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Making pro forma information more useful. (Corporate Reporting).

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The overnight collapse of Enron Corp. has served as a lightning rod for criticism of the current financial reporting system. Coupled with other high-profile failures and restatements of financial statements, it is critical that financial executives, regulators and the accounting profession work together to restore the public confidence in both audited financial statements and other reporting matters.

One area where such efforts are essential involves so-called "pro forma" results. Critics argue that the manner in which such data are presented is parallel to asserting that: "After backing out the unusual runs scored by the Diamondbacks in the seventh game, the Yankees are the 2001 World Series champions."

The intent of this article is not to add to the continuing stream of those bashing pro forma measures. Instead, the focus is on observations and recommendations to create and report useful, understandable and transparent pro forma information to complement earnings included in GAAP-based financial statements. One premise here is that generally accepted accounting principles (GAAP) are relevant in presenting financial performance, but are not all-encompassing. Because investors primarily use historical financial data to predict future results, exclusion of unique, one-time items can be informative.

Thus, meaningful presentation of pro forma results should benefit investors. Even the Securities and Exchange Commission (SEC) cites the relevance of such measures, with adequate explanations and caveats. The problem is the way some entities attempt to direct analysts and investors away from actual performance to a biased, inflated perspective of operations. Much of the criticism of such measures is that they appear in press releases, which do not comport with the financial statements included in SEC filings. An overarching observation in this article is that the location of the pro forma measures is not relevant -- they could be in a press release, management discussion, etc.

A Dual Responsibility

For pro forma disclosures to be additive to the GAAP-based measures, management needs to apply a disciplined and consistent approach. Similarly, analysts and investors must recognize that the reflexive, broad-brush dismissal of "one-time items" is both naive and potentially dangerous. Consider the case of Bethlehem Steel Corp. As noted in a recent front-page article in The Wall Street Journal, the company's press release noted that over \$1 billion in its deferred tax asset account was written off, with a reference to the notes to its quarterly financial statements. At least one analyst ignored this non-cash write-off as, effectively,

irrelevant -- but the financial statement footnote proved prescient:

Our results to date and current outlook for the balance of 2001 are worse than we anticipated at the beginning of the year. We now expect to have both a financial accounting and tax loss for 2001. In the absence of specific favorable factors... application of FASB Statement No. 109 -- and its subsequent interpretations -- require a 100% valuation allowance....

Shortly thereafter, Bethlehem Steel filed for Chapter 11 protection. The message is clear: for pro forma measures to be useful, management must present them clearly as part of the complete disclosure package, and investors must use them in this manner. This is also an excellent example of the types of accounting estimates that would comport with the SEC's required disclosure regarding the nature and implications of policies and management judgments that are critical to an understanding of the financial statements.

Criteria for Presentation of Pro Forma Information

Pro forma information must enhance the understanding and ability of investors to utilize current performance measures to more effectively predict future performance while providing a clear roadmap to GAAP-based measures. A useful perspective in assessing whether the proposed disclosure enhances financial statement measures is the oft-quoted "known trends, events and uncertainties" phrase contained in SEC guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

In essence, disclosures responsive to this concept are intended to help the reader differentiate the current economic situation from that expected in subsequent periods. Under GAAP, net income can, and often does, include elements unlikely to impact future operations -- for example, a significant gain or loss on the sale of a business, the impact of a change in accounting principle or other events clearly not expected to recur in the normal course of business. Extracting that information in a pro forma disclosure can reduce the likelihood that an investor will consider that onetime event in predicting future earnings.

Clearly, a major criticism of pro forma disclosures to date has been their one-sided nature. Companies often treat good news as part and parcel of net income and bad news as out of the ordinary. Pro forma measures must be clearly defined and their components explicitly identified. In other words, such disclosures must be transparent. In the last several years, management and investors alike have placed tremendous emphasis on EBITDA -- earnings before interest, taxes, depreciation and amortization.

