3D ADVISORS

This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues

Significant New Disclosures in Recently Filed 10K Avon Products, Inc. (NYSE:AVP) Update

March 9, 2004

Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

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:** Allowance for "sales returns" grossly and repeatedly under stated
- **Insider Trading:** Executive insider sales speak volumes
- **Insider Trading:** "Rank and file" selling continues at record pace

---

Discussion of 3DAdvisors Findings

We have been concerned about Avon's under-provisioning for Doubtful Receivables and the related effect on Revenues and Working Capital calculations. Avon's actual receivable write offs, being much larger than it's A/R allowance, have provided credible evidence that certain channel-stuffing allegations made in a class action lawsuit filed against the Company may very well have merit (see earlier 3DA reports dated 9/22/03, 1/5/04, and 1/23/04). New information has surfaced, in the recent Company 10K (released March 4th) that put a significant "exclamation point" on the subject, not to mention the related under-allowancing and its effects on revenues, reported working capital and certain asset valuations.

In the new 10K filing, the Company has for the first time fully disclosed the existence and magnitude of its *allowance for sales returns*, along with actual experience for 2003 and two prior years. It is clear that the allowances for doubtful accounts *and* allowances for sales returns as recorded on the balance sheets for at least the last three years are woefully inadequate relative to actual experience and the write offs that must ultimately be taken. Certainly this practice calls into question the fairness of the values at which accounts receivable and certain liabilities are shown on the financial statements. No explanation is offered in Management's Discussion and Analysis, or in the Financial Statement Notes as to why the subject allowances, for at least a three-year period, have been so grossly under accrued. This behavior, which now appears far more pervasive than we originally believed, has several important implications for investors.

Accounting: Allowance for "sales returns" grossly and repeatedly under stated

The Valuation and Qualifying Accounts section in Avon's new 10K caused us quite a double take. In it was revealed the fact that Avon's Allowance for Sales Returns was just $17.6 million while actual write-offs, for the period, totaled almost $290 million, and this in addition to a widening of the gap between the Company's Allowance for Doubtful A/R's, now at $49.5 million, and actual write offs which total $124.8 million. Similarly large discrepancies existed for the prior two years. Here's the related section from the 10K (red text is added by us for emphasis):

AVON PRODUCTS, INC. AND SUBSIDIARIES
SCHEDULE II -- VALUATION AND QUALIFYING ACCOUNTS
(In millions)
Years ended December 31

Description	Balance at beginning of period	Additions: Charged to costs and expenses	Additions: Charged to other accounts	Deductions	Balance at end of period
2003					
Allowance for doubtful accounts receivable	$ 49.5	$ 124.8	$ -	$ 111.2(a)	$ 63.1
Allowance for sales returns	17.6	289.8	-	287.9(b)	19.5
Allowance for inventory obsolescence	39.8	55.6	-	50.8(c)	44.6
Deferred tax asset valuation allowance	37.7	14.4(d)	-	-	52.1
2002					
Allowance for doubtful accounts receivable	$ 45.1	$ 108.3	$ -	$ 103.9(a)	$ 49.5
Allowance for sales returns	13.5	266.5	-	262.4(b)	17.6
Allowance for inventory obsolescence	45.3	58.9	-	64.4(c)	39.8
Deferred tax asset valuation allowance	28.8	8.9(d)	-	-	37.7
2001					
Allowance for doubtful accounts receivable	$ 39.2	$ 105.6	$ -	$ 99.7(a)	$ 45.1
Allowance for sales returns	11.2	261.1	-	258.8(b)	13.5
Allowance for inventory obsolescence	35.9	63.7	-	54.3(c)	45.3
Deferred tax asset valuation allowance	25.4	3.4(d)	-	-	28.8

(a) Accounts written off, net of recoveries and foreign currency translation adjustment.

(b) Returned product destroyed and foreign currency translation adjustment.
(c) Obsolete inventory destroyed and foreign currency translation adjustment.
(d) Increase in valuation allowance for tax loss and tax credit carryforward benefits is because it is more likely than not that some or all of the deferred tax assets will not be utilized in the future.

The above represents a first-time disclosure of any allowances concerning sales returns. Certainly, the Company would argue that, in the case of both A/R's and sales returns, since the write-offs are ultimately being expensed, the under-provisioning practice does not affect the bottom line and is, therefore, insignificant. There are, however, a number of items affected by this practice that we feel are significant:

- **Working Capital is grossly overstated.** In our previous reports, we voiced concern that under-allowancing for A/R's resulted in the exaggeration of Working Capital by almost $60 million at the end of F/Y 2002. This, however, was in absence of the information that we now have concerning the level of sales returns. Though the Company does not disclose how it handles for the Allowance for Sales Returns on the Balance Sheet, it is a fairly safe assumption that most, if not all, of it is included as a Current Liability, and Avon had only recorded a related liability of just $13.5 million in 2002. In reality, had the Company carried an Allowance equal to actual write-offs, the sales returns-related liability amount would have instead been $266.5 million, or $253 million in excess of what was recorded. The combination of the $60 million in overstated A/R's with the $253 million in understated current liabilities implies that Working Capital in 2002 was overstated by $313 million, and this a year when Working Capital, as recorded, was as low as $73 million at year-end.

