UNDERSTANDING FINANCIAL STATEMENTS: PROSPECTING QUICK GUIDE 2

BY DIANNA ROSS

Dianna Ross diross@vt.edu is an Instructor, Department of Accounting and Information Systems, Virginia Tech University.

Abstract

"*Get the habit of analysis- analysis will in time enable synthesis to become your habit of mind*." (Frank Lloyd Wright)

This *Quick Guide* is the second of two *Quick Guides* by Dianna Ross published in this issue of *B>Quest*. It provides an overview and supporting detail to assist would-be analysts in the challenging task of prospecting in financial statements for valuable information about company health and profitability. Whereas *Quick Guide1* provides insights needed to productively sift through the mountain of material that publicity traded companies provide, *Quick Guide 2* reviews technologies for identifying significant relationships and trends in the mined information and includes a quick 100 analysis steps to document an analyst's conclusions about a company.

Assaying the ore

"In theory there is no difference between theory and practice. In practice there is." (Yogi Berra)

Practice without knowledge is dangerous. Knowledge and theory without practice and experience are incomplete. This *Quick Guide* can provide you with the confidence to begin gaining the experience which is essential for quality analysis. Once a would-be analyst feels comfortable with the end products of the complex U.S. financial reporting system discussed in Prospecting *Quick Guide 1*, a rational approach to financial statement analysis is to follow the systematic set of steps listed below.

- **Read** the footnotes (audited) and the unaudited Management Discussion and Analysis (MD&A in the SEC-required annual 10-K filing) and consider how that information supports or conflicts with amounts reported on the financial statements themselves.
- Consider **adjusting** (changing) the reported data.
- **Compute** vertical, horizontal, and ratio analysis, which will be explained later.
- **Compare** results to the industry, to significant competitors, and to prior forecasts.
- **Forecast** future statements if either forecasted profit or forecasted cash flow is needed for valuation models.
- Draw and document **conclusions** about the company's health and prospects.

Gathering information: Financial statement data for any given company is available from a variety of sources. You should begin by downloading official financial statements (filed with the annual 10-K and quarterly 10-Q) from the Security and Exchange Commission's (SEC) EDGAR (Electronic Data Gathering, Analysis and Retrieval) system. (The SEC requires the filing of what are called 10-K and 10-Q reports.) Additional information, such as key ratios for five to ten years, company profiles, stock concentrations, stock activity, news, earnings forecasts, etc. can be found for free online

at such sites as MSN Money and Market Watch and in *The Wall Street Journal*). Each information site varies in the nature and scope of what is provided.

Considering information: Reading disclosures in the footnotes of a company's financial statements and the Management and Discussion Analysis (MD&A) enables an analyst to identify items of importance to the adjustment step which follows. (The MD&A provide an overview of a company's previous year of operations and how it fared.) Following the convention introduced in *Prospecting Quick Guide 1*, here account categories and subtotals are *italicized*, while account titles are *bolded*.

- In the initial footnote, the analyst can expect to find disclosures about reporting choices and estimates made by the company, and, in some cases, what the reported numbers would have been with other choices and other estimates.

- One may find fair value estimates of *assets* for which fair value is not the required reporting amount (such as *land* and *buildings*), which can affect the analyst's adjustments. (The fair value of an asset is what it is believed it could currently be sold for by a willing seller—not a bankruptcy sale.)

- The analyst who has done his or her research will encounter a wide range of qualitative and quantitative details underlying reported numbers, suggesting to the alert analyst possible adjustments to more closely reflect reality.

Why adjust the data as reported? Given that management generally prefers the company in the short run to appear as profitable and financially sound as possible, the analyst's overarching motivation is to approximate a more realistic depiction than that provided by the numbers reported by the company. Reasons to make adjustments are varied.

- **Optionally reported:** Analysts should consider adjusting the statements because reported numbers are the result of various reporting conventions and company reporting decisions. Adjusting the reported data can provide a depiction less distorted by both conventions and decisions. An analyst may also wish to apply to a company's data a method in general use by the company's industry in order to make comparisons with other companies more valuable.

