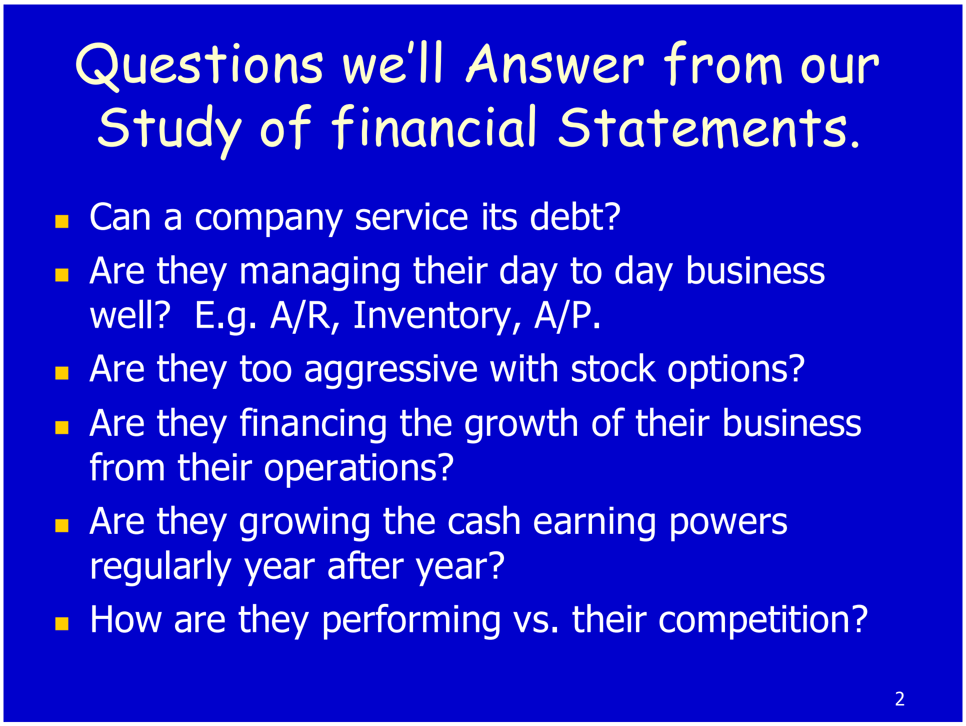
**<u>Background Information for</u>**

# <u>Mining Real Money from Financial Statements</u>




## <u>What Many People Believe Financial Statements Do</u>

You may be thinking "If I can just figure out how much money a company makes, how consistently they make it and what their prospects are for making more money in the future, I'll be able to make sound investment decisions." Further, you may believe that all you need to do is to look at a company's net income to know that is the amount of money the company has earned during the reporting period. Unfortunately, life is not that simple and using the above two assumptions can lead to serious investing mistakes. So let's begin by understanding the purpose and organization of financial statements and then see how to get our minds around what financial statements actually do and how they can help in improving judgments about companies being studied.

Public companies are required by the Securities and Exchange Commission (SEC) to provide the investing public information about specific aspects of their financial condition on a regular schedule: Annual Reports are known as 10-K's, and quarterly reports are known as 10-Q's.

## Where to Find Financial Statements.

Financial statements can be found in many places. Much of the data has been "adjusted" either by the company reporting the data or by a financial service in business to report financial information to the financial industry. If you want to be assured the data you are getting is both the most recent information and exactly what is reported, going to the SEC web site will provide you with that assurance. This web site is supported by your federal tax dollars and can be used at no added cost to you. It can be found at http://sec.gov/edgar. (Edgar is the SEC's acronym for "Electronic Data Gathering and Retrieval. You can find government filings of financial data going back many years.) For domestic companies, annual data can be found by searching for 10-K filings and quarterly data by searching for 10-Q filings. For foreign companies annual data can be found in 20-F filings. Quarterly data for foreign companies takes a little digging. The filings are 6-F filings, but the quarterly statements are intermingled with many other 6-F filings that are not quarterly filings. Thus you may need to search through ten or more 6-F filings to find a quarterly filing. The web site requires the user to enter the dash. Thus it will not recognize a search for 10K, 20F, 10Q or 6F, only 10-K, 20-F etc.

## Finding Useful Information from Financial Statements:

Finding information from these statements generally requires doing a little basic arithmetic. That is summing some numbers, taking ratios of numbers or similar basic arithmetic operations. Some web sites have already done that for you. For example, www.stockcentral.com has a Ratio Analyzer site that does the arithmetic for you and provides a discussion of what the ratios mean.

## Purpose and Organization of Financial Statements

The purpose and organization of Financial Statements must be clearly understood before individual entries are understandable and thus become a useful tool for the individual investor. We hope to provide you with the knowledge and tools to become financially literate, and to become fluent in Financial-Statement-Speak. We write this from the perspective of the investor. The intent is to provide you, the investor, with new skills and confidence that we hope will improve your personal approach to investing.

The law establishing the SEC and requiring Financial Statements was enacted after the collapse of the market in the late 1920's. The rules about HOW to provide the information are called Generally Accepted Accounting Principles (GAAP) and are in a state of continuous change as the nature of business changes and the need for changes becomes evident.

