FREQUENTLY ASKED QUESTIONS ABOUT FINANCIAL STATEMENTS

By John Bajkowski and Wayne A. Thorp

Additional member questions and answers and the complete financial statement analysis series can be found on the AAII Web site in the section titled "Focus on Financial Statements" in the Stocks Education area.

Our series on financial statement analysis generated a number of questions that our members E-mailed to the financials@aaii.com mailbox, which this article will answer. Financial statements are complex reports that require careful reading and analysis to fully understand. This question and answer session should help to shed some additional light on the use and interpretation of financial statements. [Additional member questions and answers and the complete financial statement analysis series can be found on the AAII Web site in the section titled "Focus on Financial Statements" in the Stocks Education area, www.aaii.com/stocks.]

INTANGIBLES

What are intangibles?

Most of us are familiar with physical assets such as property, plant, and equipment. These tangible assets can be counted or measured with a high level of certainty. Tangibles, however, make up only half of the picture of a company's assets. The other half, which is intangible in nature, is an entirely different beast. Intangible assets have no physical presence, nor do they carry with them any certainty of future benefits. In addition, they are non-separable from a company, have indefinite benefit periods, and are valued based on competitive circumstances. Because of these characteristics, intangible assets are also more difficult to value.

The common types of intangible assets are patents and copyrights, franchises and licenses, brand names and trademarks, computer software, and goodwill. Excluding goodwill, these types of intangible assets are sometimes referred to as identifiable intangibles. Identifiable intangibles can be developed internally or acquired, and they are linked with specific rights or privileges with limited benefit periods. On an accounting basis, identifiable intangibles are recorded at cost and are then amortized over their benefit period.

How is the amount for "goodwill" determined?

Those intangible assets that cannot be specifically identified and have indefinite benefit periods are often called unidentifiable intangibles. The most common unidentifiable intangible asset is goodwill. Goodwill is the excess of the price paid for a company or business unit over the sum of the fair market value of the net assets of the company or business unit. In simpler terms, it is the residual between the acquisition cost and the sum of the fair market values of all identifiable assets and liabilities. Goodwill is only recorded upon the purchase of another business entity. Goodwill is an attempt to balance the allocation of the cost of an acquisition against the fair market value of the assets being acquired.

Why do companies try to avoid creating goodwill?

A key issue surrounding intangibles is the need to ultimately amortize or write them off over their expected benefit period. The length of the period is dependent upon factors such as the type of intangible, the competitive envi-

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ronment, contractual agreements, and legal or regulatory limitations. However, the benefit period cannot exceed 40 years. The goodwill amortization will reduce earnings each year over the amortization period.

The other issue to remember is that goodwill amortization is not tax-deductible. There is no economic benefit to amortizing goodwill. Management has latitude in amortizing intangibles, and since reducing amortization expenses improves reported earnings, pressure exists to extend the amortization period as much as possible to keep the annual amortization expense low. Some companies will also try to write off a large chunk of goodwill through a reassessment of the economic value and one-time extraordinary charge of income, often called a "big bath." This provides a one-time hit to earnings but eliminates the slow burn of amortization. The SEC carries out a broad-based investigation of potential abuses to these types of write-downs.

STOCKHOLDER'S EQUITY

Please clarify the information regarding the stockholder's equity section (common stock and paid in capital).

Common stock represents ownership in a company and bears the ultimate rewards and risks for the owner. Common stock has no preference over other claims to the assets of a firm. It does, however, reap the residual profits and assumes net losses. For some companies, especially those with more complex capital structures, there may be different classes of stock. Typically, these classes are distinguishable by their dividends and their voting rights.

Common stock may carry a "par" value, which usually has little analytical significance. The par value of a stock is more a matter of legal and historical significance.

The contributed or paid-in capital of a company is the amount received from shareholders in return for shares of common stock. This item is typically divided into two parts:

- The first part is assigned to the stated or par value of the shares;
- The remainder is reported as additional paid in capital (also called paid in capital in excess of par, paid in capital, etc.).

