

IN THE MONEY: Google's Tax Issue Is Only Half The Story

1,150 words

1 February 2006

17:28

Dow Jones News Service

English

(c) 2006 Dow Jones & Company, Inc.

By Michael Rapoport

A Dow Jones Newswires Column

NEW YORK (Dow Jones)--Taxes were taxing for Google Inc.'s (GOOG) earnings - but maybe not as taxing as the company would like investors to think.

As maybe two or three people haven't heard by now, Google missed analysts' fourth-quarter earnings estimates in a big way on Tuesday, posting income of \$1.54 a share (excluding certain items) versus Wall Street's consensus expectation of \$1.76. But don't worry, the company said: It was just a tax issue that caused the shortfall, and Google's performance and future look bright.

Chief Financial Officer George Reyes said during a conference call that "really most of the miss was related to the tax impact" of how its expenses were allocated to international versus U.S. operations. Chief Executive Eric Schmidt told The Wall Street Journal that compared with analysts' financial models, "the big difference was a different tax computation - but the revenue and profit growth were all very strong and at or above the models."

But a look at Google's numbers indicate that it may not be that simple. In fact, the numbers suggest that only half of Google's shortfall - 11 cents a share out of 22 - may be related to the tax issue.

If that's the case, no wonder Google stock got slammed on Wednesday, declining more than 7%. "The company was being priced on ever-increasing expectations, and you had a fundamental miss," said Scott Devitt, an analyst with Stifel Nicolaus & Co., who has a "sell" rating on the stock.

The core of the issue is that Google had to record more than expected in taxes in the fourth quarter because more of its expenses were allocated to its international operations than it expected, compared with its U.S. operations. That, in turn, raised U.S. pre-tax profit as a proportion of Google's total - and Reyes says that resulted in a greater percentage of Google's profits being taxed at a higher domestic tax rate. The company's effective tax rate for the fourth quarter was 41.8%; the rate for the full year was 31.6%, compared with Google's projection of about 30%.

The issue is perfectly legitimate - it's just Google's characterization of it as the overarching cause of its earnings miss that seems out of whack. Here's why:

Google recorded \$2.142 billion in pre-tax profit for the year. If you apply Google's prior estimate of a 30% effective tax rate to that, you get \$642.6 million in taxes. Google had an actual tax provision of \$676.3 million for the year (resulting in that 31.6% effective tax rate), so that means the company paid \$33.7 million more in taxes than it expected.

That's essentially the tax impact of the international vs. U.S. expense issue, and it's all attributable to the fourth quarter. But \$33.7 million equates to only 11 cents a share, using Google's diluted share count of about 304 million - not 22 cents.

Devitt, the Stifel Nicolaus analyst, uses different numbers but agrees that the company is off-base

in blaming most or all of its shortfall on the tax issue. And whatever the particular reason for the shortfall, he said, "it's not about missing and meeting (estimates). The business was being priced for outperformance and continuing to raise expectations," and so the stock took a tumble when it didn't meet them. (Devitt doesn't own Google shares, and Stifel Nicolaus doesn't do investment banking for the company.)

Google said in a statement that its characterization of the tax issue as comprising most of the miss was based on analysts' estimates, many of which had assumed a tax rate of around 30% for the fourth quarter. There's a huge gap between that estimate and the actual 41.8%; the bigger the gap, the higher the amount of Google tax payments that analysts hadn't anticipated, and thus the more valid it is for Google to describe the tax issue as the predominant cause of its 22-cent shortfall. In fact, some analysts back up Google's contention, with some saying that Google would actually have exceeded the \$1.76 consensus estimate were it not for the tax issue.

The problem is, it simply doesn't make sense for analysts to have had a 30% estimate for Google's fourth-quarter tax rate. Logically, estimates should have been much higher, even before Tuesday's surprise.

