



FINANCIAL STATEMENT ANALYSIS

Our financial-statement-oriented approach has been thoroughly back-tested, real-time utilized and shown to be effective. Historical Analysis v2.3 provides a way to select undervalued stocks, and to avoid companies that are experiencing substantial financial stress, but before the company's stock market price reflects those risks. Review our [Sample Analyses](#). Our user pricing is flexible and depends upon which of the numerous options you select. For more information, communicate with us at: FSA@ConcernedShareholders.com.

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**Financial Statement Analysis Applied to
Stock Market Investing**

**"[T]he penalties for financial ignorance have never been so stiff." --
- *The Ascent of Money* (2008) by Niall Ferguson.**

"Happiness from wealth comes from gains of wealth more than it comes from levels of wealth. While gains of wealth brings happiness, losses of wealth brings misery." (WSJ, 8/24/09, "The Mistakes We Make --- and Why We make Them....")

"[R]esearch shows that ... focusing first on the positives of a purchase or decision makes it harder to come up with the negatives—and vice versa. ... When you're weighing an offer or decision, always start with your list of 'cons' before considering the 'pros.' It may save you a bundle." (WSJ, 8/12/09, "Fraud Doesn't Always Happen to Someone Else")

"[C]ontrarian thinking is only helpful at extraordinary inflection points in the market.... Most people think that contrarian investing means doing the opposite of what others are doing. But going against the crowd is a surefire way of getting trampled. The majority of investors are usually right. True contrarians look for points of maximum exuberance or despair, which is when the majority is generally wrong. ... The way you can tell most investors who go against the herd is from the hoofmarks on their backs." (USA Today, 4/16/10, "Contrarian investing doesn't mean 'always do the opposite'")

"Warren Buffett famously said he tries to be fearful when others are greedy and greedy when others are fearful. For some money managers, that isn't just clever advice -- it is an entire investing strategy. The idea of embracing out-of-favor stocks, sometimes called contrarian investing, isn't new. But the approach requires a strong stomach in the best markets, let alone during historic downturns." (WSJ, 5/12/09, "Contrarian Patience Pays Off -- Finally") "[T]he bubble pops when everybody has concluded that what has gone on with prices make sense. ...[T]here isn't much of a step between believing that a bubble will continue and believing that not participating in the bubble will amount to lost opportunity." (WSJ, 5/24/05, "Betting Against the House") "A bubble occurs when exaggerated expectations of future price increases generate unusual demand either by people who fear being price out of the market or by investors hoping to make a lot of money fast. A bubble is a self-fulfilling prophecy for a while, as successive rounds of buyers push prices higher and higher. But the willingness to continue to pay higher

and higher prices is fragile: It will end whenever buyers perceive that prices are no longer going up. Hence, bubbles carry the seeds of their own destruction. Only time is needed for the bubbles to end." (WSJ Opinion, 8/24/04, "Mi Casa Es Su Housing Bubble") "You can never predict when a bubble will actually burst. Some of them can continue for a remarkably long time. But when they do, they almost always do so quickly and dramatically." (WSJ, 9/14/09, "Burned by Beanie Babies and Other Bubbles")

"Boom times are always accompanied by fraud. As the Victorian journalist Walter Bagehot put it: 'All people are most credulous when they are most happy; and when money has been made . . . there is a happy opportunity for ingenious mendacity.' ... Bagehot observed, loose business practices will always prevail during boom times. During such periods, the gatekeepers of the financial system -- whether bankers, professional investors, accountants, rating agencies or regulators -- should be extra vigilant. They are often just the opposite." (WSJ, 4/17/09, "A Fortune Up in Smoke") "Investors usually dismiss worries about aggressive accounting when they involve a fast-growing company in an exploding sector. Instead, they should wonder why such a company would resort to aggressive accounting in the first place." (WSJ, 12/14/05, "Cerner's Growth Has Been Healthy, But Its Accounting Could Be Ailing") "[W]hen a company plays sneaky with one number, there's pretty good odds that they're being sneaky about other numbers too." (Footnoted.org, 4/24/09, "Pretty sneaky at FTL....")

"In 1970, he (Peter L. Bernstein) asked rhetorically, 'What are the consequences if I am wrong?' and said 'no investment decision can be rationally arrived at unless they are (based upon) the answer to this question.' He counseled investors to take big risks with small amounts of money rather than small risks with big amounts of money." (WSJ, 6/13/09, "Risk-Management Pioneer and Best-Selling Author Never Stopped Insisting Future Is Unknowable") "They didn't adequately question their own assumptions. It's an entirely human mistake." (NYT, 1/6/10, "If Fed Missed This Bubble, Will It See a New One?")

"[E]very investor has a fundamental need to believe that the world is just—that good people are ultimately rewarded, that bad people are eventually punished and that the system isn't rigged to favor an undeserving few. This belief in a just world is partly delusional; most of us realize that nice guys often finish last. But this delusion makes short-term setbacks endurable. ... This time around, however, many investors who

followed the best advice were punished the worst." (WSJ, 2/6/10, "Will We Ever Again Trust Wall Street?") "[I]f we learned anything in this crisis, it is that most of the sophisticated financial professionals in the world were no better at predicting the market than some amateur investors. (NYT, 1/14/10, "Wall St. Ethos Under Scrutiny at Hearing")

"To become a market-destroying 'it' group on Wall Street, you need some arrogance, enough brains to justify making huge financial bets, utter cluelessness about lessons from finance's booms and busts, and a sincere belief that your unique contributions to Wall Street will mean, ahem, that this time it really is different, so old truths can be ignored. ... Everybody knows, though, that to really be part of Wall Street's elite, you've got to have contempt for the little people." (Bloomberg, 2/3/10, "Quants' can't-lose ideas sink market") "When things start to go wrong, they get worse than anyone ever imagined they could. ... Regulators should ask the dozen or so top financial services firms ... what their most recent crop of top business school hires are working on --- not just their general assignments but precisely what they're doing. ... [C]rises follow the talent with a lag of about three years." (*Money, Greed, and Risk* [1999] by Charles R. Morris)

"'What's the personality of the most successful investors?' ask William Bernstein, a neurologist.... 'They aren't affected by other people's feelings. In fact, the most empathetic people I know are the worst investors.'" (WSJ, 4/3/10, "Time to Take Stock of the Recent Market Rallies")

"What goes up often keeps rising. That's the logic at the heart of momentum investing—a strategy that's been surging lately. ... What's more, some investing pros say we've entered an era well suited to momentum strategies—where one asset after another experiences a bubble that then bursts. ... These momentum trends in markets have more to do with the faddishness of human behavior than the fundamentals of economics and balance sheets. In essence, investors often flock to the stocks that have been going up, which tends to propel them further. Momentum ... traders don't analyze why ... stocks ... are on a winning streak recently or determine whether the stocks are expensive or cheap in theory. Momentum seekers jump on the bandwagon, intending to jump off again before the inevitable train wreck that ends the journey. With so many traders watching the same charts and seeing the same signals, these trends often become ... a self-fulfilling prophecy. ... [I]nvestors get excited because momentum beats the market on the way up—and often forget that

it gets hammered more than the market on the way down." (WSJ, 5/3/10, "Maybe the Rearview Mirror is Right")

"[A] crisis is not just a bad situation. ... The Chinese have a similar concept: The characters for crisis (危机) combine parts of those for danger (危险) and opportunity (机会). A crisis is a point when people have to make rapid choices under extreme pressure.... A crisis is certainly a test of character. It can be scary. ... Students of crises are fond of dividing them into phases. For example, Charles Kindleberger's 'Manias, Panics, and Crashes: A History of Financial Crises' identifies five phases of a financial crisis: an exogenous, normally positive, shock to the system; a bubble in which people exaggerate the benefits of that shock; distress when some investors realize that the game cannot last; the crash; and finally a depression. ... The bubble is typically characterized by mania and denial. Things are going well — or, at least, appear to be. Feedback loops end up magnifying confidence. ... In finance, leverage plays a big part. ... Manic individuals ... end up taking excessive risks.... But before that, there is denial. People do not wish to recognize that there is a fundamental sickness in a system, especially when they are doing so well. ... Market participants had such a strong interest in keeping the game going that they turned a blind eye to the unsustainable buildup of leverage. ... It is hard to recognize a sickness, given that there is usually some ideology that explains away the mania as a new normal. The few naysayers can be ridiculed by those who benefit from the continuation of the status quo. ... The crash, by contrast, is characterized by panic and scapegoating. People fear that the system could collapse. Negative feedback loops are in operation: The loss of confidence breeds further losses in confidence. ... Events move extremely fast, and decisions have to be made rapidly. ... [¶] In this phase, no one denies that there is a problem. But there is often no agreement over what has gone wrong. Protagonists are reluctant to accept their share of the responsibility but instead seek to blame others. Such scapegoating, though, prevents people from reforming a system fundamentally so that similar crises do not recur. [¶] Crises will always be a feature of life." (NYT, 10/7/12, "*The Dangers and Opportunities in a Crisis*")

