www.businessweek.com

BusinessWeek

NOVEMBER 26, 2001
A PUBLICATION OF THE McGRAW-HILL COMPANIES

ENRON
HOW CHEVRON AND DYNEGY WILL PLAY THEIR HANDS

COMPANIES
- E BOEING
- E HOME DEPOT
- E BLOOMBERG
- E HONEYWELL

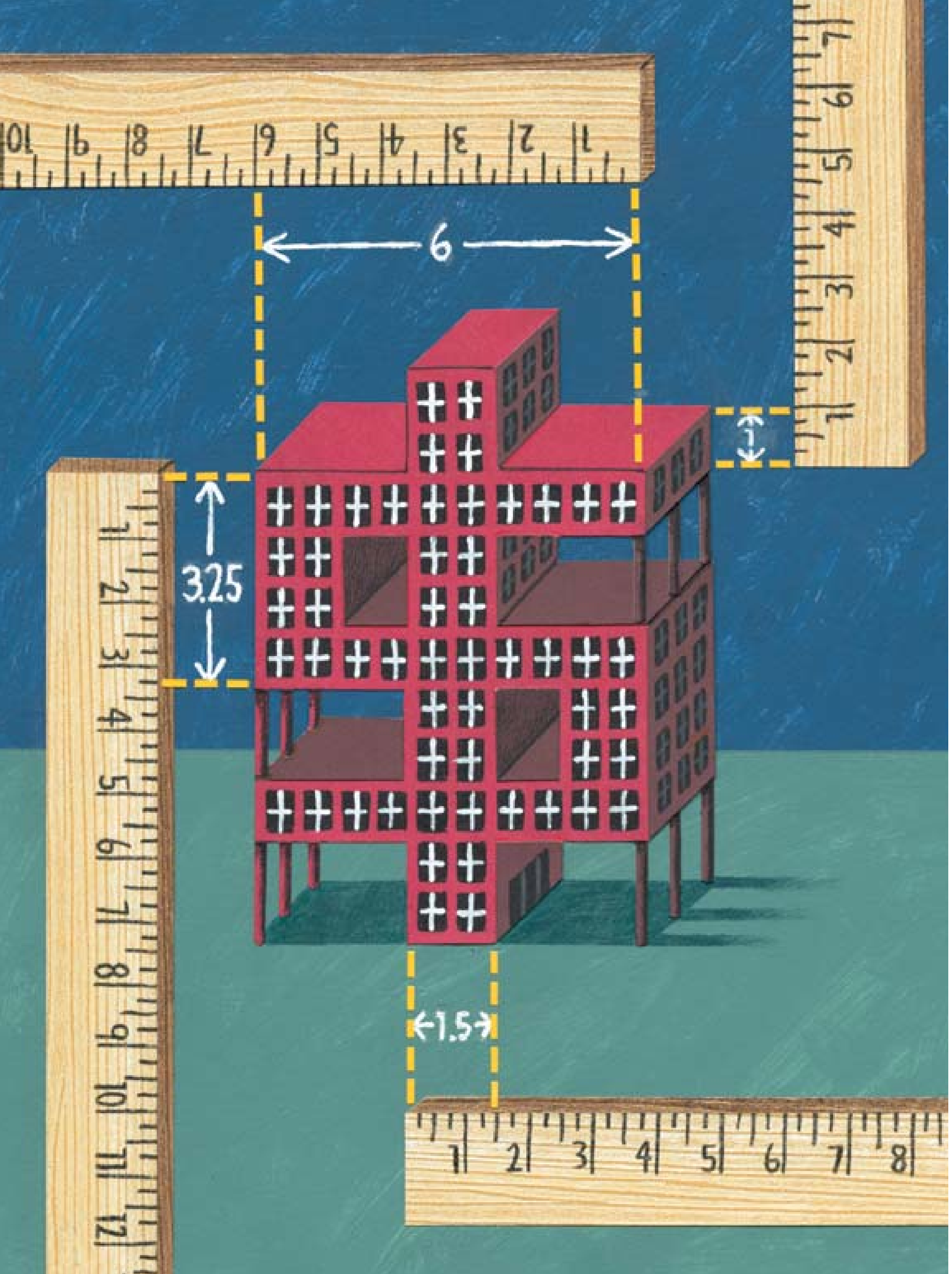
INFO TECH 100
HOW THEY'RE DOING

SILICON VALLEY
SQUABBLING AMONG THE RICH AND FAMOUS

CONFUSED ABOUT EARNINGS?

You're not alone. Here is what companies should do—and what investors need to know. PAGE 76

$4.95US $5.95CAN
48
18248
0 74367 7 2



CONFUSED ABOUT EARNINGS?

You're not alone. Here's what companies should do – and what investors need to know

BY NANETTE BYRNES AND DAVID HENRY

In an age when giant earnings write-offs have become commonplace, it's hard to shock Wall Street. But on Nov. 8, Enron Corp. managed to do it. After years of high-octane growth that had seen earnings surge by up to 24% a year, the Houston-based energy company acknowledged that results for the past three years were actually overstated by more than a half-billion dollars. It was confirmation of investors' worst fears. Three weeks earlier, Enron had announced a big drop in shareholders' equity, sparking fears that its hideously complex financial statements were distorting its true performance. Management pointed to a number of factors, including a dubious decision to exclude the results of three partnerships from its financial statements and a billion-dollar error several years earlier that had inflated the company's net worth.

Enron may be an extreme example of a company whose performance fell far short of the glowing picture painted by management in its earnings releases, but it is hardly alone. This year, Corporate America is expected to charge off a record $125 billion, much of it for assets, investments, and inventory that aren't worth as much as management thought (chart, page 79). Even if companies don't go back and restate earnings, as Enron is doing, those charges cast doubt on the record-breaking earnings growth of the late '90s.

Not since the 1930s has the quality of corporate earnings been such an issue—and so difficult for investors to determine. There's more at stake than the fortunes of those who bought shares based on misleading numbers. If even the most sophisticated financial minds can't figure out what a company actually earns, that has implications far beyond Enron. U.S. financial markets have a reputation for integrity that took decades to build. It has made the U.S. the gold standard for financial reporting and the preeminent place to invest. It has also ensured ready access to capital for U.S. corporations. That a company such as Enron, a member of the Standard & Poor's 500-stock index and one of the largest companies on the New York Stock Exchange, could fall so far so fast shows how badly that gold standard has been tarnished. "The profession of auditing and accounting is, in fact, in crisis," says Paul A. Volcker, former chairman of the Federal Reserve and now one of the leaders of the International Accounting Standards Board.

Sometimes, as in the case of Enron, fuzzy numbers result from questionable decisions in figuring net earnings. More often, though, the earnings chaos results from a disturbing trend among companies to calculate profits in their own idiosyncratic ways—and an increasing willingness among investors and analysts to accept those nonstandard tallies, which appear under a variety of names, from "pro forma" to "core." (Enron offers its own such version. Before investors untangled the importance of Enron's first announcement, its stock rose briefly because it told investors that its "recurring net income" had met expectations.) The resulting murk makes it difficult to answer the most basic question in investing: What did my company earn?

Why calculate a second set of earnings in the first place? Because the numbers reached by applying generally accepted accounting principles (GAAP) are woefully inadequate when it comes to giving investors a good sense of a company's prospects. Many institutional investors, most Wall Street analysts, and even many accountants say GAAP is irrelevant. "I don't know anyone who uses GAAP net income anymore for anything," says Lehman Brothers Inc. accounting expert

Cover Story

ILLUSTRATIONS BY GENE GREIF

Robert Willens. The problem is that GAAP includes a lot of noncash charges and one-time expenses. While investors need to be aware of those charges, they also need a number that pertains solely to the performance of ongoing operations.

That's what operating earnings are supposed to do. But because they're calculated in an ad hoc manner, with each company free to use its own rules, comparisons between companies have become meaningless. "No investor—certainly not any ordinary investor—can read these in a way that's useful," says Harvey L. Pitt, chairman of the Securities & Exchange Commission. The SEC is examining whether new rules are needed to clarify financial reports and perhaps restrict use of pro formas.

What's badly needed is a set of rules for calculating operating earnings and a requirement to make clear how they re-

late to net income. In the end, investors need two numbers—a standardized operating number and an audited net-income number—and a clear explanation of how to get from one to the other.

"OUT OF HAND." A widespread consensus is building to do just that. In early November, S&P proposed a set of rules for companies to follow when tallying operating earnings. Only the week before, the Financial Accounting Standards Board, the rulemakers for GAAP, had announced that they, too, would be taking up this issue. Volcker says the International Accounting Standards Board is also seeking a uniform definition of operating earnings.

"Over the past two or three years, the use of creative earnings measures has grown and grown and grown to the point where it has really gotten out of hand," says David M. Blitzer, S&P's chief investment strategist. "Earnings are one of the key measures that anybody looks at when they're trying to evaluate a company. If people want to use an operating-earnings measure, we better all know what we're looking at."

Without those standards in place, the gap between earnings according to generally accepted accounting principles and earnings according to Wall Street is only going to grow wider and more confusing. Look at the variance in earnings per share calculated for the S&P 500 for the third quarter: It's $10.78 according to Wall Street analysts as tallied by Thomson Financial/First Call, $9.17 according to S&P, and $6.37 according to numbers reported to the SEC under GAAP. (S&P, like *BusinessWeek*, is owned by The McGraw-Hill Companies.)

