

## Dissecting financial statements: Some helpful hints

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**The tool shed.** Finding financial documents got immensely easier when the Web came along. Every filing a public company makes with the Securities and Exchange Commission is available for free at the agency's web site, [www.sec.gov](http://www.sec.gov). The trick there is to search the Edgar database, the greatest single tool for shareholder democracy since the advent of the annual shareholder meeting. The SEC's site isn't very pretty, however, so it's not all that easy to read. For that, a myriad of free and fee-based sites are available. One of the best free sites is [www.freeedgar.com](http://www.freeedgar.com). It just recently began requiring a registration, but it's still free to use. The best site you must pay for is [www.10-Kwizard.com](http://www.10-Kwizard.com), a site that allows much more extensive searches than the freebie sites. Whichever site you use, if a company truly is important to you, consider subscribing to a watch list. For a small fee, the site will send you a notice every time your targeted company makes a filing. That's how the pros track their investments, and it's how you should too.

**Get your own green eyeshades.** A rudimentary understanding of accounting is invaluable to being an investor. You don't need to prep for the CPA exam or anything. You just need to get comfortable with income statements, balance sheets and the like enough to know what everybody's talking about. Once you're comfortable, it's time to check out the easy-to-read accounting book by the man who put "forensic" accounting on the map, Howard Schilit. A former accounting professor, Schilit advises professional investors on what stocks to avoid. His book on the subject, *Financial Shenanigans : How to Detect Accounting Gimmicks & Fraud in Financial Reports*, is the gold standard.

**What hangs in the balance.** Investors are anecdotally aware of income statements because revenues and earnings are easy-to-understand concepts. But savvy investors know it's the balance sheet that really matters. Look, for instance, at the cash a company has and compare that to its debt. Did revenues increase, but cash declined in the last quarter? That might be a problem. See if the 10-Q, a.k.a. the quarterly report, or the 10-K, the annual report, explains these types of mysteries.

**That's extraordinary!** One of the many arcane filing names is the Form 8-K. Sounds boring, no? It's not. It's actually where the best stuff is. It's literally the form that companies file to explain extraordinary events. For example, if a company changes its auditor – possibly a sign of trouble – it needs to file an 8-K. Companies often will put out press releases on transactions – say, for example, a sale of stock in a private transaction – that don't contain many details. Guess where those details are? That's right, in the 8-K. Go there to learn exactly at what price the private buyers are getting in and under what terms. You might be surprised that their deal is better than yours.

**What the boss makes.** One of the most entertaining financial documents is the definitive proxy statement, thrillingly called a Form DEF 14-A. Within this statement that includes proposals to be voted on by shareholders at an annual meeting is the compensation data for the top five executive officers of the company. Every year when the financial press runs article after article about executive compensation, the data is coming from the proxy. You'll find the CEO's pay, her bonus, the number of stock options she was granted, and other fun stuff, like the expense of the security fence around her home. You get a good sense of the management team by seeing how they pay themselves.

**All in the family.** Perhaps the most important portion of a quarterly or annual report filed with the SEC is called "related-party transactions." Search for the term and read it first. It's where the company must disclose any significant business it's doing with people who have relationships with the company. Does a board member's employer buy a lot of widgets from the company? Does the CEO sit on the board of a major supplier? Is the vice-president for purchasing getting shares in a vendor? If so, it all should be reported here. It lets you know what motives may be behind management's actions.

**Compare/Contrast.** Remember those awful essays in college? Well, this exercise is a lot more fun. Careful investors note that companies typically use the same language in their filings year after year, quarter after quarter. Or, in the case of an IPO (remember those?), the same language appears in subsequent filings as a company moves closer to going public. Hidden within those boiler-plate reports are important changes. As an investor, you want to know what they are. Assuming you use Microsoft Word (who doesn't?), finding the changes is easy. Simply cut and paste the old document and the new document into separate Word files. Next click on "tools," then "track changes," and finally on "compare documents." Presto! You've got underlined in red the parts that have been excised and highlighted in red the parts that are new.