

A MOTLEY FOOL UK SPECIAL REPORT

6 DANGER SIGNS YOU CAN CHECK IN IN 15 MINUTES



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I Spell My Name Danger

If you opened this report with some trepidation, you're certainly not alone. Most investors would no sooner go digging through a company's financial statements than have a go at a broken toaster with a butter knife (bad example, but please hear us out). With a little Foolish help, this kind of financial sleuthing can soon become old hat though. You won't believe how much fun you're having. But for now, baby steps.

Forensic Files

Danger signs, red flags — call them what you will. Fools have been running the numbers on prospective investments since at least as far back as 200 B.B.E. (Before the Buffett Era). Those were simpler times, perhaps, but it wasn't long before some renegade accountant concocted the first accounting shenanigan and the very first balance-sheet detective cried foul. Hard to believe that from such humble beginnings sprung an entire cottage industry and a devilish moniker: forensic accounting.

Forensic accounting? Think Warren Buffett and a dash of 'Sherlock'. Practitioners ply their trade at the regulators, investment banks, and money management firms down The City's backstreets. Naturally, their fees make it a wildly profitable business.

But we won't burden you with their level of sophistication, much less expense, nor do we need to. We can dig up more than enough dirt in just a few minutes.

A Hill of Beans

For all the glamour and intrigue, forensic accounting starts and ends with financial statements. We have already alluded to creative accounting or accounting shenanigans. Essentially, this entails aggressive or fraudulent reporting of a company's business results or financial condition.

But entirely above board, accurately reported results are just as important to inspect; if you know where to look, you can spot trends that reveal deterioration in a company's business.

Before we dig into all that, let's step back even further. Financial accounting — or more precisely, the ways in which a company opts to regard and report its financial results — offers a very clear window into the inner workings, even the character, of that company's leadership. And when you get right down to it, it's hard to imagine a good business without good, honest leaders at the helm.

The nuts and bolts of accounting can wait, at least until we get a good look at management for danger sign No. 1.

6 DANGER SIGNS

1 Management Churn or Scandal

Leaders come and go — be sure you know the reasons why.

2 A History of Restatements or Late Releases

Tangled financials can take their toll.

3 Swimming with the Loan Sharks

Does excessive debt have a company in over its head?

4 Disproportionate Growth in Trade Debtors

Avoid adventures in revenue recognition.

5 Disproportionate Growth in Stocks

Do the goods on hand keep up with sales?

6 Insufficient Cash Flow

Beware of rising earnings if there isn't the cash to back them up.

Danger Sign No. 1

EXECUTIVE CHURN OR SCANDAL AT THE TOP

Companies should never fit their executive suites with revolving doors. There are legitimate reasons that a managing director or financial director might step down. People retire, people look for new challenges (it helps if they've met the latest ones, of course), and sometimes things just don't work out.

Beware, however, if your company's top chaps and chapesses take flight suddenly and without explanation. If you suspect they've been forced out, or worse, if their departure seems unremarkable because their predecessors went the very same way, look sharp!

Bad actors have a way of returning to the stage. Beware if your company's boss, or for that matter, any member of its upper management, has run afoul of regulators or even manned the helm of a sinking ship before. Bad things happen to good people, and bad people change.

But forensic accounting isn't about giving a guy a break or a second chance to get his life back on track. The company's shares will trade with or without you; if you're not sure about management, let somebody else buy into it. There are plenty more shares in the sea.

Danger Sign No. 2

A HISTORY OF RESTATEMENTS OR LATE REPORTING OF RESULTS

The Day of Reckoning may be eagerly awaited by minority cults on a schedule, but it spells a grim day for investors. It's bad enough to be caught holding the baby when a business loses its edge and withers on the vine. Much worse is to have that baby dropped on your head like a ton of bricks (or metaphors).

Unfortunately, the ton of bricks scenario is a City standby. It doesn't help that panicked managers often stretch the rules to hide their multitude of sins. And here begins the bridge between management integrity and financial reporting.

Once about as common as an unbiased stockbroker, accounting restatements have become a sign of the times. This was especially characteristic of the later stages of the great bull market, as companies constantly upped the ante in the competition to boost results and drive stock prices ever higher.

When management finally does get caught, whether by an internal investigation or by outside regulators, the gig is up, and the gilded results must be restated — and the wrath of the market can be swift and merciless. A restatement of earnings can happen for any number of reasons, most of them bad. But again, this isn't jury service. You're no hangman; you're merely saying "thanks, but not thanks" to a share.

