

Accounting Ace Charles Mulford Answers Accounting Questions

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[Editor's note: Understanding accounting has become an important issue for investors. In an effort give investors a better handle on the complex financial statements, we're asking experts to explain how companies can use gimmickry to improve their reported financial results.

WSJ.com: We should begin by pointing out that Mr. Mulford's responses are intended to serve broad educational purposes and he encourages investors to seek competent professional advice if they want more detailed or personal explanations of these issues.

Our first question is about Halliburton. The company is in the news for reportedly adopting an aggressive accounting tactic related to **revenue recognition**. How does this tactic work and should investors be concerned?

Mr. Mulford: Halliburton provides engineering and construction-related services primarily to the energy sector. Much of the company's work is completed under contract over long periods of time. As such, **the company uses percentage-of-completion accounting, a common accounting method that permits recognition of revenue and profit as progress is made toward contract completion.**

Halliburton is not presently being questioned about its use of percentage-of-completion accounting generally, but rather a component of that accounting method. More specifically, **the company is being questioned about its accounting for contract claims and disagreements with customers, including those arising from changed orders.**

In an extended contractual relationship, a disagreement might arise between a contractor and customer. For example, there might be an agreement to change an original contract for which a dispute later arises regarding the billable amount. A dispute might also arise related to costs associated with a construction delay. It is accounting for such disputed claims that are in question here.

Prior to 1998 Halliburton took a very conservative approach to its accounting for disputed claims. As stated in the company's 1997 10-K annual report, "Claims for additional compensation are recognized during the period such claims are resolved." That is, the company waited until all disputes were resolved before recognizing associated revenues. In contrast, in 1998, the company recognized revenue for disputed claims before their resolution using estimates of amounts expected to be recovered. Such revenue and its related profit are more tentative and subject to possible later adjustment than revenue and profit recognized when all claims have been resolved. As a case in point the company noted that it incurred job losses of \$99 million in 1998 related to customer claims.

The accounting method put in place in 1998 is more aggressive than the company's former policy but is **still within the boundaries of generally accepted accounting principles**. In fact, according to a survey by the Construction Financial Management Association, **in 1997 47% of the contractors surveyed recognized contract claim revenue when settlement was probable and amounts could be reasonably estimated rather than when the claim was settled.** So not only was Halliburton's new accounting method within the boundaries of generally accepted accounting principles, it was not out of line with other contractors.

While we cannot know for certain until the case is made public by the SEC, it appears that the problem with Halliburton's accounting stems more from the way it handled its accounting

change than from the new accounting method itself. That is, an overt reference to the company's change in accounting method was not provided in its 1998 10-K annual report. In fact, rather than stating its new policy, the company simply deleted the sentence that described how it accounted for disputed claims. Then later, in its 1999 10-K annual report, the new accounting policy was stated.

When such changes in accounting are made, investors need to be apprised of them and their effects on the company's financial results and position. Such information is needed so that current results can be more readily compared with prior periods' and so that a more informed assessment can be made about the company's future prospects. It is this lack of information that I think has raised the attention of the SEC.

WSJ.com: Recent questions have focused on cash-flow reporting. Dynegy, Inc. is a case in point. At the urging of the SEC, the company recently moved \$300 million related to a natural-gas trading transaction from the operating to the financing section of its cash-flow statement. How are cash flows measured and what are common gimmicks that are used, within the boundaries of generally accepted accounting principles, to spruce up cash-flow numbers?

Mr. Mulford: A company uses the statement of cash flows to report the reasons for changes in the cash balance during a reporting period. The cash flows are separated into operating, investing, and financing activities. Operating cash flows arise primarily from ongoing business activities. Such cash flows can be used for re-investment, debt service, dividends, stock repurchases, and other transactions. Investing cash flows include purchases and sales of plant and equipment and the debt and equity securities of other companies. Financing cash flows report changes in how a company is financed, including information on increases and decreases in debt and equity securities and dividends paid.

