

**\*\*\*This handout is supplemental material – Used at discretion of presenter\*\*\***

## **A COMPANY’S FINANCIAL PERSONALITY** **AND COMPARING THE FINANCIALS OF INDUSTRIES**

*Morning Presentations*

### **Figuring out a Company’s Financial Personality**

- From birth: S-1 filings
- The mid-life filings: 10-Ks, 10-Qs, proxy statement, 8-Ks, and Forms 3,4,5
- The end-of-life filings: Merger-related documents (S-4s, DEFM14-A), bankruptcy

### **Finding the Personality “Tags” in Filings**

- Executive compensation
- Other perks
- Consulting contracts
- Employment agreements
- Severance/change-in-control agreements
- Related party transactions

### **Calculating Executive Pay**

- Base salary
- Bonuses
- Other income and “all other income” (perks)
- Restricted stock
- Stock options
- Long-term incentive pay plans (LTIP)
- A Closer Look: American Express’ 2005 Summary Comp Table (see “Examples”)
  - There are 105 (7x3x5) different numbers all related to compensation here.  
***Which ones pop out at you?***

### **Different Strokes in Summary Charts**

- What makes these two summary charts different?
- What do these charts tell you about each company’s personality?
- Beyond the Summary Chart:
  - Footnotes, footnotes, footnotes!
  - Options, LTIPs, Pensions
  - Summary of employment contracts, severance agreements, change-in-control agreements, etc.
  - Compensation committee report
  - A Closer Look: FedEx’s Footnotes

### **Comparing Restricted Stock with Stock Options**

- Restricted Stock
  - Stock has a “restriction,” such as requiring a certain length of time to pass or a certain goal to be achieved before the stock can be sold.
  - That’s called the “vesting period.”

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### **Comparing Restricted Stock with Stock Options (cont'd)**

- Example: Stock awarded if employee stays with the company for two years. Or when gross sales hit \$10 million.
- Stock Options
  - Right to buy a stock.
  - At a specific price (exercise price).
  - After a certain time (vesting period).
  - In the money vs. out of the money (under water).
- Options v. Restricted Stock
  - The difference is at end of the vesting period.
  - When a stock option vests, you can purchase, or not purchase, the stock at a specific price (“strike price”).
  - You do not own any stock until you exercise the option and purchase the stock. As soon as you purchase it, you can do anything you want, including sell it.
  - When a restricted stock award vests, you own the stock and you can do whatever you want with it.
  - Generally, restricted stock awards are about one-half to one-third as large as options.
  - Example: If a stock option grant were 100 shares, a restricted stock award would range from 33 to 50 shares. This is because at the end of the vesting period, the 33 to 50 shares would still have some value and the 100 stock options might not.
  - For more information, see:  
<http://management.about.com/cs/money/a/ResStkFAQ1203.htm>

### **Long-Term Incentive Plans**

- Another key part of compensation.
- These have grown increasingly popular in recent years.
- Details on the plans vary from company to company.
- Payouts are often tied to meeting a particular financial goal.

### **More Ways to Pay**

- Traditional pension
- Portable pension
- Covered compensation
- Lump-sum distribution
- Shadow accounts
- Tax gross-up
- Consulting Agreements
  - Companies routinely enter into these with former executives and directors.
  - Contracts can be short- or long-term.
  - Perks such as office space, equipment and secretarial help are common.
  - Summary of contract is in the proxy, but look for the actual contract for the nitty-gritty. The contract itself is often an exhibit at the end of a 10-K, 10-Q or 8-K filing.

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### **Employment Contracts**

- Spells out terms of employment, including salary, bonus, etc.
- Average length is 3 years.
- Provides details on perks: housing allowance, car, equipment, private school for kids, etc.
- Often includes information on severance/change-in-control situations.
- A Closer Look: Sample Contract: Steve Madden Shoes

### **Severance/Change-in-Control**

- Lump-sum payout
- Built-in consulting agreement
- Immediate vesting of options and restricted stock
- Includes miscellaneous goodies (financial planning, legal fees, cars, computers)

### **Compensation Committee Report**

- Narrative descriptions of reasons for pay and bonus
- Discussion of benchmarks
- Reliance on compensation consultant
- Summary of various forms of pay

