Company Focus 3/12/2008 12:01 AM ET

3 ways companies bury their debt

To hide the facts from shareholders, companies disguise long-term debt, stock-option obligations and other nasty numbers in some creatively tricky ways. Here are some of the biggest offenders.

By Michael Brush

As we watch companies blow up almost weekly after running into debt problems exacerbated by today's credit crunch, it's wise to check the health of your stocks.

Good luck.

Because of the way the bean counting works, the financial wizards inside companies can routinely:

- Hide the amount of pension money they've invested in risky debt instruments backed by subprime loans.
- Disguise long-term debt in off-balance-sheet leases.
- Bury the amount of your money they've promised to employees in the form of lavish stock options deep in annual financial reports, making it hard to find.

All of this helps make a company's performance look better than it is and makes stocks look safer and cheaper than they are.

"Companies have lots of hidden liabilities that aren't made available anywhere," says accounting expert David Trainer. You won't find them in news releases. You won't find many references to them in Wall Street analyst reports. They're tough to locate in the financial reports.

Trainer is a Sherlock Holmes among bean counters -- one who regularly roots out evidence of accounting tricks used to disguise sick companies. His research shop, New Constructs, runs a model portfolio of stocks -- picked in part on the basis of earnings-quality analysis -- that was up 17.8% from April 2006 through of the end of last year, compared with a 7.3% gain for the **S&P 500 Index** ($INX).

Let's be clear, though. Companies don't have to do anything illegal to disguise liabilities from shareholders. They only have to bury what's really going on deep in the fine print. That way, the big picture doesn't surface in the numbers investors find in the commonly used financial databanks. "It takes a lot of work to get to these numbers, and that's deliberate," says Trainer.

Let's take a look at some of the more common techniques and some of the bigger offenders, uncovered recently by New Constructs.

Pension time bombs?

The amount that companies are short on money needed to cover their employee pension obligations is a lot easier to figure out now that companies have to report this clearly on balance sheets.

And the shortfalls are stunning. **Ford Motor** (F, news, msgs), for example, was short $27.5 billion at the end of last year, more than twice the company's market value. Ford says it will reduce that to $7.5 billion by transferring health-care obligations to a labor-union trust. If the rest of the shortfall persists, the company may have to pump a lot of cash into its pension plan, rather than paying it out in dividends or investing in the company's future.

But we don't know how much worse that shortfall might get because so many debt instruments backed by subprime loans are blowing up these days as homeowners default. Ford, like all companies, isn't obligated to reveal how much of its pension investments are in those kinds of debt.

The long-term lease

Another common way to disguise debt is by keeping long-term leases on assets like store locations off the balance sheet -- which is supposed to be a company's description of all its assets and liabilities. Yes, lease payments are deducted from

revenue before profits are calculated, just like rent would be. But the lifetime *cost* of the lease is buried in footnotes.

This bothers critics because a lease, like debt, is a long-term obligation; a retailer, for example, has to pay on a lease even a store is closed. "It is a trick created by accountants to help companies show less debt on their balance sheets," maintains Trainer.

Video on MSN Money

Aflac CEO supports shareholder 'say on pay'

This spring the insurer will become the first publicly traded company in the US to let shareholders vote on top executives' compensation.

One way this fools investors is by increasing a company's return on assets, or ROA. This popular performance yardstick is calculated dividing a company's earnings by its assets. Think of it as a measure of how well a company uses its assets to produce profits for you, the shareholder.

Ignoring a big asset such as leased property makes ROA look a lot higher. "Management should be on the hook for generating a return on all the assets, regardless of whether those assets are on or off the balance sheet," says David Zion, an accounting expert with **Credit Suisse Group** (CS, news, msgs).

Continued: Walgreen's ROA

One company that boosts its ROA this way is drugstore chain **Walgreen** (WAG, news, msgs). Divide fiscal 2007 earnings of $2 billion by reported assets of $19.3 billion and Walgreen has an ROA of 10.5%. By this measure, Walgreen looks superior to competitor **Wal-Mart Stores** (WMT, news, msgs), which has an ROA of just 8.7%.

Walgreen's "better" performance seems to make sense. The company gets 65% of its revenue from prescription drugs -- sales of which are growing rapidly. Walgreen filled about 583 million prescriptions in its fiscal 2007, 10% more than the previous year. With 6,000 stores, it has a vast reach; about 139 million people in the country live within two miles of a Walgreen store.

But Walgreen trumps Wal-Mart on ROA merely because of leases. Trainer calculates Walgreen has $21 billion worth of off-balance-sheet debt in the form of store leases. Add that amount to its asset base when calculating ROA, and Walgreen's number drops to 5%, well below that of Wal-Mart.

Wal-Mart has some off-balance-sheet debt as well, but not enough to bring its ROA down so dramatically. By Trainer's calculations, Wal-Mart has off-balance-sheet debt worth only 4% of its market value, or capitalization, compared with 58% at Walgreen.

Walgreen says a better way to measure performance is to look at return on invested capital (ROIC), which you get by dividing earnings by an estimate of how much money has really been invested in the business -- including a share for the leases. Walgreen has an ROIC of 10.5%, which is decent for a retailer.

