Missed Signals: Stock Gurus Write Off Most Big Write-Offs, But They Shouldn't --- `Special' or `Unusual' Charges Often Hold Vital Clues To Companies' Prospects --- At Home's Future Foretold

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Conventional wisdom among Wall Street stock analysts holds that investors should ignore large write-offs because they provide little insight about future performance. Now, amid the biggest wave of write-offs in history and mounting bankruptcies, it may be time to revisit that wisdom.

Consider recent events at Bethlehem Steel Corp. In July, it reported a $1.13 billion second-quarter loss, the bulk of it a $1 billion "unusual noncash" charge against earnings to write off the value of a deferred tax asset.

The charge didn't bother Salomon Smith Barney analyst Michelle Galanter Applebaum. It "masked what was essentially an improved quarter," she wrote on July 25, retaining her buy recommendation on the stock and predicting it would more than triple.

Three months later, Bethlehem filed for Chapter 11 bankruptcy reorganization.

Far from being something investors could safely ignore, Bethlehem's write-off of deferred tax assets -- mainly deductible losses carried forward from prior years -- held a clue to its future. Such assets can be used to offset future income-tax bills. But, of course, they can be used only by companies that are profitable and paying income taxes. By taking the charge, Bethlehem was signaling that it wasn't likely to use the assets, because it probably wouldn't have taxable profits anytime soon.

Almost any kind of write-off can send a message about the soundness of a business, the competence of its management or its prospects for growth. Although Wall Street stock analysts and financial executives routinely tell investors to disregard these entries, others say they're among the things investors should most closely heed.

"When you see these large write-downs, the antenna should go up immediately, and you should start digging for the underlying business reasons for these losses," says Lynn Turner, an accounting professor at Colorado State University and a former chief accountant for the Securities and Exchange Commission.

The sheer size of recent write-offs has made understanding their nature more urgent. Companies in the Standard & Poor's 500-stock index have reported more than $165 billion of so-called unusual charges so far this year, says research firm Multex.com Inc., more than in the prior five years combined. Meanwhile, Chapter 11 and Chapter 7 bankruptcy filings by publicly traded companies through mid-December hit a record 241, compared with 176 all of last year, according to New Generation Research Inc. in Boston.

Even if bankruptcy seems like a remote prospect, an "unusual" charge against earnings -- often called a "special," "one-time" or "nonrecurring" charge -- can provide an exit signal to investors. While stocks sometimes rally on news of such a charge, as a company announces a bold housecleaning move, the rally often doesn't last. A study by Multex.com and The Wall Street Journal found that companies taking the largest unusual charges as a percentage of sales have substantially poorer stock returns in the three months following the announcement of the charge than companies with minimal or no such charges.

The study, covering the past six years, looked at stocks of all public companies with market capitalizations of $1 billion or more. It divided those that took unusual charges into 10 groups, from the smallest to the largest such charges as a percentage of revenue. Stocks of companies with the largest charges relative to sales had a median decline of 9.4% in the 90 days after the charge was taken. Stocks of companies with the smallest charges relative to sales had a median gain of 1.48%.

While it could be argued that the shares might have fared worse without the charges, Marc Gerstein, director of investment research at Multex.com, says the study shows that "if you want to weed out stocks to look at for investment purposes, companies with unusually large write-offs are a good place to start."

Sometimes the significance of special charges isn't immediately clear. But some investors grow suspicious anyway, on the "cockroach theory": Where there's one problem, there probably are more. "From seemingly minor or immaterial charges, sometimes investors can glean insight into how a company either correctly or incorrectly accounts for its business and whether a company is pushing the envelope," says James Chanos, president of Kynikos Associates, a firm that specializes in short-selling, or betting on stock declines.

Many short-sellers raised their bearish bets on Enron Corp. in mid-October after it took a $1.01 billion charge largely to write down the value of soured investments. Inside the charge was a $35 million write-off of investment losses at a partnership

controlled by the company's chief financial officer. Later revelations about that and other partnerships, which weren't consolidated into the Houston-based energy concern's financial statements, led the market to lose faith in the company's finances. Its stock now trades for under a dollar a share as the company seeks to restructure under bankruptcy law.

The significance of special charges -- whether they represent old baggage from the past or illuminate the future -- is at the center of a lively debate under way in the accounting world. One side holds that generally accepted accounting principles, or GAAP, provide the best available snapshot of a company's financial position. GAAP, which companies must use in their official financial statements, requires that nearly all charges be treated as ordinary expenses.

Others, including many stock analysts, contend the best view comes from "pro forma" financial results -- calculated "as if" many expenses didn't really exist. The idea is that these expenses aren't relevant to future performance.

Companies increasingly highlight the pro forma view in news releases they generally put out before their official filings with regulators. But pro forma calculations adhere to no particular standard. Companies essentially do what they want. Now, accountants and economists say the practice of excluding blemishes is so widespread that companies and analysts often guide investors to dismiss charges that contain prescient warnings -- like the one at Bethlehem Steel.

Ms. Applebaum, the Salomon Smith Barney analyst who played down Bethlehem's big write-off, explains that she has covered other steel companies that returned to profitability shortly after writing off deferred tax assets. She thought Bethlehem would do the same. She notes that GAAP rules on such assets obliged Bethlehem to follow strict criteria in assessing its chances of future profitability -- stricter criteria than stock analysts typically use.

As for Bethlehem, Chief Financial Officer Leonard M. Anthony says the charge the company took was to some extent "predictive of the future."

GAAP also has well-established standards for writing down other kinds of assets. Companies must reduce the value on their books of anything from a customer loan to a manufacturing plant when its worth has diminished. Again, Wall Street stock analysts tend to dismiss the resulting charges as one-time events.

Sometimes that makes sense. During the 1981-82 recession, restructuring was a part of many corporations' strategies. They took charges for streamlining, outsourcing and otherwise shedding costs to position themselves for recovery. Because the resulting earnings volatility made it hard to compare companies' growth rates or price-earnings ratios, and because the charges weren't expected to recur, there was logic to excluding them to come up with "smoothed" earnings trends.

"Investors came to look upon the charges, correctly in many cases, as evidence that those firms had recognized past mistakes and had made tough decisions to become more efficient," said a September 2001 study by the Jerome Levy Economics Institute at Bard College in Annandale-on-Hudson, N.Y.

But the practice soon got out of hand. Some companies became habitual restructurers. The Levy study estimates that "operating earnings" -- another term for pro forma earnings -- at companies in the S&P 500 index have outstripped net income by more than 10% annually on average over the past two decades, and by as much as 20% annually in recent years. One reason: While companies readily exclude all sorts of special losses from their operating earnings, they are far less likely to exclude one-time gains, such as profits from asset sales.

Investors ignore write-offs at their peril, says economist David Levy at the institute. The reason is that when a company writes down an asset, it usually has concluded the asset won't generate as much cash as once assumed. That suggests the company as a whole won't, either. "The write-down of an asset is a recognition . . . that the future is not going to be as profitable as expected," Mr. Levy says.

And if the company borrowed to buy the assets it is writing down, it could find itself squeezed by debt, as At Home Corp. was. At the start of 2001, the provider of high-speed Internet access, which did business as Excite@Home, announced a $5.43 billion net loss for the 2000 fourth quarter, on just $169.1 million in revenue. Much of the loss -- $4.63 billion -- reflected write-downs of "goodwill," the intangible asset created when one company pays a premium to buy another.

One such write-down concerned At Home's purchase of Bluemountain.com, an online greeting-card service. At Home paid $1 billion in stock and cash for the company in late 1999, taking on $350 million of debt to do so. But Bluemountain had little revenue. A year later, At Home took a $684.2 million charge for the goodwill it created by buying Bluemountain at a price far above its net worth.

