

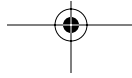
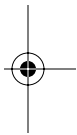
# CHAPTER 1

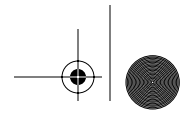
## Introduction

The investments arena is large, complex, and dynamic. These characteristics make it interesting to study, but also make it challenging to keep up with. What changes? Laws and regulations, the introduction of new types of securities and derivatives, innovations in markets and trading, an economy that is persistently changing, and company events, to name a few. Add to this mix the political, technological, and environmental changes that occur throughout the world every day, and you have quite a task to understand investment opportunities and investment management.

There is a wealth of financial information about companies available to financial analysts and investors. The Internet has made vast amounts of information available to everyone, displacing print as a means of communication. Consider the amount of information available about Microsoft Corporation. Not only can investors find annual reports, quarterly reports, press releases and links to the companies' filings with regulators on Microsoft's web site, anyone can download data for analysis in spreadsheet form and can listen in on Microsoft's management's conversations with analysts.

Availability and convenience has eased the data-gathering task of financial analysis. What remains, however, is the more challenging task of analyzing this information in a meaningful way. Recent scandals involving financial disclosures increase the importance of knowing just how to interpret financial information. In response to these scandals, Congress passed the Sarbanes-Oxley (SOX) Act of 2002, which increases the responsibility of publicly traded corporations, accounting firms performing audits, companies' management, and financial analysts. And while this Act is an attempt to restore faith in financial disclosures, investors and analysts must still be diligent in interpreting financial data





in a meaningful way. The purpose of this book is to assist the analyst and investor in understanding financial information and using this information in an effective manner.

### **WHAT IS FINANCIAL ANALYSIS?**

We focus on *financial analysis* in this book, which is the selection, evaluation, and interpretation of financial data and other pertinent information to assist in evaluating the operating performance and financial condition of a company. The operating performance of a company is a measure of how well a company has used its resources—its assets, both tangible and intangible—to produce a return on its investment. The financial condition of a company is a measure of its ability to satisfy its obligations, such as the payment of interest on its debt in a timely manner.

*Financial reporting* is the collection and presentation of current and historical financial information of a company. This reporting includes the annual reports sent to shareholders, the filings with the Securities and Exchange Commission for publicly traded companies, and press releases and other reports made by the company. Financial analysis takes that information—and much more—and makes sense out of in terms of what it says about the company's past performance and condition and—more importantly—what it says about the company's future performance and condition.

The financial analyst must determine what information to analyze (e.g., financial reports, market information, economic information) and how much information (Five years? Ten years?). The analyst must sift through the vast amount of information, selecting the information that is most important in assessing the company's current and future performance and condition. A part of this analysis requires the analyst to assess the quality of the information. Though publicly traded companies must report their financial information according to generally accepted accounting principles (GAAP), there is still some leeway that the reporting company has within these principles. The analyst must understand the extent of this leeway and what this implies for the company's future performance.

The analyst has many tools available in the analysis of financial information. These tools include financial ratio analysis and quantitative analysis. The analyst must understand how to use these tools in the most effective manner.

## WHAT HAPPENS IF WE ARE NOT LOOKING CLOSELY AT FINANCIAL INFORMATION?

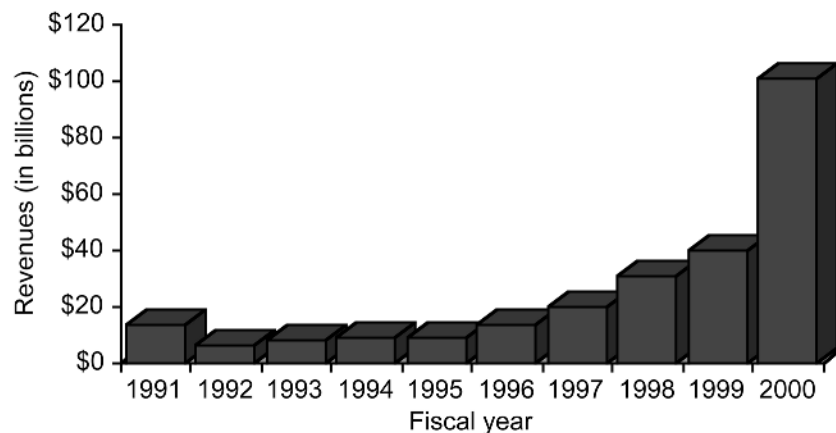
Several of the scandals that arose in the past few years were actually detectable using basic financial analysis and common sense. It is not possible to spot all cases of fraud and manipulation, but there are some telltale signs that should raise caution flags in analysis. Examples of these signs:

- Revenue growth that is out of line with others in the same industry or not reasonable given the current economic climate
- Profits that are increasing at a much faster rate than cash flows generated from operations
- Debt disappearing from the balance sheet

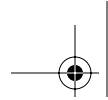
Consider Enron Corporation, Enron's revenues grew from a little over \$13.5 billion to over \$100 billion in the 10-year period from 1991 through 2000 as shown in Exhibit 1.1; in other words, its revenues grew at an average rate of over 25% per year. During this period, Enron's debts grew too, from 76% of its assets to over 82% of its assets. Enron experienced significant growth and reported significant debt, becoming one of the largest corporations in the United States within 15 years of becoming a publicly traded corporation.

Since 2001 Enron has been embroiled in a financial scandal that involved removing debt from its balance sheet into special purpose enti-

**EXHIBIT 1.1** Enron's Revenues, 1991–2000



Source: Enron, Inc. 10-K filings, various years.



ties. While the scandal was shocking, Enron had actually provided information in its financial disclosures that hinted at the problems.

Enron disclosed in footnotes to its 2000 10-K filing that it had formed wholly owned and majority-owned limited partnerships “for the purpose of holding \$1.6 billion of assets contribute by Enron.” [Enron 10-K, 2000] The result?

1. Assets and liabilities of Enron did not appear directly in its balance sheet.
2. Gains on Enron stock invested in by these partnerships found their way to Enron’s income statement.

The most notorious deal involved Joint Energy Development Investment Limited Partnership II (JEDI II). Enron executives created this partnership using Enron funds and loans fed through Chewco Investments. Though accounted for as a special purpose entity, with its assets and liabilities removed from Enron’s balance sheet, there was insufficient *independent* ownership of the entity to qualify JEDI II as a special purpose entity because Chewco was essentially Enron.

