

JUNE 2003



© Spots Illustration/Veer

CORPORATE FINANCE PRACTICE

Accounting: Now for something completely different

It's not the bottom line, but how the bottom line is calculated, that really counts.

Timothy M. Koller

Accountants, regulators, and corporate executives are again embroiled in debate, this time over the best way to figure the expense of stock options, which can change dramatically in value between when they are issued and when they are cashed. It's the latest act in a recurring drama to try and glean a more accurate assessment of a company's value by focusing on a particular item's effect on net income. A few years ago the topic was whether changing the method of accounting for goodwill in acquisitions would damage corporate earnings and investor appeal. As baby boomers grow ever grayer, the value of stated pension reserves is certain to be next.

Unfortunately, this kind of financial reductionism is a pale substitute for the kind of disclosure investors really need. Their trust has been battered by an era of stunning corporate greed, ethical lapses by accountants, and malfeasance on the

part of high-profile executives and analysts. Faced with political backlash, regulators are right to try to restore investor trust. But unless they and boards of directors start insisting on providing the information and transparency that reveals underlying performance and how it relates to future performance, investors can't be blamed if they continue to withhold that trust.

Executives regularly sweat meetings with analysts in which the focus is on whether or not a single number—quarterly net income—is met. And many apparently think that a good earnings number can boost share prices even if the earnings don't represent real underlying economic change. Armed with proper disclosure, however, markets easily see through this. For example, concerns that eliminating “pooling” accounting of acquisition goodwill would hammer share prices proved

unfounded when new rules were adopted. The elimination of goodwill amortization increased some companies' reported net income by 50 percent or more, yet their share prices didn't skyrocket compared to peers. Share prices didn't follow earnings upward because changing the accounting approach didn't alter cash flows. The market knew all along how much amortization was in those companies' income statements, where it was already displayed.

The same thing will happen if new rules for accounting for stock options are adopted. At a recent private meeting with venture capitalists and academics, one top-ranked sell-side technology analyst confessed to caring little whether or not stock options were listed as an expense at all on corporate income statements, much less what value is assigned to them. His personal bottom line: as long as the income statement or its footnotes provide him with sufficient information on the number, exercise prices, and duration of options, he could independently judge the impact of the options on the value of the company.

But what can happen when the market does not have adequate disclosure to work with it? Savvy as it is, the market cannot be expected to ferret out information that is not disclosed. For example, when one multinational corporation first reported its results under US generally accepted accounting principles (GAAP) in order to list its shares on American markets, its share price dropped by 11 percent in two days. Yet when Daimler-Benz took the identical step in 1993, its share price relative to the market remained untouched—even though its US earnings showed a loss of DM 1.8 billion versus a profit of DM 600 million under German accounting rules.

The critical difference between the two cases was the history of information each had already

disclosed. When Daimler reported under US GAAP, the major accounting differences mostly related to changes in reserves, pension items, and goodwill amortization, which had already been discernible to investors in the details of the company's annual reports. When the multinational corporation in question first reported its earnings under US GAAP, it unexpectedly disclosed that a significant portion of its profits for the previous year were actually one-time gains from real estate transactions and derivatives, rather than from recurring operating profits.

Toward genuinely helpful disclosure

As investors try to develop predictions about future cash flow and profits, past performance becomes an essential foundation for a credible forecast. From that standpoint, there are some areas in which most companies might focus if they truly wish to move away from simplistic "single-number" reporting toward disclosure that genuinely provides investors with helpful insights to assess underlying performance. They can start with more transparent, reorganized income statements, balance sheets and cash flow statements, along with clearer, more detailed business-unit disclosures. Finally, they can publish more insightful, perhaps standardized management analyses of reported results.

Details, details

Currently, most companies minimize the amount of detail in their financial statements, relegating much useful information to the footnotes. They also commonly mix up operating (recurring) with nonoperating (non-recurring) items. To make better forecasts, however, investors need to understand the details, particularly what is recurring and what is nonrecurring. Financial statements should be organized with more detail and with an aim to clearly separating operating from non-operating items. It's not easy. In fact,

current accounting rules exhibit something less than common sense in defining operating versus nonoperating nonrecurring. As a start, however, company income statements should close the biggest gaps in the current system by separately identifying the following items.

- Nonrecurring pension expense adjustments. These often have more to do with the performance of the pension fund than the operating performance of the company. Investors would benefit from being able to assess a company's operating performance compared to peers over time separately from its skills at managing its pension assets.
- Gains and losses from assets sales that are not recurring. Large companies like to bury gains from asset sales in operating results because it makes their operating performance look better, often arguing that the impact is immaterial. But investors should be the ones who decide what is material. Companies should also separate out gains from losses. Now companies sometimes sell assets to create gains to offset losses from asset sales, and some top-ranked multinationals are well known for doing this on a regular basis. This is a perverse incentive that would go away if companies were required to disclose gains and losses.
- Executive stock option expense should also be fully disclosed in a separate line item in the income statement, not because it is non-operating, but because the amounts are large and difficult to estimate.

In a more useful income statement, complex or nonrecurring items such as pension expenses, stock options, changes in restructuring reserves, and asset gains or losses would be separately disclosed, regardless of materiality (exhibit). Similarly, balance sheets should separate assets

and liabilities that are used in the operations of the business from other assets and liabilities, such as excess cash not needed to fund the operations, or investments in unrelated activities. The typical cash flow statement is in need of major reorganization, once again to separate operating activities from nonrecurring activities from financing activities. Also the reconciliation of the cash flow statement to the balance sheet should be more transparent.