"Mr. (Howard M.) Schilit's firm, the Center for Financial Research and Analysis, scours corporations' books.... He says his sleuthing cannot pinpoint fraud. Rather, examining public documents often turns up

gimmicks or aggressive accounting aimed at camouflaging problems. 'You never have a smoking gun,' he said. 'So you have to be careful about alleging wrongdoing. My job is to find an early sign of problems.'" (NYT, 1/4/04, "Once a Cassandra, Now a Sage")

The need to "do" complex

Persons "who do independent credit analysis usually do it to find undervalued instruments that represent investment opportunities...." (Treasury & Risk, 5/08, "Playing it Safer")

"4. Wall Street analysts don't 'do' complex. Isn't that what securities analysts are for, you might ask? Silly reader . . . analysis is for kids! Literally. At most large Wall Street firms, the tedious job of constructing financial models and answering client accounting queries is handled by the junior analyst on the team. It still shocks me today that when meeting with a team of 'sell-side' Wall Street analysts from a firm to discuss a particular company, the senior analyst invariably concedes the answer to a complex financial question to a junior analyst working for him. In a post-Eliot Spitzer world, how can this be? Simple. Senior analysts still spend most of their time on the road making client presentations. That is, of course, if they aren't playing golf with the CEO or organizing the menu at the next investor conference in Las Vegas. **The recent attempts by certain companies to discourage hard-hitting independent research will only serve to maintain the chasm between those that 'do the numbers' and those with, hopefully, the experience to know what the numbers mean.**" (WSJ, 5/30/06, Commentary: "Short-Lived Lessons From an Enron Short")

"[T]he lessons I (**Herb Greenberg**) have learned can be boiled down to five that are remarkably obvious and simple but are still often ignored in the heat of battle: Lesson No. 1: **The numbers don't lie. ... That is why some ... analysts don't like to talk to companies. They want to avoid the spin or the face-to-face meeting that can create a psychological connection that may skew what otherwise would be black-and-white analysis.** ... Lesson No. 2: Quality, not quantity. Ignore the 'beat the Street' headlines on earnings. It is what goes into the earnings that counts. ...[T]he real story is often on the balance sheet. And let's not forget the cash-flow statement. ... The more complex and convoluted the financial statements get, especially for businesses

that aren't overly complicated, the more reason to worry. Lesson No. 3: GAAP isn't the same as a Good Housekeeping seal. Generally Accepted Accounting Principles ... include plenty of gray areas that give management enough rope to hang themselves, if they so please. GAAP, after all, is subject to interpretation, and some managers are more conservative than others. ... Lesson No. 4: Don't confuse stocks and companies. They sometimes go in opposite directions. Stocks sometimes really do lie. Sometimes they are pushed artificially higher by a rotation by investors from one industry group to another... (or) short squeezes.... [S]ometimes they lie because of momentum. Momentum can take stocks to infinity and beyond, but ... reverse momentum ... tends to kick in when you least expect." (WSJ, 4/26/08, "A Columnist's Parting Advice")

"Outright fraud aside, if securities analysts rely solely on 'the number' (a.k.a. earnings per share), and a cursory glance at the old annual report to make their decisions, they deserve to get burned. **Abraham Briloff**, professor emeritus of accounting at Baruch College in the City University of New York and the remaining conscience of the public accountancy world, once wisely said, 'Corporate financial statements are like bikinis ... what they show is very interesting; but what they hide is vital.' You would think that given the historical reputation of Wall Street as a locker room with pinstripes, this statement alone would be enough to induce thousands of hard-working professionals to tirelessly dig deeply into financial statements. But over the latter part of the 20th century, the investment management 'industry' has de-emphasized traditional securities analysis in favor of portfolio analysis, primarily for two reasons. The first is the hegemony of Modern Portfolio Theory (MPT), which ... shifts emphasis away from individual security analysis to the analysis of the portfolio as a whole. ... The second reason why securities analysis has been de-emphasized has been the growth in the sheer asset size of the investment management industry. Peter Lynch aside, very, very few people can claim competence in managing tens of billions of dollars in portfolios composed of hundreds of stocks. It is simply impossible for even the best and the brightest to engage in reasonably deep fundamental analysis on a 300-stock portfolio. ... What has taken the place of detailed fundamental analysis over the years is the wholesale adoption of earnings per share as the sole basis for securities analysis. ... Intelligent and constructive securities analysis has always been the painstaking construction of a mosaic of factors.... The apparent solution to our seemingly collective inability to 'get it, ' is to call for more disclosure in financial statements. What is ironic is that if many investors have gotten themselves into a financial mess because they never bothered to carefully read financial statements, then I can almost certainly say that they are not going to read the colossal piles of paper being

thrown at them now. ... Crooks and frauds aside, we have generally gotten enough from GAAP disclosure to do our work. If we truly shake our heads and can't make heads or tails of a complicated set of statements, we pass and move on." (WSJ, 8/6/02, "We Need Better Stock Analysis, Not More Info")

"John C. Hueston, a well-regarded — and aggressive — prosecutor from Southern California ... advocated charging Mr. Lay with making false statements.... He (Hueston) interviewed securities analysts, seeking to understand what Mr. Lay had conveyed to the marketplace. He was shocked to find that most of them had not bothered to look closely at Enron's securities filings and were taking Enron's statements 'virtually at face value.'" (New York Times, 6/4/06, "The Enron Case That Almost Wasn't") "Securities Analysts' Recommendations: Based on available historical securities analyst information we were able to identify, as of October 18, 2001, 15 firms rated Enron a buy— 12 of the 15 considered the stock a strong buy. Even as late as November 8, 2001, the date of Enron's disclosure that nearly 5 years of earnings would have to be recalculated, although most firms downgraded their ratings, 11 of 15 continued to recommend buying the stock, 3 recommended holding, and only 1 recommended selling. In November 2001, one firm upgraded its recommendation from sell to hold." (United States General Accounting Office Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 2002, ["Financial Statement Restatements Trends, Market Impacts, Regulatory Responses, and Remaining Challenges"](#))

"Mr. (**Sam E.**) **Antar** (former chief financial officer of **Crazy Eddie** and former CPA, who stayed out of jail by turning on several others, including his cousin, Eddie Antar, who was Crazy Eddie's co-founder) says investors should do a better job 'studying' financial reports, especially the footnotes and 'risk factor' sections. 'Notice that I used the word "'study'" and not "'read'" since all information is not meant to be read like a novel, but meant to be analyzed like a project.' He adds: 'Criminals are scared of skeptics and cynics,' he says. 'We are petrified when you verify our representations.' Did he ever have remorse? 'Never ... We simply did not care about any one of our victims. We simply committed crime because we could. 'As criminals we built false walls of integrity around us,' he adds. 'We walked old ladies across the street. We built wings to hospitals. We gave huge amounts of money to charity. We wanted you to trust us. 'Simply said ... if you want to be an investor, you cannot accept information at face value. 'Unexamined acceptance' is the greatest cause of investor losses.'" (WSJ, 3/3/07, "My Lunch With 2 Fraudsters: Food for Thought for Investors")

"When Sam Antar was cooking the books for his company, he used a number of complicated accounting tricks to dupe auditors. But some tactics were simple. 'These auditors from the Big Four accounting firms are usually single kids just a few years out of school. What do kids in their 20s think about all the time? Sex,' said Antar, who was at the center of a multi-million dollar fraud 20 years ago. So Antar would pair 'cute hot female' employees with male auditors as part of his distraction strategy. 'In effect, I was a fraudster, matchmaker and pimp,' said Antar.... Another tactic: Delay. 'They would come in here with maybe six weeks to go through the books ... my goal would be to leave them 80 percent of the work for the last week, so they're rushed to finish.' ... One of the best ways to detect fraud in financial statements is to read only the footnotes, and compare how they have changed over time. Look for subtle differences, and that is where they will hide the fraud,' said Antar. 'That's what I did.'" (10/9/09, CNN.com, "Financial fraud 101 -- accounting for criminals")

"[S]hort sellers are not especially sympathetic characters. After all, they benefit from the decline in value of other people's investments. But in complex markets, short sellers are akin to investigative journalists, looking for the scoop of finding an overvalued company or industry. Also like journalists, short sellers aren't always popular with corporate management or regulators. Forensic accounting experts at hedge funds have performed the hat trick of being the first to signal, through short selling, troubles at Tyco, Enron and now Fannie Mae, Freddie Mac and banks." (WSJ, 10/20/08, "Don't Sell Hedge Funds Short")

"Many investors dismissed the spectacular failures of Enron, WorldCom, HIH and ABC Learning Centres as unforeseeable black-swan-type events. Not Jim Chanos, founder of Kynikos Associates. He predicted their demise and profited from them.... Chanos started Kynikos (Greek for "cynic") to profit from a practice known as short selling, where investors profit when the stock price of a company falls. ... You may never short a stock in your life, but if you understand what Chanos is looking for in a good short, then you'll know what shares to avoid. He offers three basic pointers: ... Chanos finds the accounting for companies that serially conduct mergers to be extremely murky. When debt is added to the mix, it often signals that all is not well – the company may have resorted to chasing new streams of revenue just to maintain the illusion of earnings growth. ... Some of Chanos' most profitable shorts have been Eastman Kodak, Blockbuster and, more recently, Hewlett-Packard. These companies appeared cheap, often selling for single-digit price-earnings ratios. But all operated in sunset industries, victims of technological change that drove their earnings down year after year. ... Betting on an ailing business is like backing a bleeding horse; the pay-off is high but the odds are stacked heavily

against you. ... Sensible, profitable investing is as much about avoiding the losers as it is betting on winners. The Jim Chanos approach will help you avoid the losers. (1/21/13, The Sidney Morning Herald, " Lessons from short seller Jim Chanos")

