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FASB: Making Financial Statements Mysterious

by T. J. Rodgers

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Executive Summary

Since the passage of the Sarbanes-Oxley Act in 2002, the Financial Accounting Standards Board has passed rules that it promises will make corporate accounting more transparent. In fact, its revised Generally Accepted Accounting Principles have made it difficult for investors—or even CEOs—to understand a company's financial report.

The first step in the wrong direction came when FASB mandated that companies list "intangibles" such as "goodwill" as corporate assets, artificially inflating balance sheets. After that, FASB meddled with the revenue recognition rules, in some cases not allowing companies to report revenue from cash payments received from a customer for a delivered product. Finally, and worst by far, FASB mandated punitive and nonsensical rules for so-called expensing of stock options.

These accounting burdens, combined with the onerous yet ineffective mandates of the Sarbanes-Oxley Act, are starting to take a real toll on American businesses and markets. In 2007, only \$8.5 billion or 7.7 percent of the total \$109 billion in issuances of Initial Public Offerings were launched on U.S. stock exchanges, down from 60.8 percent a decade ago.

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Indecipherable Financial Statements Harm Business, Markets

I first noticed the misleading nature of Generally Accepted Accounting Principles a few years ago when an investor called to complain about the small amount of cash on our balance sheet. Since we had plenty of cash, I decided to quickly quote the correct figures from our latest financial report. But to my surprise, I could not tell how much cash we had either. With its usual—and almost always incorrect—claim of making financial reporting "more transparent," the Financial Accounting Standards Board had made it difficult for a CEO to read his own financial report.

FASB is a group of seven theoretical accountants based in Norwalk, Connecticut. Its website shows that no FASB member ever started or ran a successful business and that only one member has even held a senior position in a prominent public company other than an accounting firm. Yet, FASB mandates the Generally Accepted Accounting Principles that corporations must use to report to their shareholders. The Securities and Exchange Commission enforces FASB mandates with the threat of criminal prosecution.

Although GAAP reports became more complex and less transparent during the 1990s, by 2001 GAAP accounting was good enough to enable companies to report accurately, both internally for control purposes and externally to shareholders. Since then the FASB-mandated GAAP reports have become nearly useless. I no longer bother to read the financial reports of companies I follow because I would literally need an analyst to decipher them for me.

One big step in the wrong direction came when FASB mandated that after an acquisition, companies list "intangibles" such as "goodwill" as corporate assets, artificially inflating balance sheets. After that, FASB meddled with the revenue recognition rules, in some cases not allowing companies to report revenue from cash payments received from a customer for a delivered product. Finally, and worse by far, FASB mandated punitive and nonsensical rules for so-called expensing of stock options.

These accounting burdens combined with the onerous yet ineffective mandates of the Sarbanes-Oxley Act are starting to take a real toll on American businesses and markets. In 2007 only $8.5 billion, or 7.7 percent of the total $109 billion in issuances of Initial Public Offerings, was launched on U.S. stock exchanges, down from 60.8 percent a decade ago. FASB rarely considers the bureaucratic burdens it imposes on companies. And it's getting worse. Duncan Niederauer, the CEO of the New York Stock Exchange, reports that as of July 1, 2008, "only four sponsor-backed deals (those with either venture capital or private equity investors) raised a mere U.S. $1.7 billon," down 90 percent from the 2007 figures. The increased regulation burden makes it less attractive for venture capitalists to fund small startup companies—an economic disaster for Silicon Valley, the most prolific producer of America's technology successes. On July 7, the president of the National Venture Capital Association, Mark Heesen, addressed the same IPO drought by stating, "We need to put regulators, legislators, presidential candidates and the private sector on notice that this situation represents a serious problem that will have long-reaching economic implications if not addressed. We view this quarter as the canary in the coal mine."

