January 2, 1997

The Quality of Reported Earnings Has Improved, But...

Pointers on What to Look for in Company Reports

- The quality of reported earnings has improved in recent years. This has been spurred by (1) lower inflation, (2) ongoing efforts to transform the U.S. economy and restructure individual companies, and (3) moves by the FASB to encourage conservatism in corporate accounting.

- Nevertheless, analysts and portfolio managers must still do their homework. There are still numerous legitimate ways in which company accounts can be made obscure. Further, investors must be wary of the means by which reported earnings can be manipulated or smoothed.

- Users of financial statements (e.g., shareholders, creditors, and others) are often forced to wrestle with dramatic differences in reporting practices between firms. In any event, earnings from continuing operations is usually the key measure of corporate profitability.

- Examples of accounting "gimmickry" relate to (1) the timing of revenue recognition, (2) changes in depreciation schedules or estimated useful lives, (3) loss provisions for uncollectibles, (4) the capitalization versus expensing of R&D (and other) costs, (5) the treatment and recurring use of restructuring charges, and (6) the use of the deferred-tax asset valuation allowance.
Preface

Earnings Quality Has Improved, But Analysts and Portfolio Managers Must Still Do Their Homework

There has been a notable improvement in the quality of reported earnings during the last few years. Three separate factors have been at work. First, secular disinflation in the 1980s, followed by the controlled inflation environment of the 1990s, has cleared away the earlier smoke screen that obscured the reality behind reported corporate results. Second, the ongoing transformation of the U.S. economy, toward more sophisticated manufacturing and high-level services, has rendered some older plant and equipment less profitable. The surge in corporate writeoffs that began around 1987 can be attributed in large part to the readjustment of corporate books to better reflect newer business endeavors. Third, the activism of the Financial Accounting Standards Board (FASB) has encouraged movement toward more conservative accounting approaches in several different areas, and shareholders have become more knowledgeable about the possible "gimmicks" in reported earnings.

The bulk of this report reviews some of the "opportunities" still available to companies to make their reported results less than transparent to the users of their financial statements. As is noted in the text, these may well be legitimate approaches and may indeed be the most appropriate for companies to use in many instances. The generalized descriptions of these techniques offer guidance with regard to identifying these accounting approaches and the possible impact on financial statements.

The context is important. Let's remember that the gap between operating earnings (i.e., earnings from current operations) and reported earnings (what the company announces each quarter) is the smallest it has been in several years. For example, writeoffs taken by companies in the S&P 500 were equal to 40% of reported earnings in 1991. We estimate that writeoffs will be equivalent to less than 10% of reported earnings in 1996 (see Table 1). We also believe that reported book value data are the cleanest that they have been in most investors' professional lifetimes. This introduction offers a brief review of why this is so.

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Cleaning the Scales: Earnings and Book Value

Perhaps the most important factor in "cleaning up" reported earnings and book value has been the "washing out" of the effects of inflation and inflation expectations that afflicted economic decisionmaking (by consumers and businesses) beginning in the late 1960s. In an environment of high inflation and rising inflation expectations, many companies experienced strong pricing flexibility and therefore an ability to pass along all cost increases. There was little incentive for them to keep their pencils well sharpened, and oftentimes costs and inventories were not kept under tight control. By the late 1970s, much of the growth in U.S. corporate profits was associated with inventory profits (build it now, sell it later at a higher price) and other factors such as overdepreciation. Economy-wide profit data reported by the Commerce Department required unprecedentedly large adjustments for these factors.

The situation began to ease and then reverse in the 1980s. Many companies lost their strong pricing flexibility and began to focus more attentively on controlling costs. At the same time, the inventory/sales ratio in the United States fell to the lowest levels ever. Some techno-geeks may simply say that this was due to the advent of just-in-time inventory systems. We disagree; the computerized inventory systems facilitate the lower I/S ratios, but
the principal motivation was the loss of pricing flexibility. Why hold a large inventory if it cannot be sold later at a higher price? And to add insult to injury, there is a cost of borrowing money to carry that inventory.

The reduction in inflation and inflation expectations also encouraged companies to take a closer look at the assets on their books. Shareholders began to focus on measures such as return on assets, rather than the size of those assets. (Remember the compensation incentives many managers had in the 1960s and 1970s to "grow" their businesses at the top line? This contributed to the creation of conglomerates and other business combinations that were not run for the benefit of margins or returns on assets).

