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THE NUMBERS GAME

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'Pro Forma' Earnings Cloud Important Investment Issues

You can't pick up a newspaper without seeing some mention of "pro forma" earnings. It may sound confusing, but to better grasp what pro forma can mean, just replace "pro forma" with "here are the pretty numbers" and the concept becomes clearer.

The fuzzy term stands for a popular accounting maneuver. Essentially, pro forma numbers are numbers that the company reports using its own set of assumptions, and often the pro forma numbers are different (read: better) than the Generally Accepted Accounting Principles (or GAAP) numbers. Pro forma can be used to describe individual numbers or an entire statement, like the balance sheet or income statement. The Latin translation is "for shape" so think of it as numbers the company "shapes."

Thus, when you see pro forma, grab the skeptic's hat. Sex sells, even on Wall Street, so some companies like to use "pro forma" numbers to make eyes widen and fingers click "buy" on a broker's Web site. And let's face it, sexy packaging is everything these days. Why do you think Sports Illustrated put Anna Kournikova on the cover of a recent issue? To extol the prowess of a professional tennis player who has never won a tournament? Right.

Bins, Sins and GAAPs

Like most good accounting gimmicks, the pro forma concept had a reputable start. One understandable example is when a company makes an acquisition and has to lay off a ton of people.

The huge severance payments will be a big hit to the bottom line. Since the company believes this is a one-time event, it will not include that expense in its pro forma numbers. But over time the pro forma concept has become an amorphous bin with too much room for management interpretation. That's why restructuring charges, write-downs of assets from continuing operations, stock-option expenses, write-offs of research and development purchased from other companies and even marketing expenses are sometimes left out of pro forma numbers. Management's justification? Those costs don't reflect the true business.

Of course leaving out all those charges can falsely inflate earnings. Even though GAAP typically considers these exclusions normal business expenses and believes they should be included in an earnings calculation, companies still view these things as zits on a cover girl and feel they need to be airbrushed out. But just because the pro forma numbers make it into press releases and appear on Web sites, companies still must show the GAAP-dressed face when filing with financials with the Securities Exchange Commission, with the pro forma numbers nowhere in sight.

This dual thinking has created some gaps between, well, GAAP numbers and pro forma numbers. According to a recent Bear Stearns report, technology and telecommunication companies have made heavy use of the pro forma concept. In the four quarters ending Sept. 30, 2001, the spread between actual (GAAP) earnings and pro forma earnings had grown to 55.8% in the technology hardware and equipment sector. Talk about pretty numbers. The spread in telecommunication services was nearly 9%. Consumer durables, by comparison, had a spread of 1%.

As the Bear Stearns report shows, it's not hard to see through the pro forma gambit. And, if management has any integrity, it will offer you a good explanation of what was included, excluded and why.

But given the hazy accounting that has come to light with Enron and other companies, it's wise to be skeptical. Back in the late '90s, **Kellogg**, for instance, took restructuring charges for nine quarters in a row. A restructuring charge is supposed to be a one-time event. So how can it happen nine times? Perhaps that should be part of the ordinary business expenses. Remember, GAAP thinks it should.

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ABOUT TRACY BYRNES

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.

She is currently a free-lance writer covering accounting and tax issues.

Quite frankly, GAAP has a tough time believing that any event is nonrecurring or extraordinary. A hailstorm that destroyed a crop in Hawaii is extraordinary, but the same thing in New Jersey isn't. And while you would automatically assume that the effects of Sept. 11 were no doubt extraordinary, since the consequences were so far reaching, the Financial Accounting Standards Board has ruled that those associated losses should not be reported as extraordinary numbers.

Just Trying to Help, Really

Management argues that offering pro forma numbers helps investors better understand the company. Instead of reporting the GAAP number and giving you all the facts to let you create your own pro forma number, they believe they're doing the work for you.

The Financial Accounting Standards Board has no rules governing what should go in a press release and auditors are not responsible for them, says Norman Bartczak, an accounting professor at Columbia University. Auditors instead focus on the cumbersome SEC filings.

But that may be changing. At the end of 2001, the SEC finally decided to flex some muscles concerning pro forma abuse. Newly appointed SEC commissioner Harvey Pitt resolved to go twelve rounds with companies who issue pro forma results that are deceptive and do not offer supporting detail. He warned companies that they could face civil-fraud lawsuits for publicizing misleading numbers, demanding that companies fully explain how their pro forma numbers are calculated.

The first to feel the SEC's sting: The Donald. In January, the SEC accused **Trump Hotels & Casino Resorts** of failing to mention in an October 1999 statement that its beefed-up $14 million pro forma profit included a one-time revenue gain of $17 million.

Should anyone read pro forma numbers at all? Granted, bad apples abound, but not all managements lack integrity. And pro forma numbers, when not abused, can be a very helpful comparability tool, says Eric Heiman, a research analyst at the Olstein Financial Alert fund.

For instance, many companies incurred countless expenses due to the Sept. 11 attacks, and breaking those out helped investors examine understand the nature of the specific costs associated with the attacks. Since FASB wants them included as normal business expenses, it would help you to see how the company did without them. Pro forma numbers would be helpful in this instance so you can create a fair comparison to prior periods.

In the wake of the Enron debacle, other companies are just trying to be straightforward about their numbers. **Flextronics** recently said that it would take the high road and include certain issues, like plant closings, in its pro forma numbers. So while the numbers could look a bit uglier, at least they're looking more honest.

But like a woman who won't leave the house without a push-up bra, some companies can't resist trying to readjust the truth.

Computer Associates recently said that it thinks the investing community should rely on its pro forma numbers because they include a new revenue recognition method that better fits its business model than the stodgy ol' GAAP revenue recognition policy. Read: "So it doesn't matter what the rest of the world does it, this is the way we like it." That will be useful when trying to compare the company to its peers. While the SEC is investigating whether the company adopted this brand-new accounting method in an effort to overstate profits and boost the company's stock price, CA hasn't released enough information to help investors work through the numbers themselves in the meantime. On top of that, the company has made enough acquisitions recently to make the head spin. CA has incurred a mountain of extraneous charges as a result, but -- no surprise -- you won't find most of that in its pro forma numbers.

Getting Beyond the Airbrush

When companies insist on using pro forma, make sure that's but a single data point among many that you scrutinize, says Ashok Ahuja of Icor, a Westport, Conn., firm that operates a technology hedge fund. He notes that everything you need to make an informed decision is in the SEC documents like the 10K -- the official document for annual financials that companies must file with the SEC 90 days after the close of its fiscal year -- or the 10Q, the quarterly financial report. So read them and create your own pro forma numbers.

Our hope is the SEC creates stricter guidelines for these numbers and forces companies to disclose every detail about their calculation.

In the meantime it's up to you to decide it if the pro forma numbers represent the real thing or if they had a little work done.

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