🔍 How to analyze a 10-K

It’s always crucial to **understand the companies you invest in.**

A 10-K tells you everything you need to know about a stock.

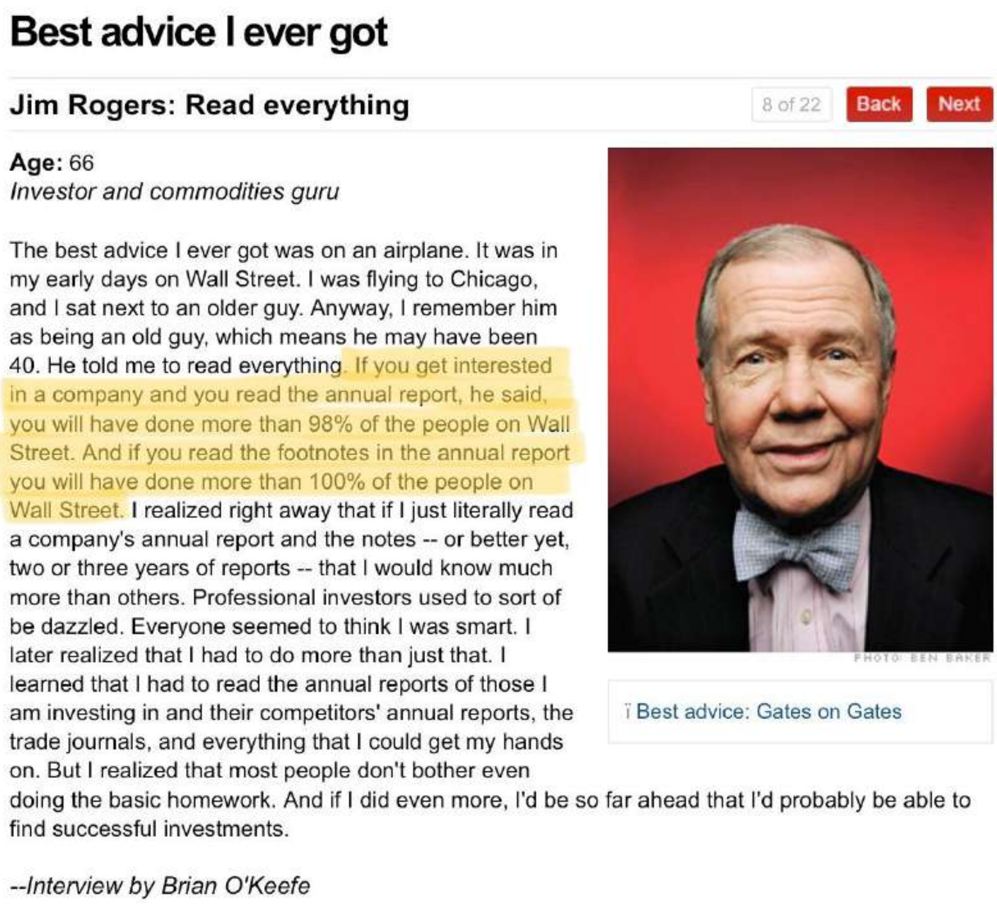
In this article, you’ll learn **how to read a 10-K like a professional.**

The importance of a 10-K

According to Jim Rogers, 98% (!) of people on Wall Street don’t read the annual report. As a Fund Manager, I can confirm that most professional investors don’t read the 10-K before they invest in a company.

This means that you can create a BIG advantage for yourself if you read 10-Ks.

Successful investing is hard work. The best way to outperform the market is by becoming a learning machine.



Best advice I ever got

Jim Rogers: Read everything 8 of 22 Back Next

Age: 66
Investor and commodities guru

The best advice I ever got was on an airplane. It was in my early days on Wall Street. I was flying to Chicago, and I sat next to an older guy. Anyway, I remember him as being an old guy, which means he may have been 40. He told me to read everything. If you get interested in a company and you read the annual report, he said, you will have done more than 98% of the people on Wall Street. And if you read the footnotes in the annual report you will have done more than 100% of the people on Wall Street. I realized right away that if I just literally read a company's annual report and the notes -- or better yet, two or three years of reports -- that I would know much more than others. Professional investors used to sort of be dazzled. Everyone seemed to think I was smart. I later realized that I had to do more than just that. I learned that I had to read the annual reports of those I am investing in and their competitors' annual reports, the trade journals, and everything that I could get my hands on. But I realized that most people don't bother even doing the basic homework. And if I did even more, I'd be so far ahead that I'd probably be able to find successful investments.

PHOTO: BEN BAKER

Best advice: Gates on Gates

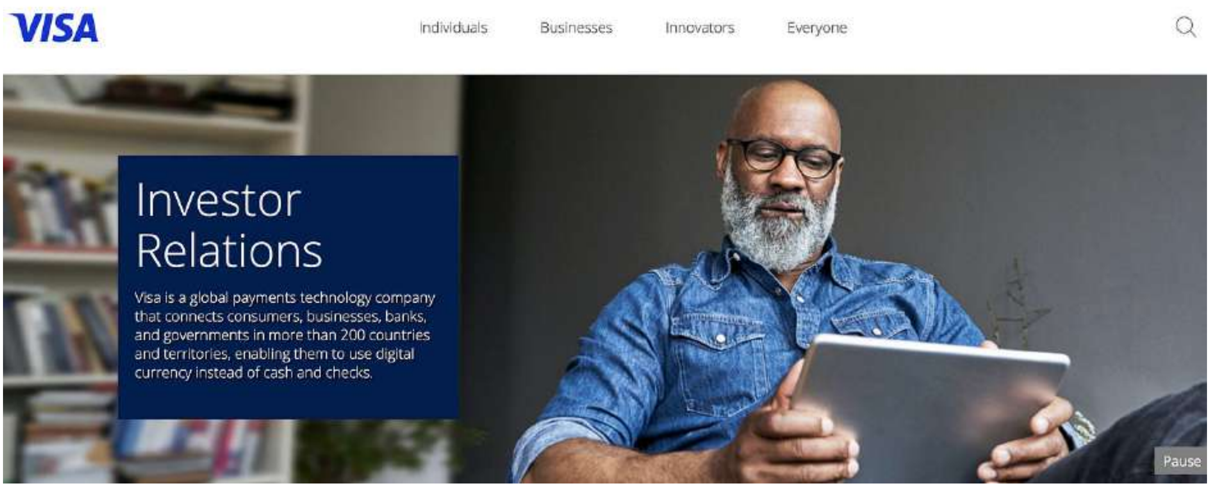
--Interview by Brian O'Keefe

What is a 10-K?

