



IOI Guide to Understanding Financial Statements

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Introduction

Although the words “financial statements” and “accounting” send cold shivers down many people’s spines, they are a core part of the language of business—a language that investors need to understand well before buying stocks. Fortunately, you don’t have to be a CPA to understand the basics of the most important financial statements: the income statement, the balance sheet, the statement of changes in shareholders’ equity, and the statement of cash flows.

There is a very good reason for knowing at least the fundamentals of these three types of financial statements, for they are windows into a company’s performance and health.

One of the main reasons that people find reading financial statements so daunting is that accountants and lawyers have worked so hard to make the subject dense and arcane. Before we look at each of the financial statements, let’s take a step back and think practically about what happens in a simple business. Nothing in multinational companies is so different from what happens from the corner grocery store (if such a thing exists anymore...), just on a larger scale and with more projects and activities going on at once.

We won’t formalize any of the concepts that we’re talking about in accounting jargon right now, but rather give a little example that you’ll intuitively understand, and then refer back to it from time to time as we’re talking about “difficult” accounting concepts.

Specialty Bookstore Example

You capitalize your own business with \$100,000 in savings

Let’s assume that you open a specialty bookstore carrying first edition and out of print classics of military history. You have about \$100,000 in savings of your own that you can use to buy some books and to rent a small storefront location. You pay a web designer to get you started on the Internet. The web developer creates a web site for you and helps you to get listed with some search engines. You start selling your books and make a pretty good profit on each one. After six months, you find that you have earned enough profit to break even on your rent and, after a year, you are able to hire a part-time employee.

Because the average price of your products is fairly high and many of your sales are completed via the Internet, almost all of your sales are made by credit card. As you read through trade magazines and the Internet for sale postings, you notice that a lot of the same titles keep appearing, but that the prices are widely varying depending on where the posting was made. You are sure that, if someone were diligent about keeping track of posted prices, one could buy from the cheaper areas and sell on the higher side—increasing one’s profits still further.

Incorporating technology to increase sales and efficiency

Acting on this idea, you pay a student at the local junior college to set up a database, and you and your part-time employee spend time entering data. It is a lot of work, but after a few months, you notice that you are making much higher profits using the new strategy.

First business acquisition

After your successful foray into competing using technology, you start to think about expanding into other specialties and start researching. It turns out that you can spend \$50,000 for a low-end collection of organic gardening books and then spend more time and money trying to beef it up, or you can make an offer to a bookseller in the next town over who has one of the best collections of that type around. You figure that you can buy him out for around \$75,000, then apply your database to his collection as well. You end up buying the other bookseller out for \$85,000 and make an agreement to keep him on as manager. You take out a mortgage and purchase a larger location so that you can consolidate both your military and gardening collections in one place. In addition to the money that you spent on the new building, you also have to spend around \$50,000 in improvements.

In the course of normal business, every once and awhile, you go to book fairs around the country and spend quite a bit locating and buying more books. After a few years, you are able to start paying yourself a salary, and are still able to bank about \$15 out of every \$100 in sales. After ten years, your business is booming and your company is the most powerful, well-known bookseller in your niches, with the broadest and deepest collections around. You thereafter spend the profits that you have earned from the past two and a half years of operations in order to take a stake in a bookseller specializing in hard-to-find scientific books. This move instantly boosts your book sales by about 30% and you figure that it will take

We will return to this example when explaining each of the financial statements

about a year before the profits from that new business will build your bank account back up to pre-transaction levels. A few years later, you take out a bank loan, collateralized by your scientific collection, to buy out your scientific book partner. You are happy because, whereas your military and gardening collections sell well in the two months before Christmas, the scientific collection sells best in the late spring and early summer and seems less variable during recessions than the other two.

Now that we have set forth a realistic and intuitively clear example, we can turn our attention to how the simple transactions described above are reflected in standard financial statements.

Flow and Stock Numbers

This guide provides a look at line items in each financial statement and what they mean. We are going to keep the discussion general, so will avoid accounting jargon as much as possible. That said, there is one bit of jargon that is helpful to introduce up front – the distinction between flow and stock numbers. Flow Numbers are quantities that make most sense to be tallied on a running basis, like sales and expenses. Stock numbers are quantities that make the most sense to be tallied as of a certain date, like cash or debt outstanding. We'll provide more examples of these two types of numbers throughout this guide.

The table below is an overview of the most important statements and sections of standard annual and quarterly filings. Where applicable, we indicate whether the statements show flow or stock numbers.

Financial Statement Overview Table

NAME OF STATEMENT	WHERE YOU FIND IT	WHAT IT SHOWS YOU	STRENGTHS AND WEAKNESSES
INCOME STATEMENT	The first few pages of a 10-Q quarterly statement or the middle of the 10-K annual statement.	Flow numbers such as sales and expenses. This is the most widely-discussed statement, starting with Revenues (the top line) and ending with Earnings (the bottom line)	For mature companies, the IS appropriately represents the ability of the firm to convert revenues into profits. The inclusion of “non-cash” charges may give a misleading picture of cash-based profitability at a business.
BALANCE SHEET	The first few pages of a 10-Q quarterly statement or the middle of the 10-K annual statement.	Stock numbers such as cash on hand, debt owed to banks, etc.	Best picture of what a company owns and owes. Does not show certain kinds of “virtual” debt, like long-term leases. May understate the value of assets.
STATEMENT OF CASH FLOWS	The first few pages of a 10-Q quarterly statement and the middle of the 10-K annual statement.	Flow numbers that lead to a change in an important stock number – cash. Split into three segments, showing cash flows generated through operations, investment, and financing (e.g., issuing debt and equity)	The most important statement in the IOI valuation framework – showing all the numbers necessary for estimating “Owners’ Cash Profits” and most of the numbers needed to estimate “Free Cash Flow to Owners”. Tends to understate the power of a new, quickly growing firm to generate economic profits for its owners.
CHANGES IN SHAREHOLDERS’ EQUITY	Not in a 10-Q but in with the other financial statements in a 10-K.	Accounting of the shares issued and bought back by a company, the dividends it paid and increase in retained earnings.	Ties together the Income Statement and the Retained Earnings portion of the Balance Sheet. Can show the numbers of shares issued—an important number in estimating anti-dilutive stock buybacks. Generally ignored by most analysts and not terribly important except with respect to share buyback calculations
NOTES TO FINANCIAL STATEMENTS	After financial statements in 10-Qs and 10-Ks.	Excruciating details about legal and accounting niceties, with the occasional gem of wisdom.	Contains important economic information that puts flesh onto the bones of the financial statements above. Boring and tedious to read in parts and filled with obfuscating jargon.
MANAGEMENT DISCUSSION & ANALYSIS (MD&A)	Before financial statements in 10-Ks.	A description of the business and a written explanation of notable year-to-year changes in revenues and profitability. Also may provide some information about important corporate events such as acquisitions, capital raises, etc.	A nice historical record of changes from year to year for past periods. Tends, however, to be fairly superficial.

For the example financial statements in this guide, we're using the example of Home Depot (HD) so you can look at an actual example. We won't go into detail with every line item, but will cover the basics of how financial statements are set up. Let's step through each statement one-by-one, starting with the Income Statement

The Income Statement

The income statement (a.k.a. "the Profit & Loss Statement") tells you how much money a company has brought in (its "revenues"), how much it has spent (its "expenses"), and the difference between the two (its "profits"). Moreover, an income statement shows a company's revenues and expenses over a specific time frame, such as three months (a "quarterly income statement") or a year (an "annual income statement"). Since the numbers found on the income statement represent a flow of products or services sold, costs spent, etc., over a certain time period, we call them "flow numbers," as mentioned above. The P&L contains the financial information that you'll most often see mentioned in news media reports—figures like total revenue, net income, and earnings per share.

The income statement answers the question, "How well is the company's business performing?" Or, in simpler terms, "Is it making money?" A firm must be able to bring in more money than it spends, or else it won't be in operation for very long.