Rather than its $5.43 billion net loss, At Home highlighted its self-defined "net operating loss" for the 2000 fourth quarter -- a mere $36 million. At Home Chairman George Bell said in a conference call that the charges had "no direct impact" on the company's operating performance.

Most stock analysts following the stock seemed to agree. Bank of America Securities' Douglas Shapiro, in a report following At Home's news release, didn't even mention the gigantic charge or net loss. "With the worst case already largely discounted into the stock, we retain our Buy rating and year-end 2001 $20 price target," Mr. Shapiro wrote on Jan. 26, 2001, when At Home

stock stood at $6.47.

At Dain Rauscher Wessels, senior analyst David Lee Smith also ignored the net loss in his commentary after At Home's earnings news release. He retained his buy rating, although he lowered his price target to $15 from $38. The company "has a long-term asset base and is appropriately valued for long-term investors," Mr. Smith wrote when the charge was announced.

But some investors voted with their feet. At Home's stock sank about 32% in the following two weeks. Even though At Home was writing down Bluemountain, it still had to pay for it. Faced with growing cash needs for interest payments and service upgrades, At Home filed for Chapter 11 bankruptcy protection in September. Its stock was last quoted at a penny.

Looking back, Mr. Smith says At Home's huge write-off was a "perfect example" of a charge overlooked by himself and other stock analysts that would have helped predict the company's future performance. "Probably too frequently we have given companies the benefit of the doubt without burrowing in and asking, `What does it say about the financial condition of the company?' " says Mr. Smith, whose firm is now called RBC Dain Rauscher Inc.

At Bank of America, Mr. Shapiro says he felt At Home's stock price already reflected how little value there was in its media businesses such as Bluemountain and the Excite Web portal. He felt cash flow from At Home's stronger business, a network for cable companies to deliver Internet access, would be sufficient -- and if it wasn't, he figured the cable companies would put up the cash to save At Home. "I was wrong about my assumptions about the fundamentals of At Home's business. But I don't think the implications of the charge itself were that significant," Mr. Shapiro says. At Home says that the actions it took "were in accordance with general accounting principles."

Companies frequently portray charges as part of a broader restructuring effort to restore profitability. But at Lucent Technologies Inc., they signaled a business plan that had failed and a management team that was struggling to find a remedy.

The telecom-equipment maker told investors in late 2000 it would drive out $1 billion of costs and take other unspecified charges over the coming months. On Jan. 24, 2001, with the stock at about $19, Lucent forecast that the charge would range from $1.2 billion to $1.6 billion. But in April, Lucent announced $2.7 billion in "one-time" charges for the just-ended quarter.

Its news release -- excluding the charges and adjusting for the spin-off of some businesses -- highlighted pro forma results, which showed the loss narrowing to $1.26 billion from $1.31 billion in the immediately preceding quarter. "Lucent delivered much improved performance in the quarter, despite continued softness in several key markets world-wide," said Chairman Henry Schacht.

Results as tabulated according to GAAP pointed to a different trend. Lucent's loss from continuing operations widened to $3.38 billion from $1.58 billion in the preceding quarter.

And the write-offs kept coming. In all, Lucent recorded $11.42 billion of "restructuring and one-time charges" in the fiscal year ended Sept. 30. Its stock, which was in the 80s two years ago and in the high teens when Lucent announced the first one-time charges, closed Friday at $6.18.

Were there clues in Lucent's early charges that might have foretold this future? Lucent's April announcement detailed an amalgam of write-offs and other expenses that showed weakness in many parts of the company's business.

A charge for layoffs, for instance, showed the company had deployed large numbers of employees in key divisions where it no longer expected profits.

A write-off for accounts receivable from a significant customer -- Winstar Communications Inc., which filed for Chapter 11 in April -- showed that some past sales had failed to bring in cash and that future sales growth could be hurt because the customer base had shrunk.

A write-off of goodwill revealed that some acquired assets wouldn't generate the expected profits. Inventory write-downs showed that previous sales projections were too high and future revenue was likely to slip.

"When you're making cuts that deep, it means the company has fundamental problems," says Mr. Turner of Colorado State. That should prompt investors to ask whether "this is the management team that's going to be able to get you back where you need to be," Mr. Turner says, and it also signals "that there's probably more to come." Indeed, had investors focused on explanations of the charges contained on page 16 of the quarterly report Lucent filed with regulators in May, they would have learned that the company anticipated taking additional restructuring charges during the year.

So why the news release's emphasis on the pro forma figure? "We highlighted it because it's the way many of our competitors provide their earnings," says Michelle Davidson, a Lucent spokeswoman, who notes that the GAAP earnings numbers were included in the release.

Asked whether the charges amounted to a warning of a deteriorating financial position, the company declines to comment.

Investors, says Ms. Davidson, should focus on Lucent's progress in delivering on its pledges of reduced capital spending and employment and increased working capital. The current management team has "dealt with the tough issues head-on, restructured in a tough market and built a solid track record in creating a plan and delivering on a plan," she says.

Sometimes, even what seems clearly to be a one-time charge can flag fundamental problems. Providian Financial Corp., a San Francisco-based credit-card issuer, reported profits soaring at a 37% compounded annual rate from the end of 1995 through 2000. Its stock more than quadrupled to $57.50.

But Providian's sales tactics came under attack. In mid-2000, Providian said it planned to settle with state and federal regulators over allegations of consumer fraud. Without admitting wrongdoing, it agreed to soften its practices by, among other things, extending late-payment grace periods and toning down telemarketing scripts. Providian recorded a $272.6 million "one-time" charge for the 2000 second quarter as a result of the settlement. It posted net income of $62.8 million.

Many stock analysts treated the charge as positive news. At CIBC World Markets, analyst Steven Eisman wrote on June 20, 2000, that "for the past year, legal issues concerning the company's sales tactics and back-office processes clouded the stock. By taking a provision for all potential future legal inquiries, we believe the financial risk associated with such legal inquiries is now behind them." Mr. Eisman has since left CIBC and says his new employer doesn't permit him to comment.

In contrast to stock analysts' optimism, bond analyst Kathleen Shanley at Gimme Credit, a New York research firm, saw a red flag. Her concern: "the potential impact of a change in marketing practices on previously sizzling revenue-growth rates."

Although Providian said it had already implemented its sales reforms by the time of the settlement, Ms. Shanley doubted their full impact was reflected in the earnings outlook. Besides worrying that Providian wouldn't have the same marketing tools to deploy in its push for customers, she thought the settlements exposed the degree to which growth had been based on loans to people with shaky credit.

Then, for the first quarter of 2001, Providian reported declining noninterest income and growing credit losses, due to rising bankruptcies and the slowing economy. Alan Elias, vice president of corporate communications, acknowledges that the settlement affected future revenue a little, by applying "some additional pressure in regards to marketing certain membership products."

Mr. Elias says there was nothing about the settlement that spoke to credit quality, even though Providian eventually had "higher-than-expected loss rates in our low-end portfolio." He adds: "To make a direct correlation that this is what is going to happen two years down the road [as a result of the settlement charge] is preposterous."

In any case, beset by rising consumer defaults and declining revenue, Providian issued a series of further profit warnings. On Oct. 18, it reported a 71% fall in third-quarter earnings, knocking the stock down 58% in a day. The stock closed Friday at $3.55, down 94% for the year.

Moving Target: What's the P/E Ratio? Well, Depends on What Is Meant by Earnings --- Terms Like `Operating,' `Core,' `Pro Forma' Catch Fire, Leave Investors Muddled --- `Earnings Before Bad Stuff'

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Few investors know it, but the U.S. stock market today is, by one way of looking at it, the most expensive it has ever been.

How could that be, after the numbing slide since the market peaked in early 2000? It turns out that for all the pain, the stock market now is far out of whack with historical norms by one common measure, the price-to-earnings ratio.

