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Should Directors Ignore Those One-Time Items?

By Tony Chapelle September 6, 2011

Most companies don't directly mislead shareholders. Yet a research analyst has found that more are masking earnings by burying one-time items in their financial statements.

"When you find $58 billion of [hidden, one-time items last year], I would say that most companies are doing it," says **David Trainer**, CEO of stock-research firm **New Constructs**.

Investors can be fooled by one-time items, since they can artificially distort earnings reports. So directors should be on the lookout. Even when they're used with good intentions, one-time items can make the profit picture cloudy for investors. What's more, the confusion can cause decreased valuations or target prices for a company's stock.

Just back in July, the **SEC** slapped down a financial statement that included a questionable one-time item.

Groupon, the discount deals website company, had to amend the financials in its IPO filing because the SEC wouldn't allow the company to use a weird new accounting metric. The SEC decided that, despite a fancy new name, the measurement was just a ruse to exclude $481 million in fairly ordinary marketing-related costs.

"That was abusive and the SEC made them take out that," says **Charles Mulford**, the director of the **Georgia Tech** Financial Analysis Lab.

Groupon had to refile its Form S-1, which delayed its offering until at least September.

"Don't think for a second that these one-time items are not material," Trainer warns. He says that manipulating accounting to maximize earnings has become a competitive requirement. "Companies cannot afford not to employ the same tricks as their peers or they risk lower earnings growth."

But a veteran board member disagrees. "I don't know any directors that would ignore one-time items," writes **Howard Carver**, a member of various public company boards and a retired **Ernst & Young** partner, in an e-mail to *Agenda*. "We are always asking for details behind such items.

"At many board and audit committee meetings I've attended, [we've talked about] the noise that these items create and how they can be disclosed transparently."

One-time items are easy to find when they're reported as extraordinary items on the income statement. But they may get obscure when they're placed in the Management Discussion & Analysis (MD&A) or footnote sections of 10-Ks.

According to Trainer, more than 13,000 one-time items were buried in the MD&A or footnotes between 1998 and 2011. His study analyzed 10-Ks for more than 3,000 of the most actively traded U.S. companies.

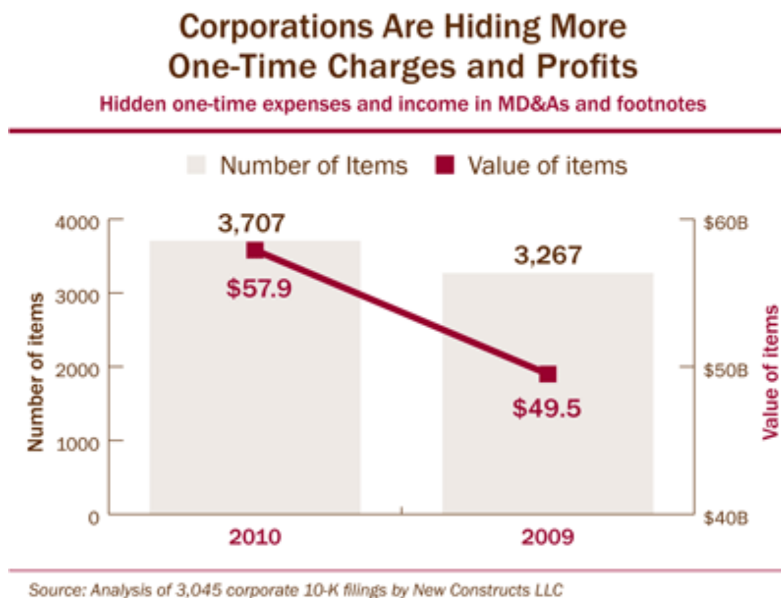
More one-time items are leaving the income statement and moving to the MD&A or footnotes. Last year, the value of those hidden items rose by 17% from 2009 to more than $57.9 billion. That was 0.4% of the companies' net revenues. The number of hidden one-time items also climbed; up by 13% last year.

By contrast, the value of non-hidden items fell by almost a third to $159.6 billion. The number of those items also fell, by more than 10%.

One definite red flag is reporting financials each and every quarter that do not use generally accepted accounting practices.

Using non-GAAP allows for easily excluding expenses. What confuses investors is when managers use GAAP or exclude items inconsistently, says **Sarah McVay**, an associate professor of accounting at the **University of Utah**. She emphasizes that the worst practice is when they exclude transitory losses but include non-transitory gains from quarter to quarter or even within the same report.

"The bad guys change their reporting behavior from quarter to quarter and from non-GAAP to GAAP in order to present a higher number when they need one. Firms that cherry-pick line items in a quarter or across quarters could be misleading investors," says McVay.



Investors account for one-time gains and losses differently than income and expenses that are recurring.

Since investors will not include them in their earnings projections, they could be way off when trying to predict an earnings estimate. In the end, investors wouldn't get their appropriate returns.

According to accountants, there are real one-time items and there are questionable ones. Charges to earnings due to a hurricane, for example, are not likely to recur. When a company restructures, however, the costs of combining its divisions may not really be one-time because restructurings are fairly typical.

There is no strict accounting guidance from the SEC or the **Financial Accounting Standards Board** about one-time versus recurring charges.

In 2002, as part of commenting on Sarbanes-Oxley rules, the SEC issued rules on pro forma disclosures. Sometimes derisively called "earnings before the bad stuff," pro forma reporting stands in contrast to GAAP earnings. Managers use it to exclude expenses that don't represent the company's actual business.

SEC staffers have interpreted the rules to mean that it's misleading to refer to something as one-time if it's likely something similar will happen in two years.

David Trainer advises that when investors see operating line terms such as "long-lived asset impairments," "non-recurring write-down of inventory" or "loss (or gain) on sale of assets," they should be on guard that those could be concealed one-time items.

For example, according to Trainer, **International Pape**r hid more than $2.1 billion of one-time tax credit income in an operating line item in 2009. Investors who didn't read the item in the footnotes may have calculated that the company increased its 2009 return on invested capital to 7.6% instead of the real 2.2%.

Although IP complied with all GAAP and SEC reporting guidelines, a study by New Constructs says that, of 16 paper companies studied, only four (including IP) bundled the credit into regular operating cost of sales.

An International Paper spokesperson called the allegation "without merit." "Not only did we meet all of the reporting requirements," writes **Tom Ryan**, "but we also [went] beyond them to help our shareholders understand the… credits."

IP's director of corporate accounting, **Kevin Ferguson**, says investors know that 10-K footnotes contain important information. He says not reading them is like "hiding" the data from themselves.

Trainer also points to other one-time accounting tricks such as the reverse psychology of the one-time "big bath."

In a big bath, the statement "pulls" future expenses forward into the current period. Although that makes the company's numbers look worse in, say, this quarter, investors were already expecting bad news. Future periods, however, will look better as those future expenses that got crammed into the bad period no longer have to be booked.

"The big takeaway is that investors and boards of directors need to study financial footnotes if they really want to understand a company," says Trainer. "But I don't think they do."

Yet Carver, the corporate director and former accounting partner, argues that his boards do ask questions about how one-time items are presented in financial statements and in the MD&A. In fact, he says managers and investor relations people know they'll have to answer questions about one-time items in earnings calls and at meetings with analysts.

Carver admits that some analysts do have a problem accounting for one-time items in their valuations and models. Most analysts and more informed investors, however, "know that many one-time items will have an impact on future financials."

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