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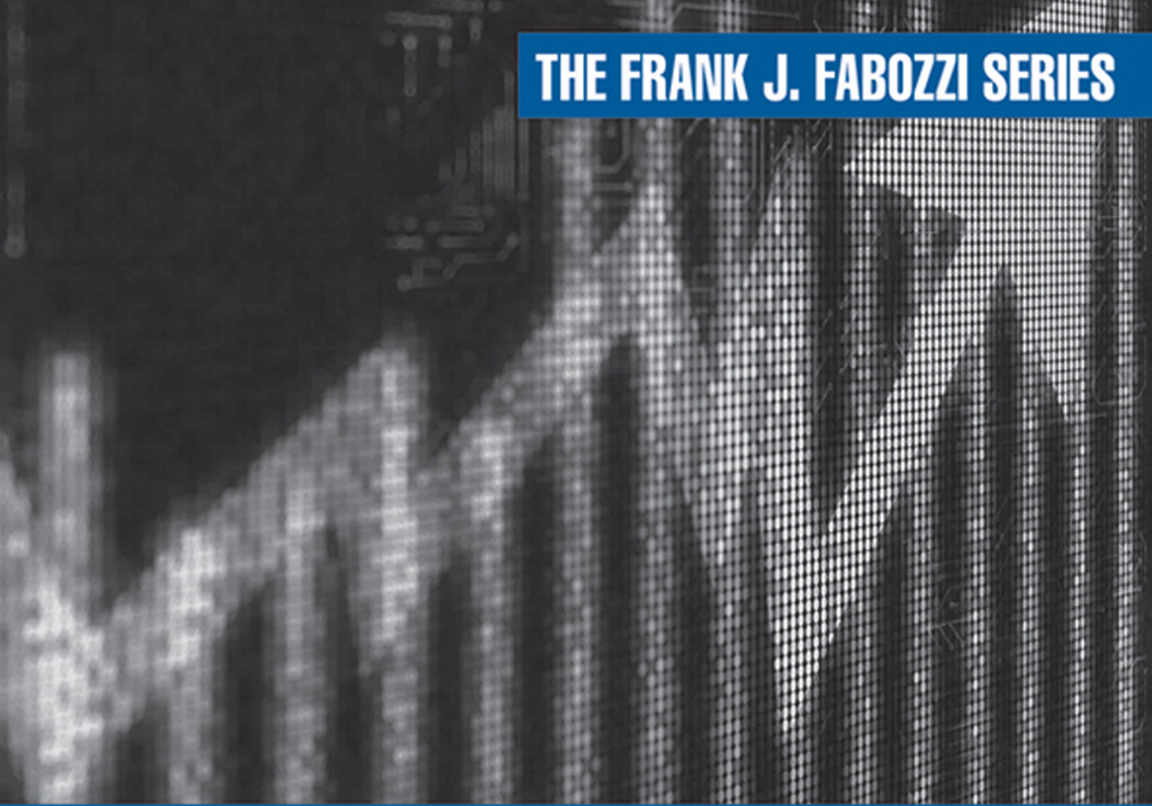

ANALYSIS *of* FINANCIAL STATEMENTS

Third Edition

PAMELA P. PETERSON • FRANK J. FABOZZI

Analysis of Financial Statements

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Analysis of Financial Statements

Third Edition

PAMELA PETERSON DRAKE
FRANK J. FABOZZI

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PPD
To my blessings: Erica, Ken, Paul, and Tony

FJF
To my beautiful wife, Donna, and our three children,
Francesco, Patricia, and Karly

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Preface

In *Analysis of Financial Statements, Third Edition*, we introduce you to the tools and techniques of financial analysis. We provide a foundation for financial analysis with the goal of assisting you in the analysis of the financial condition and operating performance of a company.

This book was first published in 1999. The most significant difference between the previous two editions and this third edition is the role of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which affects disclosures and regulation of many entities and brought attention to the importance of credit analysis. We have incorporated the changes from the Dodd-Frank Act throughout this book—and we emphasize, too, the importance of assessing the quality of financial data. Although it is important to understand how to calculate financial ratios, look at trends, use credit models, and the like, it is even more important to understand the data that you are working with. The recent financial crisis, which tested the financial condition and performance of companies, has brought to the forefront the need to understand the quality of the data as well as the risk.

