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# An Analyst's Perspective on Financial Reporting

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Analyzing financial statements is difficult because (1) the information is spread across three separate statements and a myriad of footnotes, (2) numerous assumptions underpin the numbers, and (3) the information reflects only a snapshot in time. The problem is further exacerbated by the complexity, ambiguity, and obfuscation of financial accounting rules. Nevertheless, tools exist to help astute managers and analysts work through these issues and, as a result, improve their investment odds. Numerous examples abound where analysts and managers could have identified problem stocks in advance of market reaction by digging deeper into the data with an eye on earnings quality, operating efficiency, cash flow quality, and balance sheet quality.

**T**he title of my presentation is “An Analyst’s Perspective on Financial Reporting,” but it could be subtitled “Breaking through Financial Reporting to Determine What Is Really Happening Inside a Company.” In this presentation, I will talk about how we got to the point of having to discuss this topic at the annual CFA Institute conference on equity research and valuation. Next, I will move to the topic of how to identify the problems and then look at some aggressive accounting identification issues. That discussion will be followed by ideas about identifying competitive problems and unraveling operating cash flow. Finally, my conclusion will include solutions for analysts and portfolio managers.

## Background

Existing financial statement presentations pose several challenges for analysts and portfolio managers. First, the information on a company’s performance is presented across three separate financial statements and in a myriad of footnotes. Obviously, all this information is not easily grasped by the human mind. Second, numerous assumptions underpin the earnings, cash flow, and balance sheet presentations.

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*Editor’s Note:* Mr. Gulliver would like to thank Tim Gaumer, CFA, for his comments on this presentation.

Third, the information is merely a snapshot in time and, in some cases, the reporting time periods for the three financial statements differ. As a result, traditional ratio analysis is not always predictive when it is based on those reported numbers. Thus, determining changes in a company’s fundamental performance over time is understandably difficult.

Fortunately, some tools exist that allow analysts and portfolio managers to work through these accounting issues, quantify company fundamental performance, and focus time and efforts in activities that are productive, leading to the avoidance of “torpedo” stocks that could threaten overall portfolio performance. These activities improve the odds for portfolio managers.

## How Did We Get to This Point?

In this discussion of how we got here, it is useful to start with some of my own personal experiences and confessions as a researcher and money manager. I started in this business about 18 years ago, and one of the early mistakes I made was not working with the three financial statements systematically and using the interrelationships among them. In those days, I rated stocks almost exclusively on data from the income statement. Very little information came off the balance sheet and the cash flow statements.

Another mistake of mine was not fully understanding the potential for misleading accounting treatments and the financial reporting results that are derived from them. I would accept the standard ratios, such as cash flow from operations (CFFO) and reported earnings to cash flow, which is a common earnings quality measure but one that I have learned is not always reliable. Also, I accepted traditional bond ratings as being timely, which, in fact, was not always the case.

So, how did we get to the point where Trevor Harris, chief accounting analyst at Morgan Stanley, has publicly commented: “The financial reporting system is completely broken.”<sup>1</sup>

One of the primary reasons we got to this point is the complexity, ambiguity, and obfuscation of U.S. GAAP policies. Even within the Financial Accounting Standards Board (FASB) statements, reporting rules have layers of complexity that create or facilitate obfuscation, including such things as off-balance-sheet items, stock option expensing, and the relevant assumptions made to justify the measures reported in the financial statements. According to the Huron Consulting Group, in 2003, faulty accounting estimates caused about half the restatements, suggesting that the assumptions underlying these three financial statements are extremely important.

Note that I make a distinction between areas of ambiguity, which in my mind are based on estimates, and areas of obfuscation, which in many cases are dictated by GAAP and FASB rules. Under areas of ambiguity, I include such things as sales and return estimates, bad debt expenses, and inventory obsolescence—all three of which can also be offsets to earnings. I also include the ubiquitous restructuring costs, which can be used to boost future earnings.

In the area of obfuscation, I include such things as the benefits from pension plans, stock option expenses (or the lack thereof), stock option tax benefits, and off-balance-sheet items. These items are landmarks along the road that led to analysts and portfolio managers being concerned enough to discuss these topics at conferences such as this one.

Adding to this predicament are U.S. Congressional, SEC, and FASB actions. One need only consider the legacy of stock option expensing to understand the role that politics can play in setting financial reporting policies. In addition, the Sarbanes–Oxley Act of 2002 is now the law of the land, but the real question is whether we are getting better numbers and estimates because of Sarbanes–Oxley or merely getting better documentation.

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<sup>1</sup>David Henry, “Fuzzy Numbers,” *BusinessWeek* (4 October 2004):78–88.

The FASB has made attempts to reflect asset value changes, which I believe do not necessarily improve users’ comprehension of financial statements. The best example is the amortization of goodwill from acquisitions. Although a company has to amortize the cost of hard assets that it acquires, it no longer has to depreciate the soft assets that it acquires through an acquisition, which seems somewhat nonsensical for investors, who are focused on earnings.

## Identifying Problems

To address these kinds of issues, at Jefferson Research & Management we chose to first determine exactly what matters, which we accomplished by reviewing the academic literature and dozens of SEC fraud cases, which I highly recommend as most entertaining reading. We also reviewed the few books that existed at the time along with business press accounts of fraud.

In addition, we conducted empirical testing and used the asymmetry of double-entry bookkeeping to detect problems. Because of the interrelationship of these three financial statements, many of these problems can be detected. This interrelationship also makes it difficult to totally hide the kind of problems that occurred in great numbers in the late 1990s.

And finally, we focused on how a company was actually performing. To do so, we had to recast the operating metrics by doing such things as making proper adjustments to operating cash flow and earnings. Our goal was to develop a fundamental performance measure for a company on a consistent quarter-by-quarter basis that removed as many of the ambiguities from the reported numbers as possible.

