IN THIS CHAPTER

- » Understanding what investment banking is
- » Recognizing the critical role investment banking plays in the capital formation process
- » Discovering how investment banking compares with traditional banking
- » Finding out how investment banking operations make their money
- » Looking at the different types of investment banks and what they do

Chapter 1

Introducing Investment Banking

If you're like most people, when you hear the term *investment bank*, one of a few things may cross your mind. Your eyes may glaze over as you think about mind-numbingly detailed financial statements and valuation metrics. Yawn. Or, you may think of exciting high-stakes financial maneuvers, like those out of the movie *Wall Street*, where well-dressed bankers treat companies like Monopoly squares to be dispassionately bought and sold.

But maybe you're attracted to investment banking by the mental gymnastics required and the promise of big bonuses and riches to those who are in the know. And that may be why you picked up this book.

As you can see, there are many preconceived notions about investment banking and investment bankers. Many of these ideas, though, are often pieces of fiction blended with stories of larger-than-life personalities of high finance that spill out of the pages of the money section of financial publications.

In this book, we tell you what *really* happens in the investment banking world. This chapter introduces you to the high-level reality of what investment banking is. Here, you see how Wall Street really works. In this chapter, you see that although investment banking can be extremely lucrative, it's also an important facilitator of economic growth and traces its roots to the idea of putting money into the hands of the dreamers and creators.

What Investment Banking Is

If you're like most people, you probably figure investment banking got its start in a towering office skyscraper in New York City. But the real story of the origin of investment banking is far less metropolitan, yet arguably even more interesting. Investment banking traces its roots to the age of kings and queens. Many of the most commonly used financial instruments trace their origins to centuries ago when bankers navigated the edicts of rulers and, believe it or not, religious leaders. If you're interested in the very early days of investment banking, check out the appendix for a quick history lesson.

But for now, just know that investment banking is, at its very core, pretty straightforward. Investment banking is a method of controlling the flow of money. The goal of investment banking is channeling cash from investors looking for returns into the hands of entrepreneurs and business builders who are long on ideas, but short on bucks.

REMEMBER

Investment bankers raise money from investors, by selling securities, and then transferring that money to people who need cash to start businesses, build buildings, run cities, or bring other costly projects to reality.

There are many aspects of investment banking that muddy this fundamental purpose. But in the end, investment bankers simply find opportunities to unlock the value of companies or ideas, create businesses, or route money from being idle to having a productive purpose. (In Chapter 2, you discover the purpose of investment banking.)

The role investment banking plays

Investment bankers get involved in the very early stages of funding a new project or endeavor. Investment bankers are typically contacted by people, companies, or governments who need cash to start businesses, expand factories, and build schools or bridges. Representatives from the investment banking operation then find investors or organizations like pension plans, mutual funds, and private investors who have more cash than they know what to do with (a nice problem to have) and who want a return for the use of their funds. Investment banks also offer advice regarding what investment securities should be bought or the ones an investor may want to buy.

TIP

One of the trickiest parts of understanding investment banking is that it's typically a menu of financial services. Some investment banking operations may offer some services, but not others.

The services offered by investment banks typically fall into one of a few buckets. One of the best ways to understand investment banks is to examine all the functions that some of the biggest investment banks perform. For example, Morgan Stanley, one of the world's largest investment banks, has its hands in several key business areas, including the following:

- **Capital raising:** This part of the investment banking function helps companies and organizations generate money from investors. This is typically done by selling shares of stock or debt.
- **Financial advisory:** In this role, the investment banking operation is hired to help a company or government make decisions on managing their financial resources. Advice may pertain to whether to buy another company or sell off part of the business. A common business decision tackled by this type of investment banking is whether to acquire another company or divest of a current product line. This is called *mergers and acquisitions* (M&A) advisory.
- **Corporate lending:** Investment banks typically help companies and other large borrowers sell securities to raise money. But large investment banks are also frequently involved in extending loans to their customers, often short-term loans (called *bridge loans*) to tide a company over while another transaction is in the works.
- **Sales and trading:** Investment bankers are a creative and innovative lot, in the business of constructing financial instruments to be bought and sold. It's natural for investment bankers to also buy and sell stocks and other financial instruments either on the behalf of their clients or using their own money.
- **Brokerage services:** Some investment banking operations include brokerage services where they may hold clients' assets or help them conduct trades.
- **Research:** Investment banks not only help large institutions sell securities to investors, but also assist investors looking to buy securities. Many investment banks run research units that advise investors on whether they should buy a particular investment.

