

# Digging Through the Footnotes: Stock Options, Pensions and Other Red Flags

Marc S. Katsanis, CPA, CFA

Vice President

Chaffe & Associates, Inc.

[www.chaffe-associates.com](http://www.chaffe-associates.com)

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Financial Analysts of New Orleans

# Overview

- ◆ Intangible Assets
- ◆ Defined Benefit Pension Plans
- ◆ Employee Stock Options

# Intangible Assets

Sources of future benefits which do not have a physical embodiment.

# Marketing-Related Intangible Assets

- ◆ Trademarks, trade names
- ◆ Service marks, collective marks, certification marks
- ◆ Trade dress (unique color, shape or package design)
- ◆ Newspaper mastheads
- ◆ Internet domain names
- ◆ Noncompetition agreements

# Customer-Related Intangible Assets

- ◆ Customer Lists
- ◆ Order or Production Backlog
- ◆ Customer Contracts and Related Customer Relationships
- ◆ Non-Contractual Customer Relationships

# Artistic-Related Intangible Assets

- ◆ Plays, operas, ballets
- ◆ Books, magazines, newspapers, other literary works
- ◆ Musical works such as compositions, song lyrics, advertising jingles
- ◆ Pictures, photographs
- ◆ Video and audiovisual material, including motion pictures, music videos, television programs

# Contract-Based Intangible Assets

- ◆ Licensing, royalty, standstill agreements
- ◆ Advertising, construction, management, service or supply contracts
- ◆ Lease agreements
- ◆ Construction agreements
- ◆ Franchise agreements
- ◆ Operating and broadcast rights
- ◆ Use rights such as drilling, water, mineral, timber cutting and route authorities
- ◆ Servicing contracts such as mortgage servicing contracts
- ◆ Employment contracts

# Technology-Based Intangible Assets

- ◆ Patented technology
- ◆ Computer software and mask works
- ◆ Unpatented technology
- ◆ Databases, including title plants
- ◆ Trade secrets, such as secret formulas, processes, recipes

# Goodwill versus Other Intangibles

- ◆ The intangible asset acquired arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the the acquired entity or from other rights and obligations.
- ◆ If the intangible asset does not arise from contractual or other legal rights, it should be recognized as an asset apart from goodwill only if it is separable; that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged.

# Challenges/Risks Associated with Intangibles

## ◆ Partial Excludability

- ◆ Value Dissipates
- ◆ Property Rights Hazy

## ◆ Dearth of Information

- ◆ Managers often do not identify and track intangibles in the same way that they track tangible assets
- ◆ No standardized way of measuring return on invested capital from intangible assets

# Asymmetric Accounting for Intangibles

- ◆ Acquired Intangible Assets
  - ◆ Financial Accounting Governed by FAS 141 and 142 (effective June 2001)
  - ◆ Capitalization of Intangible Assets
- ◆ Internally-Generated Intangible Assets
  - ◆ Various Accounting Rules Apply
  - ◆ In most cases, the cost of developing or maintaining these assets are expensed immediately

# Example—Purchase Price Allocation

	(Values in \$ Millions)
Current Assets	10.00
Property, Plant & Equipment	25.00
Patents, Trademarks	45.00
Goodwill	<u>20.00</u>
Total Assets	100.00
Less: Liabilities Assumed	<u>(20.00)</u>
Total Equity Value	<u><u>80.00</u></u>

# Intangible Related Indicators to Watch

- ◆ Investment in Research and Development (indication of how much is being reinvested to develop viable portfolio of new intellectual property)
- ◆ Impairment Losses on Acquired Intangibles (a significant number here may indicate that company is not making wise acquisitions)

*Note:* Qualitative factors have to play a much larger role than in other areas because not much information is available.

# Defined Benefit Pension Plans

- ◆ Financial accounting governed by FAS 87
  - ◆ Smooths earnings exposure
  - ◆ Understates balance sheet exposure
  - ◆ Provides a fictitious picture of the economics of defined benefit pension plans

# Eliminating the Accounting Fiction

## ◆ Adjusting Shareholders' Equity

- ◆ Reverse the on-balance sheet Pension assets and liabilities (the results of the smoothing and minimum liability recognition)
- ◆ Add Fair Value of Plan Assets
- ◆ Subtract Fair Value of Pension Liability, also referred to as the Projected Benefit Obligation or PBO

## ◆ Calculating Actual Pension Income/Expense

- ◆ Reverse all items except for service cost and interest cost, the “real” operating costs to the company.

# Adjusting Stockholders' Equity

PHILIP MORRIS COMPANIES INC.

at December 31, 2001

\$US in millions

Reversal of On-Balance Sheet Items	
Prepaid Pension Asset	\$ (2,700)
Accrued Pension Liability	1,400
Subtotal	(1,300)
Adjustment to Reflect "Real" Assets/Liabilities	
Fair Value of Plan Assets	11,720
Fair Value of Pension Liability (PBO)	(12,222)
Overfunded/(Underfunded) Status	<u>(502)</u>
Pre-Tax Adjustment to Stockholders' Equity	(1,802)
Tax (Expense)/Benefit at 35% rate	631
Total Post-Tax Adjustment to Equity	<u>\$ (1,171)</u>
Total Stockholders' Equity--As Reported	\$ 19,620
Total Post-Tax Adjustment to Equity	(1,171)
Total Stockholders' Equity--As Adjusted	<u>\$ 18,449</u>
Adjustment to Stockholders' Equity in %	-5.97%

# Income/Expense Adjustments

## Terms to Know

**Service Cost:** The value of the future retirement benefits that employees earned by working during the current year.

**Interest Cost:** The increase in the PBO due to the passage of time.

## Exhibit 1

GENERIC CORPORATION  
PENSION INCOME CALCULATION  
(in 000's)