"The world is awash in credit. For the sake of investors, it had better be awash in good credit analysis, too. ... The rise in bond issuance is a trifle compared with what is happening in credit-derivative markets. The issuance of credit-default swaps, which are basically insurance contracts written against debt default, is soaring. ... Banks and other debt holders can buy credit-default swaps to limit risk. If a borrower goes into default, debt holders will lose money on the debt, but the default swaps they hold will rise in value, helping to mitigate the loss. On the other side of the trade, sellers of credit-default swaps have a nice source of income, as long as the issuer whose debt they are backing doesn't go belly up. ... But in the process of spending so much brain power slicing and dicing risk and passing it around, Wall Street might miss more fundamental questions about the underlying health of companies issuing bonds. Frank Partnoy, of the University of San Diego, and David Skeel Jr. of the University of Pennsylvania Law School illustrated this point in a recent paper by pointing out that the banks that financed **Enron's** debt used massive amounts of credit derivatives to limit their own risk of the company going into default. That is one reason they might have fallen asleep at the switch." (WSJ, 11/20/06, "Portfolio Insurance") Were the issuers of the credit derivatives equally asleep at the wheel after feasting on the large fees they were earning by selling the toxic waste?

"After 32 years in the industry --- 18 of those at Merrill Lynch & Co. Inc. of New York --- and for 19 consecutive years being ranked on the Institutional Investor All-American Research Team, Mr. **(Stephen) McClellan** ... (authored) 'Full of Bull' (FT Press, 2007), half of it a critique of Wall Street research, the rest a sometime quirky but useful guide for investors (and advisors). ... Q: Do these problems (revealed during the research scandal) still exist? A: Yes. Analysts are still very bad stock pickers. Their track record is terrible. You can't rely on their buy recommendations. Q: Don't people understand all that after ... Spitzer uncovered the conflicts of interest? A: ... Research is good in terms of analyzing the business, the competition and trends, but don't pay attention to the conclusions. ... Q: You say the first round of bad news is never the last. A: Absolutely. That's always been true.... Companies never have one bad quarter, or one surprise, or one earnings shortfall. Bad news feeds on itself. It takes awhile to reverse things. Wall

Street never learns that --- it's always trying to buy the stock at the bottom." (InvestmentNews, 2/4/08, "Stephen McClellan")

"Despite an economy teetering on the brink of a recession -- if not already in one -- analysts are still painting a rosy picture of earnings growth, according to a study done by Penn State's Smeal College of Business. The report questions analysts' impartiality.... 'Wall Street analysts basically do two things: recommend stocks to buy and forecast earnings,' said J. Randall Woolridge, professor of finance. ... 'A significant factor in the upward bias in long-term earnings-rate forecasts is the reluctance of analysts to forecast' profit declines, Mr. Woolridge said. ... The study's authors said, 'Analysts are rewarded for biased forecasts by their employers, who want them to hype stocks so that the brokerage house can garner trading commissions and win underwriting deals.'" (WSJ, 3/21/08, "Study Suggests Bias in Analysts' Rosy Forecasts")

"The latest blow to the reputation of **Moody's Investors Service** in structured finance is the charge that it knew of a computer error that inflated the ratings of constant-proportion debt obligations, or CPDOs, and didn't disclose the problem. ... The safe-sounding ratings proved spurious. Aside from any calculation errors, one reason was unduly rosy assumptions. ... Rating firms like Moody's and investors are now rethinking their reliance on flawed or insufficiently time-tested assumptions and statistical techniques that didn't address worst-case scenarios. To those concerns, they can now add worries about whether the plumbing of their complex models works properly. ... **The main lesson for investors comes straight off the hymn sheet of Warren Buffett ... Don't buy what you don't understand.**" (WSJ, 5/22/08, "Black Boxes Skew Ratings") A corollary might be: to understand a potential stock investment opportunity, one must learn and perform financial statement analysis.

***Financial Statement Analysis can "do"
complex***

Historical Analysis v2.3 (HA v2.3) and Projection v2.3 (Pv2.3) are spreadsheet-oriented tools to perform financial statement and quality of earnings analyses and forecasts, respectively. The information that they produce is useful to corporate Directors (and those doing "due diligence" before accepting

Directorships), commercial lenders, credit managers, stock market investors, business school students and many others.

- [Historical Analysis v2.3](#) and [Projection v2.3](#).
- The [concept](#) was initiated in the Special Credits Department of a large West Coast commercial lender in the late 1960s to train Credit Analysts and avoid making problem loans.
- These are excellent financial statement analysis teaching tools with "Comment" cross-references to classical and recent financial techniques and associated-explanatory media articles.
- HAv2.3 and Pv2.3 contain "red flag" alerts.
- They utilize input data that are readily available, without cost, on the Internet, *e.g.*, shareholder relations section of corporate websites, SEC EDGAR, Yahoo Finance.
- Pv2.3 contains special forecasting features, *e.g.*, allocation of funds needed (to balance the Balance Sheet) to Short-Term Debt, Long-Term Debt and/or Equity based upon many user pre-specified loan covenants, *e.g.*, Worth-to-Debt, Times-Interest-Earned, Fixed-Charge-Coverage and/or Current ratios and/or minimum amount of Working Capital.
- Pv2.3 can provide stock high/low market price range forecasting.
- [Recommended Reading](#).

Background

Historical Analysis v2.3 and Projection v2.3 organize and process large amounts of financial statement data and produce thorough and easy to understand analyses. Manually imputing data into HAv2.3 input sheets causes one to think about the accounting policies employed by the subject corporation and underlying assumptions, including a careful consideration of financial statement footnotes. Pv2.3 will help one forecast financial statements based upon user provided assumptions and constraints. Further, Pv2.3 could permit a stock market investor to forecast stock market entry and exit points.

The general concept behind HAv2.3 and Pv2.3 began at the Special Credits Department of a large West Coast commercial bank in the late 1960s when dealing with retailing and manufacturing companies. The bank's goal was to develop computer software to help train Credit Analysts and to avoid making problem loans. Further, the final product was to be used in customer

development. Subsequently, the tools were extensively updated and revised with numerous added features.

Corporate Directors and prospective Directors, Credit Managers, Chief Financial Officers, accountants, commercial lenders, stock market analysts, individual investors, business planers, loan packagers and business school students could benefit from HAv2.3 and Pv2.3.

Historical Analysis v2.3

Historical Analysis v2.3 allows a user to input up to twelve (12) years of annual historical financial data and will produce many reports, *e.g.*,

- Analysis Ratios;
- Predictor of Financial Distress;
- Quality of Reported Earnings;
- Statement of Shareholders' Equity;
- Funds Statement;
- Statement of Comprehensive Income;
- Statement of Cash Flow from Operations and Free Cash Flow;
- Statement of Cash Variance;
- Cash-Generating Efficiency;
- Working Capital Analysis;
- Common Size Income Statement;
- Common Size Balance Sheet;
- Stock Performance Analysis.

HAv2.3 generates cell color shading to highlight financial "red flags," *e.g.*, questionable accounting practices, indicators of financial distress. The "red flags" are cross-referenced to explanatory comments or quotations from related articles appearing in the news media. You may click through to access an our annotated [HAv2.3 Analysis](#) of Twitter Home Entertainment.

HAv2.3 is capable of detecting various financial shenanigans and financial distress years before companies enter into Bankruptcy Court proceedings or the market price of the company's stock plummets. We have back-tested HAv2.3's capabilities using examples mentioned in the United States General Accounting Office Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, October 2002, "[Financial Statement Restatements Trends, Market Impacts, Regulatory Responses, and Remaining Challenges.](#)" Our back-testing

showed that HAv2.3 would have successfully detected impending financial disasters.

More sophisticated users could use HAv2.3 to learn the assumptions upon which another's financial statement projection is based. That can be accomplished by inputting the forecasted financial statement into HAv2.3. HAv2.3 would allow the user to judge the reasonableness of the hidden assumptions utilized in the forecast, *e.g.*, future sales growth, inventory turn-days.

Projection v2.3

Projection v2.3 allows a somewhat more sophisticated user to input a corporation's latest year-end's financial data and numerous forecasting assumptions, *e.g.*, growth rates, various turn-days, fixed charges. Much of that input data can be derived from the analyses produced by HAv2.3. Pv2.3 would then forecast annual financial statements and analyses. One could test numerous scenarios.

