



## Accounting Issues At National Technology Corporation

By Larry M. Prober, PhD, CPA

Woods is concerned that some members of the financial community see the pension items, as vehicles the company uses to “smooth earnings.” What major issue should Woods consider?

### *Abstract*

*Jim Woods, controller of National Technology Corporation, a leading technology company, defends his company’s recent changes in pension plan assumptions as appropriate and realistic. Nevertheless, he realizes that pension plans are long-term commitments and that short-term economic conditions will always differ to some degree from the long-term assumptions selected. Thus, he has second thoughts about his company’s continuous attempts to adjust assumptions in calculating pension expense. His concerns are heightened by the impact of recent changes in the company’s reported income and the criticism of some members of the investment community. Read the following case facts and determine if criticisms of the company’s accounting are justified. Does Jim Woods have reason to be concerned?*

### **Background**

National Technology Corporation (NTC) is one of the world’s largest technology companies. With offices in 45 countries, NTC provides a diversified line of computer hardware, system software and related services. Originally in the computer mainframe business, the company has significantly expanded its software, consulting and related services during the previous five years. The company continues to promote e-commerce applications while readying a new mainframe for introduction next year. With a solid reputation in research, NTC has garnered more worldwide patents than any company of its type and is readily acknowledged for its technical expertise throughout the industry.

Important advances during the previous decade in both hardware and software categories, as well as in e-commerce, have provided great opportunities and challenges for the company. Trading on its established name and through acquisitions in software and services, the company has provided investors with remarkable returns since a sharp decline in 1994. New management has helped NTC develop strategies to refocus sales and services on company strengths and use previous company inroads in networking and related areas of development. However, as the company begins the new millennium, its ability to maintain historical growth is being questioned by many industry analysts. Even though company profits have remained healthy, revenue growth has lagged behind some competitors. Consequently, there is concern about how best to meet growth expectations



of the financial community, and restore some luster to the company's stock price, which has declined sharply over the previous 12 months.

Bob Beckett, NTC's financial vice-president, and Jim Woods, the company's controller, have worked well together carrying out policies to help minimize the company's cost of capital and maximize long-term profitability. They both feel the company has performed admirably given the intense competition in each segment in which it competes. For example, despite losing market share in desktop personal computers, the company has maintained its leadership position in mobile computers. In addition, the divestiture of one global segment has freed up corporate resources and allowed the company to focus more sharply on its core competencies. With Y2K concerns laid to rest, the company hopes that information technology budgets will expand and NTC can make further progress in networking and other related services.

### **The Problem**

As the current year comes to a close, several issues have been referred to Jim Woods for his evaluation of their impact on the company's financial statements. The most significant are the current adjustments from previous corporate restructurings and the company's accounting for pension expenses. While the restructuring charges relate to overestimates from a recent period, the pension costs are of a longer-term nature, reflecting investment decisions and accounting estimates for an extended period. Mr. Woods is concerned that some members of the financial community see these items, particularly the pension items, as vehicles the company uses to "smooth earnings." He argues that restructuring charges are difficult to estimate, and the effect of those items was immaterial. He also notes that in the previous year the company's changes in actuarial assumptions used in pension accounting lowered profitability despite above-average pension plan earnings. Thus the current year's adjustment for a higher discount rate within the plan was justified. He also counters that NTC's pension consultants gave full approval to all changes and that all assumptions used for both years are within ranges found in studies involving other large companies. Thus, Jim Woods is confident that NTC has met its financial reporting obligations by disclosing all necessary pension-related information and that assumptions used for both the income statement and balance sheet are reasonable. He cannot understand why anyone questions the company's changes since "anyone with the proper background can make appropriate analytical adjustments."

Jim Woods has also been questioned about past company purchases of its own stock. He claims that action was a finance-related decision based on the stock's then-current price and management's assessment of its intrinsic worth. He points out that anyone following the company should know enough about the industry to understand its volatility and company policy to purchase stock when management believes it is undervalued. This strategy is not new. In fact, he believes it is just good business based on investment opportunities. Thus, any benefit resulting from this strategy either in terms of earnings per share or stock price is justified since it represents sound financial management.

