<u>CELL-BY-CELL HAv2.3 COMMENTS</u>

<u>INTRODUCTION</u>

Cell 1A: Cell Shading Color Coding ---

(1) Green - positive/better;
(2) Yellow - negative/worse;
(3) Red - extremely negative;
(4) Light Blue - note use or amount of item;
(5) Dark Blue - Balance Sheet not balanced.

User Techniques ---
1) To copy a file: (a) place cursor over file name and use <Ctrl> drag and drop; (b) right Click over new file name and Rename.
2) When not using a data column, replace the Year specified, e.g. 20XX, on line 5 with =“ “.
3) When not using an Income Statement or Balance Sheet item in column A, e.g. Executive Salaries, replace item with =“ “.
4) Set forth the subject corporation’s name at A3.
5) Be sure to modify the data at D3 and D4 or delete the item.

Financial Statement Analysis
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Culver City, CA 90230
(310) 838-8105
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<u>INCOME STATEMENT</u>

Cell 6B: Revenue

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has just published a follow-up study to its landmark 1987 report. Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies, examines financial reporting fraud cases the SEC has brought against U.S. public companies.

Exhibit 2: Common Revenue Fraud Techniques

* Sham sales: To cover up fraud, company representatives often falsified inventory records, shipping records and invoices. In some cases, a company recorded sales for goods merely shipped to another company location. In other cases, it pretended to ship goods to appear as if a sale had occurred and then hid the related inventory, which was never shipped to customers, from the auditors.
* Premature revenues before all the terms of the sale were completed. Generally this involved recording sales after the goods were ordered but before they were shipped to the customer.

* Conditional sales. These transactions were recorded as revenues even though the sales involved unresolved contingencies or the terms of the sale were amended subsequently by side letter agreements that often eliminated the customer's obligation to keep the merchandise.
* Improper cutoff of sales. To increase revenues, the accounting records were held open beyond the balance sheet date to record sales of the subsequent accounting period in the current period.
* Improper use of the percentage-of-completion method. Revenues were overstated by accelerating the estimated percentage of completion for projects in process.
* Unauthorized shipments. Revenues were overstated by shipping goods not ordered by the customer or by shipping defective products and recording revenues at full, rather than discounted, prices.
* Consignment sales. Revenues were recorded for consignment shipments or shipments of goods for customers to consider on a trial basis.

7/8/06 WSJ: Some Situations That May Mean Trouble Brewing in Your Portfolio

What goes in, doesn't come out. Sounds simple enough, but it's actually quite complicated, especially for a company like Palm Inc., maker of the popular Treo phones. Rather than book revenue when products sell through to consumers, Palm does what many consumer-product manufacturers do: It records a sale when its phones ship to retailers. That policy works well when retail sales are brisk, but can backfire when they're not as robust as expected. That appears to be what in part happened in Palm's fiscal fourth quarter -- the first full quarter for sales of its Treo 700 series. The phones generated good press, and Palm had the strongest unit shipments ever. But sell-through slipped slightly from the prior quarter. Palm executives cited several reasons, and (not surprisingly) guided to a fiscal first quarter that is below expectations. … Quarter-end announcements. Last-minute deals that somehow puff up a part of a company's performance always are worthy of suspicion. Take, for example, Biolase Technology, which makes dental lasers. On June 29, just before the quarter's end, it announced a strategic relationship with Procter & Gamble. Biolase offered scant detail, but disclosed that it immediately received an initial payment of $3 million in return for granting P&G rights to some of its intellectual property. The company said the timing of the deal wasn't tied to any cash needs. Good thing, because there's a catch: According to a regulatory filing, this is merely a binding letter of agreement, and the license is "provisional." If the binding agreement is breached or terminated, the filing says, Biolase will have to return the $3 million. All of which is a long-winded way to say: When it comes to earnings, it's quality, not quantity, that counts.

8/16/96 NYT: Bets on a drop in Medaphis stock zoom before the company's warning of an earnings loss.

Medaphis … said that it was having problems with a major European contract, and was reporting a loss on that contract, which involved designing and installing a computerized accounting system. It took a write-off of profits already reported on that contract. And it said that its efforts to consolidate offices in another operation, which provides accounting and billing systems for physicians and hospitals, was taking far longer than expected. The company has been controversial for some time, with bears contending that its reported profits concealed cash-flow problems. … Robert Olstein, the manager of the Olstein Financial Alert fund, a mutual fund based in Purchase, N.Y., said he had recently sold the stock short because of concerns about the company's accounting, including rises in capitalized software costs and in what are called ''unbilled revenues.'' Such revenues reflect work done on contracts for which customers have not yet been charged. Apparently, it was the profits resulting from some of those revenues that were wiped out in the write-off that provoked yesterday's plunge.

5/24/00 WSJ: SEC Widens MicroStrategy Investigation

MicroStrategy disclosed that the SEC was investigating the circumstances behind the company's restatement of revenues and profits for the past three years to reflect its new way of booking revenue. The revision related to the company's practice of booking some revenues from large contracts immediately rather than over the period of the contracts. MicroStrategy's stock has plummeted from a high of $333 on March 10 to $21.25 yesterday at 4 p.m. on the Nasdaq Stock Market. … There has been no suggestion that MicroStrategy's revenues aren't linked to legitimate contracts; rather, the question is whether the company in past years had booked some revenue from large, complex contracts prematurely. … MicroStrategy does business with more than 900 clients. … As part of its probe, the SEC likely will try to determine whether the company prematurely booked revenues so that it could report profits rather than losses…. Criticism of MicroStrategy's accounting first surfaced in reports in November and January issued by the Center for Financial Research and Analysis in Rockville, Md. The outfit questioned the propriety of MicroStrategy immediately booking $27 million from two contracts as quarterly revenues, even though the contracts were announced several days after the respective quarters ended. The revenue allowed the company to highlight at the time its apparent consecutive quarters of increased revenues. "The rule is very simple: You don't book revenue until you have a signed contract and until you actually receive revenue," said Howard Schilit, president of CFRA and a forensic accounting expert. … PricewaterhouseCoopers then did an about-face shortly after a Forbes magazine article in late February criticized MicroStrategy's accounting.

Cell 16B: Cost of Goods Sold

CGS frequently includes costs of warehousing, packing material, freight and production. Hard to verify estimated/anticipated volume-based advertising and/or vendor rebates are also included and sometimes improperly used to enhance profits. Some might improperly try to enhance Sales by considering the rebate as Income item and record an A/R increase.

6/7/06 WSJ: Target Expects Improvement In Key Indicator of Profitability Gross Margin Rate for 2006 May Top Retailer's Record; Shares Hit a 52-Week Low

Target Corp. raised its forecast for a key measure of profitability, weeks after issuing disappointing first-quarter results that pushed its stock price lower. ¶ … [I]t expects its consolidated gross margin rate to "be slightly greater" this year than its 2005 record of 31.9%. The Minneapolis company previously predicted that it could match last year's rate. ¶ Gross margin rates basically reflect the difference between what a retailer pays for goods and what it sells them for, as a percent of sales. The indicator is closely watched by Wall Street analysts and investors.

6/6/06 Press Release: On June 6, 2006, Scott+Scott, LLC, filed a class action against Home Depot, Inc. … According to the complaint, former and current Home Depot employees have revealed that the Company deceived vendors and falsified Home Depot's financial results through fraudulent return-to-vendor ("RTV'') policies. These polices inflated the price Home Depot charged vendors to cover the cost of merchandise determined to be damaged or defective. The complaint states … that as of January 2006, it was finally revealed that the ... SEC ... already had opened an informal inquiry in August 2005 into whether Home Depot had inflated its profits through vendor payments intended to cover the cost of merchandise determined to be damaged or defective.

Cell 18B: Selling and General Administration

6/23/06 WSJ: Deciphering the Black Box --- Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate --- Five Companies: How They Get Their Numbers --- IBM: 'Other Income' Can Mean Other Opinions

Critics complain that they can't calculate the impact of IBM's gains from its overfunded pension plan. That plan added $530 million to IBM's pretax income in 2000, 80% more than the previous year. Fueling the rise, IBM had raised its expected return rate on the fund's investments to 10% from 9.5% for 2000, a move that boosted 2000 pretax income by an extra $195 million. An IBM official says that the increase reflected IBM's experience with the long-term growth of its fund. IBM includes the impact of the pension fund as part of its expense line for "sales, general and administrative." For 2001, Mr. Joyce indicated to analysts that the fund contributed even more to earnings, although IBM won't break out the number until it files its 10-K report with the Securities and Exchange Commission in March. Meanwhile, investors complain that preliminary results fail to reveal various other elements that in the past have been a factor in earnings. For example, IBM includes income from royalties and licensing as part of its SG&A line, helping hold down the expense line.

Cell 20B: Advertising

"Marketing support" in the amount of the inflation, to reduce Operating Expense. The inflated costs are then depreciated, i.e., treated as an expense, but spread over the life of the associated asset.

6/23/06 WSJ: Scientific-Atlanta Agrees to Pay $20 Million in SEC Settlement

Scientific-Atlanta Inc. will pay $20 million to settle charges that it helped cable operator Adelphia Communications Corp. inflate its earnings by about $43 million. … The case is part of an expanding SEC effort to hold more third parties responsible in corporate wrongdoing. Previously, the SEC and Justice Department took action against several vendors who helped U.S. Foodservice Inc., a subsidiary of Royal Ahold NV, fraudulently inflate it earnings by nearly $830 million from 2000 to 2002. … Scientific-Atlanta aided and abetted Adelphia's financial fraud by agreeing in 2000 to raise the price of cable-TV set-top boxes it sold to Adelphia and refund the additional money to Adelphia for so-called marketing support. Although Adelphia didn't market its vendor's product, it accounted for the deal in a way that reduced its marketing expenses, thereby increasing its reported earnings… [T]he arrangement didn't affect financial results for Scientific-Atlanta. … Scientific-Atlanta was aware that Adelphia was misusing the marketing-support agreement and knew the set-top deal was driven by accounting benefits, not marketing.…

Cell 25B: Rental Expenses

The amount could imply substantial Off-Balance Sheet liabilities.

An analysis might be conducted by capitalizing Operating Leases, i.e. treating operating leases as Assets purchased with Long-Term Debt. It brings an off-Balance Sheet obligations onto the financial statements --- PP&E and Long-Term Debt are increased by the present value of the Operating Leases, Assets are depreciated (straight line with a residual value) over the term of the average Asset, the payments now consist of Interest Expense and repayment of principal, initially a Tax Deferred Asset is created for each lease that later becomes a Tax Deferred Liability individually, but not as a group. The present value of Operating Leases (excluding potential increases due to contingency rates and future leases) can be found in SEC Form 10K filings. Expenses would be adjusted by interest expense, but lack of rental payments. CFFO would be adjusted by depreciation. CFFO would be increased by principal payments. Essentially, expense recognition is accelerated.

The most basic approach would be to test the Debt/Equity ratios by increasing the PP&E and Long-Term Debt by the present value of the Operating Leases. FCC calculation already considers 1/3 of Rental Expense as Interest.

Lease Accounting rules provide the ability to make sure that no lease goes on the Balance Sheet. Yet, one has an Asset and an obligation to pay money. All leases are either capital leases or operating leases. When a company is essentially financing an asset purchase --- a capital lease --- it records the asset and lease payments on the Balance Sheet. By contrast, a rental contract --- an operating lease --- requires neither the asset nor the payment obligation be recorded on the Balance Sheet. Balance Sheet that presents an airline without any aircraft is clearly not a faithful representation of economic reality. Line managers prefer signing a lease to requesting approval for a large capital expenditure. With proposed accounting changes, there will be a lot more assets and a lot more liabilities. A lease on the Balance Sheet will not represent ownership, but the economic reality of commitment. It won't state that you own a storefront, but that you control it for a certain time and that it is both an asset and an obligation.

11/18/05 WSJ: Lease Accounting Draws Scrutiny FASB Seems Set to Study How to Overhaul Rule To Avoid More Problems

For years, some restaurants, retailers and other companies with multiple stores kept lease costs off their books about as easily as one orders a burger at a drive-through. Then came a series of increasingly high-profile earnings restatements, and now the nation's accounting-rule maker seems increasingly likely to overhaul guidelines for lease accounting to prevent further problems. The Financial Accounting Standards Board has been talking about the matter. It will probably decide early next year whether to add a formal project on lease accounting to its agenda, Robert Herz, the FASB's chairman, said at a conference in New York yesterday. In a subsequent interview, Mr. Herz said that, if approved, the project he envisions would be "a comprehensive relook at the whole model" for lease accounting, which he said hasn't had a major overhaul since 1976. However, he added that any new guidance "is going to take awhile." Lease accounting has caused controversy in part because many companies devise the terms of their leases to keep lease obligations off their books -- and so many companies have leases: According to a June report by the Securities and Exchange Commission's staff, U.S. public companies may have $1.25 trillion in operating-lease obligations that aren't carried on their balance sheets, and structuring leases to meet accounting and tax goals "has become an industry unto itself." In that report, the SEC staff recommended that the FASB pursue an overhaul of lease accounting. The report also called for the FASB to revamp pension accounting, another issue involving balance sheets, which the accounting body last week agreed to tackle. The problems with lease accounting first became prominent late last year when CKE Restaurants Inc., operator of the Hardee's and Carl's Jr. chains, restated earnings to fix problems with lease accounting, triggering reviews by other chain operators. The trend picked up steam in February, when the SEC issued a letter stressing that companies need to make sure their lease accounting is right and should restate earnings if it isn't. About 270 companies restated or otherwise adjusted or reviewed their lease accounting, according to a count by Jack Ciesielski, publisher of the Analyst's Accounting Observer. Many of them were restaurant and retail chains whose businesses are dependent on leased property, but companies from other sectors also restated earnings, including banking, wireless telecommunications and airlines. J. Edward Ketz, an associate professor of accounting at Pennsylvania State University and the author of "Hidden Financial Risk," a book on off-balance-sheet accounting, said the FASB should consider several aspects of lease accounting, including the 90% rule. That rule says the present value of the minimum lease payments to be made by a company must be at least 90% of the fair value of the leased property in order for the lease to be carried on the balance sheet. A lot of companies, Prof. Ketz said, have structured their leases to have that percentage come in at 89.9% and thus avoid the requirement. Other problems with lease accounting include using the wrong lease terms when calculating lease expenses and depreciation.

Cell 30B: Other Income

Income from Equity Affiliates, Foreign Exchange, Sales of Assets & Investments, Royalty & Technology, Technical Aid, Interest, Rent, Miscellaneous

1/23/02 WSJ: Deciphering the Black Box --- Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate --- Five Companies: How They Get Their Numbers --- IBM: `Other Income' Can Mean Other Opinions

Last week when International Business Machines Corp. reported that net income fell 4.9% in 2001 -- its first downturn in eight years -- the focus was on falling sales of personal computers and semiconductors and weak growth of services. But deep in its financial results was another reason. An unexplained category of expenses called "other income" had gone from a positive $617 million in 2000 to a negative $95 million in 2001. Without that $712 million swing IBM's pretax income would have edged upward. … In this case, the $617 million gain in 2000 came mostly from the sales of company investments in Web-related enterprises made during the

Internet bubble period. In 2001, IBM wrote down hundreds of millions of dollars in such investments, with little more than an occasional aside about the moves mentioned during conference calls with analysts. In both years, the adjustments had little to do with the performance of IBM's operations but made a significant impact on per-share earnings.

Cell 31B: Extra Item (Net)

Realizing One Time Gains and One time Losses in the Same Period
This technique is a close cousin of the Restructuring Charge technique, but it involves two unrelated transactions. A company realizes a one-time gain and offsets that gain with an unrelated write-off. In essence, it is saving the gain for a period in which it is short on earnings. For an example of this technique please see: "Learn To Play The Earnings Game, Fortune," March 31, 1997, pages 76-80.

Cell 32B: Other Expense

Expense from Foreign Exchange, Sales of Assets & Investments, Impairment of Long-Lived Assets, Amortization of Intangibles, Miscellaneous.

Cell 33B: Interest Expense

Interest Expense is composed of interest incurred, amortization on bond discount, interest portion of capitalized leases and interest capitalized, but not interest portion of operating rental expense. If yellow colored cell appears, see size of Capitalized Interest Expense, below.

Cell 34B: Minority Interest

Equity Method for Investments (20-50% ownership interest in another entity). The share of Profit/Loss is recognized in Operating Statement (with "Minority Interest" removing others' portion). "Yellow" if losses. The value of the ownership interest is recorded at lower of cost or book value in "grey area" of the Equity section of the Balance Sheet. Dividends paid by the other entity (are taxable with partial exemption). The Balance Sheet is adjusted accordingly: increase Cash by amount of Dividend & increase or reduce ownership value portion of the entities profits/losses. "Minority Interest" is eliminated from CFFO calculation, but Dividends received is included.

"When a corporation controls the operations of another company, it should consolidate the operations of both. When the parent applies the equity method instead, we can be sure that it is hiding debt." (p. 70) Hidden Financial Risk: Understanding Off Balance Sheet Accounting by J. Edward Ketz.

Keeping Debt in Subsidiaries In Which the Parent Owns Less Than 50 Percent
Carrying a high debt ratio on the balance sheet results in a less favorable credit rating and higher interest rates. A company wanting to avoid consolidation of a highly leveraged subsidiary in which it has a substantial investment would need to keep its ownership interest below 50 percent. The company then uses the equity method of recognizing these subsidiaries' operating results,

which keeps their assets and their debt off the parent's books. For an example of a company making successful use of this technique please see: Fink, Ronald, Balancing Act, CFO Magazine June 1999.

