

Financial Analysis: A User Approach
Chapter 7
An Accounting Analysis Perspective

Earnings

Revenue Recognition

Accounting to FASB Concept Statement No. 5 states that two criteria must be satisfied before revenue can be recognized – the revenue must be realized and earned

- Realized (or realizable) – Revenues are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash.
- Earned - Revenues are not recognized until earned. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues.

Concepts Statement 5 continues and provides the following additional detail related to revenue recognition:

1. The two conditions are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling activities are commonly recognized at time of sale (usually meaning delivery)
2. If sale or cash receipt (or both) precedes production and delivery, revenues may be recognized as earned by production and delivery.
3. If product is contracted for before production, revenues may be recognized by a percentage-of completion method as earned—as production takes place—provided reasonable estimates of results at completion and reliable measures of progress are available.
4. If services are rendered or rights to use assets extend continuously over time, reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.
5. If products or other assets are readily realizable because they are salable at reliably determinable prices without significant effort, revenues and some gains or losses may be recognized at completion of production or when prices of the assets change.

6. If product, services, or other assets are exchanged for nonmonetary assets that are not readily convertible into cash, revenues may be recognized on the basis that they have been earned and the transaction is completed. Recognition depends on the provision that the fair values involved can be determined within reasonable limits.
7. If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

Conservative vs. Aggressive Revenue Recognition

- Firms that try to recognize revenue as early as possible are described as having aggressive revenue recognition policies
- Firms that wait to recognize revenue until the two criteria have clearly been satisfied are described as having conservative revenue recognition policies
- Firms with aggressive revenue recognition policies are perceived to have lower earnings quality when compared to firms with conservative revenue recognition policies

SAB 101 and 104

- In 1999, SEC Staff Accounting Bulletin was issued because there were substantial concerns about aggressive revenue recognition practices among registrants
- SAB 104 was subsequently issued in 2003 as an amendment of 101
- SAB 101/104 did not change any of the revenue recognition concepts or methods that previously existed, it simply “reminded” registrants what the concepts and methods were
- SAB 101/104 did introduce a four criteria test used to evidence that revenue is both realized or realizable and earned:
 - Persuasive evidence of an arrangement exists. The use of the term "arrangement" is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction.
 - Delivery has occurred or services have been rendered.
 - The seller's price to the buyer is fixed or determinable, which means that the amount to be paid is a set amount that is not subject to refund or adjustment.
 - Collectibility is reasonably assured.
- Hundred of registrants restated their financial statements and revised their revenue recognition polices in response to SAB 101/104

Expense Recognition

- Generally expenses are the cost incurred to produce revenues, so expense recognition is linked to revenue recognition
- The general name for this approach is the “matching principle” in that expenses are matched to revenues
- Product costs are cost that can be directly related to revenues
- Period costs have no cause and effect relationship to revenues but are consumed during the period
- Allocated costs are costs that benefit more than one accounting period

Revenue and Expense Recognition Policy Disclosures

- Firms report their revenue and expense policies in the financial statements, typically this information is included in a footnote, often the first one

Excerpt from the Seagate Annual Report – Footnote #1 – Summary of Significant Accounting Policies

Revenue Recognition, Sales Returns and Allowances, and Sales Incentive Programs—The Company's revenue recognition policy complies with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition (SAB No. 104). Revenue from sales of products, including sales to distribution customers, is generally recognized when title and risk of loss has passed to the buyer, which typically occurs upon shipment from the Company or third party warehouse facilities, persuasive evidence of an arrangement exists, including a fixed or determinable price to the buyer, and when collectability is reasonably assured. For our direct retail customers, revenue is recognized on a sell-through basis.

Estimated product returns are provided for in accordance with SFAS No. 48, Revenue Recognition When Right of Return Exists. The Company also adheres to the requirements of Emerging Issue Task Force (EITF) No. 01-09 Accounting for Consideration Given by a Vendor to a Customer, (EITF No. 01-09) for sales incentive programs. Estimated reductions to revenue for sales incentive programs, such as price protection, and sales growth bonuses, are recorded when revenue is recorded. Marketing development programs are either recorded as a reduction to revenue or as an addition to marketing expense depending on the contractual nature of the program and whether the conditions of EITF No. 01-09 have been met.

