Earnings Hocus-Pocus

How companies come up with the numbers they want

When America Online's management put together quarterly financials early this summer, it was with some measure of pride, says new Chief Financial Officer J. Michael Kelly. Indeed, the results were remarkable. AOL would be posting a 900% rise in operating profits, to $57 million. At 23¢ per share, earnings would handily beat Wall Street's estimate of 19¢.

The excitement didn't last long. Soon, the Securities & Exchange Commission's officials began peppering the company with inquiries. Their beef, according to AOL: the plans to use a controversial accounting technique to instantly write off much of the value of two companies it had just purchased. By taking a charge for "in-process R&D" under way at the companies, AOL figured it could write off fully $20 million of the $29 million it was paying for NetChannel, an Internet television company, and a "substantial portion" of the $287 million it would pay for Mirabilis, a developer of real-time chat software.

The SEC appears to have found the size of the charges troubling, however, and by Aug. 4, the date of AOL's fourth-quarter earnings release, the issue hadn't been resolved. So Kelly did something rarely seen in Corporate America: He announced quarterly results that didn't go to the bottom line.

There was simply no way to calculate net income without the SEC's blessing on the charges. "We had such phenomenal operating results," says Kelly. "To hold that back for an unfinished accounting matter didn't seem appropriate." Investors didn't take the matter so lightly. In two days, they dumped 23 million shares, sending the stock down 5%.

AOL ought to have known better. After all, it's not the first time the company's accounting practices have been questioned. In 1996, after dubious investors challenged its policy of writing off marketing expenses over two years, AOL restated its numbers in a move that erased all its previous profits overnight. But a company that once might have been dismissed as a rogue is now just one face in a troubled crowd. Across Corporate America, a wave of concern is rising about the quality of corporate earnings—and the tactics companies are using to calculate them.

Headlines this summer have been dominated by spectacular cases involving allegations of outright accounting lies: Cendant Corp. accused some former executives of fraudulently inflating income before charges by $500 million over three years, in large part by booking fictitious revenues. Livent Inc. allegedly kept two sets of books to mask extravagant expenses.

But forget about fraud for now. Regulators and investors are starting to focus on a far broader problem: companies bolstering their performance by using every legal accounting game in the book. They appear to be exploiting opportunities to jazz up their earnings like never before—all without stepping outside the loose

Accounting Tricks of the Trade

IN PROCESS R&D CHARGES Taken by the buyer at the time of an acquisition, these charges represent the estimated value of R&D at the purchased company. Because it is still "in process," the research is not yet commercially viable. Since it may prove worthless, it can all be written off. But by separating the expenses from revenues that might be gained in the future from the R&D, future earnings can get a big jump.

POOLING A method of accounting for mergers and acquisitions that eliminates goodwill charges. All assets and liabilities of the companies are combined at book value, so there's no goodwill to depreciate. That boosts earnings, one reason use of pooling has exploded.

RESTRUCTING RESERVE Created by combining several years of expected future expenses and writing them all off at once as an "extraordinary" one-time charge. This jacks up future earnings.

REVENUE RECOGNITION How quickly or slowly revenue is booked. It is especially important in industries such as software, where service contracts and upgrades can stretch revenue out for years. Booking revenues too early provides fertile ground for inflating sales and earnings.