However, by the late 1980s, it had become acceptable (if not fashionable, according to some wags) for corporations to publicly announce that specific assets were not generating a required rate of return. Dramatic earnings writeoffs and reductions in reported book value followed, driven not only by the elimination of the inflation smoke screen but also encouraged by the rapid transformation of the U.S. economy and consolidation in several industries.

An important reason for the rise in aggregate price-to-reported book value for U.S. shares has been that growth in reported book value has been dramatically dampened by the huge writedowns of nonperforming and underperforming corporate assets. Bear in mind that if previously reported book value was overstated (by the inclusion of these less-than-productive assets), then previously calculated price-to-book ratios were notably understated. Further, the shift in the U.S. economy toward service (with much less need for tangible assets, and hence, reported book value) would also tend to boost the aggregate price-to-book ratio.

The FASB Rides into Town

The FASB has promulgated many new accounting standards in recent years, most aimed at encouraging conservatism with regard to the specific issues being addressed. For example, there have been moves toward requiring discounted present value of future liabilities, as opposed to the earlier pay-as-you go schemes (e.g., FAS 106, which relates to postretirement healthcare benefits). Further, the FASB has attempted to stay current with hedging practices now widely used by many industrial and financial firms, and new standards have affected the accounting flexibility of companies using these techniques. Of course, some corporate financial officers have complained that the FASB has gone further than necessary (a discussion beyond the scope of this report), but even if it is true, it demonstrates the point regarding the conservatism of earnings reports.

To the extent that the FASB guidelines have generally tended toward conservative treatment, it can be argued that the resulting quality of reported results has improved. As was noted in an earlier report, Writeons! Will There Be a Reversal of Earlier Writeoffs?, these conservative practices may have set the stage for the future diminution, if not reversal of some writeoffs.

Again, FAS 106 is a good example. When it was implemented, companies made actuarial assumptions regarding their future retirees and assumptions regarding the path of future healthcare inflation. Many built in assumptions of annual increases of 12% or more in healthcare expenditures. To the extent that healthcare inflation is now in the mid-single digits, the potential for reversals exists.

Doing Your Homework

The remainder of this report describes some of the accounting approaches that may continue to obfuscate reported corporate results. Analysts and portfolio managers may agree with us that, in general, the quality of reported results has improved. But there is still a notable need to "sweat the details" on company specifics. This report should provide some workable guidelines.

Abby Joseph Cohen, CFA
January 2, 1997
Introduction
Primary Focus: Quality of Reported Earnings

The quality of earnings has become a primary focus of investors and analysts over the past few years. It comes as no surprise that permanent earnings from core businesses, or earnings from continuing operations, has been identified as the key measure of corporate profitability. In evaluating core earnings and overall corporate performance, however, financial statements pose a significant challenge to users.

Lack of Transparency in Financial Reports Poses Unique Problems

Users of financial reports are often forced to wrestle with dramatic differences in reporting practices between companies within the same industries; asymmetry of information abounds. Intangibles, such as the credibility or reputation of corporate management must be considered. Discretionary choices in financial reporting that can ultimately lead to or create future earnings shocks that drive stock prices must be identified and adjusted for. The conclusion? Financial statements are not completely transparent in many respects.

Beware Accounting "Gimmickry": Minimizing the Torpedoes

As a result, analysts and investors must do their utmost to develop a keen understanding of the fundamentals underlying each firm's business operations. They must also be cognizant of accounting "gimmickry" that could result in balance sheet or income statement manipulation. This is often related to (1) subjective accounting assumptions or (2) discretionary choices employed by management. In order to "minimize the torpedoes," one must be wary of the means by which firms can manipulate or smooth reported earnings. These include the following:

- timing of revenue recognition,
- changes in depreciation schedules or estimated useful lives,
- use of loss reserves or allowances for doubtful accounts,
- capitalization of research and development (and other related) costs,
- recurring use of restructuring charges, and
- use of the deferred-tax asset valuation allowance.

Valuation Concerns Apply to Pooling-of-Interests versus Purchase Accounting

Concerns regarding valuation issues arising from business combinations accounted for under the purchase versus pooling-of-interest frameworks have also come to the forefront recently. Many firms go to great lengths to apply pooling-of-interest rather than purchase accounting to a business combination. They do this despite the (1) rigorous application of the 12 criteria governing a pooling and (2) fact that (if we ignore deferred tax accounting) operating cash flow, taxes, and EBITDA are equal for combined firms accounted for under the pooling versus purchase models.

