

# Financial Reporting Reading Notes

## Session 2: Earnings Quality

### The Concept of Earnings Quality

1. What is liberal accounting? What is conservative accounting? How can both of these accounting philosophies lead to degraded earnings quality?

- Liberal accounting (earnings management): Flexibility in accounting standards to inflate reported earnings. This can include tactics like recognizing revenue prematurely or manipulating reserves for losses. The goal is often to meet or beat financial targets.
- Conservative accounting: Accounting policies that tend to understate income and assets and overstate expenses and liabilities. It's a more cautious approach, aiming to present a financial picture that errs on the side of caution.
- Both liberal and conservative accounting can lead to degraded earnings quality, but in different ways. Liberal accounting degrades earnings quality by misrepresenting the true financial performance, making the reported earnings less reliable for investors and analysts. The document mentions that such practices, while often legal, can “slide into securities-law violations or even fraud.” Conservative accounting, while seemingly safer, can also distort the true earnings picture. The document “The Concept of Earnings Quality” notes that professional investors know that reported earnings are a product of deliberate choices between accounting treatments, and analysts must determine the true earning power. An overly conservative approach can obscure a company's actual profitability and growth potential, making it difficult for investors to accurately assess its performance and future prospects.

2. How can business and operational decisions affect earnings quality?

- Business and operational decisions can significantly affect earnings quality. The documents highlight that executives may make decisions to meet earnings targets that could degrade earnings quality. For example, a document states that some executives may pass up positive net present value projects, such as research and development (R&D), if these projects would depress reported earnings in the short term. The document “The Misrepresentation of Earnings” found that a significant portion of CFOs would not accept a valuable investment project if it meant they would miss an earnings target. This shows that the pursuit of short-term earnings targets can lead to operational decisions that harm the long-term value and, therefore, the quality of a company's earnings.

3. What factors affect earnings quality?

- Managerial Discretion and Accounting Policies: A key factor is the deliberate choice of accounting treatments and business options made by management. This includes using the flexibility within accounting standards for revenue recognition or setting aside reserves for losses to either boost or smooth earnings.
- Economic Environment: Tough economic times can increase the pressure on executives to manage earnings to meet investor expectations, making earnings management more common.
- Earnings Manipulation: This can range from legal “accounting tricks” to illegal fraud. The documents cite an example of a CFO who was convicted for hiding expenses and failing to write off overvalued assets to meet earnings targets.
- Corporate Culture and Pressure: The pressure from Wall Street to “make the numbers” and a corporate culture focused on short-term results can lead to a degradation of earnings quality as companies prioritize meeting targets over accurate financial reporting.

### The Misrepresentation of Earnings

1. What is high (good) earnings quality?

- High earnings quality indicates that a company's reported earnings are a reliable and sustainable measure of its true performance.
- Sustainability: The earnings reflect the long-run profitability of the company and are not a result of “grabbing earnings from the future” or “pushing earnings out into the future”.
- Predictability: The earnings are useful for predicting future earnings and cash flows.
- Backed by Cash Flows: Earnings are strongly correlated with and backed by actual cash flows over the long term, rather than being an artificial number.
- Consistent Reporting: The company uses consistent reporting choices over time.
- Minimal One-Time Items: Earnings do not include an excessive number of special or one-time charges, which can reduce credibility if they become a habit.
- Transparency: Investors can understand the underlying business drivers and assumptions that went into the earnings calculations.

2. Is earnings quality controllable?

- CFOs believe that roughly half of the factors influencing earnings quality are controllable and the other half are not.
- Controllable factors: Internal elements such as corporate governance, internal controls, proper accounting, and the audit function
- Non-controllable factors: Innate to the business and include the company's business model, industry membership, and broader macroeconomic conditions

3. How can the quality of earnings be identified? Are there red flags to watch for?

- A persistent lack of correlation between reported earnings and cash flows
- Unwarranted deviations from industry norms or those of peer companies
- The presence of numerous accruals and one-time charges
- Consistently beating analyst forecasts by a small margin
- Any changes in accounting policy, especially if they follow a termination of an auditor contract due to a disagreement

4. What factors create pressure to manage earnings?

The primary driver for earnings management is the pressure on executives to meet or exceed Wall Street's earnings targets and project a smooth earnings path. Tough economic times and a "profit-squeeze" can also amplify this pressure, as executives use accounting flexibility to boost reported earnings per share.

5. What differentiates between "good" earnings management and "bad" earnings management?

- The distinction between "good" and "bad" earnings management lies in whether the actions are legitimate or an attempt to mislead.
- Earnings management: A legal process that uses flexibility within generally accepted accounting principles (GAAP) to smooth earnings. It's often seen as a way for high-quality management to present a stable financial picture.
- Earnings manipulation: A negative form of earnings management. It involves perverting accounting rules, cutting corners, or juggling numbers outside of GAAP to make earnings reflect management's desires rather than the company's true financial performance. While some earnings manipulation may still adhere to GAAP, it is a deliberate misrepresentation of the company's performance. In some cases, manipulation can cross the line into securities-law violations and outright fraud.

6. What are the consequences of poor earnings quality?

- Poor earnings quality can have serious consequences for a company and its stakeholders.
- Erosion of Trust and Credibility: Poor quality undermines the trust that is the foundation of capital markets. Consistently using "one-time items" can lead to a loss of credibility with investors.
- Investor Panic and Price Volatility: When a company fails to provide transparent financial reporting, investors may become anxious and panic, leading to unexpected price fluctuations. A persistent gap between earnings and cash flows can lead to a significant discount in the company's stock price.
- Legal and Financial Penalties: Problematic earnings manipulation can result in securities-law violations, fraud charges, and severe penalties. These can include prison sentences for executives, large financial settlements for the company, and the costly restatement of financial statements.

## The "Numbers Game"

1. What is earnings management?

Use of discretion within generally accepted accounting principles (GAAP) to influence a company's reported earnings. The goal is often to meet or beat a financial target, such as Wall Street's earnings projections. According to the document "The Numbers Game," it is described as a "game" that can erode the quality of financial reporting. It is often a gray area where reported earnings may reflect management's desires more than the underlying financial reality.

2. What are some examples of common earnings management techniques?

- "Big bath" restructuring charges: Taking large, one-time charges in a bad year to clear out the balance sheet and make future earnings look better.
- "Cookie jar" reserves: Overstating liabilities or expenses in good years to create a "cushion" or "reserve" that can be reversed in a future, less profitable year to artificially boost earnings.
- Creative acquisition accounting: Using a merger or acquisition to manipulate earnings.
- Premature recognition of revenue: Recognizing revenue before it is actually earned, for example, by shipping products early to customers.
- "Immaterial" misapplications of accounting principles: Intentionally making small, seemingly insignificant errors that are below the threshold for materiality but collectively help to meet an earnings target.

3. This was a landmark speech in 1998. What has changed in the financial reporting environment since then?

- Corporate Responsibility: SOX requires senior executives (CEO and CFO) to individually certify the accuracy of their company's financial reports. This makes them directly responsible and subject to severe penalties for fraudulent activity.
- Auditor Independence: SOX established the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies. It also placed restrictions on the non-audit services that auditors can provide to their audit clients to reduce conflicts of interest.
- Enhanced Financial Disclosures: The act introduced stricter requirements for reporting financial transactions, including off-balance-sheet arrangements and pro forma figures. It also mandated that companies implement and report on their internal controls over financial reporting.

## SEC is focusing on earnings manipulation by companies

1. Is earnings management legal?

- Earnings management is often legal.
- “In many instances, this is perfectly legal. It can, though, in some cases slide into securities-law violations or even fraud.”
- This suggests that while some forms of earnings management are within the bounds of the law, they can easily cross the line into illegal activities.

2. Why was Gentex Corp. fined by the SEC?

- The SEC charged Gentex Corporation and its Chief Financial Officer, Kevin Nash, with violations related to financial reporting, books-and-records, and internal accounting controls. Specifically, the SEC found that Gentex had deficiencies in its accounting for its executive and employee bonus programs.
- The key issue was that during the third quarter of 2015, Kevin Nash, who was then the company's Chief Accounting Officer, directed a reduction in the accrual for a bonus program. This reduction was made without proper analysis or documentation, and it resulted in Gentex meeting its consensus earnings per share (EPS) estimate for the quarter. In an email cited by the SEC, Nash explained that the reduction was “necessary... to keep .27 a share.”
- The SEC's action was part of its “Earnings Per Share (EPS) Initiative,” which targets potential accounting and disclosure violations related to earnings management practices. Without admitting or denying the findings, Gentex agreed to pay a \$4 million penalty, and Nash agreed to pay a \$75,000 penalty.

## Session 3: Earnings Management

### SEC Whistleblower Program Expands; Record \$279 Million Whistleblower Award Went to a Tipster on Ericsson

1. Why did the SEC create a whistleblower program?

- The Securities and Exchange Commission (SEC) created a whistleblower program to incentivize individuals to report federal securities law violations
- Dodd-Frank Act in 2010, the program was a response to the 2007-2008 financial crisis and well-publicized frauds like the Bernard Madoff scandal
- The program's goal is to encourage individuals to provide specific, timely, and credible information to the SEC that leads to a successful enforcement action

2. How much money can whistleblowers receive? Do you think whistleblowers should be paid?

Under the program, whistleblowers are eligible for a monetary award if their information leads to a successful enforcement action with penalties exceeding \$1 million. The award amount is between 10% and 30% of the financial sanctions collected. The amount is determined based on several factors, including the importance of the information, the degree of cooperation provided by the whistleblower, and the extent to which they followed or interfered with internal compliance policies.

The question of whether whistleblowers should be paid is a matter of debate. On one hand, monetary awards can provide a powerful incentive for individuals to come forward with information about complex financial crimes that might otherwise go undetected. On the other hand, some argue that paying whistleblowers could be seen as a way to “buy” compliance or that it might encourage frivolous claims. The SEC has noted that a majority of corporate officers who have come forward have done so for awards of less than \$5 million, suggesting that the incentive doesn't have to be massive to be effective. The program's funding comes from monetary sanctions collected from wrongdoers, not from taxpayer money.

3. What rights and protections do whistleblowers have?

- The SEC Whistleblower Program includes key protections for individuals who report violations.
- Protection Against Retaliation: The SEC can take enforcement actions against companies that retaliate against whistleblowers by firing, demoting, suspending, or harassing them.
- Prohibition on Impeding Communication: Rule 21F-17(a) prohibits employers from taking any action to prevent an individual from communicating directly with the SEC staff about a possible securities law violation. This includes enforcing or threatening to enforce a confidentiality agreement.
- Confidentiality: The program allows for whistleblowers to submit information anonymously, and the SEC is prohibited from disclosing information that could reasonably be expected to reveal a whistleblower's identity.

4. What are the new proposed changes to the whistleblower program?

- In 2018, the SEC proposed several amendments to the program to address various areas, including eligibility and award amounts.
- Upward Award Adjustment: For awards of less than \$2 million, the SEC would have the discretion to increase the amount to up to \$2 million to better incentivize whistleblowers.
- Downward Award Adjustment: The SEC would have the discretion to reduce awards in cases where the monetary sanctions exceed \$100 million and the award amount would be greater than \$30 million. This proposed change was met with opposition from law firms and advocacy groups.
- Definition of a Whistleblower: A uniform definition would be proposed that would require a whistleblower to notify the SEC in writing to be protected by anti-retaliation provisions.

- Eliminating Double Recovery: Whistleblowers would not be eligible to receive awards from different programs, such as the IRS or CFTC, for the same information.
- Independent Analysis Clarification: The SEC provided clarification on what constitutes “independent analysis” to ensure the information provided is beyond what is publicly available.

### **Zumbrun, J. Accounting-Fraud Indicator Signals Coming Economic Trouble**

1. What is the M-Score and how is it calculated?

- The Beneish M-Score is a mathematical model that uses a company's financial statements to determine if it is manipulating its earnings. Developed by Professor Messod D. Beneish, the “M” stands for manipulation. The score acts as an early warning system for potential financial irregularities. The model gained recognition for its ability to identify Enron as a potential earnings manipulator several years before its collapse in 2001.
- How it is Calculated: The M-Score is calculated using eight financial ratios that are based on data from a company's balance sheet and earnings statements. These ratios compare the current period's financial data to that of the previous year. (DSRI; GMI; AQI; SGI; DEPI; SGAI; LVGI; TATA)

2. What might be legitimate, healthy business reasons for a higher M-Score?

While a high M-Score can be a red flag, it is not definitive proof of fraud.

- Large Orders or Mergers: A company may have a higher M-Score if a customer placed a large order at the end of a quarter but has not yet paid for it. Additionally, mergers and acquisitions can cause strange shifts in a company's metrics that may be flagged by the model.
- Valuable Intangible Assets: A high M-Score might result if a drug company, for instance, purchases a major patent that is valuable but is not a physical asset like a factory.
- Growth with Eroding Core Business: A rising M-Score may also suggest that a growing company has an eroding core business and is using aggressive accounting to prop up its numbers. In this case, even if the accounting is technically legitimate, an investor might choose to avoid the company.