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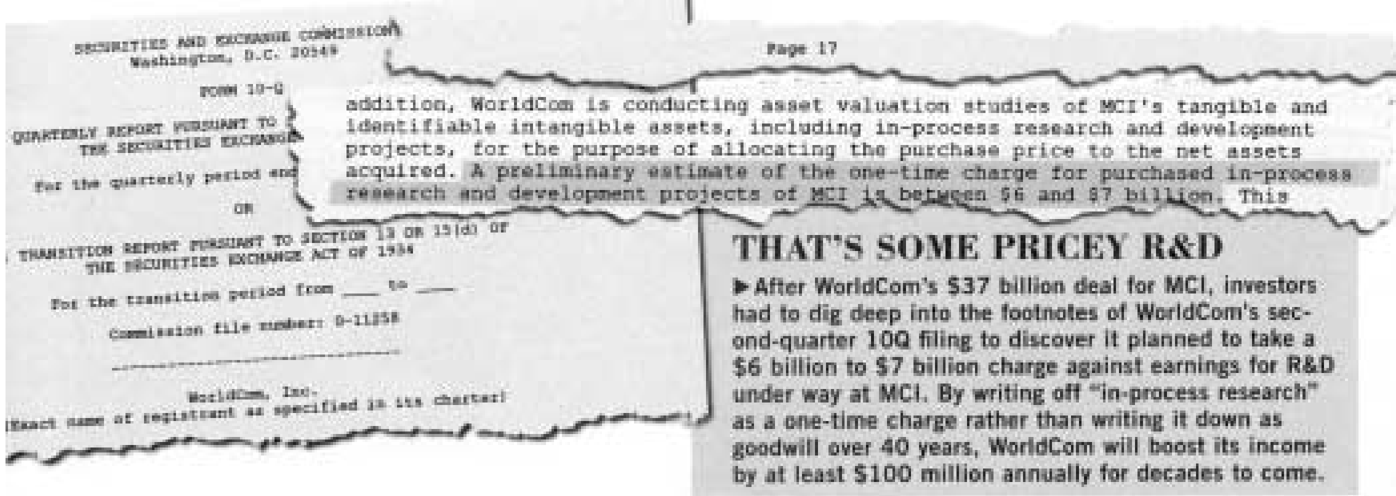

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO
THE SECURITIES EXCHANGE

For the quarterly period end

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____ to ____

Commission file number: 0-11258

WorldCom, Inc.
(Exact name of registrant as specified in its charter)

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addition, WorldCom is conducting asset valuation studies of MCI's tangible and identifiable intangible assets, including in-process research and development projects, for the purpose of allocating the purchase price to the net assets acquired. A preliminary estimate of the one-time charge for purchased in-process research and development projects of MCI is between $6 and $7 billion. This

THAT'S SOME PRICEY R&D

▶ After WorldCom's $37 billion deal for MCI, investors had to dig deep into the footnotes of WorldCom's second-quarter 10Q filing to discover it planned to take a $6 billion to $7 billion charge against earnings for R&D under way at MCI. By writing off "in-process research" as a one-time charge rather than writing it down as goodwill over 40 years, WorldCom will boost its income by at least $100 million annually for decades to come.

confines of generally accepted accounting principles (GAAP).

That has led to a slew of spectacular collapses of companies caught playing fast and loose with their numbers. Investors in such onetime highfliers as Green Tree Financial, Waste Management, and Sunbeam have seen years of seemingly solid earnings vanish overnight. The culprit: overly rosy or misleading information about sales or expenses sometimes buried deep within their financial statements.

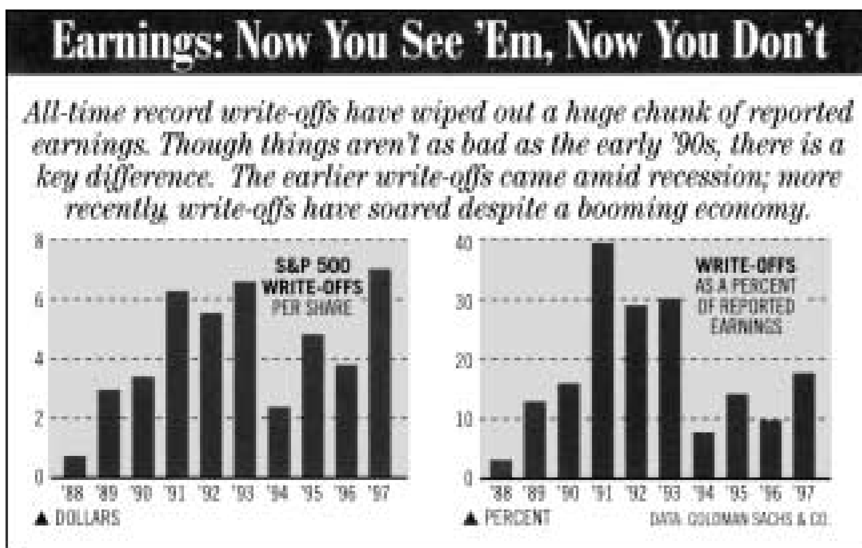
"BIG BATH." And that's only one part of the problem. SEC officials are also worried about the abuse of huge, virtually unrestricted "big-bath" write-offs. Indeed, write-offs such as Motorola's recent $1.98 billion restructuring charge have become all too common. Even that is small change compared with the multibillion-dollar charges taken by high-tech acquirers such as Compaq Computer Corp. and WorldCom Inc. to write off "in-process" research when they close a deal. Meanwhile, others have taken so many "extraordinary" charges year in and year out that the only thing truly out of the ordinary is a year without write-offs.