Mr. Woods is responsible for the company's financial reporting system, including the structure of financial reports and related disclosures. He knows that some of his decisions



are influenced by concerns about analysts' ability to understand the company's operations and judge performance. Consequently, he usually consults with other members of the finance team before any significant changes are made. In recent years he has regularly held meetings with company management before implementing new accounting pronouncements (such as those involving segments) since management decision making and related information for internal purposes have a bearing on these required disclosures. Thus, Mr. Woods understands the inherent conflict between internal and external users and the growing need for outsiders to have relevant information. Likewise, he is reluctant to offer too much to potential users since strategic policy may be hampered by this knowledge. In recent months, Mr. Woods has acknowledged to some in the company his own concerns about the use of accounting policy to influence the bottom line. Although he defends the company's right to make acceptable changes, he does not want this to be a regular year-end activity. He believes that long-term items, such as pensions, should not necessarily be fine tuned even if the changes reflect current economic events, such as Federal Reserve policy or recent investment returns. Thus, he hopes that his informal discussions with members of the finance committee will make this the last time for a while that they embark on efforts to make pension related changes.

### **Financial Information**

Here are the NTC condensed income statements for the 20X0-20X2 period.

	<b>20X2</b>	<b>20X1</b>	<b>20X0</b>
<b><i>Revenues</i></b>			
Hardware	29,650	28,330	29,304
Global services	25,600	23,120	20,146
Software	10,240	9,485	8,945
Financing	2,486	2,310	2,244
Other	<u>2,060</u>	<u>2,075</u>	<u>2,195</u>
<b><i>Total Revenues</i></b>	<b><i>70,036</i></b>	<b><i>65,320</i></b>	<b><i>62,834</i></b>
<b><i>Costs</i></b>			
Hardware	21,657	19,405	18,814
Global services	18,645	16,901	15,935
Software	1,795	1,808	2,230
Financing	1,157	1,208	1,188
Other	<u>1,246</u>	<u>1,362</u>	<u>1,387</u>
<b><i>Total Costs</i></b>	<b><i>44,500</i></b>	<b><i>40,684</i></b>	<b><i>39,554</i></b>
<b><i>Gross profit</i></b>	<b><i>25,536</i></b>	<b><i>24,636</i></b>	<b><i>23,280</i></b>



	20X2	20X1	20X0
<b>Operating expenses</b>			
Selling, general and administrative	12,371	13,330	13,305
Research and development	<u>4,220</u>	<u>4,037</u>	<u>3,902</u>
<b>Operating Income</b>	<b>8,945</b>	<b>7,269</b>	<b>6,073</b>
Other Income	442	461	515
Interest Expense	<u>561</u>	<u>558</u>	<u>562</u>
<b>Income Before Income Taxes</b>	<b>8,826</b>	<b>7,172</b>	<b>6,026</b>
Income Taxes	<u>3,086</u>	<u>2,581</u>	<u>2,079</u>
<b>Net Income</b>	<b>5,740</b>	<b>4,591</b>	<b>3,947</b>

The above statements reflect the accounting adjustments discussed earlier. Their format highlights some of the concerns addressed by analysts when reversals for restructuring and adjustments for accounting changes necessitate a detailed review of the footnote disclosures.

The following partial information is taken from the summary and pension note included as part of NTC's financial statements.

#### **Adoption of New Accounting Principles: (Details Omitted)**

During the previous three years the company has adopted the following accounting principles:

- **1999** AICPA Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.*
- **1998** Financial Accounting Standards Board Statement No.131, *Disclosures about Segments of an Enterprise & Related Information.*
- **1998** FASB Statement No. 132, *Employers Disclosures about Pension & Other Postretirement Benefits.*
- **1998** FASB Statement No. 130, *Reporting Comprehensive Income.*
- **1998** AICPA SOP 97-2, *Software Revenue Recognition.*
- **1997** FASB Statement No. 128 *Earnings Per Share.*
- **1997** FASB Statement No. 125 *Accounting for Transfers and Servicing of Financial Assets & Extinguishment of Liabilities.*

#### **Pensions**

Condensed disclosures of U.S. and non-U.S. plans combined are as follows: (\$000,000)



