

One Minute **MANAGER**

Stories of interest in the management of assets

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Tools of the Trade

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With the Enron debacle fresh in everyone's mind, we thought it might be useful to discuss an accounting tool we have successfully employed to manage uncertainty and risk. With many investors reassessing their appetite for risk, the critical importance of risk management tools has never been more important.

Ashfield employs many fundamental research tools and techniques to generate new investment ideas and to test existing ones. In this edition of the Ashfield One Minute Manager, Bradley J. Fretz discusses the uses and importance of forensic accounting as a key to managing risk in portfolios.

Cash flow analysis: effective early warning radar

It is interesting to note the dichotomy between today's sensitivities in the wake of the Enron scandal relative to the recent technology "bubble" wherein everyone seemingly abandoned time-tested accounting conventions. Then, the industry buzzwords were B2B, new economy, e-commerce and Internet, while accounting concepts like earnings, profits and inventory were disregarded. In this new paradigm, market share became the Holy Grail. However, with the current market downturn, it is apparent that George Santayana said it best: "...Those who cannot remember the past are condemned to repeat it." The facts are that earnings drive stock prices and revenues drive earnings over the long haul.

Over a full market cycle the investment component of the market return is much greater than the speculative element. Therefore, for long-term investors in businesses (as opposed to those speculating on short-term swings in stock prices), changes in both the income statement and balance sheet are critical and can serve as an important early warning system. While no amount of analysis of public data can uncover malfeasance, critical changes can be identified. The key is to get a "finger print" of how companies manage their earnings and to stay alert when the components change.

Forensic accounting: uncovering true business trends

Forensic accounting converts both income and balance sheet items into sources and uses of cash to determine trends, particularly non-operational trends. Non-operational items can often boost earnings, and potentially mask deterioration in the core business. Reported corporate earnings are based on accrual accounting in which amounts to be paid or received in the future can be recorded now. Corporate earnings can also include other sources of income and expenses not directly related to the core business. For example, income can be increased by recognizing gains from sales of external investments. Similarly, earnings can be boosted by obtaining extended credit terms from suppliers, thus reducing current expenses. We must always remember

continued on back

that the basic source of cash is sales to customers. Hence, forensic accounting uses cash flow from operations (CFFO) to measure the true health of the business. It is indicated that this change was a result of lengthening of payment terms and greater international sales where credit terms are generally longer.

Examples: earnings boosts not related to ongoing operations

The following are examples of how cash flow analysis can identify deteriorating business trends in advance of a reported earnings decline. It should be noted that these examples do not suggest corporate malfeasance, nor do they suggest that accrual accounting is inappropriate. Cash flow analysis must be used in conjunction with accrual accounting to properly understand business trends.

1. Acquisition Accounting A telecommunications company reported consensus earnings but close scrutiny of CFFO shows that a subsequent write-down of fixed assets commensurately increased goodwill which is amortized over 40 years with a net annual expense reduction of \$695 million in year 2000. Earnings were boosted from \$1.26 share to \$1.40 share.

2. Reduction in effective tax rate A technology company experienced a boost in pro-forma earnings due to a reduction in the effective tax rate from 35.5% to 34.5%. The net effect was a 1-cent boost in earnings from \$0.29 to \$0.30 or 3.4%. Many technology companies benefited over the last few years from expensing exercised employee options. This led to lower tax rates and correspondingly higher earnings. With many options now out of the money, we are concerned that tax rates will increase and reported earnings will decrease.

3. Jump in accounts receivable A software consulting firm showed a sequential increase in receivables over three quarters from 40 to 65 days without a corresponding increase in their allowance for doubtful accounts. This jump is a potential warning sign - particularly in a slowing economy - that a company's customers may be in trouble and unable to pay for their purchases. Management

4. Inventory build up: A technology company in the electronic storage solutions business reported a jump in inventory to 30 days sales inventory (DSI) or 9 days sequentially (42% increase). Our concern is that sales are slowing and are not yet reflected in reported earnings.

5. Consolidation of subsidiary A telecommunications company reported a boost in earnings due to the consolidation of a subsidiary in which they had minority ownership but controlling interest. Typically with minority ownership, the investment is carried on the balance sheet with no reported income benefit. Due to their voting control, they were able to add their proportionate share of the subsidiary's revenue, which increased revenue 8.6%.

6. Increase in soft current asset accounts A company providing software solutions for the quality control of surface materials reported an increase in pre-paid expenses and other assets to 28.2% of revenue from 25.1% in the prior quarter. Our concern is that management may be boosting earnings by capitalizing certain previously expensed costs or by amortizing costs more slowly.

The bottom line: These examples, in many cases, are just a small sampling of items that can be predictive of deteriorating earnings. However, these same items, in other circumstances, can be leading indicators of improving fundamentals. The bottom line is that we use forensic accounting to reconstruct the publicly available financial data to keep better track of the trends in companies' ongoing operations. The last three speculative bubbles all featured the same dynamic: earnings continuing to rise while CFFO were declining. While this sort of analysis cannot identify companies 'cooking the books', in many cases, it can raise red flags. We can and do learn from the past.

