

The Language of Business

Accounting: three little financial statements (and how they connect)

Agenda

SCM Education – Week 2

The purpose of accounting

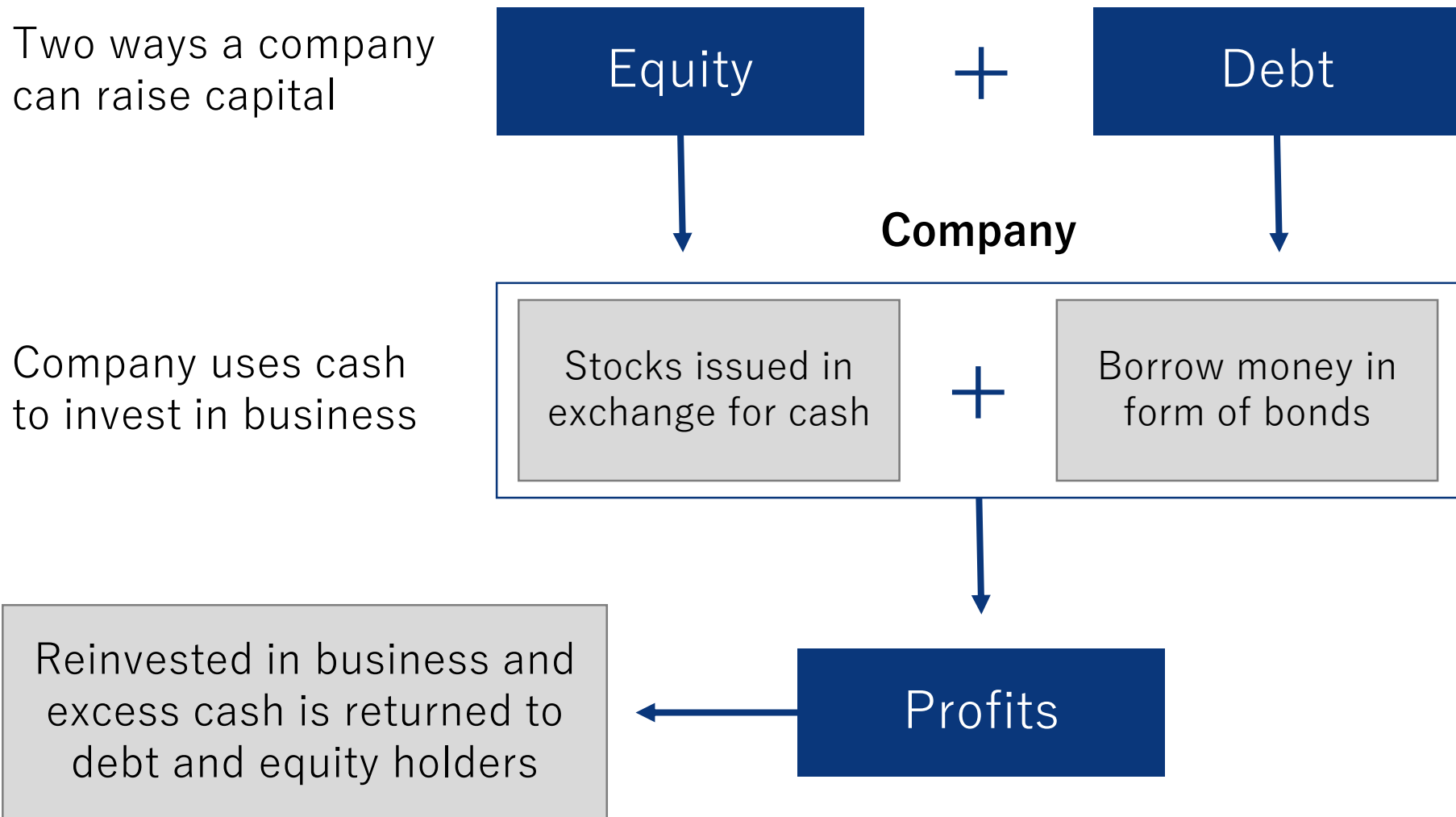
Balance sheet

Income statement

Cash flow statement

Flowing through the three statements

What is the purpose of a company?

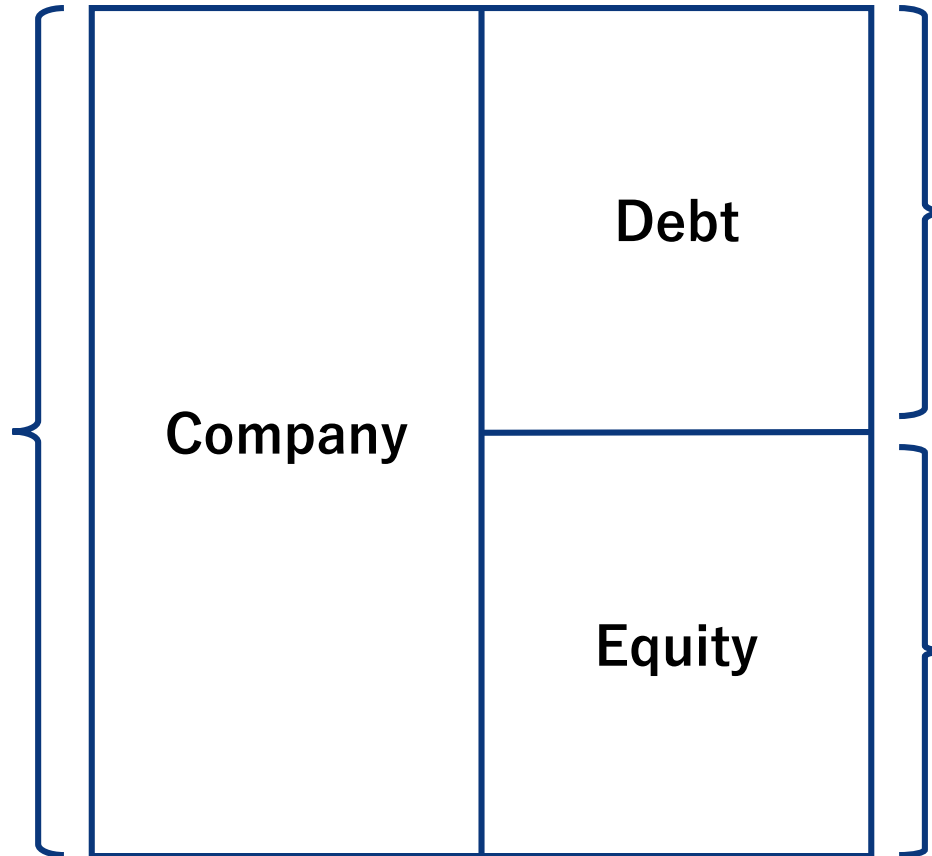


How is a company financed?

Companies need capital to buy assets that help them make money

Everything the company owns:

- > Cash
- > Inventory
- > PP&E
- > Investments
- > Intangibles
- > etc.



