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THE NUMBERS GAME

By TRACY BYRNES



FROM THE ARCHIVES: February 15, 2002

Off-Balance Sheet Items Hold The Key for Curious Investors

Here's a question for you: If an asset is "off-balance sheet," is it:

- Nowhere
- In danger of falling over
- In the CFOs personal account

Try none of the above. That's because this whole notion of off-balance sheet reporting can be as understandable as a two-year old's babbling. If a company has an asset or liability and it's not on the balance sheet, then where is it? That's what we're going to find out. It's going to be a bit grinding, but this is the kind of stuff that helps smart investors steer clear of the Enrons of the world.

Some of the confusion surrounding off-balance sheet items, which include things like lease agreements, is the name itself. "Off-balance sheet" is a bit misleading because it implies that something should be on the balance sheet instead, says Tim Lucas, the Financial Accounting Standards Board's research director.

The off-balance sheet items are usually found in the footnotes to the financials, which come after the cash flow statement. The problem is you have to read them. And, frankly, the folks who write these footnotes were not English majors. So while, in most cases, no one is pulling the wool over your eyes, the writing may be jerky and confusing.

Take **Tyco**, a company that doesn't appear in the news these days

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Tracy Byrnes graduated from Lehigh University with degrees in English and economics. She went on to complete her M.B.A. in accounting from Rutgers University and then she spent four years as an auditor at Ernst & Young.

From there she turned to journalism and wrote for Financial World magazine for a year. She spent the next 3 1/2 years as a senior writer at TheStreet.com, where she won the Newswomen's Club of New York first-place award in the Internet Breaking Business News category and a first-place award from the New York State Society of CPAs for co-authoring a piece that scrutinized how the mutual-fund industry conducted business with shareholders.

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without the words "accounting questions" nearby. Look at Note 7 in Tyco's current 10-K filing, where it discusses its sale of trade receivables. No surprise in that, but who did Tyco sell that stuff to? The note says it sold the balance to a "limited purpose subsidiary of the Company." Huh? According to the footnote, it's tough to tell who the buyer is, though it appears the buyer is affiliated with the company. And that's one reason accounting-addled investors have Tyco on their mind. (Why can't they all be like you, Mr. Buffett?)

There are certainly legitimate reasons to report an item off-balance sheet, according to FASB. And while the rationale for these off-balance sheet items is up for debate these days, it's up to FASB to change the standards. And FASB long has been accused of taking its own sweet time coming out with new standards. So as in most situations, you need to help yourself.

The four main items reported in the footnotes are lease agreements, pension assets and liabilities, investments in joint ventures and affiliates and special purpose entities, otherwise known as the securitization of assets. We'll tackle the first three today and save special purpose entities (or SPEs) for next week.

Lease Agreements

Let's look at the most obvious and oldest item being sent off-balance sheet: lease agreements.

If you lease an item and the contract doesn't have a special buy-out option at the end of the lease, then FASB says you can't really call that an asset you own. Let's say you've leased a BMW Z3 for three years and you've got a baby on the way. Your wife says it's got to go when the lease is up since it's a two-seater. While it's a joy ride today, you can't consider it a personal asset.

The accountants would dub that an operating lease since at the end of the lease you will return the item and (sadly) move on.

Lots of companies have operating leases. Take Staples, the office supplies store. It leases a bunch of different buildings for its stores but at the end of these leases, there's no guarantee for renewals or option to buy the building, says Albert Meyer, an analyst with David W. Tice & Assoc., an investment research and management firm in Dallas. Since Staples risks losing the store, it's not really an asset to them. This is all spelled out in their footnotes.

Keep in mind, there is nothing wrong with having operating leases but they are future liabilities that will need to be funded by future revenue. So it helps to compare. The total cash **Staples** would have to pay to cover its leases, which are generally over an extended period of time, is around \$4.4 billion, says Meyer. That's around 41.8% of its annual revenue. Is that bad? To find out, compare the figures to a peer company. **Office Depot's** operating leases are only 19.5% of its annual revenue, according to

Mr. Meyer, who says he would never analyze a company without taking into account its operating leases. Mr. Meyer's firm does not have a position in either Staples or Office Depot.

Pension Assets and Liabilities

Other big items not shown on the balance sheet are the pension assets and liabilities. Since the pension assets are put into a trust, a separate legal entity, the argument is that those assets belong to the employees, says FASB's Lucas. So it's not fair that the company tries to claim them.