Through our analysis, we identified five causes of stock price underperformance:

- aggressive accounting, which is talked about widely now in the years after the Enron Corporation and WorldCom scandals;
- financial deterioration, which can be hidden by a nice-looking income statement;
- change in the industry or competitive situation, which happens when an entire industry starts to deteriorate or a company loses its own competitive advantage;
- bad acquisitions, which actually became an epidemic in the late 1990s; and
- overvaluation, which we liken to a risk proxy for a particular stock. If a stock is overvalued and it has some of the other problems I mentioned, it definitely has higher risk.

This presentation will focus on the first three causes of stock price underperformance: aggressive accounting, financial deterioration, and change in an industry or company competitive situation. Although we also consider valuation in our work, I will leave that subject for other experts at this conference.

In developing measures to detect these problems, we decided to aggregate this information into four symptoms or dimensions: earnings quality, operating efficiency, cash flow quality, and balance sheet quality. These four dimensions are the result of rolling up about 50 different variables over multiple time periods.

**Earnings Quality.** In terms of earnings quality, the major considerations are:

- accrual rate,
- one-time items,
- depreciation rate,
- pension plan gains,
- bad debt allowances and expenses,
- inventory adjustments,
- supporting cash flow,
- tax rate, and
- amortization of intangibles.

The accrual rate is extremely important. Accruals are a proxy for everything that is included in income that does not generate cash. A number of academic studies have suggested that the information content in accruals is significantly better than the information in reported earnings.<sup>2</sup>

Analysts should also consider one-time items that might be boosting reported earnings, such as the depreciation rate (and changes therein), pension plan gains, bad debt allowances and expenses (is the company properly reserving and expensing for its bad debts?), inventory adjustments (particularly inventory obsolescence), the supporting cash flow that underlies the earnings (particularly on an adjusted basis), the tax rate, and intangible amortization (which is no longer required to be reported on an ongoing basis).

**Operating Efficiency.** A company can be thought of as a collection of assets that, over time, gets converted into revenues and, after subtracting expenses associated with production and overhead, results in bottom line earnings and cash flow.

In measuring a company's operating efficiency, we consider the following: turnover rate of the different types of company assets and changes in gross and net margins, EBIT (earnings before interest and taxes), cash flow, SG&A (selling, general, and administrative expenses), return on capital, and the cash conversion cycle. The latter is an occasionally used measure that reflects how long it takes to convert a company's

inventory into cash and is a shortcut to determine how efficiently the company generates cash.

**Cash Flow Quality.** I believe that cash flow quality is the next great frontier in financial analysis for detecting problems within a company. For cash flow quality, we look at several areas.

Discontinued items are a part of this cash flow analysis. Although they are generally excluded from earnings, they can be included in operating cash flow and may require an adjustment. Extraordinary items, such as receivable sales and asset sales, have broad definitions under GAAP and can influence CFFO and also need to be evaluated. Nonoperating items, which by our definition include anything that is not generated by the underlying business, must also be examined.

The two best examples in this area are the tax benefits from the exercise of stock options and the cash tax rate, which often is dictated by the balance sheet rather than by what the company is doing with its core business. An additional item to consider is trading securities (where a company designates stock as a trading instrument and can inflate the CFFO when it is sold). Another item is lending practices with customers. The net effect of some types of lending to customers can be an increase in CFFO if it is done on extended payment terms so that the receivable is reported as a note receivable (or a sale-type lease receivable) and not reported as a change in current assets. Either of these items could be shown in the cash flow from investing section of the cash flow statement. So, my caution on using CFFO as a gold standard is to understand what is behind the numbers because it can be nearly as deceptive as reported earnings.

**Balance Sheet Quality.** For balance sheet quality, we look at such items as liquidity, inventory, accounts receivable, other accrual items, and the cash position.

Most people who short stocks look at inventory and accounts receivable. These two items probably catch 20–25 percent of the stocks that blow up. But we have found it fruitful to also examine liquidity, the cash position, and other accrual items. Other accruals may include such things as prepaids, deferred charges, the tax valuation account, deferred taxes, and warranty reserves.

Many operating problems will show up on the balance sheet because of double-entry bookkeeping. Any item of net income that does not generate cash flow is generally going to show up somewhere on the balance sheet.

<sup>2</sup>For example, see Patricia M. Dechow and Catherine M. Schrand, *Earnings Quality* (Charlottesville, VA: The Research Foundation of CFA Institute, 2004): Chapter 3.

## Aggressive Accounting Techniques

Aggressive accounting can occur in four general ways: (1) through the overstatement of revenues, (2) through the understatement of expenses, (3) by using third-party entities, and (4) from one-time items.

**Overstatement of Revenues.** The most prevalent techniques used in the overstatement of revenues are stuffing the distribution channel, which essentially involves pulling forward demand to record it in the current period; using third-party sources to acquire products, which, in my mind, is a type of off-balance-sheet financing; booking revenues early (before they are actually earned); lending to customers to allow a product sale in the current period; using balance sheet accounts to boost results; and underestimating product returns. In this section, I will focus on the first three techniques. Please note that all the examples in this presentation are merely illustrative points. I am not suggesting that anything was done illegally. Rather, these cases illustrate the ambiguities that are apparent in GAAP and FASB regulations.

■ *Stuffing the channel.* Safeskin Corporation is a good example of channel stuffing. In the late 1990s, the company had developed a proprietary latex glove technology at a time when there was a great demand for these products because of the burgeoning worldwide crisis in AIDS and HIV. In essence, Safeskin's gloves were superior to the existing glove technology. It was a classic, consistent, high-growth company that was growing 30–40 percent a year in sales and earnings. When growth suddenly began to slow for Safeskin, the company began stuffing the channel. We began to detect this through our ratings on oper-

ating efficiency and balance sheet quality beginning in the third quarter of 1998.

