**Introduction to Business Valuation and Restructuring**

**Learning Outcomes**

After completing this module, students will be able to:

1. Explain the different value measures for a business or its assets and liabilities.
2. Identify applications of business valuation principles.
3. Differentiate between a sell-side analyst and a buy-side analyst, and their potential conflicts of interest.
4. Define the income, market, asset-based, and residual income methods used to value a business.
5. Describe the format of an investment research report and the content of each section.
6. Summarize the role and educational requirements of the Chartered Business Valuator (CBV) and Chartered Financial Analyst (CFA) professional designations.
7. Apply the research standards in the CFA Code of Ethics and Standards of Professional Conduct and CFA Research Objectivity Standards.

**Introduction**

Accountants and financial analysts must frequently estimate the fair market value of a business enterprise, its assets/liabilities separately, or damages that it has caused or incurred as a result of actions such as breach of contract or patent infringement. Fair market value is the price that willing and rational buyers and sellers with complete information agree upon.

Business valuation is a complex process that is prone to errors because of difficulties in accurately forecasting a company’s future operations. Therefore, having an experienced professional with a background in valuation is essential to an organization. In Canada, professionals can earn the Chartered Business Valuator (CBV) or Chartered Financial Analyst (CFA) designation to develop their skills in this critical area. Many public accounting firms offer business valuation services in addition to their traditional services in business advisory, taxation, financial reporting, and insolvency. Investment bankers apply valuation principles when advising clients on public offerings or corporate restructurings. Venture capitalists employ them to price start-up companies. Portfolio managers use business valuation to help make informed investment decisions.

The income, market multiples, asset-based and residual income approaches are used to value a business. With the income approach, a business’s future operating cash flows are forecasted and then discounted using an appropriate cost of capital. The market multiples approach is a straightforward method that utilizes industry-average ratios, such as price-to-earnings, price-to-book value, or price-to-sales. These ratios are multiplied by a company’s earnings, book value, or sales per share to determine its fair market value. The asset-based approach takes a business’s historical cost balance sheet and restates its assets and liabilities at their fair value, typically including an estimate of goodwill. Finally, residual income starts with a firm’s book value and adds any income it expects to earn over its equity investors’ required rate of return.

These business valuation methods are also used in the Module: Mergers and Acquisitions and Corporate Restructuring to determine take-over bids for business acquisitions.

**1.1 | Business Valuation Basics**

**Definitions of Value**

The value of a business can be defined in several ways.

**Market value.** The price at which a business, its specific assets, or its liabilities trade in efficient markets.

**Fair market value.** The price that a business or its specific assets or liabilities should trade at in efficient markets. Fair market value is estimated by business valuators when a market value is not available, or when markets are not operating efficiently.

**Investment or acquisition value.** By combining two companies, the acquirer can realize synergies such as higher prices or economies of scale that justify paying more than the target firm’s fair market value.

**Intrinsic value.** What an equity analyst believes a firm is worth after considering all relevant information and removing any short-term pricing irregularities. If financial markets are efficient, the intrinsic value should match the market value or the fair market value, meaning there is no mispricing due to market inefficiencies. Passive investors believe markets are efficient and typically invest in stock index mutual funds or exchange-traded funds (ETFs) with minimal stock turnover. Active investors believe that abnormal returns, or alphas, can be earned by identifying mispriced shares. If the current share price is lower than its intrinsic value, the analyst will issue a buy recommendation, believing the company is undervalued. They will issue a sell recommendation if the share price is above its intrinsic value. Continuous trading in search of alpha results in high stock turnover and trading costs. Passive investors believe this extra cost does not justify the alpha earned, while active traders consider it justified.

**Going-concern value.** The value of a business that operates on an ongoing or continuous basis to maximize shareholder value. Companies trade at a premium to the market value of their net assets and liabilities due to the goodwill that an organization can generate through its strong reputation, experienced workforce, and established systems and procedures. Market, investment, and intrinsic value all assume a business operates as a going concern.

**Liquidation or breakup value.** The value of a business or its specific assets or liabilities when a company plans to discontinue operations. The liquidation value is generally lower than the going-concern value due to the absence of goodwill; however, in some cases, when a company is poorly managed, under competitive pressure, or experiencing financial distress, it may be higher. These firms are said to be worth more “dead than alive.”

**Applications of Business Valuation**

There are numerous situations where a company needs to value a business, its specific assets, or its liabilities. The most important are:

**Private company transactions.** Most corporations are privately held by a small group of investors, including the founder(s), their family members, managers, and employees. These investors may want to buy more shares or sell them upon their death, disability, termination of employment, or if they decide to retire, change jobs, or diversify their investment portfolios. These shares do not trade publicly, so that business valuators can supply an estimate of their fair market value. Valuators also help improve a private company’s operations before it is sold, so shareholders receive the best possible price. This includes finding interested buyers, overseeing the bidding process, and completing all purchase or shareholder/partner rights agreements with the new buyers.

**Initial or secondary public offerings.** Private companies go public to improve their access to capital and provide shareholders with greater market liquidity. Public companies use secondary offerings to raise additional equity capital to fund growth opportunities when retained earnings are insufficient. Business valuators help determine an appropriate offering price in both scenarios.

**Buy, sell, or hold recommendations.** Major public companies are closely followed by a group of equity analysts who regularly issue earnings forecasts and prepare formal research reports. In these reports, analysts make buy, sell, or hold recommendations to their clients based on a thorough review of the company, its industry, and the overall economy, as well as an estimate of the share’s intrinsic value.

**Timing stock repurchases.** Stock repurchases provide management with greater financial flexibility as they are not committed to paying regular cash dividends. Repurchases are most effective when a company’s shares are undervalued, allowing it to earn a profit for its remaining shareholders. A business valuator can help determine when these shares are mispriced.

**Internal management.** A manager’s primary goal is to maximize shareholder value, so they want to know if their firm’s stock is undervalued. If it is, they will act to correct the market’s misperception. Management also wants to see the effect new strategic initiatives will have on the share price, so they can better sell these ideas to the firm’s board of directors, shareholders, and stock analysts.

**Take-over bids.** Companies sometimes acquire other businesses to generate synergies for themselves and the target firm, resulting in a higher share price after the acquisition. Business valuators carefully assess these synergies to ensure the acquirer does not overpay.

**Fairness opinions.** If shareholders receive a take-over bid from a potential acquirer, government regulators require that the firm’s management provide them with a fairness opinion before the offer expires. This opinion includes a valuation of the company and a recommendation on whether to accept or reject the offer.

**Ownership percentages for venture capitalists.** Venture capitalists provide the necessary financing to high-risk start-up companies when other investors are unwilling to do so. The value of a start-up must be measured, so the venture capitalist receives a suitable portion of the firm’s equity in exchange for their investment. This is particularly difficult for new companies as their growth prospects are uncertain and their shares do not yet trade publicly.

**Valuing divestiture, spin-off, or going-private transactions.** A company may sell or spin off part of its operations for various reasons, such as focusing on its core business or raising necessary capital. A majority owner or a group of managers may also decide to take a public company private to avoid the scrutiny of the financial markets, allowing them to focus on a business turnaround. A business valuator needs to determine a fair asking price.

