How to Invest like a Forensic Accountant

[ The FAST System ]

JOHN DEL VECCHIO'S
Hidden Profits
UNCOVERING THE STOCKS THAT PAY YOU FIRST
EVEN before I cut my teeth in the world of finance, I was at it in college, earning Beta Gamma Sigma honors in business. Then, after school, I worked my way up from junior quantitative analyst to managing multi-million dollar portfolios with the likes of Redhawk, Active Bear, and Parabolix.

One thing drove me: my passion for forensic accounting. It still drives me. I live, breathe, and eat discovering what's really going on with a company's finances. Most of the time, what these guys are doing is perfectly legal… but it's oh-so-deceptive!

I have access to information no ordinary investor on earth has, and it’s given me the ultimate inside track on which companies are about to lift off or crash to Earth. And after doing this for 20 years, it’s become like a sixth sense to me.

As a subscriber to Hidden Profits, you'll benefit (and profit) from this expertise. I’ll also help you limit your losses, which, as I explain in The Rule of 72, is more than half of the equation to successful investing.

But that doesn't mean you can't learn to do what I do. In fact, I encourage it. The more you know, the better you’ll perform with your investments. You don't need to become an expert. You definitely don't need to develop that sixth sense. But understanding what we're doing, and why we’re doing it, is important. So that’s my mission with this bonus report: to show you how to evaluate a stock like a Forensic Accountant.

Read the following pages carefully. Scribble notes in the margins. Highlight the super important bits. Send me questions if something confuses you (hiddenprofits@dentresearch.com). And then apply this knew-found knowledge (skill!) to your personal investment portfolio to make sure you're not holding any duds…

As for finding FAST companies that not only have great future potential, but that know how to treat their shareholders properly… well, that's my job, and that’s my goal with Hidden Profits! Together, we'll find the winners and losers… and profit from both.

So let's get into the nitty gritty. I'll try to keep the technical stuff to a minimum, but that's tough in this world, so forgive me if I slip into forensic accounting jargon from time to time…

My Meat Grinder

To find FAST companies that pay out incredible gains and treat shareholders like the kings and queens they are, I use an in-depth cocktail of financial instruments that are either unknown or off-limits to ordinary investors.

To be exact, there are 26 variables I take into account when determining if a company truly fits the bill for us.
I measure these variables against the company itself and then compare them to every other company in the market. I’d list them for you, but that would be getting too far into the weeds.

All you need to know is that I created proprietary computer software to enable me to do this quickly and easily. Think of it as my “meat grinder” for stocks. It takes a massive list of stocks into account, runs them through those 26 variables, and then spits a condensed list of potential investments out the other end.

Once the initial legwork is done, it’s time to roll up the sleeves and dive into the financial statements, including a look at the notes… something even institutional investors rarely do. This is where we evaluate the company like a forensic accountant.

You won’t have my meat grinder for your own personal stock evaluation – those you choose outside of our Hidden Profits model portfolio — but you can still approach a potential investment using the six tests I do…

**Grading Stocks from A+ to F**

Always be weary of stocks and management. Most stocks underperform the averages. Most management teams are mediocre. Business is cutthroat, so capitalism has winners and losers.

To decrease the risk of a blow up and increase the odds of picking the winners, put every investment candidate through six tests. Think of them as subjects you took in school. Depending on how well the company’s doing in a subject, it earns a grade from A+ to F. All six grades add up to a final grade. A stock doesn’t have to earn all As to graduate, but it must have a B, or higher, average.

The six tests include:

- **#1 Revenue Recognition.**
- **#2 Cash Flow Quality.**
- **#3 Earnings Quality.**
- **#4 Expectations Analysis.**
- **#5 Valuation.**
- **#6 Shareholder Yield.**

Let’s cover each of these in detail…

**Test #1: Revenue Recognition**

The first test is whether revenue is of good or bad quality. If sales are suspect, all other numbers are questionable. It all starts at the top line of the income statement. Everything flows down from there. So your first task is to make sure that revenue is legitimate.

Understand that declining revenue is normal in business and not a sign of monkey business. Whether they sell chicken wings, sneakers, aircraft carriers, or software, all companies hit bumps in the road. The economy weakens. Customers can’t spend as much. Competition increases. New technology becomes obsolete.

Business is messy. Things happen.

