DIFFICULTIES WITH FINANCIAL STATEMENTS

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Clients demand much from their accountants, and usually with justification. Somehow, we are expected to visibly justify our Rolls, the wife's Mercedes and a Ferrari for - shall we say the third member of the menage?

However, one of the essential functions of a financial analyst is forecasting future accounting earnings; this is not to check whether or not a new Ferrari is in the cards - or a new Ferrari user - but for the purpose of establishing the value of a company, its assets and securities. This process is part science, part art, and to me is both extremely satisfying and highly frustrating.

Meeting interesting people in many countries and in a great variety of fields, probing into their companies, gathering data, assessing it for relevance, turning it into useful information and finally extracting a range of reasonable values is exciting; that's the good stuff, and in that respect I have one of the best jobs in the world.

However, the "devil is in the details". That's where one inevitably encounters frustrating uncertainties and incomplete records. Nine times out of ten, the quality of the financial information leaves much to be desired, and repeatedly grilling the bookkeeper or the boss is not conducive to winning a popularity contest. Still, while culling facts can be trying for both sides, those facts have an enormous impact on the reasonableness of the conclusion.

Fair Market Value

It is axiomatic that Fair Market Value can only be determined through an actual sale between parties where both know all the facts. Prices established by the stock market or through available private sales are supposed to represent this, but most financial analysts have considerable doubt that the Stock market Price and Fair Market Value are the same at any particular moment. This is due to two major factors - "Investor Enthusiasm", which may be either a positive or negative force, and "Problems with Financial Statements"; we are discussing the latter subject, as the recent past has demonstrated that the first might fall more suitably into the sphere of a psychiatrist - another type of analyst......

Comments on Financial Statements

It has always seemed odd that accounting rules are developed by organizations such as The Financial Accounting Standards Board ("FASB") in the United States, and the Accounting

Standards Board in Canada, that are dominated by issuers and preparers of Financial Statements and those that opine on them, rather than by users who have experienced the trenches.

We out there in the muddy trenches have seen the enemy, and it is NOT us, a philosophy that is strongly backed by some very big guns:
"Financial Statements in accountant speech are not user friendly."
Bruce J. Wright, President, Total Systems Inc., Salt Lake City.

> "Financial Statements, including the income statement, balance sheet and statement of cash flows are as useful as an 80 year-old map of Los Angeles."
> *Robert A. Howell, Visiting Professor, Amos Tuck School of Business, Dartmouth College.*
>
> "Secondly, he may surmise that 'modern' accounting is becoming increasingly disconnected with the economic realities of wealth creation in the Information Age."
> *William Sterling, Global Strategist, C.I. Global Advisors LLP.*
>
> "We are using a 500-year-old system to make decisions in a complex business environment in which the essential assets that create value have fundamentally changed."
> *Baruch Lev, Professor, Leonard N. Stern School of Business, New York University.*
>
> "Are they [the accounting profession] still performing the budgeting control, periodic reporting and performance measurement rituals of the past? Do they realize that the old models are no longer valid and can actually cause damage?"
> *Mike Jeans, President, (UK) Chartered Institute of Management Accountants.*
>
> "The Financial Statements customarily prepared for a [privately owned] business by its accountants reflect certain view-points and possess certain attributes. These include (1) tax-related orientation, specifically with a view to minimizing taxes payable, (2) a high degree of conservatism and (3) a basically historical orientation."
> *Raymond A. Miles, Executive Director, The (US) Institute of Business Appraisers, Inc.*
>
> "We pay handsome bonuses to executives for creating illusions in current quarterly accounts ..... It's often the case that balance-sheet bandaids or profitless future revenues are the short-term motivations behind deals that are more about this week's stock price than the long-term profitability and viability of a company."
> *Leon A. Kappelman, Director, Information Systems Research Center, College of Business Administration, University of North Texas.*
>
> "Please, Sir, I want some more."
> *Charles Dickens - Oliver Twist.*

New Economy?