### **Related Party Transactions**

- Sarbanes-Oxley Act bans company loans to executives or extending terms of existing loans
- Family members work for company
- Payment for use of personal property
- Corporate jet leases
- Consulting fees or vendor deals
- Found in proxy statement

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### **CASE STUDY: DELTA AIRLINES**

1. Skim both employment contracts and review Delta's summary comp table.
2. What would the lede be on your story?

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### **Why Companies Go Public**

- To monetize value for owners
- To raise significant amounts of capital for investment
- To gain credibility in the marketplace
- To use the stock to buy other companies or as an inducement to attract new employees

### **Why Companies Go Public (cont'd)**

- Initial Public Offering (Birth) Filings
  - Forms S-1 and S-1/A (Amended): For traditional IPOs
  - Form F-1: Foreign IPOs
  - Form SB-1: Smaller companies
  - Schedule 14F-1: Reverse mergers
- Mid-Life Filings for Public Companies
  - 8-K: To report material events
  - Forms 3, 4, 5: Insider holdings
  - Form 13-D: Outsider acquisition
- End-of-Life Filings for Public Companies: Merging
  - PREM-14A: Preliminary merger proxy
  - DEFM-14A: Merger proxy to investors
  - S-4: Merger-related official filing on registration of securities

### **Why Companies Go Private**

- If the market price of the shares is substantially below their book values and the opportunity exists to buy the assets cheaply.
- To assure existing management tenure by eliminating the possibility of takeovers.
- To avoid dealing with Sarbanes-Oxley regulations.

### **Bankruptcy**

- Chapter 11 (Reorganization)
  - Under the Bankruptcy Code, company is allowed to “reorganize” business and try to become profitable again.
  - Management continues to run day-to-day business operations, but all significant business decisions must be approved by a bankruptcy court.
  - Sometimes company returns to profitability, sometimes it liquidates.
  - Court names one or more committees to represent interests of creditors (including bondholders) and stockholders, and to work with the company to develop a reorganization plan.
  - The reorganization plan must be approved by creditors and stockholders, and confirmed by the court.
- Chapter 7 (Liquidation)
  - Company is so far in debt or has other problems so serious that it can’t continue.
  - Assets are sold for cash by court-appointed trustee.
  - Secured creditors get their collateral.
  - Bondholders may get a fraction.
  - Stockholders usually get nothing.
- Hierarchy of Claims
  - Secured creditors: Often banks, holding collateral such as a mortgage, are paid first.
  - Unsecured creditors: Such as banks, suppliers and bondholders, have next claim on assets.

### **Bankruptcy: Hierarchy of Claims (cont'd)**

- Stockholders: Have last claim. May not receive anything if secured and unsecured claims aren't fully paid. Preferred stockholders are paid ahead of common stockholders.

### **Expensing Options**

- Companies will have to start reporting impact of options on bottom line of income statement.
- Companies have been reporting pro-forma version, typically in Footnote 1 or 2 of the 10-K or 10-Q.
- The issue: To expense or not expense.
- Problem with options
  - Cost of options to the company, and therefore impact on profits.
  - Dilution.
  - Cost of buying back the stock to reduce dilution's effects (i.e.: impact on earnings per share).

### **Pensions**

- Two kinds of contribution plans
  - Defined benefit
  - Defined contribution
- Pension Benefit Guaranty Corp.: federal corporation created to protect pensions
- The current scenario:
  - 1,100 pension plans covering about 15 million workers and retirees were underfunded by \$354 billion in 2004.
  - These plans had \$786.8 billion in assets to cover more than \$1.14 trillion in liabilities.
  - Only companies with more than \$50 million in unfunded liabilities must file.
  - Total shortfall in all insured pension plans exceeded \$450 billion on Sept. 30, 2004, PBGC reported.
- Actuarial present value of benefits
- Interest rates
- Expected returns on investments (assumed rate of return)
- What to watch for:
  - Fair value of plan assets
  - Projected benefit obligation
  - The difference between the two

### **Postretirement Benefits**

- Major liability for many companies, but often overlooked by reporters.
- Among other things, look for the obligation at the end of the year, the amount of assets remaining and the underfunded amount.
- They're funded out of current operations.

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### **Restructuring and Special Charges**

- Generally, a charge can't be recognized and a liability entered until management officially commits to a restructuring plan.
- Footnote should summarize changes in any restructuring-related liability accounts.
- Activity is reported in annual and quarterly filings.

