

What does an SEC 10K really tell you?

By Kathleen Kerwin

The interpretation and evaluation of Securities and Exchange Commission (SEC) filings of 10Ks and 10Qs is done through a basic financial or fundamental analysis. Both analytical methods review the 10K and 10Q balance sheet, income statement, and cash flow statement. Each method also uses ratio analysis to help you more clearly decipher the company's financial reality.

Reviewing the characteristics of different analysis methods (financial, fundamental and technical analysis) helps you to clarify their difference in goals and approaches. Which process you choose for your analysis depends upon your individual viewpoint and goals. (Investors interpret financials using fundamental analysis.)

Financial analysis, done primarily by creditors or bankers, examines a company's financial statements to determine its debt management (both long-term solvency and short-term liquidity) and ability to repay current and future debts. Financial ratios derived from the financial data help you further understand the relationships between the financial statements and economic reality.

Internal trend analysis identifies how the company's performance has changed over time. An external comparative analysis, done by matching the financial numbers and ratios to industry benchmarks, further measures the company's performance relative to its competitors within its industry. Ratio analysis of financials helps identify the relationship between management strategy and the company's actual results.

Fundamental analysis (referring to market fundamentals) follows the same methodology used in financial analysis, but its goals are oriented towards the needs of current and potential investors. Both quantitative and qualitative studies focus on understanding what the intrinsic value of the company is compared to its market value. Is the company under, over, or fairly valued?

Quantitative analysis researches the company financials. Qualitative analysis seeks to understand the business itself, management's effectiveness, the company's future prospects within the industry, and industry trends given the macro economic conditions, including inflation.

Technical analysis, on the other hand, presumes to predict the timing of the market. It is a sort of behavioral analysis – it assumes that all aspects of both financial and fundamental analysis are already known quantities.

USING MARKET FUNDAMENTALS TO DETERMINE ECONOMIC GAIN

The objective of analyzing financial statements is to interpret a company's value. For the investor, the objective is to identify whether a stock purchase will return economic gain. A company's gain comes through maintaining or improving positive earnings and revenue growth, or by increasing market share. An investor needs to know the current value of the equity stock and its intrinsic value (based on earnings estimates) on which to base a decision on whether to invest or not.

According to Ben Graham, an investor needs a "sound intelligent framework for making decisions . . . (and) . . . keep emotions from correcting the framework" (Graham, 1934). A good foundation in and understanding of fundamental analysis will give you the tools to make a more informed decision.

INTRINSIC VALUE

What is the intrinsic value of a stock? This key question makes fundamental analysis more of an art than a science. Many attempts have been made to apply a formula to provide this answer.

First you have to subscribe to the assumption that there is an intrinsic value (apart from its market price) that incorporates all of the stock's future financial prospects and that eventually the stock will reach this value. When you buy the stock you are buying the future product capability of its assets, entrusted to the management team to produce earnings in the future.

The future stream of predicted earnings is the real value, or intrinsic value, of the stock. These earnings (predicted future cash flow) are discounted to the present market value of the stock. Stocks that appraise well using fundamental analysis generally have had more consistent earnings and growth prospects. A strong foundation in understanding market fundamentals enables you to make a sounder decision.

The bottom line is identifying growth and value stocks (priced at a lower than their price-to-book value) through the evaluation process. Then buy at a discount to the stock's intrinsic value and sell at its peak price.

This sounds simple enough, but the devil is in the details. In fact during the evaluation process you'll often find yourself asking "where am I or what does it all mean?" due to the complexity of the relationship of the mountains of numerical data that represent accounting points in time and measure the on-going business.

VALUATION

A fundamental premise of valuation is that price does not equal value since the stock market is irrational. There are two means of identifying good investments: by the value method or concentrating on growth. Both techniques take valuation into the grey area of the unknown, away from the science of accounting rules (notwithstanding a rather flexible list based on GAAP principles) from which financials are documented. Therein lays the art. Whether you choose a company by the value method or for growth, you need to know what a company is worth.

