

Financial Statement Analysis for Beginners

February 02, 2011

By [John Persinos](#)

[Financial statements](#) are without a doubt the most important resource for any individual investor. All companies with [stock](#) trading on the New York Stock Exchange, the American Stock Exchange, [Nasdaq](#), etc. are required to file financial statements with the [Securities and Exchange Commission \(SEC\)](#) single quarter. Just go to www.sec.gov and click on "Search for Company Filings."

All that information is available to you, free of charge. So now we'll show you how to use it.

Think of financial statements as a company's medical charts, and you're the doctor who's using these charts to come up with a diagnosis of the company's financial health.

Here are the "Big Three" financial statements:

1) The [balance sheet](#)

The balance sheet is a snapshot of a company's financial position. The balance sheet reveals a firm's financial resources (their assets) and obligations (their liabilities) at a given moment in time.

2) The [income statement](#)

The income statement summarizes a firm's financial transactions over a defined period of time, whether it's a quarter or a whole [year](#). The income statement shows you [money](#) coming in ([revenues](#), also known as [sales](#)) versus the expenses tied to generating those revenues.

3) The [cash flow statement](#)

A company's sole reason for existing is to generate [cash](#) that can be distributed to shareholders. This dynamic is called a "positive [cash flow](#)." As we'll explain a little later, cash flow is not the same as [income](#), and it's important to know the difference.



The Balance Sheet

The Balance Sheet

The balance sheet is broken into two sides. Assets are on the left side (or the top, in the example below) and liabilities and shareholder [equity](#) are on the right side (or the bottom). The balance sheet is said to be "in balance" when the value of the assets equals the combined value of the liabilities and shareholders' equity (by the way, a balance sheet always has to be balanced).

Let's look at Walmart's balance sheet, as shown on Yahoo Finance:

Wal-Mart Stores Inc. (WMT)		
Balance Sheet		
Period Ending	Jan 31, 2010	Jan 31, 2009
Assets		
Current Assets		
Cash And Cash Equivalents	7,907,000	7,275,000
Short Term Investments	-	-
Net Receivables	4,144,000	3,905,000
Inventory	33,160,000	34,511,000
Other Current Assets	3,120,000	3,258,000
Total Current Assets	48,331,000	48,949,000
Long Term Investments	-	-
Property Plant and Equipment	102,307,000	95,653,000
Goodwill	16,126,000	15,260,000
Intangible Assets	-	-
Accumulated Amortization	-	-
Other Assets	3,942,000	3,567,000
Deferred Long Term Asset Charges	-	-
Total Assets	170,706,000	163,429,000
Liabilities		
Current Liabilities		
Accounts Payable	50,550,000	47,638,000
Short/Current Long Term Debt	4,919,000	7,669,000
Other Current Liabilities	92,000	83,000
Total Current Liabilities	55,561,000	55,390,000
Long Term Debt	36,401,000	34,549,000
Other Liabilities	-	-
Deferred Long Term Liability Charges	5,508,000	6,014,000
Minority Interest	2,180,000	1,794,000
Negative Goodwill	-	-
Total Liabilities	99,650,000	97,747,000
Stockholders' Equity		
Misc Stocks Options Warrants	307,000	397,000
Redeemable Preferred Stock	-	-
Preferred Stock	-	-
Common Stock	378,000	393,000
Retained Earnings	66,638,000	63,660,000
Treasury Stock	-	-
Capital Surplus	3,803,000	3,920,000
Other Stockholder Equity	(70,000)	(2,688,000)
Total Stockholder Equity	70,749,000	65,285,000
Net Tangible Assets	54,623,000	50,025,000

The balance sheet's underlying equation is $\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$. In other words, a company raises money through [debt](#) (liabilities) and/or contributions from owners (equity) and uses it to buy assets. A company's assets then make the products or services that the company sells to customers.

Here are some of the most important things to look for:

Current Assets: [Current assets](#) can be easily turned into cash, because they have a lifespan of 12 months or less. These short-term assets include [accounts receivable](#), [inventory](#), cash, and [cash equivalents](#). Cash equivalents are extremely [safe assets](#), like U.S. [Treasuries](#), that can be easily transformed into cash.