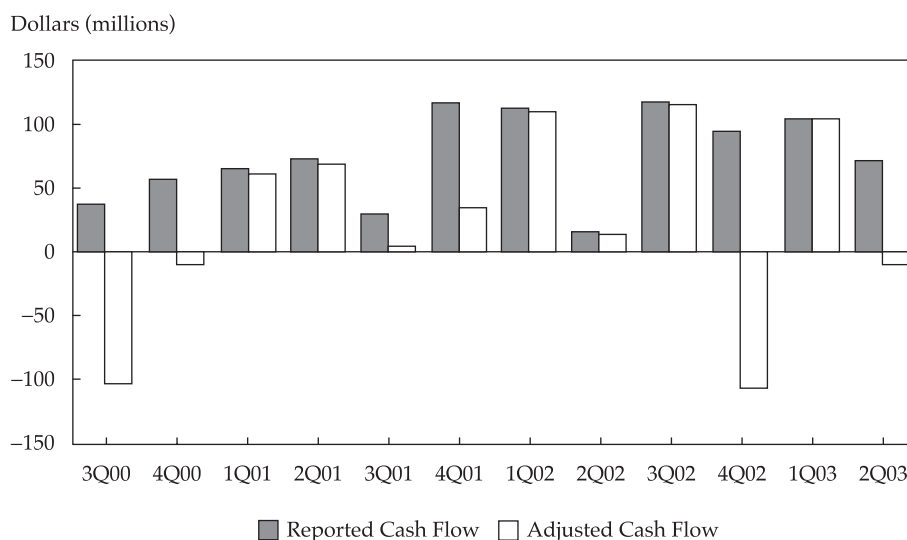
Often, a company's balance sheet will begin to deteriorate as it struggles to maintain unreasonable growth rate expectations. We found that accounts receivable had increased from about 150 days to 250 days in one quarter. The cash conversion cycle also increased dramatically from about 120 days in early 1998 to nearly twice as long by early 1999. In other words, Safeskin was having a more difficult time converting its inventory into cash.

■ *Using third-party sources.* For those who think that accounting problems involving third-party sources ended in 2000 with Enron, I have some examples that show they continue. Like several competitors, Biovail Corporation was using third-party entities for much of its research and development (R&D). In our work, we started to see problems in cash flow quality and operating efficiency beginning in late 2001. Biovail funded a start-up company that performed R&D. If the research was successful, Biovail then had the right to acquire the company. If the research was not successful, Biovail wrote off the investment as a one-time item. Reported cash flows did not track well with our adjusted cash flows, as shown in **Figure 1**, which is always a matter of concern.<sup>3</sup>

Another example of the use of third-party entities is Lernout & Hauspie. This was a Belgian company that was in the voice-recognition software

<sup>3</sup>*Editor's Note:* See the Question & Answer Session immediately following this presentation for more information on the adjustments made.

**Figure 1. Biovail Reported vs. Adjusted Cash Flow, Third Quarter 2000 to Second Quarter 2003**



business. It reported as a foreign entity until the second quarter of 2000. Consequently, the data were incomplete until the company acquired Dragon Systems in the second quarter of 2000, which resulted in a significant U.S. presence and the need to release U.S. GAAP-compliant financial statements. With better data, we began to see significant problems with operating efficiency and balance sheet quality.

Looking deeper, we noted that receivables increased significantly from about 110 days in the first quarter of 2000 to nearly 200 days by the very next quarter. What was Lernout & Hauspie doing? A couple of executives at Lernout & Hauspie had controlling interest in a venture capital firm that set up a South Korean entity that purchased software from Lernout & Hauspie. Unfortunately, that venture capital firm was not capitalized sufficiently to allow this Korean entity to actually send cash back to Lernout & Hauspie, which is why receivables increased. In this instance, because the principals have been indicted, I think I can safely say that the arrangement was a fraud.

Another way that problems might have been detected was by measuring inventory levels. Days sales in inventory were averaging less than 20 days throughout 1999 but dramatically increased to more than 80 days between the first and second quarters of 2000. Additionally, as was the case with Biovail, the adjusted cash flows for Lernout & Hauspie began to vary significantly from reported operating cash flow over the period. Some significant problems were clearly apparent.

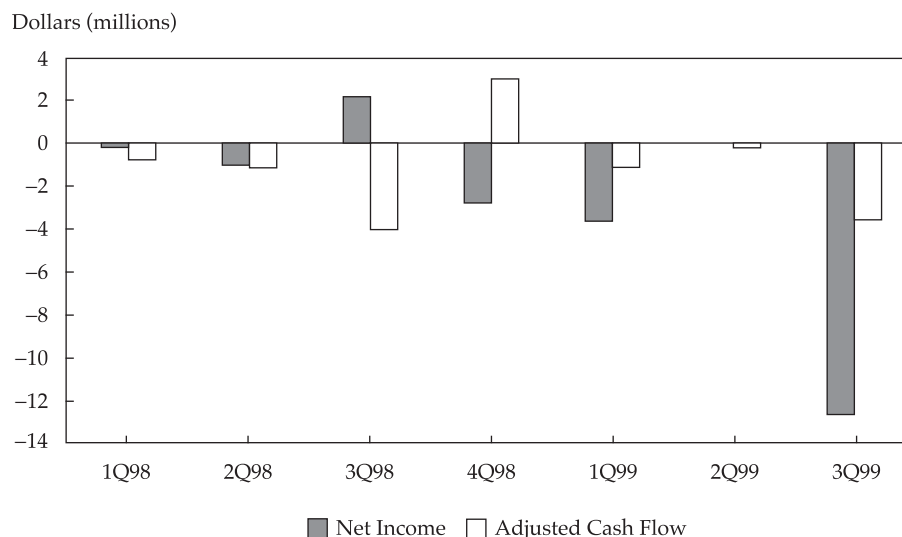
■ *Booking revenues early.* My example for booking revenues comes from MicroStrategy Inc., which

was booking service revenues up-front for software products. This practice showed up as warnings in our operating efficiency and cash flow dimensions. Again, when we looked a little closer, we saw that the company was not generating much cash flow at all. And net income compared with adjusted cash flow was very erratic, as shown in **Figure 2**. All this information implies that there really was little cash flow underlying the reported revenues and earnings.