Of course, companies have always taken write-offs and restructuring charges. But nervous regulators and investors fear that such huge multiyear write-offs are increasingly distorting corporate earnings—so much so, in fact, that some question whether the underlying meaning of profit numbers and their value as a true reflection of corporate performance is getting trampled.

To understand why, remember what the earnings number is supposed to represent: an accurate snapshot of how well a company's operations performed in a year. And one of the basic principles of accounting is that both revenues and costs should be matched to the year in which they occur. Otherwise, managers have too much leeway to massage the numbers, and "annual" performance becomes meaningless.

But the aim of many of today's giant write-offs is to frontload expenses. Charge off three years of expenses all at once, and by definition future earnings will be better. It's akin to making three years of mortgage payments at once, then claiming your income has grown.

Fueling the trend is the fact that stock traders tend to ignore big "one-time" charges, focusing instead on prospects. So even if the total dollars spent are the same, companies have a far greater incentive to take one large charge rather than stretch expenses out as money is actually spent. Indeed, the market's reaction encourages executives to make charges as big as possible. And that's got investors and the SEC worried that companies are burying all sorts of normal operating expenses into their restructuring charges. "Somebody woke up to the fact that if you take something as a restructuring charge, investors will forgive you immediately," says Robert S. Miller, the non-executive chairman brought in to clean up Waste Management. "We've almost lost the notion of what are



ONE-TIME CHARGE OR ONGOING EXPENSE?

► On July 20, McDonald's announced a $350 million restructuring charge, which included $190 million to install new cooking equipment. Shouldn't upgrading kitchens be a normal operating expense in the restaurant business? The SEC appears to think so. After it questioned the charge, McDonald's reversed it and lowered its special charge to $160 million. Booking the costs as it actually spends the money will cut an estimated $25 million to $35 million from earnings each quarter through 1999.

earnings and what are one-time charges."

Why are so many questions about the quality of earnings arising now? For one, there's a mismatch between todays deal-oriented, high-tech economy and a decades-old accounting system in which only "real" assets such as bricks and mortar can be easily valued. Throw in an eight-year bull market in which earnings growth came to be the only measure many investors looked at, and add the pressure those market forces have created on managers to make the numbers look as good as possible. If anyone had set out to invent a system in which the means, motives, and methods to encourage companies to stretch earnings all came together perfectly, they couldn't have done a better job.

But with the economy slowing and Wall Street jittery, concerns are growing that companies desperate to keep up earnings and stock prices will practice even more aggressive accounting. Warns J. Michael Cook, chairman and CEO of Deloitte & Touche: "As economic pressures get tougher over the next 3 to 12 months, I worry whether the system will measure up."

MORE DISCLOSURE? He's not the only one. On Sept. 28, SEC chief Arthur Levitt will give a speech at New York University outlining plans to improve the accuracy of earnings. "We have become concerned that the quality of financial reporting is eroding," Levitt says. In recent weeks, the SEC's new chief accountant, Lynn Turner, has met with officials of Big Five accounting firms, Wall Street analysts, and CFOs to discuss concerns. "If the basic accounting foundation ever loses credibility with investors," Turner says, "then the whole [investing] process would fall apart."

The SEC won't say what steps it plans, but it may require more disclosure about restructuring reserves and the valuation of R&D write-offs. It's also concerned about how companies account for mergers. Talks on mergers and restructuring charges are also under way at the Financial Accounting Standards Board (FASB), an industry body chartered by the SEC that created and updates GAAP. But any FASB-driven changes could take years to iron out.

Of course, not every accounting charge reflects management efforts to fool investors. In many cases, the charges reflect real operating problems. Some experts argue, too, that in some ways the earnings picture is actually clearer today. Gabrielle Napolitano, an accounting analyst and portfolio strategist at Goldman, Sachs & Co., points out that low inflation has improved accounting for inventory and depreciation expenses.