Fixed claim on assets:

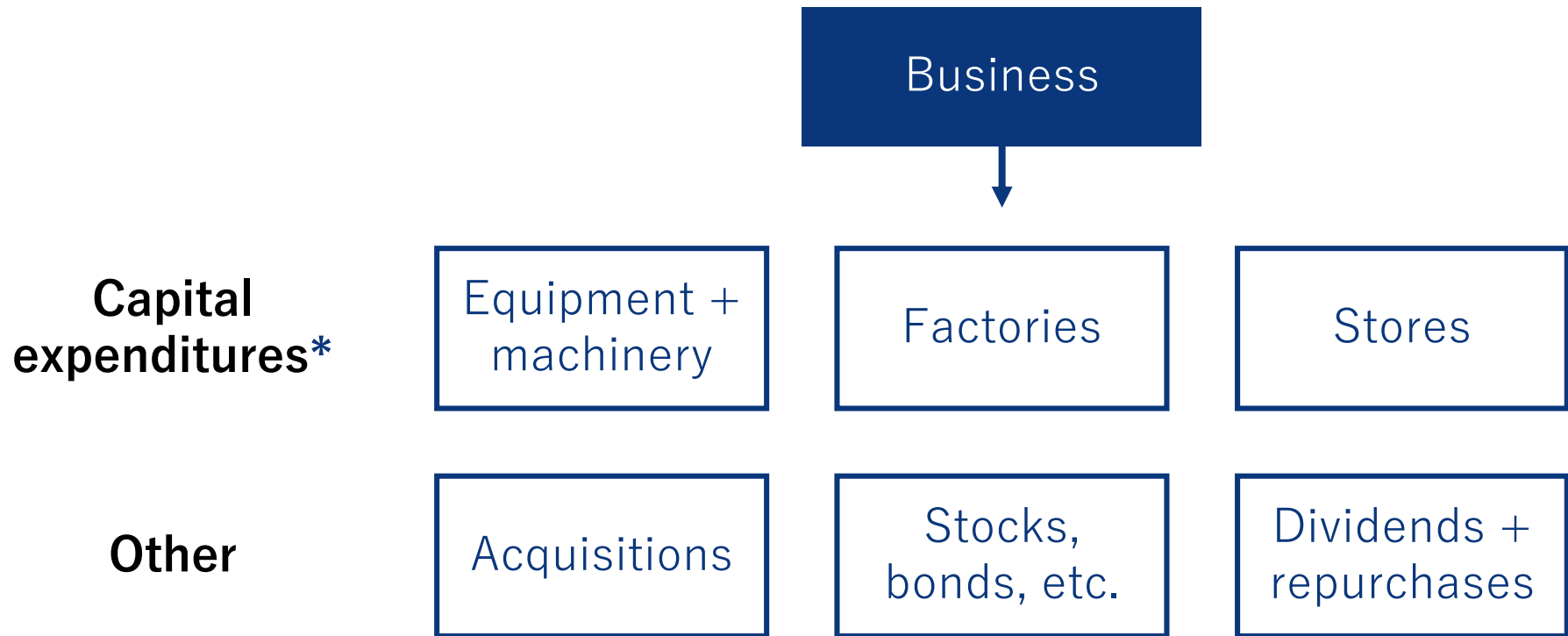
Money owed to creditors

Residual claim on assets:

Owned by stockholders

What does a company do with capital?

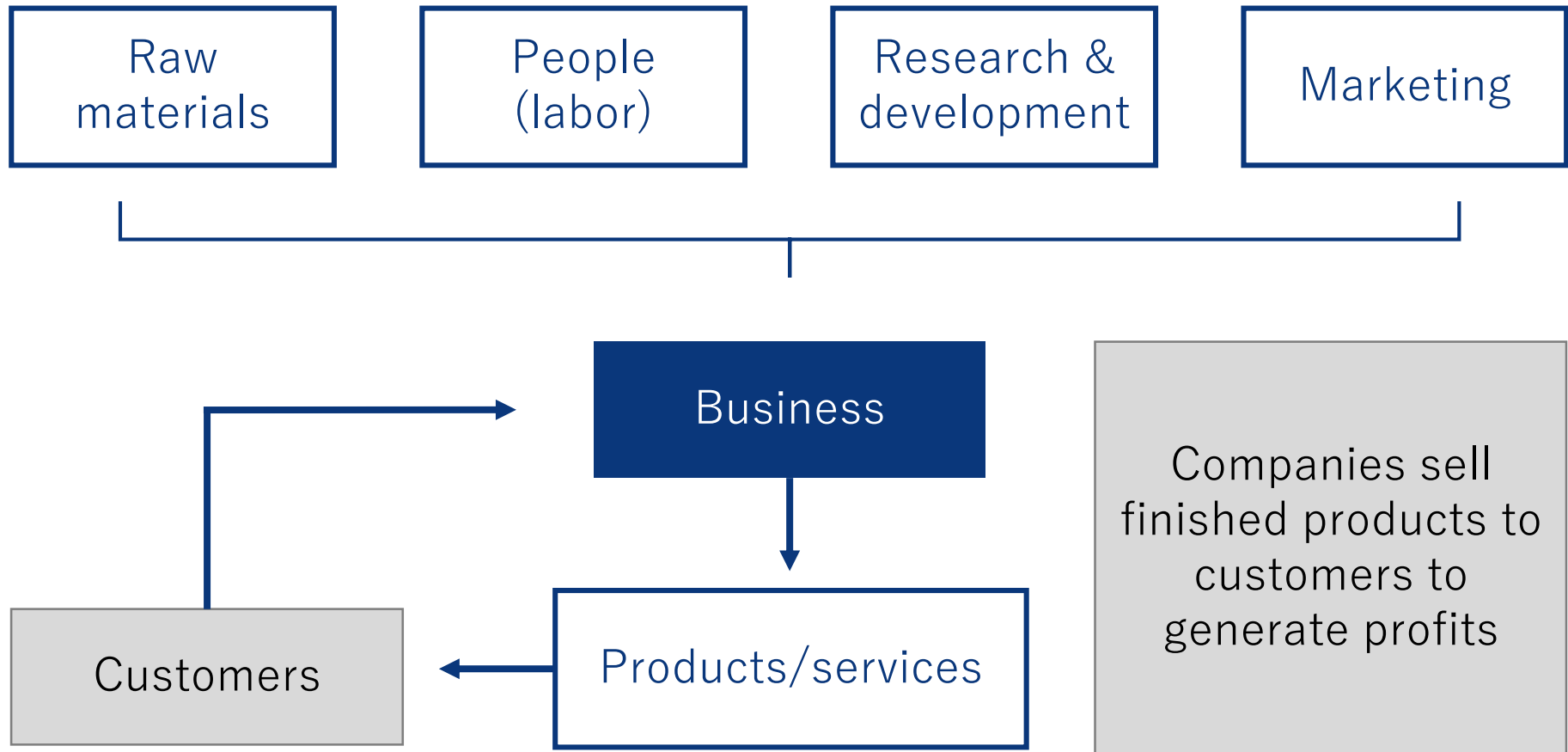
Companies invest in assets to generate returns in the future



**Capital expenditures are investments in fixed assets used in operations.*

How does a company make money?

To earn profits, companies incur costs to produce goods/services



Purpose of accounting

- > The purpose of accounting is to provide a standardized way of quantitatively analyzing a company
- > When analyzing the financials of a business, there are three main things we must understand:

Financing

- How did the business raise capital?
- How much is owed to creditors and how much is owned by stockholders?



