Rule Maker Portfolio

Accounting at Coke

By Phil Weiss (TMF Grape)

[Editor's note: In light of the recent concerns surrounding Coca-Cola's accounting, the following is an encore presentation of Phil's explanation of Coke's business structure. It was originally published on October 8, 1998.]

TOWACO, NJ (Oct. 12, 1999) -- Coca-Cola's (NYSE: KO) accounting is an issue that gets raised from time to time by both the financial media and those that read the Coke Message Board. The big question is: How does Coke account for its investments in bottlers and is it appropriate?

What amazes me about this query is that the writers generally treat it as if it's some sort of new information. Actually, Coke's method of accounting is nothing new at all. In fact, I touched upon the subject when I wrote the buy report for Coke in early 1998; I first read about the issue in mid-1997; and I've subsequently read articles on it dating farther back.

As a matter of fact, the article in which I first read about the proposed accounting changes stated that the Financial Accounting Standards Board (FASB) had originally intended to implement changes in these rules at the end of 1996. These changes were postponed and have still not been implemented. This means that the issue has been around since at least 1996.

What I'd like to do now is spend a little bit of time explaining the equity method of accounting (as well as other acceptable accounting methods) and give you some sense of how much better Coke's numbers look because it uses this method. At issue is whether Coke should be allowed to announce as earnings any of the sales of its equity ownership in the Coca-Cola bottlers.

There are three ways in which a company can account for the earnings of the companies that it invests in. The first is the same as the method that you or I would use. It's called the "Cost Method" and it records all income as received (generally dividends). Gains or losses are not recognized until the asset is sold or disposed of. These guidelines also require that, in certain situations, an asset be written down to fair market value if it becomes impaired. Generally, the accounting rules require that this method be used when a company owns less than 20% of another company. For reasons I'll discuss later, this is the least preferred method of accounting for such investments.

The second accounting model is the Equity Method. It's used when one company owns more than 20% and less than 50% of another company. Equity accounting involves reporting the income from these investments as a single line item on the financial statements. Coke generally owns less than 50% of its bottlers. As a result, it uses the Equity Method.

The third method is Consolidation. This involves combining financial statements of the parent and its controlled subsidiaries so that the net assets and liabilities of the parent and its subsidiaries are reported together. As a general rule, subsidiaries are accounted for using the consolidation rules when the parent company owns more than 50% of the subsidiary company. This is the preferred method of accounting for investments in other companies.

The issue with Coca-Cola's accounting today revolves around whether there will be any changes made to the Equity Method of accounting. The proposed changes to this model would force Coke to consolidate the results of its bottlers with its own results. The basis for the change relies on the contention that Coke does, in fact, control its bottlers -- even though it owns less than 50% of them.

Now you may be asking yourself, "So what?" To answer that, let's explore the crux of the issue here, the differences between equity accounting and consolidation.

When a company accounts for its investments using the Equity Method, it essentially keeps that investment off of its balance sheet. For instance, let's say that Coke owns 40% of one of its bottlers and that bottler earns $1,000. According to the Equity Method, Coke then adds $400 of income to its bottom line while also increasing the value of its investment in that bottler on its balance sheet by $400.

Let's consider what this means to Coke's income statement first. Over the last three years, Coke's net profit margin has risen to around 20% of sales. During this period, one of its bottlers -- **Coca Cola Enterprises** (NYSE: CCE) -- had a net profit margin last year of around 1.5% of sales. Since it uses the equity method of accounting, Coke is not required to add to its income statement all the profits AND the costs of its bottlers. That keeps the lower-margin business of the bottlers away from the higher-margin business of Coca-Cola syrup.

Now let's go over to the balance sheet. The business of Coke's bottlers is much more capital intensive than that of Coke. This means that the bottlers generally have a significant amount of capital equipment and debt to finance operations on their balance sheet. Not so for the syrup maker. At the end of 1997, The Coca-Cola Company's cash-to-long-term debt ratio was more than 2:1. In the meantime, the cash-to-debt ratio of the bottler Coca-Cola Enterprises was just 0.006. Ugly. Since Coke uses the Equity Method of accounting, Coke Enterprise's high debt level doesn't impact Coke's balance sheet at all. Its assets also don't impact Coke's return on assets either.

Interestingly enough, if Coke had consolidated its bottlers in 1996 rather than accounting for them using the equity method, its return on equity would have fallen from 61% to 39%; its return on capital would have been 25% rather than the reported 37%. And its cash-to-debt ratio would have fallen dramatically. Additionally, if Coke was forced into consolidation accounting, it wouldn't have been allowed to announce, as income, its $363 million in earnings from the sale of equity investments in its bottlers in 1997. Those sales represented 6% of Coke's total earnings for 1997. In 1996, its equity sales amounted to fully 9% of the company's earnings.

Those are some eye-opening statistics, but let's remember that the way that Coke currently accounts for these investments is well within the current accounting rules. I personally have no problem with a company following the rules in a way that enhances their financial statements -- again, provided that it is done in a legal and consistent fashion. It has been and is at Coke. The same accounting rules are used in other businesses. We must all remember that no business is responsible for accounting for its entire chain of suppliers and distributors. That Coke owns minority stakes in its distributors... well... it's just smart.

Have a Foolish evening,

Phil Weiss

Coke's Bottling Woes

Investors who like Coke need to get familiar with its bottlers and their recent struggles if they want the full picture. The Rule Maker would like to see Coca-Cola Enterprises buy fewer bottlers and pay down its debt.