The P/E ratio measures how companies' share prices compare with their profits, showing how much value the market places on each dollar of a company's earnings. The lower the P/E, as a rough rule of thumb, the cheaper the stock. Though this guide to value has lots of exceptions, it remains a venerable market benchmark.

The Standard & Poor's 500-stock index of large companies, according to Thomson Financial/First Call, finished last week with an overall P/E ratio of 22.2. While that is well above the long-term historical average of 14.5, it strikes some pros as reasonable in view of factors such as low interest rates and chances for a profit comeback. For instance, Edward Kerschner, chief global market strategist at UBS Warburg, recently called stocks "undervalued on a P/E basis."

But there's a catch. In recent years, P/E ratios have become increasingly polluted. The "E" in P/E used to refer simply to earnings as reported under generally accepted accounting principles, or GAAP. That's what it means when the historical average is cited. But in First Call's figure, the "E" relates to something fuzzier, called "operating earnings." And that can mean just about whatever a company wants it to mean.

Based on earnings as reported under GAAP, the S&P 500 actually finished last week with a P/E ratio of 36.7, according to a Wall Street Journal analysis. That is higher than any other P/E previously recorded for the index.

This suggests the overall stock market could be further from recovery than many suppose. "I don't think most people realize that the market is as overvalued as it is," says David Blitzer, chief investment strategist at S&P, a unit of McGraw-Hill Cos. "There probably are a lot of people who would sell some stock if they realized how overvalued the numbers are saying the market is."

Why the huge disparity between the two figures given as the market P/E? The answer is that, increasingly, companies are steering investors away from their actual earnings and toward some other numbers. Most common is "operating earnings." Another name for that is "pro forma," or "as if," earnings. Some companies speak instead of their "economic earnings" or "core earnings" or "ongoing earnings."

Such earnings figures typically are higher than net income, because the companies label certain expenses as "special" or "one-time" or "exceptional" or "noncash" -- and leave them out of the calculation.

However, there are no official guidelines for what goes into operating or core or pro forma earnings and what can be left out. Operating earnings and the other terms aren't concepts under GAAP. Nor is there any standard definition for what companies call special or one-time items. The items they cite rarely meet the strict accounting test for "extraordinary items."

Typically, Wall Street analysts go along with the numbers emphasized by the companies they cover. From there, the rosier numbers tend to get repeated throughout the financial-news media, from cable TV to newsletters to Web sites.

More than 300 companies in the S&P 500 now exclude some ordinary expenses, as defined by GAAP, from the operating-earnings numbers they feed to investors and analysts, a Wall Street Journal analysis shows.

In fact, for every dollar of operating earnings S&P 500 companies reported for their most recent three-month periods, 60 cents wouldn't be there if they hadn't excluded costs that are ordinary business expenses under GAAP, according to the Journal's comparison of First Call data with corporate SEC filings and news releases.

The resulting confusion can skew perceptions of value for even relatively sophisticated investors. Novices often are left bewildered.

Take Computer Sciences Corp. The technology consulting company this year has announced a series of charges, covering costs ranging from severance payments to write-offs of software. They totaled $156 million, cutting Computer Sciences' net

income for the past four quarters to $184.9 million, or $1.08 a share.

But check its earnings in analysts' research reports and many financial databases, and things don't look nearly so bad. Computer Sciences steered Wall Street analysts to ignore the big expenses, which it dubbed "special items." Looked at in this more favorable way, the company over the past year had operating earnings of $340.9 million, or $2 a share. That would give the stock, which closed yesterday at $38.30 a share, a P/E of about 19, making it seem a reasonable value.

And if the special items are included in the earnings? The shares suddenly appear far pricier, with a P/E ratio of about 35.

Sometimes, the results are nothing short of surreal. JDS Uniphase Corp. last month announced that for the fiscal year ended June 30, it had pro forma earnings of $67.4 million. Yet the fiber-optic company actually had a stunning $50.6 billion full-year net loss.

JDS's pro forma earnings excluded 98% of the company's $52 billion of operating expenses. These were mainly write-offs of assets JDS bought for inflated prices during the tech bubble. In explaining its pro forma results, JDS said the charges for those acquired assets "in no way impaired our financial health or strength" because it had bought them with stock instead of cash.

Wall Street analysts almost without exception went along with the company line. The JDS effect is so large that if the company were excluded from the index, the S&P 500's P/E ratio based on GAAP earnings would be more than five points lower, at 31.2, the Journal's analysis shows.

"A lot of companies take their numbers and present them in the best light possible," notes Don Bunnell of West Chester, Ohio, a retired General Electric Co. manager and an active investor. "Most of the analysts can see through this. But most of us lay people can't."

Although companies have long sought to present their results in the best light, the operating-earnings focus has grown so widespread that some market pros fret that Wall Street analysts' earnings measures have lost much of their meaning. "The only thing the consensus agrees on is arbitrary accounting methodologies," says Tom Galvin, chief investment officer at Credit Suisse First Boston,

Companies that stress operating or pro forma earnings say they aren't trying to mislead anyone -- just trying to help people understand their ongoing businesses by breaking out items they consider unusual or unimportant. And while those items are usually expenses, companies occasionally also break out certain "one-time" gains from their financial results. Companies also note that investors are free to look at whatever numbers they want and can ignore any nontraditional financial presentation they deem irrelevant.

Historically, pro forma financial statements were used to allow for comparisons of financial results when some extraordinary event, such as a merger, had occurred between the reporting periods. By trying to analyze the performance of two merging companies as if they had been operating together for years, analysts sought to assess future earnings power. With the same goal, they would sometimes exclude expenses or gains they deemed to be nonrecurring.

Over the past decade or so, some industries began designing their own alternative profitability measures. Radio-station operators had "broadcast cash flow." Real-estate investment trusts had "funds from operations."

The practices didn't get out of hand, though, until the start of the Internet boom.

Three years ago, for instance, Amazon.com Inc.'s sales were growing at breathtaking rates, but its net losses remained a red flag for some investors. In the second quarter of 1998, Amazon began using new pro forma profitability standards for itself. It was in the red even by those forgiving measures, but the shift made Amazon shares, then trading at 21 times trailing revenue, seem more palatable to investors.

Amazon, which had been buying other companies with its high-priced stock, explained that its quarterly expenses to write down acquired intangible assets -- so-called goodwill -- were so large that they created too much accounting noise for investors to follow.

(See related letter: "Letters to the Editor: Accountability" -- WSJ August 22, 2001)

At First Call, a unit of Toronto-based Thomson Corp., research director Chuck Hill says he first noticed the pro forma trend when Yahoo Inc. began highlighting its own pro forma measures in its financial news release for the fourth quarter of 1998. After that, he says, the floodgates opened. "Once some of these companies realized that people were accepting that, they said, `Let's push the envelope a little further,'" Mr. Hill says. "It just became an easy way to slide stuff under the rug."

Soon, hundreds of tech companies were excluding other types of regular expenses, such as stock-based compensation and even some payroll taxes, which must be included in net income under GAAP. Many Old Economy companies saw analysts

embrace the pro forma numbers and began expanding the boundaries of "special" and "one-time" charges. Today, the practices can be found in companies in nearly every industry.

According to First Call, Honeywell International Inc.'s operating earnings were $2.52 a share during its most recent four quarters, for a "trailing" P/E ratio of 15. That excludes a bevy of charges, such as losses on various customer contracts and expenses from its aborted merger with GE. Honeywell's net income actually was 77 cents a share, producing a far higher P/E of 49.

Office-supplies retailer Staples Inc.'s P/E is 27 based on operating earnings, but 132 based on its net income, which has been dragged down by write-downs of Internet investments.

