Keys to Performance

Lesson 1: Income Statements and Balance Sheets:

This is a top-to-bottom look at two reports that show how well management is doing its job of creating wealth for shareholders. We first look at the income statement, which shows sales, expenses and profits (or losses). Then we turn to the balance sheet, which adds up a business' assets and debts.

About This Tutorial

It didn't start with Enron. Wall Street analysts have often been wrong about stocks, sending out "buy" recommendations and missing danger signs until it was too late for the investors who followed their advice. What can an investor do? For starters, get some education in the basic language of finance. When you know the meaning of the numbers in financial reports, you can figure a lot out for yourself. You can learn the essential facts about a company's health and moneymaking ability from data that's readily available -- for free -- on the Internet. And you can learn to spot many of the danger signs that most of Wall Street, in its enthusiasm for a stock or industry, sometimes chooses to ignore.

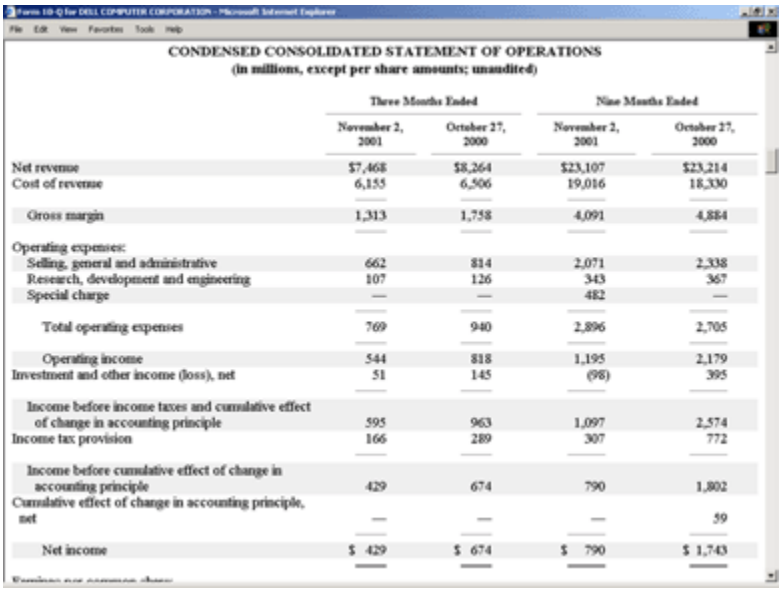
Financial reports -- a company's income statement, balance sheet and statement of cash flows -- can't predict the future for a company. Nothing can. But they can tell you a great deal about how well management is doing its job of making profits and creating shareholder wealth. They're full of facts that every investor should know and understand.

This tutorial will take you through the essentials of financial reports in two lessons. You don't need an accounting degree or advanced math skills to grasp the concepts presented here, though some simple arithmetic and algebra will come in handy. Beyond that, you need only a basic knowledge of stocks, the market, and the Internet to take advantage of this course. If you have any questions, be sure to post them on the Message Board so that your instructor and classmates can help you sort things out.

From Sales to Profit (or Loss)

The income statement, also called the "statement of operations," tells a story of subtraction. Sales or revenue, at the top line, is reduced in steps by various cost items until net income (or loss) is computed at the bottom line.

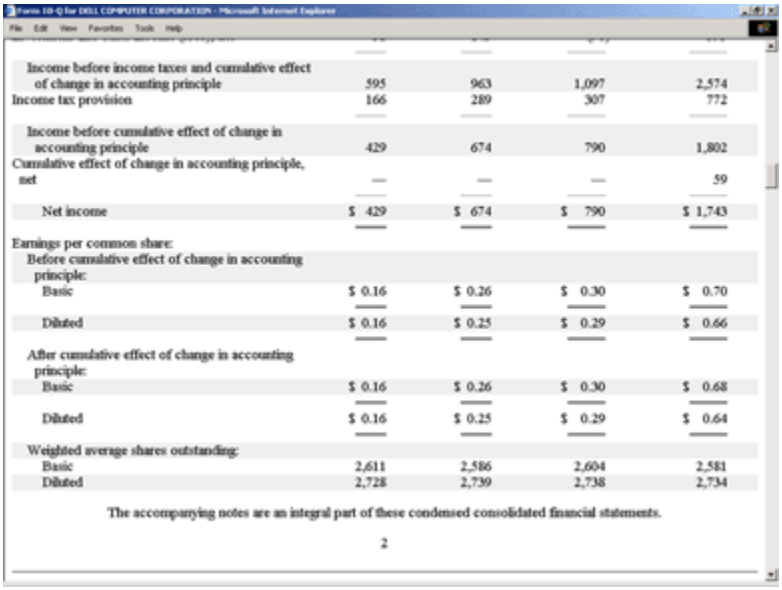
Figures 1-1 and 1-2 show a recent quarterly income statement for PC maker Dell Computer Corp., taken from the Security and Exchange Commission's EDGAR database. (See the "Routes to Reports" sidebar for more on this valuable service). Often the income statement will be labeled a "statement of operations," as it is here.



CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(in millions, except per share amounts; unaudited)

	Three Months Ended		Nine Months Ended	
	November 2, 2001	October 27, 2000	November 2, 2001	October 27, 2000
Net revenue	$7,468	$8,264	$23,107	$23,214
Cost of revenue	6,155	6,506	19,016	18,330
Gross margin	1,313	1,758	4,091	4,884
Operating expenses:				
Selling, general and administrative	662	814	2,071	2,338
Research, development and engineering	107	126	343	367
Special charge	—	—	482	—
Total operating expenses	769	940	2,896	2,705
Operating income	544	818	1,195	2,179
Investment and other income (loss), net	51	145	(98)	395
Income before income taxes and cumulative effect of change in accounting principle	595	963	1,097	2,574
Income tax provision	166	289	307	772
Income before cumulative effect of change in accounting principle	429	674	790	1,802
Cumulative effect of change in accounting principle, net	—	—	—	59
Net income	$ 429	$ 674	$ 790	$ 1,743

Figure 1-1: A quarterly income statement from Dell Computer Corp



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Cumulative effect of change in accounting principle, net	—	—	—	59
Net income	$ 429	$ 674	$ 790	$ 1,743
Earnings per common share:				
Before cumulative effect of change in accounting principle:				
Basic	$ 0.16	$ 0.26	$ 0.30	$ 0.70
Diluted	$ 0.16	$ 0.25	$ 0.29	$ 0.66
After cumulative effect of change in accounting principle:				
Basic	$ 0.16	$ 0.26	$ 0.30	$ 0.68
Diluted	$ 0.16	$ 0.25	$ 0.29	$ 0.64
Weighted average shares outstanding:				
Basic	2,611	2,586	2,604	2,581
Diluted	2,728	2,739	2,738	2,734

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Figure 1-2: More from a quarterly income statement from Dell Computer Corp.

The following six key figures together give you a good picture of a company's profit performance (see the above figures for examples of these figures):

- Net sales (or net revenue). This is the total value of sales (minus discounts) of goods or services for a quarter (shown here) or year. Like all the other figures, it is shown in comparison to quarterly figures from a year earlier. Figures for the fiscal year-to-date (six months) are compared as well.
- Cost of sales. These are costs directly due to the making or buying of products that the company sells. For a manufacturer, this includes such items as raw materials and factory labor. For retailers, it's what they paid for the goods on their shelves.
- Gross margin (or gross profit). This is what remains after the cost of sales is subtracted from net revenue.
- Operating income. Subtract the general costs of running the business -- including depreciation and amortization (to be discussed in the next lesson) -- and you're left with this number. It's the before-tax

profit from the company's business activities (such as manufacturing), rather than side activities such as investing.

- Net Income. This includes income from all sources, investments as well as operations, with all costs, including taxes and bond interest, taken out. Dividends on preferred stock are also subtracted before getting to net income, so you will sometimes see this line called "net available to common." Dividends on common stock, on the other hand, are paid out of net income. Anything left over is "retained earnings" and is added to equity on the balance sheet.

- Earnings per share (diluted). This is the net income, divided by the number of common shares. The "basic" earnings per share just above it is based on the actual number of common shares outstanding. The smaller "diluted" number is based on outstanding shares plus the shares that would be needed to cover options and other securities that can be converted to common stock.

What's Owned, What's Owed

Income-statement numbers such as earnings per share may get most of the public and media attention when companies report on their finances, but the balance sheet, a summary of a company's assets, liabilities, and owner equity, is just as necessary a tool for measuring management performance. If you want to get a true picture of a business, you need to look at both.

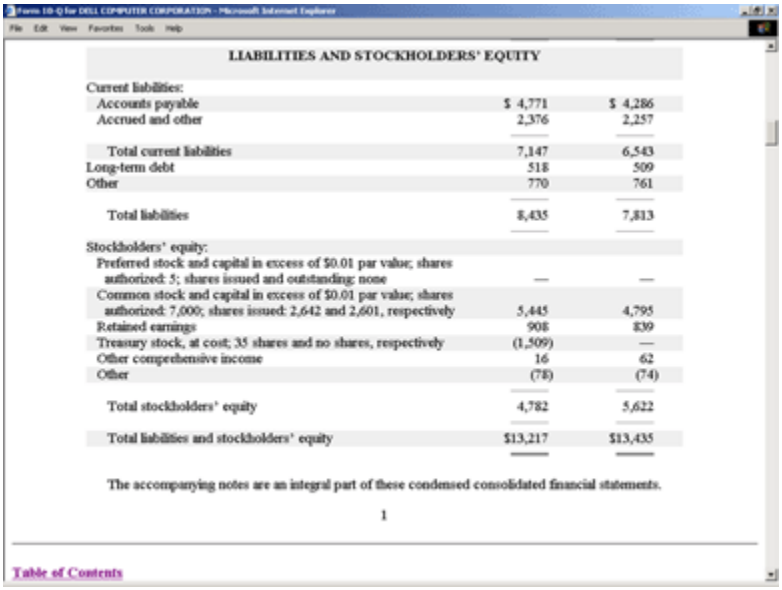
Figures 1-3 and 1-4 show the Dell balance sheet (called by another common name, statement of financial position) from the same quarterly report that we saw on the previous page.

DELL COMPUTER CORPORATION

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION
(in millions, except per share amounts; unaudited)

	November 2, 2001	February 2, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,442	$ 4,910
Short-term investments	309	528
Accounts receivable, net	2,692	2,895
Inventories	269	400
Other	918	758
Total current assets	7,630	9,491
Property, plant and equipment, net	806	996
Investments	4,267	2,418
Other non-current assets	514	530
Total assets	$13,217	$13,435
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,771	$ 4,286
Accrued and other	2,376	2,257
Total current liabilities	7,147	6,543
Long-term debt	518	509
Other	770	761
Total liabilities	8,435	7,813

Figure 1-3: A quarterly balance sheet from Dell Computer Corp.