TIP

The terms *investments* and *securities* are pretty much interchangeable.

- **Investments:** Investment banks typically serve the role of a middleman, sitting between the entities that need money and those that have it. But periodically, units of investment banking operations may invest their own money in promising companies or projects. This type of investment, often made in companies that don't have investments that the public can buy, is called *private equity.*

REMEMBER

Investment banking operations at one firm may be engaged in some of the preceding activities, but not all. There's no rule that demands investment banking operations must perform all the services described here. As investment firms grow, though, they often add functions so they're more valuable to their clients and can serve as a common source for a variety of services.

How investment banking differs from traditional banking

The critical part of the investment banking process is in the way cash is funneled from the people who have it to the people who need it. After all, traditional banks do essentially the same thing investment banks do — get cash from people who have excess amounts into the hands of those who have productive uses for it.

Traditional banks take deposits from savers with excess cash and lend the money out to borrowers. The main types of traditional banks are *commercial banks* (which deal primarily with businesses) and *retail banks* (which deal mostly with individuals).

The difference between traditional banks and investment banks, though, is the way money is transferred between the people and institutions that need it and the ones who have it. Instead of collecting deposits from savers, as traditional banks do, investment bankers usually rely on selling *financial instruments* (such as stocks and bonds), in a process called *underwriting.* By selling financial instruments to investors, the investment bankers raise the money that's provided to the people, companies, and governments that have productive uses for it.

Because banks accept deposits from Main Street savers, those deposits are protected by the Federal Deposit Insurance Corporation (FDIC), which guarantees bank deposits. To protect itself, the FDIC along with the federal government puts very strict rules on banks to make sure they're not being reckless.

On the other hand, investment banks, at least until the financial crisis of 2007 (see the appendix), were free to take bigger chances with other people's money. Investment banks could be more creative in inventing new financial tools, which sometimes don't work out so well. The idea is that clients of investment banks are more sophisticated and know the risks better than the average person with a bank account.

REMEMBER

The meaning of the term *investment bank* got even more unclear after the financial crisis that erupted in 2007. Due to a severe shock to the bond market, many of the dedicated investment banks went out of business, including venerable old-line firms such as Lehman Brothers and Bear Stearns, or were bought by banks. Many of today's largest investment banks are now units of banks or technically considered commercial or retail banks, although they still perform investment banking operations. Meanwhile, these banks will often say they perform investment banking functions. The term *investment bank* is somewhat of a misnomer, because the major financial institutions are now technically considered banks.

Now that you see that the chief role of investment banks is selling securities, the next question is: What types of securities do they sell? The primary forms of financial instruments sold by investment banks include the following:

- **Equity:** If you've ever bought stock in a company, be it an individual firm like Microsoft or an index fund that invests in companies in the Standard & Poor's (S&P) 500, you've been on the investor end of an equity deal. Investment bankers help companies raise money by selling ownership stakes, or *equity,* in the company to outside investors. After the securities are sold by the investment bank, the owners are free to buy or sell them on the stock market. Equity is first sold as part of an equity offering called an *initial public offering* (IPO).
- **Debt capital:** Some investors have no interest in owning a piece of the company, but they're more than willing to lend money to it, for a price. That's the role of debt capital. Investment banks help companies borrow money by issuing bonds, or IOUs, that are sold to investors. The company must pay the prearranged rate of interest, but it doesn't give up any ownership of the company. If a company falls onto hard times, though, the owners of the debt have a higher claim to assets than do the equity owners if a liquidation of the company is necessary.
- **Hybrid securities:** Most of what investment banks sell can be classified as either debt or equity. But some securities take on traits of both, or are an interesting spin on both. One example is *preferred shares,* which give investors an income stream that's higher than what's paid on the regular equity. But preferred shares don't come with as high a claim to assets as bonds, and this income stream can be suspended by the company if it chooses.