Corning Inc. trades for 11 times operating earnings. But factor in the fiber company's $4.8 billion of charges last quarter to write off overvalued intangible assets, and Corning has no P/E at all because it has no earnings.

In all of these cases, the more eye-pleasing profit and P/E numbers became the most widely cited ones as the companies trumpeted them in their news releases and conference calls, while downplaying their actual results. Securities analysts, who often are reluctant to pick fights with the companies they cover, simply pass on the same spin to investors. And it's up to investors to evaluate for themselves the earnings and the resulting price-earnings ratios.

To be sure, P/Es are far from a foolproof guide to value. For one thing, stocks in mature, low-growth industries habitually have low P/Es, so that a single-digit P/E on, say, a mining company doesn't necessarily mean it's a bargain. Also, a stock can sport an attractive-looking P/E because of strong earnings over earlier quarters, although its business is about to fall off a cliff.

More confusing still, a company emerging from a loss-ridden period and producing tiny profits may show a very high P/E -- just when its prospects are improving. And in the market as a whole, when corporate profits are poised to rebound after a tough period, stocks could carry relatively high P/E multiples, but this wouldn't necessarily mean it was a poor time to buy.

Once companies' earnings numbers are crunched by analysts, they enter a vast information food chain, where they are repeated, often without explanation, in hundreds of news outlets, including wire services, newspapers, investment newsletters, cable-news channels and financial Web sites. Using a fax service that's free to journalists, but operated by a third-party contractor, First Call distributes lengthy summaries of companies' historical and projected results, not all of which explain the basis for analysts' calculations.

On Yahoo Finance, a free service that's the most heavily used financial Web site, First Call's operating earnings statistics -- including those for Yahoo itself -- are displayed as actual results with no further explanation. A Yahoo spokesman says Yahoo Finance "is currently working to provide better labeling as to whether that information is pro forma or GAAP."

Michael Ching, a telecom-equipment analyst at Merrill Lynch & Co., defends his role in the chain. When Cisco Systems Inc. took a $2.25 billion inventory write-down this spring, Mr. Ching, like virtually every other analyst covering the router maker, abided by the company's wishes and excluded the charge from Cisco's pro forma earnings. Analysts and investors need "a clean number" to look at, Mr. Ching says, adding: "We exclude these one-time elements because they are not predictive about future earnings."

The problem, say accounting specialists, is that the clean numbers may be whitewashed versions of reality. That's because the excluded charges can signal that past profits were overstated. For instance, when companies take big charges to write off assets, this often means they weren't depreciating those assets quickly enough in previous years. And when companies write off bad loans they had made to customers to finance purchases, it can mean the previously recorded sales and profits generated by those loans existed only on paper.

"It's scary," says Douglas Carmichael, an accounting professor at Baruch College in New York. "Since there's no uniformity as to what goes into pro forma earnings, there's no comparability. It's just an undisciplined number that's at the heart of the calculation."

Accounting rules treat layoff-related expenses as a normal part of the business cycle. Analysts who cover Morgan Stanley and Merrill Lynch followed those companies' leads and included their layoff expenses in operating earnings. But analysts who cover Citigroup Inc., Progressive Corp. and Dow Jones & Co., publisher of The Wall Street Journal, excluded their layoff expenses.

Computer Sciences itself has flip-flopped on the issue. It has had many rounds of layoffs over the years. But last fiscal year marked the first time the company classified employee-severance expenses as special charges rather than ordinary expenses. A spokesman says it treated them as special charges because they were made as "part of a global review" of its businesses and because they were so big.

In telecommunications, analysts covering Nortel Networks Corp. submitted earnings estimates to First Call that included the company's second-quarter inventory write-downs. Analysts covering Cisco and JDS Uniphase, however, excluded those companies' inventory charges.

In the financial-services sector, analysts included large investment losses at American Express Co., for example, but excluded them at Wells Fargo & Co.

First Call's Mr. Hill is a longtime critic of aggressive pro forma accounting. But he explains that First Call's mission is to gather and publish consensus earnings targets whose accounting reflects the accepted view of the overall investment community. Whatever accounting method a majority of the analysts covering a stock want to use for their earnings estimates, First Call will use. "Certainly over time, I'd rather listen to the collective wisdom of these analysts than I would some anointed earnings pope," Mr. Hill says. Besides, "they're the only ones that'll give them to us."

To critics such as Mr. Carmichael, analysts employed by Wall Street securities brokerage firms provide anything but an accurate reflection of the broader investment community, given their well-chronicled bullishness and frequently conflicting investment-banking interests. "You're getting a view through rose-colored glasses," he says.

At the Financial Accounting Standards Board, which sets GAAP, Chairman Edmund Jenkins says he would like to see First Call collect GAAP-based earnings estimates for all the companies it follows. Mr. Hill says that would be nice, but that he would "be shocked if you had any meaningful numbers of contributors."

Securities and Exchange Commission officials also have warned investors not to get suckered by "earnings before bad stuff" news releases. But the SEC says it has little if any authority to clamp down on pro forma calculations in news releases, as long as they are mathematically accurate.

At the same time that pro forma accounting is growing, so is the start of a backlash. One example: Last month analysts who follow real-estate investment trusts for Merrill Lynch, Morgan Stanley and Citigroup's Salomon Smith Barney unit announced they would start focusing more on GAAP and less on those industries' established pro forma metrics.

Many individual investors welcome these small moves. "They shouldn't be afraid to give us a little bad news," says Janice Stonestreet of Overland Park, Kan., who manages her family's portfolio of about 40 stocks with her husband, a retired insurance executive. "I just prefer the facts -- just plain and simple accurate facts."

(See related letter: "Letters to the Editor: Forget the P/E -- Look At the Free Cash Flows" -- WSJ August 28, 2001)

How the P/E Ratios Are Figured

To calculate the price-to-earnings ratio for the Standard & Poor's 500-stock index, The Wall Street Journal divided the combined market capitalization of the 500 companies currently in the index by their most recently reported four quarters of earnings. These earnings exclude only items classified under generally accepted accounting principles as extraordinary items, discontinued operations or cumulative effects of changes in accounting principles.

This methodology differs slightly from the one used by S&P, which updates earnings statistics for the index just once a quarter. S&P doesn't revise earnings from previously reported quarters to account for additions or deletions to the index. And it historically hasn't revised previously reported earnings to account for companies' financial restatements.

The Journal's calculations show a trailing P/E of 36.7 as of Friday. S&P may report a somewhat lower P/E ratio when it releases its second-quarter earnings tally, depending on how it handles JDS Uniphase. JDS has announced a $50.6 billion loss for its fiscal year ended June 30. But JDS said it would restate results for the March 31 quarter so that most of the loss appears in that quarter, not in the June quarter. S&P has been considering revising its first-quarter earnings figures to reflect JDS's restated losses, but hasn't announced a decision.

The Journal used data from Multex.com Inc. as well as companies' news releases and filings with the Securities and Exchange Commission. The P/E ratios in the Journal's daily stock-price tables are calculated using trailing earnings, excluding extraordinary items, accounting changes and discontinued operations.

Word Games for the Numbers Game

Here's a quick glossary of accounting terms, both official and unofficial, that companies are commonly using these days to describe

their earnings -- or lack thereof.

