

# An Overview of Financial Statements by Someone Who Writes Them

A Learn & Earn Feature  
*Stephen William Beer, CPA*



**As a part-time office boy for my father's office, I would look forward to those days when it was necessary for a messenger to make a delivery to the firm's stockbroker. The office manager would always comment about how young Stephen seemed to do everything so quickly, and yet these deliveries would take him forever. It was at that time, when a young boy is faced with the choice of careers, when Stephen's decision was made.**

The young investor knew that the best way to understand and interpret financial statements was to write them. With this, he would know the intricacies of the statements themselves, and someday would have an edge over other investors. The next most important step was his introduction to NAIC, by a Wall Street portfolio manager, but that is another story.

Our education system seems to instill upon us a system of evaluation based upon tangible values, a "bird in the hand" type of attitude. A good example of this occurred a short time ago, when I was asked to participate in a roundtable discussion, with a number of other CPAs, on the subject of this article. I was amazed at how the responses by my colleagues were based so much on this "what we have" attitude.

They stressed the importance of the two sections of the financial statements (the balance sheet and income statement) which I personally feel have limited value in evaluating future potential, although they can be very helpful in evaluating management. In order to be successful growth stock investors, I think we must ignore our past "what we have" training, and concentrate on potential. After all, we must remember, we are primarily investing in the future, and not in the present nor past.

To simplify the analysis, I would like to proceed through the financial statements, beginning with what in my view is of least importance in evaluating a stock's potential, and ending with a few comments on those often overlooked but always useful footnotes.

Unless you are "bottom fishing," i.e. considering the purchase of a stock which is experiencing significant problems, the auditors' report can be ignored. Any qualifications or other problems would already be reflected in a significantly reduced stock price, making it quite obvious that these problems exist. There is extreme pressure

on the auditor to issue a clean audit opinion, so much so, that many auditors would rather resign than issue a less than favorable opinion on the financial statements.

The balance sheet represents a snapshot of the accounting for the assets and liabilities of the company, as of a specific date generally over two months ago. I intentionally used the term "accounting," since the valuations used by the company are based on generally accepted accounting principles. These principles require that assets are recorded at cost unless the fair market value is less. The estimation of fair market value allows for a substantial range for valuation, and as such, only under extreme conditions is fair market value found to be less than cost. This approach tends to hide the value of the company from the reader of the financial statements. Furthermore, since stock market evaluations are based on multiples of earnings or cash flows, I suggest the balance sheet primarily be used for management evaluation.

Since we cannot rely on the accounting valuations to provide us with a reasonable basis for evaluating a stock, we must turn to a system of evaluating future potential. By buying the future, we are really entrusting our investment to the management of the company. Before we make such a decision, it is quite important we assure ourselves of management's ability to handle our investment. Therefore, to me, there is really one and only one use for the income statement. That is for the evaluation of management's ability to consistently perform within expectations. Comparisons can be made to analysts' expectations as well as to prior year performance. These days, any variation of the final profit performance from Wall Street's expectations will be immediately reflected in the stock's price, quite sometime before the individual investor has analyzed the annual report.

*Continued on next page*

## Useful Balance Sheet Ratios

<b>Current Ratio</b>	=	<b>Current Assets divided by Current Liabilities</b>
<b>Quick Ratio</b>	=	<b>Quick cash (maturity less than 3 months) divided by Current Liabilities</b>
<b>Working Capital</b>	=	<b>(Net Current Assets less Current Liabilities) divided by Total Assets</b>
<b>Return on Average Assets</b>	=	<b>Net Income divided by Average Total Assets</b>
<b>Number of Days Accounts Receivable</b>	=	<b>Net Accounts Receivable divided by (Total Sales divided by 365 Days)</b>

Management evaluation can be quite involved. You may instead choose to use a thumbnail analysis, and if so, it is suggested you decide which of the following criteria are right for you. The NAIC Stock Selection Guide uses two of the most utilized return-type calculations, which are the review of the history of profit margins and the return on shareholders equity. I like to add an analysis of the company's ability to withstand setbacks, as well as an attempt to foresee management problems through on evaluation of asset management.

The eighties reminded us once again of the effect excessive debt can have on common stockholders' equity. When analyzing the company's debt, a comparison to assets can be helpful. While there is no set number of times total assets should exceed total liabilities, and industries do vary, several times, at a minimum, is a good guideline to follow. More important is the timing of the maturities and the ability of the company to service its debt. A comparison should be made of maturing debt, over the next five years as well as long term, to excess available cash flow to verify the company's downside protection.

As previously stated, the balance sheet is most useful for the evaluation of asset management. Important ratios can be computed based on the information in the financial statements to ascertain the company's ability to adequately manage its assets. These are highlighted in the chart above.

Now let's turn our attention to what I believe is the most overlooked financial analysis tool, the Statement of Cash Flows. Cash flow is the life blood of any business. Excess cash flow is necessary for management to do many of the things I want them to do. These include repayment of debt, increasing dividends, share

repurchases and, most importantly, acquisitions for further growth.

The Statement of Cash Flows is broken into three parts; a reconciliation of net income to cash provided by operations, cash flow from investing activities and from financing activities. By reviewing each part separately, we can gain important insights into the past and make educated guesses as to future cash needs for investment in plant and equipment. It is also possible to gauge the company's ability to raise funds through financing.

The reconciliation of net income to cash provided by operations will highlight the difference between operational income and cash flow. Improving the cash flow from operations in addition to earnings is a very promising sign, as increases in income without a corresponding increase in cash flow may lead to painful results.

This section also displays changes in current asset management in an easy-to-read format, without the calculation process required by evaluating the balance sheet as explained earlier. Significant trends can be ascertained in the important operation areas of accounts receivable, inventories and payables. Trends, such as a large rise in inventories or accounts receivable, may be a warnings sign of slow moving or returned merchandise which can lead to write offs. Significant increases in payables can indicate a cash crunch, whereby vendors are used for short-term financing not available to the Company in the credit markets.

The investing activities section will highlight the past acquisition activity as well as needs for reinvestment in property, plant and equipment. This information

can be used as a guideline in projecting the company's cash flow needs in the future, an integral part of analyzing free cash flow. These cash flow projections can then be compared to the earnings projections made as part of the completion of the Stock Selection Guide. Free cash flow is calculated by subtracting required investment in property, plant and equipment and dividends from the cash flow from operations.

The final section highlights the financing activities of the company. The annual amount of short-term paper, either repaid and sold as well as issuance of long-term debt are highlighted for your use. With this, it is possible to see how successful the company has been in obtaining financing, and will aid in your analysis of their capability of raising more funds. It is always a good idea to trace how the proceeds from financing were used. Preferences include increased investments in property, plant and equipment, stock repurchases or acquisitions. The use of financing to fund cash shortages or dividends are a good indication of an undesirable company.

The most voluminous part of the financial statements is the footnotes. They contain informative disclosures which are an integral part of the financial statements and should never be overlooked. Here we find the one place where management has independent professionals examining their commentary. Important disclosures include the company's accounting policies, commitments and potential claims. Furthermore, the only place to obtain insight into the important aspects of a company's debt is the footnotes. Details include interest rates, maturity dates and conversion privileges. Also, the amount of debt maturing over our investment horizon of five years will be highlighted.

The volume of the information presented in the financial statements, as well as in this article, can be overwhelming. Each investor should review numerous annual reports, in order to determine their personal preference for measuring a Company's performance and future potential and which criteria they will apply in analyzing financial statements.

---

*Stephen Beer is a Certified Public Accountant and president emeritus of NAIC's New York City Council.*