There are four key issues that set the stage for understanding financial statements. Three of the issues are principles GAAP employs in "Financial Reporting". The fourth is an issue regarding taxes that surprises many users of financial statements when they discover it. This is the world of "Tax Accounting" and the rules are based upon a "modified cash accounting" process. All four issues take some special effort to fully internalize so the statements can be read and understood as intended. What follows is a brief description of these

## ***Four Principles:***

| | |
|---|---|
| Accrual Accounting | Records revenues (income) and expenditures as COMMITMENTS are made, not ***necessarily*** when cash is received and not necessarily when it is spent. |
| Cash Accounting | Records cash movement as it occurs, not ***necessarily*** when commitments are made. |
| Matching Principle | Matches the expensing of an asset to its economic life. This applies to several situations. For example, items with a value above a level set by the IRS must be capitalized. Capitalized items must be expensed over their economic life. For example, an item with an expected life of five years, can only claim as a business expense one fifth of the cost of the item each of the first five years. The matching principle simply matches expensing to the useful life of the capital item purchased. |
| Tax Accounting | The tax due from a corporation is the business of the IRS, not the SEC. The IRS bases the tax it collects from companies upon money that has already been received or spent by the corporation. The one exception deals with items that must be expensed over several years, as governed by the matching principle. This is why the method is termed a "modified cash basis". |

Thus we have Financial Reporting prescribed by the SEC and tax reporting prescribed by the IRS with different procedures that yield different perspectives about the companies. SEC reports include the income statement, the balance sheet and a couple other important statements, one of which is the statement of cash flows that we will get into in more detail later.

For more information on tax accounting and financial reporting read Intermediate Accounting, Twelfth Edition, Kieso, et al, John Wiley and Sons, 2004, ISBN-13 978-0-471-74955-4, pp 963-1018.

**Some further definitions:**

| | |
|---|---|
| Cost: | The amount of money spent on an item consumed in the production of a product. An example would be the cost of the lemons to make lemonade. |
| Income Statement | An accrual based Financial Reporting Statement that summarizes the money customers have committed to pay for products or services. The income statement *covers a period* of time, i.e. the reporting period. It begins with revenue and then subtracts accrual based costs, expenses and a provision for taxes that approximates what would be due to the IRS, IF cash had been received for all shipments and cash had been paid for all costs and expenses. Statements are due to the SEC quarterly and annually.<br>Synonyms: Earnings Statement, Statement of Operations |
| Balance Sheet | An accrual based Financial Reporting Statement that balances assets the company has with the sum of liabilities (debt) it owes plus equity (what it has paid for). The balance sheet states the position of the company at *the point in time at the* *end of the reporting period*. Statements are due to the SEC quarterly and annually. |
| Assets | Assets are physical and intangible items in the possession of the company that it owns or is committed to buy. |
| Current Assets | Assets estimated to be consumed in a year or less. An example of a current asset is inventory. |
| Goodwill | An intangible asset that represents the amount a company paid for another business above its book value. Accounting rules allow companies to expense goodwill if it finds the goodwill no longer has economic value. |
| Liabilities | What the company owes in debt and other instruments. |
| Current Liabilities | Current liabilities are liabilities with a life of less than one year. An example of a current liability is the portion of long term debt that is due within the year. |
| Statement of Cash Flows | A cash based Financial Reporting Statement that displays a summary of the sources and uses of cash. Statements are due to the SEC quarterly and annually. |
| Expense: | The amount of money spent by a business other than in the production of a product. Examples include sales, marketing, general administration expenses, R&D, interest expense, etc. |

| | |
|---|---|
| Depreciation | The expense recorded on an income statement for the *portion* of a *physical* asset that no longer has economic value. For example, consider a machine a company has purchased for $5000 with an expected life of five years. Using the matching principle the company is allowed to (depreciate) expense $1000 per year for five years to account for the cost of the machine used in the business. This method of accounting is driven by the "Matching Principle" described above. |
| Amortization | An expense recorded on an income statement for a *non-physical* asset owned by the company. For example, consider a patent the company owns with an assigned value of $17,000 and that it expects to have a useful life of 17 years. The company will expense (amortize) $1000 each year for 17 years to write down the value of the patent as the business monopoly granted by the patent expires. This method of accounting is also driven by the "Matching Principle" described above. |
| Business Model: | The way the company turns its product or service into revenue and ultimately profit. For example Honda requires expensive inventory of parts, labor, marketing, sales, engineering and other expenses. Compare that to Microsoft that has very little inventory of parts, few production people, but a major R&D program and marketing effort. Comparing companies' financial data should be done with each company's business model in mind. If the business models are similar, the comparison will be more valid. |
| FASB | The Financial Accounting Standards Board is a private trust set up by the American Institute of Certified Public Accountants. It is commissioned by the SEC to conduct research on accounting issues, write financial accounting standards and advise the Securities and Exchange Commission (SEC) on the adoption of new standards and changes to older accounting standards. FASB has an advisory group with representatives from large financial institutions. There is currently no representation from individual investor organizations such as BetterInvesting. |
| Revenue | The amount of money recorded on an income statement for products or services that have been shipped or delivered, whether or not payment has been made for the products or services. Revenue is also commonly called sales. Synonym = sales |
| Deferred Revenue | The amount of money prepaid by a customer whose product has not been shipped or service whose service has not been delivered. For example, for a newspaper company, the balance of a subscription not yet sent to a subscriber. The company has an outstanding liability and |

| | |
|---|---|
| | can only relieve that liability by shipping the remainder of the papers as promised. |
| Accounts Receivable (AR) | The amount of money owed to a company for a product or service that has been shipped but for which payment has not yet been made. |
| Cost of Sales (COS) | The costs associated with manufacturing a product or delivering a service. These costs include the materials, direct labor and manufacturing overhead associated directly with building the product or delivering the service. Synonym = Cost of Goods Sold (COGS) |
| Accounts Payable (AP) | The amount of money a business owes to its suppliers. |
| Stock Option Expense | Many companies give their officers and key employees Incentive Stock Options that allows employees to buy stock in their company at today's price for some specified number of years in the future. In recent years the SEC has required companies to expense the options during the time the options become available for exercise, (purchase by the employee). |
| Notes… Financial… | Notes to the Consolidated Financial Statements: In SEC 10-K and 10-Q filings, immediately following the financial statements there are a series of notes that explain details about the statements. These often are rich in information valuable to investors. |

## Income Statement

The income statement uses accrual accounting to estimate the amount of money a company is committed to derive from its business. The first line item at the top of the income statement is revenue. Revenue is the amount of money for which the company has received orders, shipped the orders and has a reasonable expectation that it will collect the money from the products it has shipped or the services it has rendered. The portion of the revenues that have been shipped and not paid for are called "Accounts Receivable" (AR) and logged on the balance sheet as a current asset.