Financial analysis and the reliance on financial data quality are important for both traditional fundamental equity investing and quantitative equity investing—the two major styles of equity investing. In traditional fundamental equity investing, a portfolio manager—and any like analyst—begins with a broad universe of stocks and screens those stocks to a smaller group for further analysis based on certain criteria such as earnings growth, profit margins, and market share. The portfolio manager analyzes a smaller group of stocks using the techniques described in this book in consultation with a team of equity analysts. Thus, the need to understand the economic meaning of financial data, and whether adjustments must be made, are required at both levels of analysis by the portfolio manager, who follows a fundamental equity investing approach—that is, the screening and valuation analysis of individual stocks. With quantitative equity investing, the portfolio manager uses financial data to build a statistical model of stock valuation, whose explanatory variables are obtained from financial and economic data, and then applies the model to a broad universe of stocks. The focus is on determining the financial and economic variables that should be included in the model. The portfolio manager then uses the model to select stocks. Understanding the financial data is, of course, paramount in this approach even if individual stocks are not analyzed in detail.

We structure this book into three parts:

- In Part One, we introduce you to financial analysis, discuss the available financial information, and then focus on the quality of the information.
- In Part Two, we present different ways of analyzing financial data, including financial ratios and cash flow analysis. We also discuss the pitfalls that you may encounter in financial analysis, citing numerous actual cases to illustrate these pitfalls.
- In Part Three, we apply the financial analysis tools developed in Part Two to equity valuation, credit analysis, and fundamental factor models.
- We close the book with a recap of the lessons that we have learned.

New to the third edition of *Analysis of Financial Statements* are the 10 multiple choice questions that appear at the end of each chapter, which allows you to assess your comprehension of the important topics discussed before going on to the next chapter. The answer key is provided at the end of the book.

Pamela Peterson Drake
Frank J. Fabozzi

About the Authors

Pamela Peterson Drake is the J. Gray Ferguson Professor of Finance and Department Head, Finance and Business Law, at James Madison University, where she teaches financial analysis, financial management, and spreadsheet analysis. She received her Ph.D. from the University of North Carolina at Chapel Hill in 1981 and taught at Florida State University for 24 years. She was an Associate Dean in the College of Business at Florida Atlantic University prior to joining James Madison University in 2007. She earned the designation of Chartered Financial Analyst in 1992, and has authored and coauthored several readings that appear in the CFA Institute's *CFA® Program Curriculum*. She has coauthored a number of books with Frank J. Fabozzi, including *The Basics of Finance*, *Financial Management and Analysis*, and *Finance: Capital Markets, Financial Management and Investment Analysis*.

Frank J. Fabozzi is Professor of Finance at the EDHEC Business School, a member of the EDHEC Risk Institute, and editor of the *Journal of Portfolio Management*. He has held various professorial positions in finance at the Massachusetts Institute of Technology and Yale University and was a Visiting Fellow at Princeton University's Department of Operations Research and Financial Engineering. He is a trustee for the BlackRock family of closed-end funds. In 2002, he was inducted into the Fixed Income Analysts Society's Hall of Fame and is the 2007 recipient of the C. Stewart Sheppard Award given by the CFA Institute. He earned the designation of Chartered Financial Analyst and Certified Public Accountant. He earned a doctorate in economics from the Graduate Center of The City University of New York.

Analysis of Financial Statements

PART One

The Basics

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. What changes? Laws and regulations, the introduction of new types of securities, innovations in markets and trading, company events (such as the passing of the CEO or a settlement of a lawsuit), and a persistently changing economy 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 popularity of the Internet as a source of information 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.

The availability and convenience of information 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, company management, and financial analysts.[1] 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.

[1]Public Law 111-203, H.R. 4173, July 21, 2010, www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf

This need for diligence is evident in the financial crisis of 2007–2008, which tested analysts' and investors' abilities to understand complex securities and their accounting representation. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) passed in 2010 in response to the crisis, added requirements pertaining to corporate governance, security regulation, the regulation of the financial services industry, and consumer protections.[2] And, while there will likely be additional disclosures of some of the more complex instruments as a result of this act, financial instruments are constantly evolving, and analysts and investors have to stay abreast of these innovations and their implications for analysis.