### **Business is Slowing, So Companies Are Juicing Profits**

1. What are the key estimates related to depreciation expense? Can these be changed often?

- The key estimates for depreciation expense are useful life and salvage value. The useful life is the number of years a company expects to use an asset, while the salvage value is its estimated resale value at the end of that useful life.
  - Useful Life: This is an estimate of how long a company expects to use an asset. It's a subjective estimate that can be influenced by factors like expected wear and tear, technological advancements, and company policies.
  - Salvage Value: This is the estimated amount a company expects to receive when it disposes of an asset at the end of its useful life. It is also known as residual value.
- Depreciation estimates can be changed. A change in an accounting estimate, like an asset's useful life, is a consequence of management's periodic assessment of information. It is accounted for in the period of the change and in future periods, but not by restating prior financial statements.

2. Why are companies allowed to report adjustments to GAAP numbers (aka non-GAAP)?

Companies are allowed to report non-GAAP numbers to provide additional context and a different perspective on their financial performance. Non-GAAP measures are often used to supplement the official financial statements that are prepared in accordance with Generally Accepted Accounting Principles (GAAP).

One key reason for using non-GAAP measures is to exclude one-time or non-recurring expenses or gains that might distort the company's GAAP results. For instance, non-GAAP numbers might remove costs associated with acquisitions, restructuring charges, or litigation. The aim is to show a clearer picture of the company's ongoing business operations and financial health.

Non-GAAP measures can also be seen as a way to provide a view of the company's financial performance “through the eyes of management”. They can offer insights into the key metrics that management uses internally to run the business. The Securities and Exchange Commission (SEC) regulates how these alternative metrics can be presented to prevent them from being misleading. Companies that report non-GAAP measures are required to provide a reconciliation of those numbers to their most comparable GAAP figures and to not give them greater prominence than GAAP numbers.

### **Former Iconix Top Executives Charged in Accounting Fraud Scheme**

1. Why did these managers engage in a fraud?

The former executives at Iconix Brand Group, including CEO Neil Cole and COO Seth Horowitz, engaged in a fraudulent scheme to inflate the value of the company and make its financial performance appear better than it was. Their primary motive was to ensure the company could meet or exceed Wall Street analysts' financial projections. The fraud allowed them to report inflated revenue and earnings per share (EPS), which were key metrics they had touted as proof of the company's growth. As a result of the fraud, Cole and Horowitz also realized “substantial profits” on their sales of Iconix stock.

## 2. How was the fraud committed?

The fraud was committed through a series of “round trip” transactions. The executives would negotiate higher payments from joint ventures with the secret understanding that Iconix would later give the overpayments back.

Specifically, Cole and Horowitz would induce a joint venture partner to pay an artificially inflated buy-in purchase price for a stake in a joint venture. The executives had a secret agreement to then give back the inflated portion of the payment to the partner, a detail they hid from Iconix's lawyers and outside auditors. The fraudulent scheme lacked economic substance.

These “round trip” transactions allowed Iconix to record false revenue and manipulate its reported earnings. The SEC complaint also alleged that the executives worked to “find ways to paper over these givebacks so that they would look legitimate”. When the SEC began an inquiry, Cole and Horowitz allegedly deleted emails and made false statements to hide the fraud.

## **Former Brixmor Property Executives Charged with Accounting Fraud; Executives Win Rare Dismissal of U.S. Fraud Case**

### 1. Why did these managers engage in a fraud?

Managers at companies like Brixmor and MiMedx engaged in fraud to meet financial expectations and for personal gain. By manipulating financial results, they could meet or exceed analyst projections, which would help boost the company's stock price and, in turn, increase the value of their own compensation packages, which were often tied to performance. In the Brixmor case, the executives were also motivated to show a pattern of stable growth to investors.

### 2. How was the fraud committed?

- MiMedx: The former executives at MiMedx were accused of engaging in channel stuffing to inflate sales. This practice involved shipping more products to distributors than they had ordered and then improperly booking these shipments as sales to meet financial projections. The company allegedly had “side arrangements” with large distributors to misstate millions of dollars in revenue.
- Brixmor: The executives at Brixmor were charged with using cookie jar accounting. This method involves underreporting income in certain quarters to create a reserve of funds that can be used to boost earnings in future periods when the company's performance might be disappointing. The fraud was committed by manipulating a profitability metric known as “same-property net operating income,” which allowed the company to consistently meet its quarterly growth targets.
- General Fraud Methods
  - Overstating/understating revenues
  - Overvaluing assets
  - Improper timing
  - Lack of Internal controls
  - Misapplication of accounting principles

### 3. Why was this case dropped?

The criminal case against the former Brixmor executives was dropped because prosecutors said they could not prove that the 2013 accounting maneuver at the real estate investment trust was “crooked”. This was considered an unusual decision, and it followed other “blunders” by the U.S. Attorney's office in Manhattan. Despite the dismissal of the criminal charges, Brixmor had already agreed to a \$7 million settlement with the SEC to resolve civil allegations related to the improperly adjusted financial results.

## **Highflying Medical Firm, a Help to Wounded Veterans, Falls to Earth; Ex-Senior Executives Indicted on Fraud Charges**

### 1. How did this fraud occur?

The fraud at MiMedx Group was a “wide-ranging” and “pervasive” accounting fraud that took place from at least 2013 to late 2017. The scheme was orchestrated by former CEO Parker Petit and former President and COO William Taylor. The fraud's main goal was to artificially inflate the company's reported revenue to ensure it consistently met or exceeded its publicly announced revenue guidance.

The primary method used was “channel stuffing,” which involved prematurely recognizing revenue from sales to MiMedx's distributors. Petit and Taylor entered into undisclosed side arrangements with distributors that allowed the distributors to return products or conditioned their payment obligations on sales to end users. These secret agreements changed the terms of the deals, but they were concealed from MiMedx's accounting staff, auditors, and lawyers.

## 2. What consequences came from this fraud?

The fraud at MiMedx resulted in significant consequences for the company, its executives, and its investors:

- **Executive Indictments and Sentences:** Petit and Taylor were indicted and charged with securities fraud and conspiracy. Petit was convicted of securities fraud and sentenced to one year in prison and a \$1 million fine, while Taylor was convicted of conspiracy and sentenced to one year in prison and a \$250,000 fine.
- **Company Penalties:** MiMedx agreed to pay a \$1.5 million penalty to settle the SEC's claims without admitting or denying the allegations. The company also agreed to pay \$6.5 million to resolve allegations that it had violated the False Claims Act by knowingly submitting false commercial pricing to the Department of Veterans Affairs, which enabled it to charge inflated prices for its products.
- **Financial Restatement:** MiMedx announced that its financial results from 2012 to 2017 were no longer reliable and would need to be restated.
- **Stock Plummet:** As the truth about the fraud was revealed, the company's stock price plummeted, causing significant losses for investors who had purchased the stock at an artificially inflated price. A securities class action lawsuit was filed on behalf of investors who had purchased MiMedx stock between March 2013 and June 2018.

## Session 4: Accruals and Cash Flows

### Why Cash Flow Matters in Evaluating a Company

#### 1. What does the amount of cash a company has tell you about its historical performance and future expectations?

##### Historical

- **Financial Health:** A company with a strong cash position and a consistent positive cash flow from operations is generally considered financially healthy and can cover its operating expenses, pay its debts, and fund its growth without relying on external financing.
- **Operational Efficiency:** The cash flow statement shows how a company has managed its working capital.
- **Past Accounting Practices:** Analyzing the relationship between a company's net income (profit) and its operating cash flow can provide insights into its accounting practices.

##### Future

- **Survival and Resilience:** A company with significant cash reserves is better positioned to survive economic downturns or unforeseen challenges.
- **Flexibility and Growth:** Having sufficient cash on hand gives a company the flexibility to make strategic investments.
- **Investor Confidence:** Investors and creditors use a company's cash position and its projected cash flow to assess its liquidity and its ability to meet future obligations. A healthy cash position demonstrates financial responsibility and can instill confidence in a company's long-term viability.

#### 2. How is cash flow different from profit?

- **Cash Flow:** Movement of cash into and out of a company. It's a measure of liquidity and solvency. A positive cash flow means a company has more cash coming in than going out.
- **Profit (or Earnings):** Amount left after subtracting expenses from revenue, as recorded on the income statement. Accrual accounting, which is the basis for profit calculation, records revenue when it's earned and expenses when they're incurred, not when cash is received or paid. This can include non-cash items like depreciation and amortization, which can make a company look profitable on paper even if it has a negative cash flow.

#### 3. Where do you get information to evaluate a firm's cash?

##### Balance Sheet

The balance sheet provides a snapshot of a company's financial position at a specific point in time. It is organized according to the fundamental accounting equation:  $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$ .

- **Cash and Cash Equivalents:** Tells you exactly how much cash a company has on hand at that specific moment. While useful for understanding liquidity, it doesn't show where the cash came from or went during a period.

##### Cash Flow Statement

The cash flow statement shows the movement of money in and out of a company over a period of time. This statement is crucial because it can give a more complete picture of a company's financial health and liquidity than the income statement or balance sheet alone.

- **Cash Flow from Operating Activities:** This section details the cash generated or used by a company's day-to-day operations. It shows cash inflows from sales and cash outflows for expenses like paying suppliers, employees, and taxes. A positive number here indicates that the core business is generating cash.
- **Cash Flow from Investing Activities:** This section includes cash transactions related to long-term investments. This can include cash spent on purchasing property, plants, and equipment (outflow) or cash received from selling assets (inflow).

- **Cash Flow from Financing Activities:** This section shows the flow of cash between a company and its owners or creditors. It includes inflows from issuing stock or taking out loans and outflows for paying dividends or repaying debt.

## Accrual Accounting Can Be Costly

### 1. What is accrual accounting?

Accrual accounting is a method of financial accounting where a company records revenues and expenses when they are earned or incurred, regardless of when cash is exchanged. This contrasts with cash-basis accounting, which only records transactions when cash is actually received or paid.

The accrual method is based on the matching principle, which dictates that revenues and their related expenses should be recorded in the same accounting period to accurately reflect a company's profitability. This provides a more accurate picture of a company's financial health and performance over time than the cash method.

Larger public companies are often required by law to use the accrual method, as it adheres to Generally Accepted Accounting Principles (GAAP).

### 2. What role do assumptions play in accrual accounting?

Assumptions are fundamental to accrual accounting because they allow for the recognition of revenues and expenses in the correct period, even when the exact cash amounts are not yet known. Without assumptions, it would be impossible to prepare financial statements that provide a meaningful and timely picture of a company's performance and financial health.

#### Key Assumptions

- **Periodicity Assumption:** This assumption divides a company's economic life into distinct time periods (such as months, quarters, or years) for financial reporting.
- **Going Concern Assumption:** This is the assumption that a business will continue to operate for the foreseeable future.
- **Estimates:** Accrual accounting heavily relies on estimates for transactions where the final amount is uncertain.

#### Impact of Assumptions

The use of estimates, in particular, can introduce subjectivity and the risk of misstatement or bias.

- **Risk of Misleading Information:** If assumptions and estimates are not made carefully, the resulting financial statements can present a misleading picture of a company's financial health.
- **Change in Estimates:** When new information becomes available, management may need to change an accounting estimate.

### 3. What risks are faced by firms with high amounts of accruals?

Firms with a high amount of accruals face several risks, primarily related to potential misrepresentation of financial health, decreased investor trust, and legal challenges. This is because high accruals can create a significant gap between a company's reported profit and its actual cash flow, which can mislead investors and other stakeholders.

- **Misleading Financial Picture**
- **Increased Investor Scrutiny and Risk**
- **Legal and Reputational Damage**

## Variations in P/E

### 1. How is the P/E ratio interpreted?

Price per \$1 of earnings

- **High P/E Ratio:** A high P/E ratio generally suggests that investors have high expectations for the company's future growth and are willing to pay a premium for its shares. It can also signal that the stock is overvalued.
- **Low P/E Ratio:** A low P/E ratio can indicate that a stock is undervalued or that investors have low expectations for its future growth. It may also suggest that there are concerns about the company's financial health.
- **Negative P/E Ratio:** A negative P/E ratio means the company has reported negative earnings or a net loss. This makes the P/E ratio difficult to use for valuation. A negative P/E can be a temporary result of a downturn or a sign that the company is spending more than it earns.

### 2. How is the numerator in the P/E ratio calculated?

- The stock price on the specific date an analyst report or newspaper article was written
- The date earnings were released
- The peak or low stock price during a fiscal year or a specific month
- An average price over a period, such as a three-year average

3. How is the denominator in the P/E ratio calculated?

$$\text{Earnings Per Share (EPS)} = (\text{Net Income} - \text{Preferred Dividends}) / \text{Weighted Average Common Shares Outstanding}$$

- This metric is a measure of a company's profitability, indicating how much money it makes for each outstanding share of its stock
- EPS is calculated by dividing a company's net income by the number of its outstanding common shares
  - Trailing EPS: This uses a company's actual earnings from the past 12 months (or trailing twelve months, TTM). This is the most common and objective EPS measure because it's based on reported, historical data.
  - Forward EPS: This uses an estimate of a company's future earnings, usually for the next 12 months. This is more speculative as it relies on projections, often provided by analysts, which can be inaccurate.