THE HOME DEPOT, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS

	Fiscal Year Ended ⁽¹⁾		
	February 2, 2014	February 3, 2013	January 29, 2012
<i>amounts in millions, except per share data</i>			
NET SALES	\$ 78,812	\$ 74,754	\$ 70,395
Cost of Sales	51,422	48,912	46,133
GROSS PROFIT	27,390	25,842	24,262
Operating Expenses:			
Selling, General and Administrative	16,597	16,508	16,028
Depreciation and Amortization	1,627	1,568	1,573
Total Operating Expenses	18,224	18,076	17,601
OPERATING INCOME	9,166	7,766	6,661
Interest and Other (Income) Expense:			
Interest and Investment Income	(12)	(20)	(13)
Interest Expense	711	632	606
Other	—	(67)	—
Interest and Other, net	699	545	593
EARNINGS BEFORE PROVISION FOR INCOME TAXES	8,467	7,221	6,068
Provision for Income Taxes	3,082	2,686	2,185
NET EARNINGS	\$ 5,385	\$ 4,535	\$ 3,883
Weighted Average Common Shares	1,425	1,499	1,562
BASIC EARNINGS PER SHARE	\$ 3.78	\$ 3.03	\$ 2.49
Diluted Weighted Average Common Shares	1,434	1,511	1,570
DILUTED EARNINGS PER SHARE	\$ 3.76	\$ 3.00	\$ 2.47

(1) Fiscal years ended February 2, 2014 and January 29, 2012 include 52 weeks. Fiscal year ended February 3, 2013 includes 53 weeks.

See accompanying Notes to Consolidated Financial Statements.

Let's walk through the main lines of this statement one by one.

Sales (Revenues)

A company's revenues are an expression of the strength of the demand for the company's goods or services. Many professionals tend to think of revenues as an independent cause, where in fact, it is an effect of decisions made by management teams. Capital expenditures, product design, marketing, and merger decisions all exert an enormous influence on what revenues the company is able to generate.

While income statements for companies in different industries may not look exactly the same, almost all of them begin with the company's revenue for the period in question. Sales, which is sometimes called "Revenues" in the U.S. or "Turnover" in the United Kingdom, represents the amount of money that clients promise to pay a company in return for receiving its goods or services. (Because banks and some other financial institutions generate income primarily from interest—that is, they don't really "sell" anything—their income statements can appear quite different from manufacturing companies.)

Depending upon the nature of a company's revenue stream, a company will record its revenue in one of several ways, and just because moneys are listed as "revenues" does not mean that the company necessarily immediately receives cash.

The most straight-forward case of revenue-generation is when you use cash to purchase a stick of gum at the grocery store. Cash is paid, the product is immediately "delivered," and the grocery store "recognizes" that revenue. A slightly more complicated case is when you go to Best Buy and pay for a new CD using a credit card. In this case, Best Buy does not receive cash right away, but instead receives another asset—an IOU—from a credit card company. If that credit card company, for some reason, refuses to pay its IOU, the sale that had been counted as revenue never amounts to a cash inflow to Best Buy. Another more complex case occurs when you pay for an annual subscription to the Wall Street Journal up front, but receive copies of the newspaper only over time. In this case, the Wall Street Journal takes in your cash immediately, but still owes you something—310 or so issues of its paper—so that it cannot recognize that money right away as revenue.

The main point to take away from the above discussion is that timing differences like the ones mentioned here are what separates what is termed [accrual accounting](#) from the "[cash accounting](#)" that most of us are so used to in our daily lives.

In terms of our bookseller, revenue is simply the amount that you receive from clients when you deliver books to them. Because most of your sales as a bookseller are via credit cards, if you were to make out a weekly P&L statement based on accrual accounting, you would tally all the sales made that week for your revenue line. If you were making out the same P&L statement based on cash accounting, however, you would not be able to tally anything because the credit card company pays, let's say, only once every 20 days. Speaking of credit cards, American Express charges you a monthly fee as well as a per-transaction percentage of sales for the convenience of offering payment by Amex to your customers.

Operating Expenses

A company needs to spend money in order to make money, and these outflows—resulting from making and selling its products or providing and selling its services—are usually grouped into a number of categories that are common to most companies' financial statements. The first group of these—the Operating Expenses—are the most important because they record how much it costs to run the main business in which the company is engaged.

Cost of Sales

Cost of sales (also known as cost of goods sold, or COGS, or cost of services) represents all of the expenses that are directly incurred in creating the goods or services that a company sells. Examples include: raw materials, items purchased for resale, and production labor. For instance, if it costs Best Buy \$9 to acquire a DVD wholesale that you purchase retail, that \$9 is considered a "cost of sales." The steel and rubber that Harley-Davidson

must purchase in order to make its motorcycles is also considered a cost of sales. For manufacturing companies, some part of COGS are theoretical costs called “depreciation.” When a company buys a new piece of equipment, the company does not count the full cost of that equipment against the revenues from that period. In the same way that newspaper revenues cannot be recognized all up front, it would be unfair to force a company to recognize all of the costs up front for a machine that will last for many years. As such, companies allocate only a portion of the cost of its equipment to each day or week that the equipment is in use, much as if the company were buying only that time period’s worth of the equipment. In this way, the cost of the equipment is spread out over the equipment’s useful life. A similar, theoretical charge for intangible assets like patents also occurs, and is called “amortization.” The principle behind the two types of costs is the same, also though amortization charges are more often included within Selling, General, and Administrative (SG&A) or Research and Development (R&D) expenses, as described below.

In terms of our bookseller, the cost of sales for a single book includes: (1) the price that you pay for the book at the book fair; (2) one book’s worth of your travel expenses to the out-of-town book fair; (3) the salary of the buyer (you) while at the book fair; and (4) one book’s worth of shipping expenses when you ship the books back from the fair to your store via UPS. In other words, the cost of sales includes all the expenses necessary to bring the book into your possession and make it ready to sell. For a single day, your cost of goods sold, or COGS, also will include some proportion of the theoretical cost of depreciation for the shelves on which the books sit. When you buy the shelves, you have to make an estimate of how long they will probably last—say, ten years—then, for every day that the shelves are in service, you take some proportion of their original cost and deduct that from your revenues for that day. If, after 10 years you are still able to use those shelves, your profit increases because you are using “fully-depreciated” equipment, so there are no more theoretical costs to allocate. One other general cost that you might include in COGS is that of inventory damage or theft. If, each month, you can expect about \$150 worth of this kind of damage, you would spread those costs out over your monthly revenues as well.

[Selling, General, and Administrative Expenses.](#)

Selling, general, and administrative expenses (also known as “SG&A”) consist of several types of costs. Note that sometimes this expense is split into two lines: Selling & Marketing (S&M) and General & Administrative (G&A). Selling expenses are those expenses incurred in attempting to create sales for the company. Examples include marketing expenses and compensation for sales staff. General and administrative expenses, meanwhile, represent most of the overhead costs associated with operating a company. Costs related to a firm’s human resources, legal, and finance departments and costs associated with operating the company’s physical facilities (e.g., office building, parking garage) are examples of general and administrative expenses.

In terms of our bookseller, you would count all of the costs spent to set up your web site as sales and marketing expenses, and you also would count the monthly charge that you pay to Google for the advertising space that you have bought. While your store is still young and you are minding the store yourself, and then after you hire a part-timer, you will count these salary costs in sales and marketing as well. However, after you step away from day-to-day customer relations in the store, you might move your salary to general and administrative expenses (under the assumption that your role as a manager is more “administrative” than sales-related). In the case of a bookseller, though, the two types of costs (sales and marketing, and general and administrative) probably would be collected into one line in the financials. It might be kind of a stretch for a bookseller, but it is possible that, in one of your acquisitions, you bought the rights to a list of high-volume clients. According to accounting rules, you would have to place a dollar value on this list and amortize this cost over, let’s say, the next five years. (For instance, assume that you spent \$85,000 when you bought the gardening bookseller. Let’s further say that you determined that the client list was worth \$5,000 and that your accountant tells you that it is customary to amortize such a list over a five-year time horizon. Each month, you would allocate $\$83.33 = \$5,000 \text{ divided by } 5 \text{ years divided by } 12 \text{ months per year}$ to your SG&A account.) Another theoretical cost that you

might allocate to SG&A is the depreciation cost of your trusty cash register and computer. Because the cash register is integral to selling books, you might allocate the depreciation to selling costs, but because the computer is integral to administering your business, you would allocate its depreciation expense to administrative costs.

Research and Development (Not show in the Home Depot example)

Any company that employs scientists and engineers to design and test new products usually has a line for Research & Development (R&D) expenses, although this line item sometimes can be stuffed into the SG&A line if the volume of R&D expenditures is not great.

In terms of our bookseller, if you split out R&D costs, you might include the costs of hiring the junior college student to set up your database, plus the cost of Microsoft Access—the computer program on which the database runs. Perhaps you even purchase a special computer just for the database. In this case, the depreciation for that computer would be placed into the R&D line as well.