The lack of a standard measure can be costly to those who choose wrong. Use First Call's earnings for the past four quarters and you get a relatively modest price-earnings ratio of 23 for the S&P 500. But run the numbers using GAAP earnings, and suddenly the market has a far steeper p-e of 38.

CHART BY ERIC HOFFMANN/BW

THE COMPANIES

The dot-com boom accelerated a nasty trend: Companies making up their own ways to calculate earnings until they find one that shows profits

How did we get into this mess? Investors and analysts have been calculating operating earnings for years, and for years, reasonable people could more or less agree on how to do it. Then came the dot-com bubble, along with increased pressure from Wall Street for companies to meet their quarterly earnings forecasts. Suddenly, companies that hadn't turned a profit by any conventional measure started offering ever more inventive earnings variants. These customized pro forma calculations excluded a grab bag of expenses and allowed upstart companies to show a profit.

"TOWER OF BABEL." Pro forma formulas vary wildly from company to company and even from quarter to quarter within the same company, casting doubt on their validity. And these days, the gulf between net earnings and pro forma earnings is wider than ever. S&P's tallies fall between the two: S&P's numbers are more systematic than pro forma, but they aren't followed widely enough to be a standard. "Investors are facing a Tower of Babel," says Robert K. Elliott, former chief of the American Institute of Certified Public Accountants (AICPA) and a retired KPMG partner. "It's not standardized, and the numbers are not audited."

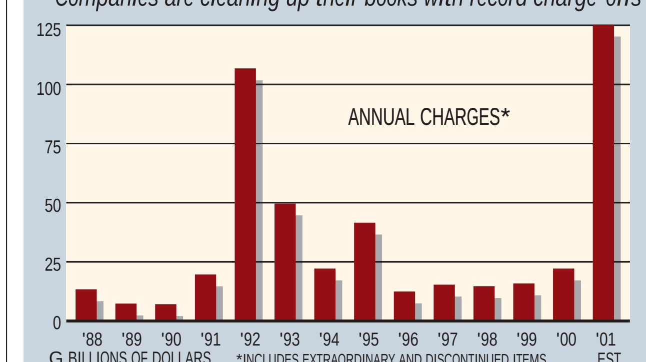
That makes it tough to evaluate a company's performance. In the quarter ended on Sept. 30, Nortel Networks Corp. offered shareholders at least three earnings numbers to choose from. By conservative GAAP accounting, the telecommunications giant lost $1.08 a share. The company also provided two possible pro forma options: a 68¢ loss that excluded "special charges," including some acquisition costs and restructuring charges, and a still better 27¢ loss that further excluded $1.9 billion of "incremental charges," such as writing down inventories and increasing provisions for receivables. Wall Street chose the rosiest one.

Confusing? You bet. Companies defend their pro forma calculations by pointing out that they're merely filling a void: Investors are clamoring for a measure that gives them better insight into their company's future. The goal is to get to the core of the business and try to measure the outlook for those operations. "There are good reasons why there is an emphasis on operating earnings," says Volcker. "It is an effort to provide some continuity and some reflection of the underlying progress of the company." Besides, as companies like to point out, they still have to report GAAP earnings, and investors are free to ignore everything else.

There's no starker lesson in the shortcomings of GAAP than the $50 billion asset write-downs by JDS Uniphase Corp., the biggest charge of the year. Near the height of the telecom bull market in July, 2000, the San Jose (Calif.) maker of fiber optics topped off a buying spree by acquiring competitor SDL Inc. for $41 billion in stock. When the deal closed in February, its assets ballooned from $25 billion to $65 billion. But by then, shares of JDS and other fiber-optics makers were collapsing. To bring its acquisitions into line with their

THE BIG BATH

Companies are cleaning up their books with record charge-offs



Data: Morgan Stanley Equity Research

new value, the company took charges of $50 billion. Despite the fact that the bulk of its losses stemmed from stock transactions and involved no cash paid, GAAP required that the charges be taken out of net income. So according to GAAP, JDS lost $56 billion in the fiscal year ending in June—a staggering figure for a company whose revenues over the past five years added up to only $5 billion.

Analysts and the company argue that besides not involving cash, the charge-off was all about the past, a right-sizing of values that had gotten out of hand. To analyze the company's

HIGH-GLOSS GLOSSARY

Companies are using a variety of accounting practices to put the best spin on their results. Here's what those terms mean:

DEFINING EARNINGS

NET INCOME The bottom line, according to generally accepted accounting principles (GAAP). Sometimes called "reported earnings," these are the numbers the Securities & Exchange Commission accepts in its filings.

OPERATING EARNINGS An adjustment of net income that excludes certain costs deemed to be unrelated to the ongoing business. Although it sounds deceptively like a GAAP figure called "operating income" (revenue minus the costs of doing business), it is not an audited figure.

CORE EARNINGS Another term for operating earnings. Neither core nor operating earnings are calculated according to set rules. They can include or exclude anything the preparer wishes.

PRO FORMA EARNINGS The 1990s term for operating earnings. Popularized by dot-coms, it sometimes excludes such basic costs as marketing and interest.

EBITDA Earnings before interest, taxes, depreciation, and amortization. The granddaddy of pro forma, it was initially highlighted by industries that carried high debt loads, such as cable TV, but has since come to be widely quoted.

ADJUSTED EARNINGS A new term for pro forma.

DEFINING COSTS

SPECIAL CHARGES A general term for anything a company wants to highlight as unusual and therefore to be excluded from future earnings projections.

ASSET IMPAIRMENTS Charges taken to bring something a company paid a high price for down to its current market value. Many companies are now taking these charges on internal venture-capital funds that bought Internet and other high-tech stocks at inflated prices.

GOODWILL IMPAIRMENTS The same idea as asset impairments except they're used to write down the premium a company paid over the fair market value of the net tangible assets acquired. These charges will explode in the first quarter of 2002 because of a change in mergers-and-acquisitions accounting that eliminates goodwill amortization and requires holdings to be carried at no more than fair values.

RESTRUCTURING RESERVES An accrued expense (not usually cash) to cover future costs of closing down a portion of a business, a plant, or of firings. These are projected costs and if overstated can later become a boost to earnings as they are reversed.

WRITE-DOWN Lowering the value of an asset, such as a plant or stock investment. It is often excused as a bookkeeping exercise, but there may have been a real cost long ago that now proves ill spent, or there may have been associated cash costs, such as investment-banking fees.

prospects, they excluded the $50 billion charge. “The accounting is not designed to make things look better but to describe what happened,” says JDS Uniphase Chief Financial Officer Anthony R. Muller, “and we'll live with the consequences, whatever they are.” Analysts make a similar defense. “My goal is to figure out what the business is going to produce so that we can value the company,” says Lehman Brothers analyst Arnab Chanda.

GLACIAL PACE. Are JDS's pro forma numbers realistic—a fair gauge of JDS's ongoing operations? Right now, it's hard for investors to judge. And that's the kind of ambiguity S&P and others would like to eliminate. In November, S&P circulated a memo on how to standardize operating earnings. Under the proposal, operating earnings would include the costs of purchases, research and development, restructuring costs (including severance), write-downs from ongoing operations, and the cost to the company of stock options. It would exclude merger-and-acquisition expenses, impairment of goodwill, litigation settlements, and the gain or loss on the sale of an asset.

When S&P applied roughly that formula to JDS Uniphase, it split the difference between Wall Street and GAAP. Because of differences in what each group included in their earnings calculations, the results were chaotic. Using GAAP, the company lost $9.39 a share. S&P figures it lost $3.19, while the company put the loss at 36¢. Meanwhile, Wall Street says it made 2¢.

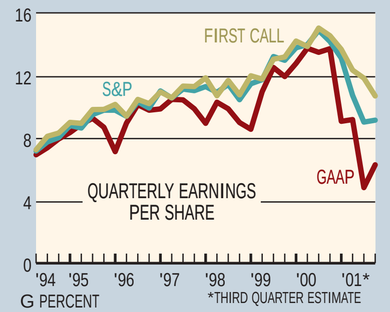
The S&P standard may make sense, but it raises the question: Where is the Financial Accounting Standards Board, the group in charge of GAAP? Chairman Edmund L. Jenkins says FASB will be addressing the problems. Still, investors shouldn't expect any improvement soon. The pace of change at FASB tends to be glacial. It typically takes four years to complete a new standard. In 1996, for example, the board realized that standards on restructuring charges had some big loopholes and it resolved to put the issue on its agenda. In June, 2000, the board finally issued a draft of a new standard, asked for comments, and held a public hearing. In October, 2001, the board said it still wasn't ready to put a fix in place. Now, the recession has set off another wave of restructuring charges, and the FASB still doesn't have new rules.

The slow pace means the standard-setters sometimes fail to react to sudden changes in the market. The most recent failure followed the terrorist attacks on September 11. An FASB task force, unable to come up with a set of rules for separating September 11 costs from general expenses, instead told companies that the disaster could not be treated as an extraordinary item. So GAAP earnings include costs stemming from the disaster as part of a company's general performance. Many companies have nevertheless broken those costs out in their unaudited press releases.