Operating earnings: This is another name for `pro forma' earnings, in which companies present their financial results `as if' certain ordinary items (usually expenses) didn't exist. Also sometimes called `core income,' `economic earnings,' `ongoing earnings' or `earnings excluding special items.' None of these terms have any particular meaning under GAAP.
Operating income: Sounds like operating earnings, but has a strict definition under GAAP: Revenue less cost of goods sold and related operating expenses stemming from a company's normal business activities. It excludes, for example, interest income and expenses, dividend income, taxes and extraordinary items.
Income from continuing operations: Also sounds like operating earnings, but this, like operating income, has a real meaning under GAAP. It's revenues and expenses stemming from a company's ongoing operations, after taxes. It includes interest income and expenses and other nonoperating gains and losses. It excludes only three things: discontinued operations, cumulative effects of changes in accounting principles, and extraordinary items.
Extraordinary items: This is a real term under GAAP, meaning items that are both unusual in nature and infrequent in occurrence, such as earthquake-related losses in an area where quakes are rare. Extraordinary items count when calculating net income, though not when calculating `income from continuing operations.'
Special charges: A term companies use for expenses that are ordinary costs of doing business, but that companies want investors to exclude when valuing their stocks. Also sometimes called `one-time,' `unusual' or `exceptional' charges. These terms have no standard definition under GAAP and the items don't meet the GAAP test of an extraordinary item.
Cash flow: A GAAP term meaning cash receipts minus cash disbursements for a given reporting period. It's separated into three categories on a financial statement: cash flow from operating activities, cash flow from financing activities and cash flow from investing activities.
Ebitda: Earnings before interest, taxes, depreciation and amortization. Most companies stick to this definition. But some use the term to refer to earnings figures that exclude not only these expenses, but others as well, such as start-up costs for new ventures and other cash charges. Though often described as cash flow, Ebitda isn't the same. For starters, it doesn't necessarily reflect changes in companies' liquidity.

(See related letter: "Letters to the Editor: Let's Speak the Same Business Language" -- WSJ Sept. 11, 2001)

Disappearing Act: Spate of Write-Offs Calls into Question Lofty 1990s Profits --- Use of Pro Forma Results Offers a Glossier Present And Much Cloudier Past --- How Goodwill Can Go Bad

By Steve Liesman and Jonathan Weil
Staff Reporters of The Wall Street Journal

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Corrections & Amplifications

THE STANDARD & POOR'S 500-STOCK INDEX registered compounded annual growth of 23.3% from 1995 through June 2000, during which time earnings grew at a 10% annual rate. A page-one article Friday about corporate write-offs incorrectly said the time period for those rates was from 1995 through 2000. (WSJ July 16, 2001)

Was the corporate-profits miracle of the late 1990s partially a mirage?

Along with tame inflation and low unemployment, outsize corporate-profit growth stood as one of the pillars of the booming economy and underpinned the stock market's historic bull run. From 1995 through 2000, the Standard and Poor's 500-stock index registered compounded annual growth of 23.3% as earnings grew at a 10% annual rate -- far above the 6.6% pace for the S&P from 1948 through 1994.

In recent months, though, many big companies -- including AT&T Corp., Cisco Systems Inc., Lucent Technologies Inc., Nortel Networks Inc., Walt Disney Co. and Wells Fargo Inc. -- have announced whopping write-offs and charges to earnings. They have slashed the value on their books of everything from investment portfolios and customer loans to inventory and the carrying value of acquisitions.

Since the economy began to slide in the fourth quarter, S&P companies have announced write-offs and other "special" charges of about $50 billion, according to data provided by Multex.com Inc., a financial-research company. That total for the six months ended March 31 is the highest dollar amount by far for any recorded six-month period and the second-highest as a percentage of pretax income since 1992. And the trend is expected to continue as companies release their second-quarter earnings in coming days and weeks.

The sheer size of these write-offs has ignited a debate among economists and Wall Street analysts about whether there is a connection between today's big write-offs and yesterday's massive profits. The question is whether some of the outsize profits rested on shaky business and accounting practices that are now in effect being restated by big charges.

For example, when a company writes off a multimillion-dollar loan that it made to finance sales to a start-up customer, some investors view that as a one-time reduction of the most recent quarter's earnings that can be shrugged off. Others see such a charge as a tacit admission that profits in prior quarters -- when the sales and earnings generated by those loans were recorded -- weren't as large as the books show.

As Wayne Shaw, an accounting professor at Southern Methodist University in Dallas sees it, "What you ought to be thinking when you see a write-down today is that the profits in the past have probably been overstated."

That's not to say that companies announcing large charges today were recording past profits in violation of generally accepted accounting principles, or GAAP. And not all of the recent charges reflect management missteps. Some of the biggest write-offs -- such as those related to layoffs and the restructuring of divisions -- appear to stem directly from the sharp economic decline that began in the fourth quarter of 2000, which many executives say couldn't be foreseen. Indeed, write-offs typically accelerate during economic downturns, especially in times of rapid technological advances. "A lot of these write-offs just reflect the new reality of the time," says Neil Soss, an economist at Credit Suisse First Boston.

Still, the idea that prior profits have been overstated helps economists explain what to them was one of the mysteries of the late 1990s. Generally, corporate profits have grown in line with the economy. For the past five years, however, S&P 500 profits have expanded about twice as fast as the economy's total economic output.

But those S&P profit figures, which are the ones Wall Street mainly cares about, don't include the recent spate of unusual charges. Exclude the write-offs, as many analysts do, and pretax earnings for the current group of S&P 500 companies during the five-year period ended March 31 grew at a compounded annual rate of 9%. Restore the unusual charges as normal expenses, and the rate falls to 7.6%. That's closer to the recent compounded annual growth rate of the economy as a whole over the period -- about 6%, including inflation.

The government's corporate-profits measure, a far broader gauge that accounts for these unusual items and includes both closely held and publicly owned companies, shows much more modest compounded annual earnings growth of just 4.4% over

the past five years.

It's easy to see how the spate of charges can create confusion among investors trying to figure out which numbers to follow. If today's charges do, in effect, eliminate past profits, a simple calculation such as a price-to-earnings ratio can become a complex exercise because it's difficult to gauge how much companies really earned.

In response, officials at the Securities and Exchange Commission recently have criticized the growing practice by many companies of issuing news releases that highlight earnings excluding these unusual charges, called "pro forma" earnings, while playing down their GAAP earnings. The commission has opened investigations into a few companies, which it declines to name, over whether their pro forma results have been misleading.

David Kotok, an economist and chief investment officer at Cumberland Advisors Inc., discounts the pro forma results in company news releases along with S&P 500 profit totals. Given all the distortions in individual companies' data from write-offs, "I don't think the small picture is a winning game," he says. Instead, Mr. Kotok relies on the government's statistics for the best assessment of corporate profitability.

In some ways, the willingness of so many other analysts and investors to disregard today's charges is a sign of the times. Wall Street has placed revenue and earnings growth on a pedestal. What has emerged is a culture in which many investors reward companies for big write-offs, viewing the charges as bad news that executives have pushed out of the way to make room for high future growth rates.

Here's a field guide to five types of write-offs currently coloring earnings reports:

Extending credit to customers is a practice as old as commerce itself. But analysts say it became far more widespread during the 1990s technology boom. In some cases, companies abandoned prudent risk-management practices and financed purchases by customers with poor credit to meet Wall Street's short-term earnings and revenue demands. In cases where customers have defaulted on those loans and companies have written them off, the question arises: Did the charges negate yesterday's profits?

Gateway Inc. executives became so eager to move computers last year that they decided to provide credit to high-risk customers that Gateway's outside financing company had shunned. The result: Gateway found itself awash in bad loans. To write off the loans, the company in the first quarter took a $100 million "special charge" on top of a $75 million operating loss associated with the consumer loans.

Gateway spokeswoman Donna Kather, confirming the high-risk lending, says Gateway has changed its policy and will refer the high-risk loans "to our lending partners."

In the early 1990s, Qualcomm Corp. thought GlobalStar Telecommunications Ltd. was engaged in a risky but promising endeavor with its effort to erect a world-wide satellite-telephone network. Qualcomm took a stake in the venture, holding as much as 6.5% of the company's equity.

