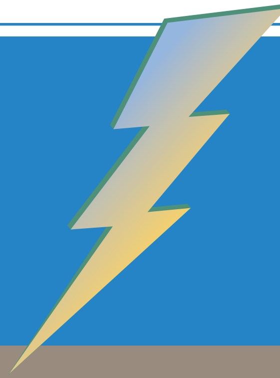
Olstein
The Olstein Funds



OLSTEIN ALERTS

REALITY CHECK: ACCOUNTING ALERTS EVERY INVESTOR SHOULD KNOW

The 1998–2000 bubble market, followed by the market crash with its poster child, Enron, created a political and media frenzy relating to the accounting and reporting games that too many companies practice. Investors must stop accepting financial reports and questionable accounting practices at face value. Portfolio managers, analysts, and investors must study the numbers in financial statements and adjust those numbers and the underlying assumptions to reflect the economic reality of a company's basic business. Only the adjusted numbers should be used to value a company for investment purposes. A keen understanding of corporate reporting practices, combined with an investor's ability to identify early warning signs of future earnings disappointments or pleasant surprises, can increase the odds of investment success.

The Importance of Excess Cash Flow

It is safer to buy only those companies that generate or are about to generate excess cash flow, and value those companies based on excess cash flow. Excess-cash-flow companies can raise dividends, buy back shares, make strategic acquisitions when credit is tight, ride out hard times without adopting short-term strategies injurious to their future, and are outstanding acquisition candidates. The challenge for investors is to cut through any accounting and financial chicanery and determine a company's true ability to generate excess cash flow. The numbers are the most important and unbiased indicator of a company's value. Better to spend one night with a company's financial statements than two days with its management.

An intensive inferential analysis of financial statements, footnotes, supporting documents, and disclosure practices is the best way to analyze the capabilities of management, the economic reality of the financial information the company provides, the conservatism of its accounting and disclosure practices, its financial strength, and, ultimately, the value of the company. An intensive forensic analysis of financial statements also enables an investor or advisor to determine true financial strength and to screen for potential problems to ascertain a company's downside risk, a critical consideration before considering its potential for capital appreciation.

For an investor, an equity security is worth the discounted value of the issuing company's future expected excess cash flow (including capital expenditures and working capital needs).Thus, to value a company according to a model of discounted excess cash flow, one must be able to adjust reported earnings to arrive at true cash earnings (excess cash flow).

Inferential analysis begins with an understanding that GAAP requires a company to report earnings on an accrual basis, which entails two basic premises. First, because accrual accounting states that revenue is recognized when a transaction occurs in which value has been exchanged, this

event may lead or lag the exchange of cash. Second, because the cost of a transaction should be recognized over the same period of time as the revenue associated with that cost, this period may also lead or lag the passing of cash.

In reporting GAAP-based earnings, companies have wide discretion, which includes many assumptions about the future. Because management has a vested interest in putting its best foot forward, the numbers produced under GAAP often leave room for unrealistic assumptions and misleading numbers. Most companies use financial accounting and reporting practices to present themselves in the most favorable light, meaning that many companies engage in some type of earnings management or make assumptions that may prove to be unrealistic.

Within limits, earnings management is neither wrong nor illegal. However, as seen during the late 1990s, some companies far exceeded what most would consider reasonable limits. In cases such as Enron, Lucent Technologies, Boston Chicken, and Sunbeam, while the financial statements may have been in accord with GAAP, they were certainly out of touch with economic reality. It is in management's best interest to report the best earnings possible to preserve financing alternatives, keep their stock options valuable and exercisable, and maintain shareholders through increasing stock prices. Thus, in instances when management identifies a problem which, due to bias or ego, it deems to be temporary, the company can adopt optimistic assumptions or accounting alternatives under GAAP to portray a positive picture until the problem is resolved.