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Accrued and other	2,376	2,257
Total current liabilities	7,147	6,543
Long-term debt	518	509
Other	770	761
Total liabilities	8,435	7,813
Stockholders' equity:		
Preferred stock and capital in excess of $0.01 par value; shares authorized: 5; shares issued and outstanding: none	—	—
Common stock and capital in excess of $0.01 par value; shares authorized: 7,000; shares issued: 2,642 and 2,601, respectively	5,445	4,795
Retained earnings	908	839
Treasury stock, at cost; 35 shares and no shares, respectively	(1,509)	—
Other comprehensive income	16	62
Other	(78)	(74)
Total stockholders' equity	4,782	5,622
Total liabilities and stockholders' equity	$13,217	$13,435

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Figure 1-4: More from a quarterly income statement from Dell Computer Corp.

The key items to review on the balance sheet are:

- Current assets. Assets and liabilities are divided into two groups based on how soon they can be liquidated or (in the case of liabilities) how soon they have to be paid. Generally speaking, the dividing line is one year. Assets and liabilities due to be closed out within a year are current. Current assets include cash and other liquid investments. Two important categories of assets are inventories and receivables (payments due from customers who buy on credit).
- Fixed assets. These longer-term assets include land, buildings, factory and office equipment and investments that the company does not expect to sell soon (these might include stakes in partner companies or joint ventures). You'll also often see goodwill and other non-physical assets, such as patents in this spot. Goodwill is the amount in excess of book value (or net value of assets) that one company pays to buy another. Like plants and equipment, it's usually written down over time.
- Current liabilities. These include all the obligations that a company faces in the coming year. It includes accrued compensation, payment for goods bought on credit and taxes coming due (pre-paid taxes, on the other hand are an asset). You will sometimes see deferred revenue, money paid to the company by customers before they've received all the goods they ordered. If the goods or services don't work out, the revenue might have to be returned.
- Long-term liabilities. This is where companies that issue bonds add up this long-term debt. Liabilities here can also include other long-term obligations such as leases.

- Shareholders' equity. A balance sheet gets its name because it has two sides that must balance. Assets, on one side of the ledger, must equal liabilities plus equity on the other side. Shareholders' equity, also called net worth or book value, is simply assets minus liabilities. It's what the shareholders actually own, after accounting for debts. The market value of the stock, reflected in the price at which shares trade, is often much higher than this.

Balance Sheet TrendSpotting

Balance sheets have figures from earlier dates (in this case, the start of the fiscal year) showing how assets and liabilities have changed. You may find clues to a company's health here. Rising inventories may mean a business is having trouble moving its products. Higher accounts receivables may mean the credit quality of customers is slipping. "Turnover" ratios on the next page will help you interpret these changes.

Income and Balance Sheet Ratios

Now it's time to do the math. Without going beyond simple arithmetic, you can learn a lot about a business by looking at ratios based on figures from the balance sheet and income statement. These measure things like growth, profit performance, financial strength and efficiency.

Here are the key ratios and what they measure (for percentages multiply by 100):

- Gross margin percentage -- gross margin divided by net sales (revenue). This measures profit before the general costs of running a business. Watch for movements up or down over time. As with most ratios, what's considered "high" and "low" varies by industry. See the "Making Comparisons" sidebar for more information.
- Net margin percentage -- net income divided by net revenue. Like the gross margin percentage, it's a way to measure profit. In this case, it shows how well a company controls fixed costs as well as the direct costs of goods and services.
- Return on equity -- annual net income divided by shareholders' equity on the balance sheet. Often abbreviated ROE, this is the most commonly seen measure of management effectiveness -- how good a return the company is getting on its capital. In general, 20% or more is considered quite good. Another common measure of profit performance is return on assets -- annual net income divided by total assets.

TIP
To compute the latest annual income from a quarterly report, just add up the latest four quarters; these can be found on the quarterly reports at the Multex Investor site, as described in the "Routes to Reports" sidebar on the previous page. You can also use a pull-down menu on a Multex quarterly report to get an annual report for the latest full fiscal year.

- Current ratio and quick ratio (acid test). The first of these is total current assets divided by total current liabilities. The second is total current assets minus inventories, again divided by current liabilities. Both are measures of liquidity -- how easily a company can pay its near-term bills. Inventory is left off the "acid test" because it is less liquid than cash or receivables (which can be sold if they can't be collected).

- Debt to equity -- total debt divided by shareholders' equity. This is a common measure of leverage, or how much a company is using borrowed capital. A related ratio is long-term debt to equity, which leaves current (short-term) debt out of the equation. As with the current and quick ratios, the "right" level of debt depends on industry standards. Technology firms tend to go very light on debt, while utilities load up on it.
- Turnover ratios. Three of these are worth checking to measure efficiency and spot signs of weakness. Asset turnover, annual sales divided by total assets, shows how well the company is putting assets to work at the top line. Inventory turnover is the annual cost of sales divided by average inventory (add up inventory numbers for the past four quarters and divide by four). It shows how fast a company is able to move its products. Receivables turnover, annual sales divided by accounts receivable, shows how well the company is turning credit sales into cash.