A major feature of Pv2.3 is that one may pre-specific desired constraint ratios and/or amounts, *e.g.*, Worth-to-Debt, Times-Interest-Earned, Fixed-Charge-Coverage and/or Current ratios along with the amount of Working Capital. Using the aforesaid assumptions and constraints, Pv2.3 would allocate the funds needed (to balance the forecasted Balance Sheet) to Short-Term Debt, Long-Term Debt and/or Equity. One would not be required to engage in the seemingly endless task of manually allocating the anticipated funds needed, checking the impact on your desired ratios and amounts, and, then re-allocating and re-checking until you reach the multiple targets. The one step non-iterative logic in Pv2.3 is more accurate and efficient than an iterative approach. Pv2.3 uses cell color shading to remind that the funds-needed-allocation logic has been invoked and highlights the numerical results. Pv2.3 could reveal the amount, timing and nature of a company's future funding needs.

Recommended Readings

The concepts of financial statement analysis that are utilized in Historical Analysis v2.3 and Projection v2.3 were derived from many sources, including, books on the subject of financial statement analysis, as follows:

1. *Analysis of Financial Statements* by Leopold A. Bernstein;
2. *Business Analysis & Valuation --- Using Financial Statements* by Krishna G. Palepu, Victor L. Bernard and Paul M Healy;
3. *Cash Flow and Security Analysis* by Kenneth S. Hackel and Joshua Livnat;
4. *Corporate Financial Reporting and Analysis* by David F. Hawkins;
5. *CPA Comprehensive Exam Review --- Financial Accounting & Reporting* by Nathan M. Bisk;
6. *Financial Fine Print: Uncovering a Company's True Value* by Michelle Leder;
7. *Financial Shenanigans --- How to Detect Accounting Gimmicks & Fraud in Financial Reports* by Howard M. Schilit;
8. *Financial Statement Analysis --- A Practitioner's Guide* by Martin S. Fridson;
9. *Financial Warnings --- Detecting Earnings Surprises - Avoiding Business Troubles - Implementing Corrective Strategy* by Charles W. Mulford and Eugene E. Comiskey;
10. *Guide to Financial Reporting and Analysis* by Eugene E. Comiskey and Charles W. Mulford;
11. *Handbook of Financial Analysis, Forecasting & Modeling* by Jae K. Shim and Joel G. Siegel;
12. *Quality of Earnings* by Thornton L. O'Glove;
13. *When Stocks Crash Nicely --- The Finer Art of Short Selling* by Kathryn F. Stacey; and,
14. *It's Earnings That Count: Findings Stocks with Earnings Power for Long-Term Profits* by Hewitt Heiserman, Jr.

Others books, dealing with stock market investing, that may be of related interest, are:

1. *Contrarian Investing* by Anthony M. Gallega and William Patalon III;
2. *Mind Over Money* by John W. Schott, M.D.;
3. *The Psychology of Smart Investing* by Ira Epstein and David Garfield, M.D.; and,
4. *Fooling Some of the People All of the Time* by David Einhorn.

Additional books, dealing with more general business/finance topics, that may be interest, are:

1. *Ahead of the Curve --- Two Years at Harvard Business School* by Philip Delves Broughton;

2. *Manias, Panics, and Crashes - A History of Financial Crises* by Charles P. Kindleberger ["One problem with warnings, of course, is embodied in the fable of the boy who cried, 'Wolf.' Economic forecasters may know the direction of a move in business conditions, prices, and credit, but their capacity to foretell its precise timing is limited. ... In warning the market, or in providing it with information that it ought to have, one must first get the bemused speculators to pay attention, and then time the announcement soon enough to do good but late enough to be credible and heeded. Neither task is easy."];
3. *A Nation of Counterfeiters* by Stephen Mihm;
4. *Billion Dollar Lessons* by Paul B. Carroll and Chunka Mui;
5. *Money, Greed, and Risk* by Charles R. Morris; and,
6. *Bailout --- An Insider Account of How Washington Abandoned Main Street While Rescuing Wall Street* by Neil Barofsky;
7. *The Payoff—Why Wall Street Always Wins* by Jeff Connaughton ["I should've known that the legal and regulatory system meant to protect us had rotten away. ... I can't explain why President Obama (and Vice President Biden) have failed to support stronger enforcement efforts or financial reform.... Obama and Biden gave the problem a sideways glance and then delegated the solutions to the same circle of Wall Street-Washington technocrats who brought the financial disaster upon us in the first place. ... Unfortunately for American, Obama and Biden ... were both financially illiterate."];
8. *Bull By The Horns---Fighting to Save Main Street from Wall Street and Wall Street from Itself* by Shelia Bair ["Financial concepts are not that difficult if you have a little time to study them. ... Sometimes I think that people in the financial sector don't want you to understand the issues."];
9. *America's First Great Depression---Economic Crisis and Political Disorder After the Panic of 1837* by Alasdair Roberts. ["'Everyone with whom I converse, talks of 100 percent as the lowest return on investment. No one is known ever to have lost anything by a purchase of real estate.' --- John M. Gordon, an investor from Baltimore, reporting on land sales in southern Michigan, 1836."]

A newspaper article and our responsive letter-to-the-editor expressed an investor vs. gambler approach to stock market activities.

1. "[Stock market classes: Never a dull moment](#)"

Learn By Negative Example

"Stock analysts have long been criticized for issuing very few 'sell' recommendations on stocks they cover. If you want to know why they still often are reluctant to be publicly negative, spend a few minutes with Eric Wold, analyst at the San Francisco investment-banking boutique Merriman Curhan Ford & Co. His reward for slapping a sell rating on **Nautilus Inc.**? He says the company won't return his phone calls anymore. ... Their lack of response, he says, appears directly related to the increasingly critical nature of his reports, which culminated in June 2006 with his downgrade to a sell 'on heightened concerns' over a variety of issues. This was one month after Mr. Wold wrote that he was 'unconvinced' the company, which had a series of missteps and disappointments, 'has turned the corner.' ... [H]e realized the new strategy was 'cannibalizing existing sales and shifting sales from high-margin channels to low-margin channels.' ... He red-flagged such things as undershooting on earnings forecasts, increased competition.... Ron Arp, Nautilus's senior vice president of corporate communications, says ... (that) it is 'not true' that the company won't talk to Mr. Wold. ... 'That is hilarious,' Mr. Wold responds. ... **In looking back, the lack of access forced Mr. Wold to rely only on publicly disclosed numbers and outside resources for his analysis, and in doing so he got it right. Maybe that is the moral of this story: Let the numbers do the talking, not the company.**" (WSJ, 7/14/07, "After an Analyst's 'Sell' Call, Nautilus Flexes Its Muscles")

"Perhaps all it takes to keep an analyst from downgrading a company's stock is a couple of favors from the chief executive officer. That, at least, is the conclusion of a new study by two business-school professors. James Westphal of the University of Michigan 's Stephen M. Ross School of Business and Michael Clement of the McCombs School of Business at the University of Texas found that nearly two-thirds of securities analysts receive advice, introductions to other high-powered executives, or other favors from top managers at the firms they cover. ... [A]s a company's reported earnings slipped, executives became more likely to do favors for analysts covering it. ... Analysts are only half as likely to downgrade a company's stock after it announced earnings below the consensus forecast if one of the firm's executives does two or more favors for the stock picker. The study also found that executives tend to reach out to the analysts with the most influence. ... The favors executives rendered most frequently included connecting an analyst with a high-ranking official at another company (comprising 28% of favors in

surveys of analysts), providing career advice (20%), offering to meet with the analyst's clients (13%), and passing along information on industry trends (10%). ... Professionally, the analysts may stand to gain considerably more from their access to executives at the firms they cover than they might lose by failing to downgrade a stock that truly deserves it. ... So, who loses? Westphal and Clement argue that executives' favor-wielding risks undermining the objectivity of analysts' reports. For big institutional investors, who probably have their own stable of analysts, other views may not be tough to come by. But individual investors should know that analysts and executives are trading favors...." (BusinessWeek, 7/27/07, "Analysts and CEOs: A Love Story?")

"**Nortel Networks Corp.** ... had a profit of \$40 million, its first positive quarterly result in four years. ... But the profits turned out to be illusory. ... [T]he company inaccurately employed an accounting maneuver to make it look profitable, when in fact it wasn't. [T]he alleged manipulation centered on the misuse of an accounting entry known as accrued liabilities. Accrued liabilities derive from the charges companies often take for matters such as merger costs, write-downs and, in Nortel's case, contractual liabilities. ... Some former employees and critics say board members, many of whom were former ambassadors and Canadian corporate leaders, should have spotted the accounting problems earlier." (WSJ, 7/2/04, "Reversing the Charges: Nortel Board Finds Accounting Tricks Behind '03 Profits; A Telecom Star Manipulated Its Reserves, Hid Losses, An Investigation Discovers; How to Empty the Cookie Jar")

"If there ever were a bell-ringer that the market's recent giddiness appeared likely to end, it was Prudential Equity Group analyst Howard Penney's recommendation of **Krispy Kreme Doughnuts Inc.** after the market's close on Oct. 26. ... Here was a company that hadn't filed quarterly reports with the Securities and Exchange Commission for more than two years; its most recently filed annual report -- in April -- was more than a year out of date. ... Mr. Penney not only initiated coverage on the stock with the equivalent of a buy, but gave it a target of nearly double its price." (WSJ, 11/4/06, "What's Behind Sugary Report On Krispy Kreme? ")