1/10/13 Georgia Tech Financial Analysis Lab Report: Misleading Signals from Operating Cash Flow in the Presence of Noncontrolling Interests

A noncontrolling interest, also known as a minority interest, exists when a subsidiary is not wholly owned by the parent company. While a careful designation of income and equity attributable to noncontrolling interests is made on the income statement and balance sheet, respectively, under GAAP a similar attribution is not made on the statement of cash flows. As such, investors, analysts and other users of financial statements may be unaware that operating cash flow includes amounts attributable to both controlling and noncontrolling interests, potentially leading to over-estimates of cash available for dividends to controlling interests.

Cell 36B: Income Tax

Income Tax consists of Current and Deferred Income Tax.

BALANCE SHEET

Cell 46B: Cash

1/9/09 WSJ: PriceWaterhouse Defends Its Audit Procedures

Another warning sign was a sharp increase in assets held in the company's bank deposits.

Cell 47B: Marketable Securities

6/27/06 WSJ: Firms Ponder What Constitutes Cash

"Cash is king" goes the old investing saw. But cash is plenty of other things at many large companies. As it is with personal finances, cash is an important component of a company's balance sheet. Companies with lots of liquid money that is easy to get enjoy favorable loan terms, among other blessings. But auditors point to ways in which companies are stashing money in high-interest investments and calling it cash when, in fact, that money may not be readily available. Some companies had to restate earnings last year because their bookkeepers decided they had too broadly interpreted which of their investments could be considered cash. The Big Four accounting firms, led by PricewaterhouseCoopers, have since expanded the not-cash list to include more investments that are popular with corporate finance managers. Companies, unsurprisingly, aren't pleased. Last week the Association for Financial Professionals asked the nation's accounting regulator, the Financial Accounting Standards Board, to review the changes imposed by auditors and update its cash-accounting rules with a goal of preserving use of the cash-management tools. "We seem to have the Big Four usurping the FASB responsibility here in terms of due process," said James Kaitz, president of the association, which is made up of finance managers at about 5,000 U.S. companies who each manage $250 million to $1 billion of cash and "equivalents." In a letter to FASB Chairman Robert Herz, Mr. Kaitz wrote the current guideline for what constitutes cash and short-term investments "fails to recognize today's investment infrastructure." Some auditors are requiring exclusion of certain types of investments from cash while others aren't, leading to "significant uncertainty" among corporate-finance officials that FASB should settle, the letter added. Besides short-term debt known as commercial paper and Treasury securities, two common financial instruments used by finance managers are auction-rate securities and variable-rate demand notes, both of which deliver higher returns than government bonds. These securities are sold by various issuers and carry maturities up to 30 years, not exactly a short-term investment. But they are auctioned in frequent batches, helping to create a deep market for the securities. Given their liquidity, most companies have classified the securities as cash. The accounting rule governing cash was written in 1987, and holds that "short-term or highly liquid investments" can be considered cash. The rule doesn't specifically mention auction- and variable-rate securities, but the finance managers, bankers and others who use and trade the securities generally believe they are as good as cash. The variable-rate securities carry a "hard put" that entitles the holder to sell the security back to the issuer if the owner so chooses, and that put is backed up with a letter of credit that guarantees liquidity when the owner demands it, said Gregory White, managing director of short-term trading for Oppenheimer & Co. The auction-rate instruments don't have the put feature, but "they do have the support of investment banks that make a market in these and carry millions of dollars of inventory and make sure it is a liquid market," Mr. White added.

In the spring, auditors began to look at auction-rate securities' liquidity after clients raised questions about how to book them, said Dave Kaplan, leader of accounting-consulting services at PricewaterhouseCoopers. Since then, the firm has repeated its concerns about treating the auction-rate securities as cash and has added variable-rate demand notes to its list of securities that companies "may also have inappropriately classified as cash equivalents." PricewaterhouseCoopers pointed out accounting rules generally consider cash-equivalent investments to be those with terms of three months or less. The rule "allows only slight leeway" for longer maturity investments and says nothing about "the frequency with which liquidity may be available through an auction, a put feature to a third party, or otherwise," the firm said in a bulletin to clients.

Cell 48B: Accounts Receivable

The amount assumes A/Rs from Sales. Recourse factored A/Rs are already included in the Balance Sheet number. Non-recourse factored A/Rs should be added to Balance Sheet number, if not already done in Company's financial statement. Securitization of A/Rs, using entities established for that purpose, requires addition of amounts securitized (as opposed to changes in those amounts) to A/Rs and "Securitiization of A/Rs" in Long-Term Liabilities section of Balance Sheet. (To obtain amounts, as opposed to changes, add cummulative changes since program began.)

6/30/06 CFO.com: Securitization: Cash Flow on Tap

A popular financing technique, sometimes criticized for its off-balance-sheet treatment, may be skewing cash flow statements too, says a new report. Securitization of customer receivables — a popular source of cash financing for many companies — often causes dramatic swings in a company's operating cash flow, and may be being used by some to manage cash flow volatility, a new report says. Securitization has occasionally come under fire because it is a form of financing that typically does not appear on the balance sheet, and thus can mislead investors about a company's leverage. But the new report, released in late June by the Georgia Tech Financial Analysis Lab, focuses primarily on an aspect of securitization that is rarely considered: Its impact on cash flow. … "It's almost like a drug," says lab director Charles W. Mulford, a professor of accounting at Georgia Tech. "It's an easy source of cash. You see companies weaning themselves off and then going back on again." A good example of that behavior, says Mulford, is Halliburton. In 2003, on track to post a negative operating cash flow of $595 million, the company terminated its securitization program, causing operating cash flow to drop even further, to $775 million. The following year, Halliburton entered into a new, $519 million securitization, boosting operating cash flow from $409 million to a reported $928 million — 56% higher than it would have been without the securitization. Last year, the company again terminated its securitization program. Had it not done so, its reported operating cash flow of $701 million would have exceeded $1.2 billion. "Securitization," the report notes, "can help companies manage the volatility of their operating cash flow." In other cases, securitization simply seems to boost cash flow. Rite Aid, which reported an operating cash flow of $228 million in 2004, boosted it to $518 million in 2005. Yet, without a new securitization of $150 million that year, operating cash flow would have been $368 million, or 29% lower. In 2006, Rite Aid's reported operating cash flow fell to $417 million. Yet without another securitization increase — this time for $180 million — it would have been just $237 million, or 43% lower. "A securitization can be used to increase or decrease operating cash flow in any reporting period," the report notes. "Thus, a securitization can obscure financial analysis based on sustainable cash flows from operations." Securitization is a process whereby companies sell receivables — money owed by customers, but not yet collected — for cash. The buyer, typically a special purpose entity (SPE) created expressly for the purpose, raises funds for the purchase by issuing commercial paper backed by the future stream of money to be collected. The commercial paper often attracts a better rate than the company could by issuing CP of its own, because the sale puts the receivables out of reach of the company's own creditors in the event of bankruptcy. …The report gives also high marks to several companies, including Metaldyne, United Stationers, and Convergys, that went beyond GAAP requirements to highlight the impact of their securitizations on operating cash flow, leverage, or both. "While not compulsory," the report notes, "these companies nonetheless decided that investors may be misled if such disclosures were not made." For example, United Stationers noted in its annual report that GAAP requires that it not report the securitization as debt. However, it noted, "Internally, the Company considers accounts receivable sold to be a financing mechanism [and]. . . therefore, believes it is helpful to provide readers of its financial statements with a measure that adds accounts receivable sold to debt." The Georgia Tech report also examines the impact of securitization on financial leverage. "In a future period, when the securitization program is reduced or unwound, those commercial paper borrowings are reduced or repaid from the firm's future cash collections," the report notes. "In effect, a current benefit is repaid with a future sacrifice, much like the repayment of borrowed funds." "In every sense of the word, it is like a borrowing," says Mulford. Indeed, the report points out that small shifts in a securitization can actually change its accounting treatment, noting that a securitization program at Arvinmeritor "shows what a thin line exists between the debt and non-debt treatment of securitized receivables." In September 2005, the company consolidated its securitization SPE, reporting its debt on its own balance sheet, and reporting the cash proceeds in the financing cash flow portion of the cash flow statement. Yet under Arvinmeritor's earlier securitization program, in which two SPEs were used, the company did not report the debt and the cash proceeds appeared in the operating cash flow section. "Arvinmeritor points to the arbitrary, rule-based nature of securitization," says Mulford. "You jump through one hoop and it shows up as debt and financing cash flow. You jump through two hoops, and it's off-balance sheet and operating cash flow."

Cell 49B: Allowance for Bad Debt

4/10/03 WSJ "Prosecutors say that HealthSouth inflated its revenue by manipulating "contractual allowances" that represented the difference between the company's gross revenue and net revenue. Those allowances, the size of which is open to wide management discretion, were set up on HealthSouth's balance sheet to reflect the difference between the amounts that HealthSouth would bill insurers for its services and the smaller amounts it actually expected to collect. By arbitrarily shrinking the allowance --- often through journal-entry adjustments after the end of the quarter --- HealthSouth artificially inflated its net revenue. HealthSouth executives also made corresponding journal entries that inflated the company's assets."

Cell 51B: Inventory

FIFO or LIFO? With LIFO, where Inventory item costs are rising, a company can increase NP by delaying purchases to dip into its Inventory --- CGS will include older and lower costs. However, Income Taxes will be increased. Look for disclosure of any LIFO impact.

8/4/05 WSJ: Costly Inventory Lesson For Some Short-Sellers -- Why Did Fall in Steel Prices Fail to Dent Ryerson Tull? It's a Matter of FIFO, LIFO

Under FIFO, the method employed by dealers in perishable goods such as food, rising market prices lead to "inventory holding gains," a rise in the value of inventory that boosts earnings. Likewise, a fall in market prices can lead to inventory-holding losses that hit earnings. Ryerson instead uses LIFO --- last-in, first-out --- which is more common for inventories of products, like steel, that don't spoil easily over time. There's good economic reason for Ryerson to do so. Companies that use LIFO don't record an increase in inventory value as market prices rise, or inventory-holding losses when market prices fall. So in an inflationary cycle they report lower earnings, and pay lower taxes, than if they used FIFO. Lower taxes means more money in the bank. In a deflationary environment, LIFO-firms tend to report higher earnings than their FIFO counterparts.

Cell 59B: Prepaids and Other

Prepaids usually represent such expenses as the costs of marketing and insurance, which are not immediately written off against earnings, but are counted when they are actually used. They are amortized where Prepaids can be short-term and/or long-term. A company with aggressive accounting would include routine expenses in Prepaids and, thus, stretch-out expenses to increase Net Profits.

Cell 62B: Buildings

11/18/05 WSJ: Lease Accounting Draws Scrutiny; FASB Seems Set to Study How to Overhaul Rule To Avoid More Problems.

FOR YEARS, some restaurants, retailers and other companies with multiple stores kept lease costs off their books about as easily as one orders a burger at a drive-through. …Lease accounting has caused controversy in part because many companies devise the terms of their leases to keep lease obligations off their books -- and so many companies have leases: According to a June report by the Securities and Exchange Commission's staff, U.S. public companies may have $1.25 trillion in operating-lease obligations that aren't carried on their balance sheets, and structuring leases to meet accounting and tax goals "has become an industry unto itself." … [T]he SEC staff recommended that the FASB pursue an overhaul of lease accounting. … The problems with lease accounting first became prominent late last year when CKE Restaurants Inc., operator of the Hardee's and Carl's Jr. chains, restated earnings to fix problems with lease accounting, triggering reviews by other chain operators. … J. Edward Ketz, an associate professor of accounting at Pennsylvania State University and the author of "Hidden Financial Risk," a book on off-balance-sheet accounting, said the FASB should consider several aspects of lease accounting, including the 90% rule. That rule says the present value of the minimum lease payments to be made by a company must be at least 90% of the fair value of the leased property in order for the lease to be carried on the balance sheet. A lot of companies, Prof. Ketz said, have structured their leases to have that percentage come in at 89.9% and thus avoid the requirement. Other problems with lease accounting include using the wrong lease terms when calculating lease expenses and depreciation.

Cell 69B: DIT

5/29/03 WSJ full page advertisement by Telsim Mobile Communications.
04/24/98 $560 vendor financing to Telsim
08/19/99 $123 vendor financing to Telsim
09/20/99 $380 vendor financing to Telsim
02/01/00 $270 vendor financing to Telsim
04/01/00 10K "TheCompany signed an agreement with Telsim ...", but nothing as to vendor financing.
Arthur Levitt, "Take on the Street: What Wall Street and Corporate America Don't Want You to Know" --- "A vigilant investor on the prowl for risky vendor financing would have spotted clues in Motorola's financial statements. The first hint of any exposure was buried on page 53 (of 104) in Motorola's 2001 proxy statement. It refers to 'one customer in Turkey' responsible for $1.7 billion out of $2.8 billion in long term finance receivables. ... Finally, in November 2001, Motorola ... announced the $1.3 billion charge in a press release."

10/30/08 Reuters: Fannie Mae to Write Down Deferred Tax Asset

The mortgage finance giant Fannie Mae said on Wednesday that it would probably write down "substantially all" of a tax-related asset that has been a major component of its capital.

Companies can use deferred tax assets as a way to offset future taxes, but must be able to show they will be profitable. Accounting for deferred tax assets became controversial for Fannie Mae after the company posted a string of surprising quarterly losses, which hamstrung its ability to raise capital to offset losses from rising foreclosures. Capital concerns at Fannie Mae and Freddie Mac eventually led to their seizure by the federal. government in September. Fannie Mae's deferred tax assets totaled $20.6 billion as of June 30. One analyst said the amount would probably be larger for the third quarter. Treatment of the assets is a focus of class-action lawsuits filed against Fannie Mae that charge the company was concealing its capital deficiency.

4/10/10 WSJ: Beauty of Tax Assets Can Prove Fleeting

No one likes taxes, and investors always should be wary of assets based on them. That is one take-away from the brouhaha over big, health-care-related charges recently announced by companies such as AT&T, 3M, Caterpillar and Deere. Those hits to profit came from write-downs of deferred-tax assets whose value was affected by the health-care overhaul. The charges caused a political storm, and some chief executives have been asked to testify before Congress. More important, they highlight that investors should be mindful that deferred-tax assets can unexpectedly spawn losses. Their usefulness also could be in doubt for financial firms if regulatory changes make businesses less profitable in future years. Deferred-tax assets and liabilities arise because of differences in tax accounting, which is based on cash payments, and accounting for financial-reporting purposes, which assigns revenue and expenses to the period in which they occur. Given this, the value of tax assets and liabilities can depend on events that mightn't happen for years. A deferred-tax asset might be based on expenses for retiree benefits that won't be actually paid out for some time, for example, or be generated by losses that can be carried forward to offset future taxable profit. The assets generally can't be sold, and some can evaporate if a company's ownership changes. Financial firms hit by big credit-crunch losses have seen deferred-tax assets swell. At the end of 2009, deferred-tax assets of about $90 billion at the big four banks, Bank of America, Citigroup, J.P. Morgan Chase and Wells Fargo, were equal to about 15% of their combined common shareholders' equity. Whether the banks will be able to use all these assets has been a point of worry, especially at Citigroup. It reported $46 billion in deferred-tax assets at the end of 2009, triple the level of two years earlier, a result of huge losses. The bank steadfastly has maintained there isn't doubt over its ability to use these assets, basing this on expectations of being able to return to profitability. The other big banks all have created allowances for at least some of their deferred-tax assets, signaling they mightn't be able to use them all. If Citigroup at some point has to do likewise, resulting charges could eat into profit. Gauging the value of these assets can be tough. Companies don't adjust the value of deferred-tax assets to reflect that some may be useful pretty soon, while others may depend on events far in the future. Bank regulators, for their part, recognize that this can be an issue. They allow banks to include in measures of regulatory capital only portions of deferred-tax assets that generally can be used in one year. Citigroup wasn't allowed to include $26 billion in deferred-tax assets in its Tier 1 capital in 2009. Perhaps the most worrisome aspect of deferred-tax assets is that their value can change due to legislation that isn't primarily aimed at the tax code. That was the case with the health-care bill, which Credit Suisse analyst David Zion estimates will result in combined charges of about $4.5 billion for S&P 500 companies. Any changes to the tax code itself potentially will affect the value of deferred-tax assets, liabilities or possibly both. Given this, investors should pay particular heed to assets that can be here today, only to be taken away by Congress tomorrow.

11/9/12 WSJ: Tax Twist: At Some Firms, Cutting Corporate Rates May Cost Billions
What Uncle Sam has given to the earnings of companies like Citigroup Inc., American International Group Inc. and Ford Motor Co., he soon might take away. President Barack Obama has said, most recently during last month's presidential debates, that the 35% U.S. corporate tax rate should be cut. That would mean lower tax bills for many companies. But it also could prompt large write-downs by Citigroup, AIG, Ford and other companies that hold piles of "deferred tax assets," or DTAs. After posting big losses, these companies have tax credits and deductions they can use to defray future tax bills, thus providing a boost to earnings. But a tax-rate reduction means some of those credits and deductions, counted as assets on the balance sheet, would be worth less, since lower tax bills would mean fewer opportunities to use them before they expire. That would force the companies to write down their value, resulting in charges against earnings. Citigroup, for instance, acknowledged during its recent third-quarter earnings conference call that a cut in the tax rate could lead to a DTA-related charge of $4 billion to $5 billion against earnings. Lockheed Martin Corp. said in its latest quarterly report that a write-down of its DTAs was possible. Any write-down also would reduce a company's "tangible book value," the sum it could realize by selling its assets in a fire sale. That could further weigh on banks' stock prices. Most large banks already trade at a discount to tangible book value because of investor concerns about their growth prospects and wariness of reported asset values. "Investors are focused on tangible book value," said Mike Mayo, a CLSA Securities banking analyst who criticized Citigroup's accounting and asked about the possibility of a write-down on Citigroup's recent earnings call. Companies other than Citigroup haven't disclosed the size of possible write-downs from a tax cut. "I think this is going to be pretty much a surprise" to investors, said Robert Willens, a tax and accounting expert. Some companies have enormous piles of these assets. Citigroup has $53.3 billion, the most of any U.S. company. Ford has $12.9 billion. But those numbers would be reduced under Mr. Obama's proposal to cut the corporate rate to 28% with an added break for manufacturers. The proposal would require congressional action. Of Citigroup's deferred tax assets, the bank said about $20 billion to $25 billion are federal DTAs that could be hit by tax-rate change. A cut in the corporate tax rate to 28%, or one-fifth below the current rate, could cause a similar one-fifth write-down of its DTAs. A Citigroup spokesman said the value of the New York company's deferred tax assets "could be reduced" if the corporate tax rate falls. AIG had about $12.8 billion in U.S. deferred tax assets at the end of 2011 that would be affected by a tax-rate reduction, suggesting AIG could face a write-down of as much as $2.6 billion. An AIG spokesman declined to comment. About three-quarters of Ford's net DTAs are in the U.S., the company said. That suggests a tax-rate cut to 28% could prompt the auto maker to take a write-down of $1.9 billion. A Ford spokesman said he can't speculate on the size of a write-down, but "as you would expect, if the corporate tax rate is reduced, net deferred tax assets would also decrease."