Making Comparisons

Interpreting a ratio can be tricky, because there's no "right" number that applies to all companies. Industry standards vary greatly, so you need to benchmark your company against similar ones. At the Multex Investor site click Ratio Comparison in the left-hand menu after calling up a stock quote. You'll see tables comparing a company's ratios to averages for its industry, its sector, and all of the S&P 500 companies.

Trends and Caution Flags

We've already seen that line items and ratios from the income statement and balance sheet might tip you off to shifts in a firm's fortunes. Now let's take a closer look at some trends that can be especially revealing.

Sales, Income and Margins

As you'll recall, the gross margin and net margin percentages tell us what share of a company's sales end up in gross profit (after the cost of sales) and in net income (after all other expenses).

All else being equal, it's usually a good sign when both ratios rise over time. A drop in either of them can be a sign that a company faces stiffer price competition or sagging demand. Once-hot products may be losing their appeal without new, highly profitable products coming on line. A company with shrinking margins can have growth in sales and still be in trouble.

But rising margins aren't necessarily a good sign if revenue isn't rising as well. If a business can't grow at the top line, the only way it can improve bottom-line results is to cut expenses or, with per-share earnings, to reduce the number of shares outstanding. There's nothing wrong with being efficient, but there's a limit to shutting down plants and firing workers. After a point, the cost reductions can start cutting a company's muscle, and thereby reducing its ability to grow.

Inventory Trends

Rising inventory can point to serious problems, especially if it keeps increasing as the economy cools and the company throttles back on manufacturing. In such cases you could see a significant fall in inventory turnover -- the cost of goods sold divided by inventory. If a company has just filed its annual report (Form 10K), you can get fresh data by comparing the turnover for the latest fiscal year with those of earlier years. With quarterly reports (10Qs), you can compute the last several quarterly ratios to see if there's a downward trend.

Sometime inventories go up for a good reason, as when a company is ramping up production for a major new product. And when looking for quarter-to-quarter trends, be careful not to get fooled by seasonal factors.

Wal-Mart, one of the best-run retailers in the world, had a 20% jump in inventories from July 31 to Oct. 31 of 2001, while sales and the cost of sales stayed flat. But that was par for the course: It was just stocking up for the holiday rush. Seasonal sales patterns are one reason why analysts tend to give more weight to year-over-year, rather than quarter-to-quarter, comparisons.

When Receivables Rise

Receivables reflect a company's role as short-term lender to those who buy its products or services. When it sells on credit, it books the sale as revenue but must wait to get paid in cash. How long it waits for that cash depends on several things, including its own credit policy.

If the receivables turnover -- sales divided by receivables -- falls sharply, it could be that the company has made a calculated decision to ease credit terms as a way of selling more products. It could however also mean that customers are in trouble. Or the company could be "channel-stuffing" by making big year-end or quarter-end shipments to customers who otherwise would have bought later (and who will be paying later). This tactic boosts sales at the expense of future quarters.

Moving Forward

In this lesson, we've surveyed two financial statements that, together, sum up the most important aspects of a company's performance. In the next lesson, we'll look at the statement of cash flows, which shows how much money actually flows into and out of a company in the course of a quarter or year.

Before moving on, you should review this lesson and its illustrations to make sure you understand the line items and ratios described here. Using the Dell financial statements, compute the key ratios for that company (use annual statements at the Multex Investor site for ratios based on annual data). Find ratios for different points in time and see if you can see meaningful trends. Use either the SEC's EDGAR or Multex Investor to find similar data on any company that interests you.

Finally, read the first three chapters of the course text, John Tracy's How to Read a Financial Report. For those who want more detail on the interplay between sales, inventory and accounts receivable, Chapters 4 and 5 are also recommended. We've already seen that line items and ratios from the income statement and balance sheet might tip you off to shifts in a firm's fortunes. Now let's take a closer look at some trends that can be especially revealing.

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Toward Truth in Earnings

To see how misleading reported earnings per share can be, read John Dorfman's "10 Ways Earnings Lie," in the July/August 1998 issue of Bloomberg Personal Finance. Dorfman shows how companies play games not only with inventories and receivables but also with asset sales, research and development (R&D), and "extraordinary" items -- which we'll examine in the next lesson.

Assignment:

Now that you know your way around an income statement and a balance sheet, it's time to put that knowledge to use in some stock research. Starting with the Dell Computer data cited in Lesson 1, find the financials for three other companies that operate in roughly the same market (such as Apple Computer, Compaq Computer and Gateway).

Compute the key ratios for all four and compare them. What can you say about the relative strengths and weaknesses of these companies? Looking at the changes in these ratios over time, compare the trends at the companies. Are there any signs that one or more of these firms have improved or declined relative to the others?

Finally, compare the stock chart of each company for the past couple of years to see if the trends you spot on their income statements and balance sheet have been reflected in their share prices. (For charting at Bloomberg.com, call up a stock quote and click Customized Charts at the More on [stock symbol] pull-down menu. On the charting page, you can add up to three symbols under Make Comparison to generate a multi-stock chart.

There's no "right" answer to this assignment. You should, however, be prepared to discuss your conclusions in discussions with other students on the Message Board. Invite their feedback and be ready to offer your insights in return.

Lesson 2: Cash Flow and Other Reality Checks

We start with the statement of cash flows, which shows how much cash a business actually produces and uses. Then it's on to the fuzzy side of finance -- practices like pro forma reporting that can trip up investors, especially those who don't read the financial statement's notes.