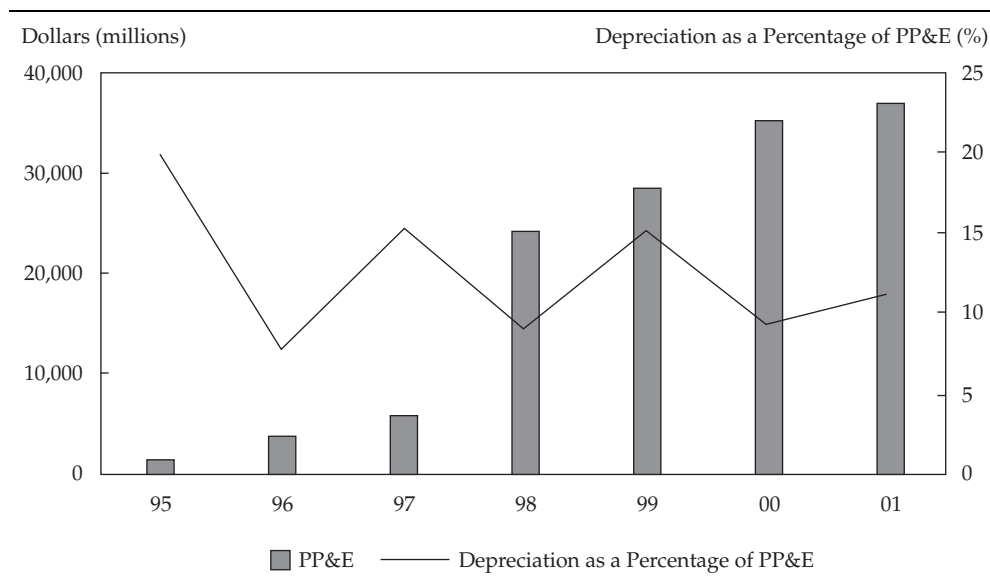
**Understatement of Expenses.** Understatement of expenses encompasses several areas—failing to record normal expenses, capitalizing costs rather than running them through the income statement, underestimating accruals, using low depreciation rates, and using valuation allowances.

One of the things that WorldCom was accused of was a failure to run through its income statement certain expenses that it had been previously recognizing. Instead, the company chose to begin capitalizing them. This practice showed up as warnings in both the balance sheet and operating efficiency dimensions beginning in the second quarter of 2000. What is interesting is that when WorldCom capitalized these expenses, they showed up in property, plant, and equipment (PP&E). As **Figure 3** shows, PP&E went from about \$5 billion to nearly \$40 billion at a time when WorldCom was making a number of acquisitions. But when we looked more closely at PP&E and depreciation as a percentage of PP&E, we found a very erratic pattern. This, by itself, suggests potential problems. Typically, if a company's business does not change, the amount of capital goods

**Figure 2. MicroStrategy Net Income vs. Adjusted Cash Flow, First Quarter 1998 to Third Quarter 1999**



**Figure 3. WorldCom PP&E vs. Depreciation as a Percentage of PP&E, 1995–2001**



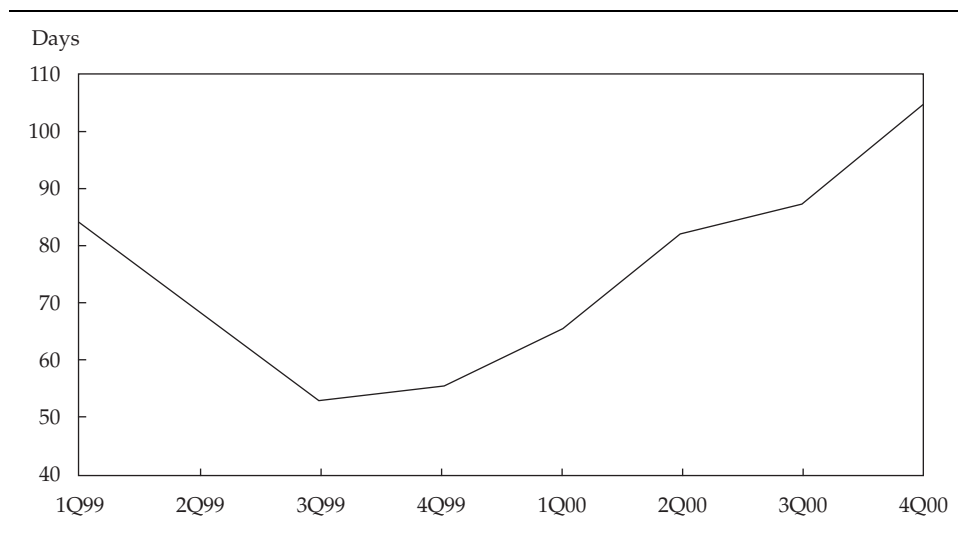
and the rate at which it depreciates them each period should be consistent. That was obviously not the case for WorldCom.

We also noted that receivable days outstanding increased steadily, as shown in **Figure 4**. Allegedly, there were a number of questionable receivables resulting from an aggressive marketing strategy that WorldCom used at that point in time. Such an activity would be consistent with this graph.

Another example of capitalizing costs is found in the story of Rainbow Technologies. We started to see problems in operating efficiency and cash flow qual-

ity in 1999 and 2000. R&D as a percentage of sales was regularly declining over that period. At the same time, however, the company chose to begin capitalizing some of its software costs as part of a new business it had entered. The reality was that those expenses went onto the balance sheet; they did not flow through the earnings statement. When we summed reported R&D expenses and increases in capitalized software, we found that this combination, as a percentage of sales, was fairly constant over that time. Rainbow Technologies eventually took a one-time write-off of these capitalized R&D expenses.

**Figure 4. WorldCom Receivable Days Outstanding, First Quarter 1999 to Fourth Quarter 2000**



The case of understatement of accruals is illustrated by Paradyne Networks, where problems with both earnings quality and operating efficiency served as warning signs. When we looked into these areas, we noted that the allowance for doubtful accounts was significantly less than the corresponding annual expense, as shown in **Figure 5**. Paradyne did something unusual, although not unique, in reflecting this information in its financial statements. Instead of running the additional expense through its allowance account, which is what most companies would do, it offset revenues. This reduced the net revenues for the company but also made determining the true credit quality of its customers very difficult because it was not fully reflected in the allowance account as it flowed through the financial statements. Paradyne is another example of how companies can understate expenses, in one sense, and also hide some of their problems.

