HAVE SFAS 141 AND 142 IMPROVED THE QUALITY OF EARNINGS?

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In 2001 and 2002, about $400 million of write-offs were taken by US public companies, of which over 80% related to Goodwill impairment. Although the number will decrease this year as the economy has improved, on average, the frequency and amount of one-time charges has been increasing for some time. Write-offs, which used to be infrequent, are now common. Analyzing these special charges for restructurings and writing-down assets, particularly Goodwill, is essential.

In many cases they are not "non-recurring", International Paper has taken a charge against earnings in each of the past six years - in total five billion dollars pre-tax. This year (2003) it announced an additional $100 million for restructuring, with more likely to come. Although management claims the restructurings have "made us a stronger company"; the write-offs make it nearly impossible to determine how much it has really earned or to value the stock.

Example

A significant example, from the technology sector, is Avaya Inc., a telephone equipment supplier spun off from Lucent in 2000. It has had non-recurring charges every year, $684 million in fiscal 2000, $872 million in 2001 and a mere $229 million in 2002. The table below, from a Note to the 2002 Financial Statements, gives details of the activities covered.

In addition to the asset impairments listed, Avaya took a $17 million charge in 2002 for soured investments in other communications companies; this was deducted from "other income".

	Employee Separation Costs	Lease Termination Obligations	Other Exit Costs	Business Restructuring Reserve	Business Asset Impairments	Incremental Period Costs	Restructuring & Related Expenses
Balance from 2001	96	78	5	179	-	-	179
Fiscal 2002							
Charges	116	84	1	201	7	21	229
Reversals	(13)	(4)	(3)	(20)	-	-	(20)
Net increase benefit obligations	(3)	-	-	(3)	-	-	(3)
Cash Payments	(128)	(56)	(3)	(187)	-	(21)	(208)
2002 Transactions	(28)	24	(5)	(9)	7	-	(2)
Asset Impairments	-	-	-	-	(7)	-	(7)
Balance September 30, 2002	68	102	-	170	-	-	170

Of the $229 million total charges in 2002, $116 (51%) related to layoffs and $84 million (37% to unneeded premises; only $7 million (3%) was for asset impairments as $95 million of those had been dealt with in 2001. At the end of the year there was $170 million still unspent, some of which might be reversed in the future.

In the year Avaya benefited from $20 million ($0.04 per share) of reversals that improved net income as there were "fewer employee separations than originally anticipated". While generally small, reversals have occurred before and since. In Q4 of 2001 a $35 million reversal added $0.07 to EPS while in Q2 of 2003 $17 million ($0.04 a share) was added to the bottom line in this way.

The SEC encourages companies to finish restructurings within a year of their announcement. It believes one way to improve the accuracy of such charges - and cut down on reversals - to calculate the costs of layoffs and plant closings just before they occur. However, the table also discloses that Avaya had not yet completed its restructuring and that the estimated future expenditures ($170 million), had hardly changed from the $179 million of September 30, 2001. Nine months later in June 2003, a balance of $81 million (48%) still remained. The Company says that although it implemented its plans within a year, some obligations take longer to pay down.

Normal Course of Business

Non-recurring charges appear now to be just a normal cost of doing business. To assess their impact on the bottom line, we look at the average annual write-offs over several years, at least five, and subtract it rather than the actual amount from Operating Profit as part of the normalization process.