Every year, companies must publish their 10-K. It's the most important document a company publishes. **The better you know how to read an annual report, the better you'll be able to understand the companies you invest in.**

But what is a 10-K?

A 10-K is an **official document** that contains a lot of information about the company. The SEC requires US listed companies to publish this report to inform (potential) investors about their financial conditions. **You'll learn about the company's history, it's organizational structure, financial statements, executive compensation and so on.**



Structure of a 10-K

The beautiful thing about a 10-K is that **they all have the same structure.**

This means that the more 10-Ks you read, the faster and the better you'll get at it.

The structure of a 10-K looks as follows:

1. **Business:** an overview of the company's main operations including its products and services. This section shows you how the company makes money
2. **Risk factors**: shows the major risks of the company. The risks are typically listed in order of importance
3. **Financial statements**: specific financial information about the business
4. **Management discussions and analysis (MD&A)**: Management's view on the business results of the past fiscal year

We'll now dig into each section using Visa as an example. You can find Visa's 10-K on the Investor Relations section of their website.

		Page
PART I		
Item 1	Business	4
Item 1A	Risk Factors	17
Item 1B	Unresolved Staff Comments	30
Item 2	Properties	30
Item 3	Legal Proceedings	30
Item 4	Mine Safety Disclosures	30
PART II		
Item 5	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	31
Item 6	[Reserved]	31
Item 7	Management's Discussion and Analysis of Financial Condition and Results of Operations	32
Item 7A	Quantitative and Qualitative Disclosures About Market Risk	46
Item 8	Financial Statements and Supplementary Data	48
Item 9	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	105
Item 9A	Controls and Procedures	105
Item 9B	Other Information	105
Item 9C	Disclosure Regarding Foreign Jurisdictions that Prevent Inspections	106
PART III		
Item 10	Directors, Executive Officers and Corporate Governance	107
Item 11	Executive Compensation	107
Item 12	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	107
Item 13	Certain Relationships and Related Transactions, and Director Independence	107
Item 14	Principal Accounting Fees and Services	107
PART IV		
Item 15	Exhibits, Financial Statement Schedules	108
Item 16	Form 10-K Summary	108

1. Business

This section describes **the company's main products and services.**

It's a good place to start as it tells you **how a company makes money.**

It's very important to **always invest within your circle of competence.** If you don't understand the business model, you can skip the company right away.

The business segment can usually be found at the beginning of the 10-K.

ITEM 1. Business

OVERVIEW

Visa is one of the world's leaders in digital payments. Our purpose is to uplift everyone, everywhere by being the best way to pay and be paid. We facilitate global commerce and money movement across more than 200 countries and territories among a global set of consumers, merchants, financial institutions and government entities through innovative technologies.

Since Visa's early days in 1958, we have been in the business of facilitating payments between consumers and businesses. As a trusted engine of commerce and with new ways to pay, we are working to provide payment solutions for everyone, everywhere. We are focused on extending, enhancing and investing in our proprietary network, VisaNet, to offer a single connection point for facilitating payment transactions to multiple endpoints through various form factors. Through our network, we offer products, solutions and services that facilitate secure, reliable and efficient money movement for participants in the ecosystem.

2. Risk factors

This section shows **the risks a company faces, usually listed in order of importance.**

Going through this section is very important. As Benjamin Graham once said:

“The essence of investment management is the management of risks, not the management of returns."

When a company has a lot of goodwill on its balance sheet, generates a significant percentage of its revenue from a few clients, has low margins, or is active in a highly competitive market, it increases the risk for you as an investor.

ITEM 1A. Risk Factors

Regulatory Risks

We are subject to complex and evolving global regulations that could harm our business and financial results.

As a global payments technology company, we are subject to complex and evolving regulations that govern our operations. See *Item 1—Business—Government Regulation* for more information on the most significant areas of regulation that affect our business. The impact of these regulations on us, our clients, and other third parties could limit our ability to enforce our payments system rules; require us to adopt new rules or change existing rules; affect our existing contractual arrangements; increase our compliance costs; and require us to make our technology or intellectual property available to third parties, including competitors, in an undesirable manner. As discussed in more detail below, we may face differing rules and regulations in matters like interchange reimbursement rates, preferred routing, domestic processing requirements, currency conversion, point-of-sale transaction rules and practices, privacy, data use or protection, licensing requirements, and associated product technology. As a result, the Visa operating rules and our other contractual commitments may differ from country to country or by product offering. Complying with these and other regulations increases our costs and reduces our revenue opportunities.

If widely varying regulations come into existence worldwide, we may have difficulty rapidly adjusting our product offerings, services, fees and other important aspects of our business to comply with the regulations. Our compliance programs and policies are designed to support our compliance with a wide array of regulations and laws, such as anti-money laundering, anti-corruption, competition, money transfer services, privacy and sanctions, and we continually adjust our compliance programs as regulations evolve. However, we cannot guarantee that our practices will be deemed compliant by all applicable regulatory authorities. In the event our controls should fail or we are found to be out of compliance for other reasons, we could be subject to monetary damages, civil and criminal penalties, litigation, investigations and proceedings, and damage to our global brands and reputation. Furthermore, the evolving and increased regulatory focus on the payments industry could negatively impact or reduce the number of Visa products our clients issue, the volume of payments we process, our revenues, our brands, our competitive positioning, our ability to use our intellectual property to differentiate our products and services, the quality and types of products and services we offer, the countries in which our products are used, and the types of consumers and merchants who can obtain or accept our products, all of which could harm our business and financial results.

Increased scrutiny and regulation of the global payments industry, including with respect to interchange reimbursement fees, merchant discount rates, operating rules, risk management protocols and other related practices, could harm our business.

3. Financial statements

As an investor you want to buy **financially healthy companies with high margins and plenty of reinvestment opportunities**.

