Still jet-lagged by 8 hours from a day and a half in London, I haven't slept for a good 48 hours and remembered I owe WSO (Wall Street Oasis) my process for dissecting a 10-k (/finance-dictionary/what-is-a-10K) in the usual form. Before I get right into it, keep in mind every business is different and that will dictate the way you should read their specific annual report. What might be important to look at for an oil & gas company might be completely ignored for a hardline retail company, so don't take this as gospel when your PM tells you to get up to speed on a company and you remember the stupid shit old BlackHat told you was right and you end up missing something crucial to making an investment decision.

So with that, here is a full breakdown of how I like to look through a 10-k for the first time, what's important to focus on, and what can be glazed over (if anything) to save time and/or not confuse yourself. As always, I'll field questions afterwards if and when I feel like it to clear anything up.

Business Description

No matter how simple the business appears to be on the outside, I always go into researching a new business assuming I know absolutely nothing because chances are I do. On the cover page alone, I'll always highlight a few things: fiscal year end, headquarters location, and shares outstanding/market cap if included. Simple stuff, but I still do it no matter what.

Moving on, business description is the first portion of every K. Things that are surprisingly important to me include the history of the business and any historical changes in the company's defined reportable segments. The way a business perceives its moving parts is really important to understanding what they consider important. Sometimes management will decide to move from functional segmentation to geographic segmentation (or the other way around), or might simply consolidate segments or anything similar. I always want this in mind before I get into the granular aspects of the business so I have a frame of reference for how management looks at their own business. If I end up disagreeing it could be an interesting angle if we end up doing something activism-ish or if this may be a short candidate.

I always read the Business section in its entirety (note: I read every section in its entirety to be honest). Besides the things I've already mentioned, the obvious things to focus on are revenue breakdown by whatever segmentation they choose, key business relationships, and key business risks. The main things I'm trying to answer in this section are:

1) Where is the crown jewel of this business?

I want to identify the cash generator/main earnings driver for the company. Most of the time this isn't going to be the same segment as what I'm looking for in #2, but it's very important to understand what the majority cash generator is for the company. Normally a company can't survive long enough without its bread and butter to develop any high-growth areas, so determining the key risks to it are just as significant as determining the catalysts to the explosion of another segment.

2) What is the major growth generator?

Having a cash cow is great, but doesn't make for a compelling investment if it's growing top line at 1% annually. Normally management will make a point to highlight any major growth in a particular segment, but then again sometimes they won't. Always have this question in your mind when you're looking through segment information. If sales as a % of revenue have moved up from something like low teens to mid-thirties over the past few years, all the sudden you may have a good idea of where growth is coming from... or where a segment will have to pick up the slack as a crown jewel business starts to wither away...

3) Where are the key risks for #1 and #2?

Section 1A will always list the risks to the business. A certain chunk of business risks seem identical in every company and can probably be skimmed, but firm-specific risks can be very important and disclose some important information. The things you can usually glaze over include the standard "macroeconomic conditions" clauses, litigation risks (unless it's a litigation-heavy business like a medical supplier, car company, airline, etc.), and key man statements. Specific things to look for might be in regards to expansion plans re: the growth engine and market share or other revenue losses re: the crown jewel. Management will usually outline what they think is scary about both of these things, and that will help you build a foundation for what you need to go out and investigate after you're done reading the K.

Properties

Skim through them, but usually not a big deal because there should be no surprises here. If it's a retailer and they provide historic square footage numbers, it's helpful to see how square footage has grown and you'll probably want to evaluate sales/sq. ft (full time). over time to see how if the business has been able to grow its store base in an efficient way.

Commitments/Contingencies (I.E. Litigation)

Again, not particularly important for most but sometimes in lock-step with the business risks section, management might highlight a certain lawsuit or risk of lawsuit that could be make or break for the company. In those cases, obviously focusing on this section becomes a must. But when Kohl's has a $12M lawsuit hanging over its head in regards to a black woman's discrimination lawsuit after she got fired for shoplifting, you probably don't need to spend too much time figuring out what's gonna happen with that one.

Market For Equity / Selected Financial Data

The market for equity section should be pretty straight forward, and chances are if you decided to take a look at the company you already know where their stock has traded recently and if they have a dividend. Other times though you might want to at least skim over this to see if there could be any plans for a dividend or discontinuation of a dividend. Usually one of the more unimportant sections to me (except maybe Mine Safety Disclosures, haha).

Selected Financial Data is your first look at the actual performance of the business. I don't spend too much time here but I like to get an idea of the recent growth trends on the important line items, a sense of the margins at a high level, and anything particular that sticks out, like enormous one-time charges or a year where all the sudden everything fell off a cliff. These are really just things that quantify our idea of business risks, and hopefully we'll see these addressed later in the MD&A or footnotes. If not, we have some phone calls to make...

Management Discussion & Analysis

This, along with the notes to the statements themselves, are pretty much the bulk of the K for understanding what the hell is going on with a business. I spend a good amount of time scrutinizing this section and tend to re-read it once or twice before I feel like I'm actually done with that particular K. This is where the management team will outline their strategy and give a breakdown of what happened during the fiscal year. It's not uncommon for this section to be a way for the company to explain away their failures, or to pump a successful plan.