But fast-growing companies or those with consistent growth are victims of their own success. Wall Street
rewards them with better ratings and investors are more likely to buy. So the slightest bump torpedoes the stock. And since the big money for management at most companies comes from stock options bumps aren’t good for their welfare. So management teams do whatever it takes to keep Wall Street happy.

The most common trick is to stuff the channel. A company does this by enticing customers to buy a product now instead of next quarter or next year. This boosts revenues to make the current quarter’s results look better.

The problem is that stuffing the channel steals revenue from the future and pulls it into the present. There aren’t more sales, they’re just earlier. Even if the company is growing, the supply of customers to stuff the channel with will run out sooner rather than later. When that comes to pass, the day of reckoning is at hand. The company falls short of Wall Street analyst estimates and it’s bye bye, stock.

There are many other ways management can accelerate revenue recognition. They can change how they recognize revenue, which could provide a huge boost to sales. But rising revenues from an accounting change is short term. When the effects halt, down goes the share price.

With this first test, you’re examining the timing of when the revenue actually hits the checking account. The longer it takes, the harder it is for the company to keep reporting growing revenues and prop up the stock price.

If management is aggressive on the top line, watch out below.

Test #2: Cash Flow Quality

You can’t spend earnings, only cash flowing into your bank account. It’s the same for companies. Only if a company produces more cash than it needs to run the business can it pay sustainable dividends, buy back cheap shares, or pay down debt — the three parts of shareholder yield we’re after in Test #6.

But companies rarely present the crucial cash flow statement with the earnings release. So it pays to be patient and wait for this information to become available in the quarterly SEC filings.

The first line item on a cash flow statement is the income statement’s bottom line — the net income. If net income has been manipulated, cash flow quality is suspect as well, and only the cash flow statement tells the real story.

Unfortunately, because we live in a world where everyone wants everything RIGHT NOW, by the time this information becomes available — days or weeks after the earnings announcement — many investors have moved on to the next thing.

Patience is your edge.

The cash flow grade is based on many factors. Look at how inventory, receivables and payables are impacting financial performance. Management can manipulate these items, collectively called “working capital,” to sneak a one-time cash flow boost. Can it be repeated? If not, what sly factors may have contributed to this unsustainable cash flow performance? Was cash flow propped up by acquisitions, when few acquisitions actually succeed?

Because businesses have good times and bad, and because they can manipulate cash flow over the short term, you want a company that shows dependable, consistent, and sustainable operating and free cash flow over time.
**Test #3: Earnings Quality**

Even though revenue is the essence of a company, both Wall Street and Main Street investors focus mostly on its earnings. Wall Street reports focus on analysts’ consensus earnings estimates and then the financial news media obsesses about every penny difference between the estimates and the results — “miss by a penny” or “beat by a penny.”

However, a focus on earnings is misguided. It’s earnings *quality* that matters.

On a company’s income statement (and statement of operations), revenue is at the top and earnings are at the bottom. The phrase “the bottom line” elsewhere means final and authoritative, but company earnings are almost always a made up number. Over 90% of companies adjust their earnings to some degree because accounting principles are not concrete. They can be vague or give management a lot of leeway to estimate a number here or there. There’s a pretty big gap between GAAP (Generally Accepted Accounting Principles) and cash reality.

Not all of these little adjustments are important alone, but they can add up as we travel from the top line to the bottom.

Our concerns about any of these items vary according to where they show up on the income statement. Since revenue is at the top, that is number one. As you move down the income statement, there are various line items that impact the bottom line. For example, a company might manipulate its gross margin by writing off obsolete inventory in one quarter only to sell it at a later date and get a 100% margin boost.

Wall Street and Main Street get all hot and bothered by expanding profit margins. But what if those margins are an accounting mirage? What’s to be excited about then? Don’t expect anyone to do real work to confirm whether expanding margins are the result of better pricing of raw materials (shaky because that might change tomorrow) or increased demand (good because more customers want the company’s products). People just glance at the headlines and move on. Don’t be one of those guys.

A company could also take a bunch of charges related to the winding down of a business and create larger-than-necessary reserves to pay severance for laying off workers. Later the company could reverse that reserve for a 100% boost to their operating margin.

Company executives have many ways to manipulate perceptions because they know few people pay attention. **PAY ATTENTION!**

**Test #4: Expectations Analysis**

Markets change, the leaders of the markets change, and technologies that drives the markets change, but Wall Street never changes. The firms and their analysts are poster children for confirmation bias: sheep roaming around in a herd and ultimately slaughtered together.

