

# RED FLAGS

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Here are some red flags that such professional investors watch out for to guard against potential trouble down the road:

**Invoices Increasing, Sales Slipping:** If a company's accounts receivables are growing faster than sales, which signals some concerns about the quality of the sales. Among other things, swelling accounts receivable could indicate "channel stuffing," or overselling to distributors to pad short-term financial results.

Similarly, if inventories are growing faster than sales, that could signal a company isn't able to sell inventory as quickly as originally believed. Depending on the type of inventory, there might be the added risk of the inventory becoming obsolete, resulting in write-downs.

In 1998, Sunbeam, a maker of household consumer products, restated earnings downward for six previous quarters. The company, which had seen a surge in accounts receivable acknowledged that the original revenue had been prematurely booked, and it cited a variety of other accounting moves that were necessary to restate. Sunbeam had inflated sales of such things as barbecue grills by offering retailers low prices and easy cancellation terms, promising, say, to hold the grills in Sunbeam's warehouses for later delivery.

Dubbed a "massive financial fraud" by the Securities and Exchange Commission, the company filed for bankruptcy reorganization in February 2001.

**Concentrate on Cash:** The cash-flow statement tracks all the changes that affect a company's cash position, be it cash flowing in from debt and stock offerings, or cash flowing out in the form of dividends. It can also serve as an indicator of potential chicanery inside a company's accounting.

A telltale sign of trouble is negative cash flow from operations while the company's so-called EBITDA (earnings before interest, taxes, depreciation and amortization) is positive. Short sellers note that in such a case, a company could be using accounting gimmickry to make its business look healthier than it really is. If operating cash flow is negative, in reality the company is consuming cash rather than generating it, as its EBITDA figure would suggest.

**Risky Returns:** At the end of the day, what makes a stock move is its return on capital -- how much profit a company generates off the assets it employs, such as its cash, inventories and property, plants and equipment.

Most financial statements break apart a company's operations to show investors which segments generated which portion of sales and profits. By isolating individual segment returns, says one short-selling analyst, investors can determine where earnings are coming from and whether they seem fishy. A few simple calculations can reveal a lot.

Consider **Mirant**, an energy peer of Enron. As part of its balance sheet, the Atlanta company shows assets and liabilities "from risk management activities," both current and non-current. Subtract the liabilities from the assets, the analyst notes, and Mirant has \$80 million of equity in that business. As part of the footnote attached to those balance-sheet items, Mirant noted that it generated essentially \$221 million off those assets during the third quarter.

That kind of stunning return, about 275%, is hard for any company to sustain, raising questions about the likelihood that such strong performance can be maintained indefinitely. The same analysis shows the other segments had far more humble returns. A Mirant financial expert wasn't available to comment.

**It's All-Relative:** Often, a company's financial statements will include a "related-party transactions" section, pointing to dealings with its own officers or related companies. Maybe the company has loaned money to its officers to buy company stock, or cash to an affiliate to buy products from the company.

Either way, investors should be aware of the potential pitfalls. Some short sellers say these dealings can signal that a company thinks of corporate cash as belonging to management and not the shareholders, and thus is more freewheeling with it than a more conservative company is. Enron may be a case in point; its downward spiral into bankruptcy-court protection started as investors focused on nettlesome related-party transactions involving the then-chief financial officer.

**Recurring Nonrecurring Charges:** Another red flag, according to Nathaniel Guild, a partner at Short Alert, a research firm in Charlotte, N.C., is the practice of repeatedly labeling restructuring and other charges as "nonrecurring," "one-time" or "unusual," when they aren't truly one-off expenses. Because most analysts ignore such charges in their earnings models, this can create a cloud of smoke that obscures the company's true earnings power. "You can write off anything, in any fashion," Mr. Guild maintains. "There is very little regulation in that area."

**Consult the Consulting Fees:** The case of Enron also has focused the spotlight on the issue of auditor independence. Thanks to new rules introduced by the Securities and Exchange Commission, companies now are required to disclose how much they pay their auditors not just for auditing, but for non-auditing work as well. The question investors should ask themselves says Rocker Partners' Mr. Cohodes, is how independent an auditing firm can be that is getting paid as much or more for consulting services as it is for auditing. "It is a huge conflict," he contends. In the Enron example, the company in 2000 paid Arthur Andersen \$25 million in audit fees and \$27 million for non-audit work, including consulting.