

Using SEC Filings to Identify Risk Factors

An Interview with Michelle Leder

Article Highlights

- SEC filings should be monitored for signs that the company is being aggressive with how it records revenues or expenses.
- Investors should pay particular attention to SEC Forms 10-K and 10-Q, especially the footnotes in both filings.
- By regularly reading the filings, individual investors can start to pick up on potential warning signs.

Michelle Leder is the founder and editor of footnoted.com, a free website that analyzes company SEC filings. I spoke with Michelle recently about things investors should watch for when reading company reports.

Charles Rotblut, CFA



Charles Rotblut (CR): Could you explain what the U.S. Securities and Exchange Commission (SEC) filings are and which filings investors need to pay attention to?

Michelle Leder (ML): There are a couple of key filings that investors need to pay attention to. And just to be clear, these are filings that investors really need to be paying attention to if they own individual stocks. And when I say “if you own individual stocks,” I mean if it’s a significantly large position for you. If you own a relatively small number of shares, then perhaps you don’t need to spend much time with these filings. But if it’s a significant position for you, I think that it makes sense to read some of these key filings, or at least certainly to skim them.

The first filing to pay attention to is the 10-K, which is the annual report. When I talk about the 10-K or the annual report, what I refer to is very different from the annual report that perhaps investors might have been used to over the years, which is the glossy report with all of the pictures. I joke around often when I’m giving a presentation: It’s the one where the CEO is shaking hands with the janitor and looking like a regular Joe; usually the guy’s in short sleeves and looking like a happy-go-lucky sort of guy. That’s the annual report, but it’s usually different from the 10-K.

The 10-K is often small type, it’s black and white, and there are no real pictures. But there’s a lot of important information in there that that you really need to be paying

closer attention to if you own enough shares. The annual report comes out once a year, obviously.

Then we have the 10-Qs—the quarterly report—and there are three 10-Qs a year. Right now, as we speak in late April, we’re in earnings season. For companies

that are on a December 31 fiscal year, we’re starting to see 10-Qs for the first quarter. The deadline for that is May 10. Over the next two weeks or so, we’re going to see a lot of 10-Qs come in. The quarterly report is much more comprehensive than the typical earnings report.

Most investors make the mistake of just paying attention to what the earnings number is: Company A was supposed to report \$1.00 per share in earnings and it reports \$1.01 per share in earnings. And that is the extent of the attention span that many investors often give. I feel that that is a very superficial view, and there’s just a lot of detail in the 10-Qs that you should be paying attention to, much more so than just figuring out that the company “beat the number.” The reason is that there are so many ways, quite frankly, to manipulate the numbers, and to get earnings to “beat the number,” that if you’re not paying attention, you can wind up getting burned in the end. And that’s really what this is all about. It’s often about spotting potential problems before they blow up in your face.

When I talk about this, I talk about it from experience. One of the reasons that I got really interested in SEC filings is because I was an ordinary investor (this was about 10 years ago), and I had bought some shares of Qwest Communications—I think at about \$39 a share. I watched as the stock marched up to about \$56, before it started to make a dive. Now, instead of looking at it going from \$39

to \$56 in a relatively short amount of time and thinking, “Hmm, let’s get out; we’ve made a nice little profit; let’s get going,” I thought, “Oh, if it’s \$56, maybe it could be \$64, maybe it could be \$70-something, who knows?”

I also wasn’t paying attention to the filings. Had I spent about an hour reading Qwest filings at the time, I would have gotten out when the going was still good and I would have been able to make money instead of riding the stock all the way down. Unfortunately, by the time I had learned my lesson, I had lost a lot of money. The way I often describe it is that it would have taken me about an hour to skim the filings and see enough red flags in there to avoid the stock or at least get out when the going was good. Had I done that, I feel like I would have been able to avoid this particular problem.