  The situation in F/Y 2003 looks equally troublesome. Using Current Assets and Current Liabilities as recorded, Working Capital appears to have improved to $683 million. Taking into account, however, the overstatement of A/R's of about $75.3 million combined with the understatement of returns-related liabilities of approximately $272 million, half of that increase in Working Capital goes away, dropping the number to $291 million. That's certainly an improvement over 2002, but a far cry from what appears to be recorded on the Balance Sheet at first glance.

- **Quality of Revenue.** Avon recognizes revenue when product reaches its customers, the Independent Representatives. Actual write-off's related to both bad A/R's and product returns represent 6% of the total sales, as these expenses totaled $414.6 million in F/Y 2003. Ditto for F/Y's 2002 and 2001 as slightly above 6% of revenues booked, when product was shipped to I/R's, proved inaccurate as they ultimately needed to be written off. Thus, we would maintain that Avon's gross sales have been consistently overstated due to either returns or non-payment from customers. At the very least it would seem that Avon has very lax returns or collections policies. If this were the case, why wouldn't an auditor challenge whether the title and, more importantly, ***risks*** of ownership have truly transferred to the I/R's upon the shipment of product, thus challenging the "true sale" criteria for recognizing revenue on delivery?

  The emergence of the class action suit, which we have covered extensively in prior reports, would imply a much different cause. The plaintiffs, who are I/R's and thus Avon customers, are alleging that Avon regularly ships ***unordered*** product to them that they are unwilling to pay for. In the lawsuit, they maintain that this practice is wide spread, and now these substantial write offs in excess of the under accrued allowances for doubtful accounts and sales returns seem to be related and directly support their case.

> Our guess is that Avon's independent auditors have forced these new disclosures. The next question, and perhaps the most significant question, is when might they force Avon to bring these Allowances up to the levels reflected by actual write-offs? Should this happen, the result would be for a significant charge during the period where the allowances are brought up to reality. The charge would, in effect, be a one-time double counting of related significant costs with one maintaining the current level of provisioning and one for anticipating the same level for the following year.

Insider Trading: Executive insider sales speak volumes

In our over 20-year history of analyzing insider behavior there are few situations more telling than ones where insiders directly responsible for a rally in their company's shares sell into the very rally they've propagated. This indeed seems to be the case with Avon. As questions about the class action suit, and overall growth prospects in general resulted in a 10% drop in Company shares, the Company retaliated, on February 3rd by raising the dividend by 50%, announcing a 2 for 1 stock split, and releasing year end results that not only beat street expectations but also implied that the Company would reverse slumping U.S. sales numbers in the near future. The resultant sharp rally in Avon shares was not wasted on CEO and Chairwoman **Andrea Jung**, who sold 60,000 shares two days later at $68 each. This was a large sale for her compared to her trading history.

What's more, on February 9th, the day Jung's filing hit the Edgar system, H/R head **Jill Kanin-Lovers** cleared out her position of $35.25 options, exercising them and selling the underlying 24,071 shares for about $68 each. The options were not set to expire until December of 2009. The timing was interesting as it occurred on the same day that Jung's filing went public, and possibly the first time Kanin-Lovers realized that Jung had sold. Just three weeks later, Kanin-Lovers sold again, this time clearing out her entire position of $38.35 options that were not to expire until May of 2010. She sold the underlying 22,334 shares in the $71 range. Interestingly enough, Kanin-Lovers seems to have resigned abruptly, the only reference to the situation appearing in the recent 10K. The reason for the "separation" disclosure was the fact that, in 1998, upon leaving her previous employer and joining Avon, she forfeited certain pension benefits. Avon agreed to allow her the same $900,000 in benefits, one-half of which were to vest in 2002 the other half to vest in 2007. Upon her "separation" she became fully vested and the Company disclosed, at that time, that she was leaving. Kanin-Lovers original employment agreement is not disclosed, making it impossible to assess how she was entitled to early vesting of the benefits upon "separation".

In an interesting side note to the Kanin-Lovers "separation" from the Company, many media reports recently have mentioned Andrea Jung as a leading candidate for the open CEO spot at Coca Cola.

Insider Trading: "Rank and file" selling continues at record pace

In addition to Section 16 insider selling, rank and file Avon employees are selling at all-time high levels. Over the years, it has been our experience that when both employees and filing insiders exercise their options, they typically sell the underlying shares. Consequently, when we see high levels of option exercises, it is a safe bet that those involved are selling the shares as well. In the case of Avon, Employee Stock Option Exercises continue to reach new levels each quarter and year over year, culminating in the large jump in 2003. The chart below is an update to the chart we showed in our report dated 9/22/03, which showed cash received from employee option exercises through the Company's fiscal third quarter. This chart shows cash received through all four quarters of 2003.

Figure 1. Cash Received From Employee Stock Option Exercises (Million $). Source: AVP SEC Filings