- **Misreported**: Analysts may conclude, after reviewing details of write-offs, write-downs, and write-ups of various *assets* (and methods of calculating the changes in value) that an asset's reported value is misstated. For instance, an analyst may conclude that *goodwill* is significantly overstated and may then adjust **the balance sheet** by reducing *goodwill* and the *retained earnings* account (as if a portion of *goodwill* had already been written off) and add an impairment loss to the **income statement**, thereby reducing *net income*. (Goodwill is included as an asset account if the company's current owners paid more to acquire the company than its previous owners paid for its assets [original cost]. Ultimately it is written off. This results in a reduction of *retained earnings* because *assets* = *liabilities*

[money owed] plus [owners] *equity,* which includes *retained earnings.* Assets such as *accounts receivable* acquired by making sales on a credit basis are written down if they are believed to be uncollectable. Fixed asset accounts like *buildings* may be written up to their market value because it exceeds their original cost. An impairment loss is calculated as the result the belief that there has been an underestimate of an expected future loss.)

- **Inconsistently reported:** Given the mixed values at which various *assets* are reported (cost, depreciated or depleted cost, market value, lower-of cost-or market), analysts may wish to adjust to market value any *assets* which are not typically reported at market value, such as *land* and *buildings*. The resulting market value **balance sheet** can provide a more relevant picture of total *assets*, albeit a possibly less reliable picture due to the need to estimate some market values. Certainly the *total asset* amount is more meaningful as it is no longer the sum of differing value denominations. (The book value of assets like machinery is gradually written down— depreciated—to reflect loss of value due to use.)

- **Unreported**: By using other information sources, analysts may identify unreported *assets* or (more likely) *liabilities* that can be added to the **balance sheet**, adjusting also for the likely effect on the **income statement**. An example would be a situation in which the company is liable under federal law to remediate a polluted property to which it has had some legal connection. Companies are only required to report probable obligations which can be reasonably *estimated*. Obligations such as environmental remediation are understandably difficult to estimate, as a large number of factors would not be known at the time of reporting, such as the extent of contamination; the unknown scope of required remediation as regulations evolve; the cost of the eventual technology which would be used in remediation; and the potential sharing of the obligation with other involved companies. Companies may avoid including such a potentially devastating obligation in their total *liabilities* (and equally devastating loss in their **income statement**) by determining that they cannot reliably estimate the probable amount and instead disclose some details in the notes. The analyst can address such a serious financial statement misstatement by estimating an amount to reduce *net income* (and therefore *retained earnings*) by and increase *liabilities*. Such an estimate may be far from the present value of the eventual cost to the company, but any estimate is more likely than no estimate to make the financial statements more representative of the eventual costs of the company's current situation. (The present value of an obligation to pay $105 a year from now at a five percent discount rate is $100. The discount rate should be a reasonable estimate of what the company can earn on its money.)

- **Reported without subsequently known information**. Some adjustments may arise due to information only known (or events which only occur) *after* the date through which the last **balance sheet** covers which nonetheless can shed light

on the value at which an item would likely have been reported if the information had been known in time.

Table 1 below provides a checklist of potential adjustments beginning analysts might wish to consider. Adjustments to the **balance sheet** would typically change an *asset* (or *liability*) and *retained earnings*. The latter is due to any **income statement** (IS) effect. There may also be related changes to *taxes payable* and *deferred taxes*. More detail about of some of these adjustments can be found online—www.Investopedia.com is recommended.

Table 1
Possible Adjustments To Reported Balance Sheet Amounts

Accounts	Potential adjustments	Related effects
Cash	• Rarely, reduction due to subsequent expropriation events for amounts deposited in such locations or significant currency exchange rate change (for foreign currency deposits).	**Loss**
Accounts receivable, *Net*	• Different method of estimating Allowance amount by which Accounts Receivable are netted (e.g., percentage of receivables vs. percentage of sales). • Different assumptions of default rates.	**Bad Debt Expense**
Inventory	• Different method of calculating Cost of Goods Sold and therefore remaining inventory (e.g., from LIFO used by the company to FIFO, which more realistically states current cost and inventory value)	**Cost of Goods Sold Expense**
	• Market value approximation (already reported at market if lower than cost.)	**Gain**
Marketable Securities	• Different categorization, changing the effect of value change: categorization as Trading Securities affects *Net Income* and **Retained Earnings**; whereas categorization as Available for Sale only affects **Accumulated Other Comprehensive Income (AOCI)**.	Change in effect of **Gain or Loss due to Change to Market Value**
Property, Plant & Equipment (PP&E)	• Different depreciation method (straight-line, vs. declining balance) or estimates of useful lives or salvage values would change *net PP&E*.	**Depreciation expense**