Other Operating Expenses

Sometimes, you'll see a line for "other operating expenses;" this represents all other expenses related to a company's primary operations that are not included in the above categories. Of all the important operating costs, these are the ones about which you should be most suspicious when inspecting a financial statement. Often, non-recurring costs or accounting gains are subsumed under this label. Some companies abuse the declaration of a "one-time" expense to the point that such items become essentially annual events. Also, the "other operating expenses" line item frequently includes such expenses as restructuring charges, which are costs incurred, for example, to close down a factory or to lay off part of a work force. This line item also may include asset write-offs or write-downs, which often are a polite way of saying that management may have paid too much for a particular asset or invested too much in an unprofitable business.

In terms of our bookseller, it turns out that when you purchased the new building and installed new fixtures, one of the plumbers did not cinch down a pipe well enough and a box of books related to anaerobic composting got soaked and ruined before you recognized the rotting smell in that corner. You would declare the entire cost of those ruined books to your business (including their proportion of travel & shipping expenses) as an "unusual" loss to inventory. And you would allocate those costs as well as the money that you spent on a civil suit against the plumber to "other operating expenses."

Note that the Home Depot financials include "Depreciation and Amortization." This is slightly unusual for an Income Statement. We'll talk more about this line item when we discuss the Statement of Cash Flows.

The costs mentioned above are all operating expenses. Now, let's look at Non-operating expenses.

Non-Operating Expenses

The second group of expenses at a company includes financial costs like interest and tax payments. While these expenses are necessary to run a business, they are not the main business in which the company is engaged, so are termed "Non-Operating Expenses."

Interest Income and Interest Expense

In order to raise funds for the purchase of assets used to operate its business, a company may issue debt or otherwise borrow money. In most cases, the company is required to pay interest on these obligations. Conversely, when a company has more cash than it currently needs for immediate operation of the business, it may invest this excess money, usually in short-term investment instruments, and consequently earn interest or investment income. On the income statement, these two items may be broken out, or they may be combined

into a single item such as “net interest and investment income,” meaning the difference between interest earned and interest paid out.

For our bookseller, it is easy to see where the interest expense is—from the mortgage on the owned location and for moneys borrowed to buy out the technical bookseller.

Taxes

Just as individuals pay taxes, so do most companies. For companies that have earned a profit, taxes are an expense on the income statement. Note, however, that the accounting rules for taxes can be tricky, and that what a company must report on its income statement as a tax expense rarely matches the actual amount of taxes that it has paid. This is because the accounting rules governing what companies must record as tax expenses vary from IRS rules of what actually has to be paid in taxes during a certain period. The difference between the two is typically listed as “deferred taxes” on the balance sheet and the statement of cash flows, which will be discussed shortly.

Commonly Discussed Income Statement Calculations

In IOI training sessions, we will spend more time on figuring out just what areas of a set of financial statements we need to hone in on in order to value a stock. However, reading analyst reports or listening to pundits talk on TV, you’ll hear various terms to describe profitability and other measures. The sections below describe what these terms mean in the context of our bookseller.

Gross Profit

“Gross profit” is the difference between revenue and cost of sales, and shows how much of a “markup” that a company receives on the goods and services that it sells (that is, how much more the company is able to sell these items for than it cost to produce or acquire them). For instance, if you paid \$12 for a DVD at Best Buy and the store’s cost of acquisition for that same DVD was \$9, Best Buy would realize a “gross profit” of \$3 on that sale—although this money wouldn’t all go into the company’s “pocket,” since it has to pay all other expenses—like SG&A, interest, and the like—out of this gross profit. Not all income statements include a line item for gross profit but, as noted, it is easy to calculate by subtracting cost of sales from revenue.

Operating Income

“Operating income” is also sometimes called “operating profit” and is calculated by subtracting the cost of sales and all operating expenses (SG&A, depreciation, amortization, restructuring costs, and other operating expenses) from total revenue. Operating income measures the profit (or, in the case of poorly performing companies, the loss) that a company is able to generate through its primary operations. Operating income is also sometimes called “earnings before interest and taxes” (EBIT) because those expenses are considered “financial” as opposed to “operational.”

EBITDA

Earnings Before Interest, Taxes, Depreciation and amortization, or “EBITDA” is simply an estimate of the cash profits of a company, ignoring the theoretical costs of depreciation. While used heavily in the financial community, it is, in our opinion, a misleading indicator of profitability in many cases.

Depreciation and Amortization are estimates for how much a company will have to spend to maintain its operations as a going concern, so ignoring them inappropriately boosts an analyst or investor’s perception of the profitability of the firm. Also, EBITDA does not include costs, sometimes quite substantial, for building inventory, granting customers credit, etc.

Cash Flow from Operations, a line item we discuss below, is a better metric for assessing the cash profitability of a firm.

Net Income

“Net income” represents what remains for a company after all expenses (including interest and taxes) have been accounted for. “Net income” is sometimes referred to as a company’s “bottom line.” Many management teams and Wall Street analysts talk quite a bit about net income, but keep in mind that many items, such as one-time costs or gains, can distort this figure. As a result, net income is generally a poor proxy for a company’s actual cash flow and hence, though important, it should not be regarded as the “be all, end all” figure to focus on.

Earnings Per Share

“Earnings per share,” or “EPS,” is the total amount of earnings spread out across all of the company’s outstanding shares of stock. EPS is calculated simply by dividing net income by the weighted average of the number of shares outstanding during the period covered by the calculation. EPS is the figure that both management and Wall Street analysts tend to focus on most, since it represents the profit left over for shareholders. However, while EPS can be sort of a useful measure, be sure to consider it in context with the company’s other financial information (especially since the numerator in the calculation—net income—can, as noted, provide a distorted view of the profitability of the company’s operations and the denominator can be changed at management whim through share issuance and repurchases).

In our bookseller example, you own the entire company, and so there is only one “share” outstanding—EPS is thus a moot point. For publicly-traded companies, however, EPS is very germane.

The Balance Sheet

Now that you have a good idea of how profits are recorded on the income statement, let's dig more deeply into a company's financial statements by exploring what is known as the "balance sheet."

The balance sheet—also known as the "statement of financial condition"—tells investors how much a company owns (its assets), how much it owes (its liabilities), and the difference between the two (its equity) at a specific point in time.

Thus, you can think of the balance sheet as a snapshot of what a company is worth—according to accounting rules—on any given day. Note that the time period covered by the balance sheet differs from that of the income statement in that it is a snapshot of what assets and obligations are owed and owned by a company at a specific instant of time. While we call the income statement numbers "flow" numbers, we call balance sheet numbers "stock" numbers. Stock numbers are fundamentally different from flow numbers, and so it is important not to confuse the two. Anything on the balance sheet is a sum total of what is owned or owed as of a particular day. Anything on the income statement is a tally of some measure that has occurred little by little over an entire period.

Assets, Liabilities, and Equity—It All Equals Out. One of the most important points to grasp about the balance sheet is that, as the name implies, its numbers must always "balance." Specifically, total assets will always equal total liabilities plus total equity.

$$A = L + E$$

If the quantity of assets exceeds the quantity of liabilities, equity is positive, but if liabilities exceed assets, then equity is negative. Holders of common stock have a claim on the equity of the company, and so if liabilities exceed assets, the claim on the equity of the company is worth nothing—the stock falls to zero as the company goes bankrupt.

You can use this relationship at different points in time in order to determine how the financial condition of a company has changed. For instance, looking at the table below, you can see that the total volume of assets increased by \$280 million in 2005 (\$1.58 billion less \$1.30 billion). After further examination of other parts of the balance sheet, you can determine that the \$280 million increase in equity was the result of a \$380 million increase in assets (\$4.280 billion less \$3.90 billion), decremented by a \$100 million increase in liabilities (\$2.70 billion less \$2.60 billion).

Let's take a deeper look now at the various sections of the balance sheet. Although there are potentially many more specific line items that we could cover, we're going to concentrate on those that you can see in the sample balance sheet above. These are the most common line items, and the ones that, in our opinion, are the most important sections of which investors should be aware.

