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How Corporate Buzzwords Hide What's Really Going On

By VITO J. RACANELL

When it comes to securities filings, the devil is in the details. Or the footnotes. Or the appendix.

Now that most regulatory filings are easily searchable on the Internet, through services such as Edgar Online, investors can troll through them for telltale phrases.

Check Independence

Clues to whether the board of a company is truly independent, for instance, can be found by searching for the key words "related party," "related-party transaction" and "consulting relationship."

Howard Schilit, a veteran forensic accountant and author, says that if an outside director is a consultant to the firm, his board votes could be colored more by his desire to retain his consulting fee than by concerns for shareholders' interests.

David Trainer, president of New Constructs, a financial-research firm in Nashville, stays on the alert for accounting-related phrases such as "changes in estimated useful life/lives," "change in revenue recognition" and "change in the depreciation period."

These could all indicate that the company is trying to manipulate revenue or depreciation figures in a way that artificially improves reported results.

A phrase like "percentage-of-completion accounting" is OK for construction work that will take years to finish (such as an all-new Boeing jetliner), but it's a red light when used by a company whose product should take less than a year to deliver.

Cash-flow statements reflect cash from three sources: operations, investments and financing (such as issuing stock). But management sometimes tries to pull cash from the latter two categories into operations, to inflate operating cash flow. The phrase "selling receivables with recourse" makes it appear as if the company is getting cash from operations, but it's often just a kind of bank loan and should be put into financing activities.

Or, management might try to hide some operating expenses. Now-defunct WorldCom took the normal expense of leasing phone lines and treated it as a capital expense, moving most of the cash outflow from operations to the financing section of accounting statements and deducting it in small amounts over many years.

Decipher Meanings

Companies with unusual definitions of common terms like "same-store sales" also can pose a problem. Simply changing that phrase to cover stores open six months instead of the more typical 12 has a huge effect on

perceived results.

Mr. Trainer says that "substantial doubt" and "materially and adversely affected" are phrases that should make investors' hair stand on end. These phrases can mean there's a strong possibility that reported figures are untrue or that a company has a severe problem of some sort.

Finding such words in a document doesn't automatically mean a company is up to no good. But if lots of them pop up, investor beware.

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