Other *Assets* *Liabilities*	• Adjustment dependent on what is in this subtotal. • Adjust **Pension Asset or Liability** due to different discount rate assumptions. • Add unreported *Liabilities* such as Environmental *Liabilities*. • Add a **Leased Asset** and a **Lease Liability** for present value of operating lease payments.	Dependent on nature of content. No Income Statement effect, affecting **AOCI** instead. **Loss** Reduces **Rent Expense**, Increase **Interest Expense**

Optionally, once the analyst has adjusted the statements, **computations** can be done on the resulting data. (The analyst can choose to *not* adjust the statements. An advantage of this choice is possible greater comparability to industry average data, which is not adjusted.)

- **Vertical analysis** of **balance sheet** and **income statement** numbers, also called common-size analysis, determines the percentage each reported amount is of the statement's largest amount. **Balance sheet** items are expressed as a percentage of *total assets*. **Income statement** accounts are expressed as a percentage of *net sales revenue*. Vertical analysis of the **statement of cash flow** can be done within two categories, as each inflow is shown as a percentage of *total inflows* and each outflow is shown as a percentage of *total outflows*. Vertical analysis enables the analyst to see changing relationships within a statement, such as a trend in which, for example, *cost of goods sold* consumes a higher and higher percentage of *net sales revenue* or in which cash received from customers makes up a lower and lower percentage of *total inflows*.

- **Horizontal analysis** compares the growth rates of related numbers, within or across statements. This enables the analyst to identify concerns within a statement (such as *cost of goods sold expense* growing at a higher rate than *net sales revenue*) and across statements (such as *accounts receivable* growing faster than *net sales revenue*).

- **Ratio analysis** enables the analyst to see significant relationships within and across statements and provides useful data for comparing the company under review with published industry averages. Examples of relevant ratios are listed in the *Quick 100 Analysis Steps* that appears at the conclusion of this article. Industry averages are available through libraries, with free select industry average information available online at such sites as Yahoo Finance.

Table 2 below lists items to identify and provides examples of how vertical, horizontal, and ratio analysis might apply in an initial analysis of an **income statement**.

Table 2
What To Assess For Each Income Statement Line Item And Subtotal

In general:

- If single-step Income Statement (IS), recast as multiple-step to highlight significant subtotals (such as *Gross Profit, Operating Income, Income before Income Tax*).
- Assess **quality** of all information, that is, the extent to which reported data seems to reflect reality.
    - Review footnotes to determine methods and estimates used to produce reported numbers and to determine the nature of what is included in reported numbers.
    - Consider which if any reported numbers might be adjusted to provide a better picture of the company, recalling that any Income Statement adjustment will affect the Balance Sheet numbers as well.
- Compare all items to industry averages (and ranges, if available) and to competitors.
- Consider whether industry is volatile (as technology industry is).
- Review segment information, and consider vulnerability of each segment.
- If *product line* data is available, calculate *Net Sales Revenue, Cost Of Goods Sold Expense* and *Gross Profit* per product line; consider likely future of products.
- Note that dollar changes and changes in vertical (common-size) percentages may move in opposite directions.
- In reading the MD&A and footnotes to see management explanations, note what is *not* explained. Consider instances of possible exaggeration and underplaying.
- If a significant explanation is not found, hypothesize.

Net Sales Revenue, horizontal analysis:

- Was change caused by changes in volume or price or both?
- What was nominal change, in dollars and percentage (and compare to *net* **Accounts Receivable** to assess the latter in light of the former).
- Assess real change, that is, was sales keeping up with inflation?
    - (Current CPI/prior CPI)(reported *Net Sales Revenue*) = real sales.

