

DOW JONES, A NEWS CORP COMPANY ▼

DJIA ▼ 23407.93 -0.11%

S&P 500 ▼ 2576.52 -0.18%

Nasdaq ▲ 6706.35 0.08%

U.S. 10 Yr ▲ 7/32 Yield 2.388%

Crude Oil ▲ 54.00 0.19%

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit <http://www.djreprints.com>.

<https://www.wsj.com/articles/ge-s-numbers-game-pick-from-four-earnings-figures-1509364801>

MARKETS

GE's Numbers Game: Pick From Four Earnings Figures

The company's heavy use of customized earnings metrics sparks investor concerns



GE's shares are now down more than 34% year-to-date. PHOTO: MICHAEL NAGLE/BLOOMBERG NEWS

By Michael Rapoport

Oct. 30, 2017 8:00 a.m. ET

What are General Electric Co.'s [GE -0.96% ▼](#) earnings? The question doesn't have a single answer—the company recently provided four different versions of them.

Investors have long grumbled about complex, aggressive accounting at GE, while the Securities and Exchange Commission has questioned some practices, too. And a lack of faith in GE'S numbers has left it with dwindling support and goodwill from investors after GE on Oct. 20 missed third-quarter earnings estimates and slashed its 2017 earnings outlook by more than a third.

GE shares have lost nearly 12% since then, tumbling to their lowest level in nearly five years. The stock is now down more than 34% year-to-date; the S&P 500 has risen about 15%.

— ADVERTISEMENT —

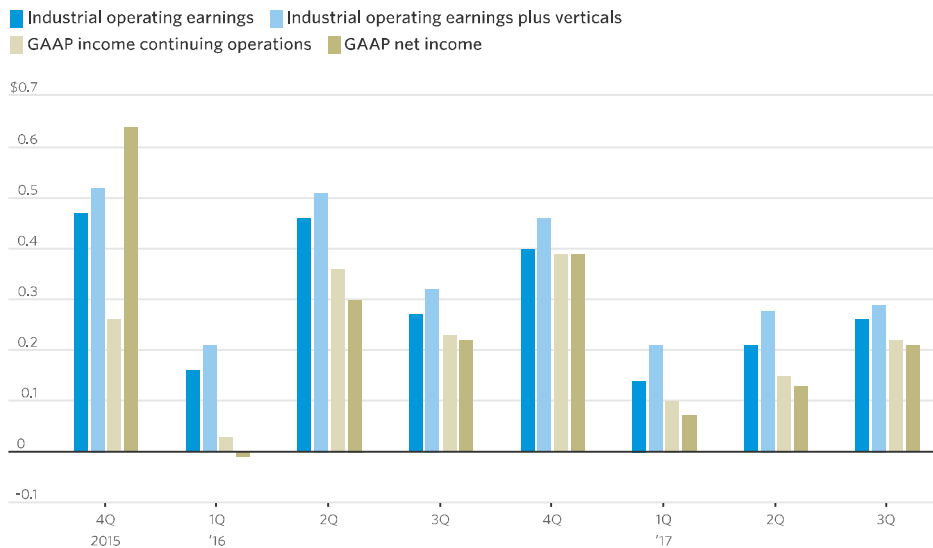


Topping investor concerns is GE's heavy use of customized earnings metrics—the company has four different measures of earnings per share in its third-quarter earnings release. These range from plain net income to “Industrial operating + Verticals earnings,” and GE also reports customized measures of revenue, margins and cash flow.

Analysts also fret over how GE handles so-called contract assets—revenues the company books on long-term contracts before it has the cash in hand—and its ability to turn earnings into cash flow.

Earnings Four Ways

General Electric earnings per share, various measures



Source: the company

THE WALL STREET JOURNAL

“Everybody knows there’s a problem,” said John Inch, a Deutsche Bank analyst who has been critical of GE over the quality of its earnings and disclosure. “If you want to rebuild from whatever the business turns out to be, you need to have conviction the numbers GE is putting up are real numbers.”

