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ACCOUNTING ISSUES & NEW AGE ECONOMY

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The economy has been recovering nicely since the 9/11 terrorist attacks; interest rates are low. The Federal Reserve is unlikely to tighten anytime soon. The stock market seems to want to go down. We believe investors are struggling with two issues:

Accounting Accuracy
The "New" Economy Stocks

Accounting Accuracy

The fraud at Enron and the overstatement of earnings at WorldCom are serious issues and threaten to seriously undermine confidence in the capital markets. Unfortunately, American financial history is replete with examples of corporate skullduggery. For some perverse reason I have always liked to read about huge corporate failures and fraud. When in high school I read about a scandal involving the Allied Crude Vegetable Oil Company, in which a man named DeAngelis produced phony warehouse receipts for salad oil. American Express was one of the companies duped. This scandal never got much publicity because the exposure occurred in the same weekend that John Kennedy was assassinated. I also recall that the legendary investor Warren Buffett made a fortune buying American Express stock right after the scandal broke.

Nonetheless, both Enron and WorldCom commanded giant market capitalizations at their peaks ($70 billion and $120 billion, respectively), which earned them a place among the largest companies in the world. Both companies have now filed for bankruptcy.

With this piece we are not going to perform an autopsy on Enron or WorldCom. We also are not going to suggest any corrective action by legislation. In fact, we believe investors have adequate information today in order to analyze public companies unless the company management and auditors collude to commit fraud and concurrently the directors are negligent. If Congress passes and the President signs legislation to try to improve the fairness and accuracy of corporate reporting, we hope their efforts do more good than harm.

Instead, we wish to focus on how we analyze financial statements. We have diligently stuck to this process in the past and are committed to doing so in the future. We hope our explanation gives you some peace of mind.

The heart of corporate financial reporting to the public lies in the reports mandated by and filed with the SEC. After the 1996 Safe Harbor legislation, corporations were given some protection from shareholder lawsuits if the companies filed accurate and timely financial statements with the SEC. The most valuable filings are the annual audited financial statements (10K's), quarterly unaudited financial statements (10Q's), and proxy statements (schedule14A's). The SEC requires these statements to be filed in a timely fashion; quarterly statements are required to be filed with the SEC no later than 45 days after the end of the quarter. Corporations who fail to file on time are punished, especially by the exchanges such as the NYSE and NASDAQ.

Review of Financial Statements

Both the 10K and the 10Q contain three critical reports: 1) the income statement, 2) the balance sheet, and 3) the cash flow statement. These three statements report different elements of the corporation's affairs but must be interrelated. The mandatory integration of these three statements offers the investor an opportunity to carefully examine how a company operates.

Most corporate attempts to manipulate financial reports will focus on the income statement. The income statement purports to reflect the GAAP (Generally Accepted Accounting Principles) earnings of the corporation. Generally over long periods of time income statements reflect the dividend paying ability of the company. Corporate abusers generally seek to inflate revenues, re-classify expenses as "one-time", and defer expenses into the future. These actions paint a distorted picture of the current earnings of the company.

Acquisitions are an especially fertile area to inflate earnings on the income statement. Company A buys company B, preferably using company A's inflated stock. Company A declares a one-time write-off of everything possible ("extraordinary write-offs") with regard to B's operations. Plant, inventory, employees are favorite items to write down. After the write-offs, Company A is now in a position to enjoy revenues and the reduced expenses from Company B. Based on the increase in reported earnings, it would seem the acquisition was a good idea. But was it? The acid test is this: if an acquisition is beneficial to Company A, then the incremental cash flow from the integration of Company B should be sufficient to justify the cost of the acquisition. The cash flow statement is very helpful in answering this question. After an acquisition, does Company A achieve a noticeable increase in cash flow? The balance sheet is also telling; after an acquisition does Company A achieve an improved return on shareholder capital?