That’s why the Financial Statements are **one of the most important sections of a 10-K.**

There are 3 Financial Statements in a 10-K:

- **Balance Sheet:** gives you an overview of a company's main assets and liabilities. You want to invest in companies which don't have too much debt
- **Income Statement:** shows the company's revenues and expenses over a certain period. You want to invest in profitable companies which can grow their revenue organically at an attractive rate

- **Cash Flow Statement:** gives an overview about how much cash goes in and out a company over a certain period. You want to invest in companies that are cash flow positive

We'll dive deeper in every financial statement in our next articles.

As of September 30, 2022 and 2021 and for the years ended September 30, 2022, 2021 and 2020

	Page
Report of Independent Registered Public Accounting Firm (KPMG LLP, Santa Clara, CA, Auditor Firm ID: 185)	49
Consolidated Balance Sheets	52
Consolidated Statements of Operations	53
Consolidated Statements of Comprehensive Income	54
Consolidated Statements of Changes in Equity	55
Consolidated Statements of Cash Flows	58
Notes to the Consolidated Financial Statements	59

4. Management discussions and analysis (MD&A)

This section shows **the view of management on the business results of the past fiscal year.**

It's always important to look at the qualitative factors behind the numbers. That's why it's important that management can tell its story in its own words.

Is the increasing revenue structural? Or is it because of a one-off event?

You want to invest in companies with an integer management with skin in the game. Management should always give you a reliable view about the performance of the company.

Avoid companies that do not give an honest representation of their results.

ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This management's discussion and analysis provides a review of the results of operations, financial condition and liquidity and capital resources of Visa Inc. and its subsidiaries (Visa, we, us, our and the Company) on a historical basis and outlines the factors that have affected recent earnings, as well as those factors that may affect future earnings. The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes included in Item 8—Financial Statements and Supplementary Data of this report.

This section of this Form 10-K generally discusses fiscal 2022 compared to fiscal 2021. Discussions of fiscal 2021 compared to 2020 that are not included in this Form 10-K can be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended September 30, 2021, filed with the United States Securities and Exchange Commission.

Overview

Visa is a global payments technology company that facilitates global commerce and money movement across more than 200 countries and territories among a global set of consumers, merchants, financial institutions and government entities through innovative technologies. We provide transaction processing services (primarily authorization, clearing and settlement) to our financial institution and merchant clients through VisaNet, our advanced transaction processing network. We offer products and solutions that facilitate secure, reliable, and efficient money movement for all participants in the ecosystem.

Financial overview. A summary of our as-reported U.S. GAAP and non-GAAP operating results is as follows:

Conclusion

- If you read the 10-K of a company you'll learn a lot and create a BIG advantage over other investors
- A 10-K is an official document that is published every year
- The 10-K can usually be found under the Investor Relations section of a company's website
- Every 10-K consists of 4 parts: business, risk factors, financial statements and management discussions & analysis (MD&A)

🔍 How to analyze a balance sheet

Knowing how to analyze a balance sheet is a must to make good investment decisions.

You want to invest in companies that are in good financial shape.

Learn everything you need to know about a balance sheet this article.

SAMPLE BALANCE SHEET

ASSETS

Current Assets	
Checking Account	5,000
Savings Account	1,000
Petty Cash	500
Accounts Receivable	22,000
Inventory	15,000
Prepaid Insurance	6,000
Total Current Assets:	49,500
Noncurrent Assets	
Accumulated Depreciation	-4,500
Computer	7,000
Building	65,000
Land	60,000
Total Noncurrent Assets:	127,000
Total Assets:	177,000

LIABILITIES & EQUITY

Liabilities	
Current Liabilities	
Accounts Payable	12,000
Line of Credit	20,000
Payroll Liabilities	7,000
Total Current Liabilities:	39,000
Noncurrent Liabilities	
Long-term Debt (loan)	48,000
Total Liabilities:	87,000
Equity	
Owner's Capital	35,000
Retained Earnings	55,000
Total Equity:	90,000
Total Liabilities & Equity:	177,000

What is a balance sheet?

A balance sheet is a **financial statement** that shows you **3 things** of a company at a specific point in time:

1. Assets
2. Liabilities
3. Shareholders equity

In child language, a balance sheet shows you what a company owns and owes.

Balance sheet = snapshot

It is very important to understand tha**t a balance sheet is a SNAPSHOT of a company's financial health** at a certain point in time.

This is a fundamental difference compared to an income statement and cash flow statement as these statements are measured OVER a period of time.

Balance sheet = snapshot —> at a certain point in time
Income statement and cash flow statement = video —> measured over a period of time

This also means that a management with bad intentions could try to fine tune their balance sheet to look more healthy. **That's why I prefer to invest in companies with an integer management and skin in the game.**