Where Cash Is King

You can learn a great deal from the income statement and balance sheet, but these two statements don't tell you (at least directly) how well a company is doing on the cash front. Cash and cash equivalents -- the liquid assets that can be readily spent -- are critical, because they pay the bills. A company can have a healthy-seeming balance sheet and even show a profit, but it can go out of business if it isn't raising enough cash to pay creditors, vendors and employees.

In the wake of the Enron bankruptcy and widespread doubts about the integrity of financial reports, cash flow numbers have gained new respect as data that are relatively hard to fudge. Even the most convoluted and confusing annual report has to include a statement showing how much cash was on hand at the beginning of the year, how much was there at the end, where the money went and how it was raised. These figures are a reality check on rosy earnings announcements.

Goodbye, Accrual World

Cash flow statements convert figures in the income statement and balance sheet, based on the accrual method of accounting, to a cash basis. In accrual accounting, revenue and costs can be recorded at times other than when the money actually changes hands. Sales on credit, for instance, are booked when the bill is sent, not when payment is received. The money paid for new factories and equipment is spread out over a number of years through depreciation. The same is done, through amortization, for intangibles such as patents, customer lists, and the "goodwill" premium that companies pay when they buy other businesses for more than their "book value," or net worth. Cash accounting brings the movement of money into real time, showing when the company actually writes the checks or receives them.

What's an EBITDA?

The most complete view of cash flow, which we'll examine in detail on the next page, is the statement of cash flows. Cash accounting is used more selectively in a performance gauge called EBITDA (earnings before interest, taxes, depreciation and amortization), which was popular with analysts during the market boom of the late 90s.

The problem with EBITDA, as its critics have noted, is that it's one-sided. It takes out a major non-cash expense (depreciation and amortization) but doesn't take out non-cash items, such as rising receivables, that can puff up net income. Like much non-standard accounting, it tells only the good news.

No Free Lunch, but Free Cash

"Free cash flow" is a more useful number, because it draws from both sides of the ledger. It shows roughly what a company keeps in profit after it has spent money on capital expenses, such as plant and equipment (for the

longer run) and the working capital, such as current assets minus current liabilities, it needs to maintain its ongoing operations. In other words, it measures that "cash in the owners' pockets" that value investors like.

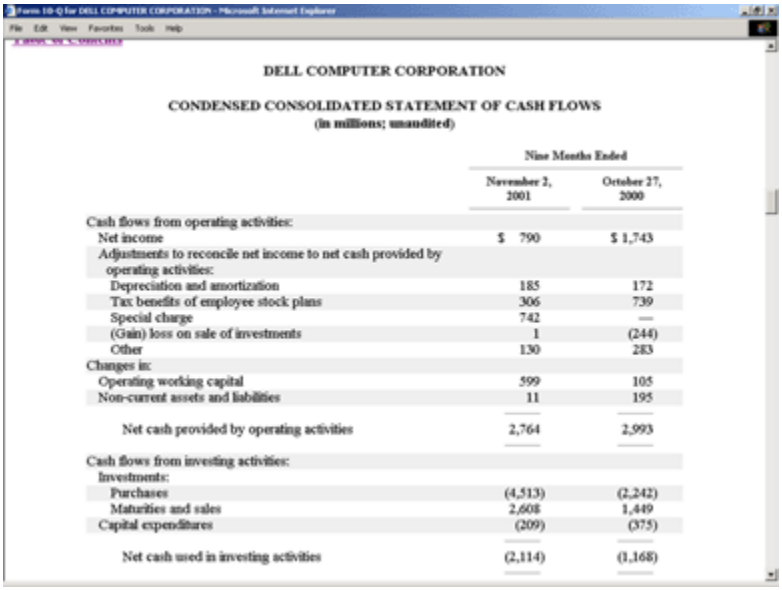
To see how free cash flow is computed, go to Campbell R. Harvey's Financial Glossary at Bloomberg.com and select the Free Cash Flows entry.

Cash Flows and Value Investing

Investors who follow the "value" style, made famous by Benjamin Graham and Warren Buffett, take cash very seriously. They realize that any business is only worth the money -- cash -- that it can ultimately put in its owners' pockets. And they see a company's cash cushion as a margin of safety (in Graham's words) breaking falls in its stock price. They place particular importance in "free cash flow," as is explained on this page.

Following the Money

Now let's look at the statement of cash flows (shown in Figures 2-1 and 2-2) from the same quarterly (10Q) report we used from Dell Computer Corp. in the first lesson. Unlike the three-month numbers on the income statement, the cash flows are stated for the fiscal year to date -- nine months.



DELL COMPUTER CORPORATION

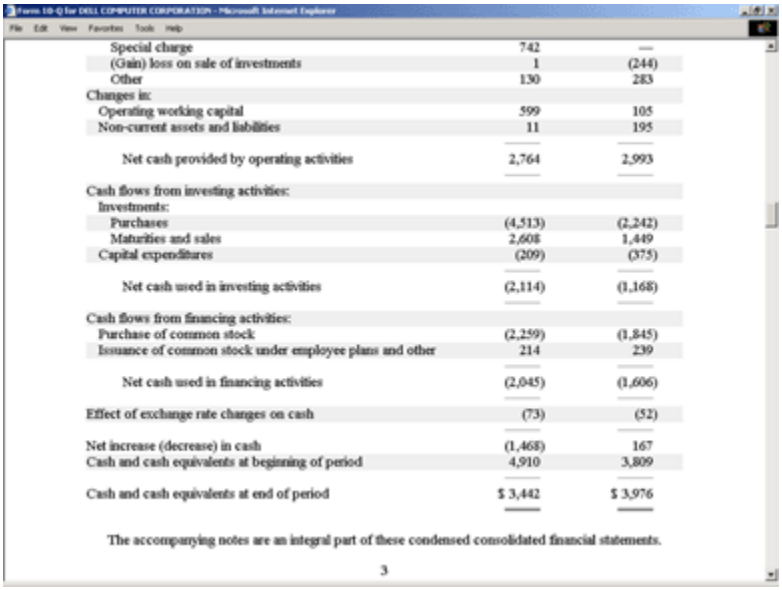
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(in millions; unaudited)