**Liquidations or reorganizations.** When a company experiences financial distress and is declared bankrupt by the courts, it can either sell its assets and pay what it raises to its creditors (i.e., liquidation) or attempt to restructure its operations to emerge from bankruptcy successfully (i.e., reorganization). Accurately valuing a business’s assets is critical to maximizing the return for creditors in a liquidation. In a reorganization, valuation principles are used to determine the percentage of ownership that creditors will receive when exchanging their debt for equity in the restructured business.

**Share-based compensation.** A substantial portion of management compensation comes from stock options and restricted shares, directly tying pay to share performance and thus reducing agency costs. Business valuation tools are used to design these plans, so companies provide their executives with adequate compensation.

**Fair value accounting in financial reporting.** International Financial Reporting Standards (IFRS) enable companies to report many of their tangible and intangible assets and liabilities at fair market value, rather than historical cost, thereby improving the quality of financial reporting. Intangible assets, such as brand names or trademarks, are complicated to appraise. Valuation principles are also used to allocate an acquisition’s purchase price between the target company’s fixed assets, intangible assets, and goodwill and to measure any subsequent goodwill impairments.

**Transfer pricing.** Transfer pricing provides an accurate measure of a division’s or geographic area’s performance by fairly valuing intercompany sales. Companies may manipulate transfer prices to lower taxable income in a high-tax jurisdiction or increase profits in a specific business unit. Business valuators can help companies develop fair transfer pricing systems, mediate company disputes, and provide expert testimony when the fairness of transfer prices is challenged in court.

**Fair value of assets for tax purposes.** Under the Income Tax Act (ITA), an asset’s fair market value is used to calculate any capital gains taxes owed in a deemed disposition of property or a non-arm’s-length transaction. A deemed disposition occurs when a person is considered to have disposed of property, even though a sale did not take place. This is common when property is transferred as a gift or when a business is given to a family member upon the death of a taxpayer. Non-arm’s-length transactions are with related persons, where the fairness of the consideration is often questioned.

**Litigation support.** The fair market value of damages must be quantified for cases such as breach of contract, insurance claims, intellectual property infringement, business interruption, product or professional liability, asset expropriations, construction contract matters, personal injury, matrimonial property issues, or disputes with minority shareholders.If the parties cannot reach an agreement, the matter is referred to the courts, and a business valuation professional may give expert testimony concerning appropriate damages.

**Sell-Side Analysts, Buy-Side Analysts, and Issuer-Paid Research**

Financial markets are divided into sell-side and buy-side activities. The sell-side primarily consists of investment bankers who construct, promote, and sell financial instruments such as stocks, bonds, and derivatives. These securities are sold to the buy-side of the market, consisting of both retail and institutional investors, including pension plans, insurance companies, banks, trust companies, hedge funds, mutual funds, ETF companies, and other investment management firms.

Investment banks employ sell-side analysts to assist in pricing initial and secondary public offerings and provide ongoing coverage of these shares in the secondary market. The earnings forecasts, research reports, and buy, sell, or hold recommendations these sell-side analysts provide are valuable sources of information. The website of a large corporation often lists the sell-side analysts that follow their firm.

Buy-side analysts work for institutional investors, providing investment recommendations that inform the management of their funds. These analysts collect information from company financial disclosures, research reports from other sell-side analysts, conference calls with management, company visits, interviews with industry experts, news media articles, social media postings, and financial information providers such as Bloomberg or Thomson Financial. Any information is used by the institutional investor only and not shared with the public.

Whether the recommendations made by sell-side analysts are objective is a contentious issue in the investment industry. Investment bankers directly benefit from any favourable coverage provided by their sell-side analysts through a higher initial public offering price or a corporate client’s promise of future work. Many investment bankers also provide investment advisory services to individual and institutional investors. Financial firms attempt to separate the activities of these units through strict ethical standards relating to the exchange of information. Despite this, investment advisory clients worry that their financial advisors will be forced to purchase shares on their behalf to support a corporate client’s share price contrary to their best interests. The movement of insider information between the investment banking and investment advisory units about possible corporate acquisitions, changes in dividend policy, or other corporate finance issues that will affect the share price is also a concern.

Sell-side analysts from major investment firms do not cover many smaller public companies. To increase their visibility in the financial markets, especially when issuing new securities, these companies can hire an outside analyst to prepare a research report. This “issuer-paid” research compensates for the poor coverage provided by investment firms, but its objectivity is even more suspect than that provided by sell-side analysts.

**Business Valuation Methods**

A business can be valued using the income, market multiples, asset-based, and residual income methods, but this process is imprecise. Instead of relying on a single approach, most analysts employ multiple valuation methods to enhance the accuracy of their results. Some methods may be eliminated because their inputs are difficult to estimate, or the final valuation is an outlier. A weighted average of the remaining valuations is then calculated.

**Income.** A share’s value equals the present value of all future dividends an investor expects to receive.

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A one-, two-, or three-stage dividend discount model (DDM) and a historical, forward-looking, or sustainable growth rate of dividends are employed depending on the circumstances. Due to the stable nature of dividends and greater use of stock repurchases, free cash flow to equity (FCFE) or free cash flow to the firm (FCFF) is often substituted for dividends to provide a more accurate valuation. The model can also be adapted for companies with a significant amount of non-operating assets, multi-business operations, cyclical sales, or those experiencing financial distress. Estimating future cash flows and selecting the proper discount rate is both time-consuming and error-prone, making it difficult to achieve accurate results.

**Market multiples.** A benchmark multiple relates share price (P) to a measure of a firm’s financial performance, such as earnings per share (EPS), book value per share (BVPS), or sales per share (SPS). This multiple is calculated using fundamentals, comparable company data, multi-regression analysis, or historical average multiples. The company then multiplies this benchmark by the firm’s own historical (i.e. trailing) or estimated (i.e. leading) EPS, BVPS, or SPS to determine the appropriate share price. Finally, this price is multiplied by the number of common shares to calculate the intrinsic value (V0) of the firm.

V0 = Benchmark () (EPS) (Number of common shares)

V0 = Benchmark () (SPS) (Number of common shares)

V0 = Benchmark () (BVPS) (Number of common shares)

Given the uncertainty of business valuations, analysts typically use more than one type of benchmark multiple to improve the accuracy of their results. Increasingly, enterprise value (EV) and earnings before interest, taxes, depreciation, and amortization (EBITDA) are used instead of P and EPS to provide more accurate valuations.

**Asset-based.** The asset-based approach values a company by taking its historical cost balance sheet and restating all its assets and liabilities at their fair value. The difference between total assets and liabilities is the fair market value of the business. This approach is used sparingly due to the difficulty valuators face in accurately pricing non-financial assets, including land, buildings, equipment, and particularly intangible assets and goodwill. Additionally, more information is typically available about an entire business operating as a going concern than about its assets and liabilities. With IFRS, more assets and liabilities are now recorded at fair value rather than historical cost, making this method more straightforward to apply.

**Residual income.** Some managers feel that if a firm is profitable, it is creating value for its investors. This is incorrect because although net income (NI) includes interest expense, which fairly compensates debt holders, there is no deduction for the cost of common equity. If NI is insufficient to meet the shareholders’ required rate of return (RRR), the company is destroying value.