The case of my company's confusing cash report was explained by a GAAP accounting rule that mandated spreading the liquid assets on our balance sheet into three categories: cash and cash equivalents; short-term investments; and "other assets," a category containing both liquid investments, like Intel stock, and illiquid investments, like the stock of a startup company. My company's actual cash position is inferable from our official 172-page 10-K report, but only by those willing to dig into the 74 pages of footnotes. Few investors would have the time to do that exercise for one stock, let alone a portfolio. Consequently, I present the first of nine rules on the unfortunate realities of GAAP financial reports. *Rule 1: GAAP reports* *do not allow the average investor to know how much cash a company has.*

My most recent encounter with inaccurate GAAP reporting came as I prepared to write the President's Letter for Cypress's 2007 annual report by reading our SEC-mandated Proxy Statement, which said that I had earned $11.3 million in 2007—a number that seemed not only wrong to me, but wrong by a factor of two. That night, my wife and domestic CFO reported to me that I had taken home $4.7 million in 2007: $1.5 million in salary and bonus; a $1.2 million special stock bonus awarded for the success of our solar energy company, SunPower; and a $2.0 million gain from exercising a decade-old 1997 stock option grant that was about to expire. For a tiebreaker, I went to our tax department the next day to find out how much they thought I earned. Both they and the IRS said I earned $4.7 million in 2007—in direct contradiction to our Proxy Statement.

How did GAAP accounting distort my reported 2007 income? One error comes from the accounting for my retirement account, which contains tax-deferred income I earned and saved over my career. The account grew by $1.7 million in 2007 because it held stock that appreciated during the year. I neither own nor can borrow against that retirement account, but GAAP and SEC rules required that the $1.7 million gain in it be reported as my 2007 personal income. *Rule 2: Old income can be reported two times—or more.*

My apparent 2007 income was also inflated by the phantom income I did not receive that is attributable to my company's having to "expense" stock options that vested during the year. I neither bought any options at a discount nor sold any for a gain. I simply received the *right* to buy some options. If I died or my company performed poorly, the potential value in those unexercised options would never be realized, yet my company was forced to declare them as actual 2007 income for me and a "loss" for the company.

According to FASB, I "earned" an extra $4.9 million in 2007 without putting a penny in the bank because at option granting, the GAAP rules simply *mandated* that my unvested shares had a built-in gain of at least 60 percent of their face value, which I received as the options vested. The GAAP rules further required that one-fifth of that unpaid "gain" be reported as income each year. This constitutes another supposedly transparent FASB accounting rule: Hypothetical income is calculated on a stock option that an employee does not own and is counted against corporate earnings. Moreover, that one-time calculation of CEO pay (and corporate loss) is locked in for five years—even if the stock goes down and the options are never even exercised.

Of course, the IRS would never dare tax me on the phantom income without losing the case in tax court. The errors and misrepresentations can get extreme. Ian Cockwell, CEO of Brookfield Homes, was reported as "earning" a *negative* $2.3 million in 2007 in his company's proxy statement. It seems that some of the "income" from prior years, which he never took home, did not materialize according to FASB's one-size-fits-all formula and had to be subtracted from his 2007 reported income. *Rule 3: Due to the faulty logic embedded in GAAP stock option expensing rules, companies overreport their CEOs' earnings and, worse yet, underreport corporate earnings. In many cases, the errors are large.*

In 2001, presumably to prevent a few companies from generating the appearance of growth through serial acquisitions, FASB decided to make acquisitions less financially appealing by implementing the deeply flawed concept of forcing acquiring companies to put intangible assets—assets that do not exist and have no value—on their balance sheets. Here is an example of the theory behind this nonsense: When one company acquires another, say for $2 billion, the acquiring company puts the value, say $1 billion, of the acquired company's real assets on its books. In this example, the acquiring company would then be required to put the remainder of the $2 billion acquisition price on its books as a $1 billion intangible asset. With this FASB edict, the real assets of U.S. corporations—cash, buildings, trucks and the like—were mixed deceptively with intangi-

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ble assets on balance sheets. *Rule 4: A company can be broke but still appear to have big assets.*

In the original version of this hallucinogenic accounting rule, the intangible assets were "amortized," taken as quarterly losses in equal amounts over a period such as five years. Thus, in the example above, the "amortization of intangibles" created a phony loss for the acquirer of $200 million per year for five years. What do you get when you merge two identical companies, each like the one described above—valued at $2 billion, with $1 billion in real assets and $100 million per year in profit? Don't say a company valued at $4 billion with $2 billion in real assets and $200 million in profit. The answer, according to FASB, is a company valued at $4 billion with $3 billion in assets—one-third of them intangible—and *zero profit*.