Many more are likely to do so in the fourth quarter. Indeed, 2001 is shaping up to be one for the record books. A poor economy and the devastating aftereffects of September 11 have resulted in a slew of unusual charges that are unlikely to recur and that no one could have foreseen. But there's a growing concern that the earnings fog is providing managers with cover to hide missteps of the past within that vast category of supposedly one-time charges. The temptation will be to take as big a charge as

EARNINGS CHAOS

First Call, Standard & Poor's, and generally accepted accounting principles (GAAP) used to yield fairly similar results for the earnings of the S&P 500 companies. Not anymore.



Data: Thomson Financial/First Call, Standard & Poor's

Cover Story

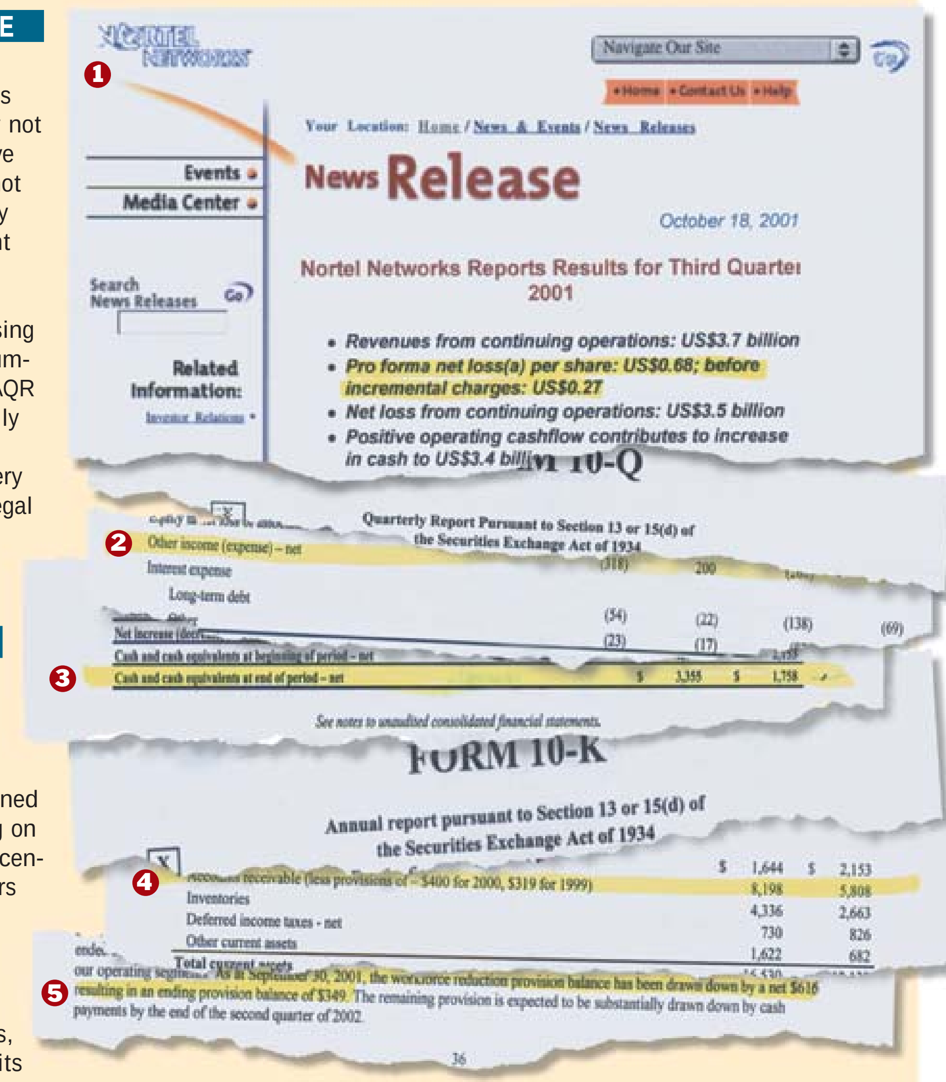
(TOP, L TO R) CHART BY ERIC HOFFMANN/BW; GRAPHIC BY ROB DOYLE/BW

THE ANALYSTS

It's their job to give investors the real story. Yet they often accept flaky earnings formulas companies concoct

NAVIGATING THE NUMBERS

There's plenty of information in a company's financial statements that can help determine the company's prospects. Here are the things accountants, analysts, and other financial sleuths focus on in their reviews.



THE EARNINGS PRESS RELEASE

1. This is a document to be read with great caution. If an earnings number is flagged in the headline, it may or may not be calculated according to conservative rules. Because these statements are not reviewed by regulators, they are largely public relations efforts. If management has included a pro forma number, be sure to read carefully for information about the charges a company is choosing to ignore. “We never use pro forma numbers,” warns investor Cliff Asness of AQR Capital. “I believe ‘pro forma' is usually just a fancy word for lying.” But announcements of other news may be very useful. A change in auditor, outside legal counsel, or the CFO makes analyst Howard Schilit's list of “10 excellent clues to detect shenanigans.”

THE STATEMENT OF OPERATIONS

2. Here's where you will find earnings as calculated by CPAs—net income. Also, there are useful line items such as “investment income,” which highlight how much money a company earned on its investment portfolio. Depending on the company, this may or may not be central to their success. Although investors tend to focus on the bottom line, the first item on the income statement—revenue—can sometimes be the most important. If it's hard to get a handle on the quality of a company's earnings, it may be easier to ascertain whether its revenue growth is slowing or increasing.

THE STATEMENT OF CASH FLOWS

3. This is rarely tacked on to the press release and usually can be found only in the quarterly report filed with the SEC about a month later. It's the most conservative measure of a company's health—how much cash its operations are creating every quarter. “Short of fraud, cash flow is much less vulnerable to manipulation” than earnings, says RL Renck's Robert Renck. It's broken into operating cash flow (money in the door), cash invested in the business, and cash from financing activities, such as issuing stock or debt.

THE BALANCE SHEET

4. “People need to be looking at something they haven't been looking at for the past few years—the balance sheet,” says former SEC chief accountant Lynn Turner. The balance sheet is prepared according to GAAP and highlights a company's cash on hand as well as what it has borrowed (liabilities), what it has yet to be paid for (receivables), and how much inventory it has on hand. If receivables or inventory are growing much faster than revenue, it's a warning sign that demand may be weakening. A company with plenty of ready cash can invest in its future growth, perhaps by making an acquisition or funding research and development.

THE FOOTNOTES

5. These can be found in SEC filings, some only in the annual report. Look for the footnote on the pension fund to see how much of net income may have come from its gains. In the bull market of the late '90s, that was an inflator at companies such as GE and IBM. Now, the issue may be shortfall. There's also a special note devoted to restructurings and how much money has been spent on layoffs and facility closings. Look for the word “reversals.” This indicates that the company overestimated how much it would have to spend and has fed that excess back into earnings.

THE REGULATORS

"An investor can't know what's been left out, why it's left out, or how it compares" with other companies, says SEC Chairman Pitt

possible now, while investors are braced for bad news. Not only can managers sweep away yesterday's errors, but tomorrow's earnings will look even better.

The basic question comes down to what constitutes a special expense—a charge so unusual that to include it in the earnings calculation would be to distort the truth about a company's performance. Usually, big charges fall into a few categories, including charges for laying off workers and restructuring a company, charges for assets that have lost value since they were purchased, charges for investments that have lost value, and charges for inventory that has become obsolete. In a recent study, Harvard Business School professor Mark T. Bradshaw found that companies are increasingly calling these charges unusual. That gives them a rationale for excluding them from their pro forma calculations.

Cover Story

Lots of critics disagree, saying such charges are often an inevitable part of the business cycle and should be reflected in a company's earnings history. They certainly should not be ignored by investors. "Charges are real shareholder wealth that's been lost," argues David W. Tice, manager of the Prudent Bear Fund, a mutual fund with a pessimistic bent that's up 17% so far this year. "It's money they spent on something no longer worth what it was, a correction of past earnings, or a reserve for costs moving forward. Whatever the reason, it's a real cost to the company, and that hurts shareholders."

Without standards, excessive write-offs from operating earnings can obscure actual performance. Without any rules, companies calculate operating earnings inconsistently in order to put their companies in the best possible light. Dell Computer Corp. is a good example of this "heads I win, tails you lose" school of accounting. For years, Dell benefited from gains in its venture-capital investments and was happy to include those gains in its reported earnings, where they appeared as a separate line on the income statement. But this year, when those gains turned to losses, the computer maker issued pro forma numbers that excluded that $260 million drag. Dell spokesman Michael Maher says the company's press releases and SEC filings break out investment income and give GAAP numbers as well as pro forma. "In our view, the numbers are reported clearly," says Maher. "It's all out there for the consuming public."

PAST PUFFERY. Many experts believe special charges are a sign that past performance was exaggerated. What should investors make of a company such as Gateway Inc.? Two restructuring charges in the first and third quarters, minus a small extraordinary gain, totaled $1.12 billion, or about $100 million more than the company made in 1998, 1999, and 2000 combined. Which is the truer picture of its performance and potential? The write-offs or the earnings? Write-offs for customer financing are another example. When Nortel increased its reserves for credit extended to customers by $767 million in September, it effectively admitted it had booked sales in the past to companies that couldn't pay—in effect overstating its performance in those earlier periods. In addition, Nortel says booking sales and accounting for credit are unrelated issues. Tech companies blame the sharp downturn in their industry for the big write-offs. And these aren't isolated examples. Peter L. Bernstein, publisher of newsletter *Economics & Portfolio Strategy*, found that from 1989 to 1993, 20% of earnings vanished into write-offs.