These comments strongly suggest the need for a new accounting methodology to reflect the "New Economy". The first IBM computer became commercially available in 1954; about the same time the US started a new economic expansion after the Korean War. In the 47 years since then, only 75 months (13%) showed a contraction in GDP. The recent record is even better: the Federal Reserve Board re-ports that the US has seen only eight months (4%) of recession in the last seventeen years. It becomes positively dizzying when put into historical context: from 1853 to 1953, the Republic was in recession about 40% of the time.

Is this a New Economy? Probably not in the sense implied by stock-market hypes and media pundits; however, the combination of more rapidly available information and communication technologies with better management tools has helped to make business and our economies more agile and responsive.

These economic trends also reflect a major shift in sources of wealth. When Luca Pacioli (1445-1517), the Venetian mathematician and amicus of Leonardo da Vinci, introduced double entry bookkeeping in 1491, wealth reflected the agricultural basis of society; most of it was in land, buildings and livestock. Persons who made a living solely with their brains and their professional, abilities were rare. The corporation did not yet exist. However, Pacioli understood the basis of management: "If you cannot be a good accountant you will grope yourself forward like a blind man and may meet great losses."

Problems with GAAP

Today, wealth, which has been growing at an explosive pace, both in amounts and participants, comes in numerous forms; many of those, such as customer relationships, software programs, pharmaceutical patents, etc. relate to Knowledge and Intellectual Property; they are invisible as well as intangible.

GAAP, which was first established in 1932, when the depression had reached its abyss, fails to record such knowledge assets; as a result, some seventy years later, they are normally only reflected in a firm's reporting systems as expenses. As the assets generated are not measured, they are often not managed either. They basically represent non-recorded value - a concept from which most accountants would recoil.

Baruch Lev estimates that traditional accounting methods are capable of tracking only 10% to 15% of the true asset value of modern companies. While I would put the figure at about 50%, his point has a sound basis.

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Earnings Management

GAAP not only omits a large number of assets; it also gives many opportunities to manage earnings. Financial Statements for private companies, as indicated by Ray Miles, want to show the minimum reasonable profit - for obvious reasons. Publicly traded entities, on the other hand, need to meet or slightly exceed analysts' expectations to prevent the price of their shares from plummeting. We have all seen such recent examples.

However, most managements fervently wish to demonstrate stable growth, a tendency that manifests itself by the significant number of comments received by FASB on any change, which say, in effect, "don't make income volatile - don't let it fluctuate."

According to Paul Rosenfield, retired Director of the AICPA Accounting Standings Division, realization and allocation, two of the central concepts of GAAP, are also major contributors to the ability to manage earnings.

Difficulties with Realization

Under the realization convention, an essential part of GAAP, Financial Statements only include transactions that alter the quantities of assets and liabilities; examples are purchases, sales, employment, receipts and payments.

However, changes in items such as prices, interest rates or technologies also affect most entities. FASB states that to determine "performance by comparing only realized gains implies a definition of performance that many people would regard as in-complete and, therefore, as an unreliable representation" of reality.

FASB concludes that "information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information." There is a contradiction: even though GAAP does not permit it, FASB favours the reporting of the effects of price changes when they occur.

Other Impartial Views

The American Accounting Association has stated: "The most general criticism to be levelled at financial statements in their present form is that they are seriously incomplete .... Because they are substantially transaction-based, they fail to recognize .... value changes [not] associated with a transaction", such as for increases in the value of inventories or real estate.

The desire to avoid volatility in earnings was shown by the reactions to a test by the Financial Executives Research Foundation of FASB's exposure draft relating to pension expenses. When the financial executives discovered it would introduce a high degree of volatility into companies'

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annual pension expenses, they objected. This resulted in FASB making changes in the final standard that helped reduce volatility. One participant commented, "they did listen, but it was not without considerable prodding."