Accounting Alerts Help Avert Trouble

An astute investor should be aware of the types of accounting smokescreens that companies use to disguise problems and to misrepresent the company's economic reality. The following alerts are sometimes clear indicators of future earnings surprises and have proved valuable to investors:

- Sizable negative divergences between cash flow and net income;
- Questionable accounting for transactions with unconsolidated affiliates or joint ventures;
- Prematurely realizing revenue that may not be sustainable;
- Reversal of past reserves to artificially inflate earnings;
- Realizing nonrecurring gains, and netting these gains to hide past mistakes;
- Lowering discretionary expenditures to meet earnings targets;
- Continual characterization of material expenses as nonrecurring;
- Unrealistic depreciation schedules;
- Capitalizing expenses based on unjustified optimism;
- Serial acquisitions under purchase accounting that overstate internal earnings growth;
- Lower inventory turns or negative inventory divergences;
- Accounts receivable rising faster than sales; and
- Unrealistic pension assumptions.

REALITY CHECK: ACCOUNTING ALERTS EVERY INVESTOR SHOULD KNOW

Real-life examples of these accounting alerts include the following:

- In the early 1970s, leasing companies had four-year (or more) depreciation schedules on equipment that turned out to have three-year useful lives. The underdepreciation overstated earnings by sizable amounts as the companies grew their leasing portfolios. Eventually the write-offs for the leasing companies were sizable, and their stocks dropped precipitously. Comparing depreciation schedules to economic reality is a must for any investor when analyzing financial statements.

- In 1997, Sunbeam reported $189 million in pretax earnings to shareholders under accrual accounting, but paid the IRS and foreign tax authorities only $5 million under cash-based accounting. The footnote section of an annual report reconciles the two set of books and should be scrutinized carefully.

- Premature recognition of revenue or income that may not be sustainable is an important alert. Sunbeam's 1997 10-K disclosed that in the fourth quarter the company recorded $50 million in sales of cooking grills under an "early buy" program that allowed retailers to delay payment for as long as six months. It was later revealed that $35 million of these "early buys" were categorized as "bill and hold" sales and never left Sunbeam's warehouse. The material increase in accounts receivable in the 1997 balance sheet would have alerted investors to the possible "channel stuffing" which, although it helped in the short run, ultimately led to disastrous results. (Accounts receivable jumped 40% and inventories rose 58%; both were well above the increase in sales.) Another example might be accelerating shipments to customers and realizing income immediately even though services are recognized over an extended period of time.

During the technology boom of the late 1990s, a handful of software companies were forced to restate earnings due to aggressive front-end recognition of revenues with material services still to be rendered.

COMPARING DEPRECIATION SCHEDULES TO ECONOMIC REALITY IS A MUST FOR ANY INVESTOR WHEN ANALYZING FINANCIAL STATEMENTS.

- Boston Chicken was reporting outstanding earnings growth and sold at a very high earnings multiple. At the same time, the company was lending money to franchisees that were losing hundreds of millions of dollars (and were unconsolidated). The parent company was not setting up reserves against these potential bad debts. The franchisees were redirecting the cash from the Boston Chicken loans back to the parent company in the form of franchise fees, yet the franchisees continued to lose money.

- Between 1993 and 1996, Sears Roebuck's allowance for doubtful accounts dropped from 4.96% to 4.04%. Yet delinquent accounts during the same time period increased from 3.55% to 5.24%. Despite the increase in actual delinquencies, Sears' stock had risen 200% between 1995 and 1997. A careful examination of the reserve account could have indicated that the company's 1993–1996 earnings growth was being fueled by reversing earlier excess reserves or relaxing credit standards. Sears stock tumbled in the second half of 1997, when the company alerted the public that earnings could be hurt by rising delinquencies and charge-offs in its credit card business.

REALITY CHECK: ACCOUNTING ALERTS EVERY INVESTOR SHOULD KNOW

- In December 1998, the SEC filed a civil complaint against W.R. Grace, stating that the company directed its main health-care subsidiary to release about $1.5 million from its reserves in order to meet earnings targets. The SEC stated that the company diverted $20 million of 1991 and 1992 earnings into reserves. Although the company stated that the amount was immaterial, an SEC spokesman questioned the accounting by asking, "Does anyone think that it is acceptable for a corporation to intentionally book an error in its financial statements just for the purpose of making earnings targets?"