## How a New Accounting Rule is Making Bank Earnings Go Wild

1. What is a loan loss reserve?

Allowance for Loan and Lease Losses (ALLL)

- Allowance, or fund, that banks and other lending institutions set aside to cover potential losses from loans that may not be repaid
- Credit enhancement tool is a crucial part of a lender's risk management strategy
- A contra-asset account on a bank's balance sheet that reduces the amount of the loan portfolio to reflect estimated credit losses (loan loss provision)
- Accounting Rules: Incurred Loss Model, Current Expected Credit Loss (CECL)

2. How did the new accounting rule for loan loss reserves affect earnings figures?

Current Expected Credit Loss (CECL): Made bank earnings more volatile because they require banks to be more forward-looking when estimating loan losses

- Timely Recognition of Losses
- Increased Volatility
- Less Useful Net Income

3. How do the banking executives view the CECL accounting rule?

Banking executives have a critical view of the CECL accounting rule. They believe the rule, which requires them to forecast potential loan losses over the entire life of a loan, exaggerates the impact of economic cycles on their earnings.

### Concerns of Banking Executives

- Volatile Earnings
- "Ink on Paper" Profit
- Reduced Usefulness of Net Income

## Session 5: Stock-based Compensation

### The Impact of Share-Based Compensation

1. What are the current GAAP for stock-based compensation?

The current Generally Accepted Accounting Principles (GAAP) for stock-based compensation are primarily outlined in Accounting Standards Codification (ASC) Topic 718, Compensation—Stock Compensation.

Different Award Types: ASC 718 applies to a wide range of equity-based awards, including:

- Restricted Stock Units (RSUs): The fair value of RSUs is generally the market price of the stock on the grant date.
- Stock Options: The fair value of stock options is typically determined using an option-pricing model, such as the Black-Scholes model. This model takes into account several factors, including the stock price, exercise price, expected life of the option, and volatility.

2. How does stock-based compensation affect the income statement?

Share-based compensation is a noncash expense that is reported over the vesting period of the equity instrument. This expense reduces the company's book income. For example, a company granting nonqualified stock options would report this as a noncash compensation expense, allocated over the service period until vesting takes place.

### 3. How does stock-based compensation affect the statement of cash flows?

- Since share-based compensation is a noncash expense, it increases operating cash flow relative to net income.
- The cash expenditure required for a company to acquire shares for employees who exercise options is classified as a financing activity on the statement of cash flows. This means that analysts who only look at operating cash flow may overstate a company's performance, as the real cost of this compensation is not fully captured in that section.
- The articles suggest that for a more accurate assessment of financial performance, analysts should reclassify the net expenditures for stock-based compensation to the operating section of the statement of cash flows.

## A Guide to Rule 10b5-1 Plans; Frequently Asked Questions About Rule 10b5-1 Plans

### 1. What is a 10b5-1 plan?

Rule 10b5-1 is a regulation adopted by the SEC in 2000 that provides an affirmative defense against insider trading allegations for corporate insiders who trade their company's stock. The rule was created to offer clarity on how and when insiders can make trades without breaking the law, especially since they often possess material non-public information (MNPI).

### 2. What is the purpose of 10b5-1 plans?

The purpose of Rule 10b5-1 plans is to provide an affirmative defense against accusations of insider trading for corporate insiders who trade their company's stock. By establishing a prearranged plan to buy or sell securities, insiders can demonstrate that their trades were not based on material non-public information (MNPI), even if they later become aware of such information when the trade is executed.

### 3. What rules are there for 10b5-1 plans?

- Establishment When Unaware of MNPI: A person must enter into the plan at a time when they are not aware of any material non-public information about the company. The plan must be adopted in good faith and not as a scheme to evade insider trading laws.
- Written Instructions: The plan must be a binding written document that specifies the amount, price, and date of the trades. Alternatively, it can include a formula, algorithm, or computer program to determine these factors.
- No Subsequent Influence: Once the plan is in place, the person cannot exercise any subsequent influence over how, when, or whether the trades are made.

### Recent SEC Amendments: The SEC has implemented new rules to address potential abuses of these plans.

These new rules include:

- Cooling-Off Periods: Directors and officers must wait at least 90 days after adopting or modifying a plan before any trades can begin. This cooling-off period can be up to 120 days, depending on the timing of a company's financial report filings. For other individuals, the cooling-off period is 30 days.
- Certification: At the time of adopting or modifying a plan, directors and officers are required to certify in writing that they are not aware of any material non-public information and are acting in good faith.
- Limitations on Multiple Plans: Insiders, other than the company itself, are generally prohibited from having multiple, overlapping 10b5-1 plans for open market trades.
- Public Disclosure: Companies must now disclose the use of 10b5-1 plans by directors and officers in their quarterly and annual reports. Form 4 and 5 filings, which report transactions, now require filers to indicate with a checkbox if a trade was made pursuant to a 10b5-1 plan.

## Dimons Aren't Forever, but Boards Act That Way

### 1. Why did the Board at JPMorgan grant more stock options to CEO Jamie Dimon?

- Long-Term Leadership: The primary reason was the board's desire for Dimon to continue leading the firm for a "further significant number of years". The award was a specific incentive to retain him in a "highly competitive landscape for executive leadership talent".
- Strong Performance: The board considered the bank's strong performance under Dimon's stewardship since he became CEO in 2005. The stock has significantly outperformed both the S&P 500 and the S&P Financials Index over his tenure.
- Succession Planning: The award was also part of a broader management succession plan, as it required Dimon's continued leadership for at least five years before the awards would vest. This was structured to incentivize a successful leadership transition.
- Unique Award Structure: This was a special, non-recurring award, and its terms were more restrictive than the bank's regular equity grants. Dimon cannot exercise the options for at least five years, and any shares he gains must be held until 2031. The award was also subject to clawback provisions in certain circumstances.

2. Was this compensation in the best interest of the shareholders?

### Arguments for the Compensation Package

- **Performance-Based Justification:** The board's primary argument is that Dimon's leadership has driven significant value for shareholders. Under his tenure, JPMorgan Chase's shares have delivered a 524% total return, which greatly surpasses the 145% return of the S&P 1500 Financials Index. The board views his continued leadership as crucial for maintaining this outperformance.
- **Incentivizing Retention and Succession:** The special stock option award was specifically designed to incentivize Dimon to stay with the company for a "further significant number of years" and to ensure a "successful leadership transition". The options had a long vesting period and a 10-year holding requirement, which the company argued aligned Dimon's interests with long-term shareholder value.

### Arguments Against the Compensation Package

- **Shareholder Rejection:** Despite the board's rationale, shareholders voiced strong discontent. In a nonbinding "say on pay" vote in May 2022, only 31% of shareholders supported the executive compensation plan, which included the award to Dimon. This was a significant drop from the 90% support the bank's compensation proposals typically received in prior years.
- **Disconnect from Performance:** Influential proxy advisory firms like Glass Lewis and Institutional Shareholder Services (ISS) recommended that shareholders vote against the package. They argued that the "excessive one-off grants" were not sufficiently tied to performance-based vesting conditions. Glass Lewis noted a "sustained disconnect between executive pay and performance" at JPMorgan Chase over a nine-year period and criticized the awards for not being tied to any specific performance metrics.
- **Excessive and "Unusual" Pay:** The award was seen as "excessive" and an "extremely rare" bonus granted outside of the company's regular incentive schemes, which critics argued could undermine the integrity of the standard pay-for-performance model. Furthermore, some argued that the bank's one-year total shareholder return lagged behind the S&P 500, even as Dimon's total compensation package saw a 10% year-over-year increase.

## CEO's Dad Gets a \$3.6 Billion Stock Windfall at Carvana

1. Does Carvana operate with the best interests of the shareholder in mind?

While a Carvana spokeswoman stated the company has "robust governance" and has delivered over 2000% returns to its investors since its public offering, analysts and critics point to the company's dual-class ownership structure and specific transactions as evidence that the company is managed for the benefit of the controlling family, potentially at the expense of other shareholders.

### Corporate Structure and Control

Carvana's ownership structure gives its founder, Ernie Garcia III, and his father, Ernie Garcia II, "effective control" over the company, even though they do not hold a majority of the outstanding shares. This is due to a dual-class share structure where shares held by the Garcias have 10 votes each, compared to one vote per share for the public Class A shares. This arrangement allows the family to maintain control of more than 85% of the voting shares, even after selling billions of dollars in stock.

### Actions Benefiting the Controlling Family

- **Tax Receivable Agreement:** When Carvana went public, it created a tax receivable agreement. Under this arrangement, the company is on the hook to pay its early investors, primarily Ernie Garcia II, 85% of the value of any tax savings it realizes from tax assets. Critics argue that these deals "privilege those investors over public shareholders" because tax savings would normally be used for company operations or returned to all shareholders.
- **Favorable Stock Purchases:** When Carvana's stock price tumbled at the start of the COVID-19 pandemic, the Garcias bought \$25 million each in a private stock offering at an 8.2% discount to the market price. This offering diluted other shareholders by 26%. Shareholders later filed a lawsuit, alleging the sale enriched the Garcias while cheating the company out of millions in fair value for its shares.

### Trading Practices and Disclosure

- **10b5-1 Plan Modifications:** Ernie Garcia II modified his Rule 10b5-1 share-sale plans twice as the company's stock price rose. This action raised concerns among regulators and corporate governance experts, as frequent modifications can suggest that the owner is reacting to inside information. One expert noted that they had not seen a plan of this size modified so frequently.
- **Company's Own Warning:** Carvana's own securities filings warned investors that "The interests of the Garcia parties may not in all cases be aligned with your interests" and that the CEO and his father might "try to boost their profits at a risk to shareholders".

2. How did Mr. Garcia use 10b5-1 plans to sell stock? Was it legal?

Mr. Garcia II used an automated share-sale program, known as a Rule 10b5-1 plan, to sell his stock in Carvana. He started a string of sales in October 2020 after the company's stock soared. Under his initial plan, he began selling 30,000 shares a day in November. He later modified the plan two times. In November, he modified it to sell 50,000 shares daily for most of December. Then, he modified it again in May to sell 60,000 shares on most days as the stock price continued to soar.

## Legality of the Sales

The legality of his actions has been questioned and scrutinized by regulators and in lawsuits, but the documents do not state a definitive legal ruling.

- **Questionable Practices:** According to a professor of accounting, frequent modification of 10b5-1 plans is concerning to regulators because it raises the chance that the owner is reacting to inside information. The professor stated that he couldn't recall another plan of this size with modifications every six months.
- **Legal Challenges:** Shareholders filed a lawsuit alleging that the Garcias benefited at the expense of the company and that the sales were a breach of fiduciary duties. A lawsuit in Delaware sought to revive insider trading claims against Mr. Garcia II, arguing that he began selling stock before the company disclosed potential business risks from not complying with state motor vehicle laws.
- **Company's Position:** Carvana has maintained that it has "robust governance" and operates in accordance with all rules and regulations. In a legal defense against a lawsuit, the company's special litigation committee found that no wrongdoing occurred, a motion to dismiss was granted, and a court found that the investigation was "thorough and reasonable in good faith".

## Every CEO Should Follow Mark Zuckerberg's Stock-Trading Example

1. How does Mark Zuckerberg trade shares of his company? Why does he do it this way?

Mark Zuckerberg trades shares in his company, Meta Platforms, by selling them each trading day in equal sums. This approach ensures that his diversification is done randomly. He sets a diversification goal for the year and then divides it by the number of trading days.

He trades this way to avoid the possibility of benefiting from insider information. By not timing the market, he avoids putting himself or Meta at legal risk. This strategy is seen as the opposite of dollar-cost averaging, which involves buying shares at regular intervals. While selling every day means some sales will be more or less profitable, the trades will, on average, randomly reflect the yearly change in the stock price. The article suggests that more executives should follow his lead and that the Securities and Exchange Commission (SEC) might even mandate this type of trading.

2. Should CEOs have diversified portfolios? Or should they have more exposure to the company they are leading?

In practice, the ideal approach often involves a balance. CEOs are encouraged to diversify a portion of their holdings to manage personal risk, while maintaining a significant stake to demonstrate commitment and align their interests with long-term company performance. The SEC and companies themselves have put rules in place, such as mandatory cooling-off periods for 10b5-1 plans, to facilitate this diversification while minimizing the risk of insider trading.

### Arguments for Diversification

- **Risk Mitigation:** The core principle of diversification is to reduce risk. A significant portion of a CEO's personal income and wealth is already tied to the company they lead, making their financial situation highly concentrated. If the company were to fail or its stock price were to drop, the CEO could suffer a catastrophic loss of both their job and their personal wealth. Diversifying their portfolio protects against this "single basket" risk.
- **Aligning with Shareholder Goals:** A well-diversified CEO may be less risk-averse in their business decisions, as they are not overly concerned with the short-term fluctuations of a single stock. This can align their long-term interests with those of a typical diversified shareholder.
- **Avoiding Insider Trading Scrutiny:** Selling shares through a prearranged plan, like a Rule 10b5-1 plan, is a common method for executives to diversify without being accused of trading on non-public information. This strategy reduces legal and reputational risks for both the executive and the company.

### Arguments for More Company Exposure

- **Alignment with Shareholders:** A high level of company stock ownership is often seen as the ultimate form of alignment between a CEO and shareholders. It ensures that the CEO's interests are directly linked to the company's long-term success. The belief is that a CEO with "skin in the game" is more motivated to make decisions that will increase shareholder value.
- **Confidence in the Business:** A CEO who holds a substantial stake in their company is publicly signaling their strong belief in the company's future prospects. This can instill confidence in investors, employees, and the market.
- **Meeting Holding Requirements:** Many companies have policies that require top executives to hold a minimum amount of company stock, often a multiple of their salary, to ensure this alignment. These requirements can be a significant barrier to full diversification.