Perhaps the catalyst for this preference is the different equity market response that is generated by use of the different accounting models. In general, companies' stock prices tend to be penalized for adopting the purchase accounting methodology to effect a business combination; the equity market often reacts favorably to a pooling. The question to ask is, "Why?"

One reason for this phenomenon can perhaps be explained by reported earnings. Unlike purchase accounting, pooling requires the continued use of the historical costs of the combining entities and does not create goodwill. Hence, companies can avoid the need to amortize or write off goodwill against income; earnings are not reduced as a result.

Reported earnings are perhaps the most widely used financial statistic. And, because stock prices can respond dramatically to positive or negative earnings surprises, management is often driven to boost the "bottom line." Analysts and investors should be cognizant of the fact, however, that the method of accounting used to effect a business combination does not change the intrinsic value of the combined entity.
Financial Ratios Can Offer Assistance

In addition, significant changes in specific financial ratios, such as accounts receivable (A/R) turnover (i.e., sales as a percentage of A/R), sales as a percentage of accounts payable (A/P), and inventory turnover (i.e., cost of goods sold as a percentage of average inventory), may “flag” potential problem areas. These could include weak operating conditions and reduced customer demand.

Topics Covered in This Report

These issues were highlighted at the Association for Investment Management and Research’s (AIMR’s) recent conference, “Finding Reality in Reported Earnings.” Herein we describe in greater detail the caveats associated with the above-mentioned corporate reporting practices and a generic framework for assessing a firm’s quality of earnings.

Primary Objectives of Financial Statements

Assisting Users in Projecting Firms’ Future Earnings Power and Cash Flows

Few would argue that the fundamental objectives of financial statements are to provide information that is useful to users in (1) making rational investment, credit, and similar economic decisions; (2) predicting, comparing, and evaluating enterprise earnings power; and (3) predicting the amounts, timing, and related uncertainty of prospective cash flows. Accounting standards and the financial reporting model are essential to the efficient functioning of the economy. It is the financial reporting model, as governed by the Financial Accounting Standards Board (FASB), that is intended to present an accurate representation of the past to assist users in making appropriate future economic decisions.

However, some analysts contend that as businesses have become increasingly complex and global, the relative usefulness of financial reports has declined. A 1996 study conducted by Collins, Maydew, and Weiss indicates that the incremental explanatory power of reported earnings in individual stock prices has declined over time. This can be accounted for by (1) the significant increase in extraordinary items, (2) compositional changes in the overall broad market indices, and (3) uncertainty regarding the timeliness of accounting data. As a result, the statistical association between reported earnings and stock returns, although historically weak, has deteriorated substantially over the past 40 years.

Multiple Factors Drive Relative Stock Prices

The movement of future stock prices relative to the overall market have multiple drivers. Analysts and investors need to incorporate a broader set of financial data, such as (1) business strategy, opportunities, risks, and uncertainties; (2) management’s ability to execute its business plan; and (3) “soft” assets (such as franchise value and brand name), that will create long-term value to enhance the correlation. They must also realize that the relationship between earnings and stock returns is inversely related to business change. In addition, macroeconomic factors, such as gross domestic product, industrial production, and inflation, are involved.

Warning Flags: Means by Which Companies Can Manipulate or Smooth Reported Earnings

(1) Timing of Revenue Recognition

In general, revenue recognition involves questions of both timing and measurement. Application of the "matching principle" relates expense recognition to revenue recognition.

What Conditions Must Be Met for Revenue to be Recognized?

The FASB’s Statement of Financial Accounting Concepts (SFAC) 5, Recognition and Measurement in Financial Statements of Business Enterprises, specifies that two conditions must be met for revenue recognition to take place: (1) completion of the earnings process and (2) its realization or assurance of realizability. In other words, revenue can be recognized when goods or services have been provided and their cost can be reliably determined.

This concept is delineated in paragraphs 83(b) and 84 of SFAC 5, which explicitly state that “revenues are not recognized until earned. An entity’s revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central
operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues."

"...the two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time the product or merchandise is delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning delivery)."

**Sales Basis of Revenue Recognition Is the Most Popular and the Most Conservative Method**

The most popular (as well as the most conservative) method of revenue recognition is the sales basis, in which companies recognize revenue at the time of sale. Goods or services are provided, and the sale is for cash or to purchasers whose ability to pay is highly probable.

