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

Accounting and Insider Behavior Tell Different Story
Avon Products, Inc. (NYSE: AVP)

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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:** Repeated understatement of ‘allowance for doubtful accounts’
- **Accounting:** Law suit suggests aggressive channel stuffing
- **Insider Trading:** Employee stock sales at all-time highs
- **Accounting:** Stock repurchases continue despite volatile cash flow
- **Accounting:** Pension plan continues to be a drain on cash flow

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Discussion of 3DAdvisors Findings

Avon’s share price has survived significant issues: A formal investigation by the SEC which resulted in restatement of three years financials, Pension funding headwinds, the sputtering BeComing cosmetic line (for which the Company had built $300 million into its revenue forecasts by 2005), the SARS threat and the Latin American currency issues which surfaced en-masse last year. Current Company forecasts cheerily imply that, instead of headwinds, benign tailwinds are forming: Avon’s positive foreign currency assumptions, combined with the expected efficiencies coming from the two-year old Business Transformation initiative and new product line roll-outs remain the cornerstones of the Company’s forward view.

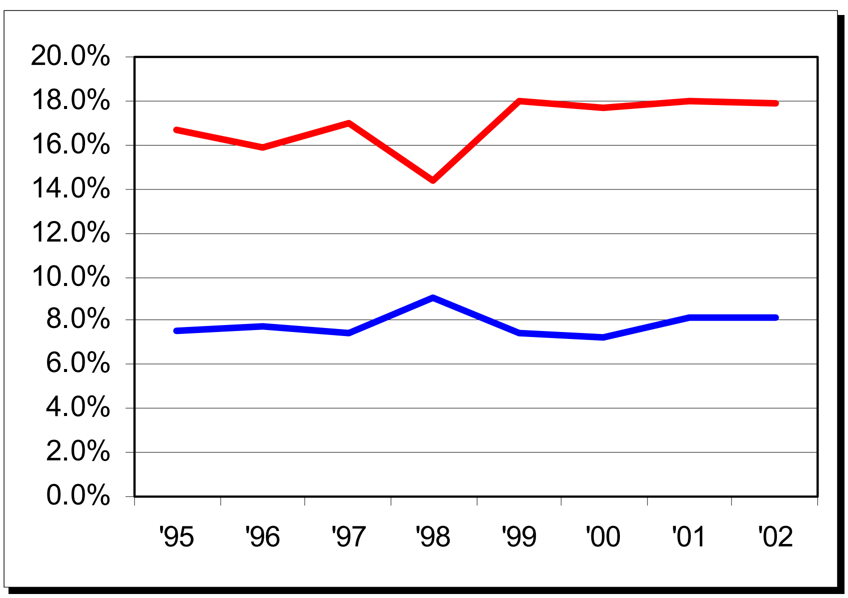
Our research, however, shows that not only do a number of old issues continue to linger but we've also observed some recent accounting and insider trading behaviors that seem to tell a different story than one the Company wants us to believe.

Accounting: Consistent understatement of 'allowance for doubtful accounts'

Avon's well-known sales model relies on over 3.9 million worldwide independent sales representatives. These representatives are independent contractors, not employees of the Company. Consequently, they are in effect Avon's customers. Avon recognizes revenue when product is delivered to its Independent Representatives.

Accounts Receivable are in the $540 million range, where they have remained for several quarters. At Y/E 2002, the Company carried an Allowance for Doubtful A/R's of $49.5 million, or about 8.9% of A/R's. This percentage has remained consistent for at least the past three years. There is an significant disconnect however, between the Allowance for Doubtful Accounts and what the actual A/R write-offs have been in any given year. In 2002, for instance, written-off A/R's totaled $108.3 million, or about 18% of gross A/R's, far above the $49.5 million Allowance. The same holds true for prior years as well:

Figure 1. Avon Products, Inc. Allowance for Doubtful Accounts (Blue) Vs. Actual Write Offs (Red) Expressed as a Percentage of Gross A/Rs. Source: AVP SEC Filings



Written-off receivables, far in excess of the booked Allowance, have been charged to Costs & Expenses in each year. It would seem that, by not increasing the Allowance, the Company may be obfuscating the fact that its collection policies with its Independent Representatives, where about 18% of Receivables are not good, is much looser than it would like the public to know. Or could there be other motives behind this behavior?

The practice certainly raises some questions. One boils down to revenue recognition. Based on the Company's liberal write-off policy, one must wonder whether the Company may be on the fringes of GAAP compliance with the requirement that, for a true sale to exist and be booked, both title and risks and rewards of ownership must pass to the Independent Representatives. In Avon's case, in almost 18% of Accounts Receivable, it would appear that these Representatives may either not be getting payment from the end customer or, more importantly, have been shipped product they were not able to sell. In both cases, revenues had been booked on delivery of product to the Representatives. Given Avon's apparently lax collections policies, it would seem that the Representatives have little fear that Avon will pursue them for outstanding balances.

