CHAPTER 1

Don't Get Fooled Again

REMEMBER WHEN PICKING winning stocks seemed virtually idiot-proof? You'd catch an analyst on TV, glimpse a headline in some newspaper or magazine, or listen in awe as one of your neighbors boasted about how they had managed to double their money in less than a year. Doubled in less than a year! And then you'd click a button or two on your computer and buy 100 shares, or maybe even more, if you were feeling bullish that day. After all, time was a-wasting and there was money to be made.

If you were feeling particularly ambitious, maybe you spent a few extra minutes and skimmed the company's most recent earnings release, just to make sure things were as rosy as you thought they were. Or maybe you checked out an online message board to see what other investors had to say about the company. Still, you didn't want to waste too much time on research, or you'd never be able to afford your own tropical island, just like that tow truck driver had done in that commercial for one of the big online brokerage firms. Wasn't ignorance bliss?

Now, of course, things look and feel very different. After a spate of multibillion-dollar accounting scandals that have tarnished many on Wall Street (not to mention much of the accounting profession) and a steady drumbeat of companies restating billions of dollars in earnings, it's hard for individual investors to know whom or what to believe anymore. Meanwhile, the list of people whom many of us feel we can no longer trust—accountants, analysts, corporate executives, financial commentators, professional money managers, regulators, and stockbrokers—seems to keep growing every day.

We've learned the hard way—by looking at our monthly brokerage account statements—that the myriad people we were counting on to advise and protect us haven't exactly been doing such a great job.

So whom can this country's 85 million individual investors count on? It would have to be someone who can't be influenced by a hodge-podge of lobbying groups or be tempted by million-dollar bonuses or even hefty stock options—all of which are designed to maintain the status quo.

The answer is amazingly simple: *ourselves.* For individual investors who are willing to put some time and a bit more effort into doing our own research, there's plenty of information available to help us make our own informed decisions and, perhaps more important, avoid much of the hype that surrounds the business of investing.

Granted, we should have been doing this from the beginning. But it was hard not to get swept up in the euphoria of the moment. Certainly, lots of other people did. And since so many of us were new to investing—35 million investors entered the market for the first time during the late 1990s boom—many of us didn't understand the way things really worked. We didn't stop to ask what type of earnings the companies that we invested in were reporting—operating, pro forma, normalized, or some variation on the theme—just so long as they were going up. Sometimes it didn't even matter if the company had any earnings at all. We didn't realize that some of the big-name stock analysts who were talking up stocks in public were secretly bashing them in private. Some of us even honestly thought that with the advent of Internet trading, we could quit our real jobs and count our money all day long.

We won't get fooled again.

One of the few benefits from the wave of accounting scandals that have swept the country is that many companies are now going to great lengths to demonstrate that they're not another Enron or WorldCom. They're providing much more detailed financial information than they ever did before. The bad news is that much of that information is being buried in the fine print in the annual (10-K) and quarterly (10-Q) reports that companies file with the Securities and Exchange Commission (SEC).

Unlike the glossy annual reports with smiling executives and rising bar graphs that individual investors tend to be more familiar with, little of the material in these documents makes for easy reading, at least at first.* There are no colorful charts or pictures—just lots of small black type that seems written in some strange variation of English called accounting-speak. In addition, because the 10-Ks and 10-Qs come out weeks or even months after a company first reports its earnings, many investors mistakenly believe these reports are old news.

* A study in August 2002 by Dr. Deanna Oxender Burgess, an accounting professor at Florida Gulf Coast University, found that at least 10 percent of the graphics that appeared in annual reports did not accurately represent the actual numbers.

Yet because the 10-Ks and 10-Qs are subject to SEC scrutiny, they present a much more complete picture of the company than a quarterly or annual earnings press release does and should be considered a must-read for people who want to pick their own stocks. Although professional money managers and analysts have been reading these SEC filings for decades, most individual investors are not very familiar with them. In an effort to make these documents more accessible to their shareholders, some companies have begun posting them on their corporate web sites and sometimes even mailing 10-Ks directly to shareholders in place of the more elaborate annual reports.