The services investment banks provide

Investment banks do much more than just raise capital by selling investments. Although selling securities to raise money is arguably the primary function of investment banks, they also serve several other roles. All the functions of investment banks typically fall into one of two primary categories: selling or buying.

- **The sell side:** Investment banks are best known for the part of their business that sells securities, or the *sell side.* This function of the investment bank is responsible for finding investors to buy the securities being sold, which raises the money needed by businesses and governments to grow and prosper.
- **The buy side:** Investment banks may also take the role of advising the large investors who are interested in buying financial instruments. Serving in its role on the buy side, the investment bank can offer suggestions to large institutional investors like mutual funds, pension plans, or endowments on which securities may be appropriate for it to buy in order to meet return targets.

WARNING

The dual role played by investment banking operations, serving both buyers and sellers of securities, raises constant worries of double dealing and conflicts of interest. Some people rightly question whether it's possible for the same investment bank that makes money selling shares of an IPO, for instance, to give honest and unbiased investment advice to investors trying to decide whether they should buy or sell. The question of conflicts of interest in investment banking operations has become paramount since the financial crisis began in 2007.

How investment banks are organized

Investment banks may seem like financial behemoths that have their hands in just about any matter that involves large sums of money. And to a large degree, that's true. Investment banks are usually involved in some fashion when it comes to financing major projects, conducting trading in financial instruments, or developing new ways to generate capital.

With that said, nearly all major investment banks divide their operations into several key areas, including the front office, middle office, and back office. When you talk to someone about investment banking, or even listen to the heads of investment banks talk, they'll often refer to these three common parts of a traditional investment bank:

- **The front office:** The *front office* is exactly what it sounds like. It's not only the part of the investment bank that sells investments, but also the part that courts companies looking to do deals. Traditionally, companies that are looking to find a fast way to turbo-charge growth may think about buying another company (say, a rival with similar customers or complementary technology).

  From the front office, investment banks help usher along the M&A process by pairing up buyers and sellers. The front office is also the part of the investment bank that conducts *trading* (frenetic buying and selling of securities to take advantage of any mispricings — even if the holding period is for only a few seconds).

REMEMBER

Investment banks used to do some trading using complicated mathematical formulas and using the firm's money (not the clients' money). This type of trading is often called *proprietary trading.* Many investment banks used to operate a business where they bought and sold securities themselves. Proprietary trading was quite profitable for investment banks. But most types of so-called prop trading by investment banks were abolished in mid-2015 by the Volcker Rule. The rule is named after former Federal Reserve Board Chairman Paul Volcker. Volcker said risky trading put large financial institutions at risk. Such trading was blamed in part for the financial crisis of 2008. Investment banks will continue to wind down this part of their businesses into the early 2020s.

REMEMBER

Another part of the front office is the part of the business involved in conducting research on companies. The front office often employs sell-side analysts, whose job it is to closely monitor companies and industries and produce reports used by large investors trying to decide whether to buy or sell particular securities. (You can find out more about research analysts in Chapter 2.)