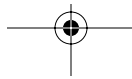
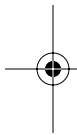
In all of this, keep in mind that Enron left a trail for the analyst to find in the filings of Enron and these entities. The limited partnerships and their relation to Enron were reported in the footnotes to Enron’s filings and in other filings with the SEC. Not all the pieces were there, but enough to raise concerns.

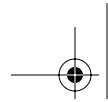
## **WHERE DO WE FIND THE FINANCIAL INFORMATION?**

There are many sources of information available to analysts and investors. One source of information is the company itself, preparing documents for regulators and distribution to shareholders. Another source is information prepared by government agencies that compile and report information about industries and the economy. Still another source is information prepared by financial service firms that compile, analyze, and report financial and other information about the company, the industry, and the economy.

The basic information about a company can be gleaned from publication (both print and Internet), annual reports, and sources such as the federal government and commercial financial information providers. The basic information about a company consists of the following:

- Type of business (e.g., manufacturer, retailer, service, utility)
- Primary products





- Strategic objectives
- Financial condition and operating performance
- Major competitors (domestic and foreign)
- Degree of competitiveness of the industry (domestic and foreign)
- Position of the company in the industry (e.g., market share)
- Industry trends (domestic and foreign)
- Regulatory issues (if applicable)
- Economic environment
- Recent and planned acquisitions and divestitures

A thorough financial analysis of a company requires examining events that help explain the firm's present condition and affect on its future prospects. For example, did the firm recently incur some extraordinary losses? Is the firm developing a new product, or acquiring another firm? Current events can provide useful information to the financial analyst. A good place to start is with the company itself and the disclosures that it makes—both financial and otherwise.

Most of the company-specific information can be picked up through company annual reports, press releases, and other information that the company provides to inform investors and customers about itself. Information about competitors and the markets for the company's products must be determined through familiarity with the products of the company and its competitors. Information about the economic environment can be found in many available sources. We take a brief look at the different types of information in the remainder of this chapter.

## **WHO GETS WHAT TYPE OF INFORMATION AND WHEN?**

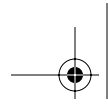
### **Disclosures Required by Regulatory Authorities**

Companies whose stock is traded in public markets are subject to a number of securities laws that require specific disclosures. Several of these securities laws are described briefly in Exhibit 1.2. Publicly traded companies are required by these securities laws to disclose information through filings with the Securities and Exchange Commission (SEC). The SEC is a federal agency that administers federal securities laws.

The SEC, established by the Securities and Exchange Act of 1934, carries out the following activities:

- Issues rules that clarify securities laws or trading procedure issues
- Requires disclosure of specific information



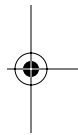
**EXHIBIT 1.2** Federal Regulations of Securities and Markets in the United States

Law	Description
Securities Act of 1933	Regulates new offerings of securities to the public; requires the filing of a registration statement containing specific information about the issuing corporation and prohibits fraudulent and deceptive practices related to security offers
Securities and Exchange Act of 1934	Establishes the Securities and Exchange Commission (SEC) to enforce securities regulations and extends regulation to the secondary markets
Investment Company Act of 1940	Gives the SEC regulatory authority over publicly held companies that are in the business of investing and trading in securities
Investment Advisers Act of 1940	Requires registration of investment advisors and regulates their activities
Federal Securities Act of 1964	Extends the regulatory authority of the SEC to include the over-the-counter securities markets
Sarbanes-Oxley Act of 2002	Wide-ranging law that creates the Public Accounting Oversight Board, requires auditor independence, increases corporate responsibility for financial disclosures, enhances financial disclosures, and extends the authority of the SEC

- Makes public statements on current issues
- Oversees self-regulation of the securities industry by the stock exchanges and professional groups such as the National Association of Securities Dealers

A publicly traded company must make a number of periodic and occasional filings with the SEC. In addition, major shareholders and executives must make periodic and occasional filings. A number of these filings are described in Exhibit 1.3. Company filings to the Securities and Exchange Commission are available free, in real-time, from the SEC's EDGAR web site, at [www.sec.gov](http://www.sec.gov).

By law the SEC has the authority to specify accounting principles for corporations under its jurisdiction. The SEC has largely delegated this responsibility to the Financial Accounting Standards Board (FASB). While recognizing FASB Statements of Financial Accounting Standards (SFAS) as authoritative, the SEC also issues accounting rules, often dealing with supplementary disclosures. Therefore, the financial information provided in the company's 10-K filing is more comprehensive than that provided in its annual report provided to shareholders.



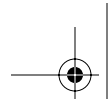
**EXHIBIT 1.3** Summary of Filings of Publicly Traded Companies, Their Owners, and Executives

Statement	Purpose	Information
10-K report	Annual disclosure of financial information required of all publicly traded companies; due 90 days following the company's fiscal year-end	Description of the company's business, financial statement data found in the company's annual report, notes to the financial statements, and additional disclosures including a management discussion and analysis
10-Q report	Quarterly disclosure by publicly traded companies; required 45 days following the end of each of the company's first three fiscal quarters	A brief presentation of quarterly financial statements, notes, and management's discussion and analysis
8-K filing	Filed to report unscheduled, material events or events that may be considered of importance to shareholders of the SEC	Description of significant events that are of interest to investors and are filed as these events occur
Prospectus	Filing made by a company intending to issue securities; registration statement complying with the Securities Act of 1933	Basic company and financial information of the issuing company
Proxy statement (Schedule 14A) <sup>a</sup>	Issued by the company pertaining to issues to be put to a vote by shareholders; complies with Regulation 14A; circumstances that are required for a vote are determined by state law	Description of issues to be put to a vote; management's recommendations regarding these issues; compensation of senior management; shareholdings of officers and directors

<sup>a</sup> There are different types of proxy: preliminary, confidential, and definitive. The most common is the definitive proxy, generally indicated with the abbreviation DEF (e.g., DEF 14A).

