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13 ACCOUNTING RED FLAGS FOR 2013

Al and Mark Rosen / January 15, 2013

Having scoured financial statements for decades, we've identified more accounting red flags than we can count. But the following stand out as perennial portfolio risks.

1. GROWTH BY ACQUISITION

Some companies seem to exist to gobble up others. It can be a smart, and sometimes necessary strategy to grow through acquisition, as when oil and gas companies need to replace production. The approach works when the acquirer can leverage its value in the market to swallow companies priced at lower multiples. The risk comes when the acquisition metrics are not transparent or the accounting is lacking relevant details. What is often easier to understand in the energy space is not necessarily so straightforward in, say, pharmaceuticals (e.g. Valeant).

Suggestion: If you can't understand where the figures came from, ignore them or heavily discount the amounts, building a margin on safety into what you will pay for the shares.

2. SENSITIVITY TO INTEREST RATES

For some companies, nothing derails business like a prolonged downturn in interest rates. Banks and life insurers are most susceptible. Some large Canadian insurers, for instance, have guaranteed products that carry heightened interest-rate risk. In addition to mark-to-market losses from lower interest rates, a prolonged period of low yields can cause these companies to incur charges related to their ultimate reinvestment rates.

Suggestion: Hedge all bets when it comes to interest rate movements. Making a big wager that rates will rebound soon could result in a lagging portfolio.

3. CASH-FLOW DISTORTIONS

Some analysts misinterpret cash-flow statements, leaving advisors to clean up the mess. Focusing on free cash flow ignores roughly 60% of the cash-flow statement. We liken that to stopping at the gross margin line on the income statement—when's the last time an analyst valued a company on a multiple of gross margin? You're playing with fire if you ignore the investing and financing sections of the cash-flow statement since that could be where the real story is.

Suggestion: Read more about this problem in "**Don't be Suckered by Cash Flow Statements**" and "**Shielding Portfolios Against the Next Sino-Forest**".

4. RELATED-PARTY TRANSACTIONS

This is just a nicer way of saying self-dealing, which is when a company does business with its executives, directors, related companies or otherwise non-independent entities. Related-party transactions are a hornet's nest of potential problems.

Loblaw, for example, recently announced it would spin out some of its real estate into a REIT, over which it would maintain majority control. Would you invest in a REIT with overexposure to a single tenant with the ability to sell more assets to you on its own terms? What discount on the $9-billion to $10-billion asset value established by management would be appropriate when assessing the value of both Loblaw and the REIT?

Suggestion: Heavily discount any figures companies estimate on their own, especially when the deal involves a related-party transaction.

5. CHANGES IN ACCOUNTING STANDARDS

Canadian companies have the option to use either U.S. accounting rules or International Financial Reporting Standards (IFRS), with roughly 20% of the S&P/TSX 60 choosing the American standards. With the switch from old Canadian rules to IFRS occurring just two years ago, there have already been some second thoughts, which raises the spectre of standards shopping. Encana, for instance, switched to using U.S. rules after just one year with IFRS.

Suggestion: Check a company's results under the accounting rules they just abandoned to quantify the impact of any boost in perceived value they got from switching horses mid-race. It might be enough to change your opinion on the stock.

6. INTANGIBLE ASSETS

Analysts frequently turn a blind eye to red flags like high proportions of intangible assets and minimal shareholders' equity, leaving advisors to catch the warning signs. For example, CML Healthcare's long-term debt outstrips its tangible assets by 2.2 to 1, and debt to equity is over 7:1. These weak metrics existed well before the company's share price collapse last year.

Suggestion: Don't ignore the classic warning signs of an overleveraged company susceptible to a crunch.

7. COMPLEX ACCOUNTING SITUATIONS

Some stocks invite seemingly endless questions, leaving even the most persistent advisors befuddled. In looking at the most nebulous examples, rarely have we found a case where a company using complex accounting is undervalued by the market. Analysts tend to oversimplify, and in doing so, focus too much on the positive while ignoring telltale risks.

Suggestion: Take a pass when analysts overexert themselves trying to explain away legitimate concerns. Too many unanswered questions can leave clients unnecessarily exposed.

8. NON-STANDARD OPERATING METRICS

Some companies provide alternatives to EBIT or EBITDA, the standard measures of net income. The risk for investors is in the items excluded from the customary measure.

There are legitimate reasons to use alternative metrics, such as to exclude one-time gains or adjust for a 53-week retail year. But when a company removes recurring operating expenses other companies routinely include, it can be a serious red flag (e.g., Just Energy: the company produces its own earnings measure known as Adjusted EBITDA, which excludes a significant portion of marketing expenses, as well as other adjustments).

Suggestion: Base valuation on a company's results using standard, unadjusted measures.

9. HIDDEN PENSION LIABILITIES

Companies can delete billions of dollars in liabilities from their balance sheets by simply choosing an overly enthusiastic discount rate on their defined-benefit pension liabilities. BCE provides an excellent example of these loose accounting rules at work.

Suggestion: For more details, read "**Companies Hide Billions in Pension Liabilities**".

10. CAPITALIZED EXPENSES

This well-worn stunt never loses steam because it's so easy to pull off. Management can capitalize expenses either to mislead (think Livent), or simply muddy the process of valuing its stock. Loose accounting requirements and weak auditing efforts can result in normal expenses being turned into purported assets. While fraud does occur, the biggest risk to investors is when results are simply mis-interpreted by the market.

Suggestion: Check to see if peer companies are also capitalizing expenses. If not, adjust valuation multiples accordingly to even the accounting playing field.

11. REVENUE RECOGNITION

Revenue recognition is usually not an issue for most companies. But there are enough recurring problems to give advisors reason to pay close attention to companies that grow revenue quickly or are engaged in complex product and service deals.

Suggestion: Be particularly mindful of multi-year contracts covering a mix of products and services, as well as companies that invest in firms they do business with.

12. MARK-TO-MARKET GAINS AND LOSSES

Under IFRS, real estate companies can choose whether to mark-to-market the value of their property portfolio every quarter. RioCan is an example of one that does. Many advisors don't know these adjustments can be based primarily on internal estimates by management.

Suggestion: Look deeper into the financial statements to find out whether the company uses third-party independent valuations to support its balance sheet.

13. STRETCHING FOR YIELD

With interest rates so low, many companies try to attract attention through dividends, leading some to push the envelope and offer yields in the 10% and higher range. Last year saw several examples of companies cutting their payouts when cash started drying up.

A big warning sign is when companies have payout ratios that exceed 100% of operating cash flows and resort to paying their dividends with borrowed money. When these companies have weak prospects for improving the operating cash flows needed to start paying back the borrowed funds, investors should consider abandoning ship (e.g. Bell Aliant. The stock yields approximately 7%, but is saddled with a legacy business in long-term decline).

Suggestion: Avoid most ultra-high-yield plays, and invest in safer alternatives.

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