Corporations can increase earnings by aggressively deferring ("capitalizing") expenses. When an expense is capitalized, that expense is booked directly on the balance sheet and does not flow through the income statement as depreciation or amortization until subsequent periods. There are many legitimate capitalized expenses, such as buildings and other long-term investments. Corporate abusers will cross the line by aggressively capitalizing expenses that should more properly be expensed; this type of expense recognition increases current earnings and reduces future earnings. Because capitalized expenses must be recorded on the balance sheet, the financial analyst must look there to determine the amount and appropriateness of the deferred expenses. The analyst can then challenge the company management on any questionable items.

Revenue recognition is ripe for manipulation. Revenues are typically recognized upon completion and delivery of a product or service. For example, companies can boost revenues by offering easier financing terms. This tactic will cause accounts receivable (reported in the balance sheet) to rise relative to sales. Clues to this kind of attempt to increase earnings often are found in the balance sheet.

Additional Filings

In addition to the three financial statements in the 10K and 10Q, there is other information in the SEC filings helpful to the outside investor. The proxy statements list management compensation, including stock options. The 10K contains extensive mandated footnotes to the financial statements. Topics in the footnotes include related party transactions, litigation activity, pension fund obligations, debt maturity schedules, and stock options expense.

Because of the emergence of the Web and electronic filing of financial statements, anyone can obtain SEC-mandated financial statements at virtually no cost. Why isn't it used more? Consistently successful analysis of financial statements requires diligent reading of material which tends to increase the weight of one's eyelids! One cannot simply read one 10K on a company; one must examine subsequently issued reports year after year. Second, even if an investor diligently reads financial statements, one must have a clear idea of what to do with the information contained therein. We at DGI are in the business of calculating the economic value of a company. Financial statements offer a strong basis for determining the economic (as opposed to accounting value) of a company.

Today it is fair to say the investment community is obsessed with the income statement. Yet the most cursory analysis of balance sheets can easily yield an important investment insight to the analyst willing to look. Here is a straightforward example. In the early 1970's Ben Graham introduced a concept called "net-net working capital". "Net-net working capital" was a calculation of the net value of the liquid assets on the balance sheet after payment of all debts, including long-term debt. If market conditions caused a stock to sell at or below the "net-net working capital" value of the company, the investor was purchasing the business and the long-term assets for free! This is like buying a $20,000 car and finding $20,000 in liquid assets (cash, receivables, and inventory) in the trunk and in the glove compartment! And the seller of the car knew that $20,000 in liquid assets was in the car but was so disgusted with the car that he was willing to sell! In today's market environment there are good companies selling for less than net-net working capital!

In closing this section, we offer three observations. First, the combination of the Web and electronic filing of SEC-mandated financial reports offers everyone access to timely financial information on public companies at negligible expense. Second, while the current system of financial reporting involving outside auditors and independent board members on the audit committee is generally sound, no system can completely protect investors from fraudulent collusion by corporate managers and their auditors and negligent directors. Third, the job of the financial analyst is to calculate the economic value of a company. Inevitably, the economic value of a company is based on the amount of the future cash available for distribution to shareholders. Financial statements offer the most important data for the analyst. Financial statements are based on GAAP accounting rules. It is up to the analyst to understand and convert GAAP accounting into economic reality.

The "New" Economy Stocks

We wish now to extend the discussion on accounting issues and examine the phenomenon known as the "new" economy. With this paper we will argue emphatically that there is substance to the "new" economy companies. We believe the new economy companies offer substantially superior profit models than old economy companies.

We believe the boom-bust action of the "new" economy stocks over the past five years was primarily based on the investment community's myopic focus on income statements plus wildly inflated and then deflated expectations for earnings growth. We have believed for years that this "earnings momentum" approach to investing was simply wrong and would not reward its advocates. Under this investment approach stocks command the highest P/E ratios when recent quarterly earnings growth is the greatest and Wall Street analysts are the most confident. Conversely, stocks sell at the most depressed valuations when earnings growth is slow and analysts are issuing subdued forecasts.