A general consensus holds that while earnings are open to manipulation, cash flow, or more specifically, operating cash flow, is not as malleable. In fact, some companies, when questioned about their reported earnings, will tout their cash flow numbers as evidence that their earnings can be trusted.

There are, however, many steps a company may use to manage reported cash flow within the boundaries of generally accepted accounting principles. Typically, the objective is to boost operating cash flow because it is the cash-flow measure of business success. Then, as not to misstate the total change in cash for a reporting period, the increase in operating cash flow will be offset with an accompanying increase in investing or financing use of cash. Consider the examples listed below.

Cash flows from the purchase and sale of most investments are reported in the investing section of the cash flow statement. However, when an investment is classified as a trading position, which is an investment made for very short-term speculative gain, the cash flow associated with its purchase and sale is classified in the operating section of the cash flow statement. Accordingly, operating cash flow can be boosted by changing an investment's classification to trading. It is understandable that financial institutions will have trading desks and consider the purchase and sale of trading investments as part of operations. It is out of character, however, for non-financial companies to have trading positions and classify them as part of operations.

A company can take longer to pay its vendors, thus increasing accounts payable. The operating cash flow provided in this manner is effectively vendor financing. While it is properly reported in the operating section, such cash flow is not inherently sustainable.

Collections of accounts receivable, reported as an operating source of cash, can be accelerated through securitization. In effect, accounts receivable are sold and become the collateral supporting a financing transaction. Many companies, but not all, will report cash flow derived in this manner as an operating item. While it is not improper to report such transactions as operating events, such cash flow is effectively borrowed from future periods. However, if the amount of securitized accounts receivable per period remains relatively level over time, the net effect on operating cash flow will be zero.

Capitalized expenditures such as software and interest are reported as investing uses of cash. As such, increases in amounts capitalized will boost operating cash flow and be offset with increases in cash used in the investing section.

Acquisitions play havoc with the statement of cash flows. Cash paid to acquire net assets -- assets less liabilities -- in an acquisition is reported as an investing activity. Among the assets acquired are working capital items such as accounts receivable and inventory less accounts payable. When acquired as part of operations, the cash employed in building working capital is reported as an operating use of cash. The realization of this working capital is an operating source of cash. When working capital is acquired in an acquisition, however, the cash paid to acquire the related accounts is reported as an investing use of cash, though their realization is still an operating source of cash. Thus companies can effectively "purchase" operating cash flow through acquisitions. Investors may see signs of the effects of acquisitions on operating cash flow by examining the cash flow statement. For example, an increase in accounts receivable from one balance sheet to the next may not equal the amount reported as the increase in accounts receivable on the cash flow statement because accounts receivable acquired in a business acquisition were reclassified to the investing section. The same can be said for other operating accounts such as inventory and accounts payable.

I am personally somewhat leery of reported operating cash flow when a company discloses numerous acquisitions during a reporting period. It would be helpful if the FASB would require companies to disclose pro-forma operating cash flow for a combined entity as though the combining companies had been consolidated for all periods presented. Such information would help investors get a clearer reading on sustainable operating cash flow.

Regardless of their source, generally accepted accounting principles require that all income taxes be reported in the operating section of the cash flow statement. Accordingly, tax benefits accruing from the exercise of stock options, ostensibly a financing activity, are properly reported in the operating section of the cash flow statement. Such cash flows are inherently very volatile, increasing during periods when high stock prices are accompanied with increased exercises of stock options and decreasing during other periods. Because of this volatility the tax benefits arising from the exercise of stock options should not be considered as part of sustainable operating cash flow.

Some companies will reclassify outstanding checks to accounts payable, increasing the cash balance in the process. Such a reclassification boosts operating cash flow. Because cash is defined as amounts available for immediate use, outstanding checks are not cash. Reclassifying them to accounts payable is tantamount to saying that the amount due a vendor has not been paid and the cash is available for any other desired use. This, of course, is not true because the check has already been written.