THE HOME DEPOT, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

<i>amounts in millions, except share and per share data</i>	February 2, 2014	February 3, 2013
ASSETS		
Current Assets:		
Cash and Cash Equivalents	\$ 1,929	\$ 2,494
Receivables, net	1,398	1,395
Merchandise Inventories	11,057	10,710
Other Current Assets	895	773
Total Current Assets	15,279	15,372
Property and Equipment, at cost	39,064	38,491
Less Accumulated Depreciation and Amortization	15,716	14,422
Net Property and Equipment	23,348	24,069
Goodwill	1,289	1,170
Other Assets	602	473
Total Assets	\$ 40,518	\$ 41,084
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts Payable	\$ 5,797	\$ 5,376
Accrued Salaries and Related Expenses	1,428	1,414
Sales Taxes Payable	396	472
Deferred Revenue	1,337	1,270
Income Taxes Payable	12	22
Current Installments of Long-Term Debt	33	1,321
Other Accrued Expenses	1,746	1,587
Total Current Liabilities	10,749	11,462
Long-Term Debt, excluding current installments	14,691	9,475
Other Long-Term Liabilities	2,042	2,051
Deferred Income Taxes	514	319
Total Liabilities	27,996	23,307
STOCKHOLDERS' EQUITY		
Common Stock, par value \$0.05; authorized: 10 billion shares; issued: 1.761 billion shares at February 2, 2014 and 1.754 billion shares at February 3, 2013; outstanding: 1.380 billion shares at February 2, 2014 and 1.484 billion shares at February 3, 2013	88	88
Paid-In Capital	8,402	7,948
Retained Earnings	23,180	20,038
Accumulated Other Comprehensive Income	46	397
Treasury Stock, at cost, 381 million shares at February 2, 2014 and 270 million shares at February 3, 2013	(19,194)	(10,694)
Total Stockholders' Equity	12,522	17,777
Total Liabilities and Stockholders' Equity	\$ 40,518	\$ 41,084

See accompanying Notes to Consolidated Financial Statements.

Current Assets

"Assets" are property that can be owned which fit two criteria:

1. Resources must be expended to acquire them
2. They can reasonably be expected to generate a cash flow in the future

There are two main types of assets: current and noncurrent. Within these two categories, there are numerous subcategories, or line items, which we will detail below.

"Current assets" are assets that a business owns that are likely to be used up or converted into cash within one business cycle—usually defined as one year. The most common line

items in this category are cash and cash equivalents, short-term investments, accounts receivable, inventories, and other various current assets, as follows:

Cash and Cash Equivalents

This line item doesn't necessarily refer to dollar bills sitting in a cash register or vault. Rather, it applies to any financial instrument that can easily and quickly be converted into cash, such as money market funds. Such holdings can be liquidated quickly and with little or no price risk. They are thus considered (along with actual cash) as money that can be used essentially immediately for any purpose that the company wants.

To return to the bookseller example, when you launch your bookselling business, your balance sheet is very simple. On the assets side, you have \$100,000 in Cash and Equivalents and, balancing that, you have \$100,000 of Equity in the business. Perform the equation above: \$100,000 of cash assets = \$0 liabilities + \$100,000 of Owner Equity.

Short-Term Investments

This line item refers to money invested in bonds or other securities that have less than one year to maturity and that earn a higher rate of return than cash. These investments may require a little more effort to dispose of and may be subject to somewhat greater price risk, but, in most cases, investors can lump them in with cash in order to figure out how much money a firm has on hand to meet its immediate needs.

Again, let's return to the bookseller example. After a few years in business, the cash that you have earned starts to pile up in your bank account. You realize that you can purchase an AAA-rated money market mutual fund that will generate more interest for you than what your local bank is giving you on your savings account. You shift some of your cash into a mutual fund and now have a "Short-Term Investments" account.

Receivables ("Accounts Receivable")

Receivables are represented by the bills that a company sends to its customers for goods or services that the company has provided, but for which the customer has not yet paid (and is expected to pay within the next year). In other words, these are sales (as recorded on the income statement) that haven't yet been paid for with cash. Generally, accounts receivable are shown as a net amount that the company expects to be able to collect, with the residual shown as a "bad debt expense."

In the Revenues section above, we talked about one week's worth of sales at your bookselling business. Now, we know that cash sales at a bookseller results in an increase of cash on the balance sheet and credit card sales result in an increase in accounts receivable. This fact illustrates two key points—first, the difference between flow and stock numbers, and second, the difference between cash and accrual accounting. The flow numbers are the revenues received over the entire week. The stock numbers are the cash and accounts receivable that pile up and can be counted at the end of the week. Regarding the difference between cash and accrual accounting, we pointed out before that if you were using cash accounting, you would not be able to recognize sales whenever anyone paid by credit card. Now, we see definitely that this is misrepresentative of the economic truth. The accounts receivable account has economic value to the extent that the parties owing you money has the ability and willingness to pay. If you realize that one of your customers who paid by check did not have funds to cover the check, then skipped town, you would have to concede that the accounts receivable associated with that sale would not be paid back (i.e., they would be a "bad debt"). When this bad debt occurred, you would take the amount involved out of the "stock" of accounts receivable and flow them as a part of COGS through the income statement.

Inventories

Most companies maintain several different types of inventory, including raw materials, partially finished products (a.k.a. "Work-In-Progress" or "WIP"), and finished products that are waiting to be sold or shipped. This line item is especially important to watch for

manufacturing and retail firms, which often are saddled with large amounts of physical inventory.

When looking at the financials of a large company, you might be tempted to forget, but as the owner of a bookstore, you know very well that “building up” inventory means that you have to spend cold hard cash to do it! Looked at in terms of flow numbers and stock numbers again, revenues flow into the bookseller and you allocate costs. Some of these costs are cash costs and some are not (remember depreciation and amortization?). Whatever cash is left over from the flow of revenues through your bookselling operations collects as cash. To replenish your stock of books, you have to use some of that cash. If you buy the wrong books—books that no one wants—you would have inventory that doesn’t translate into revenues!

Other Current Assets

There are numerous other current assets that a firm may expect to be turned into cash within the coming year. Other assets, such as a prepayment on a year-long insurance policy, will not be turned into cash but rather dissipated as the year goes on. These are considered assets because they continue to provide economic value without requiring additional, ongoing payments.

Noncurrent Assets

“Noncurrent assets” are defined as any asset that is not “current” or that will not generate wealth for the company over the period of the next year. In general, assets (both current and non-current) are accounted for at the historical cost to the company to acquire it in the first place. The main line items in this category are as follows:

Property, Plant, and Equipment

Property, plant, and equipment (“PP&E”) represents the “bricks and mortar” of a company—its land, buildings, factories, furniture, equipment, and so forth. There are two important twists to PP&E that an investor must consider. First, do you remember the ‘imaginary’ expense of depreciation that is recorded for each use of a tool employed to manufacture a good for sale? This cost flows through the income statement and creates a stock of a “contra-asset” that we call “accumulated depreciation” on the balance sheet. This stock of accumulated depreciation represents the useful life of a piece of equipment that was used up in producing a good, and so is a stock of a quantity that lessens the value of an asset (hence, the term “contra-asset”). The concept of accumulated depreciation helps bean-counters allocate production costs, but in the case of a fixed asset like a building, looking at the net value of the building less its depreciation is of little value in understanding what the building would be worth if the company tried to sell it. If we imagine that the United States had a balance sheet, for instance, the White House, which was built in the late 1700s, is long since fully depreciated and would be accounted for as being worth \$0, but economically this is clearly not the case.

Second, especially for land and other assets that accrue greater value over time (like Disney’s film library), the number reported on the balance sheet can again greatly underestimate the actual value to the company in the present day. Again, looking at the United States’ theoretical balance sheet, the value of Manhattan would be recorded at the historical value of \$24 in glass beads. Even Boston Red Sox fans would have to admit the true present value of all of Manhattan real estate is worth something north of \$24 in the present day.

The main thing to remember about all of this is that company managers and accounting policy have a lot more to do with what is recorded as an asset value in some cases than does pure economics. Sometimes, if there were underappreciated assets on a company’s balance sheet, the market value of the stock represents only a fraction of the cash flow

creation potential available to the company. If you can find a company like this, you have found a free “call option” and should buy, buy, buy!

Goodwill and Other Intangible Assets

Just as the name implies, “intangible assets” are just that: assets that have financial value but that cannot physically be touched or held. The most common form of intangible asset is so-called “goodwill,” an accounting entry that is created when one company buys another and pays more than the company’s hard assets are worth. You should view this line item with a great degree of skepticism, since most companies tend to pay too much when making acquisitions, and therefore the value of goodwill that shows up on the balance sheet is often far higher than what the intangible assets are really worth.