Big charge-offs can also distort future performance. Critics contend that excess reserves are often used as a sort of "cookie jar" from which earnings can be taken in future quarters to meet Wall Street's expectations. Or charges taken this year, for example, which is apt to be a lousy one for most companies anyway, might include costs that would otherwise have been taken in future periods. Prepaying those costs gives a big boost to later earnings. Rules for figuring operating earnings would help, but this is an area that will always involve a certain amount of judgment—and therefore invite a certain amount of abuse. "People are going to write off everything they can in the next two quarters because they're having a bad year anyway," says Robert G. Atkins, a Mercer Management consultant.

Part of the lure of big special charges is that investors tend to shrug them off, believing that with the bad news out in the open, the company is poised for a brighter future. Since Gateway detailed its third-quarter charge of $571 million on Oct. 18, Wall Street has bid the stock up 48%, compared with a 6% runup for the S&P 500.

Often, though, investors should take exactly the opposite message. If, for example, part of a restructuring involves slashing employee training, information-technology spending, or research and development, the cuts could depress future performance, says Baruch Lev, a professor of accounting at the Stern School of Business at New York University. "Are these really one-time events?" he asks. "Or is this the beginning of an avalanche?" Indeed, Morgan Stanley Dean Witter & Co. strategist Steve Galbraith has found that in the year following a big charge-off to earnings companies have underperformed the stock market by 20 percentage points.

"LA LA LAND." Investors are apt to be faced with more huge write-offs next year, even if the economy doesn't continue to worsen. Why? The transition to a new GAAP rule that changes the way companies account for goodwill—a balance-sheet asset that reflects the amount paid for an acquisition over the net value of the tangible assets. Under the new rule, companies will have to assess their properties periodically and decrease their worth on the balance sheet if their value falls. An informal survey by Financial Executives International of its member controllers and financial officers found that at least a third expect to take more charges.

But figuring out the proper value of those assets is no easy task. Unless there is a comparable company or factory with an established market price, valuing them involves a lot of guesswork for which there are no firm rules. "What this is really coming down to is corporations and their auditors coming up with their own tests for impairment," says the Stern School's Professor Paul R. Brown. "It's La La Land."

While the tidal wave of special charges is providing cover for earnings games, it could also be an impetus for change—especially in the wake of the dot-com fiasco. Indeed, there are some signs of a backlash. The real estate investment trust industry was a pioneer of engineered earnings, with its "funds from operations," or FFO. But now some REITs have begun to revert to plain old GAAP earnings. Hamid R. Moghadam, CEO of San Francisco-based AMB Property Corp., shifted back to GAAP in 1999. "The reason I don't like FFO is very simple," says Moghadam. "One company's numbers look better than another one's even if they had identical fundamental results."

THE SOLUTION

Needed: A set of rules for calculating operating earnings and a requirement to make clear how they relate to net income

There are other steps FASB could take to improve financial reporting and restore GAAP's status. Trevor S. Harris, an accounting expert at Morgan Stanley, says it could force companies to make clear distinctions between income from operations and income from financial transactions. Lehman's Willens says companies should provide more information on cash expenses and how they bear on earnings. An easy step would be to require companies to file their press releases with the SEC.

At the least, says Lev, companies must clearly explain how their pro forma numbers relate to the GAAP numbers. Otherwise, he says, investors "see numbers floating there, and where did they come from?" In today's environment of unregulated pro forma calculations and supersize write-offs, no question is more important to investors.

With Mike McNamee in Washington

BusinessWeek online

For an interview with SEC chief Harvey Pitt, go to the Nov. 26 issue online at www.businessweek.com.

BONUS SUPPLEMENT: THE NEW E-BIZ 25

www.businessweek.com

BusinessWeek

MAY 14, 2001

A PUBLICATION OF THE McGRAW-HILL COMPANIES

Mutual Funds

When to dump a dog

Energy

The economic threat of high prices

Missile Defense

Does it really make sense?

McDonald's

How it revived Boston Market

$4.95US $5.95CAN

20

18248

0 743677 2

THE NUMBERS GAME

Companies use every trick to pump up earnings and fool investors. The latest abuse: 'Pro forma' reporting. PAGE 100

Companies use every trick to pump earnings and fool investors. The latest abuse: "Pro forma" reporting

THE NUMBERS GAME

Cover Story

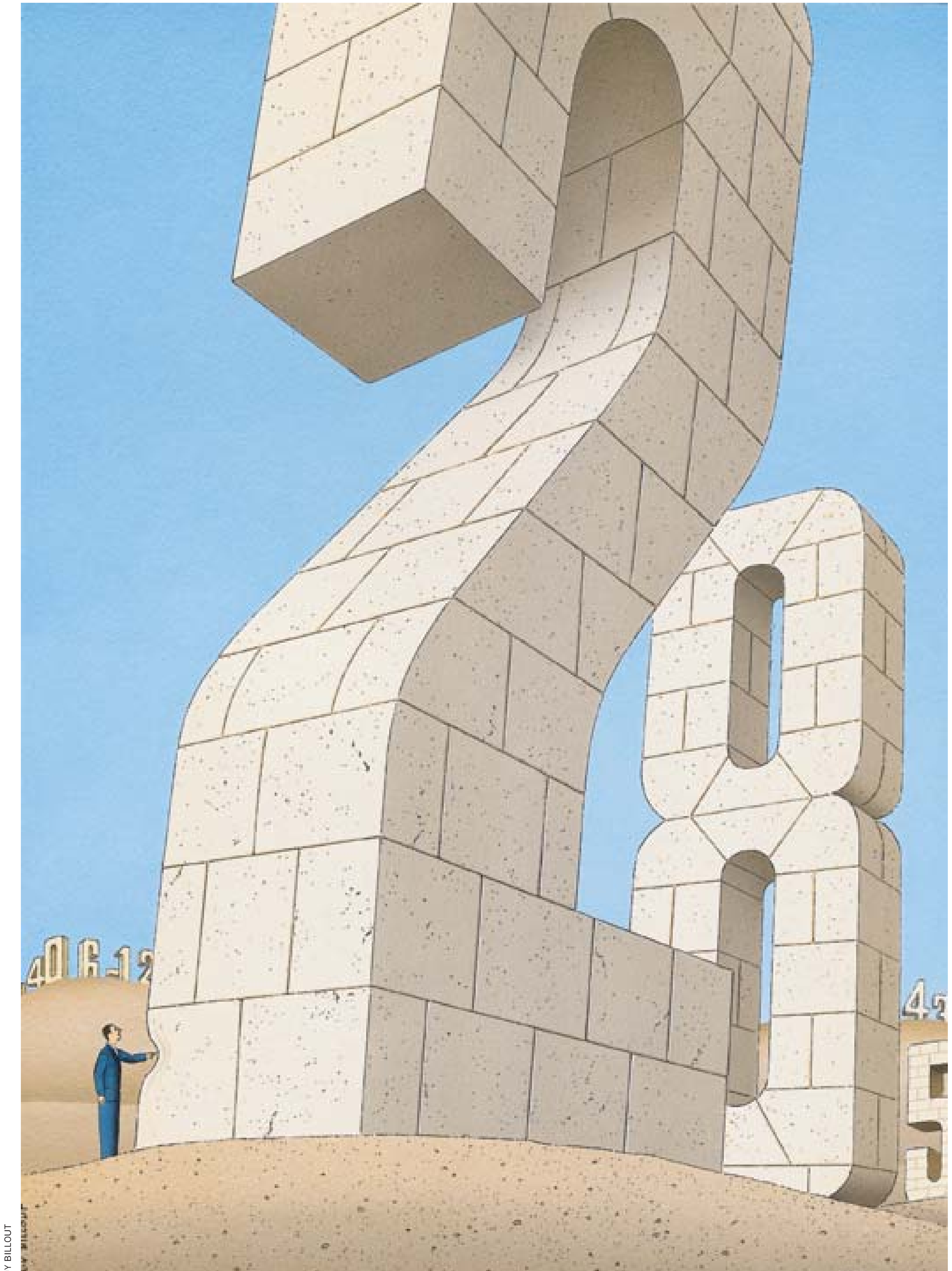
By David Henry

"It is simply a matter of creative accounting," says Matthew Broderick, playing bean counter Leopold Bloom in the hit musical *The Producers*. "Under the right circumstances, a producer could make more money with a flop than he could with a hit." Max Bialystock, Bloom's client, immediately sees the potential for solving his money woes. He raises as much as he can from rich widows to finance a new Broadway musical, *Springtime for Hitler*. He blows the money on himself, intending for the show to bomb so that nobody will ask awkward questions.

For all the hoopla on the Great White Way, Bloom is a primitive in the numbers game. He's operating without pro forma accounting, which allows all kinds of fictions in the way companies present their earnings. In the great bull market of the 1990s, companies and their CEOs used aggressive tricks to deliver the continually rising sales and earnings that Wall Street wanted to see. It's gotten far worse in the market slump. The pricking of the Wall Street bubble has stepped up pressure on desperate CEOs to shore up earnings ravaged by the sudden economic slowdown. Whether it's boom time or bust, companies have cast aside constraints on how they report sales and earnings to the public. They are dodging accounting rules built up over decades, choosing instead a slew of unconventional and often questionable practices that would turn Bloom green with envy.