Residual income (RI) is the difference between a company’s NI and its shareholders’ RRR. If this amount is positive, the firm is creating value, and its share price will rise above its BVPS. If RI is negative, the share price will fall below BVPS as the firm is destroying value. If the firm generates no RI, its BVPS should approximate its share price. The following formulas are equivalent and demonstrate this relationship and the different ways to calculate RI:

**1.2 | Format of a Research Report**

The CFA Institute defines a research report as a “written or electronic communication that firms sell or distribute to clients or the general public, which presents information about a corporate issuer and may express an opinion or make a recommendation about the investment potential of the corporate issuer’s equity securities, fixed income securities, or derivatives of such securities.” These reports are attractively formatted with a consistent appearance. A two-column layout is often adopted, featuring a large column for the report's text and a smaller column on the side that contains figures summarizing key information. If a figure is too big to fit in the side margin, it can be stretched across the page. The report is concisely written in simple language, focusing on the main points that influenced the analyst’s recommendation. The report typically ranges from 10 to 20 pages, excluding the appendices that provide additional detail. Good financial analysts avoid overwhelming users with too much data. A typical equity research report is divided into the following sections:

**Header and footer.** Contains the issuing company’s name, ticker symbol, stock exchange(s), industrial classification (i.e., sector, industry group, industry, and sub-industry), the analyst’s investment recommendation (i.e., buy, hold, or sell), the issuer’s current share price, the analyst’s target price typically in one year, and any required disclosures and disclaimers. These disclosures and disclaimers include the analyst’s name, whether they have an ownership position in the company, how they are being compensated for their research, if they work for the issuer or their investment banker, if they are a market maker in the issuer’s shares, if they have insider information about the issuer, or have any other conflicts of interest that may influence their opinions.

**Investment summary.** An executive summary of the key elements of the report, including any significant trends or developments, financial projections, valuation results, scenario analyses, and the analyst’s buy, hold, or sell recommendation. A synopsis of recent news headlines concerning the issuer can also be included.

**Company description.** A summary of the issuer’s head office location, ownership structure, history, business model, and business strategy. The business model includes a general description of the issuer’s products, customers, distribution channels, pricing policies, credit policies, supplier network, production and inventory practices, and any partnerships with other companies. A breakdown of sales, profits and total assets by operating segment assesses each segment's contribution to the company’s overall performance. Sales are also divided by product lines, customers, and domestic and international sales.

An issuer’s business strategy is a long-term plan describing how it will achieve its goals and objectives and remain competitive. For example, a warehouse store like Costco carries a limited assortment of high-quality branded and private-label products across a wide variety of categories. These products have high sales volumes and turnover ratios, as the store only carries the most popular models, sizes, and colours. Products are shipped directly to stores from the manufacturers or a centralized distribution facility. Upon arrival, products are immediately moved to the sales floor on their shipping pallets, where they are stored on vertical racks until they are displayed at ground level using a no-frills format. Costs are reduced by quantity discounts received when purchasing fewer products in bulk and through transportation and handling efficiencies. Prices for these high-quality products are lower than those of competitors, but profit margins remain high due to these cost savings. If the company cannot negotiate a suitable price for a national brand in the desired model, size, and colour, supply agreements are quickly negotiated with a network of high-quality suppliers and sold under the store’s private-label brand. Membership fees are charged to attract higher-income customers who spend more per visit. Customers earn credit based on how much they purchase and receive a cheque once a year, which they must spend at the store. The store also offers customers discounts on gas and a variety of other products, including window blinds, flooring, furnaces, and air conditioners, and assistance in finding qualified installers. The company's online platform offers an even greater variety of products that do not have sufficient volume to be carried in-store. These products are delivered through third-party delivery services. Customer satisfaction is high due to a generous returns policy and excellent customer relations. Stores attract the best employees by offering more full-time employment with higher pay and benefits than other retailers.

Another example is Premium Brands Holdings (PBH), which acquires high-growth, premium-priced, specialty food manufacturers and distributors. By selecting products focused on quality, convenience, health, and lifestyle over price, PBH avoids intense price competition with its much larger national and international competitors, yielding higher and more stable profit margins. PBH purchases innovative companies that already sell superior products and helps them reach their full potential. These businesses continue to operate autonomously to encourage innovation, customer focus, faster response times, and avoid bureaucratic decision-making. PBH adds value by providing improved distribution, access to capital, risk diversification, lower-cost global purchasing, idea sharing among firms, and enhanced management services, such as information systems.

**Industry analysis and competitive positioning.** An issuer’s industry is the primary determinant of its financial performance. Companies in the same industry are exposed to similar opportunities and risks, so their performance tends to converge to the industry average due to competition. There are short-term variations related to company-specific factors like product improvements, but returns are similar in the long term. The steps in an industry analysis include:

* Define the industry
* Describe the industry
* Analyzing the industry’s structure
* Describe the issuer’s competitive positioning

**Define the industry.** An industry is a group of companies selling similar products. Most analysts rely on third-party industrial classification systems, such as the Global Industry Classification Standard (GICS). This system classifies public companies generally by sector and then more precisely by industry group, industry, and sub-industry. Classifications are updated annually. Below is an example of how an auto parts and equipment producer is classified.

**Exhibit 1: GICS**

**Sector – 11 Categories (Consumer Discretionary)**

Energy

Materials

Industrials

Consumer Discretionary

Consumer Staples

Health Care

Financials

Information Technology

Telecommunication Services

Utilities

Real Estate

**Industry Group – 5 Categories (Automobiles and Components)**

Automobiles and components

Consumer durables and apparel

Consumer services

Media

Retailing

**Industry – 2 Categories (Auto Components)**

Auto components

Automobiles

**Sub-industry – 2 Categories (Auto Parts and Equipment)**

Auto parts and equipment

Tires and rubber

Companies are selected from the relevant sub-industry group for the closest comparison possible, but third-party classification systems have several limitations. First, companies in the same sub-industry are often defined too broadly, encompassing products with very different characteristics, which makes financial data less comparable. Second, most companies operate in multiple businesses but are assigned to just a single grouping. Third, these systems are global, encompassing all companies that produce goods or services worldwide. This is not suitable for companies that only operate locally or nationally. Finally, companies may be reclassified when the system is updated, making comparisons over time more difficult.

**Describe the industry.** Analysts calculate the industry’s size by sales and its year-to-year or compound annual growth rate. Sales are forecasted using data from government sources, industry associations, and outside consultants. Measuring industry sales is difficult due to a lack of information about private companies.

Sales growth is defined as mature or growth. Mature industries are often saturated, so demand estimates are typically based on the broader economic growth rate; however, demand may decline if customers start to transition out of the industry as new substitutes become available. The rate of decline is difficult to estimate, as inter-company rivalry is likely to intensify as sales decline. Growth industries typically exhibit higher growth rates because they have not yet fully penetrated their respective markets. Historical growth rates can be used to estimate future growth; however, past rates may not persist as the market becomes increasingly saturated.

Sales are influenced by the business cycle. Defensive companies sell non-discretionary items, such as food, whose demand is relatively constant over the years. Cyclical companies sell discretionary products, such as appliances, that consumers can delay purchasing during a downturn, causing sales instability. Additionally, commodity prices, such as those for crude oil, fluctuate significantly over the business cycle as demand shifts. The demand for big-ticket items, such as homes or cars, that require financing is negatively affected by rising interest rates at the end of an economic upturn.