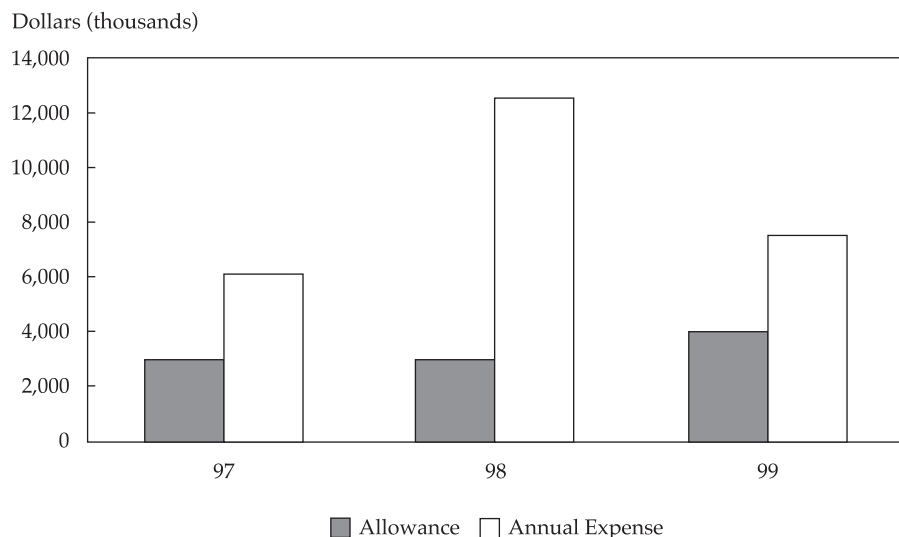
**Enron.** I could not give a talk on accounting issues without talking about Enron. As we now know, Enron had a number of things going on inside the big tent masquerading as financial accounting. It used third-party entities (the so-called special purpose entities); it used nonrecurring items (some of them with totally nonsensical descriptions); it used off-balance-sheet accounts; and it misused mark-to-market accounting. Enron used mark-to-market accounting as a means to pull forward into current reported earnings what were really future earnings—in some cases earnings that were 15–20 years in the future. For those who want to learn more about the details of Enron, I highly recommend the book *The*

*Smartest Guys in the Room*.<sup>4</sup> It not only talks about some of the accounting games, but it also has a good description of some of the personalities and the culture of the company. In my mind, Enron took the third-party entities and the off-balance-sheet accounts to a new level. Most of the companies that engage in this kind of activity, such as Lernout & Hauspie, are not able to send cash back to the parent company from these third-party entities. But Enron was able to do it, which was part of the reason the game went on as long as it did. And, of course, it was able to do it primarily by getting banks to lend money under a technique where Enron essentially guaranteed its stock price to get those loans.

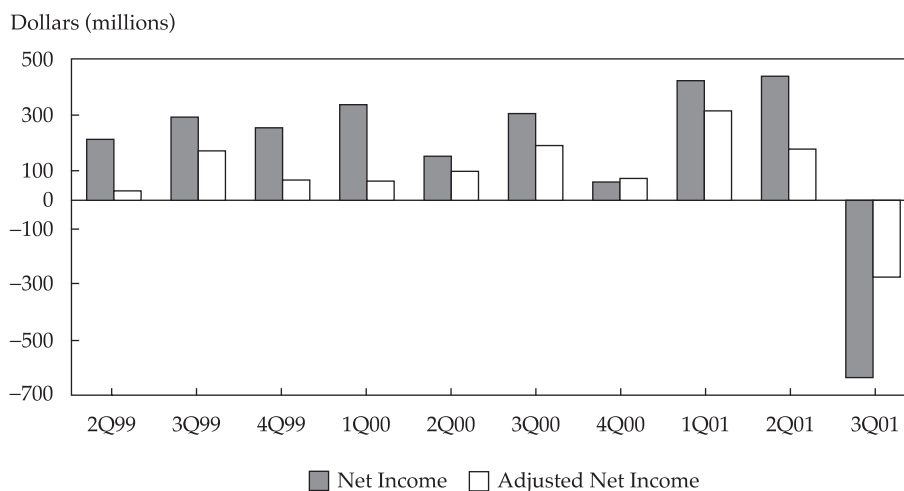
So, what kind of indicators might have been there for anybody who chose to look for them? Our analysis indicated problems beginning in the second quarter of 1999 for three dimensions: earnings quality, investment quality, and cash flow quality. Earnings quality was a consistent problem from the third quarter of 1998 to the fourth quarter of 2000, and we saw a significant deviation between reported earnings and what we consider to be adjusted earnings, as shown in **Figure 6**. It was an ongoing issue because a lot of what Enron was reporting as earnings included one-time items, in some cases bringing forward, through mark-to-market accounting, revenue and earnings that were many years out. Mark-to-market accounting is permitted under GAAP—provided that proper disclosure is made of changes in the expected results over time.

<sup>4</sup>Bethany McLean and Peter Elkind, *The Smartest Guys in the Room* (New York: Penguin, 2003).

**Figure 5. Paradyne Networks Allowance vs. Annual Expense, 1997–1999**



**Figure 6. Enron Net Income vs. Adjusted Net Income, Second Quarter 1999 to Third Quarter 2001**



We found similar problems when we looked at cash flow. As shown in **Figure 7**, operating cash flow was significantly different from adjusted cash flow. In my experience, when I see these kinds of problems with earnings quality and cash flow going on simultaneously, the company generally has a big problem. I must say that some of the line items that showed up in as-reported cash flow were classics, such as “receipt of cash associated with the assumption of a contractual obligation.” These were the kinds of things that Enron was reporting in its financial statements that were blessed by its accounting firm.

**Figure 8** shows the return on invested capital (ROIC) versus our adjusted ROIC for Enron. I think Jim Chanos said it best when he said that Enron was basically a slightly disguised hedge fund that was earning about 4 percent on its assets. And when

examined more closely, it was actually making less than that.

