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FEATURE

# Watch Their Language

By VITO J. RACANELLI

***Certain phrases that appear in financial reports should be viewed as red flags signaling potential trouble -- and maybe even a scam. Video: Dirty Words in the Fine Print***

**ANYONE WHO HAS SLOGGED THROUGH THE** legalese of a thick Securities and Exchange Commission filing knows the devil is often in the footnotes or the appendix. A good rule of thumb, particularly for adverse corporate information, is that the further back in the report, the more important the information. The urge to skip sections of a 100-page 10K is a strong one, but you do so at your peril.

Now that most regulatory filings are easily searchable on the Internet, investors can troll through the documents for key phrases suggesting something could be amiss -- let's call them dirty words.

REUTERS/Shannon Stapleton

Some words and phrases can signal perils subtler than Ponzi schemes.

*Barron's* has come up with a list of key words that should set off alarm bells. Our list isn't exhaustive, but the appearance of these phrases in a filing indicates the company might be trying to put its best face on a bad situation, or worse, obfuscating its financial condition.

We received help from two experts: Howard Schilit, a 25-year veteran forensic accountant and the author of the forthcoming third edition of *Financial Shenanigans*, and David Trainer, president of New Constructs, an independent research outfit in Nashville, Tenn. New Constructs puts out a monthly roll call of Most Attractive and Most Dangerous stocks, based on companies whose profits and valuations are understated or overstated by accounting metrics. The potential shenanigans that these key words address are divided into four main areas: corporate governance, earnings, cash flow and company-generated metrics.

**Corporate Governance**

Board independence is a healthy aspect of a properly run company. Searches of filings here should begin with the key words "related party," "related-party transaction" and "consulting relationship."

The investor, says Schilit, should be looking for outside board members who might not be as independent as advertised. If a director is getting paid as a consultant for some service to the firm, for example, his board decisions could be colored more by his consulting fee than by concerns for shareholders.

Similarly, companies with celebrities nominated to the board, or folks who couldn't be expected to know how to read a financial statement, are cause for concern. Management could be trying to install board members who aren't in a position to challenge the CEO and the management team, Schilit points out. "Look for people who just don't belong," he adds, like pop stars, athletes, and former politicians.

**Earnings**

Over the years, the ability of companies to manipulate earnings numbers has been reduced, but not eliminated, by stricter regulations. Changes in accounting policies are always a potential danger and among the reddest of flags, says Trainer. Companies often make those changes to dress up and improve their earnings.

"Something may be fishy about the finances or the prospects of companies that use these words in their filings," he warns. Look for phrases like "changes in estimated useful life/lives" and "change in revenue recognition" and "change in the depreciation period."

Schilit says "bill and hold" applied to revenue is an approved accounting method that is often misapplied. Under this method, the company says a customer bought its product and asked that the delivery be delayed, often for a long term. "This could happen, but it is rarely initiated by the buyer," Schilit notes. Sunbeam, which filed for Chapter 11 bankruptcy protection in 2001 after problems first exposed in *Barron's*, used this method among others to manipulate earnings.

A problematic phrase for nonfinancial companies is "mark to market" for asset valuation, something Enron once did. That valuation method is generally used by financial corporations, where investors expect it. When applied by nonfinancial companies, it requires a closer look by investors.

"Percentage-of-completion accounting" could also be worrisome. It's OK for construction work that will take years to complete or for jet makers like Boeing, but consider it a blinking red warning light when used by a software producer or any company whose product takes less than a year to deliver, Schilit explains. Also, "unbilled receivables" and "long term" or "accrued" in combination with "receivables" should draw an investor's gimlet eye. Receivables should cover money owed less than a year. Anything longer could be bad news.

Some dirty words haven't been seen much lately, but they can always make a comeback. For example, about a decade ago there were "two-way transactions," or sales without substance, such as occurred between Global Crossing and Qwest Communications International, two companies that settled with the Securities and Exchange Commission after fraud investigations. In such deals, one company sells its wares to another, and in exchange agrees to buy products made by its customer, a kind of swap. "It's a boomerang transaction," Schilit says, and sometimes the revenue goes on the profit-and-loss statement, boosting earnings, but the expense is capitalized and most of it put on the balance sheet instead of the income statement.

**Cash Flow**

Accounting rules for cash flow are less strict than those for earnings. "Cash flow from operations is a figure that can be easily manipulated," says Schilit, adding that over the long term, cash flow should roughly correspond to earnings. If one moves consistently up while the other falls, it's cause for concern.

The cash-flow statement consists of cash from three main activities: operations, which is where everyone looks first; investment, like capitalized expenses; and financing, such as stock issuance. Management sometimes tries to pull cash from the latter two categories into operations in order to inflate the operating-cash-flow number.

For example, look for "selling receivables with recourse." This makes it appear as if the company were getting cash from operations, but it's often just a kind of bank loan and should be put into financing activities. And watch out for terms like "accounts payable" combined with "financing" and "extended payment terms."

## Worrisome Words

Some phrases that should make an investor suspicious, or at least more cautious:

| Phrase | Potential Concern |
|---|---|
| **"Related party"** | It could mean a board member might not be as independent as advertised. |
| **"Bill and hold"** | When revenue is booked this way, the company might be "creating" earnings, as Sunbeam once did. |
| **"Percentage-of-completion accounting"** | OK for construction companies or other producers of products that take a long time to build, but not so much for software makers or any firm whose products can be made relatively quickly. |
| **"Unbilled receivables"** | Almost an oxymoron. Receivables generally should cover money owed for less than a year. |
| **"Change in revenue recognition"** | An accounting change sometimes aimed at simply pumping up perceived sales. |
| **"Substantial doubt"** | Obvious worry, but it's often buried in the filing and sometimes ignored. |

Or management might try to move some expenses from the operations portion into the investments section. A typical example is an expense capitalized on the balance sheet over many years that should have been considered an operational expense for the quarter the expense was paid and deducted fully from operational cash flow.

Now that most filings are searchable on the Internet, investors can troll through documents for important key phrases that suggest a company might be trying to put its best face on a bad situation, or worse, reports Barron's Vito Racanelli.

For example, WorldCom took the normal expense of leasing phone lines and treated it as a capital expense, moving most of the cash outflow from quarterly operations to the financing portion, deducting it in smaller amounts over many years.

**Company Metrics**

Areas of potential danger are companies that have unique definitions of, for example, organic growth, same-store sales, revenue per store and backlogs. Sometimes it's as simple as changing the definition of same-store sales to those open six months instead of the more typical 12. The word "change" in combination with any of these metrics should be studied carefully.

Beyond these four categories, there are other potential dirty words. Trainer points out that "substantial doubt," which has popped up in filings of insurance company American International Group (ticker: AIG), among other troubled companies, and "materially and adversely affected" are phrases that should make investors' hair stand on end.

And if "sale leaseback" pops up in a filing, investors should know that it is sometimes used to hide assets and debt, he says.

The use of these search terms can save a lot of time wading through those 100-page SEC filings. And while finding some of these words in an SEC document doesn't automatically mean the company is up to no good, if lots of these dirty words are found, run from the stock.

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