- **The middle office:** The *middle office* of an investment bank is generally out of the limelight. It's the part of the bank with the job of cooking up new types of securities that can be sold to investors. Some innovations in investment banking are useful, but others can wind up putting investors and the markets in general in an unfavorable light. Some of the infamous financial instruments cooked up in the middle office of investment banks that came back to haunt the system include *auction-rate securities* and *credit default swaps.*

TECHNICAL STUFF

Auction-rate securities are debt instruments that promise investors higher rates of return than are available in savings accounts. Instead of selling debt at a prearranged interest rate, the investment bank would conduct auctions, and the rate would be set by a bidding process. That's great as long as there are willing buyers and sellers. But the auction-rate market relied on auctions, many of which weren't successful during the financial crisis that erupted in 2007. Many investors holding the securities found they couldn't sell them because the market had dried up, causing a huge headache for the investors and investment banks. Credit default swaps are tools that allow lenders to sell the risk that borrowers won't be able to meet their obligations. Credit default swaps operate as a form of unregulated insurance policies. These instruments got so complicated, though, that they exacerbated the financial interdependencies between giant financial firms, worsening the financial crisis that erupted between 2007 and 2009.

- **The back office:** The *back office* is the part of the investment bank that is far from the glamour of the front office. It's primarily made up of the systems and procedures that allow investment bankers to gather the data they need to do their jobs well. The back office, for instance, maintains the computer systems used by investment bankers to gauge interest in certain securities and provides traders the ability to make short-term bets on market movements. The parts of investment banking considered more operational in nature tend to fall into the back office.

REMEMBER

Investment banking operations are rarely identical between firms. Some banks and investment banks are engaged in some front-office areas, while others steer clear of them completely. There are also some peripheral areas of business some banks and investment banks include as part of their services that don't fall in one of the traditional "offices." One example of a service that is often grouped in investment banking is *investment management.* In an investment management unit, investment professionals are paid to invest money on behalf of individual clients or institutions.

The current lay of the investment banking land

After the tumultuous changes in the investment banking business following the financial crisis of 2007 through 2009, the entire landscape changed. Following the banking crisis, investment banks needed capital. Some of the most storied investment banks, unable to raise money, merged with other banks or became commercial banks themselves. Suddenly, the financial system was comprised of behemoth banks that have the deposit-taking abilities of banks but also engage in investment banking. The result is the formation of several mega-institutions that many people fear are "too big to fail," including the ones shown in Table 1-1.

TABLE 1-1 Among the Last Banks Standing

Firm	2018 Revenue ($ billions)
JPMorgan Chase	104.0
Bank of America	88.7
Wells Fargo	84.7
Citigroup	65.5
Morgan Stanley	40.1
Goldman Sachs	35.9

Source: S&P Global Market Intelligence

Types of investment banking operations

Insiders in the investment banking business use all sorts of terms, some decidedly derogatory, to classify the players in the business. Some classifications that investment banks fall into include the following:

- **Bulge bracket:** Bulge bracket investment firms aren't the ones that ate too many slices of cheesecake. Instead, *bulge bracket* is a commonly used slang term to describe the biggest of the big investment banking operations. The bulge bracket firms are the behemoths, like the ones in Table 1-1. They have their hands in most areas of investment banking.
- **Boutique:** Boutique investment firms are smaller investment banks and traditional banks that choose to focus on one or a select few areas of the business. Some firms, for instance, focus on selling securities for smaller companies.
- **Regional:** Regional firms typically focus on a particular part of the country. Whereas the bulge bracket firms continually try to grow and take market share from rivals, there seems to be plenty of room for smaller players like these. Some regional firms also often concentrate on a particular type of investment banking service, be it trading services or underwriting of securities.

How investment banks get paid

As you can imagine, although investment banking plays an important role in funding economic progress, there's also lots of money to be made. Investment bankers can't afford those fancy suits if they're not getting paid.

Investment bankers perform services for customers and collect money in a number of ways, include the following:

- **Commissions:** Investment banks sometimes collect fees in exchange for conducting a financial transaction between a buyer and seller. One of the more common forms of commissions is often collected in the brokerage operations by some traditional banks and investment banks. For instance, Merrill Lynch, the brokerage and investment banking unit of Bank of America, charges commissions when purchasing stock for its customers. But that's just a small example.

