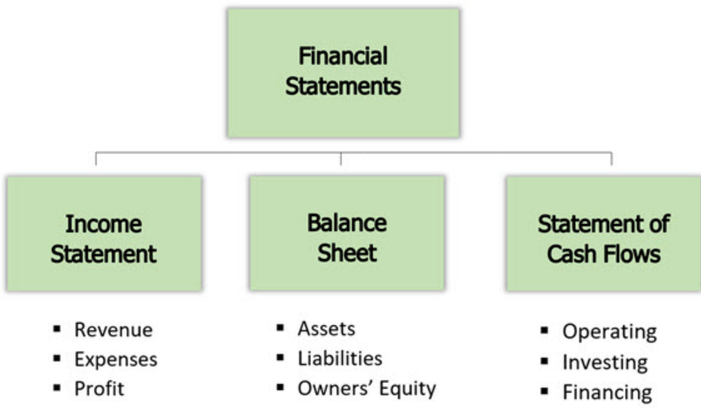
2.1: Key Financial Statements

Key Financial Statements

There are three key financial statements that are important to investors, security analysts, management, and creditors. These are the INCOME STATEMENT, BALANCE SHEET, and STATEMENT OF CASH FLOWS. Note that there is a fourth financial statement (statement of retained earnings) that is provided in financial reports. However, the other three capture the majority of the information needed for financial statement analysis and are where we will focus our attention in this chapter. See the sample financial statements from Wal-Mart and Target in Appendix B. Note that these financial statements are compiled from Yahoo!Finance which attempts to fit financial statements to a (mostly) common template. In practice, financial analysts will use the financial statements provided directly from the company as part of the firm's 10-Q and 10-K reports required by the SEC. These official statements provide many additional details and notes that are not available from places that provide general financial information, but are essential to providing the context to make maximum use of the financial statements.



Income Statement

The income statement provides information on the company's revenues and expenses over a specific time period (usually annually or quarterly). These revenues and expenses are accounting-based and not necessarily reflective of cash flows generated. For example, when a long-term asset is purchased the cash is spent at that time. However, its expenses are recognized over time as depreciation instead of at the point of purchase. Also, the method chosen to account for inventory can cause discrepancies between net income and cash flows from operations. The cost of our inventory is recognized when it is sold not when it is paid for. While the income statement is not cash based, that does not imply that it is meaningless. It still provides a good picture of how well the company is doing, but we must recognize that net income is not cash.

Balance Sheet

The balance sheet provides a snapshot of the company's assets, liabilities, and owners' equity at a specific point in time. The company's assets must be financed by either debt (liabilities) or ownership interest (equity). Therefore, assets will always equal liabilities plus owners equity (A = L + OE). It is important to remember that the values reported on the balance sheet are "book values" and do not necessarily represent the market value of the asset or ownership interest for a variety of reasons:

- The value of brand names, patents and other intellectual property which are often quite valuable to a corporation are not typically recorded on the balance sheet.
- The book (balance sheet) value of assets is based on historical cost less accumulated depreciation. The real (market) value of the assets is based on the ability of the firm to generate cash flows from those assets.
- The market value of a firm may incorporate value from assets that are not actually on the balance sheet, but are anticipated to enhance the firm's ability to generate cash flows in the future. An example of this would be Tesla, which would likely lose significant market value if Elon Musk was not associated with the company.

Typically, investors are willing to pay more for the firm than the balance sheet tells us it is worth because the balance sheet tends to be a conservative estimate of the true value of the firm's assets (although sometimes the balance sheet will overstate the market value of the firm's shares). Also, remember that the balance sheet represents a point in time and may not be the same throughout the year. For example, a company like Wal-Mart may have relatively high inventory and low cash at the end of the 3rd quarter (start of Christmas shopping season) and relatively low inventory at the end of the fourth quarter (end of Christmas shopping season).

Statement of Cash Flows

The statement of cash flows attempts to reconcile the differences between net income according to Generally Accepted Accounting Principles (GAAP) and cash flows. Cash flows are broken down into three primary areas — Cash Flow from Operating Activities, Cash Flow from Investing Activities, and Cash Flow from Financing Activities.

Cash Flow from Operating Activities

This is the most critical component of the statement of cash flows. Cash flow from operating activities provides insights into how well the firm is doing at generating cash flows from its day-to-day operations before factoring in any capital investments or financing issues. This is done by starting with net income and then adjusting back to a cash-based version of income. For example, depreciation lowers net income, but is not a cash expense. Therefore, depreciation is added back in. If our accounts receivable declines, that means we've collected additional cash from sales (remember from accounting that revenue is recorded when the sale is made, not when the cash is collected). Therefore, a decline in accounts receivable indicates that our cash flow this period is higher than indicated by our net income. Ideally, we want to see this be positive and growing over time. The idea is that if a firm is going to survive as a going concern it needs to be able to generate positive cash flows from its basic business operations. In addition, investors like to see companies grow over time. As we will see in our chapter on stock valuation, the faster a company grows, all else equal, the more valuable it will be. Sometimes one (or both) of these conditions are not met. If so, it is incumbent on the analyst/management to understand why not and how it can be addressed. Operating cash flows can be negative due to short-term operating problems that are being addressed, due to economic/industry issues, or due to more significant operating problems. The impact on the firm will vary depending on how likely the negative operating cash flows are to be a short-term vs. a long-term issue. Growth, while less important, is also something that analysts/management want to address if it is stagnant or declining.

Cash Flow from Investing Activities

Again, it is important for firm's to operate as a going concern, which means that they need to invest in their business. This may be updating long-term assets that are getting worn out, spending money on new equipment to improve productivity, or spending money on expanding the business. These investments into long-term assets are commonly referred to as capital expenditures and are essential to a firm remaining competitive and successful. They are also a key element in the cash flow from investing activities segment of the statement of cash flows as they represent investment into the company. Because the firm is spending money on these investments, they will typically be negative (cash outflows). While we want cash flows overall to be positive, negative cash flows from investing activities are not a concern and instead are an essential part of a firm's long-term success. The reason for concern would be if a firm is underinvesting in its long-term assets or if it is spending too much on unproductive assets. These both can be difficult to identify in the short-run as there is often a lag between when investments are made and when the payoffs show up in the cash flow from operating activities section.

Cash Flow from Financing Activities

If a firm generates more cash flow from its operating activities than it spends on investing activities, it will have cash left over to return to investors (or add to cash balances). Alternatively, if a firm spends more cash flow on its investing activities than it generates from operating activities, it will need to raise additional cash from investors (or draw down cash balances). This is an area that can be as much about where a firm is in its growth cycle as it is about the firm's health. Typically, younger firms and/or rapidly growing firms need to spend a lot of cash on expanding the business and may not have enough operating cash flows to fund those investing activities. As such, it is common for them to be raising capital by issuing shares of stock or issuing debt and they are unlikely to be using much, if any, cash to pay dividends. This leads to positive cash flows from financing activities. Alternatively, more mature companies are likely to be generating more than enough cash from their operating activities to meet their investment demands. Therefore, they will have cash to pay dividends, buy back outstanding shares of stock, and/or pay back existing debt. This leads to negative cash flows from financing activities. All else equal, negative cash flows from financing activities are a better sign of a company's health than positive cash flows from financing activities. However, as mentioned above, an analyst needs to consider where the firm is in its growth cycle before jumping to conclusions.

Sample Financial Statements

You can see examples of Garmin's Financial Statements within the 2019 Garmin Annual Report. Note the Financial Statements start on p. 64 (based on the bottom of the page). You can also see a slide show where Garmin discussed their 2020 3rd Quarter results with investors.