Companies that have deferred tax assets but aren't currently posting profits might have it even worse. They would have to take big write-downs immediately if the tax rate were cut, but they wouldn't see the benefits until after they start posting taxable profits again and use up their stored credits and deductions, noted Michelle Hanlon, a professor of accounting at the Massachusetts Institute of Technology. For instance, Navistar International Corp. has $2.4

billion in deferred tax assets and posted a $616 million pretax loss for the nine months ended July 31. A Navistar spokeswoman said the truck maker's immediate results would be hurt by a rate reduction, but that Navistar still would welcome such a cut, because it "would ultimately help U.S. companies be more competitive in the global marketplace."

The double-edged sword has some tax watchers wondering whether companies may pressure Congress for a provision enabling them to avoid write-downs if rates are lowered. A spokeswoman for Lockheed Martin, which has $5.4 billion in deferred tax assets, said the company believes tax change should "include transition measures that mitigate impacts and avoid negative unintended results" for companies that based their planning on the current tax system.

11/26/12 WSJ: The impact of a "deferred tax assets" write-down when corporate tax rates are lowered will be offset in the future when the temporary differences between tax and book accounting reverse ("Cutting Tax Rates May Hurt," Money & Investing, Nov. 9). Lowered tax costs are an unambiguously good thing for a company's prospects. However, pressuring Congress for a provision enabling companies "to avoid write-downs if rates are lowered" would be an incredibly poor idea. Congress has no business interfering with private-sector financial accounting standards, and the envisioned provision would only pile arbitrary absurdities on top of an imperfect substructure in order to achieve a misleading cosmetic effect.

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Cell 73B: Intangibles (Net)

See details in Form 10-K. What are being considered "intangibles"? Should they be and are they being amortized? If so, at what rate over what period? What would be the impact on NP if they were amortized? Dark "Yellow" means that during the year, the stock's market price was low enough to imply that Intangibles have no value.

1/09 CFO Magazine: Goodwill Hunting "At dozens of public companies, market value now languish below (tangible) book values, a situation that makes write-offs likely. ... While shareholders may react favorably based on their perspection of future prosperity, lenders react to write-offs in a different way. They wield legal contracts that impose penalties if goodwill write-offs violate asset-based covenants."

11/24/12 WSJ: 'Tis No Season for Goodwill to Investors

As Hewlett-Packard's Autonomy mess shows, goodwill is a squishy asset that investors shouldn't lean on too hard. … Goodwill represents the difference between what a company paid for something and the net value of what it acquired. Thought of another way, goodwill is akin to the difference between what someone pays for a house and the actual value of the bricks and windows and floors. Hewlett-Packard said earlier this week that it was taking an $8.8 billion charge in its fiscal fourth quarter related to the impairment of goodwill and other intangible assets. Of this, more than $5 billion was a goodwill write-down related to “accounting improprieties, disclosure failures and misrepresentations” at Autonomy, a U.K. software make H-P acquired in 2011 for $11.1 billion. … This is the second time this year H-P has taken a big charge to write-down the value of goodwill. (It took a $9.1 billion hit in the previous quarter relating to another deal.) Even after the latest write down, the value of H-P’s goodwill and other intangibles is about $12 billion more than its market value. H-P is far from alone in facing goodwill issues. Earlier this year, Microsoft took a $6.2 billion charge to write down goodwill related to its purchase of online-advertising company aQuantive Inc. In 2011 and 2010, Bank of America was hit with a combined $15.6 billion in goodwill impairment charges. Overall, nearly 40 U.S. companies with market values greater than $1 billion have goodwill and other intangible assets that are worth more than the company’s market capitalization, according to Capital IQ data. That is a worrisome sign that write-downs may eventually have to be taken. While goodwill write-downs are admissions of serious misjudgment—or in H-P’s case of allegedly nefarious issues—companies often try to downplay the charges by highlighting that they are noncash expenses. That is true for the period in which they are reported, but value has still been destroyed. So investors shouldn’t allow themselves to be fooled. And goodwill, along with some other intangible assets, isn’t something a company can sell or monetize to raise cash if needed. Given its ephemeral nature, investors should pay particular care to how much hard value they place on such assets. 1/19/13 Reuters: Caterpillar Writes Off Most of China Deal after Fraud

Caterpillar uncovered “deliberate, multi-year, coordinated accounting misconduct” at a subsidiary of a Chinese company it acquired last summer, leading it to write off most of the value of the deal and wipe out half a quarter’s profits. Caterpillar, the world’s largest maker of tractors and excavators, said on Friday it would take a noncash goodwill impairment charge of $580 million, or 87 cents per share, in the fourth quarter of 2012. Analysts had expected the company to earn $1.70 per share in the fourth quarter, according to Thomson Reuters I/B/E/S. Caterpillar closed the purchase of ERA Mining Machinery Ltd and its subsidiary Siwei last June, paying HK$5.06 billion, or $653.4 million at current exchange rates. A member of the Caterpillar board during the course of the Siwei deal told Reuters the board was distracted at the time by a larger transaction and paid relatively little attention to the Siwei acquisition. “It came as a complete surprise to us,” the former board member said of the fraud, speaking on condition of anonymity because of the sensitivity of the situation. “It was presented to us as a pretty straightforward transaction. It’s a shame. It should have been investigated further.” In a statement, Caterpillar said an ongoing investigation launched after the deal closed “determined several Siwei senior managers engaged in deliberate misconduct beginning several years prior to Caterpillar’s acquisition of Siwei.” The company said it had replaced several senior managers at Siwei, adding that their conduct was “offensive and completely unacceptable.” Caterpillar was not immediately available for further comment. Representatives for Siwei were not immediately available for comment before business hours on Saturday morning in China. Representatives for Citigroup and Freshfields Bruckhaus Deringer LLP, which served as financial and legal advisers to Caterpillar on the transaction, could not be immediately reached for comment. Blackstone and DLA Piper, which acted as ERA’s financial and legal advisers, were not immediately available for comment.

2/15/15 WSJ: VF Writes Down Its Sevens, As Premium Denim Fades
Apparel Maker's Fourth-Quarter Profit Falls 67%

Six And A Half For All Mankind, anybody? Apparel conglomerate VF Corp. said Friday it wrote down the value of the once hot denim brand Seven For All Mankind along with two other contemporary lines by $396 million.

Cell 74B: Other

Other Long-Term Assets" is a "soft" asset account where a substantial period-to-period increase may indicate an attempt to boost reported earnings by capitalizing operating costs that, perhaps, should have been expensed. Further, CFFO could be enhanced if otherwise properly classified Current Assets are improperly classified as Long-Term Assets.

"Other types of manipulations include capitalizing expenses or creating fictitious assets (e.g., WorldCom). This occurs in about 25.7% of the firms." (Predicting Material Accounting Manipulations [5/29/08])

5/8/96 WSJ: Excel's Accounting Methods Raise Red Flags Among IPO Watchers

What has some people particularly concerned is Excel's accounting methods. Excel defers a large portion of the costs it incurs to sign up new subscribers -- $85 million in the first two months of 1996 alone. It also defers a smaller amount of revenue it receives for "management services," the fees the company charges its independent reps for managerial materials and such. Excel amortizes these costs and revenue over 12 months, the company notes in its prospectus, as a way to "appropriately match revenues and expenses."I n essence, the company is pushing a huge portion of expenses into the future. The net effect is that it substantially boosts reported earnings, making Excel appear healthier than it is. … [T]he strategy increased 1995 earnings by $22.7 million, or slightly more than half the company's reported net income of $44.4 million. While deferring expenses is an acceptable practice, accountants say it's aggressive and should raise red flags. They point out that cash flow from operations was $5.5 million in the red through the first two months of 1996. "Bad things happen" when net income is positive and cash from operations is negative, says Howard Schilit, an accounting professor at American University, Washington, D.C., and the author a book on how corporations improve their financial results through accounting gimmicks. … Mr. Schilit says, "is a good early-warning sign of a company that will have a substantial write-off in the future, or a restatement of its numbers." Either event can be bad news for a stock.

5/26/06 CFO.com: Software Capitalization Clouds Comparisons

Although many companies expense their software development costs, according to a new study, differences in accounting approaches can give ''the impression those that are capitalizing are doing better financially.'' Fewer than 30 percent of software companies capitalize their development costs, according to a new study. But the companies that take a less conservative accounting approach and capitalize those costs do so at a high rate and make cross-industry comparisons difficult, says accounting professor Charles Mulford of the Georgia Institute of

Technology. Mulford, who conducted his study on “Capitalization of Software Development Costs” with MBA student Jack Roberts, reviewed the financial filings (generally from fiscal 2005) of 207 companies that develop software. Only 61 companies capitalized software development costs, they found, at a mean rate of 20 percent; about one-third of the companies capitalized those costs at a higher rate, with the highest at 82 percent.

CA 1999

Intangibles: Excess of cost over net assets acquired is being amortized by the straight-line method over the expected period of benefit, between 10 and 20 years. Costs of purchased software, acquired rights to market software products, and software development costs (costs incurred after development of a working model or a detailed program design) are capitalized and amortized by the straight-line method over five years or based on the product’s useful economic life, commencing with product release. Unamortized capitalized development costs included in other assets at March 31, 1999 and 1998 were $72 million and $62 million, respectively. Amortization of capitalized development costs was $18 million, $15 million, and $17 million for the fiscal years ended March 31, 1999, 1998, and 1997, respectively.

Technological Feasibility
End of Revenues
↓
↓

(expense) Software Development (capitalize) Available for Sale (expense)
↑ ↑
Begin Project Product Released

5/18/04 WSJ: At Nortel, Warning Signs Existed Months Ago; Reserves, Long-Term Assets May Harbor Discrepancies; Large Cuts Boosted Margins

NORTEL NETWORKS Corp. isn’t volunteering many facts about how half of its 2003 profit was faked. But this much, in hindsight, is clear: There were warning signs of possible accounting shenanigans that outsiders could have spotted months ago. … The company said its internal review of the matter is focusing on “management’s practices regarding accruals and provisions.” And while 2003 net income will be halved, the company said, the overstated profit largely will be shifted into prior years’ results, and there will be “no material impact” to prior periods’ revenues or cash.… [I]t suggests that Nortel Networks’ misdeeds probably are similar to the “cookie-jar reserves” seen in the past at Sunbeam Corp. and Xerox Corp. The way this trick works is that a company sets up excess provisions or liabilities on its balance sheet for future expenses that it doesn’t really expect to incur. Then, it dips into the cookie jar during later periods and reverses the provisions to create the appearance of profit. Basically, it’s a big paper shuffle. So, could an ordinary investor have sniffed out early on that something smelled funny at

Nortel? Itzhak Sharav, a Columbia University accounting professor, thinks so and says the company's 2003 earnings release in January "should have raised eyebrows for several reasons." While that's little comfort to anybody who got blindsided, there are lessons to be drawn, namely how to spot what the accountants call "red flags" -- strange movements in a company's numbers that cry out for explanations by management and further digging by anyone holding its shares. Chief among the red flags: While Nortel in January said income from continuing operations soared to $387 million last year from a loss of $3.29 billion in 2002, revenue went in the opposite direction, falling 7% to $9.81 billion. And by recording $2.17 billion in "special charges" to earnings in 2002 for various asset write-downs and restructuring activities, on top of $15.66 billion of "special charges" in 2001, Nortel relieved 2003 of many expenses that otherwise would have counted as routine operating costs. … Now for the big question: Which accounts were manipulated? … Meanwhile, Mr. Sharav says he's found some possible candidates:

-- Reserves for accounts receivable: This is the balance-sheet account that companies set up to estimate how much of their customers' bills will go unpaid. Normally, these provisions fluctuate roughly in tandem with receivables, or money that customers owe the company. Last year, Nortel's gross receivables remained basically flat at $2.62 billion. But the company cut its reserves for doubtful accounts by more than half, to $256 million from $517 million, boosting earnings. Still unclear is whether the reserves might have been set too high in 2002, slashed too much in 2003, or both. Whatever the case, … the cut was suspiciously large and boosted operating margins and net income.

-- Inventory reserves: Many Wall Street analysts cheered in January when Nortel said its gross profit -- revenue minus the cost of goods sold -- soared 22% to $4.61 billion in 2003. On a percentage basis, gross profit margins were an astonishing 47% in 2003, up from 35.7% in 2002. Mr. Sharav says the numbers suggest Nortel might have taken excessive inventory write-offs in 2002, artificially lowering the costs of goods sold in 2003 and thus boosting margins. At the end of 2001, Nortel's inventory reserves were equal to 31% of gross inventory. By the end of 2002, they were 52%. Nortel didn't release comparable year-end 2003 reserve figures in its January earnings news release.

-- Other long-term assets: This hodge-podge item on Nortel's balance sheet includes long-term customer receivables. And here, too, Nortel slashed its allowance for doubtful accounts last year, to $288 million from $736 million. As a percentage of the gross, the allowance fell to 35% of other long-term assets in 2003 from 45% a year earlier.

4/18/04 WSJ: Helen of Troy Is Attracting Skeptics; Some Analysts Question Personal-Care Firm's Use of 'Capitalized' Costs

Helen of Troy Ltd., an El Paso, Texas, personal-care products maker whose accounting for certain costs and other practices has got skeptical analysts raising questions. The analysts' No. 1 concern: "capitalized" costs -- that is, costs reported as assets. While most costs are supposed to be expensed immediately, accounting rules do allow some costs to be booked as assets, namely those that relate to the direct production of goods, so that they can be amortized over time. The idea is that those costs associated with future periods are expensed in the periods they affect....

The benefit of such treatment is that the costs get written off over time rather than in a single quarter, helping to smooth earnings. At Helen of Troy, whose products include hair-care and other appliances sold under licensed trade names such as Vidal Sassoon and Revlon, these costs pertain to inventory bought at a Hong Kong office, where the company has procurement and sales operations. But there's a debate about whether Helen of Troy is being too aggressive in its interpretation of the capitalized-costs rule. In its latest annual filing, Helen of Troy included a lengthy disclosure of these costs, stating that "capitalized general and administrative expenses include all the expenses of operating the company's Hong Kong sourcing facility," as well as expenses incurred for production forecasting, product design, engineering and packaging. Some analysts beg to differ that these expenses qualify as part of the actual production of goods, as accounting rules require. The company's decision to lump procurement costs in with inventory, rather than treating them as quarterly general and administrative expenses, could have inflated earnings by more than 5% in the most-recent fiscal year, more than 9% the prior year and nearly 16% in the year before that, these analysts note. The issue is particularly relevant as Helen of Troy expands and makes further use of capitalization. In June, for example, Helen of Troy completed its $273 million acquisition of household-gadget manufacturer OXO International, increasing sales about 25%. … To be sure, broad interpretation of the capitalization rules isn't necessarily contrary to generally accepted accounting principles. In their 2002 book, "The Financial Numbers Game: Detecting Creative Accounting Practices," Georgia Institute of Technology accounting Profs. Charles Mulford and Eugene Comiskey devote a 30-page chapter to "Aggressive Capitalization and Extended Amortization Policies." … Helen of Troy's capitalized general and administrative costs were only $4.7 million for the fiscal year ended Feb. 29. Still, to some critics, the treatment is part of a larger strategy of aggressive accounting. Another cause for concern, they say, is the company's classification of certain intangible assets as having indefinite lives, which means the company currently avoids writing these assets down and running more than $2 million in annual expenses through the income statement. Some critics also cite the company's reincorporation in Bermuda in 1994 to minimize its tax burden, a decision that has received scrutiny from both the U.S. Internal Revenue Service and Hong Kong Inland Revenue Department ."There is a moderate level of concern here," says Leah Townsend, a research analyst at Glass Lewis & Co., a proxy-advisory firm in Broomfield, Colo., who recently issued a "Yellow Card Company Alert" on Helen of Troy highlighting the capitalization and other accounting issues. "Any of the items by themselves don't raise a flag, but together they do." In her report, Ms. Townsend also notes the company's "strong balance sheet, net income and cash-flow generation." ... In the past few years, Helen of Troy has grown through operational improvements and acquisitions. Earnings rose more than 56% in fiscal 2004, and the company's stock has gained 30% since last August. Its debt is low, even after the company recently sold a $225 million note to help finance the OXO acquisition. But some analysts also say the business is getting too complicated. They point to Helen of Troy's growing dependence on brand licensing, substantial manufacturing contracts in Asia and the company's determination to expand through purchases like OXO that take it into barbecue, garden and automotive products. … Recently, some companies' cost write-off practices have drawn the attention of the Securities and Exchange Commission….