The money it takes to build products is often called the "Cost of Sales" (COS). This is generally the second line on the income statement and is of course subtracted from revenue. The result is the amount of money left after taking away the materials, labor and overhead costs of making the product. This is called ***"gross margin."*** The costs of the materials used may or may not have been paid for by the company. The unpaid part of the COS is "Accounts Payable" (AP). COS may also include some small amounts of accrued (not paid for yet) labor and other miscellaneous items. AP is logged on the balance sheet a current liability.

Expenses are then listed. Expenses are costs that are incurred by a business to sell their products, design new ones, and recover the business costs associated with buying items that last one year or longer, (depreciation, amortization, depletion allowances, and incentive stock option expense.) The latter items are called non-cash expenses (NCE) because there is no expenditure of cash for these items during the current reporting period. The accrual parts of expenses include accrued and prepaid expenses. Expenses are summed and subtracted from the gross margin to arrive at "***operating profit."***

Next, other income the company has received from various sources and interest expense on things such as its short term and long term debt is summed and subtracted from operating profit. The result is generally termed ***"income before provision for taxes".*** BI calls this pre-tax profit or ***PTP.***

Next, taxes are estimated based upon several factors. The line item describing these taxes is often called ***"provision for taxes", as stated earlier.*** It is important to note that these are not the taxes due or the taxes paid. Remember that the income statement, balance sheet and statement of cash flows are for "Financial Reporting". Tax reporting is NOT accrual accounting based, but uses "modified cash accounting". The taxes paid during the reporting period can generally be found in the Notes to the Consolidated Financial Statements.

Next, the provision for taxes is subtracted from PTP to arrive at N***et Income (NI***). NI is then divided by the number of shares outstanding to arrive at ***"basic earnings per share"*** Many corporations issue Incentive Stock Options to their officers, directors and key employees with the intent of giving them more incentive to do those things that will make the stock price rise. In doing this, more new shares are issued, making it necessary to divide more shares into the same earnings, thus diluting the value of each share. Recognizing that many of these options are financially significant ***"diluted earnings per share"*** is also calculated. This is done by adding the number of shares of stock not yet issued but "in the money" (meaning if the holder of the option were to exercise the option, they would be able to buy it at a price lower than the market price.) to the shares outstanding and then dividing the net income by that sum.

## The Balance Sheet

The Balance Sheet uses a simple formula:

Assets = Liabilities + Shareholders' Equity.

A company has two ways of funding itself:
1. Creditors who loan money that must be paid back with interest
2. Owners, who expect compensation for risking their money and delaying consumption (the Equity part of the equation).

The Assets are listed in order of liquidity; typically:

Cash and cash equivalents
Marketable securities available within a year
Accounts receivable
Inventories
etc.etc.

These **Current Assets**, (Current = available within 1 year), are subtotaled

Then Property and Equipment, Goodwill and other assets are listed for a **Total Assets** sum.

Liabilities and Shareholders' Equity also have a **Current Liability** section first, showing obligations that must be paid within 1 year:

Current portion of long-term debt
Accounts payable
Accrued expenses (a variety here)

Then long term debts, resulting in a **Total Liabilities** line.

Subtract the total liabilities from the total assets and what is left over is what the company owns, often called the **Shareholders Equity.**

## <u>Interpretting Income Statements and Balance Sheets</u>

Income Statements and Balance Sheets are required by the SEC quarterly and annually. The theory behind using accrual accounting for these statements is that the information contained in accrual statements better shows *<u>what is happening</u>* in the business process. In this way the sales and costs of operating a business and projecting what *might* happen in the future is easier to forecast. However, these statements often reflect an optimistic picture of the future in that the data assumes money not received *will* be collected, debts owed by the company to its suppliers *will* be paid, inventory acquired *will* be built into product that will sell, etc. Of course they are incapable of predicting the many up ticks and down ticks in the general economy which often disrupt the best of businesses. Still, many investors argue that this accounting method allows for meaningful comparisons from quarter to quarter and year to year and represents economic reality. In fact, these statements are the most common financial statements used to judge the value of a company and to make comparisons among them.

However, these two statements don't tell much about hard cash. Clearly cash is what it takes to keep a company healthy. In fact, a company can be growing its profitability while taking on huge debt and running out of the cash needed to operate the business. Thus, well informed investors should understand the Statement of Cash Flows.

## <u>The Statement of Cash Flows</u>

We begin the study of the Statement of Cash Flows and recall that:

***Revenue***
***minus Costs***
***minus Expenses***
***minus Provision for Taxes***

## *= Net Income*

**<u>The Statement of Cash Flows, (SCF)</u>**

Starting in the 1980's a third statement was required that uses ***cash accounting*** to explain changes in balance sheet accounts that were not the result of transactions recorded in the income statement. It became a financial statement required by the SEC in 1988. This statement continues to evolve a little more each year since it became a required filing.

The SCF requires all monetary transactions of a business to be presented in one of three categories: Cash Flow from Operating Activities, Cash Flow from Investing Activities, or Cash Flow from Financing Activities. It is intended to show the changes in a company's cash position during an accounting period.

