

FINANCIAL REPORTING and BALANCE SHEETS

Some Key Issues to Keep an Eye on:

- Changing, more complex accounting rules, the Sarbanes-Oxley bill being foremost
- Stock options: How will they be accounted for?
- Black box accounting: Thanks to the folks at Enron
- Pro forma earnings: The company spin on its numbers

Ownership Models for Companies

- Privately held
- Publicly held

To Assess a Company, a Reporter Must Look at:

- Context
- Industry trends
- SEC documents
- Outsiders as sources
- Insiders as sources
- Numbers
 - Unaudited
 - Audited
 - Accountants
 - Certified Public Accountants (CPAs)

Securities and Exchange Commission (<http://www.sec.gov>)

- Created in wake of 1929 crash to restore faith in the financial markets
 - To protect investors by requiring companies to disclose certain financial information through various filings
 - To maintain investor confidence through a fair and orderly trading market
- Who files with the agency?
 - Companies with more than \$10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports.
 - Many private companies with more than 500 shareholders or debt offerings.
 - Foreign companies whose shares may be traded on a U.S. exchange via American Depositary Receipts, or ADRs.
- SEC Challenges
 - 15,000+ public companies
 - Before 2004, SEC had about 3,100 employees (low for a federal agency)
 - For three years before Enron's bankruptcy, the SEC did not review its filings
 - Twice the turnover of the average government agency (2.5 years average tenure of an SEC attorney). In the summer of 2004:
 - Enforcement division manager and regional director left to be partners in major law firms (white-collar defense)
 - Deputy director, investment management, to major bank (compliance)
 - Associate director to major law firm (securities practice)

SEC (cont'd)

- SEC Improvements
 - On track to hire more than 800 lawyers, accountants and inspectors in 2004
 - Received 12.5 percent increase in government's FY 2005 budget
 - Using a \$300,000 video to recruit
- SEC Commissioners
 - William H. Donaldson, Chairman
 - Cynthia A. Glassman, Commissioner
 - Harvey J. Goldschmid, Commissioner
 - Paul S. Atkins, Commissioner
 - Roel C. Campos, Commissioner
 - Serve five-year terms
 - Appointed by the president
 - No more than three from the same political party
 - What do they do:
 - Interpret federal securities laws
 - Amend existing rules
 - Propose new rules to address changing market conditions
 - Enforce rules and laws

Generally Accepted Accounting Principles (GAAP)

- Financial reporting guidelines that are based on theory and practice
 - So can be vague and ambiguous, and can lead to different interpretations
- Evolved over time primarily through efforts of
 - American Institute of Certified Public Accountants
 - Securities and Exchange Commission
 - Financial Accounting Standards Board
 - Internal Revenue Service
- GAAP Assumptions – basic financial accounting assumptions
 - Periodicity: information prepared and reported in specific time periods
 - Going concern: business will operate for the foreseeable future
 - Economic entity: separate, distinct financial entity from other businesses
 - Monetary unit: results are recorded in monetary units, i.e. dollars
- GAAP Principles – principles as a result of those basic assumptions
 - Full disclosure: necessary information is disclosed in understandable form
 - Matching: revenues and expenses are matched in period earned and incurred
 - Historical costs: assets reported at original cost, without a markup in value
 - Revenue realization: revenue reported when everything goes into creating revenue is completed
 - These principles give Consistency to financial statements. Changes to principles will be noted in Footnotes to a company's Annual Report (10-K).
- GAAP Considerations – commonly observed modifications to GAAP principles
 - Materiality: the information an investor needs to make an informed decision
 - Industry practices: accepted industry practices often trump GAAP
 - Conservatism: in equally acceptable principles, companies should opt for the more conservative practice

GAAP Rules for Specialized Industries

- Banking and thrift industries
- Benefit plans, including pension funds
- Broadcasting industry
- Cable television industry
- Computer software
- Finance companies
- Investment companies