Leases hide debt risks

Keeping leases out of sight can also fool investors about the amount of risk in a stock, says accounting expert Charles Mulford. He's the director of the Financial Analysis Lab at Georgia Institute of Technology's College of Management.

Companies with higher debt tend to have more-volatile stocks. More of their costs are fixed, so if business slows down, they have less freedom to trim costs, says Mulford, a co-author of a great book on deciphering accounting tricks called "Created Cash Flow Reporting: Uncovering Sustainable Financial Performance." Those companies are also considered riskier because they'll have to make interest payments even when profits slow down.

Off-balance-sheet leases hide that risk. To see how, let's look at Walgreen competitor **CVS Caremark** (CVS, news, msgs). On the surface, it looks like Caremark has a comfy debt-to-equity ratio of just 17%, if you weigh its $10.4 billion in short- and long-term debt as a percentage of its market capitalization, $55.7 billion. But add in Trainer's estimated $17 billion in leases and Caremark's debt-to-equity ratio balloons to 47%.

"We strongly disagree with your inference that CVS Caremark's financial condition is at all risky," responds finance chief Dave Rickard. "We have enormous free cash flow -- $2 billion in 2007 and a projected $3 billion in 2008." CVS also has solid credit ratings, he adds.

Rickard says his company is constrained by accounting rules to leave leases off the balance sheet and report them in footnotes.

"You appear to be under the misperception that it is a choice," he says. "Your premise may be a popular theme among the financially unsophisticated, but for anyone who understands financial statements, it is just plain wrong."

And Walgreen? Its debt-to-equity ratio jumps to 65% from an innocent looking 4% when you add Trainer's estimate of lease obligations to its reported $1.4 billion in debt.

Walgreen responds that it has a high credit rating of A+ from Standard & Poor's and that some analysts think it should take on more debt to fund further growth.

More expensive than it looks

Keeping leases off the books can also make a stock look cheaper than it really is.

A common way to value companies is to look at enterprise value -- market capitalization plus debt -- compared with cash flow. To calculate this ratio, analysts use a proxy for cash flow called earnings before interest, tax, depreciation and amortization expenses (EBITDA).

When a company moves a lot of its debt off the balance sheet, it lowers enterprise value, or EV. This reduces the EV/EBITDA value measure, making a stock look cheaper -- and thus more attractive.

Let's look at an example: On the surface, it looks like Walgreen has a value of $36.6 billion -- a market cap of $35.2 billion plus $1.4 billion in reported debt. With cash flow of $3.2 billion, it appears to have an EV/EBITDA ratio of 11.4, reasonable for a big retailer. Add the $21.6 billion in leases to the debt mix and the EV/EBITDA valuation measure goes up to 18, which looks expensive for a retailer.

Hidden employee options

Because of new accounting rules, companies now have to account for a portion of the employee options they issue each year. But balance sheets don't include a clear picture of the total cost of all the employee options a company has ever issued, Trainer says. That's buried in a table deep inside filings.

This number matters a lot to shareholders. When employees exercise options, companies have to either cut into profits to buy back stock or issue more shares so they can pass them to the employees. Either way, existing shareholders lose.

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"We have been indoctrinated to think that all stock buybacks are good, with no distinction made between buybacks that shrink the share count and those that merely offset the dilution created by stock options," says Albert Meyer, a money manager at Bastiat Capital. Meyer manages the **Mirzam Capital Appreciation Fund** (MIRZX), up 7.8% since its August launch, compared with a decline of 7.9% for the S&P 500.

Meyer says he gets those outsized returns in part by carefully avoiding companies that have issued so many stock options that they will have to divert too much future cash flow away from shareholders.

Here are some of the bigger offenders in this department, according to Trainer's research:

Cisco Systems (CSCO, news, msgs) had $8.6 billion worth of outstanding employee stock options at the end of its fiscal 2007 last summer (the most recent data available). That's enough to eat up 10% of Cisco's $10 billion in annual cash flow from operations for the next eight years, money that could otherwise be used to invest in growth or support dividends.

"Cisco views stock options as an important tool for employee attraction and retention," company spokeswoman Heather Dickinson says. Cisco also says Trainer's estimated options costs are based on out-of-date information.

Trainer used data from Cisco's 10-K released last summer; he says today's wouldn't be substantially different.

Cisco also questions assumptions used by Trainer but has declined to provide an options estimate of its own. Trainer says he

uses assumptions drawn from company financials.

Hewlett-Packard (HPQ, news, msgs) had $6.5 billion worth of options outstanding as of October, the end of its most recent fiscal year, or 67% of last year's $9.6 billion in cash from operations.

Procter & Gamble (PG, news, msgs) had $6 billion outstanding last June, at the end of its most recent fiscal year, or 45% of its $13.4 billion in cash from operations. The company says it plans to buy back $8 billion to $10 billion in stock a year for the next three years and that the buybacks will more than offset any earnings dilution from options.

H-P and Procter & Gamble did not respond to requests for comment.

At the time of publication, Michael Brush did not own or control shares of any of the companies mentioned in this column.