Blockbuster filed a non-reliance 8-K covering its 2004 and 2003 financials; they'll be restated in the 2005 10-K to be filed. Reason: after SEC discussions "over the past few months related to its accounting practices for the rental library and rental library activities, it was decided that

Blockbuster's rental library assets should be classified as a current asset. Consequently, additions to the library should be shown as an operating cash outflow in the statement of cash flows. …. Probably, the vast majority of Blockbuster's library expenditures are rented out in the next twelve months; that's the implication from the current asset classification. … The classification implies that the value of the library is realized near-term; the emphasis on new releases reinforces that implication. And additions to current assets are, of course, operating cash outflows. That wreaks some unfavorable changes in Blockbuster's financials. … The shift of library assets from non-current to current classification improves the firm's current position, naturally, but it makes for some radical changes in the cash flow statement. For 2004, the cash from operations ratchets down from a positive $1,215 million to a positive $417 million; for 2003, from a positive $1,430.3 million to a positive $$593.7 million. For the nine months reported in 2005, the positive cash flow of $492.4 million turns into a negative $146.1 million.

9/12/05 WSJ: Expanding Investigations Increase the Heat on Dell

The hole for Dell Inc. seems to keep getting deeper. The computer maker said it would delay filing its fiscal second-quarter report because of a widening Securities and Exchange Commission investigation and its own probe into its financial accounting. … Dell isn't ruling out needing to restate prior results. … Dell was already being investigated by the SEC for the timing with which it recorded its revenue. Yesterday, Dell said in a statement that the investigations indicated potential issues "relating to accruals, reserves and other balance sheet items." … Companies use accruals and reserves when they sell services but deliver them at a later date. In Dell's case, the company typically sets aside funds from current operations to cover the cost of future warranty claims. Dell said that in responding to the SEC in mid-August, it discovered information that "raises potential issues" related to the fiscal years before 2006. … While Dell declined to give any other details of its possible financial misstatements, accounting experts said the company could potentially have engaged in "cookie-jar reserves," which have also been seen at Xerox Corp. and Sunbeam Corp. When using "cookie-jar reserves," a company is in effect creating a rainy day fund by setting up excess provisions on its balance sheet for future expenses that it doesn't truly expect to incur. It can then dip into the jar in leaner times to create the appearance of profit. In a report in November, accounting expert Albert Meyer, then at research firm 2nd Opinion Research, wrote that he found one "cookie-jar reserve" that Dell created following its fiscal 2005 results. In that instance, Dell repatriated $4.1 billion in foreign earnings in its fiscal 2005. The repatriation tax charge is 5.25%, meaning the tax provision Dell should have taken would have amounted to $215 million. Instead, Mr. Meyer said in his report, the company accrued $280 million, resulting in a $65 million "cookie jar." Such a tactic could have added 5% to Dell's earnings-per-share growth rate in fiscal 2006, Mr. Meyer calculated. "They overaccrued," Mr. Meyer -- now president of money-management firm Bastiat Capital in Plano, Texas -- said in an interview. In his report, he wrote that such a tactic "smells."

Cell 80B: Accounts Payable

Assumes A/Ps from only purchases of Inventory, i.e., vendor financing. Inventory and A/P balances generally move in tandem. If Inventory increases much more quickly than A/P, Company is paying Cash or paying vendors too slowly. Financial Warnings, p. 229. Adjustment: any amount attributable to checks written, but not yet cleared bank should be deducted from

A/Ps and added to Short-Term Debt or Cash. Note whether 10K Statement of Cash Flow improperly attributes such amounts to Cash Flow From Operations or properly to Cash Flow From Financing. It is a Quality of Earnings clue.

Cell 81B: DIT

This entry could be used as short-term DIT liability. To do so, change the name to "DIT" and related calculations will be adjusted accordingly.

Cell 82B: Deferred Revenues

Cash has been received from customers and services not yet rendered. Thus, amount not yet recognized as revenue. Declines are unusual and provide an accounting means to obtain needed Net Profits in slow times.

10/19/12 LAT: Microsoft Corp.'s net income fell 22% in the latest quarter as its deferred revenue from the sale of its upcoming Windows 8 operating system to PC makers --- and as its PC sales in general took a dive.

Cell 91B: Warranty Costs

One would suspect that as Sales increase, Warranty Costs (accruals) would increase as well. An unjustified decline in this reserve account could be used to improperly inflate Net Profit. Even more suspect would be the significant decline in the warranty liability. (Financial Warnings, pps. 301-2.)

Cell 96B: Capital Leases

9/30/13 Crain's

Many New York-based companies that lease real estate and other assets instead of owning them will show much higher levels of debt on their balance sheets once a new accounting method that authorities will likely adopt next year takes effect.

The change will require companies to more clearly disclose the amount of financing they employ to lease such assets in their financial statements. Under the new method, they will have to include the financing with other debt on their balance sheets instead of reporting it in their footnotes, as current rules allow.

For companies that use significant amounts of leasing arrangements to finance their operations, the rise in debt on their balance sheets could be significant, according to an analysis for Crain's by the Georgia Tech Financial Analysis Lab in Atlanta. Although investors won't see the effect of the change for at least another three years, experts expect companies to start grappling with the change soon because of the extent of its impact.

Five New York City-based retailers, for example, could see a marked increase in their total reported liabilities because they lease significant amounts of real estate, according to the analysis. Total balance-sheet liabilities could rise by 225.4% for Aéropostale, 222.4% for Foot Locker, 193.4% for Ann Taylor, 57% for Tiffany & Co., and 50.6% for Barnes & Noble.

The new standard "will certainly have a significant effect on the presentation of our balance sheet," said John Maurer, vice president, investor relations and treasurer at Foot Locker, in an email. Representatives for Aérospostale and Ann Taylor declined to comment, and Crain's did not receive responses from Tiffany and Barnes & Noble at press time.
Charles Mulford, an accounting professor at Georgia Tech who directs the lab, said the accounting change will be "far-reaching" and have "material effects" on various measures that investors focus on, including profitability, financial leverage, debt coverage and cash flow.

According to the lab, the leverage measure of total liabilities to equity could increase to 262.1% from 80.5% for Aéropostale; to 134.3% from 41.6% for Foot Locker; to 424.4% from 144.7% for Ann Taylor; to 637.1% from 423% for Barnes & Noble; and to 121.7% from 77.3% for Tiffany.

The degree to which these companies' securities will be affected by such changes is unclear at this point. Although many observers contend stock and bond prices already reflect such off-balance-sheet liabilities, the fact that companies go to the trouble of burying such debt in their footnotes argues otherwise.

In any case, companies have been able to do so under the current accounting standard since 1977, which, Mr. Mulford said, is a clear example of "standards-setting gone awry."

Originally intended to bring more leases onto the balance sheet, the rule had precisely the opposite effect. That's because it established four "bright-line tests" to determine whether a lease is classified as a "capital lease" that must be reported on the balance sheet, or as an "operating lease." If the lease is classified as the latter, a company must report the interest and principal payments it makes as an expense on its income statement but can exclude the liability from its balance sheet.

Corporate Houdinis Rising debt

225%—Aéropostale could see its balance sheet liabilities soar under a new accounting rule
222%—Foot Locker's reported liabilities could rise nearly as much
193%—Ann Taylor's reported debt could nearly triple
57%—Tiffany's reported debt could rise by almost 60%
51%—Barnes & Noble's balance sheet liabilities could rise by more than half
Source: Georgia Tech Financial Analysis Lab

"Corporate managements and the financial institutions that negotiate lease contracts are intimately aware of these four criteria and take great pains to avoid them, if possible," Mr. Mulford said. "It's a lot to avoid, but they're Houdinis in avoiding them." The result is that "the practice of excluding leases from balance sheets is so pervasive that most financial analysts and credit analysts adjust financial statements to include the off-balance-sheet transactions," he said.

With a nudge from the Securities and Exchange Commission (which expressed its concerns about off-balance-sheet transactions, including leases, in 2005), the Financial Accounting Standards Board and the International Accounting Standards Board launched a joint leases project. They've since gone through many rounds of meetings with "end users," accounting-speak for analysts and investors. Comments were due in mid-September on a revised exposure draft issued by FASB.

Two questions

"In meetings with users, the boards have been focused on two questions," said Kimber Bascom, a partner at KPMG, and the accounting firm's subject-matter leader on lease accounting, during a recent webcast. "One is, does a lease create assets and liabilities, and the second is, if so, should the leases be on-balance-sheet?" he said. "Those questions are to me a little bit like motherhood and apple pie. It's pretty hard to say no to either one of those questions if you're a financial-statement user."

But citing a "fatigue" after years of meetings and roundtable discussions between the boards and end users, Mr. Bascom said he believes that at this point "the boards are very determined to wrap this project, and to try to do it soon, and to do so in a way where they can assert that they have the support of financial-statement users."

Cullen Walsh, FASB's assistant director, confirmed that the board wants to complete the project in 2014, though he couldn't predict when. "Some companies are concerned about having to put these liabilities on their balance sheets, but the information is there in the notes," he said, and he echoes others concerning the potential market impact. "Users of balance sheets are already making adjustments."

But some observers doubt that stock and bond prices already reflect companies' footnote disclosures. Jack Ciesielski, an investment adviser who publishes the newsletter and website The Analyst's Accounting Observer, said, "That is not a statement that I think anyone can make with any degree of certainty."

Indeed, companies' concerns over the rule change was one reason it took so long, said Mr. Walsh. KPMG partner John McGaw noted that even if the accounting boards finalize their joint standard in 2014, the "earliest effective date" will be 2017. But he cautions that companies need to start taking action now to understand the types of leases they have, and "where and how they administer and account for those leases."

Cell 103B: Securitized A/Rs

6/16/06 WSJ: Quick Cash via Receivables Deals Can Leave a Blurry Fiscal Picture

One way cash flow is getting distorted these days involves the way companies turn receivables -- money they are owed by customers -- into quick cash. Some companies, like drugstore chain

Rite Aid Corp. and oil-field and construction services titan Halliburton Co., have seen reported cash flow from operations boosted or cut sharply in recent years because they have securitized their receivables, according to a coming report from the Financial Analysis Lab at the Georgia Institute of Technology in Atlanta. Securitizing can also obscure true debt. Securitization of receivables is sort of like selling them -- but not quite. By packaging up the IOUs from customers into marketable securities that they then sell to investors in a structured, multistep transaction, companies effectively get to collect on receivables sooner. The proceeds get counted as operating cash in the cash-flow statements that accompany income statements. … [I]nvestors should strip out the impact of securitization to get a true picture of the cash the company's operations are producing. Rite Aid's operating cash flow last year would have been 43% lower without securitization. Halliburton's would have been 74% higher, but 56% lower the previous year. Here is how it works: An off-balance-sheet entity related to the company acts as a go between, taking receivables from the company and selling commercial paper or other securities to investors. The company gets quick cash; investors get shares of the proceeds the receivables will generate. In effect, the company is borrowing against its receivables and has to repay investors later when the receivables are actually collected. Ordinarily borrowing via the issuance of a security counts as what is known as financing cash flow -- in other words, it is money that does not come from operations. And that borrowing does cause a company to put debt on its balance sheet. The securitization structure is the workaround that allows the company to account for the transaction as if it were a simple sale of its receivables: operating cash flow, no debt. It is a nifty trick that breaks absolutely no rules. It is also logical, from a company's perspective: Securitization is often a lower-risk, lower-cost way of raising cash than other means of borrowing. …[O]nce a company is securitizing receivables, it can push operating cash flow up or down in any given period, depending on the level of receivables involved and how quickly the securities are repaid. "You're borrowing against future operating cash flows, so it's not sustainable as cash flow," said Charles Mulford, a Georgia Tech accounting professor. Whether or not securitization-related debt has to be carried on a company's books, economically it counts, he added. Rite Aid, for instance, reported $417.2 million in operating cash flow in its most recent fiscal year, ended in March. But $180 million of that came from securitization of receivables; without it, operating cash flow would have been $237.2 million, or 43% lower. Also, Rite Aid's reported $3.05 billion in debt doesn't include $330 million in receivables the company securitized in the past two years. Work them back in, and Rite Aid's debt climbs by nearly 11%. Jody Cook, a Rite Aid spokeswoman, said the company follows generally accepted accounting principles, or GAAP, and doesn't regard securitized receivables as boosting debt. "We treat it the same way GAAP treats it," she said. At Halliburton, securitizations inflated operating cash flow in 2004 and reduced it in 2005, by $519 million each year. In 2004, operating cash flow would have been $409 million without the transactions, down from the reported $928 million; in 2005, it would have been $1.2 billion, up from $701 million.

4/16/04 WSJ: "Cash Flow Never Lies" -- Or Does It?; One Company's Investment Is Another's Core Operation; Tripping on the Footnotes

Consider the issue of "vendor financing" and customer IOUs… Many companies lend their customers money to buy their products. Usually, the initial accounting is fairly simple. Revenue is recorded. Customer receivables go up. Inventory goes down. The company's operating cash flow remains unchanged. Except that isn't how everybody does it. Take the automotive industry. When Ford Motor Co. or General Motors Corp. lends money to dealers so they can buy wholesale inventory, the auto manufacturers recognize revenue on the sales. But they classify the loans as part of their investing activities. The result: Operating cash flow gets a boost before the loan is collected -- and it stays that way, even if the dealer later fails to pay what it owes. Harley-Davidson Inc., the motorcycle maker, uses the same practice. All this can be pieced together from the numbers in the companies' footnotes. But to unsuspecting investors, the companies' operating cash flows may look stronger than they really are… The dealer loans, called "notes receivable," are made by captive finance subsidiaries, such as Ford Motor Credit Co. or General Motors Acceptance Corp. Therefore, they say, these notes must be treated as part of investing activities on the parent companies' consolidated cash-flow statements. … Compare these practices with the approach at Navistar International Corp., which makes commercial trucks and school buses. Navistar also uses a captive finance subsidiary to finance its dealers' inventory purchases. The finance subsidiary shows the loans as part of investing activities on its own cash-flow statements. But when Navistar reports consolidated results, it reclassifies the receivables as part of operating cash flow. "At the end of the day, we define ourselves as a manufacturing company with a finance subsidiary," rather than the other way around, says Mark Oberle, Navistar's director of investor relations. "That sale and the associated change in receivables would be considered cash flow from operations, because it's part of our core business." Mr. Mulford opines that Navistar's approach is the superior one. As for the other companies, "by including these notes in the investing section of the cash-flow statement at a time when these notes are growing, you end up with a materially higher operating cash flow number," Mr. Mulford says. "And that's what can mislead an investor." To be sure, the practice cuts both ways. When notes are shrinking, that can result in a drag on operating cash flow for companies that treat them as part of investing activities.

Cell 104B: Other –Non-Interest Debt

5/15/04 WSJ: The Red Flag Called 'Self Insurance'; Goodyear's Restatement Is Warning for Investors; 'I Find It Confounding'

Goodyear Tire & Rubber Co. said it would restate financial results for 1999 through 2003, trimming $16 million from operating earnings during that period and reducing shareholders' equity by $23 million as of Sept. 30, in large part because it had understated workers' compensation-claims accruals at a single U.S. plant. … Investors had some warning this could happen: In the company's annual report filed with the Securities and Exchange Commission last April, Goodyear noted that it relies on estimates to set its liabilities for projecting workers' compensation costs, typically incurred when employees are hurt on the job. "Goodyear's ultimate liability in respect of these matters may differ from these estimates," that report said. Many companies make similar disclosures, notes Jack Ciesielski, publisher of the Analyst's Accounting Observer. Last year, for instance, he found that of Standard & Poor's 100-stock index, 16 included self-insurance liabilities among their "critical accounting policies" -- those crucial areas where incorrect estimates or projections by the company could have a material impact on its finances. Many companies self-insure a variety of risks, and workers' compensation costs is a common one, especially at manufacturers and labor-intensive service companies. By self-insuring, companies essentially decide to absorb any losses themselves, at least up until some set level at which a more traditional insurance policy kicks in. Under generally accepted accounting principles, companies must record liabilities annually for each year's expected insurance losses. …[J]ust because a company lists insurance reserves as a critical accounting policy doesn't mean it will ever report a restatement like Goodyear's. … McClatchy, a Sacramento, Calif., newspaper publisher, says it self-insures its workers' compensation risks in California and Alaska, as well as group health-insurance costs. Company Treasurer Elaine Lintecum says McClatchy uses past claims experience to estimate liabilities and also consults with actuaries and others. … In fact, Goodyear had better disclosure than some. In its annual report filed with the SEC in April 2003, the company noted that it had recorded $136.7 million in workers' compensation liabilities as of Dec. 31, 2002. "The costs include an estimate of expected settlements on pending claims, defense costs and a provision for claims incurred but not reported . . . based on Goodyear's assessment of potential liability using an analysis of available information with respect to pending claims, historical experience, and current cost trends," the report said.

Cell 105B: Post-Retirement Obligation

Companies make assumptions to estimate obligations and returns and, thus, current pension expenses, which have an effect on current income. "Cookie jar" reserves can be used to boost income.

10/25/00 WSJ: Health Advisory: Investors Should Do a Checkup On Firms That Use Medical Plans to Lift Profits

Here's a way Procter & Gamble has made money that a lot of investors don't realize: Since the early 1990s, the purveyor of paper towels and countless other consumer products has had an investment trust to fund its retiree health benefits. The combination of rising stock prices and slowing health-care inflation has yielded a small bounty to its bottom line.