Still, what's troubling is that massive charge-offs have been wiping out earnings at a time when the economy is booming. According to earnings-watcher First Call Corp., the number of companies taking restructuring charges jumped from 96 in 1995 to 230 last year. And despite a then seven-year-old expansion, companies in the Standard & Poor's 500-stock index wrote off $7.04 a share in earnings in 1997, topping the previous high of $6.61 in 1993, when Corporate America was struggling to dig out from the lingering effect of a recession. Fueled by merger-related charges, the S&P companies wrote off fully 17.7% of their earnings last year—more than triple the 5.6% Napolitano predicted at the year's start.

That's why the manner in which companies handle big write-offs is far from an arcane accounting debate. They can significantly alter the earnings picture investors see. Consider the case of Lucent Technologies Inc. As part of the process of Lucent's spin-off from AT&T in a 1996

public offering, the company took a big-bath charge in which it set up a $2.8 billion reserve to cover restructuring costs. To come up with that figure, the company in late 1995 estimated how much the restructuring would cost over several years. Lucent's reserve was to cover severance for 20,000 employees and the cost of exiting businesses such as AT&T's Phone Center Stores.

So far, so good—and there's where the first benefit comes in. By writing off several years worth of costs all at once rather than taking them each year as the money is spent, Lucent eliminated future costs from its books. It's a common practice—and one that automatically improves earnings down the line.

The gains didn't end there. As it turned out, Lucent put aside far more than was needed to cover the restructuring expenses—and the excess reserves have since helped the company smooth out what might otherwise have been much choppier earnings. One reason for the excess: The booming economy helped lower Lucent's costs as former employees quickly found new work. So Lucent converted some of its restructuring reserve back into income. Over three years, it took $382 million from reserves and added it back to pretax income. Thus, even as the reserve cut expenses, Lucent's income got a big boost, too.

Lucent has also benefited from an accounting technique that's becoming wildly popular among high-tech companies—while drawing increased scrutiny from the SEC. As Lucent bought companies over the past two years, it wrote off $2.3 billion of in-process research and development. That figure—Lucent's estimate of the future value of R&D at the companies it bought—has allowed Lucent to avoid $2.3 billion in "goodwill." That's an accounting term for the premium paid for a business or asset above the value recorded on its books, which would normally have to be written off as an expense over many years.

Now, it's worth emphasizing that everything Lucent has done has been found to be in accordance with GAAP by its auditors, PricewaterhouseCoopers. The SEC has not challenged one of these moves. The company filings and press releases clearly disclose exactly what it is doing. Indeed, every decision was made under the "letter and intent of the law," says controller James S. Lusk. "I don't believe in accounting cocaine." And Wall Street certainly likes the results: Lucent's shares have outperformed the S&P by 255% since its IPO.

But the question remains: What if Lucent hadn't taken a one-time charge but spread restructuring costs over the years it took to clean up? And what if the R&D had been written off over 10 years, a typical period?

The answer, according to Jack T. Ciesielski, a well-known accounting expert and money manager, is that Lucent's books would have reflected a much less smooth but possibly more accurate picture of management's ability to drive growth. Using the numbers Lucent reported in its SEC filings, Ciesielski first eliminated the effects of the restructuring reserve. Instead, he treated the expenses as normal costs in the years they occurred. Then, he eliminated the income created by the reserve reversals and calculated what goodwill would have been without the R&D write-offs. Along the way, he assumed all acquisitions came at the start of the year, and he used the corporate tax rate Lucent paid each year.

How do his figures compare with Lucent's operating income—net profits excluding special charges—the number that investors most closely watch? He calculates that in 1996, Lucent would have lost $49 million rather than its $1.05 billion operating earnings gain. Earnings last year, he figures, would have been a modest $1.11 billion, well below Lucent's $1.51 billion. And for the first three quarters of fiscal 1998, Lucent would have made $1.51 billion, $229 million less than the $1.74 billion it reported. "The reason managers love these [moves] is that they buy them time," says Ciesielski, publisher of *The Analyst's Accounting Observer*. "You wouldn't have a stock trading at the multiple Lucent is if they hadn't had this time to work all this out."

Lucent declined to comment on Ciesielski's analysis, saying through a spokesman: "To speculate or hypothesize about 'what if' scenarios when we adhered to strict accounting standards is simply not meaningful or productive."