There are a few key sections that investors should pay attention to in the 10-Ks, including the Management's Discussion and Analysis (MD&A) and the risk factors. But professional money managers tend to skip over much of this and focus the bulk of their time on the really fine print—the footnotes. In a nutshell, the footnotes provide context for the numbers that appear in the company's key financial tables: the income statement, the balance sheet, and the statement of cash flows. Because they tell the story behind the story, they are critical to understanding a company's true financial health.

"Too many companies would prefer that you not read the footnotes," notes former SEC Chairman Arthur Levitt. "That should be incentive enough to delve into them."[1]

While accounting rules require companies to provide details about how they arrive at many of the key numbers that investors tend to focus on—such as income and revenues—nothing requires companies to make this information easy to find. As a result, most of these details are buried in the footnotes. Companies point this out to investors at the bottom of their financial statements, where a one-line note typically states: "The accompanying notes are an integral part to the consolidated financial statements."

Some companies have begun to provide helpful hints in their financial statements directing investors to a specific footnote in order to get a better understanding of a particular number. Exhibit 1.1 is an example from General Motors' balance sheet in its 2002 10-K.

Enron, for example, disclosed several details on its off-balance sheet transactions—complicated deals that pumped up its earnings and kept debt off the company's balance sheet—in the footnotes to its 1999 and 2000 10-Ks. It was those deals that led to the company's unraveling. Even though the disclosures weren't particularly clear, some savvy investors picked up on them early on and were able to avoid getting burned, as most of Enron's shareholders and employees did. (For more on this, see Chapter 2.)

EXHIBIT 1.1

Helpful Hints from General Motors 2002 10-K

Years Ended December 31,	2002	2001	2000
(dollars in millions)			
GENERAL MOTORS CORPORATION AND SUBSIDIARIES			
Total net sales and revenues (Notes 1, 2 and 23)	$186,763	$177,260	$184,632
Cost of sales and other expenses (Notes 2 and 3)	153,344	144,093	145,664
Selling, general, and administrative expenses	23,624	23,302	22,252
Interest expense (Note 13)	7,715	8,347	9,552

The bankrupt energy trading company was hardly the first company in the history of the markets to disclose questionable accounting practices in its footnotes. For years, decades even, companies have used the footnotes to bury all sorts of unusual transactions, hoping that as few people as possible would notice. Professional investors, analysts, accountants, and regulators were all aware of how things worked. But sometime during the 1990s, fueled by a raging bull market, the people who normally read those footnotes—who were being paid to read them—either stopped or didn't bother to ask questions about what they were reading.

"Everyone went into a period of suspended disbelief. It was like going to the movies. Nobody was paying attention," says Lynn Turner, the former chief accountant at the SEC who now teaches at Colorado State University's Center for Quality Financial Reporting. "Now it's like walking out of the movie theater and into reality again. There's a real getting back to basics."

In the wake of the massive accounting scandals, companies are putting much more detailed information into their footnotes and in their disclosures in their annual proxy statements. Although some of that is probably designed to protect companies from future investor lawsuits, this greater level of disclosure also benefits investors at all levels of sophistication—from novice to expert. Still, all of this additional information doesn't mean very much unless we take the time to read it.

For example, General Electric Corp., which has long been considered by many professional investors to have some of the most confusing financial statements, provided its investors with 57 percent more pages of financial information in its 2002 10-K than it did in its 2000 filing, the year before Enron imploded. During that time, the number of pages devoted to footnotes increased by over 20 percent.

For all of the companies in the Dow 30, the average number of pages devoted to footnotes in their 10-Ks grew 23 percent between 2001 and 2002 and was up 77 percent from five years earlier. (See Exhibit 1.2.) Companies also are disclosing much more information in the footnotes to their 10-Qs, some of which are now almost as long as 10-Ks used to be. Dick Weiss, who co-manages the $2.5 billion Strong Opportunity Fund, says that 10-Qs never used to provide him with much useful information, but he's noticed a significant change in recent years.