The SCF is balanced by the following equation: Cash and Cash Equivalents from the prior period + cash flow from operating activities + cash flow from investing activities + cash flow from financing activities = cash and cash equivalents for the current period. Another way of saying this is that the balance of cash from the prior period plus the sum of operations, investing and financial activities is equal to the cash left at the end of the current period. So a company starts with some amount of cash, generates new cash from operations, spends that cash on investing activities and financing activities and is left with a balance of cash at the end of the current period. These activities are summarized in the Statement of Cash Flows.

Cash Flow from Operating Activities (CFO) is very important to the investor. That's because when a company starts to have financial difficulties it shows up first in CFO. Most of the time it is written by taking the Income Statement and modifying it with data from the Balance Sheet (BS) and Notes from the Consolidated Financial Statements (NCS) to arrive at the amount of cash the company has retained from its operations. Note this isn't the same as the amount of money the operation of the business has actually made during this period although it is perhaps the closest thing to it.

Below is an explanation of how CFO is developed from the Income Statement, Balance sheet and Notes to the Consolidated Financial Statements. It is unlikely you will need to remember much of what is written about how to make theses adjustments. However, by going through them once, you should understand the reasons and the arithmetic involved and build confidence in what the numbers mean so you will be in a better position to make investment decisions. Please take a moment and reward yourself by understanding how the SCF is developed. By doing so you will better understand what these two statements mean.

## <u>Algebraic Summary of CFO</u>

**The summary below may be all the readers need to convince themselves of the validity of using the indirect method as described in detail below for generating the CFO portion of a Statement of Cash Flows.**

**Equation 1**
Net Income (NI) = Revenue – Costs – Expenses – Non-cash Expenses(NCE) – Provision for Taxes.

To covert NI to CFO make adjustments to each part of the income statement to change it from an accrual based document to a cash based document, as follows:

**Equation 2**
CFO = Revenue ± AR – COS ± AP – Expenses ± Accrued Expenses (AE) – NCE + NCE
– Provision for taxes ± Taxes Paid in Period

Note that the shaded items are = NI. Substituting NI for Revenue – Costs – Expenses – NCE – Provision for Taxes in the CFO equation above yields:

**Equation 3**
*CFO = NI ± AR ± AP ± AE + NCE ± Taxes Paid in Period*

*A cash flow statement prepared by 99+% of companies filing under U.S. GAAP uses the above format. It explains why these adjustments result in the cash generated and preserved at the end of a reporting period.*

## A more detailed explanation follows:

We begin a detailed explanation of how and why this works by noting that the income statement starts at the top of the statement with revenue and deducts costs, expenses and a provision for taxes, all with accrual elements. The bottom line of the income statement is net profit.

**Equation 1 above**

***Revenue***
***minus Costs***
***minus Expenses***
***minus Provision for Taxes***
***= Net Income***

The SCF is written by making the following adjustments:

**Equation 2 above**

***Revenue adjusted to cash***
***minus Costs adjusted to cash***
***minus Expenses adjusted to cash***

***minus Provision for Taxes adjusted to cash***
***= Cash Flow from Operating Activities***

***Let's first consider a company at the end of its first year of business. (Year 2 will be slightly more complex.) It must now generate a Statement of Cash Flows for the SEC. Here is a hypothetical example of what is done to adjust the income statement for accruals and create that statement.***

***1.*** . Revenue is adjusted by subtracting increases in AR. If the business model involves significant deferred revenue, increases will be added to revenue. The result is the actual cash receipts received.

***Revenue***
***minus Accounts Receivable***
***plus Deferred Revenue***
***= Cash Receipts***

2. COS is adjusted by subtracting increases in AP. Note that when the corporation has not yet paid a bill, it has more cash than after it has paid the bill. Thus the result of increasing AP is more cash on hand. This is not to say that the bill won't be paid. It may be paid the day after the filing, but cash will look better if AP increases.

***COS***
***Plus Accounts Payable***
***= Period Cash Costs***

3. It is easier to understand the adjustments made on expenses by breaking them down into two categories. The more important of these categories is non-cash expenses. These are expenses that have not resulted in the expenditure of cash during the reporting period. These include deprecation, amortization, stock option expense and perhaps a few others. Since no expenditure of cash occurred during the reporting period for any of these items, the entire amount of these expenditures is <u>*subtracted*</u> from the amount expensed on the income statement. Later it will be shown how this results in adding these non-cash expenses back into cash flow from operations.
   Next, any expenses accrued are subtracted, (such as salaries owed to but not yet paid to employees involved in the sales, R&D or other functions of a corporation not directly involved in the manufacture of product.)

***Expenses***
***minus Non-cash Expenses***
***minus Accrued Expenses***

***= Period Cash Expenses***

4. Next, any accrued interest income is subtracted from net interest and any prepaid (accrued) interest is subtracted from (added to) interest expense.

***Other Income***
***Minus accrued interest***
***Minus prepaid interest expense***
***Plus accrued interest expense***
***= Net Period Other Cash Income***

Finally the Provision for taxes is adjusted for taxes actually paid during the period. Current taxes, deferred tax assets and liabilities can generally be found in the first few pages after the Notes to the Consolidated Financial Statements. Adjust provision for taxes by first netting the deferred tax assets and liabilities due for the period, adding the current taxes due. The result is the total taxes payable that year. Since net income already includes provision for taxes, it is then necessary to subtract the total taxes payable from the provision for taxes. If the result is positive (negative), subtract (add) it from the provision for taxes

***Provision for Taxes***
***Plus or minus actual taxes paid***
***= Period Cash Taxes Paid***

### *Statements of Cash Flows After Year One*

There is inevitably some carry over of AP, AR, Inventory and various other period expenses. Therefore, to prepare statements in years after the first year, it is necessary to take the difference between this year's items and last year's items for the various items described above. For example, if AR has changed from year one to year two, it is necessary to find the change in AR and adjust revenue for that. To make the adjustment, if the change represents an increase (decrease) in AR, then this difference must be subtracted from (added to) year 2 revenue to arrive at year 2 Cash receipts.