However, firms may also recognize revenues prior to sale or delivery when the earnings process is virtually complete and sale proceeds are reasonably determined. For example, the percentage-of-completion method recognizes revenues and costs in proportion to work completed — production activity is the critical factor driving revenue recognition. The completed contract method recognizes revenues and expenses only at the end of the contract.

In cases where the vendor’s fee is not fixed or determinable or collection is not probable, then revenues may not be recognized at the time of sale. Either the installment method or the cost recovery method would then be used.

**Financial Statement Users Beware**

It is important for users of financial statements to be cognizant of the assumptions underlying the different methods of revenue recognition for purposes of company comparison and the forecasting of future earnings and cash flows. *Income patterns for firms in similar industries can vary quite dramatically as a result of management’s choice of a particular revenue recognition policy (conservative versus liberal).* For example, two companies with the same operations could recognize positive income or no income in a given reporting period depending on the revenue recognition policy in place. *In general, the cash flow, rather than the income, statement is less likely to be affected by variations in accounting principles and assumptions used by management.*

(2) Changes in Depreciation Schedules or Estimated Useful Lives

Financial statement users should always analyze the impact of a change in depreciation method or estimated useful lives on operating performance. Such revisions can have a dramatic effect on current and future depreciation expenses as well as patterns of reported income.

Corporations systematically allocate the capitalized cost of an asset to income over its useful life. Depreciation refers to the allocation of the cost of tangible assets, while amortization applies to the cost of intangibles. In general, annual income should reflect the rate of return earned by a corporation’s assets during a given reporting period. Different methods of depreciation may apply. These include (1) straight-line (an equal depreciation expense is recorded each year) and (2) accelerated depreciation methods, such as the sum-of-years'-digits, the double-declining balance, and the unspecified accelerated method.

With accelerated depreciation methods, companies record higher depreciation charges in early years and smaller ones in later years. *As such, they tend to depress both net income and stockholders’ equity compared with straight-line approaches; return ratios also tend to be lower.* The primary reason for the use of accelerated depreciation methods relates to their beneficial effect on a firm’s tax burden. These act to reduce the amount of taxes to be paid in a given year. Hence, reduced taxes result in higher cash flows in earlier years.

**The Choice of Depreciation Method Can Have a Dramatic Effect on Reported Income**

For some capital-intensive firms, the choice of depreciation method can have a dramatic effect on the pattern of reported income and book value. *In addition, companies using the same depreciation
method may not be comparable due to other factors that can affect reported depreciation, such as differences in useful lives and, to a lesser extent, salvage values. Firms can change their reported depreciation of fixed assets by (1) changing the method for newly acquired assets only, (2) changing the method for all assets, or (3) changing useful lives or salvage values.

No specific disclosures are required for the first change. The impact of a new method applied to newly acquired assets will often be gradual, increasing only as fixed assets acquired after the change grow in importance.

The second approach can have a material effect on current and future depreciation expense and, hence, on net income. The cumulative effect of this change must be reported as a change in accounting principle and reported separately net of taxes.

*Beware of the Effect Changes in Discretionary Assumptions Can Have on Reported Earnings*

Changes in asset lives and salvage values are changes in accounting estimates and are not considered changes in accounting principles. Their effect is only reported on current and future periods; retroactive or cumulative effects are not recognized. Disclosures are usually not fully transparent.

*In essence, management can make a discretionary decision to lengthen the depreciable lives of their existing assets. This change will lower depreciation expense in current and future years and artificially increase reported earnings.* Analysts and investors should therefore scrutinize firms’ footnotes to assure themselves that no changes in such accounting estimates have been made.

(3) Use of Loss Reserves or Allowances for Doubtful Accounts

Accounts receivables are classified as assets because they will eventually result in the collection of cash. They are reported at their net realizable value. A service has already been provided; receipt of cash completes the transaction.

*Oftentimes, questions as to the probability of ultimate cash collection are raised.* These may arise as a result of poor creditworthiness on the part of the customer, volatile business environments, or external shocks that limit growth opportunities.

