



## OLSTEIN ALERTS

### THE IMPACT OF THE QUALITY OF EARNINGS ON VALUING COMPANIES

#### The Importance of Error Avoidance

**A** fundamental premise of the Olstein investment philosophy is that there is a strong correlation between above-average performance and error avoidance. We believe that in order to achieve long-term investment success, an investor must first consider the financial risk inherent in each investment opportunity before considering the potential for capital appreciation. Thus, when considering any security for the portfolio, we analyze the downside risk before assessing upside potential. Our assessment of downside risk starts with an analysis of a company's quality of earnings. We assess the quality of a company's earnings by answering three important questions:

1. Do financial statements and other filings allow us to understand the reality of the company's unique business fundamentals, competitive edge and ability to generate free cash flow?
2. Does company management engage in conservative or aggressive accounting practices?
3. Is all material information necessary to evaluate the company properly disclosed?

We define a high quality of earnings by how realistically we believe a company's financial

statements portray what is taking place within the business (especially within the company's core business operations) and how accurately the financial statements characterize the sustainability of the company's earnings from operations.

#### GAAP-Based Earnings vs. Economic Reality

**T**o understand why the quality of earnings is important to estimating the value of an equity security, it is important to understand the philosophy and mechanics of the current system of corporate accounting. An equity security is worth the discounted value of the future expected cash earnings to be generated by the underlying company. However, Generally Accepted Accounting Principles (GAAP) requires that a company report earnings based on an accrual accounting. The first premise of accrual accounting states that revenue is recognized when a transaction occurs in which value has been exchanged. The revenue recognition may lead or lag the passing of cash. The other basic premise of GAAP accrual accounting is that the cost of a transaction should be recognized over the same period of time that the revenue associated with the cost is generated. The cost or expense recognition also may lead or lag the passing of cash.

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### Eliminating Management Bias in Financial Reporting

In reporting GAAP-based earnings, companies are given wide discretion within the rules. Some companies make conservative assumptions, while others are overly aggressive, which can produce widely differing results depending how management sees the future. In our opinion, most companies engage in some type of earnings management. It is an investment analyst's job to determine the economic realism of management's assumptions and to eliminate management biases by making the appropriate adjustments to reported earnings data. We believe there is nothing wrong or illegal about earnings management within limits. However, some companies exceed acceptable limits, and while their financial statements may be in accord with GAAP, they may not concur with economic reality. It is in management's best interest to report the best earnings possible to preserve financing alternatives, keep their stock options valuable and exercisable, and to keep shareholders happy through increasing stock prices. Thus, when management identifies problems it deems to be temporary, it has the option to adopt more optimistic assumptions. The optimism could result in income being recognized more rapidly because reserves are lowered or depreciation has been lengthened (over more years). The end result is that the reporting of an earnings disappointment is virtually eliminated under the belief that short-term problems will soon end. Unfortunately, in many cases, the future earnings disappointment that has been temporarily shelved becomes larger as the optimistic assumptions can no longer be justified. Although earnings management is an everyday occurrence, this process makes it difficult to get a clear picture of the company's basic business without

performing an intensive, inferential analysis of financial statements. So even under GAAP, a true measure of the earnings power of a firm's basic business can be distorted based on management's biased view of reality.

**IT IS AN INVESTMENT ANALYST'S JOB TO DETERMINE THE ECONOMIC REALISM OF MANAGEMENT'S ASSUMPTIONS AND TO ELIMINATE MANAGEMENT BIASES BY MAKING THE APPROPRIATE ADJUSTMENTS TO REPORTED EARNINGS DATA.**

Although there has been a vast improvement in the disclosure practices of public corporations over the past thirty years, the financial reporting system can always use additional improvement as new business practices evolve. However, it is important to note that all reporting systems rely on management judgment, leaving room for potential abuse or unrealistic assumptions. Improvement in disclosure practices over the past thirty years has made financial statement analysis more difficult and time consuming. Today a wealth of additional information, not available 30 years ago, is contained in the footnotes and management discussions in annual reports for anyone who wants to read with a skeptical eye. In order to value a company correctly and at the same time play defense as an investor, it is important to analyze and sort through the new information and adjust reported earnings to reflect economic reality. It is just as important to assess whether or not all the necessary information has been disclosed to properly assess a company's free cash flow.

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### Accounting Alerts – Factors that May Affect Future Cash Flow

**A**lthough we use several valuation methods to determine a company's private market value, they are all based on free cash flow. For us, reliable valuations require a thorough understanding of a company's accounting and reporting techniques as well as an assessment of the company's quality of earnings. In order to estimate sustainable free cash flow, the investment team undertakes an intensive, inferential analysis of the historical and current information contained in the company's publicly disclosed financial statements and accompanying footnotes, shareholder reports and other required disclosures. The goal is to assess a company's quality of earnings and to alert us to positive or negative factors affecting a company's future free cash flow that may or may not be recognized by the financial markets.