Sure, companies have always tried to present themselves in the best possible light. But some of today's practices, though perfectly legal, sail close to the wind: They seem designed to mislead unwary investors about the real financial state of companies that use them. Fading dot-coms, new tech giants, and venerable blue chips all hype their earnings. Cisco Systems Inc. subtracts payroll taxes on employee stock options in its earnings-per-share numbers. IBM lifts its earnings by assuming it would pay less into its pension fund, and Motorola Inc. boosts sales by lending huge sums to customers. "CEOs were obsessed with growth," says Christopher M. Davis, portfolio manager at the family firm of Davis Selected Advisers. "They, as in the past, tortured accounting to produce income statements that would be applauded by Wall Street."

The full extent of bad stuff that happened during the boom is only now becoming clear—and it is worse than any-



GUY BILLOUT

one thought. Ordinary investors and Wall Street pros alike are beginning to cry foul.

What's alarming them is that the games affect the stock market and its integrity every day. It's getting harder to answer the basic questions that underlie rational investment decisions. What is a company's bottom line? Is it making money or not? What is the price-earnings ratio on its stock? The answers are all over the place.

Variations in how companies report their results make it harder to know if their valuation is cheap or rich compared with their peers and the rest of the market. Chipmaker Intel Corp. includes gains from stock investments in its preferred earnings measure; Cisco does not. And with

Cover Story

inconsistent numbers seeping into calculations of p-e's for the major indexes, it's harder to gauge whether the market is valued high or low compared with the past. Companies "are destroying the credibility of the profits they are producing," says Robert Olstein, manager of Olstein Financial Alert, a mutual fund. "There is no way some of these companies were growing at the rates they were representing."

CREDIBILITY GAAP. The emergence of pro forma accounting is what enables companies to play the numbers game to the hilt. Tech companies in particular discovered a powerful new way to obscure what was really happening in their often shaky businesses. Traditionally, pro forma accounts were a way of giving an idea of what earnings would look like in completely new businesses or in those that would result from a merger. But real New Economy companies now conjure up a second set of figures—created outside generally accepted accounting principles, or GAAP, which still must be used in reports to the Securities & Exchange Commission—and call them pro forma. "It is open season [for companies] to say what they want in press releases," says Chuck Hill, research director at Thomson Financial/First Call, an earnings tracking service.

GAAP is a set of accounting rules hammered out by regulators, companies, and their auditors over decades. It aims to give a fair and true picture of a company's financial position and make it harder for executives to hype their results. GAAP rules are applied to every company, no matter what its business or stage of development. A small biotech startup with little more than patentable ideas is treated the same way as a fast-food empire or a giant auto maker with billions invested in plants. Some companies argue that GAAP isn't always the best way of measuring how they're doing. And on some points, even skeptical investors agree with them. But the virtue of GAAP is that it is the most consistent and objective way to compare results across companies and industries.

That can't be said of pro forma. Each company uses it any way it wishes. Yahoo! Inc., one of the first to emphasize pro forma, in January, 1999, presented results 35% better than GAAP by excluding a variety of costs of buying Internet companies. In its latest set of results, issued on Apr. 11, Yahoo excluded yet more items, such as payroll taxes on stock options. Data center operator Exodus Communications Inc., in its version of pro forma, also excludes some acquisition costs, but apparently not options taxes. Network Associates Inc. (table, page 106), meanwhile, conveniently drops a loss-making 80%-owned subsidiary, McAfee.com Corp., in working out its pro forma results, which show only half the loss reached under GAAP. In a Mar. 27 press release, software company Xcare.net Inc. reported revenues before subtracting the cost of warrants to buy Xcare shares that it gave to a customer. The value of the warrants was given lower down in the release, but the headline numbers boosted the company's apparent sales by 69% and cut its losses by 40%. Xcare Chief Financial Officer Gary T. Scherping says he wasn't trying to fool anybody. "I could probably have come up with another three things that I could have excluded had I wanted to play those games…that other people regularly do," he says.

Amazon.com Inc. can't even settle on a single definition of pro forma. In its Apr. 24 results announcement, it reported a "pro forma operating" loss of $49 million in the first quarter of this year. Confusingly, it also reported a "pro forma net" loss of 21¢ a share, equivalent to $76 million. Investors had to pick carefully among a slew of numbers to see that Amazon actually had a net loss of $234 million, or 66¢ a share, using GAAP. Among the items excluded from pro forma operating losses were a net interest expense of $24 million and a $114 million charge for restructuring costs, such as closing a warehouse. "The pro forma numbers are how we think about our business" and how Wall Street analysts follow it, says Amazon spokesman Bill Curry, emphasizing that the GAAP numbers are included.

The magic of pro forma can turn losses into profits. That's just what happened at Computer Associates International Inc., whose accounting was challenged in an Apr. 29 story in *The New York Times*. By changing the terms of its software sales and how it accounts for them, CA reported 42¢ of pro forma earnings per share in the final quarter of last year, vs. a 59¢ loss under GAAP. Company officials say the new presentation is actually more conservative and not done to enhance growth. Similarly, giant telecom carrier Qwest Communications International Inc. reported $2 billion in quarterly earnings before interest, taxes, depreciation, and amortization, or EBITDA, an early version of pro forma, in a Jan. 24 release. Shareholders had to wait weeks to find out, in a footnote to the annual results, that Qwest actually lost $116 million, according to GAAP rules. Qwest says the variation is extreme because of adjustments for its takeover of U S West Inc.

Some companies with profits can really give themselves a lift. Take Quintiles Transnational Corp., a number cruncher that sells statistical services to the drug industry. In press releases, it excludes the costs of Internet operations when it reports earnings from "core operations." The result: a 77% higher net income. Quintiles' investor relations officer, Greg Connors, says there's nothing wrong since GAAP results are attached: "We thought this was the best way to describe ourselves to the market." Including the cost would make it hard for investors to compare Quintiles with rivals that don't invest so much in the Net, he says, calling the cost "unusual." But the expenses aren't a one-time event: They have been going on for a year, and they are continuing.

The spread of pro forma earnings has plunged investors into an Alice-in-Wonderland world. SEC Chief Accountant Lynn E. Turner calls pro forma results "EBS earnings"—for Everything but Bad Stuff. "Way too often, they seem to be used to distract investors from the actual results," Turner says. Wall Street, of course, is happy to play along: First Call's Hill says more than 260 companies have persuaded a majority of top financial analysts to abandon GAAP when making earnings estimates.

Pro forma is the most egregious of the numbers games. But new variants of old accounting tricks are also flourishing throughout the corporate world. Here are the gambits for which investors should be on the lookout:

■ **VENDOR FINANCING.** Pressure from Wall Street for ever increasing sales generated lots of bad numbers as high-tech companies took to overstating their revenues by lending big to customers. In moderation, vendor financing is a sound selling technique; abused, it's a dangerous way to do business. Just ask some telecom-equipment suppliers: By the end of 2000, they were collectively owed as much as $15 billion by customers, a 25% increase in a single

TRICKS OF THE TRADE

How companies pump up sales and earnings



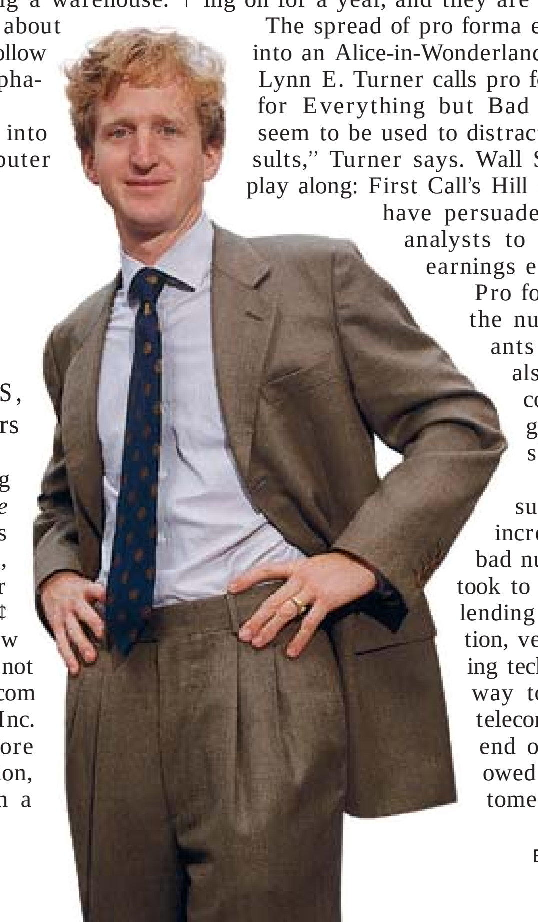


PLOY	BIG BATH	VENDOR FINANCING	PENSION GAMBIT	BEFORE ITS TIME	BACKDOOR BARGAINS
HOW IT WORKS	Takes a large write-off, booking costs now to boost earnings and margins in the future.	Lends money to financially fragile customers so that they can buy products, pumping sales and profits.	Decides pension plan is overfunded and cuts company contributions. Hides gain in financial footnotes.	Treats pending sales as if they have already occurred, books sales without subtracting promised rebates.	Promotes sales by buying a big customer's stock or granting it cheap warrants.
DRAWBACK	Unless operations improve, more charges must be taken to maintain earnings. Eventually, investors shun the stock.	Company can be left with bad debts—and falling sales, when it stops lending.	Rates of return on pension investments may worsen, requiring bigger future contributions.	Cuts future sales and earnings, giving appearance of faltering company performance unless operation is repeated.	Investors may be suspicious of stated values; hard to do over again, so future results could falter.
WHO'S DONE IT	Cisco, DaimlerChrysler, Kodak	Motorola, Lucent, Nortel	IBM, GE	MicroStrategy, Informix, Cendant	Flextronics, Amazon

ILLUSTRATIONS BY RAY VELLA/BW

"They, as in the past, have tortured income statements that would be applauded accounting to produce by Wall Street"

— CHRISTOPHER M. DAVIS, Davis Selected Advisers



PHOTOGRAPH BY THOMAS IANNUZZI

> "Way too often, [pro forma results] seem to be used to distract investors from the actual results"
>
> — LYNN E. TURNER, Securities & Exchange Commission

year. Effectively, they were buying their own products with their own money, exaggerating the size and sustainability of their sales and earnings growth. "It is only now, in hindsight, that it is turning out that it wasn't real revenue growth at all, just bad receivables," says Hank Herrmann, chief investment officer at Waddell & Reed Financial Inc., a fund manager.