3. How soon can a CEO trade stock after entering into a 10b5-1 plan?

According to recent amendments by the SEC, a CEO or other corporate officer must wait a certain period before trading stock after adopting or modifying a Rule 10b5-1 plan. This waiting period is called a "cooling-off period".

Specifically for officers and directors, the cooling-off period is the later of:

- 90 days after the adoption or modification of the plan.
- Two business days following the company's disclosure of its financial results in a Form 10-K or 10-Q for the fiscal quarter in which the plan was adopted or modified.
- This cooling-off period cannot exceed 120 days.

Prior to these recent amendments, there was no mandatory cooling-off period, and executives could sometimes trade on the same day they adopted a plan. The new rules were implemented to curb potential abuses and address research that showed executives who traded soon after adopting plans often achieved abnormal returns.

## CEO Stock Sales Raise Questions about Insider Trading

1. Do CEOs and other executives engage in insider trading? How would you know?

CEOs and other executives are legally allowed to buy and sell stock in their own company. However, engaging in “insider trading” — buying or selling stock based on material, non-public information — is illegal. While this is prohibited, it can be difficult to prove and enforce, and there is evidence suggesting that it does occur.

Based on the documents provided and public information, CEOs and other executives are legally allowed to buy and sell stock in their own company. However, engaging in “insider trading” — buying or selling stock based on material, non-public information — is illegal. While this is prohibited, it can be difficult to prove and enforce, and there is evidence suggesting that it does occur.

**How to Detect It** - Academics, regulators, and analysts use several methods to identify potentially abusive or illegal insider trading:

- **Abnormal Returns:** Studies show that executives who trade under prearranged plans often earn “abnormally high returns”. For instance, a Wall Street Journal analysis found that insiders who sold shares within 60 days of adopting a trading plan reaped \$500 million more in profits than if they had waited three months.
- **Suspicious Timing:** Trading that occurs just before a significant, market-moving announcement—such as a large stock offering, an earnings report, or a financial restatement—raises red flags. The SEC has called trades initiated soon after a plan's adoption “potentially abusive”.
- **Frequent Plan Modifications:** Modifying or canceling a trading plan, especially when it results in a financial benefit for the insider, is a red flag. For example, a CFO terminating a plan because they know of impending disappointing earnings can appear suspicious and can be seen as a violation of the “good faith” requirement of Rule 10b5-1 plans.
- **“Smoking Bazooka”:** A professor of finance describes a CEO using a recently adopted plan to sell stock ahead of negative news as a “smoking bazooka,” as it creates a reasonable suspicion that the CEO was trading on inside information.
- **Comparison to Legal Trades:** The SEC has investigated and brought cases where executives allegedly used their trading plans to trade illegally on inside information. The legality of a trade often comes down to whether the plan was established in “good faith” when the insider was not aware of any MNPI.

**How to Know** - Companies, regulators, and investors rely on public filings and data analysis to monitor insider trading:

- **Public Filings:** Insiders are required to report their stock transactions to the SEC on forms such as Form 4. While these forms are publicly available, under old rules, they did not always disclose the adoption date of a 10b5-1 plan, which made it difficult for investors to know if a trade was made soon after the plan was created. The new SEC rules now require this information to be disclosed.
- **Third-Party Analysis:** Research firms and financial journalists analyze these public filings to identify patterns. They look for instances where insiders trade just before a stock price decline, or if they adopt multiple overlapping plans, which may suggest manipulation.
- **Enforcement Actions:** The SEC takes public enforcement actions when it finds evidence of illegal insider trading. These actions can be brought against a wide range of individuals, including corporate insiders, financial professionals, and others who obtain non-public information.

2. What is insider trading?

Insider trading is the illegal act of buying or selling a security while in possession of confidential, material, non-public information about the company. This practice is considered a breach of a fiduciary duty or other relationship of trust and confidence. The goal is to gain an unfair advantage in the market.

- **Material Information:** Information is “material” if it would likely affect a company's stock price or influence an investor's decision to buy, sell, or hold a security. Examples include news of a merger or acquisition, future earnings reports, or new product launches that haven't been made public.
- **Non-public Information:** The information is “non-public” if it has not been disclosed to the general public through official channels like press releases or SEC filings, and public investors have not had a reasonable time to react to it.
- **Who can be an “insider”:** The term “insider” is not limited to corporate executives. It can include officers, directors, and employees, as well as friends, family members, or business associates who receive a “tip”. Individuals who misappropriate confidential information, such as lawyers or consultants working for the company, can also be held liable.
- **Consequences:** Insider trading is subject to civil penalties from the SEC, which can be up to three times the profits gained or losses avoided. It can also be a criminal offense, punishable with fines and a prison sentence of up to 20 years.

## New SEC Rules Target Corporate Insider Trading

1. What are the new disclosure requirements related to 10b5-1 plans?

The SEC has implemented new disclosure requirements to enhance investor protection against insider trading. These changes affect not only the conditions for the Rule 10b5-1 affirmative defense but also the public reporting of trading plans.

- Quarterly Disclosure of Trading Plans: Companies are now required to disclose, on a quarterly basis in their Forms 10-Q and 10-K, whether any director or officer has adopted, modified, or terminated a Rule 10b5-1 trading arrangement during the quarter. The disclosure must include the material terms of the plan, such as the name and title of the person, the date of adoption or termination, and the duration of the plan.
- Annual Insider Trading Policy Disclosure: Companies must now annually disclose in their Forms 10-K and proxy statements whether they have adopted an insider trading policy. If they have, they must file a copy of the policy as an exhibit.
- Checkbox on Form 4/5: When officers and directors report their transactions on Forms 4 and 5, they must now check a box to indicate whether the transaction was made pursuant to a Rule 10b5-1 plan. They must also disclose the date the plan was adopted.
- Disclosure of Option Grants: The new rules require companies to provide tabular disclosure of any stock option awards made to named executive officers within four business days before the filing of a periodic report (Form 10-Q or 10-K) or a Form 8-K that discloses material non-public information, such as earnings information.
- Gifts of Securities: Bona fide gifts of securities, which were previously reported on Form 5, must now be reported on Form 4 within two business days.

## SEC Demands More Information about Companies' Stock Buybacks

1. What is the frequency of the tallies companies must keep of their stock buybacks?

Domestic U.S. companies that file with the SEC on Forms 10-Q and 10-K must provide a tabular disclosure of their buyback activity on a quarterly basis. This disclosure must contain a daily tally of the shares repurchased, including information such as the number of shares and the average price paid. For foreign private issuers (FPIs), the disclosure is also on a quarterly basis on a new Form F-SR. This daily disclosure requirement replaces the previous monthly disclosure requirement.

**Status of the Rule** It is important to note that while this rule was adopted by the SEC in 2023, it was challenged and subsequently vacated by the U.S. Court of Appeals for the Fifth Circuit. The SEC was unable to correct the defects identified by the court. Therefore, the previous rules requiring monthly aggregate disclosure of repurchases remain in effect.

2. What are the other requirements of the new stock buyback disclosure?

- Daily Disclosures: The rule would have required most public companies to provide a daily tally of their buybacks during the previous quarter, rather than the monthly aggregates previously required. This information would have been filed in exhibits to Forms 10-Q and 10-K for domestic filers.
- Narrative Disclosures: Companies were to provide more extensive narrative disclosures, including the objectives or rationales for their buybacks, the process and criteria used to determine the amount of repurchases, and any policies for insider trading during a buyback program.
- Checkbox for Insider Trading: Companies would have to check a box to indicate if their officers or directors bought or sold shares within four business days of announcing a new repurchase program.
- Disclosure of 10b5-1 Plans: The rule would have required companies to disclose the adoption and termination of any Rule 10b5-1 trading plans during the quarter.

## SEC Buyback-Disclosure Rule Stirs Worry Over Costs and Compliance

1. How did companies respond to the new stock buyback disclosure rule?

Companies had a mixed and, in some cases, strongly negative response to the new stock buyback disclosure rule.

- Opposition from Industry Groups: Corporate and industry groups, such as the Business Roundtable and the U.S. Chamber of Commerce, pushed back against the rule. They argued that the reporting requirements were “unnecessary and costly” and that the extensive mandates were “overly complicated and burdensome”.
- Legal Action: The U.S. Chamber of Commerce took legal action to block the rule from going into effect. They argued that the SEC acted “arbitrarily and capriciously” by failing to justify the costs and benefits of the rule and that it violated the First Amendment by “impermissibly compelling their speech”.
- Concerns about Unintended Consequences: Some companies, including PNC Financial Services Group, expressed concern that the new rules could have “unintended or undesirable side effects” that outweigh any benefits. They were particularly worried that required disclosures could make it harder for companies to execute share repurchase programs effectively.
- Welcome Revisions: While expressing broader opposition, some companies and legal experts welcomed the revisions the SEC made to the initial proposal. For example, the final rule dropped the requirement for companies to disclose buybacks within one business day, opting instead for daily tallies at the end of each quarter. Kinder Morgan's CFO stated they were glad to see the revision to quarterly instead of daily filing, which would reduce the potential for market disruption.
- Acceptance and Compliance: Some companies acknowledged the rule as an “additional burden” but did not view it as a deterrent to buybacks if they were in the best interest of shareholders. CarParts.com's finance chief, for instance, stated that the new requirements would not deter repurchases if the shares were undervalued and it was a good return for shareholders. He added that it's important to have improved transparency for the capital markets.

Ultimately, the legal challenge was successful, and a federal court vacated the rule, finding that the SEC failed to adequately respond to public comments and conduct a proper cost-benefit analysis.

## Session 6: Disclosure Choice

### Do the SEC's Safe Harbor Provisions Encourage Forward-Looking Disclosures?

1. Why are CEOs hesitant to provide forward-looking information?

CEOs are primarily hesitant to provide forward-looking information due to the risk of stockholder litigation, which they fear will follow if their optimistic projections fail to materialize.

This fear is driven by the perceived consequences of making a forecast that turns out to be wrong:

- Exposure to Lawsuits (Strike Suits)
- Perceived Strict Liability
- The Safe Harbor's Limitations
- Volatility and Uncertainty

In short, while they “are afraid to talk about the upside” and not making projections “because by their very nature we could be wrong”, the core issue is the legal and financial cost associated with a prediction that proves to be inaccurate.

2. What role do analysts play in obtaining and providing information to the market participants?

Financial analysts play an essential intermediary role in the flow of information to market participants by gathering data, interpreting it, and translating complex financial information into actionable insights and recommendations.

#### Key Roles of Financial Analysts

Financial analysts perform a crucial function in the capital markets, primarily by acting as a bridge between companies and investors:

- **Information Collection and Processing:** Analysts gather information from various sources, including regulatory filings, press releases, public announcements, and by asking unique questions on earnings calls. Crucially, they also supplement these with private conversations with management, which provide them with additional context to interpret news and develop a deeper understanding of the firm's operations and strategy.
- **Interpretation and Translation:** They translate complex financial data, market trends, and economic indicators into a usable and comprehensible form for investors. This involves analyzing historical results and financial statements, applying various financial modeling techniques (like discounted cash flow), and conducting risk assessments.
- **Creating Value-Relevant Information:** Analysts use this processed information to:
  - **Formulate Earnings Estimates:** They develop forecasts and projections about a company's future performance.
  - **Develop Recommendations:** They generate concrete investment recommendations, often in the form of detailed analyst reports.
- **Public Dissemination:** Analysts' forecasts, recommendations, and opinions are widely sought after by investors and frequently cited by the financial press, ultimately influencing share prices globally. This process creates a channel where information flows privately from managers to analysts (who process it) to the public.

If companies were to provide fewer public disclosures, value-relevant information would increasingly flow privately to analysts, who then disseminate their findings publicly as earnings estimates. This highlights their importance in keeping the market informed.

3. How is the disclosure of good news different than the disclosure of bad news? Do managers treat them differently? Does the stock market react differently?

The disclosure of good news is handled differently than the disclosure of bad news by managers, primarily because of the asymmetric threat of stockholder litigation.

#### Stock Market Reaction

- **Magnitude of Reaction:** The stock price reaction to bad-news disclosures is substantially larger (in absolute value) than the stock price reaction to good-news disclosures. (For a sample of voluntary disclosures, the average stock price reaction to bad news was  $-6\%$  compared with  $+2.5\%$  for good news.)
- **Interpretation:** This larger, negative reaction supports the idea that bad-news disclosures are specifically timed and structured to reduce the chances of an even larger, more costly stock price decline on the mandatory earnings announcement day.

## Managers Treat Good and Bad News Differently

Feature	Bad News Disclosure	Good News Disclosure
Purpose	To preempt negative earnings surprises and stock price declines, thereby reducing the chance and cost of stockholder litigation.	To convey optimistic information, but with high caution due to litigation risk if projections are missed.
Timing/Frequency	Managers preempt large, negative earnings surprises more often than other types of earnings news.	Disclosure of good news forecasts tends to be suppressed or withheld due to fear of lawsuits if the forecast is too optimistic.
Form/Specificity	More likely to be qualitative statements about quarterly EPS. This links the bad news to a near-term result and is viewed as a way to preempt a quarterly surprise and the resulting lawsuit.	Tends to be a point or range forecast of annual EPS.
Forecast Revisions	When managers revise forecasts, the vast majority are downward revisions. This shows that managers are more concerned about outstanding forecasts that are too optimistic.	Managers are more reluctant to make upward revisions, as it increases the risk of the final results falling short and triggering a lawsuit.