Instead, I used it as a teaching lesson. I learned that if I’m buying a stock, and it’s a significant holding for me, I want to quickly skim the filings and look for certain things, and look to see if I think the company is being aggressive with its accounting. And that’s really where my book—“Financial Fine Print” (John Wiley & Sons, 2003)—sprang from. It talked about the lessons that I learned as an investor from investing in Qwest and not reading the filings: why it’s important to read the filings, why ordinary investors can do this sort of thing and why they can take it on and start to gain a better understanding of what’s really going on.

CR: *What are some of the things you look for in the 10-K or the 10-Q?*

ML: One, I look for significant changes in the accounting policy, whether the company is making a lot of changes to the way it accounts for certain things. In the end, there’s basically two ways that you can manipulate the numbers. You can overstate your revenues, or you can understate your expenses. Of course, that’s a very simplistic view because within that universe, there are thousands of different ways to really manipulate the numbers. But basically you want to look for any kind of signs that the company is engaged in

either of those things—overstating its revenues or understating its expenses. And throughout history there are lots of examples. Enron would be an example of a company overstating its revenues. WorldCom: overstating its revenues. Qwest: overstating its revenues, just being super aggressive on how it was counting every single thing before it really was money in the account. There are also lots of examples of companies understating their expenses or manipulating their expenses in one way or another. Those are the sorts of things that I like to look at. Obviously, there’s a lot of different ways that you can manipulate expenses and revenues, but I think in general that’s sort of what you’re looking for—signs of aggressive accounting.

One of my mentors, [Thorton] “Ted” O’Glove, who wrote an excellent book called “Quality of Earnings” (Free Press, 1998), told me very early on: Imagine you have two identical companies, Company A and Company B. Now, obviously, you never have two identical companies, but let’s just say you do, for argument’s sake. Based on current accounting rules, Company A could report \$0.75 per share in earnings and Company B could report \$1.50 per share in earnings. Now remember that these are two identical companies. So how could one company report such a significant difference in its earnings from the other? The answer is that it’s all based on the accounting rules and the interpretation of those accounting rules: Whether the company chooses to be more aggressive or less aggressive.

I would argue that, especially for long-term investing, you do not want to be in companies that are playing fast and loose with the numbers, companies that are being overly aggressive. You make one false assumption and the stock can just blow up on you; we’ve seen it happen time and time again with a company that just looks like everything is going great. One of my earlier finds was Krispy Kreme (KKD), back when I first started my website, footnoted.com. Krispy Kreme was trading in the \$40s back then; who would have thought that something would have gone wrong and

that the stock would have gone down to \$2? We didn’t predict the \$2, but we said there was something very wrong about the company’s accounting long before others caught on. That kind of accounting is the type of thing that I think investors need to learn how to avoid.

CR: *Where in the documents should investors look—are there any specific things that suggest that the company is being aggressive?*

ML: When it looks like companies are booking revenue, I often joke that it’s like counting their chickens before they’re hatched. A company announces a deal and they book all of that revenue up front. Let’s say they’ve announced a \$100 million deal with XYZ Company. They’re booking all of that revenue at once, even though it’s a multi-year deal. Those sorts of things are obvious red flags, but I think that there are others too. There are many examples of companies that are just playing fast and loose with the numbers. And it’s not always cut and dry.

In accounting, everyone thinks that a number is a number. How could a dollar be anything other than a dollar? That’s sort of your common thinking about it. But if you think about it a little more, there are different ways to count that dollar. And whether the company has an aggressive or non-aggressive chief financial officer, how willing the board of directors is—those are the sorts of things that you need to take into account.

If this is something that you find is too much for you, then perhaps you shouldn’t be in individual stocks. If you’re not willing to take all of these different factors into account, maybe individual stocks are not for you and maybe it makes more sense to have someone else do this for you.

CR: *Are you usually looking at management’s discussion, then, to get a sense of what their accounting policies are?*

ML: As my website might suggest, I really tend to pay attention to the footnotes. I really don’t pay much attention to the management’s discussion because

Common SEC Filings

The U.S. Securities and Exchange Commission (SEC) maintains a database that lists corporate filings by their type, designated by letters and numbers. Here is description of the most common types of filings. A complete listing of all SEC filings can be found at www.sec.gov/info/edgar/forms/edgform.pdf. Filings for individual companies can be found at www.sec.gov/edgar/searchedgar/webusers.htm.