Investors were spooked to discover, deep in a company filing to the SEC on Mar. 30, that Motorola is owed $1.7 billion by Turkey's No. 2 wireless carrier, Telsim. In a Feb. 3, 2000, press release announcing a $1.5 billion order from Telsim, Motorola made no mention of any loans. "That is a risk I would have liked to have known about years ago," complains portfolio manager Davis. The risk is not just that the customer won't pay, but that the customer won't buy more products unless Motorola lends it more. Since the original announcement of the Telsim order, Motorola stock has fallen 69%, losing about $75 billion of its market value. Motorola says it properly disclosed its financing practices in filings to the SEC. The loan is backed by a claim on "significantly" more than half of Telsim's stock, says spokesman Scott Wyman.

Employee stock options have proved useful throughout the economy in recruiting and holding staff. But companies don't have to deduct the cost of options from their income, as they must for wages paid in cash. So they have a powerful tool to pump up profits in the short run—at the cost of diluting ordinary shareholders' equity as employees exercise their options. A handful of companies, such as Boeing Co. and Winn-Dixie Stores Inc., decline to play that game, and charge the estimated value of options immediately. But most don't expense the costs—some to terrific effect. At coffee chain Starbucks Corp., for example, expensing the value of options would have reduced reported net income by $28 million, or 30%, in the year through October. At Cisco, it would have reduced reported income by $1.1 billion, or 42%, in the year through July. Furthermore, the compounded annual growth of Cisco's reported net income for the three previous years would have sunk to 33% from 41%, according to Bear, Stearns & Co. accounting analyst Pat McConnell. Veteran short-seller James Chanos of Kynikos Associates Ltd. calls the treatment of options "a national outrage... an ongoing shame."

Aggressive options accounting makes overall corporate profits look much higher than they really are. McConnell of Bear Stearns figures the average earnings growth rate for companies in the Standard & Poor's 500-stock index with options fully expensed would have been cut from 11% to 9% for the three years to mid-2000. But the information is hard to come by. Companies are required only to disclose their option costs in a footnote to their annual reports.

■ **SQUEEZE AND STRETCH.** Companies that need to show earnings growth can help themselves by booking sales early or costs late. For instance, software company MicroStrategy Inc. reported revenue in three quarters in 1998 and 1999 based on contracts it did not complete until after the quarters had ended, the SEC found. The company restated three years' worth of profits to losses and settled the matter with the SEC, neither admitting nor denying the allegations. Three corporate officers agreed to pay penalties totaling $1 million.

More companies than ever are boosting earnings by changing assumptions that will lower their reported expenses, says the SEC's Turner. Typically, executives use stratagems such as extending the expected life of assets to reduce depreciation charges or betting that they'll have fewer bad debts. Reader's Digest Association Inc. became more optimistic about the number of customers who would pay their bills on time and gained about 16¢ a share in last year's December quarter, says fund manager Olstein. Reader's Digest spokesman William Adler says the company's collection estimate "is not put in to

RED FLAGS

Companies may be up to hanky-panky when...

- ✔ **Profits grow** faster than cash flow
- ✔ **Sales slow** while inventories pile up faster
- ✔ **Reserves** against bad debts are cut sharply
- ✔ **Ways of calculating** revenue and expenses change
- ✔ **Unpaid customer bills** outpace sales
- ✔ **Sales are booked** before payments are received
- ✔ **Gross margins** increase or decrease dramatically
- ✔ **Auditors**, lawyers, or key execs change

(TOP TO BOTTOM) PHOTOGRAPHS BY KATHERINE LAMBERT; GERRY BROOME/AP/WIDE WORLD

SPINNING EARNINGS

The pro forma per share earnings look a lot better than GAAP in the latest quarter

COMPANY	PRO FORMA	GAAP	CHANGE
JDS UNIPHASE	$0.14	–$1.13	$1.27
CHECKFREE	–0.04	–1.17	1.13
TERAYON	–0.43	–1.01	0.58
AMAZON.COM	–0.22	–0.66	0.44
PMC-SIERRA	0.02	–0.38	0.40
CORNING	0.29	0.14	0.15
QUALCOMM	0.29	0.18	0.11
CISCO SYSTEMS	0.18	0.12	0.06
EBAY	0.11	0.08	0.03
YAHOO!	0.01	–0.02	0.03

Data: Company announcements

affect income in any way." He says the estimate was raised properly, because its mix of business had shifted from books toward subscriptions, which are more likely to be paid.

In some cases, there has been no change in assumptions at all, but a questionable judgment from the start. The SEC recently took issue with Verizon Wireless Inc.'s decision to amortize the cost of its wireless licenses over 40 years instead of 20 years or less. The longer amortization, which Verizon says is appropriate because the licenses are renewable, helps earnings, but assumes the licenses will never lose value because of another technology.

Company pension plans can become a fruitful source of extra earnings. Companies can't generally take money out of their pension funds, but by juggling several factors, including the actuarial present value of benefits, interest rates, and expected returns on assets, they can reduce or even eliminate what they have to pay into their plans in any given year, according to Gabrielle Napolitano, accounting maven at Goldman, Sachs & Co. For example, IBM picked up $195 million—1.7% of pretax income—in 2000, when it raised the expected rate of investment return from 9.5% to 10%.

Companies, of course, would rather have investors imagine that all their earnings are coming from their businesses. So some try to disguise the pension lift by lumping it with other retirement benefits costs, says Jack T. Ciesielski, publisher of the *Analyst's Accounting Observer* newsletter. General Electric Co.'s annual report says 6.5% of its $12.7 billion net earnings in 2000 were from "post-employment benefit plans," which cover everything from pensions to retiree health plans. Take out the cost of retiree health- and life-insurance benefits, which are found in footnotes, and the boost from the pension plan leaps to 9%. With the stock market in a funk, companies may not be able to count on the same gains in the future. Indeed, they may have to cough up to keep their plans whole.

■ **BIG BATH.** The slowing economy is giving a maneuver known as the big bath a whole new lease on life. A company takes a huge restructuring charge one year, often when it's making losses or much lower profits than before. It may sound crazy to make losses look worse, but the ploy gives the company big help in reducing expenses and enhancing earnings in the future. On Apr. 16, Cisco announced two whoppers. One charge, of up to $1.2 billion, is for the cost of laying off workers, closing buildings, and erasing goodwill from its balance sheet. The other is to write off $2.5 billion of excess inventory, primarily raw materials that Cisco says have zero value. Will Cisco sell the inventory, or use it in products later? A Cisco spokesman said the inventory is worthless and "we have no plans to use it, period."

Worried about the possible abuse of the big bath technique, the SEC in late 1999 directed companies to disclose sizable charges in more detail. But the facts are still sometimes hard to find. Even before Computer Associates' issues with revenue recognition surfaced, analysts were suspicious of its earnings numbers. Last year, Sterling Software Inc. apparently took a charge right before being acquired by CA, a move that may have accelerated operating expenses to the benefit of CA's later earnings, according to Howard Schilit, head of the Center for Financial Research & Analysis, an earnings watch service. CA says the charges were described in its filings to the SEC and notes that it reported lower-than-projected earnings following the merger.

How did earnings reports slide into such chaos? It's tempting to finger the auditors, who after all are supposed to be the first line of defense against financial chicanery. But that would be too simple. "Auditors are really not responsible for doing analysis on financial reports," says Schilit. A more serious problem is that strict accounting is losing its champions within companies. Fewer and fewer chief financial officers are certified public accountants, notes the SEC's Turner.