Fortunately, the mystery losses caused by amortized intangibles led to the rise of reporting non-GAAP earnings, in which the GAAP phantom-asset distortions were excluded from otherwise nominal GAAP reporting for acquisitions. Today, my company and many other publicly traded American companies are judged by analysts and investors according to non-GAAP earnings (approximating pre-2001 GAAP earnings).

The final saga in the Alice in Wonderland "intangibles" accounting tale occurred in 2001, when I testified at a hearing of the Senate committee, which was forced to deal with the uproar over the evaporating GAAP earnings of acquisitive companies. Since no one was sworn in at that strange hearing, no one had to bear responsibility for the outcome, a compromise that kept intangible "assets" on the books. However, the amortization of intangibles was dropped in favor of an annual evaluation. Now, once a year, all companies are required to review their goodwill assets—to review the accounting residuals of acquired companies that ceased to exist years before—and debate whether the evanescent assets have gone down in value, creating a phantom loss in GAAP earnings.

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Institutional investors and analysts have always ignored this folly, but FASB mandates the foolish and expensive yearly exercise of valuing things that don't exist. And, as is true with most government mandates, there is now a camp following of firms which, for a bargain price of tens of thousands of dollars, will provide an opinion on the value of—nothing. *Rule 5: Beware of the balance sheet, it contains things that do not exist.*

Companies can fund themselves by borrowing money or by selling stock. The cost of selling stock is dilution, the loss of earnings per share (EPS) due to a rising share count. The cost of borrowing money is interest expense that lowers EPS. One preferred form of financing for technology companies is the convertible debenture, a hybrid of debt and a stock option, in which investors lend money to companies. At the end of a typical five-year convertible debenture, the borrowing company must pay back the loan in cash with interest—or, alternatively, if the company's share price is above a "conversion price," pay off the debt with stock at that price. If the share price at settlement is well above the conversion price, the investor has the option to take stock and make a significant capital gain.

The accounting rule used to compute the cost of a typical convertible debenture on its issuer's financial statements is conservative, but reasonable. Companies calculate their quarterly earnings both for the case of paying back the convertible debenture in stock and the case of paying it back in cash—and report the less favorable outcome. By contrast, FASB's treatment of employee stock options is outright punitive. It requires companies to report employee options in an unrealizable worst-case scenario—both as EPS dilution *and* as an expense that reduces EPS further. It seems that FASB has gone out of its way to make employee stock options unaffordable by double-counting their cost. Most unfortunately, this change has caused many Silicon Valley companies to reduce or eliminate stock options given to rank-and-file engineers. *Rule 6: The profits of companies that grant employee options are often grossly understated by GAAP rules because of the double counting of stock option losses. Without a deep dive into complicated GAAP reports, investors can no longer know what a technology company's true (cash) profits are.*

In a recent review of potential acquisition candidates, I noted an obvious error in the financial analysis of one very good target company. Its financial statements showed the company nearly breaking even, when I knew that it consistently produced 20 percent pretax profit. The disconnect came from the fact that the young MBA doing the analysis used GAAP financial statements that included all the accounting distortions described above. We adjourned the meeting until a useful analysis could be completed. *Rule 7: If a long-tenured CEO of a New York Stock Exchange technology company cannot decide whether to buy a company based on its GAAP financials, neither can investors.*

GAAP accounting even misrepresents the revenue that some companies report. One would think that if a company receives a cash payment for delivering a product, it would recognize revenue and profit, and pay taxes. Not so. As a board member reviewing financial statements of a startup Silicon Valley data communications company, I became very confused by the company's reported revenue, which was factors below the company's actual shipments.

