Making a Statement: 10-Ks, 10-Qs and Company Financials

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Peter Hand is an investment analyst with the North American Equity Team at Aberdeen Asset Management in Philadelphia. Hand joined Aberdeen full-time in 2010 as a graduate business analyst, having interned with the North American Equity Team in 2008. Previously, he worked as an economist for the Department of Homeland Security in Washington, D.C. Hand graduated with an economics degree from Princeton University in 2009. He sat down with Knowledge@Wharton High School editor Diana Drake to discuss 10-Ks, balance sheets and other important company financial statements.

Below is an edited transcript of the conversation.

KWHS: Peter Hand is an investment analyst on the North American Equity Team at Aberdeen Asset Management in Philadelphia. He's going to talk with us today about the key to understanding financial statements. Peter, thank you for joining us.

Peter Hand: My pleasure.

KWHS: Before we get into 10-Ks and balance sheets, can you tell us a little about yourself and your job at Aberdeen? What is an investment analyst on the North American Equity Team? What exactly do you do?

Hand: Sure. Our team has about a dozen members split up between equity managers and equity analysts. Basically, all managers are analysts as well. So, what we all do is look at a wide range of companies. Our accessible markets are public securities [shares of companies that trade on the stock market] in the United States and Canada. We analyze companies to create portfolios [collections of varied investments] for our clients that we feel will achieve a sensible but positive return, with the ultimate goal of increasing our clients' wealth. Daily activities include meeting with management teams from companies in a wide range of sectors, as well as occasionally [meeting with] analysts from other firms who can give us insights into some different sectors and give us in-depth analysis of industry trends. We also meet with clients on a regular basis to update them on the state of the portfolios.

KWHS: Describe your career track. How did you make your way to Aberdeen?

Hand: I started as an intern with Aberdeen in 2008. I was a junior in college at the time, so I did the familiar track of college internship towards future employment. I did graduate in 2009, which was not the most desirable job market. Aberdeen was not hiring at the time. I went down to Washington, and I worked as an economist for a year for [the federal department of] Homeland Security. I got a call from Aberdeen saying it was hiring for a new program, a rotational program that ultimately led me back to the U.S. Equity Team, where I started in the first place.

KWHS: Why did you choose finance?

Hand: I've always thought it was an interesting field. I went to Princeton University, where we don't have a finance department – it's not a major. So, I majored in economics and took a few financial classes on the side. It had always been something that interested me. I had a number of friends who were older than I, who had gone on to work in various sectors of finance and investment banking, asset management. It's just something that I always found fascinating —

watching CNBC and the financial markets. It was something I thought I'd like to try my hand at. My internship proved to me that it was something that I was capable of doing, but also something that I really enjoyed — and that I think I'd like to build a career around.

KWHS: Okay, now onto financial statements.

Hand: Sure.

KWHS: First of all, what is the U.S. Securities and Exchange Commission?

Hand: The Securities and Exchange Commission, or the SEC, is a government agency that's based in Washington, D.C., which is tasked with controlling publicly traded securities and the markets in which they are traded. All companies that are publicly traded have to file their reports with the SEC on a regular basis. They are subject to the stringent standards that the SEC imposes … with the overall goal of protecting the investing public.

KWHS: What does it mean to be a publicly traded company, versus a privately held company?

Hand: The United States has any number of companies — I couldn't even fathom a guess [as to how many]. Some are privately held, and some are publicly traded. Publicly traded companies are those that list on a stock exchange, and their shares are freely traded among investors – either individual investors, if you trade in your personal account, or institutional investors who trade for clients that are pension funds and endowments. It just means that the shares are freely traded on the open market. If investors think that a share is undervalued — that a company is worth more than the market would suggest — then they will buy the shares in the hopes that the security will appreciate, and they can eventually make money on the long-run return.

KWHS: What are the primary disclosure documents that a company must file, and why do they have to file them?

Hand: There are two or three main documents that companies file regularly with the SEC, that investors like myself generally look at. The first is the 10-K, which is an annual form that's filed with the SEC, which is an update on the state of the business over the last year. It has to be filed within a certain time frame at the end of the year, after the company's fiscal fourth quarter, and it includes three basic financial statements: the income statement, the balance sheet and the statement of cash flows [which are defined later in this interview]. It also includes a management discussion and analysis, where the management team will update the reader on what happened over the last year, how the company fared in the markets, how the operations went, any major changes that the company underwent to strategy, or in terms of business operations. It's an in-depth look at how the company performed, and how the company is positioned to perform, going forward.

The 10-Q is almost the same document, but it's filed on a quarterly basis, at the end of each quarter. It's a briefer document that basically goes over the results for the quarter and any major changes. It has consolidated versions of everything I just spoke about for the 10-K. So, it has the financial statements, and it has a brief discussion and analysis. The third document that is filed is the proxy statement, in which the company's [board of directors] lays out plans for the general meeting of shareholders — which all shareholders are eligible to attend — and certain items that shareholders are eligible to vote on, such as management compensation, the election of directors and any kind of major changes to the business that require shareholder approval.

Those are the three documents that are filed regularly. There are tons of others that are filed with the SEC on an ongoing basis. [For example], any time a director sells a lot of shares, [he or she] is required to disclose that to the SEC. So, there are a ton of these other smaller documents that you can read through to get a sense of where things are in the intermediate term, between the 10-Qs and 10-Ks.

