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TALES OF THE TAPE: Rule Change Would Shed Light On Growth

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NEW YORK -- Not all growth is created equal, but it's about to get easier to measure.

Finding the origin of a company's growth, whether it is from existing business lines or from acquired operations, can be mind-boggling for investors, as companies don't have to make such distinctions in financial data.

Now comes the encouraging news. The rule-making Financial Accounting Standards Board is moving to require companies to break out profit and revenue figures of entities they bought for at least a period of time running from the acquisition date through the end of a company's fiscal year. "The users (of financial statements) have indicated to us that they need to understand how much growth comes from existing operations versus acquired businesses, to do their forecasting," says FASB's Chairman Robert Herz.

The seven-member board recently voted to include the disclosure requirement into merger accounting guidelines it expects to propose by the end of the year. FASB will also propose asking companies to disclose asset and liability amounts for acquisitions that are small individually but "material" collectively.

For investors, such a move will make it easier to assess where a company's growth is coming from. Companies currently use so-called "pro forma" models for recognizing acquisitions, reporting overall sales and profits as if acquisitions closed during a given year were completed at the beginning of that year and even through the prior year.

Such an approach was designed to try to allow for an apples-to-apples comparison of results. But in practice it is "grossly insufficient" to assess the acquiring company's underlying growth trend, said Patricia McConnell, an accounting analyst at Bear Stearns Cos. (BSC).

The new FASB disclosure requirements, if implemented, "will be extremely useful" for investors, McConnell said.

Calls For More Disclosure

Corporate America has resisted such disclosure in the past. But companies hoping to sidetrack the new FASB requirements would have a big hurdle: an investor base clamoring for more disclosure and higher transparency in the wake of accounting scandals that mostly involved acquisitive companies such as Tyco International Ltd. (TYC). To these investors, organic growth is a more reliable driver for shareholder value and acquisitions only represent a complement to companies' core businesses.

Some companies have already been inching toward better disclosure. General Electric Co. (GE), for example, has made it a practice for more than a year to break out earnings from acquisitions in its financial reports, according to spokesman David Frail. The Fairfield, Conn., conglomerate usually makes

more than 50 acquisitions a year.

GE's second-quarter report shows that acquisitions contributed \$88 million to its overall earnings of \$3.8 billion. But the report doesn't provide a similar disclosure about acquisition-related revenue. Asked about the coming FASB proposal, Frail said the company will wait until it comes out before commenting.

Often, the less companies say about where they are making money from and how they are spending their resources, the more cautious investors are about their stocks. "For companies with poor disclosures," said Tony Sondhi, president of financial consultancy A.C. Sondhi & Associates LLC, "the uncertainty of your estimates are significantly higher."

Therefore, Sondhi advises his clients either to stay away from those with a tightlipped mentality, or at the very least to demand higher risk premium for investing in their stocks.

Kenneth Broad, a stock-fund manager at Transamerica Investment Management, is among the investors who tend to shy away acquisitive companies because of the difficulty in distinguish their intrinsic growth from the growth through acquisitions.

One big issue for companies, acquisitive or not, Broad notes, is whether they intend to run the acquired business as "an autonomous entity" or to "integrate it from day one." While the former would mean separate data under existing rules mandating breakdown by segments, the latter objective, he said, could very well make a legitimate reason not to strip out the numbers.

Consider, for instance, Moody's Corp. (MCO) and Paychex Inc. (PAYX), both in Broad's portfolio.

In its second-quarter report, Moody's, based in New York, breaks out revenue, operating expenses and operating income from the credit assessment services, named KMV, it acquired in April 2002, for \$210 million. Moody's has been giving out the breakdown since the second quarter of last year, when it added KMV as a reporting segment. Historically, the company reported its financial results under the one segment of the ratings operation run by Moody's Investors Service, which accounted for about 90% of its total revenue.

Paychex, a payroll processing company based in Rochester, N.Y., bought Advantage Payroll Services for \$314 million last September and Interpay for \$128 million in April. Paychex's chief financial officer, John Morphy, made it clear in a June conference call that as the company accelerates the integration efforts, "the ability to separately distinguish and report Advantage and Interpay operating results will no longer be possible."

The Advantage and Interpay sales forces had been fully combined with the sales force of Paychex by the end of its fiscal year in May. Its full-year financial results, he said, included the results of Advantage and Interpay since the respective dates of acquisition.

' Impracticability Loophole '

Even under pressure from investors companies may still balk, as often happens with any new FASB proposal that winds its way through its public-comment period. Many companies had put forth arguments in 1999 and 2000 that derailed the last attempt at changing disclosure. It would be impractical, the argument went, for companies to keep data separate while they are integrating acquired entities into their overall businesses.

"What's relevant to users are not always practical for companies to do," said Dennis Beresford, a former FASB chairman and now an accounting professor at University of Georgia.

Apparently with that in mind, the FASB would allow an alternative, exempting companies from breaking

out the data if such a move isn't deemed practical. However, companies would have to explain why they could not provide such a breakout in their financial reports.

While such a safety valve looks set to be welcomed by companies, some accounting analysts hope that it doesn't dilute the spirit of the new FASB initiative.

"I would be concerned," Bear Stearns's McConnell adds, "that the impracticability loophole will result in many companies not providing the information."

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