10-K: An annual report that discusses the company's business and annual financial performance. Amended filings are designated as 10-K/A.

10-Q: A quarterly report that discusses the company's business and financial performance. Amended filings are designated as 10-Q/A.

20-F: Foreign companies file these annual reports. The report discusses the company's business and annual financial performance. Amended filings are designated as 20-F/A.

8-K: A "current report" that announces major events that shareholders should know about.

6-K: Similar to the 8-K, but filed by foreign companies, this is a "current report" that announces major events that shareholders should know about.

DEF 14A: The definitive proxy statement, this contains material information about matters subject to a shareholder vote.

S-1: A general form of registration. This is commonly filed by companies looking to complete an initial public offering. The form can be amended several times; those changes are filed under S-1/A.

SC 13G: A notice of a change in beneficial ownership, meaning the acquisition of 5% or more of outstanding stock by passive investors and certain institutions.

13F-HR: A quarterly report filed by institutional money managers that discloses their large holdings.

I find that that's a lot of PR, quite frankly, and a lot of spin. I really tend to pay close attention to the footnotes, and what I'm looking for is how they're describing the way that they're counting those chickens: How are they counting those expenses, what are they doing there and how aggressive are they really being? A very simple example is: How does the earnings release that they're putting out differ from what they're publishing in the 10-K and the 10-Q? If there's a lot of distance between the two of them, that also is a red flag for me.

If a company reports earnings of \$1.25 per share pro forma non-GAAP (generally accepted accounting principles) in the press release—because there are no rules that dictate what you have to say in your press release; you can pretty much say just about anything there—and then you look at the 10-Q and they're reporting earnings of \$0.35 per share once all the GAAP are figured in, I think you need to ask yourself, what's going on here? How is

it \$1.25 in the press release and \$0.35 in the 10-Q, and why is nobody really paying attention to the difference?

CR: *Aside from the 10-K and the 10-Q, are there any other filings that investors should pay attention to?*

ML: I also like to read the proxy statement, and right now we're kind of coming to the tail end of proxy season. The proxy statement gives us a lot of good information on executive compensation. It also gives us a lot of good information on director compensation and on related-party transactions. For me, it was the related-party transactions that really prompted me to look a lot more harshly at Krispy Kreme a number of years ago. Because when I started looking at it, I just said, "Something is not quite right here at Krispy Kreme; they're reporting all these related-party transactions, and it just all looks a bit bogus to me." That's when I said people ought to be paying attention to this sort of thing.

At the time, when I first said this, it was September of 2003. My book, "Financial Fine Print," was a month old, footnoted.com had just launched, and I probably had about four people reading the website, including my mother. And, unfortunately, I proved myself correct on Krispy Kreme.

I guess that's part of my point: I couldn't believe that none of the so-called smart people on Wall Street or off Wall Street were paying attention to these things. It was there in publicly available documents. It's not like you have to file some Freedom of Information Act request or that they're hidden away in some vault somewhere. They're publicly available; you can download them on your computer. They're there for the reading, and yet it seemed like none of the analysts who were following Krispy Kreme, who were rating it a "buy," were really paying attention to this, and it was just amazing to me. I was just a lone blogger in suburban New York. How could these so-called smart

people not be reading these publicly available documents? It was really kind of shocking.

CR: *Are there any differences in filing requirements for a company that is a large cap versus a small cap or micro cap, or for foreign firms?*

ML: The foreign companies have a different filing requirement. They do not file 10-Ks or 10-Qs, they file 20-Fs and 6-Ks. The disclosure requirements are not as significant. So I find that because of that, it's hard to pick up on the subtle signals that perhaps you can with companies that are trading on American exchanges.