Investing

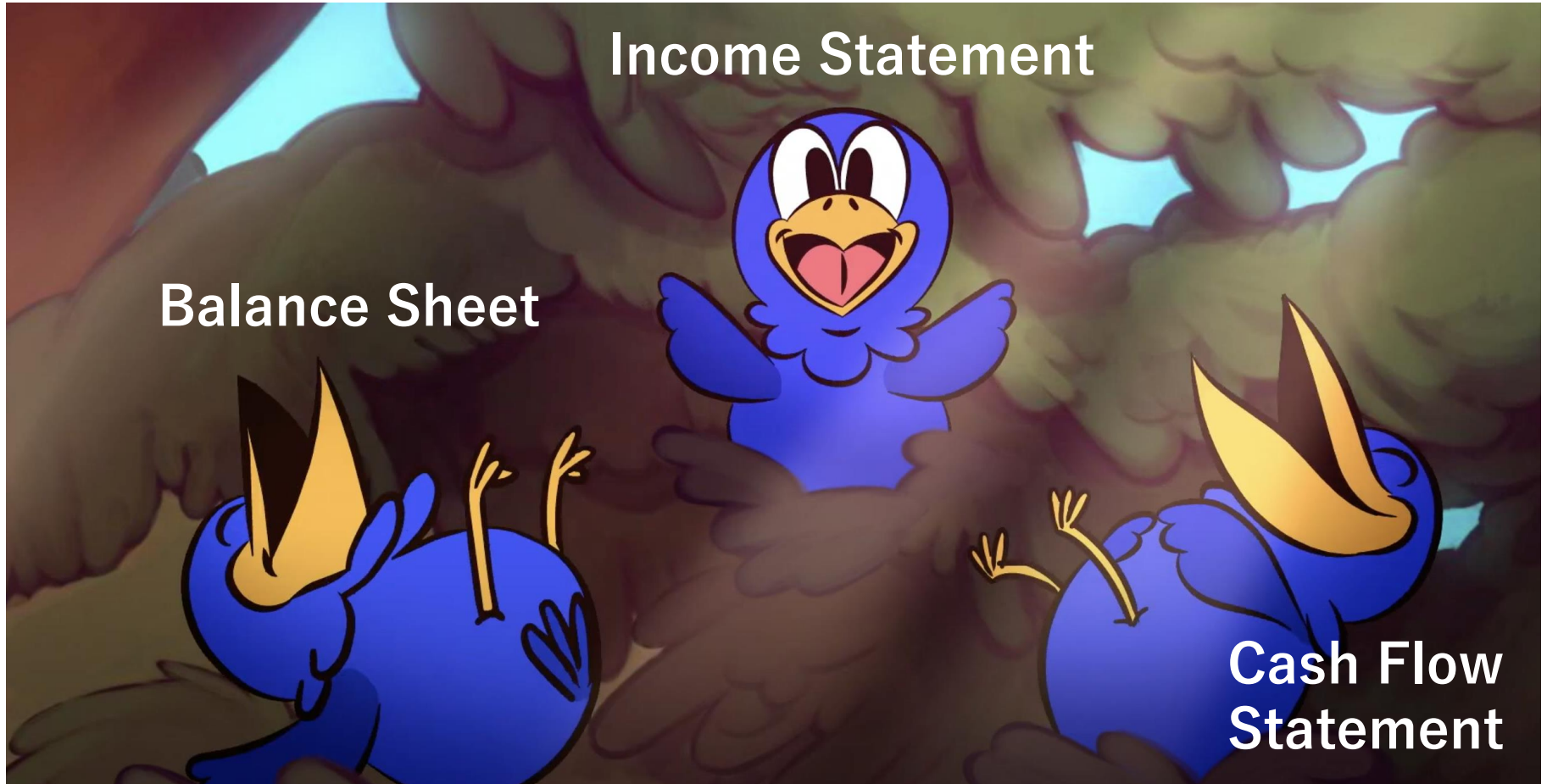
- What did the company do with the capital it raised?
- What assets does the company own?



Operations

- How is the company making money?
- How successful is the company at using the assets it purchased to generate profits?

Three little financial statements



Purpose of accounting

Balance Sheet:

- > Provides snapshot of company's financial position at a single point in time (how much they have and owe)

Income Statement:

- > Shows results of a company's operations over a certain time frame (how much a company earns in profits)

Cash Flow Statement:

- > Describes the cash flows into and out of the company over a period of time

Balance sheet

Balance Sheet:

- > Provides snapshot of company's financial position at a single point in time (how much they have and owe)

Financing

- How did the business raise capital?
- How much is owed to creditors and how much is owned by stockholders?



Investing

- What did the company do with the capital it raised?
- What assets does the company own?



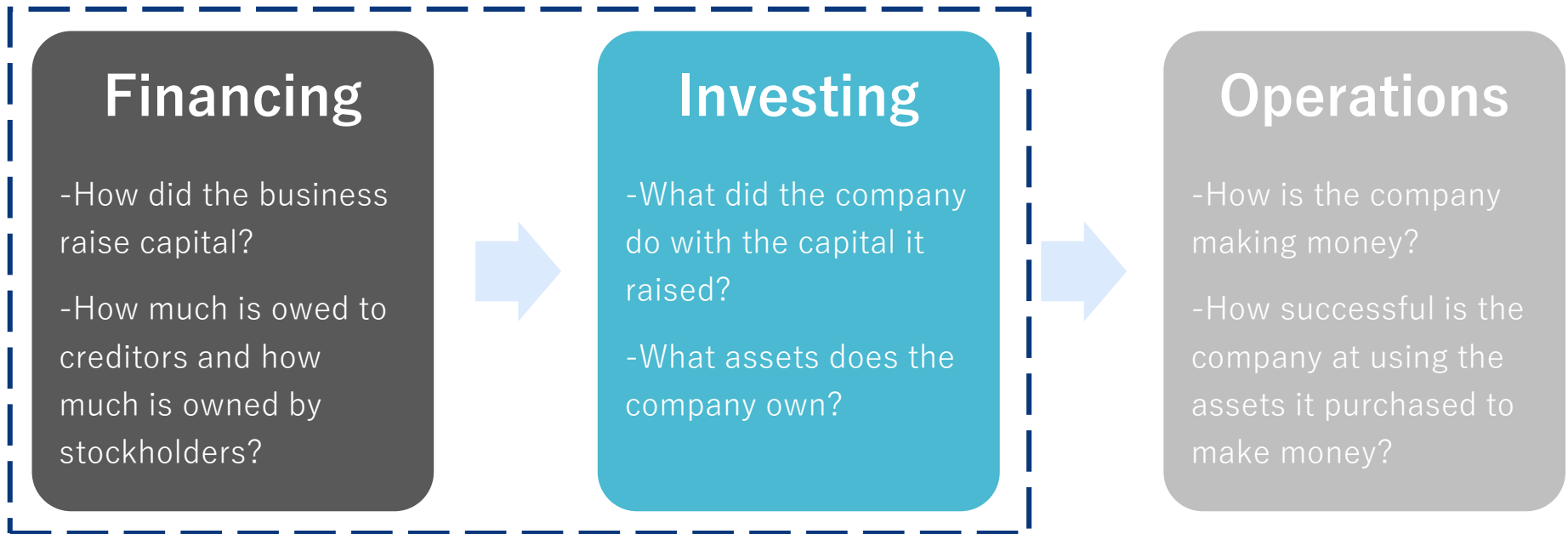
Operations

- How is the company making money?
- How successful is the company at using the assets it purchased to make money?

Balance sheet

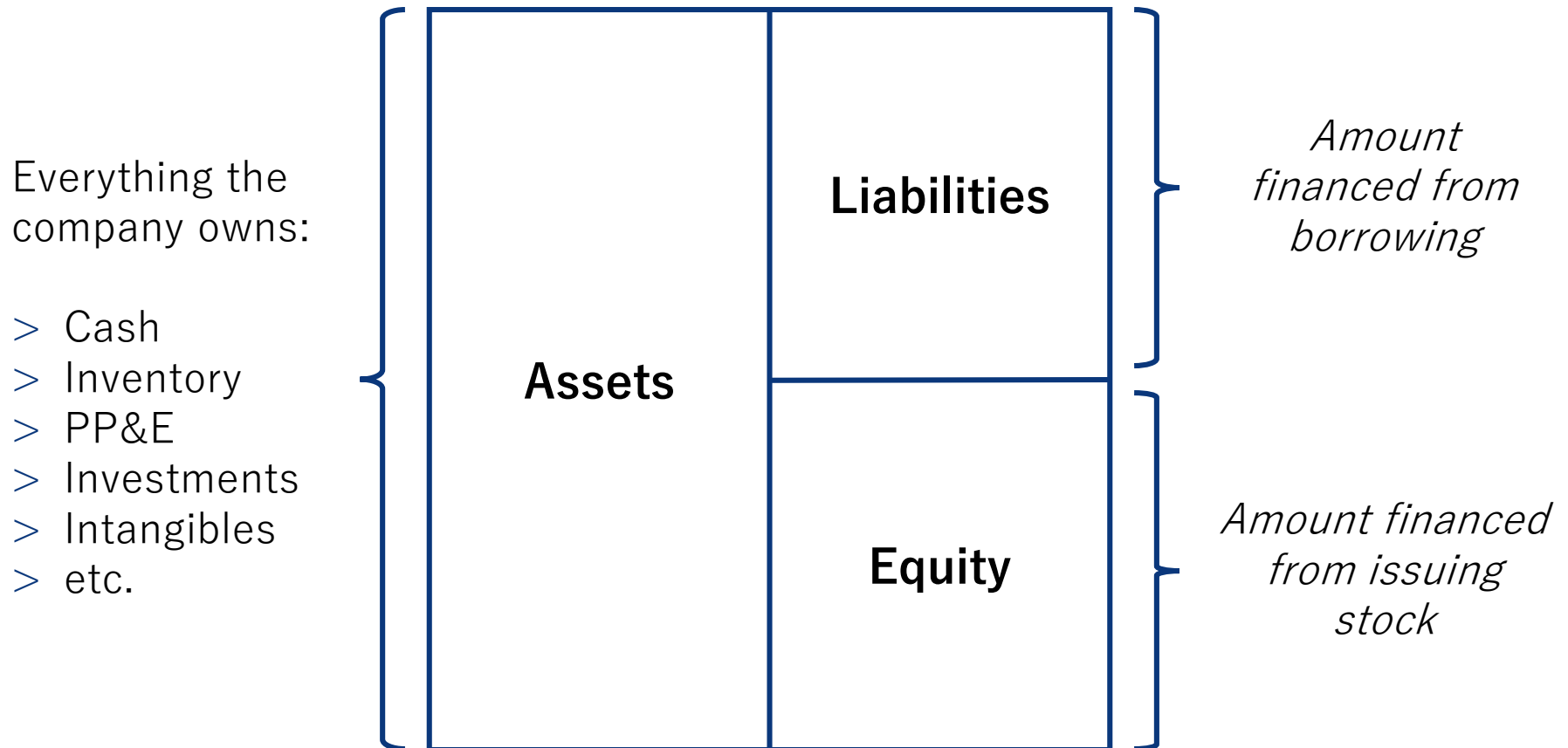
Balance Sheet:

- > Provides snapshot of company's financial position at a single point in time (how much they have and owe)



Balance sheet

Balance sheet provides snapshot of how a company is capitalized



The accounting equation

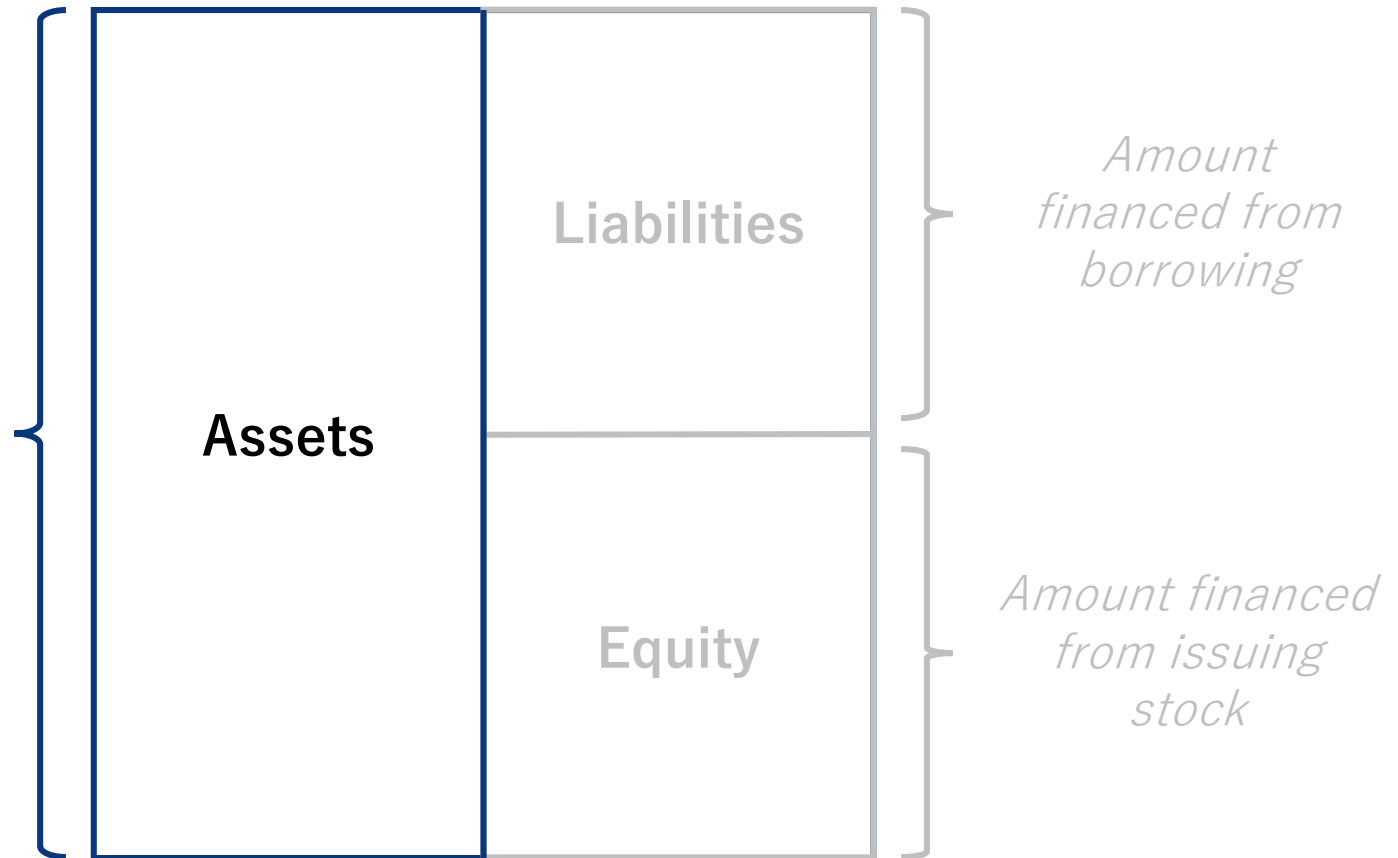
$$\textit{Assets} = \textit{Liabilities} + \textit{Equity}$$

Balance sheet assets

Asset side on balance sheet shows everything the company owns

Everything the company owns:

- > Cash
- > Inventory
- > PP&E
- > Investments
- > Intangibles
- > etc.



Accounting assets \neq economic assets

Not all economic assets (i.e. assets that provide economic benefit) are recognized on the balance sheet as accounting assets

Accounting Assets

An economic asset is recognized on the balance sheet if it is:

1. An asset owned by the company
2. Purchased by the company via an acquisition
3. Expected to provide economic benefits to the company

Not Accounting Assets

Some intangible assets that provide economic benefit are not recognized as accounting assets:

E.g. brands, trademarks, patents, customer relationships, etc.

An intangible asset is only recognized as an accounting asset if it is acquired from purchasing another company

Balance sheet assets

Current assets are turned into cash within 12 months while non-current assets are not expected to be turned into cash within 12 months

Current Assets

- > **Cash & cash equivalents**: money in the bank and highly liquid securities like treasury bills or money markets
- > **Short-term marketable securities**: stocks, bonds, derivatives, etc.
- > **Accounts receivable**: money due from customers, but not yet collected
- > **Inventories**: raw materials, work-in-progress goods, and finished goods
- > **Prepaid expenses**: payments made for a product/service not yet received

Non-Current Assets

- > **PP&E**: property, plant, & equipment, often referred to as fixed assets (i.e. buildings, land, machinery, etc.)
- > **Goodwill**: amount paid for a company in excess of the fair value of net assets acquired
- > **Intangible assets**: non-physical assets acquired from another company (i.e. patents, trademarks, customer relationships)
- > **Equity method investees**: ownership of 20-50% of another company

Balance sheet assets: structure

COSTCO WHOLESALE CORPORATION
CONSOLIDATED BALANCE SHEETS
(amounts in millions, except par value and share data)

| ASSETS | August 29, 2021 | August 30, 2020 |
|-------------------------------------|--------------------|--------------------|
| CURRENT ASSETS | | |
| Cash and cash equivalents | 11,258 | \$ 12,277 |
| Short-term investments | 917 | 1,028 |
| Receivables, net | 1,803 | 1,550 |
| Merchandise inventories | 14,215 | 12,242 |
| Other current assets | 1,312 | 1,023 |
| Total current assets | 29,505 | 28,120 |
| OTHER ASSETS | | |
| Property and equipment, net | 23,492 | 21,807 |
| Operating lease right-of-use assets | 2,890 | 2,788 |
| Other long-term assets | 3,381 | 2,841 |
| TOTAL ASSETS | 59,268 | \$ 55,556 |

Cash: most liquid asset

PP&E + other LT assets

**Balance sheet assets are organized with most liquid assets on top and least liquid assets on the bottom*

Balance sheet assets: real life example

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CONSOLIDATED BALANCE SHEETS
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Increase in PP&E means Costco invested in additional fixed assets

Balance sheet assets: real life example

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What are “other current/long-term assets?”