**EXHIBIT 1.3 (Continued)**

Statement	Purpose	Information
Registration statements (e.g., S-1, S-2, F-1)	A registration statement is a filing made by a company issuing securities to the public; required by the 1933 Act	Financial statement information as well as information that describes the business and management of the firm
Schedule 13D	Filing made by a person reporting beneficial ownership of shares of common stock of a publicly traded company such that the filer's beneficial ownership is more than 5% of a class of registered stock; filed within 10 days of the shares' acquisition	Report of an acquisition of shares, including information on the identity of the acquiring party, the source and amount of funds used to make the purchase, and the purpose of the purchase
Schedule 14D-1	Filing for a tender offer by someone other than the issuer such that the filer's beneficial ownership is more than 5% of a class of registered stock	Report of an offer to buy shares including information on the identity of the acquiring party, the source and amount of funds used to make the purchase, and the purpose of the purchase, and the terms of the offer

**Form 10-K**

The *Form 10-K* filing contains the information provided in the annual report (that is, balance sheet, income statement, statement of cash flows, statement of stockholders' equity, and footnotes), plus additional disclosures, such as the *management discussion and analysis* (MDA). For most large corporations, the 10-K must be filed within 60 days after close of corporation's fiscal year.<sup>1</sup> We provide a list of the required disclosures for Form 10-K in Exhibit 1.4, as identified using the SEC's numbering system of requirements.

**EXHIBIT 1.4** Required Disclosures of the Form 10-K Filing

## Part I

1. Business
2. Properties
3. Legal proceedings
4. Submission of matters to a vote of security holders

## Part II

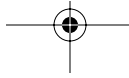
5. Market for registrants common equity, related stockholder matters and issue purchases of equity securities
6. Selected financial data
7. Management's discussion and analysis of financial conditions and results of operations
- 7A. Quantitative and qualitative disclosures about market risk
8. Financial statements, and supplementary data
9. Changes in and disagreement with accountants on accounting and financial disclosure
- 9A. Controls and procedures
- 9B. Other information

## Part III

10. Directors and executive officers
11. Executive compensation
12. Security ownership of certain beneficial owners and management and related stockholder matters
13. Certain relationships and related transactions
14. Principal accounting fees and services
15. Exhibits and financial statement schedules

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<sup>1</sup> The deadline was 90 days after the fiscal year prior to the SEC's RIN 3235-AI33, "Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports," (Effective November 15, 2002). The revised deadline of sixty days was phased in over three years and applies to issuers with a public float of at least \$75 million.



The disclosure requirements in the 10-K have changed over time as the SEC seeks additional information from companies regarding risk, internal controls, and the company's auditing firm.

The MDA is generally viewed as an important disclosure, providing additional transparency of financial statements. In the MDA, the company's management provides a discussion of risks, trends, unusual or infrequent events, and uncertainties that pertain to the company and is a useful device for management to explain the financial results in terms of the company's strategies, recent actions (e.g., mergers) and the company's competitors.

In addition, the company's management must provide a discussion of significant components of revenues and expenses that are important in understanding the company's results of operations. The MDA also provides information that may help reconcile previous years' financial results with the current year's results. Effective in 2003, the MDA must also provide additional information about off-balance sheet arrangements, as well as a table that discloses contractual obligations.<sup>2</sup>

### **Form 10-Q**

A similar form, *Form 10-Q*, must be filed within 35 days after close of corporation's fiscal quarter.<sup>3</sup> This filing is similar to the 10-K, yet there is much less detailed information. We list the required contents of the Form 10-Q in Exhibit 1.5.

### **8-K Statement**

The *8-K statement* is an occasional filing that provides useful information about the company that is not generally found in the financial statements. A company files the 8-K statement within four business days of the event. There are currently 22 specific events for which a company is required to file the 8-K statement, as detailed in Exhibit 1.6.<sup>4</sup> Previous to the SOX Act and the resulting SEC rules, the company was required to file an 8-K for any of eight events. The SOX Act shifted four additional requirements from the 10-K disclosures and added eight additional events.

<sup>2</sup> Securities and Exchange Commission, RIN3235-AI170, "Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations," effective April 7, 2003.

<sup>3</sup> SEC's RIN 3235-AI33.

<sup>4</sup> Securities and Exchange Commission, RIN3235-AI46, "Additional form 8-K Disclosure Requirements and Acceleration of Filing Date," (August 23, 2004). Under the previous rule, the SEC required 8-K filings for disclosure of nine different events. The 2002 rule added eight additional events that require 8-K disclosure and shifted four disclosure requirements from the 10-K and 10-Q disclosures.

**EXHIBIT 1.5** Required Disclosures of the Form 10-Q Filing

## Part I

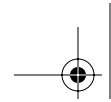
1. Financial statements
2. Management's discussion and analysis of financial conditions and results of operations
3. Quantitative and qualitative disclosures about market risk legal proceedings
4. Controls and procedures

## Part II

1. Legal proceedings
2. Unregistered sales of equity securities and use of proceeds
3. Defaults upon senior securities
4. Submission of matters to a vote of security holders
5. Other information
6. Exhibits

**EXHIBIT 1.6** Events Requiring Disclosure of 8-K

	Pre-SOX Act Requirement for 8-K Filings	Previous Requirement for 10-K and 10-Q Filings	Post-SOX Act Require- ments
1. Bankruptcy or receivership	✓		
2. Completion of an acquisition or disposition of assets	✓		
3. Changes in registrant's certifying accountant	✓		
4. Changes in the control of the registrant.	✓		
5. Change in fiscal year	✓		
6. Temporary suspension of trading under registrants employee benefit plans	✓		
7. Amendments to the registrant's code of ethics or the waiver of a provision of the code of ethics.	✓		
8. Regulation FD disclosure	✓		
9. Departure of directors or principal officers, election of directors, or appointment of principal officers.		✓	
10. Unregistered sales of equity securities		✓	
11. Material modifications to rights of security holders		✓	
12. Amendments to articles of incorporation or bylaws		✓	

**EXHIBIT 1.6** (Continued)

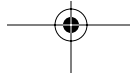
	Pre-SOX Act Requirement for 8-K Filings	Previous Requirement for 10-K and 10-Q Filings	Post-SOX Act Require- ments
13. Entry into a material definitive agreement			✓
14. Termination of a material definitive agreement			✓
15. Creation of a direct financial obligation or an obligation under an off-balance sheet arrangement			✓
16. Events that accelerate or increase a direct financial obligation of an obligation under an off-balance sheet arrangement			✓
17. Costs associated with exit or disposal activities			✓
18. Material impairments			✓
19. Notice of delisting or failure to satisfy a continued listing rule or standard, or a transfer of listing			✓
20. Unregistered sales of equity securities			✓
21. Material modifications to rights of security holders			✓
22. Nonreliance on previous issued financial statements or a related audit report or completed interim review			✓

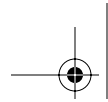
In addition, any other event that the company deems important to shareholders may be reported using an 8-K filing. Because 8-K filings are triggered by major company events, it is useful for the analyst to keep abreast of any such filings for the companies that they follow.