Why? Google had said publicly as far back as its third-quarter earnings announcement in October that it expected a tax rate of "approximately" 30% for the full year - but at that point, through the first nine months of 2005, its effective tax rate was only 27.2%. Google never issued a tax-rate forecast for the fourth quarter specifically, but to get from 27% for nine months to 30% for the full year certainly implies that expectations for the fourth-quarter tax rate should have been well above 30%.

If estimates had been that high beforehand, that would have meant one of two things - either that the amount of Google's unexpected tax payments would have been lower, and thus made up a smaller percentage of the earnings shortfall; or that analysts would have come up with lower earnings estimates to begin with, and the consensus would have been below \$1.76 a share.

And, to be fair, that "approximately" in Google's full-year tax-rate estimate is significant. If you assume the base estimate for the tax rate is 29% instead of 30%, say, and run the numbers that way, that boosts Google's unexpected taxes from \$33.7 million to \$55.2 million, or 18 cents a share - much closer to comprising all of the 22-cent shortfall.

What all of this suggests is a deficiency in Google's forecasting abilities - no matter what the exact numbers or the exact proportion of the earnings miss caused by this issue, this is a pretty big miss to have happened because Google was wrong about how its expenses should be allocated. In addition, it suggests that Google's policy of avoiding short-term earnings guidance leaves something to be desired.

The matter is "indicative of the company's ability to effectively plan and evaluate," said Scott Kessler, an analyst for Standard & Poor's, who has a "sell" rating on Google. And, he added, "other companies do a much more thorough job about communicating what guidance should be and the nuanced aspect of that guidance."

That's getting down to brass tax. Uh, tacks.

- Michael Rapoport, Dow Jones Newswires; 201-938-5976; michael.rapoport@dowjones.com [02-01-06 1728ET]

70768

Document DJ00000020060201e221000qk



IN THE MONEY: PCAOB Panel Takes Up Auditor Liability Caps

925 words

8 February 2006

15:55

Dow Jones News Service

English

(c) 2006 Dow Jones & Company, Inc.

By Michael Rapoport

A Dow Jones Newswires Column

NEW YORK (Dow Jones)--Audit-firm liability caps, controversial provisions that limit a company's right to sue its auditors in the event of an accounting meltdown, are getting more attention from regulators.

An advisory panel of the Public Company Accounting Oversight Board is set to discuss the issue on Thursday. That's a sign, observers say, that the PCAOB wants to find out more about liability caps and could ultimately set policy governing their use.

The issue is on the agenda for Thursday's meeting in Washington of the PCAOB's Standing Advisory Group, a 31-member panel that advises the board on establishing auditing standards. The discussion comes amid indications that the debate over liability caps is heating up. Just last week, a group of banking regulators softened a key part of its separate attempt to restrict the use of liability caps.

Mike Shokouhi, a PCAOB spokesman, said the board uses the SAG to gather information about emerging issues in auditing, and uses that information to evaluate whether any new or revised rules are needed. The fact that the advisory panel is discussing the liability-cap issue means that "obviously it's on our radar," he said.

That doesn't mean the PCAOB will necessarily take action to restrict the use of liability caps, which has raised concerns that they could affect auditor independence and performance. But "it certainly means they're aware of the issue and paying attention," said Barbara Roper, a member of the advisory panel and director of investor protection for the Consumer Federation of America, who stressed that she was speaking for herself and not the panel.

Liability caps are contained in the "engagement" agreements through which a company hires its auditor. They take a number of forms, such as barring a client from seeking punitive damages from its auditor in the event of a dispute, or requiring that all disputes between the two sides go through mediation and arbitration rather than to court. (The provisions don't affect the right of outside parties like shareholders to sue an audit firm.)

It isn't known how prevalent the use of liability caps is; most investors weren't aware they existed until last fall, when a few companies disclosed that their agreements with their auditors contained the caps. But use of the caps is believed to be on the increase, and some firms may be using them as part of their standard agreements with audit clients.

From the auditors' perspective, the idea behind liability caps is to provide them some protection if

a client has an accounting problem, blames its auditor and wants to sue, as high-profile accounting casualties like HealthSouth Corp. (HLSH) and Adelphia Communications Corp. (ADELQ) have done.