If a company's financial reporting has ever gotten so tangled that it was forced to miss or put off reporting its results, run for the hills. Management will do almost anything to avoid this, so if the firm's stumbled this badly, it can be really bad news.

So how do you know? Earnings and accounting restatements are not the types of things companies like to broadcast to prospective investors, but restatements aren't easily swept under the carpet. First, search the company's two or three most recent annual reports, and also look for any RNS releases announcing a restatement of earnings.

Such announcements are available online from company websites and from online investing websites. For a belt-and-braces approach, try searching for news on the company using your Internet search engine of choice, and keywords like 'accounting', 'restatement', and 'restated earnings'.

This might all sound like a bit of work, but it's a sure way to get to know any company you own.

Danger Sign No. 3

SWIMMING WITH THE LOAN SHARKS

Back in the day — 'the day' being any time up to and including yesterday, but in this case, the 1990s — investors had little use for corporate balance sheets. All that mattered was what a company earned or seemed poised to earn in the future. The bear market put paid to such boundless optimism.

The balance sheet is where companies report what they owe and what they own, and perhaps more importantly, what it's all worth. We'll look into the latter in danger signs Nos. 4 and 5, but for now let's focus on debt.

If you've ever bought a house or a car or an engagement ring, you know that debt has its place. As always, the key is moderation. Enron, Connaught, Polly Peck: Pick a debacle, any debacle. This particular 'axis of evil' had company specific problems, but all three shared something else, and they share it with most of the other roadkill in the stock market: serious, serious debt.

The thing about bills is that the harder times get, the more likely the burden of paying them will send a company into a death spiral. And heaven help us should management miss a debt service payment or suffer a crippling credit downgrade.

So how much debt is too much? We may be pressing our 15-minute mandate, but the fact is, it's all relative, so you'll do best to compare a company's debt levels with those of its competitors. And for this, you must resort to ratios (raw numbers won't work; £1 million is loose change for your local Russian Oligarch, but a lottery win for you and me).

Any number of good ratios can do the job, but let's focus on

the tried-and-true: the debt-to-equity ratio. To get started, find the value for total debt off the company's latest balance sheet and slap it atop the value for shareholders' equity. By comparing debt to equity like this, we get a feel for the resources a company might possibly toss out to keep the wolves at bay should they show up at the door.

You've probably weighed your own obligations against your own personal possessions (if you're like us, about 10 times a day). You certainly want to have more than you owe (a debt-to-equity ratio less than 1, preferably comfortably less). Just as importantly, when it comes to investing, you really don't want your horse carrying more debt than the rival runners and riders.

Things may well go swimmingly, but if the economy or sector turns sour, it can be a long way down for those with the biggest loads. Why take the risk? The beauty of investing is that you never, ever have to roll the debt dice.

LIVING ON A PRAYER

We're halfway there. The first three danger signs clearly sport a scandalous hint of... well, scandal (or at least poor judgment). But like we said, bad things sometimes do happen to good people. Our remaining danger signs deal with what might be termed "business deterioration." All three can result from "creative accounting," but each might also afflict rigorous, thrifty, and downright ethical leaders. Give them the benefit of the doubt if you like, but management's good intentions in no way mitigate the threat to your portfolio. All three of the following can lead to the dreaded accounting restatement, and all three are signs you don't want to see, beginning with No. 4.

Danger Sign No. 4

UNEXPECTED BUMPS IN TRADE DEBTORS RELATIVE TO SALES

Because they represent future cash receipts, trade debtors — like stocks — are considered an asset, but they can at times be more of a liability. After all, while we like to have money coming to us, growing trade debtors might well imply that customers are unwilling, unlikely, or unable to pay up. Worse yet, trade debtors also rise relative to sales when sales have been booked before the goods are ordered or delivered (known as channel stuffing), or simply booked by unscrupulous managers with no intention of ever delivering the goods.

In the biz, that's what's known as premature or fictitious revenue recognition, and it's really bad news. But you can easily spot trouble by seeing if the company's trade debtors are growing faster than sales.

Another handy trick is to calculate what is known as 'days sales outstanding'. Simply divide 'Trade debtors' by annual revenue, and then multiply that by 365. This tells you how

many days it takes your company to collect on any one day's sales. If this number is growing over time, you could have a problem; if it exceeds industry norms or what you'd consider reasonable credit terms (for example, 60 days), you most assuredly do.