After calculating the size and growth rate of the industry, identifying its competitors, and determining their market shares, the next step is to analyze the data. An increasing market share indicates a company’s products have been successful. Analysts should ascertain if the increase is due to organic growth or acquisition. Growing through acquisition can reduce the intensity of competition and increase profitability, but a company may take on excessive debt and overpay for the target in the process. The industry concentration level should be calculated. Concentration is measured using the Herfindahl-Hirschman Index (HHI), which equals the sum of the squares of each competitor's market share. For example, an industry consisting of five companies with market shares of 26%, 22%, 20%, 17%, and 15% would have an HHI of 262 + 222 + 202 + 172 + 152 = 2,074. An HHI between 1,500 and 2,500 is considered moderately concentrated, while over 2,500 is considered highly concentrated. The HHI of a monopoly is 10,000 (i.e., 1002).

A highly profitable industry is preferred, especially if profits are trending upwards. A time series of the rate of return on invested capital (ROIC) should be calculated for the industry.

ROIC =

The numerator represents income before interest and taxes, while the denominator encompasses all invested capital. ROIC is the return the industry earns, regardless of how it is financed. The ratios should be calculated using public company data only if private company data is not available.

**Analyzing the industry’s structure.** Industry structure is assessed using Porter’s Five Forces, which are industry rivalry, the threat of new entrants, the threat of substitutes, the bargaining power of suppliers, and the bargaining power of customers.

**Exhibit 2: Porter’s Five Forces**

Fast-growing industries with fewer competing firms have less intercompany rivalry, resulting in higher prices and margins, especially if there is a minimal threat of new entrants. Entry is discouraged by barriers such as 1) large economies of scale or scope, 2) limited access to distribution channels, 3) established competitors, 4) high capital or advertising expenditures, 5) patent protection and government regulations, such as licenses, quotas, or trade restrictions, and 6) product differentiation like high product quality, customer loyalty, technical innovation, and brand recognition. Mature industries with numerous competitors and low barriers to entry tend to exhibit more intercompany rivalry as they can only grow by taking sales from other firms.

Industry prices and profits are lower when 1) customers are large and concentrated, giving them significant bargaining power, 2) the product purchased is standardized and undifferentiated, resulting in little customer brand loyalty, 3) switching costs are low and benefits are high. 4) customers can build the substitute themselves instead of buying it, 5) the product is not critical to customers, making them unwilling to pay a higher price, and 6) the input makes up a significant part of the customer’s budget.

If there are only a few large suppliers in the industry, they can charge more because of their market power. This is especially true if the customer’s switching costs are high, the product is specialized, or in short supply, making it difficult to source.

**Describe the firm’s competitive positioning.** Competitive positioning explains how an issuer establishes an advantage over other companies in the industry. Porter identifies three general positioning strategies: cost leadership, differentiation, and focus. Cost leadership is being the low-cost producer and generating high profits through low prices, lower costs, and high turnover. Differentiation means developing a unique appeal, such as high quality, superior technology, or brand recognition, that allows a firm to charge a premium price. Focus means targeting a specific market segment and serving it better, employing either a cost leadership or differentiation strategy.

A SWOT analysis (i.e., strengths, weaknesses, opportunities, and threats) is another tool analysts use to evaluate an issuer’s competitive position. Strengths are the areas in which a company excels, such as superior quality or innovative product design. Weaknesses are areas where improvement is needed, such as poor overseas sales or high debt. Opportunities are business developments that may enhance future growth and profitability, such as new bilateral trade agreements or greater government support for R&D spending. Threats are potential obstacles such as higher taxes or an aging workforce. As the example shows, strengths and weaknesses are determined by internal company factors, while opportunities and threats depend on the external business environment. Companies must build on their strengths, address weaknesses, capitalize on opportunities, and overcome threats to achieve success.

**Exhibit 3: SWOT Analysis**

|  |  |  |
| --- | --- | --- |
|  | **Strengths** | **Weaknesses** |
| **Internal** | * Superior brand * Valuable intellectual property * Modern equipment * High customer retention * Good supplier relationships | * Gaps in management expertise * High staff turnover * Low asset turnover * Slow collections * Lack of financing |
|  | **Opportunities** | **Threats** |
| **External** | * Increasing domestic population * Rising disposable income * Expanding overseas markets * New materials technology * Growing environmentally conscientious | * Skilled labour shortage * Increasing overseas competition * More product substitutes * Higher rate of technological change * Greater government regulation |

A PESTLE (political, economic, social, technological, legal, environmental) analysis is used to examine further the external influences affecting an issuer’s performance.

**Exhibit 4: PESTLE Analysis**

|  |  |
| --- | --- |
| **Political** | Political factors include government stability, tax policies, trade tariffs, labour laws, and political agendas. These shape the legal and regulatory environment, influence investor confidence, and impact business operations, international expansion, and strategic decisions. |
| **Economic** | Economic factors involve inflation, interest rates, unemployment, GDP growth, and consumer income. These indicators affect purchasing power, demand, investment capacity, and pricing strategies. |
| **Social** | Social factors encompass cultural norms, population demographics, educational levels, health consciousness, and lifestyle changes. These influence consumer preferences, brand perception, labour availability, and social responsibility expectations. |
| **Technological** | Technological factors encompass advancements in innovation, automation, research and development, artificial intelligence, and communication tools. These shape production processes, product offerings, data management, and competitive differentiation. |
| **Legal** | Legal factors encompass employment law, intellectual property rights, antitrust regulations, consumer protection, and industry standards. Adherence to legal frameworks is essential to avoid litigation, fines, or reputational damage. |
| **Environmental** | Environmental factors relate to climate change, sustainability, pollution control, waste management, and resource conservation. Stakeholder expectations and regulations increasingly demand eco-conscious practices. |
| Source: ProjectManager | |

**Environmental, social, and governance (ESG)**. The strengths and weaknesses of an issuer’s corporate governance and executive compensation systems are identified, along with any company initiatives in the areas of social responsibility and sustainability, such as increasing the representation of women, indigenous peoples, and visible minorities on the board, and any plans to reduce the company's environmental footprint. The qualifications and experience of all directors and senior managers are outlined, along with the results of any independent ESG ratings.

**Investment risks.** In addition to identifying the most critical investment risks, research analysts estimate the potential impact (i.e., low, moderate, high) of each risk, its probability (i.e., low, moderate, high) of occurrence, and any risk mitigation strategies the company has adopted to limit potential losses.

**Exhibit 5: Types of Investment Risks**

|  |  |
| --- | --- |
| Market risk | * Slowing economy * Rising interest rates * Higher input costs * Lower product prices * Changing exchange rates * Rising protectionism |
| Operating risk | * New lower-cost competition * Expanded product offerings by competitors * Industry overcapacity * Failed acquisitions strategy * Outdated technology * Declining product quality or customer service * Falling net working capital and fixed asset utilization * Reliance on a single customer, product, or geographical area * Higher political risk in certain countries or regions * Risk of natural disaster |
| Legal, tax, and regulatory risk | * Pending lawsuits * Rising tax rates * Lower CCA rates and fewer fast write-offs * Shorter loss carryback and carryforward provisions * New health and safety regulations * Higher pollution standards |
| Financial risk | * Higher financial leverage and debt servicing costs * Limited liquidity using cash and unused lines of credit * Inability to afford required capital expenditures * Lower bond rating * Potential violation of loan covenants |
| Other risks | * Poor corporate governance and compensation practices * Difficulty attracting new executive talent |