But investor advocates and other observers are concerned that these liability-limiting agreements between companies and their auditors would harm auditor independence. The theory is that by giving an auditor this protection, they could weaken the auditor's incentive to do a thorough and impartial audit.

"It's going to impact their ability to exercise professional skepticism," said SAG member Cynthia Richson, corporate governance officer for the Ohio Public Employees Retirement System.

A spokesman for KPMG LLP said going through mediation and arbitration "allows both parties the ability to control the cost normally associated with litigation." The other three major accounting firms - Pricewaterhousecoopers LLP, Ernst & Young LLP and Deloitte & Touche LLP - either couldn't be reached for comment or had no comment.

But the U.S. Chamber of Commerce is critical of regulators' attempts to get involved in the issue. It issued a report last month that said any attempt to restrict the use of liability caps would be "regulatory over reach" and would subject audit firms to greater risk of litigation.

"I don't think turning up the heat on litigation risk has many benefits," said David Chavern, the Chamber's vice president and chief of staff.

The PCAOB advisory panel's discussion will come less than a week after an interagency group of banking regulators that had criticized liability caps last year altered part of its stance.

The group - which includes the Federal Reserve, the Office of Thrift Supervision, the Federal Deposit Insurance Corp. and other regulators - had issued a draft advisory last May warning that financial institutions and their auditors shouldn't use liability-limiting provisions because they could weaken the auditors' "objectivity, impartiality and performance."

But when the regulators issued their final advisory last week, after a public comment period, they said that provisions under which clients give up their right to seek punitive damages from their auditors would be allowed, at least for the time being.

The comment letters raised "extensive" concerns about limiting the use of punitive-damage waivers, the group of regulators said, and so it would "take the issue under advisement" rather than prevent their use.

"The final (advisory) was not as strong as it was in the proposal on punitive damages," acknowledged Jeff Geer, chief accountant of the OTS, the lead agency on the project. He noted that banking regulators might have a different perspective on the matter than other regulators, since their focus is the "safety and soundness" of financial institutions, and that stability wouldn't be harmed if banks aren't allowed to collect punitive damages from their auditors.

- Michael Rapoport, Dow Jones Newswires; 201-938-5976; michael.rapoport@dowjones.com [02-08-06 1555ET]

70768

Document DJ00000020060208e228000hu



IN THE MONEY: How Blockbuster, Netflix Differ (Or Don't)

1,067 words

22 March 2006

16:03

Dow Jones News Service

English

(c) 2006 Dow Jones & Company, Inc.

By Michael Rapoport

A Dow Jones Newswires Column

NEW YORK (Dow Jones)--Blockbuster Inc. (BBI) and Netflix Inc. (NFLX) are more alike than not. Sure, one's mostly a retail chain and the other's an online venture, but at their core, both companies are fierce rivals in the same business - getting customers to rent little plastic discs with movies on them.

So why, as of earlier this month, are these two similar video-rental companies calculating a key measurement of their financial health in radically different ways?

Blockbuster decided recently to change how it accounts for the costs of buying the DVDs it rents out to customers. It reclassified those costs as cash flow from operations instead of from investing. Meanwhile, Netflix decided not to make that same change, and left its DVD costs as part of investing cash flow.

Arcane accounting minutiae, perhaps. But it's had a huge impact on the companies' respective operating cash flows, a critical metric for how their businesses are performing.

Because it reclassified its DVD costs, Blockbuster's operating cash flow for last year, which had been nearly five times higher than Netflix's, is now much lower - in fact, it's swung from positive to negative. By contrast, by not reclassifying its costs, Netflix avoided a drop of more than two-thirds in its operating cash flow.

No matter which company is right here - and both could be right, as we'll see - the end result poses an unusual problem for investors: The two most prominent companies in the video-rental business are no longer on an apples-to-apples basis when it comes to their reported operating cash flow. To compare them fairly on a cash-flow basis, you have to rejigger their numbers.