In cases where collection is uncertain, companies are required to assess whether a loss contingency has occurred as stipulated by Financial Accounting Statement (FAS) 5, *Accounting for Contingencies*. Management must classify the likelihood that future events will confirm a loss as either (1) probable (likely to occur), (2) reasonably possible (between probable and remote), or (3) remote (slight chance of occurring). These classifications will determine whether a loss contingency is (1) accrued as a charge to income, (2) disclosed in the footnotes, or (3) neither accrued nor disclosed.

*Loss Contingencies for Uncollectible Receivables Are Reflected as a Charge to Income*

If a firm determines that it is probable at the date of the financial statements that it does not expect to collect the full amount of its accounts receivable and the amount of uncollectibles can be reasonably estimated, then an accrual for such an estimate must be recorded. *The loss contingency is reflected as a charge to income.* Management may base its forecast of uncollectible receivables on its prior experience, the experience of other firms in the same industry, the customer’s ability to pay, or an appraisal of current economic conditions.

*Management Discretion Should Raise Warnings Flags*

Management has some leeway and discretion in the assumptions employed to determine the existence of a loss contingency for uncollectible accounts. Hence, users of financial statements must be wary of material reductions (or increases) in loss provisions related to uncollectibles that can result in increases (or declines) in reported income. They should analyze the specific event that results in the significant change, assumptions underlying management’s estimates, and the reliability of the firm in creating loss provisions in the past.
(4) Capitalization of Research and Development (and Other Related) Costs

The costs of acquiring resources that provide services over more than one operating cycle are generally capitalized and carried as assets on the balance sheet. Such costs include invoice price, applicable sales tax, freight and insurance, and insurance costs. In general, application of this principle is clear. However, the decision to capitalize or expense some costs, such as those related to software development, advertising, research and development (R&D), and exploration for oil and gas properties, depends to some extent on management choice.

FAS 2 requires the immediate expensing of virtually all R&D costs (both direct and indirect) which do not have an alternative future use. These amounts must be disclosed in the financial reports. However, assets used in R&D activities, such as machinery, equipment, facilities, and patents that have alternative future uses, are capitalized. Depreciation and amortization on such capitalized R&D related assets is charged to R&D expense.

Capitalization Versus Expensing: The Choice Affects Valuation Ratios and Profitability Measures

The discretionary decisions associated with such costs affect the balance sheet, income and cash flow statements, and related ratios in the year the choice is made and over the life of the asset. Such choices can result in the smoothing or manipulation of reported income, cash flows, and other measures of financial performance.

For example, firms that capitalize costs and depreciate them over time will show a "smoother" pattern of reported income. Firms that expense costs as incurred tend to have greater variability in reported income until a "steady state" is achieved. Expensing firms also tend to show lower assets and equity on the balance sheet. Hence, debt-to-equity and debt-to-asset solvency ratios will appear to be worse for expensing firms compared with firms that capitalize the same costs. In addition, cash flow from operations tends to be higher for capitalizing firms, and the cumulative difference increases over time.

Given the potential effect that the choice between expensing and capitalizing can have on ratios used for valuation purposes and other profitability measures, users of financial statements must exercise great care when assessing financial performance of firms within the same or similar industries.

(5) Potential Abuse: Recurring Use of Restructuring Charges

Over the last decade, U.S. companies and their shareholders have become accustomed to large writeoffs and other charges related to accounting changes. The gap between reported (after writeoffs) and operating (before writeoffs) earnings has boosted the cynicism of many investors. This gap has narrowed in the last several years. For example, writeoffs taken by companies in the S&P 500 were about 40% of reported earnings in 1991. We estimate that writeoffs will be about 10% of reported earnings in 1996.

The gibes about "recurring nonrecurring" charges have been commonplace. These "extraordinary" charges have been recorded to account for corporate restructurings, discontinued operations, plant closings, personnel headcount reductions, losses on asset sales, debt redemptions, the writedown of underperforming assets, reserve provisions, and accounting adjustments.

Restructuring Charges Should, in Most Cases, Be Presented as a Component of Operating Expense

Restructuring charges are one of the worst offenders. They commonly result from (1) consolidation or relocation of operations, (2) the abandonment of operations or productive assets, or (3) the impairment of productive or other long-lived assets. In general, writeoffs for restructurings typically consist of a reduction in the carrying value of long-lived assets or provisions for terminations and/or relocations of operations and employees. Such charges should typically be presented as a component of income from continuing operations and separately disclosed, if material. They should not be preceded by a subtotal that could be construed as representing "income from continuing operations before restructuring charges."
The Exception: Discontinued Operations

Oftentimes, however, many firms do not include their restructuring charges as a portion of operating expense but disclose them net of taxes below the line. In fact, after-tax below-the-line writeoffs related to restructurings should only be recorded to reflect discontinued operations. Formally, discontinued operations related to (1) single, separate major lines of businesses or classes of customers or (2) assets, results of operations, and activities that have been sold, abandoned, or spun off or are subject to a formal plan of disposal that will be completed within one year.