**Exhibit 6: Risk Impact, Probability, and Mitigation Disclosures**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Risk** | **Description** | **Mitigation Strategy** | **Impact** | **Probability** |
| Gas price | Exposed to short-term changes in the market price of natural gas. | Enter long-term fixed-price supply contracts. | Moderate | Moderate |
| Foreign currency | Exposed to currency risk on operating transactions and foreign borrowing. | Use forward currency contracts. | Low | Moderate |
| Interest rate | Exposed to interest rate risk on variable-rate debt. | Finance fixed assets with long-term fixed-rate loans.  Use interest rate swaps to lock in fixed rates on variable-rate loans. | Moderate | Moderate |
| Credit | Exposed to credit risk when the counterparties on gas sales, derivative contracts, and other trade receivables do not honour their obligations. | Ensure all counterparties have strong credit histories and investment-grade credit ratings. | High | Moderate |
| Liquidity | Exposed to liquidity risk when customers or subsidiaries do not honour their obligations. | Monitor compliance with debt covenants.  Maintain a strong credit rating to ensure ready access to credit markets. | High | Low |
| Political | Exposed to political risk that impacts a customer’s ability to pay their obligations and hinders the operation of global properties. | Maintain a geographically diverse project portfolio.  Monitor political news and elections.  Develop close relationships with governments. | Moderate | Moderate to high |
| Acquisition | Exposed to poor financial results at newly acquired resource properties. | Carefully research new investments.  Diversify global holdings.  Maintain strong mentorships with new subsidiaries. | Moderate to high | Low |
| Taxes | Exposed to changes in tax regulations. | Monitor tax regulations.  Lobby governments and tax authorities. | Moderate | Low |

**Financial analysis.** The issuer’s liquidity, asset management, long-term solvency, profitability, and market valuation are carefully analyzed using ratio analysis, a five-way analysis of the return on equity, segmented analysis, cash flow statement analysis, and cash flow-based financial ratios. Major trends such as rapidly increasing sales, declining profit margins, a changing sales mix towards more profitable products or customers, increasing financial leverage, falling net working capital and fixed asset turnover, higher capital expenditures (CAPEX), or shrinking cash flow from operations are the focus.

**Valuation.** Analysts summarize the approaches used to value the business, including key model inputs such as the cost of capital, financial projections, growth rates, and benchmark market multiples, as well as the results of any scenario analyses. The analyst then makes a buy, hold, or sell recommendation and provides the reasons for their position.

**Appendices.** These expand on the information provided in the main report. They may include a glossary of key terms; macroeconomic forecasts; detailed Porter’s Five Forces, SWOT, and PESTLE analyses; description of the governance structure; biographical information for the directors and executives; ESG ratings; M-Scores measuring earnings quality; Z-Scores measuring the probability of bankruptcy; a comprehensive ratio analysis including industry benchmarks; detailed cost of capital calculations; financial projections for the next three to five years; terminal growth rate estimates for subsequent periods; a description of how the market multiples used were estimated; the valuation model (i.e., income, market multiples, asset-based, and residual income) results; and the findings of “bull” an “bear” scenario analyses.

Much of the information used to prepare a research report is found in the issuer’s audited financial statements, notes to the financial statements, management discussion and analysis, annual information form, management information circular, press releases, and other disclosures available on its website or through the System for Electronic Documents and Retrieval (SEDAR). Financial information providers, like Bloomberg or FactSet, supply much of the same information, along with industry comparisons. Analysts participate in conference calls with the company’s executives and site visits sponsored by the firm’s investor relations department. They interview industry experts, customers, suppliers, contractors, and competitors and review research reports from government agencies, sell-side analysts, industry associations, or paid consultants specializing in particular industries. The issuer’s website, general or industry-specific news outlets, and social media posts also provide valuable information.

After an initial equity research report is published, shorter follow-up reports are typically issued by the analyst each quarter or when significant events occur. It is assumed that users are familiar with the initial report; therefore, follow-up reports focus on new information that impacts the analyst’s valuation and recommendation. This information may include revised earnings projections, earnings announcements, or senior management changes.

The annual CFA Institute Research Challenge invites finance students from across the globe to compete in preparing and presenting company research reports that include a buy, hold, or sell recommendation. The competition begins at the local level, where student teams are assigned to research a domestic company under the joint supervision of a faculty advisor and an industry practitioner. The report is presented to a panel of judges composed of CFA members. Successful teams advance to regional competitions in the Americas, Asia Pacific, Europe, the Middle East, and Africa, and the winners from these competitions qualify for the global finals. Students gain valuable experience preparing and presenting their high-quality research reports to industry experts.

**1.3 | Professional Designations**

There are two professional designations available in Canada for those interested in a career in business valuations.

**Chartered Business Valuator.** These professionals focus on valuing individual transactions, assets, liabilities, or entire business enterprises, as well as providing litigation support, which includes quantifying business damages arising from legal disputes and supplying expert testimony at trial if necessary. Most CBVs in Canada are also CPAs who work primarily as associates or partners in public accounting firms supplying business valuation and other accounting services, including business advisory, taxation, financial reporting, and insolvency. Candidates typically complete their CPA first and then pursue a CBV designation to develop their skills further. Public accounting firms offer excellent mentorship opportunities for candidates and the opportunity to participate in a variety of complex valuation engagements. After becoming a CBV, members may join firms specializing in business valuations, while others work as self-employed contractors.

To be accepted into the CBV program, candidates must have a degree or hold either a CPA or CFA designation. To earn a CBV, candidates must:

1. Complete six courses

Level I – Introductory Business Valuation

Level II – Intermediate Business Valuation

Level III – Advanced Business Valuation

Level IV – Special Topics in Business Valuation

Two electives from the following:

Litigation Support in Business Valuation

Corporate Finance

Valuation for Financial Reporting

Private Investments

2. Acquire a minimum of 1,500 hours of suitable experience

1. Pass the Membership Qualification Exam (MQE)

The 1,500 hours of work experience must include at least 750 hours of Core Valuation Experience. According to the CBV Institute, this experience “… involves activities in connection with business valuations, corporate finance, private investments, and litigation support, where a conclusion as to the value related to a business, or where a conclusion of economic loss is reached.” The remaining hours consist of Non-Core Valuation Experience and are activities in similar areas that do not result in a conclusion of value. The MQE is a four-hour event held every September. Candidates must complete their work experience within three years of writing the MQE to qualify for the designation. CPAs, CFAs, and graduates of specific university courses in business valuation are eligible for program exemptions.

**Chartered Financial Analyst.** CFAs manage investment portfolios for high-net-worth individuals or institutions, such as pension funds, endowments, insurance companies, and mutual funds. They are experts in various areas of investing, including equities, fixed income, and alternative investments like real estate, venture capital, and private equity. They are also skilled in risk management and hedging against commodity price movements, currency fluctuations, and credit risk. CFAs, unlike CBVS, focus primarily on valuing financial securities.

To be accepted into the CFA program, candidates typically must hold a degree; however, they can enroll in and complete the first level of the program before graduating. They are also admitted if they have a combination of four years of post-secondary education and full-time work experience in an investment or non-investment area.

To earn the CFA designation, candidates must complete three levels of study over three years and pass a six-hour exam at the end of each level. The program requires well over 900 hours of self-study in 10 topical areas, including ethical and professional standards, quantitative methods, economics, financial reporting and analysis, corporate finance, equity investments, fixed income, derivatives, alternative investments, and portfolio management and wealth planning. The curriculum is based on an ongoing analysis of what practicing professionals feel is needed to succeed in the competitive investment industry.

