Evaluation of One-Time Gains: Looking Through the Right Side of a Telescope

CFRA receives many inquiries from subscribers about accounting issues and financial reporting anomalies. Recently, various callers have raised concern over the apparent increase in the use of one-time gains to prop up earnings. Related questions include: (1) when should we be concerned? and (2) does the market “penalize” companies for lower quality of earnings related to one-time gains?

One-time gains typically fall into two groups:

(1) Recurring income or gains from “non-core” business activities (i.e., income from ancillary services to clients or pension income from overfunded pension plan).

(2) Non-recurring income or gains from “non-core” business activities (i.e., investment gains, accounting changes).

The following case studies illustrate different types of one-time gains. The first two examples illustrate the worst-case scenario – companies careening toward bankruptcy in which investors could have been spared the massive losses.

Case A: The Charter Company (CHART): Boosting profits with accounting tricks and one-time gains may make managers happy, but investors and lenders often have little to smile about. Such reports often present an image of a healthy company when, in reality, the opposite is true. For example, consider how investors in and lenders to The Charter Company must have felt when, shortly after reporting a $50.4 million profit in 1983, the Company filed for bankruptcy. Were there any warning signs? You bet – take a look at the income from “core operations.”

($millions)
Income from continuing operations $ 50,382
Less: Change in accounting estimate $ 3,003
Less: Liquidation of LIFO layers $ 12,803
Less: Gain from contract renegotiation $ 33,600
Less: Gain on exchange of investment $ 17,125
Less: Equity in earnings in excess of dividends $117,958
Plus: Write down of refinery $ 49,428
Plus: Write down of tanker $ 7,772
Plus: Equity in net losses of affiliates $ 12,511
Adjusted loss from continuing core operations ($ 64,396)

Lesson: Always compute income (loss) from continuing core operations and compare to reported net income. If income from core operations lags considerably behind total net income, loud warning signs should sound.
A decade later, surging one-time gains hide the rapid deterioration of a high-flying restaurant chain.

**Case B: Boston Chicken (BOST):** During 1996 investors were still enamored with BOST, with pre-tax earnings surging to $109.9 million. A close analysis of the source of its income would have alerted investors to a major problem with the company’s restaurant operation. Excluding $124.6 million earned from ancillary services (such as lending money and selling products to franchisees), BOST actually lost $14.7 million from its core restaurant business.

($ millions)
Total Pre-tax income $109.9
Less: Core restaurant business ($ 14.7)
Equals: Non core business* $124.6

* Interest income from franchisees, lease and real estate services, software and license income

In our next example, the company eventually solved its business problems the following year, and its stock price has soared.

**Case C: Apple Computer (AAPL):** AAPL reported a surprisingly strong June 1998 quarter, despite sluggish sales and declining margins in its core hardware and software business. A close review of the financial reports revealed that realized investment gains and (questionable accounting for) unrealized gains accounted to the steep jump in earnings. Specifically, almost one-third of AAPL’s income resulted from: (1) a realized gain from selling a part of its position in ARM Holdings (ARM) with the IPO sale and, and (2) an unrealized gain on AAPL’s remaining holding in ARM by marking the investment to market.

($ millions)
Total Net Income $101
Less: Realized gain from ARM IPO $ 17
Less: Unrealized gain related to ARM $ 16
Income from “non core” business $ 33
Income from “core business” $ 68

While AAPL’s performance has impressed after reporting one-time gains in 1998, our next company began 2000 with a thud.

**Case D: Lucent Technologies (LU):** As a fortuitous result of investment gains in recent years, resulting in an overfunded pension plan, LU during fiscal 1998 recorded pension income of $558 million from its pension plan. Moreover, LU’s pension income was boosted as a result of changes in certain pension assumptions made in conjunction with a prior year restructuring charge. Normally, companies record pension expense, not pension income. Pension income accrues to the following type of company: one that has been successful for many years, has fully funded its pension plan, and has achieved stellar performance in investing its pension assets. With a healthy stock market during the last two decades, finding companies with pension income is not unusual or a reason for concern. (In fact, a Bear Stearns analysis found that 124 of the companies in the S&P 500 stock index had such gains in 1998, providing a 3% boost to profits that year.) Investors should be concerned, however, if pension income results from a company changing certain pension assumptions and/or if rising pension income compensates for deteriorating “core income.”
Our final two examples show companies with sizable investment gains compensating for an apparent operational deterioration.