Other companies have taken additional steps to turn retiree health-care benefits into shareholder benefits. These include slashing benefits, something P&G hasn't done. While investors have begun picking up recently on the fact that pension plans are contributing handsomely to earnings at dozens of large companies, they appear to be oblivious to this latest twist in how retiree programs have become profit centers. But are profits from health-care plans as valuable as profits from selling soap or movies or power tools? Some investors say no, they're not. These gains are desirable, but similar in nature to one-time gains that investors should factor in when analyzing price/earnings ratios… In its latest fiscal year, P&G's retiree medical program boosted corporate pretax income by $336 million. That contribution amounted to more than 6% of the company's earnings before taxes. That is far more than P&G earns on average from the 300 brands it sells. P&G has had a boost to its bottom line from the retiree medical program each year from 1994 to the present. Altogether, the retiree medical plan has contributed $909 million to pretax income. Thanks are due largely to returns on the fund, whose assets grew to $1.3 billion on June 30, the end of P&G's fiscal year. (The fund had actually grown to $2.5 billion on June 30, 1999, but poor investment results have slashed the size since then.) … How, specifically, did P&G turn burdensome health-care liabilities into profits? The answer lies in Financial Accounting Standard 106. Put into effect by large employers between 1992 and 1993, it required companies to estimate their retiree health-care costs, which at the time appeared huge and bound to keep increasing, given then-double-digit medical inflation. The standard required those costs to be run through the income statement and identified on the balance sheet as a liability. Meanwhile, some companies set up trust funds to pay for these future benefits. One-third to one-half of large companies -- predominantly utilities, defense contractors, banks, and pharmaceutical companies -- fund their post-retirement benefit plans. As it turns out, the medical inflation rate tapered off sharply within a few years of the accounting standard's enactment. This meant the liabilities that companies had put on their balance sheets needed to be reduced. In shrinking these liabilities, companies created "gains" that had to be accounted for on the income statement. As for those trust funds, meanwhile, the booming stock market was creating investment returns that vastly exceeded expected returns, and the result also was a boost to income. Whether a result of the reduced inflation or the bull stock market, the gains are usually run through the income statement over a period of years. It is the long, drawn-out nature of the gains' impact on earnings that worries some critics, such as Jack Ciesielski, an accountant and publisher of The Analyst's Accounting Observer. If these gains (or losses) impacted income in the same year that they occurred, investors would be more likely to discount them, rather than treating them like a business's actual income, Mr. Ciesielski says. To some investors, the retiree health plans are an example of the feedback effect between the stock market and corporate earnings. Stock prices rise, which in certain circumstances can actually boost earnings at companies, which then becomes a reason for stock prices to rise even further. …. The fund at P&G now mimics an overfunded pension plan: It has far more assets than it needs to provide the benefits. Unlike a pension plan, which can invest no more than 10% of the assets in the employer's stock, retiree medical funds can be 100% invested in the company stock. P&G's fund, invested in P&G preferred stock, had investment returns of $803 million in fiscal 1998, which was more than it needed to pay the $67 million for retiree medical benefits.

Cell 109B: DIT

DIT = Deferred Income Tax = future tax payments, as the taxable expense reported in financial statements was less than the actual tax payments to tax authorities --- expenses incurred were more for financial statement purposes than for tax purposes. Long-term tax assets and liabilities are generally netted. Short-term tax assets and liabilities are generally netted. One may separate and analyze details of each from disclosures in Form 10K. DIT should continue to grow as a firm grows.

"We examine the usefulness of deferred tax expense as compared to various accrual measures employed in prior research in detecting earnings management in three settings where earnings management likely occurs. The motivation for using deferred tax expense to detect earnings management is that there is typically more discretion under generally accepted accounting principles than under tax rules, and we assume that managers exploit such discretion to manage income upwards primarily in ways that do not affect current taxable income. Thus, we expect that decisions to manage earnings upwards will generate book-tax differences that increase deferred tax expense. ... An increase in deferred tax liabilities is consistent with a firm currently recognizing revenue and/or deferring expense for book purposes relative to its tax reporting, resulting in a future taxable amount. Alternatively, deferred tax assets increase as firms currently recognize expense and/or defer revenue for book vis-à-vis tax purposes, thereby producing a future deductible amount. All else equal, firms report higher pre-tax book income than taxable income when they have increases in their net deferred tax liabilities (defined as the change in deferred tax liabilities less the change in deferred tax assets), and vice versa." (Earnings Management: New Evidence Based on Deferred Tax Expense, 2002, Phillips, Pincus & Rego)

Cell 110B: Minority Interest

See, Minority Interest in Operating Statement. This amount could only fall below zero if Minority Interest loss amount(s) in Operating Statement total greater than initial amount(s) invested and there is either an obligation or intent to provide additional capital to the third-party entity.

"When a corporation controls the operations of another company, it should consolidate the operations of both. When the parent applies the equity method instead, we can be sure that it is hiding debt." (p. 70) Hidden Financial Risk: Understanding Off Balance Sheet Accounting by J. Edward Ketz.

Cell 111B: Reserves

7/2/04 WSJ: Reversing the Charges: Nortel Board Finds Accounting Tricks Behind '03 Profits; A Telecom Star Manipulated Its Reserves, Hid Losses, An Investigation Discovers; How to Empty the Cookie Jar

Nortel Networks Corp. … had a profit of $40 million, its first positive quarterly result in four years. …[T]he profits turned out to be illusory. …[T]he company inaccurately employed an accounting maneuver to make it look profitable, when in fact it wasn't. … [A]s Nortel struggled to meet ambitious earnings targets, it resorted to a series of accounting maneuvers to artificially transform its finances…. [T]he alleged manipulation centered on the misuse of an accounting entry known as accrued liabilities. Accrued liabilities derive from the charges companies often take for matters such as merger costs, write-downs and, in Nortel's case, contractual liabilities. For example, a company might take a charge if it missed a deadline on a $10 million contract and reasonably believed the error would cost it $1 million in the future -- through a customer refund, perhaps. The company would count the $1 million future liability as an expense, which would reduce its earnings in the quarter. It would be entered on the balance sheet as a liability until it was paid. Over time, these liabilities can add up.Under certain rules, companies can dip into their accrued liabilities and count the withdrawn sum as income. For example, if the company agreed to pay its customer $600,000 for the missed deadline, instead of the $1 million set aside, the company would be able to count the unused $400,000 as profit in the quarter when the customer was paid.This system can be abused two ways. Companies can exaggerate the liability or hold it on their books too long, in both cases hoping to use the reserves to plump earnings at a later date. This is known in the finance world as "cookie jar" accounting, which is among the most common financial frauds, accounting experts say. … In the first and second quarters of 2003, … Nortel emptied the cookie jar. Reserves were inappropriately taken off the balance sheet and added to the company's earnings. The board hasn't found a legitimate trigger for the reserves to be released. Nortel had also overstated the size of its reserves, a move that gave it a larger pot to dip into. The company said in filings with the SEC in October 2003 that some of its reserves "were recorded in excess of the amounts that now have been determined would have been appropriate at the time of recording." Although taking inflated reserves would initially depress a company's net income, Nortel, like many other companies, dubbed the taking of reserves a "one time" or "special" event, which it encouraged investors to overlook. The "pro forma" earnings Nortel released until recently didn't include these charges. … Behind the losses was a rash of charges. From 1989 until 1997, Nortel took a charge just once. In 24 quarters from 1998 until the end of last year, Nortel took charges in 19 of them…. An unknown number of these charges related to setting up reserve accounts that were later used to boost earnings….Inflating reserve accounts had been a routine end-of-the-quarter game among finance executives at Nortel for years, several former finance executives say. The practice of holding extra reserves was so common that Nortel executives gave it a name: "hardness." In Nortel parlance, having hardness meant having reserves on hand that could be released at some later date to help the company meet Wall Street's profit targets. … Former finance officials say Nortel sometimes used balance-sheet releases to improve earnings. … Investors used to ignore charges relating to reserves, especially if they occur amid otherwise very good or very bad years. Given that Nortel lost $34 billion from 2000 to 2002, investors didn't pay much attention to several hundred million dollars in reserve-related losses. But in the summer of 2002, some investors voiced concern to Nortel's executives because the company's accrued liabilities had ballooned to $5 billion. Investors worried Nortel would collapse if they all came due at the same time. …. In the first half of 2003, the long-standing practice of dipping into reserves became more significant when it was used to turn losses into profits. … After investors broadly criticized that formulation for not conforming to standard accounting principles, Nortel, like many other companies, stopped reporting pro forma incoming in 2003. It still used that number internally for matters including calculating bonuses. At the time, Nortel's reported first-quarter net income was $54 million. Out of public view, Nortel included in its first-quarter profits about $361 million in reserves. Roughly $160 million of that, the company's board has determined, was inappropriately released. At the time, Nortel identified $80 million of releases in a regulatory filing, saying they were no longer needed. When directors pressed executives at an April 2003 board meeting, they were told the remaining releases related to normal business operations and didn't need to be disclosed, people with knowledge of the meeting said. … The size of the first quarter releases was relatively small compared with Nortel's revenue -- the company had sales of $2.3 billion -- but they made the difference between a profit and a loss. Under accounting rules, unusual factors leading to such a swing must be disclosed. "If you make [a profit] by doing something that's out of the ordinary you need to tell people about that," says Charles Mulford, an accounting professor at the Georgia Institute of Technology. … But in the executive suite, the reserve accounting was causing a rift. Some executives worried the reserves were being released inconsistently, a problem that could make the decisions harder to justify if that was necessary… [T]he board pushed the company's executives to clean up the company's balance sheet and reduce confusion caused by years of accumulated reserve accounting. … As a result of the house-cleaning, Nortel restated 3 1/2 years of financial results in December 2003. The company announced it had discovered $950 million in faulty reserves; some were inappropriately taken and others should have been released earlier. Nortel retroactively shifted them among past quarterly earnings totals, including the first two quarters of 2003 that are under question. In the filing that detailed the restatement, Nortel's auditor, Deloitte & Touche, said the company had "material weakness" in its internal controls and specifically cited the balance-sheet-reserve accounts. … The board's inquiry began in late December. By the spring, it discovered something it wasn't looking for: the alleged manipulation of the company's reserve accounts. … Some former employees and critics say board members, many of whom were former ambassadors and Canadian corporate leaders, should have spotted the accounting problems earlier.

10/25/13 WSJ: Big Banks Are Padding Profits With 'Reserve' Cash; As Revenue Slows, Some Banks Increasingly Use Loan-Loss Reserves to Boost Income

Federal regulators have warned banks to be careful about padding their profits with money set aside to cover bad loans. But some of the nation's biggest banks did more of it in the third quarter than earlier this year.

Federal regulators have warned banks to be careful about padding their profits with money set aside to cover bad loans. But some of the nation's biggest banks did more of it in the third quarter than earlier this year. J.P. Morgan Chase & Co., Wells Fargo & Co., Bank of America Corp. and Citigroup Inc., the nation's largest banks by assets, tapped a total of $4.9 billion in loan-loss reserves in the third quarter, up by about a third from both the second quarter and the year-ago quarter after adjustments. All the banks except Citigroup showed significant increases compared with the second quarter. Accounting rules allow the money to flow directly into profits. In all, it made up 18% of the banks' third-quarter pretax income excluding special items, the highest percentage in a year, according to an analysis by The Wall Street Journal. The moves come at a time when banks are being slammed by revenue slowdowns. Big commercial banks have suffered from a double whammy of plunging mortgage lending and trading activity. Third-quarter revenue for the four banks dropped an average of 8% from the previous quarter. The KBW Bank Index has declined 2% in the past three months, while the S&P 500 stock index has gained 4% over the same period. The accounting maneuvers show how banks can prop up earnings when business hits a rough patch. "You've seen reserve releases improve the stated numbers," said Justin Fuller, a Fitch Ratings analyst. "Going forward, I think there's fewer levers to pull for the banks." Investment banks are feeling the squeeze as well. Goldman Sachs Group Inc. cut the funds it set aside for compensation in the third quarter, a move that bolstered its results in the face of a 20% revenue decline from the same quarter a year earlier. Such moves are "very emblematic of what's going on," said Charles Peabody, partner in charge of research at Portales Partners LLC, a financial-services research firm. The degree to which the banks' earnings rely on loan-loss reserves "exposes the lack of growth" in their traditional businesses, he said. The banks justify the releases. They cite improvements in credit quality and economic conditions—which make it less necessary for them to hold large amounts of reserves as a cushion against loans that go sour—and they say they are following accounting rules that require them to release funds as losses ease. A Bank of America spokesman said "the significant impact in credit quality we've seen in the last 12 months" has driven the reserve releases. J.P. Morgan, Wells Fargo and Citigroup all pointed to previous comments their top executives recently made indicating that reserve releases were merited because of factors like improving credit quality and the recent increase in housing prices. But the Office of the Comptroller of the Currency, which regulates nationally chartered banks and federal savings associations, is reiterating warnings to banks about overdoing it. In a statement to the Journal, Comptroller Thomas Curry said the OCC is monitoring banks' loan-loss allowances "very closely" and that "we continue to caution banks not to move too quickly to reduce reserves or become too dependent on these unsustainable releases." He didn't comment specifically on the banks' third-quarter releases, but said OCC examiners "will continue to challenge allowances on a bank-by-bank basis if necessary." If the regulator finds problems with a bank's reserves, it can issue a "matter requiring attention," a specific finding of a deficiency that a bank must address, an OCC spokesman said. The agency has thousands of such findings outstanding on a variety of subjects, but the OCC spokesman wouldn't say how many, if any, were related to banks' reserve releases. Mr. Curry has been vocal on the issue for more than a year. In September 2012, he called it a "matter of great concern," warning banks that "too much of the increase in reported profits is being driven by loan-loss-reserve releases." Last month, Mr. Curry said in a speech that when economic growth is slow, as it is now, banks might take more risks to maximize their returns, and so it is "particularly important" they maintain appropriate reserves. While some level of reserve releases is "certainly warranted," he said, the ease of boosting earnings through the practice "has proved habit-forming" at some banks, though he didn't single out any specific institutions. Mr. Curry said his previous concerns initially seemed to get banks' attention, and reserve releases temporarily eased, but that was "an anomaly." Since then, he said, the releases have increased again, despite "loosening credit underwriting standards" that suggest banks are facing higher risks. The OCC isn't alone in its concern. Last year, Federal Deposit Insurance Corp. Chairman Martin Gruenberg said the trend of earnings driven by lower loan-loss provisions "cannot go on forever." An FDIC spokesman said Friday, "We will continue to evaluate and confirm the ongoing adequacy of reserves during our regular examinations." Other banks are releasing reserves, as well, though the amounts drop off drastically below the top four. In the second quarter, the most-recent period for which industry-wide figures are available, nearly 40% of all FDIC-insured banks released reserves, according to the FDIC. As of June 30, the industry's bad-loan reserves had fallen to their lowest level as a percentage of total loans since before the financial crisis began, according to FDIC data. J.P. Morgan released $1.8 billion in the third quarter, including $1.6 billion from its consumer and community banking unit, accounting for 19% of its pretax income after the bank's giant litigation expenses in the quarter are excluded. That is higher than in recent quarters, though the bank's nonperforming assets have declined 18% over the past year, helping to justify a larger release.Bank of America released $1.4 billion, comprising 29% of pretax income, and Wells released $900 million, or 11% of pretax income, its biggest release in more than two years. Citigroup released $778 million, down slightly from the second quarter, and the release amounted to 18% of pretax income. At all three, the percentage of pretax income was up from the second quarter, and nonperforming assets have fallen at all four banks at least 18% compared with a year ago. Bankers say current accounting rules essentially compel them to release reserves when loan losses ease, because the rules use past and current loan losses as the criteria for determining the proper level of reserves. James Dimon, J.P. Morgan's chairman and chief executive, has been particularly vocal on the issue—at one point in 2012, he said that, while the bank wants to be conservative on its reserves, "the accountants look at a whole bunch of numbers. They make you take it down. So we had to take it down." But critics said banks have more discretion than that, and rule makers at the Financial Accounting Standards Board have proposed changes that would require banks to recognize losses based on expectations of further losses. Such a move would lead banks to record loan losses sooner and set aside reserves more quickly, analysts say. Those potential changes are still pending, and Mr. Curry said in his speech last month that he supports the "thrust" of the FASB proposal.

Cell 117B: Deferred Compensation

The Company recognizes a deferred compensation cost, e.g. the fair value of stock options, which is amortized over the vesting period.

6/23/06 WSJ: Deferring Compensation Also Creates A Company Debt to Executives

Besides pensions, most large companies owe their executives another retirement debt: deferred compensation. … Deferred-compensation plans let executives put off receiving large chunks of their salary and bonus until retirement. The plans have often let executives defer other pay as well, such as gains from exercising stock options. The deferred sums grow tax-free. Sometimes they increase at an above-market interest rate guaranteed by the company. Some companies also add to the balances with contributions from time to time. "Deferred-comp" plans are similar to pensions in that they represent money a company must pay in the future for work done today. As a result, the plans are liabilities for the companies -- that is, debts. The carrying cost of this debt is something that companies must deduct from their earnings each quarter. Deferred-comp plans resemble executive pensions, in particular, because they often aren't "funded." That is, companies usually don't lock away assets in the plans to pay the money when due. So deferred-comp plans affect company profits in much the same way as executive pensions do: by reducing them.

Cell 118B: Treasury Stock

7/11/06 WSJ: Corporate Debt Begins to Worry Bond Investors Issues Are Often Used to Fund Stock Buybacks and Dividends; Ratings Firms Look Askance

Corporate executives are increasingly turning to debt for the cash they need to feed stock investors with share repurchases, dividends and empire-building exercises, a trend that is starting to worry some bondholders. …[S]ome bondholders complain about companies that use debt to help fund stock buybacks and dividends, because it uses up cash without creating new growth opportunities. That, in turn, can lead to ratings downgrades and put downward pressure on bond prices as buyers demand more yield to compensate for the added risk. … When a company buys back its stock, it reduces the pool of shares available to investors, which can help to raise its stock price. … Even though debt levels have been increasing this year, broad measures of the financial health of companies -- like comparisons of their debt to their cash flow or to their equity -- haven't changed much from a year ago and remain lower than they were in 2002 and 2003…. While many companies are in strong financial positions, credit-rating services are starting to point out signs of stress. The number of corporate-ratings downgrades looks to be rising as debt loads build. Among consumer-oriented companies, there have been 2.7 downgrades for every ratings upgrade this year….