In our bookseller example, you ended up paying \$85,000 for the organic gardening book business. We allocated \$5,000 of this payment to the cost of buying the list of high-volume customers, \$70,000 to the fair market value for the books themselves. That leaves \$10,000 unaccounted for. As it turns out, the missing \$10,000—a cash outlay over and above the fair market value of the books and the list that the seller demanded—is the intangible, “good will” payment. In other words, you paid the bookseller an extra \$10,000, and he now has a warm, fuzzy feeling toward you—a feeling of goodwill.

Long-Term Investments (Not shown in the HD example above)

Long-term investments comprise money that is invested either in bonds with longer terms than one year or in the stock of other companies. These investments aren’t as liquid as the “current investments” described above, and their prices may fluctuate more substantially, so it is possible that the value shown on the balance sheet may wind up being too high or too low vis-à-vis what the company could receive if it tried to sell the assets quickly.

At your bookstore, when you get a bit ahead financially, you decide to store some of your excess cash in U.S. Treasury bonds. This part of your Long-Term Investment account is worth about the same as cash. However, the equity stake that you take in the scientific bookseller is more of a “strategic” asset, since it is part of your strategy to increase revenues and to broaden your business portfolio. That equity stake is also much more difficult to liquidate in a pinch because there is not an active market in equity in specialized booksellers like there is in U.S. Treasury Bonds. If someone were interested in buying our book business, but didn’t want the scientific bookseller, he or she would likely count this part of our Long-Term Investment account (the scientific bookseller investment) as being worth less than the T-bond part.

Current Liabilities

Unlike assets, which represent what a company *owns*, “liabilities” are financial quantities that a company *owes*.

Another way to think of it is that if assets represent ownership of something that has the potential to generate future cash inflows for a company, liabilities represent an obligation with the potential to generate future cash outflows for a company.

Holders of a company’s liabilities have precedence over owners’ claims on equity (common stock is referred to as a “contingent claim” because it is an ownership claim on a company that is contingent upon the bondholders being made whole first). As with assets, there are

two forms of liabilities: current liabilities and noncurrent liabilities. We describe each concept below.

“Current liabilities” are obligations of a firm that must be paid back within one year. The principal types of current liabilities are short-term debts and accounts payable, which are described presently.

Accounts Payable

The “accounts payable” line item represents bills that the company owes for goods or services that it hasn’t paid yet. It is the mirror-image of the accounts receivable line item and, generally speaking, investors like to see opposing trends for the two items. For example, with receivables, investors would prefer to see a company collect what it is owed as soon as possible. However, if a company can postpone what it owes for a longer period of time (its payables)—without getting into trouble—it will hold on to its cash for a longer period of time, a plus for cash flow. Note that Home Depot has a lot of “payables” lines—depending on the company, you may see more or fewer of these lines.

At our bookseller, let’s assume that you usually use your own credit card to pay for books and shipping and to pay for your plane fares. This credit card debt is what is known as “revolving credit,” which should be paid off soon after the charge is incurred, and so your business would treat this amount as an “accounts payable.”

Deferred Revenue

Some companies receive money from clients before they provide the products or services, as in the example of the Wall Street Journal selling subscriptions and owing its subscribers newspapers over the next year. In this case, the revenues associated with the newspapers to be delivered over the next year is counted as a current liability.

Current Installment of Long-Term Debt

Also known as “Current Portion of Long-Term Debt” or sometimes as “Short-term debt.” This line item refers to money that a company must repay over the next year. Often, short-term debt comes in the form of a line of credit that may be drawn down at the company’s discretion. Typically, the proceeds from such short-term debts are used to meet short-term company operational needs. The amount of short-term borrowings is an important gauge of company financial health—especially if the firm is in financial distress or pays a high dividend, since the entire amount of debt must be repaid relatively quickly, leaving little maneuvering room.

At the bookselling business, when you bought the new location, the bank offered you a line of credit (LOC) to pay for improvements to the store in addition to the mortgage that you received to buy the place. The bank offered you a good deal on the LOC, so you decided to use the funds from the LOC until one of your CDs matured and you could pay the whole amount back. The money borrowed under this LOC goes into your “Short-Term Debt” account.

Noncurrent Liabilities

“Noncurrent liabilities,” as one might expect, are the opposite of noncurrent assets. These liabilities represent money that the company owes beyond one year into the future. Although an investor will see a variety of line items in this category, the most important one by far is long-term debt.

Long-Term Debt

The category of “long-term debt” represents money that the company has borrowed, typically by issuing bonds that do not need to be paid back for more than a year—and, typically, for several years. Although issuing a modest amount of long-term debt can be strategically beneficial and even financially necessary if the company, say, must invest a great deal in a potentially lucrative new factory or technology, too much long-term debt is generally considered risky for a company because the interest on this debt must be repaid

no matter how well financially the business is doing. Determining how much debt is “too much” is a very firm-specific exercise and depends on many factors, including the interest rate that a company pays on its debt and the stability of its earnings and cash flows.

At our booksellers, you’ll find that you have two components of Long-Term Debt: (1) whatever remains as principal on your mortgage; and (2) the principal owed on the moneys borrowed to buy out your scientific bookseller partner.

Other Long-Term Liabilities

Usually this line refers to liabilities related to pensions and the like, and for some firms, this can represent a very significant long-term liability. The payout stream for these benefits can be very difficult to calculate and is open to a number of subjective interpretations, and so these are not discussed here. Nevertheless, investors should be aware of these post-retirement liabilities and look more deeply if they appear to be a significant, even “unfunded” liability for these companies.

At the bookseller, you obviously don’t have a pension or other post-retirement benefit obligation directly, nor in fact do most companies founded in the last 30 years or so and operating only in the United States.

Equity

As mentioned above, “equity” is equal to the total assets of a company less its total liabilities, and represents that portion of the company that is owned by the shareholders—thus, “equity” is often referred to as “shareholders’ equity,” and is often called “net assets” or “net worth” as well.

Common Stock

The common stock line is not important except that it will give you an “authorized” and “outstanding” share count number. Usually, outstanding shares are a fraction of those authorized and you should concentrate on the outstanding ones unless there is the possibility (due to financial distress) that the company will have to issue more shares. Each share has a “par value” which is mostly meaningless in the U.S. The common stock account is simply the number of outstanding shares times the par value.

Paid-in Capital

(a.k.a. “Additional Paid-in Capital” or “APIC”). When a company issues stock, the issuance price is determined by market forces—how much buyers are willing to pay for the stock. APIC is simply the amount over and above the par value that investors originally paid in to own a piece of the company. Obviously, for a company with a long operating history, this amount is also just about meaningless (in the same way that the book value of the White House on the U.S. national balance sheet would be), but for new companies, you can see clearly how the company got the money it needed to start operations from this line.

Retained Earnings

The “retained earnings” line item represents the total profits that a company has earned since its inception, less whatever it has paid out to shareholders in the form of dividends. Because retained earnings is a cumulative figure, if a company has lost money over time, retained earnings actually can be negative and, in such a case, would be renamed “accumulated deficit.” The “retained earnings” or “accumulated deficit” line item is the place on the balance sheet where the flow numbers from the income statement finally accrue. While you might be tempted to look at this number as if it were similar to the balance of a savings account, it really has a much less tangible meaning and most analysts don’t care

too much about it. After all, what is the value of whatever is left of Sears' 1902 fiscal year earnings to an investor in the company today?

Treasury Stock

"Treasury stock" is a line item that documents how much of its own stock a company has repurchased. We will discuss this in depth in IOI training sessions.

The Statement of Cash Flows

Now that we have examined the income statement and balance sheet, it's time to take a look at what IOI regards as the most important of the three major types of financial statements: the statement of cash flows. It is the statement of cash flows that ties the flow numbers from the income statement to the stock numbers from the balance sheet, and hence shows investors how much cash went into or out of a company during a specific time frame, such as a quarter or a year. Whereas the income statement operates on the concept of accrual accounting, the statement of cash flows operates in the way most of us think about our own personal income and outflow—on the concept of "cash accounting." put simply, the statement of cash flows reveals how much cash a company is generating from one time period to the next—and cash is king.