The goal of investors is to entrust their money to strong companies with good earnings prospects that will increase market value and their own portfolio value. A fundamental analysis framework places each ratio in a category based on certain criteria: efficiency, liquidity, solvency, profitability, and valuation. Sub categories further define what to look for from the ratio. This goal oriented means of understanding ratios gives you the background and perspective from which to base your analysis of a company's financial strength.

Financial statements give you only past performance based on financial numbers and are therefore limited in what they can reveal. For the details on what the financial numbers mean you need to look in the text portion of the financials. For forward looking projections to evaluate the intrinsic value of a company, you'll need a good source of projected earnings estimates (which are only as good as the reputation of the company).

A NOTE ABOUT STANDARDS

FASB, the Financial Accounting Standards Board, has established financial accounting guidelines and standards which include ratio analysis of financial statements. However, how ratios and financial data are used everyday (by those data resources not accountable to regulatory agencies) is not standardized – you can not be sure about the source of the financial data numbers or which composite fields were used to create the ratio results unless your data resource states this explicitly.

At minimum, interpretation of ratio result values requires a comparison of how the numbers have increased or decreased or their percentage change. Most ratio data resources use different formats and may state different reporting periods. These periods use either the annual or quarterly company reporting periods or more relative updated frequencies such as most recent quarter (MRQ) or trailing twelve months (TTM), making the comparison process confusing. Other issues are differences in composite fields or labeling.

The quality of online SEC filings of financial data and ratio analysis has significantly improved over the last year. This is most likely a result of the greater accountability required in the financial services market not only to stay in business but to stay out of the focus of SEC scrutiny and to minimize legal liability. The presentation and formatting of ratio data between data resources appears to be the most common point of difficulty you'll have to transcend to compare ratio result data.

AN EXAMPLE OF COMPOSITE FIELD VARIATION

The quick ratio is a good example of the issue of composite fields. Accounting textbooks commonly define the quick ratio as $(\text{current assets} - \text{inventory}) / \text{current liabilities}$. Most commonly found quick ratio numbers from online resources substitute quick assets for current assets $[(\text{cash} + \text{short term investments} + \text{receivables}) / \text{current liabilities}]$.

Understanding which actual composite fields are used in each ratio can help you look deeper into the financials and make more complex connections. Knowing that a different mix of composite fields can be used to build a ratio makes you a more discriminate consumer. It will also trigger you to ask more questions about the data source to more completely evaluate the reliability of the resource. The value is not the ratio itself but in the composite fields that are used to arrive at the result.

Table 1 is an example of ratio result differences and reporting period update frequency variations from several data sources. The differences in ratio result values and reporting periods make comparisons confusing at best and give you reason to lose confidence in the resources at worst.

Comparing the meaning of ratio results for different reporting periods (annual or quarterly vs. up-to-date TTM

TABLE 1: RATIO RESULT DIFFERENCES

DELL 2004	Argus Year End 1/27/04	Charles Schwab Equity 1/26/04	Multex 1/27/04	Reuters 1/21/04	Mergent Online 1/30/04
PROFITABILITY					
ROE	46%	41.5%	48.1% ttm	48.09 ttm	42.12
ROA			15.5 ttm	15.51 ttm	13.7
Net Margin	6.3%	6.0%	6.3%	6.3%	10.11
LIQUIDITY					
Current Ratio	1.00		1.0	.99	0.98
Quick Ratio			.8	.8	0.81
VALUATION					
Market Cap.	89.17 Billion	88.155 Billion	89.7 Billion	89.5 Billion	
P/E	35.68 ttm	34.1, 36.2 ttm	36.7	36.64	33.7
Price/Sales	2.25	2.5	2.3	2.31	
Price/Book	15.03		15.3 mrq	15.26	
SOLVENCY					
Debt to Equity			0.10 (10%)	.09 (9%)	.08 (8%)

or MRQ data) simply takes practice. Although there are differences in the ratio results, most can be accounted for within minimum percentage differences. This will most likely not change your interpretation or evaluation.