Accounting Firms

- Big Eight (back when)
 - Arthur Young
 - Ernst & Winney
 - Deloitte Haskins & Sells
 - Touche Ross
 - Price Waterhouse
 - Coopers & Lybrand
 - Peat Marwick Mitchell
 - Arthur Andersen
- Big Four (now)
 - Ernst & Young
 - Deloitte & Touche
 - Price Waterhouse Coopers
 - KPMG Peat Marwick
- Future of Big Four
 - Is in question, after the U.K. government refused in summer 2004 to propose a bill that limits the liability that auditors face because of corporate blowups.
 - Little hope for such legislation in the U.S.
 - After Arthur Andersen collapse, the Big Four has warned of a huge lawsuit that could force one of them out of business.

Accounting Oversight

- Bodies that set standards and oversee compliance
 - SEC
 - Public Company Accounting Oversight Board
 - FASB
 - Financial institution regulatory agencies
 - NASD and stock exchanges
 - State government securities commissions, legislatures
- Additional entities for compliance
 - Courts
 - Independent public accountants

Sarbanes-Oxley Act

- Passed in 2002 after scandals, such as Enron, Arthur Anderson, WorldCom, to protect investors by improving reliability and accuracy of corporate disclosure.

Sarbanes-Oxley Act (cont'd)

- Considered most significant change to federal securities laws since the New Deal.
 - Radically redesigned federal regulations of public company governance and reporting obligations.
 - Significantly tightened accountability standards for directors and officers, auditors, securities analysts and legal counsel.
- www.aicpa.org/info/sarbanes_oxley_summary.htm – An excellent overview of the Sarbanes-Oxley Act

Public Company Accounting Oversight Board (<http://www.pcaobus.org>)

- Created by Sarbanes-Oxley Act as an independent group to oversee accounting data and reporting
- Five members named by SEC
 - Must be full-time.
 - Two must be CPAs
 - Must be “prominent individuals of integrity and reputation...”
- Board began operating in 2003
 - William J. McDonough, Chairman and CEO
 - Charles D. Niemeier
 - Daniel L. Goelzer
 - Kayla J. Gillan
 - Bill D. Gradison

Strategy for Reading Annual Reports (10-K's)

- First, look at the auditor's report
 - It says we (auditors) looked at these statements
 - We followed the rules in our audits and here's what an audit involves
 - They're management's responsibility; we're just here to express our opinion, which will be one of the following categories:
 - Clean: Financial statements fairly present company's position (majority)
 - Qualified: In general, statements are fairly presented with a notable exception or two. Look for phrases like “except for” or “subject to.”
 - Disclaimer: Auditor can't give an opinion because the audit was so restricted by the company.
 - Adverse: Auditor finds that company statements are presented unfairly (rare, but definitely a story)
- Next, look at financial data (income statement, balance sheet, cash flow statement)
 - Note changes in amounts year to year, especially in revenues and expenses
 - Look at cash flow, particularly *free* cash flow and its use
 - Don't be fooled by extraordinary items making net income look better than is
- Next, try to match the financial data to the Footnotes, which explain and/or elaborate on the numbers, or on changes in the way they're reported.
- Then read the Management's letter
- Then read the Management's discussion and analysis
- Overall, the numbers and footnotes are more important than the glossy, PR sections

Cash or Operating Cycle

- Start with cash in the form of:
 - Cash
 - Receivables
 - Debt
- Then use the cash to purchase inventory
 - Raw materials
 - Work in progress
 - Finished goods
- Then use the inventory to produce product
- Then sell product in return for:
 - Accounts receivable (collections)
 - Cash
 - Collect receivables as cash
- Use those returns to pay off accounts payables (bills)
- Start over

