



Intro to Fundamental Analysis Tutorial

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Introduction

The massive amount of numbers in a company's financial statements can be bewildering and intimidating to many investors. On the other hand, if you know what to look for, the financial statements are a gold mine of information.

Financial statement analysis is the biggest part of fundamental analysis. Also known as quantitative analysis, this involves looking at historical performance data to estimate the future performance. Followers of quantitative analysis want as much data as they can find on things like revenue, expenses, assets, liabilities, etc. This information, and not just its stock price, is what they believe will give insight into how a company's share price will perform in the future.

Before we learn different ways to estimate future performance, it is important to understand the basics of the financial statements (both quarterly and annual reports).

The Quarterly and Annual Reports

We find most historical data in the annual and quarterly reports released by the management. These can be found over the Internet (see: [Where can I find a company's annual report and its SEC filings?](#)) or in physical form, which is usually a glossy and colorful publication.

Financial statements are required by law and must include a balance sheet, income statement, statement of cash flows, auditor's report, and a somewhat detailed description of the company's operations and prospects for the upcoming year.

The annual report is sometimes also referred to as the [10-K](#), but don't be fooled. The 10-K contains the same information but in much more detail than many annual reports.

The following information is presented in most financial reports, note that the order in which these are presented might vary:

- Summary of the previous year.
- Information about the company in general, its history, products and line of business.
- Letter to shareholders from the President or the CEO.
- Auditor's report telling you that the results are accurate.
- An in-depth discussion about the financial results and other factors within the business.
- The complete set of financial statements (balance sheet, income statement, statement of retained earnings, and cash flow statement)
- Notes to the Financial Statements.
- Other information on the company's management, officers, offices, new locations, etc.

How you read the financial statements really depends on who you are and what's your interest in the company. Financial statements are used by management, creditors/lenders, partners, and investors. Each group is interested in different things. For example, an investor might assess profitability, growth, stability, and the rate of dividends while a creditor is much more interested in the amount of debt that a company currently has and whether it has the ability to make repayments.

Let's take a tour through some of the most important sections of financial statements and look more closely at what each section means.

Management Discussion and Analysis (MD&A)

As a preface to the financial statements, a company's management will typically spend a few pages talking about the recent year (or quarter) and give a background on the company. While this is not the guts of the financial statements, it does give investors a better understanding of what the company does and usually points out some key areas where they performed well.

Though, don't expect the letter from management to delve into all the juicy details affecting the company's performance. The management's analysis is at their discretion, so take it for what it's worth. Things to look out for are:

- How candid and accurate are the managers' comments?
- Does the manager discuss significant financial trends over past few years?
- How clear are the managers comments? If they try to confuse you with big words and jargon then perhaps they are trying to hide something.
- Do they mention potential risks or uncertainties moving forward?

Disclosure is the name of the game. The more information a company mentions in the MD&A the greater likelihood that management is not trying to hide anything. If the MD&A portion of the financial statements ignores serious problems that the company has been facing, then it should raise a red flag. A good example would be a company that is known to have large portions of outstanding debt but doesn't mention anything about it in the MD&A. Withholding important information not only deceives those who read the financial statements, but in extreme cases also makes the company liable for lack of disclosure.

The Auditor's Report

If you had a large sum of money invested in a company, wouldn't it make you feel better if there was someone (other than management itself) keeping an eye on things? This is the main purpose behind the auditor's report, which is sometimes called the " Report of Independent Accountants." The job of the auditors is to express an opinion on whether the financial statements are reasonably accurate and provide adequate disclosure.

By law, every public company with stocks or bonds trading on an exchange must have their annual reports audited by a Certified Public Accountant firm. An auditor's report is meant to scour the company and identify anything that might undermine the integrity of the financial statements.

The typical auditor's report is almost always broken into three paragraphs and written in the following fashion:

Independent Auditor's Report	
Paragraph 1	The first tells the responsibilities of the auditor and directors in general and lists the areas of the financial statements that were audited.
Paragraph 2	This paragraph lists the scope that GAAP was used, and what areas of the company were assessed.
Paragraph 3	The third paragraph gives the auditor's opinion on the financial statements of the company being audited. This is by no means a guarantee of accuracy, it is simply an opinion.

Generally, the auditor's report won't uncover any big nuggets of information on a company, but it is crucial that you at least ensure that the financial statements have been audited. Audits give credibility to the figures reported by the management. Financial statements that have not been audited are close to worthless. Unaudited financial statements have a higher probability of being misleading and fraudulent, something no investor can utilize to make an educated decision.

The Balance Sheet

The balance sheet is often overlooked by investors. In fact, "overlooked" is an understatement at best. Investors tend to focus more on earnings, which are important, but don't tell the whole story. There is a lot to be said for this integral part of the financial statements.