**Proxy Statement**

In addition to the financial statement and management discussion information available in the periodic 10-Q and 10-K filings, companies provide useful nonfinancial information in proxy statements. The *proxy statement* is the company's notification to the shareholders of matters to be voted upon at a shareholders' meeting. The proxy statement provides an array of information on issues such as:

- The reappointment of the independent auditor
- Compensation (salary, bonus, and options) of the top five executives and the stock ownership of executives and directors





- Detailed information about proposals subject to a vote by the shareholders

### ***Other Filings***

In addition, when a corporation offers a new security to the public, the SEC requires that the corporation prepare and file a registration statement. The registration statement presents financial statement data, along with detailed information about the new security. A condensed version of this statement, referred to as a *prospectus*, is made available to potential investors.

### ***Documents Distributed to Shareholders***

The objective of financial reporting is to

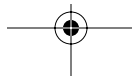
provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.<sup>5</sup>

With that objective in mind, the financial reports prepared and distributed by the company should help users in assessing “the amounts, timing and uncertainty of prospective net cash inflows of the enterprise.”<sup>6</sup> Therefore, the financial reports to shareholders are not simply a presentation of the basic financial statements—the balance sheet, the income statement, the statement of cash flows, and the statement of stockholders’ equity—but also a device to communicate additional non-financial information, such as information about the relevant risks and uncertainties of the company. To that end, recent changes in accounting standards have broadened the extent and type of the information presented within the financial statements and in notes to the financial statements. For example, companies are now required to disclose risks and uncertainties related to their operations, how they use estimates in the preparation of financial statements, and the vulnerability of the company to geographic and customer concentrations.<sup>7</sup>

<sup>5</sup> Financial Accounting Concept 1, *Objectives of Financial Reporting by Business Enterprises* (Stamford: Financial Accounting Standards Board, November 1978).

<sup>6</sup> Financial Accounting Concept 1, *Objectives of Financial Reporting by Business Enterprises*.

<sup>7</sup> Statement of Position 94-6 *Disclosure of Significant Risks and Uncertainties* (Accounting Standards Executive Committee, 1994), effective for fiscal years beginning after December 15, 1995.



The annual report is the principal document used by corporations to communicate with shareholders. It is not an official Securities and Exchange Commission (SEC) filing; consequently, companies have significant discretion in deciding on what types of information is reported and the way it is presented. The annual report presents the financial statements, notes to these statements, a discussion of the company by management, the report of the independent accountants, and financial information on operating segments, product and services, geographical areas, and major customers.<sup>8</sup> Along with this basic information, annual reports may present five or ten-year summaries of key financial data, quarterly data, and other descriptions of the business or its products.

Quarterly reports to shareholders provide limited financial information on operations. These reports are simpler and more compact in presentation than their annual counterpart. In addition to the annual and quarterly reports, companies provide information through press releases using the services of commercial wire services such as Reuters ([www.reuters.com](http://www.reuters.com)), PR Newswire ([www.prnewswire.com](http://www.prnewswire.com)), Business Wire ([www.businesswire.com](http://www.businesswire.com)), First Call ([www.firstcall.com](http://www.firstcall.com)), or Dow Jones ([www.dow-jones.com](http://www.dow-jones.com)). The wire services then distribute this information to print and Internet mediums. The information provided in press releases includes earnings, dividend, new product, and acquisition announcements.

### **Issues**

There are a number of issues that should be considered in using the financial statement data provided in company annual and quarterly reports. We will discuss many of these issues in later chapters that focus on financial analysis, cash flow analysis, and earnings quality.

For example, consider the following examples:

- The restatement of prior years' data
- The different accounting standards used by non-U.S. companies
- There may be "off-balance sheet" activity

**The Restatement of Prior Years' Data** When a company reports financial data for more than one year, which is often the case, previous years' financial data is restated to reflect any changes in accounting methods or acquisitions that have taken place since the previous data had been reported. Consider the case of J. C. Penney, shown in Exhibit 1.7. The originally reported data for 2002 is shown alongside the restated data. Therefore,

<sup>8</sup> Statement of Financial Accounting Standards, No. 131 *Disclosures about Segments of an Enterprise and Related Information* (Stamford: Financial Accounting Standards Board, June 1997).

**EXHIBIT 1.7** Selected Data for J.C. Penney

	2002 As Originally Reported (in millions)	2002 As Restated to Reflect the Sale of Eckerd (in millions)
Sales	\$32,347	\$17,633
Net profit	\$405	\$120
Total assets	\$18,300	\$17,787
Shareholders' equity	\$5,425	\$6,370

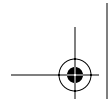
Source: Form 10-K filings with the Securities and Exchange Commission

the analyst must consider which data is most appropriate to use in the analysis.<sup>9</sup> If, for example, the analyst were looking at J. C. Penney and its competitive position in 2002, the analyst would want to use the as-reported 2002 data. If, on the other hand, the analyst is looking at trends in some of the data in an effort to forecast future performance or condition, the restated 2002 data is more appropriate.

**The Different Accounting Standards Used by Non-U.S. Companies** Another concern is dealing with financial statements of non-U.S. reporting entities. There are several reasons for this concern. First, as of this writing, there are no internationally acceptable standards of financial reporting. This includes not only the accounting methods that are acceptable for handling certain economic transactions and the degree of disclosure, but other issues. Specifically, there is no uniform treatment of the frequency of disclosure. Some countries require only annual or semiannual reporting rather than quarterly as in the United States.