A closely related act is to reclassify cash overdrafts, a negative cash balance, to accounts payable. Overdrafts are checks written for which there is no available cash. It is a liability but is more properly reported as a bank financing obligation than as accounts payable, an operating liability.

To my knowledge there are no accounting rules permitting the reclassification of outstanding checks and overdrafts to accounts payable. I suspect that companies take these actions because the amounts involved are considered to be immaterial. Granted this reclassification entails a balance-sheet only adjustment and does not affect net income. It does, however, affect operating cash flow and, in my view, can affect an investor's assessment of a company's financial performance.

While the items described here may not be outside the boundaries of generally accepted accounting principles, their use does distort operating cash flow. As such, investors should carefully consider whether operating cash flow should be adjusted, where possible, to remove their effects.

WSJ.com: There has been a great deal of chatter about [stock options and accounting](#). Do you think that compensation expense should be recorded for stock options or do you think that footnote disclosure is sufficient?

Mr. Mulford: [Companies presently have a choice in how they account for compensation expense associated with stock-option grants -- an intrinsic-value approach or a fair-value approach.](#) Under the [intrinsic-value approach compensation expense](#) is recorded for the option's intrinsic value. This is the amount by which the exercise price of an option granted is exceeded by the market price of the underlying stock on the measurement date, typically the date of grant. With the fair-value approach compensation expense is recorded for the estimated fair value of the options granted using an established valuation model such as the Black-Scholes option-pricing model. With both approaches any compensation expense recorded is spread over the estimated service period of the recipient, usually the vesting period.

Most option grants entail qualified options that [afford certain tax benefits to the recipient](#), mainly that no income tax is due on shares obtained through stock-option exercise until the acquired shares are sold. At that point capital-gains treatment is applied. However, qualified plans require that an option's exercise price cannot be less than the market price of the underlying stock on the date of grant. Thus, such options have no intrinsic value. Accordingly, under the intrinsic-value approach there is no compensation expense to be recorded.

[The vast majority of all companies use the intrinsic-value approach. While companies choosing this method will not, in most cases, record compensation expense, they still must disclose in a footnote to their financial statements an estimate of the cost of the options granted using the fair-value approach.](#)

[Thus, as long as options are granted with no intrinsic value on the date of grant, generally no compensation expense is recorded. This is not to say that the options do not have value. Recipients certainly do not consider options to worthless or they would not be inclined to accept what in many instances is a below-market cash-based rate of pay.](#)

In the early 1990s the Financial Accounting Standards Board proposed requiring companies to use a fair-value approach to recording compensation expense for stock options. Companies, especially technology firms that had been generous in their stock-option grants, argued forcefully against such a measure. Their argument held that requiring expense recognition for stock options would affect the viability of many technology firms by significantly reducing their ability to use options as compensation and in the process would threaten our nation's technology edge. In Congress they found a sympathetic ear and pressure mounted on the FASB to back down. The compromise solution reached is our present practice of permitting a choice in the method used to account for stock options but requiring footnote disclosure of the effects on earnings of the fair-value approach if it were not used in recording compensation expense.

In the past year, as serious questions about accounting generally in the U.S. have been raised, the option-accounting issue resurfaced. The use of options as a form of compensation soared in the late 1990s and into the new decade, all without the recording of compensation expense. Were earnings being properly measured? Also putting pressure on our regulators to reconsider the issue is talk that the International Accounting Standards Board, a board that is gaining stature in its pursuit of a body of common accounting standards internationally, is considering adopting a fair-value approach. In addition, very recently Standard & Poor's announced that it would incorporate estimated compensation expense for stock options in its calculations of operating earnings.

I personally side with those who think that a fair-value approach should be used in recording compensation expense for stock-option grants. The options have value, they are being used as a form of currency to pay for services and accordingly, there is an accompanying expense to be recorded. While measuring the value of options is based on an estimate, we use estimates for many items reported in financial statements.