4. How has the SEC updated disclosure-related provisions/mandates/safe harbors since the writing of this article?

Since the article's publication (July 2014), the SEC has undertaken a broad Disclosure Effectiveness Initiative aimed at modernizing and simplifying disclosure rules, generally by shifting from prescriptive requirements to a more principles-based, registrant-specific approach.

The major updates have focused primarily on Regulation S-K (qualitative and forward-looking disclosures) and Regulation S-X (financial statement disclosures), with less change to the statutory Safe Harbor itself.

### Forward-Looking Information

1. What is forward-looking information?

Forward-Looking Information (FLI) consists of predictions, projections, or expectations about future events, business conditions, or financial performance, often made by corporate management. Unlike historical statements, which describe past events, FLI anticipates or speculates on future developments.

2. Why is forward-looking information useful to investors?

Forward-Looking Information (FLI) is considered decision-useful and an essential element of financial reporting because it enables investors to evaluate a company's future value and prospects.

It provides investors with a window into management's beliefs and opinions about the future, which is necessary for making informed investment decisions.

### Reasons for Usefulness

- Relevance over Reliability
- Aids Valuation and Projections
- Transparency of Assumptions
- Highlights Risks and Uncertainties
- Drives Management Accountability
- Improves Stock Liquidity

Forward-looking measurements, such as those used for fair value and liquidity disclosures, are seen as inherently more relevant than disclosures based solely on historical measures, as they provide insight into current or future expectations.

3. Does GAAP allow forward-looking information?

Yes, U.S. Generally Accepted Accounting Principles (GAAP) allows and, in many cases, requires the inclusion of forward-looking information in financial statements, despite a widespread misconception that it does not belong there.

The fact that "forward-looking information" is not explicitly defined within GAAP often leads users and preparers to assume it must be disclosed outside of the financial statements, often in the MD&A (Management's Discussion and Analysis).

- Forward-Looking Information is Embedded in GAAP: GAAP standards already incorporate substantial degrees of forward-looking information in both measurements and disclosures. The "conceptual Rubicon" has already been crossed.
- The Disclosure Debate (GAAP vs. SEC): The major conflict arises not over whether GAAP permits FLI, but over where it should be located in the public filings: Location Constraint and Inconsistency

## Google Parent Debuts YouTube, Cloud Results, Reports Weak Earnings; What Investors Learned From the First Peek Inside YouTube's Financials

1. What did Google's segment reporting change?

Google's parent company, Alphabet Inc., introduced expanded revenue disclosures in its Fourth Quarter (Q4) 2019 earnings report, providing financial details for businesses that had previously been aggregated.

**The key change was the more granular breakdown of the “Google” segment revenue:**

- YouTube Advertising Revenue: Alphabet disclosed YouTube ads revenue separately for the first time. In 2019, YouTube's annual ad revenue was reported at \$15.149 billion. (Note: YouTube's non-advertising revenues, such as from subscriptions like YouTube TV and Music/Premium, remained aggregated under “Google other revenues”.)
- Google Cloud Revenue: Alphabet began reporting Google Cloud revenue separately for the first time. Cloud revenue for 2019 was reported at \$8.918 billion, with the business ending the year at a greater than \$10 billion annual run rate.
- Google Search & Other: This category was specified to separately report revenue from the company's core search business and other non-YouTube ad revenue.

This shift in segment reporting was done “to provide further insight into [Alphabet's] business and the opportunities ahead”.

2. What was the value of the new information being provided?

The new segment reporting information provided by Alphabet Inc. in its Q4 2019 earnings was highly valuable to investors and analysts for several reasons, despite the company's overall disappointing earnings in its core advertising business.

### Increased Transparency and Clarity

- Dismantling the “Black Box”
- Insight into Growth Engines

### Specific Financial Metrics Provided

YouTube Ad Revenue: Disclosing that YouTube logged \$15.1 billion in annual ad revenue in 2019 confirmed its status as a digital video juggernaut and the third-largest seller of advertising behind Google's flagship businesses and Facebook.

- It also revealed that the business was smaller than many outsiders expected (analyst projections had ranged as high as \$25 billion), leading to a recalibration of expectations.
- The figures highlighted untapped room for growth, as YouTube monetized its users at a significantly lower rate (\$7 to \$8 per year) than competitors like Facebook.

Google Cloud Revenue: The segment was on track for \$10 billion in revenue in 2020 (a \$10 billion run rate at the time of the report), which was viewed as better-than-expected performance in a market dominated by rivals like Amazon and Microsoft.

Subscription Growth: The non-advertising revenue of \$3 billion for YouTube, mostly from subscriptions, beat expectations. This included over 2 million paid YouTube TV subscribers and over 20 million music and premium subscribers.

## Session 7: Management Forecasts / Non-GAAP Earnings

### Management Disclosures: Analysts Prefer Facts to Management's Predictions

1. What information do analysts most want from management?

#### Preferred Information Categories

- Facts and Historical Financial Statements
- Underlying Assumptions for Forecasts
- Assessment of the Future Economic Environment

#### Management Forecasts

- Range Estimates: Analysts expressed a strong preference for range estimates over point estimates.
- Future Sales: 84% of analysts opted for the inclusion of future sales.
- Time Horizon: Forecasts should cover the next 12 months as a minimum.

2. What rules does the SEC have today related to management forecasts? What connection does this have to the 1995 forward-looking statement safe harbor rules?

### Current SEC Rules on Management Forecasts

The SEC's rules regarding management forecasts, which are generally voluntary disclosures, do not mandate them but instead focus on the quality and integrity of the forecasts if a company chooses to issue them.

- Encouragement
- Reasonable Basis
- Non-Misleading Presentation
  - Specificity
  - Distinction and Prominence
  - Non-GAAP Measures

### Connection to the 1995 Forward-Looking Statement Safe Harbor

The most significant legal protection for management forecasts today comes from the Safe Harbor for Forward-Looking Statements, enacted by Congress in the Private Securities Litigation Reform Act of 1995 (PSLRA). This Act was designed to encourage companies to provide investors with forward-looking information by protecting them from abusive private securities litigation.

### Impact

The PSLRA's Safe Harbor effectively shields companies who make good-faith projections from being sued simply because the projections turn out to be wrong. This statutory protection supplements the SEC's earlier, broader safe harbor rules (Rules 175 and 3b-6, adopted in 1979) and the judicially created "bespeaks caution" doctrine. The Safe Harbor directly addresses the concern that the potential for liability was creating a "chilling effect" on management's willingness to disclose future plans and prospects.

3. Who do analysts work for? What are their incentives?

### Sell-Side Analysts

- Employers: Investment banks, brokerage firms, securities firms, and independent research houses.
- Role: They follow specific companies or industries and issue public research reports and stock ratings (e.g., "buy," "sell," "hold") to advise their firm's clients.
- Incentives: Their compensation and primary incentive are often tied to generating revenue and trading activity for their firm.

### Buy-Side Analysts

- Employers: Hedge funds, mutual funds, pension funds, insurance companies, private equity firms, and non-profit organizations with large endowments.
- Role: They identify investment opportunities, build financial models, analyze risks, and advise portfolio managers within their own firm on which securities to buy, hold, or sell to meet the fund's investment goals.
- Incentives: Their compensation is much more directly dependent on the quality of their recommendations and the fund's overall investment performance.

### Management Forecasts: What Do We Know?

1. What is the expectations-adjustment hypothesis?

The expectations-adjustment hypothesis is the widely supported motivation for why managers voluntarily issue earnings forecasts. It posits that managers release forecasts in an attempt to align investor expectations with their own.

2. What are the characteristics of firms that do issue management forecasts?

The characteristics of firms that voluntarily issue management forecasts, as documented by empirical research, generally suggest they are attempting to reduce information risk and asymmetry.

Characteristic	Description	Context/Comparison
Lower Risk Profile	They have less variability in earnings and lower operating leverage.	Research suggests they do not have different market risks (betas) compared to nonforecasting firms, after controlling for industry, size, and earnings variability.

Characteristic	Description	Context/Comparison
Financing Needs	They are more concerned with information asymmetry and transaction costs.	They release more management forecasts than other firms when they use external financing. However, they do not necessarily increase the frequency of forecasting shortly before a public offering.
Stock Market Profile	They tend to have greater analyst following and smaller market values when issuing more-precise forecasts (point and range).	The increase in firm value from reducing information asymmetry is believed to be greater for larger, more-closely followed firms, leading them to provide more information on an ongoing basis.
Earnings Performance	They have higher positive percentage changes in earnings compared to a matched sample of nonforecasting firms during the same period.	Managers may be more likely to issue forecasts when the company is doing well relative to the past or relative to other firms.

3. What is good-news bias? What is optimism? How are these measured?

### Good-News Bias

Good-news bias refers to whether managers systematically choose to issue forecasts only when they have favorable information compared to what the market already expects.

- What it is: The tendency for managers to release a forecast only when the projected earnings are systematically greater than existing financial analyst forecasts (i.e., when they have “good news” relative to existing expectations).
- How it is Measured: It is measured by comparing the management forecast against the existing financial analyst forecasts.

### Optimism

Optimism refers to whether management's forecasts are systematically too high compared to what the firm ultimately achieves.

- What it is: The tendency for management forecasts to be, on average, higher than the actual earnings later announced.
- How it is Measured: It is measured by comparing the management forecast against the actual earnings later announced.

### Research Findings on Bias and Optimism

Empirical research on both biases has produced varying results, which appear to be driven by the time period examined.

- Historical Findings: Many examinations of forecasts released in the 1960s and early 1970s found evidence of both a good-news bias and optimism.
- Recent Findings: More recent tests, conducted after the SEC's discussions and rulings in the 1970s, indicate that management forecasts generally do not appear to be systematically greater than existing analyst forecasts (no good-news bias) or actual earnings (no optimism).

4. How does the market react to management forecasts? To analysts' forecasts? Why does the market react at all?

### Reaction to Management Forecasts

The market reaction to the release of a management forecast is generally measured as the difference between the management forecast and the existing analyst consensus forecast.

**Symmetrical Reaction:** The market reacts without bias to management forecasts. This means that the price reaction is similar for both good news and bad news (e.g., when the management forecast exceeds the existing analyst forecast, the stock price goes up, and vice versa). This is consistent with the expectations-adjustment hypothesis.

**Strength of Reaction:** The price reaction is stronger (larger) under certain conditions:

- When the management forecast is for an interim period rather than an annual one.
- When the forecast is more precise (point or range estimates).
- The reaction to a management forecast can be just as strong as the reaction to the official earnings announcement itself.

### Reaction to Analysts' Forecasts

The market also reacts to analyst forecasts, but there are nuanced effects when they follow a management forecast:

**Initial Baseline:** The price reaction to an official earnings announcement is measured as the difference between the actual earnings and the expected earnings, with the expected earnings often based on analyst forecasts or time-series models.

**Confirmation Effect:** When analysts subsequently revise their forecasts to confirm a good-news management forecast, an additional price reaction occurs. This suggests the market views good-news forecasts from management with some skepticism, and the analyst's confirmation is treated as new, credible information. No similar additional reaction is documented following confirmations of bad news.

### Why the Market Reacts

The market reacts because it views the difference between expected and newly released information as “surprise” information that must be reflected in the security price.

**Management Forecasts:** The reaction is consistent with the market viewing the difference between the management forecast and the existing analyst forecast as price-relevant information. Similarly, the market reacts to earnings announcements following a management forecast, viewing the difference between the actual earnings and the prior management forecast as price-relevant information.

**Analyst Credibility:** The reaction to analyst revisions confirms that the market finds this information useful in price determination. The “confirmation effect” highlights the market's mechanism for evaluating credibility—while management forecasts are informative, analyst consensus sometimes provides the necessary assurance, particularly for good news.

### The Problem with Non-GAAP Earnings

1. What are non-GAAP earnings? Why do firms use them? How are they disclosed?

- **Non-GAAP (Non-Generally Accepted Accounting Principles) earnings:** Financial measures that companies choose to report which deviate from the standardized rules of U.S. GAAP. They are often referred to as “pro forma” figures.
- **Reasons Firms Use Non-GAAP Earnings:** Firms use non-GAAP metrics to present a more favorable or specific view of their financial health, primarily by attempting to show what they consider their “core” or ongoing performance.
- **How Non-GAAP Earnings Are Disclosed:** Non-GAAP metrics are disclosed in both formal and informal communication, but they are subject to SEC rules to mitigate their potential for misleading investors.

2. What are the current SEC rules related to non-GAAP disclosures?

The current SEC rules related to non-GAAP disclosures are primarily governed by Regulation G and additional guidance, which focus on preventing these metrics from misleading investors and ensuring they are clearly reconciled to GAAP measures.

3. Is the use of non-GAAP numbers legal? ethical?

The use of non-GAAP numbers is legal, but their use is a constant subject of debate regarding their ethics and potential to mislead investors.