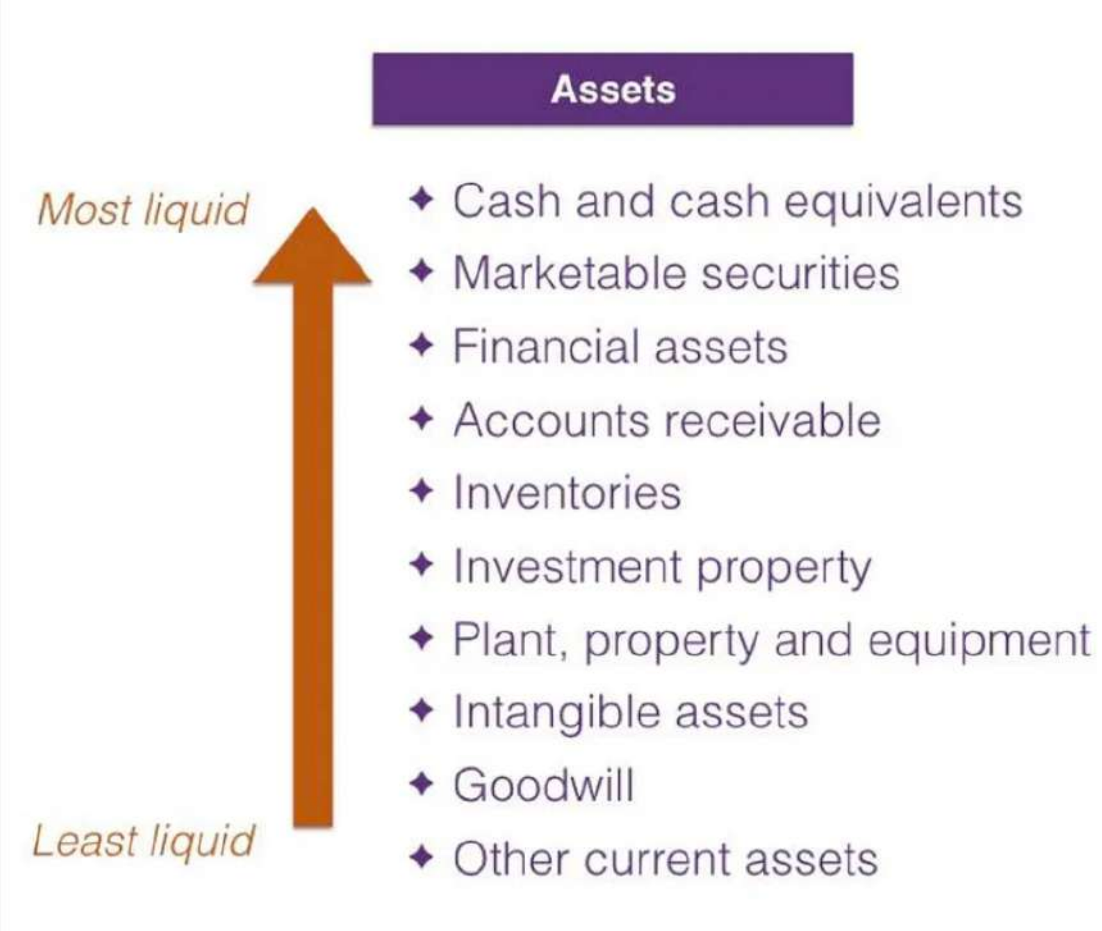
Assets

The **assets** of a company show you **everything the company owns.**

A distinction can be made between **current assets** and **non-current assets.**

- **Current assets:** assets that can be converted into cash within 1 year
  - **Examples of current assets:** cash and cash equivalents, short-term investments, accounts receivable and inventories
- **Non-current assets:** assets that are harder to convert into cash
  - **Examples of non-current assets:** buildings, stores, goodwill (premium paid to make an acquisition) and patents

A company's assets are always ranked from most liquid to least liquid:



Questions to ask yourself about a company's assets

1. How much cash and cash equivalents does the company have (the more, the better)?
2. How much goodwill does the company have (the less, the better)?
3. Does the company have a lot of intangible assets?

Liabilities

The **liabilities** of a company show you **how much the company owes.**

A distinction can be made between **short-term liabilities** and **long-term liabilities.**

- **Short-term liabilities:** a financial obligation that has to be paid within 1 year
  - Examples of short-term liabilities: short-term debt and accounts payable
- **Long-term liabilities:** debt that has to be paid > 1 year
  - Examples of long-term liabilities: long-term debt and pension plans

It goes without saying that **you don't want to invest in companies which have too much debt.**

Liabilities		
Current Liabilities		
	Accounts Payable	$700,000
	Notes Payable	$200,000
	Accrued Expense	$150,000
	Income Taxes Payable	$100,000
Total Current Liabilities		***$1,150,000***
Long-term Liabilities		
	Long-term Debt	$3,300,000
Total Liabilities		$4,450,000

Just like a company's assets, liabilities are also ranked from most liquid to least liquid:

Questions to ask yourself about the company's liabilities:

- Does the company have more short-term than long-term liabilities (bad sign)?
- Does the company have more cash than short-term debt (good sign)?
- Are total liabilities increasing or decreasing? And why?

Shareholders equity

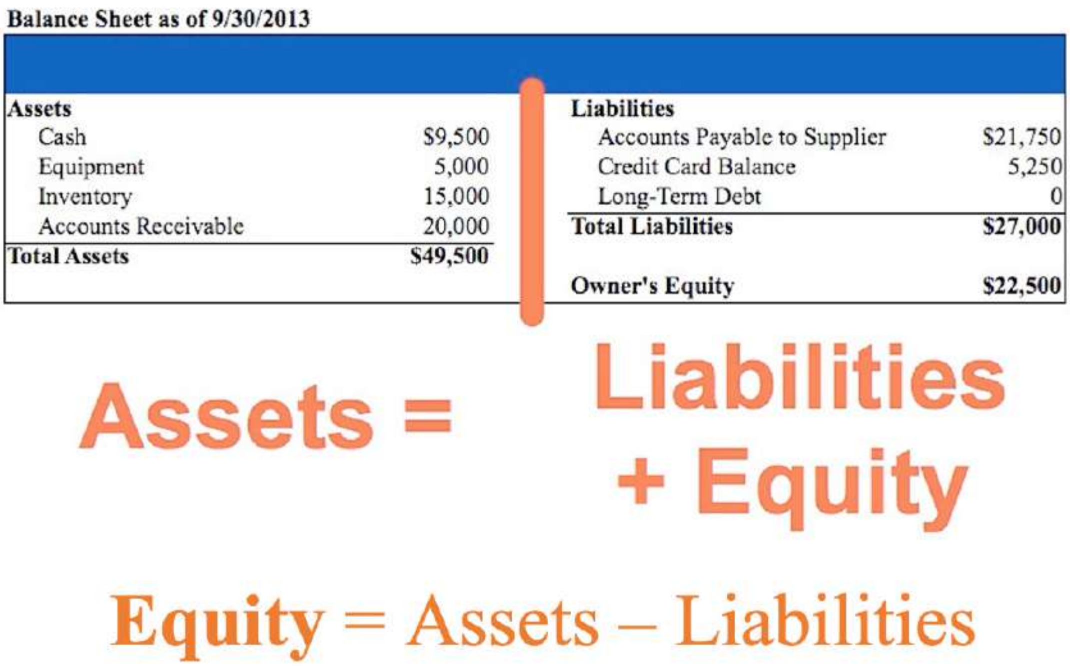
The shareholders equity shows you **how much money the owners (shareholders) have invested in the company.**

You can calculate the shareholders equity of a company yourself very easily:

Shareholders equity = Total assets - Total liabilities

In general, there are 3 categories of shareholders equity:

- **Contributed capital:** the amount shareholders have invested in the company to buy their stake
- **Retained earnings**: profits a company has reserved to reinvest in the business
- **Treasury stock:** cash the company uses to buy back its own shares


Balance Sheet as of 9/30/2013

Assets		**Liabilities**	
Cash	$9,500	Accounts Payable to Supplier	$21,750
Equipment	5,000	Credit Card Balance	5,250
Inventory	15,000	Long-Term Debt	0
Accounts Receivable	20,000	**Total Liabilities**	**$27,000**
Total Assets	**$49,500**		
		Owner's Equity	**$22,500**

Questions to ask yourself about the company's shareholders equity:

- Does the company have a lot of retained earnings (good sign)?
- Are there a lot of preferred stocks (bad sign)?
- Does the company buy back shares (good sign)?

