

Financial Statements: A Crash Course

No sorcery required, just curiosity (and some basic math).

By Nathan Alderman

On Wall Street, whoever knows the most, and knows it best, wins. Michael Lewis's 1985 classic *Liar's Poker* depicts traders profiting by selling investments they know are garbage to people who believe otherwise. Publicly traded companies fight tooth and nail to maintain this information advantage. Even when they're required by law to disclose accurate financial information, many companies make those releases as opaque and intimidating as possible. The less you understand, the more power they retain.

Wall Street doesn't always respond rationally to the information companies provide it – at least, not in the short term. A thriving, profitable company can still watch the market wallop its shares if its profits aren't quite as lavish as investors expected. Comparing a company's performance as a business and a stock can offer you useful insights.

I've spent years editing, fact-checking, and researching financial and investing news. That meant wading into a hip-deep, occasionally alligator-infested pool of numbers, forms, and filings. I've learned how to pluck useful information from that morass of data. So can you!

In general, when you look at numbers, look for two crucial aspects:

- **Changes.** Are key numbers getting bigger or smaller? Growing (or shrinking) faster or more slowly? How things are changing can tell you a *lot*.
- **Comparisons.** Weighing a company's current numbers against its past ones, or against similar figures at its rivals, can also reveal all kinds of useful insights.

Here are some key numbers to look for and what they mean. **You don't need all these figures to make sense of every company.** Different industries or types of stocks lean more heavily on some types of numbers than others do.

These aren't the *only* numbers that matter, but they matter the *most*. And when you know *why* they matter, they can tell you all kinds of interesting stories.

Share prices and other basic data

WHERE TO FIND THEM: Type the name or ticker of the company you're looking for into the search box at any investing research site, such as [Yahoo Finance](#) or [Google Finance](#).

Yahoo Finance also gathers a lot of the key numbers we'll discuss below in one convenient place; [here's an example](#). Just search the ticker on Yahoo Finance and select Financials, and you can toggle between quarterly and annual figures.

The primary sources I'll list in the next section are always worth consulting when you have the time, but shortcuts like these will do just fine in a pinch.

WHAT TO LOOK FOR:

Market capitalization

"Market cap," for short. The total dollar value of a company's shares. Multiply the current share price by the current number of **shares outstanding** to get it.

What it tells you: How big is this company? How much power and prestige has the market given it? The bigger the market cap, the more investors respect a company and believe in its future.

Volume

How many shares did investors worldwide buy and sell over the past day?

What it tells you: The higher its trading volume, the more popular a stock is – and the easier it is for someone to buy or sell shares of it, a factor known as **liquidity**.

Dividends per share

When companies literally have more money than they know what to do with, they give some of it to shareholders as a dividend. This figure measures how much of that money gets paid out per share. The **dividend yield** measures that dollar amount as a percentage of the stock's current price.

What it tells you: Dividend stocks have a reputation as safe investments, since they can afford to be so generous. Investors *love* it when companies raise their dividends and *hate* it when lean times force companies to cut their dividends; companies try to avoid the latter at all costs.

High yields aren't always good news – sometimes, they can signal that the company's share price has plunged (share price goes down, dividend stays the same, yield goes up), and that the dividend payment is about to follow suit.

Price-to-earnings (P/E) ratio

Market cap divided by net income. (We'll get into that below, but it's basically the profit the company has left after all its expenses.)

What it tells you: The multiple of current earnings that investors are willing to pay for a piece of the company. The higher that multiple, the more profit investors believe the company will make in the years ahead.

Trailing P/E measures the current price against the company's net income over the past 12

months. **Forward** P/E weighs the current share price against what the company is expected to earn in the year ahead – basically, what investors think about the company's near future.

By measuring price against performance, P/Es (and their cousins, the **price-to-sales ratio** for companies that aren't yet profitable, or **price-to-book-value** for companies like banks whose worth is best measured by the vast assets they hold) make a better gauge of whether a company is cheap or expensive than the dollar amount of its share price.

P/Es and similar metrics tell you the most when you **compare them against the same measurements for rival companies** (which company is the better bargain?), or **against their historical average over the past few years** (is the company cheaper or more expensive now than it previously was?).

Annual reports (Form 10-K) and quarterly reports (Form 10-Q)

WHERE TO FIND THEM: [The SEC's EDGAR search engine](#). Search by company name or ticker symbol. You can also find them on many companies' investor relations pages on their web sites.

Publicly traded companies must file reports once a year and every three months with the Securities and Exchange Commission. By law, everything in these reports must be scrupulously true and accurate. Annual reports are longer and more detailed, with information about **the company itself, how it operates, and its risk factors**. Quarterly reports are shorter and less detailed. (The annual report tends to include data for the full year *and* the final three-month period within it.) Both include **financial statements** with numbers you'll want to know.