Property Plant & Equipment (PP&E): PP&E is often the largest line item on a firm's balance sheet. That makes sense, considering that many companies make huge [investme](#) in things like factories, computer equipment and machinery.

Intangible Assets: An [intangible asset](#) is something without a physical substance. Examples include trademarks, copyrights and [patents](#).

Goodwill: [Goodwill](#) is an [accounting](#) construct that's a little confusing to explain and is probably beyond the scope of a beginner's tutorial. But in short, when a company buys another company, and it pays more than the [fair value](#) of the assets it buys, the excess purchase price is listed on the acquiring company's balance sheet as goodwill. Goodwill can't be bought or sold, so many [analysts](#) prefer to not consider it when they are examining a firm's assets.

Current liabilities: These are [debts](#) that must be paid within 12 months. They include both short-term borrowings, such as accounts payables, and the current payment on [long term debt](#).

Long-term Debt: Long-term debts are due in one year or more. A company records the [market value](#) of its long-term debt on the balance sheet, which is the amount necessary to pay off the debt.

Shareholder equity: Also known as stockholder equity, shareholder equity represents the portion of the company that belongs to its owners. Equity can be increased by reinvesting profits or by paying down debt.

To learn how to tease out even more information from the balance sheet, click here to read, [Ten Things You Need To Know About Every Balance Sheet](#).

The Income Statement

The Income Statement

With a greater understanding of the balance sheet and how it is constructed, we can now look at the income statement.

The basic equation underlying the income statement is Revenue - Expense = **Net Income**.

The equation is simple, but the terminology can be convoluted.

The income statement is also known as a "**profit & loss statement**", or a "P&L." Revenue is also known as "sales," and is also called "**the top line**." Net income is also known as "**earnings**" and "profit," in addition to being called "**the bottom line**." Clear as mud, right?

But I promise if you take some time to get comfortable with the vocabulary, the income statement **will** reveal some remarkable information. Again, let's take a look at Walmart's income statement, as reported on Yahoo Finance:

Wal-Mart Stores Inc. (WMT)		
Income Statement		
Period Ending	Jan 31, 2010	Jan 31, 2009
Total Revenue	408,214,000	404,374,000
Cost of Revenue	304,657,000	304,056,000
Gross Profit	103,557,000	100,318,000
Operating Expenses		
Research Development	-	-
Selling General and Administrative	79,607,000	77,520,000
Non Recurring	-	-
Others	-	-
Total Operating Expenses	-	-
Operating Income or Loss	23,950,000	22,798,000
Income from Continuing Operations		
Total Other Income/Expenses Net	181,000	284,000
Earnings Before Interest And Taxes	24,131,000	23,082,000
Interest Expense	2,065,000	2,184,000
Income Before Tax	22,066,000	20,898,000
Income Tax Expense	7,139,000	7,145,000
Minority Interest	(513,000)	(499,000)
Net Income From Continuing Ops	14,927,000	13,753,000
Non-recurring Events		
Discontinued Operations	(79,000)	146,000
Extraordinary Items	-	-
Effect Of Accounting Changes	-	-
Other Items	-	-
Net Income	14,335,000	13,400,000
Preferred Stock And Other Adjustments	-	-
Net Income Applicable To Common Shares	14,335,000	13,400,000

Here are some of the most important things to look for:

Total Revenue: If you compare total **revenue** from one year (or quarter) to the next, you should be able to see patterns. Are revenues growing? Are they shrinking? A company needs to sell its product in order to stay in business, and this is where you can see that process in action.

Gross profit: **Gross profit** is the difference between sales price and the cost of producing the products. If this is negative, the company is in real trouble.

Operating Expenses: Operating expenses are costs that a company must pay in the normal course of business. A company needs to pay employees, research & develop new products, pay rent, and so on.

Operating Profit: Operating Profit = **Operating Revenue** – Operating Expenses. Operating profits are earned from a company's everyday core business operations. Operating profits also are called "Earnings Before Interest and **Taxes (EBIT)**."