"Mr. Van (S. Bradley) Cleve (a lawyer for the 34 biggest industrial customers of Portland General Electric) sought a subpoena for all the correspondence between Standard & Poor's and the utility for the previous 21 months. Those newly disclosed documents open a rare window into the internal workings of the corporate credit rating business. As such, the documents raise questions about the independence and integrity of the rating services, whose

reports are relied upon by millions of investors in choosing stocks and bonds. The documents show that Standard & Poor's solicited comment from the utility on a draft report and then made at least 48 changes that the utility sought before releasing its report on Sept. 25. Those changes included ... (a) crucial phrase supporting Portland G.E.'s request to shift all fuel-cost risks off its shareholders and onto customers. The utility then used the report as independent corroboration of its request to raise rates. ... The biggest credit rating services — S.& P. and Moody's Investors Service as well as Fitch Ratings — have been roundly criticized since they failed to publicly report the declining fortunes of Enron and WorldCom until it was too late. Congress, European securities regulators, investor advocates and even some rival credit ratings agencies questioned the independence and integrity of the credit rating system, in part because since the early 1970s the services have been paid by the very companies whose creditworthiness they evaluate. ... Congress passed laws in 2002, 2005 and in October directing the Securities and Exchange Commission to get tough on the ratings agencies. An S.E.C. spokesman, John Heine, said the commission was still studying the issues and had not released new rules yet. The Oregon documents suggest that little has changed since the collapse of Enron five years ago. ... In the Oregon case ... the changes made by S.& P. cast increased doubt on the financial strength of Portland G.E., bolstering its case to raise rates, increase its profit margin and shift all fuel-price risks onto customers. ... The utility cited the report as independent corroboration of its request to raise rates by 9 percent and to shift all fuel-cost risks off shareholders. ... Normally investors who rely on these reports never get any hint of what revisions are sought by companies whose finances are being evaluated. ... In documents released last week, the staff of the Oregon Public Utility Commission determined that S.& P.'s Sept. 25 report was so compromised that 'it is impossible to conclude that S.& P. conducted a timely independent inquiry.' ... Both Moody's Investor Services and Fitch Ratings, said they, like S.& P., typically show advance copies of reports to client companies to check facts." (NYT, 12/12/06, "Objectivity of a Rating Questioned")

"Paid-for research firms typically follow tiny, little-known companies the big brokerage firms ignore. Without them, there likely would be no research reports at all on these companies. Critics of paid-for research say it is less reliable, because an analyst could be influenced to be more bullish or bearish in his or her report, depending on who pays for it. Others note that paid-for research isn't that different from companies paying credit-rating firms that assess their debt. ... The full reports include disclosure information about potential conflicts of interest. ... Those who can access the full reports and read

the fine-print disclosures will see that.... Some say the paid-for research isn't that different from other reports. 'Really, on a very basic level, what research isn't paid for?' says Todd Essary, chief executive of Investrend Research, member of a consortium of about 15 paid-for research firms...." (WSJ, 12/13/06, "In Quiet Niche, Paid-For Stock Research Persists")

"Nobody can see the future; yet every quarter it's the same old song and dance: Will they or won't they? (Beat the estimates, that is.) Estimates by analysts, of course, aren't necessarily the same as guidance provided by a company. But guidance creates a target analysts can work from. Sometimes companies beat the consensus estimate by low-balling guidance. Other times they beat numbers that everybody conveniently forgets had been revised downward. And sometimes, as if miraculously clairvoyant, they hit the number they forecast quarters or even years earlier on the nose. Part of running a business includes making internal forecasts. ... Some companies are even modifying their annual guidance by adopting rolling guidance, which involves setting an annual target that's reaffirmed or revised quarterly. ... 'I don't deny there's a game going on with analyst forecasts and with guidance,' says one of the study's (a new academic paper on the subject, titled, 'To Guide or Not to Guide') authors, Baruch Lev of New York University's Stern School of Business. But he adds he believes that guidance is important. Without it, he says, analysts will continue to forecast. 'All you'll have is forecasts,' he says, 'some of them completely wide. Guidance is a way for managers to induce some reason into them.' That's assuming management has a better handle on the numbers than the analysts. Given the amount of guidance that is often revised downward -- three for every two revised upward in the past four weeks alone, according to Zack's Investment Research -- it's not altogether clear they do." (WSJ, 2/3/07, "If Earnings Guidance Lacks Clear Direction, Why Bother?")

"Jerry W. Levin says he welcomed help from **Sunbeam Corp.** directors when he was named CEO of the consumer-products maker in 1998 after directors fired Albert J. Dunlap amid accounting problems. Mr. Levin previously had run Coleman Co., before Sunbeam acquired it. Directors met almost every day by phone for months, recalls Mr. (Charles) Elson, the Delaware governance expert who was a Sunbeam director at the time. The board counseled Mr. Levin on such subjects as strategic shifts and executive recruitment. 'I was plenty happy to have their support,' says Mr. Levin. But Mr. Levin says he was surprised that the board knew so little about the extent of Sunbeam's accounting problems, as his team uncovered them. "'They said, 'It's unimaginable that such massive fraud could have taken place under our noses,'"

Mr. Levin recalls. Mr. Elson replies, 'The board had been seriously misled by prior management.' Sunbeam ultimately restated 18 months of earnings and filed for bankruptcy protection." (WSJ, 3/19/07, "More Outside Directors Taking Lead in Crises")

"[T]he vast majority of analyst recommendations remain bullish. ... [I]ndividuals and institutions alike want to see stocks go up, so they prefer bullish analysts over bearish ones. But another, greater source of pressure are the companies the analysts cover. Managements that are showered in stock options have their personal wealth directly tied to a rising stock price, so they are often infuriated when an analyst puts out a critical report or downgrades a rating to a sell. And they retaliate. They refuse to allow the negative analyst to ask questions on conference calls. They somehow 'forget' to include him in e-mail messages that are sent to other analysts. They decline to attend that analyst's conferences. They complain to his boss, who then inquires as to why the analyst has to be so darn negative all the time. Many companies still use investment banking business as a way to reward the firms that employ analysts they like and punish the ones with analysts they don't like.... And sometimes companies sue.... [I]t works. ... These are bullish times in the stock market, so it is easy to forget how important it is to have skeptical -- and even negative -- voices to counterbalance all the happy talk surrounding stocks. Even when the skeptics are wrong, they make the market healthier because they offer a point of view that people need to hear." (NYT, 5/12/07, "Making Sure The Negative Can Be Heard")

"[C]orporate earnings reports have outstripped analysts' expectations, contributing in no small part to the fizzy mood on Wall Street. But here's a sobering thought: those expectations were way too low in the first place. ... But why were analysts so far off the mark? Largely because of the so-called guidance provided by company after company, setting investors up for a pleasant surprise when earnings were announced." (NYT, 5/13/07, "Surprised? Maybe You Shouldn't Be")

"Journalist **Michelle Leder** learned the hard way about not reading the footnotes. ... Afterward, she decided to go back to see what she might have found had she looked more closely at the footnotes in the company's Securities and Exchange Commission filings. There was plenty, says Ms. Leder, who used the experience as the launching pad for her Web site, **Footnoted.org**, which tries to ferret out facts that otherwise might go unnoticed. ... [S]ophisticated investors will dig into the footnotes to determine if everything is as the company said it was. ... In 10-Ks, **Bob Olstein** of **Olstein Funds** ... starts with a review of the note on income taxes. 'What I want to see,' Mr.

Olstein says, 'is a reconciliation of the income the company is reporting to shareholders and the income being reported to the [Internal Revenue Service].' A big difference between the two can be a red flag that requires further research, which he says was the case with Sunbeam, the appliance maker that got caught up in an accounting scandal in the late 1990s. ... Mr. Olstein ... also look(s) at the footnotes on raw materials, work in progress and finished goods. 'A huge build in raw materials and work in progress relative to finished goods can mean orders are picking up,' Mr. Olstein says. 'The reverse can be if finished goods are building and raw materials are not.'" (WSJ, 6/2/07, "An Eye-Poke to Investors Who Ignore the Small Print")

"Nobody cares much about accounting scandals anymore. Proof is the stock market's reaction (or lack, thereof) to the continuing saga surrounding 'accounting irregularities' at **International Rectifier**, a Wall Street favorite and stalwart among technology companies. ... [H]ere's a company with a market value of nearly \$3 billion, revenue of more than \$1 billion and earnings exceeding \$100 million -- whose disclosure of 'accounting irregularities' caused the equivalent of a yawn. The meek reaction, oddly enough, is understandable: The original announcement skirted details, saying the irregularities were limited to a foreign subsidiary and 'include, among other things, premature revenue recognition of product sales.' The bad stuff appeared to occur in the preceding six quarters and the fiscal year that ended June 30, 2006. Pretty humdrum, if you didn't know better. Analyst Todd Cooper of Stephens & Co. told clients ... the most likely outcome 'could be that revenue could move from one quarter to the next but that overall revenue would not change.' He added that 'issues with shipments around the end of a quarter and when those shipments should be recognized as revenue are probably at the root of this issue.' ... [F]ilings with the Securities and Exchange Commission (reported) ... the company's investigation found that 'among other things' the foreign subsidiary would occasionally enter 'unsubstantiated orders' into the system. ... 'The practice included routing certain product shipments to warehouses not on the company's logistical system.' ... [T]he market's indifference to possible fraud, no matter the size, is astounding -- especially since, at times, aggressive behavior reflects a company's culture. ... Over the past six years, the skepticism analysts and portfolio managers built up after Enron has evaporated and therefore, they simply don't care about accounting scandals. Not yet, at least." (WSJ, 7/7/07, "Accounting Scandals: Not a Problem?")