Great ratios to analyze a company's balance sheet

You've now learned that you should invest in companies which are in **good financial share**.

Just like Terry Smith, I like to **look at 2 ratios to determine the healthiness of a balance sheet:**

1. Interest coverage
2. Net debt / free cash flow

Interest coverage

This ratio shows you **how easily a company can pay back the interests on its outstanding debt.**

You can calculate it as follows:

Interest coverage = (EBIT / Interest payments)

The higher this ratio, the better. I prefer to invest in company's with **an interest coverage of at least 10x.**

Net Debt / Free Cash Flow

This ratio shows you **how many years it would take the company to pay down all its debt when it would use all available free cash flow.**

The formula for this ratio is very obvious:

Net Debt / Free Cash Flow = (Net Debt / Free Cash Flow)

The lower this ratio, the better. Personally I prefer companies with a Net Debt / Free Cash Flow **lower than 4**.

Conclusion

That's it for this article. Here's what you should remember:

- A balance sheet tells you what a company owns and owes
- The balance sheet consists of 3 parts: assets, liabilities and shareholders equity
- The interest coverage and net debt / free cash flow are 2 great ratios to analyze a balance sheet

🔍 How to analyze an income statement

Knowing **how to analyze an income statement** is a must to make good investment decisions.

As an investor, you want to buy profitable companies which make money for you while you sleep.

Learn everything you need to know about Income Statements in this article.

What is an income statement?

An **income statement** is also called a **profit and loss account.**

It shows **the company's revenue and expenses over a certain period**.

The income statement provides you with a lot of insights as it tells you **how much revenue is translated into net income, the efficiency of management, and much more.**

An income statement always has the same format:

COMPANY B
INCOME STATEMENT

For Year Ended September 28, 2019 (In thousands)

NET SALES	$	4,358,100
COST OF SALES		2,738,714
GROSS PROFIT		**1,619,386**
SELLING AND OPERATING EXPENSES		560,430
GENERAL AND ADMINISTRATIVE EXPENSES		293,729
TOTAL OPERATING EXPENSES		**854,159**
OPERATING INCOME		**765,227**
OTHER INCOME		960
GAIN (LOSS) ON FINANCIAL INSTRUMENTS		5,513
(LOSS) GAIN ON FOREIGN CURRENCY		(12,649)
INTEREST EXPENSE		(18,177)
INCOME BEFORE TAXES		**740,874**
INCOME TAX EXPENSE		257,642
NET INCOME	**$**	**483,232**

Harvard Business School Online

I will show you step by step how you can go from **revenue to net income.**

Revenue

For a company, it all starts with its **revenue** or **sales**.

Revenue is the money a company receives from selling its products and/or services.

Let's say that a fictional company Drink Inc sells 2,179,050 drinks at a price of $2 per drink.

In this example, the company's revenue is equal to $4,358,100 ($2 * 2,179,050 drinks).

Cost Of Goods Sold (COGS)

The section **cost of sales** or **costs of goods sold (COGS)** shows you all the costs a company makes to produce its products and/or services.

When Drink Inc. would need $1.25684 to produce a drink, its COGS would be equal to $2,738,714 million (2,179,050 million drinks * $1.25684 per drink).

- Revenue Drink Inc. : $4,358,100
- COGS Drink Inc: : $2,738,714

Gross profit

After you know the revenue and COGS of a company, you can calculate the company's **gross profit:**

Gross profit = Revenue - COGS
Gross profit Drink Inc. = $4,358,100 - $2,738,714 = $1,619,386

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Gross margin

Now you know the gross profit, you can also calculate the **gross margin:**

Gross margin = Gross profit / Revenue
Gross margin Drink. Inc = $1,619,386 / $4,358,100 = 37.2%

A gross margin of 37.2% means that a company needs $0.628 to produce its products while it can sell them for $1.

The higher the gross margin, the better.

When a company has a **very stable and high gross margin,** it is often an indication that the company has **pricing power.**

Operating expenses (OPEX)

The operating expenses or OPEX show you **all the expenses a company makes to run its daily operations.**

Operating expenses consist out of 4 pillars:

- Sales & Marketing
- Depreciation & Amortization
- Research & Development (R&D)
- General & Administrative expenses

In our example Drink Inc. has $560,430 in selling and operating expenses and has $293,729 in general and administrative expenses. As a result, OPEX is equal to $854,159.

Operating income

Now you've taken a look at the operating expenses, you can calculate the **operating income or EBIT** of a company.

The operating income shows you how much money a company earns from its normal business activities.

You can calculate it as follows:

Operating income = Gross profit - Operating expenses
Operating income Drink Inc = $1,619,386 - $854,159 = $765,227

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Non-operating income and expenses

Income and expenses that aren't related to the normal business activities of the company are classified under **non-operating income and expenses.**

Non-operating income and expenses consist of 4 parts:

- Other income
- Gain (loss) on financial instruments
- Gain (loss) on foreign currency
- Interest expenses

Drink Inc. gained $5,513 from financial instruments as well as $960 from the sale of a fixed asset (other income). Drink Inc. also made a loss on foreign currency of $12,649 and has interest expenses of $18,177. This mean non-operating expenses are equal to $24,353 ($5,513 + $960 - $18,177 - $12,649).

Income before taxes

The **income before taxes or earnings before taxes (EBT)** shows you **how much profit the company has made before taxes.**

All other costs have now already been taken into account .

Income before taxes = Operating income - Non-operating income and expenses
Income before taxes Drink. Inc = $765,227 - $24,353 = $740,874

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Income tax expense

It goes without saying that **every company needs to pay taxes.**

These taxes are paid to federal, state and local governments.