(But they can manipulate them to pump up earnings, can't they? **IBM** recently raised the rate of return on its pension assets from 9.5% to 10%. In this market? But, in very simple terms, that will increase its pension assets, thereby decreasing its pension liability and, voila, earnings go up. We'll look into that accounting maneuver on a future date.)

One thing to look for: "net pension liability," found on the company's balance sheet. Why only the net? Here's the current logic. Let's assume there are \$300 million in pension assets. But if everyone retired, the company would need to pay out \$500 million. So the company is short \$200 million at this time. That's a liability to the company and it better show up on its balance sheet (and management better come up with the money before we all retire.)

After the go-go market of the late 90's many companies actually had a surplus in their pension funds thanks to those rocketing returns. But things no doubt will change. **Sprint PCS**, for instance, had a surplus in its pension plan over the last few years. But in 2000, the plan's assets actually lost \$157 million, according to Mr. Meyer of Tice & Assoc. If that keeps up Sprint will have to add money to the fund and that will take away from the cash it needs for its day-to-day business. Mr. Meyer's firm doesn't have a position in Sprint PCS.

Joint Ventures and Affiliates

If a company owns a piece of an affiliate or joint venture, in many instances, it doesn't have to separately report its proportional piece of the assets and liabilities on its balance sheet. Again, only the footnotes need the details.

If a company owns 50% or less of an affiliate or a joint venture, then only the net of the assets and liabilities the company owns pertaining to that affiliate should hit the balance sheet. In most instances, you'll find that number under the investments section.

This net number is the result of the "equity method," in accounting-speak. So if our company owns 50% of a company with \$10 million in assets and \$8 million in debt, net assets are \$2 million, assuming no goodwill. Since the company owns half, it reports \$1 million as an asset in the investment section of its balance sheet.

But isn't the company responsible for \$4 million in debt? Why doesn't that ever hit its books? Technically, the company doesn't have to pay that debt back, says Ed Ketz, associate accounting

professor at Penn State University. The affiliate is given the benefit of the doubt that it will come up with the money to repay anything outstanding.

No surprise this stuff can appear fishy. And this kind of accounting may be one reason the stock of highly-acquisitive **Cendant** stock was hit earlier this year. Investors were concerned that it was not fully disclosing all the details of its off-balance sheet investments. Cendant, no stranger to accounting flub-ups, posted an explanation of its investment in affiliates on its Web site to attempt to appease the troops. The stock has since recovered.

Holy Leveraged

It's very easy to argue that showing a net number on the balance sheet and leaving all the meat in the footnotes will not give you a clear picture of a company's total leverage. But let's face it, your portfolio will be long gone if you wait for FASB to heroically jump to your aid. So take ownership and do your own digging.

And just doing a debt-to-equity ratio (which is long-term liabilities divided by stockholders' equity) won't cut it these days. Tally total debt but then comb through those footnotes and find the total pension liability, leases outstanding, and affiliate liabilities to name a few. Then run your debt-to-equity ratio. And be sure to compare that number to its industry peers.

Whew. Nothing like a little straightforward accounting. And we've only just begun. Tune in next week as we dissect special purpose entities.

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THE NUMBERS GAME

By TRACY BYRNES



FROM THE ARCHIVES: February 1, 2002

Sorting Out the Recent Changes In 'Goodwill' Accounting Rules

AOL Time Warner is everywhere. Whether you hold it in your 401(k) or you're a huge Madonna fan, the company has infiltrated our lives.

That's why everyone was floored when the company announced it might get smacked with a write-off of as much as \$60 billion this year. What's going on here? Hint: It is not the result of punitive damages from the Gerald Levin-Ted Turner boardroom brawls.

The charge is from the impairment of goodwill. The Financial Accounting Standards Board created an "impairment" test that must be applied annually to see if a company's acquisition is still worth its purchase price.

And AOL Time Warner is not alone. Any company that has been involved in M&A activity will have to apply this test to its acquisitions. If the acquisition is not worth the purchase price -- and what is these days -- the company will have an impairment charge. So be prepared to hear about these charges regularly.

But don't panic. In order to understand how this new accounting treatment might impact your investments, you'll need to think like an analyst. Let's walk through the logistics.