The GAAP accounting theory behind this problem is explained in the following example: If a company ships a product for $1 million and warranties the product for five years, there is a possibility that the product will have to be repaired or replaced. Under GAAP accounting, the result might be stated by reporting $700,000 in revenue immediately and $300,000 in revenue over time as the product warranty period winds down; for example, $60,000 in revenue per year for five years. Thus, the last $60,000 in revenue for a system shipped in 2008 might not be reported until 2013.

Unless returns and warranty expenses are significant relative to revenue, the previous and time-tested method for revenue recognition is to record revenue when a system is shipped and to handle returns as they occur. This method gives much more realistic picture of a company's performance to investors—and to management. Under FASB's "improved" system, companies must keep two revenue records to know what is actually going on internally. While the splitting of revenue may make sense to theoretical accountants, consider the practical burden it puts on companies. Think about shipping hundreds of different products with different warranty terms to thousands of customers with many different contracts. In that environment, just calculating "revenue" can take weeks for a large group of accountants. Furthermore, once a company has built up a large reservoir of deferred revenue, it can have a real revenue problem that is obscured by the fact that it is still reporting revenue from products shipped years before. *Rule 8: The investor often cannot decipher the true revenue of high-tech systems companies by reading their GAAP profit-and-loss statement.*

GAAP accounting rules and the Sarbanes-Oxley mandates are no longer just a source of colorful stories; they are starting to cause tangible harm to American businesses and markets. With the IPO revenue hurdle rising because of bureaucratic costs, venture capitalists are now focusing on mega-startups that can better bear the costs of government-mandated bureaucracy. Unfortunately, small startups are a crucial component of the Silicon Valley economic model—one that has consistently prevailed over old-line companies in Japan and Europe.

Silicon Valley always creates "too many" innovative companies in each new technology field—and later consolidates the *intellectual property* and *people* of those companies into dominant companies, like Cisco Systems, the world's leading data communications systems company. The Valley's winning formula is to develop new technologies in many competing startups, rather than the less effective practice of developing technology in the form of a few big projects in one or two big companies. FASB is now forcing Silicon Valley down the big-company path. Small companies with great ideas often die unfunded. *Rule 9: Despite its theater of public hearings, FASB rarely considers the bureaucratic burdens it imposes on companies and seems incapable of understanding the impact its utopian accounting schemes have on markets.*

The Wall Street of Silicon Valley is Sand Hill Road in Palo Alto, where one drives by

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tens of billions of venture capital dollars on the way to Stanford University, the epicenter of Silicon Valley. The premier venture firms on Sand Hill Road always have all the money they need. Indeed, in years past, many of them have returned funds to investors because they felt there were not enough good investment opportunities. Thus, the GAAP rules that discourage the venture funding of smaller companies directly harm Silicon Valley's economy.

Our company's *215 accountants* and I live daily with indecipherable GAAP financial reports and draconian Sarbanes-Oxley mandates. I have become firmly convinced that we have given too much power to a board of seven accountants who have a tendency to regulate to death the wealth-creating companies that they themselves are incapable of creating—or even understanding.

When Wall Street is no longer the center of the financial world and Sand Hill Road no longer rules venture capital, all Americans will be harmed—and we will wish we had demanded simple common sense from the counterproductive bureaucrats who control our financial system.

Silicon Valley changes continuously. Over time it became Personal Computer Valley, Workstation Valley, Biotech Valley, Communications Valley, and Search Engine Valley. We are now becoming Renewable Energy Valley. This place runs on free markets, abundant venture capital, and the unbridled entrepreneurial spirit of smart, hard-working, well-educated people.

The underlying mechanism of our success is a new economic social contract, under which the economic pie is broadly distributed to rank-and-file engineers, who can earn life-changing wealth from the stock options. The CEOs of Silicon Valley successes like Google often brag about the dozens, or even hundreds, of millionaires created by their companies. This spreading of wealth drives a different work ethic in Silicon Valley.

A job in a startup company is a personal mission, not a paycheck. Computers turn the lights off in our buildings at 7:00 p.m. to remind our employees that it's time to go home. It deeply angers me that government lawyers and naive theoretical accountants have been allowed to impair the economic miracle that democratized the silicon chip, the personal computer, and the Internet.

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