1/31/06 WSJ: Moving the Market -- Tracking the Numbers / Outside Audit: Buybacks via Loophole Can Have Hidden Cost

In a traditional buyback program, a company announces a plan to repurchase shares worth a certain dollar value, then buys its stock in the market over time. If the stock gets too expensive or cash-flow circumstances change, the company can stop the buyback.

In an ASR, a company buys all the shares at once from an investment bank, which usually obtains the stock by borrowing it from institutional owners. Thus, the company shaves its shareholding base right then, so its earnings start to look better when divided by the fewer remaining shares.

But there is more to the arrangement. To cover its "short" positions, the investment bank buys back shares in the open market over time to replace those it has borrowed. If the stock price rises while the bank is buying the stock, the company has to compensate it for the difference. This settlement, which is part of a complex forward-sale contract, can be made in cash or shares, and is based on the stock's average price over the buyback period. If the share price falls during the buyback period, then the bank makes a payment to the company. Critics term ASRs a type of derivative contract. Under accounting rules, many derivatives have to be "marked to market" each quarter, with any gains or losses recorded in the income statement. This isn't the case with ASRs. Although some of the potential settlement amount is reflected in the earnings-per-share calculation while the ASR contract remains outstanding, accounting rules allow the sum to be excluded from the company's balance sheet and net-income calculation -- in effect creating off-balance-sheet liabilities or assets.

Even when the company makes its final settlement with the investment bank, the sum the company pays or receives doesn't count in figuring net income, but is included in per-share earnings calculations for that quarter. …

Charles Mulford, an accounting professor at Georgia Institute of Technology in Atlanta, says … "My biggest concern is that it creates these off-balance-sheet assets or liabilities that can be quite substantial," he says. "The cynical view is that the whole motive is to get this immediate reduction in shares outstanding to help the next quarter. The problem is, you have the outstanding derivative that doesn't show up anywhere and may come back to bite you."

Consider the example of Intergraph Corp., a Nasdaq-listed software company based in Huntsville, Ala. In March 2005, it repurchased 5.4 million shares from Goldman Sachs Group Inc. in an ASR for a total of $150 million, or $27.74 a share. Because the buyback removed about 16% of the company's outstanding stock, it boosted earnings per share for the rest of 2005.

But since the deal was struck, Intergraph's shares have risen significantly, hitting more than $50 early this year before pulling back some. The stock's rise already caused Intergraph to assume an increase in its outstanding shares in calculating diluted earnings per share, diminishing the buyback's impact. With final settlement scheduled for late this quarter, Intergraph last week said it might have to pay up to $83 million to Goldman in cash or shares when the deal concludes. If the company pays cash, that won't affect net income, but almost certainly would more than wipe out its per share earnings for the first quarter, and possibly for all of 2006.

MISCELLANEOUS DATA

Cell 133B: Other Non-Cash Charges

E.G. depletion(+); amortization of goodwill, original issue bond discount, previously capitalized interest, trademarks & patents(+); gain on sale of available-for-sale securities and land(-); equity earnings in excess of cash dividends(-).

Cell 139B: Equity Dividends

9/1/06 WSJ: Where Accounting Meets Language How Firms Use 'On' or 'Of' In Citing Investment Returns May Cut Into Cash Flow

Consider this proposition: The choice of one little preposition can mean a big difference in how much cash a company appears to be generating. The fine distinction is the difference between return "on" investment and return "of" investment. Many companies are making a choice that, while not at all an impropriety, has the effect of making them look less capable than they really are in expanding their main operations. And that choice gets baked into the cash-flow statements closely watched by large investors. Specifically, these companies are misclassifying the cash dividends and distributions they receive from their investments in other companies. At some companies, like General Mills Inc., the misclassification can mean that tens of millions of dollars should be added to operating cash flow, according to Charles Mulford and Eugene Comiskey, two accounting professors at the Georgia Institute of Technology. At least one company, Schnitzer Steel Industries Inc., would have nearly doubled its operating cash flow last year if the distributions were handled the right way, according to a report by the professors. … Accounting rules say that when a company receives a cash return on an equity investment such as a joint venture, that money is like a dividend and should be recorded under operating cash flow, the most important and scrutinized part of the cash-flow statement. The distribution is being paid out of the earnings the investment is generating -- literally a return "on" investment. But when the money a company earns from another company is less than the distribution paid to it by that company, that means the joint venture or other investment entity had to dip into its capital to return some of the funds that were originally invested in order to pay the distribution. In that case, it is a return "of" investment, and accounting rules call for that sort of distribution to be counted under the less-significant category of investing cash flow. Professional investors pay less heed to investing cash flows, figuring that it is more important for a business to be good at expanding its main operations rather than investing money on the side. … For instance, General Mills reported receiving $83 million in dividends from several international joint ventures in fiscal 2005, and the food maker counted that money under investing cash flow. But because that amount was less than the income the company reported from the joint ventures, the $83 million belongs under operating cash flow, according to the Georgia Tech report. Such a reclassification would have lifted General Mills's operating cash flow by nearly 5%. … Schnitzer Steel Industries, on the other hand, decided to redo its cash-flow statements for the past three fiscal years to move its joint-venture distributions from investing to operating cash flow. The original placement under investing cash flow was "an error in classification," the company said in its restatement Wednesday. While the changes for fiscal 2004 and 2003 were minor, for 2005 the revised operating cash flow jumped 99%, to $146.3 million from the originally reported $73.5 million.

Cell 146B: CF Income Tax Paid

1/17/02 NYT: Enron Avoided Income Taxes In 4 of 5 Years

Enron paid no income taxes in four of the last five years, using almost 900 subsidiaries in tax-haven countries and other techniques, an analysis of its financial reports to shareholders shows. It was also eligible for $382 million in tax refunds. … The tax-haven subsidiaries enabled Enron to create partnerships to eliminate taxes using techniques that came under attack from the Treasury Department and the Internal Revenue Service during the Clinton administration. The basic technique involves having profits go to a partner not subject to American taxes, like a bank in a tax-haven country. The partner, after taking its fee, then returns the profits in a form that is recognized as not taxable by American law. Enron avoided taxes for another big reason: deductions for stock options. When executives exercise stock options the company takes a deduction on its corporate income tax return equal to the profit realized by the executive, even though it is not required to show an expense on its profit-and-loss statement to shareholders. The benefits to the company can be great, particularly if a soaring stock price leads to the exercise of large numbers of options. That was true at Enron when its shares were soaring in 1998 through 2000. It is not clear from Enron's financial reports how much the tax-haven operations reduced the company's taxes. … Indeed, the company paid taxes in only one of the years from 1996 to 2000, while the government paid the company hundreds of millions of dollars in refunds. … <u>If shareholders had read just the large print in Enron's financial reports, they might have come away thinking the company did pay income taxes. The reports say the company paid hundreds of millions of dollars in corporate income taxes over the last five years. But company financial reports often disclose numbers different from what the companies actually pay because of such matters as when income is recognized and when expenses are deducted. So only in the fine print -- the footnotes -- of Enron's reports does it become clear that no tax was due.</u>

Cell 150B: Tax Value Allowance

A tax deferred asset must be recorded for all potential tax benefits even if its realization is so low that immediate write-off through a deferred tax asset valuation is planned. In cases of such immediate write-off, the tax value allowance has no effect on the current tax provision and CFFO should not be adjusted.

11/28/05 WSJ: Taxing Times

General Motors Corp. last week said big restructuring charges are just around the corner. It hasn't yet said what kind. But keep your eyes on this balance-sheet item: deferred-tax assets. These assets basically consist of tax-deductible losses and expenses carried forward from prior years, which can be used to offset future income-tax bills. They're valuable only to companies that are profitable and paying income taxes. General Motors, of course, hasn't been profitable for the past year. If GM concludes that it can't use all its tax assets, under accounting rules, the company would have to record a charge against net income to reflect their diminished value --

just like banks periodically take charges for bad loans. A big charge effectively would flag that GM's prospects for profits are bleak for the foreseeable future. As of Dec. 31, GM's net deferred-tax assets were $19.2 billion. That included a $3.4 billion "valuation allowance" -- accounting lingo for the portion of the tax assets it expects to go unused. At Sept. 30, net deferred-tax assets were $21.8 billion; the allowance isn't disclosed in GM's quarterly filings. For a sense of how big these assets are, consider: GM's total shareholder equity at Sept. 30 was $22.4 billion. "It wouldn't surprise me if, in the near term, they announced a substantial increase" to the valuation allowance, says Charles Mulford, a Georgia Tech accounting professor. To be sure, he adds, GM could find ways to generate taxable income and avoid that, even if its operations keep losing money. For example, it could sell GMAC. Asked about the tax assets, a GM spokeswoman says "we have not done an adjustment at this point in time." Any such change, she says, "would be disclosed at the appropriate time." For outsiders, the problem is that "GM is the only one that has access to all the evidence," notes Jack Ciesielski, editor of the Analyst's Accounting Observer. "If you're an investor, and you think the future is going to be a lot like the recent past losses, you're going to be expecting a write-down." Should such an event come to pass, ignoring it could be perilous. Delta Air Lines, Delphi and Bethlehem Steel all took big charges to boost their allowances for deferred-tax assets -- shortly before filing for Chapter 11.

7/21/06 WSJ: Nortel's Appeal Is Also a Detraction Company Battles Suggestion It Write Down Key Credits; Billions of Dollars at Stake

Nortel Networks Corp., the Canadian telecommunications-equipment company that is looking to get back on track after years of losses, has billions of dollars in valuable credits that could aid its financial recovery. Trouble is, there is disagreement over whether those credits -- the company's largest asset -- should still be on its balance sheet. A recent report from research firm Glass, Lewis & Co. says that company's string of losses suggests it might need to write down the value of tax credits earned in past years that have been held over to offset tax liabilities on future earnings. The company hasn't done so, citing the likelihood of near-term profits. Such a write-down could wipe out Nortel's shareholder equity, or the total of its assets less its liabilities. Nortel expects higher revenue this year and is taking a series of steps intended to bring its operations back to profitability. But any improvement would follow a series of losses in recent years, and those losses are an important factor in determining how to book the tax credits, Glass Lewis and other accounting observers say. As of March 31, the most recent figures available, Nortel had $3.9 billion in net deferred tax assets, an amount larger than any other asset on its balance sheet and one that dwarfed its $675 million in shareholder equity. Deferred tax credits are valuable to a company only if it's posting profits. Without taxable profits, the company isn't generating tax liabilities against which it can use those credits and deductions, which often are good only for limited periods. Under accounting rules, a company is supposed to write down the value of its deferred tax assets -- or establish or increase a "valuation allowance" tied to them, in accounting language -- if it appears more likely that it won't be able to use some or all of them before they expire. Crucial in deciding whether to write down the credits is the company's history of recent losses. From 2003 to 2005, excluding a big 2005 charge for a lawsuit settlement, Nortel had a combined pretax operating loss of $218 million. The company continued that trend in the first quarter of 2006, with a pretax operating loss of $159 million. A Nortel spokesman said the company follows U.S. generally accepted accounting principles and wouldn't comment further. In securities filings, however, Nortel notes that it decided not to take write-downs on the tax credits because of its forecasts of future profits and because most of the credits won't expire for several years or more. But Jason Williams, the Glass Lewis analyst who wrote the firm's report on Nortel, said the company's series of losses "probably outweighs" the other factors in arguing for a write-down. "I think what you have to look at is the history." This isn't a new issue for Nortel. Since the end of 2002, the company has added less than $500 million to its valuation allowance, leaving billions of dollars of deferred tax assets alone. And in three of the past five quarters, Nortel has actually reduced its valuation allowance on a quarter-to-quarter basis. In other words, it essentially reversed a portion of the write-downs it had previously taken against its deferred tax assets. One of those reversals was tied to an acquisition, which accounting observers said makes sense. But one of the other reversals isn't so clear cut. In last year's fourth quarter, Nortel reduced its valuation allowance by $111 million. That added three cents a share to the company's earnings for the quarter by giving it an income-tax benefit on its earnings statement, instead of an expense. As it happens, that boost enabled Nortel to meet analysts' consensus earnings expectations for the quarter. What makes this change look especially odd is that in the following quarter, the first quarter of 2006, Nortel added back $90 million to its valuation allowance -- effectively re-establishing most of the write-down it had reversed just a quarter earlier. Mr. Williams said he's "skeptical" of a situation like that. He said, "It begs the question: Are they using this to massage their earnings?" In its 2005 annual report, Nortel said its valuation allowance in that year declined because of "foreign exchange, deferred taxes that expired during the year and tax return and other adjustments," offset in part by additional write-downs taken. Nortel has said it expects revenue growth in the high single digits this year and profit margins of about 40%. It is cutting costs and otherwise restructuring. "I am confident in the progress we are making in turning around Nortel and recreating a great company Mike Zafirovski, Nortel's president and chief executive, said in a statement last month. Yet the company is still hunting for profits to use the tax credits against: In the first quarter of this year, revenue dipped slightly from last year, and the company posted a net loss of $167 million. And in quarters to come, it appears the company is going to be paying a lot more in interest, since in recent months it has refinanced some of its debt at higher interest rates.

Cell 157B: Accountants

10/1/97 WSJ: Keep a Close Watch on How Firms Account for Changing Auditors

Warning signals to note when a company changes auditors:
-- Company is late in disclosing change
-- Departing auditor isn't replaced relatively soon
-- Auditor quits over a dispute
-- Auditor abruptly drops new client
-- Company fires auditor after adverse opinion is issued
-- Company hires new auditor every year

Cell 162B: Long-Term Lease Obligations

Long-Term Lease Obligation = LT Lease Obligation minus amount due within 1 year.

5/13/14 SeekingAlpha: The balance sheet should not be mentioned without clarification that while AEO carries no debt, they do carry large operating lease obligations, $1.755 billion worth, to be exact. Operating leases are not the same as debt. At least some of the leases carry early termination options. Further, leases can be renegotiated without triggering a default that leaves the stock worthless. So they are not the same as debt, but they cannot be ignored either.

7/18/06 WSJ: Up for Overhaul: Lease Accounting Rule Makers Aim to Rein In Off-the-Books Approaches, Possibly Exposing Billions

Accounting bodies on both sides of the Atlantic are expected tomorrow to begin a formal overhaul of rules on leases, potentially forcing companies to recognize billions of dollars in liabilities currently kept off their books. The joint effort by the Financial Accounting Standards Board in the U.S. and the International Accounting Standards Board in London to create new rules for leases comes after the Securities and Exchange Commission called last year for a revamp in a report critical of off-the-books arrangements like those that were instrumental in the implosion of Enron Corp. …In trying to bring more leases onto balance sheets, rule makers face a multiyear task likely to raise hackles among a wide array of businesses. Companies lease everything from personal computers to heavy equipment to corporate headquarters and stores. Currently, if leases for such items are structured to meet certain criteria, a company can keep them off its balance sheet and so report lower debt figures. Today's lease accounting lets companies in the Standard & Poor's 500-stock index, for example, keep about $400 billion in liabilities off their books…. Leasing is also big business: While a large portion of leases relate to real estate, equipment leasing is a more than $200 billion-a-year industry in the U.S.… Businesses are expected to push back. … To determine whether a lease should be included on a balance sheet, current accounting rules test whether a company effectively takes ownership of the property or equipment being leased. But the rules also let companies and their advisers structure transactions so that they aren't considered to be taking ownership. That means they don't have to record an asset and corresponding liability on their books; instead, such information is included only in financial-statement footnotes. If, for example, a company can show that the present value of minimum lease payments is less than 90% of an asset's value, along with other criteria, the lease stays off the balance sheet. "But there are professionals out there who will run the calculations to make sure the present value comes to 89.999%," said J. Edward Ketz, an associate accounting professor at Pennsylvania State University, who calls current leasing accounting rules "ridiculous, absurd, contorted and illogical." Among S&P 500 companies, more than 90% of leases have been kept off balance sheets….

Cell 188B: Stock-Based Compensation

1/31/09 WSJ: Analysts, Expensing Isn't Optional

Three and a half years should be long enough. That is how long it has been since a new accounting rule went into effect requiring expensing of employee stock options. But a casual investor could be excused for thinking the accounting treatment was, well, optional. Many tech companies, most notably Google, still present earnings excluding stock-based compensation -- or not based on generally accepted accounting principles -- alongside the GAAP numbers in earnings releases. It is no minor difference. Google's $1.1 billion in stock-compensation expense in 2008 amounts to 5% of revenue; including it reduces net income 17%. But the real problem is that so many Wall Street analysts still seem to buy the line that option expenses aren't a real cost, excluding them from earnings forecasts. (Google has cited analysts' use of non-GAAP numbers for its approach.) It doesn't help that Thomson Reuters's survey of earnings excludes option expense for a specific company if that is what a majority of analysts do. The firm publishes a separate number reflecting the minority view, but it is questionable whether that number gets attention. The approach creates anomalies. Thomson's consensus estimate for Amazon.com includes stock-compensation expense, while eBay's excludes it, even though the two companies are in broadly the same business. It is the same story with Google, where most analysts exclude the expense, unlike those covering Yahoo. The unequal treatment means it is tough for investors to readily compare price-earnings multiples and profitability of companies in the same industry, let alone different industries. Admittedly, options expense is only one item excluded from non-GAAP earnings. But it is a big one. There is no question the dilution of a company's share count caused by issuing options is a real cost for shareholders, best measured by the cost of neutralizing that dilution by buying back stock. Morgan Stanley analyst Mark Lipacis, after studying several semiconductor companies, found that option expense was generally a "very good proxy" for the money that companies would have to spend repurchasing stock if they wanted to neutralize option-related dilution. Analog Devices, for example, expensed $753 million in stock compensation between mid-2003 and mid-2008 and would have had to spend $726 million buying back stock to offset the option-related dilution, he calculated. To be sure, the expense underestimates the cash needed when stocks rise in value -- that is, when the options become more valuable -- and overestimates what is needed when stocks fall. That highlights the uncertainty inherent in valuing options. But as Google showed last week, when it announced its intention to reprice employee options to current market level, out-of-the-money options often can quickly, and unexpectedly, regain their value. It is time for Wall Street tech-industry analysts to drop the pretense and start treating options as a real cost. Then maybe tech companies will give GAAP numbers the star treatment they deserve.