In its recent "Pro Forma Financial Information: Tips for Investors," the SEC cited this measure as one that "can be misleading unless the company clearly describes what transactions are omitted and how the numbers might compare to other periods."

To comply with the spirit of this statement, the earnings serving as a starting point should be clearly identified, along with modifications to the GAAP-based equivalent. Further, the nature and dollar amounts of the interest expense and non-cash components must be identified. For example, in a footnote to the EBITDA numbers included in a recent Form 10-Q, a publishing company identified five items that comprise depreciation and amortization (including "other"), but did not present any details in arriving at the final figure. This lack of transparency created a significant barrier in our attempt to reconstruct a final number. Compounding the problem, the company's press release makes no reference to any

elements of EBITDA, presenting the measure with no explanation. If companies truly believe such measures are relevant, they must be presented in a clear and comparable manner.

The requisite transparency is directly linked to another facet of presenting pro forma information: reconciliation to GAAP-based earnings. Such reconciliation is required by the SEC in its recent release, "Cautionary Advice Regarding the Use Of 'Pro Forma' Financial Information in Earnings Releases," and was recommended in the FEI/NIRI Earnings Press Release Guidelines issued last year. We endorse reconciliation, not only to comply with regulatory requirements, but also because it is consistent with using pro forma information as a component of a comprehensive disclosure package.

Investors must be able to connect the dots in order to utilize pro forma information as complementary to, and not competing with, GAAP-based measures. In addition, full and complete disclosure of the components that vary between the two reporting approaches would enhance the credibility of the pro forma measures and go a long way toward dispelling the view that their purpose is to mask problems. Management should also explain why it believes such measures are a better indicator of economic performance than Net Income and Other Comprehensive Income.

Perhaps the major obstacle to establishing the credibility and usefulness of pro forma measures has been the overuse and occasional misuse of descriptors such as "unusual" and "non-recurring." In the vast majority of cases, the items so described and excluded from pro forma measures reduce reported earnings. This approach has served as a focal point for critics, who argue that pro forma numbers equate to "everything but the bad stuff" or "earnings as the company wishes they were."

To the extent that management has presented pro forma information in this manner, the critics are correct. As noted above, to achieve credibility, pro forma measures must be presented in a balanced, transparent and good-faith manner. Further, the excluded items must actually reflect one-time, non-recurring situations. To the extent that cryptic disclosures are presented, without underlying explanation, the investor cannot determine their veracity and usefulness. The importance of transparency is evident in a recent enforcement case brought by the SEC against Trump Hotels & Casino Resorts Inc. The key issue there was the selective disclosure in a press release of one-time items impacting earnings. The SEC concluded that the resulting lack of transparency was misleading to investors.

Common Disclosures and Recommendations

A common disclosure relates to receivable and inventory levels, and might read: "After adjusting for the unusual write down of receivables, net income reached a record high." To be informative to investors, management must provide a context for the descriptor "unusual." This categorization would be relevant if the receivables write-off was due to a one-time, unforeseeable event. On the other hand, if the write-off resulted from the ongoing management of credit risk, including monitoring major customers' financial positions, it should not be segregated and excluded when assessing performance. In fact, it may warrant highlighting in MD&A during a review of continuing operations.

Many times a rise in receivables write-offs is related to a more aggressive sales strategy -- granting credit to customers with higher risk profiles, say, or a weakness in the overall collection and credit process that comes to light when the economy slumps. Disclosure of how current revenues and net income were impacted by such an aggressive sales strategy would also be useful. Any discussion in MD&A

should also address the actions management expects to take to remedy the situation.

Similarly, inventory management is a top priority of every executive team. An "unusual" write-off should reflect a dramatic, unexpected drop in demand that is not likely to reverse. Conversely, if the write-off reflects inaccurate forecasting and/or lack of coordination between sales and operations, it should not be presented as if it were unrelated to normal operations. MD&A should explain the write-off and address steps being taken to prevent any recurrence.