- **Legality of Non-GAAP Numbers:** The use of non-GAAP earnings is legal, provided that companies adhere to specific rules set by the Securities and Exchange Commission (SEC).
- **Ethical Concerns and Debate:** The ethics of using non-GAAP measures are heavily debated among analysts and critics due to the potential for these figures to create a misleading impression of a company's financial health.

### WeWork Was Wrestling with SEC over Key Financial Metric Just before It Scrapped IPO

1. Was the key metric being used by WeWork useful? Informative?

The key financial metric WeWork used, which was a version of “contribution margin” formerly known as “community-adjusted Ebitda,” was considered misleading and ultimately led to intense scrutiny from the SEC and investors. While management found it useful for their own narrative, outside observers found it to be a measure of dubious informational value.

- **Informational Value and Utility:** Management's Perspective (Useful for Internal Narrative)
- **SEC and Investor Perspective (Misleading and Not Informative):** The metric was widely derided by external parties and was a central reason the IPO crumbled.

2. If 97% of firms in the S&P 500 are using non-GAAP numbers, does that indicate that investors, analysts, and the market want these numbers?

The fact that nearly all S&P 500 companies use non-GAAP numbers does not necessarily mean investors and analysts want or prefer them, but rather that the market uses them and companies feel compelled to supply them.

The high prevalence (97% of S&P 500 companies use at least one non-GAAP metric) reflects a mix of demand for specific insights and a strong sense of competitive necessity (a “race to the bottom” effect).

### 3. How should the SEC regulate non-GAAP numbers?

The question asks for a forward-looking regulatory suggestion, which requires synthesizing the problems and proposed solutions discussed in the provided documents. No new search is needed. The articles provide both existing rules and various suggestions for regulating non-GAAP numbers. The SEC should regulate non-GAAP numbers by strengthening existing transparency rules and potentially restricting where these metrics can be prominently displayed to prevent them from obscuring GAAP results.

#### Proposed Regulatory Enhancements

- Restricting Public Release Venues
- Standardization or Elimination of Highly Tailored Metrics
- Situating Guidance in Long-Term Planning

### Why Charlie Munger's 'Bull—t Earnings' Metric is Used by so Many Tech Companies

#### 1. What is adjusted EBITDA? What adjustments are being made?

Adjusted EBITDA is a non-GAAP (Non-Generally Accepted Accounting Principles) financial metric that extends the traditional calculation of EBITDA by excluding various non-operating, non-cash, or one-time charges that management believes distort a company's core operational performance.

#### What is Adjusted EBITDA?

- EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. It is a pre-tax measure of income that removes financing costs (Interest) and non-cash charges for the consumption of fixed and intangible assets (Depreciation and Amortization).
- Adjusted EBITDA takes the standard EBITDA calculation and then makes further discretionary adjustments, adding back other expense items deemed by management to be non-cash or non-recurring.

#### Common Adjustments Being Made

Adjustment Category	Purpose / Rationale
Stock-Based Compensation (SBC)	This is the most significant adjustment for many high-growth, unprofitable tech companies (e.g., Uber, Yelp). It is a non-cash expense used heavily for employee compensation and recruiting, and companies argue it doesn't represent an actual cash outlay.
Amortization of Intangible Assets	A non-cash charge associated with past acquisitions. Removing it is common to provide a view of earnings without the impact of historical M&A accounting.
Restructuring Charges	These are typically one-time costs associated with reorganizing the business, such as layoffs or facility closures. Management excludes them because they are viewed as non-recurring.
Asset Impairment Charges	Charges taken to write down the value of an asset. These are generally considered non-recurring and are removed to show core earnings.
Litigation and Foreign Currency Charges	Costs associated with lawsuits or fluctuations in foreign exchange rates are sometimes excluded, as management deems them non-operating or non-recurring.

#### 2. Why does Charlie Munger not like this measure?

Charlie Munger, the late Vice Chairman of Berkshire Hathaway, strongly disliked non-GAAP measures like Adjusted EBITDA because he viewed them as fundamentally dishonest and misleading attempts by companies to manipulate their reported profitability.

## Session 8: Firm Performance Analysis

### Improving Critical Thinking through Data Analysis

#### 1. What is critical thinking and why is it important for accounting analysis?

Critical thinking is a manner of thinking that employs curiosity, creativity, skepticism, analysis, and logic. It is paramount for accounting analysis because it moves professionals beyond mere data processing to dissecting information, identifying patterns, forming sound judgments, and ensuring the accuracy and integrity of financial reports. Critical thinking is essential in accounting and financial analysis because it is an interdependent skill with data analysis; improving one improves the other.

## 2. What are the steps for data analysis?

Data analysis is an iterative process that requires applying critical thinking at every step to ensure the results are reliable and useful for decision-making.

1. Identify Data Analysis Opportunities
2. Specify the Objectives of the Analysis
3. Develop Expectations and Define Anomalies
4. Analyze the Data and Investigate Anomalies
5. Evaluate the Results
6. Formulate a Remedial Action Plan

## What's In SG&A?

### 1. Why is SG&A not broken down more in financial statements? Why does it matter?

SG&A (Selling, General, and Administrative) is often not broken down more in financial statements primarily because there are no broad requirements in US GAAP (Generally Accepted Accounting Principles) to disaggregate it on the face of the income statement. This allows companies to commingle a vast array of expenditures into one line item.

The limited disclosure matters significantly because it hides key information about a company's investment quality, long-term value creation, and true performance, making it difficult for investors and analysts to accurately value the business.

SG&A is essentially a "catch-all" category for a company's day-to-day operating expenses that are not directly tied to production (Cost of Goods Sold or COGS).

## Why Detailed SG&A Disclosure Matters

1. Distorts Profitability and Valuation
  - Understated Book Value
  - Misvaluation
  - Intangible Investment Risk
2. Hinders Forecasting and Performance Assessment
  - Inability to Forecast
  - Hides Managerial Action
    - Controlling Costs
    - Sacrificing Future Growth

## What Happened When United Stopped Trying to Predict the Pandemic

### 1. In an industry that relies on long-term forecasts of demand, how did United navigate demand uncertainties with Covid-19?

United Airlines navigated the extreme demand uncertainties of the Covid-19 pandemic by shifting its strategy away from long-term demand prediction and instead prioritizing flexibility, operational stability, and preparation for a rebound.

- Abandoning Prediction and Planning for Scenarios
- Prioritizing Operational Readiness over Short-Term Gains
- Betting on Long-Term Recovery

### 2. How did other airline carriers perform during the uncertainties with Covid-19?

The U.S. airline industry, including major carriers like American Airlines, Delta Air Lines, and Southwest Airlines, was hit faster and harder than most sectors, resulting in massive financial losses and a reliance on government assistance.

Many rivals were quicker to restore capacity and experienced subsequent struggles with staffing, a problem United largely avoided due to its strategy of retaining its core workforce and making more conservative schedule additions.

### 3. What are future performance indicators in the airline industry?

Future performance indicators in the airline industry go beyond traditional profitability and rely heavily on metrics that assess unit economics, capacity utilization, and key intangible assets. These indicators help analysts forecast demand, revenue, and cost competitiveness.

They are generally analyzed on a per available seat mile (ASM) or per available seat kilometer (ASK) basis to provide insights into the unit economics of the business.

## Session 9.1: Intangible Assets

### Brand Value: 'Hidden' Asset in Plain View

#### 1. What is brand value?

Brand value is a financial tool used to measure the value of a company's marketing expenditures. It is essentially an estimate of the value a company gets from its brand name, identity, recognition, and reputation. This asset embodies a core promise of values and benefits consistently delivered to the customer.

In a financial context, measuring brand value can help quantify the expected benefit of future marketing expenditures, allowing the Chief Financial Officer (CFO) to evaluate past spending and allocate funds for the best projects. Brand value is considered a company asset, and an increase in its value is like adding to the firm's equity.

#### 2. When can brand value be added to the balance sheet?

The recognition of brand value on a company's balance sheet is primarily governed by how the brand was acquired, due to the requirements of Generally Accepted Accounting Principles (GAAP).

#### 3. How is brand value measured?

Brand value is typically measured using a valuation methodology that focuses on quantifying the future economic benefits generated by the brand, which often centers around the concept of a royalty rate.

### Goodwill Sparks Deep Division, at Least on Balance Sheets

#### 1. What is Goodwill?

Goodwill is an accounting term for the premium a company pays when it acquires another company for more than the value of that company's identifiable net assets (its assets minus its liabilities). It is the most common example of a non-identifiable intangible asset because, unlike a patent or a trademark, it cannot be easily separated and sold on its own. Goodwill captures the non-physical value inherent in the acquired business that allows it to generate higher earnings than might be expected from its physical assets alone. Goodwill is recorded on the balance sheet only when an entire business is purchased.

#### 2. What is the current test for goodwill impairment?

The current test for goodwill impairment requires public companies to assess the recorded value of goodwill at least once a year. Instead of systematic amortization, the Financial Accounting Standards Board (FASB) requires companies to use a non-amortization approach that mandates an annual review for impairment.

1. Annual Evaluation: A company is supposed to evaluate, or test, the goodwill on its books every year to see if its value still holds.
2. Estimate Fair Value: This test involves estimating the fair value of the reporting unit to which the goodwill is assigned. This estimation uses assumptions about growth and market conditions.
3. Comparison and Write-Down: If the fair value of the reporting unit is determined to be less than its carrying amount (which includes the goodwill), the company must write down a portion of the goodwill. This write-down is recorded as a goodwill impairment charge, which is a non-cash adjustment that cuts profit.

#### 3. What is the proposed alternative accounting treatment for goodwill?

The main alternative accounting treatment being considered by the Financial Accounting Standards Board (FASB) for goodwill is a return to amortization. One potential option being discussed for the future is a combination of the two methods: amortization coupled with reduced impairment testing. This could mean testing for impairment only in the first three years after a deal or only when an event specifically triggers a likely write-down. There is believed to be "momentum on the board to move toward amortization," primarily driven by concern over the high cost of the current impairment test.

### Verizon to Book \$5.8 Billion Charge on Business Unit

#### 1. Which business line was affected by Verizon's impairment charge, and why?

The Verizon impairment charge, announced in January 2024, affected the business line that offers landline and internet services to businesses. The specific segment that took the charge was the one that provides services to a range of companies, from small retailers to multinational corporations, and also serves some wireless accounts. Verizon said it took the \$5.8 billion noncash charge because a strategic review prompted the company to lower its financial projections and revise its estimate of the unit's overall value. The charge was a write-down of goodwill, which is an estimate of the unit's value beyond its assets. Following the charge, the unit has \$1.7 billion in year-end goodwill remaining.

# Session 9.2: ESG Reporting

## The ABCs of ESG Reporting

1. What are ESG and sustainability reports, why are they important, and what do CFOs need to know

ESG and sustainability reports are formal disclosures that communicate a company's environmental, social, and governance activities and performance, and they have become an important tool for attracting investors and financing.

### What are ESG and Sustainability Reports?

ESG Reporting is the disclosure of environmental, social, and corporate governance (ESG) data. It serves as an external investment framework or a set of metrics to help companies communicate their initiatives and allow investors to assess the company's performance and risk. Its purpose is to provide transparency on a company's ESG activities and demonstrate that it is meeting its goals and avoiding "greenwashing". Sustainability Reports are disclosures that generally refer to a company's relationship with the environment. Sustainability is viewed as an internal framework that guides an organization's capital investments. In essence, sustainability is the motivation, and ESG is the reported outcome.

### Why are They Important?

ESG and sustainability reports are important for several reasons:

- **Attracting Investors and Financing:** Investors, particularly millennials and Gen Z, are increasingly interested in sustainable investing and view a company's sustainability efforts as closely aligned with its long-term profitability.
- **Transparency and Trust:** Reporting helps organizations demonstrate that their ESG projects are genuine, which builds trust and distinguishes them from competitors.
- **Risk Assessment:** The reports help stakeholders (like investors) screen their investments and evaluate the company's risk exposure related to environmental damage, social missteps, or corruption.
- **Global Alignment:** With 80% of N100 firms worldwide now reporting on sustainability, a global framework is becoming a question of "when, not if," making current reporting essential for global business relevance.

### What CFOs Need to Know

Chief Financial Officers often oversee sustainability and diversity efforts. As ESG reporting is increasingly recognized as a business tool, CFOs need to be aware of the following:

#### Complexity and Compliance

- **Evolving Regulations:** CFOs must stay current with the evolving global standards, as a universal standard does not yet exist. For example, the new SEC Climate Disclosure Rules require disclosures in financial statements and periodic reports, which are subject to new thresholds and phased-in assurance requirements.
- **Data Collection and Systems:** Effective adoption of new rules requires gathering and reporting incremental disclosures, necessitating significant changes to a registrant's systems, processes, and controls
- **Cross-Functional Coordination:** Adopting new reporting standards requires coordination across finance, financial reporting, legal, and investor relations teams.

#### Financial Materiality and Risk

- **Materiality Thresholds:** The SEC's final rules require disclosure of financial effects from severe weather events and other natural conditions, but only if the aggregated impact meets specific thresholds (e.g., 1% of stockholders' equity or 1% of income/loss before taxes). CFOs need to be ready to analyze and report these climate-related financial statement effects.
- **Financial Impact of Targets:** CFOs must track and disclose the quantitative and qualitative impacts of any climate-related target or goal that is reasonably likely to materially affect the company's financials, including material expenditures and impacts on financial estimates.