	<b>20X2</b>	<b>20X1</b>	<b>20X0</b>
Service cost	829	750	610
Interest cost	2,950	2,785	2,718
Expected return on plan assets	(4,320)	(3,897)	(3,491)
Net amortization of unrecognized gains, etc.	(122)	(87)	(88)
Net pension provision	(663)	(449)	(251)

The effects on the company's results of operations and financial position from most changes in the assumptions and estimates used in calculations are mitigated by the delayed recognition provisions of FASB Statement No. 87, *Employers Accounting for Pensions*. The effects of settlement gains and early terminations are recognized immediately. In 20X2, the company increased the discount rate assumption by 1.25%, which resulted in an actuarial gain of \$4.001 billion. In 20X1, the company decreased the discount rate by 0.5%, which resulted in an actuarial loss of \$1.7 billion.

#### Weighted Average Assumptions Used In Pension Calculations

	<b>20X2</b>	<b>20X1</b>	<b>20X0</b>
Discount rate	7.8	6.5	7.0
Expected return on plan assets	9.5	9.5	9.5
Rate of salary progression	6.5	5.5	5.5

It is the company's practice to fund amounts for pensions sufficient to meet the minimum requirements set by accounting and tax regulations.

A condensed summary of the benefit obligations and plan assets of combined U. S. and non-U. S. defined benefit plans for 20X2 and 20X1 is as follows: (000,000)

	<b>20X2</b>	<b>20X1</b>
Benefit obligation at end of year	44,963	46,887
Fair value of plan assets	58,741	53,508
Fair value of plan assets in excess of benefit obligations	13,778	6,621
Unrecognized net actuarial gains	9,280	2,904

What is your opinion of Jim Wood's role in the NTC reporting process? How would you handle this situation? What major issues should Mr. Woods consider?

### ***Comments on "Accounting Issues at National Technology Corporation"***

**Martin S. Fridson, CFA, is Chief High Yield Strategist and Managing Director at Merrill Lynch.**

*Mr. Fridson is author of several books on Financial Statement Analysis.*

Note: Martin's comments are based on a fictitious case, any resemblance to person living or dead is coincidental.



*"Securities regulators can compel the accounting rulemakers to crack down further on year-to-year changes in retirement plan assumptions if they believe it would serve a useful social purpose."*

Jim Woods' ambivalence is understandable. On the one hand, no company would proclaim with pride that it uses discretionary accounting decisions to make its profits appear less volatile than they truly are. On the other hand, Wood's comments about the ability of individuals with the proper background to make appropriate adjustments is valid. NTC can fairly claim to have achieved transparency, as long as it properly discloses items such as the changing actuarial assumptions in its notes to financial statements.

In the case of the pension fund adjustments, the smoothing lies in plain sight. There is no economic justification for fine-tuning the discount rate each year, but analysts can adjust the price-earnings multiple they assign to National Technology to take into account the true underlying volatility of its profits. Analysts can exact an additional valuation penalty if they believe the obvious smoothing effort reflects poorly on the company's management.

The restructuring charges are less visible. Woods is clearly rationalizing when he argues that these charges are difficult to estimate. It is just too convenient that NTC can move the restructuring costs up and down as necessary to maintain its gross profit growth in the face of declining margins in its largest business. If the item is immaterial, as Woods also claims, why bother to adjust it?

As for National Technology's segment reporting, one cannot be too critical because Woods has accommodated operating management's desire to limit disclosure. Over the



years, corporate issuers have lobbied successfully against detailed product-line reporting that would genuinely enable outside analysts to understand and forecast earnings. Without stronger support from the accounting rulemakers, Woods can push only so hard for NTC to be more forthcoming than its competitors. He could resign on principle, but doing so would not lead to more transparent segment reporting at NTC.

A final issue is the impact of earnings smoothing on unsophisticated users of financial statements. Small investors may take the company's reported income at face value, oblivious to the impact of discretionary accounting decisions that are fully disclosed. When earnings per share rise in response to dubious stock buybacks and changes in actuarial assumptions, small investors may bid up NTC's stock. They will thereby expose themselves to losses when management takes subsequent actions to reduce unusually large profits that it wishes to smooth downward.

