CHAIRMAN'S CORNER

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"Dirty" Words, Dirty Deeds

Audit Integrity Cracks the Code

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Barron's Magazine recently ran a feature entitled "Watch Their Language,'[1] which focused on some "dirty words" used in 10-K and 10-Q filings. Key words, such as "related party transaction," "change in revenue recognition," "change in the depreciation period," "sale leaseback," and others are listed in the article.

I concur with the article's findings. It turns out that "dirty words" are frequently associated with management's discretion to massage a company's reported numbers in a manner that doesn't fairly reflect the underlying facts. Euphemism, or "spin," is the process of substituting inoffensive words for words that are considered offensive or unacceptable -- a common practice in company reporting.

Walter Smiechewicz, our Chief Consultant of Governance and Risk, recently prepared a list of the Audit Integrity risk metrics that appear consistently as identifiers of problematic companies. He dubbed this list the "Risky Business Catalogue" because, while these events do occur from time to time even in trustworthy companies, the aggregation of multiple flagged risk metrics occurring together indicates a potentially dirty company.

The more "dirty words" we identify for a given company, the lower the company's AGR® ranking. I estimate that of more than 8,000 public companies we follow in North America, approximately 500 have a financial vocabulary full of "dirty words." It is this relatively small population that is polluting the investment industry.

Of course, the opposite is also true. The absence of "dirty words" in 10-K and 10-Q filings indicates a clean company with transparent financial reporting and responsible governance.

Let's look at some of Audit Integrity's proprietary metrics. **With tongue firmly in cheek**, I take the liberty of de-coding 20 common euphemisms.

1. *The company has entered into multiple mergers within the last 12 months.*
   Translation: Management is unable to grow the company organically.

2. *The CEO's and CFO's compensation is more highly weighted toward incentive compensation than base compensation.*
   Translation: Management is ignoring long-term sustainability in favor of short-term gain.

3. *The Board Chairman is also the CEO.*
   Translation: The CEO controls the Board.

4. *The company has undergone a restructuring in the last 12 months.*
   Translation: Serious fundamental problems.

5. *The company has encountered a public regulatory action in the last 12 months.*
   Translation: Risk issues and/or control issues were actually documented by regulators. Possibly the tip of an iceberg.

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[1] "Watch Their Language," *Barron's* Magazine, August 31, 2009

6. *The amount of Goodwill carried on the balance sheet, when compared to Total Assets, is high.* ***Translation: The company overpaid for acquisitions****.*

7. *The ratio of the CEO's total compensation to that of the CFO is high.* ***Translation: Too much power is centered in one position (see No. 3 above).***

8. *Operating Revenue is high when compared to Operating Expenses.* ***Translation: The company is relying on financial engineering to mask a weak condition.***

9. *A Divestiture has occurred in the last 12 months.* ***Translation: Management had to rectify a mistake.***

10. *The Debt to Equity ratio is high.* ***Translation: The company is taking on excessive risk.***

11. *A repurchase of company stock has taken place in the last 12 months.* ***Translation: Management boosted the share price via a buy-back rather than improving operations.***

12. *Inventory Valuation to Total Revenue is increasing.* ***Translation: The company is understating future expenses.***

13. *The ratio of Accounts Receivables to Sales is increasing.* ***Translation: The company is over-stating revenues.***

14. *Asset turnover has slowed when compared to industry peers.* ***Translation: Organic growth slowed, or merger is not accretive.***

15. *Assets driven by financial models make up a larger portion of the balance sheet.* ***Translation: Financial engineering is being used to obfuscate the company's actual fundamentals.***

16. *Prepaid Expenses are high.* ***Translation: The company is putting off current expenses to pretty-up earnings.***

17. *Deferred Tax Assets are high.* ***Translation: Current expenses are understated.***

18. *The Pension Plan Expected Return and Discount Rate are high.* ***Translation: Current and future pension expenses are understated.***

19. *The ratio of Work in Process over Inventory is high.* ***Translation: The company is getting ready to write down inventory and whack Cost of Goods Sold.***

20. *Intangible Assets are high.* ***Translation: Subjectively-valued assets are waiting to be written off.***

Every company that uses a plethora of "dirty words" to describe its financial condition will, of course, also offer a euphemistic explanation for red-flagged metrics. I hear "business strategy" invoked most of the time! But by definition, "dirty companies" are good with euphemisms.

Again, please bear in mind that none of these events is necessarily indicative of malfeasance. In combination, however, there is a statistical likelihood of increased risk.

It is our job at Audit Integrity to penetrate opacity in financial statements and shed light on a company's actual financial condition. By highlighting potential manipulation, we direct stakeholders' attention to problems that should be investigated. I strongly suggest that stakeholders not be lulled into a level of trust that is not earned. Remember those no-documentation Mortgage-Backed Securities? Despite their AAA ratings, anyone who failed to recognize that no-documentation was a euphemism for "no assets" and "no income" was blind-sided when the securities collapsed.

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