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?

Our focus in this book is on *financial analysis*, 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 (SEC) 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 it 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 (5 years? 10 years?) to review. 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

[2]Public Law 107-204, 116 Stat. 745, July 30, 2002, www.gpo.gov/fdsys/pkg/PLAW-107publ204/pdf/PLAW-107publ204.pdf

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 key to analysis, however, is understanding how to use these tools in the most effective manner.

What happens if we're not looking closely at financial information? Lots. 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 include:

- 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.

Example: Enron

Consider Enron Corporation, which filed for bankruptcy in 2001 following a financial-reporting scandal. Enron's revenues grew from a little over \$9.1 billion to over \$100 billion in the 10-year period from 1995 through 2000 as we show in Exhibit 1.1; in other words, its revenues grew at an average rate of over 61% 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

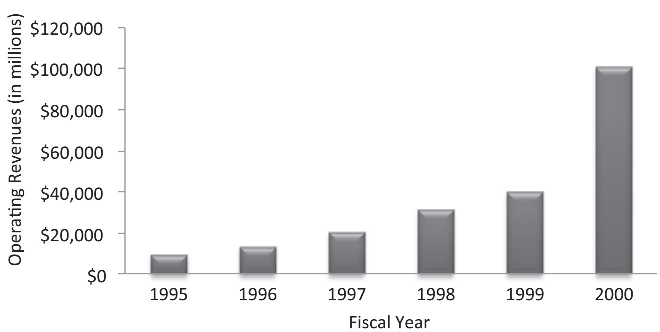

EXHIBIT 1.1 Enron's Revenues, 1995–2000
Source of data: Enron, Inc. 10-K filings, various years.

corporations in the United States within 15 years of becoming a publicly traded corporation.

An interesting aspect of Enron's growth is that the company produced revenues far in excess of what other companies of similar size could produce. For example, in 2000, Enron produced over $5 million in revenues per employee, whereas Exxon Mobil could only produce $2 million per employee and General Electric only $0.4 million per employee.[3]

Enron became embroiled in an accounting scandal that involved, in part, removing debt from its balance sheet into special purpose entities. While the scandal proved 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 (SPE), and hence its assets and liabilities were removed from Enron's balance sheet, there was insufficient independent ownership of the entity to qualify JEDI II as a SPE because Chewco was, essentially, Enron.[4]

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.

Example: AIG

As another example, consider AIG, an insurance company that settled a case of fraud in 2010 after six years for $725 million. Along with

[3]This dimension was pointed out by Dan Ackman. "Enron The Incredible," *Forbes*, January 15, 2002, www.forbes.com/2002/01/15/0115enron.html.

[4]The keys for accounting that would remove the SPE from the balance sheet are the requirement that at least 3% of the equity capital of the SPE be owned by independent parties, and that an investor other than Enron exercises control over the entity. Other names for an SPE include special purpose vehicle (SPV), conduit, or transformer.

anticompetitive charges and stock price manipulation, AIG was accused of accounting manipulations perpetrated between 1999 and 2005 that inflated its claims reserves by reporting what was, essentially, a deposit with a reinsurance company as a reinsurance transaction.[5] The result of this inflation represented that it had more assets available to meet claims than it actually had, making itself look more profitable and less risky. As you can see in Exhibit 1.2, AIG reported underwriting profits instead of losses in 2000 and 2001, which then overstated net income, especially in 2000 and 2001.