A focus on business units

Today's large companies are complex, with multiple business units that rarely have the same growth potential and profitability. Sophisticated investors will try to value each business unit separately or build up consolidated forecasts from the sum of the individual business units. Yet many companies report only the minimum required information and often not enough for investors to understand the underlying health of the business units. Nearly always, business-unit results are relegated to the footnotes at the back of the annual report.

Business-unit reporting should be much more prominent and detailed than it currently is. A good case can be made that business-unit reporting is in fact more important than the consolidated results and should be the focus of corporate reporting. At a minimum, companies should produce a clear operating income statement for each business unit in a format similar to the consolidated income statement (though it isn't necessary to allocate non-operating and financial items such as interest expense). Similarly, companies should disclose operating balance sheets, including working capital, property plant and equipment, goodwill, and any other operating assets. It isn't necessary to allocate cash, debt, pension liabilities, or other non-operating items to the business units. Business unit financial statements should be clearly reconciled to the consolidated reports.

Exhibit

What more helpful reporting would look like

Income statement, current format

Revenues	1,000
Cost of sales	(600)
Selling, general and administrative expenses	(257)
Other expenses	(20)
Amortization of intangibles	(5)
Earnings before interest and taxes	118
Interest income	2
Interest expense	(20)
Earnings before taxes	100
Income taxes	(40)
Net income	60

Balance sheet, current format**Current assets**

Cash and equivalents	75
Accounts receivable	150
Inventories	175
Other current assets	50
Total current assets	450

Net property, plant, equipment	200
Goodwill	60
Other intangibles	50
Deferred taxes	20
Equity investments	30
Total assets	810

Current liabilities

Notes payable	50
Accounts payable	160
Accrued liabilities	40
Dividends payable	10
Total current liabilities	260

Long-term debt	200
Deferred taxes	60
Pension obligations	50
Shareholders' equity	240
Total liabilities and equity	810

Income statement, proposed format

Revenues	1,000
Cost of sales	(600)
Selling, general and administrative expenses	(307)
Recurring operating profit	93
Amortization of intangibles	(5)
Gains from asset sales	20
Changes in restructuring reserve	25
Pension accounting adjustments	(15)
Interest income	2
Interest expense	(20)
Earnings before taxes	100
Income taxes—current	(30)
Income taxes—deferred	(10)
Net income	60

Balance sheet, proposed format**Operating working capital**

Accounts receivable	150
Inventories	175
Other current assets	50
Accounts payable	(160)
Accrued liabilities	(40)
Operating work capital	175

Net property, plant, equipment	200
Operating capital	375

Goodwill	60
Other intangibles	50
Equity investments	30
Cash	75
Total investor capital	590

Notes payable	50
Long-term debt	200
Dividends payable	10
Pension obligations	50
Net deferred taxes	40
Shareholders' equity	240
Total investor capital	590

Analysis that counts

Under US accounting rules managers must publish with their financial statements a document called “Management’s Discussion and Analysis of Results of Operations and Financial Position.” Many of these amount to little more than boilerplate disclosure. Other approaches, however, might bring investors real insights into company performance. For example, analysis might include separate discussion of results by business unit, rather than on a consolidated basis. Changes in business-unit measures are more useful than consolidated revenues and margins. Regulators might also require certain common analyses, such as an explanation of revenue changes caused by acquisitions and foreign currency effects, as opposed to organic growth. To attain a better baseline for forecasting, investors need to know that of a company’s 8 percent revenue growth, 5 percent was from acquisitions, and therefore only 3 percent was organic.

Objections overruled

Such supplemental disclosure is already the norm in some industries. For example, many retailers break down how the combination of same-store sales growth and changes in the number of stores affect revenues. Similarly, pharmaceutical companies routinely disclose the sales of their major products.

But such disclosure isn’t as widespread as it should be. And as with other accounting debates, it’s likely that any movement toward expanded, more detailed accounting would spark criticism that it would prove too expensive, too complex, and result in a giveaway of competitive information.

We disagree. As for expense, there should be no significant added costs to produce information that is—or should be—already prepared for

management and the board of directors. If companies don’t have this information, it raises questions about their financial systems.

Complex? Sure, and it’s likely that some investors will neither understand nor appreciate more detailed disclosures. But the fact is that large public companies are complex operations with complex financial performance. Understanding their real performance prospects can come only with understanding the underlying complexity of their operations. Disclosures can be oriented to the sophisticated investors who ultimately drive share prices, with an expectation that transparency will ultimately prove more valuable to less sophisticated investors than simpler, yet more opaque, financial statements.

Companies should rightly be allowed to protect competitive information. In limited cases, some companies may need to opt out of certain disclosures that could damage their competitive position. Yet, we believe any argument that more complete financial reporting will produce widespread leakage of competitive information is, for the most part, bogus.



Chief executives and senior executives like to be able to smooth out their performance. They like to have the option of offsetting poor performance in one part of the company with good performance elsewhere. They like to be able to hide low organic growth by making acquisitions. But we are convinced that investors will be better served, and will trust companies more, only when companies drop their preference for accounting designed to produce a smooth, simple bottom line and opt to open up to investors the true complexity of their business. ○