There is an effort to harmonize accounting standards around the world. The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) are working toward the development of international accounting standards. In addition, the IASB and the FASB have agreed to produce joint pronouncement regarding new accounting standards. Beginning January 1, 2005, most companies listed in the European Union are required to prepare their financial

<sup>9</sup> In academic studies that examine the relation between stock prices and accounting information, the "as originally reported" data is most often the relevant data to use because the researcher is examining the market's reaction to the accounting information as it is released. It is reasonable to assume that investors use all currently available information, but it is not reasonable to assume that investors are psychic and, therefore, know what the information will be restated as in future years.



statements according to the International Financial Reporting Standards (IFRS), which are promulgated by the IASB. The adoption of IFRS, along with the convergence of the standards of IASB and FASB, are significant strides toward consistent international accounting standards.<sup>10</sup>

**There May Be "Off-Balance Sheet" Activity** There is always some investment or financing activity that simply does not show up in financial statements. Though there have been improvements in accounting standards that have moved much of this activity to the financial statements (e.g., leases, pension benefits, postretirement benefits, asset retirement obligations), opportunities remain to conduct business that is not represented adequately in the financial statements. An example is the case of joint ventures. As long as the investing corporation does not have a controlling interest in the joint venture, the assets and financing of the venture can remain off of the balance sheet. Limited information is provided in notes to the statements, but this information is insufficient to adjudge the performance and risks of the joint venture.

The opportunity to keep some information from the financial statements places a greater burden on the financial analyst to dig deep into the company's notes to the financial statements, filings with the SEC, and the financial press.

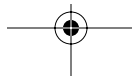
### ***Interviewing Company Representatives***

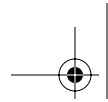
Interviewing representatives of a company may produce additional information and insight into the company's business. The starting place for the interview is the company's investors' relations (IR) office, which is generally well prepared to address the analyst's questions.

The key is for the analyst to do their homework before meeting with the IR officer so that the interview questions can be well focused. This preparation includes understanding the company's business, its products, the industry in which it operates, and its recent financial disclosures. The analyst must understand the industry-specific terminology and any industry-specific accounting methods. In the telecommunications industry, for example, the analyst must understand measures such as *giga-hertz* and *minutes-in-use*, and such terms as *bandwidth*, *point-of-presence*, and *spectrum*.<sup>11</sup> As another example, an analyst for the oil and gas industry should understand that a *degree-day* is a measure of temperature variation from a reference temperature.

<sup>10</sup> We discuss the IFRS and compare it with U.S. GAAP in Chapter 2.

<sup>11</sup> *The Telecommunications Industry* (Charlottesville: Association for Investment Management and Research, 1994), pp. 108–110.





The analyst must keep in mind that the IR officer has an obligation to treat all investors in a fair manner, which means that the IR officer cannot give a financial analyst material information that is not also available to others. There is also information that the IR officer *cannot* give the analyst. For example, in a very competitive industry it may not be appropriate to give monthly sales figures for specific products. The analyst must understand the competitive nature of the industry and understand what information is typically not revealed in the industry.

Because the analyst comes armed with knowledge of the company's financial statements, the questions should focus on taking a closer look at the information provided by these disclosures:

- Extraordinary or unusual revenues and expenses
- Large differences between earnings and cash flows
- Changes in how data is reported
- Explanations for deviations from consensus earnings expectations
- How the company values itself versus the market's valuation
- Sales to major customers

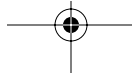
An analyst that uses a statistical model to develop forecasts for the company or its industry may, of course, require very specific data that may not be readily available in the financial statements.

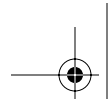
It is sometimes useful to determine what the company expects to earn in the future. Though companies may be reluctant to provide a specific earnings forecast, they will sometimes respond to a query regarding analysts' consensus earnings forecasts. In their response about analysts' forecasts, the company may reveal their own forecast. If a company provides a forecast of its earnings, the analyst must consider the forecast in light of the company's previous forecasting; for example, some companies may consistently underestimate future earnings in order to avoid a negative earnings surprise. Further, the company's forecast or response to a consensus forecast might be accompanied by significant defensive disclosures that concern the risks that the company may not meet projected earnings.

### **Regulation FD**

In an attempt to "level the playing field", the Securities and Exchange Commission in 2000 adopted new rules regarding selective disclosure.<sup>12</sup> These rules, in the form of the Fair Disclosure regulation, are referred to

<sup>12</sup> Securities and Exchange Commission, RIN 3235-AH82, "Selective disclosure and Insider Trading," effective October 23, 2000.





as Regulation FD. Basically, if a publicly traded company or anyone acting on its behalf makes a material, nonpublic information available to certain persons, the company must make a *public* disclosure of this information. All intentional disclosures must be made simultaneously to the public. If someone makes an *unintentional* disclosure, the company is required to make a prompt, public disclosure of the information.

### **Information Prepared by Government Agencies**

Federal and state governmental agencies provide a wealth of information that may be useful in analyzing a company, its industry, or the economic environment.

#### ***Company-Specific Information***

One of the most prominent innovations in the delivery of company information is the Securities and Exchange Commission's Electronic Data Gathering and Retrieval (EDGAR) system that is available on the Internet ([www.sec.gov](http://www.sec.gov)). The EDGAR system provides online access to most SEC filings for all public domestic companies from 1994 forward. The EDGAR system provides real-time access to filings, providing up-to-date information accessible to everyone.

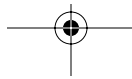
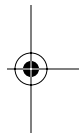
In addition to the EDGAR system at the SEC site, several financial service companies provide free or fee access to the information in the EDGAR system in different data base forms that assist in searching or data base creation tasks.<sup>13</sup>

#### ***Industry Data***

The analysis of a company requires that the analyst look at the other firms that operate in the same line of business. The purpose of examining these other companies is to get an idea of the market in which the company's products are sold: What is the degree of competition? What are the trends? What is the financial condition of the company's competitors?

Several government agencies provide information that is useful in an analysis of an industry. The primary governmental providers of industry data are the U. S. Bureau of the Census and the Bureau of Economic Analysis, an agency of the U. S. Department of Commerce. A recent innovation is the creation of Stat-USA, a fee-based collection of governmental data. Stat-USA is an electronic provider of industry and sector data that is produced by the U.S. Department of Commerce. The available data pro-

<sup>13</sup> These services include EDGAR Online ([www.edgar-online.com](http://www.edgar-online.com)) and EDGAR from Compustat ([www.compustat.com](http://www.compustat.com))



vided for different industries includes gross domestic product, shipments of products, inventories, orders, and plant capacity utilization.<sup>14</sup>

The government classification of businesses into industries is based on the *North American Industry Classification System (NAICS)*.<sup>15</sup> NAICS is a recently adopted system of industry identification, replacing the Standard Industrial Classification (SIC) system in 1997.<sup>16</sup> The NAICS is a six-digit system that classifies businesses using 350 different classes. The broadest classification comprises the first two digits of the six-digit code and is listed in Exhibit 1.8. The NAICS is now the basis for the classification of industry-specific data produced by governmental agencies. Like the SIC system before it, the NAICS will, over time, become the basis for the classification of companies for industry-specific data used by nongovernmental information providers as well.