KWHS: These are filed just to make sure that everybody out there knows what's going on within the company?

Hand: Right. They're filed for the purposes of transparency and full disclosure. The SEC doesn't want a disconnect between what management knows and what the investing public knows. Obviously, there will be some disconnect, because otherwise we get into instances of insider trading, where management will know certain things that the public can't know until a certain date, such as pending acquisitions or transactions. But the general point of these documents is so that the investors and the general public can see how things are going — and management can't hide anything.

KWHS: Let's get into some of these specific statements. What is an income statement and what does it tell investors about a company?

Hand: The income statement actually has a couple of names that give insight into what it is. It's also called the profit-and-loss statement, or P&L. It basically outlines all the income and expenses that the company has incurred or received over the past year. What they call the top line is revenues, and that's how much money the company [made] in sales over the last year. Then when you subtract out cost of goods sold and general expenses, you get down to a general level of earnings for the company, [also called] a broad profit, or gross profit. Then when you subtract out further line items from there, you get down to the actual net income that the company made, accounting for stuff like interest expense, or how much they have to pay on debt. that brings you down to [the company's] operating profit for the year.

Operating profit is then divided by the number of outstanding shares for a metric that we call "earnings per share," which is ultimately what most people look at each quarter [to evaluate how the company is doing]. [Is the company's] earnings per share increasing at a sustainable rate? That's the ultimate indicator of how the business fared over the last quarter.

KWHS: What is a balance sheet, and what does it tell investors?

Hand: A balance sheet outlines, at a specific point in time, the assets [property of some kind owned by a company that has value] and liabilities [amounts owed by a business] that the company has to its name. It is required to balance the general equation that assets equal liability plus equity [the value of an ownership interest in property]. The assets and the liabilities, plus the total shareholder's equity, must always be in balance. Anything that increases assets must have a corresponding increase to liabilities. Shareholders equity is the number of shares outstanding, times the market price, or how much you can buy [the company] for on a stock exchange. The assets that are included in [the balance sheet] include inventory and receivables, which are how much stuff the company has in their books, or in their warehouses, at the end of the quarter. Liabilities include debt, accounts payable, or how much [the company] owes people or other companies or customers. [The balance sheet] is a snapshot of how the company's assets and liabilities stack up at any point in time.

KWHS: Okay. How about a cash flow statement?

Hand: A cash flow statement is the third financial statement that comes with the filings. It's a metric to figure out how the company's cash and cash equivalents change through the quarter — how much actual money the company has on its books. It's broken down into three parts: cash flow from operations, cash flow from investing and cash flow from financing. There are several intricacies about how things are classified. But generally, cash flow from operations includes any major purchases or transactions the company made during the quarter. It's anything that happened during the normal course of business. Cash flow from investing involves debt securities and dividends paid. And cash flow from financing includes dividends received, or money that the company received from issuing debt. A broad list of things goes into each of these categories. But generally, it's how the company's cash balances changed throughout the quarter, or the year.

KWHS: And it's important for investors to follow all these statements in order to understand the financial health of a company, correct?

Hand: Yes. Each one ties into the others. There are certain items that flow through multiple financial statements. So, it's always important to look at all three of them, so you can tell how companies fared overall. If a company did well but it meant that it incurred a lot of debt to do so, then that changes its overall position in terms of its liquidity, or its solvency. You really want to pay attention to how all these things are evolving together to get a true sense of the company's overall health.

KWHS: It sounds like a lot of statements to keep track of within a company. Who at the business actually handles that?

Hand: Filing the statements?

KWHS: Yes. I mean, is there a department within a corporation that actually [deals with all the financial statements]?

Hand: Yes. Depending on the size of the corporation, it can be one person, it can be outsourced or it can be a whole broad department of people. If you're talking a very small company, it will be a small operation because the calculations involved are much smaller. If you're talking a multinational conglomerate, it will be a much more complicated operation. The corporate finance department — or the accounting department, depending on what you're looking at — will generally handle all of the calculations and all of the filings.

KWHS: Now that we understand financial statements, can you give us a little more insight into the finance world? What personality traits and skills do you think are especially valuable for a successful career in financial management?

Hand: There's a lot of reading that you have to go through. So, it's important to be able to pick up on broad trends, but also to read deeper, in between the lines, to pick up on things that might not be publicly stated, but things that you can infer from what management has to say. So, I'd say you have to have a keen eye for detail — but also, the willingness to stay at it and to read through all these statements. Sometimes these are multi-hundred page statements – so, attention to detail, but also the tenacity to stick with reading through all these different financial statements, quarter after quarter.

It is a fun thing to do, learning about all these different companies. It certainly has to be something that interests you. A lot of people aren't really interested in reading all these documents and running through all these financial filings. I'd say if you have a keen interest in disciplined, focused research – if you have a research-driven mind — that would play as a strength in this business.

KWHS: And you also have to know about various industries as well, right?

Hand: Yes, that's something that comes with the job. One thing that I've certainly benefited from at Aberdeen is that everybody on our team is a generalist. We cover every sector that is in our portfolio. So, you learn a tremendous amount about how integrated the world economy really is, how certain sectors affect other sectors, how certain firms affect other firms and the way that things that seem really different can actually [make an impact] in the same way.

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What can financial statements tell you about a company? Why is it important to read more than one?

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