To assist candidates in preparing for their rigorous accreditation exams, the CFA Institute provides a detailed online curriculum and other learning resources, including end-of-reading problems and mock exams. Private educational companies also offer preparation courses and practice exams to supplement the offerings of the CFA Institute. Before receiving their professional designations, candidates must complete 4,000 hours of qualified work experience and receive letters of reference from three professionals who attest to their expertise and character. Compared to an MBA or Master of Finance, the CFA is an affordable program that allows professionals to complete a graduate-level credential in finance without taking time off work.

**1.4 | CFA Institute Research Standards**

CFA Institute members agree annually to follow the Institute’s Code of Ethics and Standards of Professional Conduct, which governs their behaviour as investment professionals.

**The Code of Ethics**

CFA Institute members and CFA candidates must:

* Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, and prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
* Place the integrity of the investment profession and the interests of clients above their own personal interests.
* Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
* Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
* Promote the integrity and viability of the global markets for the ultimate benefit of society.
* Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

**Standards of Professional Conduct**

1. **Professionalism**
2. **Knowledge of the Law.** Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of a conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate in or assist in and must dissociate from any violation of such laws, rules, or regulations.
3. **Independence and Objectivity.** Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another’s independence and objectivity.
4. **Misrepresentation.** Members and Candidates must not knowingly make any misrepresentation relating to investment analysis, recommendations, actions, or other professional activities.
5. **Misconduct.** Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.
6. **Integrity of Capital Markets**
7. **Material Nonpublic Information.** Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.
8. **Market Manipulation.** Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.
9. **Duties to Clients**
10. **Loyalty, Prudence, Care.** Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients’ interests before their employer’s or their own interests.
11. **Fair Dealing.** Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.
12. **Suitability**
13. When Members and Candidates are in an advisory relationship with a client, they must:

a. Make a reasonable inquiry into a client’s or prospective client’s investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.

b. Determine that an investment is suitable to the client’s financial situation and consistent with the client’s written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

c. Judge the suitability of investments in the context of the client’s total portfolio.

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

1. **Performance Presentation.** When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.
2. **Preservation of Confidentiality.** Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,

2. Disclosure is required by law, or

3. The client or prospective client permits disclosure of the information.

1. **Duties to Employers**
2. **Loyalty.** In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.
3. **Additional Compensation Arrangements.** Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer’s interest unless they obtain written consent from all parties involved.
4. **Responsibilities of Supervisors.** Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.
5. **Investment Analyst, Recommendations, and Actions**
6. **Diligence and Reasonable Basis.** Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

1. **Communication with Clients.** Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.

3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.

4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

1. **Record Retention.** Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.
2. **Conflicts of Interest**
3. **Disclosure of Conflicts.** Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with their respective duties to their clients, prospective clients, and employers. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.
4. **Priority of Transactions.** Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.
5. **Referral Fees.** Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.
6. **Responsibilities as a CFA Institute Member or CFA Candidate**
7. **Conduct as Participants in CFA Institute Programs.** Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA Institute programs.
8. **Reference to CFA Institute, the CFA Designation, and the CFA Program.** When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

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Specific Standards of Professional Conduct are particularly relevant to analysts when preparing research reports. These include:

**I(B) Independence and Objectivity.** Analysts must avoid situations that impede their independence and objectivity when preparing research reports. Subject companies often pressure analysts to expand coverage of their firms or issue more favourable recommendations, which can inflate their share price, especially when they are issuing new securities or exercising executive stock options. Analysts should not:

* Accept gifts, tickets to cultural/sporting events, paid travel or vacations, job referrals, contributions to charities on their behalf, personal favours, or other benefits.
* Accept paid travel for themselves and their families to attend meetings with executives, site visits, investment conferences, or other events sponsored by the subject company.
* Allow professional/personal relationships or biases to influence their recommendations.
* Accept an allocation of shares from a subject company in an oversubscribed initial public offering (IPO) to trade in their personal accounts.
* Be pressured by their firm’s investment banking unit to provide favourable recommendations to benefit a current or prospective client.
* Agree to a compensation arrangement linked to the success of a security issue managed by their firm’s investment banking unit.
* Be pressured by a subject company to provide favourable recommendations by threatening not to arrange interviews with executives or permit them to attend or ask questions during conference calls when announcing quarterly earnings. Some subject companies even promise to take legal action against analysts and/or their firms for negatively impacting their reputations.
* Be pressured by a portfolio manager to give a more favourable recommendation to increase the value of their client’s investments.
* Circumvent “firewalls” that prevent the flow of confidential information between the investment banking and research units at an investment firm.
* Agree to a compensation arrangement for preparing “issuer-paid” research that is linked to an increase in the subject company’s share price, such as stock options or warrants. Analysts should only accept a flat fee and never try to convince readers that the research report is written by a more established and objective research firm.

Investment firms establish compliance policies and procedures to ensure the independence and objectivity of their research analysts. They include:

* Investment recommendations are the unbiased opinions of research analysts and should be free of outside influences. If an investment firm does want an analyst to publish an unfavourable opinion about a client or prospective client, it should cease covering the company and only provide factual information about its performance.
* Strict limits are placed on accepting gifts and other benefits. Customary gifts, based on local business practices and regular business-related entertainment, are acceptable up to a specific amount per gift or an annual limit, provided they do not influence the independence and objectivity of the analyst.
* Analysts need to use commercial transportation and pay for their lodgings when meeting with subject companies unless they are unavailable due to a site’s remoteness. The frequency of company visits by analysts is monitored for potential abuse, particularly when the subject company consistently hosts them.
* Compensation systems are designed so that financial analysts are not tempted to put their personal financial interests ahead of their clients.
* A research unit is independent and does not report to another business unit that may attempt to influence its recommendations.
* An analyst’s personal trading is regulated, particularly their involvement in IPOs and private placements, where abuses are more common.

**I(C) Misrepresentation.** Truthful investment information is critical in maintaining investor confidence and the integrity of the financial markets. Analysts must not make false or misleading statements or omit material information in their research reports and other communications such as presentations, media interviews, marketing brochures, newsletters, e-mails, texts, or social media posts. Analysts should not exaggerate their qualifications or those of their firm, the services either can competently provide or their performance records. All information sources, such as websites, must be kept up-to-date and do not guarantee investors specific returns. Valuation model results are presented as opinions, not facts, and must incorporate all relevant variables. Investment performance should be measured against an appropriate benchmark. When estimating returns on illiquid or non-trading assets, such as real estate, analysts should not deceive investors by manipulating the results or seeking out external information providers that supply more favourable valuations. When using investment information from third parties, such as credit ratings, other analysts, interviews with outside experts, government and private data sources, or financial filings, analysts must ensure that the information is accurate, that the other parties have given their permission to use it, and that the sources are correctly identified. Research reports may summarize the work of others, but analysts cannot claim ownership of the work.

An investment firm should clearly define its qualifications and the services it can provide, and communicate these to its employees to avoid any misrepresentation. Each analyst should also maintain an up-to-date summary of their qualifications, experience, and competencies. This information should be reviewed by a supervisor or the compliance department, which may include random spot checks of claims made by analysts in correspondence or research reports, and then made available to clients. A supervisor or review committee should approve all research reports to ensure they are free of misrepresentations and plagiarism.