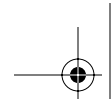
**EXHIBIT 1.8** North American Industry Classification System Sector Codes

Code	NAICS Sectors
11	Agriculture, Forestry, Fishing and Hunting
21	Mining
22	Utilities
23	Construction
31–33	Manufacturing
42	Wholesale Trade
44–45	Retail Trade
48–49	Transportation and Warehousing
51	Information
52	Finance and Insurance
53	Real Estate and Rental and Leasing
54	Professional, Scientific, and Technical Services
55	Management of Companies and Enterprises
56	Administrative and Support, Waste Management and Remediation Services

<sup>14</sup> Web access to this data is available through the Department of Commerce site ([www.doc.gov](http://www.doc.gov)), Stat-USA ([www.stat-usa.gov](http://www.stat-usa.gov)) and the Census Bureau ([www.census.gov](http://www.census.gov)).

<sup>15</sup> This classification system is the result of the joint efforts of the U.S. Bureau of Economic Analysis (BEA), the U.S. Bureau of Labor Statistics, the U.S. Census Bureau, Statistics Canada, and Mexico's Instituto Nacional de Estadística, Geografía e Informática (INEGI).

<sup>16</sup> The SIC system was developed by the Office of Management and Budget and had been in use since the 1930s.

**EXHIBIT 1.8** (Continued)

Code	NAICS Sectors
61	Education Services
62	Health Care and Social Assistance
71	Arts, Entertainment, and Recreation
72	Accommodation and Foodservices
81	Other Services (except Public Administration)
92	Public Administration

Source: <http://www.census.gov/epcd/www/naics.html>

**EXHIBIT 1.9** Examples of Government Sources of Economic Data

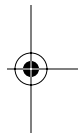
Publisher	Web Sources	Print or CD-ROM Product
Board of Governors of the Federal Reserve System	<a href="http://www.bog.frb.fed.us">www.bog.frb.fed.us</a>	Federal Reserve Bulletin
Bureau of Economic Analysis	<a href="http://www.bea.doc.gov">www.bea.doc.gov</a>	National Product Accounts Business Inventories Gross Product by Industry
Federal Reserve Bank of St. Louis, FRED II	<a href="http://research.stlouisfed.org/fred2/">research.stlouisfed.org/fred2/</a>	
Stat-USA	<a href="http://www.stat-usa.gov">www.stat-usa.gov</a>	National Trade Data Bank
U.S. Census Bureau	<a href="http://www.census.gov">www.census.gov</a>	CenStats
U.S. Department of Commerce	<a href="http://www.doc.gov">www.doc.gov</a>	Survey of Current Business

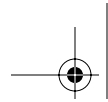
**Economic Data**

Another source of information for financial analysis is economic data, such as the gross domestic product and consumer price index, which may be useful in assessing the recent performance or future prospects of a firm or industry. For example, suppose you are evaluating a firm that owns a chain of retail outlets. What information do you need to judge the firm's performance and financial condition? You need financial data, but they do not tell the whole story. You also need information on consumer spending, producer prices, and consumer prices. These economic data are readily available from government sources, a few of which are listed in Exhibit 1.9.

**Information Prepared by Financial Service Companies**

A whole industry exists to provide financial and related information about individual companies, industries, and the economy. The ease and





low cost of providing such data on the Internet has fostered a proliferation of information providers. However, the prominent providers in today's Internet-based world are some of the same providers that were prominent in print medium.

### ***Company-Specific Information***

Information about an individual company is available from a vast number of sources, including the company itself through its own web pages. In addition to relaying the company's financial information that is presented by the company through its communication with shareholders and regulators, there are many financial service firms that compile the financial data and present analyses.

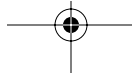
Several sources of data on individual companies are listed in Exhibit 1.10. This is by no means an exhaustive listing because of the large and ever-growing number of information providers. The providers distinguish themselves in the market for information through the breadth of coverage (in terms of the number of companies in their data base), the depth of coverage (in terms of the extensive nature of their data for individual companies), or their specialty (e.g., the collection of analyst recommendations and forecasts).

Just what data is used to analyze an industry depends on the particular industry. We provide examples of industry-specific data in Exhibit 1.11.

A number of financial information providers offer industry-specific data and compile financial data by industry. Some services, such as Standard & Poor's Compustat and Value Line, provide industry data based on their large universe of stocks covered in their database of individual company financial data.

### ***Economic Data***

Much of the economic data that is used in financial analysis is taken from government sources, though some information is independently produced through surveys and research. There are many commercial services that collect and disseminate this and other information. These services include AP Business News ([www.ap.org](http://www.ap.org)), Bridge ([www.bridge.com](http://www.bridge.com)), and Business Wire ([www.businesswire.com](http://www.businesswire.com)). Financial publications, such as the *Wall Street Journal* ([www.wsj.com](http://www.wsj.com)), *Investors Business Daily* ([www.investors.com](http://www.investors.com)) and the *Financial Times* ([www.ft.com](http://www.ft.com)), provide economic data in both in print and electronic forms. In addition, databases such as the DRI U.S. Central database (USCEN) offer an historical series of U.S. economic and financial data.

