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VALUE WIZARD INSIGHTER - January 2000

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1. Quality of Earnings

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The quality of earnings is contrasted with the reported quantitative amount of earnings. Quality can refer to accounting methods, earnings management, or deceptive reporting. A company that adopts aggressive accounting methods with no conservative balance, manages its reported earnings rather than its operations to create consistent growth, or practices misleading reporting can also impair the image of the company and its common stock.

An example of questionable accounting practices can be found in IBM's third quarter 1999 report. The following data is from the Income Statement and from the Notes to Consolidated Financial Statements in the Form 10-Q filing dated 11/12/99 from FreeEdgar.com using the ticker symbol IBM.

(Dollars in millions Nine Months Ended Nine Months Ended  
except per share amounts) September 30, 1999 September 30, 1998

Total revenue	\$63,366	\$56,536
Total cost	40,320	35,473
Gross profit	23,046	21,063

Operating expenses:		
SG&A	10,284	11,588
R&D and engineering	3,857	3,639
Total operating expenses	14,141	15,227
Operating income	8,905	5,836
Other income	423	402
Interest expense	556	500
Income before income taxes	8,772	5,738
Income tax provision	3,149	1,756
Net income	5,623	3,982
Preferred stock dividends	15	15
Net income applicable to common shareholders	\$5,608	\$3,967

(The accompanying notes are an integral part of the financial statements.)

To find the notes, go to the Body: (Entire Filing) and use the browser search feature.

#### Notes to Consolidated Financial Statements.

6. The third quarter 1999 results include a pre-tax benefit of \$201 million (\$63 million after tax, or \$.03 per diluted common share) related to the sale of IBM's Global Network, actions within the company's Technology Group, and charges for acquired in-process research and development related to three purchase acquisitions.

**Sale of the Global Network.** In December 1998, the company announced that it would sell its Global Network business to AT&T for \$5 billion. The IBM Global Network generated revenues of approximately \$1.2 billion in 1998.

During the third quarter of 1999, the company completed the sales of its Global Network business in 34 countries for approximately \$727 million, bringing the year-to-date total to 38 countries and \$4,919 million. More than 5,100 IBM employees joined AT&T as a result of these sales.

The company recognized a pre-tax gain of \$586 million on the third-quarter sales (\$366 million after tax, or \$.19 per diluted common share). The net gain reflects dispositions of Plant, rental machines and other property of \$62 million and contractual obligations of \$79 million.

An article in The Wall Street Journal dated November 24, 1999, page C1, entitled "IBM's Accounting Method Faces Scrutiny : One-Time Gains Raises Questions" discusses IBM's unusual choice of accounting for non-operating income.

Reported revenues grew by 12% from \$56.5 to \$63.4 billion while operating income grew by 53% from \$5.8 to \$8.9 billion. Very impressive until you read the footnotes where it is disclosed that IBM recorded as revenue about \$4.9 billion in non-operating gains from its sale of a subsidiary group and included these one-time gains in selling, general and administrative expenses (SG&A). The effect of this accounting treatment of these non-recurring gains is to reduce reported costs and thus increase reported operating income.

As the WSJ article states, the treatment of one-time gains is important because operating income is more important to investors than net income. Operating income excludes taxes, interest and other items that have little to do with success in making and selling products or services, and it reflects how well management is running the things under its direct control. Net income includes taxes, interest, foreign-exchange translations, M&A's, and other things not under the control of management.

The emphasis on reported numbers as opposed to the interpretation of reported numbers recalls the investor-specific circle of competence. Each investor must go from what the numbers are (data) to his or her interpretation of what the numbers mean (information). There are books cited in the Global Value Investing Books & Links section that discuss financial reporting and accounting shenanigans.

This example also illustrates two important stock valuation issues. First, the use of either data or information from public sources is always subject to scrutiny of original documents to identify any misleading accounting and reporting practices. Taking such data or information at face value is imprudent for the individual intrinsic value investor. Second, commercial company financial databases offer the convenience of quick and easy computerized access to standardized data on public companies, but every such standardization must be based on one chart of accounts to serve all needs and all users. Such adjusted and sanitized data still cannot be taken at face value.

If an analysis of standardized data looks promising for a subject company valuation, then the next step is to repeat the analysis with the data and information in the original documents filed with the U.S. Securities and Exchange Commission. Secondary sources of company financial data and information, whether merely reformatted for improved readability or standardized for computerized access, are preliminary at best. No stock valuation is complete without detailed scrutiny of the relevant original documents.

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## 2. Marketable Securities

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The universe of investment opportunities of greatest practical interest consists of securities that are traded in organized markets and that are issued by companies that provide regular financial reports to public regulators. In addition, the focus is on common stock equities rather than bonds, commodities, and options or other derivatives. In the United States, this opportunity set is composed of the companies that submit the Annual Report to Stockholders on Form 10-K to the Securities and Exchange Commission (SEC). These and other documents filed with the SEC are available through the EDGAR database which is accessible on the Internet free of charge.

In academic finance, Modern Portfolio Theory and the Efficient Markets Hypothesis are the basis for p-r-i-c-i-n-g models as opposed to valuation models. Pricing models presume that investor expectations are homogeneous because all investors have access to the same information at all times. This and similar unreal assumptions are necessary in order to make the pricing models mathematically tractable. The first conceptual problem with universal omniscience of price-related

information is that market-generated and company-generated data is not information. Useful information results from the interpretation of mere data. It is not what the numbers are, but rather what the numbers mean, that matters.

The diametrically opposite assumption is made for valuation models based on intrinsic value determined from estimated expected dividends or free cash flow to the common stock equity owners' account. Investor expectations are heterogeneous and investor-specific because each investor has his or her own circle of competence. And within each investor-specific circle of competence, there will be a unique investor-specific interpretation of the facts.

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### 3. Global Opportunities

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An investor can invest both in local companies (headquartered in his or her home country) and non-locally (headquartered outside his or her home country). The term foreign is relative to the investor and thus ambiguous. The purposes of investing in the common stocks of non-local companies are more choice and greater diversification. An investor can gain both access to a wider opportunity set of common stocks and exposure to a wider variety of economies on which common stock investments depend.

There are three ways to obtain such diversification. First, invest locally in local multinational companies that have operations in both local and non-local economies and currencies. Second, invest locally in non-local companies that have their common stocks traded as global depository receipts (GDRs). Third, invest non-locally in non-local companies through non-local stock exchanges or bourses.

There are two kinds of GDRs, sponsored and non-sponsored. Sponsored GDRs provide more reliable forwarding of company financial reports and dividend distributions.

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