The boom-bust cycle of these stocks has obscured the emerging and sustainable advantage of the companies themselves. Simply, the "new " economy companies have far better balance sheets and profit models than the "old" economy companies.

There are at least three significant differences between the “new” and “old’ economy companies. “Old” economy companies have significantly large employment liabilities, especially pension and retiree health costs. These liabilities are often listed only in the footnotes to the financial statements. Make no mistake; these are real obligations. Most corporations have established investment portfolios to fund pension liabilities. By the end of 1999 the amount of unfunded pension obligations were reduced by surging stock market prices. Over the past two years the stock market decline has re-opened the deficit. Moreover, the estimate of future expected returns from plan investments is probably too high; this means the funding status of the plans is likely to worsen. “New” economy stocks have grown up in the past 30 years. These companies almost universally use 401k and defined contribution plans for employee retirements. There are little or no future obligations.

The second difference lies in the capital intensity of the businesses. “Old” economy companies own tangible assets, plants and inventory. The keys to success for “old” economy companies are efficient asset management and superior employee productivity. “Old” economy companies achieved success with a superior manufacturing system, excellent inventory management, and an efficient distribution system. “New” economy companies own intellectual property and access to customers. “New” economy companies achieve success by commercializing new products which offer dramatically better values than existing products. Disciplined research and development spending and customer mindshare are critical.

The third major difference lies in the capitalization of expenses. An “old” economy company can invest in a physical facility and capitalize that investment to be written off over many years. “New” economy companies typically invest heavily in R&D. GAAP accounting rules require that all R&D be expensed immediately. This means that current reported GAAP earnings for many “new” economy companies are understated relative to “old” economy companies.

Large Employment Liabilities

The unfunded pension liabilities of the “old” economy companies are explained in the footnotes to the financial statements but not listed on the balance sheets. Not only are the “old” economy companies directly liable for unfunded pension obligations but they often must fund large departments whose sole mission is to track pension fund assets. Here are some relevant statistics regarding the funding status of the above “old” economy companies with the exception of Wal-Mart, which does have material pension liabilities:

Company	12/31/2001 Pension Plan Assets	12/31/2001 Pension Plan Liability	Amount Over/(under) Funded
IBM	$61.1B	$60.4B	$686M
Exxon/Mobil	$5.4B	$8.2B	($2.7B)
Alcoa	$8.4B	$8.5B	($54M)
Verizon	$48.6B	$36.4B	$12.1B
Merck	$2.9B	$3.3B	($746M)
GM	$73.7B	$86.3B	($12.7B)

Source: Baseline, SEC filings

The stock market is down thus far in 2002. At yearend 2002 each of the above companies is likely to suffer an erosion in the funded status of their plans. Further we believe the estimate of future returns is probably too high, which means the capital markets will not likely close the funding gap. "New" economy companies do not have defined benefit plans.

Capital Intensity of the Business

The differences between "old" economy financial models and "new" economy financial models are profound. Here are some key metrics which compare the two types of companies:

"Old" Economy stocks

Company	Est. Annual Revenues	Net fixed Plant	R&D	Cash Balances	Inventory	Debt
Wal-Mart	$218B	$46.8 B	0	$2.4 B	$22.6 B	$22.4B
IBM	$86B	$16.5 B	$5.3B	$3.9B	$4.3B	$27.0B
Exxon/Mobil	$187B	$89.2B	0	$6.6B	$8.3B	$10.5B
Alcoa	$23B	$11.9B	$203M	$617M	$2.4B	$7.0B
Verizon	$67B	$74.4B	0	$3.0B	$2.0B	$69.9B
Merck	$48B	$13.1B	$2.1B	$11.5B	$3.1B	$9.9B
GM	$192B	$34.4B	0	$31.6B	$9.8B	$166.40B