Now, as you can see from the above chart, this discrepancy has been going on for quite some time. There are some very interesting effects. First, the overbooking of revenues implies that Revenues are consistently overstated. This probably doesn't get much attention because the written off A/R's are ultimately charged to costs and expenses. The timing of those write-offs, however, raises some important questions. Just how discretionary is the timing for the write-offs? If the Company has considerable discretion here, it doesn't take much imagination to see how they could serve as a throttling device with which to manage earnings. In our conversations with Avon, the Company representative could not shed light on this issue. The fact that A/R write offs consistently outpace the A/R Allowance, which has yet to be adjusted, was not disputed. The individual "did not know" the answer to the timing question and promised to get back to us. No response yet.

It also clear that this arrangement allows for Working Capital to be overstated by the amount that A/R write-offs exceed the Allowance for Doubtful Accounts. In Avon's case, this is not necessarily a small matter: At F/Y end 2002, Avon showed Working Capital of just $72.7 million. However, since the A/R component of Working Capital is shown net of the Allowance for Doubtful Accounts, A/R's are being overstated by the amount of the excess write-offs over the Allowance. If, for instance, the Company carried a Bad Debt Allowance approximating actual write off experience, A/R's (net of the Allowance) would have been $59 million lighter on the balance sheet, a fact that would have reduced reported Working Capital from the already-low $72.7 million to just $13.7 million.

This holds for prior years as well. Working capital for 2001 should be considered overstated by $55 million, from $428 million to $373 million. Ditto for 2001 where the reported Working Capital number of $186 million would have dropped $55 million to $131 million. Even though we could not find evidence that Working Capital requirements exist in Avon's current debt covenants, we feel that the consistent overstatement of this important measure, by about $50 million/year is something we want our clients to be aware of.

Relative to total revenues and total assets, the Company could argue the amounts in question are immaterial. However, if a practice is known to be incorrect and results in a misstatement, materiality cannot be the sole basis for failing to correct the error. To us this matter is significant and might best be characterized as a consistent, known misstatement of revenues and inadequate allowances for uncollectible accounts. Even though the Company will state that, since expenses are ultimately charged (albeit not in the same period the revenues are booked), this situation is a wash, it still represents a bad business practice and overstatement of not only revenues but asset values as well, notwithstanding the issue related to the timing of the actual write-offs.

Accounting: Lawsuit suggests aggressive channel stuffing

Although it didn't generate much coverage at first, a lawsuit filed back in March in Los Angeles Superior Court strongly suggests the company is indeed aggressively engaged in "channel stuffing". We are monitoring this suit very carefully as it has the potential to become a catalyst that could expose accounting and other behaviors that we have observed.

The suit, filed by L.A. law firm Masry & Vititoe on behalf of Avon Representative Raven Blakemore, alleges that Avon regularly ships products that its independent sales representatives never ordered and then demands payment, even if the rep returned the unordered goods to Avon. The lawsuit also alleges that Avon immediately accounts for the unordered shipments as revenues, a fact we know likely to be true. Class action status is being sought.

In its formal legal response asking for a dismissal of the lawsuit, Avon says "at best," the lawsuit is a "customer service issue" that hasn't harmed the plaintiff or anyone in the putative class. "At worse," Avon says the lawsuit is an attempt "to inflate a simple account crediting issue into a predicate for a nationwide class action."

Should class action status be granted here, it would be a horse of a different color, as it would involve not shareholders or end users, but the core of Avon's distribution channel, its Independent Representatives. The last group, we would argue, that Avon would want to see alienated.

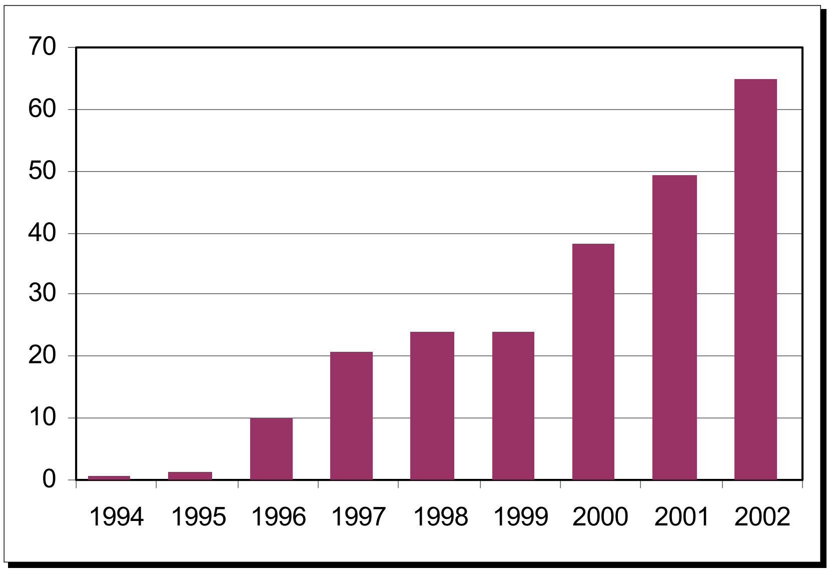
The key individual driving this suit (from law firm Masry & Vititoe) is none other than Erin Brockovich, the firm's research director. Brockovich is not only known for the movie made about her but also for successfully suing Pacific Gas & Electric in recent past. News of this suit, however, seems to have gone largely unnoticed until recently when it appeared in a Forbes.com piece (September 10, 2003). We did also note its appearance, however, in some Latin American publications, most notably, in Santiago, Chile. Let's not forget that Latin America accounts for 28% of Avon's worldwide revenues.