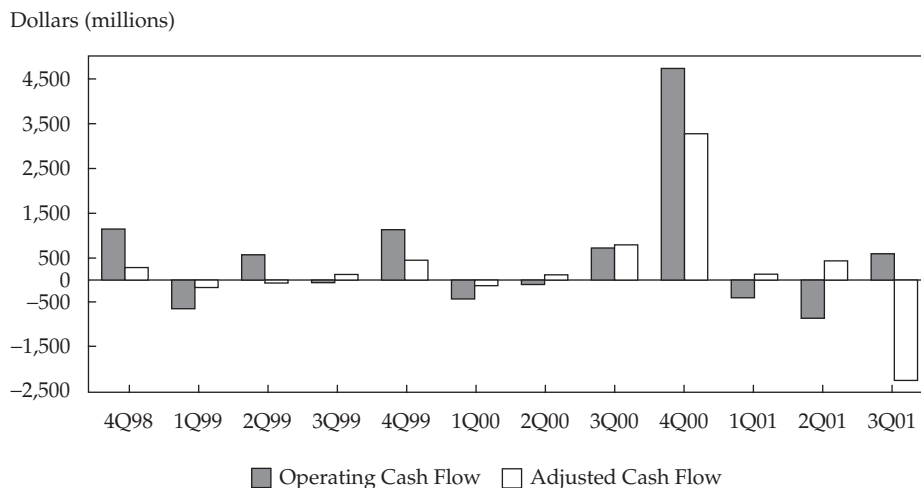
So, the point is that for anybody who really wanted to look at Enron, there were a lot of warning signs out there to see.

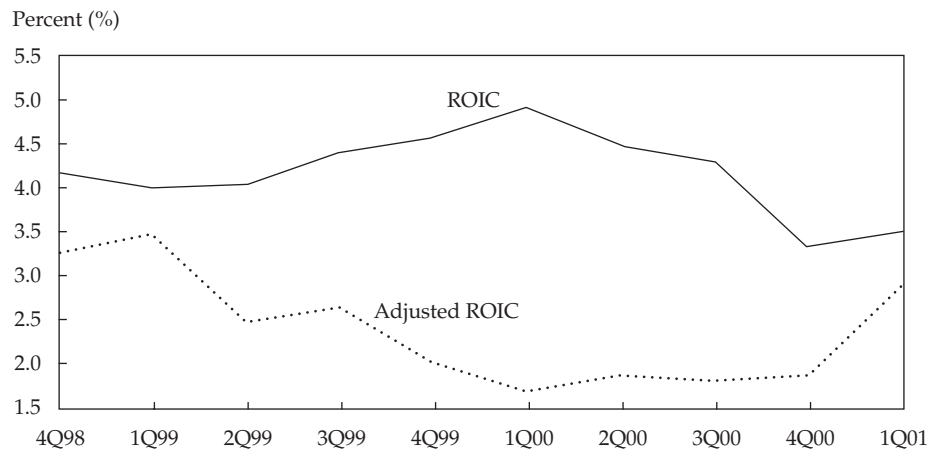
### Identifying Competitive Problems

Analysis of competitive problems has received less attention than the problems of aggressive accounting. Nonetheless, competitive problems can serve as valuable indicators of trouble ahead. Some of these competitive problems are pricing pressures, a deteriorating product position, and lending to customers.

Lexar Media, which makes flash memory devices used to store pictures in digital cameras, is a recent example. In April 2004, it was an \$18 stock; by the summer, it closed at about \$5. Beginning in the

**Figure 7. Enron Operating vs. Adjusted Cash Flow, Fourth Quarter 1998 to Third Quarter 2001**



**Figure 8. Enron ROIC vs. Adjusted ROIC, Fourth Quarter 1998 to First Quarter 2001**

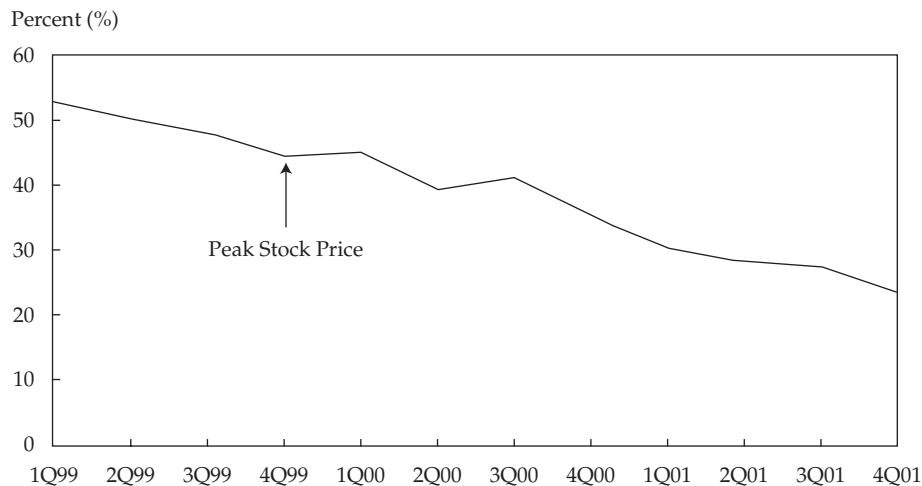
third quarter of 2003, earnings quality, operating efficiency, and cash flow quality warnings were showing up. When we dug a little bit deeper, one of the things that was apparent was that gross margins, although never extremely high, declined significantly from an average of more than 25 percent in early 2003 to less than 20 percent in the first quarter of 2004. This sort of drop is often a sign of a competitive problem; in this case, it was driven by a competitor that was willing to cut prices. Problems were also evident in looking at the cash flow return on investment, which was consistently negative.

We then looked at ROIC, which peaked in the first quarter of 2003 at more than 50 percent and declined fairly steadily thereafter, to about 30 percent by the time that the first quarter of 2004 rolled around.

Likewise, inventory turnover was in a sustained downturn. In the second quarter of 2002, the com-

pany was actually able to turn its inventory about nine times, which is quite high. But by the first quarter of 2002, inventory turnover had declined to about five times. This was a stock that traded up primarily on the promise and expectation of rapid sales driven by the boom in digital cameras, but operating problems became apparent even as the price appreciated.