Balance sheet assets: real life example

Check the footnotes! Helpful to use “ctrl+f” on the annual report...

Goodwill and Acquired Intangible Assets

Goodwill represents the excess of acquisition cost over the fair value of the net assets acquired and is not subject to amortization. The Company reviews goodwill annually in the fourth quarter for impairment or when circumstances indicate carrying value may exceed the fair value. This evaluation is performed at the reporting unit level. If a qualitative assessment indicates that it is more likely than not that the fair value is less than carrying value, a quantitative analysis is completed using either the income or market approach, or a combination of both. The income approach estimates fair value based on expected discounted future cash flows, while the market approach uses comparable public companies and transactions to develop metrics to be applied to historical and expected future operating results.

Goodwill is included in other long-term assets in the consolidated balance sheets. The following table summarizes goodwill by reportable segment:

Definite-lived intangible assets, which are not material, are included in other long-term assets on the consolidated balance sheets and are amortized on a straight-line basis over their estimated lives, which approximates the pattern of expected economic benefit.

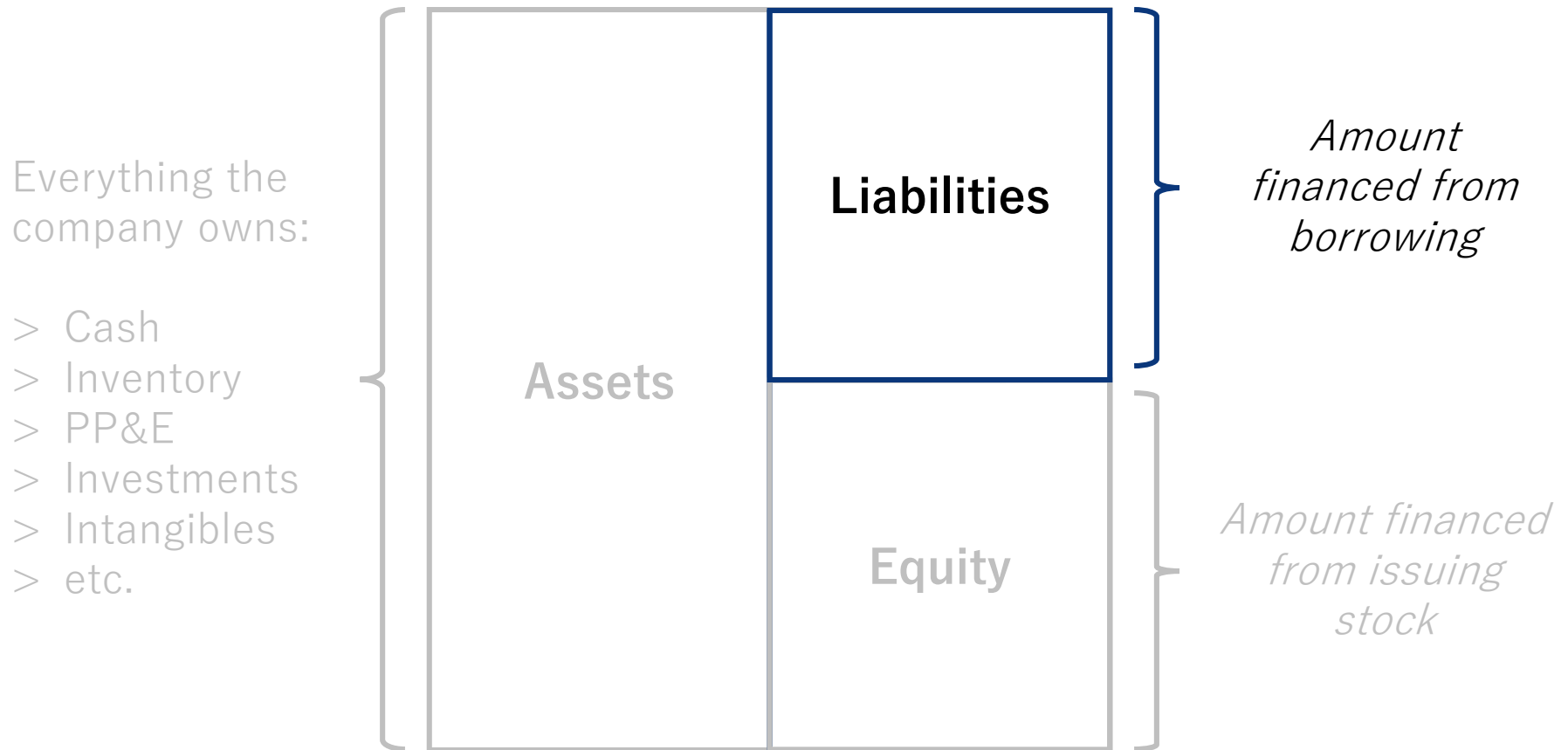
The deferred tax accounts at the end of 2021 and 2020 include deferred income tax assets of \$444 and \$406, respectively, included in other long-term assets; and deferred income tax liabilities of \$754 and \$665, respectively, included in other long-term liabilities.

*Turns out, Costco lumps goodwill, intangible assets, and deferred tax assets into “other long-term assets”

**Source: pages 45, 46, and 58 of Costco’s FY 2021 10-K*

Balance sheet

Liabilities are fixed claims on the company's assets and obligations to other parties that the company is expected to pay in the future



Balance sheet liabilities

Current liabilities are due within the next 12 months while non-current liabilities are not due after the next 12 months

Current Liabilities

- > **Accounts payable:** amount the company owes to its suppliers (similar to credit debt)
- > **Accrued expenses:** goods/services that have been received, but haven't been paid for yet
- > **Deferred revenue:** cash received for goods/services that the company has not yet delivered (unearned)
- > **Current portion of LT debt:** portion of long-term debt that is due within the next 12 months

Non-Current Liabilities

- > **Deferred income taxes:** amount owed to federal, local, and state tax authorities at a future date (1Y+)
- > **Long-term debt:** money received by the company as a loan from bondholders who eventually need to be paid back (with interest)
- > **Unfunded benefit obligations:** net difference between the accumulated benefit obligation owed to retirees of the company and the current market value of the pension fund

Balance sheet liabilities: structure

| | August 29, 2021 | August 30, 2020 |
|---|--------------------|--------------------|
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 16,278 | \$ 14,172 |
| Accrued salaries and benefits | 4,090 | 3,605 |
| Accrued member rewards | 1,671 | 1,393 |
| Deferred membership fees | 2,042 | 1,851 |
| Current portion of long-term debt | 799 | 95 |
| Other current liabilities | 4,561 | 3,728 |
| Total current liabilities | 29,441 | 24,844 |
| OTHER LIABILITIES | | |
| Long-term debt, excluding current portion | 6,692 | 7,514 |
| Long-term operating lease liabilities | 2,642 | 2,558 |
| Other long-term liabilities | 2,415 | 1,935 |
| TOTAL LIABILITIES | 41,190 | 36,851 |

Accounts payable:
due the earliest

Lease liabilities + LT
debt: due the latest

**Balance sheet liabilities are organized with liabilities due the earliest at the top and liabilities due the latest at bottom*

