MODULE 17

It All Starts With The Financials

In the financial world, information is power, and understanding a company's financial health is crucial for informed investing.

We dive into the three fundamental financial statements: the Income Statement, Balance Sheet, and Cash Flow Statement in order to learn how to analyze a company's profitability, liquidity, and financial sustainability.

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Key Takeaways From This Module

Guiding Questions

- Where do companies report their financial progress and what information do these reports tell us?
- How can investors track a company's growth and future plans?
- Why are investors able to trust company financials that they report?
- What is the key information for investors to look out for in company documents?
- What are some ways to analyze a stock?
- How do investors choose what to invest in?

Enduring Understandings

- The 3 major components of financial statements include the Income Statement, Balance Sheet, and Cash Flow Statement.
- How to read and analyze company financial documents with basic accounting.
- The type of information present in financial reports and its relevance.
- Investors should look to the future to understand a company's potential for growth.
- Don't let FOMO inform your investments.

Reasons Why We Report Financials

Financial reports are super important to everyone who has an interest in the company as they provide insight on a company's innerworkings. Stakeholders who care about a company's financials include:

Management
wants the reports to see their performance and where to improve

Investors
want the report to be able to further analyze the company and its worth

Government
wants to know to ensure you are in compliance of all laws and paying the proper taxes

Employees
want to know the success of their work or if they have pay attached to performance

The All Important 10K

What is a 10K?

It's a report that consists of all the financial information about the company for that year. It is required by the Securities and Exchange Commission (SEC) annually from public traded companies. This report is incredibly long and very detailed.

Where to find a 10K

10-k filings are public information and are typically being posted on a company's website under investor relations.
If they are not there though they can be found on the SEC website.

Why are they important?

- **10Ks are the most comprehensive report on a company**
- **The information on company operations and financial health allows you to make informed decisions**
- **10Ks allow for comparisons across different years which allows for more accurate predictions**

What's Included in the 10-k?

Business Description

Risk Factors

Selected Financial Data

Financial Statements

Management's Discussion & Analysis

The Balance Sheet

A **balance sheet** is one of the most recognized financial statements. The best way to describe it is as a snapshot of the company's financial position. **It shows you what a company owns and owes and what is invested in the company**.

More precisely, it gives the exact amount of the **assets, liabilities, and stockholders equity** of a company at a specific time and date.

This is where your accounting equation comes in! In every balance sheet, the company's stockholders' equity and liabilities will be equal to its assets. If you are constructing a balance sheet and that's not the case, then you know something's wrong.

As an investor you definitely want to check out the balance sheet as it helps you calculate the **rates of returns** and evaluate a **company's capital structure**.

The Cash Flow Statement

This statement summarizes the cash and cash equivalents going in and out of the company. It is one of the most used financial statements by investors as it shows you how well the company is able to manage its cash, if it will be able to meet debt obligations and pay operating expenses, and its general financial stability. The ending value of a cash flow statement is usually equal to the cash balance in the balance sheet. It has 3 parts:

Operating Activities

This section is the most looked at. It shows you the company's day to day action in the form of sales, cost of goods sold, wage expenses, etc. If a company is not showing a positive operating income, that's usually a bad sign

Financing Activities

This section tells you about the company's cash inflows and outflows from creditors and shareholders. Taking on debt/ equity raises would be a positive entry whereas debt repayments would be a negative entry.

Investing Activities

This section tells you about asset purchases and sales, and does not include non-cash asset expenses like depreciation. An asset sale would be a positive entry while an asset purchase would be a negative entry.

The Income Statement

The Income statement is one of the three important financial statements. It is used to show the company's financial performance over a specific period. This is also known as the Profit and Loss Statement. It includes cash and non-cash incomes and expenses which ultimately give you the total net income.

Income

The categories included under incomes typically are:

- **Operating revenue:** income from regular sale of good/services
- **Non-operating revenue:** income from peripheral activities eg: interest income
- **Gains:** incidental incomes, examples include profit on sale of an asset and lawsuit settlements

Expenses

The categories included under expenses typically are:

- **Primary activity:** expenses incurred in the production of goods and services, or in the operation of the business
- **Secondary activity:** expenses from non-core business activities eg: interest payments
- **Losses:** incidental expenses, examples include loss on sale of an asset and lawsuit settlement payments

The Accounting Balancing Act

The accounting equation is the key to EVERYTHING. This equation must always hold true for the financial statements to be valid. This is because every transaction always has two equal parts to it, a **Debit side** and a **Credit side**.