This development is very significant, in our view. It tends to confirm our suspicions (above) that Avon is overly aggressive in its shipments, and associated booking of revenues, to its Independent Representatives. More importantly, it raises the question as to whether Avon has been shipping unordered goods to its Independent Representatives. If these plaintiff allegations prove true, our original suspicions that Avon has lax collections policies evolve into additional concerns that the Company has been stuffing its distribution channels with unordered goods.

Insider Trading: Employee stock sales at all-time highs

When we evaluate any company's insider picture, we not only check into its Section 16 insider filings (read: executive insider selling) but also its levels of Employee Stock Option Exercises (read: regular employee selling).

Figure 2. Cash Received From Employee Stock Option Exercises (Millions of $)
Source: AVP SEC Filings



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 stock option exercises, the assumption is safe that those involved are selling the shares as well. In the case of Avon, Employee Stock Option Exercises are running at record levels as indicated by the amount of cash the company has received from employees.

The data in the above chart does not include Q1 and Q2 of F/Y 2003. A glance at the current data for 2003 indicates that selling is running at a higher rate than even 2002 with $53 million, in stock option exercise-related cash, already booked through six months. So, thus far into 2003, selling is already greater than any full year, except for 2002, and it seems to be a cinch that 2002 will be surpassed in Q3.

In addition to general employee selling, Section 16 insider selling is running at historical highs as well, and showing some very interesting participants selling large pieces of their existing holdings:

- **Brian Connolly (47)** – Senior V.P. and President, Avon North America. On July 25th Connolly exercised options across four of his long-vested option series, effectively clearing them out. In doing so, he sold the underlying 46,167 shares at $63 each in the process. These options were not set to expire until June of 2007 at the earliest. These sales, his first and largest on record, dropped his actionable holdings (common stock plus vested options) by 47%. Connolly's

2002 compensation (salary and bonus) totaled $877,000. His stock sales (after paying for options exercises) netted him $1.3 million.

- **Janice Marolda (42)** – Controller. On August 21st, Marolda exercised options for 10,306 shares, which she immediately sold for $62 each. These are, by far, her largest-ever sales, which dropped her actionable holdings by 41%. An interesting aspect to her sales is that she exercised recently vested options that were not set to expire until 2010 at the earliest. Making matters more intriguing is the fact that the exercise prices were high, between $33 and $53 each. The trades netted her just $194,114 after paying for the options. It is more typical to see insiders retain high-priced options with much time to run until expiration. Cashing them in early, as we see in this case, can mean that the person involved senses that the risk of evaporating option premiums outweighs the potential rewards from holding the derivatives.

- **Jill Kanin-Lovers (51)** – Senior V.P. Human Resources. Kanin-Lovers exercised options for 25,000 shares, for $35.25 each, and sold them for prices around $62. These options were not set to expire until 2009. The sales, which netted her $669,000, dropped her actionable holdings by about 16%.

- **Susan Kropf (54)** – COO and Director. Kropf exercised options for, and sold, 46,728 shares on the same day as Connolly (above). These options were exercisable for between $30 and $31 and the shares were sold for $63. This represented 10% of her actionable holdings. Kropf, whose 2002 cash compensation totaled $1.6 million, netted $1.5 million in this transaction (after consideration paid for options).