Drink Inc. needs to pay 34,7754% in taxes (rounded). With an income before taxes of $740,874, this is equal to $257,642.

Net income

The bottom line or net income of an income statement shows you **how much money the company has made after subtracting all costs and taxes.**

Net income is also known as **'earnings'** or **'profit'.**

You want this number to be positive as this means the company is making money. Furthermore, **the company should be able to grow its earnings at an attractive rate**.

Net income = Income before taxes - Taxes
Net income Drink Inc. = $740,874 - $257,642 = $483,232

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Profit margin

You can now also calculate the company's **profit margin:**

Profit margin = Net income / Revenue
Profit margin Drink Inc. = $483,232 / $4,358,100 = 11,1%

The higher the profit margin, the better.

Why? Because **you want to invest in companies that manage to translate most sales into earnings.**

Earnings per share

For shareholders, it is very handy to take a look at the **earnings per share** of a company.

Let’s say that Drink Inc. has 100,000 shares outstanding.

Earnings per share = Earnings / Outstanding shares
Earnings per share Drink Inc = $483,232/ 100,000 = $4.83

Looking at the earnings per share of a company is handy as it allows you to take a look a the valuation by comparing the stock price with its earnings per share.

Let’s say that in our example Drink Inc. has a stock price of $90.

P/E ratio = Stock price / earnings per share
P/E ratio Drink Inc = $90 / $4.83 = 18.6

The lower, the P/E ratio, the cheaper the stock.

Learn more about valuation here: everything you need to know about valuation.

Questions to ask yourself

While looking at an income statement, **the following questions can help you to determine whether a company might be interesting:**

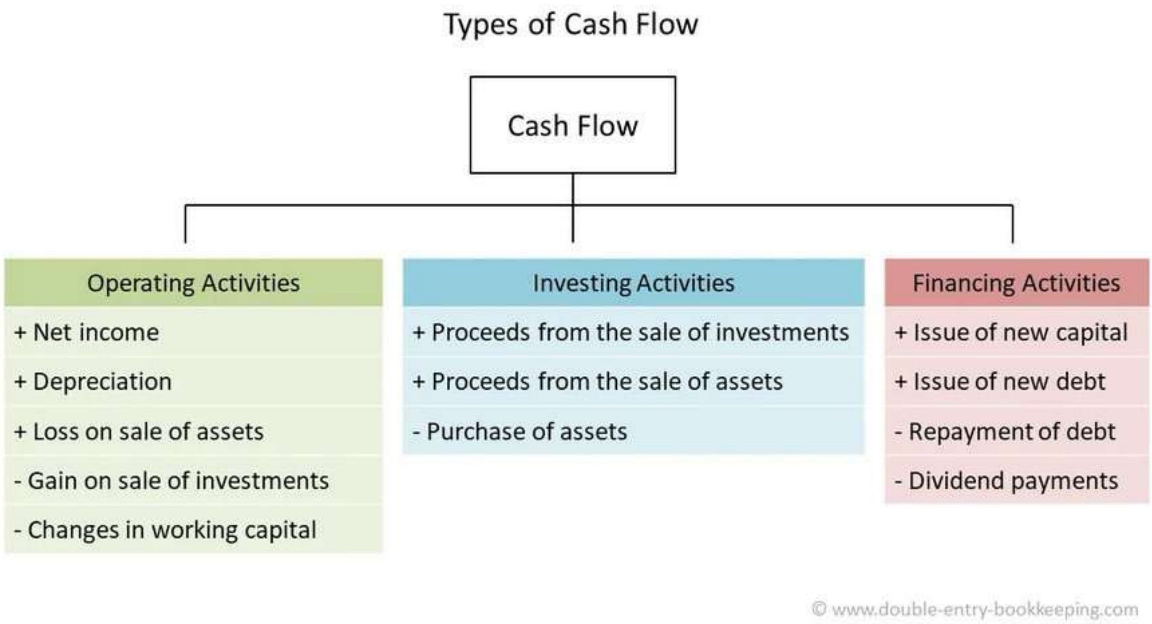
- Are revenues and net income predictable and robust?
- Are revenues steadily increasing over time?
- Does the company have a high gross margin?
- Is the company structurally profitable?
- How much revenue is translated into net income?

🔍 How to analyze a Statement of Cash Flows

EBITDA is an opinion, cash flow is a fact.

The Cash Flow Statement is **one of the most important statements in a 10-K.**

In this article, I'll teach you **how to analyze a Statement of Cash Flows in a few minutes.**



What is a Cash Flow statement?

A cash flow statement shows you **how much cash goes in and out a company over a certain period.**

The purpose of this statement is to **track how much cash is moving through a business.**

You want to **invest in companies that generate cash and manage their cash position very well.**

Every cash flow statement consists of 3 parts:

- Cash Flow from Operating Activities
- Cash Flow from Investing Activities
- Cash Flow from Financing Activities

In this article, we'll use an example to make everything clear:

COMPANY A
STATEMENT OF CASH FLOWS

Year Ended September 28, 2019 (In millions)

CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR	$ 10,746
OPERATING ACTIVITIES:	
NET INCOME	37,037
ADJUSTMENTS TO RECONCILE NET INCOME TO CASH GENERATED BY OPERATING ACTIVITIES:	
DEPRECIATION AND AMORTIZATION	6,757
DEFERRED INCOME TAX EXPENSE	1,141
OTHER	2,253
CHANGES IN OPERATING ASSETS AND LIABILITIES:	
ACCOUNTS RECEIVABLE, NET	(2,172)
INVENTORIES	(973)
VENDOR NON-TRADE RECEIVABLES	223
OTHER CURRENT AND NON-CURRENT ASSETS	1,080
ACCOUNTS PAYABLE	2,340
DEFERRED REVENUE	1,459
OTHER CURRENT AND NON-CURRENT LIABILITIES	4,521
CASH GENERATED BY OPERATING ACTIVITIES	53,666
INVESTING ACTIVITIES:	
PURCHASES OF MARKETABLE SECURITIES	(148,489)
PROCEEDS FROM MATURITIES OF MARKETABLE SECURITIES	20,317
PROCEEDS FROM SALES OF MARKETABLE SECURITIES	104,130
PAYMENTS MADE IN CONNECTION WITH BUSINESS ACQUISITIONS, NET OF CASH ACQUIRED	(496)
PAYMENTS FOR ACQUISITION OF PROPERTY, PLANT, AND EQUIPMENT	(8,165)
PAYMENTS FOR ACQUISITION OF INTANGIBLE ASSETS	(911)
OTHER	(160)
CASH USED IN INVESTING ACTIVITIES	(33,774)
FINANCING ACTIVITIES:	
DIVIDENDS AND DIVIDEND EQUIVALENT RIGHTS PAID	(10,564)
REPURCHASE OF COMMON STOCK	(22,860)
PROCEEDS FROM ISSUANCE OF LONG-TERM DEBT, NET	16,896
OTHER	149
CASH USED IN FINANCING ACTIVITIES	(16,379)
INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	3,513
CASH AND CASH EQUIVALENTS, END OF YEAR	**$ 14,259**