So how can there be such disagreement over how to crunch the numbers? One culprit is an accounting system that many find obtuse and out of touch with an economy that is increasingly driven by technology and deal-making. The gray areas in GAAP are plentiful, and its terminology can be ill-defined. What constitutes a legitimate "one-time" charge, and how does it differ from the normal operating costs of doing business every quarter? GAAP offers few clues. Some vital intangible assets, such as the brainpower of a team of microchip designers, aren't measured at all. Other intangibles, such as patents, are valued by appraisals—a type of educated guess that is far from foolproof. Concludes Lawrence Revsine, a prominent accounting professor at Northwestern's J. L. Kellogg Graduate School of Management: "Accounting stinks."

One of the best illustrations of the mismatch between yesterday's accounting system and today's economy is seen in the exploding use of those R&D write-offs. Virtually unknown a decade ago, they have soared since IBM successfully used the technique to write off much of the cost of its 1995 acquisition of software maker Lotus Development.

To see why they're so popular, check out the payoff in WorldCom's $37 billion purchase of MCI Communications Corp. World-Com estimates that MCI has R&D worth $6 billion to $7 billion under way but not yet ready for commercial application. Since WorldCom may never see any benefit from that R&D—

conceivably, it could all come to naught—accounting rules allow WorldCom to write it all off at once.

Does that mean MCI was really only worth $31 billion? Not necessarily. The real significance of that number lies elsewhere. Normally, any premium paid over "book value" would be called goodwill, which WorldCom would have to depreciate. Since that would cut into expenses for years, acquirers generally want to keep goodwill to a minimum.

Now here's where things get good. Since every dollar WorldCom can assign to in-process R&D is one less it has to call goodwill, it has every incentive to make the charge as big as possible. And acquirers have enormous leeway in valuing R&D. That's what really has the SEC worked up. It fears that companies are overstating these charges. Moreover, as with all front-loaded charges, writing off all R&D costs today will likely give future earnings a boost. When WorldCom actually turns some of that R&D into salable products, its earnings will look far juicier than they would have otherwise.

Gary Brandt, WorldCom's chief of investor relations, defends the treatment. But he concedes that if the charge were considered goodwill, WorldCom earnings would be cut by a minimum of $100 million a year, or 5¢ per 1.9 billion shares outstanding. If the SEC doesn't challenge the charge and it isn't reduced by WorldCom, it will be the largest in-process R&D write-off ever.

But the potential to inflate research costs isn't the SEC's only worry concerning write-offs. Some of these charges can also provide cover for ongoing operating costs that should be booked as they occur. McDonald's Corp. got its hand slapped for just such a move in August. The hamburger vendor elected to take all at once a $190 million charge for the cost of ditching old grills and ovens and installing new ones. But the SEC disagreed that these charges were a one-time extraordinary cost. After all, if upgrading kitchen equipment isn't a normal cost of doing business for a restaurant chain, what is?

HOOKED. After discussions with the SEC, McDonald's decided to take the expenses as they are incurred. The company says it was not attempting to boost earnings by taking the onetime charge. Still, the shift will chop $25 million to $35 million a quarter from earnings through late 1999, estimates Merrill Lynch & Co. analyst Peter Oakes.

CONCERN "If the basic accounting foundation loses credibility with investors, the whole process would fall apart"

If companies get away with them, big charges can become addictive. Kellogg, AT&T, and General Motors have all taken a remarkable number of restructuring write-offs this decade—leading critics to question how extraordinary they are. For a clean picture of the benefits a company can derive from repeated write-offs, look no further than Eastman Kodak Co. Since 1991, Kodak has taken six extraordinary write-offs totaling $4.5 billion. That's more than all of its net profits for the past nine years.

Kodak has been in a major transition period, exiting five major business lines as sales have dropped 25% since the write-offs began. Still, critics point out that Kodak managed to report operating earnings throughout that period—but the repeated need for such extraordinary charges implies that those operating figures may have been of little value. "Charges after charges after charges—that says Kodak over-reported earnings," says David W. Tice, publisher of *Behind the Numbers* and manager of the Prudent Bear Fund, which invests in undervalued stocks. Kodak declined to comment.