"Everybody is to blame here," says a veteran hedge-fund manager, who admits that he, too, was buying rising stocks

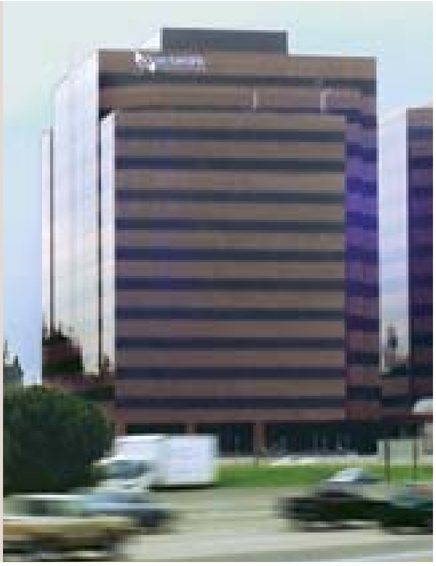
HOW NETWORK ASSOCIATES HALVED ITS LOSS

By making adjustments to the GAAP net, the company sliced first-quarter, 2001, losses in two

	CONSOLIDATED GAAP RESULTS (MILLIONS)	PRO FORMA RESULTS* (MILLIONS)
GROSS PROFIT	**$136.4**	**$127.0**
LESS R&D, sales, marketing, administrative expenses	–178.8	–168.1
LESS Amortization of intangibles and stock charge	–17.5	0
OPERATING LOSS	**59.9**	**41.1**
PLUS Net interest income, minority stakes, tax benefits	+12.5	+16.7**
NET LOSS	**47.4**	**24.3**
PER SHARE LOSS	**35¢**	**17¢**

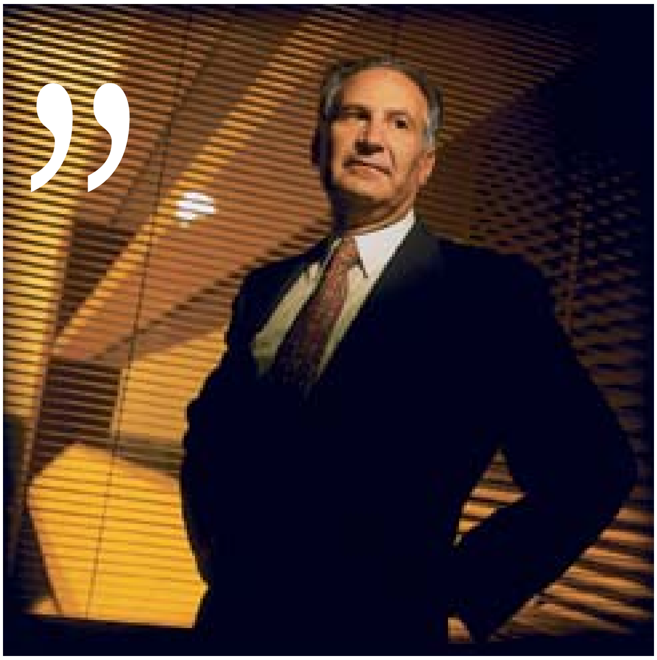
*Excludes results of 80%-owned McAfee.com **Omits interest paid on convertible debt

Data: Apr. 19 company earnings announcement



COURTESY NETWORK ASSOCIATES

> *"Auditors are really not responsible for doing analysis on financial reports"*
>
> — HOWARD SCHILIT, Center for Financial Research & Analysis



with little regard to how companies were spinning their numbers. Mutual-fund portfolio managers learned in the bull market that if they took time to check details in financial reports before buying a stock, competitors would have already bid up prices. Analysts at Wall Street investment banks started spending more time soliciting underwriting business and less time verifying what managements were telling them, complains Philip T. Orlando, chief investment officer at Value Line Asset Management Services, a money manager.

AOL'S PAYOFF. Today's abundance of ways of calculating earnings has its roots in the 1980s heyday of the junk-bond market and, ironically, in deliberations by the Financial Accounting Standards Board, the major accounting rulemaker. Purveyors of junk made EBITDA part of Wall Street's daily vocabulary because it measured how much debt a company could carry in a leveraged buyout. LBO firms then used it to promote sales of stock back to the public in the mid-1990s. FASB responded to the interest by considering a rule under which companies would also report something to be called "cash earnings" that would have been similar to EBITDA. FASB ultimately dropped the idea but by then had opened a Pandora's box, encouraging companies to ignore GAAP as the prime measure of earnings.

But now, with the renewed skepticism that comes amid big stock market losses, investors and regulators are much less inclined to tolerate aggressive accounting. "We're going to force better disclosure," promises money manager Herrmann.

Trouble is, it takes the regulators ages to clamp down on questionable practices, allowing companies to hoodwink investors in the meantime. For years, America Online Inc. aggressively deferred the marketing expenses of sending out millions of computer disks to potential customers. That enabled AOL to look more profitable than it really was, helping it issue securities for cash and acquisitions that fed its growth. By the time AOL submitted to an SEC settlement on May 15, 2000 (without admitting or denying any wrongdoing), paid a $3.5 million fine, and restated its former income to losses, the company was home free. It was an Internet giant. Now, AOL owns communications giant Time Warner and is called AOL Time Warner Inc. "If AOL were by itself today, its stock price would be a lot lower... [so] the accounting aggressiveness paid off," says David W. Tice, a money manager who publishes the earnings watch bulletin *Behind the Numbers.*

Under former Chairman Arthur Levitt, the SEC started a campaign against numbers games in September, 1998 (table). Among the results: a financial fraud task force, which SEC enforcement chief Richard Walker says has been "working

A REPORT CARD ON THE REGULATORS

How the SEC is doing on implementing plans to reduce accounting hocus-pocus

PLAN	RESULT	GRADE
ACCOUNTING ASSUMPTIONS Any changes must be disclosed in detail.	Rule proposed in Jan. 2000; still pending	D
RULES Accounting bodies to clarify R&D rules and issue new ones for restructurings, write-offs in large acquisitions, and revenue recognition.	AICPA will issue R&D and write-offs guide by yearend; FASB rules for restructuring by third quarter. No timetable for FASB action on complete revenue-recognition rules.	C
REVENUE RECOGNITION Issue new guidelines.	Accounting bulletin issued in December, 1999. Revision expected.	B
MATERIAL FACTS Issue guidelines to compel correction of deliberate factual misstatements claimed to be insignificant.	Issued August, 1999.	A
LIABILITIES FASB to issue better definition.	First of two reports may appear by fall.	C
ENFORCEMENT SEC to beef up.	Financial fraud task force set up June, 2000.	A
AUDIT COMMITTEES Strengthen role of such committees of corporate boards.	SEC issued new rules in December, 1999.	A

Data: Securities & Exchange Commission, BusinessWeek

KATHERINE LAMBERT

on some very, very substantial matters, which the public will learn about shortly." They involve some of the largest companies in the country and the biggest accounting firms, he says.

Private groups are getting involved, too. At the behest of the SEC's Turner, Financial Executives International, an organization of financial officers, on Apr. 26 issued guidelines aimed at reining in the excesses of pro forma reporting. At the New York Society of Security Analysts Inc., a discussion group has focused attention on the way Amazon reports its results. Gary Lutin, an investment banker and co-sponsor of the group, says: "I hope we are helping to accelerate the natural process of the cycle" back to reality-based financial reporting. Apparently, he has made some progress. Amazon included a table reconciling pro forma and GAAP data in its latest results.

Still, cleaning up financial reporting won't be easy, given that the stakes for companies are so high. But so are those for ordinary investors whose wealth and retirement prospects are ultimately on the line in the numbers game. Unless they and their advisers want to end up as thoroughly fleeced as Max Bialystock's rich widows, they need to pay a lot more attention to the numbers than they did during the bull market.

With Christopher H. Schmitt in Washington

BusinessWeek online

For continuing coverage on corporate earnings, go to www.businessweek/today.htm

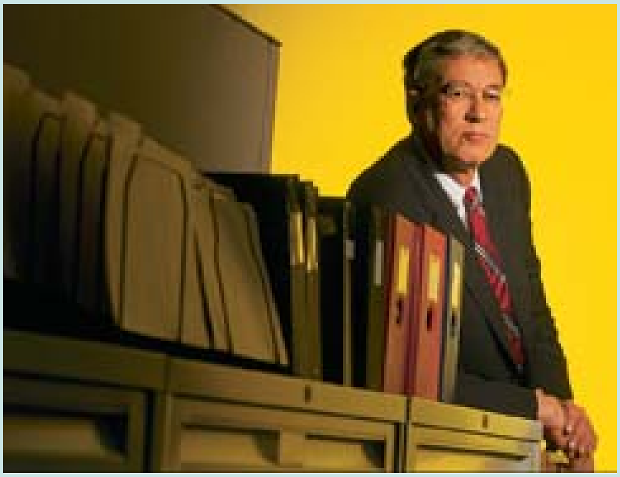
THE LAST WORD AT FIRST CALL

Charles L. "Chuck" Hill is a big man on Wall Street. The 6-foot-5-inch director of research at Thomson Financial/First Call is ringmaster to the frenzied circus of earnings reports every quarter. Stocks regularly soar or crater according to whether companies beat or fall below the per share earnings that Hill says are the consensus among brokerage analysts.

Hill, 63, aims to make his market-moving numbers credible by having all estimates calculated the same way. So he polls the Street's financial analysts to see how exactly they're working out their figures and enforces a standard, normally the one used by the majority. Getting everyone in line leads to a lot of screaming and shouting. "They'll be proactive in calling and yelling at you," says Lehman Brothers Inc. analyst Robert Rouse.

LIST MAKER. Tempers often run high because of the billions at stake. For starters, analysts often try to distinguish themselves from competitors and gain lucrative business by finding different ways to measure a company's results. But there are genuine differences of opinion about how to calculate earnings. Consider "one-time" gains and losses. Many analysts want to exclude them from regular earnings. They have a point, because such items generally don't reflect a trend. And not everyone agrees what "one-time" means.