DATA QUALITY

The quality of data should not be overlooked. Free data comes with no guarantees of accuracy. Identify the sources of your ratio results. Are they trustworthy and up-to-date? Pinpoint the date ranges that they cover to put them into perspective.

When looking at the sources of financial data, identify and verify that the financial numbers are taken from 10K's and 10Q's filed with the SEC. The 10K sources are the preferred resource since their financials are audited and signed off by the company's CEO.

There is another issue regarding standards in that the formulas for ratio equations can be simple for educational purposes or quite complex when accounting realities are

accurately measured. The ratio's result value using the more accurate accounting realities may differ with the simpler academic solution and give you reason to question the numerical results. Both are correct but look more closely for additional documentation from the financial ratio resource identifying the composite fields and formula used.

RANGES AND UNITS OF RATIOS

Industry norms and averages of ratio results are benchmarks primarily used to compare the financials from different companies. But a list of numerical results from ratios is difficult to evaluate until you know that the results have a range (minimum and maximum) and a typical range that helps you gain perspective. Identifying possible ranges can give you a better perspective when interpreting the ratio results.

A good example is working capital (WC = current assets – current liabilities). The result measures how much money is available to pay short term bills. Bills have to be paid in

cash so there has to be at least enough money (current assets) to cover bills (current liabilities) or the company has to take out a loan or use up credit. The minimum baseline result is that working capital should be equal to or greater than zero [$WC \geq 0$]. This may not seem important on the surface, but if [$WC < 0$] the company is at greater risk because the cash to pay the bills needs to be found somewhere else such as through credit or a loan.

To understand a ratio result it helps to identify its possible different result range sets. The baseline range is the minimum range possible for ratio result values. They are taken from a list of non-industry specific acceptable numbers (such as the baseline range of $WC \geq 0$) or those commonly referenced by standard finance and accounting textbooks of non-industry specific numbers (such as Current Ratio = 2).

A typical range is also useful to help you gain perspective when interpreting ratios. A ratio with day units may use a 30, 60, or 90 day typical range based on a monthly billing or accounting period. For example Revenue Collection has a typical range defined by monthly billing and credit policy such as 30-40 days, 45-60 days or 60-90 days. Without understanding the different range sets that lend real meaning to ratio interpretation, you're only looking at the difference between the ratio result values of a list of numbers.

UNIT VALUE

The unit value is critical as well because it gives you knowledge of what you are measuring. The working capital (WC) units are in dollars which again may not seem important to know when comparing a list of ratios. The list of possible unit ratio formats include dollars, a pure ratio relationship with units canceling out such as [(nominator in \$'s)/(denominator in \$'s)], percent (ratio * 100), times, and days.

Without applying the specific unit value to each ratio as you evaluate, the ratio result values remain as just the difference between a list of numbers. But a number of what?

The unit values can be somewhat interchangeable, such as a ratio relationship (nom/denom) and percent (ratio * 100). If you can quickly do the math it's not a problem – except that the developer of the ratio list can make any decision they wish to, interchanging the ratio result value between a ratio relationship or percent format in their written presentation. There is no standard. It's a matter of the result form the public expects to see for the ratio result value or how the ratio developer documents it.

Comparing ratio results can be quite confusing when the result is mixed in a long list of company ratios. Comparing the results between multiple data sources with mixed result forms is even more challenging. Liquidity ratios (current ratio, cash ratio and quick ratio) are commonly in the ratio relationship form. But profitability (ROE, ROA and margin ratios) and solvency (debt ratio and debt to equity) are

SIDEBAR 1: EFFICIENCY, LIQUIDITY AND SOLVENCY

Efficiency

Receivables Management: Assesses collection and discount/credit policies, how quickly are assets being turned into sales? Look at Receivables Collection Period and Receivables Turnover.

Inventory Management: Weighs manufacturing efficiency and production management. Look at Age of Inventory and Inventory Turnover.

Asset Management: Balances capacity utilization and capability management of assets. Look at Fixed Asset, Total Asset and Working Capital Turnover.