Financial statements come in three types:

THE BALANCE SHEET

A snapshot, from the day the company's most recent quarter or year ended, of the company's **assets** (cash, investments, and other things it has in its favor), **liabilities** (debts and other obligations it needs to pay off at some point), and **equity** (intangible factors in the company's favor, like the shares of itself that it holds, or retained earnings it can invest in the business).

WHAT YOU CAN FIND HERE:

Cash

How much money does it have in the bank? Some writers lump short- and long-term investments in with a company's actual, literal cash hoard when writing about this.

What it tells you: Companies flush with lots of cash can withstand economic downturns, buy other businesses, or easily invest in key projects. If a company runs low on cash, it'll have to get

more by selling shares of stock (which can lower share prices, with more shares each demanding a smaller piece of the same-sized company) or taking on debt.

Debt

How much has the company borrowed? Comes in short- and long-term flavors (including the “current portion” of a company’s long-term debt, which gets its own line item).

What it tells you: Debt isn’t always bad – even debt that exceeds a company’s cash. But the more debt a company has, the more it has to pay in interest, which can hurt its profits. More debt can also limit a company’s ability and flexibility to borrow even *more* to fund its growth.

Debt-to-equity ratio

Add up a company’s total debt – make sure to include all the short- and long-term kinds! – then divide by **total shareholders’ equity**, which you’ll also find on the balance sheet. (That’s the “equity” we mentioned above – basically, whatever’s left over when you subtract a company’s liabilities from its assets).

What it tells you: It’s a good way to measure whether a company has too much debt. The higher this ratio, the harder a company has to work to pay off what it owes. Try comparing this metric against the same number at similar or rival companies.

Inventory

The dollar value of all the stuff the company has in stores or warehouses, waiting to be sold.

What it tells you: Steadily rising inventory can suggest that a company’s having trouble making things that people want to buy – and wasting money storing stuff that it’ll have to write off entirely or sell at a steep, profit-pinching discount.

Goodwill

When a company buys another business or asset, goodwill is the difference between what the physical *stuff* of that purchase is actually, literally worth, and what the company *paid* to get it.

What it tells you: If a company has to “write down” goodwill – reduce the dollar amount it records on its balance sheet – that means it paid too much, and has discovered that it’s not getting its money’s worth. In short, it made a dumb move.

Shares outstanding

How many shares a company has issued into the public markets. Keep this figure handy to calculate earnings per share, dividends per share, and other useful numbers.

What it tells you: Big jumps in share counts mean a company’s either issuing new shares to raise quick cash, or paying its employees in stock; either measure can make existing shares

worth less. Steadily falling share counts can improve a company's value by making existing shares worth more.

THE INCOME STATEMENT

How much money the company brought in and paid out during the period covered by the report – so, three months for a 10-Q, a year for a 10-K.

WHAT YOU CAN FIND HERE:

Revenue

How much money did the company make selling goods or services? This is called the “top line,” because you start with this figure, then begin subtracting costs and expenses to get down to a company's profits.

What it tells you: How much money's coming in the door.

Gross profit

Revenue minus the cost of making and selling the stuff: worker salaries, retail store leases, raw materials, etc. Divide gross profit by total revenue to get **gross margin** – the percentage of total sales that gross profit represents.

What it tells you: Higher gross profit and margins suggest a company has **pricing power** – people want what it offers, and they're willing to pay up for it. Changes in gross profit and margin can also tell you how well a company is controlling its costs. Growing margins at this or any of the levels below suggest a company's getting stronger and better at what it does.

Operating profit (or income)

Gross profit, minus the cost of running the rest of the company, including ...

- **Research & development.** How much is the company spending to invent new products or services? Measure this as a percentage of revenue to see how important innovation is to the company's operations.
- **Sales & marketing.** How much is the company spending to get people to buy its wares?
- **General & administrative.** How much is the company spending on midlevel and executive salaries? Office space? Other corporate costs and perks?

Operating margin

Operating profit divided by revenue.

What it tells you: How efficient are the company's overall operations?

Net profit (or income)

Operating profit, minus taxes, interest payments on its debt, the cost of giving its employees shares as part of their pay, and other accounting measures. Known as “the bottom line.” Divide it by revenue to get **net margin**.

What it tells you: Net income is pure profit – what the company gets to keep (at least on paper) after paying the bills. Not all companies are profitable, and not all companies *need* to be in the short term. Some young, growing companies run at a loss while they ramp up revenue and invest in themselves. See whether losses are growing or shrinking, and how quickly they’re doing so.

Earnings per share (or EPS)

Net income, divided by the number of shares the company has floating around the market.

What it tells you: Each share represents a piece of the company and its profits. EPS tells you how much that piece of the profits works out to. Higher EPS = better.

THE CASH FLOW STATEMENT

Net income is important, but because accounting rules can distort the actual amount of money the company’s making *right this moment*, it’s not the *best* way to measure a company’s true financial strength. The cash flow statement starts with how much the company’s making on paper, subtracts all the accounting adjustments, and ends up with how much real cash is actually coming in the door.