Product Warranty—The Company warrants its products for periods ranging from three to five years. A provision for estimated future costs relating to warranty returns is recorded when revenue is recognized and is included in cost of revenue. Shipping and handling costs are also included in cost of revenue.

Inventory—Inventories are valued at the lower of cost (which approximates actual cost using the first-in, first-out method) or market. Market value is based upon an estimated average selling price reduced by estimated cost of completion and disposal.

Property, Equipment, and Leasehold Improvements—Land, equipment, buildings and leasehold improvements are stated at cost. Equipment and buildings are depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated life of the asset or the remaining term of the lease. The cost of additions and substantial improvements to property, equipment and leasehold improvements are capitalized. The cost of maintenance repairs to property, equipment and leasehold improvements is expensed as incurred.

The Company establishes certain **distributor** and **OEM sales programs** aimed at increasing customer demand. For the distribution channel, these programs typically involve rebates related to a distributor's level of sales, order size, advertising or point of sale activity and price protection adjustments. For OEM sales, rebates are typically based on an OEM customer's volume of purchases from the Company or other agreed upon rebate programs. The Company provides for these obligations at the time that revenue is recorded based on estimated requirements. The Company estimates these contra-revenue rebates and adjustments based on various factors, including price reductions during the period reported, estimated future price erosion, customer orders, distributor sell-through and inventory levels, program participation, customer claim submittals and sales returns. The Company's estimates reflect contractual arrangements but also the Company's judgment relating to variables such as customer claim rates and attainment of program goals, and inventory and sell-through levels reported by the Company's distribution customers. During periods in which the Company's distributors' inventories of its products are at higher than historical levels, the Company's sales programs estimates are subject to a greater degree of subjectivity and the potential for actual results to vary is accordingly higher. Currently, the Company's distributors' inventories are within the historical range. Significant actual variations in any of the factors upon which the Company bases its contra-revenue estimates could have a material effect on the Company's operating results. In addition, the Company's failure to accurately predict the level of future sales returns by its distribution customers could have a material impact on the Company's financial condition and results of operations.

The Company estimates probable product warranty costs at the time revenue is recognized. The Company generally warrants its products for a period of three to five years. The Company's warranty provision considers estimated product failure rates and trends (including the timing of product returns during the warranty periods), estimated repair or replacement costs and estimated costs for customer compensatory claims related to product quality issues, if any. The Company uses a statistical model to help with its estimates and the Company exercises considerable judgment in determining the underlying estimates. Should actual experience in any future period differ significantly from its estimates, or should the rate of future product technological advancements fail to keep pace with the past, the Company's future results of operations could be materially affected. The Company's judgment is subject to a greater degree of subjectivity with respect to newly introduced products because of limited experience with those products upon which to base its warranty estimates. The Company continually introduces new products.

The actual results with regard to warranty expenditures could have a material adverse effect on the Company's results of operations if the actual rate of unit failure, the cost to repair a unit, or the actual cost required to satisfy customer compensatory claims are greater than that which the Company has used in estimating the warranty accrual. The Company also exercises judgment in estimating its ability to sell certain repaired disc drives. To the extent such sales fall below the Company's forecast, warranty cost will be adversely impacted.

EBIT and EBITDA

- EBIT is earnings before interest and taxes (a/k/a operating earnings)
- EBITDA is earnings before interest, taxes, depreciation, and amortization. EBITDA is somewhat similar to the cash flow from operating activities, but with smoothing related to accruals.
- EBIT and EBITDA will be different from net income when:
 - There are large nonrecurring items
 - The company has a lot of debt or a lot of cash
 - The company owns a lot of depreciable assets and limited-life intangibles