Lucent Technologies is another good example of a company that had many red flags. Among other actions, Lucent was engaged in lending significant amounts to its customers. Beginning in late 1999, we started to see problems in cash flow quality and in operating efficiency. The peak stock price occurred sometime in the fourth quarter of 1999, and as shown in **Figure 9**, at that point, Lucent's gross margins had already begun a significant decline. Margins continued to decline through the fourth quarter of 2001. If

**Figure 9. Lucent Technologies Gross Margin, First Quarter 1999 to Fourth Quarter 2001**

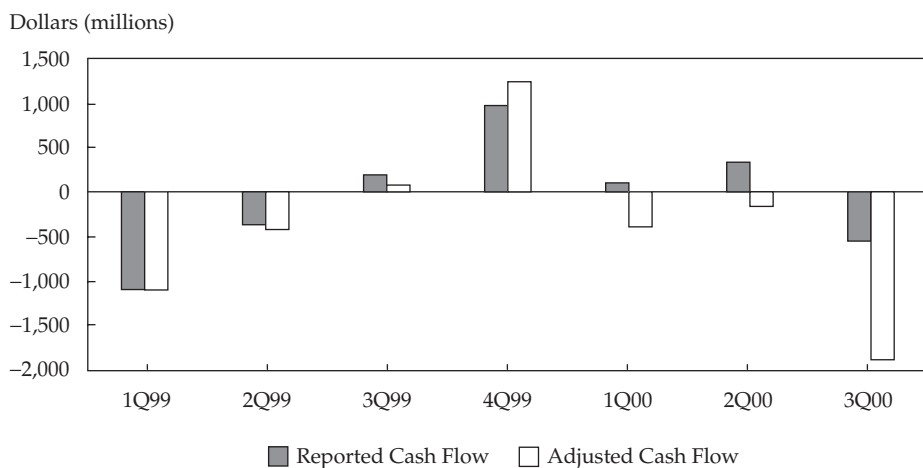
one had looked at the operating cash flow compared with the adjusted cash flow, as shown in **Figure 10**, until about the fourth quarter of 1999, they matched up pretty well. In fact, in the fourth quarter of 1999, the adjusted number was the higher of the two. Then, everything changed. Lucent began lending heavily to its customers who, for whatever reason, did not have the cash to pay Lucent for their purchases.

Something else we noted about Lucent was the deterioration in the cash conversion cycle, which was a respectable 140 days at the end of 1998. From late 1998 through the first quarter of 2000, the cash conversion cycle steadily increased until it had nearly doubled, indicating that it took Lucent nearly twice as long in 2000 to convert inventory into cash as it did in 1998.

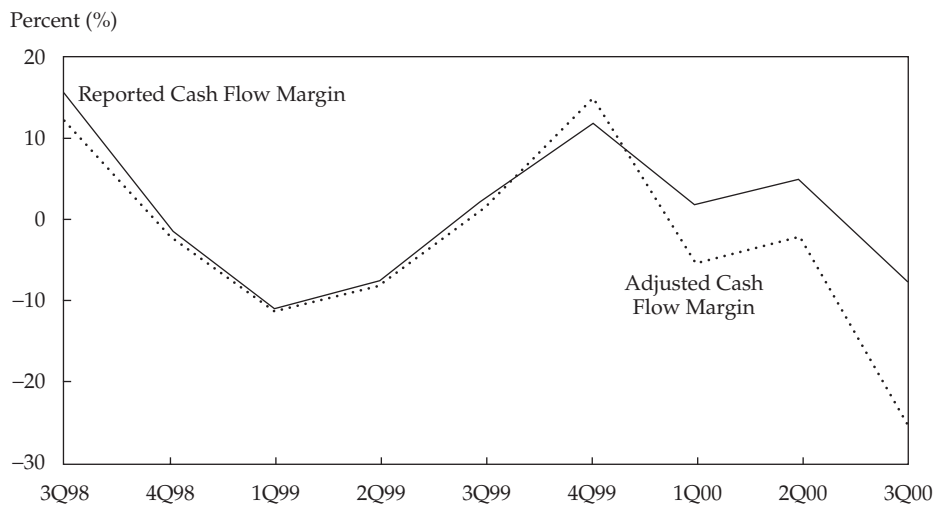
This is another example of a company using its balance sheet to maintain an unsustainable growth rate.

Another interesting indicator that we look at is what we call the “adjusted cash flow margin,” where we take out the one-time items from cash flow and calculate a margin based on revenues. As shown in **Figure 11**, the cash flow margin reported was declining, but after stripping out some of the one-time items in cash flow (i.e., looking at the adjusted cash flow margin), we saw that the decline was even more precipitous. The adjusted cash flow margin offered another way of showing that Lucent’s cash flow position was precarious—primarily because it was lending to its customers in the form of increasingly generous extended payment terms.

**Figure 10. Lucent Technologies Reported vs. Adjusted Cash Flow, First Quarter 1999 to Third Quarter 2000**



**Figure 11. Lucent Technologies Reported vs. Adjusted Cash Flow Margin, Third Quarter 1998 to Third Quarter 2000**



## Unraveling Operating Cash Flow

I think unraveling operating cash flow is the next great frontier in financial analysis. A lot of discussion has focused on earnings quality, which is extremely important. But CFFO can be just as susceptible to manipulation as reported earnings. The CFFO adjustments we look at include discontinued items, the stock option tax benefit, receivable sales, and the cash tax rate.

The Corporate Executive Board is a company that has a significant amount of CFFO generated from its stock options.<sup>5</sup> Over the course of 2000 and 2001, about 30 percent of its CFFO was from the tax benefit generated by the exercise of employee stock options. For those who do not understand how this tax benefit works, the company can deduct the difference between the actual market value when the option is exercised and the option price when granted and claim the difference as a deduction on the company's taxes even though, for most companies, the option expense is not reported as a cost on the company's income statement.

## The Solutions

Our first solution to working through the nearly indecipherable accounting numbers is to dig deeper for the data. For example, we are now investigating certain data items in the footnotes and footnote schedules and bringing them into the analysis. We also adjust the data and the traditional ratios.