Because companies can generate cash in several different ways, the statement of cash flows is normally separated into three sections, as can be noted in the table below. These sections are:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financial activities

THE HOME DEPOT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>amounts in millions</i>	Fiscal Year Ended ⁽¹⁾		
	February 2, 2014	February 3, 2013	January 29, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net Earnings	\$ 5,385	\$ 4,535	\$ 3,883
Reconciliation of Net Earnings to Net Cash Provided by Operating Activities:			
Depreciation and Amortization	1,757	1,684	1,682
Stock-Based Compensation Expense	228	218	215
Goodwill Impairment	—	97	—
Changes in Assets and Liabilities, net of the effects of acquisitions and disposition:			
Receivables, net	(15)	(143)	(170)
Merchandise Inventories	(455)	(350)	256
Other Current Assets	(5)	93	159
Accounts Payable and Accrued Expenses	605	698	422
Deferred Revenue	75	121	(29)
Income Taxes Payable	119	87	14
Deferred Income Taxes	(31)	107	170
Other Long-Term Liabilities	13	(180)	(2)
Other	(48)	8	51
Net Cash Provided by Operating Activities	<u>7,628</u>	<u>6,975</u>	<u>6,651</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Capital Expenditures, net of \$46, \$98 and \$25 of non-cash capital expenditures in fiscal 2013, 2012 and 2011, respectively	(1,389)	(1,312)	(1,221)
Proceeds from Sale of Business, net	—	—	101
Payments for Businesses Acquired, net	(206)	(170)	(65)
Proceeds from Sales of Property and Equipment	88	50	56
Net Cash Used in Investing Activities	<u>(1,507)</u>	<u>(1,432)</u>	<u>(1,129)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from Long-Term Borrowings, net of discount	5,222	—	1,994
Repayments of Long-Term Debt	(1,289)	(32)	(1,028)
Repurchases of Common Stock	(8,546)	(3,984)	(3,470)
Proceeds from Sales of Common Stock	241	784	306
Cash Dividends Paid to Stockholders	(2,243)	(1,743)	(1,632)
Other Financing Activities	(37)	(59)	(218)
Net Cash Used in Financing Activities	<u>(6,652)</u>	<u>(5,034)</u>	<u>(4,048)</u>
Change in Cash and Cash Equivalents	(531)	509	1,474
Effect of Exchange Rate Changes on Cash and Cash Equivalents	(34)	(2)	(32)
Cash and Cash Equivalents at Beginning of Year	2,494	1,987	545
Cash and Cash Equivalents at End of Year	<u>\$ 1,929</u>	<u>\$ 2,494</u>	<u>\$ 1,987</u>
SUPPLEMENTAL DISCLOSURE OF CASH PAYMENTS MADE FOR:			
Interest, net of interest capitalized	\$ 639	\$ 617	\$ 580
Income Taxes	\$ 2,839	\$ 2,482	\$ 1,865

(1) Fiscal years ended February 2, 2014 and January 29, 2012 include 52 weeks. Fiscal year ended February 3, 2013 includes 53 weeks.

See accompanying Notes to Consolidated Financial Statements.

Cash Flows from Operating Activities

The statement of cash flows from operating activities typically is presented first in the overall statement of cash flows, and tells you how much cash the company generated from its core business, as opposed to peripheral activities such as investing or borrowing. This is the area where you, as an investor, should focus most of your attention because it paints the most accurate picture of how well a company's core business operations are producing cash—an activity that ultimately will benefit its shareholders. We encourage you to follow along throughout this discussion by inspecting the sample statement of cash flows presented above (as well as the balance sheet, presented earlier). Some of the main line items to be found in this section of the statement of cash flows are:

Net Income

“Net income,” a figure taken directly from a company's income statement, is the starting point for determining how much cash a company provides from its core operations. However, there are plenty of items on the income statement that affect income but don't affect cash flow, so that all of the remaining items are simply adjustments to net income that help you to reconstruct how much actual cash was generated by the business.

Depreciation and Amortization

As indicated above, depreciation is the accounting profession's way of recording wear and tear on a company's physical PP&E. Even though depreciation is an expense on the income statement, depreciation is not an actual cash charge, and so it is added back to net income. (Remember that amortization functions similarly, but applies to intangible or non-physical company assets, like patents and other intellectual property.)

Changes in Working Capital

In the Home Depot example, this line is “Changes in Assets and Liabilities, Net of the effects of acquisitions and dispositions.”

“Working capital,” or the capital that a company has available for investment in its operations, is calculated as current assets less current liabilities on the balance sheet. Just as the name suggests, “working capital” is the money that the company needs in order to “work,” or “operate.” Therefore, any cash that is used or provided by working capital is included in the “cash flows from operations” section of the statement of cash flows. It is in this section where we see the effect of the change in stock numbers on the cash flow of the company.

Returning to our bookseller example, as we noticed when discussing inventory, you must spend money in order to build up assets and receive money when liabilities are paid off. As such, increasing working capital means that you, as a bookseller, spent more money to build your firm's “working” assets (i.e., buy more books, accept more credit card transactions, etc.) than you received from the parties (like credit cards and banks) that owed you money. When you, as a bookseller, were just starting out and your revenues were increasing from nothing to something, the changes in your working capital were strongly negative. Whereas before, you had no inventory, now you have a great deal. Whereas before, you had no receivables from American Express, now you have some. This is the period in which the effects of cash accounting differ the most from those of accrual accounting—you are spending prodigious amounts of cash to fund and build your business and are purposely delaying bringing in cash (by accepting credit cards). Is the act of building inventory an expense? The income statement says “no,” the statement of cash flows says “yes.” However, as your business matures and you develop a stable base of operations and a steady influx of customers, your changes to working capital from one period to the next should pretty much even out over time.

Other Non-Cash Charges

There are also a host of other items that are often included in the cash flow from operating activities (CFO). The important thing is that if you see a negative number in the CFO, it means that something that was counted as a positive on the income statement did not result

in an actual cash inflow in that period and vice versa. One large positive number that shows up for some companies is related to the cost related to issuing employees stock options. When a company issues stock options to its employees in lieu of cash payment, the company must account for that as a cost on the income statement. However, the cost associated with issuing stock options does not cause cash to be paid out, so this cost appears as a positive on the statement of cash flows (SCF).

In terms of the bookseller, the biggest non-cash charge that you probably would see added back to your SCF would be an increase in “deferred taxes.” We don’t want to go into a great deal of detail here, but suffice it to say that, if you were trying to sell your business to someone else, you would prepare financial statements that made your business look as if it were on fire—steady revenues and high operational profits. However, as April 15 drew closer, you would start figuring out how to prepare some financial statements for the IRS that made your business look like you were struggling and just scraping by with a little pre-tax profit. According to accounting rules, when you showed your financial statements to interested buyers, you would have to show your pre-tax profits taxed at the statutory rate (somewhere in the range of 35% for a profitable U.S. domestic firm) on your income statement, but you would get to show the amount that you reported on the income statement less the actual cash amount that you actually paid the IRS as an inflow on the statement of cash flows.

After all adjustments to net income are accounted for, what’s left over is the “net cash provided by operating activities,” also known as “operating cash flow.”

Cash Flows from Investing Activities

The “cash flows from investing activities” section of the statement of cash flows indicates the amount of cash that a firm spends on investments. Investments are usually classified as either capital expenditures (which we care about) or monetary investments such as the purchase or sale of securities (which we care about only if the company is putting its money into the wrong securities). Regarding capital expenditures, remember back to our definition of what an asset is: an object that has the ability to generate future wealth. Capital expenditures are the moneys spent to purchase objects that will maintain or expand the long-term productive capacity of the firm—in other words, the money spent on long-term assets. If you want to maintain or expand the productive capacity of the firm, you either can buy individual pieces of equipment or you can purchase entire companies that hold the kind of assets that you want. In accounting, “capital expenditures” means buying equipment, while; “acquisitions” means buying businesses that hold equipment. However, the two are economically about the same.

Capital Expenditures

The “capital expenditures” line item represents the amount of cash that a company has spent on items that last a long time, such as PP&E. Basically, capital expenditures—sometimes referred to as “capex”—are brick-and-mortar types of investments that are necessary to keep the company running and growing in its current form. For example, in order for a supermarket to keep operating and growing, it typically will need to remodel its existing stores, replace the meat-carving and dock-loading equipment, and build new stores. These expenditures will show up in the capex line item in the “cash flows from investing activities” section. This line may be offset by sales of assets; in the case of Home Depot this is shown as “Proceeds from Sales of Property and Equipment.”

As a bookseller, your first capital expenditure likely will be on a cash register and a computer. A few years later, you may make a large capital expenditure to buy a piece of property of your own.

Cash Used for Acquisitions / Received in Dispositions

The “cash used for acquisitions” line item refers to how much cash a company has paid to acquire another. Because companies tend to overpay for acquisitions, it’s a good idea to watch this line item closely in order to observe how much a given company is paying for

acquisitions. This line item also will give you a good sense of how much of a company's growth is coming from internal operations versus external acquisitions.