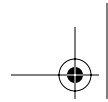


**EXHIBIT 1.10 Sources of Individual Company Financial Data**

Provider	URL	Products
Dun & Bradstreet	www.dnb.com	<i>Principal International Businesses</i> . Electronic data base of selected information on 50,000 companies in 140 countries
Fitch IBCA	www.fitchibca.com	<i>BankScope</i> . Comprehensive database of financials on 10,000 international banks <i>CreditDisk</i> . International bank rating service on CD-ROM <i>FitchResearch</i> . In-depth research on U.S. corporations
Mergent	www.mergentonline.com	<i>Mergent Online</i> . U.S. and International Company data (formerly, Moody's® Manual)
Microsoft's MSN Money	moneycentral.msn.com	Company profiles, SEC filings, daily stock price data
Moody's Investor Services	www.moody.com	<i>Company Data Direct</i> . An online database of information on companies' history, financial statements, and long-term debt.
Standard and Poor's, McGraw-Hill, Inc.	www.standardandpoors.com	<i>Company Data with EDGAR</i> . An electronic database consisting of company SEC filings coverage for over 18,000 North American and 11,000 global companies. <i>Market Insight</i> . Web-based access to individual company financial statement data on the Standard & Poor's universe of companies.
Thomson	thomson.com/financial/	<i>Thomson Research</i> . Electronic database of companies' financial statements and financial analyst forecasts (formerly Disclosure Global Access).
Value Line, Inc.	www.valueline.com	<i>Value Line DataFile</i> . Electronic database with annual and quarterly financial statement and monthly market price data for over 5,000 securities on an "as reported" basis since 1955. <i>Estimates &amp; Projections File</i> . Electronic data with Value Line's proprietary estimates of earnings and dividends for the 1,700 companies.
Yahoo! Finance	Finance.yahoo.com	Company profiles, company links, three years of annual financial statement data, and daily stock price data.
Zack's Investment Research	www.zackspro.com	<i>Zacks Historical Data</i> . Electronic database comprised of financial statement data, analyst forecasts, earnings surprise and stock recommendations. <i>Zacks Research System (ZRA)</i> . An electronic database that includes financial statement, price, and earnings data for over 6,000 companies.

**EXHIBIT 1.11** Examples of Industry-Specific Factors

Industry	Factor	Explanation
Advertising	Gross billings	Total dollar amount of revenues from advertising
Air transport	Load factor	Percentage of seats sold
Aircraft manufacturer	Backlog	Number of aircraft ordered for production not completed
Banking/Credit	Loan origination	Dollar amount of loans made
	Loan loss provision	Percentage of loans considered being bad debt
	Cards in force	Number of credit cards outstanding
Electric Utility	Load factor	Average of the percentage of total capacity used
Retail	Same-store sales	Revenues of the same store in a previous period
Savings and Loan	Interest cost to gross income	Percentage of interest paid on deposits to total gross income
Semiconductor	Book-to-bill ratio	Ratio of orders to completed orders
Telecommunications	Cost per access line	Ratio of operating cost to number of lines of service



## WHAT DOES SARBANES-OXLEY MEAN TO COMPANIES AND INVESTORS?

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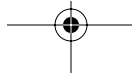
The financial scandals that arose recently created problems in terms of the public's confidence in the capital markets, companies' financial disclosures, and the reliance on the auditing by public accounting firms. In response to this lack of confidence, the Sarbanes Oxley Act of 2002 was passed in mid-2002.<sup>17</sup> The Sarbanes-Oxley Act of 2002 has changed the landscape with respect to financial disclosures, corporate governance, auditing, and penalties for financial misdeeds. A list of key provisions that affect financial analysis of companies is provided in Exhibit 1.12.

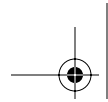
### EXHIBIT 1.12 Key Provisions of the Sarbanes-Oxley Act of 2002

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- |           |   |
|-----------|---|
| Title I   | Public Company Accounting Oversight Board <ul style="list-style-type: none"><li>• Establishes the oversight board, as well as provide policies and procedures for registration of accounting firms. The purpose of the board is to provide oversight of auditing firms and develop standards for auditors, auditing, and auditing reports, as well as to inspect accounting firms for compliance [Sec. 101].</li></ul>  |
| Title II  | Auditor Independence <ul style="list-style-type: none"><li>• Prohibits most types of nonaudit services of client by auditing accounting firm [Sec. 201]. Any nonaudit service by an auditor must be approved by the audit committee of the client [Sec. 202].</li></ul>   |
| Title III | Corporate Responsibility <ul style="list-style-type: none"><li>• Requires that members of the client's audit committee be independent (i.e., not an employee of the client or consultant or advisor other than in capacity as a member of the board of directors) [Sec. 301]</li><li>• Requires certification of the annual and quarterly filings with the SEC by the chief financial officer and the chief executive officer, attesting to the internal controls of the firms [Sec. 302]</li><li>• Prohibits improper influence on audits [Sec. 303]</li><li>• Specifies forfeiture of bonuses and profits on securities in the event of financial restatements [Sec. 304]</li><li>• Prohibits insider trading during pension fund blackouts and requires sufficient communication to fund participants and beneficiaries in the event of a blackout period [Sec. 306]</li></ul> |
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<sup>17</sup> Public Law 107-204, July 30, 2002 116 stat.745.





**EXHIBIT 1.12** (Continued)

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- Title IV Enhanced Financial Disclosures
- Enhances disclosure of off-balance sheet transactions [Sec 401]
  - Requires reconciliation of pro forma financial information with results according to generally accepted accounting principles [Sec. 401]
  - Prohibits many types of personal loans to directors or executives [Sec. 402]
  - Increases disclosure requirements for transactions with directors, executives and principal shareholders [Sec. 403]
  - Requires disclosure of whether the firm has a code of ethics for financial officers [Sec. 406]
  - Requires disclosure whether there is at least one financial expert on the audit committee [Sec. 407]
- Title V Analyst Conflicts of Interest
- Increase the independence of analysts and investment banking activities and requires disclosure of potential conflicts of interest of analysts [Sec. 501]
- Title VIII Corporate and Criminal Fraud Accountability
- Imposes criminal penalties for destruction of documents [Sec. 802]
  - Provides whistleblower protection in fraud actions. [Sec. 806]
  - Provides criminal penalties for defrauding shareholders. [Sec. 807]
- Title IX White-Collar Crime Penalty Enhancements
- Provides increased criminal penalties for white-collar crimes, such as mail and wire fraud [Sec. 902]
  - Imposes criminal penalties for false certification of financial reports [Sec. 906]
- Title XI Corporate Fraud and Accountability
- Imposes fines and possible imprisonment for tampering with documents in an investigation [Sec. 1102]
  - Provides the SEC with authority to freeze payments in the event of an investigation [Sec. 1103]
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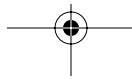
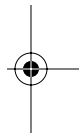
**Auditors**

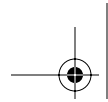
The role of the auditing accounting firm is to attest to whether the client company is providing financial statements that are prepared consistent with generally accepted accounting principles. Consider the Supreme Court of the United States opinion in the case of *United States v. Arthur Young*:<sup>18</sup>

This ‘public watchdog’ function demands that the accountant maintain total independence from the client

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<sup>18</sup> *United States v. Arthur Young & Co., Et. Al* 465 U. S. 805 (1984).





at all times and requires complete fidelity to the public trust. . . . Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.