- **Underwriting fees:** A lucrative area of investment banking generates fees for selling securities in the *primary market* (the collection of buyers' and sellers' interest in trading brand-new securities). When a company sells stock to the public for the first time, for instance, the investment banker who handles the deal, called the *underwriter,* collects a fee. (You can read more about companies selling stock to the public for the first time in IPOs in Chapter 3.)
- **Trading income:** Investment banks usually handle other people's money. But many investment banking operations also include a trading division. This unit attempts to take advantage of temporarily mispriced financial instruments. This high-risk proprietary trading is designed to generate profits for the firm.
- **Asset management fees:** Some investment banks help their clients make decisions on how to invest their money. Investment banks generate asset management fees when they help clients decide which securities they should buy or sell.
- **Advisory fees:** Companies often look to their investment banks for advice, especially in the cases of M&A deals. And in these cases, the investment bankers are brought in to provide in-depth, numerical analysis of a proposed deal. The companies pay substantial fees for this high-level assistance. (Read more about M&A deal making in Chapter 4.)

DISSECTING AN INVESTMENT BANKING OPERATION: USING GOLDMAN SACHS AS AN EXAMPLE

Of all the investment banks, few are as well known — and even as infamous — as Goldman Sachs. The firm's long history in investment banking and its seeming omnipresence in markets around the world cement its recognized role as a premier investment bank.

Remember: It's important to note that Goldman, too, found itself in a world of hurt during the financial crisis, and it had to turn to famed investor Warren Buffett to invest billions to help the company avoid a liquidity crisis. Goldman also borrowed billions from taxpayers, too. Nonetheless, those hoping to learn about investment banking, what it is, and how it works, are well served to look at the way Goldman Sachs structures its business and the size of those pieces, including the following:

- **Institutional client services:** The biggest part of Goldman's business is what it calls *institutional client services.* Here, the firm arranges and helps conduct transactions for clients who want to buy and sell everything from bonds to foreign currencies and commodities, in a process called *market making.* Typically, the clients of this part of the business include big financial institutions, governments, and companies.
- **Investing and lending:** Goldman may consider itself to be an investment bank, but it also makes loan to businesses and governments. Most of the loans Goldman is involved in are long term; they may involve everything from financing real estate deals to building power plants.
- **Investment management:** Here's where Goldman serves the role of helping its clients put their money to work. Goldman offers financial advice to institutions through mutual funds, accounts it manages on behalf of clients, wealth management services, and financial counseling. Goldman serves some very wealthy individuals and families in this part of its business.
- **Investment banking:** This part of Goldman is the one most interesting to readers of this book. Here, Goldman guides companies embarking on M&A, provides assistance in bringing companies public, and conducts financial restructurings.

You can see how the different parts of Goldman rank in order of importance to revenue in the following table.

Business Unit	2018 Revenue ($ millions)	2017 Revenue ($ millions)	2016 Revenue ($ millions)
Institutional client services	13,482	11,902	14,467
Investing and lending	8,250	7,238	4,262
Investment management	7,022	6,219	5,788
Investment banking	7,862	7,371	6,273

Source: Goldman Sachs 2018 annual report

How Investment Banking Is Done

Investment banking isn't just a theory or subject. Investment banking isn't just an economic function, either. Investment banking is a profession that requires the efforts and expertise of armies of trained financial experts. You may have studied English in college, for instance, but you don't "do" English. But you can practice investment banking (which is something you find out about in Chapter 6). At this point in the book, you go from understanding what investment banking is to how it's applied in the business world.

Finding the financial statements

Chocolate factories need milk, sugar, and cocoa to produce their delicious products. But the raw materials used by many investment banking firms is the information contained on the *financial statements.* These documents released by companies provide investment bankers with much of the information they need to start analyzing companies and looking for investment banking opportunities.

But these important documents can't do you any good if you can't find them. That's what you find out how to do in Chapter 6. There you discover tools that make it easy for an expert investment banker to retrieve and find all the relevant data from the financial statements, even information the companies may not realized is as valuable as it is.

