

Reading Financial Statements — Workbook

This workbook turns the course into practice. You will pull a real filing from SEC EDGAR, walk it line by line, calculate the core ratios, and run the red-flag checks on an actual company. Work through one section per module, then use the action plan and templates to make this a repeatable habit.

Financial Statement Foundations

Get oriented in real filings and confirm you understand accrual accounting before touching the numbers.

Exercise: Find and stage a real filing

Choose one public company you know as a customer (for example Costco, Nike, or Starbucks). Open its most recent 10-K on SEC EDGAR and answer the prompts in your own words.

- Which accounting standard does it use, GAAP or IFRS, and how do you know?

- Is the auditor's opinion clean (unqualified), or something else? Quote the key sentence.

- What are the exact dates or period each of the three statements covers?

- Name one accounting choice disclosed in the notes that you did not expect.

Worksheet: Accrual vs cash timing

Take one transaction from your own life or business (a subscription, an annual insurance premium, or a project paid on delivery). Fill in how it would be recorded under each method.

Transaction description

Total amount

Date cash actually moves

Period(s) revenue or expense is earned/incurred

Amount recognized per period under accrual

Amount recognized under cash accounting

Resulting receivable, payable, or deferred item

Checklist: Before you trust any statement

- Confirmed the filing is the latest 10-K or 10-Q, not an outdated one
- Read the audit opinion letter and noted its type
- Located all three statements (usually in Item 8)
- Skimmed the MD&A for management's own narrative
- Opened the notes and bookmarked the revenue recognition and debt notes

The Income Statement

Walk one company's income statement from top line to bottom line and judge the quality of its earnings.

Worksheet: Income statement walk-down

Using your chosen company, copy each subtotal from the most recent full year and compute the three margins. Round to the nearest thousand.

Revenue

Cost of goods sold

Gross profit

Gross margin percent

Operating expenses

Operating income (EBIT)

Operating margin percent

Net income

Net margin percent

Exercise: Two-year margin and quality check

Pull the same income statement for the prior year, convert both years to common-size percentages of revenue, and analyze the movement.

- Which margin moved the most between the two years, and in which direction?
- Does the year-over-year revenue growth roughly match operating cash flow growth?
- Did any one-time gain or loss flatter or depress net income this year?
- How many times does management use the words adjusted, pro forma, or excluding?

Checklist: Income statement red-flag scan

- Revenue is not growing far faster than cash collections
- Gross and operating margins are stable or improving across periods
- Profit is driven by operations, not one-time asset sales

- [] Operating expenses are not being slashed in a way that starves the future
- [] Any adjusted figures are reconciled clearly to GAAP numbers

The Balance Sheet

Confirm the balance sheet balances, then measure liquidity, leverage, and the return owners earn.

Worksheet: Balance sheet and ratio sheet

Record the headline balance sheet figures for your company at the latest period end, verify the accounting equation, then compute each ratio.

Total current assets

Inventory

Total assets

Total current liabilities

Total liabilities

Shareholders equity

Working capital (current assets minus current liabilities)

Current ratio

Quick ratio

Debt-to-equity ratio

Interest coverage (operating income divided by interest expense)

Return on equity (net income divided by equity)

Exercise: Interpret the leverage and liquidity picture

Using the ratios you just calculated, write a short verdict on the company's financial position.

- Does assets equal liabilities plus equity to the dollar? If not, recheck your figures.

- Is the quick ratio at or above 1.0, and what does that imply for short-term survival?

- Is interest coverage comfortably above 2.0, or is the company close to the edge?

- Using the DuPont idea, is high or low ROE driven mainly by margin, turnover, or leverage?

Checklist: Balance sheet health checks

- Verified the accounting equation balances exactly
- Working capital is positive, or you understand why negative is acceptable here
- Debt-to-equity is in line with industry peers
- Goodwill is not so large that it dwarfs tangible equity unexpectedly
- Checked the debt maturity note for large amounts coming due soon

Cash Flow and Connecting the Statements

Follow the cash, compute free cash flow, and prove you can trace one transaction through all three statements.

Worksheet: Cash flow and free cash flow

Record the three section totals from the cash flow statement, then compute free cash flow and compare it to net income.

Operating cash flow

Investing cash flow

Financing cash flow

Capital expenditures

Free cash flow (operating cash flow minus capital expenditures)

Net income (from the income statement)

Gap between net income and operating cash flow

Main reason for the gap (from working-capital changes)

Exercise: Trace one transaction through all three statements

Take a single hypothetical transaction, a 10,000 dollar credit sale, and describe its effect on each statement to prove you understand the links.

- What changes on the income statement, and by how much?

- What two balance sheet accounts change, and do they keep the equation balanced?

- What adjustment appears in the operating section of the cash flow statement, and why?

- Now repeat the exercise for taking out a 50,000 dollar loan.

Checklist: Cash flow red-flag scan

- Operating cash flow is positive and roughly tracks net income over time
- The company is not surviving mainly on financing inflows
- Receivables and inventory are not growing far faster than sales
- Capital expenditures are not being cut just to inflate free cash flow
- Ending cash on the cash flow statement matches cash on the balance sheet

Your Action Plan

1. Pick one public company you already understand as a customer and download its latest 10-K from SEC EDGAR.
2. Read the audit opinion and the MD&A before looking at any numbers.
3. Walk the income statement top to bottom and compute gross, operating, and net margins.
4. Pull the prior year and run common-size analysis to find the biggest margin shift.
5. Verify the balance sheet equation, then compute current, quick, debt-to-equity, interest coverage, and ROE.
6. Compute operating cash flow, free cash flow, and the gap between profit and cash.
7. Run all three red-flag checklists and write a one-paragraph verdict on the company.
8. Trace one real transaction from the notes through all three statements to confirm they tie.
9. Repeat the entire process on a direct competitor and compare the two side by side.
10. Schedule a recurring quarterly review so reading statements becomes a standing habit.