Nonrecurring Items

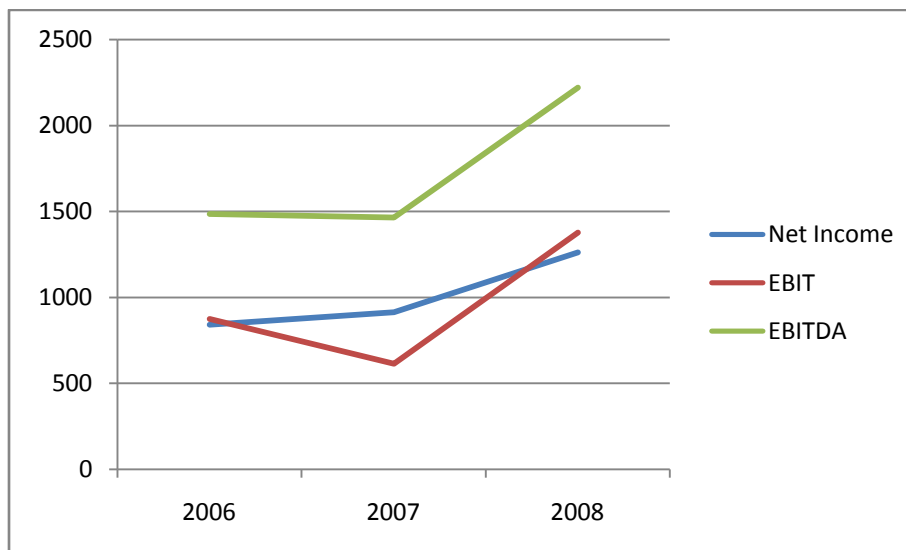
- Required Nonrecurring Items – the following items, if material, must be reported separately, below the net income from continuing operations:
 - Extraordinary Items – Unusual AND Infrequent
 - Discontinued Operations
 - Cumulative Effect of Change in Accounting Principle
- Other Nonrecurring Items – these items are often shown separately and need to be evaluated to determine if they are truly non-recurring
 - Restructuring Charges
 - Impairment Losses
 - Gain/Losses from Assets Sales
- Judgment must be used in evaluating the reported nonrecurring items and in considering whether any unreported nonrecurring items exist

SEAGATE TECHNOLOGY
CONSOLIDATED STATEMENTS OF OPERATIONS
(In millions, except per share data)

	Fiscal Year Ended		
	June 27,	June 29,	June 30,
	2008	2007	2006
Revenue	\$ 12,708	\$ 11,360	\$ 9,206
Cost of revenue	9,503	9,175	7,069
Product development	1,028	904	805
Marketing and administrative	659	589	447
Amortization of intangibles	54	49	7
Restructuring and other	88	29	4
Total operating expenses	<u>11,332</u>	<u>10,746</u>	<u>8,332</u>
Income from operations	1,376	614	874
Interest income	57	73	69
Interest expense	(126)	(141)	(41)
Other, net	22	15	22
Other income (expense), net	<u>(47)</u>	<u>(53)</u>	<u>50</u>
Income before income taxes	1,329	561	924
Provision for (benefit from) income taxes	67	(352)	84
Net income	<u>\$ 1,262</u>	<u>\$ 913</u>	<u>\$ 840</u>

	2008	2007	2006
Net Income	1,262	913	840
Interest & Taxes	114	(299)	34
EBIT	1,376	614	874
Deprec. & Amort.*	844	851	612
EBITDA	2,220	1,465	1,486

* From Statement of Cash Flows



Comprehensive Income

- Recall that companies must report both Net Income and Comprehensive Income
- The most common differences are:
 - Translation Gains and Losses Related to Foreign Operations
 - Unrealized Holding Gains and Losses on Available for Sale Securities
 - Fair Value Gains and Losses Related to Derivatives Used as Cash Flow Hedges
- Comprehensive Income is most commonly reported in the Statement of Changes in Stockholders' Equity

Other Earnings Concepts

- Many companies compute *pro forma* earnings
- Pro forma earnings are computed as if certain items included in net income are treated differently
- A/K/A EBBS – Earnings Before the Bad Stuff
- In 2003, the SEC adopted a rule which requires that when a company reports any “non-GAAP financial measure” (SEC’s term for pro forma amounts) it must be reconciled to the reported GAAP measure
- S&P has its own earnings measure called “Core Earnings”