Properly assessing a company's quality of earnings is important to our valuation methodology because it provides us with:

- a) reliable estimates about future cash flow that are critical to projecting the future value of a company
- b) a measure of the sensitivity of our valuations to projected and unexpected changes in future free cash flow
- c) a measure of balance sheet strength and the company's ability to withstand problems that may last longer than originally expected
- d) the ability to assess the conservativeness of a company's management as well as its reporting and disclosure practices
- e) an ability to detect early signs as to whether or not a company's business policies and

strategic direction are capable of achieving the financial objectives necessary to reach our calculated values.

- f) the ability of a company's management to create shareholder value

**FOR US, RELIABLE VALUATIONS REQUIRE A THOROUGH UNDERSTANDING OF A COMPANY'S ACCOUNTING AND REPORTING TECHNIQUES AS WELL AS AN ASSESSMENT OF THE COMPANY'S QUALITY OF EARNINGS.**

### A Forensic Analysis of Financial Statements

**O**utlined below is a sampling of the forensic analysis we undertake when assessing and analyzing a company's quality of earnings. The ultimate objective of our analysis is to determine the sustainability of a company's free cash flow for valuation purposes.

1. Using the company's cash-flow statements, we begin by reconciling the difference between free cash flow and reported earnings under accrual accounting. The smaller the difference between free cash flow and reported earnings, the higher the quality of earnings.
2. Our next step is to look at a company's footnote on taxes, which reconciles the differences between earnings reported to shareholders under accrual accounting and earnings reported to the IRS under the cash basis of accounting. The lesser the difference, the higher the quality of earnings.

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3. We then analyze receivables and inventories to determine changes in each relative to changes in sales. Inventories or receivables increasing faster than sales could be early warning alerts of future slowdowns.
4. The company's investment activities are also extremely important to us, and we always compare depreciation provisions to capital expenditures when assessing sustainable free cash flow, the potential for future growth and management's ability to create shareholder value.
5. The next step in our quest to measure the quality of earnings is to look for non-recurring factors that have contributed to or reduced earnings. We measure whether or not earnings have been helped or hindered by monitoring historical changes in reserve accounts or determining whether bad debt provisions are temporarily above or below normalized amounts.
6. Balance sheet ratios, especially relating to debt and returns on equity, are carefully assessed to determine a company's ability to withstand temporary problems or an economic downturn without adopting harmful short-term strategies.
7. Another important factor that we consider is the repetitiveness of so-called non-recurring losses, which we believe represent corrections to historical financial statements.

**D**espite an exhaustive inferential analysis of a company's financial statements prior to investment, once in a while a company in our portfolio surprises us by engaging in questionable accounting practices. However, it is our objective to keep these surprises to a minimum. We continue to believe that paying attention to the quality of a company's earnings as well as its disclosure practices (presenting the relevant information necessary for assessing value) is critical to lessening the probability of making serious investment errors.

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### **OLSTEIN'S TOP TWENTY QUALITY OF EARNINGS ALERTS**

1. Material deviations between net income and free cash flow
2. Material differences between the tax books and shareholder books as measured by deferred taxes
3. Material changes in balance sheet debt and liquidity ratios
4. Inventories, especially finished goods or raw materials, increasing or decreasing faster than sales
5. Accounts receivable increasing or decreasing faster than revenue
6. Deviations between depreciation and capital expenditures
7. The repetitiveness and materiality of non-recurring write-offs
8. The role that non-trend line changes in reserves contribute to, or negatively impact, current earnings
9. The repetitiveness and materiality of non-recurring gains such as sales from venture capital portfolios
10. The impact and reality of a company's deferred expense capitalization policies as it effects reported free cash flow
11. Discretionary expenses deviating materially above and below trend lines
12. The reality, consistency and conservativeness of revenue recognition techniques when measured against the passing of cash
13. The impact that acquisitions have on sustainable free cash flow and the growth thereof
14. Changes in other asset accounts
15. The impact of transactions with special-purpose vehicles
16. Pension income and expense recognition measured against the pension plan's assumptions and the funded status of the plan
17. Large deviations between pro forma and reported earnings
18. The impact of option transactions on reported free cash flow and the impact on future results and valuations of the company
19. The capabilities of management as measured by their long-term decision-making capabilities; especially when problems develop; their attitude toward risk as measured by the quality of the balance sheet; and their preparation for a rainy day; their methodology of communicating with shareholders; and finally their ability and emphasis on returning value to shareholders
20. Disclosure of material information needed to assess the value of the company



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