For all remaining line items and subtotals, calculate vertical analysis (to see how *Net Sales Revenue* **was consumed) and horizontal analysis to determine differential growth rates. Determine which part of vertical change is due to numerator vs. denominator change. Determine through company disclosures underlying or likely causes of change.**

Cost of Goods Sold Expense:

- Recall effect of fixed costs and sales volume, makes less comparable.

*Gross profit***:**

- Use results of horizontal analysis to parse vertical change into change due to size of Net Sales versus change in Cost of Goods Sold Expense.

Operating expenses, for category total and for individual line items of interest.

- Impairment charges are recognition of decreases to net *Assets* (consider carefully whether these are recurring or non-recurring);
- Trends in and causes of trends, e.g.,

- Depreciation Expense/ Depreciable *Assets*
- Repair Expense / Depreciable *Assets*.

Operating profit (earnings before interest and income tax)

Other (non-operating) income and expense

- Assess materiality and variability over time of expenses.
- Analyze **Interest Expense** in light of outstanding debt.
- Distinguish recurring from nonrecurring items.
- Distinguish cash-related items (**Interest Expense**) from noncash (**Equity Earnings**, the reporting of a company's proportional interest in earnings of certain non-subsidiary company's equity in which they have invested).

Earnings Before Income Tax ≠ taxable income. Income tax is calculated on the latter, the subtotal reported on the Income Statement is the amount of that year's income tax related to that year's Income Statement.

Provision for Income Tax (Income Tax Expense)

- Determine trend in the effective tax rate: *Income Tax Expense*/ *Earnings Before Income Tax*.
- In comparing companies, consider relative effects of foreign tax rates.

Discontinued Operations (nonrecurring, shown net of own tax effect): Judge effect on the bottom line, as this component of *Net Income* is not expected to be repeated.

Extraordinary Items (unusual, infrequent, shown net of tax): Judge effect of any extraordinary item, as this portion of earnings or loss is not expected to be repeated.

Net Income (*Earnings, Profit*): Determine the trend in *Net Profit Margin*: *Net Profit/Net Sales Revenue*. Is a greater or less portion of *Net Sales Revenue* being retained as *Net Income*?

Earnings Per Share (EPS), *Basic*: *Net Income* available to common shareholders / weighted average outstanding shares of common stock. Note whether changes were largely due to *Net Income* or changes in number of shares.

EPS, Diluted: same calculation as above but includes the theoretical number of shares if all dilutive convertible instruments had been exercised. This worst case calculation can be interpreted as the least that each common stock share would have "earned" had all convertible instruments been converted into common stock prior to the Balance Sheet date.

Comprehensive Income = Net Income + / - (other comprehensive income items) and must be reported in a combined **statement of Income and comprehensive Income** or in its own statement. It may, however, be explained again in the **equity statement** as *net income* and *other comprehensive income items* affect *retained earnings and accumulated comprehensive income***,** respectively. (Net income is total revenue less total expense [includes taxes.] *Comprehensive income* is the sum of *net income* and other items [such as gains on foreign currency holdings] that, because they haven't been realized, do not appear on the **income statement**.)

Table 3 below lists points to understand about changes to *equity* accounts in order to attempt to capture net economic changes other than those caused by stock events such as the

issue of new stock. (Incorporated companies' equity consists of common stock, retained earnings, and sometimes preferred stock.)

Table 3
Analyzing The *Equity* Statement, Line By Line

Preferred stock:

- Determine the nature of dividend attributes (participating, dividend %, in arrears) as well as dividend amounts declared or in arrears.
- Determine the relative significance and cause of the change in shares outstanding.
- Determine value of stock transactions compared to share value at year-end.

Common Stock and Treasury Stock (repurchased Common Stock):

- Determine change in shares outstanding due to stock issuances or repurchases or both.
- Determine value of stock transactions compared to share value at year-end.

Retained Earnings: Any change other than *Net Income* (or *Net Loss*) and **Dividends**?