There are other valid arguments against the fair-value approach. In estimating the value of stock options, the Black-Scholes model incorporates assumptions for such factors as the exercise price of the option, the market price of the underlying share and the volatility of that price, the level of interest rates, the underlying share's dividend yield, and the option's term to expiration. It was developed more for publicly traded options with relatively short expiration periods. Stock options granted to employees and others are not publicly traded and carry expiration dates that often extend out as far as ten years. Whether the assumptions employed by the Black-Scholes model are appropriate for such options is open to debate. Though it would seem that even if the model were not perfect for estimating the values of stock options it is better than assigning no value to those options.

Others note that the granting of options involves no cash payment and indeed results in cash inflows for the amount of any exercise price received plus, in some instances, a tax benefit. How can there be expense with no ultimate cash payment? Many companies that issue options will use cash to repurchase their own stock in order to avoid the dilutive effects of stock-option exercises. Others may use treasury shares, purchased earlier for cash, to satisfy exercises of stock options. However, even without using cash to repurchase shares there is a foregone cash inflow for the excess of the market price of the stock over the exercise price on the date of exercise. In fact, it is roughly the present value of this excess that a valuation model such as the Black-Scholes model attempts to estimate when assigning a value to stock options on the date of grant.

Another argument against the fair-value approach is that the effects of options are seen in the dilutive effects caused by an increase in the number of shares outstanding used in the calculation of earnings per share. That is, the inclusion of the effect of options on earnings and on shares outstanding would result in a double counting of their impact. It should be noted that dilution reflects a division of equity ownership and of earnings and does not affect the absolute amount of that equity or those earnings. Stated differently, the dilutive effect of options does not appear in reported net income or shareholders' equity. Also, there is no debate about the need to record expense when shares are granted outright for services. Yet even here there is an expense effect and a dilution effect.

These are all valid arguments, but I think that they can be addressed in a satisfactory manner. Unfortunately, the issue of whether or not to record compensation expense remains a political one subject to pressure from lobbyists and political rhetoric. In such a politically charged environment it is difficult to get objective discourse. If we can move the debate away from politics, something that is important if there is to be more trust in our accounting standards, I

think that there would be an excellent opportunity to make meaningful change to our accounting practices for options. Unfortunately, this may be a tall order to fill.

WSJ.com: We have seen a rash of restatements in the past six months, almost all of them downward. Will this trend continue or do you believe that accounting practices have become more conservative in the past two quarters?

Mr. Mulford: Certainly it is difficult and possibly foolhardy not to be conservative in this environment.

I personally think that during the bull market of the 1990s and into 2000, the power pendulum in discussions on accounting issues between managers and their auditors swung solidly to the side of management. High and rising share prices led to a general feeling of success on the part of managers. With this success also came the pressure to perform. Financial results were being carefully scrutinized by investors. Given this intense scrutiny and the high level of share prices at the time, there was no room for unpleasant surprises. Emboldened by their success but under pressure from investors to perform, managers pressed their auditors to agree to more aggressive accounting practices. In this environment, auditors felt more pressure to abide by managers' wishes and did so. Financial reporting became more aggressive.

Since the demise of Enron Corp. and the ensuing problems at Arthur Andersen, the power pendulum has swung back to the auditor's side. Both sides -- managers and auditors -- now see clearly the negative consequences of overly aggressive financing reporting. In addition, there is a general consensus that investors now require compensation for aggressive accounting and a lack of reporting transparency. They are exacting this charge through lower debt and equity prices for firms that are not forthcoming. As a result, managers now see that conservative accounting and full disclosure are good for business, helping to reduce the cost of capital.

The recession has also helped lead to more conservative reporting. It has lowered earnings expectations and with them, share prices. Accordingly, there is less pressure on managers to meet optimistic and ever-growing earnings forecasts.

