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# SEVEN HABITS FOR FINANCIAL STATEMENT ANALYSIS AND BUSINESS NEWS REPORTING

Journalists and analysts know that "earnings" may not really be earnings and that press releases can be a way for a company to spotlight good news only. Add to that the myriad of technical terms, semantic issues, and acronyms, and one can easily get lost trying to discern the real headline.

To help navigate through the maze of financial data, CFA Institute created this checklist to use when analyzing a company and its financial statements and to better understand the due diligence that professionals undertake in developing successful investment strategies for 2006..

**Habit #1 - Read the 10-K and 10-Q Reports *Before* the Earnings Season Starts**

Read thoroughly the company's latest 10-K and its most recent 10-Q reports before earnings season begins. Doing so helps you to better understand the company's structure, the nature of the industry, and how the company actually makes money. If you have been covering the same company, a review will remind you of what the company has recently earned. If you haven't followed the company before, a review will give you a baseline upon which to compare the upcoming report.

At a minimum, read and review these 10-K sections:

1. Business Overview
2. Products and Services Offered
3. Industry Overview and Competition
4. Management Strategy
5. Management's Discussion and Analysis (MD&A) of the Period Covered
6. The Independent Auditor's Opinion
7. Cash Flow Statement
8. Balance Sheet
9. Income Statement
10. Footnotes to the Financial Statements
11. **And last, but most important, Key Risk Factors**

Key Risk Factors is a severely underreported and overlooked topic in business news today. Journalists should report these risks relative to how the company announces its performance. Imagine if, during the years of the Internet bubble, a technology company included any one of its Key Risk Factors in its earnings release. Would investors have learned and paid more attention to the fact that these companies would not make a profit for several years?

Also, journalists should study annual reports to garner interesting and useful insights into why things are happening — and not just what appears to be happening. Obviously, this objective is not different from analysts' goals. Analysts can easily determine what is happening, but it is the "why" that matters, and the implications of that "why" for the future of an investment. In this case, the interests of journalists and analysts are aligned here.

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Reading the press release after doing this homework will make the acronyms easier to understand, the "smoke and mirrors" more obvious, and the context of the company's financials more apparent.

**Habit #2 - Maintain Spreadsheets of Historical Company Financial Statements**

Track financial statements through the same tool financial analysts use: spreadsheet software. Developing these spreadsheets now will save time.

Journalists should keep a database of a company's financial statements for the last five years and, separately, the last 12 quarters. Include the Cash Flow Statement, Balance Sheet, and Income Statement.

By reviewing trends in the financial statements, you will have a broader understanding of the company's:

→ Financial health
→ Profitability
→ Cash balance and cash flow generation
→ Debt levels
→ Asset financing

With this spreadsheet, you can then easily add calculations, determine ratios, and develop a benchmark of the company's performance and financial condition against its competitors. Maintain a separate spreadsheet for each company analyzed – just like Wall Street analysts do. Doing so will build a better picture of the company and its historical performance.

**Habit #3 - Never Assume That Increased Revenue and Net Income Mean That a Company Is Making More Money**

When a company shows increasing revenue and net income, it does not necessarily mean that it has the money to pay its bills. Prior to the biggest bankruptcies in recent history, revenue and net income were always overstated and never showed a company's true financial health.

Here are some examples to consider:

→ **Reported revenue can actually be estimated.** Publicly traded hospitals recognize revenue based on optimistic estimates of what they think they will collect from Medicare and other insurers. This may not reflect the true amount actually collected and could be significantly less than what the hospital billed the government (the typical hospital's largest customer).

→ **Reported revenue can reflect sales to distributors, not to the ultimate user.** The automobile industry recognizes revenue when the car leaves the factory for delivery to the dealership, not when it is actually sold.

→ **Revenues are recognized when credit is given to the customer.** The more credit a company offers, the more revenue it recognizes – even though cash is not received. This may not reflect the true health of the company's operations.

Simply put, if revenues can be estimated or overstated, so can net income. Before reporting percentage increases or decreases as part of a headline or first paragraph, journalists should review the company's Income Statement and revenue footnotes to see how the company is actually recognizing revenue. Journalists and investors need to know not only why reported revenue increased or decreased, but also how the company came to that conclusion. This information and whether it results from volume changes, price changes, increased credit extension, etc. is reported in the MD&A.

