

INTERMEDIATE FINANCIALS

Why do business journalists hate earnings?

- We didn't go into journalism because of our math skills.
- If we were good with numbers, we'd be making real money.
- It's the same thing quarter after quarter.
- They always come out after 4 p.m.
- They always seem to come out in clumps.

You can make earnings interesting

- Learn how and where companies manipulate their numbers.
- Understand what motivates companies to do this (hint: making the number).
- Trust your own ability to analyze the numbers without relying on the company's PR-spin or an analyst.

Rules for earnings releases

- Essentially none: A company can say pretty much whatever they want.
- Companies will always emphasize the most positive information in the lede, no matter how contrived the number.
- Net income isn't always net income.
- So what's the fluff here?
 - "Fully taxed"
 - "Excluding one-time items/charges"
 - Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
 - Quarterly membership growth
 - All of these words mean whatever the company wants them to mean, but they're clearly trying to steer you to an upbeat picture.

Headlines from major papers about AOL earnings:

- *The Wall Street Journal*: AOL net more than doubled
- *USA Today*: Leap in users helps lift AOL profit 160 percent. Report expected to quash fears about AOL-Time Warner deal
- *The New York Times*: AOL posts gain in second quarter income

What was missing from the release?

- Net income
- GAAP income (Generally Accepted Accounting Principals)
- Stock option expense
- In-kind/round-trip deals

Diving into Securities and Exchange Commission filings

- 10-K: Annual report
- 10-Q: Quarterly earnings report
- DEF 14A: Proxy statement

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

Diving into Securities and Exchange Commission filings (cont'd)

- 8-K: Material event
- S-1: Initial public offering
- S-4 or DEFM14A: Merger-related documents

What you can find in these filings

- Liberal revenue recognition policies
- Massive benefits from stock options
- Round-trip deals with various companies
- Tricks companies use to get you to avoid reading the filings
 - Filing the Q or the K on the same day they announce significant news
 - Packing them with repetitive information
 - Burying the good stuff in the footnotes or exhibits
 - Requiring you to read several Ks or Qs to detect a pattern

The 10-K – Annual Report

- Format
 - **Item 1: Business**
 - Item 2: Properties
 - **Item 3: Legal proceedings/risk factors**
 - Item 4: Submission of matters to a vote
 - Item 5: Market for common stock
 - Item 6: Selected financial data
 - Item 7: MD&A
 - **Item 8: Financial statements and supplementary data**
 - Item 9: Changes/disagreements with accts
 - Items 10-14: Proxy statement material
 - **Item 15: Exhibits**
- What to look for in the 10-K
 - If the company has pensions, what interest rate is it using to calculate the pension income?
 - Has the company made any significant changes in the way it recognizes revenue?
 - How is the company handling restructuring charges?
 - How has the level and type of debt changed over the past year?
 - How has the company's income tax rate changed?
 - What is the company including in other assets/liabilities and other income/loss? Are derivatives a substantial component?
 - How has stockholders' equity changed over the past year?
 - Are there any new employment/severance contracts and what are the terms?

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The 10-Q – Quarterly Report

- What to look for in the 10-Q
 - How does the net income in the press release compare with the numbers in the Q? What sorts of expenses is the company excluding to arrive at the proforma number that they offer in their press release?
 - Are there other significant differences between the numbers in the press release and those in the Q?
 - How do stock options impact net income? Has the company substantially changed the assumptions it uses for calculating stock option expenses?
 - How does the company account for Special Purpose Entities (SPEs), a.k.a. off-balance sheet obligations?

The proxy statement

- Format
 - Profiles of directors up for election/re-election
 - **Director compensation**
 - Various committees (audit, compensation, etc.)
 - Auditor fees
 - **Option grants for executive officers**
 - **Executive compensation** (don't just focus on CEO pay)
 - Five-year stock performance
 - **Certain relationships/Related party transactions**
 - **Shareholder proposals**
- What to look for in the proxy
 - How many times did the audit committee meet in the past year? Are they truly independent?
 - What types of related party transactions are being disclosed? Do they meet the “smell” test and sound reasonable, or do they stink?
 - How much stock do executive officers and directors own?
 - How much are directors making?
 - What percentage of stock options was given to top execs last year?
 - Do executive salaries correspond to company performance?
 - Do retirement benefits/perks seem excessive?
 - What sorts of shareholder proposals are included in the proxy?

Where there's smoke

- Anything filed late on a Friday is often worth looking at.
- If the size of a 10-K or 10-Q is substantially larger, it's usually because of additional footnotes and legal issues.
- Amended filings – look for explanatory notes, and be particularly wary if they're not there
- Late filings
- Long after-the-fact disclosures

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My favorite footnotes

- Summary of accounting principals: Cliff notes version on how and when companies recognize revenue and expense
- Restructuring and special charges: Graveyard for all sorts of things
- Stock options
- Depreciation
- Special purpose entities
- Pensions/Other post-retirement benefits

Signs of financial shenanigans

- Unusual effective tax rates
- Changing depreciation
- Changing revenue recognition
- Changing options assumptions
- Quarter-by-quarter comparisons
- Special charges every quarter
- Incomprehensible footnotes

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