The establishment of a the oversight board for accounting firms and the requirements pertaining to auditor independence are in response to the problems encountered when the relationship between the auditor and the audit client becomes too close, inhibiting the audit firm from being the "public watchdog" of the client's compliance with generally accepted accounting principles. Consider the case of Enron Corporation. In 2000, the year before the scandal erupted, Enron paid its auditing accounting firm a total of \$52 million in fees: \$25 million for audit services and \$27 million for consulting services.<sup>19</sup>

### ***Corporate Responsibility***

There are a number of provisions in the SOX Act that affect the responsibilities of publicly traded corporations and build upon previous attempts to strengthen the role of the audit committee, which is a committee comprised of members of the company's board of directors.<sup>20</sup> The SOX Act provisions affect the corporate governance with respect to the composition of the audit committee that has responsibilities related to financial reporting, monitoring choices of accounting policies, monitor the internal control process, and oversee the hiring and performance of the auditors.

In addition to the enhanced role of the audit committee, the SOX Act and subsequently issued rules prohibit insider trading during a pension blackout period.<sup>21</sup> A blackout period is the period of time in which participants in a participant-directed pension plan cannot trade employer securities. This is, again, a response to problems observed at firms involved in scandals in which the executives were able to sell their stock in the company before the company's demise, but other employees were not able to do so.<sup>22</sup>

<sup>19</sup> Enron Corporation's definitive proxy, DEF 14A, filed March 28, 2001, p. 11.

<sup>20</sup> Previous movements to strengthen the role of the audit committee include the Treadway Commission, which was the National Commission on Fraudulent Financial Reporting.

<sup>21</sup> SEC RIN3235-AI171, "Insider Trades During Pension Fund Blackout Periods," effective January 23, 2003.



### Financial Disclosures

Financial disclosures were enhanced in three ways with the SOX Act. First, more information must be disclosed regarding off-balance sheet transactions. Second, companies are required to reconcile pro forma financial information with financial information determined using generally accepted accounting principles. Pro forma results are financial statement information, such as earnings, that are calculated by the company using their own creative approach to accounting. For example, Trump Hotels & Casinos Resorts, Inc. released earnings results for 1999 that selectively included some information (a one-time gain), but excluded other information (a one-time charge):<sup>23</sup>

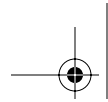
	As Reported October 25, 1999 (in millions)	Per GAAP (in millions)
Revenues before one-time gain		\$385.9
One-time gain		17.2
Revenues	\$403	\$403.1
Net income before any one-time losses		
One-time charge		-81.4
Net income	\$14.0	-\$67.5

As you can see, investors get a different picture of Trump Hotels & Casinos Resorts' performance, depending on which results they focus on.

In addition, companies must now make disclosures regarding the corporation's governance, such as whether there is a financial expert on the audit committee, whether there is a code of ethics for financial officers. Further, there are greater restrictions on loans to executives.

<sup>22</sup> Many Enron employees had the majority of their retirement savings in Enron stock prior to the scandal. Making matters worse was the while Enron's stock fell, the 401(k) plan was "locked down" during an pension "blackout period," prohibiting those over 50 years of age from selling their shares. However, this prohibition did not apply to the company's executives. As the stock was falling from around \$90 per share to less than \$1 a share following the news of the scandal, most Enron employees had lost the vast majority of their retirement savings. The executives, many of whom sold their stock prior to the stock's bottom price, took home millions of dollars.

<sup>23</sup> Accounting and Auditing Enforcement Release No. 1499, January 16, 2002, Administrative Proceeding File No. 3-10680.



### Analysts

There is a potential for a conflict of interest in the case of financial analysts that are employed by firms that perform investment banking functions. One of the important functions of an investment banking firm is to help companies bring stock and bond issues to the market, providing capital for corporations. If the investment banking part of the company is not sufficiently independent of the financial analysts of the same company, who may be making stock or bond recommendations, there is a potential for biased ratings on the stock or bond issue.

The goal of the analyst provisions in the SOX Act, among other actions taken by the SEC, is to insure that there is no link between the investment banking and the financial analyst functions within a company.<sup>24</sup>

### Accountability

There are a number of deterrents to financial fraud included in the SOX Act. There are criminal penalties included for defrauding shareholders, destroying documents, false certification of financial reports, and mail fraud. There is also increased protection of whistleblowers. Many of the expanded criminal penalties are the direct result of recent scandals.

### SUMMARY

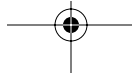
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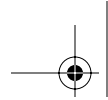
Financial analysis is the selection, evaluation and interpretation of financial data and other information with the objective of formulating forecasts of future cash flows of a company. Financial analysis is different from financial reporting; financial reporting conveys past and current financial information, whereas financial analysis is forward-looking. A challenge of financial analysis is to sort through the wealth of information and develop a meaningful analysis of a company.

Companies prepare and distribute information for regulators and shareholders. This information includes annual and quarterly financial reports (e.g., 10-K, 10-Q). Additional information may be gathered from 8-K filings, company press releases, proxy statements, and through interviewing a company's representatives. Government agencies and commercial services prepare and disseminate information about individual companies, industries, and the economy.

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<sup>24</sup> An example is the Merrill Lynch, which settled with the SEC, paying \$100 million in 2002, in a case that involved an analyst who gave high ratings to a stock of a company that was an investment banking client of the firm. However, in private emails that same analyst did not believe that the stock was of high quality.





The Sarbanes-Oxley Act of 2002 has changed financial reporting and disclosures through additional disclosure requirements and through enhanced penalties for financial misconduct. This Act has also changed the responsibilities of the company's audit committee, as well as the relation with the auditor. In addition, the Act has provisions that require the independence of the financial analyst from any investment banking functions of the analyst's employer.