- Prior period adjustments?
- Cumulative effects of select items (e.g., from LIFO?
- Effect of reselling treasury stock for less than its cost?

Accumulated Other Comprehensive Income: Assess if possible the causes of and likelihood of realization or recurrence of any **AOCI** within these categories:

- *Additional Pension Liability* (estimates),
- *Foreign Currency Translation* effects,
- Certain *Unrealized Gains/Losses* (AFS marketable securities), and
- Cash flow hedge *Unrealized Gain/Loss*, later to be possibly reclassified in *Net Income*.

These four items attempt to capture tentative, possibly temporary changes in economic value which are not yet appropriate to be included in *Net Income*, but may be reversed or included in future.

Comprehensive Income (affecting both **Retained Earnings** and **AOCI**): Determine the size and direction (profit or loss?) compared to *Net Income*.

Table 4 below provides points to consider in analyzing a statement of cash flow.

Table 4
Statement of Cash Flow Analysis

Analyst essentials:

- Companies reporting *direct Cash Flow from Operations* (*CFO)* must also disclose a reconciliation of *Net Income* to *CFO*.
- As *CFO* includes *all* cash effects related to Income Statement items, it also includes cash in from **Dividend Revenue** and **Interest Revenue**, and cash out for **Interest Expense** (which otherwise might have been expected to be reported in financing).

- The positive adjustments in *indirect CFO* (such as addition of depreciation to *Net Income*) are NOT increases in cash, nor are the negative adjustments (such as removal of **Gain On Sale**) decreases in cash. They are adjustments because they are not cash at all.

Analysis of the SCF should include examining all cash inflows (outflows) as % of total inflows (outflows). SCF Analysis should identify trends of significant components of cash in and cash out, enabling the analyst to answer such questions as:

- Trend of *CFO* versus *Net Income* (look for manipulation of both):
  - CFO consistently < *Net Income*? Consider possible income manipulation.
  - CFO consistently > *Net Income*? Consider possible operational manipulation (e.g., delaying bill payment, evidenced by an A/P increase)
- How sustainable might primary sources of cash in be? How stable might primary uses of cash out be?
- What are investing sources of cash (operations, sale of other investments, financing)?

Examples of helpful SCF calculations are provided within Table 5.

One goal of analysis might be to **forecast** cash flows to use in various models and decisions. (A company that might be profitable in the long run can be forced into bankruptcy in the short run by a negative cash flow. The use of accrual accounting, which recognizes revenue in the period in which it is earned and expenses as they are incurred can obscure a negative cash flow a cash **flow statement** reveals.) Recalling how interrelated the financial statements are, projecting cash flow is best accomplished in the context of forecasting all financial statements. The trends established in the computational analysis introduced above can serve as the basis for projections, taking into account expected changes in underlying conditions. Given estimations of future growth rates, an analyst can forecast the next period's financial statements. All analysts are recommended to do so at least once to gain a more intuitive understanding of how interrelated the financial statements are. Of course, any forecast made by management is suspect, as the immediate stock price is affected by such forecasts.

One approach to forecasting statements is to follow these steps:

- Start with most recent financial statements.

- Project the next Income Statement based on past trends (maintaining vertical relationships unless other relationships are suggested by company announcements or anticipated changes in economy, product demand, or industry).

- Project cash flows based on beginning *cash*, projected Income Statement results, likelihood of *investing* cash flows in and out and *financing* cash flows in and out,

- Project the resulting **balance sheet** (with implications to *assets*, *liabilities* and *equity* from forecasted **income statement** and cash changes described above).

Documenting conclusions

The final table included in this *Prospecting Quick Guide 2* is the *Quick 100 Analysis Steps*. For occasions when time is limited, and adjustments and forecasts are not required, documenting the results of these steps can communicate a basic understanding of a company's financial statements. Commonly used ratios are italicized in Tables 5a-5f below. Because formulas for most of these measures are readily available online, formulas are provided here for only a few of the less common ratios. Note that these 100 steps should be applied to the several most recent years, whether three, five or even ten. Having determined these 100 facts about a company enables an analyst to assess judgments about the company in the financial press. Familiarity with these facts adds value to any conversation, summary, or decision about the company.

