The Importance of SEC Filings in Due Diligence Inquiries

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The U.S. Securities and Exchange Commission (SEC) was established in 1934 during a period in American history that was marked by the Great Depression. The SEC evolved out of the Securities Act of 1933 and the Securities Exchange Act of 1934 and was designed to restore investor confidence in the capital markets by providing investors and the markets with more reliable information and a clear set of rules for honest dealing.

The SEC requires public companies to disclose meaningful financial and other information to the public, which enables investors to refer to a common pool of knowledge on a specific company in order to make sound and informed business decisions. By collecting this information from public companies, the SEC is able to accomplish its primary mission, which is to promote the disclosure of important market-related information, while maintaining fair dealing and protecting against fraud.

In conducting due diligence inquiries, recognition and analysis of SEC filings is vital to the development of a complete profile of a company. While some high-profile investigations and litigation are captured in the media and elicit public attention, other less widespread or noteworthy probes, which are required by law to be disclosed in SEC filings, may be just as important to those seeking an accurate picture of a company and its business operations.

The practice of backdating stock options was widespread in Silicon Valley during the explosion of dot-com companies in the late 1990s, which eventually led to billions of dollars in financial restatements that occurred over the past several years. A company that was the focus of the government's investigation into the practice of backdating stock options was San Jose, California-based Brocade Communications Systems, Inc. A class action settlement with plaintiffs who sued the company over its backdating practices resulted in a US$160 million payment. This was on top of the US$7 million settlement that Brocade reached in May 2008 with the SEC without admitting or denying guilt into stock option backdating at the company. A review of Brocade's SEC filings would document the financial restatements that were necessary to correct inaccurate filings that were made as a result of the backdating practices. A review of these filings would provide a detailed explanation of the actual revenues and expenses for the company.

While the SEC plays a critical oversight role, there is no guarantee that all the filings a company submits to the Commission are accurate. In 2001 and 2002, WorldCom was at the center of a lawsuit the SEC filed alleging widespread fraud. The company was forced to restate its financial reports for 2001 and the first quarter of 2002 after accounting irregularities were discovered totaling nearly US$4 billion. In its SEC filings, the company reportedly booked expenses improperly as investments in order to hide losses. This type of material overstatement in income not only can signal a red flag for a company's financial statements, but it could also raise concerns about its overall business activities and its corporate culture.

The fact that a company has submitted a filing to the SEC does not guarantee its accuracy; however, since the SEC mandated that top corporate management sign off on all financial statements as of August 15, 2002, it does decrease the likelihood of fraudulent filings considering the potential risk of legal action against executives for signing off on inaccurate statements. In the case of Cabletron Systems and its spinoff, Enterasys Networks, a conspiracy occurred between 2000 and 2002 to fraudulently inflate revenue at the companies for more than 10 quarters. Several executives were indicted on securities fraud charges and four were found guilty and received prison sentences ranging from three to 12 years. Through a careful review of a company's SEC filings not only before, but also after, such a scandal is uncovered can provide valuable information. What happened after any necessary financial restatements were made? Did earnings and revenue go up or down? What happened to the company's stock price? Are the salaries and bonuses of executives and board members on par with other companies in the industry? Has the company laid off any of its workforce?

The information that is disclosed in SEC filings includes, but is not limited to shares of ownership of common stock by company executives and board members, yearly salary and bonus awards to executives and board members, internal or external investigations into the company's business practices, quarterly and annual financial reports, pending lawsuits that involve the company, related party transactions, and financial restatements. A thorough review of the information that is filed with the SEC allows for potential red flags to be identified and properly evaluated in order to determine the risks they may pose to future business transactions.

There are numerous different types of filings that companies make with the SEC. Some of these filings provide insight into a company's financial status, changes in executive leadership, or intentions to pursue a merger with another company. Below are some of the most common SEC filings, which provide crucial information as to the business dealings and transactions that are occurring at a company:

» Form 10-K, 10-K/A – Annual report on a company. This filing includes information on the company's business and services, acquisitions and investments, legal proceedings, executives' and board members' compensation, and related party transactions, along with other comprehensive information about the dealings of the company during the past year. These filings can also contain useful biographical information on officers and directors.

» Form 10-Q, 10-Q/A – Quarterly report on a company. This filing includes information on the company's financial status during the preceding three months.

» Form 8-K, 8-K/A – Current report filing. This filing includes information on recently announced news pertaining to a company and its business activities. This may include information such as amendments that are made to a company's articles of incorporation or bylaws.

» Form S-1, S-1/A – Registration statement. This filing will include information on the commencement date of proposed sales of securities to the public.

» Form DEF 14A, DEFM14A – Definitive proxy statements. This filing includes information on any mergers or acquisitions involving a company. It also provides information on annual stockholders meetings.

» Form 4 – Statement of changes in beneficial ownership of securities. This filing includes information on changes that are made to the shares of common stock that are held by a company executive or board member (purchases or sales of shares of common stock).

Reviewing SEC filings can also prove to be valuable when looking at non-public companies. A wide range of information on private companies is often disclosed in public filings. For example, lawsuits in which private companies are named as a party to litigation involving a public entity will appear in SEC filings. Information on corporate executives and board members will also appear in these public filings, which often reveal that executives may serve on the boards of one or more public or private companies.

A review of public filings with the SEC provides a complete picture of the business activities of a company, which is crucial to the completion of a full risk assessment. As highlighted above in the cases of Brocade Communications, WorldCom, and Cabletron Systems, there is pertinent information filed with the SEC (and when necessary, investigated by the SEC), which provides valuable insight into the potential risks and liabilities associated with a particular company. Whether evaluated on its own or combined with a full suite of due diligence checks, a thorough review of applicable SEC filings can provide one with valuable information that is necessary in making an informed and sound business decision.

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