As an analyst, it doesn’t pay to think too differently from the crowd; it can cost you your job. Too high or too low an estimate risks making you look foolish or incompetent when the company numbers come out.

Taken as a group, earnings estimates move toward a consensus.

Let’s say Wall Street analysts expect XYZ Company to earn $1.00 per share this year, but it ends up earning
$1.25, blowing away expectations by 25%. A “smart” analyst on the Street who saw better than $1.00 for the year didn’t come out with an initial $1.25 earnings target. She might have stuck her neck out a tiny bit to $1.05… but that’s about it.

Then, throughout the year, if the company reports its earnings and things are looking good, analysts may increase their estimates slowly. Soon the consensus view starts to match the financial performance the company actually realizes. (The estimates may start to decline through the same process.)

You want to be ahead of — not behind — rising or falling estimates.

If we look closely at the financials and see something different than the herd does, we can invest before the estimates start rising or sell before they fall. Everyone else is looking in the rearview mirror, expecting the road ahead to be smooth and safe. We’re not that foolish.

Earnings quality work ignores estimates as an investment tool but benefits from them. Evaluate the overall earnings quality of a company’s reported results using Price-to-Earnings Quality. If earnings quality is high and the valuation of the stock is reasonable in relation to the quality of earnings, then rising estimates over the next couple of quarters are likely to attract buyers and a higher stock price.

If earnings quality is low and the valuation is high in relation to the poor earnings quality, estimates are likely to come down in future quarters and bring the stock price with them.

**Test #5: Valuation**

Next to shareholder yield, valuation is the most important test. When investors get sucked into the glossy growth story surrounding a company’s prospects, they often ignore a critical factor: what valuation are they paying for those prospects? If the rosy forecast is already baked into the cake, then the upside to owning the stock is limited.

Every investment must have a margin of safety, an estimate of how you can lose if everything goes badly. You must find those situations where you’re paying $0.50 for an asset worth $1.00.

Plus, when stocks are on sale at bargain basement prices, the companies may look very ugly. The stock market doesn’t just give away $1.00 for $0.50 without your having to hold your nose and close your eyes. So don’t dismiss a company out of hand just because Wall Street does. In fact, if the pros aren’t showing much interest, sit up and do some forensic accounting of your own.

If the report card you create is strong or improving and the stock is cheap enough, buy it. It doesn’t need to be on the Dean’s List with As in every subject. As long as it earns good grades on these six tests and detention is unlikely, the stock offers very good odds of making money.

To be clear about valuation (and its importance), just think about your home. How often do you wonder what a property is worth? All the time, I’d say. How often do you consider what another housing crash would do to it? Not nearly as often, I’d imagine. That’s because most of us care only about comparable prices and the monthly payment.

But like gold or a painting, a house has no intrinsic
value other than wood, windows, wiring and pipes. It’s worth what people say it is. But rent it out and suddenly it has real value based on the amount of its net rental income. It becomes an investment with income, expenses, and profit or loss.

This is the only protection there is: if the price of any income-producing asset declines, someone will buy it when the potential income — after expenses — is great enough to justify the price.

This is exactly what happened in the housing crash of 2008. Buyers ranging from individuals to large real estate investment trusts snapped up hundreds of thousands of houses from desperate sellers. To know whether they would earn a sufficient return on their investment, they used the real estate concept called capitalization, or “cap” rate.

The formula is:

\[
\text{Cap rate} = \frac{\text{Income} - \text{Expenses}}{\text{Sales Price}} \text{ (expressed as a percentage)}.
\]

For a home that could produce $12,000 a year (after expenses), a sales price of $150,000 results in a cap rate of 8% (8% of $150,000 is $12,000).

The chart below shows the relationship between cap rate and sales price. As you can see, for any given sales price, cap rate, or net income, the relationship between sales price and cap rate is the same. As the cap rate (dashed line) declines, the implied sales price (solid line) rises. As the cap rate rises, the implied sales price declines.

Buyers want a higher cap rate — to pay less for more. And sellers want to get more money for less — a lower cap rate.

With stocks, we want to pay a low multiple — such as a low P/E or free cash flow ratio — but for real estate we want a high cap rate — lower valuation multiple. Pay or own real estate at a high cap rate and you have a greater margin of safety. It’s that easy.

At the end of the day, valuation determines future returns. Pay too high a valuation and you immediately lower your potential returns. Pay a low one and sometimes downside risk is so small that your upside is practically free.