Source: Baseline, SEC filings

"New" Economy stocks

Company	Est. Annual Revenues	Net Fixed Plant	R&D	Cash Balances	Inventory	Debt
Microsoft	$25B	$2.2B	$4.3B	$33.6B	0	0
Cisco	$22B	$4.0B	$3.9B	$9.9B	$869M	0
Oracle	$11B	$985M	$1.2B	$5.6B	0	$300M
Dell	$32B	$834M	$440M	$3.9B	$284M	$520M
Sun Micro	$13B	$2.5B	$1.8B	$5.9B	$554M	$1.5B
Intuit	$1.5B	$185M	$207M	$1.6B	0	0
Adobe	$1.3B	$79M	$224M	$620M	0	0
Marketwatch	$45M	$8.4M	$6M	$37M	0	0
Hoover's	$40M	$4.1M	$2.3M	$33M	0	0

Source: Baseline, SEC filings

As the above tables show, the "new" economy companies have significantly higher revenues per dollar of fixed plant. The "new' economy companies have huge cash balances, little or no inventory, and little or no debt. The balance sheets of the "old" economy companies are littered with inventory and debt.

Capitalization of Expenses

GAAP accounting rules are causing "new" economy companies to understate current reported earnings. "New" economy companies invest in research and development and expense it when incurred. "Old" economy companies can capitalize investments in plant and equipment and depreciate that expense in future years.

Let us examine how GAAP accounting rules cause a technology company to understate earnings. Sun Micro, for example, spent about $1.8 billion on R&D over the past twelve months, about 15% of revenues. This amount was fully expensed. My educated guess is that a significant portion of Sun's R&D spending was for development of products which will not be available until 2003 and later years. To make a fair comparison of Sun's stock versus "old" economy companies, this R&D spending should be capitalized and expensed when the products are ready for commercial acceptance. Sun is currently reporting breakeven results, with R&D fully expensed. Let's say 50% of Sun's R&D is for products available in future years. Capitalizing those expenses would cause Sun to report GAAP earnings of about 20 cents per share at the current depressed level of revenues. Comparative treatment of Sun's R&D spending would put Sun's P/E ratio at about 25x depressed earnings.

We hasten to add that we generally like conservative accounting practices. While we can prove no direct link, it seems like corporate managements who follow conservative accounting policies also engage in good business practices. Nonetheless, we wish to assert that whether accounting practices are liberal or conservative, the investor must analyze the financial statements to calculate the economic value of the company under consideration. In view of the current requirement to expense high R&D spending by many "new" economy companies suggests that the GAAP earnings currently reported by these companies can understate the economic value of the companies.

The conservative treatment of R&D spending will mean that future GAAP earnings of these companies are likely to be materially higher than expected. Further, the well-managed "new" economy companies are investing heavily for the future and maintaining or even improving the quality of their balance sheet. In the case of Sun Micro, despite breakeven GAAP earnings and heavy R&D spending, the company's balance sheet is the strongest in its history! When Sun's business recovers, the cash flow available to shareholders should be very strong.

Finally, astute analysts will raise the issue of stock options. We believe options are an expense and should be recorded. An estimate of options expense is presently reported in the footnotes of the 10K reports. We note that the cost of options is variable based on percentage exercised and future stock price movement. Computing the proper economic impact of stock options clearly falls to the analyst. We will have much more to write on this topic later.

While the "new" economy companies enjoy radically better financial models than the "old" economy companies, this does not mean that every "new" economy company will be a financial success. Sad to say, many corporate managements will dissipate this naturally powerful profit model with ill-advised acquisitions and strategic misjudgments. However, the astute, long-term investor should fish in this pond. The "new" economy companies contain the great stocks of tomorrow.

To receive a complete list and description of Disciplined Growth Investors, Inc.'s composites and/or a presentation that adheres to the AIMR-PPS Standards, contact Cynthia Lennie at Disciplined Growth Investors, Inc., 100 South Fifth Street, Suite 2100, Minneapolis, MN 55402; telephone: 612.317.4108; fax# 612.904.2546; email: cindyl@dginv.com.