WHAT YOU CAN FIND HERE:

Capital expenditures

Sometimes called “property and equipment” or something similar. How much the company is spending on *physical stuff* – buildings, employees, utility bills, etc.

What it tells you: Higher capital expenditures – “capex,” for short – can suggest that a company’s investing in itself to grow.

Free cash flow

Operating cash flow (sometimes called “cash from operations”) minus capital expenditures.

What it tells you: How much cold, hard cash a company’s churning out – or burning up. Positive numbers mean a company’s got cash to spare after paying its bills. It can use that money to pay dividends, buy back its shares, repay debt, or reinvest to grow its business. Negative numbers mean a company’s losing money, eating into the cash on its balance sheet.

Share repurchases

How much the company's spending to buy back its own shares.

What it tells you: Fewer shares mean each remaining share has a bigger claim to the same pool of profits, which can (artificially) boost earnings per share. Companies repurchase shares to juice EPS, increase share prices, and reward existing investors.

Ideally, companies buy back their own shares when the market has priced those shares below what they're actually worth. Poke around elsewhere in the 10-K, and you can usually find the average price the company paid for the shares it bought back. Compare it to the current share price. If the share price is higher now, the company probably spent wisely. If the price is lower now, the company wasted its money.

Dividend payments

How much the company's spending, in total, to pay its dividend.

THE PROXY STATEMENT (DEF 14A)

WHERE TO FIND IT: [The SEC's EDGAR search engine](#) or investor relations pages.

The proxy statement comes out once a year, in advance of the company's annual meeting. It tells you:

Who runs the company

It lists members of the company's board and its top executives, including short bios. Do these folks seem qualified to be here? Do they have relevant experience? Are a suspicious number of them related to one another?

How and how much they get paid

Search for "compensation." Look for how much executives and board members are getting paid in:

- Salary (often the smallest part of their annual pay)
- Cash bonuses
- Stock grants ("here, have some shares")
- Restricted stock units ("you can have these shares in a few years, if you do a good job")
- Options ("we're giving you the right to buy a bunch of shares, usually at a whopping discount, at some point in the future; doing so will instantly score you a huge profit").

Look for previous years' compensation to see whether executive pay is rising faster than the company's revenue and profits.

Who owns how much stock in the company

Search for “beneficial ownership.” You’ll find a chart of how much stock its top executives and board members own, and what percent of the company’s holdings those amounts represent. Not every company’s leaders own big chunks of its shares. But those who do are often more personally invested in the company’s success or failure – and likely to exert tighter control over it. Look for **voting power** to see whether one shareholder, or a group of them, have the ability to overrule every other shareholder in determining the company’s direction.

Intra-company dealings

Search for “related-party.” The company’s legally obligated to disclose whether it’s doing business with or otherwise doling out favors to other companies owned by one of its executives or board members. Companies funneling substantial money under the table into their executives’ pockets? Generally a bad sign.

The board’s priorities, and shareholders’ priorities

Every year at the annual meeting, the board votes to re-elect old members or elect new ones. Shareholders can also propose other things that the company ought to do. The shareholders collectively vote yes or no on all these things. (Companies usually hate shareholder requests and recommend that everyone vote against them.)

EARNINGS RELEASES, TRANSCRIPTS, AND PRESENTATIONS

WHERE TO FIND THEM: You’ll usually find earnings releases – and, if the company offers them, presentations – on a company’s investor relations page. (Not all companies put out presentations. Sometimes they’re lumped together under “Events and Presentations.”)

Companies have to file reports with the SEC. But once a quarter, they often announce those reports through press releases. Sometimes, they put out presentations or “shareholder letters” to accompany those releases. And many companies hold a conference call with Wall Street analysts when they release earnings, where executives report on the numbers and answer questions about them. Various companies and investing sites, such as [Conference Call Transcripts](#), transcribe and publish these calls to sate investors’ curiosity.

All these materials often **contain information that the SEC filings don’t** – or at least present it in a way that’s easier to find and read quickly.

These materials vary from company to company, but can include useful figures like:

- Free cash flow, pre-calculated for your convenience
- Customer counts
- Information about how each individual segment within a company is performing – useful to see where the company’s growing and/or struggling

They also tend to offer **guidance**, the company's own in-house forecast about how much money it thinks it will make in the next quarter or year. Investors tend to like it when companies surpass their guidance, and punish companies – rationally or not – when they miss that guidance.

As you read, look carefully for the words “**non-GAAP**” (“we didn’t have to follow the strict legal requirements of Generally Accepted Accounting Principles when we calculated these numbers”) or “**adjusted**” (“we did basically whatever we felt like to these numbers to make them and us look better”). I’m not saying you *can’t* or *shouldn’t* trust these numbers – but you should always approach them with at least some skepticism.