### **Reporting Revenue and Expenses**

- Revenue Recognition
  - Revenue should be recognized after the earnings process is completed and an exchange has occurred.
  - Are goods ordered, but not shipped?
  - Are goods shipped, but not ordered?
  - SEC criteria for recognizing revenue:
    - Persuasive evidence of an arrangement.
    - Delivery has occurred or services have been rendered.
    - Seller's price is fixed or determinable.
    - Collectibility is reasonably assured.
  - Watch accounts receivable
    - Unusual increases in accounts receivable
    - Long-term receivables
    - Look at collectibility of accounts
    - Seller-provided financing
    - Extended payment terms, especially on new products
    - Customers whose financing is uncertain
- Expense Recognition
  - Companies help earnings by amortizing costs too slowly, failing to write down or write off impaired assets, or reducing asset reserves.
  - They change assumptions that will lower reported expenses, such as extending life of assets to reduce depreciation charges or reducing reserves for bad debts.
  - Capitalize vs. Expense
    - Companies should capitalize costs that produce future benefit and expense costs that produce no such benefit.
    - Capitalize: spread out costs. Expense: book costs now
    - Aggressive companies try to capitalize expenses that should be expensed.

### **Taxes**

- Companies report two sets of results: for shareholders and for IRS.
- Earnings reported to investors almost always are more than what's reported to IRS.
- Tax footnote tells the story.
- "Net deferred tax asset (or liability):" difference between what a company is *supposed* to pay and what it *does* pay.
  - Be sure to note the direction in which numbers are moving over time.
  - Examine large differences closely.
  - How well does the company explain the difference?
  - Tax rates that fall outside the expected range of 30 to 40 percent can be a sign of tax tinkering.

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**Other Income, Other Expense**

- Always look for “others.” Footnotes are the key.
- Often will see big swings in numbers categorized as “other.”
- “Others” can range from interest income to hedging techniques.
- Might learn more about “others” by reading the Management Discussion & Analysis section of the 10-K.

**Commitments, Contingencies and SPEs**

- Commitments: Long-term purchase deals, outstanding loans, lines of credit, lease arrangements, etc.
- Contingencies: Company could gain or lose from a past transaction or event.
- SPE: Special purpose entity. Enron had approximately 900.

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## **ANALYZING AND COMPARING COMPANIES AND INDUSTRIES**

### **How to Analyze**

- Ratio Analysis
- Common Size Analysis
  - Restructure Income Statement or Balance Sheet so that everything is stated as a percentage of a key measure, not in dollar amounts.
  - Income Statement: usually stated in terms of revenue or sales. Balance Sheet: assets usually stated in terms of total assets and liabilities, while stockholders' equity usually stated in terms of the total liabilities and stockholders' equity.
  - Value of Common Size Analysis
    - Especially helpful to identify trends and changes. Much easier to see trends and changes in percentage terms than in raw numbers.
    - Makes it easier to compare companies, especially those of different sizes.
  - Doing Common Size Analysis (cont'd)
    - Look carefully at the company's Income Statement.
    - Develop a master Income Statement template to make comparisons easier. You want to be able to compare similar entries across companies.
    - Put the template in Excel.
    - Enter your numbers.
    - Do the analysis.
  - Common Size Template

<b>Name of company</b>
<i>Amounts in thousands</i>
<b>Revenues</b>
Cost of goods sold
<b>Gross profit</b>
<b>Operating expenses</b>
Sales, general, admin, etc.
<b>Operating income</b>
<b>Other revenues or expenses</b>
Discontinued items
Sale of investment
Accounting change
Impairment charge
Unusual or extraordinary item
Effect of change in vacation policy
Minority interest
<b>Total other revenues or expenses</b>
<b>Interest expense, income</b>
Interest expense or income
<b>Income before provision for taxes</b>
Provision for taxes
<b>Net Income</b>

### **Comparing Companies:**

- in different industries: 3M vs. Starbucks
- in same industry: Wal-Mart vs. Neiman Marcus

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### **Quality of Earnings**

- Analysts want to assess how the firm generates its profits.
- Higher marks go to firms whose earnings are derived from profits from the primary business operation and asset management, rather than excessive use of debt or aggressive accounting.

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