- Under GAAP, costs should be matched against the revenues they produce. Investors should monitor companies that defer current expenses to later periods. The year-to-year increases in the capitalized asset account on the balance sheet should be tracked as a percentage of reported earnings. In addition, footnote disclosures relating to the assumptions behind the amortization of these expenses to income should be scrutinized for economic reality.

- America Online, in its early stages of development, surprised and disappointed investors when the reality of the company's accounting policy of deferring marketing costs came under scrutiny. AOL's year-to-year increases in deferred marketing costs accounted for more than 100% of its earnings. Subscriber cancellations were more rapid than AOL's two-year write-off policy. Interestingly, during the period when the company's marketing expense capitalization policies deviated from economic reality, the stock was penalized in the market. When AOL wrote off its marketing expenses and changed its accounting policy, recognizing marketing expenses on a current basis, the stock rallied strongly. Investors were enthusiastic over the company's future once the accounting cloud was removed.

- Earnings-per-share increases may be a function of acquisitions. Under purchase accounting, an acquired company is included in the purchaser's financial statements from the date of acquisition forward. Through clever financing, or the issuance of high price/earnings ratio stock to buy a company with a lower price/earnings ratio, a company can create an illusion of above-average growth. Maintaining this illusion requires consummating larger and larger acquisitions each year, increasing the chances of a mistake. To detect a company relying on nonrecurring growth created by acquisitions, one must examine the footnote relating to pro forma earnings. The pro forma earnings footnote provides earnings data as if the acquisition was made at the beginning of the previous year to compare reported earnings against acquisition-generated earnings.

Starting in 1993, Cendant Corporation, through purchase-acquisition accounting, was able to report growth rates, including acquisitions to shareholders, in excess of 30%, far beyond its true internal growth rate, estimated at 11% or less (excluding acquisition). Cendant eventually paid the price for acquisition-driven growth after its 1997 acquisition of CUC International, a company that was cooking the books. An investor could have reached this conclusion through careful analysis of Cendant's footnotes pertaining to acquisitions.

- Inventories or receivables growing faster than sales have been valuable alerts over the years. Comparing inventories and receivables to sales in the aforementioned Sunbeam example would have provided a valuable early warning alert.

- Serial nonrecurring write-offs can disguise the trend of operating earnings and are a valuable early warning of future potential problems. Few investors look at so-called nonrecurring charges as

management's admission that past years' earnings may not have been as good as originally reported. Retained earnings growth (before dividends) should be compared to reported recurring earnings for deviations. AT&T's earnings grew by 10% annually, from $1.21 a share to $3.12, in the 10 years ended 1994. During the same decade, however, $14.2 billion of nonrecurring write-offs exceeded the $10.3 billion in earnings that the company actually reported. The market ignored how the so-called nonrecurring write-offs distorted the the company's financial results during those years.

- Beginning in 1989, IBM took a series of restructuring charges. It started with $1.5 billion in 1989, followed by $2.7 billion in 1991, $8.3 billion in 1992, and $8 billion in 1993. IBM's stock was a market underperformer from 1989 through 1995, after being the darling of Wall Street for 30 years. Investors realized that the growth rate was slowing and regarded these write-offs as recurring in nature.
- Costs of activities beneficial to future operations and profitability, such as research and development, advertising, and maintenance, may have been cut to produce short-term benefits at the expense of future growth. Year-to-year expenditures are critical to future growth and should be compared for a few years to determine whether declines are contributing to year-to-year earnings growth.

For example, a review of Eastman Kodak's fourth-quarter 1998 shareholder release showed that the company reduced R&D expenditures in 1998, contributing $0.33 per share to year-to-year earnings comparisons. Technology companies should not derive their growth from cuts in research-and-development expenditures. Maintenance expenditures are important to airlines and offshore drillers and should be monitored on a comparative basis. Marketing expenses are important to consumer-product companies, and reductions in such key expenses should not be the source of year-to-year earnings growth.