For COS, if AP increased (decreased) in year 2 over year 1, subtract (add) the difference to arrive at year 2 Period Cash Costs.

Follow similar procedures for other accruals on the remaining parts of the income statement.

## Algebraic Summary of CFO Repeated here

**The summary below may be all the readers need to convince themselves of the validity of using the indirect method as described in detail below for generating the CFO portion of a Statement of Cash Flows works.**

**Equation 1**
Net Income = Revenue – Costs – Expenses – Non-cash Expenses(NCE) – Provision for Taxes.

**Equation 2**
CFO = Revenue ± AR – COS ± AP – Expenses ± Accrued Expenses (AE) – [NCE – NCE] – Provision for taxes ± Taxes Paid in Period

Substituting NI for Revenue – Costs – Expenses – NCE – Provision for Taxes in the CFO equation above yields:

***Equation 3***
*CFO = NI ± AR ± AP ± AE + NCE ± Taxes Paid in Period*

*A cash flow statement prepared by 99+% of companies filing under U.S. GAAP uses the above format. It explains why these adjustments result in the cash generated and preserved at the end of a reporting period.*

## Cash Flow from Investing Activities

If cash is (*spent),* it is enclosed in parentheses. If it is *generated*, it is not.
The bottom line for investing activities is the net figure *used* in investing activities, such as:

(Purchase) sale of property, plant and equipment
(Purchase) sale of short-term marketable financial instruments
(Cash investments in acquisitions or affiliates)

One's judgment of how healthy a company is can be greatly improved by understanding this portion of the statement of cash flows. For example, if the company is in a capital intensive business or is rapidly expanding, one would expect to see growth in the amount of money it is investing in plant and equipment. If it sees fewer opportunities for growth, it may cut back on spending in this area.

It is generally desirable to see a company with large reserves of marketable securities. This positions the company to take advantage of opportunities to buy smaller companies, invest in new business opportunities that come up and generally operate with greater financial flexibility.

## Cash Flow from Financing Activities

This portion of the statement of cash flows tracks money that flows between company, creditors and shareholders. (Amount is enclosed in parentheses if money goes out; if money comes in, no parentheses are present.)

Sales and (repurchases) of stock
Issuance and (repayment) of debt
` Cash received from the exercise of stock options
(Payment of dividends)

This is a particularly useful area for sharpening your judgment about an investment. The new issue of stock dilutes your stock and is a bad thing. You'll want to make sure the new issues do not result in a significant dilution of the company's earnings.

Excessive stock option grants to officers and employees also dilute your stock. The author's guideline is to keep stock options to less than 1 ½% of outstanding shares per year.

The assumption and repayment of debt provides the investor with additional data useful in deciding if the company is doing a good job managing its debt.

**Cash and Cash Equivalents (CCE)**

CCD tracks changes in cash from year to year. From the point of view of the investor, this generally is not a good source of information about the company. CCE can be and is increased or decreased at the complete discretion of management. It can be decreased by making a decision to buy more for sale securities and it can be increased simply by selling those securities or by taking on more debt. These decisions can be made at any time between reporting periods as the need for cash changes. Management simply makes a decision regarding how much money it needs on hand and from which source they would like to use to satisfy that need.

The following financial statements are copied and pasted directly from two companies most recent 10-K filings. Test your skills at reading these statements using what you have learned from the discussion above.

Panera Bread (PNRA) is a relatively new and fast growing company with a simple business model. It has been attempting to manage its business through the recent financial crisis, by paying off its debt, reducing the rate at which it adds new stores and addressing itself to the 90% of the population that is still employed. It has increased prices a small amount, increased new, higher margin items to its menu and reduced costs.

Eastman Kodak (EK) has been transitioning from a photographic film company to a digital photography and printing company. It was chosen as an example of a medium size company that has been going through difficult times and has a relatively complex set of financial statements.

**PANERA BREAD COMPANY**
**CONSOLIDATED BALANCE SHEETS**
**(in thousands, except share and per share information)**

| | December 30, 2008 | December 25, 2007 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 74,710 | $ 68,242 |
| Short-term investments | 2,400 | 23,198 |
| Trade accounts receivable, net | 15,198 | 25,152 |
| Other accounts receivable | 9,944 | 11,640 |
| Inventories | 11,959 | 11,394 |
| Prepaid expenses | 14,265 | 5,299 |
| Deferred income taxes | 9,937 | 7,199 |
| Total current assets | 138,413 | 152,124 |
| Property and equipment, net | 417,006 | 429,992 |
| Other assets: | | |
| Goodwill | 87,334 | 87,092 |
| Other intangible assets, net | 20,475 | 21,827 |
| Long-term investments | 1,726 | — |
| Deposits and other | 8,963 | 7,717 |
| Total other assets | 118,498 | 116,636 |
| Total assets | $ 673,917 | $ 698,752 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 4,036 | $ 6,326 |
| Accrued expenses | 109,978 | 121,440 |
| Total current liabilities | 114,014 | 127,766 |
| Long-term debt | — | 75,000 |
| Deferred rent | 39,780 | 33,569 |
| Other long-term liabilities | 21,437 | 14,238 |
| Total liabilities | 175,231 | 250,573 |
| Commitments and contingencies (Note 13) | | |
| Minority interest | 3,524 | 2,015 |
| Stockholders' equity: | | |
| Common stock, $.0001 par value: | | |
| Class A, 75,000,000 shares authorized; 29,557,849 issued and 29,421,877 outstanding in 2008; and 30,213,869 issued and 30,098,275 outstanding in 2007 | 3 | 3 |
| Class B, 10,000,000 shares authorized; 1,398,242 issued and outstanding in 2008 and 1,398,588 in 2007 | — | — |
| Treasury stock, carried at cost; 135,972 shares at December 30, 2008 and 115,594 shares at December 25, 2007 | (2,204) | (1,188) |
| Additional paid-in capital | 151,358 | 168,386 |
| Accumulated other comprehensive loss | (394) | — |
| Retained earnings | 346,399 | 278,963 |
| Total stockholders' equity | 495,162 | 446,164 |
| Total liabilities and stockholders' equity | $ 673,917 | $ 698,752 |