Like segment reporting, this is an issue that can only be dealt with--if, indeed, it needs to be dealt with--on a broader front than NTC's accounting decisions. Securities regulators can compel the accounting rulemakers to crack down further on year-to-year changes in retirement plan assumptions if they believe it would serve a useful social purpose. At the same time, one can ask how far the financial reporting requirements should be tightened to protect unsophisticated users. After all, these individuals have the option of hiring professional money managers (by investing in mutual funds) instead of attempting to pick stocks on their own. In any event, Woods can have a clear conscience regarding actuarial assumptions and stock buybacks, as long as NTC enables professional analysts to discern the impact of these actions on its earnings.

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*He is editor-in-chief of The Journal of Corporate Accounting & Finance and the author of "Progress on Impairments and Business Combinations", The Journal of Corporate Accounting & Finance, November/December 2000.*

*"The company's financial reporting group is charged with meeting the statutory requirements as well as some aspects of investor relations—that is, responding to investors' information needs."*

Mr. Woods finds himself in the same position as many controllers and directors of financial reporting: defending the company's accounting practices when questions arise. Indeed, Mr. Woods notes that there is an inherent conflict between the information needs of internal management and those of external parties. This is a conflict that financial reporting personnel face on a regular basis. Often upper management is reluctant to provide more than the absolute minimum amount of information to the external constituents (and even then sometimes only grudgingly so). Yet the company's financial reporting group is charged with meeting the statutory requirements as well as some aspects of investor relations—that is, responding to investors' information needs.



More and more frequently today, external parties focus not just on the company's earnings and/or earnings trend, but also on the quality of the company's earnings. Unfortunately, it is difficult to quantify the concept of earnings quality, but, fundamentally, it relates to the company's willingness to be open and frank with its investors as well as the sustainability of its earnings.

National Technology Corporation is running a serious risk of having investors question its earnings quality because of its reluctance to clearly show the impact of certain assumptions and revisions in those assumptions. For example, the company reports the adoption of several new accounting pronouncements in the past three years, including Statement of Position No. 98-1 and 97-2 and Financial Accounting Standards Board Statement Nos. 131, 132, 130, 128 and 125. While some deal only with presentation and disclosure (FASB Statement Nos. 128, 130, 131 and 132), with a technology company an external party would be justified in asking about the effect of adopting SOP No. 98-1 (on the capitalization of computer software development costs) and SOP No. 97-2 (on the recognition of revenues from sales of software). That information is not given in the company's disclosures.

Additionally, there are implications for the company's financial reporting from changes in the discount rate assumption related to the defined benefit pension plans and with respect to the restructuring reserve. An external party does not know what line in the income statement includes these expenses or how much the expenses are affected by the adjustments—another failure to openly disclose information to the investors. This question is extremely interesting because the company has made significant adjustments to its pension discount rate assumption (from 7% down to 6.5% and back up to 7.75%). This has resulted in a \$5.7 billion change in the obligation from 20X1 to 20X2 (a gain of \$4 billion in 20X2 compared with a loss of \$1.7 billion in 20X1), yet little information is provided about the impact on current and future earnings.

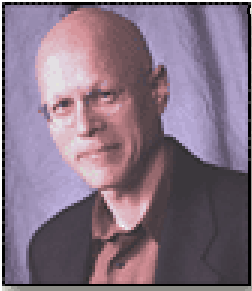
Even more distressing is Mr. Woods' attitude. For example, he says that he cannot understand why anyone questions the company's changes since "anyone with a proper background can make appropriate analytical adjustments." While this may or may not be true (given the sparsity of the company's disclosures and the fact that changes in pension plan assumptions do not have a linear effect on company's earnings), the point is that investors shouldn't have to make the adjustments. The company's financial reporting should clearly provide the information. Additionally, Mr. Woods argues that the change in the discount rate is appropriate in light of the pension plan earnings. This displays a lack of knowledge about the discount rate computation. The discount rate relates to the pension plan obligation, not to the return on the pension plan assets.

The effect of the changes in assumptions on the pension plan has gotten to the point where the unrecognized amount is significant. From 20X1 to 20X2, the unrecognized amount increased by \$6.376 billion to \$9.28 billion. The unrecognized amount now represents 20.6% of the pension obligation and 67.3% of the net pension assets at year-end, compared with 6.1% and 43.9%, respectively, at the end of 20X1.