While I think this section is different for every company, the big things to watch for in getting acquainted with the way the business runs are 1) the important operating metrics that management uses to gauge performance, 2) any non-GAAP accounting that you might otherwise come across in an earnings release and be confused by, and 3) understanding the cash position of the business and seeing where any cash burn might be coming from. I always find myself playing the role of operator of a competitor, trying to scrutinize management's positions on everything they explain and coming up with a list of questions - no matter how basic - that I might have if they're still unanswered by the time I finish the annual report. This section also helps for providing some outlook and giving you better visibility/confidence in any projections you might make for an operating model.

Financial Statements / Notes

Before I get too excited, I always force myself to highlight in the auditor's note the phrase "fairly, in all material respects" twice, and "maintained, in all material respects" once. While most companies will have an unqualified opinion from their auditors, it's just a good exercise to make sure you don't miss any language changes or anything from year to year that might indicate something is a little fishy. I think it's a good habit to get into if you can help it.

Into the financial statements, I always go line item by line item to see if everything jives with what I think I now know based on the MD&A section. I'll highlight any lines or year-over-year changes that indicate significant strength or weakness, and all that good stuff. This post isn't about analyzing financial statements (and I don't want it to get too long) so I'm not going to dive into the color of what would be important... not to mention the fact that it varies from business to business.

Another good habit to get into here though is, while picking apart the statements and identifying any strange areas or major changes that manifest themselves in the numbers, create an ad-hoc checklist on a sticky note or notepad or something and write down all the things you wish you had an explanation for. When you go through the Notes to the Financial Statements (yes, you should go through this section with more detail than any other, no matter how long it is) you can then cross off every concern as they get answered in the notes. The ones left over are the ones you will probably want to ask IR about, or perhaps answer on your own from external sources such as other operators or sell-side analysts (if it's something they'd have expertise in).

Also a quick note: I have a (possibly dangerous) habit of almost completely ignoring the statement of comprehensive income. To this day I don't really understand what the point is and yet to be punished by it. I'm not sure if there's much intelligence to be gained from it and anything important enough to be on it is probably going to manifest itself elsewhere. This could be something I need to change, but like I said I haven't been punished for ignoring it yet.

Of particular interest to me are Revenue Recognition, Stock-Based Compensation, anything related to Inventory Management (if applicable for the company), and any accounting standards that require a significant level of subjectivity. I'll also make sure to understand how the company is accounting for their pension and evaluating the discount rates and other assumptions they use for it, which can often be indicative of the aggressiveness with which the company accounts for other things. It's a fair measuring stick in most circumstances, particularly when you're skeptical they might be a bit aggressive in their accounting.

Another thing about the notes to the financial statements... you will notice a lot of repeated language from earlier in the K, particularly from the MD&A and business description, but sometimes the company will slip little changes into the same language over time, and that's something to look for if your ADD will allow it. I guess this is really just my way of stressing the practice of reading the notes in their entirety even when you think you've already read something earlier. A lot of analysts will be too passive and possibly trust the company too much to notice funny little changes, but they can be the difference between recommending the stock and having a clear, fundamental misgiving that keeps you from doing so.

Apologies for the way this is scattered, but I have no other way of thinking about it... yet another thing to look at is the stock repurchase history of the business. As always, the three main questions I want answered to determine whether or not we're dealing with a quality management team: 1) are they skilled operators, 2) do they have capital allocation expertise, and 3) do they have industry-leading vision? Most of the time, only one of these is even required to have a good management team, and anyone with multiple traits is a slam dunk. So anything that quantifies these is important, and stock repurchase is one of many that do. Be sure to see how much is left on their repurchase program and factor that into your models as needed.

The Segment Information section is the last (I promise) part of the notes that should always get extra scrutiny. This is where you get the full breakdown of how much each segment contributed to the company as a whole, how much each subsegment (if that's a word) contributed to their respective segments, and how profitable each segment was. This usually is just a way to get more color in identifying or evaluating the crown jewel and growth engine areas of the business.

Follow-Up

After finishing with the notes and everything else, hopefully you have some questions left over. If you don't, chances are you just weren't asking enough questions and unfortunately might need to double back because you've been too lenient on the company. Now that we feel good about the K, I always move on to the most recent Q or two, an earnings transcript, etc. But before I do that, I always go to the proxy statement (/finance-dictionary/what-is-a-proxy-statement). Making sure you have a good grasp on the management team's background/history, their incentives, and how well they are lined up with yours as an investor, is just as important as having a good grasp on the actual business itself. Management quality is more or less important depending on how defensible an industry is, so the level of care to address that with is really up to the situation. Anyway - proxy statement, recent quarterly releases and transcripts, and any conference transcripts you can dig up are next on the docket after the K. If after all that you still have questions left (I hope you do) then it's time to hit the phones and any less than orthodox sources of information you can find. When you're looking for a business you want to own (or short) for the long-haul, you really need to understand what they're doing, and a lot of the time you just don't know what you don't know yet... so never pull the trigger too soon. Regret is a better feeling than poverty, or so my boss says.

Hope this wasn't too long for you guys, and I'm pretty sure I've rambled plenty enough in here. I found myself having trouble explaining what to actually look for since it varies so much from situation to situation, but if you can take one or two little pieces of information away from this then I think it's served its purpose.

I'll try and answer anything in more detail in the comments. Enjoy!

Mod Note: Best of WSO (Wall Street Oasis), this was originally posted January 2014

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