Meanwhile, the SEC is also talking a close look at another corporate addiction: merger mania. Some $1.2 trillion worth of deals have been announced already this year—greater than in all of 1997—and as many as one-third would not have been done without the in-process R&D charge or a technique known as pooling-of-interest accounting, says Stephen S. Smith, a managing director at investment bank Broadview Associates. Pooling lets companies combine their assets at book value, eliminating goodwill. Miller estimates that when USA Waste Services Inc. and Waste Management used pooling to combine in March in a $16 billion deal, they added $3 billion to $4 billion to earnings over the next several decades.

It isn't supposed to be easy to qualify for a pooling; companies must meet 12 tough criteria. Still, the incentive is so strong that pooling deals jumped from just 11 in 1990 to 364 so far this year, according to Securities Data Co. That's a problem, critics say, because the result can be to hide the premium one company is paying for another. "The real concern is that the acquiring company overpaid," says Bear, Stearns & Co. accounting analyst Pat McConnell. "If they overpaid and management was stupid, that's important."

If many of the problems stem from ambiguities in GAAP, however, only so much blame can go to the system. After all, accounting's rules have been loose for years. What's pushing more managers through the loopholes today is the rise of momentum investing. For many on Wall Street, the only number that counts is the quarterly growth of earnings per share. One measure of the intensified interest: For years, First Call compiled daily lists during weeks when companies issue earnings, of which companies made, missed, or beat analysts' estimates. Now, First Call updates those lists two or three times a day. It even puts out lists during what's now called "pre-announcement season."

Meanwhile, many ignore the fundamentals behind the numbers. "There aren't enough skeptical investors," says the manager of a $4

SERIAL WRITE-OFFS

▶ Eastman Kodak can't seem to kick the write-off habit. Six times in the past seven years, the film manufacturer has racked up restructuring charges, for a total of $4.5 billion. That's more than all the company's profits for the past nine years. Sure, Kodak had plenty of reason to restructure: depressed sales, a price war with Fuji, problems with new digital photography. But how "extraordinary" can these charges be if they happen almost every year?

billion mutual fund. "When investors punish companies for missing their quarterly earnings, it sends a message that they don't care how they get there."

KILLING FIELD. That shift in market psychology has vastly increased the pressure for managers to meet earnings projections. And those that don't make the numbers generally get killed. "The penalties for missing your earnings are intense," says T. J. Rodgers, president and CEO of Cypress Semiconductor Corp. "If you miss one or two quarters, you can see your net worth and market cap cut in half... It's harder to retain people if their stock options aren't worth anything. ... Lots of CEOs have succumbed to that pressure." Indeed, the resulting pain is intensely personal, since more than half of CEO pay comes from stock options.

That market pressure can lead to disastrous accounting tricks such as those at Sunbeam, Waste Management, and Cendant. New management at the latter two have since conceded that the desire to meet Wall Street expectations seems to have been a huge driver of the problems, and analysts think it played a big role in Sunbeam's downfall as well.

The good times have also served to take investors' eyes off the ball. During the eight-year-long bull market, many took a "don't ask, don't tell" approach. As long as earnings were up, why look too closely at how management pulled it off? But those days are over. "There's a phenomenon in up markets that most analysts don't pay too much attention to accounting," says Gerald I. White of New York investment firm Grace & White Inc. "In bad markets, these problems come home to roost, and that's when people pay attention."

Those are exactly the sorts of issues that the stock market is starting to sort out. One result is that investors may put companies under more pressure to show that they have a solid foundation under their earnings. But the SEC seems more concerned there will be a rush in the other direction, toward more accounting smoke and mirrors. And some investment pros are arguing for a return to more fundamentals-driven stock picking. White argues that the current trend confirms his view that searching out companies with conservative accounting is best. Other investors are turning to other measures of corporate performance, such as Economic Value Added—net operating profit after taxes in excess of the cost of capital. That tool is used at Goldman Sachs and Credit Suisse First Boston.

The argument for those numbers is that they are harder to manipulate. But they are still not foolproof. Any company intent on jazzing up the numbers is probably going to figure out a way to obscure its true performance. "Increasingly, this culture is one of getting away with what you can," says investor Gary L. Pilgrim, founder of Pilgrim Baxter & Associates. "What we need is more integrity"—integrity in managers and integrity in their numbers.

By Nanette Byrnes in New York and Richard A. Melcher in Chicago, with Debra Sparks in New York