Liquidity

Cash Management: Calculates availability of liquid Assets and Working Capital with the interest return on Short Term investments and availability of Cash. Look at Cash Flow Ratio, Current Ratio, Quick Ratio (aka Acid Test Ratio) and Cash Ratio.

Solvency

Debt Management: Measures Debt utilization from external resources for current and future growth, as well as, opportunities for Operating activities. Look at CFO to Debt, Debt Ratio and Debt to Equity Ratio.

Interest Coverage: Measures how many times the current Interest Expense can be covered by Operating Income before interest and taxes. Look at (EBIT) or EBITDA, EBITDA Coverage RATIO and Times Interest Earned (TIE).

Capital Structure: Balances the debt and equity with the overall cost of capital with the appropriate structure for the time horizon of the assets purchased. Look at Capital Expenditures Ratio.

interchangeably in the ratio relationship or percent form. The difference is simply a decimal point, but that requires an additional evaluation step for each ratio in question in an already complex interpretation process.

TREND ANALYSIS

Numerical trend analysis is based on several periods of observations from past performance. It can be as simple as measuring the percentage change of the financial numbers from one period to another or it can be a more complex in-depth analysis. You get the percentage change of a number when it is then compared to a base year multiplied by 100.

Compare a selected year against the percentage change of the previous or future years. Percentage change comparisons can be made for internal company trend analysis, externally among industry competitors forming a competitive analysis using industry benchmarks, and across industries using common size statement for comparative analysis.

HOW TO START YOUR ANALYSIS

A good place to start is reviewing the balance sheet for efficiency, liquidity, and solvency, then continue to the

income statement for profitability and valuation. The cash flow statement helps you understand where the cash was spent and made during the year. The interconnectivity of the financials helps provide a check from where you can better understand the complete financial picture.

Review the balance sheet

The balance sheet lists the company's assets which were financed by debt (liabilities) or stockholder's equity (common stock, retained earnings and additional paid-in capital). Therefore assets = liabilities + stockholder's equity. The assets are listed in order of liquidity and liabilities in order of immediacy (i.e., those that have the most senior claim on a firm's assets are listed first).

- Assets: What the company owns.
- Liabilities: What the company owes.
- Shareholder's Equity: Is "net worth" of the company.

SIDEBAR 2: INCOME STATEMENT REVIEW

Method 1 (step wise)

Total Revenues	18243.00
-Cost of Goods Sold (COGS) w/ Depreciation	14137
=Gross Profit	4106
-Operating Expenses	2060
Operating Income After Depreciation	2046
-Other Income, Net	38
=Total Income Avail for Int Exp (EBIT)	2084
-Interest Expense	0
=Pre-tax Income (EBT)	2084
-Income Taxes	624
Total Net Income	1460

Then consider:

Operating Income After Depreciation	2046
+Depreciation	103
+Amortization	0
+Amortization of Intangibles	0
= Operating Income b/f Depreciation (EBITDA)	2149

Method 2 (successive)

Total Revenues	18243.00
- Cost of Goods Sold (COGS) w/ Depreciation	14137
=Gross Profit	4106
-Operating Expenses	2060
Operating Income b/f Depreciation (EBITDA)	2149
-Depreciation	103
-Amortization	0
-Amortization of Intangibles	0
=Operating Income After Depreciation	2046
+Other Income, Net	38
=Total Income Avail for Int Exp (EBIT)	2084
-Interest Expense	0
=Pre-tax Income (EBT)	2084
-Income Taxes	624
Total Net Income	1460

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The stockholder's equity (assets – liabilities = stockholder's equity) is the net worth of a company – a.k.a book value.

Assets

Review the balance sheet for the overall structure of the company. What are the short-term assets (cash, inventory, receivables etc. anticipated to be turned into cash within one year or operating cycle)? What are the long-term (property, plant and equipment) fixed assets? If the assets don't fit with the main operating activities of the company ask why. The operating activities define the company.