If you ever wanted to see how an angels-dancing-on-the-head-of-a-pin accounting interpretation can make a major difference in a company's financial results, here's Exhibit A - or maybe that should be Exhibit DVD. Talk about "show me the money."

"There's so much flexibility in reporting that it's difficult to compare one company with another," said Charles Mulford, an accounting professor at Georgia Institute of Technology and an expert on cash-flow accounting.

As reported in this column, Blockbuster decided to move its DVD-library purchases to operating from investing cash flow - thus reducing operating cash flow - after discussing the matter with the

Securities and Exchange Commission. Steve Swasey, a Netflix spokesman, said Netflix approached the SEC after Blockbuster's move, but "those discussions resulted in reaffirming that Netflix's accounting for its library is appropriate." That is, Netflix kept its DVD-library costs in investing cash flow, where they don't hurt the operating figure. (Total cash flows, which include operating, investing and financing, aren't affected.)

And it makes an enormous difference. Before Blockbuster's change, the company would have reported \$784.9 million in operating cash flow for 2005, compared with Netflix's \$163 million. But once it shifted its \$855.4 million in DVD-acquisition costs over to operating cash flow, Blockbuster's operating cash flow went into the red, to negative \$70.5 million.

Meanwhile, Netflix had about \$114 million in DVD-acquisition costs in 2005 that it's keeping in investing cash flow. If it had moved those costs over to operating cash flow, its operating figure would have plunged from the reported \$163 million to \$49 million.

So why the different approaches? Both Blockbuster and Netflix are being close-mouthed about how they reached their decisions, and neither would comment on the other's decision. But this apparently has to do with a distinction between how the two companies' customers behave.

When a customer walks into a Blockbuster store, chances are good he or she is looking for the latest new-release DVD, rather than a back-catalog item that's been out for a while. That suggests that Blockbuster tends to get the bulk of its revenue from renting its DVDs upfront, not long after the company buys them. In accounting terms, that implies that Blockbuster's costs of buying the DVDs are more like a current, operating item rather than a longer-term investing item, and hence belong under operating cash flow.

Netflix, on the other hand, says more than 70% of its rentals are for back-catalog items rather than new releases. That suggests its DVDs have a longer useful life than Blockbuster's, and the revenue from them will come over a much longer period - hence, Netflix's DVD-purchase costs are more like an investment, and belong under investing cash flow in the company's view.

In movie terms, it's the difference between, say, "Walk the Line" and "Casablanca." Blockbuster gets its revenue predominantly from hot new DVD releases like "Walk the Line," which its customers want to rent as soon as possible after they're issued. Netflix gets its revenue largely from back-catalog movies like "Casablanca," which its customers will rent for years.

Is this distinction valid, or is Netflix just trying to keep its operating cash flow from getting pummeled the way Blockbuster's was? Jack Ciesielski, publisher of The Analyst's Accounting Observer, said he is "uneasy with Netflix's rationale" and thinks the company should back it up by providing more details about its DVD library to justify its accounting. (In addition to Ciesielski, research firm Glass Lewis & Co. recently issued a report to its clients that was apparently critical of Netflix's accounting, but it hasn't been publicly released.)

Mulford thinks Netflix may have a point, but he notes the situation "gets even murkier" because Blockbuster has started its own online-rental business. That accounted for only 4.3% of the company's rental revenues in the latest quarter, but as that grows, he said, "they may have an argument for saying 'let's put some of this back in the other direction'" - that is, to move some of its DVD costs back to investing cash flow.

It just goes to show that video companies' cash flow seems to have become like Forrest Gump's box of chocolates: You never know what you're gonna get.

- Michael Rapoport, Dow Jones Newswires; 201-938-5976; michael.rapoport@dowjones.com [03-22-06 1603ET]

70768



IN THE MONEY: Lucent Pensions Make It 'Unequal' To Alcatel

791 words

24 March 2006

17:24

Dow Jones News Service

English

(c) 2006 Dow Jones & Company, Inc.