Net Income: Net income is always found toward the bottom of the income statement (hence, the bottom line), and it's the most-watched number of any in finance. Let's look back at the equation we introduced earlier: Revenue - Expense = Net Income. Net income is, in theory, the amount of sales that are left over to be distributed to shareholders.

To take your examination of the income statement a step further, you need to measure all of these line items in relation to one another. That's called "**margin analysis**." You can learn more about it here: [How to Use Margin Analysis as an Investment Tool](#).

The Cash Flow Statement

The Cash Flow Statement

The cash flow statement is probably the most misunderstood, but most important of the financial reports filed by companies. Have you ever heard the phrase, "Cash Is King?"

Many value investors base all of their decisions on how well a company can generate cash.

[Click here to learn [How to Invest Alongside the Great Value Investors](#) by emphasizing cash flow.]

The cash flow statement reports a company's cash receipts and cash payments over a particular period of time. It leaves out transactions that don't directly affect cash receipts and payments.

For example, the income statement includes a non-cash expense called [depreciation](#). Depreciation is a [term](#) made up by accountants -- it's not a person or a place to which a company can write a check for "depreciation" expenses. The income statement accounts for non-cash expenses, and the cash flow statement undoes that accounting so invest can see exactly where the company generates (and uses) all its cash.

The cash flow statement divides up sources and uses of cash into these three areas: financing, operating and [investing](#). Let's look at Walmart again:

Wal-Mart Stores Inc. (WMT)		
Cash Flow		
Period Ending	Jan 31, 2010	Jan 31, 2009
Net Income	14,335,000	13,400,000
Operating Activities, Cash Flows Provided By or Used In		
Depreciation	7,157,000	6,739,000
Adjustments To Net Income	(425,000)	435,000
Changes In Accounts Receivables	(297,000)	(101,000)
Changes In Liabilities	2,400,000	1,626,000
Changes In Inventories	2,265,000	(220,000)
Changes In Other Operating Activities	301,000	769,000
Total Cash Flow From Operating Activities	26,249,000	23,147,000
Investing Activities, Cash Flows Provided By or Used In		
Capital Expenditures	(12,184,000)	(11,499,000)
Investments	-	-
Other Cash flows from Investing Activities	564,000	757,000
Total Cash Flows From Investing Activities	(11,620,000)	(10,742,000)
Financing Activities, Cash Flows Provided By or Used In		
Dividends Paid	(4,217,000)	(3,746,000)
Sale Purchase of Stock	(7,712,000)	(3,521,000)
Net Borrowings	(1,866,000)	(2,918,000)
Other Cash Flows from Financing Activities	(396,000)	267,000
Total Cash Flows From Financing Activities	(14,191,000)	(9,918,000)
Effect Of Exchange Rate Changes	194,000	(781,000)
Change In Cash and Cash Equivalents	632,000	1,706,000

Now let's take a closer look at those 3 main categories:

Cash Flow from Operations (CFO): CFO is the cash generated by the company's core business activities. You want a company to generate cash from the business it operate. It sounds obvious, but there are a ton of companies that don't generate cash from operations and eventually fail.

Cash Flow from Investing (CFI): Remember the Property Plant & Equipment line from the balance sheet? When a company invests in these long-lived assets (or sells them) the cash they spend buying the [asset](#) or the cash they generate from selling the asset is recorded here. If a company is growing, CFI will almost always be negative. That's a good thing, because it means the company is investing in assets that will create profits for shareholders.

Cash Flow from Financing (CFF): CFF is the cash that is provided by or repaid to outside investors. If a company borrows \$1 million, that is \$1 million dollars that flows into the company, and CFF is positive. When the company repays the \$1 million, that is a \$1 million outflow of cash, and CFF is negative.

There's a [lot](#) more to learn about the beauty of cash flows, so click here to read the [10 Things to Know about Every Cash Flow Statement](#).

Now that you're armed with the basics of financial statement analysis, sharpen your pencil and pull out your calculator. You're ready to do some financial sleuthing -- if not for fun then certainly for profit!