The balance sheet is the statement that highlights the financial condition of a company at a single point in time. This is an important distinction, the cash flow and income statements record performance over a period of time while the balance sheet is a snapshot in time.

Managers, creditors, and investors all need to familiarize themselves with the [assets](#), [liabilities](#), and [equity](#) of a company. The balance sheet is where this info is found. It lists all of the assets held by a company and what portion of those assets are financed by debt (liabilities) or equity (retained earnings and stock).

The reason it's called a balance sheet is that both the sides balance. That is:

Assets = Liabilities + Equity

Assets, liabilities, and equity are also broken down into sub-categories:

Left Hand Side (Assets)

Current Assets - this includes cash, [accounts receivable](#), and other assets that can be converted in to cash relatively quickly.

Property & Equipment - this is not exclusive to equipment and property, it can be more accurately described as long term operating assets (less depreciation on these assets).

Other Assets - includes anything that doesn't fit in the above categories

Goodwill - the excess of the purchase price over the fair market value of an asset.

Right Hand Side (Liabilities & Stockholders' Equity)

Current Liabilities - this includes a company's liabilities that will come due within the next 12 months.

Long-term Liabilities - debt not maturing in the next 12 months. A good example is outstanding bonds that don't mature for several years.

Stockholders' Equity - this reveals how the remainder of the company's assets are financed including common and preferred stock, treasury stock, and retained earnings.

For a sample balance sheet, see:

<http://www.investopedia.com/university/fundamentalanalysis/balancesheet.asp>

The Income Statement

The income statement is the most looked at financial statement in an annual or quarterly report. The income statement is the "sexy" portion of the financial statements because it includes figures such as [revenue](#), [net income](#), and [earnings per share \(EPS\)](#). In essence, an income statement tells you how much money a company brought in (its revenues), how much it spent (its expenses), and the difference between the two (its profit/loss), over a specified time.

Profit is, after all, the reason companies are in business. While some new companies are not expected to be profitable for a few years, over the long run, no company can survive without profits.

The income statement is easily designed, and even easier to read. The statement is looked at from top to bottom. The [top line](#) lists the revenue (sales) brought in. Each subsequent line deducts expenses and costs from the revenue figure until you finally get to the [bottom line](#) (net income). Each item that has a line above the number means that it is a subtotal or total (the net income usually has a bold or double line below the number).

Below is the typical layout of an income statement:

Income Statement	
Revenue	- the proceeds that come from sales to customers
Cost of Goods Sold	- an expense that reflects the cost of the product or good that generates revenue. For example, if a loaf of bread costs 50 cents to make, then COGS is 50 cents.
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Gross Margin	- also called gross profit, this is revenue minus COGS
Operating Expenses	- any expense that doesn't fit under COGS such as administration and marketing expenses.
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Net Income before Interest and Tax	- net income before taking interest and income tax expenses into account.
Interest Expense	- the payments made on the company's outstanding debt.
Income Tax Expense	- the amount payable to the federal and state governments.
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Net Income	- the final profit after deducting all expenses from revenue.
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Net Income Per Share	- the net income divided by the number of shares

(stock) owned by the public. Otherwise known as EPS.

There isn't one cookie cutter way to present a company's income statement as the exact information presented depends, to some extent, on the type of business the company is in. For example, some will break down their operating expenses into various categories while others do not. Furthermore, some companies list depreciation expense as a separate line item, while others do not.

For a sample income statement, see:

<http://www.investopedia.com/university/fundamentalanalysis/incomestatement.asp>

The Cash Flow Statement

As we mentioned in the introduction, there are several different groups of people who read the financial statements, each looking for different types of information. Earnings might be one of the most important areas for investors, but the statement of cash flow is extremely important to management, lenders, and tax authorities as well as investors.

The cash-flow statement is fairly new to the financial statements that companies report. In fact, it has only been a requirement since 1988. Currently every company filing reports with the [Securities and Exchange Commission \(SEC\)](#) is required to include a cash flow statement within their quarterly and annual reports.

Cash flow is similar to the income statement in that it records a company's performance over a specified period of time, usually over the quarter or year. The difference between the two is that the income statement also takes into account some non-cash accounting items such as depreciation. The cash-flow statement strips away all of this and tells you how much actual money the company has generated. Cash flow shows us how the company has performed in managing inflows and outflows of cash and better gives a better picture of the company's ability to pay bills, creditors, and finance growth.