Table 5a
Quick 19 Analysis Steps--What to Document About a Company

1. Fiscal year end date(s) and decision rule (e.g., Best Buy's last Saturday nearest January end)
2. Company self-description (such as Best Buy's "We are a multi-national, multi-channel retailer of technology products such as…and provider of related services.")
3. Industry and industry characteristics including regulatory considerations
4. Products
5. Suppliers
6. Competitors
7. Subsidiaries (number, names, industries)
8. Segments (geographic, product line, or other)
9. Customers (classes of and most significant)
10. Organizational chart/top execs/experience/compensation arrangements/changes to these
11. Auditors, whether auditor-company unresolved issues, audit opinion type
12. Plans (such as disclosed in 10-K Management Discussion & Analysis)
13. Commitments & contingencies (such as unresolved lawsuits)
14. Accounting methods and practices (footnote number 1) including industry-specific
15. Major issues discussed in financial press
16. Exchange(s) on which stock is traded
17. Common stock characteristics (par or stated value), # shares authorized, issued, outstanding
18. Preferred stock characteristics (participating, cumulative, dividend %), number of shares authorized, issued, outstanding
19. Shareholder blocks if any (controlling shareholders)

Table 5b
Quick 22 Analysis Steps—What to Document About Profitability

Company profitability, recent trends for company, segments, products

1. *Net Profit (Loss*) amount
2. *Comprehensive Income (Loss*) & nature/amounts of *Other Comprehensive Income*
3. *Net Sales Revenue* growth rate
4. **Cost of Goods Sold Expense** and *Gross Profit* growth rates & margins (% of sales)
5. *Other operating expenses (SG&A) & Operating Profit* growth rates & margins
6. *Non-operating Income* items (e.g. **Interest Expense** and **Interest Income**), growth rates & margins
7. *Earnings Before Taxes* (*and Special Items)* growth rates & margins
8. Income taxes growth rates and margins, effective tax rates
9. Special items margins (**Extraordinary Gains/Losses** & **Discontinued Operations**, net of tax)
10. *Net Profit* for company (growth rate & margins)
11. *Net Profit* of minority shareholders in subsidiaries (growth rates, margins)
12. *Net Profit* of shareholders & for owned % of subsidiaries) (rates, margins)
13. *EPS*, basic and diluted for special items, for non-controlling shareholders, for company shareholders
14. Nature and characteristics of dilutive instruments
15. Comparable store sales if retail
16. Comparison of above items to forecasts, industry averages, specific competitors
17. *Return on Assets*
18. *Return on Equity*
19. Activity analysis, sales generated by asset use (*Accounts Receivable Turnover, Inventory Turnover, Accounts Payable Turnover, Fixed Asset Turnover, Total Assets Turnover)*
20. DuPont analysis of *Return on Equity* (*Return on Sales, Asset Turnover, Leverage)*
21. Explanations for any changes disclosed (from MD&A, from footnotes) or theorized
22. Overall assessment of profitability

Table 5c
Quick 14 Analysis Steps—What to Document About Cash Flow

1. Vertical/Common size analysis: primary sources of cash in and cash out as percentages of total cash in and total cash out
2. *CFO* trend
3. *CFO* trend vs. profit trend
4. *Cash flow margin: CFO/net sales*
5. Note significant and/or unusual items in Indirect *CFO* adjustments
6. Prepare Direct *CFO* and examine trends
7. Investing (capital expenditure) trends

8. Financing trends (how company is being financed, dividends trend)
9. *CFO Liquidity*: (Cash *and Cash Equivalents* + Marketable Securities + *CFO*) / *Current Liabilities.*
10. *CFO Adequacy*: *CFO / (Capital Expenditures* + *Loan repay* + *Dividends*)…relative size of CFO to needs
11. *Free cash flow*: *CFO – Capital Expenditures* (that is, $ available to repay loans and provide dividends)
12. *Cash Return on Assets*
13. *Cash Interest Coverage*
14. Overall cash assessment