Impact of Allocation

Many expenditures by a business have an impact on more than one accounting period. Therefore, when GAAP was first established, accounting was defined, in part, as a process of allocating costs to match revenues; this definition is still in place.

The allocation process uses formulas selected at the beginning of the period to "spread" the cost over time. The objective is to represent the effects of prospective underlying economic events; these, of course, do not occur as regularly as the formulas imply.

Examples of common allocation formulas are the straight-line and deciding-balance methods for depreciation and the present value (compounded interest) approach for certain liabilities. Such allocated costs obviously do not reflect the real world economic and physical changes in assets or liabilities, nor the activities of the companies to which they refer. The effect is to "make the empirical phenomena appear to be smooth regardless of the actual variations."

And Now to EPS

The Price/Earnings Ratio is a straightforward concept: divide the price of a share by its earnings-per-share (EPS). The result is intended to show how expensive the share is; refinement divides the PER by the earnings growth rate to arrive at the PEG ratio.

Determining the price of the share is simple, the EPS are rather more difficult.

The price of the share is simple; the EPS is rather more difficult. Many Annual Reports offer a smorgasbord of figures for EPS rather than a single number. Many show separately current and year-ago figures for earnings from: continuing operations; dis-continued operations; one-time gains and losses; and special items, such as the write-off of in-process R&D and the amortization of goodwill relating to acquisitions.

For example, the 2000 Annual Report of Nortel Networks, one of Canada's major enterprises, has the following table at the beginning of its 150-page annual report.

	US$ million		
	1999	**2000**	**Change**
Revenues	21,287	30,275	42.2%
Gross Profit	9,265	13,110	41.5%
Gross Margin	43.5%	43.3%	
Other Expenses	7,831	10,803	38.0%
Net earnings applicable to common shares from operations*	1,434	2,307	60.9%
Other Charges	1,785	5,777	223.6%
Net loss applicable to common shares	(351)	(3,470)	888.6%
Earnings per common share from operations - diluted*	$ 0.52	$ 0.74	42.3%
Loss per common share – diluted	$ (0.13)	$ (1.17)	800.0%

* Excludes the after tax impact of Acquisition Related Costs (in-process research and development expenses and the amortization of acquired technology and goodwill from all acquisitions subsequent to July 1998), stock option compensation and certain one-time gains and charges.

The table shows that, on a reported (GAAP) basis, the position of Nortel deteriorated considerably during the year, as the loss per share widened from $0.13 to $1.17. Using the figures from operations, EPS rose 42% from $0.52 to $0.74; those were the ones stressed by management. Might the choice of reality be an indicator of Nortel's debacle?

Another telecom supplier, Motorola, adopts a similar approach. Sales grew 17.5% in 2000, to $37.6 billion from $32.0 billion in 1999. It reported $1.3 billion, or $0.58 a share in 2000 from its ongoing operations, up 45.9% from $891 million, or $0.41 a share in 1999. There was also a second, higher figure for earnings from country operations which excludes: special charges for the shut-down of a wireless telephone products business; severance costs, offset by non-recurring gains on the sale of securities. On that basis, 2000 earnings rose 35.7% to $1.9 billion, or $0.84 a share, from $1.4 billion ($0.63 a share) a year earlier.

How About Cash Flow

If one turns to cash flow, there are again major difficulties. An example is depreciation; this is not necessarily an imaginary expense, as some represent actual wear-and-tear which requires replacement capital. For that reason, one cannot merely add back depreciation. However, it is more difficult to manipulate this figure, which in my view makes it a more satisfactory basis for establishing value.

Conclusion

So - what can be done? At present, very little; we simply have to grin and bear it, and life will always be vexing in more ways than one. There was this man who passed his granddaughter's room and overheard her reciting the alphabet in a most reverent tone; he wondered what she was up to. "I am saying my prayers," she explained, "but I can't think of the right words tonight, so I am just saying the letters. God will put them together, for he knows what I am thinking."