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

# Overselling the Good News, Downplaying Risks
# 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:** Status of class action lawsuit ("channel stuffing" lawsuit)
- **Accounting:** Was Q1 all it was cranked up to be?
- **Accounting:** Pattern of understating certain liabilities appears to continue
- **Accounting:** Questions about cash flow, option exercises and stock repurchases
- **Governance:** Noteworthy detail to director resignation
- **Insider Trading:** Director has now sold 75% of holdings

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## Discussion of 3DAdvisors Findings

The run-up in Avon shares over the past quarter or so has done nothing to diminish our interest in executive behavior at the Company. One of the more consistent behaviors we've observed that continues to keep our attention is a tendency of management to oversell good news while ignoring, or downplaying risk. In our view, this is one of the principal reasons for the rally in Avon shares. While aggressive corporate self-promotion is certainly nothing new, Avon's efforts interest us because a reading of the fine print raises plenty of questions, not the least of which is certain accounting behavior that strongly suggests channel stuffing may have contributed significantly to the perception of sales growth and hence lofty valuation. We start this Avon Update with a status report on the "channel stuffing" lawsuit filed against the Company by former independent reps in California, and then follow that up with a reading of the “fine print” in the Q1 earnings release.

<u>Accounting: Status of class action lawsuit (“channel stuffing” lawsuit)</u>

We recently spoke with Jeffrey Huron of Huron Maki and Johnson, the lead law firm representing Raven Blakemore and other former Avon independent representatives (the plaintiffs) in a class action complaint filed against the Company in California. The suit alleges, among other things, that the Company regularly ships unordered products to its independent reps, upon which it recognizes revenue even though the goods were never ordered. This claim is consistent with certain accounting behavior that we have observed that shows gross and repeated under accruals for doubtful accounts and sales returns, which in effect overstates current period revenue (for details on this suit, see our AVP report of 01/23/04, which includes a copy of the Second Amended Complaint). In late March, the judge hearing the case in California Superior Court for the County of Los Angeles dismissed two of the four “causes of action” in the complaint (see below).

Mr. Huron tells us that they have filed on the behalf of the plaintiffs a Petition for Writ of Mandate, which under California law is a legal device to request the court to review its decision, in this case, to dismiss two of the original causes of action. Filing the writ is an expeditious alternative to the appeal process, which would not start until the still active portions of the suit are heard. Often, similar writs are summarily dismissed soon after they are filed. In this instance, almost four weeks have passed with no comment from the judge. Mr. Huron feels that this is an indication that the judge is considering their request. Should this be the case, one or both of the two dismissed claims could be reinstated. Be advised that writs of this nature usually *do not* receive favorable rulings and should this prove true now, the plaintiffs would have to wait until the other two causes of action are heard before appealing the two that were dismissed. Huron feels that a decision on this writ should be forthcoming by June 1 or thereabouts.

The four original causes of action include:

1. Fraud – Dismissed because the plaintiffs knew that they had not ordered the products that had been delivered and therefore were not deceived.

2. Breach of Contract – Dismissed because there was no allegation of any contract term that was breached.

3. Unjust Enrichment – Still active.

4. Violation of Business and Professions Code Section 17200 (California State) – Still active. This includes the channel-stuffing allegations.

We continue to monitor the suit carefully and will report any developments as soon as they become available to us.

Accounting: Was Q1 all it was cranked up to be?

In a behavioral pattern that is now very familiar, Avon executives have proven adept at maximizing and accentuating the positive in any news release, even when some would argue that the Company might be at times a little too aggressive when the details are more carefully examined. For example, back in early December of 2003, the Company put out a press release with the headline “Avon Expects Record Fourth Quarter Earnings Of $1.03-$1.04 Per Share, Up Nearly 30%”. Buried down in the release, however, was acknowledgement that domestic sales growth would be in the “low to mid single digits”. Already concerned about growth in the Company’s largest market, investors reacted swiftly and the stock dropped almost 8% the day of the press release.

Avon of course touted its strong Q1 (2004) results, but were the results everything the Company suggested they were? First off, Q1 results were aided rather heavily by currency tailwinds. The overall 19% sales increase was a more modest 14% in local currencies. Not only was there a strong boost in Q1 of 2004, the quarter over quarter comparison was even more skewed by the fact that the Company experienced currency *headwinds* (i.e. unfavorable currency translations) in Q1 of 2003 which had clipped 5% from revenue growth during the period, of course making for an easier quarterly comparison in Q1 of 2004.

Also benefiting the comparison was a special charge occurring in Q1 of 2003 where Avon had recorded an $18 million charge for its floundering BeComing line. Another thing that helped the quarter over quarter comparison was the consolidation of its Turkish subsidiary in 2004 Q1. In all of 2003, the Turkish unit generated net sales of $47.2 and net income of $14.6 million. This subsidiary’s results, included in Avon’s Q1 2004 numbers, were not included in Q1 of 2003. In Q1 of 2004, this subsidiary contributed $19.2 million in sales and $10.9 million in net income vs. an immaterial amount in Q1, 2003. Without these deltas, Avon’s apples to apples operating profit growth number would have been 20% (Q1 of 2004 over Q1 2003), not the Company’s much-heralded 40%.

A good portion of the U.S. 8% sales growth in Q1 came from inventory clearance activities, which have not helped margins. Inventory clearance caused the quarter’s $90 million U.S. operating profit to be down 7% from last year. Inventory clearance activity accounted for almost a quarter of Avon’s much-touted U.S. growth during the quarter.