From fiscal years 1995 to 2000, GlobalStar in any given year accounted for 7% to 19% of Qualcomm's annual revenue. Qualcomm, however, received cash for only about half of its GlobalStar sales. Qualcomm financed the rest, according to its SEC filings, and booked the revenue from the loan-generated sales -- about $667 million from 1995 through 2000.

As sales throughout its businesses took off, Qualcomm's stock soared. The San Diego-based telecommunications company's shares rose more than 27-fold in 1999, the best performance by any stock that year. For the fiscal year that ended in September 2000, its profits nearly tripled to $670 million. That capped a remarkable five-year run, during which Qualcomm's net income grew by a compounded annual rate of 67%.

Or did it? GlobalStar failed to attract many customers, and in January it defaulted on its Qualcomm loans. That prompted Qualcomm to take a $595 million write-off for the loans for its fiscal first quarter ended Dec. 31, in effect saying that some or all of the sales made possible by those loans never generated any cash and that the profit associated with those sales existed on paper only.

Qualcomm still beat the analysts' consensus earnings estimate by a penny a share, reporting pro forma earnings of 28 cents a share for its fiscal first quarter ended Dec. 31. How? It excluded the GlobalStar loan losses, among other expenses, from its pro forma results, despite having included the profits generated by those loans in earlier quarters' pro forma results.

Qualcomm's treasurer, Dick Grannis, says the exclusion of the GlobalStar losses from the pro forma figures is sensible because "GlobalStar is not really relevant anymore to our ongoing business. The purpose of pro forma results is to show investors the ongoing recurring operating results of the company." Mr. Grannis adds that the company used generally accepted accounting principles in deciding to record the GlobalStar revenue, and disclosed the loans' risks to investors in its SEC filings.

It's impossible to know precisely how much money Qualcomm has made since the mid-1990s without a formal earnings restatement, which Qualcomm says is unnecessary under GAAP. But since the beginning of 1996, on a pro forma basis excluding unusual charges, Qualcomm reported pretax income of $2.02 billion, according to Multex. Including all unusual charges, its pretax income was $1.44 billion over the same period, making it nearly 30% less profitable.

Lynn Turner, the SEC's chief accountant, says the recent spate of write-offs of vendor-financed receivables raises troubling questions, though he declines to comment on specific companies. "I get very concerned when the accounting rules turn out an answer that just doesn't reflect the economics," Mr. Turner says.

Many companies during the bull market threw gobs of money at start-up firms. When times were good, they booked the resulting paper investment gains as part of their ordinary income. But when those investments headed south, they suddenly found themselves saddled with huge "special" losses.

Wells Fargo, the San Francisco-based financial-services giant, announced on June 6 that it will take $1.05 billion in "special charges" this quarter to account for declines in the value of its portfolio of venture-capital investments. On a pretax basis, Wells Fargo says the charges will total about $1.7 billion.

To put that in perspective, according to estimates by Prudential Securities analyst Michael Mayo, Wells Fargo's pretax earnings for 1999 and 2000 got a combined $1.12 billion boost as a result of increases in the value of its venture-capital portfolio. That accounted for about 9% of the company's pretax income during those two years. However, when the value of those investment holdings was on the rise during 1999 and 2000, the company didn't characterize as "special gains" the resulting noncash, unrealized gains that flowed through its income statement.

"If you take back some of the venture-capital gains from the past two years, then the firm didn't really make their numbers," Mr. Mayo says.

While Wells Fargo doesn't disclose how much of its past earnings were boosted by unrealized venture-capital gains, the company's chief financial officer, Ross Kari, says Mr. Mayo's estimates are "in the ballpark." He notes that Wells Fargo over the past two years had cautioned investors that there could be wide fluctuations in the value of its venture-capital portfolio. As for the company's use of the word "special" to depict the charges, Mr. Kari says: "We tried to use language to indicate that these were certainly not of a recurring nature."

The debate over whether past profits have been overstated isn't limited to lending practices or investment losses. Some questions also focus on whether earnings were higher because past expenses were understated. One example has been the latest rash of inventory charges in the telecom-equipment industry, where demand has fallen precipitously during the past year, and the glut of equipment has become huge.

Technology bellwether Cisco this spring took a $2.25 billion pretax inventory charge, which the company told investors to exclude from its pro forma earnings. Critics wondered why all of Cisco's write-downs ended up in a single quarter, when the problem appeared to have surfaced as far back as mid-2000.

The company, based in San Jose, Calif., responded that it built up inventories last year to resolve a parts shortage that was hobbling sales, agreeing to buy parts as much as six months in advance. Those parts arrived just as sales unexpectedly slowed, the company said. In addition to what it had in its storehouses, Cisco remained under contract to buy other supplies that had yet to arrive.

Robert Bayless, chief accountant for the SEC's division of corporation finance, says he doesn't understand why investors would accept companies' explanations that inventory charges should be excluded from their pro forma earnings calculations, though he declines to discuss specific companies. "If the way that I was able to generate good sales was by making sure my customer didn't have to wait and also had the full choice of items, then these write-downs are the cost of that policy," he says.

Inventory charges highlight another complication for investors from write-offs: They have the potential to gussy up future earnings. By writing down the value of parts now, companies can sell them at zero or little cost later. Cisco itself acknowledges this dilemma, promising to break out revenue from the written-down inventory in future quarters.

"If I have to take a write-off, I'm going to take a big bath, load the decks, and get rid of everything so that, by definition, future earnings will be higher," SMU's Mr. Shaw says.

Questions about charges related to goodwill assets figure prominently in the debate about whether past profits were overstated. Goodwill represents the premium a company pays to acquire another business. According to current GAAP, companies have been able to write down their goodwill assets over periods as long as 40 years. But when the value of that goodwill becomes impaired, companies must write off the impaired amount all at once.

That's what Safeco Corp. did earlier this year. The Seattle financial-services company took a $1.2 billion pretax, goodwill-

impairment charge during the first quarter, calling it a "one-time write-off" in its earnings release. Safeco originally planned to take 30 years to write down the goodwill, which resulted from the company's $3.1 billion all-cash acquisition of property-casualty insurer American States Financial Corp. in October 1997. As it turned out, Safeco's amortization period proved to be more than 26 years too long.

To be sure, picking the correct number of years to write down an asset is largely a guessing game because companies can never be sure if an acquisition will be successful. Unexpected events, such as the stock market's recent decline, can drastically reduce the market value of an acquired asset, forcing a write-down. Paul Lowber, vice president and controller for Safeco, says the company simply followed signals put out by the stock market when it wrote off the American States goodwill. Prior to the charge, the market had been valuing Safeco stock at less than its book value, or assets minus liabilities.

Still, accounting specialists say that goodwill charges amount to acknowledgments by companies that they either overpaid for acquisitions or weren't writing them down quickly enough. "Had the goodwill originally been assigned a proper useful life, the annual charges would have been greater and net income would have been correspondingly lower," says Robert Willens, an accounting analyst at Lehman Brothers.

If Safeco had started out using a four-year amortization period, it would have recognized $300 million a year in amortization expenses, instead of $40 million a year. In fact, the $1.2 billion write-off exceeded the $1.06 billion in pretax earnings that Safeco had reported since the acquisition.

Mr. Lowber doesn't dispute that Safeco overpaid for American States, calling the goodwill charge "a bit of a reality check." But he doesn't believe Safeco made a bad acquisition and disagrees with the notion that prior profits were inflated. "I think that what most shareholders are going to be looking at is . . . our ongoing earnings capacity," Mr. Lowber says. The charge is "an unusual thing and doesn't happen regularly."

There's a flip side to the profits miracle. Many start-up companies during the tech bubble reported famously large losses. Could it be that today's charges suggest those losses actually may have been understated?