#### Strategic Communication and Risk

- **"Green-Hushing" vs. Disclosure:** While companies may be quieter about ESG topics in public forums like earnings calls due to culture war boycotts and investor pressure, they must still prepare for new mandatory disclosure rules.
- **Avoiding Greenwashing:** Being careful about what is put into the public domain can help companies avoid running afoul of new reporting requirements and the charge of "greenwashing".
- **Focus on Value:** Some experts argue that instead of focusing solely on the politicized term "ESG," companies should focus on "intangible assets" and how these initiatives improve long-term value and financial performance.

## 2. What is ESG reporting?

ESG reporting is the disclosure of environmental, social, and corporate governance (ESG) data.

Its core purpose is to shed light on a company's ESG activities while improving investor transparency and inspiring other organizations to do the same. It also serves as an effective way to demonstrate a company is meeting its goals and that its projects are genuine, preventing claims of “greenwashing”.

ESG is an external investment framework, or a form of metrics, that helps companies communicate their initiatives and allows investors to assess the company's performance and risk. It is more relevant to publicly traded companies looking to attract and inform investors or any other business seeking financing.

## 3. Who governs ESG reporting?

ESG reporting is governed by a complex and evolving mix of national regulators, regional mandates, and influential global standard-setting organizations. There is no single, universal governing body. The governance structure can be separated into mandatory legal requirements and voluntary global frameworks.

### 1. Mandatory Regulatory Bodies (Governmental)

- US: SEC
- EU: CSRD, ESRS, SFDR

### 2. Global Standard-Setting Organizations (Frameworks)

- International Sustainability Standards Board (ISSB)
- Global Reporting Initiative (GRI)
- Task Force on Climate-related Financial Disclosures (TCFD)
- Sustainability Accounting Standards Board (SASB)
- Carbon Disclosure Project (CDP)

## 4. What value do corporations get from ESG reporting?

Corporations gain significant value from ESG reporting that extends beyond mere compliance, primarily by enhancing their financial prospects, reducing risks, and improving stakeholder relationships.

### **Key Value and Benefits for Corporations**

- Attracting Investors and Capital
- Risk Management and Legal Defense
- Operational and Strategic Improvement

## **SEC Considers Easing Climate-Disclosure Rules After Investor Pushback**

### 1. What are the proposed climate disclosures for firms?

The requirements for climate disclosures vary significantly across major regulatory bodies, with each issuing its own set of rules and standards. The most notable are the U.S. SEC, the EU's Corporate Sustainability Reporting Directive (CSRD), and the International Sustainability Standards Board (ISSB).

### 2. What are the key complaints by firms?

The key complaints and pushback from firms regarding the original and final ESG/climate disclosure proposals mainly revolve around cost, complexity, the scope of disclosure, and the political nature of the requirements.

## **Companies' quiet diversity and sustainability talk amid culture boycotts**

### 1. Why are executives mentioning ESG initiatives and efforts less on earnings conference calls?

Executives are mentioning ESG and related initiatives less on earnings calls, a trend sometimes called “greenhushing,” due to a confluence of political, regulatory, and market pressures. The drop in mentions has been significant, reversing a trend that picked up after 2020.

### **Key Drivers for the Silence**

#### 1. Political and Ideological Backlash

- Anti-ESG Movement
- Political Risk
- Avoiding Controversial Terms

#### 2. Regulatory and Litigation Risk

- Fear of “Greenwashing”
- Increased Scrutiny

### 3. Investor Focus and Time Constraints

- Short-Term Focus of Earnings Calls
- Alternative Channels

#### What This Silence Means

The retreat from public talk appears to be more rhetorical than real. While companies talk less in public forums, they are often continuing their underlying initiatives and preparing for mandatory disclosures. Companies are still voluntarily issuing detailed sustainability reports and preparing for forthcoming SEC rules. They are simply doing the work with greater discretion.

#### 2. What is “green washing?” What is “green hushing”?

**Greenwashing** is the practice of touting overly optimistic or unsubstantiated projections and claims for sustainability. It involves bold or deceptive environmental advertising where a company's claims about its progress and commitment to green goals are exaggerated, incomplete, or inconsistent with reality. Regulators have been scrutinizing these discrepancies and delivering fines, leading to heightened legal and reputational risk for companies.

**Greenhushing** is the phenomenon where companies quiet down or avoid discussing their environmental and sustainability efforts in public settings like earnings calls. It is essentially the corporate silence on ESG efforts. This practice is largely a reaction to the fear of the legal risks, fines, and reputational damage associated with greenwashing allegations, as companies become more cautious about what they put into the public domain. By being quieter, they aim to avoid running afoul of new and proposed sustainability reporting requirements.

#### 3. What effect do ESG programs have on financial performance? What are the metrics?

The effect of ESG programs on financial performance is generally seen as positive, especially over the long term, with a key focus on risk mitigation and efficiency. The performance is measured using a combination of traditional financial indicators and specific quantitative and qualitative ESG metrics.

#### A Progressive's Case for Getting Rid of 'ESG'

##### 1. What are the key points of this author's argument?

The author's argument, presented in “A Progressive's Case for Getting Rid of 'ESG',” is that the term “ESG” has outlived its usefulness and should be scrapped. While initially helpful in drawing attention to non-financial factors, the focus on the ESG label now distracts companies and investors from their primary goals and should be replaced with a focus on “intangible assets” and “long-term value”. The author is a self-described ESG advocate, making the case from a progressive perspective.

##### 2. How is putting ESG on a pedestal potentially damaging to firms?

The author argues that putting the concept of ESG on a pedestal is potentially damaging to firms in several ways, primarily by introducing intellectual confusion and practical constraints that impede genuine value creation. The author suggests shifting the discussion to “intangible assets” and “long-term value” to avoid these pitfalls, as those terms are not political and do not put a halo on certain elements over others.

#### New SEC Climate Disclosure Rule

##### 1. What are the new disclosure rules?

The term “new disclosure rules” most prominently refers to the SEC's final rules on climate-related disclosures in the United States and the EU's Corporate Sustainability Reporting Directive (CSRD), both of which mandate extensive reporting on environmental, social, and governance (ESG) matters.

## Session 10: Value Investing

### The End of Accounting

#### 1. Are accounting rules producing financial measures that are irrelevant and/or misleading?

Yes, a significant argument exists that current accounting rules—particularly Generally Accepted Accounting Principles (GAAP)—produce financial measures that are increasingly irrelevant or can be misleading when assessing modern businesses. This criticism is not about accounting for simple transactions, but how GAAP handles certain key components of a modern company's value.

#### 2. How do the authors propose to fix the corporate earnings problem?

The authors, Baruch Lev and Feng Gu, propose to fix the corporate earnings problem by moving away from reliance on backward-looking financial statements and toward a system of systematic disclosure of forward-looking, fundamental business indicators. The key distinction is that these fundamental indicators are forward-looking indicators of performance and growth, unlike the backward-oriented financials, and thus highlight the company's strategy and the success of its execution.

## Why the Traditional Way of Measuring 'Value' Stocks May Be History

1. Why has the price-to-book ratio potentially lost its relevance?

The price-to-book (P/B) ratio has potentially lost its relevance primarily because of the increasing significance of intangible assets in the modern economy. The main critique is that the P/B ratio relies on book value, a measure heavily impacted by accounting rules that are outdated for today's knowledge-based companies. As a result, critics argue that the traditional P/B ratio is an imperfect and noisy measure of a firm's value, particularly for new-economy, technology-based companies.

2. Are there arguments for still using the price-to-book ratio to differentiate between underpriced and overpriced stocks?

Yes, despite its noted limitations, there are strong arguments for still using the Price-to-Book (P/B) ratio to differentiate between underpriced and overpriced stocks, especially when applied selectively or with adjustments. The P/B ratio remains a valuable tool for valuation due to its stability and usefulness in specific contexts.

In summary, while critics advocate for a multi-factor approach or other ratios for technology and intangible-heavy firms, the P/B ratio remains a cornerstone of fundamental analysis, especially for traditional asset-heavy businesses and when its components are appropriately adjusted for the modern economy.

## Value Investing: What It is, How It Works & Strategy

1. What is value investing?

Value investing is a strategy focused on finding and buying stocks or securities that are selling at a discount to their perceived intrinsic value or "true worth". It operates on the core belief that the market sometimes misprices stocks due to factors like short-term news or overreactions, creating an opportunity for investors to purchase a high-quality company for a bargain price. Value investing is often contrasted with growth investing, where the latter seeks stocks with the best ability to grow their earnings over time and generally have higher P/E multiples, while value stocks generally have lower P/E multiples and may pay dividends.

2. What are the key measures used to indicate a "value" stock?

The key measures traditionally and currently used to indicate a "value" stock are financial ratios that suggest the company's market price is low relative to its underlying financial metrics.

- Price-to-Book (P/B) Ratio
- Price-to-Earnings (P/E) Ratio
- Discounted Cash Flow (DCF) Value
- Price-to-Sales (P/S) Ratio
- Price-to-Cash Flow Ratio
- Dividend Yield
- Price/Earnings-Growth (PEG) Ratio

The trend in modern value investing is moving toward a composite value indicator that utilizes many different measures—not just P/B alone—to get a more complete picture of a company's value, especially due to the limitations of P/B in an economy dominated by intangible assets.

3. What are the risks to value investing?

- Value Traps: The biggest danger is buying a stock that appears cheap but is priced correctly because the company is in permanent decline or facing severe, insurmountable issues, meaning it will never rebound to its perceived value.
- Time and Patience: The strategy requires significant time and patience. Investors face the risk that the market may not recognize the stock's intrinsic value for many years, leading to a long period of underperformance.
- Subjectivity and Loss: The process is exposed to subjectivity in estimating a stock's intrinsic value, which can lead to incorrect valuations. As with any stock, there is always the principal risk that the investment will fall below the initial purchase price.

## Facebook, Netflix, and PayPal are Value Stocks Now

1. What is the benchmark measure that the FTSE Russell uses to determine value stocks?

FTSE Russell does not use a single benchmark measure; instead, it employs a multi-variable approach to determine value stocks for its style indexes (like the Russell 1000 Value Index). The companies that exhibit a relatively lower Book-to-Price ratio and lower expected growth values are generally included in the value index. When a company's characteristics do not result in a clear distinction, its market capitalization may be allocated proportionately between both the value and growth style indexes.

2. Tech stocks have historically been considered growth stocks. Why are so many tech stocks now being classified as value stocks?

Tech stocks are now being classified as value stocks primarily because of a sharp decline in their stock prices combined with the objective, rules-based methodology used by major index providers. This shift reflects a change in the market environment and how the stock market is viewing these companies.

## Value Investing Is Back. But How Do You Choose the Right ETF?

1. In the past 10 years, which stocks have performed better, growth or value?

The core risk to value investing lies in the danger of falling into a value trap. This occurs when a stock, despite having a seemingly low valuation (e.g., a low P/B or P/E ratio), is correctly priced because the company is in secular decline or faces fundamental business issues that will prevent its price from ever recovering to the perceived intrinsic value. Investors must exercise extreme caution to avoid buying a stock that is simply cheap for a very good reason.

The strategy also carries significant practical and analytical risks. Value investing is inherently time-consuming, requiring active management and a laborious process of fundamental analysis to correctly appraise a company's financial health. Even with diligent research, the calculation of intrinsic value is subject to guesswork and subjectivity, as it relies on estimated inputs for future earnings and cash flows. An error in these subjective assumptions can lead to an incorrect valuation and subsequent capital loss. This risk is compounded by the fact that the market may take years to recognize a stock's true value, demanding extreme patience from the investor to avoid liquidating the position at a loss.

Finally, as with any equity investment, value stocks carry principal risk, meaning the investment may decline below the original purchase price. These stocks can also be exposed to methodological risks, particularly the reliance on traditional metrics like the Price-to-Book ratio, which can be limited or misleading when evaluating modern companies whose worth is increasingly tied up in intangible assets not captured on the balance sheet.

2. What metrics does the S&P Dow Jones use to rate a firm's value?

S&P Dow Jones Indices (S&P DJI) uses a multi-factor approach incorporating traditional financial metrics to rate a firm's value, particularly when constructing its Value Style Indexes (such as the S&P Composite 1500 Value Index).

The key financial ratios S&P DJI uses to evaluate a stock's value characteristics are:

- Price-to-Book (P/B) Ratio
- Price-to-Earnings (P/E) Ratio
- Price-to-Sales (P/S) Ratio

A low reading in these ratios generally indicates a stronger "value" score.

### Other Relevant Measures and Ratings

- Financial Viability (for Index Inclusion)
- Credit Ratings (S&P Global Ratings)
- ESG Scores
- Cyclically Adjusted P/E (CAPE)

3. What is a large-cap, mid-cap, and small-cap firm?

Category	Market Cap Range	Key Characteristics	Risk & Growth Profile
Large-Cap	\$10 Billion or more	Well-established, mature companies; often called "blue-chip" stocks	Stability and lower volatility; steady returns; often pay dividends
Mid-Cap	\$2 Billion to \$10 Billion	Growing businesses with established models and room for expansion	Balanced approach; moderate volatility; higher growth potential than large caps
Small-Cap	\$250 Million to \$2 Billion	Emerging businesses; younger; niche markets or early growth phase	Higher risk and volatility; potential for substantial returns

4. Are all value ETFs the same? How are they different?

No, all value Exchange-Traded Funds (ETFs) are not the same. They differ significantly based on their underlying investment strategies, the metrics they use to define "value," and how they construct their portfolios.