This growth trend seems likely to continue. Indeed, a survey by *CFO* magazine in August 2002 found that 59 percent of the senior financial executives surveyed already had begun to disclose more information in their financial statements over the past three months; 72 percent of that increased disclosure took place in the footnotes.[2] Asked whether they planned to disclose more information over the next 12 months, 57 percent of executives answered yes, and 70 percent indicated that the additional disclosure would take place in the footnotes.

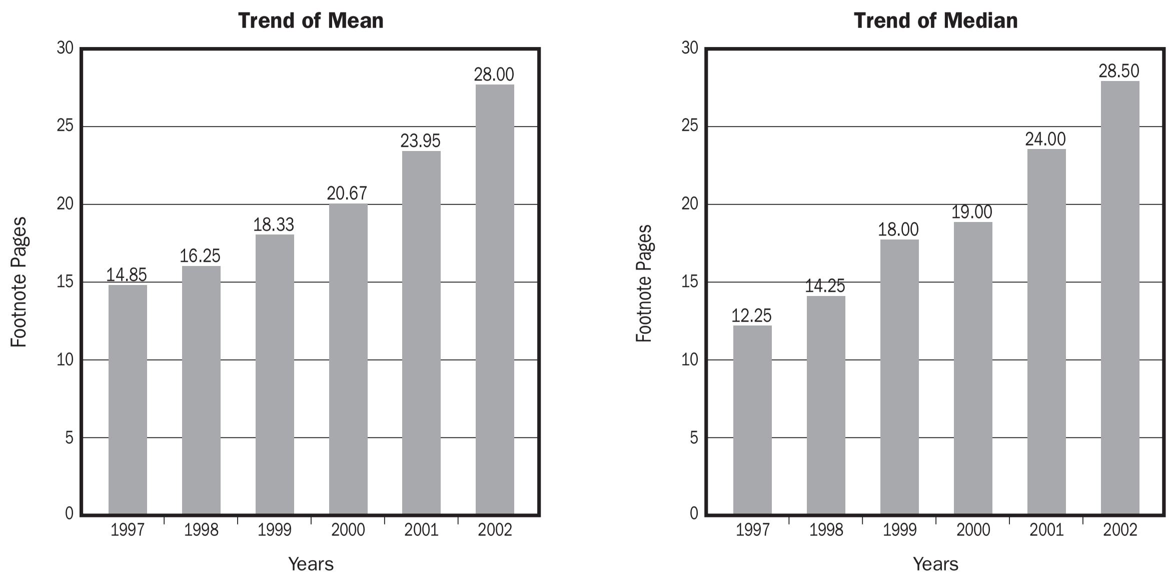
That sharp increase has prompted many professional investors to devote dozens of hours to reading and analyzing these additional pages of disclosure before making an investment decision.

"I want those Ks and Qs read from the back," says J. Thomas Madden, vice chairman for investment management at Federated Investors, which manages about $25 billion. "I want you to read the footnotes first. If you go to one less analyst conference sponsored by some [Wall] Street firm in order to sit in your office reading footnotes and asking tough questions about what those footnotes do and don't say, you're going to be much more likely to catch the next problem."[3]

Even for those relatively new to investing, reading the footnotes isn't as daunting as it might seem at first blush. Yes, the type

EXHIBIT 1.2

Trends in the Number of Pages for Footnotes in 10-Ks for Dow 30 Companies



The median number of pages devoted to footnotes has doubled between 1998 and 2002 for the companies in the Dow 30.

is small and the words may seem unfamiliar. But don't let that stop you. First, there's no need to read the footnotes word for word. As you'll see throughout this book, there are ways to take shortcuts and still get a sense on whether a company is being overly aggressive when it comes to the numbers it is reporting. Simply looking at the interest rate that a company uses to calculate its pension assets—something that takes a few seconds at best once you know where to look—can tell you whether a company is likely to be aggressive in other areas too. (For a more complete discussion of pensions, see Chapter 7.)