Last year, for instance, Amazon.com Inc. recorded $79 million in revenue from dot-com customers that used their own high-priced stock, rather than cash, to pay the Seattle online retailer for various services. Those customers included such dot-com disasters as Internet furniture site Living.com Inc., which shut its doors and filed for Chapter 7 bankruptcy protection in August 2000, six months after Amazon announced the pact.

After the dot-com bubble burst, Amazon last year took charges to write off most of the value of the stock that it was paid, including $14 million for its Living.com holdings. In news releases, Amazon described the losses as noncash items that should be excluded from the company's results. Some investment professionals have accused Amazon of being hypocritical because the company's pro forma results exclude a bevy of noncash expenses but not noncash revenues. For 2000, Amazon reported a net loss of $1.41 billion on revenue of $2.76 billion. But Amazon's "pro forma operating losses" -- the measure by which the company tells investors and analysts it should be judged -- totaled $317 million last year.

"There were good business reasons for those deals at the time," Amazon spokesman Bill Curry says of the stock-based deals. "Did some of them prove to be mistakes? Obviously."

Heard on the Street
Nasdaq Companies' Losses Erase 5 Years of Profit
By Steve Liesman
Staff Reporter of The Wall Street Journal

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Mounting losses have wiped out all the corporate profits from the technology-stock boom of the late 1990s, which could make the road back to the previous level of profitability longer and harder than previously estimated.

The massive losses reported over the most recent four quarters by companies listed on the Nasdaq Stock Market have erased five years' worth of profits, according to figures from investment-research company Multex.com that were analyzed by The Wall Street Journal.

Put another way, the companies currently listed on the market that symbolized the New Economy haven't made a collective dime since the fall of 1995, when Intel introduced the 200-megahertz computer chip, Bill Clinton was in his first term in office and the O.J. Simpson trial obsessed the nation. "What it means is that with the benefit of hindsight, the late '90s never happened," says Robert Barbera, chief economist at Hoenig & Co.

The Wall Street Journal analysis looked at earnings excluding extraordinary items going back to September 1995 for about 4,200 companies listed on Nasdaq, which is heavily weighted toward technology stocks but also includes hundreds of financial and other growth companies. For the most recently reported four quarters, those companies tallied $148.3 billion in losses. That roughly equaled the $145.3 billion in profit before extraordinary items these companies have reported since September 1995. Because companies have different quarter-ending dates, the analysis doesn't entirely correspond to calendar quarters.

Large charges that aren't considered extraordinary items were responsible for much of the red ink, including restructuring expenses and huge write-downs of inventories and assets acquired at high prices during the technology bubble.

Analysts, economists and accountants say these losses raise significant doubts about both the quality of past reported earnings and the potential future profit growth for these companies. Ed Yardeni, chief investment strategist at Deutsche Banc Alex. Brown, said the losses raise the question of "whether the Nasdaq is still too expensive. These companies aren't going to give us the kind of awesome performance they did in the '90s, because lot of it wasn't really sustainable."

The Nasdaq Composite Index stood at around 1043 in September 1995, soared to 5048.62 in March 2000 and now stands at 1918.89. Because companies in the Nasdaq Composite Index now have a cumulative loss, for the first time in memory the Nasdaq's value can't be gauged using the popular price-earnings ratio, which divides the price of stocks by their earnings. That means it is impossible to say whether the market is cheap or expensive in historical terms.

The extent of the losses surprised a senior Nasdaq official, who asked not to be named. "I wouldn't have thought they were that high," he said.

Nasdaq spokesman Andrew MacMillan, while not disputing the losses, pointed to the $1.5 trillion in revenue Nasdaq companies generated over the past year, saying that represented "a huge contribution to the economy, to productivity, and to people's lives . . . regardless of what's happening to the bottom line during a rough business cycle."

Satya Pradhuman, director of small-capitalization research at Merrill Lynch, says the recent massive losses tell a story of a market where investors became focused on revenue instead of earnings. With billions of dollars in financing chasing every glimmer of an Internet idea, Mr. Pradhuman says, a lot of companies came to market long before they were ready.

"The underwriting was very aggressive, so earlier-stage companies came to market than the kind of companies that came to market five or 10 years ago," he adds. He believes there is plenty of potential profitability out there in this crop of young companies. But, he notes, "only among those that survive."

The data show that the very companies whose technology products were supposed to boost productivity and help smooth out the business cycle by providing better information have been among the hardest-hit in this economic slowdown. "Management got caught up with how smart they were and completely forgot about the business cycle and competition," says Mr. Yardeni. "They were managed for only ongoing success."

To be sure, some of Nasdaq's largest star-powered companies earned substantial sums over the period. Intel led the pack with $37.6 billion in profit before extraordinary items since September 1995, followed closely by Microsoft's $34.6 billion in earnings. Together, the 20 most profitable companies earned $153.3 billion, compared with losses of $140.9 billion for the 20 least profitable. Included in the losses was a $44.8 billion write-down of acquisitions by JDS Uniphase and an $11.2 billion

charge by VeriSign, also to reduce the value on its book of companies it had bought with its high-price stock.

These charges lead some analysts and economists to believe that including these losses overstates the magnitude of the decline. According to generally accepted accounting principles, these write-offs are treated as regular expenses. But corporate executives say they should be treated as one-time items. "It's an accounting entry rather than a true loss," maintains Bill Dudley, chief U.S. economist at Goldman Sachs Group.

Removing these unusual charges, the losses over the most recently reported four quarters shrink to $6.5 billion on a before-tax basis. By writing down the value of assets, companies have used the slowdown to clean up their balance sheets, a move that should allow them to move forward with a smaller expense base and could pump up future earnings.

"It sets the table for future dramatic growth," says independent accounting analyst Jack Ciesielski. Because of the write-downs, "when the natural cycle begins again, the returns on assets and returns on equity will look fantastic." But Mr. Ciesielski adds that this benefit will be short-lived.

Cisco Systems in the first quarter took a $2.25 billion pretax inventory charge. This quarter, it partly reversed that write-down, taking a gain of $187 million from the revaluation of the previously written-down inventory. The reversal pushed Cisco into the black.

But Mr. Barbera warns that investors shouldn't be so quick to ignore the unusual charges. For example, during good times it wasn't unusual for companies to book large gains from investments in other companies. Now that the value of those investments are under water, companies are calling the losses unusual. "If they are going to exclude the unusual losses, then they should exclude the unusual gains," says Mr. Barbera.

(See related letter: "Letters to the Editor: Unreliable Accounting" -- WSJ August 21, 2001)

Economy

Two Profit Calculations for S&P 500 Differ --- `Special Items' Are Key to Gap Between First Call, S&P Figures

By Steve Liesman and Jonathan Weil
Staff Reporters of The Wall Street Journal

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Will the real earnings decline please stand up?

In a sign of how confusing earnings calculations have become, two well-known financial-services companies are reporting widely different second-quarter corporate-profit declines for the Standard & Poor's 500-stock index of large companies.

S&P, the unit of McGraw-Hill Cos. that compiles the index, says that so-called operating earnings have fallen 32.9%, to $9.99 a share, compared with one year ago. But Thomson Financial/First Call puts the decline at just 17%, to $11.81 share. Both figures are preliminary as both First Call and S&P continue to adjust them throughout this quarter.

The gap is the widest it has been in at least the past 10 years. A small part of the disparity results from the use by each service of a slightly different set of companies in the second quarter this year and last, which, among other things, resulted in differing baseline numbers. But the biggest part of the gap reflects a growing disagreement between First Call and S&P over the expenses companies should be allowed to exclude and have treated as "special items" in their so-called operating-earnings figure.

Over the past several quarters, S&P has taken a tougher line than First Call, refusing to exclude expenses that it considers part of normal operations. But First Call says it follows the lead of Wall Street analysts, backing out the same expenses they do.