Operating Section

Investing Section

Financing Section

Harvard Business School Online

Difference with an income statement and balance sheet

There is an important difference between a cash flow statement and an income statement and balance sheet.

A balance sheet and income statement use ACCRUAL ACCOUNTING. This is a method where revenue and expenses are recorded when an accounting transaction occurs.

A cash flow statement uses CASH ACCOUNTING. As a result, the cash flow statement only records transactions **when money effectively enters or exits the company.**

This a very important difference.

Balance sheet and income statement = Accrual accounting
Cash flow statement = Cash accounting

Income Statement	Cash Flow Statement
• Prepared based on accrual basis (Income and expenses of a particular period are considered)	• Prepared based on cash basis (Actual money flows are considered)
• Provided information about profitability and owners' equity	• Provides information about liquidity and solvency of a business
• Application of accounting policies, standards and concepts is comparatively higher	• Less number of standers, policies and concepts to follow; hence objectivity is high
• Prepared referring to various records and ledger accounts	• Prepared using income statement's and balance sheet's details

Now you know the difference between accrual accounting and cash accounting, we'll dig into each section of the Cash Flow Statement.

Cash Flow from Operating Activities

This section shows **all cash the company generated from its normal business activities.**

In other words: **it shows you all the cash a company earned from selling its normal products and/or services.**

When a beer company generates $2 per beer in operating cash flow and sold 2 million beers in a certain year, its cash flow from operating activities would be equal to $4 million.

AT&T Fiscal Year 2012

Cash from Operating Activities	
+Net Income	$7,264.00
+Depreciation & Amortization	$18,143.00
+Other Non-cash Adjustments	$12,319.00
+Changes in Non-cash Captial	$1,450.00
Cash From Operations	$39,176.00

Investopedia

The cash flow from operating activities is comparable to net income, but it **filters out a few income and expense posts that didn't cause actual cash to enter or exit the company.**

You can calculate the cash flow from operating activities as follows:

Cash Flow from operating activities = net income + non-cash charges +/- changes in working capital

Non-cash charges

A **non-cash charge** is a **write down or accounting expense that does not involve a cash payment.**

A few examples of non-cash items:

- Depreciation and amortization
- Asset impairment
- Deferred income tax
- Write-downs of goodwill
- Stock-based compensation

Working capital

Working capital is t**he money a company has available to meet its current, short-term obligations.**

Working capital = Accounts receivable + Inventory - Accounts payable

As can be seen in the formula, working capital consists of 3 parts:

- **Accounts receivable:** the money customers owe the company
- **Accounts payable:** the money the company owes its suppliers
- **Inventory**: the value of the goods that the company hasn't sold yet

The less working capital a company needs, the better.

Why? **Because it means that a company doesn't need much cash to fund its ongoing business activities.**

A few companies even have a negative working capital. This means that its clients are funding the ongoing business activities of the company as the accounts payable are larger than the accounts receivable + inventories.

Changes in working capital

Remember that from going to net income to operating cash flow, you only needed to take the changes in working capital into account.

Let's show the formula again to refresh your mind:

Net cash provided by operating activities = net income + non-cash charges +/- changes in working capital

Why do you only need to take the changes in working capital into account? Because when a company needed $5 million to fund its operations last year and it also needs $5 million to fund its operations this year, there were **no cash changes**.

Changes in working capital:

- **Accounts receivable: negative if it increases.**
  - Why? Because clients not paying you immediately can be seen as giving a small loan to your customers for a short period
- **Inventory: negative if it increases**
  - Why? Because you aren't earning money on products in your inventory
- **Accounts payable: positive if it increases**
  - Why? Because if you don't pay your suppliers immediately, your suppliers are giving a 'free loan' to you

Example Cash Flow from Operating Activities

You don't understand everything completely yet? No worries.

An example will make everything a lot more clear. Let's use these numbers:

OPERATING ACTIVITIES:

NET INCOME	37,037
ADJUSTMENTS TO RECONCILE NET INCOME TO CASH GENERATED BY OPERATING ACTIVITIES:	
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Operating Section

Net cash provided by operating activities = net income + non-cash charges +/- changes in working capital

Net cash provided by operating activities = $37,037 + ($6,757 + $1,141 + $2,253) + (-$2,172 - $973 + $223 + $1,080 + $2,340 + $1,459 + $4,521) = $53,666

Cash Flow from Investing Activities

The Cash Flow from Investing Activities gives you an overview about **the company's investment related income and expenditures**.

The Cash Flow from Investing Activities consists of 3 major parts:

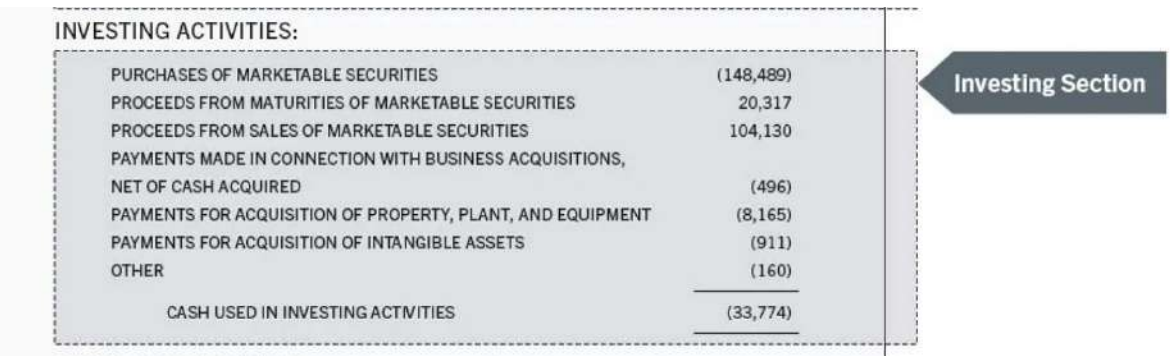
- **Capital expenditures (CAPEX)**
  - The cash a company spends to buy, maintain or improve its fixed assets (buildings, vehicles, equipment, land, …)
- **Mergers & Acquisitions**
- **Purchase/Sale of marketable securities**
  - Marketable securities are assets that can be liquidated to cash quickly. These securities can be bought and sold on a public stock exchange

