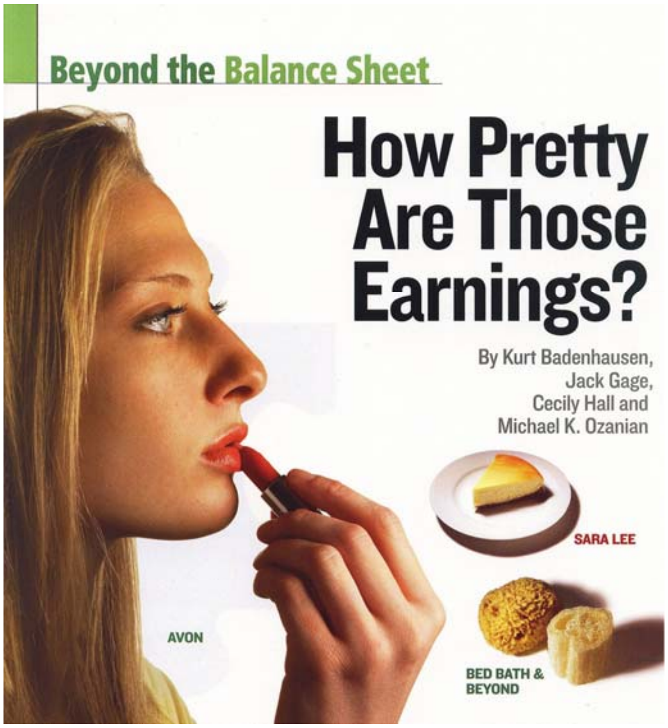
Forbes



KRISPY KREME DOUGHNUTS is the latest illustration of the fact that stunning earnings growth can mask a lot of trouble. Not long ago the doughnutmaker was a glamour stock with a 60% earnings-per-share growth rate and a multiple to match-70 times trailing earnings. Now the stock is at $9.61, down 72% from May, when the company first issued an earnings warning. Turns out Krispy Kreme may have leavened profits in the way it accounted for the purchase of franchised stores and by failing to book adequate reserves for doubtful accounts. So claims a shareholder lawsuit against the company. Krispy Kreme would not comment on the suit.

Investors are not auditors, they don't have subpoena power, and they can't know about such disasters in advance. But sometimes they can get hints that the quality of a company's earnings is a little shaky. In Krispy's case an indication that it was straining to deliver its growth story came three years ago in its use of synthetic leases to finance expansion. Forbes described these leases in a Feb. 18, 2002 story that did not please the company. Another straw in the wind: weak free cash flow from operations. You get that number by taking the "cash flow from operations" reported on the "consolidated statement of cash flows," then subtracting capital expenditures. Solid earners usually throw off lots of positive free cash flow. At Krispy the figure was negative.

Is there a Krispy Kreme lurking in your portfolio? For this, the fifth installment in our Beyond the Balance Sheet series, we asked the experts at RateFinancials of New York City (www.ratefinancials.com) to look into earnings quality among the companies included in the S&P 500 Index. The tables at right display the outfits that RateFinancials puts at the top and at the bottom of the quality scale. The ratings are to a degree subjective and, not surprisingly, some of the companies at the bottom take exception. General Motors feels that RateFinancials understates its cash flow. But at minimum RateFinancials' work warns investors to look closely at the financial statements of the suspect companies.

A lot of factors went into the ratings produced by cofounders Victor Germack and Harold Paumgarten, research director Allan Young and ten analysts. A company that expenses stock options is probably not straining to meet earnings forecasts, so it gets a plus. Overoptimistic assumptions about future earnings on a pension fund artificially prop up earnings and thus rate a minus. A low tax rate is a potential indicator of trouble: Maybe the low profit reported to the Internal Revenue Service is all too true and the high profit reported to shareholders an exaggeration. Other factors relate to discontinued operations (booking a one-time gain from selling a business is bad), corporate governance (companies get black marks for having poison pills), inventory (if it piles up faster than sales, then business may be weakening) and free cash flow (a declining number is bad).

DEPENDABILITY

Earnings from a company's operations are of higher quality than earnings from stock market investments or from selling off business units. The companies at left received the highest percentage of their reported earnings from their main operation during the latest fiscal year; the companies at right, the lowest percentage.

Normalized[1] Earnings as % of Reported Earnings

HERSHEY FOODS	100%	SOUTHWEST AIRLINES	49%
LENNAR	100	UNION PACIFIC	65
STANDARD PACIFIC	100	DELL	68
RYDER SYSTEM	99	GENERAL MOTORS	73
HARMAN INTERNATIONAL	97	HONEYWELL INTERNATIONAL	77

[1]Earnings adjusted for restructuring charges, investment income, stock options and tax-rate fluctuations. *Source: RateFinancials*

RateFinancials "Beyond the Balance Sheet" feature from the February 14, 2005 edition.