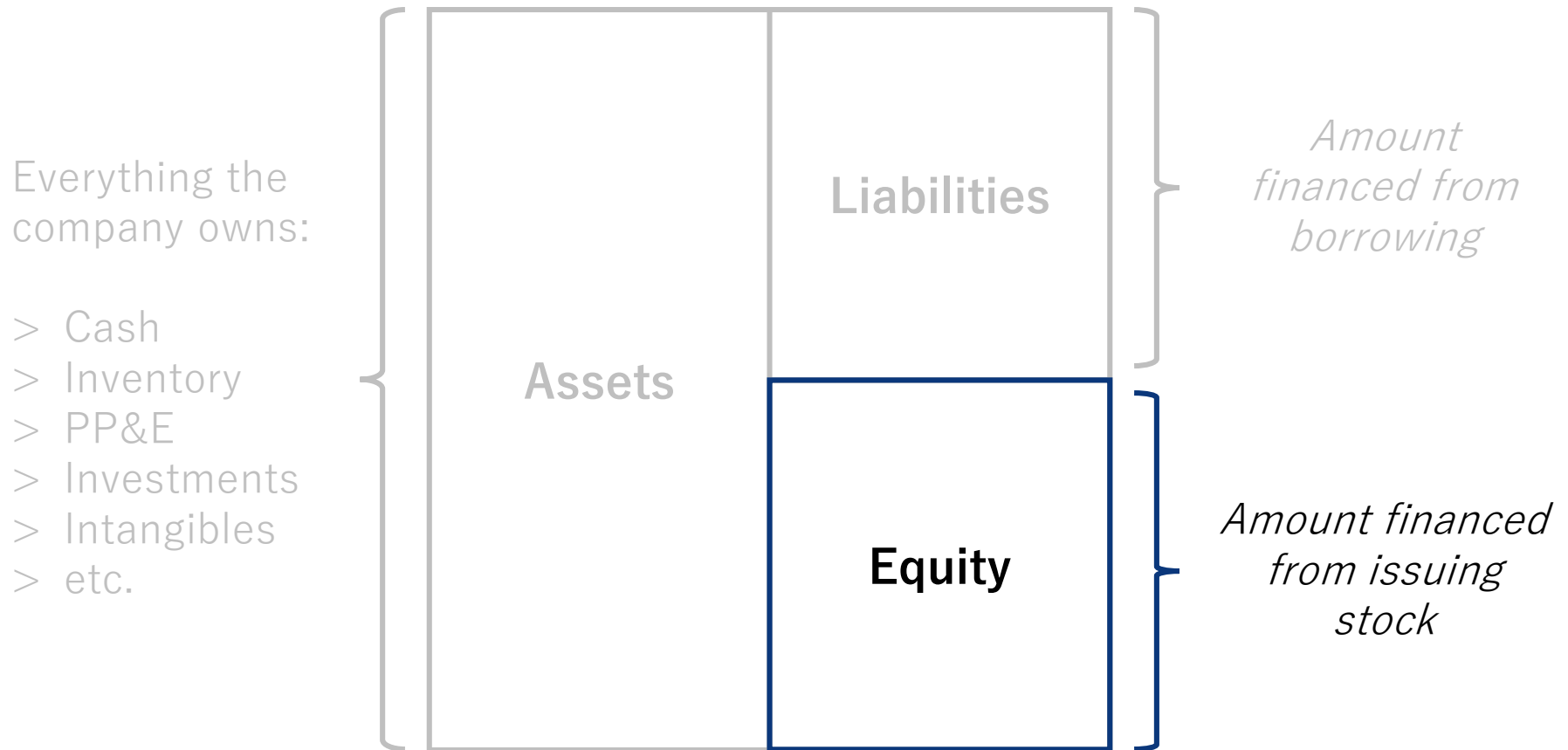
Balance sheet liabilities: example

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| TOTAL LIABILITIES | 41,190 | 36,851 |

*Increase in current portion of LT debt means some LT debt is maturing soon

Balance sheet

Equity section of the balance sheet shows what portion of assets are left over for stockholder's net of all liabilities



Balance sheet equity

- > **Preferred stock**: special type of stock that offers a fixed dividend; has priority over common stock—check footnotes for specifics!
- > **Common stock + additional paid-in capital**: show how much money the company has raised by selling shares of stock to outside investors
- > **Retained earnings**: the sum of the company's cumulative accounting profits (net income) less dividends paid to shareholders; these are the total accounting profits that the company has either reinvested or is holding onto
- > **Treasury stock**: previously outstanding shares that the company has repurchased from stockholders (recorded as a negative account)
- > **Equity method investees (balance sheet asset)**: when a company holds 20-50% of the stock of another company (an equity investment)
- > **Non-controlling interest**: also known as *minority interest*, is when a company owns greater than 50%, but less than 100% of one of its subsidiaries, and therefore, does not have full ownership of all the subsidiary's earnings

Balance sheet equity: example

| | August 29, 2021 | August 30, 2020 |
|---|--------------------|--------------------|
| EQUITY | | |
| Preferred stock \$0.01 par value; 100,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock \$0.01 par value; 900,000,000 shares authorized; 441,825,000 and 441,255,000 shares issued and outstanding | 4 | 4 |
| Additional paid-in capital | 7,031 | 6,698 |
| Accumulated other comprehensive loss | (1,137) | (1,297) |
| Retained earnings | 11,666 | 12,879 |
| Total Costco stockholders' equity | 17,564 | 18,284 |
| Noncontrolling interests | 514 | 421 |
| TOTAL EQUITY | 18,078 | 18,705 |
| TOTAL LIABILITIES AND EQUITY | \$ 59,268 | \$ 55,556 |

*Decrease in retained earnings means Costco either had negative net income or paid out dividends exceeding total net income

The accounting equation

$$\textit{Assets} = \textit{Liabilities} + \textit{Equity}$$

$$\textit{Equity} = \textit{Assets} - \textit{Liabilities}$$

Balance sheet equity: example

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| TOTAL LIABILITIES AND EQUITY | \$ 59,268 | \$ 55,556 |

Total equity (also called “book value”) must give us a pretty good understanding of what the company is worth... Right?

Book value vs. market value

What is the value of a company? What does it mean when someone says a company is worth a certain amount of money?

Book Value

- > Accounting assets net of all accounting liabilities
- > This is the number that makes the balance sheet balance
- > Remember: not all “economic assets” appear on the balance sheet as “accounting assets”
- > Oftentimes, assets are recorded on the balance sheet at their historical cost, which may not reflect economic/market value

Market Value

- > Share price multiplied by the total number of shares outstanding
- > Often referred to as the market value of equity
- > This is the price you could theoretically purchase 100% of the company excluding cash/debt
- > Most companies trade above BV because they are willing to pay more for expectations of future profitable growth in value

Income statement

Income Statement:

- > Shows results of a company's operations over a certain time frame (how much a company earns in profits)

Financing

- How did the business raise capital?
- How much is owed to creditors and how much is owned by stockholders?



Investing

- What did the company do with the capital it raised?
- What assets does the company own?



Operations

- How is the company making money?
- How successful is the company at using the assets it purchased to make money?

Income statement

Income Statement:

- > Shows results of a company's operations over a certain time frame (how much a company earns in profits)



Income statement

Income statement tells us how much a company is earning or losing

$$\text{Revenue} - \text{expenses} - \text{taxes} = \text{net profit}/(\text{loss})$$

| | |
|---|------------------------|
| Revenue | |
| (-) Cost of goods sold | |
| (=) Gross profit | Operating expenses |
| (-) Selling, general, & administrative (SG&A) | |
| (-) Research & development (R&D) | |
| (=) Operating income (EBIT) | Non-Operating expenses |
| (-) Interest expense | |
| (=) Earnings before taxes (EBT) | Taxes |
| (-) Income tax expense | |
| (=) Net income | |

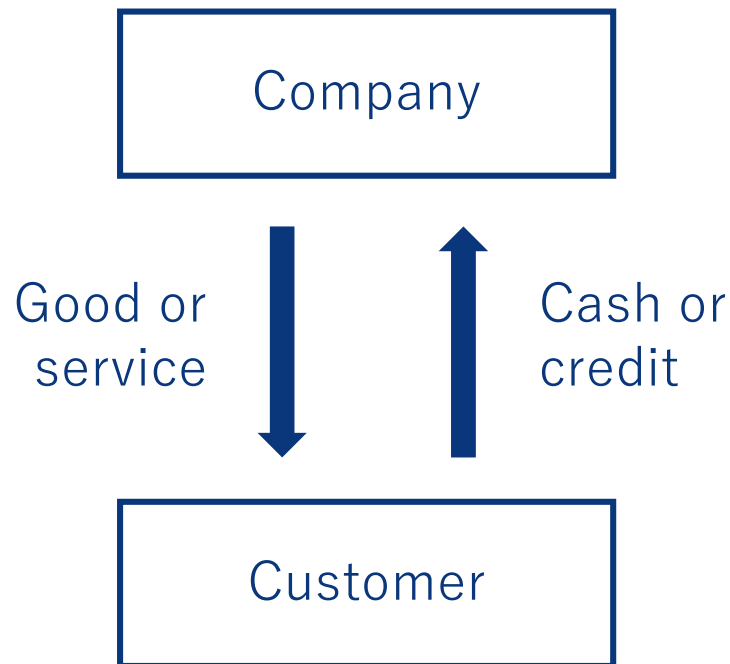
What is revenue?