**II(A) Material Non-public Information.** Analysts may receive material, non-public information when researching a subject company. Making investment recommendations based on this information erodes investor confidence in the financial markets as the markets appear “rigged” in favour of a select group of wealthier investors who often receive the information first. This leads to lower business investment, resulting in a decline in economic activity.

Information is material if it is likely to have a significant impact on the price of a company’s securities. This information can be specific to a company, like quarterly earnings, a change in senior management, a potential business acquisition, or the loss of a major customer. It can also be influenced by outside factors that impact the price of a firm’s shares, such as the bankruptcy of a competitor, a change in the firm’s credit rating, or new economic data on housing starts, employment, or inflation. Whether this information is material or not is influenced by the reliability of its source. For example, information coming from a company’s vice president of marketing about the potential success of a new product is likely very material. In contrast, the opinion of an outside industry expert is probably not. Even if the information comes from a corporate insider, such as a senior executive, if its impact on security prices is uncertain, it is less likely to be considered material. For example, a decision to introduce a new human resource management system is unlikely to be material.

Information is non-public if it is disseminated to a select group of investors, either intentionally or unintentionally, and not to the entire market. Material, non-public information disclosed to a meeting of analysts is considered selective disclosure and could lead to charges of insider trading if acted upon or given to others (i.e., tipping). Companies go to great lengths to ensure all disclosures of material information are made to the general market first, usually through a press release on SEDAR. Any subsequent meetings or conference calls with analysts are carefully scripted to ensure executives do not disclose any new material information. If it occurs accidentally, a company immediately contacts any analysts present and instructs them not to trade while they make the information public. Regulators are informed so they can monitor the financial markets for insider trading. Companies are also careful to treat all research analysts fairly. Analysts from larger investment firms do not receive preferential access to information, and those who have previously issued a negative recommendation to the company are not excluded.

Research analysts aim to provide insightful recommendations about subject companies, based on thorough research that yields above-average returns for their clients. Under the Mosaic Theory, an analyst can make a recommendation based on public information or immaterial non-public information without fear of being prosecuted for insider trading. All analysts should maintain a detailed record of their research, so they can prove to regulators that their superior results were due to skill. Successful analysts whose research has a significant impact on security prices are not guilty of insider trading when they selectively disclose their findings to their clients. Analysts should be cautious when interviewing industry experts or studying the internet and various social media platforms, as they may receive material, non-public information. Social media platforms, such as blogs with limited membership, are particularly concerning.

Investment firms, especially those with both investment banking and research units, implement a variety of compliance policies and procedures to help prevent insider trading. They include:

* Firms physically separate their investment banking and research units and prohibit employees from working in both areas. This limits the exchange of material, non-public information about subject companies that are also investment banking clients.
* “Firewalls” control interdepartmental communications to limit the flow of insider information. An independent compliance officer or supervisor reviews, authorizes, and documents all contacts between departments. Employees who frequently deal with sensitive material are trained to protect it.
* Written policies and procedures on insider trading are circulated to employees. Training is provided on the seriousness of insider training and how to identify it. Analysts are warned not to pressure a subject company to disclose material, non-public information.
* Analysts who obtain insider information, or know of others who have, are instructed to immediately report it to a supervisor or the firm’s compliance department, which will encourage the subject company to make it public. The analyst should not trade on this information, encourage others to do so, or alter their investment recommendations until it is made public.
* Analysts report all personal trading activity to their employers so it can be monitored for insider trading. When a firm has material, non-public information about a company, its shares are typically placed on a “restricted” list, and employees are prohibited from trading in them. Broadly distributing a restricted list to all employees may encourage the same behaviour that the list is trying to prevent. Hence, firms instead use a “watch” list that is only given to compliance personnel who monitor trading.

**V(A) Diligence and Reasonable Basis.** An analyst must demonstrate great care, impartiality, and thoroughness when preparing a research report about a subject company and have a sound basis for their investment recommendation that reflects all pertinent facts. Data from internal or external sources must be carefully monitored to ensure its reliability. Internet sources such as blogs should be checked more carefully than data from established financial information services firms. Investment firms may pre-approve external information sources; however, analysts should only use them if they believe the firm has demonstrated due diligence. Analysts must thoroughly understand all quantitative valuation models and include all relevant variables. Reliable input data representing multiple economic scenarios, especially adverse market events, should be used. Research reports are often prepared by groups of analysts who make a final recommendation by consensus. Even if an analyst disagrees with the recommendation, they can sign the research report if proper research methods are followed.

The investment firm should establish the following compliance policies and procedures to ensure diligence and a reasonable basis:

* Research reports follow specific guidelines as to their format and content.
* A supervisor or review committee approves all reports, including any quantitative valuation models.
* A supervisor or review committee evaluates the quality of an analyst’s research according to specific criteria, which are used to determine their compensation.
* External research providers are regularly evaluated based on set criteria.

**V(B) Communication with Clients.** Analysts must describe to clients and prospective clients the decision-making process they followed when making investment recommendations in their research reports. They should discuss the limitations of the approach and any significant risks that may impact the subject company’s valuation. Analysts can focus on specific areas of the firm’s performance that they deem important and ignore others, provided this is justified by a comprehensive analysis of the company. Quantitative models must be thoroughly described, including all assumptions and any changes in methodology from previous reports. Analysts must distinguish between fact and opinion when making investment recommendations. Estimates of future cash flows, comparable company multiples, or the cost of capital are opinions regardless of the complexity of the statistical analysis. Supervisors or review committees must ensure that research reports are thorough and consider all relevant factors, so the firm’s clients are well-informed. Analysts should maintain detailed records so they can address clients’ questions that are not covered in the research report. All reports and recommendations should be kept up to date as conditions change. If research findings are communicated in a condensed form, such as a simple buy or hold recommendation in an investor presentation, media interview, phone conversation, or email message, the analyst should indicate that the full report is also available for review.

**V(C) Record Retention.** Analysts must maintain accurate and relevant records to support the findings in their research reports. This requirement is not met just by keeping a copy of the report on file. Records should include any other information about a subject company, in paper or electronic form, used to prepare the report, including:

* Notes from any conference calls or direct meetings with executives or members of the company’s investor relations department
* Notes from company visits
* Notes from interviews with outside sources such as economists, industry experts, customers, suppliers, contractors, or competitors
* Copies of press releases and financial filings
* Copies of news media articles
* Copies of e-mails, text messages, blog posts, Twitter posts, and other social media communications
* Research reports prepared by other analysts
* Secondary data from governments or financial information services firms
* Discussion of any computer-based valuation models and the inputs used
* Analysis of the valuation model’s outputs

Investment firms establish policies and procedures regarding the records they require and how they should be stored. The CFA Institute recommends that records be kept for at least seven years unless a firm or industry regulator stipulates a longer period. These records are the property of an analyst’s employer. If an analyst changes firms, they cannot take these records with them without their employer's consent. They also cannot use the published research report, even if it is made public, because the supporting records are not available to them. An analyst can only recreate records using disclosures made directly by the subject company and other public information. An analyst’s memory of what was included in the supporting records cannot be used.

