Understanding a Company Through its Accounting Practices

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In prior articles, we have discussed the primary Riverbridge investment disciplines. These include investing in companies offering predictable unit growth and an enduring competitive edge in their respective marketplaces. Owning a strategic market position is integral to sustaining this competitive advantage while also providing pricing flexibility to guard against inflationary pressures. Riverbridge seeks companies possessing the ability to internally finance their growth and thus are not dependent on borrowing money or raising capital to grow. This discipline allows our companies to better control their own destinies'. Overarching all these disciplines is our insistence upon high quality management teams as defined by their industry peers. The final discipline is our requirement that companies adopt conservative accounting practices. While some may consider conservative accounting to be mundane when compared to our other disciplines, it is certainly no less important and cannot be overlooked.

Generally Accepted Accounting Principles (GAAP) govern the standards corporations must use when issuing their quarterly financial statements. GAAP is a common set of rules and guidelines established by policy boards that include principles of consistency, prudence, and sincerity. While GAAP does provide an accounting construct, much latitude still exists in how companies recognize revenues, account for expenses, and classify assets on a balance sheet. Many investors take accounting policies for granted, comforted knowing they must conform to GAAP. The only accounting line items that seem to be regularly discussed are revenues and earnings per share. By ignoring accounting policies or narrowly focusing on reported earnings, investors are doing themselves a disservice as it relates to investment returns and risk management.

> Accounting practices serve as a reflection of the management team.

The Riverbridge investment team meticulously examines the revenue recognition policies of owned or prospective companies, comparing them to the practices within their industry. We have no interest in investing with a management team deploying aggressive revenue recognition policies. If management is willing to operate in a more aggressive fashion with respect to revenue recognition relative to their peers, they are likely taking other outsized business risks.

We also spend significant time reviewing financial statements for changes in accounting policies. Oftentimes changes in accounting polices presage a fundamental deterioration in the underlying business. As an investment team, it is our goal to detect such a business deterioration long before the income statement is adversely impacted.

For more than 30 years, our insistence on carefully examining accounting philosophies and policies has served our portfolios and clients well. Several years ago, we were invested in a surgical company that had developed a novel procedure that significantly reduced convalescence time. This company epitomized our investment disciplines, including a dominant market position and robust unit growth. After two years of investment in this company, we noticed an accounting policy change in how they recognized revenues. According to the change, when their products reached the surgical center, revenue would be recognized. Prior, revenue was recognized only when their product was actually used in a surgical procedure. This more aggressive accounting technique captured the attention of our investment team. Conversations with management ensued. It was explained to us that this change was more in line with industry standards–but we weren't convinced and sold the security.

For the next two quarters, as we watched from the sidelines, the company reported stellar earnings. In fact, they had record revenues each quarter. The third quarterly report, however, told a different story. The company missed their projections badly and a major inventory write-off followed. The company was shipping their product to the surgery centers at a rate faster than the product was being consumed. Their customers instructed the company to discontinue orders and even returned some shipments. Effectively, this company was "stuffing the channel" to bolster their reported earnings. Our insistence on conservative accounting standards spared Riverbridge and our clients from a major downturn in this company's stock price.

It is risky to focus only on revenues and reported earnings while ignoring how these figures are actually constructed. When analyzed properly, accounting does not answer many questions. Rather, it raises questions and topics to be addressed with the management team. Thoroughly understanding a company's accounting practices and philosophy provides a much richer fundamental understanding of the company and the integrity of its management team.