Accounting 101

These days, when two companies merge, the buyer goes out and

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appraises the fair market value of the target company. Let's assume the buyer likes the target and is willing to pay a higher price. That's great. But this makes the accountants jump to attention. They need to keep track of that premium. When the numbers from this acquisition are reported, the fair market value of the company and the premium will be reported as separately in the asset section of the balance sheet. That premium is dubbed "goodwill," in accounting-speak and the method of reporting the appraised price and goodwill separately is called the "purchase method" of accounting.

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So now the buyer has a big asset called goodwill on his books. Why doesn't everyone pay more? Because nothing good lasts forever, not even goodwill. Before this new accounting rule, goodwill was amortized -- or gradually eliminated -- over 20 years. That meant each year, a piece of that goodwill balance was recorded as an expense. Remember, expenses eat into revenues and reduce earnings.

But the new rule, approved back in July 2001, changed all this. Now, companies, beginning with firms whose fiscal years end this December, don't have to expense a piece of goodwill each year. Instead, they must use this new "impairment" test on each of their purchases to see if the acquisition is still worth what they paid for it.

How do they do that? Say Byrnes Industries reported \$20 million as goodwill after the acquisition of Tracy & Co. If the new division is still prospering a year later, then the goodwill amount needn't be adjusted, because that extra \$20 million was obviously well spent. In this case, they will have a fat asset on their books, at least until they apply the test again the following year.

But if the acquired division is in the toilet, Byrnes Industries can't continue to say it has a \$20 million benefit. So the goodwill balance needs to be lowered to, say, \$5 million. Byrnes Industries then will take a \$15 million hit for buying a loser company.

The \$15 million isn't a "cash charge," notes Robert Willens, a tax and accounting analyst with Lehman Brothers. The accounting treatment has nothing to do with how much cash comes in through sales and investments and how much goes out from expenses, a.k.a. the company's fiscal health. So it has no bearing on whether the company is producing a product that people want to buy. It's just the result of an accounting change. It does not necessarily foretell impending doom.

On the plus side, if companies follow the rules and test for impairment by the end of the second quarter, any charge will show up on the financial statements as a "change in accounting policy." That's a below-the-line charge. That means first operating income is computed, then this charge is subtracted. And operating income is the number that tells you how the company's day-to-day business is doing. That's what you should care about.

If they don't test until later in the year, the charge will be reported as income from continuing

operations. That shows up "above-the-line" so it will appear that there's a problem with the business.

Should You Care?

OK, you know the fundamentals. Use that info to make informed decisions.

Why is your company taking this hit? Was it caught up in the M&A frenzy of a few years ago? If so, one of two things might've happened:

1. The acquired business is still sound, but the market just bites or
2. Once you bought the acquisition-with-the-supposed-sunny-future, it flopped (kind of like appearing on the cover of Sports Illustrated).

Many impairment charges can be blamed on the market. Say you bought a company that was trading at \$30 in 1999 and paid \$10 in goodwill. Now it's appraised at \$2 a share, although the business still seems viable. That \$10 premium no longer exists so you have to take an impairment charge for it.

That's a big reason for the AOL-Time Warner write-down. The value of merged companies had fallen dramatically since its January 2001 marriage, forcing it to write-down almost half of its current goodwill balance of \$127 billion at September 30, 2001.

Others will argue that you could use these charges as a test of management's decision-making, suggests Jack Ciesielski, publisher of The Analyst's Accounting Observer. Did the folks up top buy a rotten company? That's worth investigating further.

So look at your portfolio. Any company that participated in M&A activity may fall victim. About 75%-80% of impairment charges will fall within the tech and telecom stocks, says Mr. Willens.

Also expect to see these charges from companies that used purchase accounting in the past. (Big note: Pooling accounting used to be an option for companies that merged. It did not create goodwill and is no longer allowed.) **AT&T** used purchase accounting when it merged with MediaOne and TCI. So expect pretty substantial write-offs from Grandma Bell.

There's an Upside

On the plus side, since goodwill no longer needs to be expensed each year, companies that don't have impairment charges will be looking prettier than their impaired brethren. Why? Their bottom line may appear to be higher since goodwill expense is gone. So a company like **PepsiCo**, which purchased Tropicana a few years ago, probably will be just fine. Orange juice still sells like liquid gold in supermarkets across the country. So no impairment problems are likely there.

But again, don't be fooled. It's just an accounting change. It has nothing to do with the sales of pulpy

Vitamin C-laced drinks.

That is also why you shouldn't see any major stock-price dips when these charges are announced. These charges should come as no surprise to the pros.