Business is inherently risky, and volatility is the norm. A presentation of pro forma disclosures that attempts to portray a steady growth in earnings and sales shortchanges the investment community by not discussing the impact that changing conditions have on the entity's performance.

Tremendous attention is paid to so-called non-cash items when recasting GAAP-based earnings into a pro forma presentation. Statements like this are common: "Excluding the write-off of goodwill, operating profit was positive." This statement is laced with potential trip wires. The SEC has explicitly identified as suspect any situations in which pro forma results convert a loss to a profit. Of particular concern is the intent in some pro forma measures to portray the write-off of goodwill as a non-cash charge.

In actuality, a goodwill write-off represents management's view that the company overpaid for a business or that the acquired business has deteriorated to such a point that the investment's fair value is less than the current carrying value. In either case, the reasons for the impairment should be openly discussed and the charge should not simply be characterized as an irrelevant "accounting charge." The issuance of Financial Accounting Statement No. 142 will hopefully go a long way toward improving disclosure in this area. FAS 141 and 142 require extensive disclosures regarding the reasons for an acquisition, and, when impairments are recorded, detailed disclosures on why they are warranted.

A common statement introducing pro forma measures uses language like: "Excluding restructuring and severance charges, net income was..." There are situations in which unique, one-time costs occur because of organic changes in the organization and/or acquisitions or dispositions. Investors can benefit from explicit recognition of this fact in recasting GAAP-based measures into pro forma results. The litmus test, however, is that these costs really are unique and will not recur in the foreseeable future. The credibility of such a presentation is, at the least, undermined when a company records restructuring and related charges in most reporting periods.

The reality is that such charges reflect the normal and expected: expansion and contraction of activities, acquisitions and dispositions of assets and recurring modifications classified under the label "restructuring." Several companies have begun referring to such costs as "recurring, non-recurring charges." For pro forma measures to be useful and complement GAAP-based numbers, they must meaningfully reflect only onetime charges. Companies must discuss why these charges need to be backed out to understand its economic performance. Furthermore, the underlying reasons for the charges and the expected future benefits need to be discussed.

Additional Recommendations

In the spirit of FAS 131, the usefulness of pro forma measures can be enhanced through disclosure and discussion of the key performance metrics that companies use to manage the business. Such disclosures will provide useful insights into management's priorities and the execution of the corresponding strategy. These data

also provide a benchmark allowing investors to assess management's performance. Disclosure of such performance metrics should be linked to underlying business drivers, which will enhance the quality of MD&A.

Performance metrics can be industry-specific and, in some cases, company-specific. However, there are a number of meaningful measures that are readily understood and should be used as a basis for disclosure, such as inventory and accounts receivable turnover. (This information would also provide a more substantive discussion regarding a company's cash flow statement within the MD&A). Additionally, disclosure of revenue by major customer group or distribution channel would be informative. Companies also need to consider using performance metrics such as revenue per employee, cost per unit or market share data, which help investors because they can be easily benchmarked to other companies in the industry.

Finally, disclosures regarding the role and relevance of estimates underlying financial data must be enhanced. Disclosures under SOP 94-6 -- "Disclosure of Certain Significant Risks and Uncertainties" -- have often resulted in boilerplate language to the effect that these financial statements contain estimates. The SEC's recent FRR 60 offers cautionary advice, reminding companies to ensure that they provide clear and transparent disclosure regarding their accounting policies; it specifically mentions the importance of complying with SOP 94-6.

There is currently a crisis in confidence in our financial reporting system as a result of the undisciplined use of pro forma financial information, the rise in financial statement restatements, the dot-corn bubble, questions regarding analyst objectivity and conflicts of interest and, of paramount importance, the sudden collapse of Enron, the seventh most valuable company in the U.S. In this uncertain environment, companies should take any and all steps to transform pro forma information into a useful, relevant and well-accepted complement to GAAP-based financial statements.

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---- INDEX REFERENCES ----

COMPANY: BETHLEHEM STEEL CORP; TRUMP HOTELS AND CASINO RESORTS INC; ENRON CORP

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