As a bookseller, you spend cash when you acquire the organic gardening books dealer. Remember that we analyzed whether it was better for you to buy a collection of books or to purchase an established bookseller? You ultimately decided on the acquisition because you thought that having access to the expertise of the organic book collection's owner, plus access to his good clients, offered greater value than a collection of books alone.

Other Cash Flows from Investing

There are a number of less important investing cash flows listed here as well that usually are not very important to the analysis of a company's financials. Basically, whatever cash flows into a company because of its operations must be translated into a stock number on the balance sheet. This cash is usually placed into various investments; short term investments are rolled each quarter, and so you will see a large positive investing cash flow associated with "sales of short-term investments" and a mostly balancing large negative investing cash flow associated with "purchases of short-term investments." Just think of these categories as bookkeeping items. Capex and acquisitions above are the most important investing cash flows at which you'll have to look.

Cash Flows from Financing Activities

The final section of the statement of cash flows is "cash flows from financing activities." This section includes any activities that involve the company's owners or creditors. For example, the issuance or purchase of common stock, the issuance or repayment of debt, and dividends paid to investors all will be found in this section. Although these line items are relatively self-explanatory—"dividends paid," for instance, is exactly what it says—investors nevertheless should look carefully at how much a company is engaging in each of these respective financial activities. In particular:

Issuance of Common Stock

Newer companies and rapidly growing firms often need to issue a great deal of new stock in order to fund their growth, but more mature companies usually do not need to do so. The upside of stock issuance is that for heavily indebted companies, it is a source of capital that does not increase the risk of bankruptcy. However, the downside of this activity is that new stock issuance typically dilutes the ownership interests of existing shareholders—that is, they own a smaller piece of the whole pie. Sometimes, you will see a line entry referencing "proceeds from shares issued to employee incentive plans." This line item represents the cash that an employee pays to a company when the employee exercises a stock option.

Dividends Paid

Some companies pay part of their profits directly to shareholders. The aggregate amount of cash paid as dividends is recorded in this section of Statement of Cash Flows.

Repurchase of Common Stock

Mature companies that have ample cash flow often will seek to buy back their own stock from existing shareholders. There are a few reasons why companies might want to do this. First, some large investors do not want to receive dividends because they will have to pay tax on the cash received. They would rather a company buy back shares—an act that tends to increase the stock price—because capital gains are taxed only when they are realized (i.e., when the investor sells the shares at a profit). A company management's buying back of stock also allows large institutional investors to manage the timing of its tax payments.

Second, for companies that are issuing employees stock as an incentive for service, upper management does not want these employee-incentive programs to eat away at their earnings per share (EPS). Recall that if the earnings of a company stay flat from year to year but the number of shares outstanding increases, the EPS would show a year-over-year decrease. Since Wall Streeters are so hungry to see EPS increases, CEOs and CFOs

are motivated to do whatever they can to make sure that EPS increases year-over-year. Sometimes, this happens through managers' spending the owners' cash in order to buy back shares—boosting EPS through a kind of “window dressing.” Another less-than-exemplary reason for a company's buying back of shares is when a CEO attempts to hurt prominent short-sellers by creating his own demand for the company's shares. For a particularly ridiculous example of just this effect, see the call-out below.

The last major reason for a company's buying back of shares that happens infrequently is when company management believes that the market price of its shares does not reflect the true value of the enterprise. In this case, management might signal that the shares are undervalued by buying the shares themselves. Basically, in this case, management is saying that “we've got this extra cash lying around and we see an investment in our own shares as the highest-return investment that we could make.” Unfortunately, most companies buy back shares during boom times, then cease their buy-back programs when the market falls—the opposite of what a good investor would do!

The Statement of Shareholders' Equity

One statement does not get a lot of attention is the Statement of Shareholders' (or Stockholders') Equity. IOI analyses uses this statement to see how many shares a company is issuing as a form of compensation to its employees or as a form of currency when acquiring companies. Note that the example below for Home Depot shows both numbers of shares issued (left-most column) and the dollar amount associated with those shares (all other columns). We will discuss this statement more in IOI training sessions.

THE HOME DEPOT, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

<i>amounts in millions, except per share data</i>	Common Stock		Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock		Stockholders' Equity
	Shares	Amount				Shares	Amount	
Balance, January 30, 2011	1,722	\$ 86	\$ 6,556	\$ 14,995	\$ 445	(99)	\$ (3,193)	\$ 18,889
Net Earnings	—	—	—	3,883	—	—	—	3,883
Shares Issued Under Employee Stock Plans	11	1	196	—	—	—	—	197
Tax Effect of Stock-Based Compensation	—	—	(2)	—	—	—	—	(2)
Foreign Currency Translation Adjustments	—	—	—	—	(143)	—	—	(143)
Cash Flow Hedges, net of tax	—	—	—	—	5	—	—	5
Stock Options, Awards and Amortization of Restricted Stock	—	—	215	—	—	—	—	215
Repurchases of Common Stock	—	—	—	—	—	(97)	(3,501)	(3,501)
Cash Dividends (\$1.04 per share)	—	—	—	(1,632)	—	—	—	(1,632)
Other	—	—	1	—	(14)	—	—	(13)
Balance, January 29, 2012	1,733	\$ 87	\$ 6,966	\$ 17,246	\$ 293	(196)	\$ (6,694)	\$ 17,898
Net Earnings	—	—	—	4,535	—	—	—	4,535
Shares Issued Under Employee Stock Plans	21	1	678	—	—	—	—	679
Tax Effect of Stock-Based Compensation	—	—	82	—	—	—	—	82
Foreign Currency Translation Adjustments	—	—	—	—	100	—	—	100
Cash Flow Hedges, net of tax	—	—	—	—	5	—	—	5
Stock Options, Awards and Amortization of Restricted Stock	—	—	218	—	—	—	—	218
Repurchases of Common Stock	—	—	—	—	—	(74)	(4,000)	(4,000)
Cash Dividends (\$1.16 per share)	—	—	—	(1,743)	—	—	—	(1,743)
Other	—	—	4	—	(1)	—	—	3
Balance, February 3, 2013	1,754	\$ 88	\$ 7,948	\$ 20,038	\$ 397	(270)	\$ (10,694)	\$ 17,777
Net Earnings	—	—	—	5,385	—	—	—	5,385
Shares Issued Under Employee Stock Plans	7	—	103	—	—	—	—	103
Tax Effect of Stock-Based Compensation	—	—	123	—	—	—	—	123
Foreign Currency Translation Adjustments	—	—	—	—	(329)	—	—	(329)
Cash Flow Hedges, net of tax	—	—	—	—	(12)	—	—	(12)
Stock Options, Awards and Amortization of Restricted Stock	—	—	228	—	—	—	—	228
Repurchases of Common Stock	—	—	—	—	—	(111)	(8,500)	(8,500)
Cash Dividends (\$1.56 per share)	—	—	—	(2,243)	—	—	—	(2,243)
Other	—	—	—	—	(10)	—	—	(10)
Balance, February 2, 2014	1,761	\$ 88	\$ 8,402	\$ 23,180	\$ 46	(381)	\$ (19,194)	\$ 12,522

See accompanying Notes to Consolidated Financial Statements.

The Financial Statements of Financial Firms

Throughout the above, we have focused on what you are most likely to see in the financial statements of a traditional manufacturing, retail, or similar company. In general, these traditional firms—the Wal-Marts, the Home Depots, and the Dells of the world—sell products for prices above what it costs to make or buy the products, and profit from any excess money that remains over and above what it costs to operate the company. For the most part, the financial statements of these traditional companies look very similar in form and structure.

However, if you were to inspect the financial statements of a typical financial institution, you would find that those statements usually appear much different than what we have been discussing. Although a detailed examination of financial-services firms is beyond the scope of this guide, some of the key differences to look for in financial-services companies are found below. (For simplicity's sake, we'll focus on the financial statements of a bank, although there are obviously many other types of financial-services firms as well.)

Income Statement

Even though you won't see sales and cost of goods sold in a bank's income statement, the banking business model is very simple. Banks borrow money from depositors (such as the holders of checking accounts) and the capital markets, and then use the money to make loans to borrowers. The difference between what a bank earns on its loans (interest income) and what it pays on its borrowings (interest expense) is known as "net interest income," commonly referred to as "spread."

In addition to net interest income, banks also earn revenues from various fees and other services. These additional revenues are not related to interest spreads and are cleverly called "noninterest income." When you add net interest income and noninterest income together, you wind up with "net revenues," a figure that is widely regarded as a bank's "top line." Because not all borrowers pay all that they owe, banks are subject to credit losses, and the difference between a bank's net interest income and its provision for loan losses is often referred to as a "risk-adjusted margin"—a good measure of comparison among banks to determine which banks have the most profitable lending operations.