GE is re-evaluating its earnings metrics and is looking to take “a back-to-the-basics approach” to its financial reporting, Jamie Miller, GE’s incoming finance chief, said during the company’s recent earnings call.

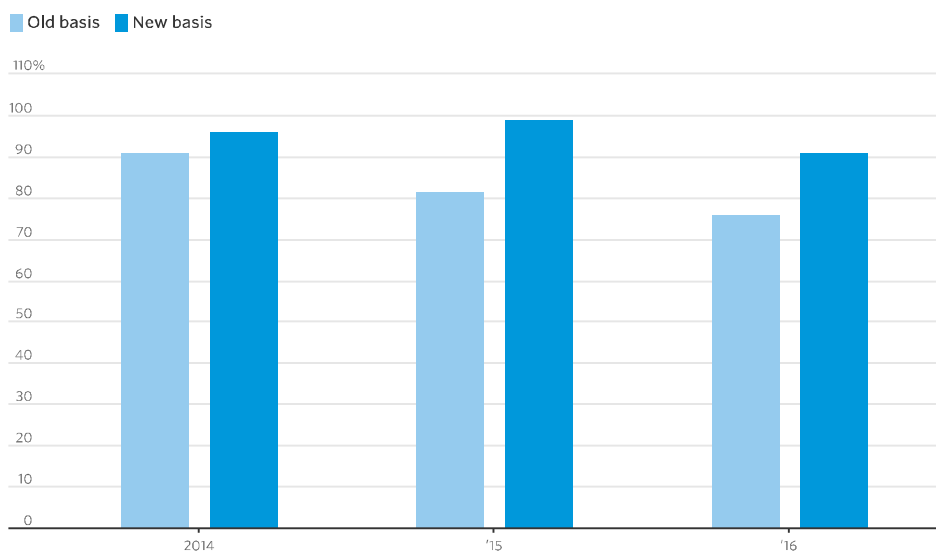
In a statement, GE said complexity in its accounting was “due to the scale and breadth of our operations.” Additionally, the company said its moves to sell most of its GE Capital finance arm have affected financial results and led it to provide additional metrics. From now on, “we anticipate needing to use fewer metrics and therefore will have less complexity going forward,” GE said. The company said it plans to provide more details on Nov. 13.

GE’s customized earnings measures strip out various costs to present what the company has contended is a more accurate picture of its operating performance. Of its different measures, the one GE focuses on most in its earnings reports is called “Industrial operating + Verticals” earnings, which excludes certain pension costs and businesses the company expects to sell.

In the third quarter, GE had earnings of \$1.9 billion from continuing operations. But it then took out \$371 million in pension costs such as interest expenses and expected return on assets, and added in only \$299 million in “Verticals” earnings—from the slice of GE Capital that the company plans to retain. The result: “Industrial operating + Verticals” earnings were \$2.55 billion.

Methodology

Industrial free-cash flow conversion rate under General Electric's old method and new method



Source: the company

THE WALL STREET JOURNAL

GE also reports customized metrics like “industrial segment organic revenues,” “industrial operating margin” and “industrial cash flows from operating activities,” with and without certain items.

Multiple non-GAAP metrics—those that don't comply with generally accepted accounting principles—“make it very confusing for investors to know how well they are really doing,” said Peter Cohan, a management consultant and author who teaches business strategy and entrepreneurship at Babson College.

The SEC has focused on GE's non-GAAP reporting and said in a June 2016 comment letter to the company that investors “may find it difficult to understand the differences” among measures and how each provides useful information. In a July 2017 letter, the SEC said GE's practice of lumping together in a single line item all its non-GAAP adjustments “makes it difficult to fully understand the nature and amounts of each of the adjustments.”

In both cases, GE agreed to change disclosures. The SEC completed its inquiries without taking action.