**Habit #4 - Always Review the Cash Flow Statement First**

A company's true value is based on the amount of cash flow, not net income, it produces (see Habit #2 for the logic). The Cash Flow Statement allows investors to compare how much cash came into the company during the period, where it came from, how much was used, and what it was used for.

Each section of this statement is self-descriptive, reflects management's strategy and actions, and can be a leading indicator of what will eventually show up on the Income Statement. Cash inflows are positive numbers, while cash outflows are negative numbers, usually noted in parentheses.

→ **Cash Flow from Operating Activities** - shows how much cash came from sales of the company's goods and services, less how much cash was used to create and sell those goods and services. Analysts generally like a positive number for the net number for this section. Nonetheless, high growth companies (such as biotech and tech) tend to show negative Cash Flow from Operations in the early years because of their need to manufacture more products to meet increased demand.

→ **Cash Flow from Investing Activities** - typically a negative number, this reflects what the company has spent on "capital expenditures" (e.g., new equipment) and "acquisitions." Analysts normally would like to see a company re-invest capital into its business by at least the rate of depreciation expense each year. If a company does not reinvest, it may artificially show higher cash inflow in the current year that may not be sustainable for the business's long-term health. Analysts prefer to see a company always reinvesting in itself.

→ **Cash Flow from Financing Activities** – Studies have shown that expansion plans for a company, which are generally reflected in the Investing Activities section, tend to be 70 percent funded by Cash Flow from Operations. The remaining 30 percent usually comes from outside sources such as issuance of debt security or stock. *All* cash inflows and outflows from issuances, repayments, stock buybacks, or shareholder dividend payments are reflected here.

Journalists should track and report two key cash flow measures and the changes in those measures over time – rather than simply net income or earnings per share.

→ **Cash Flow from Operations** - shows how much cash the business generated from operations during the quarter or year. Changes in this clearly pre-empt changes in future net income. Analysts love seeing this go up.

→ **Free Cash Flow = Cash Flow from Operations less Capital Expenditures** (or also known as Purchase of Property, Plant and Equipment). The more free cash flow generated during the period, the more power a company has to expand, pay dividends, pay down debt, or buy back stock.

Also, be sure to read the "Liquidity and Capital Expenditures" footnotes section of the 10-K Report that shed light on changes in the Cash Flow Statement. It can usually be found in a section called the Management

Discussion and Analysis (MD&A), and typically describes where the cash was spent and how the company plans on financing its future growth.

**Habit #5 - Review the Balance Sheet in Terms of Dollars and Percentage of Total Assets**

The balance sheet gives the reader a greater sense of what the company owns and what it owes. It gives an indication of the resources a company has to help it grow during economic booms and to survive during bad times. Key line items to review and track include:

→ **Accounts Receivable** - This item is an indication of the methods a company uses to sell its products and services and how quickly it is collecting cash from its customers, a prime factor in a company's ability to pay bills and remain solvent and profitable.

→ **Inventory** (if part of business model) – Some companies (such as retailers after a holiday season) have a high risk of getting caught with too much inventory. When companies find themselves in that situation, they have little option but to sell their inventory at reduced values, sometimes below cost. Tracking inventory size relative to total assets and revenues indicates how the business and the industry are doing. The inventory growth rate compared to the revenue growth rate is a good indicator. If inventories grow faster than sales, it is almost always a negative factor.

→ **Debt Levels** - Having too much debt, relative to cash flows require to pay for interest and debt repayments, is one way a company can quickly go bankrupt. Having too little debt may restrict a company's ability to grow. For many capital-intensive / manufacturing businesses, debt can be a very high number that journalists always need to track. Journalists need to look at what is reported both under the current liabilities – those that are due within the next year, including current maturities of long-term debt – and the amount of long-term debt, net of current maturities.

Tracking the numbers is great, but futile without a benchmark. Converting all Balance Sheet line items to a Percentage of Total Assets will present a better picture of both the company's financial stability and how the company compares with its competitors and industry.