**Test #6: Shareholder Yield**

The final exam tests whether the company meets my FAST criteria and it’s all about what it does with the cash — our cash, because as investors we’re part owners.

All day long CEOs decide whether to put money here or there. Their daily lives are all about opportunity cost. We want them to make choices that offer the greatest odds of success.

Most CEOs concentrate on growth investing — building more manufacturing and distribution facilities, hiring more software developers, buying other companies and growing empires! But that’s not the best use of shareholder money. More often than not, these fail to create a more valuable company. The investments don’t earn a sufficient return, and roughly 85% of mergers and acquisitions fail to add shareholder value.

So test companies to see if they put us first through shareholder yield, which they make possible with
sustainable dividends, stock buybacks at value prices, and higher-interest debt pay down.

The more of these three ways the company pays us to own its stock, the more risk is taken out of the investment decision, and the better odds of stock gains.

Shareholder yield removes cash from management’s hot little hands. It limits their choices.

Paying down debt saves on interest payments, freeing up more cash.

If the company’s shares are selling at a price that places a very low value on the company, buying its own stock is a good investment. And when the company buys back shares, our shares own more of the company, earnings and cash flow per share rise, and the stock price eventually rises.

Plus, if a company pays dividends, every share it buys back eliminates paying the dividend on that share, forever. If the dividend yield is 4% a share, the company “earns” 4% a year forever just by not spending it anymore.

But beware. It’s not enough to check the three off a list. Any management can offer shareholder yield, but few can do it well.

Here’s how you can tell…

- **Dividend Analysis:** Dividend analysis for shareholder yield is crucial. Fortunately, it’s brief and easy. Simply answer the question: does the company have enough cash on hand and coming in to maintain the current dividend through thick and thin, and potentially grow it?

  The guideline is that a company should not pay out more than 50% of its net income or free cash flow in dividends. No matter how good its quality is, earnings or cash flow must be available for the inevitable rough patches a business goes through.

  You don’t want to own a stock yielding 4% only to see the dividend cut when the company needs cash. If that happens, the stock losses will dwarf any dividends received.

- **Buyback Analysis:** As for buybacks, there are good and bad ones.

  The rule is that management should spend money where it can earn the most return. Sometimes it’s right to buy the company’s own stock. Management is in the best position to know whether the stock is undervalued. If it’s selling for a good discount, it not only makes sense to buy it, it should probably be required.

  Buybacks may also be a sleight of hand. Many companies will buy back shares because they fear that if shareholders knew how many options were issued they wouldn’t like it. The company actually uses our money to buy shares at higher prices so they can reissue them as options at lower prices. The options then show up in the share count, but who’s squinting to see? They shrink the value of our ownership and use our own money to do it! Avoid these companies.

- **Debt Pay-down:** And finally, to provide the shareholder yield we deserve, make sure a company is paying down high-interest debt.

  Debt pay down is easy to understand, because everyone who uses a credit card can play
along. Let’s say you carry a $1,000 balance at 15%. Every dollar you pay off saves you 15 cents a year in interest. That’s a 15% gain, in effect, and a great return on investment.

There are some advantages to company debt, however. For example, a business can deduct interest from income for tax purposes. This can make debt very attractive for companies that plan to use it for projects that may earn them more than the cost of interest (one opportunity cost). Second, company debt can be bonds, which pay out interest and then the full amount of the debt at maturity, but companies typically never pay it off, refinancing debt into the future.

And then companies can and do have revolving loans or lines of credit that are like credit cards or a home equity line of credit, and paying those down offers the same immediate savings as when you pay off your credit card debt. You want the companies paying down their high-interest debt.

There you have it. Now you can evaluate a stock like a forensic accountant. To wrap up, here’s a quick checklist to use…

Insist on high grades on these six tests to pad your investment account with solid returns.

Here’s to finding those hidden profits!

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About John Del Vecchio

Co-Author of What's Behind the Numbers?: A Guide to Exposing Financial Chicanery and Avoiding Huge Losses In Your Portfolio (2013) and The Rule of 72 (2016). John is a Forensic Accountant at heart. Standing on the shoulders of the great David Tice, James O'Shaughnessy, and Dr. Howard Schilit, he built a framework of algorithms and a multi-factor grading system that has made him one of the more successful short-sellers around. John graduated Summa Cum Laude from Bryant College with a B.S. in Finance and was awarded Beta Gamma Sigma honors. He earned the right to use the Chartered Financial Analyst designation in September 2001.