11/9/13 NYT: Earnings, Without the Bad Stuff

Twitter's red-hot stock offering last week makes clear that, as in the first Internet bubble, investors will pay up for a company even if it hasn't turned a profit. And managers of companies that have generated only losses, like Twitter — and even those that are profitable — are happy to suggest metrics that they think are better suited for assessing their operations. Managements' recommended measures, typically not found in generally accepted accounting principles, have an uncanny way of burnishing a company's results. They do so by eliminating some pesky costs of doing business. As such, these benchmarks are also known as earnings without the bad stuff. They were central to the valuations that propelled Internet stocks skyward in the late 1990s. Then, the higher the market climbed, the kookier the metrics became. My favorite measure was used by analysts to hype the prospects of Homestore.com, a web-based provider of real estate services. They lauded its potential because of the "share of mind" it enjoyed among its customers. That "share" may have been meaningful in early 2000, as the company's stock hit $489, but it vanished quickly when Homestore.com crashed in 2001. (Stuart Wolff, a former C.E.O., was sentenced to prison in 2010 after pleading guilty to conspiracy to commit securities fraud.) The company now operates as Move Inc.; its stock closed Friday at $16.09. What costs do companies want investors to remove from the income statement? Among the most popular are those associated with stock-based compensation, like options and restricted stock. Because these forms of pay aren't made in cash, the theory goes, they should be backed out of a company's expenses. Twitter's recent prospectus serves as an example. Its management suggests that investors not focus solely on its $134 million net loss for the first nine months of 2013, a figure calculated under generally accepted accounting principles. If you want to see the company's operating results "through the eyes of management," the prospectus suggests, look at its "non-GAAP net loss" of $44 million for the period. To get to that figure, Twitter backs out two large costs. Stock compensation for the first three quarters of 2013 is the biggest, at $79 million. Twitter also removes $11 million in costs associated with amortizing or reducing the value of intangible assets it acquired previously. There's nothing improper in Twitter's filing. But the idea that these items don't cost the company is nonsense, says Jack T. Ciesielski, an accounting expert at R.G. Associates in Baltimore and publisher of The Analyst's Accounting Observer. "When they back out stock-based compensation they're basically saying that management is working for free," Mr. Ciesielski said. "And we know that's not the case." Ditto for the intangibles, he said. "When they acquired a company, they spent money for things like in-process research and development, contracts and customer lists," he added. "To back out those intangibles is bogus." Twitter is just one of many companies that point shareholders to rosier earnings measures. And when they do so, they're adhering to a 2002 rule prescribed by the Securities and Exchange Commission in response to the Enron and WorldCom accounting frauds. That rule, known as Regulation G, allows companies to use nontraditional metrics in financial reports, but only if they present generally accepted accounting measures alongside so that investors can compare the two. If the S.E.C. wanted its rule to discourage accounting gimmickry, it failed, Mr. Ciesielski said. "The S.E.C. inadvertently legitimized the practice with Regulation G," he added. "It's defining behavior down — once people start doing this, everybody's got to be on the same page. If company Y is backing out stock-based compensation, why wouldn't company X do the same? Its results would only look worse if it didn't." To plumb the popularity and pervasiveness of such metrics, Mr. Ciesielski and his associates analyzed filings from technology and health care companies in the Standard & Poor's 500-stock index. They identified those that presented nontraditional figures to investors and compared those results with the companies' actual earnings for 2011 and 2012. Technology and health care industries are both heavy users of adjusted earnings measures in their financial statements, Mr. Ciesielski said. Of the 69 technology companies in the index, he found that 56 used non-GAAP earnings presentations; of the 54 health care companies, 45 used them. Among technology companies in 2011 and 2012, Mr. Ciesielski found that nontraditional metrics resulted in so-called earnings that were 19.5 percent higher than actual profits in 2011 and 36 percent higher in 2012. And in the health care group, earnings using the adjusted measurements were 39 percent and 45 percent higher, respectively, than reported profits in those years. The nontraditional calculations almost always produced better-looking results than those reported under accounting rules, Mr. Ciesielski said. Only seven companies' figures resulted in flat or lower earnings. They were Analog Devices, Yahoo, Agilent Technologies, Waters, Eli Lilly, WellPoint and Regeneron Pharmaceuticals. Five companies on Mr. Ciesielski's list managed to transform losses into gains when applying their nontraditional earnings metrics. Those were First Solar, Hewlett-Packard, Salesforce.com, Boston Scientific and Forest Laboratories. For technology companies, stock and deferred compensation accounted for 25 percent of the difference between real earnings and nontraditional results last year, Mr. Ciesielski found. Among health care companies, adjustments related to acquisition costs accounted for 40 percent of the difference between managements' favored metrics and reported profits. Companies are within their rights to accentuate the positive in their operations, and the regulations still require the company to present standard GAAP accounting as well. If investors choose to look beyond management's cheerful opinions, they can find numbers more grounded in reality. But Mr. Ciesielski said companies' creativity in accounting metrics was on the way to becoming ridiculous. "You are almost getting back to share of mind and share of eyeballs again," he said. The Wall Street herd might favor these measures, Mr. Ciesielski said, but it is worth remembering that net income captures more of a company's economic activity than metrics that exclude expenses. Investors would be well served, Mr. Ciesielski added, if the S.E.C. policed these disclosures more assiduously and called out some of the more aggressive tactics. "It would be helpful to readers and users of financial statements," he said, "to make income mean something again."

ANALYSIS RATIOS

Cell 204B: Debt/Equity

Classic debt (all interest bearing debt)-to-equity (all equity including intangibles) ratio test where more than 75% is considered problematic. "It's Earnings That Count" by Heiserman at pps. 46-49. "[T]he best practice is to count convertible debt in total debt, but to consider the possibility of conversion when comparing the borrower's leverage with its peer group's. ... Many analysts argue that net worth in understated by the amount of deferred tax liability, since it will in all likelihood never come due and is therefore not really a liability at all." "Financial Statement Analysis" by Fridson at pps. 180-181, 184-185.

Cell 208B: Solvency Ratio

Investopedia: One of many ratios used to measure a company's ability to meet long-term obligations. It measures the size of a company's <u>after-tax income, excluding non-cash depreciation expenses, as compared to the company's total debt obligations</u>. It provides a measurement of how likely a company will continue meeting its debt obligations. ... Acceptable solvency ratios will vary from industry to industry, but as a general rule of thumb, a solvency ratio of greater than 20% is considered financially healthy. Generally speaking, the lower a company's solvency ratio, the greater the probability that the company will default on its debt obligations.

Cell 209B: Debt/CFFO

"(O)ne [ratio of Debt/CFFO] of the best single measures of credit quality." Financial Statement Analysis --- A Practitioner's Guide (Fridson), p. 199.

12/27/06 WSJ: Buyout Bonanza Compels Firms To Pile On Debt Cash Flows Are Being Stretched To Cover Interest Payments, Raising Risk if Times Turn Lean

Behind the terms of Harrah's Entertainment Inc.'s agreement to be acquired by two private-equity firms last week were some potentially important signals about where the current buyout boom is going. Harrah's last Tuesday accepted a $17.1 billion buyout offer from Texas Pacific

Group and Apollo Management that would involve the casino operator's taking on around $10 billion in new debt, nearly doubling down on $10.7 billion in existing obligations. Harrah's, which generates around $2.5 billion in cash flow each year, will end up with total debt that is more than eight times that amount, a ratio "that is high by any standard," says Adam Cohen, an analyst at debt-research firm CreditSights. Analysts look closely at a company's ratio of debt to cash flow -- as measured by operating earnings before charges like interest, tax, depreciation and amortization -- for a sense of whether it is taking on more debt than it can handle. A look at recent buyout deals shows not only that they are getting bigger in dollar terms, but also that larger companies are being pushed to pile on increasingly heavy loads of debt. ... Corporations that were acquired in leveraged buyouts in the fourth quarter have a ratio of debt to cash flow of 5.7 times on average, according to Standard & Poor's Leveraged Commentary & Data Group. That is up from an average of 5.3 times in 2005. In 2002, when lenders were less willing to finance risky deals, this ratio was close to four. The last time leverage in buyout deals averaged 5.7 times cash flow was during the merger boom of the mid-to-late 1990s. In the years that followed, some debt-heavy companies, like barbecue-products maker Diamond Brands and animal-feed producer Purina Mills, defaulted on their debt when their bets went wrong. This time around, analysts expect leverage to rise further before cracks show, and some of the buyouts this year already are stretching those limits. Hospital operator HCA Inc., which was taken private this fall, now has total debt of close to $28 billion, 6.5 times its current cash flow. Kinder Morgan Inc.'s buyout will boost its debt to around $14.5 billion, also more than six times its cash flow. Station Casinos Inc., which this month received a buyout offer, could end up with debt of more than nine times its cash flow.

The rising leverage in transactions means companies "have to make sure they hit all their targets and fire on all cylinders," says Gregory Peters, a credit strategist at Morgan Stanley. "They are putting more of their business model at risk, and there is no room for error," he adds. As buyouts become more prevalent, shareholders are demanding higher prices for their shares before they will allow their companies to be taken private. To meet those demands, private-equity investors are borrowing more to finance their acquisitions, and banks and credit markets that are flush with cash are more than willing to lend money to them. The question is whether many of these companies can handle larger debt burdens in the longer run, especially if interest rates rise or business conditions change and their revenue and cash flow decline. At some point, many firms that were bought out may seek to borrow more money to refinance their debt or cover their expenses, and there is no guarantee the credit markets will be as hospitable as they are now. "If a company isn't doing well and can't raise more capital at a reasonable cost to cover its shortfalls, it'll get hit from both sides," says John Lonski, chief economist at Moody's Investors Service. To be sure, the debt behind deals today might not be as great as those that took place in the 1980s. Retailer R.H. Macy, for example, had its debt load rise more than tenfold in 1986 to $3.7 billion when it was acquired in a management buyout. In the following years, it ran into challenging operating conditions and couldn't generate enough cash to cover its debt payments. The company filed for bankruptcy protection in 1992. It also is hard to draw a line between how much debt is manageable and how much is dangerously high for a particular company. Depending on which industry they are in, some firms will be more resilient to economic and cyclical changes than others. Private-equity buyers also have the option of selling assets to raise cash to pay down debt, or to trim costs and operating expenses to improve profit and cash flow. Analysts also are paying close attention to how well companies are servicing their interest payments, as measured by how much their cash flow exceed the interest they pay to service the debt. This ratio has been slipping as corporations take on more debt, and was 2.1 times on average in the fourth quarter, versus 3.4 times in 2004, when it was at a 10-year peak, according to S&P. Still, it isn't as low as the 2.0 level reached in 1997.

2/11/09 LAT: CB Richard Ellis likely to ask bankers to change terms of its loans

International commercial real estate services giant CB Richard Ellis Group Inc., battered by the dismal real estate market and icy credit climate, is likely to ask its bankers for a break on repaying its loans and has continued to lay off employees, the company said Wednesday. ... At the same time, CB Richard Ellis has a debt of $500 million coming due in the next two years and is required to maintain specific ratios of cash flow to net debt to meet its obligations to lenders. Falling revenue may put the company in danger of breaking loan covenants, which would allow bankers to demand full payment of the loans if they wished. As a result, CB Richard Ellis is seriously considering asking lenders to change the terms of its loans, Chief Executive Brett White said.

Form 8K: The impairment charge recorded will be non-cash in nature and will not affect liquidity, cash flows from operating activities, or compliance with debt covenants.

12/31/09 WSJ: And 7 Businesses That Did Not Survive

Business: Knight-Celotex, a Northfield, Ill. maker of fiberboard. Opened: 1920. Closed: June.

At its peak: When Jim Knight bought the Celotex brand in 2001, it was taking in $46 million a year in revenue. By 2006, it was up to $115 million in revenue and 500 employees in four manufacturing locations. It was the world's largest maker of fiberboard.

What went wrong: The collapse of the construction industry. Revenue fell to an annualized rate of $50 million in the last quarter of 2008. Soon after, Bank of America — which had taken over the Chicago-based regional bank that held Knight-Celotex's loans — declared the company in technical default because its debt exceeded the percentage of cash flow established in its contract. The company was sold in pieces in bankruptcy. Looking back: "One of the key things to be aware of is who your partners are and choose them wisely," Mr. Knight, 55, said "Although all money's green, it's not all the same. It can come at a terrible cost."

Cell 213B: Debt/EBITDA

Leverage Ratio Covenant. Many loan covenants are expressed in terms of "Debt"/EBITDA. "Red" if Debt/EBITDA > 5.0. "Yellow" if > 3.0. EBITDA is a measure of ability to service "Debt." EBITDA = Net Income + "Interest" + "Taxes" + Depreciation + Amortization. (The EBITDA is for the last 12 months. Lenders look at it on a quarterly basis.) For a conservative calculation, use the maximum of Income Statement Interest and Taxes or that available in the Supplemental Data. "Debt" is an interest bearing obligation, less Cash (and Cash equivalents). "Debt" is total debt, i.e., LTD and STD. In these calculations, "Debt" does not include (1) current value of operating leases; (2) unfunded portion of pension liabilities; (3) post retirement benefits.

8/12/05 WSJ: New at Blockbuster: Debt Troubles; Lenders Grant a Waiver On Borrowing Covenants, But Risks Still Are Looming

This drama actually began in May, when the company apparently saw it might have a problem with its "leverage ratio" covenant. That is essentially a requirement in its credit facility that Blockbuster maintain a certain level of Ebitda -- earnings before interest, taxes, depreciation and amortization -- in relation to its net debt, or total debt minus cash on hand. As Ebitda goes down, however, the leverage ratio goes up -- and Blockbuster's Ebitda wasn't good because of a weak market for videos, increased competition from DVD-sale discounters and technologies like video on demand as well as it own move to end late fees on rentals. So, in May, Blockbuster got its lenders to relax the leverage-ratio levels it had to meet. Instead of keeping net debt to 3.25 times its last 12 months' Ebitda, the company would be allowed to go to four times Ebitda for the second quarter and 3.75 times Ebitda for the third quarter -- effectively allowing its Ebitda to be lower and still stay in good graces with its lenders. …. Under Blockbuster's credit agreement, if it violates a covenant its lenders have the right not only to cut Blockbuster off from borrowing, but they can also demand immediate repayment of the $850 million the company has already borrowed -- money the company doesn't have.

2/13/04 WSJ: Ahead of the Tape

But Ebitda is a lousy proxy for cash flow from operations, because "most of the fun and games happen in changes in operating assets," says accounting watchdog Howard Schilit. Companies have huge leeway to play with balance-sheet items such as inventory and receivables. "If a company is using it as a metric for operating cash flow . . . it has no value." Hedge-fund manager Jim Chanos … says, "The only case in which you can use Ebitda with absolute certainty is when you know the company doesn't have to reinvest anything in the core business to maintain its competitive position, and there are very few businesses where that is the case." The Ebitda concept always has snookered cable investors in particular because of the never-ending capital-spending requirements. Indeed, after years of monopolistic safety, the cable industry faces unprecedented threats from the Baby Bells, satellite providers and wireless broadband. Prudent investors prefer free cash flow, which is typically defined as cash flow from operations (not Ebitda) minus capital expenditure. Even this might overstate the true earnings power of a company. Because technology changes can upend a company's competitive position, a company might be underinvesting in technologies that aren't counted in capital expenditure.

8/11/06 WSJ: For Movie Gallery, A Happy Ending May Prove Tough Avoiding a Painful Sequel Will Require Better Results Or Leniency From Lenders

More than half the stock-market value of Movie Gallery Inc. disappeared after the film-rental chain reported a large and unexpected second-quarter loss. … Movie Gallery must dramatically cut its debt, massively boost its cash flow or at least get more breathing room from its lenders. … For months, Movie Gallery has had problems with its debt covenants, the financial thresholds it must meet to stay in good graces with its lenders. In March, the company got its banks to relax those levels temporarily so that it could stay in compliance with them throughout 2006. Without that relief, the company would already have violated its covenants -- tantamount to a default. But that relief runs out in 2007, and Movie Gallery must go back to meeting the old, stricter covenant levels, a hurdle that its current financial performance suggests is too high. One covenant requires Movie Gallery to keep its net debt, or debt minus cash on hand, to a certain level in relation to its earnings before interest, taxes, depreciation and amortization, or Ebitda. A back-of-the-envelope calculation shows the company's net debt right now is about 4.63 times its Ebitda for the last 12 months. That is within the relaxed maximum level of 5.75 that Movie Gallery must meet -- but in next year's first quarter, once the current relief ends, that maximum will drop to 2.25 times Ebitda. To be in compliance then, Movie Gallery would have to either double its Ebitda, cut its debt in half, or achieve some combination of major changes on both. The company is in trouble on another covenant, too, that requires a minimum level of Ebitda in relation to its interest payments on its debt. Another rough calculation shows that the company's ratio on that measure right now is about 2.13, above the relaxed, minimum requirement of 1.75. But next year, that requirement rises to Ebitda of three times interest.

11/08 CFO Magazine: "The key to maintaining an investment-grade rating (A-2 by Moody's) by adhering to targeted ratios: debt to total capital of 45 to 50 percent and debt to total EBITDA of about 1.7."