The SEC's role in encouraging more conservative financial reporting has also been a significant one. The Commission increased resources devoted to its enforcement division and has stated that it will more carefully review public filings made with it. As part of changes being made the filings of larger companies will now be more carefully scrutinized than in the past. Adding weight to the SEC's moves has been the never-ending litany of enforcement actions taken by the Commission against errant companies and their managers. The SEC publishes enforcement actions against companies, individual managers and auditors in what are referred to as Accounting and Auditing Enforcement Releases. Many of these actions, but not all, lead to restatements of financial reports. Often more than one enforcement action is filed for an individual reporting violation. For example, a company, one or more key managers and the company's auditor might be named in separate enforcement actions involving a single event. Nonetheless, given the high volume of enforcement actions being filed recently, it is clear that the SEC has been very active. For example, between 1990 and 1999 the Commission filed on average a little over 100 enforcement actions per year. That number increased to approximately 144 in 2000 and was 126 in 2001. Given the prominence it is placing on enforcing the securities laws many more such filings are expected for 2002.

Given all of these factors it is not surprising that managers and their auditors have taken a more conservative reporting bias. Returning to the question, I think that we will continue to see a higher than average number of restatements as the excesses of recent years are worked off. However, as the storm subsides, and it will, I think that the number of restatements will decline markedly reflecting a new and more conservative financial reporting environment.

WSJ.com: Are there other accounting issues that might emerge in the coming weeks and months that we should be aware of?

Mr. Mulford: I think that we will continue to see examples of many of the same issues we have seen recently. Companies will be reprimanded for overstating revenues and understating expenses, for off-balance sheet liabilities and for insufficient disclosure of related-party transactions. That said, I do have a few thoughts on other items that may surface in the near to mid-term.

Last week I provided a few thoughts about how companies might manage operating cash flow within the boundaries of generally accepted accounting principles. If the SEC's move against Dynegy Inc. to reclassify \$300 million from operating to financing cash flow is any indication, that agency is starting to think more seriously about how companies report cash flows. I would not be surprised to see the SEC require other companies to reclassify their cash flow statements.

While we are in this mode of forward-looking, let's look at the supplemental reporting of **EBITDA** or earnings before interest, taxes, depreciation and amortization. This is a big topic and one that could easily be dealt with as a stand-alone subject. But here are a few observations. Because EBITDA, which is often used as a pro-forma measure of earnings, is calculated before key expense measures such as interest and income taxes, depreciation and amortization, it obviously provides a more positive view of financial performance. Many proponents of EBITDA would also remove certain nonrecurring items, typically charges, in calculating EBITDA. Thus companies just look better when measured on an EBITDA basis. I think that this fascination with the metric will decline as a more conservative reporting environment takes hold and investors begin to make more sober assessments of financial performance. EBITDA gained its popularity during the 1990s and I think will lose its luster during this new decade. EBITDA will become a metric for companies that cannot generate normal shareholder earnings. Lenders, I believe, will continue to use EBITDA as such earnings are available for debt service. It is shareholders who I think will begin to more forcefully question the reporting of EBITDA as a supplemental earnings statistic. EBITDA are simply not earnings that are available for shareholders.

Some recently released Statements from the Emerging Issues Task Force (EITF) of the FASB are changing how manufacturers account for certain promotion and marketing expenses. Consider, for example, a consumer packaged goods company that sells to a grocery chain. Historically, any promotional payments made by the manufacturer to the grocery chain would be accounted for as part of selling, general and administrative expense (SG&A). Beginning this year those same payments must now be netted against revenue. This appears to me to be a significant issue to watch. While it will not alter reported net income it does affect amounts reported as revenue.

The FASB is presently working on the definition of control. That is, when does an entity "control" another one requiring consolidation of financial reporting. Historically, control was defined as an ownership interest of over 50% of the voting shares. However, it is not difficult to identify situations where one entity does not own over 50% of the voting shares but through a large minority ownership interest and other arrangements, including significant board representation, the entity has effective control. Prior to all of the discussions about off-balance sheet obligations surrounding Enron Corp.'s restatements, the FASB had tabled this topic. After Enron, it is easy to see the need for a clearer definition of what constitutes control. I think that we will see something from the FASB on this before too long.