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

**PANERA BREAD COMPANY**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(in thousands, except per share information)**

| | For the fiscal year ended | | |
|---|---|---|---|
| | December 30, 2008 | December 25, 2007 | December 26, 2006 |
| Revenues: | | | |
| Bakery-cafe sales | $ 1,106,295 | $ 894,902 | $ 666,141 |
| Franchise royalties and fees | 74,800 | 67,188 | 61,531 |
| Fresh dough sales to franchisees | 117,758 | 104,601 | 101,299 |
| Total revenue | 1,298,853 | 1,066,691 | 828,971 |
| Costs and expenses: | | | |
| Bakery-cafe expenses: | | | |
| Cost of food and paper products | 332,697 | 271,442 | 196,849 |
| Labor | 352,462 | 286,238 | 204,956 |
| Occupancy | 90,390 | 70,398 | 48,602 |
| Other operating expenses | 147,033 | 121,325 | 92,176 |
| Total bakery-cafe expenses | 922,582 | 749,403 | 542,583 |
| Fresh dough cost of sales to franchisees | 108,573 | 92,852 | 85,951 |
| Depreciation and amortization | 67,225 | 57,903 | 44,166 |
| General and administrative expenses | 84,393 | 68,966 | 59,306 |
| Pre-opening expenses | 3,374 | 8,289 | 6,173 |
| Total costs and expenses | 1,186,147 | 977,413 | 738,179 |
| Operating profit | 112,706 | 89,278 | 90,792 |
| Interest expense | 1,606 | 483 | 92 |
| Other (income) expense, net | 883 | 333 | (1,976) |
| Income before minority interest and income taxes | 110,217 | 88,462 | 92,676 |
| Income (loss) allocable to minority interest | 1,509 | (428) | — |
| Income before income taxes | 108,708 | 88,890 | 92,676 |
| Income taxes | 41,272 | 31,434 | 33,827 |
| Net income | 67,436 | $ 57,456 | $ 58,849 |
| Per share data: | | | |
| Net income per share | | | |
| Basic | $ 2.24 | $ 1.81 | $ 1.88 |
| Diluted | $ 2.22 | $ 1.79 | $ 1.84 |
| Weighted average shares of common and common equivalent shares outstanding: | | | |
| Basic | 30,059 | 31,708 | 31,313 |
| Diluted | 30,422 | 32,178 | 32,044 |

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

PANERA BREAD COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | For the fiscal year ended December 30, 2008 | December 25, 2007 | December 26, 2006 |
|---|---|---|---|
| Cash flows from operations: | | | |
| Net income | $ 67,436 | $ 57,456 | $ 58,849 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 67,225 | 57,903 | 44,166 |
| Loss from short-term investments | 1,910 | 967 | — |
| Stock-based compensation expense | 7,954 | 7,255 | 8,171 |
| Tax benefit from exercise of stock options | (3,376) | (3,731) | (4,346) |
| Income (loss) allocable to minority interest | 1,509 | (428) | — |
| Deferred income taxes | (4,107) | (7,276) | (3,065) |
| Other | 228 | 725 | (222) |
| Changes in operating assets and liabilities, excluding the effect of acquisitions: | | | |
| Trade and other accounts receivable | 11,650 | (5,549) | (4,515) |
| Inventories | (565) | (1,798) | (1,156) |
| Prepaid expenses | (8,966) | 6,884 | (6,300) |
| Accounts payable | (2,290) | (815) | 1,378 |
| Accrued expenses | 5,450 | 32,398 | 7,629 |
| Deferred rent | 6,211 | 5,885 | 3,749 |
| Other long-term liabilities | 6,013 | 4,138 | 2,557 |
| Net cash provided by operating activities | 156,282 | 154,014 | 104,895 |
| Cash flows from investing activities: | | | |
| Additions to property and equipment | (83,163) | (124,133) | (109,296) |
| Proceeds from sale of assets | — | 1,844 | 1,883 |
| Acquisitions, net of cash acquired | (2,704) | (71,039) | (9,101) |
| Short-term investments transferred from cash and cash equivalents | — | (26,526) | — |
| Purchase of investments | — | — | (30,619) |
| Investment maturities proceeds | 17,162 | 22,361 | 57,200 |
| Decrease (increase) in deposits and other | 1,042 | 231 | (984) |
| Net cash used in investing activities | (47,663) | (197,262) | (90,917) |
| ing activities: | | | |
| Net (payments) borrowing under credit facility | (75,000) | 75,000 | — |
| Repurchase of common stock | (48,893) | (27,487) | — |
| Exercise of employee stock options | 17,621 | 6,576 | 7,716 |
| Tax benefit from exercise of stock options | 3,376 | 3,731 | 4,346 |
| Proceeds from issuance of common stock | 1,898 | 1,782 | 1,606 |
| Capitalized debt issuance costs | (1,153) | (209) | — |
| Net cash (used in) provided by financing activities | (102,151) | 59,393 | 13,668 |
| Net increase in cash and cash equivalents | 6,468 | 16,145 | 27,646 |
| Cash and cash equivalents at beginning of period | 68,242 | 52,097 | 24,451 |
| Cash and cash equivalents at end of period | $ 74,710 | $ 68,242 | $ 52,097 |
| | | | |
| Supplemental cash flow information: | | | |
| Cash paid during the year for: | | | |
| Interest | $ 1,748 | $ 165 | $ — |
| Income taxes | $ 37,328 | $ 28,493 | $ 42,227 |
| Noncash investing activities: | | | |
| Accrued property and equipment purchases | $ 6,448 | $ 17,473 | $ 23,396 |
| Accrued acquisition purchase price | $ — | $ 2,501 | $ 8,650 |