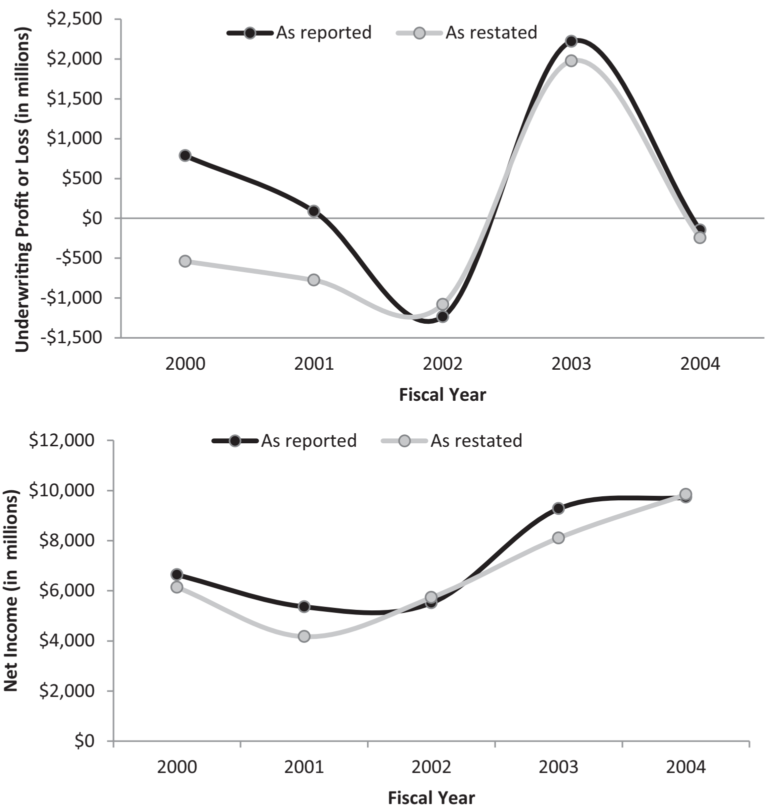

EXHIBIT 1.2 AIG Profits, 2000–2004
Source of data: AIG 10-K filings with the SEC, various years.

[5] A reinsurance company is an insurance company that insures an insurance company. The reinsurance company in this case was General Re. This follows a $10 million penalty in 2003 for inflating its balance sheet in a case brought by the SEC and the U.S. Justice Department, and does not include other settlements and penalties for other issues.

Were there bread crumbs to follow? A few. First, AIG was known for its opaque accounting:

> *It's been an open secret for years on Wall Street that no one outside the company really understood its accounting. AIG has long been called "opaque" on Wall Street, which is what analysts say when they can't figure out a company's books because much of the detail is off the books.*[6]

Second, reinsurance accounting at the time was murky, so the arrangement with General Re, which involved an unusual insurance product that increased AIG's loss reserves to acceptable levels, should have raised questions. The particular 'insurance' product itself was unusual.

A typical insurance product involves the insurance company receiving a periodic premium to insure for a particular type of loss (e.g., some sort of casualty). If a loss does not occur, the insurance company comes out ahead; if a loss event occurs, the insured is protected from loss by the insurance company. The AIG contract was a bit different: A multiyear insurance contract, with the premium up front that would cover most or all of the potential losses, with any unused premium refunded at the end of the contract. This AIG product is more of a loan than it is an insurance contract, which would require different accounting. However, AIG reported the proceeds from this product as insurance, not as a loan.[7]

Following the bread crumbs should have at least raised concerns about the financial performance and financial condition of AIG. And opaque accounting should be a significant crumb to follow.

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

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[6]Jim Jubak, "At AIG, The Real Mess Is Far From Over," Jubak's Journal, *The Street,* April 13, 2005 www.thestreet.com/story/10217149/1/aigs-real-mess-is-far-from-over.html.

[7]An executive of AIG and four executives of General Re were convicted of fraud in 2008 for the scheme to manipulate loss reserves, a fraud that the SEC estimated cost investors $1.4 billion (*Securities and Exchange Commission v. Ronald Ferguson, Elizabeth Monrad, Christian Milton, Robert Graham and Christopher Garand*, February 2, 2006; and *Litigation Release No. 21235*, October 1, 2009).

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 publications (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).
- Corporate governance.
- Economic environment.
- Recent and planned acquisitions and divestitures.

A thorough financial analysis of a company requires examining events that help explain the company's present condition and effect on its future prospects. For example, did the company recently incur some extraordinary losses? Is the company developing a new product, or acquiring another company? Current events can provide useful information to the 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 for a publicly traded company can be picked up through company annual reports, press releases, and other information that the company provides to inform investors and customers. 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. We list several of these securities laws in Exhibit 1.3. Publicly traded companies are required by these securities laws to disclose information through filings with the SEC, the 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 1.3 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 extend 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.
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	Broad law that encompasses changes in the regulation and oversight of the financial services industry, the markets for derivatives, investor protections, credit rating agencies, executive compensation, and mortgages and other lending.