

Are You Meeting Your Fiduciary Duties?

By Raymond M. Mullaney – April 9, 2024

Are the companies your clients hold becoming **stronger and more durable** or **riskier and less durable**? Consider the following essential accounting factors and analytical insights:

1. **Capital Structure Analysis:** Analyze the various sources of a company's capital. How much came from their IPO? How much came from stock options exercised by insiders? From a secondary offering? From the sale of assets? From net profits? From other sources? Each source has different implications for the company's financial health.
2. **Use of Proceeds:** Determine how investors' capital was used. Insider compensation? Stock buybacks? Reinvestment in long-term assets, research and development? Investments in high-risk intangible assets may prove fruitless in the long term.
3. **Depreciation and Amortization:** Non-cash expenses reduce the book value of tangible assets, reflecting their consumption and loss of value as they are used in operations. Yet, some assets which are depreciated for accounting purposes increase in "real" value over time.
4. **Impairment Losses:** A company may have recognized impairment losses on its assets, which reduces the carrying value of those assets on the balance sheet. This could be due to changes in the business, market conditions, or asset obsolescence. Considerable historic macro data suggests that the great majority of "intangible assets" eventually turn into "impairment losses", thus reducing book value.
5. **Net Income/Losses:** Persistent net losses erode equity and tangible value.
6. **Dividend Payments:** Dividends reduce retained earnings and overall equity.
7. **Share Repurchases:** Stock buybacks are a common corporate strategy, as they frequently drive up the company's share price in the short term. However, the evidence is inconclusive on whether this strategy results in long-term increases in shareholder value.
8. **Financial Statement Footnotes:** Review the notes accompanying the financial statements for details on equity transactions, asset valuations, and other relevant information.
9. **Market Value vs. Book Value:** All values change, sometimes very significantly. Book value of equity is neither a conservative nor realistic number.
10. **Liquidity and Solvency:** Assessing a company's liquidity and solvency ratios, and their long-term trends, is vital to measuring and rating the statistical probability of a company's ability to meet short-term liabilities, long-term obligations and future investments for growth.

A fiduciary must make a complete and accurate assessment of a company's financial condition, including an analysis of both its past and current financial strategies and the degree to which the company has actually increased or decreased the shareholders' tangible equity per share. The stock's price performance tells you what other investors believe about the company. Its price does NOT reflect a company's business risks, financial risks or potential for appreciation. The prices of nearly every

company vary greatly within a year's time. Even the largest and most established companies in the US rise and fall by 50% over a year or two.

A fiduciary has an affirmative duty to independently evaluate the risks of every investment he holds. This duty includes going through the company's financial statements, understanding the nature of their transactions, and considering both accounting and strategic business factors. Fulfilling this duty requires a thorough analysis of the company's financial statements. ERS provides this service. If you're in need, reach out and we'll assist you.