**Case E: Microsoft (MSFT):** During the December 1999 quarter, MSFT recorded $773 million in profits from selling its own stock, generating an important boost to its uninspiring operating results. This one-time gain comes on the heels of certain indicators of operational deterioration, such as sluggish sales growth, lengthening collection period on receivables, and declines in deferred revenue. Moreover, the December results follow a September period with declining sales and unearned revenue. Clearly, the company needs Windows 2000 to be a blockbuster product.

<table>
<thead>
<tr>
<th>($ millions)</th>
<th>Dec 99</th>
<th>Dec 98</th>
<th>% change</th>
</tr>
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<tbody>
<tr>
<td>Revenue</td>
<td>$6,112</td>
<td>$5,195</td>
<td>17.7%</td>
</tr>
<tr>
<td>Operating income</td>
<td>$2,918</td>
<td>$2,714</td>
<td>7.5%</td>
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<tr>
<td>Gain on stock sales</td>
<td>$ 773</td>
<td>$ 337</td>
<td>129.4%</td>
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<tr>
<td>Net Income</td>
<td>$2,436</td>
<td>$1,983</td>
<td>22.8%</td>
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<thead>
<tr>
<th>Dec 99</th>
<th>June 99</th>
<th>% change</th>
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</thead>
<tbody>
<tr>
<td>Unearned Revenue</td>
<td>$4,259</td>
<td>$4,239</td>
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**Case F: Intel (INTC):** During the December 1999 quarter, INTC recorded $508 million in profits from interest and other non-core activities – double the amount during the 1998 quarter. At the same time, sales are limping ahead in single digits and operating income has declined by 3% over the December 1998 period.

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<tr>
<th>($ millions)</th>
<th>Dec 99</th>
<th>Dec 98</th>
<th>% change</th>
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<tbody>
<tr>
<td>Revenue</td>
<td>$8,212</td>
<td>$7,614</td>
<td>8.0%</td>
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<tr>
<td>Operating income</td>
<td>$2,754</td>
<td>$2,836</td>
<td>(3.0%)</td>
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<tr>
<td>Interest and other</td>
<td>$ 508*</td>
<td>$ 244</td>
<td>108%</td>
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<tr>
<td>Net Income</td>
<td>$2,108</td>
<td>$2,064</td>
<td>2.0%</td>
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* Includes $327 million gain from sales of investments

**Conclusions:** A key element to detecting problems is focusing on a company’s core business, not the one-time gains or “non-core” business. If its core business remains healthy with solid sales growth, firm margins, and strong operating cash flows, any one-time gains should be considered “icing on the cake.” Alternatively, if the core business deteriorates and one-time gains and non-core income fill the earnings void, investors will likely suffer losses holding such stocks. By looking out the right side of the telescope (that is, looking at the core business), investors should spot early signs of problems on a regular basis.

Another word of caution is in order. Until now, the strong stock market for technology companies has produced substantial gains for MSFT, INTC, etc. who hold such investments in other such technology companies. What will happen to their earnings and stock price if such investments start producing losses? It’s a double-edged sword and the investment gains may turn to losses, producing a domino effect on stock prices.
At the outset, we posed two questions: (1) when should investors be concerned about one-time gains? and (2) does the market “penalize” companies for lower quality of earnings? CFRA believes that failing to notice one-time gains and/or accounting changes that camouflage operational deterioration may hurt investors. Moreover, once questions are raised about aggressive accounting practices (i.e., Tyco), earnings multiples tend to contract, penalizing companies with poor quality of earnings.