Accrual Method of Reporting Revenues

- “Revenue Realization” accounting method used by all publicly traded companies.
- Records revenues as soon as the “sale” occurs
 - For example, the day the dealer “sells” car, not when it receives full payment.
- Records expenses as soon as the bill is received, not when the money flows out
- So transactions enter the financial records when they occur, not when cash changes actually hands
- Accrual method, therefore, shows “scores,” not real spendable dollars

About Corporate Numbers: They’re Squishy Because:

- Goods will not necessarily be paid for
- Goods are not necessarily going to be kept
- Inventory might be out of date, obsolete or unable to be sold
- Status of some inventory may be uncertain
- Intangible assets are estimates
- Machinery or other fixed assets might be obsolete or falling apart before expected
- Accounting conventions
- Goodwill
- Timing issues
- Bottom line: In many ways, statements are a collection of estimates.
- And because they’re squishy:
 - Companies create reserves, or allowances, to compensate.
 - You don’t see reserves? Be alert!

How to Give Meaning to the Numbers

- Calculate percentage change, year to year, especially revenues and expenses
- Common size analysis: Compare numbers at similar companies in the same industry
- Look at cash flow, particularly *free* cash flow and its use
- Don’t be fooled by extraordinary items that make net income look better than is

BALANCE SHEETS

- Snapshot of financial activity at a point in time, and its balances
- $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$

Assets

- Current assets
 - Cash and cash equivalents (can be converted to cash within 90 days)
 - Accounts receivable
 - Inventories
 - Prepaids
- Investments and other assets
- Property, plant and equipment, net
 - Land, buildings and improvements to both
 - Equipment
 - Companies calculate an estimated depreciation of these assets in their books
- Goodwill
 - Difference between what a firm pays to buy another company and the book value (total assets minus total liabilities) of that company.
 - Has been written off over time, typically 40 years
 - In future, will no longer be amortized, per 2002 FASB rule change (amortization = accounting procedure that gradually reduces a statement's cost value through periodic charges to income)
 - Other intangible assets will continue to be amortized over useful lives
- Impairment
 - Instead of goodwill, now "impairment testing" (writing down to market value)
 - The impairment is expensed on the income statement – check footnotes

Liabilities

- Current liabilities
 - Accounts payable
 - Accrued liabilities
 - Income taxes
 - Current maturity of long-term debt
- Non-current liabilities
 - Long-term debt
 - Deferred income taxes
- Commitments and contingencies

Shareholders' Equity

- Capital stock
 - Both Preferred and Common stock
- Additional paid-in capital
- Retained earnings
- Treasury stock
 - Total shareholders' equity
 - $\text{Total L} + \text{OE}$

INCOME STATEMENT

- Also known as
 - Statement of earnings
 - Statement of operations
 - Statement of income and comprehensive income
- Covers a period of time, typically a quarter or a year
- Reports income from ongoing activities, as well as other activities beyond management's control (comprehensive income)
- Involves estimates
- Basic income statement consists of:
 - Sales or revenues
 - Cost of goods sold
 - Gross profit
 - Operating expenses, include:
 - Sales, general and administrative (salaries, etc.)
 - Depreciation: the decrease in value of an asset
 - Operating profit
 - Income taxes
 - Net profit after taxes (proverbial "bottom line")
 - Other considerations
 - Discontinued operations
 - Extraordinary items
 - Changes in an accounting principle
 - Other changes, such as depreciation
 - Earnings per share (typically refers to common stock)
 - Basic earnings per share (Bloomberg uses) (Net income/Weighted average number of outstanding common shares)
 - Diluted earnings per share (*The Wall Street Journal* uses "fully diluted")
 1. Includes all convertible shares: common and preferred stock, unexercised stock options and warrants (and sometimes convertible debt)
 2. Some argue it is a more accurate reflection of EPS numbers

