

Cash Profit Equivalency (CPE)TM Testing
A Copywrited Earnings Confidence Ratings System

THE NEED FOR TESTING THE QUALITY OF REPORTED EARNINGS

Even with more stringent post Enron new auditing disciplines, current accounting principles (generally accepted accounting principles or GAAP) allow reporting entities an alarmingly high degree of legal flexibility in interpreting and applying GAAP. However, over the long run (i.e. 5 to 10 years), earnings should be corroborated by the amount of actual cash generated. Any significant variation between reported earnings and actual cash generated is indicative of overly liberal or conservative application of GAAP by management, perhaps to improperly manage or manipulate earnings. This is the basic postulate of **Cash Profit Equivalency (CPE)TM Testing** and the related **Earnings Corroboration Ratings System (ECR)[®]**. Even though such varying GAAP interpretation and application may be legal and acceptable, it is vital and critical that a prospective investor be able to judge the confidence in the historical reported earnings. The **CPETM** testing and the related **ECR[®]** rating is intended to provide this unfilled need. We have had bond-rating agencies, independent auditors' opinions, and brilliant Wall Street research analysis, which have collectively proven incapable of providing this desperately needed reported earnings confidence. Various companies claim to practice conservative accounting but there has not been a concrete measurement/corroboration of this claim. This need can be met in the future with **CPETM** testing and the related **ECR[®]** rating. Of course, this all assumes that the Enron types of off balance sheet "shenanigans" are behind us.

EARNINGS CORROBORATION WITH CPETM TESTING

Over the long run, the only fail-safe confirmation of reported earnings reliability is **Actual Cash Generation (ACG)TM**. In theory, cumulative reported earnings and **ACGTM** should match with the only difference being the timing of an actual cash transaction compared with the bookkeeping. Over a long enough period of time, capital expenditures and depreciation will "wash" on a cumulative basis, for example. And bookkeeper generated accruals/reserves will, in theory, eventually become cash payments. Even a GAAP created cash flow statement (sometimes called a funds statement) is not a reliable indication of **ACGTM** because some of the largest funds statement's line items (e.g. net income, depreciation, etc.) are highly dependent on widely ranging application of GAAP and, therefore, not always accurate measures of true cash provided from operations, as a funds statement categorically implies.

Cash Profit Equivalency (CPE)TM Testing, on the other hand, relies only on a copywrited formula to arrive at the **Actual Cash Generation (ACG)TM**, which starts with the change in actual net cash (i.e. short and long term interesting bearing debt less cash) over the period being tested (preferably a 5 to 10 year period) adjusted

for: (a) shareholder equity transactions, (b) acquisition and divestiture activities, (c) non operating investing activities, and (d) working capital needed or liquidated from core (i.e. exclusive of acquisition growth) business revenue growth or decline.

Shareholder equity activities include cash dividends paid and cash used to buy back common stock, which would be added back to the net cash change, and cash proceeds from new shares issued, which would be deducted from the net cash change in the computation of ACG™. This data is readily available and usually accurately presented in a company's funds statement

Acquisition/divestiture activities include the actual cash paid and assumed interest bearing debt in any acquisition transaction and it, importantly, includes any future cash restructuring expenses, which are commonly added to goodwill in the first year of a company's acquisition accounting routines. This acquisition payment (including debt assumed) would be added to the net cash change in the ACG™ formula. However, this acquisition data is not readily available in a company's funds statement and may require soliciting the company for the exact amounts. The proceeds from any divestiture of discontinued businesses are readily available in the funds statement and this would be deducted from the net cash change in the ACG™ formula.

Non-operating investing activities would include cash spent to invest in any area outside operations like venture capital, unconsolidated investments in other companies, investment in non-operating real estate, etc. These cash investments would be added to the net cash change in the ACG™ creation exercise. They may be available in the company's funds statement if they are material enough to warrant line item disclosure.

A pro forma working capital ACG™ adjustment must be made to the net cash change in an amount equal to the working capital required to fund the core (i.e. ex acquisitions) revenue growth of the company. It will be an addition to the net cash change when the company has core sales growth and a deduction when core sales decline. This will be the only pro forma data required in ACG™ since the rest is based upon actual data. It will have to be provided by the company.

THE CRITICAL COMPARISON OF ACG™ TO REPORTED EARNINGS

Reported earnings will be comprised of bottom line net income after everything including special items (e.g. restructuring charges) and discontinued operations since these are cash generating items and/or corrections of prior years' accounting, which are very relevant to ACG™. The only modification to reported net income would be to deduct or add back: (a) any gains/losses on the sale of a business or a non-operating investment and (b) any goodwill amortization or impairment write-off. This is not to infer or suggest that the degree of goodwill or the goodwill write-off should be ignored or disregarded. It needs to be added back to reported earnings to make it comparable to ACG™, which disregards all elements of goodwill accounting. Perhaps, a better way of evaluating and testing goodwill would be to

measure the return on invested capital using **ACG**TM cash basis income as the measure of return on gross invested capital (i.e. add back all goodwill amortization and impairment write off's to the company's book invested capital). Gains from sale of non-operating assets and/or from the sale of businesses also must be removed from reported earnings because the cash from these activities has been removed in the previously described **ACG**TM formulation. The important **Earnings Corroboration Rating (ECR)**[©] is the ratio of **ACG**TM compared with this modified reported net income.

