Earnings Quality: Summary Reports on Select Companies
A Case Study of Unsustainable Reported Earnings

EXECUTIVE SUMMARY

In this report, we examine the reported earnings of fourteen selected companies. Each of these companies has much higher reported income from continuing operations than what we refer to as sustainable earnings. Sustainable earnings are calculated without nonrecurring gains or losses, including nonrecurring adjustments to the effective tax rate.

In reviewing the 10-K filings for the subject companies, we noted that ten of the fourteen selected companies benefited significantly from an adjusted to their deferred tax valuation allowance. These valuation allowances were established against deferred tax assets that arose from net operating loss carryforwards. The valuation allowance adjustments primarily resulted in a decrease in the effective tax rate, which artificially boosted earnings.

Other nonrecurring gains observed include included gains on sale of assets, forgiveness of debt, sale of global trademarks, extinguishment of debt, legal settlements, acquisition, and on commodity derivatives.

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Georgia Tech Financial Analysis Lab

College of Management
Georgia Institute of Technology
Atlanta, GA 30332-0520

Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Earnings Quality: Summary Reports on Select Companies  
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Earnings Quality: Background and Definition
Earnings quality is an evaluation of the extent to which a firm’s earnings are generated from sustainable sources that are backed by cash flow. There are two dimensions to earnings quality: the persistence and cash flow dimensions. In examining the persistence dimension of earnings quality, we identify whether reported earnings have been boosted by nonrecurring items. For example, earnings increased by a nonrecurring gain from an asset sale or a one-time reduction in the effective tax rate due to a tax-loss carryforward would impair earnings quality on the persistence dimension. In evaluating the cash dimension of earnings quality, we seek to determine whether reported earnings are supported by cash flow. For example, cash flow would lag earnings for a company that has provided its customers with extended payment terms or that has accumulated inventory in anticipation of increased future sales. Such lagging cash flow would impair earnings quality on the cash dimension.

Earnings that are of low quality increase the likelihood that future earnings will decline from current levels. This is not to say that future earnings will decline, but the likelihood of a decline is increased for companies with low earnings quality. For example, in the case of the nonrecurring gain or the low effective tax rate, future earnings will decline when that gain is excluded or the tax-loss carryforward is no longer available. For the firm that has provided extended payment terms or that has accumulated inventory, future earnings will decline if the resulting receivables or accumulated inventory cannot be realized and writedowns ensue.

In assessing earnings quality, the balance sheet also plays an important role. We use the term position quality to refer to the effects of the balance sheet on earnings quality. We say that position quality is impaired when assets are carried at amounts that exceed fair value or when obligations are carried at less than the amounts needed to liquidate them. Companies that accumulate overvalued assets or undervalued liabilities will see their earnings decline when those overvalued assets are written down or those undervalued liabilities are written up. For example, at some point an investment in a debt security of a financially-troubled issuer that is held to maturity and carried at cost will need to be written down. Similarly, a charge will be needed to increase the balance of an underaccrued warranty obligation. In both instances future earnings will suffer.

The purpose of our summary reports on individual companies is to enable us to focus our attention on one or more dimensions of earnings quality. For example, we might identify nonrecurring gains that we think have impaired a company’s earnings on the persistence dimension. Or, declining cash flow may be our focus, impairing earnings quality on the cash dimension. Finally, for some firms we may look at the balance sheet where position quality may be impaired due to overvalued assets or undervalued liabilities.

A Caveat
In our reports we are not saying that we believe that the earnings or stock price of the company in question will decline. Rather, we are pointing out what we have found in publicly available filings that we think is worthy of closer scrutiny by analysts and investors.
Introduction
In this report we examine issues impacting earnings quality on the persistence dimension. In particular, we are interested in companies reporting significant nonrecurring gains which boost reported income in a manner that cannot likely be sustained. In the study we look at fourteen companies with markets caps exceeding $1 billion reporting annual results for the year 2011.

The items we found were many and varied. While factors that substantially lowered the effective tax rate played a role in 10 of the companies, many other factors were also identified, including gains on sale of assets, forgiveness of debt, sale of global trademarks, extinguishment of debt, legal settlements, acquisition, and on commodity derivatives.

In the report we look at each of the fifteen companies separately. We provide a summary of the identified nonrecurring items together with a schedule that shows a recalculation of reported earnings to sustainable earnings.

Unless otherwise indicated, all amounts are reported in thousands of dollars.
**Broadsoft, Inc. (BSFT)**

The company reported income (loss) from continuing operations of $32,297 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a decrease in the deferred tax valuation allowance. Other adjustment items include business tax credits and net-operating loss carryovers. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $14,081. A summary of our adjustments is provided below.