For example, First Call puts the earnings for Loews Corp. at $1.14 a share, excluding most of the losses that the company and analysts treated as "one time." S&P treated those expenses as ordinary costs of business and recorded a loss for Loews in the second quarter of $7.18 a share.

For investors, the disparity adds to the growing problems of how to gauge the market's value at a time when more and more companies are presenting glossy earnings that exclude expenses that they call special, unusual or one-time. These include charges for restructuring and layoffs, and write-downs in asset values.

The gap is significant because "investors need to assess what they are benchmarking against and need to gauge how their portfolio is performing," said Karina Mayer, managing director at International Strategy & Investment Group Inc., a New York economic-research firm.

Operating earnings differ from operating income and net income, which have strict definitions under generally accepted accounting principles. Virtually all of the expenses that companies call "special" are treated as regular charges under GAAP and can't be excluded. Despite its fuzziness, operating earnings is the profitability figure most widely watched by Wall Street analysts and many investors. When a company announces earnings that meet or beat "the Street" -- a significant factor that often moves a stock -- it does so based on the difference between estimated and reported operating earnings.

But the gap between operating earnings and earnings calculated according to GAAP standards has widened in the past several years as companies have taken to excluding a broad array of ordinary expenses in their earnings releases in an apparent attempt to meet Wall Street expectations.

And now, the gap between the two different operating-earnings figures is growing as well, creating confusion over the market's value. Based on the previous four quarters' operating-earnings estimates, S&P figures yield a price-to-earnings ratio of 24.2 for the S&P 500. The First Call numbers yield a P/E of 22.2. Based on earnings as reported under GAAP, excluding a very limited range of expenses known as "extraordinary items," the S&P 500 finished Wednesday with a P/E ratio of 36.8, the highest ever recorded for the index, according to a Wall Street Journal analysis.

In the staid world of data gathering, the gap has led to some strong words from both sides over how they calculate their figures. In an interview, Chuck Hill, director of research at First Call, accused S&P of acting like a self-appointed "earnings pope," including expenses in its operating earnings that most analysts believe should be excluded.

Howard Silverblatt, editor of quantitative services at S&P, responded: "We have no problem with being the pope. It is our index, and it is our name that we are dealing with." He said the company was actually reviewing its standards and would likely grow more conservative in choosing to accept "special items."

New York investment banker Gary Lutin said the gap shows the dangers of using operating figures in any situation, because there is no standard.

"It could just be a question of what color fairy dust you prefer," he said. "The issue is really whether you should do anything that strays away from reality-based numbers."

Economy

SEC Threatens to Sue Companies For Misleading `Pro Forma' Results

By Jonathan Weil
Staff Reporter of The Wall Street Journal

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The Securities and Exchange Commission issued a formal warning to corporations that they could face civil-fraud lawsuits for touting potentially misleading "pro forma" financial metrics in their earnings news releases if they don't also fully explain how they were calculated.

The "cautionary advice" yesterday from the SEC included the strongest signal yet of the agency's increasing discomfort with the practice of announcing quarterly earnings "as if" certain ordinary expenses didn't exist. "We believe it is appropriate to sound a warning to public companies and other registrants who present to the public their earnings and results of operations on the basis of" accounting metrics that have no standard definitions, the SEC said. "We wish to caution public companies on their use of `pro forma' financial information and to alert investors to the potential dangers of such information."

The SEC advisory could prompt companies to provide more details in their news releases about the expenses they exclude from their pro forma calculations. For instance, it is common for companies to cite vague categories such as restructuring charges, merger-related expenses or "unusual" charges -- without further details -- to describe expenses excluded from their pro forma results. The SEC said yesterday that companies' news releases must "describe the particular transactions and the kind of transactions" related to the expenses excluded from any pro forma calculations.

The advisory places into a formal document some of the warnings that SEC officials repeatedly have delivered in public speeches in the past several months. Still, the advisory isn't likely to force major overhauls in many companies' public-relations practices. In the past few years, companies increasingly have prettied up their earnings announcements by highlighting what their results would have been absent unpleasant blemishes, while granting less prominence to their actual results. That practice, which can be found in all industries, remains perfectly legal.

By contrast, there have been occasional instances where companies announced their pro forma results without simultaneously disclosing how they calculated them or what their actual results were under generally accepted accounting principles. It is this practice that the SEC identified as its chief source of concern. The SEC said companies should provide "clear and comprehensible explanations of the nature and size of the omissions" so they don't mislead investors. The guidance was based in part on a similar proposal this year by Financial Executives International, a professional organization for corporate executives.

Earlier this year, SEC officials announced that they were investigating a handful of companies suspected of issuing misleading pro forma earnings news releases. However, the SEC to date has never filed a fraud action in such a case. The commission gave no indication yesterday of whether actual cases would be forthcoming.

S&P to Wade Into Pro-Forma Earnings Mess
By Steve Liesman and Jonathan Weil
Staff Reporters of The Wall Street Journal

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C1

Standard & Poor's, responding to growing concerns about the worsening quality of corporate earnings reports, is expected to send out a letter today to top Wall Street executives suggesting a potentially significant change in so-called operating earnings.

The move by S&P, a unit of McGraw-Hill Cos., represents the latest twist in the growing controversy over "pro forma" profitability measures, which are calculated by many companies across all industries "as if" certain ordinary items -- usually expenses -- didn't exist. Normally, companies label these nonstandard profit measures with terms like "pro forma earnings," "cash earnings" or "operating earnings." S&P says it would like to create industry standards to eliminate confusion for analysts and investors, by creating a uniform definition for the term "operating earnings," which today has no generally accepted definition.

S&P in its letter says that it is reacting to an increasing number of complaints from the investment community that earnings reports are "becoming harder to understand, more difficult to compare across companies and less useful to analysts and investors."

S&P compiles the much-watched S&P 500-stock index, as well as the combined earnings of these companies. The earnings measure is one of several widely used by investors to determine the price-earnings ratio of the index, one way of gauging the relative overall value of the stocks in the index. If S&P should adopt these standards for the calculation of the index, it potentially could have a radical effect on perceptions of overall stock-market valuations.

S&P has no power to force anyone but its own analysts to change the way they present earnings, and it says its letter is just the opening salvo in what it expects to be a wide debate over how operating earnings should be defined.

In its letter, S&P suggests that several items that companies routinely exclude as part of operating earnings be included, because they "are normally part of a company's operations." These include restructuring charges, write-downs of assets from continuing operations, stock-option expenses and write-offs of research and development purchased from other companies.

S&P said its initial inclination is to exclude four broad categories of expenses from future operating-earnings calculations. Those are charges from write-downs of goodwill, the intangible asset created when one company pays a premium to buy another; charges from litigation settlements; gains and losses on asset sales; and "acquisition/merger related expenses," a term the letter does not define.

There are lots of other unanswered questions yet to be worked out. For instance, the letter says write-downs from "ongoing operations" should be included in operating earnings. But it says nothing about whether unrealized gains and losses on investments -- which are considered a nonoperating item under generally accepted accounting principles, or GAAP -- should be counted in so-called operating earnings. Similarly, the letter says litigation settlement costs should be excluded, but it doesn't say whether expenses associated with increasing reserves in anticipation of future settlements should be excluded -- or whether gains should be included or excluded when such reserves are reversed.

Another area of uncertainty has to do with S&P's inclination to include stock-option expenses in operating earnings. Under GAAP, stock options paid to employees don't count as expenses, and companies only have to disclose their stock-option compensation tallies annually. It's not yet clear how S&P would go about including stock options in operating earnings on a quarterly basis. And of course, even if S&P succeeds in persuading many analysts and companies to use its new definition for operating earnings, companies would remain free to define their non-GAAP earnings measurements as they see fit.