Pro Forma Results

- Selectively defined earnings that companies like to use in their press releases to make them look better than they really are or to emphasize certain industry metrics.
- Not the most accurate indicators.
- SEC's Regulation G (1/03) states that non-GAAP numbers used in an earnings release must be accompanied by, and reconciled with, the "most directly comparable" GAAP number
- Expenses against earnings are not standardized across an industry
- A common pro forma: Earnings Before Interest, Taxes, Depreciation, Amortization
 - Calculated by looking at earnings before the subtractions of interest expenses, taxes, depreciation and amortization, so the income number looks better.
- Recommendation: GAAP results should precede pro forma results in earnings stories and headlines

CASH FLOW STATEMENT

- Record of cash provided by *cash sources* and of cash consumed by *cash uses*.
 - From operations
 - From investing
 - From financing
- Information about use of cash
- Information about investing and financing
- Shows ability to continue as a going concern
- Shows ability to generate future positive cash flows
- Shows ability to meet obligations and pay dividends
- Has received a lot of attention in recent years, after the bubble burst

Free Cash Flow

- Powerful tool for making a company successful and powerful indicator for investors
- Cash that is left over after the productive capacity is maintained
- Permits expansion, paying down debt, buying back shares, etc.
- Several ways to calculate it. Companies create their own models. The easy way:
 - Take cash flow from operating activities
 - Subtract capital expenditures
 - That equals free cash flow
 - If there's too little, that could mean imminent demise.

Flexibility

- Companies have some flexibility in categories for entries on cash flow statement.
- Total change in cash, however, will not change.
- Overwhelming majority of accounting standards deal with balance sheet and income statement, not cash flow statements.

Footnotes

- Explain how the company applies GAAP, including recognizing revenue, depreciation, stock options, etc.
- Explain any changes in how the company uses those GAAP practices from the last earnings report. That will significantly change the financials, but reporters won't know the real reason for that change unless they read the footnotes.
- First note is a summary of significant accounting policies, such as:
 - Cash and cash equivalents
 - Short-term investments
 - Inventories
 - Property, plant and equipment
 - Goodwill
 - Accounting pronouncements
 - Revenue recognition

Other Footnotes tell how the company reports:

- Other income
- Debt
- Financial instruments
- Short-term borrowings
- Supplemental income/cost information
- Taxes
- Inventories
- Earnings per share data
- Commitments and contingencies
- Quarterly financial information
- Options
 - To expense or not to expense
 - Problems with options
 - Cost of the options to the company, and therefore impact on profits
 - Dilution
 - Cost of buying back the stock to reduce dilution's effects
 - Now you can find this information in footnotes or proxy statement
 - A proposed FASB rule will require companies to start expensing options on income statement. If approved, that will take effect in June.
- Pensions
 - Actuarial present value of benefits
 - Interest rates
 - Check the Assumed Rate of Return/Expected Returns on Assets – can sometimes be reported to be too high, upwards of 8 percent to 9 percent.

What to Watch For:

- Early Warning Signs for Reporters
 - Weak corporate control environment
 - Management facing extreme competitive pressures
 - Management known for or suspected of questionable character (Al Dunlap)
- Types of Companies to Watch
 - “Fast-growth” companies whose real financial growth is beginning to slow
 - Basket-case companies struggling to survive
 - Newly public companies
 - Private companies
- Earnings management (or manipulation) by company
 - Using GAAP flexibility or just outright manipulating earnings to guide them toward a predetermined target
 - Why? Preoccupation with meeting Wall Street expectations
 - Result: Not meeting target results and stock price declines
 - Changing depreciation methods
 - Changing useful lives used for depreciation
 - Changing estimate of salvage value for depreciation
 - Estimating write-downs
 - Estimating impaired assets

What to Watch For (cont'd)

- Reporting regular expenses as one-time/special charge
- Changing pension assumptions, especially rate of return
- Switch from conservative to aggressive approaches
- One-time special charges
- Offsetting increases/decreases
- Announcing accounting changes just before the end of the quarter
- Suspicious disclosures
- Unusual, nonrecurring items
- Fourth-quarter adjustments
- Vague explanations
- No detail on reserves

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