	Example 1		Example 2		Example 3		
	Pension Income & Expenses		Pension Income & Expenses		Pension Income & Expenses		
	GAAP	Included in Core Earnings	Excluded from Core Earnings	Included in Core Earnings	Excluded from Core Earnings	Included in Core Earnings	Excluded from Core Earnings
Expected return on plan assets	4,000		4,000		4,000		4,000
Service cost	-900	-900	---	-900	---	-900	---
Interest cost (1)	-2,000	0	-2,000	-1,500	-500	-2,000	---
Prior service cost	-200		-200		-200		-200
Net actuarial gain recognized	900		900		900		900
<b>GAAP PRE-TAX PENSION INCOME</b>	<b>\$1,800</b>						
<b>PRE-TAX CORE EARNINGS PENSION ADJUSTMENT</b>			<b>\$2,700</b>		<b>\$4,200</b>		<b>\$4,700</b>
<b>CORE EARNINGS PENSION ADJUSTMENT (2)</b>			<b>\$1,755</b>		<b>\$2,730</b>		<b>\$3,055</b>

## (1) Interest Cost Calculation

Interest cost	-2,000	-2,000	-2,000
Actual return on plan assets	\$2,000	\$500	\$0 OR <\$0
<b>INTEREST COST</b>	<b>\$0</b>	<b>-\$1,500</b>	<b>-\$2,000</b>

(2) Core Earnings pension adjustment is an after-tax adjustment (35% statutory tax rate)

# Pension Indicators to Watch

## Liability Exposure

- ◆ Overfunded/(Underfunded) Status = Value of Plan Assets – PBO
  - ◆ Auto and Airline industries are the most underfunded
  - ◆ Diversified Telecom Services are the most overfunded
- ◆ Funded Status/Market Capitalization
- ◆ PBO/Market Capitalization
- ◆ PBO/Total Liabilities of Company

*Note:* In general, the higher these indicators, the greater the liability expense.

# Pension Indicators to Watch

## Quality of Earnings

- ◆ Reported Pension Income or Loss/Revenue
- ◆ Reported Pension Income or Loss/Net Income
- ◆ Core Earnings Pension Adjustment/Revenue
- ◆ Core Earnings Pension Adjustment/Net Income

*Note:* If net income is negative or near zero, the net income indicators may not be meaningful.

# The Economic Cost of Employee Stock Options

- ◆ The dilutive effect of options already outstanding
- ◆ The dilutive effect of options expected to be granted in the future (which can be compared to the cost of option grants made in past years)

## What is Not Reflected in the Financial Statements?

- ◆ The cost or dilution associated with currently outstanding options
- ◆ Diluted shares outstanding does not consider the cost or dilution associated with the time value of outstanding options; therefore, out-of-the-money options are completely ignored.

# What is Not Reflected in the Financial Statements?

- ◆ The cost or dilution associated with options granted in the current year
  - ✚ A true depiction of the economic cost (that is, the amount of economic value transferred to option grantees) of options granted in the current year. Amortization of this expense over multiple years smoothes the value transfer effect.

## Indicators used by Compensation Consultants

- ◆ Run Rate - Equal to the # of options granted divided by the # of common shares outstanding at beginning of year
- ◆ Basic Overhang - Equal to the # of options outstanding at the end of the year divided by the # of common shares outstanding at end of year

# Stock Option Indicators to Watch

- ◆ Estimate of Option Grant Cost Based on Company's Valuation
  - ◆ Option Cost - Company estimate
  - ◆ Option Cost as a % of Revenue
  - ◆ Option Cost as a % of Total Shareholder Value
- ◆ Indicators to Test the Reasonableness of Company's Valuation
  - ◆ Valuation on Absolute Dollar Basis
  - ◆ Discount to Maximum Black-Scholes Value
  - ◆ Weighted Average Expected Life as a % of Max. Contractual Life

# Stock Option Statistics for Cisco

## ESO Report

Historical Cost Analysis

## Cisco Systems Inc

Ticker: CSCO

Industry: Communications Equipment

Company Valuation Statistics	Post-Tax Option Cash Equivalent Cost			Pre-Tax Option Cash Equivalent Cost		
	<u>7/31/99</u>	<u>7/31/00</u>	<u>7/31/01</u>	<u>7/31/99</u>	<u>7/31/00</u>	<u>7/31/01</u>
Option Cost-Company Est. (in \$1,000s)	\$1,299,823	\$3,523,013	\$2,768,480	\$2,058,000	\$5,734,800	\$4,259,200
Option Cost as a % of Revenue	10.68%	18.61%	12.42%	16.91%	30.30%	19.11%
Opt. Cost as a % of Sh. Value						
Month-End Average	0.9%	0.9%	1.1%	1.4%	1.5%	1.7%
Month-End High	0.6%	0.7%	0.6%	1.0%	1.1%	0.9%
Month-End Low	1.5%	1.6%	2.4%	2.4%	2.6%	3.7%
Tax Rate	36.84%	38.57%	35.00%	Option Pricing Model Used By Company: Black-Scholes		
<b>ESO Report Valuation Tests</b>						
Option Cost-If Traded Value (in \$1,000s)	\$1,890,025	\$5,476,590	\$5,172,228	\$2,992,461	\$8,914,854	\$7,957,274
Option Cost-Valrex Value (in \$1,000s)	\$1,230,696	\$3,819,624	\$3,162,117	\$1,948,551	\$6,217,627	\$4,864,796
<b>Lack of Transferability Discount Analysis--Company</b>						
Discount to Max. Cont. Life--B-S Value (in %)	41.84%	44.26%	43.60%			
Wtd. Avg. Exp. Life as a % of Max. Cont. Life	34.44%	34.44%	34.44%			

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