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

**Eastman Kodak Company**
**CONSOLIDATED STATEMENT OF OPERATIONS**

| (in millions, except per share data) | For the Year Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| Net sales | $ 9,416 | $ 10,301 | $ 10,568 |
| Cost of goods sold | 7,247 | 7,757 | 8,122 |
| Gross profit | 2,169 | 2,544 | 2,446 |
| Selling, general and administrative expenses | 1,583 | 1,778 | 1,969 |
| Research and development costs | 501 | 549 | 596 |
| Restructuring costs, rationalization and other | 140 | 543 | 416 |
| Other operating expenses (income), net | 766 | (96) | (59) |
| Loss from continuing operations before interest expense, other income (charges), net and income taxes | (821) | (230) | (476) |
| Interest expense | 108 | 113 | 172 |
| Other income (charges), net | 55 | 87 | 65 |
| Loss from continuing operations before income taxes | (874) | (256) | (583) |
| (Benefit) provision for income taxes | (147) | (51) | 221 |
| Loss from continuing operations | (727) | (205) | (804) |
| Earnings from discontinued operations, net of income taxes | 285 | 881 | 203 |
| NET (LOSS) EARNINGS | $ (442) | $ 676 | $ (601) |
| Basic and diluted net (loss) earnings per share: | | | |
| Continuing operations | $ (2.58) | $ (0.71) | $ (2.80) |
| Discontinued operations | 1.01 | 3.06 | 0.71 |
| Total | $ (1.57) | $ 2.35 | $ (2.09) |
| Cash dividends per share | $ 0.50 | $ 0.50 | $ 0.50 |

**Eastman Kodak Company**
**CONSOLIDATED STATEMENT OF FINANCIAL POSITION**

| (in millions, except share and per share data) | As of December 31, 2008 | 2007 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS** | | |
| Cash and cash equivalents | $ 2,145 | $ 2,947 |
| Receivables, net | 1,716 | 1,939 |
| Inventories, net | 948 | 943 |
| Other current assets | 195 | 224 |
| Total current assets | 5,004 | 6,053 |
| | | |
| Property, plant and equipment, net | 1,551 | 1,811 |
| Goodwill | 896 | 1,657 |
| Other long-term assets | 1,728 | 4,138 |
| **TOTAL ASSETS** | $ 9,179 | $ 13,659 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **CURRENT LIABILITIES** | | |
| Accounts payable and other current liabilities | $ 3,267 | $ 3,794 |
| Short-term borrowings and current portion of long-term debt | 51 | 308 |
| Accrued income and other taxes | 144 | 344 |
| Total current liabilities | 3,462 | 4,446 |
| | | |
| Long-term debt, net of current portion | 1,252 | 1,289 |
| Pension and other postretirement liabilities | 2,382 | 3,444 |
| Other long-term liabilities | 1,122 | 1,451 |
| Total liabilities | 8,218 | 10,630 |
| | | |
| Commitments and Contingencies (Note 10) | | |
| | | |
| **SHAREHOLDERS' EQUITY** | | |
| Common stock, $2.50 par value, 950,000,000 shares authorized; 391,292,760 shares issued as of December 31, 2008 and 2007; 268,169,055 and 287,999,830 shares outstanding as of December 31, 2008 and 2007 | 978 | 978 |
| Additional paid in capital | 901 | 889 |
| Retained earnings | 5,879 | 6,474 |
| Accumulated other comprehensive (loss) income | (749) | 452 |
| | 7,009 | 8,793 |
| Treasury stock, at cost; 123,123,705 shares as of December 31, 2008 and 103,292,930 shares as of December 31, 2007 | (6,048) | (5,764) |
| Total shareholders' equity | 961 | 3,029 |
| **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | $ 9,179 | $ 13,659 |

**Eastman Kodak Company**
**CONSOLIDATED STATEMENT OF CASH FLOWS**
(in millions)

| | For the Year Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net (loss) earnings | $ (442) | $ 676 | $ (601) |
| Adjustments to reconcile to net cash provided by operating activities: | | | |
| Earnings from discontinued operations, net of income taxes | (285) | (881) | (203) |
| Depreciation and amortization | 500 | 785 | 1,195 |
| Gain on sales of businesses/assets | (14) | (157) | (65) |
| Non-cash restructuring and rationalization costs, asset impairments and other charges | 801 | 336 | 138 |
| Provision (benefit) for deferred income taxes | 16 | 54 | (168) |
| Decrease in receivables | 148 | 161 | 163 |
| (Increase) decrease in inventories | (20) | 108 | 292 |
| (Decrease) increase in liabilities excluding borrowings | (720) | (624) | 153 |
| Other items, net | (127) | (107) | (219) |
| Total adjustments | 299 | (325) | 1,286 |
| Net cash (used in) provided by continuing operations | (143) | 351 | 685 |
| Net cash provided by (used in) discontinued operations | 296 | (37) | 271 |
| Net cash provided by operating activities | 153 | 314 | 956 |
| Cash flows from investing activities: | | | |
| Additions to properties | (254) | (259) | (335) |
| Proceeds from sales of businesses/assets | 92 | 227 | 178 |
| Acquisitions, net of cash acquired | (38) | (2) | (3) |
| Investments in unconsolidated affiliates | - | - | (19) |
| Marketable securities - sales | 162 | 166 | 133 |
| Marketable securities - purchases | (150) | (173) | (135) |
| Net cash used in continuing operations | (188) | (41) | (181) |
| Net cash provided by (used in) discontinued operations | - | 2,449 | (44) |
| Net cash (used in) provided by investing activities | (188) | 2,408 | (225) |
| Cash flows from financing activities: | | | |
| Stock repurchases | (301) | - | - |
| Proceeds from borrowings | 155 | 177 | 765 |
| Repayment of borrowings | (446) | (1,363) | (1,568) |
| Dividends to shareholders | (139) | (144) | (144) |
| Exercise of employee stock options | - | 6 | - |
| Net cash used in continuing operations | (731) | (1,324) | (947) |
| Net cash provided by discontinued operations | - | 44 | - |
| Net cash used in financing activities | (731) | (1,280) | (947) |
| Effect of exchange rate changes on cash | (36) | 36 | 20 |
| Net (decrease) increase in cash and cash equivalents | (802) | 1,478 | (196) |
| Cash and cash equivalents, beginning of year | 2,947 | 1,469 | 1,665 |
| Cash and cash equivalents, end of year | $ 2,145 | $ 2,947 | $ 1,469 |