Assets

=

Liabilities

+

Stockholders Equity

How Do We Know The Value of A Company?

When deciding where to invest your money, it is important to understand the *inherent* value of companies you're interested in.

Many times, share prices are not a good indicator of what a company is actually worth. From soft drinks to biotech, every business should be evaluated based on its assets, revenues and quality of management.

Application Activity

Think about a few companies you are interested in, or that you buy a lot of products from. Look up their share prices. Do any of them trade for similar prices? Do any of them trade higher or lower than you expected?

Book Value

Formula:

- Total Assets - (intangible assets + liabilities)

Breaking It Down:

- **Total Assets:** This value is found on a company's balance sheet. It includes cash, equipment, buildings, patents, inventory; anything a company has that is worth money.
- **Intangible Assets:** Assets that are not physical; trademarks, patents, copyrights, brand recognition, etc.
- **Liabilities:** Anything a company owes; loans, expenses, wages, taxes, etc.

Why It's Important:

- The formula returns the value of a company's physical assets.
- If a company goes bankrupt, investors could expect to receive the book value/total shares
- Compare the Book Value to the Market Value and share price to see how they differ.

Relative Value With Comps

Process:
- Identify similar corporations in an industry
- Collect important figures
- Calculate price multiples
- Compare multiples across competitors

Breaking It Down:
- **Important Figures:** These are found in companies' financial statements and include revenue, market cap, share price, etc
- **Multiples :** These are ratios or values produced by plugging fundamental figures into formulas. Common multiples include P/E ratio, Enterprise Value(EV), EBIT(Earnings before Interest and Taxes), and more

Why It's Important:
- Comparing key company metrics across an industry will show whether your investment is overvalued or undervalued

Discounted Cash Flow Model

Process and Formula:

- Estimate Future cash flows
- Choose discount rate
- Discount future cash flows to the present day

$$DCF = \frac{CF_1}{1+r}^{1} + \frac{CF_2}{1+r}^{2} + \frac{CF_n}{1+r}^{n}$$

Breaking It Down:

- **Future Cash Flow:** This is the projected amount of money a company will generate in future years. Future Cash Flow projections are estimates based on past performance.
- **Discount Rate(r):** The rate used to discount cash flows to the present day. Investors usually choose a discount rate that is equal to the % return they expect to receive on their investment. E.g. if you know you could get a 5% return from a different investment, you could use a 5% discount rate.

Why It's Important:

- The formula returns the estimated value of future cash flows in the present day. If the DCF is greater than the actual current cash flow, then the investment could yield positive returns.

Limitations of Valuations

They're Estimates

DCF analysis requires *lots* of estimation, from the discount rate to the projected future cash flows. While they may be accurate in normal circumstances, they are not guaranteed to be correct.

They're Time Based

For any of the valuation strategies, numbers change from day to day. They need to be frequently updated to reflect the fluctuations of the market.

They're Complex

Especially for Relative Value and DCF analyses, the required calculations are robust. If one number is missed or incorrectly factored in, the end result could be very misleading.

They're Broad

The Book Value, while a helpful metric, only provides insight for one number on the balance sheet. All companies should be analyzed holistically, taking into account both qualitative and quantitative information.

Key Takeaways From This Module

CORE & FUNDAMENTALS

- All public companies report their financials and is a great place to start when analyzing a company.
- The most important documents of the financial statements are the balance sheet and income statement.
- With those you can create many different ratios and compare companies across markets.

APPLIED KNOWLEDGE

- Reading financial statements gets y7ou to different ratios that are useful when evaluating a company.
- These financial statements are audited by CPAs and are almost always correct.

RELEVANCE FOR YOU

- Most of the ratios you will use to analyze companies will be provided or easy to research without going into the financials, however, it is important to know where those numbers came from and what they mean.