**Broadsoft, Inc. – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)**

| Reported Income (Loss) from Continuing Operations | 32,297 |
| Non-recurring tax benefits: | |
| Decrease to valuation allowance (after tax adjustment) | (16,388) |
| Other items (after tax adjustment) | (1,828) |
| **Sustainable Income (Loss) from Continuing Operations** | **14,081** |

**Carrizo Oil (CRZO)**

The company reported income (loss) from continuing operations of $36,629 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a gain on sale of Barnett Shale properties. Other adjustment items include business tax credits and net-operating loss carryovers. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is ($68,442). A summary of our adjustments is provided below.

**Carrizo Oil – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)**

| Reported Income (Loss) from Continuing Operations | 36,629 |
| Expense due to extinguishment of debt | 900 |
| Pretax $900, no tax benefit | |
| Gain on sale of Barnett Shale properties | (64,672) |
| Pretax $98,000, adjusted by sustainable tax rate of 34.01% | |
| Gain on sale of Eagle Ford Shale | (42,037) |
| Pretax $63,700, adjusted by sustainable tax rate of 34.01% | |
| Non-recurring tax benefits: | |
| Adjustment to prior period UK net operating losses | 4,735 |
| Pretax $4,735, no tax benefit | |
| Benefit for prior year loss UK net operating losses | (3,997) |
| Pretax $3,997, no tax benefit | |
| **Sustainable Income (Loss) from Continuing Operations** | **(68,442)** |
DealerTrak Holdings

The company reported income (loss) from continuing operations of $65,135 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a gain on sale of ALG. Other adjustment items include business tax credits and decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $12,179. A summary of our adjustments is provided below.

DealerTrak Holdings – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>65,135</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on sale of ALG (pre-tax $47,300, adjusted by sustainable tax rate of 35.50%)</td>
<td>(30,509)</td>
</tr>
<tr>
<td>Expense on sale of AGL (pretax $2,400, adjusted by adjusted by sustainable tax rate of 35.50%)</td>
<td>1,548</td>
</tr>
<tr>
<td><strong>Non-recurring tax benefits:</strong></td>
<td></td>
</tr>
<tr>
<td>Decrease to valuation allowance (after tax adjustment)</td>
<td>(23,148)</td>
</tr>
<tr>
<td>Other items (after tax adjustment)</td>
<td>(847)</td>
</tr>
<tr>
<td><strong>Sustainable Income (Loss) from Continuing Operations</strong></td>
<td><strong>12,179</strong></td>
</tr>
</tbody>
</table>

Ford (F)

The company reported income (loss) from continuing operations of $20,222 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $5,517. A summary of our adjustments is provided below.

Ford – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>20,222</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense for disposition and restructuring (pre-tax $590, adjusted by sustainable tax rate of 26.60%)</td>
<td>434</td>
</tr>
<tr>
<td><strong>Non-recurring tax benefits:</strong></td>
<td></td>
</tr>
<tr>
<td>Decrease to valuation allowance (after tax adjustment)</td>
<td>(14,957)</td>
</tr>
<tr>
<td>Other items (after tax adjustment)</td>
<td>(182)</td>
</tr>
<tr>
<td><strong>Sustainable Income (Loss) from Continuing Operations</strong></td>
<td><strong>5,517</strong></td>
</tr>
</tbody>
</table>
Generic Holdings

The company reported income (loss) from continuing operations of $324,643 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $59,545. A summary of our adjustments is provided below.

Generic Holdings – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>324,643</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense from trade-name write-down</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $9,398, adjusted by sustainable tax rate of 39.00%)</td>
<td>5,733</td>
</tr>
<tr>
<td>Expense due to extinguishment of debt</td>
<td></td>
</tr>
<tr>
<td>(pretax $377, adjusted by sustainable tax rate of 39.00%)</td>
<td>230</td>
</tr>
<tr>
<td>Expense related to acquisition</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $875, adjusted by sustainable tax rate of 39.00%)</td>
<td>534</td>
</tr>
<tr>
<td>Non-recurring tax benefits:</td>
<td></td>
</tr>
<tr>
<td>Decrease to valuation allowance (after tax adjustment)</td>
<td>(271,595)</td>
</tr>
<tr>
<td>Sustainable Income (Loss) from Continuing Operations</td>
<td>59,545</td>
</tr>
</tbody>
</table>

Gold Resource Corporation

The company reported income (loss) from continuing operations of $60,125 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $35,522. A summary of our adjustments is provided below.

