



#### This 3DAdvisors Report Covers:

- ✓ **Insider Trading:** Insider Trading Behavior
- ✓ **Accounting:** Quality of Earnings Issues
- ✓ **Governance:** Corporate Governance Issues

## Running Out of Options on “Channel Stuffing” Suit Avon Products, Inc. (NYSE:AVP) Update

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Avon Products, Inc. is a global manufacturer and marketer of beauty and related products. The Company's business is comprised of direct selling, which is conducted in North America, Latin America, Europe and the Pacific. Avon's products fall into four product categories: Beauty, which consists of cosmetics, fragrances and toiletries (CFTs); Beauty Plus, which consists of jewelry, watches and apparel and accessories; Beyond Beauty, which consists of home products, gifts, decorative items and candles, and Health and Wellness, which consists of vitamins, an aromatherapy line, exercise equipment and stress relief and weight management products. The Company has operations in 58 countries, including the United States, and its products are distributed in 85 more countries, for a total coverage of 143 markets.

### Summary of 3DAdvisors Findings for AVP

- **Accounting:** AVP runs out of options with California Superior Court decision

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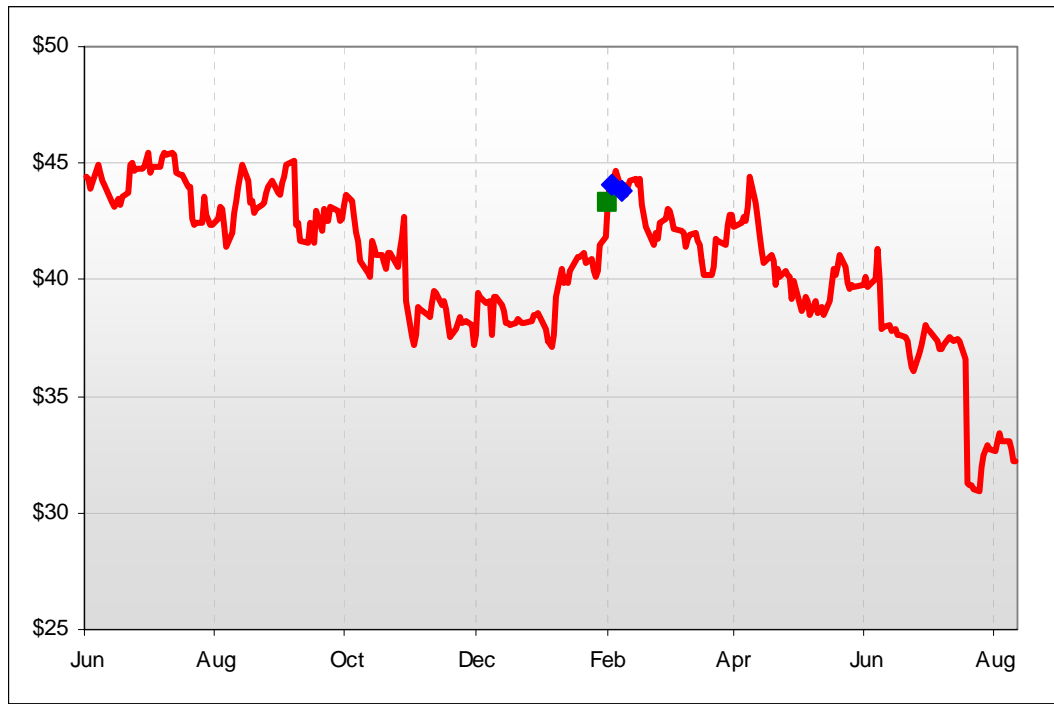
### Discussion of 3DAdvisors Findings

We were not at all surprised by Avon's weak second quarter results and the lowering of its full-year guidance back on July 19<sup>th</sup>. The stock of course took a pretty good beating, trading almost 70 million shares over the next 5 sessions before hitting a nearly 15 month low of \$30.89 on July 25<sup>th</sup>, down \$5.71 or 15.6% from the closing price of \$36.60 on the day before the earnings release.

We say the results came as no surprise because the specific problems that became evident in the Q2 results were gleaned by us from the executive behavior during the Q1 conference call. In our AVP update published on 02/15/05 immediately following the Q1 call, we noted that the behavior of Chairwoman **Andrea Jung**, who repeatedly dodged key questions about overseas sales, margins, and inventories, was remarkably similar to the evasive behavior Company executives displayed when questions started to surface regarding the slowing U.S. market in late 2003 and early 2004. Underscoring the slippery behavior, President and COO **Susan Kropf**, CFO **Robert Corti**, and Director **Stanley Gault** all executed their largest sales on record within just a couple of

days of the conference call. Corti's behavior in particular stood out to us, as he made a dramatic break from his conservative behavior of the past and unloaded 204,224 shares, or **56% of his actionable position** (common stock plus exercisable options), just three days after the conference call. As we said in the update, this is a big reduction for any CFO, but especially for one where the Chairwoman is quoted in the earnings press release making glowing remarks about the Company's continued positive outlook for "unleashing further growth as we continue to move forward with Avon's transformation."

**Figure 1.** AVP Daily Closing Price, June 1, 2004 through August 11, 2005. Blue diamonds are the dates of sales by Corti and Gault (02/03/05) and Kropf (02/09/05). Green square is the date of the Q1 earnings release and conference call (02/01/05). Source: Reuters and AVP SEC Filings.



