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# PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

We would like to share some exciting news about PDV Financial Management!

## OFFICE EXPANSION

As we begin our tenth year of business operations serving valued clients and helping them achieve their financial goals, we are most gratified by and grateful for the extraordinary business growth we have experienced over the years. Due to the trust, confidence and loyalty of our wonderful clients, assets under PDV's management recently reached yet another new record high and continue to grow. Client satisfaction appears high, as many clients have either consolidated accounts previously managed elsewhere with us or referred relatives, friends and colleagues to us, or both. We greatly appreciate your support—thank you!

To accommodate and service the tremendous growth in our business, we're excited to announce that we will be expanding our operations by adding another office suite in early October. After this expansion, our offices will roughly double in size. Please come by to say hello and see our new offices!

## LAUNCH OF PDV WEBSITE

Also, we will be launching PDV's new website http://www.pdvfinancial.com soon. Please bookmark our site and come visit often. Our website will contain, among other things, the following:

- Description of our services
- Description of our investment philosophy—our buy as well as sell discipline
- Archived copies of our newsletters
- Links to news and financial articles of interest and useful web resources
- Extensive list of commonly asked questions and related responses

We welcome your comments and/or suggestions in the space provided on our website for this purpose. It is our goal to update and improve on the site continuously, and to make it a convenient and effective forum for communication, information and interaction with our clients, friends and prospective clients.

### *Inside This Issue:*

# THE DECEPTION OF REPORTED EARNINGS

By Che H. Lee
*President*

Investors often evaluate the attractiveness of a potential investment by analyzing its financial statements. No financial metric is of more interest than the "bottom line" or the reported earnings per share ("EPS") on the income statement. However, using the reported EPS at face value could lead to misleading analysis. This is because generally accepted accounting principles ("GAAP") that govern the calculation and presentation of EPS are far from perfect.

No set of accounting principles can completely and accurately capture the economic reality of a company's business. Economic reality is dynamic and shaped as much by future events as the past. GAAP permits companies to make numerous assumptions in an attempt to capture the spirit of a dynamic economic reality. Management is granted great latitude in how it makes these assumptions, from conservatively to aggressively. As such, reported EPS is the end result or ultimate reflection of what assumptions were made. It is the task of the prudent investor to determine whether these assumptions are appropriate and realistic.

Reported EPS, as presented according to GAAP, should therefore always be a ***starting point only*** for analysis, and not accepted as a definitive reflection of economic reality. Armed with the requisite accounting knowledge (either directly acquired or with the help of an investment professional), each investor can begin making his/her own adjustments to reported EPS to get a better (though still not perfect) reflection of economic reality.

Goodwill valuation and depreciation practices are two major areas that can significantly impact reported EPS, depending on the assumptions made by company management. They are discussed below.

## Treatment of Goodwill

By Chad Escarcega
*Portfolio Specialist*

In early 2002, The Financial Accounting Standards Board (FASB) adopted Statement No. 142 for the proper accounting of goodwill and intangibles on financial statements. Under the new rule, companies are no longer required to amortize goodwill or intangibles with "indefinite lives" over a prescribed time period. Instead, these assets are to be tested for value impairment once a year unless unusual circumstances warrant more frequent tests. Ostensibly introduced as an accounting improvement, the new rule, perhaps inadvertently, offers aggressive management much leeway in potential reported earnings manipulation.

When a company purchases another company, the excess of the purchase price over the fair value of the assets acquired and liabilities assumed is reported as accounting "goodwill" on the merged company's balance sheet. Accounting goodwill, while an intangible asset, is usually reported separately on the balance sheet from other intangible assets, such as patents, copyrights, customer lists and trademarks.

Under the old FASB rule, a company had to amortize goodwill and other intangibles on a straight-line basis over a period not to exceed forty years. Therefore, the value of the company's goodwill and other intangibles as reflected on its balance sheet would be diminished evenly and predictably over time, regardless of the true economic value of these assets. Since this periodic and regular value diminution would be reflected as amortization charges on the company's income statement, its reported net income would be affected in a predictable and regular way.