Many of the items on this statement are also found in either the income statement or the balance sheet, but here, they're arranged to highlight the cash generated and how it relates to reported earnings. The cash-flow statement is divided into three parts:

Statement of Cash Flow

- | | |
|-----------------------------|---|
| Cash from Operations | - this is cash generated from day-to-day business operations. |
| Cash from Investing | - cash used to invest in, or proceeds from the sale of other businesses, equipment, or other long-term assets. |
| Cash from Financing | - cash paid or received from issuing and borrowing of funds. This section also includes dividends paid. (Although it is sometimes listed under cash from operations.) |

**Net Increase or
Decrease in Cash**

- increases in cash from previous year will be written normally, and decreases in cash are typically written in (brackets).

Why is cash flow so important? Unlike reported earnings, there is little a company can do to manipulate their cash situation. Notwithstanding outright fraud, this statement tells the whole story, you either have the cash or you don't. The cash flow statement requires just as much attention as the other statements, at the very least, look to see if the company is increasing cash over previous years.

For a sample statement of cash flow, see:

<http://www.investopedia.com/university/fundamentalanalysis/cashflow.asp>

Notes to the Financial Statements

The notes to the financial statements (sometimes called footnotes) are also an integral part of the overall picture. If the income statement, balance sheet, and statement of cash flow are the heart of the financial statements, then the footnotes are the glue that keeps everything in tact. If you aren't reading the footnotes you're missing out on a lot of information.

The footnotes list everything that could not be included in the actual ledgers, but that are important for stakeholders to know. Could you imagine if the company listed out individual expenses on the income statement instead of putting them under one or two neat headings? The income statement would be 20 pages long!

The notes will list important things like outstanding leases, the maturity dates of outstanding debt, and even details on where the revenue actually came from. Generally speaking there are two types of footnotes:

- **Accounting Methods** - This type of footnote identifies and explains the major accounting policies of the business. This portion of the footnotes will tell you the nature of the company's business, when its fiscal year starts and ends, how inventory costs are determined, and any other significant accounting policies that the company feels that you should be aware of. This is especially important if a company has changed accounting policies. It may be that a firm is practicing "[cookie jar accounting](#)" and is changing policies only to take advantage of current conditions to hide poor performance.
- **Disclosure** - The second type of footnote provides additional disclosure that simply could not be put in the financial statements. The financial statements in an [annual report](#) are supposed to be clean and easy to follow. To maintain this cleanliness, other calculations are left for the footnotes. For example, details of long-term debt such as [maturity dates](#) and the interest rates at which debt was issued, can give you a better idea of how borrowing costs are laid out. Other areas of disclosure include pension plan liabilities to existing employees and even looming legal proceedings the company is involved in.

The balance sheet, income statement, and cash flow statement are read by a lot of investors and analysts. But for whatever reason, the footnotes are often overlooked. What sets informed investors apart is digging deeper and looking for information that others typically wouldn't. No matter how boring it might be, read the fine print and it'll make you a better investor.

Conclusion and Resources

One of the most important areas for any investor to look when researching a company is the financial statements. It is essential to understand what each part of the statement is meant for and how to interpret it.

Let's recap what we've learned:

- Financial reports are required by law and are published both quarterly and annually.
- Management discussion give investors a better understanding of what the company does and usually points out some key areas where they did well.
- Audited financial reports have much more credibility than unaudited ones.
- The balance sheet lists the assets, liabilities, and shareholder's equity.
- For all balance sheets: **Assets = Liabilities + Equity**. These two sides must always equal each other (balance).
- The income statement includes figures such as revenue, expenses, earnings, and earnings per share.
- For a company, the top line is the revenue while the bottom line is net income.
- The income statement takes into account some non-cash items such as depreciation. The cash-flow statement strips away all non-cash items and tells you how much actual money the company generated.
- The cash-flow statement is divided into three parts: cash from operations, financing, and investing.
- Always read the notes to the financial statements, they give you more in-depth information on a wide range of figures reported in the 3 financial statements.

Also:

1. If you think we missed something and have a question, [tell us about it](#).
2. If you enjoyed this tutorial, make sure to [Tell a Friend!](#)
3. If you still aren't [on our newsletter](#), why not?

Related Articles and Tutorials

[Ratio Analysis by Investopedia](#) - Now that you've learned the basics of the financial statements, you are ready to learn about the many financial ratios that are used to scrutinize the performance of companies.

If you are still unsure about many of the terms we discussed in this tutorial then please check out our [list of Fundamental Analysis and Financial Reporting terms](#).

[Learn to Look at the Cash Flow](#) - An article discussing the key items to look at

when reviewing the statement of cash flow.

[Off Balance Sheet Entities: The Good, The Bad and The Ugly](#) - Companies have used off balance sheet entities responsibly, and irresponsibly, for some time. This article will define some typical off balance sheet items and discuss whether they are "good" or "bad."

[Inventory Valuation for Investors: FIFO and LIFO](#) - If you are an investor who ignores how a company values its inventory, it's time to get the lowdown.