Gold Resource Corporation – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>60,125</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjustment for deferred tax assets</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $2,820, adjusted by sustainable tax rate of 21.46%)</td>
<td>2,215</td>
</tr>
<tr>
<td>Tax expense related to extraordinary items</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $1,756, no tax benefit)</td>
<td>1,756</td>
</tr>
<tr>
<td>Non-recurring tax benefits:</td>
<td></td>
</tr>
<tr>
<td>Decrease to valuation allowance (after tax adjustment)</td>
<td>(28,574)</td>
</tr>
<tr>
<td>Sustainable Income (Loss) from Continuing Operations</td>
<td>35,522</td>
</tr>
</tbody>
</table>
Leucadia National Corp.

The company reported income (loss) from continuing operations of $410,735 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was a gain on forgiveness of debt. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $361,369. A summary of our adjustments is provided below.

Leucadia National Corp. – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>410,735</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on forgiveness of debt related to Myrtle Beach project (pre-tax $81,848, adjusted by sustainable tax rate of 39.69%)</td>
<td>(49,366)</td>
</tr>
<tr>
<td>Sustainable Income (Loss) from Continuing Operations</td>
<td>361,369</td>
</tr>
</tbody>
</table>

Liz Claiborne Inc. (LIZ)

The company reported income (loss) from continuing operations of $144,748 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was a gain on sale of global trademarks. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is ($16,249). A summary of our adjustments is provided below.

Liz Claiborne Inc. – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>144,748</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment of intangible and other assets (pre-tax $1,024 with no tax benefit)</td>
<td>1,024</td>
</tr>
<tr>
<td>Gain on sale of global trademarks (pre-tax $286,979 with no tax expense)</td>
<td>(286,979)</td>
</tr>
<tr>
<td>Gain on extinguishment of debt (pre-tax $5,157 adjusted by sustainable tax rate of 36.8%)</td>
<td>(3,259)</td>
</tr>
<tr>
<td>Expenses with streamlining initiatives (pre-tax $90,100 adjusted by sustainable tax rate of 36.8%)</td>
<td>56,943</td>
</tr>
<tr>
<td>Foreign currency gain (pre-tax $5,000 adjusted by sustainable tax rate of 36.8%)</td>
<td>(3,160)</td>
</tr>
<tr>
<td><strong>Non-recurring tax benefits:</strong></td>
<td></td>
</tr>
<tr>
<td>Increase in valuation allowance (after-tax adjustment)</td>
<td>72,408</td>
</tr>
<tr>
<td>Other items</td>
<td>2,026</td>
</tr>
<tr>
<td><strong>Sustainable Income (Loss) from Continuing Operations</strong></td>
<td>(16,249)</td>
</tr>
</tbody>
</table>
The Medicine Company (MDCO)

The company reported income (loss) from continuing operations of $127,877 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was a gain on sale of global trademarks and a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $42,948. A summary of our adjustments is provided below.

The Medicine Company – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

| Reported Income (Loss) from Continuing Operations | 127,877 |
| Legal settlement Wilmet Cutler (pre-tax $17,984 with tax expense of $1,950) | (16,034) |
| Non-recurring tax benefits: | |
| (Decrease) increase to valuation allowance (after-tax adjustment) | (66,509) |
| Other items (after-tax adjustment) | (2,386) |
| **Sustainable Income (Loss) from Continuing Operations** | **42,948** |

Metro-Goldwyn-Mayer (MGM)

The company reported income (loss) from continuing operations of $3,234,944 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a gain on the 1% interest acquisition of MGM China which gave MGM a 51% controlling interest in the company and required them to consolidate their statements. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is ($252,401). A summary of our adjustments is provided below.

Metro-Goldwyn-Mayer – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

| Reported Income (Loss) from Continuing Operations | 3,234,944 |
| MGM China acquisition gain (pre-tax $3,496,005 with no tax expense) | (3,496,005) |
| Non-Cash impairment charges (pre-tax $191,000 adjusted by sustainable tax rate of 33.2%) | 127,588 |
| Non-recurring tax benefits: | |
| Foreign jurisdiction tax rate change (after-tax adjustment) | (130,255) |
| Other items (after-tax adjustment) | 11,327 |
| **Sustainable Income (Loss) from Continuing Operations** | **(252,401)** |
Moneygram International (MGI)

The company reported income (loss) from continuing operations of $59,406 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a gain on recognized settlements and a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $44,715. A summary of our adjustments is provided below.