"When it comes to government investigations, 'investors are dangerously complacent,' says **John Gavin**, president of **Disclosure Insight**, a research firm that analyzes SEC filings with a focus on uncovering investigations before they

are publicly disclosed. Too often, he says, they are simply 'too generous' in their assessment of regulatory risk. He says that is because management often gives little in the way of facts while analysts don't probe 'because they're afraid' of getting frozen out by the company. ... [M]any companies avoid disclosing investigations until long after they are under way. ... The reality: There isn't a rule that says a company must disclose investigations until they are deemed, by the company, as material. ... Mr. Gavin adds, '**Dell** sat on its revenue-recognition investigation for a year and then disclosed it.' ... [R]estatements, which would appear to put overly aggressive accounting in the past, don't necessarily establish a clean slate in the eyes of investors. According to a Treasury Department restatements report this past week by University of Kansas associate professor of accounting **Susan Scholz**, while there are some indications of apathy by investors, 'returns are statistically negative for restatements involving fraud' in every year but 2004. Restatements, alone, aren't as ominous for investors as outside investigations. From 'the first revelation of misconduct' until an investigation is resolved, stocks of target companies tend to fall by an average of 40%, says **Jonathan Karpoff**, a finance professor at the University of Washington, who co-authored a study on the topic. ... Lenders, for example, might be reluctant to lend to companies that have been tagged as having inadequate internal controls." (WSJ, 4/11/08, "Why Do Investors Ignore Inquiries?")

"The public stock markets are in the throes of one of the biggest and most egregious financial scandals in modern history.... This unprecedented scandal is documented in succinct but gory detail by Mr. (**Louis**) **Lowenstein** in *The Investor's Dilemma: How Mutual Funds Are Betraying Your Trust and What to Do About It*. Mr. Lowenstein is a lawyer, a former business executive and a professor emeritus of finance and law at Columbia Law School. ... [H]e is a proud disciple of the 'value investing' principles outlined by Columbia professors Benjamin Graham and David L. Dodd in 1934. ... [A]s summarized by Mr. Lowenstein: 'There is a profound conflict of interest built into the industry's structure, one that grows out of the fact that the management companies are independently owned, separate from the funds themselves, and managers profit by maximizing the funds under management because their fees are based on assets, not performance.' ... [T]he performance of the vast majority of mutual funds ranges from dismal to atrocious, especially in comparison to the highly profitable performance of the management companies that own them. ... Mr. Lowenstein cites several structural reasons for the failure of mutual funds to serve the best interests of their investors. ... Mr. Lowenstein balances his critique of rapacious mutual funds with an analysis of two relatively new funds ... (with) business models (that) mirror the Graham-Dodd

philosophy of focusing on a few carefully selected stocks rather than diversifying in the name of safety, which is typically a euphemism for lazy research, Mr. Lowenstein says." (NYT, 4/20/08, "Some Mutual Fund Numbers Look Great, but for Whom?")

"Most of **David Einhorn's** ideas work out brilliantly. He is a 39-year-old hedge-fund manager in Manhattan who oversees \$6 billion. Bull markets? Bear markets? It hardly matters. His stock portfolio has averaged 25% annual returns since 1996, when he opened **Greenlight Capital**. Now Mr. Einhorn has written a book. ... In 'Fooling Some of the People All of the Time' The story starts in 2002, with Mr. Einhorn rightly proud of his ability to spot companies with shoddy accounting practices. ... Convinced that he has found another juicy target, he zeroes in on **Allied Capital**, a business-financing company that seems to dawdle when it comes to marking down the value of its troubled loans. ... Allied eventually did take big write-downs.... He grew so irate about the company's accounting that he alerted the Securities and Exchange Commission. The SEC did little with his complaint; in fact, it investigated *him* instead for spreading negative views about Allied. ... An SEC lawyer who quizzed him aggressively about his short-selling methods later went into private practice and registered as a lobbyist for Allied. ... The book also shows why good accounting really matters. It is easy to mock finicky people with green eyeshades who worry about financial footnotes. But reliable numbers are essential if capital is to be allocated properly in our economy. ... Mr. Einhorn is a hard-liner, wanting strict accounting standards that punish missteps quickly. Allied Capital, to judge by his version of events, liked living in a more lenient world, where there was plenty of time to patch up problems quietly. Regulators were comfortable with an easy-credit philosophy, too, to a degree that startled Mr. Einhorn. In the current financial shakeout, people like Mr. Einhorn are entitled to say: 'I told you so.'" (WSJ, *Bookshelf*, 4/23/08, "The Money Kept Vanishing")

"Sometimes Wall Street seems a bit like the make-believe Lake Wobegon: Most stocks are above average, and it is always a good time to buy. ... But Merrill Lynch, the nation's largest brokerage firm, unveiled a new system on Tuesday for rating stocks that suggests Wall Street finally may be mustering up its courage to say 'sell' more often. Starting in June, Merrill will require that its analysts assign 'underperform' ratings to 1 out of every 5 stocks they cover. About 12 percent fall into that category now. ... [S]ome in the financial industry say it may be too late for research departments at Merrill or other investment banks to reclaim the credibility and prestige they lost after the technology stock bust. Hedge funds, which account for up to 75 percent of trading on some

markets, conduct much of their own research and often pay twice the going rate on the Street for analysts. Many banks, by contrast, have cut research budgets. ... Today, the company has 750 analysts covering 3,600 stocks, compared with 900 analysts covering 3,500 companies in 1999. Some analysts say the market does not value investment research about stocks as much as it used to because hedge funds and other investors are more focused on short-term results than they used to be. ... Yet some investors say they still use Wall Street research, just not in a way that would hearten big investment banks. Mr. Melcher of Balestra Capital said he found the research to be a guide to the prevailing view about a company or industry. Often, he takes Wall Street's ratings as a contrarian indicator and does the opposite of what the analysts are recommending. In other words, when all the analysts say 'buy,' it's often a good time to sell. **'When we see all the analysts go one way, we take a very serious look at going the other way,'** he said. **'And it has paid off over the years.'**" (NYT, 5/15/08, "Merrill Tries to Temper the Pollyannas in Its Ranks")

"When it comes to one-day losses, it doesn't get much uglier than shares of **NexCen Brands**. The stock plunged 77% in trading Monday.... It raised doubts about its own survival, questioning its 'ability to continue as a going concern.' ... NexCen shares have been steadily deteriorating over the past year and a half. Analysts at Brean Murray Carret & Co., who steadfastly held a 'buy' rating on the company since April 2007, downgraded NexCen to 'hold' Monday, saying they were 'tired of making excuses for NexCen and touting the strength of the business model while virtually continual top- and bottom-line misses and, now, poor negotiating of the debt covenants, show a lack of controls.' ... NexCen was founded in 2006 by Bob D'Loren, who merged his investment bank, UCC Capital Corp., with a defunct wireless provider to reap a tax benefit. He has since bought a number of franchises looking for turnaround potential.... The bizarre part of this is that all four of the research analysts covering NexCen had moldering 'buy' ratings on the company. During Brean Murray's 'buy' rating, the shares fell 80% -- and that isn't including Monday's trading. Two other analysts -- at Sidoti & Co. and Lazard Capital Markets -- held 'buy' ratings since August and October, respectively, and in that time, the shares are down more than 60% (again, not including the decline Monday). Sidoti dropped coverage of the stock Monday to 'focus on stocks with greater market capitalization.' ... C.L. King, the fourth firm covering the company, has an 'accumulate' rating, its second highest, which projects a 10% return or more over a 12-month period. Since this upgrade from 'neutral' in September, the stock is down 65%." (WSJ, 5/20/08, "Staunch NexCen Fans Head for Exit") A "buy" rating is not what it used to be --- or is it?

"A group of **Archway & Mother's Cookie Co.** creditors has sued Catterton Partners, charging the private-equity firm with participating in an accounting fraud at the collapsed cookie maker. Archway closed its doors in October. ... It filed for bankruptcy protection from its creditors and laid off all 673 full-time employees. The lawsuit, filed in U.S. Bankruptcy Court in Delaware, alleges Catterton turned a blind eye to a widespread accounting fraud at Archway that was neither 'particularly sophisticated or ingenious.' Company executives created phony sales and inflated inventory, the complaint says. These financial maneuvers enabled Archway to increase the amount of credit available under its lending facility with **Wachovia Corp.** ... 'The accounting fraud was the most convenient way of continuing to receive senior financing and trade credit to keep the business afloat,' say the Archway creditors' committee in the lawsuit." (WSJ, 1/24/09, "Creditors Sue Archway Owner") One is left to wonder whether Wachovia bothered to perform a financial statement analysis. There are methods to detect "phony sales and inflated inventory."