When you look at the shareholder's equity section of the balance sheet, you may well run across some additional accounts. These may include:

- Treasury stock represents shares of company stock that have been reacquired by the issuing company after having been previously issued. It is important to realize that treasury stock is not an asset. It is a contra equity account that reduces both assets and shareholder's equity.
- Retained earnings is the accounting of undistributed earnings or losses of a company since inception. The contribution to retained earnings for any given year is the residual amount of net income (or loss) after dividends, if any, have been paid.
- Prior period adjustments are corrections for errors in prior periods' financial statements. These adjustments are made directly to the beginning balance of retained earnings in order to exclude them from the income statement.
- Appropriations of retained earnings are reclassifications of retained earnings for specific purposes. These appropriations recognize the fact that a company does not plan to distribute these amounts as dividends. Instead, the company reserves them for future expenditures such as expansion.
- Restrictions (or covenants) on retained earnings are constraints placed on a certain amount of retained earnings. A common example is the limitation a company has in paying dividends. These restrictions typically arise from bond indentures or through loan agreements.

STOCK REPURCHASES

Can you discuss the impact of stock repurchase programs?

A stock buyback or repurchase occurs when a company acquires its own shares that were once issued and outstanding. Shares may be repurchased on the open market through the services of a broker or with a tender offer. The value of these reacquired shares is typically presented in the equity segment of the balance sheet and labeled treasury stock. Some companies retire the reacquired shares, reducing the number of shares outstanding; others use the shares for stock-related compensation plans.

With a share repurchase, the company spends capital resources to reduce equity ownership in the firm. Therefore, it is not surprising that share repurchases are the domain of lower growth companies and industries such as tobacco and food processing. With these firms, a share repurchase signals that the company does not have as many profitable investment opportunities.

If the overall level of net income is maintained, the share repurchase plan will affect a number of per share calculations and ratios. A reduced number of outstanding shares and lower level of shareholder's equity will boost items such as earnings per share and return on equity. Financial leverage will also go up as the level of liabilities relative to equity increases.

The board of directors establishes a company's intention for a share repurchase through a share repurchase plan. It is important to remember that share repurchase plans do not usually obligate a company to buy back its shares, and many companies fail to fulfill the repurchase plan completely. Most announcements are worded to indicated that a company has intentions to purchase up to X dollars or up to X million shares over the next X number of years.

A study found that open market repurchase plans are typically announced after an abnormal price decline. The announcement is often seen as signal from the company that it believes its stock is priced attractively. The share repurchase program helps to calm investor fears and provide proof that company executives still have confidence in their company and are willing to act on their belief.

The study also found that company stock prices typically jump on the announcement of a share repurchase plan, and that the stock price does not tend to fall back to the pronouncement level. In other words, stock repurchase announcements typically have a positive and lasting effect on stock prices.

How can I follow details of stock buyback programs?

Repurchase plans are announced in the major financial newspapers such as the Wall Street Journal and Barron's.

The Online Investor Web site (www.theonlineinvestor.com) highlights share repurchase announcements in a section titled "Buybacks." The site provides a two-week history of announcements and includes details about the number of shares or dollar value of the shares covered by the repurchase plan. SmartMoney.com (www.smartmoney.com) provides details on stock repurchases within the "Investor Calendar" section of its Web site.

STOCK DIVIDENDS AND SPLITS

What is the difference between a stock dividend and a stock split?

Stock dividends and splits are usually announced with great fanfare and receive extensive press coverage. The accounting treatment of stock dividends and splits is slightly different, but for the investor stock dividends and splits are identical except in magnitude.

Stock dividends are distributions of additional shares of stock to shareholders instead of cash. For an investor holding 100 shares of stock, a 5% stock dividend would entitle the investor to another five shares of stock. If the stock were selling at $100, after the stock dividend it will open at about 95¼, making the market value (price times number of shares) the same before and after the stock dividend.

When stock dividends are over 25%, they are typically called splits. If a stock had a 2-for-1 stock split instead of a stock dividend, the investor would have 200 shares of stock, but they would be trading at $50—half their previous price.

What is a reverse split?

Splits do not necessarily increase the number of shares outstanding—a reverse split will decrease the number of outstanding shares. A 1-for-5 split would leave an investor with one share of a company stock for every five owned, boosting the share price by a factor of five.

Why do companies split their shares?

It is obvious that, unless the splits or dividends make the shares more desirable, they represent nothing but paper shuffling. The usual argument for splits is that investors prefer stocks of companies that trade within some common range—$20 to $100. Stocks priced very low may not meet exchange requirements and may be considered too speculative for investors, while very high-priced stocks require a larger investment to purchase in a round lot (100-share block) and therefore limit the number of interested investors. With the company's price in a more accessible range, the theory goes, more investors should flock to the stock, bidding up its price.