Table 5d
Quick 13 Analysis Steps—Documenting Assets

1. Cash *and Cash Equivalents* split (between Cash and *Equivalents*), growth rates, % total *Assets*
2. *Marketable Securities*, growth rates, % total *Assets*
3. **Accounts Receivable** gross, growth rates, % total *Assets*
4. **Allowance for Doubtful Accounts**, growth rates, % of AR gross, % sales and *Accounts Receivable net*, growth rates, % total *Assets*
5. **Inventory** growth rates, % total *Assets*
6. Inventory valuation methods
7. *Other Current Assets*, nature of, amounts,
8. Non-depreciable *PP&E* (**Land**) growth rates, % total *Assets*
9. Depreciable *PP&E* gross: nature, growth rates, % total *Assets*), write-offs
10. **Accumulated Depreciation** (% of gross PP&E), depreciation methods and estimates
11. Amortizable *Intangible Assets*: nature, growth rates, % total *Assets*), write-offs
12. Depletable *Natural Resources*: nature, growth rates, % total *Assets*), write-offs
13. **Goodwill**: acquisition sources, impairment write-offs

Table 5e
Quick 26 Analysis Steps—Liabilities, Liquidity and Capital Structure

1. *Current Liabilities*, growth rates and % total *Assets*
2. *Other Current Liabilities*, nature of, growth rates, % total *Assets*
3. *Long-term Liabilities*, nature, growth rates, % total *Assets*
4. *Other Long-term Liabilities*, nature of, growth rates, % total *Assets*
5. **Retained Earnings**: confirm its change = *Net Income* – Dividends (otherwise, identify other components such as prior period adjustments), growth rate, % of *Assets.*
6. *Capital stock* issues, repurchases, retirements, stock dividends, stock splits
7. Explanations for above changes from MD&A, notes, financial press, co, website

8. Overall assessment of Financial Condition

Liquidity

9. *Current ratio* trend
10. *Quick ratio* trend
11. *Collection days*, trend and compare to credit terms if disclosed & industry averages
12. *Inventory days* trend
13. *Payables days* trend
14. Operating cycle length: *Cash Conversion (Net Trade) Cycle* trend
15. Explanations disclosed (MD&A, notes) or theorized
16. Overall liquidity assessment

Capital structure (not how financed during year but by year-end)

17. *Leverage*
18. *Debt Ratio*
19. *Debt to Equity*
20. *Long-term Debt to Capitalization*: *Long-term Debt* / (*Long-term Debt* + *Equity*), shows *Long-term Debt* as % of "permanent" financing
21. *Financial Leverage Index* = *Return on Equity* / [*Net Income* + **Interest Expense** (1- tax rate) / *Assets*. If > 1, debt is being used profitably.
22. *Times Interest Earned* & *Fixed Charge Coverage* (if company has lease payments)
23. Nature of debt: (amounts, instruments, due dates, interest rates, debt covenants)
24. Bond ratings
25. Explanations for changes disclosed (MD&A, notes) or theorized
26. Overall assessment of capital structure

Table 5f
Quick 6 Analysis Steps—Market Measures and Overall Assessment

1. Share price trend
2. Market cap trend
3. *Price/Earnings* trend vs. competitors
4. *Dividend Payout & Dividend Yield*
5. Other financial analyst forecasts and buy/sell/hold recommendations
6. Overall assessment of likely direction of future company profit, condition, cash flows.

Completing the Quick 100 has been streamlined by not requiring adjusting statements and forecasting statements, although of course, these same 100 steps can be applied to adjusted and/or forecasted statements. Regardless of how the Quick 100 steps are applied, the time investment required is more than amply repaid by the analyst's new understanding of analysis in general and of the particular company under review.

Summary

Once analysts have negotiated the difficulties inherent in discerning relevant valuable information within the financial statements described in *Prospecting Quick Guide 1*, that information can be assessed by applying a thoughtful structured approach, such as that described here in *Prospecting Quick Guide 2*. As experience is gained, analysts can develop an individualized approach based on knowledge gained over time, enabling them to take financial statements apart to build a coherent picture of a company's health and prospects.

Note: Photograph of coins by Carole E. Scott