The problem becomes acute when it comes to deciding how to treat companies' gains from their investments in other companies. Last year, chipmaker Intel Corp. said the large gains it made were ongoing and should be included in earnings. Some analysts disagreed strongly. "I was sympathetic with them," says Hill, himself a tech-stock analyst on the Street for 22 years. But the majority wanted to do it Intel's way. Hill reluctantly adopted their view as the First Call standard.



TOUGH GUY: *Hill keeps the numbers—and analysts—in line*

Still a keen rugby player with a team of Harvard Business School alums, Hill is tough with analysts he thinks are getting out of line. His sanctions can be deadly: He drops them from his A-list of analysts. The list, used by institutional investors to determine who offers useful opinions on stocks in which they're interested, is a powerful marketing tool for brokerages looking to earn trading commissions. Hill did just that to Rouse in a spat over the estimates of pharmaceutical researcher Quintiles Transnational Corp. earlier this year. Rouse, like many analysts on the stock, was excluding its Internet spending. Says Hill: "I just thought it was outrageous."

His role in these debates gives Hill enormous power to determine what companies can pass off as earnings in their press releases. That leads critics like Rouse to contend that First Call should "present whatever analysts put out, not define what the formulas need to be."

CRUSADE. That was just what First Call was doing when Hill signed on as one of its first employees in 1991. Brokerage firms would use First Call to send analysts' reports electronically to clients all at once so that everyone would get the "first call" on what could be a stock-moving view.

It was because Hill found wide discrepancies in the figures that different houses were using that he decided to change things and began his long-running crusade for consistent numbers. These days, clients, too, demand a more sophisticated service. So Hill now churns out an array of services ranging from putting together Wall Street's collective insight on next year's earnings by companies in the Standard & Poor's 500-stock index to tracking how well estimates eventually match actual results. That's why he appears on TV and in the press so much—and why he's such a power on Wall Street.

By David Henry in New York

PAULA LERNER/AURORA

Finance

PENSIONS

WHY EARNINGS ARE TOO ROSY

Companies are using pension surpluses built up during the boom to bolster this year's bottom line

If you think corporate earnings are bad this year, you're wrong—they're even worse than reported. Companies are inflating earnings with income from pension-plan assets, making their results look better than what's really happening with their businesses. More surprisingly, the income boost is coming when plan assets are earning less because of the stock market slump. How can that be? Easy. The feat is possible—and consistent with accounting standards—because outsized gains early in the bull market pumped up pension coffers to more than cover obligations to pay benefits. The phenomenon will likely continue at least another year. But if stocks stay in the doldrums, the plans will lose that earnings kick and become drags on their companies.

The current impact on earnings varies widely, from adding a tiny 0.7% to pretax income in 2000 at Emerson Electric to 13% at DuPont, and a bountiful 253% at Qwest Communications International, according to Credit Suisse First Boston. For the market overall, as measured by companies in Standard & Poor's 500-stock index, pension plans are hyping earnings by about 5%, estimates Trevor S. Harris, accounting analyst at Morgan Stanley Dean Witter & Co.

Some 171 companies in the S&P 500 have pension plans that are contributing to earnings. The plans are called defined-benefit plans through which companies invest to pay for the benefits they've promised employees. The plans are different from increasingly popular defined-contribution plans, which include 401(k)s, where employees direct the investments and bear the risks and rewards. Companies with defined-benefit plans tend to be in older industries, such as autos, metals, aerospace, forest products, and old Baby Bell telephone systems.

MAGIC. The logic behind reporting income from well-funded plans is simple: Company accounts ought to reflect the advantage of not having to pay into the funds. For these companies, what started as pension expense has become pension income.

ALL PUFFED UP

S&P 500

	1999	2000	2001*
COMPANIES WITH DEFINED-BENEFIT PLANS	356	352	352
COMPANIES WITH PLANS CONTRIBUTING TO INCOME	110	160	171
INCREASE IN OVERALL S&P OPERATING INCOME	3.1%	5.0%	5.3%

*Estimate Data: Morgan Stanley Dean Witter & Co.

The plans are lifting earnings in spite of damage from the bear market. In a tally of plans at the 20 biggest corporations reporting annual results through December, actual returns on assets in 2000 fell $19.2 billion short of the estimated cost of benefits for the year, according to actuarial and consulting firm Milliman USA. While it looks as if the companies suffered a $19.2 billion expense for the plans, together they reported $7 billion pretax pension income.

Here's how the magic works: The key is expected return-on-pension assets. Under current accounting standards, companies start each year estimating the cost of pension benefits and the return that plan assets will earn. If the return exceeds the cost, the difference is booked as income. If the return is less than the cost, the difference is booked as pension expense. The 20 companies surveyed projected an average rate of return of 9.5% for 2000 on their boom-enhanced assets. At that rate, the plans would have returned $32.7 billion, or $7 billion more than the cost of benefits.

As 2000 unfolded, the strength of the bond market offset losses in stocks, and the plans eked out a collective gain, but it was only 1.3%. That left the actual return $26 billion short of estimates. But accounting rules don't require companies to adjust for such shortfalls immediately. So the companies went ahead and reported the $7 billion worth of pension income they had originally estimated. And they projected a 9.5% return again this year.

Big shortfalls get tossed into accounts to be amortized later, typically over 15 years. Those accounts at many companies are chock-full of unrecognized gains left from the bull-market years when returns were much more than expected. Thus, companies can raise their expected returns, and pension income, with little risk, says Jane Adams, accounting analyst at Credit Suisse First Boston. If the companies are wrong in their estimates, the pain will be virtually unnoticeable and dissipated far into the future.

Some 63 companies in the S&P 500 raised their expected rates for this year, while 31 adjusted downward, says Adams. The hikes averaged 0.44 percentage points. Of the companies that raised their rates, 34 did so even though their investment returns in 2000 were lower than they had expected and lower than their actual results the year before.

EARNINGS DESPITE DECLINES

COMPANY	Companies are reporting earnings from pension plans... INCREASE IN 2000 INCOME* (MILLIONS)	AS % OF EARNINGS	...even as lousy markets reduced assets DECLINE IN PLAN SURPLUS (MILLIONS)	AS % OF SURPLUS
VERIZON COMMUNICATIONS	$2,328	19.7%	$4,056	15.5%
GENERAL ELECTRIC	1,744	13.7	3,499	14.2
SBC COMMUNICATIONS	1,145	14.4	5,036	24.8
IBM	896	11.1	4,095	36.7
AT&T	767	16.4	186	2.1
PHILIP MORRIS	290	3.4	1,086	28.4
EXXON MOBIL	263	1.5	789**	N.A.
FORD MOTOR	188	5.4	2,451	27.2
CHEVRON	125	2.4	307	44.1
BANK OF AMERICA	118	1.6	1170	64.6
CITIGROUP	29	0.2	912	45.4
WORLDCOM	24	0.6	14	15.7
McKESSON HBOC	6	0.8	31	40.5

*From U.S. plans **Plan already underfunded
Data: *BusinessWeek*, Milliman USA

These higher expected returns foretell yet more reported pension income in 2001. Ford Motor Co. raised its rate from 9% to 9.5%. After the first six months, pension plans for its worldwide automotive business contributed $161 million to income, up from $13 million of expense at this time last year. Why would Ford expect a higher rate after last year's low actual results of 2.5% brought in $2 billion less than expected? Ford says 9.5% is consistent with past investment performance and changes in how the assets are managed.

LESS IMPACT. Companies can not only play around with the expected rate of return on assets but also with the value of the assets themselves. Accounting standards allow them to use a mechanism known as "smoothing." Smoothing blends the market values of plan assets from recent years. The aim is to dilute the impact of market volatility on pension income and expense. Most companies smooth over five years, so the asset values underlying their expected returns in 2001 are based on stock market levels from 1996 through 2000. For now, pension income is still enjoying bull-market growth, says Adams, even though asset values have fallen from their peaks.

Ford, like most companies, doesn't disclose how it smooths assets. But its financial reports strongly suggest that the company is calculating returns from an asset level that is still rising. Its 2000 pension income was apparently based on a blended value of $36.5 billion. This year, that value could rise to $37.1 billion as smoothing replaces a lower asset value from the mid-1990s with a higher one from the start of 2001. The rise in blended value could contribute an additional $60 million to Ford's pretax income even though the market is way down this year.

While pension earnings aren't as valuable as earnings from normal business, losing them to a long market decline would be bad. Companies with pension income do not generally pay cash toward this employee compensation. "Pension plans give you financial flexibility" to work through problems with operating businesses, says Harris. Sometimes, companies can tap plans indirectly. Last year, Qwest's plan paid $27 million toward employee severance. Companies can hike plan benefits to lure employees and sometimes use assets for retiree health benefits.

If the stock market doesn't get back to its historical 11% annual returns before long, companies will likely hear complaints that they are exaggerating pension income. "Auditors will start to put pressure on plan sponsors to use lower projected returns," says Alan H. Perry, a Milliman consultant. The impact could be severe. If the typical big plan were to lower expected returns even 2 percentage points, to 7.5%, pension income would fall by 50% next year and keep going down, says Perry.

If returns continue to decline, corporations will find that their pension plans have turned from blessings to burdens.

By David Henry in New York

At Qwest Communications, the bounty from pension plans contributed 253% to pretax income in 2000