Total amount of sales made over a period of time (typically 1Y or 1Q)

$$\text{Revenue} = \text{average price} * \text{quantity}$$

The income statement is prepared on an accrual basis

- > This means revenue and expenses are recognized regardless of whether cash transactions have occurred
- > There are two ways revenue can be paid/recognized: **cash** and **credit**
- > When a company sells a good or service paid in credit, they record that credit as an **accounts receivable** asset
- > When a company receives cash for a good or service that isn't delivered yet, it is recorded as a **deferred revenue** liability



What is COGS?

All direct costs of producing the goods/services sold

Types of COGS (cost of goods sold):

- > Raw materials
- > Direct labor
- > Factory overhead
- > Storage costs
- > Transportation costs
- > Purchase returns + discounts

How is COGS recognized?

- > When a company purchases raw materials from suppliers and turns it into a finished good or service, the company records it as an **inventory** asset on the balance sheet
- > When the company sells the finished good or service, it is removed from the balance sheet and **expensed** as a **cost of goods sold**

What is SG&A?

Operating expenses not directly related to production of goods/services

Types of SG&A (selling, general, & administrative) expenses:

- > Salaries of staff and executives not involved in production
- > Marketing, advertising, and promotional expenses
- > Rent, utilities, insurance payments, accounting costs, etc.

Some companies split up SG&A expenses into separate categories:

| ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA | | | |
|---|--------|--------|--------|
| INCOME STATEMENTS | | | |
| (In millions, except per share amounts) | | | |
| Year Ended June 30, | 2021 | 2020 | 2019 |
| Sales and marketing | 20,117 | 19,598 | 18,213 |
| General and administrative | 5,107 | 5,111 | 4,885 |

**Source: Microsoft's FY 2021 10-K*

Operating vs. non-operating expenses

Operating expenses are costs the company incurs that are required for running the primary business/operations

Operating Expenses

- > Typically, most expenses are operating expenses...
- > If an expense is related to normal business operations, then it is an operating expense
- > Unless you have a good reason for why it is a non-operating expense, it's probably an operating expense
- > E.g. COGS, SG&A, R&D, etc.

Non-Operating expenses

- > A non-operating expense is a cost that is not related to normal business operations
- > E.g. interest expense (for non-banks), unrealized gains/losses on marketable securities, losses from discontinued operations, etc.
- > Expenses that occur outside a company's day-to-day activities are typically non-operating expenses

**Sometimes, it can be a bit more ambiguous whether an expense is operating or non-operating; E.g. company ABC incurs a one-off \$1M restructuring charge in 2020*

Sometimes one-off charges are recurring

General Motors (and most auto companies) consistently incur restructuring/legal costs and they leave them out of “adjusted” EBIT

| | Years Ended | |
|--|----------------------|----------------------|
| | December 31, 2017 | December 31, 2016 |
| Operating segments | | |
| GM North America (GMNA) | \$ 11,889 | \$ 12,388 |
| GM International (GMI)(a) | 1,300 | 767 |
| General Motors Financial Company, Inc. (GM Financial)(b) | 1,196 | 763 |
| Total operating segments | 14,385 | 13,918 |
| Corporate and eliminations(c) | (1,541) | (1,070) |
| EBIT-adjusted | 12,844 | 12,848 |
| Special items | | |
| GMI restructuring(d) | (460) | — |
| Venezuela-related matters(e) | (80) | — |
| Ignition switch recall and related legal matters(f) | (114) | (300) |
| Total special items | (654) | (300) |

**Source: General Motors' FY 2017 earnings release*

Income statement example

COSTCO WHOLESALE CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(amounts in millions, except per share data)

■ = operating expenses

■ = non-operating expenses

| | 52 Weeks Ended August 29, 2021 | 52 Weeks Ended August 30, 2020 | 52 Weeks Ended September 1, 2019 |
|--|--------------------------------------|--------------------------------------|--|
| REVENUE | | | |
| Net sales | \$ 192,052 | \$ 163,220 | \$ 149,351 |
| Membership fees | 3,877 | 3,541 | 3,352 |
| Total revenue | 195,929 | 166,761 | 152,703 |
| OPERATING EXPENSES | | | |
| Merchandise costs | 170,684 | 144,939 | 132,886 |
| Selling, general and administrative | 18,461 | 16,332 | 14,994 |
| Preopening expenses | 76 | 55 | 86 |
| Operating income | 6,708 | 5,435 | 4,737 |
| OTHER INCOME (EXPENSE) | | | |
| Interest expense | (171) | (160) | (150) |
| Interest income and other, net | 143 | 92 | 178 |
| INCOME BEFORE INCOME TAXES | 6,680 | 5,367 | 4,765 |
| Provision for income taxes | 1,601 | 1,308 | 1,061 |
| Net income including noncontrolling interests | 5,079 | 4,059 | 3,704 |
| Net income attributable to noncontrolling interests | (72) | (57) | (45) |
| NET INCOME ATTRIBUTABLE TO COSTCO | \$ 5,007 | \$ 4,002 | \$ 3,659 |
| NET INCOME PER COMMON SHARE ATTRIBUTABLE TO COSTCO: | | | |
| Basic | \$ 11.30 | \$ 9.05 | \$ 8.32 |
| Diluted | \$ 11.27 | \$ 9.02 | \$ 8.26 |
| Shares used in calculation (000's) | | | |
| Basic | 443,089 | 442,297 | 439,755 |
| Diluted | 444,346 | 443,901 | 442,923 |

Cash flow statement

Cash Flow Statement:

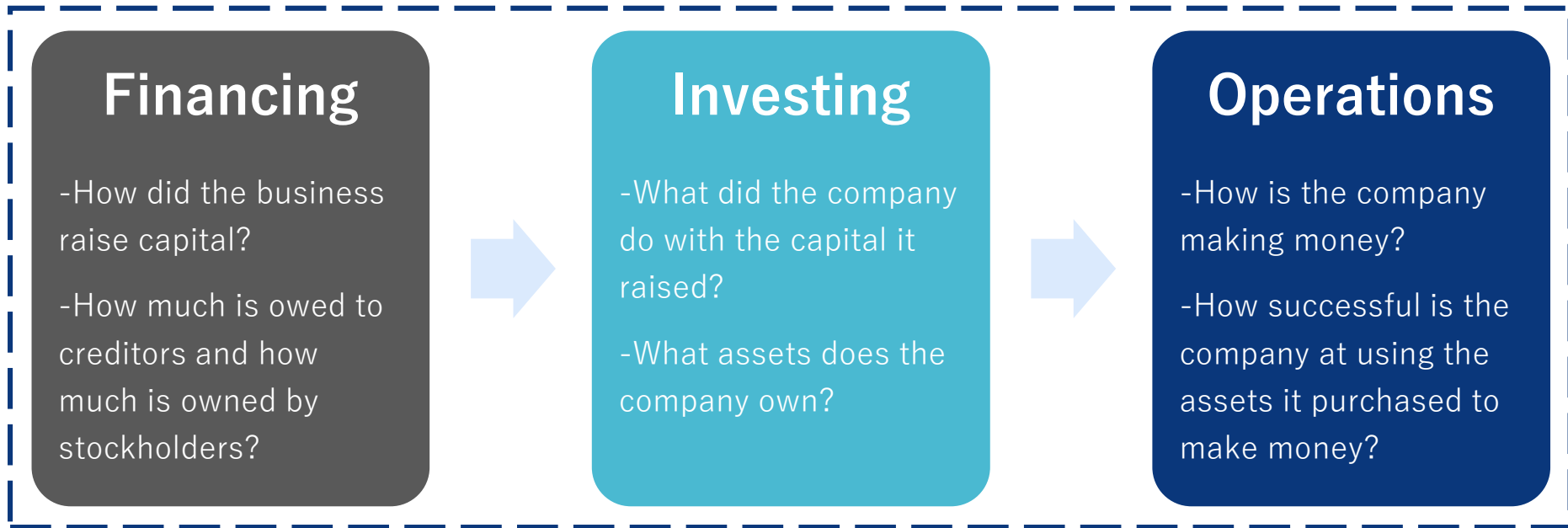
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Cash flow statement

Cash Flow Statement:

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Cash flow statement

Cash flow from *operations* (CFFO):

- > How much cash did the company's operations generate before reinvestment + returning cash to shareholders?