	Nine Months Ended	
	November 2, 2001	October 27, 2000
Cash flows from operating activities:		
Net income	$ 790	$ 1,743
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	185	172
Tax benefits of employee stock plans	306	739
Special charge	742	—
(Gain) loss on sale of investments	1	(244)
Other	130	283
Changes in:		
Operating working capital	599	105
Non-current assets and liabilities	11	195
Net cash provided by operating activities	2,764	2,993
Cash flows from investing activities:		
Investments:		
Purchases	(4,513)	(2,242)
Maturities and sales	2,608	1,449
Capital expenditures	(209)	(375)
Net cash used in investing activities	(2,114)	(1,168)

Figure 2-1: A statement of cash flows from Dell Computer Corp.

What Was So Special About It?

The largest single item in the adjustments for operating activities is a "special charge" added back as a cash inflow. This means that, at some point in the nine months covered, the company took a non-cash write-off against earnings. How significant was that event? As we'll see a bit later, investors can (and should) find out more about such "special," "one-time" or "non-recurring" charges by reading the financial statement's notes.



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Capital expenditures	(209)	(375)
Net cash used in investing activities	(2,114)	(1,168)
Cash flows from financing activities:		
Purchase of common stock	(2,259)	(1,845)
Issuance of common stock under employee plans and other	214	239
Net cash used in financing activities	(2,045)	(1,606)
Effect of exchange rate changes on cash	(73)	(52)
Net increase (decrease) in cash	(1,468)	167
Cash and cash equivalents at beginning of period	4,910	3,809
Cash and cash equivalents at end of period	$ 3,442	$ 3,976

The accompanying notes are an integral part of these condensed consolidated financial statements.

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Figure 2-2: More from a statement of cash flows from Dell Computer Corp.

The cash flow statement always starts with reported net income and it adjusts this figure to show how changes on the balance sheet affected the company's cash position. If receivables or inventories rise, for instance, cash is adjusted downward, because the company is tying up more money in assets that haven't been liquidated. If accounts payable rise, that would add to cash because the company is deferring more expenses.

The statement is organized to show how cash was gained ("provided") or spent ("used") in three types of activity: operating, investing and financing. Here are the key items on the cash flow statement:

- Net Income. This is the nine-month net income ($790 million) from the income statement that you saw on Figure 1-2 in our first lesson.
- Cash flows from operating activities. The figures in this section are for gains or losses incurred in the core business activities of making, buying and selling goods and services. The line "Net cash provided by operating activities" shows that Dell's cash gain from operations was larger than its reported net income.
- Cash flows from investing activities. This category covers the buying and selling of moneymaking assets. It includes payments for plants and equipment as well as for acquisitions and strategic investments in partner firms. Income statements stretch much of this spending over a number of years through depreciation and amortization. Here, it's recorded when the cash is actually paid. The "net cash" line shows that more cash flowed out than in.

- Cash flows from financing activities. Pulled together here are all the transactions involved in raising capital for the business. The largest item on the Dell report (an outflow) was for buying back stock. When a company sells stock or bonds, as Dell did to employee plans, it raises cash and shows up as an inflow. If a company pays stock dividends or bond interest and principal, these show up as an outflow. On this report, financing used more cash than it produced.

- Net increase (decrease) in cash. This figure sums up the net income, from the top of the statement, and the three "net cash" subtotals for operating, investing and financing activities. It's the difference between the cash balances at the beginning and end of the period, shown just below it.

So How's Business, Really?

Take a moment to review the balance sheet and income statements from Lesson 1. Note how the cash balances at the bottom of the cash flow statement show up at the top of the balance sheet. This is an example of what John Tracy calls the "interlocking nature" of financial statements. Tracy illustrates this in a diagram (Exhibit D) on page 18 of the course text, showing how the three statements, as he puts it, "fit together like tongue-in-groove woodwork."

Cash Flow Diagnosis

The one difference between the statement of cash flows and the other two reports is that it lacks standard benchmarks. Analysts and accountants don't have a ready list of cash flow ratios that can be used to evaluate companies. But Tracy (in Chapter 22, "Ratios for Creditors and Investors") points to some numbers worth watching.

One of these is cash flow from operating activities, especially as it compares to cash flow from investing activities. The first of these is basically the firm's cash profits, and the second (investing) is the money that must be plowed back into the business to sustain and grow it.

Recall the "free cash flow" concept. This relationship of operating to investing flows is related to it. If you're looking for a company that generates plenty of money for the shareholders, you'll want to avoid one that has to spend most of its profits on depreciating assets such as plant and equipment.

Dell, as seen in Figure 2-1, used up $2.11 billion on the investing side. But it provided $650 million more than that -- cash for the owners -- from operations.