"[**J.P. Morgan Chase** analyst **Paul Coster**, who Wednesday published a bullish report about software company **Sonic Solutions**. His 'overweight' recommendation was based on a stock-price target of \$13, 55% higher than Tuesday's closing price. One problem: His price target was based on a share-count projection for Sonic that was far too low. ... Using a cash-flow analysis, Mr. Coster estimated Sonic was worth \$378 million, which he divided by 29.1 million shares to arrive at a \$13 target price. But in a note on Thursday, he revised the projected share count up to 50.4 million shares. With that higher count, the per-share value should have fallen to \$7.50—lower than where the stock traded before the note. But Mr. Coster's per-share valuation didn't fall, primarily because he simultaneously raised his revenue projections for fiscal years 2012 through 2017, thereby lifting Sonic's estimated value more than 70% to \$648 million. The new share count and company value combined to produce almost exactly the same per-share value for Sonic, allowing Mr. Coster to maintain his \$13 price target. ... [M]r. Coster suggested a good share of the extra value in Sonic was going to come from a product called RoxioNow. But the question needs to be asked: Did Mr. Coster raise his long-term revenue projections to avoid an embarrassing cut to his price target? ... Investors can draw their own conclusions." (WSJ, 6/12/10, "Red Flag for Bull Case on Sonic") Houston, we have another credibility gap roaming Wall Street. If you can't trust a securities analyst, who can you trust?

An Approach to Stock Investing

The stock market investing approach outlined here is based upon the underlying assumption that there is a positive correlation between the quality of a company's financial statements and the eventual market performance of the company's publicly traded securities. However, that may not always be true. You be the judge.

“It all starts with a well-defined process that is executed with a high degree of discipline. ... There are a lot of smart people in the investment business, but not very many of them are consistently successful. ... We think the reason is that not many of them have a truly well-defined process and are truly disciplined in executing it. (WSJ, 11/7/05, "He Recruits Managers with Passion and Focus for Stocking-Picking Teams") "In this world, data can be used to make sense of mind-bogglingly complex situations. Data can help compensate for our overconfidence in our own intuitions and can help reduce the extent to which our desires distort our perceptions." (2/18/13, NYT, "What Data Can't Do")

"Call it the consumer's Catch 22: Buyers love bargains, but when they finally arrive—thanks to a financial crisis—many feel too cash-strapped to take advantage of them. ... Valuation — always a tricky affair — becomes even more challenging in turbulent times. For example, traditional measures based on earnings multiples are less meaningful when profits are erratic, or nonexistent." (NYT, 5/22/09, "The Art of Buying in Bearish Times") As John Maynard Keynes famously put it: **"The market can stay irrational longer than you can stay solvent."** "The technical term for it is 'negative feedback loop.' The rest of us just call it a panic. How else to explain yet another plunge in the stock market Tuesday that sent the Standard & Poor's 500-stock index to its lowest level in five years — particularly in the absence of another nasty surprise? ... Anybody searching for cause-and-effect logic in the daily gyrations of the market will be disappointed — even if the overarching problem of a crisis of confidence in the global economy is now becoming clear. Instead, the market has become a case study in the psychology of crowds, many experts say. In normal times, it runs on a healthy mix of fear and greed. But fear now seems to rule, with investors often exhibiting a Wall Street version of the fight-or-flight mechanism — they are selling first, and asking questions later. ... To some, signs of capitulation can be read as an indicator that the bottom may be near. Indeed, Sam Stovall, chief investment

strategist at Standard & Poor's Equity Research, is among those who say the market may be close to a bottom. ... The opposite of capitulation, of course, is investing at the height of a bubble. ... **At this point, any spreadsheet analysis of underlying and intrinsic values of stocks becomes meaningless**, and concern for preserving wealth overrides the desire to grow it — what some may call greed." (NYT, 10/8/08, "Forget Logic; Fear Appears to Have Edge") "You could've been highly leveraged.... Leverage may turbo-charge results on the way up, but it's crushing on the way down." (WSJ, 11/25/08, "A Reason to Be Thankful: It Could Have Been Worse") "[W]hen the fear system of the brain is active, exploratory activity and risk-taking are turned off. The first order of business, then, is to neutralize that system. This means not being a fearmonger. It means avoiding people who are overly pessimistic about the economy. It means tuning out media that fan emotional flames. ... [I]t means closing the Web page with the market ticker. It does mean being prepared, but not being a hypervigilant, everyone-in-the-bunker type." (NYT, 12/7/08, "In Hard Times, Fear Can Impair Decision-Making") "[M]ost retail investors rush into the market at the top and bail out at the bottom." (Registered Representative, 9/09, "The 0% Return") "Experts say amateur investors tend to make two basic mistakes: they are swayed by emotion, and assume that recent performance will predict the future. ... 'Often, the best investments for the future are those that have been performing the worst,' Mr. (Stephen) Utkus (head of the Center for Retirement Research at Vanguard) said. Unfortunately, taking advantage of underpricing implies a contrarian style of investing that 'most of us aren't emotionally equipped to handle,' he said." (NYT, 9/22/09, "The Forest, the Trees and Your Portfolio")

"To be a value investor, it isn't enough to buy cheap stocks or the funds that own them. You have to stick around until the market recognizes their worth. Mr. [Jean-Marie] Eveillard, now 73 years old ... is prepared to 'suffer' until the market proves him right." (WSJ, 2/16/13, "Value Stocks Are Hot--- But Most Investors Will Burn Out") It may not be prudent to purchase securities of well-known companies based solely upon the fact that the company's stock price declined 30% to 50% from its prior 52-week high. A prudent investor might prove to be wiser by avoiding that which first might appear to be a tempting investment opportunity. "Value investors like Ms. (Kim) Forrest hunt for stocks of companies that are underappreciated and undervalued. It is an approach championed by Warren Buffett and many other bargain hunters. But a low share price isn't the same thing as a good value, particularly if the weakness reflects some fundamental problem facing a company or its industry. Investors who conflate the two may be succumbing to a common desire to buy cheaper stocks in order to avoid overpaying, says Meir

Statman, a finance professor at Santa Clara University in California. It is similar to the impulse that compels investors to cling to stocks they already own that have declined in price, he says. Research suggests that is a bad strategy, Mr. Statman says, because stocks that have gone down over the past six months to a year are more likely to keep going down for roughly the same amount of time. 'Usually, losers continue to lose,' he adds. ... 'Don't expect these things to shoot up in 2013,' says Fort Pitt Capital's Ms. Forrest. She thinks it could take three to five years for some laggards to rebound. That could pay off for investors who have lots of patience. But many investors are more like 'hyperactive kindergartners playing musical chairs,' says Sam Stovall, chief equity strategist at S&P Capital IQ. 'They don't have the patience.' ... 'A lot of investors have been waiting for a strong correction,' Mr. (Sam) Stovall says. If that happens, the stocks that have climbed the most this year could skid, he says—but the same stocks are the most likely to bounce back strongly if investors see the slide as a buying opportunity. Rather than buying up laggards, Mr. Stovall says, the appropriate response to this year's rally may be to 'let your winners run and cut your losers short.'" (5/25/13, WSJ, "Beware of 'Bargain' Stocks---Why a Low Share Price Alone Doesn't Make for a Good Value")

During those times when the stock market is rational, investors may use stock market screens, available through securities brokerage firms where they maintain accounts, to locate potential investment opportunities. They may employ various search criteria, *e.g.*, EV/EBITDA, PEG, ROIC, Price/Earnings, Price/Sales, Price/Operating-Cash-Flow and/or Price/Book Value ratios. There will be few, if any, candidates near market tops---of course, depending how conservative the criteria. Using HAV2.3, one can verify that the favorable search results were not produced by a company's manipulative accounting and/or unsound management practices. On the other hand, a short-seller might view companies with manipulative accounting and/or unsound management practices, where its stock is reaching new highs, as an investment opportunity.

After assuring oneself of the quality of the company, *e.g.*, Predictor of Financial Distress showing that bankruptcy is unlikely, a stock purchaser might feel very comfortable increasing his/her investment position at specified levels of decline. An "early bird" investor, who "averages-down," could ultimately profit more than one who is able to pick the stock price bottom with his/her initial purchase. This approach takes much emotional stamina and available reserve funds. There are risks. "The 'strong hands' have what it takes to survive.... Not only are they emotionally strong enough to avoid selling into a panic, but they also have deep-enough pockets to avoid doing so for

financial reasons. In fact, the 'strong hands' can actually profit by buying at cheap prices near the bottom of a market." (NYT, 8/9/09, "Hold or Fold, but Don't Waver") "Value investors are known for buying low and selling high, but some big-name mutual-fund managers who thought they bought low are now selling far lower and are posting big losses.... [V]alue managers are unloading some traditional holdings that have disappointed. ... Fund managers try to look at the bright side, telling shareholders the losses will help cut their taxes." (WSJ, 8/30/08, "Value Investors Cut Losses")

"Make sure you don't get killed on the downside," he (Hersh Cohen, chief investment officer of ClearBridge Advisors, a Legg Mason subsidiary) said. ... Mr. Cohen has managed the Legg Mason Partners Appreciation fund for 30 years, over which he has beaten the S.& P. 500.... Last year was 'the worst in my career in 40 years of managing funds,' Mr. Cohen said. ... **Mr. Cohen focuses on companies with 'superior balance sheets'... Mr. Cohen holds a doctorate in psychology—a background he calls most helpful in 'market extremes.'** He says he tries 'to act on extremes — but to act the other way,' cutting back when the market is euphoric, and increasing his bets when others panic 'and stuff is being given away.'" (NYT, 7/26/09, "Up 40%, but Still Feeling Down")

One might exit an investment --- at a profit or a loss --- if and when HAv2.3 indicates unreasonably high valuations and/or developing financial stress and/or mismanagement. "[M]ost people are better attuned to buying than selling. It's especially hard to part with stocks that have had a stellar performance. ... [T]he highest price-to-growth (PEG) ratios, which are often indicators of over-valued stocks. A high PEG suggests that the price is high relative to the expected earnings; a PEG over 4 is a warning sign. ... PEG ratios are hardly infallible guides to future performance.... But they do provide an objective measure of valuation, rather than relying on your gut feelings." (WSJ, 8/12/09 WSJ, "A Time to Let Go Of Overvalued Stock") "If you want to bail out, you have to do so on the way up and not worry about missing the peak." (WSJ, 8/26/09, "How I Got Burned by Beanie Babies") Bernard Baruch noted, "I made my money by selling too soon."