Writedowns of discontinued operations are deemed to be extraordinary in nature because they meet two conditions. First, they are unusual in nature. Second, they occur infrequently. In other words, it is not expected that the disposal of operations will recur in the foreseeable future. Hence, users of financial statements must be keen to distinguish between restructuring charges that reflect discontinued operations and are recorded "below the line" on an after-tax basis and those that do not qualify as discontinued operations and are recorded "above the line" on a pretax operating basis. Reported earnings can be manipulated by those firms that mischaracterize the nature and accounting treatment of these expenses.

(6) Use of Deferred-Tax Asset Valuation Allowance

Under FAS 109, the accounting standard governing income taxes, firms have leeway in their treatment of deferred-tax assets (DTAs.). DTAs reflect future tax benefits that arise as a result of temporary deductible differences, an operating loss, or tax-credit carryforwards.

FAS 109 requires an evaluation of the realizability of future taxable income in order for a firm to recognize DTAs. Hence, if management determines that it is "more likely than not" that the firm will have sufficient income in the future to benefit from the deductions or carryforwards, then the deferred-tax asset is recorded. If it is "more likely than not" that some portion or all of the deferred-tax asset will not be realized, then a valuation allowance will be created to reflect the deferral of the unrealized amount. The deferred-tax asset will also be reduced by a commensurate amount. Changes in the valuation allowance are reflected in income from continuing operations.

Management Has Discretion in Judging the Potential Future DTA Realization

In general, management has discretion in judging whether it is "more likely than not" that the future benefits associated with DTAs will be realized. Thus, the use of the valuation allowance lends itself to potential manipulation. For example, a company may decide to reduce the amount of its valuation allowance because it determines that operating conditions have improved and the firm will be profitable in the future. The reduction in the valuation allowance flows through income from continuing operations, resulting in a one-time boost to reported earnings. Hence, users of financial statements should be aware of the tax-planning strategies that companies may implement to (1) reduce the required valuation allowance and, in turn, (2) increase net income. Firms are required to fully disclose such policies.

Generic Framework: Initial Steps in Evaluating Quality of Earnings

Assessing the quality of earnings for individual companies is sometimes daunting. According to the FASB and Dr. E. Richard Brownlee, II of the University of Virginia, financial statement users should apply the following framework to individual company analysis:

- develop a thorough understanding of the nature of the business, its markets, and its customers;

- rank the degree of difficulty in determining the company’s periodic revenues and expenses and in identifying and measuring its assets and liabilities;

- develop a familiarity with and understanding of management’s accounting policies and reporting practices. Identify those that embrace conservative as opposed to liberal accounting guidelines;

- understand the limits of historical financial statements. Identify the significant revenues and/or expenses most subject to misstatement. Identify the effects of such misstatements on the
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balance sheet. Compare significant differences in industry practices with respect to accounting methods and/or estimates;

- determine how subjective the accounting and reporting practices followed by management are. Formulate related judgments regarding its competence and integrity; and

- rethink the business and quality of management again.

It is apparent from this "check list" that there is little substitute for in-depth knowledge of the primary factors driving a company's core business operations. The analyst or investor must also be aware of the level of conservatism reflected in a firm's financials. This information assists them in formulating judgments about management's reliability and credibility. Cautionary flags may then be raised or lowered.

Issues of the Next Decade

Some analysts have identified a few key issues that may be the focal point of accounting regulators going forward: (1) the existence and proper measurement and reporting (on the balance sheet) of "soft assets," such as global brands, strategic alliances, and goodwill, as well as (2) disclosure of risks and opportunities associated with environmental remediation activities by U.S. corporations in the wake of heightened regulation. Many believe that the financial markets may soon begin to reward environmentally successful companies and penalize those that are insensitive or careless regarding pollution control and/or the full disclosure of potential or existing environmental liabilities. These issues are expected to dominate the attention of accounting policymakers in the future.

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