Watch for Borrowed

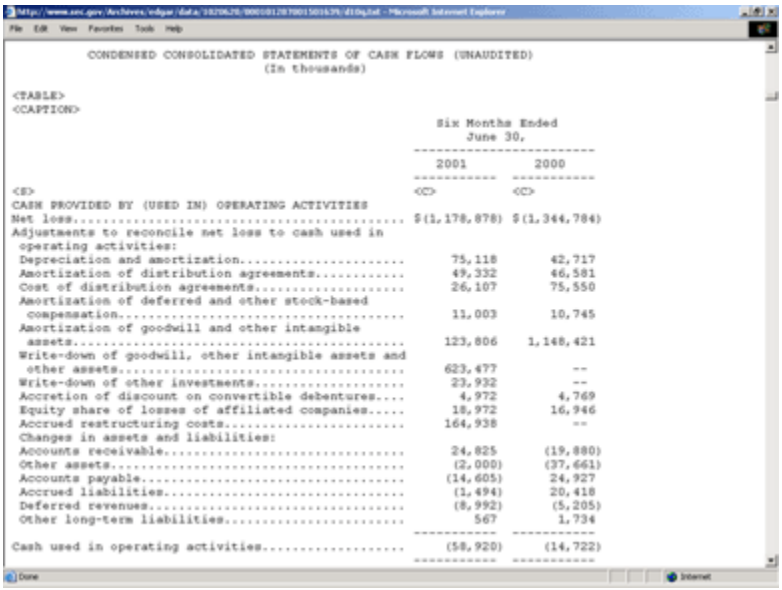
As for declining cash balances (which Dell had in the first nine months of 2001), these obviously can't go on forever. But a rising cash balance is not necessarily a good sign. Plenty of money-losing Internet firms kept the cash rolling in for a time by floating stock or debt, but as every investor knows, the party had to end.

For an example of this see Figures 2-3 and 2-4, which show the six-month cash flow statement for the broadband internet firm At Home Corp. not long before it filed for bankruptcy protection. The $76.8 million rise in cash (from $98.6 million to $175.4 million) looks robust, but it all came from emergency financing.

The company used up a net $58.9 million from operations and $9.6 million from investing. The financing activities included $183.2 million added to cash in "proceeds from issuance of debt." Most of this came from $100 million in notes that, among other things, could only be sold by pledging $100 million in company assets as collateral.

Taking It to The Street

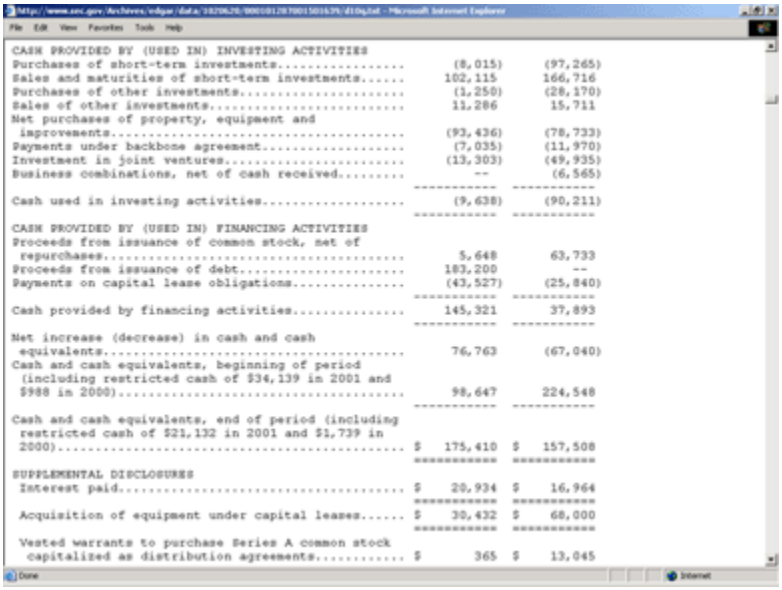
A financial statement doesn't include stock prices, but it gives you data for important valuation ratios used by analysts and investors. The most common, the price-earnings ratio, is the share price divided by the diluted earnings per share for the past four quarters. Also cited often is price-to-sales, the company's market cap divided by the past 12 months revenues. Price ratios based on cash flows, however, haven't yet caught on.



CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Six Months Ended June 30,	
	2001	2000
<S>	<C>	<C>
CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Net loss	$(1,178,878)	$(1,344,784)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	75,118	42,717
Amortization of distribution agreements	49,332	46,581
Cost of distribution agreements	26,107	75,550
Amortization of deferred and other stock-based compensation	11,003	10,745
Amortization of goodwill and other intangible assets	123,806	1,148,421
Write-down of goodwill, other intangible assets and other assets	623,477	--
Write-down of other investments	23,932	--
Accretion of discount on convertible debentures	4,972	4,769
Equity share of losses of affiliated companies	18,972	16,946
Accrued restructuring costs	164,938	--
Changes in assets and liabilities:		
Accounts receivable	24,825	(19,880)
Other assets	(2,000)	(37,661)
Accounts payable	(14,605)	24,927
Accrued liabilities	(1,494)	20,418
Deferred revenues	(8,992)	(5,205)
Other long-term liabilities	567	1,734
Cash used in operating activities	(58,920)	(14,722)

Figure 2-3: The six-month cash flow statement for At Home Corp.



CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES		
Purchases of short-term investments	(8,015)	(97,265)
Sales and maturities of short-term investments	102,115	166,716
Purchases of other investments	(1,250)	(28,170)
Sales of other investments	11,286	15,711
Net purchases of property, equipment and improvements	(93,436)	(78,733)
Payments under backbone agreement	(7,035)	(11,970)
Investment in joint ventures	(13,303)	(49,935)
Business combinations, net of cash received	--	(6,565)
Cash used in investing activities	(9,638)	(90,211)
CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES		
Proceeds from issuance of common stock, net of repurchases	5,648	63,733
Proceeds from issuance of debt	183,200	--
Payments on capital lease obligations	(43,527)	(25,840)
Cash provided by financing activities	145,321	37,893
Net increase (decrease) in cash and cash equivalents	76,763	(67,040)
Cash and cash equivalents, beginning of period (including restricted cash of $34,139 in 2001 and $988 in 2000)	98,647	224,548
Cash and cash equivalents, end of period (including restricted cash of $21,132 in 2001 and $1,739 in 2000)	$ 175,410	$ 157,508
SUPPLEMENTAL DISCLOSURES		
Interest paid	$ 20,934	$ 16,964
Acquisition of equipment under capital leases	$ 30,432	$ 68,000
Vested warrants to purchase Series A common stock capitalized as distribution agreements	$ 365	$ 13,045

Figure 2-4: More from the six-month cash flow statement for At Home Corp.

Must Reading and Pro Forma Pitfalls

Financials don't stop with the numbers. Investors invariably are reminded of this at the end of the tables when they read, "The accompanying notes are an integral part of these . . . financial statements." That means you need to read those notes if you truly want to understand what's going on with those numbers.

Of course, you may read (and re-read) the notes and still not get what's going on. Unfortunately, the companies sometimes seem to want it this way. Enron Corp., the energy trader dragged into bankruptcy by off-balance-sheet debts, conflicts of interest and other funny business, actually had a lot to say about its convoluted related-party arrangements when it filed reports with the SEC.

Its annual report (10K) filed on April 2, 2001 notes, among many other things, that in 2000 and 1999 it "entered into transactions with limited partnerships . . . whose general partner's managing member is a senior officer of Enron." It went on to describe these financial ties in much more detail -- far too much for the typical investor to absorb.

In a way, though, this just proves the value of trying to crack the notes. There's an old bit of wisdom that you should never invest in something you don't understand. If the financial statement leaves questions unanswered (about things like "special charges"), you might put your money elsewhere -- or turn to a trusted expert to explain this company.

GAAP and the Problem with Pro Forma

Throughout this course, we've been looking at financial statements prepared according to Generally Accepted Accounting Practices, or GAAP for short. GAAP standards aren't perfect, and they will probably be revised in light of the Enron scandal (hopefully to make a firm's financial state clearer to investors). But they do represent the accounting professions best effort to get at the truth of a company's financial strength and performance. Alternative methods of stating results must be approached with extreme caution, because they're often designed to make a company's results look better than GAAP would allow.

These "pro forma" statements often get wide play in earnings announcements, though companies must still state earnings according to GAAP as well. Now and then pro forma statements do serve a useful purpose. A pro forma financial statement that treats past earnings of merged companies as if they were together in the past can help investors track real earnings growth. But often a pro forma statement (like EBITDA) is just a way to downplay bad news and pad the positive. The SEC has some helpful tips for interpreting pro forma financials at http://www.sec.gov/investor/pubs/proforma12-4.htm.

Goodbye and Good Sleuthing

This ends our short course in financial statements, the essential survival tools of any wise investor. You are tackling this subject at a time when the need for sound fundamental analysis of stocks is clearer than ever, so I urge you to keep studying it. A good start would be to read John Tracy's How to Read a Financial Report from cover to cover, starting with a careful review of the first three chapters and a close look at Chapter 22, "Ratios for Creditors and Investors."

Also, you should get in the habit of looking at quarterly and annual statements, either on the Multex.com or SEC EDGAR sites, for any stock that you're interested in buying. And remember that companies are supposed to be making you -- the shareholder -- money. That's hard to do without consistent cash profits, and the financials can help you find out which firms take their moneymaking task seriously, and do it well.

Assignment 1: Value-Minded Stock Picking

Using the same companies you analyzed in your first assignment on the basis of their income statements and balance sheets ratios, take a look this time at their cash flow statements. How do the companies compare in their ability to generate cash from operations? Which ones have more cash left over after investing activities -- free cash flow? Can you make any guess as to which one might meet the common "value" criteria of healthy cash flows to shareholders and a strong cash balance?

Next, take out your calculator (if you have one handy) and figure out some per-share ratios for these stocks based on all three financial statements. You can use the latest average number of shares from the income statement. What is their book value per share (remember, book value is total assets minus total liabilities, or

shareholders' equity)? What's their cash (and cash equivalents) per share? On a per-share basis, try computing their net cash flow from operations, minus any cash used in investing activities. How does this compare to earnings-per-share?

Finally, compare these criteria -- book value per share, cash balance, etc. -- to the stock prices. Which stocks have the lowest ratios of price to book value, price to cash, price to free cash flow? How have these performed over the past year? Are these the same as the stocks that have grown the fastest in earnings and sales?

As in the first assignment, there is no single answer to these questions. We'd like you to draw some conclusions about these stocks and share them with other students on the Message Board. One question you should all try to answer is this: Is there anything you'd like to know about a company's financial condition that is not found on financial statements? In other words, how can these documents be improved to help investors? Share your views, and maybe even the SEC will take notice.