INTRODUCTION TO FINANCIAL STATEMENT ANALYSIS

CHECKLIST AND HELPFUL HINTS

By Tom Taulli, author of *The EDGAR Online Guide to Decoding Financial Statements*

THE RED FLAGS

POTENTIAL BAD SIGNS…	YES	NO
Late filing of a required document with the SEC		
Change in auditor because of a dispute		
Resignation of a top executive without a replacement in the wings		
Press releases that hype the business		
Highlighting pro forma numbers over GAAP numbers		
Potentially major litigation exposure, such as for environmental liabilities or patent battles		
A “qualified opinion” or “going concern” statement from the company’s auditor		
Incorporation in an exotic locale such as the Caribbean		
Labor dispute		
A variety of related-party transactions (Special Purpose Entities - SPEs)		
Loan default		
Several insiders dumping substantial amounts of stock		
A major write-down for inventory or goodwill		
Excessively large salaries and option grants		
Major product recall		

Specifically for the Balance Sheet

POTENTIAL BAD SIGNS…	YES	NO
Increased debt levels combined with slowing revenue growth		
Use of optimistic estimates to pump up returns on the pension fund assets		
Use of operating leases as a way to get debts off the balance sheet		
Use of SPEs and other techniques to get debts off the balance sheet		
Convertible financing maneuvers that involve “resets” or “floorless” features		

Specifically for the Cash Flow Statement

POTENTIAL BAD SIGNS…	YES	NO
Erratic cash flows		
Companies with negative cash flows. In most cases, avoid the stock.		
Companies whose free cash flow does not meet mandatory interest payments. You want some margin of error for being able to meet these obligations.		

SPECIFICALLY FOR THE INCOME STATEMENT

POTENTIAL BAD SIGNS…	YES	NO
Changes in revenue mix. Is it changing to lower-margin products or services? If so, the company may see lower profits and a lower stock price in the future.		
Mature or declining industry stage. Is the industry full of competitors or falling into a slump? If so, you probably want to avoid or sell the stock.		
Too many acquisitions. Engaging in numerous acquisitions may be a way to keep pumping up sales and profits while the underlying (core) business is deteriorating.		
An immediate jump in revenue after a merger. It can be a sign that a company is engaging in accounting shenanigans.		
A decline in backlog. It is a sign of slackening growth.		
Increased vendor financing. It may cast doubts on the quality of sales		
Allowance for doubtful accounts. If sales are increasing, but this figure is staying the same, it could mean problems in the future.		
Accounts receivable growing faster than sales? If the ratio is increasing, the company may be having trouble collecting sales or is granting sales/credit terms to customers that are too generous.		
Practices such as “unbilled revenues” and “bill and hold”		
Significant cuts in R&D. Cuts of 25 percent or more indicate that the company may be damaging its ability to generate new revenue streams in the future to project better earnings numbers now.		
Changes in accounting polices, such as capitalizing expenses and lengthening the period for depreciation or amortization. It generally indicates a wish to look better than the actual condition justifies.		

The Green Flags

POTENTIAL GOOD SIGNS…	YES	NO
Company buy-back of shares (assuming the company is healthy)		
Use of innovative management techniques, such as Six Sigma, Lean		
Large amounts of insider buys		
Several insiders buying stock (that is, cluster buying)		
Insider buying when the stock hits a new low or a new high		

Other Helpful Tips…

1. The Business Model

What is the business model? Can it be sustained? What are the threats? If it sounds too good to be true, it probably is.

2. Listen to the Company

What's the vision of the company? Clear and sustainable? Vague and unrealistic? Be sure to read the shareholder letters, Management Discussion and Analysis and Footnotes in the annual report, listen to conference calls & watch TV interviews. Follow the company like your favorite sports team.

3. Ratio Comparisons

Look at the Excel Spreadsheet that comes with this toolkit to see how the ratios are computed and to become familiar with them. Compare the ratios to industry peers and the company's past and predicted performance. Better? Worse? What's the trend?

4. Information Is Everything

Look everywhere for information. Be creative. Talk to experts, read trade publications, attend trade shows, join an investment club and read local (to the company) newspapers.