Journalists should calculate the Percentage of Total Asset numbers on a spreadsheet for the last five years and, separately, for the last 12 quarters. Since some industries are cyclical and are leading indicators of the economy's health and this technique may predict a recession. Also, looking for large changes and unusual trends will help when questioning management and extracting a clearer picture of the company's financial strategy and ultimately its health.

***Caveat: The Balance Sheet does not report everything that a company owns or owes and is prone to financial manipulation. Certain types of "debts" may not be included in the financial statements, but rather in the footnotes. This is what accountants call Off-Balance Sheet (OBS) Debt, examples of which include:***

→ Leases (specifically Operating Leases)
→ Guarantees
→ Special Purpose Entities (or subsidiaries not included)
→ Contingent Liabilities

OBS Debt must always be added to the Total Debt amounts found on the Balance Sheet to come up with an adjusted debt number.

Likewise, companies have assets such as patents, trademarks, and research on new products and services that are not always reported on the balance sheet. Information about these factors often can be found either in the footnotes to the financial statements or the MD&A. Increasingly, these are the assets that generate the most value for a company and, consequently, should be reviewed closely.

**Habit #6 - Review the Income Statement Items Both in Terms of Dollars and as a Percentage of Total Revenues**

After analyzing the Cash Flow Statement and Balance Sheet, journalists can reaffirm their conclusions about the company's financial health by reviewing the Income Statement. As an example, had you analyzed an airline's financial statements, you would have actually noticed if its business model was not working and whether profitability was declining or negative. These conclusions can be found on the company's Cash Flow Statements, namely with a negative Cash Flow from Operations and negative Free Cash Flow.

When reviewing the Income Statement, it is very easy to get caught up in the actual dollar amounts (e.g., Gross Margin going from $500,000 to $600,000). However, Gross Margin as a Percentage of Total Revenue is more important and should be calculated to determine whether profit margins are increasing or declining.

Again, an Income Statement benchmark is necessary. Converting all Income Statement line items to a Percentage of Total Revenue gives a better picture of performance trends and margins and how both compare with a company's history, competitors and industry peers.

Calculate each line item as a Percentage of Total Revenue on a spreadsheet for at least the last five years and separately for the last 12 quarters. Some industries are cyclical and are leading indicators of the economy's health and, as such, can even predict a recession using this technique. Also, looking for large changes and unusual trends will help when asking questions of management and may provide a clearer picture of the company's financial health.

**Habit #7 - Read the Company's Earnings Release**

As you write your story, keep a few things in mind:

→ **Net income or earnings can easily be manipulated within the Income Statement** given the flexibility of accounting rules. Think about why companies are always beating earnings per share (EPS) estimates by a penny? Why not two or three or four pennies? Also, note that under conditions of generally rising prices, even when inflation is just 1% or 2%, records for earnings and revenues are not unusual.

→ **Flag anything that seems like or acts like "Pro-Forma" Earnings.** This is the company's way of saying it has a one-time explanation for why it lost money or did not make as much as it did the prior year or quarter. Examples of this are words like "write-offs," "charge-offs," and "one-time charge." The money was spent on something that is no longer useful.

→ **Regularly reference Cash Flow from Operations and Free Cash Flow and generally explain what the terms include and exclude.** These numbers are powerful tools that tell an audience

about the financial health of a company. These two calculations are also less prone to manipulation as they represent large movements in cash and quickly reflect management's strategy.

→ **Always read the footnotes to financial statements.** A majority of the truth of the company's health is buried here; the numbers alone rarely tell the full story. Take time to review and ask questions regarding any vague statements.

Want to learn more? CFA Institute offers twelve one-hour Webcasts on financial statement analysis, accounting tomfoolery, and corporate disclosure practices. Also available at www.cfainstitute.org/pressroom are archived issues of the *Financial Journalist Newsletter*, an online newsletter that explains important accounting terms and practices, comments on corporate disclosure practices and potential accounting manipulations, and answer frequently asked questions - all from the perspective of professional financial analysts and portfolio managers who analyze financial statements and potential investments. Other media resources may be found at www.cfainstitute.org/pressroom/media_services.html.