By Michael Rapoport

A Dow Jones Newswires Column

NEW YORK (Dow Jones)--Some "merger of equals."

That's how Lucent Technologies Inc. (LU) and Alcatel SA (ALA) are describing their potential combination. Apparently they skipped the Math 101 lesson which teaches that \$12.7 billion, Lucent's approximate market capitalization before its stock jumped Friday, is decidedly unequal to \$21 billion, Alcatel's market cap.

But even if you were to overlook this bit of cognitive dissonance, there's still a big problem with calling these two companies "equals." When you compare their operating results fairly, on an apples-to-apples basis, it appears Lucent is being valued by the market far more richly than Alcatel - even with its share price only around \$3.

The difference: Lucent's pension plan, from which the company has been deriving a huge chunk of its recent earnings. Strip out the pension earnings, and Lucent's valuation - its market value as a multiple of its operating profit, which otherwise looks roughly comparable to Alcatel's - suddenly soars.

Yet Lucent and Alcatel insist this is a merger of equals, intended to be priced at market - i.e., without any premium for either side. If the companies really believe that, it makes Alcatel look a little foolish. Essentially, for Lucent the market price is a premium.

Caroline Mille, an Alcatel spokeswoman, said that "of course we are aware" that Lucent derives much of its income from its pension plan, but she wouldn't comment further. Mary Lou Ambrus, a Lucent spokeswoman, declined to comment.

When you calculate the two companies' valuations on the basis of their operating earnings, Lucent and Alcatel are actually reasonably close: Lucent trades at about 12 times its calendar 2005 operating income, while Alcatel trades at about 15 times operating income. Both are roughly in the range of other telecommunications-equipment companies: Motorola Inc. (MOT) trades at about 12 times operating income, while Nokia Corp.'s (NOK) multiple is 17.

What sets Lucent apart from the others, however, is the large degree to which its earnings rely on income generated by its pension plan. During calendar 2005, Lucent reported \$647 million in credits from its pension and retiree-benefit plans combined.

That amount gets factored into Lucent's operating income, even though retiree plans aren't part of

a company's operations. (More cognitive dissonance.) The pension and retiree credits made up about 61% of Lucent's \$1.06 billion in operating income for the year, excluding one-time items.

Strip those out, and Lucent's real operating income - the amount actually generated by its business - falls to \$413 million for calendar '05. And its multiple rockets from 12 times operating income to 31 times - making the company's stock look pretty expensive. (After Lucent stock rose 8.5% Friday on news of the talks, the multiple is now 33.)

Alcatel has nothing like that. In fact, in 2004, the last year for which complete figures are available, Alcatel recorded a loss of 54 million euros (about \$65 million) from its pension plan as part of its operating income. Stripping that out causes its multiple to drop a fraction of a point, though it's still 15 times operating earnings.

Let's call this potential deal what it appears to be, then: an acquisition of Lucent by Alcatel, not a "merger of equals," at a price that provides no premium to Lucent shareholders and yet is still arguably inflated.

If Alcatel does buy Lucent, that's something that may become more apparent in the next couple of years. U.S. accounting rulemakers have begun a complete overhaul of pension-accounting rules, and among the areas they're expected to look at are how companies calculate pension income and how they count it as part of earnings. When the rulemakers are done, it's possible that companies like Lucent may be far less able to rely on pension plans to make their broader earnings look good.

Granted, acquiring Lucent would better secure Alcatel's position in the changing landscape of the telecommunications industry. And granted, even if Lucent looks expensive, it simply wouldn't fly for Alcatel to offer to buy Lucent for below its market price. Still, one wonders whether Alcatel is willing to go through a "merger of equals" with a company that looks much worse off than Alcatel itself does.

The last time these two companies came close to a no-premium merger, in 2001, Lucent walked away in the end. One wonders whether this time it might be Alcatel's turn.

-By Michael Rapoport, Dow Jones Newswires; 201-938-5976; michael.rapoport@dowjones.com [03-24-06 1724ET]

70768

Document DJ00000020060324e23o000hp