If you're a typical investor, you probably assume that the generally accepted accounting principles, or GAAP, which companies follow when reporting their results, are ironclad rules that leave little room for interpretation. But in reality, these "rules" leave lots of wiggle room for companies looking to take a more aggressive approach when it comes to their accounting practices. In a nutshell, earnings as defined by GAAP require a company's management to make all sorts of assumptions that can have a sizable impact on revenues and expenses, producing very different numbers if those assumptions are wrong. As a result, two identical companies (assuming there were such a thing) could report vastly different results, simply by making different assumptions as allowed under GAAP, notes Thornton "Ted" Oglove. Oglove's groundbreaking 1987 book, *Quality of Earnings*, described the many ways that public companies manipulate accounting rules to present their financial results in the best possible light.

"Companies are legally manipulating their earnings and nobody is ever going to be able to stop them from doing it," says Oglove. "Management whitewashes everything."

For example, Tyco International, the conglomerate whose chief executive officer and chief financial officer were charged by federal prosecutors with orchestrating a $600 million fraud, announced in December 2002 that it had done nothing more than engage in "a pattern of using aggressive accounting."[4] Investors who had taken the time to read Tyco's footnotes in earlier SEC filings might have been able to pick up on unusual accounting patterns related to the company's many acquisitions. In 1998, for example, Tyco disclosed that it had spent $4.2 billion to acquire different companies and then also disclosed that it had written off $4.1 billion in goodwill and other merger-related expenses.[5] In later years, these numbers only grew larger.

Getting a handle on the nuances of GAAP and its thousands of pages of rules is simply too much for most investors, even for many pros. What individual investors can learn, however, are the techniques that companies use to present their earnings and other so-called headline numbers—the numbers that most often appear in news reports—in the best possible light.

Weiss, of the Strong Opportunity Fund, says he's seen companies report a 25 percent increase in operating earnings to investors, only to do some quick calculations after the 10-K or 10-Q came out and realize that the company's results were actually negative. "You can have a company report good results, but then you start doing adjustments and you realize that things aren't as they seem," says Weiss.

Some people want you to believe that reading 10-Ks and 10-Qs is next to impossible, that you need to have a background in finance, be a certified public accountant, and have a solid understanding of the many accounting rules put out by the Financial Accounting Standards Board (FASB). None of that would hurt, of course, but chances are that anyone who's telling you that reading the Ks and Qs is too difficult has a vested interest in keeping you uninformed. If that's the case, you had better hope that you're paying that person enough money to read these filings for you.

Even as Ks and Qs continue to grow in size and complexity, it shouldn't take more than an hour to skim a K once you understand what you're supposed to be looking for. A typical Q should take about 15 minutes. To figure out whether this is worth your time, just think about how much an hour of your time is normally worth. Chances are that an hour spent reading a K and spotting potential problems will more than pay for itself.

These reports are accessible online from many different web sites, including *www.10kwizard.com*, a good site because it enables investors to skip to the footnotes quickly, as well as the SEC's own site *www.sec.gov*. In addition, many companies post the reports on their own corporate web sites or provide links to other sites that enable investors to access the filings.

While there are many different techniques for reading a 10-K, depending on an individual's investment style, many professional investors start reading these filings from the back to the front, reading the footnotes even before they read the financials. By skimming the footnotes for red flags, such as aggressive accounting policies, as was the case with Tyco, many pros are able to make a quick decision on whether it pays to invest additional time on research.

"We're much more interested in what the numbers mean, rather than what the numbers are," says Marty Whitman, co-chief investment officer of the Third Avenue Value Fund and a longtime critic of aggressive accounting. "It's sort of a translation thing. The audited financial statements do not and cannot be expected to tell us the truth. We use them as tools to discover our own version of the truth."

Jim Chanos, a New York–based hedge fund manager who was one of the first professional investors to bet big money that Enron was a house of cards, uncovered many of the company's problems by reading the footnotes in Enron's SEC filings.

"Earnings as defined in the U.S. are subject to lots of assumptions that management can make. In order to figure out those assumptions, you have to go beyond the earnings to the financial statements and then beyond that to the footnotes to understand what assumptions management is making," says Chanos. "Just looking at the balance sheet, cash flow, and profit and loss statement is not enough anymore. Too many companies are putting too much information into their footnotes."