These different methodologies mean investors must carefully consider how a value ETF is constructed and how it fits with their investment goals (i.e., whether they want a tactical short-term holding or a strategic long-term core holding).

# Session 11: Textual Analysis

## Detecting Linguistic Traces of Destructive Narcissism At-a-Distance in a CEO's Letter to Shareholders

1. What is narcissism? Is this a common trait in CEO's? Is that good or bad?

Narcissism is a personality trait that involves a pervasive pattern of grandiosity (in fantasy or behavior), a persistent need for admiration, and a lack of empathy. Individuals with these characteristics may overestimate their talents, be preoccupied with fantasies of unlimited success, believe they are special and unique, and expect special favors. In a corporate context, this set of traits is considered more common in CEOs than in the general population. While some experts estimate that about 5% of the general population is narcissistic, studies suggest that up to 18% of CEOs score moderately or highly for these traits. This is because the traits often associated with narcissism—such as high self-confidence, a focus on goal achievement, and risk tolerance—are also those that can propel an individual into top leadership roles.

The presence of narcissism in a CEO can be both good (constructive) and bad (destructive) for a company. The constructive side occurs when a healthy or optimal level of the traits is channeled for the organization's benefit. These leaders are often charismatic, visionary, and a force for creativity, driving strategic dynamism, innovation, and necessary change, which can lead to success in volatile environments. However, the destructive side emerges when these traits are excessive or pathological. Destructive narcissists, such as those at Enron, are self-serving, lack integrity, and are more likely to engage in unethical or illegal behavior like earnings manipulation or fraud. Their sense of entitlement, arrogance, and lack of empathy can also create destructive work environments, result in poor corporate governance, and is associated with lower stock-price performance.

2. How can words in a letter to shareholders reveal to you anything about the CEO's personality?

Words in a CEO's letter to shareholders can reveal a great deal about their personality and leadership style, particularly through the use of specific language that provides linguistic traces of traits like narcissism, overconfidence, or humility. Analyzing these documents offers insight into the “tone at the top” of the corporation, which can have implications for the company's ethical culture and financial reporting.

3. How does the “Tone at the Top” play a role in financial analysis?

The “Tone at the Top” plays a critical role in financial analysis because it is an important reflection of the corporate ethical culture and leadership mindset, providing investors and stakeholders with insights into the integrity of a company's financial reporting and risk management. In essence, while the CEO letter provides a narrative of corporate accountability, textual analysis allows stakeholders to systematically look beyond the explicit words for implicit patterns that reveal the leadership's true mindset and its associated risks.

## CEOs Simple Trick on Earnings Calls: Saying ‘I,’ ‘We’ and ‘Us’

1. Can a CEO's language usage affect investors' reactions to information shared on an earnings call?

Yes, a CEO's language usage can absolutely affect investors' reactions to information shared on an earnings call. Research suggests that the executive's linguistic choices during these calls can influence how investors respond to the disclosures, regardless of the company's actual financial results.

This phenomenon is notable because it highlights the impact of function words (such as pronouns, articles, and prepositions) over content words (such as nouns and adjectives), which are generally seen as more substantive. While function words are not the most memorable, they are a vital aspect of language and make up around 60% of everyday speech, subtly shaping investor reactions.

2. What does the use of less inclusive pronouns by the CEO in an earnings call tell us?

Pronoun Usage	Implication on Leadership and Personality
Less Inclusive (e.g. primarily "I"; "my")	Individual Focus/Self-Attribution: This style emphasizes the CEO's personal role in company outcomes. It can suggest they are taking exclusive credit for successes, which aligns with egocentricity and a grandiose sense of self-importance. - Potential Narcissism: A strong focus on "I"; "me"; and "my" can be a linguistic trace consistent with a narcissistic mindset as it promotes a perception that the CEO is solely responsible for success.
More Inclusive (e.g. primarily "we"; "us")	Collective Leadership/Accountability: The use of "we" and "us" is generally a reflection of a collective leadership narrative and suggests shared responsibility. - Team-Oriented Culture: It signals a more inclusive considerate and reassuring style which can be seen as the antithesis of a destructively narcissistic approach.

## Textual Analysis for Accountants

1. Why is textual analysis even more important in today's digital information world?

Textual analysis is even more important in today's digital information world primarily because of the rapid growth in unstructured data and the need for accountants and auditors to efficiently extract valuable insights from it.

2. How is textual analysis being applied in accounting and auditing settings?

Textual analysis is being applied in accounting and auditing settings to efficiently process and analyze the vast amounts of unstructured data that exist today, providing new insights for decision-making and risk management.

## SEC Digs Deeper Into Companies' EPS Manipulation

1. How often does the SEC review the earnings per share for most US public companies?

The Securities and Exchange Commission (SEC) does not review the Earnings Per Share (EPS) for every public company at a fixed, frequent interval. Instead, the review of EPS falls under two main programs:

### 1. The Mandated Periodic Review

The SEC's Division of Corporation Finance (Corp Fin) reviews public company reports according to a mandate under the Sarbanes-Oxley Act:

- The SEC is required to undertake some level of review of each reporting company at least once every three years.
- The Division reviews a significant number of companies more frequently than the three-year minimum.
- These reviews often involve an examination of the financial statements and related disclosure, which includes EPS figures and related discussion.

### 2. The EPS Initiative (Targeted Review)

The SEC's Division of Enforcement has a specialized, ongoing effort called the EPS Initiative that targets specific companies based on high-risk factors related to earnings management:

- Risk-Based Analytics: The initiative uses risk-based data analytics to uncover potential accounting and disclosure violations caused by earnings management practices.
- Targeted Scrutiny: This initiative specifically looks for patterns that suggest EPS manipulation, such as a company consistently meeting or slightly exceeding analyst consensus EPS estimates for consecutive quarters, followed by a significant drop in EPS.
- Continuous Monitoring: While a full investigation isn't constant, the underlying data analytics program runs continuously, scrutinizing the earnings information and accounting disclosures made by thousands of public companies. This allows the SEC to identify companies that may have engaged in improper accounting, even with small adjustments that affected EPS by as little as a penny.

2. Why does the SEC focus on the earnings per share number?

The SEC focuses intensely on the Earnings Per Share (EPS) number because it is a crucial measure of a company's financial performance that is susceptible to manipulation, directly impacting investors and the integrity of the capital markets. The SEC's focus is driven by two key factors: the extreme importance of EPS to investors, and the ease with which companies may manipulate the figure.

3. What did academic researchers discover about the number 4 that helps the SEC when analyzing earnings per share?

Academic researchers discovered that the numeral "4" is often underrepresented in the unrounded quarterly earnings per share (EPS) figures reported by companies. By leveraging this discovery in their risk-based data analytics, the SEC can use the underrepresentation of "4" as a benchmark to quickly flag companies that may be improperly rounding up their earnings to meet or exceed analyst estimates, thereby focusing their investigative resources on the highest-risk filers.

## Session 12: Corporate Governance

### Corporate Governance 2.0

1. How can corporate governance support a long-term perspective to managing a firm?

Corporate governance can support a long-term perspective in managing a firm by implementing practices that resist the pressure for short-term gains and ensure a focused, well-evaluated, and accountable board.

1. Shifting Focus from Short-Term Performance
2. Promoting Board Stability and Continuity
3. Ensuring High-Quality, Accountable Directors

## 2. How are directors appointed? Evaluated? Compensated?

Directors are typically appointed through the company's nominating committee and ultimately elected by shareholders. For this process to be effective, it should ensure ongoing board refreshment, attracting qualified individuals and managing the tenure of current members. Shareholder activists advocate for proxy access, which gives shareholders with a significant stake the right to nominate director candidates to the company's ballot as a backstop against a deficient nominating process. For director evaluations, the standard practice of internal reviews by the chairman is seen as inadequate. The proposed Corporate Governance 2.0 model favors engaging an independent third party to design and conduct rigorous, ongoing evaluations based on company-specific attributes. This more objective process is intended to provide clear evidence for difficult conversations and encourage underperforming directors to voluntarily step down, which is considered superior to the blunt instruments of age or term limits.

Director compensation, particularly at large public companies like Tesla, is heavily weighted toward stock options. Tesla's directors, for instance, have made hundreds of millions of dollars from selling shares earned through their board service, a figure "significantly more than" the compensation for typical directors at other large U.S. companies. The Compensation Committee, which oversees executive incentives, is scrutinized by stewardship officers to ensure there is a clear link between company goals and rewards. However, this lucrative compensation, combined with extensive personal and financial ties to the CEO—as seen at Tesla—can undermine board independence, causing conflicts of interest and leading to a board that is " beholden " to management. Shareholders and judges are increasingly questioning director independence in cases where deep financial entanglement and personal loyalties might interfere with objective judgment.

## 3. Do directors represent shareholders? What conflicts exist?

Directors are intended to represent the interests of the shareholders, but the relationship is often complicated by various conflicts of interest and differing priorities, particularly with the rise of different investor types. In theory and by fiduciary duty, directors are charged with overseeing the company for the benefit of its owners, the shareholders.

Significant conflicts exist that can compromise a director's ability to act as a pure representative of all shareholders:

1. Conflict of Independence and Loyalty to the CEO
2. Short-Term vs. Long-Term Priorities
3. Conflicts of Interest within Investor Groups

## Evolving Investor Relations

### 1. Do passive money managers have the same goals as other investors?

Passive money managers, such as index funds like BlackRock and Vanguard, do not have the same goals as other investors, especially when it comes to short-term performance and the use of financial information.

### 2. How do shareholders monitor managers? Does the principal-agent model still apply?

Shareholders monitor managers through a variety of governance mechanisms, and while the principal-agent model still applies, its dynamics are heavily altered by the rise of large institutional investors. The principal-agent model describes the core conflict in corporate governance where shareholders (the principals) hire managers (the agents) to run the company, but the agents' self-interest may conflict with the principals' goal of maximizing long-term wealth.

### 3. What are the key committees on a board of directors?

Committee	Primary Function and Focus	Concerns of Passive Investors
Nominating Committee	Responsible for recruiting new directors and managing the board refreshment process.	Attracting skilled directors
Audit Committee	Seeks to keep a company's financial reports free of material misstatement, selecting the independent auditor, and reviewing critical accounting policies.	Identifying
Compensation Committee	Oversees incentives given to a company's senior executives to ensure pay plans contribute to company goals.	Searching for clear links between company goals

#### 4. How has investor relations changed?

Investor relations (IR) has significantly changed due to the rising influence of passive investors (index funds) and a shift in focus from short-term financial performance to long-term corporate governance.

##### **Shift in Focus and Key Players**

- The primary goal has moved from helping outsiders value the company's shares to understanding how decisions are made in the boardroom.
- The key shareholder representative is no longer the Security analyst but the Stewardship officer from passive funds.
- The primary company representative is no longer the Chief financial officer (CFO) offering guidance, but the Lead director (an independent director).
- The typical discussion topic has changed from competitor threats and earnings models to board refreshment and governance.
- The relevant investment horizon is no longer roughly two years, but indefinite.

##### **New Priorities and Practices**

- **Long-Term Metrics over Short-Term Accounting:** The focus has shifted from short-term performance measures like revenues and earnings to sustainability risks and the quality of the board. Accounting topics like revenue recognition or credit impairment matter little to these long-term owners. Instead, investors seek information on the identification, measurement, and disclosure of long-term risks facing the company, viewing sustainability as a strategic financial risk.
- **Direct Access to Independent Directors:** The new model requires management to prepare and allow independent directors to meet privately with stewardship officers. This direct engagement seeks to determine the board's ability and willingness to hold management accountable—information that cannot be gained by talking to management alone.
- **Reduced Usefulness of Traditional Reporting:** Information used to forecast the amount, timing, and certainty of a company's earnings or cash flows is of limited use to passive investors, as they have limited discretion over security selection.

#### **The Money and Drugs That Tie Elon Musk to Some Tesla Directors**

1. SOX 2002 and stock-exchanges like NASDAQ require a majority independent directors on publicly listed companies' boards. What are the rules to be classified as an independent director?

The Sarbanes-Oxley Act of 2002 (SOX) and stock exchanges like Nasdaq require publicly listed companies to have a majority of independent directors on their boards. The rules for classifying a director as independent are designed to ensure the individual can exercise objective, disinterested judgment free from conflicts of interest.

2. What is the role of the board of directors in overseeing and governing a firm?

The board of directors plays a pivotal role in overseeing and governing a firm by acting as the crucial link between the owners (shareholders) and the management. Their primary function is to provide strategic direction, ensure the company is run effectively, and prioritize long-term value creation. The board achieves this by recruiting, overseeing, and compensating top executives, including the CEO, while also establishing executive compensation plans.

They are responsible for implementing sound risk management and internal control systems, maintaining accountability, and promoting transparency through clear and timely disclosures to all stakeholders. The board has the responsibility to ensure a diverse and skilled composition, holding management accountable for its actions and performance in the best interest of the company.