to pay a lot more attention to the numbers than they did during the bull market.

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By David Henry  
With Christopher H. Schmitt in Washington

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