- Unrealistic pension assumptions should trigger an alert. GM's pension expense is based on assumed investment returns of 9% per year. If the assumed return expectations are deemed aggressive, the pension expense is too low and the earnings need to be adjusted downward.
- The most important alert is a sizable negative divergence between free cash flow and net income. The statement of cash flow contained in the annual report is the main source of such information. A simple calculation can indicate whether a company is cash-flow positive or negative:

Net Income + Depreciation – Capital Expenditures +/– Changes in Working Capital = Free Cash Flow

Rather than relying on numbers for only one year, investors should evaluate normalized levels for capital expenditures and working capital needs over many years. A company consistently reporting earnings that are materially higher than cash flow from operations raises a red flag alert. Identifying Enron's continued reporting of negative cash flow despite reporting sizeable earnings to shareholders could have saved knowledgeable investors from eventual disaster. It is very important to continually assess a company's ability to produce future excess cash flow, as accrual accounting numbers under GAAP can be distorted based on unrealistic assumptions.

Disclosed Information May Not Tell the Whole Story

It is also important to assess a company's disclosure practices and determine whether information

essential to its valuation is omitted from the financial statements and supporting schedules. The risk of undisclosed information must be factored into the valuation process by reducing the multiple of cash flow (as far as zero) that an investor is willing to pay to purchase a company. Enron had limited disclosure as to the nature of the earnings developed by its off–balance-sheet entities, yet these entities were material earnings contributors to the company's bottom line.

The latest bout of Wall Street's casual acceptance of the numbers as presented, however suspicious, is similar to past financial and accounting crises. The current period is reminiscent of the 1970s, when audit failures such as Equity Funding and Stirling Homex, as well as the accounting games played by computer lessors and land development companies, wiped out billions of dollars of net worth while an economic boom turned into a recession. Like today, the investing public, the financial press, and government representatives called for more government regulation. Despite the recent bad news, the disclosure practices of public corporations have greatly improved over the past 30 years. While the financial reporting system can always be improved, and new business practices require constant adaptation, all reporting relies on management judgment, leaving room for unrealistic assumptions or potential abuse.

Improvements in disclosure practices have resulted in financial statement analysis becoming more difficult and time-consuming. Today, a wealth of information not available 30 years ago is found in the footnotes and management discussions of annual reports, for anyone with a skeptical eye. The analyst and investor community has the responsibility to assess these new disclosures, adjust earnings for unrealistic reporting, and expose corporations whose disclosures are inadequate.

An investment discipline that adjusts corporate earnings for economic reality in both bull and bear markets provides investors with a competitive advantage over others in seeking long-term capital appreciation. A discipline that values companies on the basis of their ability to create excess cash flow in all markets gives investors an edge. GAAP and economic reality can be worlds apart, but an inferential analysis of financial statements will help bridge the gap when it occurs. If the portfolio management and financial analyst community regularly adjusted reported corporate earnings for deviations from economic reality in all markets, future accounting crises could be greatly diminished.

Robert A. Olstein, an expert in corporate financial disclosure and reporting practices, is Chairman and Chief Investment Officer of Olstein Capital Management, L.P.

The preceding commentary represents the opinion of the Manager and is not intended to be a forecast of future events, a guarantee of future results or investment advice.

The Fund does not maintain a position in any of the following securities mentioned and is subject to change: Lucent Technologies, Enron, Boston Chicken, Sunbeam, Sears Roebuck, W.R. Grace, America Online, Cendant Corporation, AT&T, IBM, Eastman Kodak, General Motors, Equity Funding, and Stirling Homex. Do not make investments based on the securities referenced above.

This information should be preceded or accompanied by a current prospectus, which contains more complete information, including investment objectives, risks, charges and expenses of The Olstein Funds and should be read carefully before investing. A current prospectus may be obtained by calling (800) 799-2113 or by visiting the Fund's Website at www.olsteinfunds.com.

Not FDIC insured / Not bank-guaranteed / May lose value.

Olstein Capital Management, L. P. – Distributor
Member FINRA 03/09