Under FASB Statement No. 142, companies now must subject goodwill and intangibles with "indefinite lives" to an annual value impairment test. Each year a company must decide if the fair value of the assets acquired in the transaction that originally created the goodwill has dropped below their carrying value (i.e. the amount originally recorded on the balance sheet). If such is the case, the assets are considered impaired and their carrying value must be written down to reflect their updated fair value. This impairment write-down will decrease the goodwill and retained earnings accounts on the balance sheet and produce a pre-tax expense entry on the income statement, all by the amount of the value impairment.

Due to the subjective nature of the impairment testing process, management has tremendous flexibility to influence the amount of reported earnings in any one reporting period by either delaying the recognition or reducing the size of any impairment. A closer look at the rule will explain the scope of this flexibility and the latitude afforded for mischief.

FASB recommends that a company generally use the expected present value method of determining the fair value of goodwill and other intangibles. This method is based on assigning probabilities to certain cash flow assumptions and discounting them to their expected present value. Mathematically, slightly altering any one of the inputs or assumptions—probabilities, cash flows or discount rates—can have a tremendous effect on the outcome of the fair value computation. The wide latitude afforded by the new FASB rule as to the assumptions that can be made permits aggressive management to do any one of the following to manage its reported earnings: 1) delay recognition of value impairment and correspondingly defer any adverse impact on reported earnings on the income statements, perhaps to a later date when there is an offsetting one-time gain; 2) shape the amount of any impairment to levels deemed more acceptable to Wall Street; or 3) spread recognition of value impairment over several years to minimize impact on reported earnings in any one reporting period.

When considering a potential investment in a company that has created large accounting goodwill via acquisitions, it behooves the intelligent and informed investor to analyze whether reported earnings might have been affected by any of the above accounting tricks.

# Depreciation Practices

By Louisa Ho
*Assistant Portfolio Specialist*

A company's depreciation practices with respect to the fixed assets on its balance sheet can have a major impact on reported earnings on its income statement. This interrelationship of items on the balance sheet and income statement derives from the fact that the periodic loss in productivity from aging fixed assets must be reflected as depreciation expense that reduces reported earnings.

Under GAAP, a company can use different methods for calculating depreciation expense for 1) financial reporting purposes, and 2) tax purposes. Since 1986, the Modified Accelerated Cost Recovery System (MACRS) has governed the computation of depreciation expenses for tax purposes. In contrast, there are two different methods commonly used for financial reporting purpose: A) "straight-line," and 2) "declining-balance." MACRS and "declining-balance" methods tend to produce greater depreciation expenses in the early years, while the "straight-line" method yields constant annual depreciation expenses. Each of these methods produces depreciation expenses that differ from each other as well as from those under MACRS.

Common to all three types of depreciation methods is the need to determine the following before depreciation expense can be calculated: 1) the fixed asset's initial cost, 2) expected useful life, and 3) estimated value at the end of its useful life (a.k.a. the residual or salvage value).

A company may have an incentive to maximize reported earnings for financial reporting purposes (to appease lenders or the market, or in anticipation of raising capital in the public markets), while minimizing income reported as taxable to the IRS to save taxes. GAAP gives such a company considerable leeway to accomplish this by any of the following: 1) using MACRS to accelerate recognizing depreciation expenses for tax purposes, while using the "straight-line" method to defer running depreciation charges through the income statement (this would result in reported income exceeding taxable income); or 2) over-estimating the expected useful life and/or salvage value.

With respect to any company whose fixed assets are a large portion of its total assets, its depreciation practices are likely to have a huge potential impact on reported income. A prudent investor should analyze the above factors to make sure the methods and assumptions used by management are appropriate. Comparing its depreciation practices to those of its competitors in the same industry will yield valuable insight as to whether any adjustments need to be made to the reported depreciation expenses and earnings, prior to considering the company for possible investment.

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