Some people suggest that the U.S. Congress, the SEC, and the FASB are coming to the rescue by virtue

<sup>5</sup>The Corporate Executive Board is a for-profit firm that provides business research and analysis services to corporations and non-profit institutions.

of the internal control certification that is required by auditors and the additional disclosures that might occur. Although all those actions are welcome, we should not expect or delude ourselves into expecting that whatever Congress, the SEC, and the FASB do will totally eliminate the problems that I talked about in this presentation.

Resources are available to help analysts and portfolio managers with these accounting issues. They can attend seminars, such as this one, and they can read books that have been written on the subject. I highly recommend the Mulford and Comiskey books—in particular *Financial Warnings*.<sup>6</sup> Data and information services are available, although I would caution analysts and portfolio managers to seek out information more than data because the data can be misleading. Research tools are also available.

## Conclusion

In spite of what appears to be overwhelming odds, the detection of many of these problems is possible, although I must be honest in saying that not all of these problems can be detected. The regulatory and accounting initiatives will help, but they are not going to totally resolve the detection problems and the potential for misrepresentation. Successful analysis requires systematic and consistent effort and also integration into the investment process, which, strangely enough, is one of the most difficult things for many long managers to implement. Nevertheless, the net result is that this kind of analysis will improve the probabilities of investing wisely, which, after all, is what we are here to do for our clients.

<sup>6</sup>Charles W. Mulford and Eugene E. Comiskey, *Financial Warnings* (New York: Wiley, 1996).

# Question and Answer Session

Bruce A. Gulliver, CFA

**Question:** What kind of adjustments are you making to, for example, cash flow?

**Gulliver:** When adjusting CFFO, we look very closely at any one-time items that are entering into CFFO. We also look at the tax benefit from stock options, which many companies disclose and include in the CFFO. We also take out any nonoperating items that we can identify from such things as the sale of receivables or other balance sheet maneuverings that somehow are flowing through the CFFO.

**Question:** Do you adjust the operating income for financing income?

**Gulliver:** That is one of the items that we are working to bring into our current adjustments because it is an item that is worth attention. We do exclude interest income from net income in our adjusted net income number.

**Question:** Why not just go directly to a company's income tax return and forget the financials reported?

**Gulliver:** That is a rather new source of information. I'm quite interested myself in exploring what information might be in there that would allow further reconciliation or testing of the reported GAAP earnings, cash flow statements, and balance sheets. I do think it is an interesting additional source of information that we should pay some attention to as analysts.

**Question:** In your analysis, do you weight earnings quality, operating efficiency, cash flow quality, and balance sheet quality equally? Or do you give varying weights to these dimensions?

**Gulliver:** In the course of developing our system of analysis, we came to weight both the dimensions themselves and the variables underlying them differently. They do not carry equal weight across time or across companies.

**Question:** Does the pressure on growth companies to deliver tend to lead them astray?

**Gulliver:** People pay great attention to the ability of growth companies to exceed expectations because as soon as they disappoint, the stock price tends to get punished quickly. I think there is reason to believe, particularly with the reinforcement from the stock options programs that were fairly ubiquitous in those kinds of companies, that management wants to, or is under incentives to, get their numbers up and outperform expectations.

**Question:** Did investors drive management to these missteps?

**Gulliver:** A lot of actors are responsible for what happened. But in some cases, analysts were on an analytical holiday and the results were highly predictable. Hopefully, in the future, we will not forget the lessons that we learned only three or four years ago and do the analysis that is required. We must take a careful look at what the companies are reporting and use that information to make our decisions, rather than rely on some expectations or some story that we've heard from a Wall Street analyst or the company itself.

**Question:** In your examples, were the practices actually legal?

**Gulliver:** I don't want to suggest that any of those companies were doing anything illegal. We might

have an idea about Enron at this point, but it is very hard to draw that distinction between illegal and the legally gray area in accounting simply because the rules of GAAP and the rules of the FASB give companies wide latitude in the assumptions that they make and how they report those numbers. The situation gives management, if they're so inclined, the ability to manipulate and misrepresent their actual operating performance, although I would argue these behaviors are detectable in the financial statements. Moreover, these problems cannot continue forever because at some point the reality of what a company is doing will become apparent in how it is performing.

**Question:** How do you incorporate the quality of these numbers into your use of a discount rate?

**Gulliver:** We do not assign a discount rate as part of our rating process. My belief is that valuation techniques, models, and discount rates are valuable tools. But they are much more what I would call "long-term equilibrium pricing" in economics. What we've tried to do is identify near-term changes in performance that are much more likely to be reflected in the stock price in the next, say, six months.

**Question:** How do the third-party transactions work?

**Gulliver:** Enron is a good example. Among other things Enron did, it had third-party entities that would buy and sell between each other. In Enron's case, it really took these third-party entities to a new level. And because Enron had the ability to borrow on these entities from the banks, it was able to extract cash from them.

Another example is when R&D, which might traditionally be included in a company's income statement and balance sheet, is handled by a third-party entity, as was the case with Biovail. Often, a company has some controlling interest in, and maybe even effective control over, that third-party entity.

**Question:** For third-party entities, does that mean the company is not expensing R&D and that any impact from R&D comes through as an equity item?

**Gulliver:** Right. In other words, if the third party doesn't come up with a good product, then the

investment just gets written off as a one-time item, and for the most part, nobody pays any attention to it. But if it is successful, then it is acquired and it goes on the balance sheet and the company is ready with a product to roll out. In this case, it would be booked as goodwill, which does not have to be amortized under current accounting rules. The R&D expense never flows through the income statement.

**Question:** Stuffing the channel and lending to customers are similar transactions. How might you differentiate between them?

**Gulliver:** If you're talking about stuffing the channel, you're probably going to see it in inventory or accounts receivable. If you are talking about lending to the customers, you'll see that primarily in the properly adjusted cash flows or accounts receivable, either current or long term. It will not necessarily show up in the reported numbers; if a company is lending to a customer, it is possible to flip that into a financing activity, so it will show up below the CFFO line as cash flow from investing activities.