2/9/09 WSJ: Junk Funds Dabble in Best of the Worst

As the economic slump deepens and more companies teeter at the edge of bankruptcy, a number of junk-fund managers are buying riskier bonds. .... The terrain remains treacherous. Overall, credit quality in the high-yield arena is getting worse rather than better. ... Junk bonds are issued by the most debt-laden companies. The ones rated single-B or below pay the highest yields, and the best of those stand to appreciate once the market wakes up to their strengths. The trick is to find them. ... One way managers like to pick bonds is to subject them to a stress test. The ideal they look for: issuers whose total debt is three times or less earnings before interest, taxes, depreciation and amortization. If the multiple is around 4.5, that is still good. What managers call "the line of death" is six times. Thus, casino owner Harrah's Entertainment Inc., whose multiple is 8.2, and retailer Michaels Stores Inc., at seven, are way too risky for all but the most intrepid of value hunters. Mr. Vaselkiv holds bonds in the dicey retail sector -- from Sears Holdings Corp., maturing in 2011. This retailer, like others, has seen same-store sales plunge lately, and its bond prices have been punished. The Sears bond now changes hands for around 72 cents on the dollar. But the debt/Ebitda multiple is just 2.0. So Mr. Vaselkiv's bet is that the price will bounce back and meanwhile he will collect its rich yield, 21.5%. He is confident that Sears will weather the storm. "They've got $1.1 billion in cash and they've been buying back debt," he says. The cash on hand is enough to buy back the 2011 bonds, and by then he figures the company will have an easier time raising capital. He isn't always wedded to the multiple if a bond is near-term and it has other things going for it. Consider the Ford Motor Credit bonds that his fund owns -- it doesn't even have a multiple because its cash flow is negative. Since last fall, its bonds have risen in price from 52 cents on the dollar to around 89. Like its parent, the auto-financing entity has refused direct federal bailout money, saying it is strong enough stand alone. But Mr. Vaselkiv believes the company is strong enough to survive on its own, but if things get worse, it will accept federal bailout money. Another positive factor: Ford Motor Credit is in talks with the

Federal Deposit Insurance Corp. about opening a subsidiary bank, which would allow it to receive cheaper financing. For Matt Philo, manager of MainStay High Yield Corporate Bond fund, good value can be found in Penn National Gaming Inc., a casino operator whose bonds due 2015 go for 83 cents on the dollar. One attraction is its debt multiple of just <u>three</u> times cash flow.

4/28/09 WSJ: Sticky Leverage

At the end of 2008, U.S. nonfinancial companies had an average net debt equivalent of 3.5 times earnings before tax, depreciation and amortization, up from 3.1 times at the end of the third quarter....

6/8/09 Forbes: Money & Investing --- Bargains Among Leveraged Loan Borrowers (Jack Gage)

Shares of companies tarred by junk loans--but far from default--could be ready to bounce. Junk-grade companies that owe a lot of money to banks have been hammered in the credit crunch. But not all so-called leveraged loans are created equal. Among those with stringent credit agreements, a hiccup in a borrower's quarterly results can trigger a default. "Covenant lite" loans, by contrast, offer more breathing room. In the credit panic investors have scarcely pondered the differences between one leveraged loan borrower and another. With a semblance of normalcy returning to credit markets, however, borrowers solidly in compliance with loan covenants should outperform the broad market in coming months, says Justin M. Smith, senior covenant analyst at the Bank Debt Review. For help finding winners, we asked BDR publisher Xtract Research to look at the two most common covenants for 50 public companies with the biggest leveraged loans tracked by S&P's LCDX index.

Firms in the table below comfortably meet the bank loans' mandates for maximum levels of debt/Ebitda and interest expense/Ebitda. Consensus forecasts for second-quarter results show improvement (or at least stability) from a year ago. Enterprise multiples (market value plus net debt, divided by Ebitda) don't exceed the market's 8.4.
An additional safety net for investors: Banks are less likely than ever to nudge struggling borrowers into bankruptcy, says S&P credit analyst Christopher Donnelly. That's because distressed financing is scarce and expensive, making reemergence from bankruptcy difficult. Liquidation values are also near their nadir.Rather than allow MGM Mirage to default in March, its lenders extended the deadline for complying with its leverage limits. Despite disappointing earnings, the casino operator's shares rallied.

In Debt but Not in Doubt ---These companies have been shunned lately, along with other junk-loan borrowers. But with ample earnings their stocks could jump as investors take a closer look.
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			Debt/EBITDA		EBITDA Interest Expense	
Company	Recent Price	Enterprise Multiple*	Limit**	Current***	Minimum**	Current***
BURGER KING	$18.28	7.5	3.5	1.9	3.5	5.8
EL PASO	$8.81	5.2	5.3	3.7	2.0	2.8
MYLAN	$13.84	6.8	5.3****	3.8	1.1	2.6

NRG ENERGY	$20.64	3.7	6.0	3.4	1.8	4.5
WARNER CHILCOTT	$11.41	7.1	6.0	1.9	2.1	2.9

*Market value plus net debt divided by Ebitda. **Limits for quarter ending June 30. ***Ratio as of Mar. 31. ****Debt limit for senior secured loans only. Sources: Xtract Research; Reuters Fundamentals via FactSet Research Systems

Cell 214B: EBITDA/Interest

12/27/06 WSJ: Buyout Bonanza Compels Firms To Pile On Debt Cash Flows Are Being Stretched To Cover Interest Payments, Raising Risk if Times Turn Lean

Behind the terms of Harrah's Entertainment Inc.'s agreement to be acquired by two private-equity firms last week were some potentially important signals about where the current buyout boom is going. Harrah's last Tuesday accepted a $17.1 billion buyout offer from Texas Pacific Group and Apollo Management that would involve the casino operator's taking on around $10 billion in new debt, nearly doubling down on $10.7 billion in existing obligations. Harrah's, which generates around $2.5 billion in cash flow each year, will end up with total debt that is more than eight times that amount, a ratio "that is high by any standard," says Adam Cohen, an analyst at debt-research firm CreditSights.

Analysts look closely at a company's ratio of debt to cash flow -- as measured by operating earnings before charges like interest, tax, depreciation and amortization -- for a sense of whether it is taking on more debt than it can handle.

A look at recent buyout deals shows not only that they are getting bigger in dollar terms, but also that larger companies are being pushed to pile on increasingly heavy loads of debt. ... Corporations that were acquired in leveraged buyouts in the fourth quarter have a ratio of debt to cash flow of 5.7 times on average, according to Standard & Poor's Leveraged Commentary & Data Group. That is up from an average of 5.3 times in 2005. In 2002, when lenders were less willing to finance risky deals, this ratio was close to four. The last time leverage in buyout deals averaged 5.7 times cash flow was during the merger boom of the mid-to-late 1990s. In the years that followed, some debt-heavy companies, like barbecue-products maker Diamond Brands and animal-feed producer Purina Mills, defaulted on their debt when their bets went wrong. This time around, analysts expect leverage to rise further before cracks show, and some of the buyouts this year already are stretching those limits. Hospital operator HCA Inc., which was taken private this fall, now has total debt of close to $28 billion, 6.5 times its current cash flow. Kinder Morgan Inc.'s buyout will boost its debt to around $14.5 billion, also more than six times its cash flow. Station Casinos Inc., which this month received a buyout offer, could end up with debt of more than nine times its cash flow. The rising leverage in transactions means companies "have to make sure they hit all their targets and fire on all cylinders," says Gregory Peters, a credit strategist at Morgan Stanley. "They are putting more of their business model at risk, and there is no room for error," he adds. As buyouts become more prevalent, shareholders are demanding higher prices for their shares before they will allow their companies to be taken private. To meet those demands, private-equity investors are borrowing more to finance their acquisitions, and banks and credit markets that are flush with cash are more than willing to lend money to them.

The question is whether many of these companies can handle larger debt burdens in the longer run, especially if interest rates rise or business conditions change and their revenue and cash flow decline. At some point, many firms that were bought out may seek to borrow more money to refinance their debt or cover their expenses, and there is no guarantee the credit markets will be as hospitable as they are now. “If a company isn’t doing well and can’t raise more capital at a reasonable cost to cover its shortfalls, it’ll get hit from both sides,” says John Lonski, chief economist at Moody’s Investors Service. To be sure, the debt behind deals today might not be as great as those that took place in the 1980s. Retailer R.H. Macy, for example, had its debt load rise more than tenfold in 1986 to $3.7 billion when it was acquired in a management buyout. In the following years, it ran into challenging operating conditions and couldn’t generate enough cash to cover its debt payments. The company filed for bankruptcy protection in 1992. It also is hard to draw a line between how much debt is manageable and how much is dangerously high for a particular company. Depending on which industry they are in, some firms will be more resilient to economic and cyclical changes than others. Private-equity buyers also have the option of selling assets to raise cash to pay down debt, or to trim costs and operating expenses to improve profit and cash flow.

Analysts also are paying close attention to how well companies are servicing their interest payments, as measured by how much their cash flow exceed the interest they pay to service the debt. This ratio has been slipping as corporations take on more debt, and was 2.1 times on average in the fourth quarter, versus 3.4 times in 2004, when it was at a 10-year peak, according to S&P. Still, it isn’t as low as the 2.0 level reached in 1997.

11/21/12 CNBC: Analysts Had Questioned Autonomy’s Accounting Years Ago

Hewitt Packard’s surprising announcement of accounting irregularities at Autonomy caught the market by surprise on Tuesday and led to a nearly 12 percent decline in the company’s stock. But Autonomy’s accounting had been questioned by analysts years ago. Paul Morland, technology research analyst at broking and advisory house Peel Hunt, told CNBC that he had noticed three red flags in Autonomy’s accounts in the years leading up to the HP acquisition: poor cash conversion.... In an analyst note published by Morland in June 2009 titled “Accounting Red Flags,” when he worked at Astaire Securities, he wrote: “Although investors do not have access to the same detailed information as auditors, there are plenty of analytical techniques that can be used to help identify when a company’s performance might not be quite as good as it seems.” Morland said he had specifically questioned the company’s cash conversion ratio (the ratio of cash flow from operations and EBITDA), which seemed lower than other software companies.
“[Autonomy] countered that by saying that they were high growth, which can absorb working capital and make conversion worse … my model suggested that it was still lower than it should have been even though they were growing higher,” he said. “And now we know — we think we know — that they weren’t growing as fast as they said they were, and therefore the cash conversion should have been even better than I thought it should have been at the time,” Morland added.

Wikipedia: EBITDA and Bankruptcy
EBITDA is often used as a proxy for cash flow from operations, for the purpose of calculating debt coverage ratios. The key ratios used by lenders and investors are Debt/EBITDA and

EBITDA/Interest expense. These ratios describe a company's ability to service its debt and make its interest payments. Occasionally the number EBITDA-Capital expenditures is used, and this number better approximates free cash flow. Generally lenders look for Debt/EBITDA ratios less than 5, and EBITDA/Interest expense ratios greater than 2.

Cell 219B: EV/EBITDA

Takeover Targets --- companies with excess of cash and low EV/Ebitda ratios. EV is enterprise value --- the cost to buy all of the company's shares, pay off debt, while putting the cash toward the purchase price. EV/Ebitda is a company's talkeover price relative to its earnings potential. Low one suggest bargains.

SeekingAlpha: "Private buyers (those playing with their own money) prefer to buy at an EV / EBITDA of 4 or less, and may go to 6 (maybe 7)."

More current EV/EBITDA (ttm) is available from Yahoo! Finance "Key Statistics."

6/13/14 Breakout: Bernstein Research periodically scans the universe of public stocks to compile a list of LBO candidates based on several quantitative factors that a buyout shop would consider in determining if a company could be profitably acquired using a mix of cash and debt. On its latest screen, 25 of the 88 stocks that surfaced were in the consumer cyclical sector, and most of those were chain retailers.

Aside from Chico's, the list includes Petsmart Inc. (PETM), Urban Outfitters Inc. (URBN), UGG boot maker Deckers Outdoor Corp. (DECK), Guess Inc. (GES), Buckle Inc. (BKE), Steven Madden Ltd. (SHOO), American Eagle Outfitters Inc. (AEO) and Fossil Group Inc. (FOSL).

Shares of these companies are down an average of 33% from their all-time highs, with the median stock off 24% from its peak.

The Bernstein screen is not meant as an outright predictor of likely buyout targets, but rather highlights companies that look cheap relative to cash flow, with lots of cash on the books and little debt, among other technical characteristics. They represent beaten-up value sectors of the market where buyout firms might hunt.

There are some retailers on the list that would appear rather too big for private equity to plausibly swallow, such as Bed Bath & Beyond Inc. (BBBY) and Kohl's Corp. (KSS). For an investor, this is a mark of once-beloved consumer-growth companies that the market is no longer valuing as if they can reliably grow any more.

Specialty retailers tend to trace a beguiling and then humbling lifecycle, with the best of them hitting on a mix of brand appeal and merchandising smarts that underwrites rapid expansion. Sales often stay buoyant for years before either over-expansion or fading fashion value slows them down.

Managers who know mostly aggressive growth often have a hard time husbanding capital and delivering decent returns when the top line decelerates. And that's when analysts and growth portfolio managers turn away.

This sector was an under-appreciated beneficiary of the loose credit, housing and consumer boom of a decade ago, following customers into fresh suburbs and exurbs where home-equity credit lines supported spending on clothing and gadgets. From 1995 to 2009, shopping center square footage in the U.S. expanded by 30%, more than twice the 14% growth in the population, according to Deutsche Bank's RREEF Research. And not much has been eliminated since then.

The standard pitch for why private buyouts can make sense is that it allows once-public companies to operate free of the glare and short-term pressures of Wall Street. This is often a euphemistic way of saying that when private, a company that needs to shrink toward viable profitability is able to do so. It's quite hard to be a public company without promising investors growth -- especially a consumer company.

The trouble for private-equity operators in soaking up some of the excess retail competitors is that it's tough to gauge what a "normalized" level of mall traffic or in-store soft-goods sales might be. Online retailers have accelerated their market-share gains and consumer behavior is showing few signs of reverting back to a mall-centric consumption habit.

This leaves wide open the risk that struggling specialty retailers are "cheap for a reason," and perhaps explains why there hasn't been much deal activity here despite buyout shops rolling in cash and promiscuous debt markets happy to enable their next conquest.

Leonard Green Partners, which owns a small stake in Chico's, is a longtime opportunistic buyer of bedraggled retail operators, as well as stronger ones. It is now an owner of J. Crew and Sports Authority.

6/14/14 TheStreet.com: Will Express Lead to Other Retailers Being Snapped Up?

NEW YORK (TheStreet) -- Private equity firm, Sycamore Partners, announced last night in a Securities and Exchange Commission filing it had purchased a 9.9% stake in Express (EXPR) with intentions to acquire the teen retailer, but analysts are already speculating if there will be more retailers heading down the M&A rabbit hole.

The Sycamore filing will "lead to a search for the next potential M&A candidate in specialty," Wedbush Securities analyst Morry Brown wrote in a June 12 research note to clients. "We note the most attractive candidates are likely to screen in the bottom half of the group on valuation."

Based on the ratio EV/EBITDA, (enterprise value divided by earnings before interest, taxes, depreciation and amortization), Express is the cheapest stock based on that ratio at 3.6 times, according to the Wedbush note. Other cheap retailers on Wedbush's list include: American Eagle Outfitters (AEO) at 4.9 times EV/EBITDA; Guess (GES) at 5.4 times; and Abercrombie & Fitch (ANF) at 5.8 times, Chico's (CHS) at 6 times and Ann Taylor (ANN) at 6.3 times, and Francesca's Holdings (FRAN) at 6.8 times.

Express, American Eagle, Abercrombie and even Francesca's cater to the teen and early twenties-aged clientele.

7/4/14 In My Shoes by Tamara Mellon: p. 103 "The Holy Grail of private equity is an accounting metric known as EBITDA.... EBITDA multiplied by a certain number--usually around 10-12 in the fashion business--is the basis for valuation upon exit. And in private equity, it's all about the exit."

8/1/14 TheStreet.com: PetSmart Math Supports Activist Sale Thesis

Though activist investor Jana Partners said in a regulatory filing this week it believes the best option is for pet retailer PetSmart (PETM) to sell itself -- preferably to a financial sponsor -- industry experts are trying to figure out how that math would work. One of the reasons for that is the perceived success rate of the activist. When Jana revealed it had a 9.9% activist stake at the start of the month, the stock predictably spiked. That, and other financial metrics, led news outlets to suggest a deal might be a stretch for PE.

A review of the numbers suggests otherwise. Ebitda at the company is projected to grow, though, at a slower pace, according to analysts' estimates compiled by Bloomberg. For the fiscal year ended Feb. 3, PetSmart had almost $930 million in Ebitda as compared to $890 million for the prior year. And Ebitda is expected to grow to about $940 million for the curent fiscal year ending Jan. 31, 2015 while the fiscal year after that Ebitda is projected to grow to roughly $960 million. On July 2, the day before Jana revealed its stake, PetSmart's unaffected stock price closed at nearly $60 a share, giving the company a market cap of about $5.95 billion. Adding debt of nearly $520 million and subtracting cash of about $230 million to that amount (per Bloomberg data), would equate to an enterprise value of $6.24 billion or a valuation multiple of 6.7 times Ebitda (using the $930 million Ebitda figure for its current fiscal year). That's under the unaffected 7 times multiple PE firms look for when considering potential buyout targets. But since Jana revealed its stake on July 3, the stock has jumped, now trading at around $68 per share, giving it a market cap of almost $6.75 billion and an enterprise value of roughly $7 billion, or close to 7.6 times Ebitda.

A industry source said at that price, PetSmart is becoming rich in price for PE. But PE usually assumes around a 20% premium to the unaffected stock price, if the enterprise value is below 7 times Ebitda. That would mean PE might be willing to pony up around $72 a share for a company with stable but solid Ebitda and cash flow, even if the company has issues, with the idea that it can bring in new management and cut costs. A $72 per share offer would equate to a market cap of about $7.14 billion, based on about 99.2 million shares outstanding, and an enterprise value of $7.43 billion, or a multiple of nearly 8 times Ebitda -- within the range of what PE firms have been willing to pay for retailers.