In terms of small caps versus large caps, there are different filing deadlines. Large caps are asked to get their filings in quicker than small caps. Also, a company like Apple (AAPL) or General Electric (GE) has hundreds if not thousands of people working on their annual report, on their 10-K. A smaller company—a company with \$400 million to \$500 million in market cap—maybe has five or 10 people working on their annual report, on their 10-K. So, it's going to be much more carefully vetted for a larger company than it is, perhaps, for a smaller company. But that doesn't mean that you don't see obvious red flags at larger companies; I think it's still possible to find those sorts of things. You just have to look.

CR: *You say that an investor can just skim through the filings rather than reading through them, correct?*

ML: Yes.

CR: *And when you are skimming, are there any common warning signs that you see jump out, that cause you to stop and take a closer look?*

ML: Well, as I said, one red flag is if the company is being aggressive on either the revenues or the expenses. And I think it's a warning sign if there are a lot of related-party transactions.

If directors are being paid very high amounts of money for what is essentially a part-time job, that jumps out at me; if a lot of that money is in cash as opposed to stocks, that is a red flag.

I think that there are any number of red flags that could prompt you to take a closer look. Really what this is all about is that you see one red flag and you're kind of like, "Okay, are there more, or is this just a fluke?" That's really what you have to do. A lot of it is learning by doing. Quite frankly, when I first started doing this almost 10 years ago, I didn't really know what I was looking for in SEC filings. But I sat down, and I went through a couple of filings, and I was like, "Oh, this doesn't seem right to me, this seems a little odd to me." I don't hold the CFA designation; I don't have an MBA. I had no expertise in this when I started out, so it has really only been learning by doing. And I think that's the message, that you can be an ordinary investor and kind of pick up on these sorts of things; you don't need to be a super investor. You shouldn't be intimidated by company filings.

CR: *What about the risk factors that appear early in the 10-K? Some of it is boilerplate and I think on your website you had a post about how the Japan disaster was suddenly showing up. But if someone's looking at the risk factors section, how do they determine what's boilerplate and what might be something to really pay attention to?*

ML: Well, I think you get a feel for it. Any time a company discloses that something could be material, you want to pay attention to it. If it's a lawsuit, if it's a particular event, if it's some kind of political unrest, if it's a Deepwater Horizon sort of thing—those are things that you want to pay attention to, because they could be potentially significant. That's really what it's all about: trying to find these things before something blows up in your face, before you see a stock that you own go from \$56 down to \$3. That's not where you want to be.

CR: *Is there anything that's been particularly obnoxious or bizarre that you've seen when reviewing these files?*

ML: Well, there are a lot of examples. One of my favorites was a disclosure last year where the chief executive officer of Abercrombie & Fitch (ANF) got millions of dollars not to use the corporate jet as much. He was a big frequent flier, and a lot of these top executives make frequent personal use of the corporate jet. Now, I don't have a problem if you're based in California and you've got a meeting in New York and you want to hop on the corporate jet. Because let's face it, air travel these days is cumbersome, it's annoying and it's a giant waste of time. But for personal trips, if you have to be in New York for the weekend because your wife wants to shop the latest at Bloomingdale's, and if you're using shareholder money to do that, I have a problem with that. These disclosures about personal use of the corporate jet or a company leasing a corporate jet that happens to be owned by the CEO of the company, I find these sorts of things particularly obnoxious.

I also see examples of companies covering the purchase of an executive's house. This was another example at Qwest—the CEO was moving from San Francisco to Denver and the company spent close to \$3 million dollars buying his house in San Francisco. Then, because of the real estate market, the company wound up taking a significant loss on the house. Now, shareholders should not have to bail out the CEO—that's not, in my view, a great use of funds. If I buy a house in a particular area, and the house goes down in value, that's what capitalism is all about. Why are we protecting some of these top executives from the vagaries of the market? My house right now is not worth what it might have been four or five years ago, but I don't expect Morningstar to make up the difference now that footnoted.com is part of Morningstar. ▲

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