Ideally, companies will recalculate prior years numbers to show the affects of this new test. Then it will be easier for investors to do comparisons of each year. Unfortunately, companies are only required to show this restatement in the footnotes to the financial statements. So be sure to read them.

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By TRACY BYRNES



FROM THE ARCHIVES: February 7, 2002

Too Many Thin Mints: Spotting The Practice of 'Channel Stuffing'

With financial chicanery popping up everywhere these days, it's painful to read a newspaper or turn on the TV. To make matters worse, the financial pundits, who spend their days dissecting this stuff, seem to have their own language. They claim companies "massage earnings" or "cook the books." Or how about this: They even talk about companies "stuffing the channel."

Well, what the heck does that mean?

Stuffing the channel refers to getting customers to buy more than they really need now to pump up sales figures.

Take the Girl Scout that comes to the door hawking cookies. I ordered three boxes of Thin Mints and paid her. But when she got home she tallied all the boxes she sold and realized that she needed 10 more boxes to win those free tickets to Six Flags Great Adventure.

So what does she do? She doubles my Thin Mints order, along with a few other customers', unbeknownst to all of us. She just knows this won't be an issue since everyone loves Thin Mints. Two problems though. She's got to come back and sell more cookies and get more money from me -- and it could take me weeks to scrape up another \$3 for the box. And if I do come through, by the time she shows up in March to sell me Easter candy, I'll still be eating Thin Mints and won't buy a thing from her.

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She stuffed the channel -- and my face for that matter.

When companies do this, once the merchandise is shipped, they record it as a sale in their books, regardless of whether the products are paid for or not. This makes sales appear much higher and that translates into higher earnings. And that makes the analysts happy. But when stretched, it makes sales figures misleading and regulators unhappy.

To be sure, recording a sale as it ships is not illegal. It is the revenue-recognition policy for many companies, especially manufacturing ones. It is just much easier for these companies to stuff the channel. But be aware that companies with different revenue-recognition policies can just as easily take a gamble at channel stuffing.

Picture it. It's the end of December, and a salesperson who sells heated stadium pillows has to make his sales quota for the year. So he ships out extra pillows. He makes his number, not worrying that his customer will not need so many pillows in January. He'll worry about that then. He'll just steal from February to make his January sales number.

He has become a serial stuffer. And since his company wants growth, by March he's trying to sell his customer three months of pillows in one month.

Eventually this will catch up with him as customers groan under mountains of unused or unsold pillows. In real life, stuffing can have grave consequences. **Lucent Technologies**, for instance, came under Securities and Exchange Commission investigation in February 2001 for several issues, including [stuffing the channel](#)² with its telecommunications equipment. For that and several other reasons, its stock now trades below \$6 from around \$20 when the stuffing issue arose. [Sunbeam famously stuffed](#)³ the channel with barbecue grills and other outdoor items, and that aggressive practice contributed to the company's demise. Personal-computer makers have also had brushes with channel stuffing.

It's possible to spot channel stuffing. You can look for evidence of this practice in the financial statements. First read the summary of accounting policies footnote near the end of the financial statements to determine the company's revenue-recognition policy. Remember, recording revenue at shipment is not necessarily bad, it just may be a tip-off to some aggressive behavior.

Then check out the receivable balance on the balance sheet. That shows how much money the company is still owed from products shipped or services rendered. Is it higher than last quarter? Last year? Figure out an easy ratio: days to sales outstanding. That's the amount of time a customer takes to pay. Just divide the total balance in accounts receivable, found on the balance sheet, by the average sales per day (which is annual sales divided by 365). Compare to last year. Is it getting longer? That could indicate that the sales team offered an extended payment plan in effort to get the customer to buy

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more goods. If so, now the company has to wait longer to get paid. That's bad news.

Then look at the inventory number. Is that growing too? Too much inventory in the warehouse means no one is buying anything. That could mean that customers have everything they need thanks to a build up in supplies from previous months. And that scenario is precisely why channel stuffing is more than just a funny accounting phrase. It's a potentially toxic situation.

Which reminds me. Want a thin mint? I've got plenty.

Thanks for your e-mail after last week's column. I intend to use some of your suggestions to address additional accounting issues moving forward. I realize there are lots of questions about accounting these days, so if you've got something that makes you curious, fire me a note at tracy_byrnes@yahoo.com⁴, and I'll get on the case.

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