I believe that Mr. Woods and, in the long run, NTC would be better served by openly disclosing the impact of the changes in the assumptions (related to both the pension plan and the restructuring) and by clearly indicating where in the income statement these amounts are reported. Anything less could dilute investor confidence, which will ultimately lead to an increase in the company's cost of capital and a resulting reduction in long-term profitability.

**Steven Wallman, J.D., is founder and CEO of FOLIOfn founded in 1998.**

*Using the FOLIOfn system, investors can purchase customized portfolios. He is a former commissioner of the U.S. Securities and Exchange Commission and a former partner, Covington and Burling. He is a non-resident senior fellow of economic study at Brookings.*



*“Jim Woods is right to think that the analysts will be suspicious of frequent changes in assumptions... to satisfy various earnings expectations.”*

Jim Woods is right on to be worried; in fact, he needs to be. But he should be confident that he has done the right thing and provided the correct advice to the finance committee, based on where the committee seems to be heading.

First, the market is fickle, and so are many analysts. Times change quickly and what seemed like a very reasonable long-term assumption a year ago may not seem so today. Only a couple of years ago, for example, the markets thought nothing of expecting stock price returns year-over-year in excess of 20%. They accepted companies with multiple-billion-dollar valuations and almost no earnings. Today, many find it hard to believe that previous market behavior. What's interesting, of course, is that no matter what happens for the next few years, circumstances will change again and these “corrected” markets will look out of place themselves. And analysts, including those who defended the markets of last year (and now are defending themselves), will once again look prescient.

There is no doubt also that analysts and other interested parties would prefer not to have to delve into financial statement footnotes in order to understand a company. Programs that analyze companies and look for outliers don't do that well when they have to read the footnotes and figure out what's really going on. Maybe that will be standard in a few years, but for now one strong reason to have financial statements with generally accepted means of presenting high-level information is so that users can make reasonable use of that information without having to search through the backup and do their own analysis



(although that is what we would expect from someone making a substantial income as an analyst).

So what is Mr. Woods to do? He has every right to assume that even the most basic long-term assumptions well may change from year to year. And it is best to continue to adjust them and approximate them as well as one can as they change. If a company waits until outsiders believe they have changed materially from where they should have been, then it leaves itself open to lawsuits, investigations and claims of non-compliance.

On the other hand, there is the great potential for manipulation and “earnings management” when management conveniently makes some “appropriate” adjustments to assumptions to allow the company to enhance what it reports. Simply observing that those who want to second guess the company can get the information in the footnotes and figure it out for themselves (“anyone with the proper background can make appropriate analytical adjustments”) is not a sufficient answer, even if it might insulate the company from certain forms of liability.

The bottom line is that Woods needs to do the right thing. The right thing here is to continue to make adjustments as needed, when there is a perception based on experience, observable data and other indicia that a change in base assumptions is necessary. It is not to second guess what changes management might like to see, or to allow the company’s desire to meet certain earnings targets influence his decisions on the right assumptions or how best to change them.

He is also right that the analysts will be suspicious of frequent changes--especially changes that are always in the direction that one might expect management would advocate to satisfy various earnings expectations. Were that to occur his credibility would quickly be lost. If his actions were found to be unjustified, his commitment to complying with legal requirements might be called into question, as well. But he cannot let that paralyze his judgment or lead him to postpone necessary changes.

This case study demonstrates that as long as we have a system that puts tremendous weight on a few top-line numbers there will always be the temptation to “manage” those numbers and some suspicion that such management is occurring even when it is not. If we move more towards a system that relies on presenting the raw numbers and data to users in a fashion that allows for easy use and analysis (as described in an article written by the author<sup>3</sup> and as part of the AICPA’s mission in its XBRL initiative), some of these problems will disappear. At that time, Jim Wood’s will be correct to observe that since users have the information they can make changes as they want. But that day is still some time away, and so the hard decisions and work still sit squarely on the shoulders of good financial officers like Jim Woods.

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<sup>3</sup> The Future of Accounting and Financial Reporting, Part IV: Access Accounting,” Accounting Horizons (June, 1997), Vol. 11, No. 2