**Eastman Kodak Company**
**CONSOLIDATED STATEMENT OF CASH FLOWS (Continued)**

**SUPPLEMENTAL CASH FLOW INFORMATION**
(in millions)

| | For the Year Ended December 31, 2008 | 2007 | 2006 |
|---|---|---|---|
| **Cash paid for interest and income taxes was:** | | | |
| Interest, net of portion capitalized of $3, $2 and $3 (1) | $ 85 | $ 138 | $ 255 |
| Income taxes (1) | 145 | 150 | 96 |
| | | | |
| **The following non-cash items are not reflected in the Consolidated Statement of Cash Flows:** | | | |
| | | | |
| Pension and other postretirement benefits liability adjustments | $ 1,105 | $ 953 | $ 136 |
| Adjustment to initially apply SFAS No. 158 | - | - | 386 |
| Liabilities assumed in acquisitions | 2 | - | - |
| Issuance of unvested stock, net of forfeitures | 1 | 6 | 1 |

(1) Includes payments included in expense of discontinued operations.

45

The following are selected copies of slides used in a hands on workshop on Financial Statements conducted in May, 2009 at a BetterInvesting Workshop Event. The workshop taught how to use ratios and judgments on information in the financial reports of select companies to aid in making buy and sell decisions on stocks of these companies.

# Improving SSG Judgments by using Financial Statements

## Approach to Investing

- Evaluate many, choose few.
- Screen with SSG including QTG
- Research independent opinions
- Check out recent financials from SEC
- Finalize the SSG and make a decision.

## The Plan

- Make it Hands On
  - Get onto web
- A few tips on the SSG
- Finding Financial Statements
- Finding Definitions of Line Items
- Interpreting the Statements
- Practice

## The Big Important Stuff (for all companies)

- Evidence of good management, SSG screen
- Room to Run (QTG or PERT Graph)
  - Growth Companies = growing market
  - Value Companies = legs to recover
- Strongest of head-on competitors
- Morningstar 4-5 star or *independent* analysts buy recommendation
- Financials
  - Easy to understand
  - Manageable or no debt.
  - Marketable securities
  - Sales growth (rate faster than) earnings
  - P/E lower than 1 yr historical average = low stock price
  - Mid or small cap.
  - Solid OPERATIONS cash management, (A/R, Inventory, A/P)
  - Attractive business model

## Getting Financial Data

- Get latest & historical data
- As submitted to SEC
- http://sec.gov/edgar
- Edgar is Electronic data gathering and retrieval.
- Free (except for the Fed taxes you pay!)

## What do those line items mean?

- www.betterinvestingsandiego.org
  - Tools & Resources
  - Background on Financial Statements
- Google searches for "Financial Terms", "Financial Dictionary", etc. will work.
- http://www.finance-glossary.com/

# Operations Management

- Average collection times from customers, Inventory management, Paying their suppliers.
- Failure can lead to bankruptcy
- Divide quarterly A/R by quarterly revenue = fraction of quarter it takes to collect from customers.
- Divide quarterly Inv by quarterly COS = fraction of a quarter's inventory.
- Divide quarterly A/P by quarterly COS = time it takes to pay suppliers.

# Marketable Securities

- Strong companies make enough money to invest in treasuries and other conservative readily marketable securities.
- These can be used to acquire other companies, buy capital equipment, etc.  All good stuff.
- Go to Cash Flow Statement, Investing Activities.  Net

# Change in Shares Outstanding

- Go to cash flow from financing activities
- Is the company issuing new shares, net or buying back shares?
- Issuing new shares by granting options, new public issues dilute the value of your investment.

# Incentive Stock Options

- Granting stock options helps attract the best people but dilutes eps.
- For a growth tech company or high growth pharma company about 1%/yr increase in stock is the norm.
- Go to the “Financing Activities” of the cash flow statement to evaluate this.

## Operating Cash Flow

- Is operating cash flow growing steadily with net income?
- Some companies go bankrupt because they go far into debt and run out of cash to pay their employees, suppliers and debt holders
- Consider companies whose CFO grows in proportion to its net income.
- Lucent sold to Alcatel when it failed to manage CFO

## Plant, Property & Equipment

- Does the growth of their business depend upon the company continuing to invest in new capital?
- Slowing business = slowing CapX. Growing business = growing CapX
- Go to Investing Activities in the cash flow statement and compare several years.

# Acquisitions

- Requires big expenditures
  - Cash
  - Stock
  - Debt
- Always follow the Debt of companies growing by acquisition.
- Be careful of all Stock acquisitions
- Cash from marketable securities