3D ADVISORS

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

Propping Up CLX While Insiders Cash Out?
The Clorox Company (NYSE:CLX)

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

The Clorox Company is engaged in the production and marketing of non-durable household consumer products. Principal products include bleach, household cleaners and salad dressings and other food flavorings.

Summary of 3DAdvisors Findings for CLX

- **Accounting:** Currency and other overseas issues
- **Accounting:** Pension plan funding
- **Accounting:** Treasury repurchases and capital expenditures
- **Insider Trading:** Insider selling, executive loans and other comp issues

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Discussion of 3DAdvisors Findings

Accounting: Currency and other overseas issues

South America (about 13% of total revenues) delivered a blow in '02 (F/Y ended in June) as Clorox recorded Goodwill and Trademark impairment charges of $196 million for Argentina, Brazil and Columbia. The Company also recorded foreign currency "Deferred Translation Charges" (read: translation adjustments which subtract from Shareholders' Equity) for the Argentine peso of $137 million during the period. In all, these "Deferred Translation Adjustments" for all currencies totaled $222 million in '02. Accordingly, Accumulated Other Comprehensive Losses (which are charged against Shareholders Equity) jumped to $308 million in '02. The currency problem did not go away in Q1 '03 (ended 9/30). Another $27 million of these charges contributed Accumulated Other Comprehensive Losses to rising to $325 million during the period, or 25% of Shareholder's Equity.

Outside of further impairment issues, Argentina may cost Clorox at least another penny/share in '02. The Argentine government has decreed, "certain trade non-peso denominated currencies be converted to the Argentine peso currency". With about $7 million in U.S. dollar cash deposits subject to this repatriation requirement, Clorox estimates that the decree will cost it $2 million in currency exchange losses, which would translate to a penny per share.

Accounting: Pension plan funding

Up to now, the Company's Pension Fund has not been faced with under-funding problems. This has changed. In '02, the Plan moved into under-funded status as Fair Value of Plan Assets fell behind its Benefit Obligation by $90 million, triggering a Minimum Pension Liability adjustment of $65 million. This adjustment is included in the $325 million Accumulated Other Comprehensive Loss mentioned in the above paragraph. As is the case with so many companies currently, both Discount Rate and Expected Return on Plan Assets assumptions will need to come down to reality this year. Though the Company acknowledges that additional pension contributions will be required (starting in '04) it stops short of providing guidance as to their amount.

Even after the impairment charges in '02, the Company's Goodwill and Intangibles represent an awful big slice of the total asset picture. Y/E intangibles (including Goodwill, Trademarks and Intangibles) were at $1.3 billion, representing 36% of total assets and 96% of Shareholders Equity. In '01, the $1.57 billion intangible number was 39% of total assets and 83% of Shareholders' Equity.

Accounting: Treasury repurchases and capital expenditures

Treasury repurchases have reduced Shareholders' Equity from $1.9 billion at Y/E '02 to $1.3 billion at Q1 '03. The program has reduced the number of diluted outstanding shares, for income calculation purposes, from 239.5 million to 224.1 million. The reduction in the denominator has provided .05 per share to the Q1 '03 earnings picture and .03 per share for the '02 earnings picture. The Company also got an additional earnings boost in '02 by reversing its net accrued liability for its Performance Unit Programs (incentive compensation). Due to a year-end review of these programs, the Company had determined that "the initial vesting criteria had not been met as of June 30, '02 (year end) and may not be met as of June 30, '03. As a result, the Company reversed its net accrued liability of $10 million for the performance unit program. This reversal provided an additional .04 to earnings in the '02 period.

In the fourth quarter of '02, the Company had outstanding share repurchase contracts for 5.52 million shares. Of this total, 2.26 million ($43 strike price) were to expire on 9/15/'02, another 2.26 million ($43 strike price) were to expire on 9/15/'04 and 1 million (strike price of $51.70) were to expire on 11/1/'03. In July, Clorox shares dropped to $32, down well over 25% from their June peak. It almost looks as if the Company saw this coming. We say this because on June 30, '02, prior to the drop, Clorox settled all three of the above contracts for $257 million, or $46.56 per share. We would offer that, if the probability loomed that the company was to be taken out, either by Henkel or some other entity, it is unlikely that Clorox would have settled these contracts so early, before their respective expiration dates.

Treasury repurchase activity, already on the rise, looks like it has a way to go yet. Total repurchases, both through open market and the above repurchase contracts, topped $669 million in '02, up from $10 million in '01 and $211 million in '00. In July '02, the Company increased its repurchase program by another $500 million.

All this repurchase activity may be at the expense of capital expenditures, which were down, in '02 to $177 million from $192 million in '01. The company is in the process of implementing new information systems in a two-year project that will cost $250 million. In '02, $83 million of this was spent, but with most of it being capitalized as "deferred software costs". At the end of '02, the Company had $102 million in "deferred software costs" listed under "Other Assets". I found it interesting that, in Q1, the Company reclassified these "deferred software costs" (the $102 million from Q4 and an additional $89 million from Q1 of '03) from "Other Assets" to "Property, Plant and Equipment". There was no explanation for the move, which could have occurred to provide better disclosure for the items involved. The fact that they had been capitalizing this $191 million in software costs, however, makes me wonder if they might not have another agenda here, such as reclassifying them to a more permanent asset category to somehow justify stretching out the amortization period of this item a bit. This is difficult to prove, however, because the Company does not provide amortization information related to this item.

<u>Insider Trading: Insider selling, executive loans and other comp issues</u>

On July 12, '02, the Company announced that CEO **Craig Sullivan** had filed a 144 to sell up to 857,728 (25% of this position) Clorox shares "covered by an irrevocable prearranged trading plan". The press release was less than clear in providing an explanation for the transaction, which had to do with expiring options. We have also found the sales by CFO **Karen Rose** to be interesting, not so much for their size but for their timing. Her recent selling occurred after the stock had rebounded from a sharp July drop. Prior to this, she had not been an open market seller since June of '99 when the shares were near their all-time peak.

It's also worth noting that in general the Company compensates executives very handsomely. It is prone to offering interest-free loans to its executives for home purchases. It also is paying for company cars as well. An item in employment agreements of Craig Sullivan and other executives alludes to this. In the event of termination, these contracts have an "automobile component"…"the executive shall be entitled to purchase the Company-leased automobile, if any, used by the Executive prior to termination". Sullivan gets a base salary of $1 million and received a bonus of an additional $2 million in '02. In addition, he received a special option grant of 750,000 shares, and another 100,000 Restricted Stock Units as a part of his new two-year employment agreement (signed in November of '01). According to the Proxy, this Restricted Stock Award has a value of $4.1 million, assuming a $41.35 per share price for Clorox shares.

All in, the Company has been absorbing lots of counter-punches from bad economies, mature markets and associated competition and currency problems. Recent write-offs and restructuring moves have put some analysts in the camp that the Company has seen the worst and has put its problems behind. The nature of the insider sales, albeit subtle, fly in the face of such assumptions.