U.S. Earnings Reports Miss Point -- How Much Did Company Earn?

New York, Aug. 3 (Bloomberg) -- Cisco Systems Inc. calls it ``pro forma net income.'' Procter & Gamble Co. prefers ``core net earnings.'' And SCI Systems Inc. presents ``cash earnings per share before realignment charges.''

Earnings aren't what they used to be, as reported by scores of U.S. companies facing pressure to show shareholders perpetual growth. Many are departing from the standard measure of net income. Instead, they pick and choose what to highlight. They may include gains that gild their results or exclude routine costs such as stock-based compensation.

Investors aren't being fooled, though, and they're fed up with the sleight of hand. The manipulated calculations make it harder to compare companies and to get a true picture of performance, some investors say.

``It's rampant, it's terrible,'' said David Yucius, president of Aurora Investment Counsel in Atlanta, which manages $100 million in funds. ``Companies want to show smooth, upwardly sloping earnings, and the best way to do that is to factor out all these costs.''

As many as 300 companies have switched to reporting some type of pro-forma earnings, estimates Thomson Financial/First Call, a Boston-based research firm that tracks analysts' estimates.

At Cisco, for example, pro-forma net income was $230 million in the fiscal third quarter. Pro forma, by Cisco's definition, means before acquisition-related costs, payroll taxes on exercises of stock options, restructuring costs, investment gains and a $2.25 billion pretax charge for writing down the value of inventory. What Cisco terms its ``actual loss'' was $2.69 billion.

Take a Closer Look

SCI, an electronics maker being acquired by Sanmina Corp., bragged in its fiscal fourth-quarter release that it met or beat Wall Street estimates with ``cash EPS'' of 27 cents.

There was less to brag about to investors diligent enough to read the accompanying table. It showed $46.9 million in ``special charges'' that led to a bottom-line loss of $843,000, or 1 cent a share. SCI called the charges ``nonrecurring,'' even though it may take $70 million to $100 million of similar charges for job cuts and plant closings this quarter.

Many investors prefer numbers that exclude items that might distort comparisons, said Jim Moylan, SCI's chief financial officer.

Not all investors agree with that. Some want analysts to scrutinize results more closely, instead of computing estimates by each company's yardstick of choice -- excluding ``special'' or ``unusual'' items on the grounds that they don't reflect the underlying business. Other analysts may be reluctant to seem critical for fear of jeopardizing their firm's efforts to win investment-banking business, investors say.

``Whether it's naivete or laziness or pressure, they haven't done the job,'' said Chuck Hill, First Call's research director.

Trendsetters

Companies typically try to present their results in the best light. The change is in how far they're willing to go to reach that end. The rise of high-flying Internet stocks like Amazon.com Inc. and Yahoo! Inc., which popularized pro-forma earnings to minimize losses in the late 1990s, made it more acceptable for companies to pitch alternate profit measures, analysts said.

Not all companies are following the fad. International Business Machines Corp. announced in 1996 that it would take no more restructuring charges, and it's sticking with that policy. It doesn't break out the cost of restructuring steps from net income.

``We considered these charges normal course of business,'' said Carol Makovich, an IBM spokeswoman.

FASB's Role

Hill complained that the Financial Accounting Standards Board, the private group the Securities and Exchange Commission relies on to set accounting standards, ``helped sprinkle these things with holy water'' by easing the earnings impact of accounting for goodwill from acquisitions.

Goodwill is the amount a purchaser pays beyond book value for a company's assets -- substantial sums in the case of technology companies with soaring stocks.

New FASB rules, passed last month, allow companies to assess the value of goodwill on their books periodically and take charges only when that value has fallen. The group backed away from a proposal that would have forced companies to ``amortize,'' or write off, the value over 20 years.

Lynn Turner, the SEC's chief accountant, has put the issue on the agency's radar screen. More than once, he has referred to the pro-forma trend as ``everything but bad stuff'' earnings reports.

Turner said in June that the SEC is investigating whether four companies misled investors with pro-forma earnings statements. He has prodded Financial Executives International, a trade group, to release guidelines calling on companies to ensure that any pro-forma earnings cited in press releases are clearly reconciled with generally accepted accounting principles.

``It just seems like people are not always shooting straight with their investors,'' Turner said.

Preparing for Hurricanes

The GAAP basis is strict about what constitutes an ``extraordinary item,'' requiring it to be both unusual and infrequent, said Julia Grant, associate professor of accountancy at Case Western Reserve University. A company based in Florida, for example, couldn't claim the costs of hurricane damage as an extraordinary item because hurricanes are frequent in the state.

In theory, that rules out ``some things we see a lot,'' Grant said, such as inventory writedowns, gains or losses from property sales and charges for corporate reorganizations. Unlike SEC filings, statements to the public and press don't have to meet GAAP standards.

Intel Corp.dd last year pressed analysts to include investment gains in earnings estimates. Analysts who follow Microsoft Corp. did the same -- until the gains turned into a $2.6 billion investment loss for its fiscal fourth quarter, when they were excluded.

Terry Ragsdale, a semiconductor analyst at Goldman, Sachs & Co., said he had thought it was more informative to exclude Intel's investment gains from his estimates. Eventually, though, it became so confusing to be using a different formula than colleagues that he gave in and joined them.

Cisco's Way

Cisco excluded the $2.25 billion pretax charge for inventory it says is worthless, and many analysts did the same. But Nortel Networks Corp. included $650 million of pretax inventory charges in its second-quarter earnings, while excluding some of the same things Cisco did, such as stock-based compensation and goodwill from acquisitions. Again, many analysts followed.

``The way results are coming out now, it's just way too subjective,'' Yucius said. ``There used to be a commonly understood set of principles.''

Cisco spokeswoman Abby Smith said the company's reporting style isn't arbitrary. Cisco has used a ``consistent methodology'' for more than five years for calculating and reporting inventory, she said.

Procter & Gamble's Turnabout

Procter & Gamble for years advised analysts to include sales of product lines as a continuing part of its business because the company is constantly reshuffling the portfolio. But in June, Procter & Gamble said it would take a $1.2 billion charge to cut jobs, phase out lines such as Olay cosmetics and write off food-manufacturing assets. Analysts excluded the costs from earnings forecasts, as they had done for $2.59 billion in other charges since 1999.

``Things are getting really bad when you see classy companies like Procter & Gamble playing these games,'' said Peter Skirkanich, president of Fox Asset Management in Little Silver, New Jersey, which manages $2 billion. Skirkanich said he was so annoyed that he sold Procter & Gamble stock. Procter & Gamble declined to comment.

Skirkanich called on regulators to enforce more uniform standards of reporting. Even if they don't, he said, companies aren't likely to be able to keep investors at bay much longer, especially as the stock market drops and the economy slows.

``When it works and people are making lots of money, they don't care,'' Skirkanich said. ``But at the end of the day, you've got to have real cash flow and good products and balance sheets.''

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