3Com Inventory Gain Bares Faults of Pro-Forma Results

By ROBIN SIDEL  WJS (July 2)

SOMETIMES EVEN READING between the lines isn't enough.

That is the case for investors of 3Com Corp., who could have read the company's most recent earnings release, backward and forward, fine print and all and still wouldn't have discerned exactly how the company was able to post $12.8 million in pro-forma profit.

The issue at hand: Of the $12.8 million, $7 million was an accounting gain that came from the sale of inventory that 3Com in an earlier quarter had deemed unneeded and obsolete. In other words, in an earlier quarter, 3Com took a charge to write down the value of this particular inventory and the company enjoyed something of a windfall profit when it later was sold. But the $7 million gain—which doubled the company's pro-forma profit to four cents a share in the fiscal fourth quarter ended May 31—wasn't mentioned in the earnings release.

In contrast, in its fiscal year ended June 1, 2001, 3Com, of Santa Clara, Calif., took more than $300 million in inventory write-downs that it did flag—as exclusions in its pro-forma earnings. The company dubbed those write-downs "non-recurring," in effect telling investors they could ignore them in assessing the company's financial performance.

So why did the company, which told investors to ignore those big inventory write-downs, keep quiet about an unexpected development with inventory that boosted profits? To some accounting professors and other critics, the answer points to the many shortcomings of the pro-forma earnings approach. Under it, companies have huge discretion to include or exclude whatever they want. Typically, a wide range of costs—dubbed nonrecurring or one-time—are excluded. But companies may be less eager to classify a gain as nonrecurring, unwilling to draw attention to their reliance on unusual items to boost the bottom line. So instead, they include the gains in the pro-forma results.

For its part, 3Com acknowledges the situation is somewhat confusing, but says it included the gain in its pro-forma results in order to be consistent with the way it treated the charge last year. While the company has indeed excluded other inventory write-downs from pro-forma results, it maintains it...
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didn't exclude this particular $7 million one when it occurred in the fiscal first quarter ended Aug. 31. The company also notes that it explained the unusual gain in a conference call with investors after issuing the June 25 earnings release.

"It hurt the bottom line in the first quarter and it's helping us now," says Matt Shimao, head of 3Com's investor relations.

THE STREET

In the wide world of corporate profits, $7 million isn't a lot of money. And analysts say 3Com's balance sheet is improving, in part because of aggressive cost-cutting. Still, it posted a $24 million net loss for the fiscal fourth quarter, and the $338.5 million in revenue it posted for the period slightly missed Wall Street estimates. Shares of 3Com were down nine cents at $4.29 as of 4 p.m. on the Nasdaq Stock Market. The stock is down about 36% this year and is off 71% from an all-time high in March 2000.

As small as the 3Com amount may be, it speaks volumes about the way companies report results on a pro-forma basis. "This whole example shines a spotlight on how gray the whole issue is," says Michael Cristinziano, who follows 3Com for Gerard Klauer Mattison & Co. "These kinds of little things can easily be manipulated if one is inclined."

Pro-forma earnings have been under the microscope following the bankruptcy-court filings of energy company Enron Corp., telecommunications company Global Crossing Ltd. and other once highlyflying businesses that were big supporters of the pro-forma earnings approach. The many accounting scandals of recent months have highlighted the myriad ways in which companies portray their financial health. Despite the criticism, though, pro-forma earnings are still everywhere. And for investors who already are dizzy from the roller-coaster stock market, the onset of another earnings season is bound to bring more confusion.

"Some public companies have taken an increasingly arbitrary and permissive approach to the determination of their pro-forma results, and we see many inconsistencies cropping up from company to company within the same industry and sometimes by the same company from one quarter to the next to manipulate performance," writes Andy Schopick, vice president of research at boutique brokerage firm Nutmeg Securities Ltd., in a report this week focused on the use of pro-forma reporting in the communications-equipment sector.

In the report, Mr. Schopick analyzes the financial-reporting trends of 20 companies, rating them based on their use of pro forma metrics. He takes particular aim at 3Com, voting it into his "Hall of Shame" for "creating a misleading picture that clearly inflated the strength of its pro forma reported results."

But 3Com says its disclosure of the $7 million charge and subsequent gain, in the conference call, actually provides more clarity than required to investors. "At the end of the day, this shows we are coming forward because we are providing more information than" is required, says Mr. Shimao of 3Com.

Besides the more than $300 million in earnings charges in 2001 to reflect excess and obsolete inventory that accompanied a slowdown in computer demand, 3Com took another "nonrecurring inventory charge" of $6 million in the fiscal first quarter ended last Aug. 31 that also was excluded from the pro-forma results.

This was the same quarter with the $7 million write-down that yielded the $7 million gain. The $7 million write-down wasn't disclosed in the company's earnings release for the quarter, even as the $6 million one was. The company says it noted the $7 million write-down at the time in a conference call with investors.

Wall Street analysts have expressed little concern about the discrepancy, noting that 3Com's pro-forma results would have beaten industry estimates for the quarter even if the two-cent-a-share benefit had been removed. Wall Street analysts had expected 3Com to post a loss of four cents a share on a pro-forma basis.

"If they had tried to hide it, then certainly that would be an issue. But they did disclose it and it was well known," says Chris Sessing, an analyst at Crowell, Weedon & Co. in Los Angeles.