Understanding the importance of financial statements and ratios

Investment bankers in the movies may be best known for roaming the concrete alleys of Wall Street, ears glued to their cellphones, constantly on the hunt for deals. But much of the most important work done by investment bankers is done in front of a computer screen, examining rows of numbers and statistics using spreadsheets and other financial analysis tools. In Chapter 7, you find out how to make sense of all the information that's contained in financial statements and why these documents are so precious to investment bankers and vital to their success.

TIP

Investment bankers know it's not necessary to read financial statements from cover to cover like a book. Financial statements, like *For Dummies* books, can be read in sections — you jump to areas that interest you at the time. Additionally, some of the best insights that come from the financial statements result from putting the numbers through the paces by applying financial ratios, which we introduce you to in Chapter 8.

Zeroing in on past transactions

Putting a price tag on companies and other investments is a big part of what investment bankers do. Talk about *The Price Is Right* on a grand scale! Luckily, you don't have to play Plinko and guess what companies are worth. There's no shortage of analysis tools that investors can use to calculate the value of companies. Investment bankers use ratios, such as the price-to-earnings ratio and price-to-book ratio, discussed in Chapter 8, to value companies.

Sometimes, though, the best yardstick of a company's value isn't what an investment banker can calculate, but what the market will bear. Understanding how to obtain and analyze past transactions is one way investment bankers can accurately gauge the value that investors will likely put on a company. In Chapter 10, you see how investment bankers handle the process of studying past transactions, and what that means for the value of investments.

Seeing the value of fixed income

Splashy debuts of new companies and their stocks often grab the attention of individual investors. Who can't resist the success story of an entrepreneur with a dream who brings a company to sell shares to the public for the first time and becomes an instant millionaire? That's the American way.

But although equity IPOs may get all the attention, much of the heavy lifting of the financial markets is done using *fixed-income instruments,* also known as debt. Investment bankers are critical cogs in the process of helping companies borrow money at attractive rates in the bond market. You see the role investment bankers play in the bond market and how fixed income fuels the capitalistic system in Chapter 11.

Turning Into an Investment Banking Pro

Investment banking is one of those disciplines that you can delve into for decades and still not master. There are corners of investment banking that go well beyond the understanding of the capital markets and even the mechanics of gathering information about companies and their needs for investment to continue to grow.

If you're willing to put in the time and effort, you can discover very profound ways to understand companies, how they're valued, and the ways they use financial engineering and investment banking products to maximize their returns.

Putting the discounted cash flow analysis to work

When it comes to the top skills that serious investment bankers must hone, the discounted cash flow analysis is certainly high on the list. The *discounted cash flow* is a culmination of many of the tools beginning investment bankers have to create in-depth and comprehensive models of what companies are worth.

TIP

The concept of a discounted cash flow may be something you can learn in school. But it's the assumptions and the quality of the inputs embedded in the analysis that make this technique essential to the investment banker. In many ways, investment bankers can show off everything they know when they create a detailed discounted cash flow analysis, which you find out about in Chapter 12.

Seeing how leverage becomes a force in investment banking

Light a stick of dynamite, and you pretty much know what's going to happen. Bang! But sometimes that explosive power can be used to build as well as to destroy. Explosive power can be used to clear mountains to make way for freeways or tunnels. But dynamite can have some predictable negative uses, too.

In many ways, the use of debt, in a process called *leverage*, can be much like dynamite. When used prudently, leverage can be a creative force that gives companies the power to grow and create wealth faster than they would have otherwise. But at the same time, leverage can be abused and lead to great destruction of wealth, jobs, and enterprise. The graveyard of companies is littered with examples of businesses that lit the leverage bomb and didn't know how to harness the power.

In Chapter 13, you see how investment bankers can prudently apply leverage to deals as a way to get very positive results. Success with leverage requires extreme caution, knowledge, and discipline.