Moneygram International – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>59,406</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restructuring and related activities</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $23,570 adjusted by sustainable tax rate of 45.34%)</td>
<td>12,883</td>
</tr>
<tr>
<td>Gain on recognized settlements</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $32,816 adjusted by sustainable tax rate of 45.34%)</td>
<td>(17,938)</td>
</tr>
<tr>
<td>Losses from foreign currency transactions</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $8,659 adjusted by sustainable tax rate of 45.34%)</td>
<td>4,733</td>
</tr>
<tr>
<td>Disposition of assets</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $5,100 adjusted by sustainable tax rate of 45.34%)</td>
<td>2,788</td>
</tr>
<tr>
<td>Debt extinguishment losses</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $37,522 adjusted by sustainable tax rate of 45.34%)</td>
<td>20,510</td>
</tr>
<tr>
<td>Non-recurring tax benefits (after-tax adjustment)</td>
<td>(31,442)</td>
</tr>
<tr>
<td>Other items (after-tax adjustment)</td>
<td>(6,225)</td>
</tr>
<tr>
<td>Sustainable Income (Loss) from Continuing Operations</td>
<td>44,715</td>
</tr>
</tbody>
</table>

Opko Health Inc. (OPK)

The company reported income (loss) from continuing operations of ($6,464) for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is ($15,326). A summary of our adjustments is provided below.

Opko Health Inc. – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>(6,464)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Losses</td>
<td></td>
</tr>
<tr>
<td>(pre-tax $1,589 adjusted by sustainable tax rate of 36.7%)</td>
<td>1,006</td>
</tr>
<tr>
<td>Non-recurring tax benefits:</td>
<td></td>
</tr>
<tr>
<td>Valuation Allowance (after-tax adjustment)</td>
<td>(9,791)</td>
</tr>
<tr>
<td>Other items (after-tax adjustment)</td>
<td>(77)</td>
</tr>
<tr>
<td>Sustainable Income (Loss) from Continuing Operations</td>
<td>(15,326)</td>
</tr>
</tbody>
</table>
Teradyne Inc. (TER)

The company reported income (loss) from continuing operations of $347,893 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a decrease in the valuation allowance. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $171,663. A summary of our adjustments is provided below.

Teradyne Inc. – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>347,893</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency forward contracts</td>
<td>947</td>
</tr>
<tr>
<td>(pre-tax $1,327 adjusted by sustainable tax rate of 28.6%)</td>
<td></td>
</tr>
<tr>
<td>LitePoint acquired inventory charge</td>
<td>8,711</td>
</tr>
<tr>
<td>(pre-tax $12,200 adjusted by sustainable tax rate of 28.6%)</td>
<td></td>
</tr>
<tr>
<td>Restructuring costs</td>
<td>5,857</td>
</tr>
<tr>
<td>(pre-tax $8,203 adjusted by sustainable tax rate of 28.6%)</td>
<td></td>
</tr>
<tr>
<td><strong>Non-recurring tax benefits:</strong></td>
<td></td>
</tr>
<tr>
<td>Valuation allowance (after-tax adjustment)</td>
<td>(191,745)</td>
</tr>
<tr>
<td><strong>Sustainable Income (Loss) from Continuing Operations</strong></td>
<td>171,663</td>
</tr>
</tbody>
</table>

Ultra Petroleum Corp. (UPL)

The company reported income (loss) from continuing operations of $453,202 for the year ended 2011. In deriving sustainable income from continuing operations, our primary adjustment was for a gain on commodity derivatives. After adjusting for the non-recurring gains (losses) as well as the non-recurring tax benefits, the company’s sustainable income (loss) from continuing operations is $255,551. A summary of our adjustments is provided below.

Ultra Petroleum Corp. – Reconciliation of Reported Income from Continuing Operations to Sustainable Income from Continuing Operations (amounts in thousands)

<table>
<thead>
<tr>
<th>Reported Income (Loss) from Continuing Operations</th>
<th>453,202</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on commodity derivatives</td>
<td>(201,879)</td>
</tr>
<tr>
<td>(pre-tax $313,732 adjusted by sustainable tax rate of 35.65%)</td>
<td></td>
</tr>
<tr>
<td><strong>Non-recurring tax benefits:</strong></td>
<td></td>
</tr>
<tr>
<td>Tax effect of rate change (after-tax adjustment)</td>
<td>4,228</td>
</tr>
<tr>
<td><strong>Sustainable Income (Loss) from Continuing Operations</strong></td>
<td>255,551</td>
</tr>
</tbody>
</table>