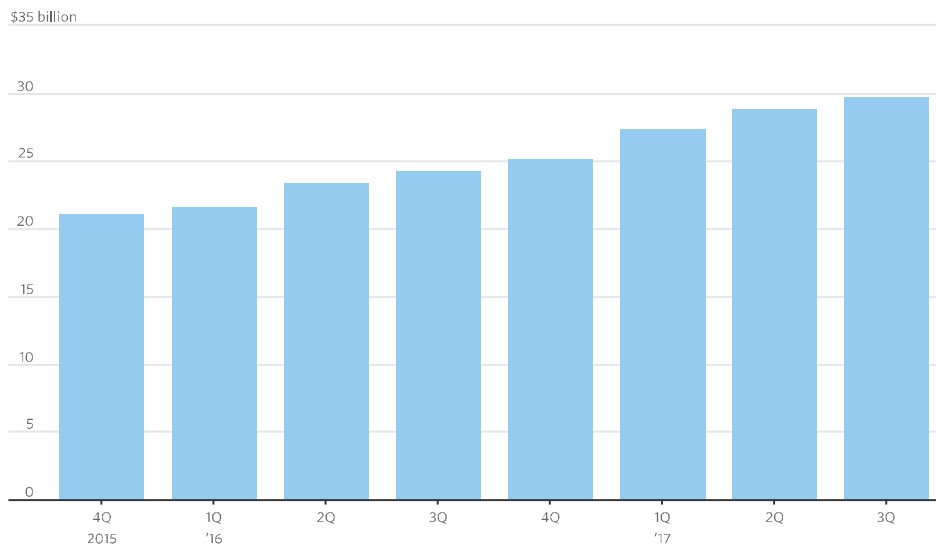
Another area of concern is how GE accounts for its \$29.8 billion portfolio of assets relating to long-term equipment and product-service contracts. That portfolio has grown 18% this year, as GE adjusts estimates and assumptions about how much profit it will ultimately reap from those contracts. Such adjustments added \$2.2 billion to GE's earnings in 2016, the company said in its annual report.

Some analysts are concerned because GE provides little visibility into those estimates and assumptions—and because the company's actions can boost its earnings but not current free cash flow. Typically, big gaps between earnings, which are calculated on an accrual basis, and cash flow, which is money going into and out of a company, are a red flag for investors.

GE says its contract assets have grown significantly for valid reasons, and that

Under Contract

Contract assets on General Electric's balance sheet



Source: the company

THE WALL STREET JOURNAL

ultimately all the assets will turn into cash for the company. Ms. Miller, who was GE's chief accounting officer when she started at the company in 2008, said during the earnings call that she had "seen nothing that gives me any indication of an accounting issue here."

Yet investors remain focused on this area. "Contract accounting is probably something the company needs to explain if they want to do a reset for investors," Deutsche's Mr. Inch said.

Plus, cash flow became a bigger issue after GE last Friday also slashed its estimate for 2017 cash flow from industrial operations to \$7 billion from previous expectations of \$12 billion to \$14 billion.

Investors were already on edge about cash flow after GE in May revised the way it calculates the rate at which its operating earnings convert into free cash flow, typically a measure of operational cash flow minus capital expenditures. It did so by adding back cash payments for restructuring charges to cash flow and no longer adding back nonoperating pension costs to operating earnings.

Under the company's previous method, 76% of earnings in 2016 were converted to free cash flow. After the changes, the conversion rate jumped to 91%.

GE's accounting has long been a subject of scrutiny. The company regularly beat Wall Street's estimates under former CEO Jack Welch. The precision with which it did so, though, led critics to claim GE was managing earnings.

In 2009, GE paid \$50 million to settle SEC allegations that it had used improper accounting methods to boost earnings and revenues in 2002 and 2003. The company didn't admit or deny the SEC's allegations in agreeing to the settlement.

Write to Michael Rapoport at Michael.Rapoport@wsj.com

Copyright ©2017 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit <http://www.djreprints.com>.