Pinpointing buyout targets

Investment bankers often find themselves playing the role of a corporate matchmaker. A big part of the job description is finding new ways to raise money and help companies restructure themselves in a way that makes them more profitable for their owners.

There are many tools companies can use to boost profits, one of which is pushing along M&A deals. Sometimes the investment bankers are contacted by a company eager to sell themselves by looking for so-called *strategic alternatives.* But other times, the investment bankers are called on by big companies with money to burn looking for a deal. The big companies in the hunt call investment bankers to help identify and court targets.

Investment bankers, in large part, are hired due to their contacts in the business community and their ability to use financial modeling analysis to find deals that make economic sense. In Chapter 14, we explore many of the tools used by investment bankers to identify companies that are ripe for a buyout and discover ways to pair them up with the buyers.

Putting Investment Banking to Work

CEOs may be good at the things they do — such as controlling costs, finding new products, tapping new markets, and playing golf — but when it comes to investment banking operations, including tapping investors for money or cooking up M&A deals, CEOs often find themselves well out of their comfort zone.

TIP

Only the largest companies can afford to maintain an in-house staff dedicated to analyzing the company's investment banking options. It's most common for a company's board of directors or top management to contact an investment banking firm to lend expertise.

Because investment bankers are dedicated to being the conduit between companies and investors' money, they're expected to be the experts on all things financial. Investment bankers must be able to go beyond just what a company's management team is telling them in order to independently understand a business situation. Starting in Chapter 15, you discover some of the most advanced skills that the best investment bankers have.

Staying in compliance with the rules

Perhaps the most important thing for investment bankers to do is stay out of jail. And these days that seems to be tougher than it sounds, as regulators are routinely fining investment bankers for not complying with the rules. It's a sensitive area because the investment banking business is filled with rules and regulations. Running afoul of these regulations is usually a one-way ticket to jail, or at least enough to be prevented from engaging in investment banking in the future. You find out how to avoid wearing jailbird pinstripes in Chapter 15.

Looking beyond the published financial statements

Financial statements can sometimes be the only things investment bankers can trust. Company management has a big incentive to puff their chests and try to act like their companies are performing better than they really are. And even investors can be misleading, aggravating for change at the company even if things are going fine.

TIP

Investment bankers must be extremely comfortable diving into the financial statements. These statements, which must adhere to strict rules and be overseen by independent accountants, may be the only unbiased pieces of information that investment bankers get.

But despite the value of financial statements to investment bankers, these documents, too, need to be looked at with at least an ounce — and at times pounds — of skepticism. Although it's not common, executives at companies sometimes attempt to fudge the numbers to mislead investors or (gasp!) investment bankers. When a company's performance is faltering, and investors are likely to be disappointed, some dishonest executives and accountants may decide to distort the financial results through liberal interpretations of accounting or outright fraud.

Individual investors, who may not take the time to read the financials, can often fall for such accounting gimmicks. But investment bankers are held to a much higher standard and are generally considered to be above the tricks. In Chapter 16, you find out some of the ways investment bankers can look for accounting sleight of hand in the financial statements and avoid getting duped.

Making adjustments to financial statements for comparability

Accountants don't like surprises. Some accountants may be startled if a pen they thought had blue ink turns out to be black. But although the predictability of accountants may be subject for good-natured ribbing at cocktail parties, that uniformity is essential in financial analysis.

To accurately compare and contrast companies in different industries — something investment bankers have to do frequently — the companies' financials must be subject to the same ground rules. Accounting rules usually do a pretty good job aligning the financials of different companies. *Generally accepted accounting principles* (GAAP) are a set of accounting standards that attempt to create a measure of performance that is somewhat comparable across industries.

But despite the value of GAAP, it's up to investment bankers to take greater efforts to make sure that the financial results of companies are truly apples-to-apples comparisons.

In Chapter 17, you find out ways that investment bankers are able to modify and adjust the financial results of companies to make their results comparable. These techniques, as well as everything you read about in this book, all come into play when you try your hand at an investment banking analysis case study in Chapter 18.