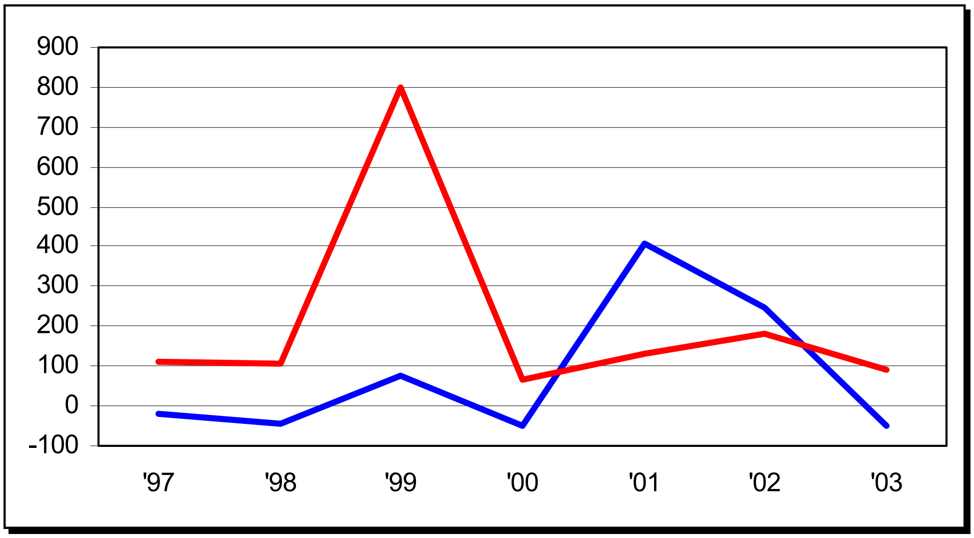
- **Robert Toth (50)** – Executive V.P. Asia Pacific, Europe, Middle East and Africa. Toth dropped 10% of his holdings by exercising options for, and selling, 11,432 shares in June. The sale price was $62 each. These are Toth's first sales on record and his options were not set to expire until 2007 at the earliest.

<u>Accounting: Stock repurchases continue despite volatile cash flow</u>

Avon consistently represents its cash flows as being healthy. Facts show, however, that for the past three years, cash flows have been somewhat volatile and the Company has been flirting with negative free cash flows. In F/Y 2000, free cash flow was negative. In 2001, the Company stated that it had turned this situation around. The "turnaround" however, was helped largely by the one time events of a federal income tax refund totaling $95 million and a $26 million contract settlement. Positive Free Cash Flow in 2002 however, appears to have been followed by additional drains. In fact, through Q2 of 2003, Free Cash Flow has once-again dropped to negative levels, this time by about $49 million. The Company is quick to point out that the dip is caused by one time items such as a $48 million tax audit settlement and a $60 million pension fund contribution ($40 in Q1 and $20 in Q2).

Erratic cash flows have resulted in little letup in the level of Avon share repurchases, however. Spending for repurchases consistently outpace available Free Cash Flow:

Figure 3. AVP Share Repurchases (Red) and Free Cash Flow (Blue) (Millions $)
Source: AVP SEC Filings



Perhaps this should be no surprise when one looks into the compensation packages of top company officers. The majority (70%) of the incentive Compensation for Avon's CEO, COO and Global Officers is tied to Global Sales and EPS, rather than net income or some other measure. Though actual targets are not specified, it's clear that an aggressive share repurchase program inures directly to the benefit of Avon's top management. Indeed, Avon spent almost $180 million in F/Y 2002 to repurchase 7.4 million shares. Without those repurchases, Avon's basic EPS (for 2002) would have been $2.20 per share instead of the reported $2.26. Ditto for 2001 where earnings would have been three cents lighter without the repurchases (four cents for 2000).

To this we would add that, on Avon's compensation committee is former Avon Chairman Stanley Gault. Gault, who relinquished his role as Avon's Chairman in 2001, has also been chairman and CEO of Rubbermaid Inc. and Chairman of Goodyear Tire & Rubber and currently serves on the boards of both Timken and Wal-Mart. We find it interesting that a number of the behaviors we are observing here seem to have origins while Gault served as Chairman of the Avon board.

So far in 2003 repurchases continue, in spite of the tighter cash flow picture, albeit at a lower rate. Through Q2, the Company has bought 1.7 million shares. EPS would have been half a cent lower without the buybacks. It will be interesting to see if Avon management increases repurchases as year-end approaches.

Accounting: Pension plan continues to be a drain on cash flow

In F/Y 2002, Avon had to bite the bullet on its Pension Assumptions, lowering its Expected Rate of Return on Plan Assets to 8.3% (globally) and its Discount Rate Assumption to 6.7% (globally). The effect of the changes caused the Plan's $999 million Benefit Obligation to swell to $1.14 billion. Even after $166 million in Pension contributions (including Non-U.S. plans) during 2002, the plans remained significantly under-funded, causing Avon to record a Minimum Pension Liability adjustment to Shareholders' Equity of $239 million.

Thanks to the Pension adjustment, and foreign exchange effects, Accumulated Other Comprehensive Losses reduced Shareholders' Equity by $761 million at the end of Q2, 2003. That's a far cry from the $489 million deduction this item represented at Y/E 2001.

As we mentioned earlier, in spite of last year's assumption adjustments and contributions, Pension issues continue to affect Avon's cash flows. Through Q2, the Company has contributed an additional $60 million to its Pension Plans in F/Y 2003.