VALUE AND USE OF THE ECRTM **RATING**

First, the higher the **ECR**[©] rating (i.e. **ACG**TM divided by modified reported net income), the higher confidence the investor should have in the quality of the cumulative reported earnings for the number of years **CPE**TM tested. This means that we can substantiate the reported earnings with cash generation (i.e. **ACG**TM) for the number of years tested. It does not mean that each year was accurate but that the years of earnings accounting, taken together, is substantiated by cash generation. The upshot of this is that the investor must look at the 5 to 10 years of earnings metrics together, including special restructuring charges, which are genuine negatives to earnings and often year-to-year reported earnings manipulation devices. The high **ECR**[©] rating is merely verification that the company's accounting is probably conservative and that the cumulative reported earnings for the years tested are reasonably reflective of the average annual earning power of that company. It is not a predictor of the future in any way and it cannot verify the accuracy of any of the years individually.

A low **ECR**[©] rating, on the other hand, presents a serious concern to the investor since it warns that, even over a long period (i.e. 5 to 10 years), there was not enough cash generated to support the reported earnings. As previously stated, over a long enough period, there should be little difference between accrual and cash accounting. This could mean a variety of things but mostly casts considerable doubt over the accounting methods used and/or working capital excesses which often lead to subsequent accounting write off's. It does not automatically rule the company out as a potential investment, but it means someone has to "drill down" much further into the balance sheet to find out where the balance sheet issues exist and the potential magnitude of the required accounting corrections. It is not surprising that balance sheets frequently receive an accounting cleansing immediately after a tenured CEO is forced out for not meeting expectations. They usually stretch the balance sheet with over valued assets or understated liabilities to delay the inevitable earnings demise. The **ECR**[©] rating after such an event might be excessively high, indicating that there were overly aggressive write off's "booked" by the new regime to facilitate the first few years of managing earnings growth. This is equally hazardous to an investor since it exaggerates the earning power but, again, continued **Cash Profit Equivalency (CPE)**TM **Testing** will portend the eventual earnings fall to the more real natural levels.

WHAT ARE THE SUCCESS IMPEDIMENTS WITH THE CPE™ TESTING SYSTEM?

The biggest challenge will be building the data base 5 to 10 years back in time. Also, the **CPE™** testing results are likely to be easier to understand with smaller non-acquisitive type entities. Conversely, it will be much more difficult with larger diverse acquisitive companies. It will also be more difficult to implement for financial institutions where short-term debt must be considered in working capital (it's cost of sales to a financial institute) not in the determination of net cash for **ACG™** purposes. General Electric, for example, would have to submit two entirely separate sets of numbers (i.e. one for GE Capital and one for GE Industrial) for such **CPE™** testing to be meaningful and useful. Insurance entities would also require a slightly tailored **CPE™** testing process.

HOW WILL CASH PROFIT EQUIVALENCY (CPE)™ TESTING BE MARKETED?

The financial world must be convinced that striving to receive an excellent **ECR©** rating is a worthwhile effort and a revered rating similar to a AAA bond rating. Therefore, we will have to start with a select group of companies who are likely to score well in order to build a data base and prove retroactively that their historical 5 to 10 year performance did earn them a good **ECR©** rating which, in turn, confirms their conservative accounting interpretation and application of GAAP. We will work with this pilot group on a no charge confidential basis in order to get the data to fine-tune and prove out this **CPE™** testing process.

We will then use the pilot group's results as a testimonial to the success and value of receiving a good **ECR©** rating by marketing to broad cross section of publicly owned entities. Subscribers would pay a nominal annual fee (e.g. \$1,500). We might also license the testing process to third parties for selective use in acquisition due diligence work. Our intention would be to keep the precise formula a closely guarded secret and merely send the client an e-mail kind of "fill in the blanks" data sheet, which would get the data but conceal the actual formula process that has been described herein. The biggest financial reward might be in performing ad hoc fee based consulting for clients who score poorly to determine corrective action.

IS THERE ACTUALLY THAT MUCH ACCOUNTING EARNINGS MANAGEMENT?

Just let me count the ways! There is much cause for concern and it does not have to be as egregious or as spectacular as Enron and Tyco. There are many temptations and many sinners in this regard. The biggest trick of all involves overly aggressive acquisition accounting on opening balance sheets. Over reserving and erroneously loading up goodwill with operating expense in opening balance sheets is a "biggie". And now more than ever since goodwill is no longer amortized. Failure to properly reserve for bad debts and inventory obsolescence is another favorite. Using ludicrously lengthy depreciation lives is another one. Letting warranty, product liability, and environmental reserves run down to low is all too common. Desperate managements have done the arbitrary assignment of more value to inventory frequently. The use of fake billings with "no questions asked"

return policies was made famous by Sunbeam just before their bankruptcy. Who can understand GE's frequent pension accounting trickery? How about those low tax provisions that can be wiped out by subsequent tax audits? And the "grand daddy" of them all involves capitalizing items that should be expensed into fixed assets.

Many of these accounting transgressions are timing differences, which wash out over time. But some will never be converted into cash and this will be clearly reflected in the **CPE**[™] testing process and the related **ECR**[©] rating. Amen and end of sales pitch!

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