A bank's noninterest expenses are really no different from those of any non-financial firm's expenses, and reflect the normal cost of running a business. A useful method of comparing the expense levels of various banks is to examine what is commonly called the "efficiency ratio." The efficiency ratio measures noninterest expenses as a percentage of net revenues. Generally speaking, the lower this ratio, the better.

Balance Sheet

On the asset side of the balance sheet, banks typically own large numbers of loans and investments. These core assets represent the true earning power of the business—hence, they are aptly termed "earning assets." On the liability side of the balance sheet, one of the most significant liabilities listed—deposits—easily could be considered assets. And with good reason: these low-cost deposits are very stable and represent a relatively inexpensive source of funds, which are then used to make profitable loans at high spread. Still, because banks ultimately must repay these deposits on demand (which is why they are often termed "demand deposits"), they remain a liability.

Statement of Cash Flows

Looking through a financial institution's statement of cash flows can be a rather forbidding experience. Unlike non-financial firms, the cash flows from an operations section usually does not do a very good job of showing how much cash a bank actually generates. As a result, a very valuable metric for non-financial companies—free cash flow—is not easy to calculate for banks. Although a bank's statement of cash flows should not be completely disregarded, just keep in mind that this statement does not offer as much insight for a bank or other financial institution as it does for a non-financial company.

Filings and Where to Find Them

Now that you understand the primary financial statements of a company and the elements of these statements that represent important considerations for investors, another question quickly arises: how do you go about locating this information. Because knowledge truly is power when it comes to investing, your success as a stock investor will depend heavily upon your ability to find and analyze the information that you need and then to determine its importance and relevance. A key source of this information is the collection of public filings that must be submitted by public companies.

Indeed, if a firm offers stock through a major exchange like the New York Stock Exchange (NYSE), it is required by law to regularly file certain documents for public consumption with the U.S. Securities and Exchange Commission (SEC). The SEC imposes guidelines on what information must be published in these findings, with the result that most such filings are relatively uniform in form and structure. The following sections briefly describe some of the major filings that you should review—most of which contain a wealth of financial information, including the three financial statements discussed above.

Unfortunately, while the original intent of regulations requiring audited financial statements was to make it easier for investors to understand the workings of companies, over time, these statements have become bloated and confusing examples of a litigious society run amok. One CEO of a small-cap firm once remarked that he considered financial statements to be “marketing flyers written by lawyers and accountants for the benefit of other lawyers and accountants.” While downloading and reading through an entire financial statement is a daunting task, in the IOI Boot Camp, we’ll show you how to cut to the chase and garner the information that you most need to make an investing decision.

The 10-K Filing

Among the public filings that are available, the most comprehensive is the 10-K (a.k.a. “The K”). The 10-K is an annual report that provides a wide variety of general information about a company, including its go-to-market strategies, number of employees, business risks, description of properties, and many other items. (The 10-K annual report differs from the often glossy booklet that companies typically provide shareholders at annual meetings, which—while similar in some respects—contains a lot more marketing material.) The 10-K also contains the company’s audited, year-end financial statements. Finally, in addition to possessing crucial facts and figures, the 10-K presents management’s discussion and analysis of the past business year and compares it with the results of preceding business years.

Every 10-K annual report contains at least these sections:

Business

This section describes the general business operation of the company—what it is and what it does, the subsidiaries that it owns, the markets in which it operates, the competitive environment, and other information. This section represents the same kind of information that forms the bulk of most company business plans.

Risk Factors

In this section, the company discusses events or other factors that could take place that could cause any projected financials or other forward-looking statements to be off the mark—or, in the worst case, to cause the company to fail completely. Think of this as a comprehensive “disclaimer.”

Properties

This section lists and describes any significant properties and physical assets that the company owns, as well as intangible assets like brands and intellectual property. If you suspect that a company’s assets as listed on its balance sheet are significantly understated (as we discussed above), this is a good place to start looking.

Legal Proceedings

This section discloses any significant pending legal actions against the company (which also may be detailed in the “risks” section). The company has to list all legal actions that have a potential material impact on its business. Only when the company believes that it

has a significant risk of losing a legal case will a cost associated with the case hit the income statement.

Market

This section discusses the performance of the company's stock on the stock market. It is mostly useless for someone who has access to a personal computer, since much more comprehensive stock market information can be found online.

Management's Discussion and Analysis

(a.k.a. the MD&A) In this section, management discusses the strategies and operations of the company in great depth, usually by comparing the current year to prior years. These comparisons offer investors a summary of key operational and other issues that may affect the company's growth and profitability in years ahead. This is a good place to look if you notice a significant jump in a certain expense from one year to the next. The MD&A usually will call out particularly large changes and explain the specific business situation driving them. It is a look at the reasons for certain large changes that can yield clues as to what the real drivers behind a company business are.

Financial Statements

This section provides the independent auditor's report on the company's financials, as well as complete versions of all of the company's main financial statements. Here is where potential informational treasures are buried and where potential snakes sleep hidden in the grass. It is the section on which you should spend most of your investigative time.

We suggest making the 10-K filing your first stop in researching a candidate company. But where do you find a firm's 10-K? Just visit the SEC web site (www.sec.gov), click on "Search for Company Filings" under "Filings & Forms," and then follow the instructions thereupon presented.

The 10-Q Filing

The 10-Q filing (a.k.a. "The Q") is very similar to the 10-K filing, except that it is published on a quarterly basis. Although it's a little less comprehensive than the 10-K and the financial statements that it includes are typically unaudited, the 10-Q data is timelier, and so provides investors with a good way to keep tabs on a company throughout the year. Information for the final quarter of a firm's fiscal year is included in the 10-K, and so only three standalone 10-Q filings are made each year. The 10-Q form must be filed within 45 days of the end of the firm's fiscal quarters. You can find the 10-Q filings in the same places where you can obtain 10-Ks. The best thing about 10-Qs is that it lists the financial statements on the first few pages rather than buried in the middle like the Ks do.

The 8-K Filing

If you're interested in a recent event pertaining to a company, such as an earnings release or a major company announcement, you can locate the details in the firm's most recent 8-K filing. The 8-K is required to be filed whenever a significant event occurs that potentially

affects the company's operations and/or profitability, and must be filed within four business days after the event. Precipitating events include:

- Entry into or termination of a significant business agreement
- Bankruptcy or receiverships
- Completion of acquisition or disposition of significant assets
- Report of results of operations and financial condition
- Creation of a major financial obligation
- Notice of exchange delisting
- Unregistered sale of equity securities
- Material modification of rights to security holders
- Changes in the control of the company
- Addition or departure of directors or certain major officers
- Amendments to the company's articles of incorporation
- Amendments to the company's code of ethics

The 8-K is one of the most common forms filed with the SEC. You can find the 8-K filings in the same places where you can obtain 10-Ks.

The Form 4 Filing

Every time company insiders make a transaction involving company stock, they are required to file the Form 4. While this is theoretically important information (since it might show when insiders are getting particularly bullish or bearish), the Form 4s are difficult to read and, without context, it is difficult to know what specific sales and purchases really mean. Nowadays, financial web sites have a service that overlays information from Form 4s on top of a stock price chart. If you see a lot of sales as the share price approaches a certain level and a lot of buys as the price approaches a lower certain level, this can give you an indication of what insiders think of the firm's future prospects. This information can be deceiving, since there are a lot of reasons why insiders might want to sell or buy. It's best to take a look and see if there are any identifiable patterns, but not to take this as the final word one way or another.

The DEF 14A Filing

Another important statement worth reviewing is the annual proxy statement, also called the DEF 14A. In the proxy statement, you will find detailed information about executive compensation, the board of directors, and the shareholder voting process. The proxy is a "must read" for gaining greater insight into the governance of the company that you are researching and for determining your rights should you become an investor. Reading this with a critical eye is helpful. Does the CEO really need a housing allowance of \$1.5 million each year in addition to his salary in order to do an effective job managing the company? Whether or not good or poor corporate governance influences common stock returns one way or another is a matter of heated academic debate, but looking at the proxy statement gives an investor an idea of how a management team (the management team that theoretically you as shareholder are responsible for hiring and firing) spends money and rewards themselves.

Options involve risk and are not suitable for all investors. For more information, please read the [Characteristics and Risks of Standardized Options](#).

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