Avon raised guidance uncharacteristically early in Q1, prompting at least one conference call attendee to question what was behind the move, so early in the year. When asked to talk about what was generating such early optimism (was it top line or cost savings?), **Andrea Jung** qualified her answer (“all factors, both below and above the line”) by implying that their optimism assumed the absence of negative foreign exchange and negative interest rate effects. Her assumptions are consistent with the Company’s history of downplaying the negative side of potential macro forces, such as currency effects, when forecasting results.

While there is certainly nothing wrong with trumpeting a strong quarter, what we note is a repeated pattern of behavior where executives seem to exaggerate and over-promote the positive, while downplaying, or simply seeming to ignore risks.

Accounting: Pattern of understating certain liabilities appears to continue

With regards to those net sales increases, nothing appears to have changed with regards to Avon's overstatement of revenues that we have been highlighting in past reports (most recently, 3/9/2004) where the Company persistently books a high level of sales whose receivables are destined to be written off or whose returns will be charged to costs and expenses at levels far exceeding the related allowances: As of 12/31/2003, Avon's Allowance for Doubtful Accounts stood at $49.5 million in spite of the fact that $125 million in A/R's had to be written off for the period. Sales Returns were much worse with an Allowance of $17.6 million vs. actual Sales Returns, charged to Costs and Expenses, totaling $290 million. These issues were covered in our earlier Avon reports on 09/22/03 and 03/09/04.

Consistent with Avon's policy of under-reserving for contingencies, we note that Avon has recorded no allowances for any of the large, and ongoing, legal contingencies. In fact, in one such case, the Company discloses "Management is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome but, under some of the damage theories presented, an adverse award could be material to the Consolidated Financial Statements."

In addition to insufficient reserving, we have been tracking an interesting new disclosure from Avon's 10-K. Avon's three-year Transformation Long-Term Incentive Plan provides for cash awards to employees based on the achievement of related goals over the period 2002-2004. The Company discloses, "While it is possible that total cash payments of approximately $50 million will be made in the first quarter of 2005 in connection with this program, no expense has been recognized under this plan due to the aggressive nature of the goals." Avon consistently heralds efficiencies from this plan as one of the reasons for recent successes. The absence of any related expense recognition causes us pause to wonder: Why not accrue some of the award liability if the plan is working so well? This seems to be yet another example as to, when posed with various recognition options, Avon chooses the most aggressive route in most cases. On the other hand, perhaps the real message here is that they are forecasting that the thresholds that must be met in order to pay out the awards will not be reached.

Accounting: Questions about cash flow, option exercises and stock repurchases

Avon's presentation of its cash flow picture boasted that "Cash and Equivalents finished Q1 at $562 million, over $100 million higher than a year ago." The Company presentation went on to boast that the Q1 cash numbers "included two incremental cash outlays versus last year: a $69 million tax audit settlement payment and pension plan contributions of $64 million. The net result was a $28 million increase in Cash from Operations (Q1 over Q1). What the Company did not provide, in the release, was the fact that, just after Q1's close, in April, Avon made an additional $45 million payment to its pension plan and anticipates contributing an additional $18 million in 2004. Even though the Company had previously disclosed it would be making plan contributions totaling about $128 million in 2004, the timing of the contributions we find interesting. The disclosure of the April payment was made in Avon's 10-Q, not in the earnings release or the subsequent conference call. We found it curious that the Q1 10-Q was released on April 30th, the same day as the Q1 earnings release. An early 10-Q release by Avon, such as this, has not occurred in the past. Indeed, it is rare to see any company release its 10-Q on the same day as earnings. Pure speculation on our part, but we are forced to wonder if there was an advantage to releasing the 10-Q early, while all the news appears positive and not risk having something negative show up in the interim, something that may have to be disclosed.

Another interesting dimension to Avon's cash flow picture is the $45 million the Company pulled in from employee stock option exercises in Q1 of 2004. This tops the totals for any ***full year*** prior to 2002. 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 at the same time. Employee stock option exercises reached $100 million in 2003 and, with $45 million in through Q1, it seems that 2004 will result in another record year for employee selling.

The exercises of Avon employee stock options have provided plenty of fuel for the Company's aggressive stock repurchase program, which spent $214 million in 2003 and another $60 million in Q1 of 2004, despite the fact that the stock was at an all-time high. These repurchases are basically offsetting the dilution caused by the high level of exercises, and subsequent sales, that have been transacted by employees. Suffice it to say that these repurchases inure to the benefit of Avon's top global executives (CEO, COO, CFO) whose targets under the Company's Executive Incentive Plan are related 70% to EPS growth and net sales increases.

## Governance: Noteworthy detail to director resignation

Audit committee member **Brenda Barnes** is leaving. Avon's May 3rd press release cites her recent appointment as President and COO of Sara Lee as the reason for her departure from the Company board. We see, however, no evidence of Barnes leaving her director posts at Sears, Staples or the New York Times. She has been a director of Sears since '97 (term expires next year), New York Times since '98 (expires annually), Staples since '02 (expires in '05) and Avon since '94 (expires in '05).

## Insider Trading: Director has now sold 75% of holdings

Avon director **Paula Stern** has sold another 12,000 shares in May. This action is particularly interesting to us. Stern had sold 12,000 last December. At the time, it was by far her largest sale in Avon shares. We had noticed that she had been retaining shares in other companies whose boards she sat on (Neiman Marcus, Hasbro and Avaya). In making her May 12th sale (12,000 shares at prices around $83), she cleared out of three separate option series ($51.38, $43.12 and $52.80) none of which were set to expire until between May of 2009 and March of 2013. More importantly, at the time, her December sale was her largest to date, and between her December and May sales, she has slashed her actionable holdings by 75%. We note that she has still not sold any shares of the other companies where she also serves on the board.