WORKING CAPITAL

A company's cash cycle is a big component of its earnings quality. The quicker a company can turn over its inventory, the faster it collects its receivables, or the longer it can stretch out its payables, the greater its operating cash flow. The companies at left have shown the biggest improvement in turning their cash cycle the past two fiscal years. The companies at right have shown the largest erosion.

Cash Cycle[1] Improvement	Cash Cycle[1] Erosion
DEERE 53 DAYS	RYLAND GROUP 20 DAYS
QLOGIC 44	ENGELHARD 18
NORTHROP GRUMMAN 38	RYDER SYSTEM 15
ELECTRONIC ARTS 24	CAMPBELL SOUP 11
BED BATH & BEYOND 15	SAFEWAY 5

[1]Accounts receivable days outstanding, plus inventory days, minus payable days.

A QUESTION OF QUALITY

It's not how *much* money a company is making that counts, it's *how* it makes its money. The earnings quality scores from RateFinancials aim to evaluate how closely reported earnings reflect the cash that the companies' businesses are generating and how well their balance sheets reflect their true economic position. Companies in the winners table have the best earnings quality (they are generating a lot of sustainable cash from their operations), while companies in the losers table have been boosting their reported earnings with such tricks as unexpensed stock options, low tax rates, asset sales, off-balance-sheet financing and deferred maintenance of the pension fund.

EARNINGS QUALITY WINNERS

COMPANY/BUSINESS	PRICE	52-WEEK HIGH	P/E 2005E	SALES ($BIL)	EARNINGS QUALITY STRENGTH
Avon Products/personal care	$40.06	$46.65	20	$7.5	strong cash flow
Bed Bath & Beyond/specialty retail stores	40.40	44.43	21	5.0	large and growing cash position
Capital One Financial/financial services	81.52	84.75	12	10.4	conservative capitalization
Ecolab/consumer products	33.61	35.59	25	4.1	good management of working capital
Family Dollar Stores/discount stores	31.55	39.66	18	5.4	no capitalized interest or goodwill
Home Depot/specialty retail stores	41.74	44.30	16	71.4	improved working capital turnover
International Flavors & Fragrances/personal care	41.33	43.20	17	2.0	conservative tax accounting
Lockheed Martin/aerospace	55.45	61.77	17	34.5	accelerating inventory turnover
Sysco/food distribution	36.05	41.27	21	29.7	conservative doubtful accounts reserve
Timberland/footwear & apparel	63.63	67.98	14	1.5	minimal off-balance-sheet commitments

Sources: RateFinancials; Reuters Fundamentals via FactSet Research Systems.

Leverage

After making certain adjustments, such as subtracting goodwill from assets and shareholders' equity and capitalizing operating leases (which are added to both assets and liabilities), these companies' balance sheets go from being top-heavy to being extremely leveraged. Other things being equal, leveraged companies are worthy of lower price/earnings multiples than companies with clean balance sheets.

EARNINGS QUALITY LOSERS

COMPANY/BUSINESS	PRICE	52-WEEK HIGH	P/E 2005E	SALES ($BIL)	EARNINGS QUALITY WEAKNESS
CVS/drug stores	$47.08	$47.65	18	$29.1	big lease obligations
Ford Motor/autos	14.32	16.48	8	172.4	high debt and underfunded pension plan
General Motors/autos	38.39	54.67	8	190.8	lower free cash flow last five years
HJ Heinz/food processing	37.71	40.61	15	8.6	revenue growth from non-operating items
Kroger/supermarkets	16.66	19.67	13	55.8	high goodwill and debt
Raytheon/defense	37.25	41.89	20	19.6	pension plan funding gap
Ryder System/leasing	46.26	55.55	14	5.0	negative free cash flow
Sara Lee/food processing	23.90	24.49	14	19.8	incessant restructuring charges
Supervalu/supermarkets	33.10	35.15	13	20.0	loan and lease guarantees to retailers
Teco Energy/utilities	15.22	15.97	15	2.7	sale of assets to meet liquidity needs

Lofty Liabilities

CUMMINS
$537(MIL) OF UNRECOGNIZED PENSION LIABILITIES

CVS
$6.6(BIL) OF UNCAPITALIZED LEASE OBLIGATIONS

DANAHER
$3.8(BIL) OF GOODWILL

HONEYWELL INTERNATIONAL
$5.9(BIL) OF GOODWILL,
$4.4(BIL) OF UNRECOGNIZED PENSION LIABILITIES

WALGREEN
$12.3(BIL) OF UNCAPITALIZED LEASE OBLIGATIONS

Source: RateFinancials