

Spring/Summer Newsletter

“TO GAAP OR NOT TO GAAP...”

THE QUEST FOR “MORE REALISTIC AND ACCURATE” FINANCIAL DATA

Applying generally-accepted accounting procedures (GAAP) presents an overview of a company’s financial position at a moment in time. But the “snapshot” represents a single viewpoint and can be two-dimensional. Does booking a company’s “non-recurring expenses” provide a true picture of its operating performance. Where on a GAAP compliant financial statement is the company’s potential for growth measured or presented?

Investors and lenders were looking for more “realistic” procedures for determining the financial attractiveness of a company. Particularly in the boom years of the 90’s in the technology sector, a company might have tremendous potential, but limited assets. Non-GAAP financial analysis methodologies were developed to provide a more realistic view of a company’s performance, trends, and potential.

EBITDA

One of these non-GAAP measurements of financial performance was EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). The purpose of EBITDA was to quantify what management was generating in the way of earnings from its operations.

The obvious problem with this analysis is that it does not reflect the cost of debt. It also provides a distorted picture of the financial position of a company highly dependent upon its equipment to do business. At some point the equipment will have to be replaced, so the cost of financing the equipment (interest and the repayment of principal) and of “wear and tear” on it (depreciation) are real components of the cost of doing business for this company. Additionally, corporate taxes must be paid out of pretax profits, and realistically are subtracted from the money available to pay investors or repay loans.

EBITDA ABUSED

Some obvious ways in which EBITDA can be abused are for a company, for which plant and equipment are critical cost issues, to rely exclusively on EBITDA. WorldCom began to use EBITA to accurately reflect its telecommunications operating income separately from its depreciation and long-term amortization. However, investors were not advised of future capital expenses that would be required. WorldCom began to abuse the use of this analysis, when it booked ordinary expenses as capital expenditures, which are not accounted for by EBITDA.

DIFFERENT METHODOLOGIES; RADICALLY DIFFERENT RESULTS

Non-GAAP analysis can produce widely varying results. Consider the company with the following financial information:

Operating Revenues ----- \$3,000,000
Non Recurring Revenues --- \$1,000,000
Non Recurring Expenses --- \$2,500,000
Operating Expenses --- -----\$2,000,000.

What should be reported as the Company's income?

GAAP would report a loss of \$500,000:

Operating Revenues ----- \$3,000,000
Non Recurring Revenues --- \$1,000,000

Total Revenue-----\$4,000,000

Non Recurring Expenses ---- \$2,500,000
Operating Expenses -----\$2,000,000

Total Expenses-----\$4,500,000

Total Revenues
less Total Expenses-----\$ (500,000)

EBITDA would report a profit of \$1,000,000 as the "true" operating profit.

Operating Revenues ----- \$3,000,000
Operating Expenses -----\$2,000,000

Total Operating Revenues
Less Operating Expenses---\$1,000,000

This significant variation could be increased even further to \$2,000,000 by some analysts who might include non recurring revenue without recognizing non recurring expense.

THE ETHICAL DIMENSION

In some cases, non- GAAP financial analyses, such as EBITDA, are useful. These are best used in conjunction with GAAP financial statements. The methodologies should be clearly represented. The purpose of these procedures is analysis, not misrepresentation or the concealment of future costs. When they are used primarily to present a misleadingly positive financial picture, their use is clearly unprofessional and generally unethical.

John C. Stillwaggon, CPA, CGFM

Editor's Note --- John is the firm's newest Partner. He practices from the Grove City Office, and is the director of the firm's Nonprofit Services Group. John has twenty years of audit experience and remains current on all GAAP guidelines.