Investment Guide: Stocks and Bonds

Pro Forma Puff Jobs

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We're still a long way from getting straight talk from companies on their profits. The gaps between companies' net income and their own version of earnings are worse than you thought.

If you were an executive at **VeriSign** (nasdaq: VRSN), the leading seller of Web addresses, which quarterly earnings number would you prefer: negative $4.8 billion or positive $50 million? The huge loss, for 2002's second quarter ending June 30, is a standard net income figure. The profit is a "pro forma" number, which means throwing out the bad stuff.

Pro forma earnings are oxygen to unhealthy companies, especially tech ones. Typically, pro forma fanciers argue that the more pleasant number better reflects the ongoing business while the ugly number only rakes over the dead past. Under generally accepted accounting principles, a large chunk ($4.6 billion) of the VeriSign loss is a noncash writedown of goodwill and intangible assets, reflecting now-soured acquisitions made in the good times. The remaining red ink is related to other nightmares from the dot-com bust, like employee severance and contract terminations.

Trouble is, all those nice plans that went wrong were not illusions. If VeriSign launches a venture that--wonder of wonders--is profitable, the company would surely want us to count this. So why ignore a figure capturing VeriSign's substantial distress, which will continue to affect the company? As Fredric E. Russell, a Tulsa money manager, sees the situation: "'Pro forma' by definition suggests that the expense won't happen again, which isn't true."

Charges are a chronic condition at VeriSign. In the third quarter VeriSign's GAAP loss had shrunk to a still-substantial $80 million, yet it became a tidy $44 million pro forma gain--courtesy of ignoring ever more intangible charges and restructuring costs. A review of VeriSign earnings releases back through 2000 shows a similar use of pro forma alchemy.

Despite all the proposals to make accounting more transparent, pro forma obfuscations are as bad as ever--and cover a shocking number of public companies, according to data compiled by **Multex** (nasdaq: MLTX), a New York financial research company. **Jaroslaw Czarzasty**, the global estimates manager at Multex, says half of the publicly traded companies in the U.S. are either losing money or breaking even on a trailing 12-month GAAP earnings basis. Nevertheless, a stunning 81% of these profit-challenged companies put themselves in the black using pro forma calculations. The year before it was 72%.

Pro forma first came in vogue in the merger-mad 1980s, as it was used to help investors see what the new combination would have looked like financially had it been a single entity for the previous year or so. Then, as unprofitable tech outfits caught the popular imagination, creative minds began monkeying with pro forma to show how wonderful the cool upstarts were without all that distracting stuff like acquisition and restructuring expenses. In 1986 and 1987 just 18% of earnings announcements mentioned pro forma results, according to a study of earnings releases from 200 companies by Harvard Business School's **Mark T. Bradshaw** and

University of Michigan's **Richard G. Sloan**. But in 1998 and 1999, they found, pro forma earnings had crept into 72%.

We've assembled a rogue's gallery of companies where pro forma adjustments are significant in relation to the company's market value *(see table)*. For VeriSign and United Airlines parent UAL, the difference between GAAP profit and pro forma profit was nearly triple the market capitalization.

For these companies, pro forma adjustments make for a huge swing in (un)profitability.

		NET INCOME*		DIFFERENCE BETWEEN GAAP AND PRO FORMA		
Company/business	**Recent price**	**GAAP ($mil)**	**pro forma ($mil)**	**($mil)**	**as % of market cap**	**Market cap ($mil)**
VeriSign/digital certificate services	$7.42	-$4,803	$50	$4,853	276%	$1,756
UAL/airline	2.34	-889	-503	386	249	155
GlobespanVirata/semiconductors	2.55	-552	-11	541	149	362
Solectron**/electronics	2.20	-2,647	-33	2,614	144	1,812
Aquila**/electric utility, gas distributor	4.15	-810	49	859	115	748
McDermott International**/oilfield services	3.39	-234	-10	224	104	215
Quanta Services/telecom services	2.81	-177	2	179	92	195
Avaya/networking products	1.55	-534	-67	467	83	561
Sapient/software	1.25	-140	-21	119	78	153
Palm/hardware	11.40	-259	-36	223	68	330

**Latest quarter reported on or before Oct. 23. **GAAP net income results noted first in earnings releases. Source: Multex.*

In their campaign to discredit GAAP, the pro forma companies have almost completely won over the analysts on Wall Street. Look at the earnings forecasts from Thomson First Call, the authoritative database of analyst reports. Since writedowns are supposed to be sudden and unpredictable, the analysts make no effort to forecast them. So they gravitate naturally to pro forma numbers that exclude writedowns.

Pro forma numbers move stock prices more than GAAP ones, says a study of 25,000 earnings reports from 1989 through 1997 by two accounting professors, Georgia State's Lawrence D. Brown and Boston University's Kumar N. Sivakumar. And this continues even unto this day of supposed financial puritanism. VeriSign's 21-cent second-quarter earnings per share and its 19-cent third quarter won The Street's accolades. The numbers give VeriSign an apparent trailing price/earnings multiple of 12. By GAAP standards, there is no P/E because the earnings are negative.

VeriSign believes we are overlooking its inherent strengths. A company spokesman says it "has been consistently banking cash every quarter." And in the third quarter, he points out, cash increased to $327 million. That is true: Cash was just $282 million at midyear. But last Dec. 31 cash was higher than now, $727 million.

VeriSign has its defenders. Steven M. Ashley of the investment firm Robert W. Baird in Milwaukee rates the stock an "outperform," contending that "fears of deteriorating fundamentals and/or accounting shenanigans are unfounded." And to be sure, net wipeout or no, VeriSign has been increasing revenue, up 35%, to $947 million this year through Sept. 30, versus the same period a year ago.

But the revenue may not be as good as it looks. From 2001 through 2002's first quarter VeriSign pumped up revenues by $119.5 million via barter and roundtrip revenue deals, where it swapped software licenses for goods and services or booked sales from companies it had invested in. That's 9% of its sales for the period. (It reported no such round deals for the second and third quarters.) VeriSign confirms the numbers, but argues the moves are kosher.

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