Whatever goods the company makes or services it sells are the primary operating activities. If the company makes and sells goods, the result of the operating activities is inventory that is sold either for cash or credit (receivables). Review inventory and receivables management. For example, if the inventory is growing faster than sales, look at whether the inventory is obsolete or outdated. Why is it growing and why is it not selling? How many times is the receivables account turning over per year?

If the receivables account is older than the terms in the credit policy, there is a collection problem. For example, if the receivables turn over every 72 days and the credit policy states 60 days, you need to look closer. Perhaps the company's credit and discount policy need to be reviewed. A more liberal discount policy can encourage customers to pay on time. Late fees in the credit policy provide additional motivation to pay on time.

Liabilities

How are the assets capitalized, by debt or equity? The long-term assets should be financed by long-term debt. What is the capital structure percentage? Have the long-term and short-term debt increased or decreased? Has the accounts payable increased or decreased? If yes, ask why.

REVIEW INCOME STATEMENT

The income statement is a summarized list of inflows (revenues) and outflows (expenses) over a period of time (quarter or year). The difference between revenues and expenses is the net income (loss) bottom line. The statement provides information whether the company is making money and is profitable or operating at a loss. Ratios built upon the operating activities measure performance.

The Income Statement is read using a step-wise approach (method 1.) EBITDA is the exception unless the stepwise approach includes the successive steps for EBITDA, EBIT then EBT (method 2) reaching net income after subtotals are calculated after each major expense line item is subtracted. (See Sidebar 2.)

In method 1 EBITDA is then added somewhere in this successive list of subtractions breaking the pattern. A

novice analyst should be able to quickly take the pattern into perspective understanding the income statement as a straight forward successive calculation ignoring EBITDA. After which review the EBITDA calculation separately.

$$\text{EBITDA} =$$

$$\text{Operating Income} + \text{Depreciation} + \text{Amortization}$$

The key items are revenues, operating income and net income (loss):

- Gross profit = revenue – revenues with depreciation (COGS)
- Operating income = gross profit – all operating expenses
- Net income = operating income – interest and taxes

CONCLUSION

At first the fundamental analysis evaluation and interpretation process appears daunting. It's not necessarily as complex as it appears. Gain a high level perspective of the analysis framework (categories of efficiency, liquidity, profitability, solvency and valuation) and the applicable ratios in category. Apply a goal oriented approach to what you wish to learn and understand about a company by asking questions such as:

SIDEBAR 3: PROFITABILITY AND VALUATION

Profitability

Earnings Management: Assess profits in relation to the resources used. Gross Margin and Operating Margin Ratio.

Return on Sales: Profit Margin

Return on Investment: Return on Assets (ROA) and Return on Owner's (Stockholders) Investment (ROE).

Valuation

Assessment of the market price compared to assets and earnings, as well as, investor confidence.

- Dividend Payout
- Dividend Yield
- Market Book/Ratio
- Price / Cash Flow
- Price /Earnings Ratio
- Price / Sales

- Is the company well run? (Efficiency-inventory, receivables and asset management)
- Is there enough cash to pay the bills? (Liquidity-cash management)
- Is the company making a profit? (Profitability-earnings management and ROI)
- How is the company financed and is it able to pay interest and principle? (Solvency-debt management and interest coverage)
- What is the value of the company? (Valuation-market value and investor confidence)

Discover the typical ranges and units for each ratio so that the numbers become meaningful. Get a good knowledge of the ratio composite fields which will give you a more in-depth understanding of what the ratio result value really means. Analyze the financials of a company you know well such as your own company.

Combine this with the personal knowledge you have of a company, and build your fundamental analysis using the entire analysis framework. Once you have a good handle on what type of insight the ratios can give you about a company using trend analysis, broaden your research and compare

multiple companies in a competitive or comparative analysis using the same approach.

A disciplined plan of attack provides you with an overall financial picture that gives you the tools from which to make financial decisions on your own analysis and give you the ability to review third party opinions based on the same market fundamentals.

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