**VI(A) Disclosure of Conflicts.** Research analysts should avoid actual conflicts of interest or the appearance of conflicts with their clients, potential clients, and employers that may impact their ability to act independently and objectively. When conflicts do exist, analysts must disclose them prominently in plain language and update these disclosures as material changes occur. Conflicts of interest arise when the research analyst owns shares in the subject company or serves as a consultant or corporate director, as they may receive insider information. The analyst’s employer could also be the subject company’s investment banker and require the analyst to help market new security issues, linking their compensation to the success of these issues. The subject company may pay the analyst directly for an “issuer-paid” research report, where the analyst provides a favourable recommendation, regardless of the firm’s actual performance. Regardless of the conflict, analysts must inform clients and potential clients of any compensation or other benefits they receive for their recommendations, as well as how these benefits are determined.

Research analysts are encouraged to purchase the shares of companies they recommend to better align their financial interests with those of their clients and employers. Analysts should trade in a manner consistent with their firm’s recommendations, prioritizing their clients' trades over their own, and then their employer's trades, before engaging in any personal transactions to avoid conflicts of interest. Personal trades are those that benefit the analyst or an immediate family member, such as a spouse or child who resides at the same principal residence. Other family members, such as parents or siblings, are treated the same as regular fee-paying clients. Analysts can trade on their behalf or through a trust or pension plan in which they are beneficial owners. They do not have to disclose trades in well-diversified equity and fixed-income funds in trusts or pension plans, as these investments are not in specific companies.

Investment firms implement various compliance policies and procedures to prevent conflicts of interest and accurately disclose any that do arise. These may include:

* Disclose compensation arrangements such as bonuses, commissions, performance fees, referral fees, or stock option grants that may impact an employee’s ability to act independently and objectively
* Shares in initial public offerings (IPOs) are allocated to all interested clients first before research analysts are allowed to trade. Allocations should be done fairly and not used to reward larger clients or generate future business.
* “Blackout” or “restricted” periods prohibit employees from “front-running” or trading in advance of the firm’s clients when a research recommendation is announced.
* All personal trading is precleared by the compliance department, and employees must supply a confirmation once the transaction is completed. Employees are also required to provide a summary of their investment holdings at least annually.

**CFA Institute’s Research Objectivity Standards**

The CFA Institute’s Research Objectivity Standards supplement the requirements in the CFA Code of Ethics and Standards of Professional Conduct. These additional standards focus on sell-side analysts who work for investment banking, wealth management, and independent research firms, preparing research reports. Each firm should have a compliance or legal department that implements and enforces these standards, as well as any additional policies and procedures adopted by the company, government, or industry regulators. A summary of the CFA Research Objectivity Standards includes:

* Firms should have a written policy governing research objectivity and independence and distribute it to their covered employees and clients. Employees should receive regular training concerning their responsibilities under the policy. Firms should have an effective compliance system that clearly outlines all potential violations and the appropriate disciplinary actions that will be taken, including dismissal. Supervisors will ensure employees comply with the policy, and senior officers will attest that it is being followed. The system is continuously monitored and audited, and proper records are maintained. All types of violations and their corresponding penalties are disclosed to clients.
* Research analysts should provide the audience during a public appearance, such as an investment seminar, forum, or media interview, with sufficient information to make an informed judgment about the objectivity of the research report and the suitability of the investment for each investor. A copy of the full research report should be made available to audience members at a reasonable price on the firm’s website. During the appearance, analysts should disclose any conflicts of interest, such as whether their firm has an investment banking relationship with the subject company, if their compensation is linked to the firm’s investment banking efforts, or if the research analyst has or is currently participating in marketing activities of the subject company.
* Research analysts should have a reasonable and adequate basis for their recommendations. A supervisor or review committee should evaluate and approve all reports and recommendations. Written procedures should be developed to describe the due diligence process to be followed when determining whether there are reasonable and adequate grounds for any recommendation.
* Firms should separate their research and investment banking units and ensure that investment banking personnel are not able to influence recommendations. The research unit cannot report to the investment banking unit, and investment banking personnel are not authorized to review, modify, approve, or reject research reports and recommendations. The research unit should only communicate with the investment banking unit to verify information about the company. Any communications between the two units should be documented, and the compliance department should serve as an intermediary. A “quiet period” should be respected by research analysts for 10 days after a secondary offering and 30 days after an initial public offering managed by the investment banking unit. During a quiet period, research analysts are prohibited from issuing research reports and recommendations or speaking publicly about a subject company. This helps them remain objective and avoid disclosing any insider information to select investors.
* Research analysts should be compensated based on the quality of their research and not on the success of their firm’s investment banking activities in which they collaborated. Firms should establish specific criteria to evaluate the quality and accuracy of an analyst’s research over time.
* Policies should be developed so research analysts remain at arm’s length with the subject company. Analysts must be able to freely communicate with a subject company during conference calls or company visits. Still, they cannot accept material gifts or paid travel to attend these events. Research analysts should ensure that any information they receive from the subject company is not considered insider information. If the subject company discloses insider information, the analyst should work quickly with the company to disclose it publicly. Analysts cannot give the subject company advanced notice of their recommendations, promise a favourable report or specific price target, or threaten to change their recommendation or price target. Subject companies can only be asked to fact-check portions of the report before publication. The compliance department should oversee and document any communication with the subject company. They should receive a copy of the report before it is shared with the subject company, and approve any subsequent changes by the research analyst, who should provide a written justification.
* Research analysts are encouraged to invest in subject companies to align their interests with their clients better. Still, policies should be implemented to ensure the interests of the clients always come first. Research analysts or members of their immediate family (i.e. people with whom they share the same residence) should not be allowed to trade in advance of new information (i.e. front-running), purchase securities before an initial or secondary public offering, trade in a manner that is inconsistent with the firm’s current recommendation (i.e. buy, hold, or sell), invest in derivative securities relating to the subject company’s share, or engage in speculative short-term trading. All trades must be approved in advance by the compliance department, and each employee is required to provide a list of their investment holdings regularly. A “restricted period” should be maintained that bars trading in any subject company’s shares before a new security offering, before the release of a research report and other recommendations, or while the firm has material, non-public information to prevent front-running and insider trading. All shares should be held for at least 60 days to stop short-term speculation unless the analyst can demonstrate extreme financial hardship. Companies should have a strict definition of what constitutes financial hardship to prevent abuse of this provision.
* Once a firm initiates coverage of the subject company, it should update its recommendation regularly, usually quarterly, or when the company makes a significant announcement that may affect its operations. A firm should not discontinue coverage without providing a final research report and recommendation. They should also provide a clear explanation of why they are stopping coverage.
* Rating systems for stock recommendations can be absolute (e.g. buy, hold, sell) or relative to a market index or other benchmark (e.g. outperform, neutral, underperform). Ratings should also provide the period, typically one year, over which the price target is expected to be achieved, as well as an indication of the investment's riskiness. All communications of ratings in research reports or public appearances should include these three elements. The firm should only communicate the official rating and provide clients with a description of the rating system. Employees are prohibited from communicating any alternative ratings.
* All a firm’s or research analyst’s conflicts of interest should be disclosed prominently in language that clients can easily understand. Disclosures should be made in the research report, on the company’s website, or using the most appropriate method in the situation. Conflicts of interest may include a firm serving as a subject company’s investment banker; a firm acting as a market maker for a subject company’s shares; an analyst collaborating in a public offering being managed by their firm’s investment banking unit; an analyst assisting in marketing efforts such as “roadshows” to help sell a subject company’s securities; a firm or analyst investing in a subject company; an analyst being compensated based on the success of a public offering; an analyst receiving material gifts from a subject company; or a member of a firm or analyst serving as an advisor, officer, or director of a subject company.