You can calculate the cash flow from investing activities as follows:

Cash flow from investing activities = Sale of marketable securities + divestments - CAPEX - Mergers & Acquisitions - purchase of marketable securities

Example Cash Flow from Investing Activities

Now let's make everything concrete again with our example:



INVESTING ACTIVITIES:

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Cash flow from Investing Activities = Sale of marketable securities + divestments - CAPEX - Mergers & Acquisitions - purchase of marketable securities +/- other

Cash flow from investing activities = ($104,130 + $20,317) + $0 - $0 - ($496 + $8,165 + $911) - $148,489 - $160 = -$33,774

Free cash flow

After you've taken a look at a company's cash flow from operations and cash flow from investing activities, you can calculate the **free cash flow.**

Free cash flow = operating cash flow - CAPEX

The free cash flow of a company is one of the most important financial metrics.

If you want to learn more about free cash flow, take a look at this article: [What you need to know about free cash flow](#).

Cash Flow from Financing Activities

Last but not least, the Cash Flow from Financing Activities measures **the cash movements between a company and its owners (shareholders) and its debtors (bondholders).**

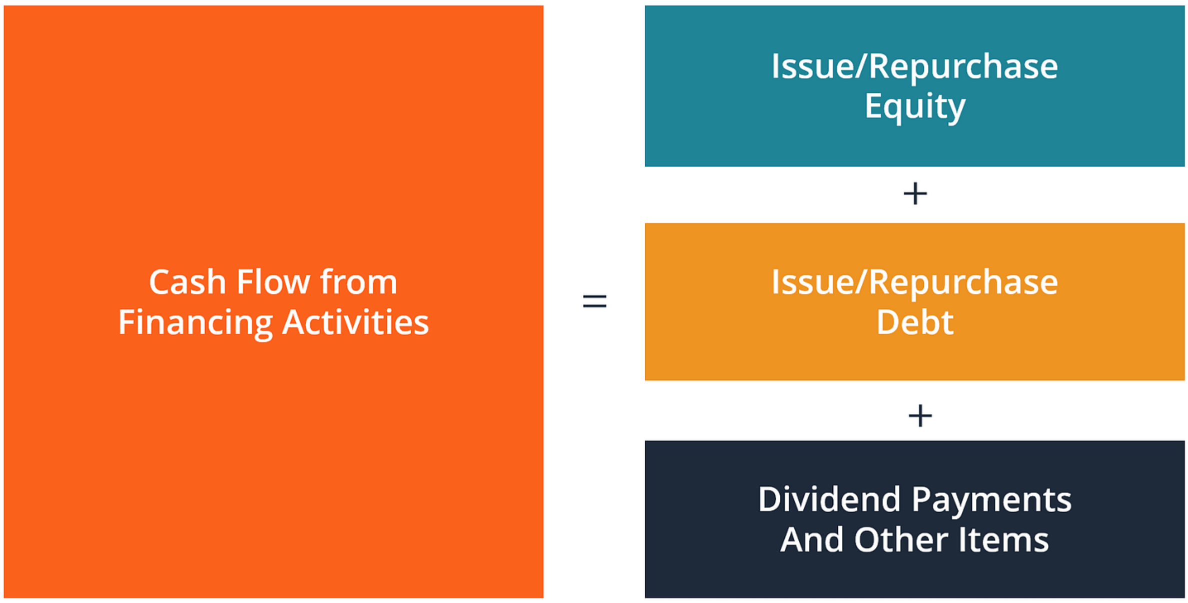
This section gives you an insight about **how the company is financing its business activities.**

The Cash Flow from Financing Activities consists of 3 major parts:

- Borrowing and repaying debt
- Issuance of stocks and share buybacks
- Dividends

You can calculate the cash flow from financing activities as follows:

Cash Flow from financing activities = Debt issuance + issuance of new stocks - dividends - debt repayments - share buybacks



Example of Cash Flow from Financing Activities

Now you know the formula to calculate the Cash Flow from Financing Activities, we can calculate it for our example:

FINANCING ACTIVITIES:

DIVIDENDS AND DIVIDEND EQUIVALENT RIGHTS PAID	(10,564)
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Financing Section

Cash Flow from financing activities = Debt issuance + issuance of new stocks - dividends - debt repayments - share buybacks +/- other

Cash flow from financing activities = $16,896 + $0 - $10,564 - $0 - $22,860 + $149 = -$16,379

Changes in cash balance

Finally, you can calculate **the total changes in the cash balance:**

Cash at the end of the year = Cash at the beginning of the year + CF from operating activities + CF from investing activities + CF from financing activities

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In our example:

Cash at the end of the year = cash at the beginning of the year + operating cash flow + investing cash flow + investing cash flow

Cash at the end of the year = $10,746 + $53,666 - $33,774 - $16,379 = $14,259

It is a good sign when the cash at the end of the year is higher than the cash at the beginning of the year.

Why? Because it means that there is **a positive difference between the cash that has entered the company and the cash that has left the company over a certain period.**

Conclusion

That's it for today. Here's what you should remember:

- The cash flow statement shows **how much cash goes in and out a company over a certain period.**
- It consists of 3 parts: **Cash Flow from Operating Activities, Investing Activities and Financing Activities**
- **Cash Flow from Operating Activities:** cash that enters and leaves the company from its normal business activities (selling its products and services)
- **Cash Flow from Investing Activities:** cash the company needs to (dis)invest to maintain its normal business activities
- **Cash Flow from Financing Activities**: cash movements between a company and its owners (shareholders) and its debtors (bondholders)

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