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The relationship between **Coca-Cola** (NYSE: KO) and its bottlers is an ongoing topic on The Motley Fool discussion boards. Much of the scrum involves Coke's method of accounting for its minority investments in bottlers such as **Coca-Cola Enterprises** (NYSE: CCE), the world's largest soft drink bottler. Coke owns 40% of CCE; CCE accounted for 17% of Coke's revenue last year.

For those unfamiliar with the setup, here's a quick summary. Coke reports its proportionate share of income or losses from CCE on its income statement, but doesn't report any of the expenses associated with generating those profits on its balance sheet. This is perfectly legal, but does it mislead investors?

Clearly, the bottlers are a critical part of the Coke franchise. Not only do they bottle and distribute the beverages, they manage relationships with retailers. If Coke owned more than 50% of Coca-Cola Enterprises, however, it would have to consolidate the two companies' financial statements, which would mean adding roughly $10 billion in long-term debt to Coke's balance sheet. Ouch.

This was the whole idea behind spinning off the bottler in the late 1980s: Coke's core operations became focused on selling high-margin syrup to bottlers and building the Coke brand name, while the bottlers remained focused on bottling and distribution, a capital-intensive business with low margins.

However, if you don't understand the importance of bottling and distribution to Coke's franchise, you probably shouldn't go anywhere near the stock. As such, if you don't feel like keeping up with Coca-Cola Enterprises' financial statements, at least to get a feel for the distribution side of the business, you're going to be in the dark. It's kind of like watching your favorite football team only when its offense is on the field -- you're missing half the game.

The debate isn't new. I have a textbook that presents the two companies' 1995 financial statements as a case study on the issue of equity accounting. Here's the dilemma: Does sweeping all those low-margin, asset-intensive items off the balance sheet distort Coke's economic reality, since it needs healthy bottlers to grow? Or, does separating the two very different aspects of Coke's business give investors a better feel for the economic characteristics of each entity?

Personally, I don't think there's a right or wrong answer here, just a lot of opinions, mostly from reasonable people on both sides of the issue. Investors should decide for themselves where they stand. Since financial statements for both entities are disclosed, investors can treat the companies anyway they want. If you don't like the present arrangement, it's possible to combine the financial statements for a wholistic view. Be assured you'll see a lower return on assets and a slew of altered ratios, including a higher debt-to-equity ratio.

This isn't exactly a secret, and the problems the companies face are well documented: weak volume growth, too rapid expansion into territories such as Russia and India, management struggles, a resurgent competitor in **PepsiCo** (NYSE: PEP), a weak euro, and too much inventory in the channel until recently. None of this is obscured as a result of equity accounting, and I don't have to combine financial statements to see these problems clearly.

I will say this, however. Ignoring the position Coca-Cola Enterprises has gotten itself into over the last five years isn't smart. Since we own Coke in the Rule Maker, I think there's reason for concern. (FYI, I wrote about Coca-Cola Enterprises' second-quarter performance a few months ago and probably didn't take a wide enough look to represent where the company stands. Also, the Coca-Cola discussion board is a great place to get educated about many of these issues.)

The biggest problem I see is Coca-Cola Enterprises' debt. It acquired eight bottling companies last year alone and, from 1986 through 1999, spent $13.1 billion on acquisitions.

Here are a few relevant figures from Coca-Cola Enterprises (numbers in millions).

	1995	1999
Sales	$6,773	$14,406
Owner Earn.	$ 496	$ 559
LT Debt	$4,138	$10,153
Interest	$ 326	$ 751
Cap Ex	$ 501	$ 1,480

First, Coca-Cola Enterprises spends a lot of time focused on cash operating profits, a measure of its earnings before interest, taxes, depreciation, and amortization (EBITDA). I think it's a mistake for investors to think of cash operating profits as cash flows, since it doesn't include changes in working capital or needed capital expenditures. While it might, to some degree, reflect Coca-Cola Enterprises' earnings power, this figure doesn't represent cash the company is free to deploy as it chooses. Here's how Coca-Cola Enterprises reported cash operating profits at the end of last year:

Cash operating profit as a percentage of revenues

1999	1998	1997

It looks pretty good. However, I calculated Coca-Cola Enterprises' owner earnings, a measure of operating profits, plus noncash charges minus capital expenditures, a number that better represents Coca-Cola Enterprises' earnings power. Basically, this number takes into consideration how much Coca-Cola Enterprises is spending to expand and maintain its property, plant, and equipment (PP&E), costs that are essential to maintaining its competitive position. Things aren't sparkling by this estimate.

Owner earnings as a percentage of sales

1999	1998	1997
3.9%	3.3%	6.2%

Now compare Coca-Cola Enterprises' owner earnings with its interest payments. Last year, the company didn't earn enough to fund PP&E and make its annual interest payments. Owner earnings came in at $559 million while annual interest expense on its debt totaled a whopping $751 million. This is the second year in a row that Coca-Cola Enterprises has been in this fix, and while I understand the need to expand its bottling footprint, investors aren't crazy to expect Coca-Cola Enterprises to expand prudently. Looking at its cash flow statements you can see that Coca-Cola Enterprises regularly issues debt and taps its credit line to help finance the business. On the whole, that's just not what we want to see for companies in this portfolio.

So, what's the take-away from this? I'd like to see Coca-Cola Enterprises spend a lot more time paying down debt than buying new bottlers and repurchasing shares. While Coke needs a global footprint to distribute its beverages, it also needs healthy bottlers.

What do you think? Post your thoughts on the Rule Maker Strategy discussion board and Coke discussion board.

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