The ultimate use of Projection v2.3 is to forecast a high/low stock price ranges, which is based, in part, upon user specified Price/Earnings, Price/Sales, Price/Cash Flow and/or Price/Book Value ratios and associated weights. Historic ratios and weights are calculated in HAv2.3.

What if your analysis is wrong? "A mind is a terrible thing to change. ... [O]ur own mind acts like a compulsive yes-man who echoes whatever you want to believe. Psychologists call this mental gremlin the 'confirmation bias.' ... [P]eople are twice as likely to seek information that confirms what they already believe as they are to consider evidence that would challenge those beliefs. Why is a mind-made-up so hard to penetrate? ... So how can you counteract confirmation bias? Gary Klein, a psychologist at Applied Research Associates, of Albuquerque, N.M., recommends imagining that you have looked into a crystal ball and have seen that your investment has gone bust. Next, come up with the most compelling explanations you can find for the failure. This exercise ... can help you realize that your beliefs mightn't be as solid as you thought. Try estimating the odds that your analysis is wrong. ... This way, if the investment does go awry, you will be less likely to dig in your analytical heels and desperately try to prove that you are still right." (WSJ, 11/13/09, "How to Ignore the Yes-Man in Your Head')

"Famed economist Paul Samuelson once said: 'Investing should be more like watching paint dry or watching grass grow. If you want excitement, take \$800 and go to Las Vegas.' That's not to say investing can't be exciting; it's an amazing feeling to watch the positive effects on your portfolio after an investment thesis comes to fruition. Mr. Samuelson, however, had a point: If you think investing is like gambling, you're doing it wrong. ... [Y]our investments should allow you to sleep peacefully." (11/13/12, Motley Fool, "Beat the market and sleep well with this stock")

Financial Statements in the News

"J.C. Penney has been a train wreck whose comeback always seems just around the next earnings corner, but people are beginning to doubt...." (1/10/13, MotleyFool) [HAv2.3 Analysis](#) saw problems with JCP several years ago.

Herbalife Ltd. has been in the news due to the battle between Bill Ackman of Pershing Square Capital Management, L.P. and Carl Icahn. [HAv2.3 Analysis](#) revealed some interesting points of concern.

"The chairman of one of India's largest information technology companies admitted he concocted key financial results including a fictitious

cash balance of more than \$1 billion, a revelation that sent shock waves across corporate India and is likely to prompt investors to question the validity of corporate results as the once-hot economy slows. B. Ramalinga Raju, founder and chairman of **Satyam Computer Services Ltd.** -- "satyam" means truth in Sanskrit -- said in a letter of resignation that he also overstated profits for the past several years, overstated the amount of debt owed to the company and understated its liabilities. Eventually, he said, the scheme reached 'simply unmanageable proportions' and he was left in a position 'like riding a tiger, not knowing how to get off without being eaten.' The news prompted concerns about corporate governance and accounting standards across Indian industry, especially since Satyam was audited by **PricewaterhouseCoopers** and had high-profile independent directors, including a Harvard Business School professor, on its board until recently. ... Immediate comparisons were drawn to the watershed in U.S. corporate accounting and governance standards that stemmed from the Enron crisis. ... In New York, the company's American depositary receipts were suspended from trading Wednesday. ... Satyam ... chairman resigned after admitting to inflating revenue and profit figures over several years. ... The corporation grew into India 's fourth-largest technology company by sales, employing 53,000.... It counts among its clients global giants such as Nestlé SA, General Electric Co., Caterpillar Inc., Sony Corp. and Nissan Motor Corp. ... In his five-page confessional letter to Satyam's board, Mr. Raju said that initially the gap between the company's actual operating profit and the one reflected in the books had been marginal. But as Satyam grew in size and its costs increased, so did the size of the gap. Mr. Raju fretted that if the company was seen to perform poorly, it could prompt a takeover attempt that would expose the gap, so he concocted ways to plug it. Among them: pledging the shares he and other company backers owned to raise a total of \$250 million in funds for Satyam in the past two years. He said the loans, which weren't reported on Satyam's balance sheet, were based on 'all kinds of assurances' and were designed to allow Satyam's operations to continue. ... But the ruse became increasingly difficult to maintain as the company's fortunes dwindled. Among the directors at the time were **Krishna Palepu**, professor at Harvard Business School resigned late last month. ... The lenders who had lent money to Mr. Raju to keep the company running began to sell the pledged shares to meet margin calls, or the forced selling of shares to cover losses. ... Mr. Raju's letter doesn't spell out why exactly that ended his efforts to maintain the façade but it may have deprived him of the funds needed to keep the company going." (WSJ, 1/9/09, "Fraud Rocks Satyam as Chairman Resigns Overstated Profits Raise Investor Concern About India Oversight") *Business Analysis & Valuation* --- Using Financial Statements by Krishna G. Palepu,

PhD, Thomas D. Casserly, Jr. Professor of Business Administration, Harvard University, has long been on our list of Recommended Readings.

Our Satyam [HAv2.3 Analysis](#) detected accounting problems, *e.g.*, 62% Probability of Manipulation in 2004, and our Enron [HAv2.3 Analysis](#) detected accounting problems while the market price of its stock was near its all-time high.

"PricewaterhouseCoopers, which signed off on **Satyam Computer Services Ltd.**'s finances for several years without detecting the fraud by Satyam's founder and chairman, defended its procedures on Thursday. ... Satyam Chairman B. Ramalinga Raju said Wednesday that he had created a fictitious cash balance of more than \$1 billion and inflated accrued interest, profits and debts owed to the company. ... Among the bookkeeping problems, Mr. Raju said the company stated the amount owed to it by debtors as \$545.65 million, compared with an actual position of \$444.81 million. As part of an end-of-year audit, accountants would have had to verify the amount of money owed to the client.... Also in his letter, Mr. Raju said the company's cash and bank balance had been inflated by more than \$1 billion dollars. ... Normally, checking bank statements wouldn't be considered sufficient under Indian or U.S. rules -- the auditor would also need to get direct confirmation from the bank. For investors who relied on Satyam's financial statements, the fraud would have been difficult or impossible to discover. 'When a fraud goes so far as to misreport cash, finding warning signs of the fraud becomes quite problematic,' said **Charles Mulford**, an accounting professor at the Georgia Institute of Technology. There were some red flags though. One indication of fraud accountants often look for is a discrepancy between net income and operating cash flow, the amount of cash a company spits out from its operations. ... Another warning sign was a sharp increase in assets held in the company's bank deposits." (WSJ, 1/9/09, "Pricewaterhouse Defends Its Audit Procedures") Books authored by Professor Charles Mulford have long been on our list of Recommended Readings.

Sample Analyses

We have produced various HAv2.3 analyses that timely revealed financial statement distress, *e.g.*, [Enron](#), [Satyam](#), [Twitter](#), [J.C. Penney](#). Using HAv2.3, a stock investor could have avoided costly errors, or, a very aggressive investor could have initiated a short position.

Disclaimer

"Finance Sharing Is for Chumps. Financial experts argue for a great variety of investment strategies, but these approaches all have one thing in common: Once the word is out about them, their returns shrink. That's the finding of a couple of finance professors who looked at 82 market strategies—differences in valuations that gave investors a chance to profit and were then described in academic papers. In a working paper, the authors estimate that the average return decays after publication by about 35%. This seems to happen mostly because investors learn about the strategy from the academic papers and trade on it, thereby diminishing the advantage (in keeping with the way markets are supposed to work). The effect is most pronounced, the professors write, with strategies focusing on stocks with large market capitalization, high-dollar-volume trading and dividends. Does Academic Research Destroy Stock Return Predictability?' R. David McLean and Jeffrey Pontiff, Social Science Research Network (October)" (11/9/12, WSJ, "Week in Ideas")

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FINANCIAL STATEMENT ANALYSIS

For more information and/or to make comments or suggestions, please communicate with us at:

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