LIPPER HEDGEWORLD NEWS

The Short Story May Be All in the Footnotes

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Fresh out of ideas for stocks to short? Inspiration may be in plain sight, provided you have the time and inclination to decipher blocks of financial fine print.

Alternatively, you could pay someone to do it for you. The independent risk research firm RateFinancials, which bases its business on sifting through public companies' financial reports, this week released a study in which it identifies 50 companies with questionable financial statements—and concluded that companies demonstrating poor accounting and corporate governance practices underperformed the Standard & Poor's 500 Stock Index by 11% in 2005.

"We know their reported earnings many times are not reflective of the true nature of the company … there's noise," said Victor Germack, founder and president of the RateFinancials, in an interview. His firm looks at the composition of the company's earnings and cash flow and whether the accounting policies have changed, whether anything has been sold off or there is a one-time gain. "We live in the footnotes," he said.

For the 2005 study, RateFinancials pooled the companies it rated low between July 1, 2004, and Dec. 31, 2005 and examined the share price difference throughout 2005. From there the firm looked for deviation between reported earnings and normalized earnings by reconstructing the balance sheet, factoring in items like operating leases and fixed future obligations and examining cash flow management; accruals are evaluated, as are accounting policies (whether conservative or aggressive), until a clear economic picture of the company begins to take shape. The end results, according to the company, show whether the reported company financials present a clear picture of the company's economic position or reflect future value creation.

RateFinancials, established in 2002, doesn't speak to the management of the rated companies. The firm doesn't make recommendations and doesn't have any trading operations, nor is it related to any trading businesses, Mr. Germack said. What it does do is provide this information to its clients, mostly made up of hedge funds, long/short shops, state pension funds and credit reporting agencies. It's up to them to figure out whether this information has been factored into the stock price and how it fits into their trading strategies.

"We try to present the facts as we see them," he said. "I believe we are as close to unbiased research as you can possibly get."

That's not always the perspective of the company that's being rated, however. RateFinancials did its first report on Calpine in July 2004, when the San Jose, Calif.-based power producer's stock was trading in the five dollar-plus range; the report found that Calpine wouldn't be able to fully fund its fixed charges without additional borrowing. In response, Calpine blasted RateFinancials in a press release, accusing "bias" and spreading "significantly misleading information."

Mr. Germack's firm was ultimately vindicated. After its stock declined by 94% through most of 2005, Calpine filed for bankruptcy in December Previous HedgeWorld Story.

It remains to be seen whether any of the companies identified in the 2005 report as having poor earnings quality and shaky corporate governance—among them General Motors, Ford, Jupiter Media and Helen of Troy—will object to RateFinancials' findings. But it doesn't appear as though the firm will run out of material anytime soon. Mr. Germack noted that approximately 1,200 companies restated their earnings in 2005, nearly twice the number that did so in 2004, and he added that financial restatements generally are a prelude to declining share prices.

While Mr. Germack is hesitant to say what's driving the increase in financial restatements—he attributes it in part to the institution of the Sarbanes-Oxley Act and auditors digging deeper into their clients' statements—he did note that 81% of the financial restatements in 2004 involved companies with a market capitalization of US$1 billion or less. "What that tells me is these small and mid-cap companies probably don't have the financial infrastructure in place to really begin to pinpoint these issues, or the procedures," he said.

Firms like RateFinancials may be on the cusp of a growing industry built around analyzing financial statements. Michelle Leder, a business journalist for 10 years and author of a book on the subject called *Financial Fine Print*, said that companies possibly are trying to be more forthcoming in the wake of corporate governance scandals at Enron and Tyson

Foods—though that doesn't mean financial statements will get any easier to read.

"There has definitely been growing research in this area," said Ms. Leder, who updates her blog, Footnoted.org, daily with tidbits she finds while perusing filings. Her most celebrated exposé was in September 2003, when she raised an eyebrow at a questionable deal made for a handful of Krispy Kreme stores in Texas and Louisiana by former executives. At the time, Krispy's stock was trading in the US$40 range.

"I think the general feeling is that nobody thought these were items that impacted performance … why would you look for something when you have no evidence it would have any impact?" Ms. Leder said. She noted that typical sell-side researchers cover 10 to 15 companies, a lot of financials to dig through for researchers who aren't looking for negatives anyway. Buy-side researchers, on the other hand, typically cover 100 to 150 companies.

More attention is starting to be paid to the issue, however. One of the first studies on the relationship between questionable corporate governance and performance was done in early 2004 by New York University Stern Associate Professor of Finance David Yermack, who found that companies allowing their chief executives to make personal use of company aircraft underperformed the market by approximately four percent. "If you sold short companies that give this perk and bought all other companies, you would really clean up," Mr. Yermack told *NYU Today* at the time of the study's publication.

Ms. Leder tends to agree. In mid-January she posted on her site about an unusual disclosure in a filing by Chicago Bridge & Iron Co., released on a Friday morning. The following Monday, the stock went down almost 30%. "That's an example of something in a filing that you could use to your trading advantage," she said.