We were also not surprised to see that four proposed or filed securities class-action lawsuits were announced, nor were we surprised to see the Company try to sooth the concerns of investors by announcing a \$500 million addition to its share buy back program. The suits all allege essentially the same thing: that the Company and its board knew that it was having difficulties in China and Russia and other foreign markets, and gave misleading guidance to investors in violation of securities laws. Interestingly, in none of the announcements is there any reference to any of the accounting or trading behaviors we have observed, which would obviously give the suits some teeth.

Amidst all of this activity in the wake of the Q2 earnings debacle, we believe something potentially much more important has occurred that our clients need to be aware of. On Wednesday, August 10, the California Superior Court quietly ruled against Avon in the "channel stuffing" class-action lawsuit which we have been following very closely for over a year. This suit may now be much closer to acting as a catalyst

by revealing certain behaviors that have allowed the Company to overstate revenue and income in the U.S. and overseas.

#### Accounting: AVP runs out of options with California Superior Court decision

We mentioned in the 02/15/05 update that the “channel stuffing” lawsuit brought by former Avon reps was still very much alive, and that the California Court of Appeal was about to hear oral arguments concerning the Appeals Court decision to overturn the trial judge’s ruling to dismiss three of the four original “causes of action”. In a subsequent update we published on 05/09/05, we notified our clients that the Court of Appeal ruled against Avon, and ordered the causes of action reinstated, along with the former reps which the trial judge had removed from the case. Even though this decision was handed down in early May, the Company did not disclose this reversal until the recently filed SEC Form 10-Q, nearly three months after the fact.

From the Company’s second quarter SEC Form 10-Q (page 10), filed on July 28<sup>th</sup> (bolding is ours for emphasis):

*Blakemore, et al. v. Avon Products, Inc., et al.* is a purported class action pending in the Superior Court of the State of California on behalf of Avon Sales Representatives who “since March 24, 1999, received products from Avon they did not order, thereafter returned the unordered products to Avon, and did not receive credit for those returned products.” The complaint seeks unspecified compensatory and punitive damages, restitution and injunctive relief for alleged unjust enrichment and violation of the California Business and Professions Code. This action was commenced in March 2003. The Company filed demurrers to the original complaint and three subsequent amended complaints, asserting that they failed to state a cause of action. The Superior Court sustained the Company’s demurrers and dismissed plaintiffs’ causes of action except for the unjust enrichment claim of one plaintiff. The court also struck plaintiffs’ class allegations. Plaintiffs sought review of these decisions by the Court of Appeal of the State of California and, in May 2005, the Court of Appeal reinstated the dismissed causes of action and the class allegations. Avon has filed a Petition for Certiorari with the California Supreme Court seeking clarification of the standard for appellate court review of a trial court’s decision striking class allegations. The Company believes that this action is a dispute over purported customer service issues and is an inappropriate subject for consideration as a class action. While it is not possible to predict the outcome of litigation, management believes that there are meritorious defenses to the claims asserted and that this action should not have a material adverse effect on the Consolidated Financial Statements. This action is being vigorously contested.

The “Petition for Certiorari”, highlighted above, which was a last ditch stalling effort on the part of Avon, was denied by the California Supreme Court on Wednesday, August 10<sup>th</sup>. We asked Jeffrey Huron, the lead attorney for the plaintiffs, what the practical significance of the denial meant. He told us, “Avon has no further recourse for overturning the court of appeal decision [to re-instate the original “causes of action” and each of the plaintiffs that were dismissed by the trial judge]. The case now proceeds to discovery (we get to see their cards) and then our motion for class certification. The court of appeal has already said that they believe certification is possible. There is nowhere for Avon to go now.” Huron also indicated that he felt Avon has made a tactical error by not initially accepting the Court of Appeal ruling that reversed the trial judge, because by forcing the oral arguments before the appellate court, the court indicated in its written opinion that the plaintiff’s probably do represent a certifiable class.

We bring these legal developments to the attention of our clients because we believe the discovery process could be quite revealing, as Huron has plans to depose **Brian Connolly**, EVP and President of Avon North America, **John Flemming**, former VP of Avon West, and several individuals involved in credit and collections in Avon's western region. From these depositions, many important details could emerge, such as how and when Avon decides to ship goods to its independent representatives and how and when it decides to take write offs for "doubtful accounts" and "sales returns" (a key issue), and why it has consistently under accrued for these items in its financials despite repeated operating experience that shows the accruals should be dramatically increased. We believe the Company has been able to manage its revenue and earning numbers effectively by simply shipping unordered goods to reps, and when forced to accept returns, simply timing the write-offs in periods when it could afford to take them. In addition, as we also pointed out in the 02/15/05 update, there is evidence that the channel stuffing behavior extends beyond domestic borders, a very damaging possibility for a firm that until recently has convinced Wall Street that it's status as a growth company is well deserved due to the opportunities afforded it in taking its proven brand and distribution model overseas.

In short, the "channel stuffing" suit is very much alive and we *still* think it has the potential to act as a catalyst by revealing that the Company has engaged in certain practices that have in effect over-stated revenues, and hence earnings, both in the U.S. and overseas. Huron tells us it will probably be 60 days before depositions are taken, but it is uncertain how long it will be before any information revealed in the discovery process might become public. We will continue to follow developments regarding the suit very closely and report any new information as soon as it becomes available to us.

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