What importance do stock splits have for shareholders?

While logic would dictate that splits are not meaningful, market participants perceive stock splits to have value and tend to react positively to announcements. Most stock dividends or splits come after periods of strong price performance, so the company is highlighting its good stock performance and continued confidence of the future company potential through its split announcement. Many stock split candidates are also momentum stocks still on the move, with the similar downside risk of greater volatility.

Reverse splits have interesting consequences for the stock price. In these instances, studies have found substantial negative price performance when the announcement is made, approved, and executed. In a large number of cases, the stock price continued to decline even in the long run.

Following a stock split strategy makes sense if you are a believer in price momentum strategies.

What are sources of information for stock splits?

Stock splits are announced in the major financial newspapers. Briefing.com (www.briefing.com), SmartMoney.com (www.smartmoney.com), The Online Investor (www.theonlineinvestor.com), and Yahoo!Finance (biz.yahoo.com/c/s.html) are Web sites that provide listings of stock split announcements.

EARNINGS

I'm having trouble understanding exactly what is meant by the term "diluted EPS." Would you clarify it for me?

Companies have been required to report basic and diluted earnings per share (EPS) since December 15, 1997. Basic EPS is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding during the reporting period. Diluted EPS tries to capture the impact the holders of securities convertible into stock might have on the basic EPS figure. Some companies issue securities, such as preferred stock and bonds, that can be converted into a number of common stock shares at a given price. With a larger number of outstanding shares, a given level of income would reduce or dilute earnings for a given share. Diluted EPS reflects the potential dilution that could occur if securities with rights to issue common stock were exercised or converted into common stock. If there are no convertible securities, basic EPS and diluted EPS will be the same. However, if a company has convertibles, the diluted EPS will be less than the basic EPS.

Some companies are reporting "cash" earnings or "pro forma" income. What are cash earnings and why are companies reporting them?

Traditional valuation measures rely on the value and growth potential of variables such as earnings, cash flow, and dividends. However, it is difficult to value many technology and Internet companies because of their lack of bottom line profitability—net income. These companies have been pushing for analysts to judge them higher up the income statement on a figure they are calling cash earnings or pro forma income—operating income before depreciation and amortization. Cash earnings consider sales and expenses such as cost of goods and selling, administrative and general expenses, but ignore items such as amortization, depreciation, non-operating expenses, interest, taxes, and extraordinary expenses.

The Financial Accounting Standards Board also seems to be bowing to pressure from companies and has plans to allow companies to formally publish earnings per share figures without goodwill charges.

What are "whisper" earnings?

Every earnings announcement season, analysts and investors alike anxiously await word of whether companies are able to meet or exceed the earnings estimates that have been set forth for them. Stock prices quickly adjust to surprises—actual earnings significantly above or below the consensus earnings expectation.

Estimates are made by analysts after consulting with company management and analyzing the firm's financial strength, competitive environment, and other factors.

Critics charge that to avoid negative surprises and the accompanying stock price drop, companies try to manage the earnings process by guiding analysts towards conservative earnings estimates.

Services such as I/B/E/S, Zacks Investment Research, and First Call track these official estimates made by the analysts and publish consensus estimates as well as the analyst changes over time.

Over the past couple of years, a new estimate figure has been tossed around—whisper earnings. Whisper earnings estimates are the unofficial earnings numbers that are circulated among analysts about the time of the actual earnings announcement, but not passed on to the tracking services. These whisper earnings are considered to be the actual earnings expectations of the analysts tracking the company, free of any company influence.

Whisper numbers have garnered much attention recently because of the apparent weight they carry with investors. There have been incidences where a company has met or even exceeded its consensus earnings but failed to meet the whisper numbers, and its stock price has plummeted.

How should an investor view whispers?

Whisper numbers tend to come from unknown or unnamed sources. They may come from company insiders, perceptive investors, or those who are attempting to manipulate a stock's price. To further muddy the proverbial waters, sites that collect whisper estimates rarely disclose their sources. If you make decisions on these figures, you are doing so at your own risk. If whisper earnings interest you, they are provided on the Internet by the sites Whispernumber.com (www.whispernumber.com), Earningswhispers.com (www.earningswhispers.com), The Whisper Numbers (www.thewhispernumber.com), StreetIQ.com (www.streetiq.com), and StockLab.com (www.StockLab.com).✦