Arista Corporation

Quality of Earnings
Case Study

On the next three pages you will find Arista Corporation's income statement and selected footnotes which have been condensed.

1. Look these three pages over and note what you feel are one-time or infrequent items.
2. Place these items on the Atrista Corporation "Reconciliation Worksheet" which you will find four pages back.
3. Add up your results on the worksheet to arrive at Arista's true earnings figure.
4. Comment on your findings. What are the implications of your analysis to a banker or investment manager who might be reviewing your work?

Arista Corporation
Income Statement

	(Millions of Dollars)	
	2009	2008
Revenue	26,180	26,009
Cost of sales	(18,850)	(18,909)
Gross margin	7,330	7,100
Selling,general, & administrative	(5,200)	(5,301)
Operating income	2,130	1,799
Other expense (income):		
Interest expense	(224)	(130)
Impairment of investment	(21)	-
Restructuring charges	(43)	(13)
Other income	119	-
Unusual items	(16)	-
Income before tax, extraordinary gain, and cumulative effect of accounting change	1,945	1,656
Income tax	(585)	(527)
Income before extraordinary item and cumulative effect of change in accounting principle	1,360	1,129
Extraordinary gain, net of tax	238	-
Cumulative effect on prior years of a change in accounting principle, net of tax	49	-
Net income	1,647	1,129

Arista Corporation—Selected Notes to Financial Statements (CONDENSED)

(in millions)

Note 1: Revenue Recognition

Our Company recognizes revenue when title of our products is transferred to our customers.

Note 2: Inventories

Cost of sales has been reduced and as a result operating income increased by $172 in 2009 as a result of LIFO inventory liquidations.

Net income for 2009 included a pretax charge of $11 to write down the value of finished goods inventory. These charges have been included in cost of goods sold.

Note 3: Property, Plant & Equipment

Effective January 1, 2009, our Company changed to the straight-line method of depreciation from an accelerated method (double declining balance), in order to match practices of what others in our industry do. As a result, net income was increased by $49, net of tax, for the cumulative effect of this change for the period through December 31, 2008. This amount is included in the income statement under "Cumulative effect on prior years of a change in accounting principle."

Note 4: Other Income

In 2009, Other Income included a pretax gain of $32 million from the sale of various fixed assets and an $87 million pretax gain from the sale of real estate.

Note 5: Impairment of Investment:

Our Company regularly evaluates the carrying value of its investments. If there is a decline in fair value of an investment and it is considered to be other than temporary, the investment is reduced to its net realizable value and the reduction is accounted for as a realized impairment expense. In 2009 we recorded a $21 charge for writing down the value of an investment that had become permanently impaired.

Note 6: Extinguishment of Debt:

In 2009, our Company extinguished $700 principal amount of debt through an in-substance defeasance resulting in a net of tax extraordinary gain of $238.

Note 7: Restructuring:

During 2009 management instituted various actions designed to cut costs in our Company's manufacturing operations and refocus the operation on its most profitable product lines and channels of distribution. As a result of the actions taken, we incurred restructuring charges of $43.

Note 8: Impairment of Long-Lived Assets:

Long-lived assets are reviewed for impairment whenever events such as product discontinuances, plant closures, product dispositions or other changes in circumstances indicate that the carrying amount (net book value of the asset) may not be recoverable. An impairment loss is measured as the amount by which the carrying amount exceeds its fair value. In 2009 our Company's evaluation resulted in a $16 impairment loss which is recorded as a component of Unusual Items in the accompanying Income Statement.

Arista Corporation

QUALITY OF EARNINGS
RECONCILIATION WORKSHEET

*****Deduct gains, income, and recoveries
*****Add, losses, write-downs, charges, expenses

		Year -2005	
Reported net income (loss)	a	1,647	
Additions (deductions):			
Losses (gains) on fixed asset sales			
Losses (gains) on sales of investments			
Restructuring charges			
Investment write-downs			
Inventory write-downs			
Equity losses (gains)			
Impairment write-downs			
LIFO liquidation (gains)			
Litigation losses (recoveries)			
Nonrecurring expense increases (decreases)			
Temporary revenue decreases (increases)			
Other			
Net additions (deductions) subtotal	b		
Multiply net subtotal by			
(1-combined federal and state tax rates)	c	0.7	See note 1 below
Net tax adjusted additions (deductions)	b x c = d		
Additions (deductions):			
Losses (gains) on discontinued operations			
Extraordinary losses (gains)			
Cumulative effect of accounting changes (gain) loss			
Other			
Net additions (deductions) subtotal	e		
Total additions (deductions)	d + e = f		
"True" net income (loss)	a +(-)f		

Note 1: Arista's income before taxes is $1,945 and income tax is $585. The income tax rate is calculated by dividing 585/1,945 = 30%. 1-30% = 70% or .7