Again, creeping debtors can be caused either by bad business or by bad business practices. Either way, you don't want to see accounts receivables growing more rapidly than sales.

Not only because of what this implies directly, but because, like characters in a bad sitcom, fear of discovery could goad ordinarily law-abiding (if morally irresolute) managers into ever-more creative accounting or outright fraud.

Danger Sign No. 5

UNEXPECTED BUMPS IN STOCKS RELATIVE TO SALES

As we've just seen, in addition to posting assets and liabilities, the balance sheet offers an unexpected glimpse into a company's operations. One of the oldest and simplest tricks of the sleuthing trade is to watch for increases in stock on hand.

We know what you're thinking: Lots of stock has got to be a good thing, right? Not exactly. In fact, much as we covet the image of warehouses full of stuff, stocks aren't cheap to carry, and growing inventories could signal a weakening customer base, or worse, that the company has changed the way it values its unsold goods.

With stocks, there's an added twist. It represents the cost of unsold goods on the balance sheet. When those goods are sold, their cost is transferred to the income statement and subtracted as cost of sales sold on the way down to net income. Remember, when you're in business, your livelihood depends on your ability to sell stuff for more than it costs you to sell it.

Overvaluing stocks, essentially what remains on the shelf after all sales have been made, understates the cost of goods already sold, which in turn overstates net income or profit.

If this all sounds like a bit much, the good news is you don't even have to remember any of it to run our simple check. As with trade debtors, just compare stocks to sales. Again, you don't want to see stocks growing faster. It's that simple.

Like we said, there exists any number of reasons why stocks might grow faster than sales, but none of them is good. If the situation persists, all can lead to a stock writedown against future profits, which is definitely not good.

Danger Sign No. 6

MY CUP RUNNETH UNDER

If tracking debtors and stocks sounds like too much work, there is a shortcut. Both are susceptible to one quick test.

Ever notice how when The City says ‘results’, it really means profits? Well, surprise! Reported profit is a favourite target of creative accountants. It’s a sitting duck. And when you get right down to it, cash is what matters anyway.

You can therefore learn a lot by comparing operating cash flow to operating profit (a.k.a. ‘profits from operations’). Put plainly, you don’t want operating profit increasing when operating cash flow isn’t.

Fortunately, companies are required to report their sources and uses of cash, as well as their cash on hand for the most recent years in their annual reports. It’s all laid out right there on the statement of cash flows. And not only is the statement of cash flows pretty easy to use, it’s extremely difficult for management to abuse.

All we have to do is make a note of profit from operations from the income statement, then seek out the statement of cash flows, pluck the net cash flow from operations, and voilà!

The trick here is to compare the changes from one year to the next. If you find that operating profit is increasing at a faster clip than cash flow from operations, beware. If profits are rising year to year and cash flow is not, danger! Either way, something’s not right.

While the fact that profits are rising faster than cash flow doesn’t necessarily mean that management is up to no good, it’s never a good thing. It can indicate one of the problems we’ve highlighted above with trade debtors or stocks. Or could mean a company is treating a lot of costs as fixed assets. So rather than charging costs as they are incurred, they might be written off over several years, flattering profits in the process.

Conclusion

SO, THERE YOU HAVE IT:

1. Management churn or scandal
2. A history of restatements or late filings
3. Excessive debt
4. Disproportionate growth in trade debtors
5. Disproportionate growth in stocks
6. Insufficient cash flow relative to profits

These six danger signs are easily unearthed and frequently spawn turmoil somewhere down the road. And while none carries a mandatory death sentence, all can mean trouble for your portfolio. Generally you’re better off without them.

RISK WARNING

- The prices of all shares, and the income from them, can fall as well as rise.
- You run an extra risk of losing money when you buy shares in certain smaller companies including “penny shares”.
- There is a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up and you may not get back the full amount invested. It may be difficult to sell or realize the investment.
- You should not speculate using money you cannot afford to lose, or rely on dividend income for non-discretionary living expenses.
- Some securities may be traded in currencies other than sterling, and may also pay dividends in other currencies. Changes in rates of exchange may have an adverse effect on the value of these investments in sterling terms. You should also consult your stockbroker about any additional dealing or administrative charges.
- We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material aspects.
- Investors should seek appropriate professional advice from their stockbroker or other adviser if any points are unclear.
- This report gives general advice only, and the investments mentioned may not necessarily be suitable for any individual.

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