Cash Flow Statement Analysis

- Cash flows reported in operating, investing, and financing sections
- Free Cash Flow = CFO-CFI
- CFO/Total Liabilities to measure the company's ability to cover debt from current cash flows
- CFO/# Shares to measure Operating Cash Flow per Share
- Cash Flow Adequacy = (Sum of CFO for 3 years)/(CapEx + Inventory Additions + Cash Dividends for 3 years)
 - If 1 or above basic cash needs are being covered internally
 - If below 1 the company is not creating enough cash to sustain growth and dividends

SEAGATE TECHNOLOGY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)

	Fiscal Year Ended		
	June 27,	June 29,	June 30,
OPERATING ACTIVITIES			
Net income	\$ 1,262	\$ 913	\$ 840
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	844	851	612
Stock-based compensation	113	128	90
Deferred income taxes	10	(365)	23
Allowance for doubtful accounts receivable, net of recoveries	(3)	40	—
Redemption charges on 8% Senior Notes due 2009	—	19	—
In-process research and development	4	4	—
Tax benefit from stock options	(6)	—	(44)
Non-cash portion of restructuring and other	2	19	—
Other non-cash operating activities, net	(12)	17	12
Changes in operating assets and liabilities:			
Accounts receivable	(67)	34	(190)
Inventories	(151)	106	(113)
Accounts payable	351	(391)	91
Accrued expenses, employee compensation and warranty	154	(465)	120
Accrued income taxes	13	8	54
Other assets and liabilities	24	25	(38)
Net cash provided by operating activities	<u>2,538</u>	<u>943</u>	<u>1,457</u>
INVESTING ACTIVITIES			
Acquisition of property, equipment and leasehold improvements	(930)	(906)	(1,008)
Proceeds from sale of fixed assets	29	55	—
Purchases of short-term investments	(486)	(322)	(3,220)
Maturities and sales of short-term investments	460	997	3,528
Net cash and cash equivalents acquired from Maxtor	—	—	297
Acquisitions, net of cash and cash equivalents acquired	(78)	(178)	(28)
Other investing activities, net	14	(48)	(130)
Net cash used in investing activities	<u>(991)</u>	<u>(402)</u>	<u>(561)</u>
FINANCING ACTIVITIES			
Net proceeds from issuance of long-term debt	—	1,477	—
Repayment of long-term debt	(34)	(5)	(340)
Redemption of 8% Senior Notes due 2009	—	(400)	—
Redemption premium on 8% Senior Notes due 2009	—	(16)	—
Proceeds from exercise of employee stock options and employee stock purchase plan	178	219	118
Dividends to shareholders	(216)	(212)	(155)
Tax benefit from stock options	6	—	44
Repurchases of common shares	(1,479)	(1,526)	(399)
Net cash used in financing activities	<u>(1,545)</u>	<u>(463)</u>	<u>(732)</u>
Increase in cash and cash equivalents	2	78	164
Cash and cash equivalents at the beginning of the period	988	910	746
Cash and cash equivalents at the end of the period	<u>\$ 990</u>	<u>\$ 988</u>	<u>\$ 910</u>
Supplemental Disclosure of Cash Flow Information			
Cash paid for interest	\$ 121	\$ 88	\$ 38
Cash paid for income taxes, net of refunds	34	38	15

	2008	2007	2006
CFO	2,538	943	1,457
CFI	(991)	(402)	(561)
CFF	(1,545)	(463)	(732)
Inc/(Dec) in Cash	2	78	164
FCF	1,547	541	896
Total Liabilities	5,534	4,735	4,332
CFO/TL	.46	.20	.34
# Shares (Basic)	542	558	495
EPS	2.46	1.64	1.70
CFOPS	4.68	1.68	2.94
CapEx	930	906	1,008
Inventory Inc/(Dec)	151	(106)	113
Cash Dividends	216	212	155

$$\text{CFA} = \frac{(2,538 + 943 + 1,457)}{((930+906+1,008)+(151-106+113)+(216+212+155))} = 1.38$$

Detailed Accounting Analysis

1. Conduct a financial accounting review
2. Evaluate reporting completeness
3. Evaluate the potential for earnings management
4. Consider potential red flags
5. Reevaluate or restate financial information