Cash flow from *investing* (CFFI):

- > How much cash did the company spend/receive from buying/selling assets (PP&E, investments, etc.)?

Cash flow from *financing* (CFFF):

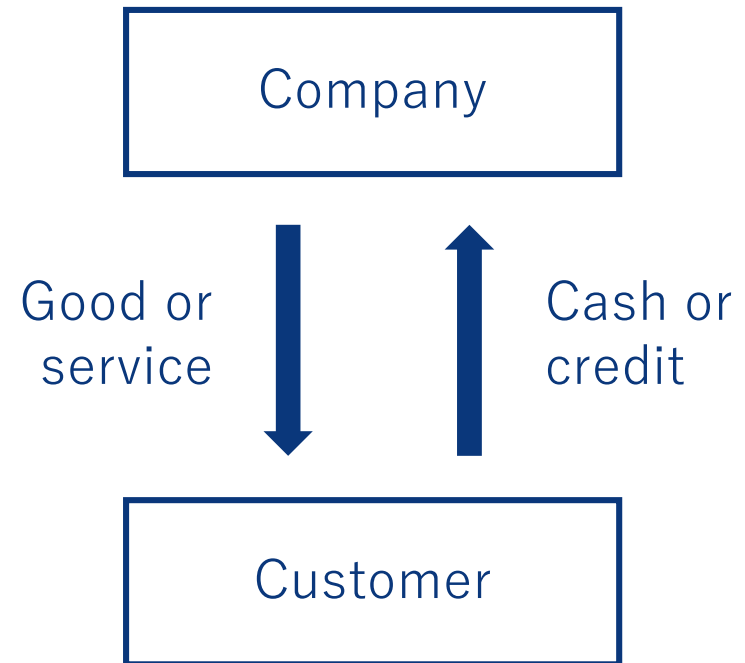
- > How much cash did was raised through debt/equity or paid out to shareholders via buybacks + dividends?

Cash flow from operations

How much cash did the company's operations generate before reinvestment + returning cash to shareholders?

Profits on the income statement are not always in the form of cash

- > If we want to know how much cash a business generated, we must make adjustments to the earnings on the income statement
- > $\text{CFFO} = \text{Net Income} + \text{Cash Adjustments}$
- > Some cash adjustments include: add back depreciation & amortization and stock-based compensation, subtract changes in accounts receivable and changes in inventories, etc.



Depreciation (straight-line method)

A company's fixed assets (PP&E e.g. factory, equipment, etc.) decline in value over time if money is not spent on repairs due to wear and tear, so the value of those fixed assets are depreciated over their useful life and expensed on the income statement (usually lumped into COGS)

Factory purchased for \$100 has a useful life of 5 years with salvage value of \$25

Annual depreciation expense:
$$\frac{(\text{Purchase Price} - \text{Salvage Value})}{\text{Useful Life}}$$

| Time | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
|----------------------|--------|--------|--------|--------|--------|--------|
| Net PP&E | \$100 | \$85 | \$70 | \$55 | \$40 | \$25 |
| Depreciation expense | | (\$15) | (\$15) | (\$15) | (\$15) | (\$15) |

Amortization

Amortization is calculated in a similar way to depreciation, but is used for intangible assets (customer relationships, patents, trademarks, etc.)

Typically, amortization of intangibles isn't an economic cost:

- > When you own a factory, you have to outlay cash to maintain/repair it, so there is a required cash expense: maintenance capex
- > If you acquire another company that owns a trademark with a finite useful life, you don't necessarily need to outlay cash to maintain that trademark... but you expense it on the income statement

Sometimes, companies do not report amortization separately:

- > Companies are not required to report amortization separately and most companies lump them together on the cash flow statement
- > To find the amortization expense, use “ctrl+f” and search amortization; it's usually on a separate table or footnote

Amortization

Meta/Facebook lumps depreciation and amortization together on the cash flow statement but has a footnote that separates out amortization

| | Weighted-Average Remaining Useful Lives (in years) | December 31, 2018 | | | December 31, 2017 | | |
|-------------------------|--|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
| | | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Acquired users | 2.8 | \$ 2,056 | \$ (1,260) | \$ 796 | \$ 2,056 | \$ (971) | \$ 1,085 |
| Acquired technology | 1.2 | 1,002 | (871) | 131 | 972 | (711) | 261 |
| Acquired patents | 5.2 | 805 | (565) | 240 | 785 | (499) | 286 |
| Trade names | 1.4 | 629 | (517) | 112 | 629 | (406) | 223 |
| Other | 2.4 | 162 | (147) | 15 | 162 | (133) | 29 |
| Total intangible assets | 2.9 | <u>\$ 4,654</u> | <u>\$ (3,360)</u> | <u>\$ 1,294</u> | <u>\$ 4,604</u> | <u>\$ (2,720)</u> | <u>\$ 1,884</u> |

Amortization expense of intangible assets for the years ended December 31, 2018, 2017, and 2016 was \$640 million, \$692 million, and \$751 million, respectively.

**Source: Pg. 76 of Meta's (NASDAQ: FB) 2021 10-K*

Cash flow statement (CFFO example)

COSTCO WHOLESALE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(amounts in millions)

| | 52 Weeks Ended August 29, 2021 | 52 Weeks Ended August 30, 2020 | 52 Weeks Ended September 1, 2019 |
|--|--------------------------------------|--------------------------------------|--|
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income including noncontrolling interests | \$ 5,079 | \$ 4,059 | \$ 3,704 |
| Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities: | | | |
| Depreciation and amortization | 1,781 | 1,645 | 1,492 |
| Non-cash lease expense | 286 | 194 | — |
| Stock-based compensation | 665 | 619 | 595 |
| Other non-cash operating activities, net | 85 | 42 | 9 |
| Deferred income taxes | 59 | 104 | 147 |
| Changes in operating assets and liabilities: | | | |
| Merchandise inventories | (1,892) | (791) | (536) |
| Accounts payable | 1,838 | 2,261 | 322 |
| Other operating assets and liabilities, net | 1,057 | 728 | 623 |
| Net cash provided by operating activities | 8,958 | 8,861 | 6,356 |

*Costco does not report depreciation and amortization separately

*The company **increased inventories** in 2021, which had an **adverse effect** on cash flow from operations

Cash flow from investing

How much cash did the company spend/receive from buying/selling fixed assets (PP&E), investments, acquiring companies, etc.?

CFFI shows how much the company is spending on asset purchases:

- > A particularly important line item on CFFI is **capital expenditures** or **capex** (often recorded as purchase/addition of PP&E)
- > Capital expenditures shows us how much the company is spending on **organic reinvestment** in the business operations
- > There's an important term called **free cash flow** which tells us the amount of cash generated each year from operations less all reinvestment requirements
- > To calculate free cash flow, we can subtract **capex** from **CFFO**:

Operating Cash Flows – Capex = Free Cash Flow

Cash flow statement (CFFI example)

COSTCO WHOLESALE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(amounts in millions)

| | 52 Weeks Ended August 29, 2021 | 52 Weeks Ended August 30, 2020 | 52 Weeks Ended September 1, 2019 |
|--|--------------------------------------|--------------------------------------|--|
| CASH FLOWS FROM OPERATING ACTIVITIES | | | |
| Net income including noncontrolling interests | \$ 5,079 | \$ 4,059 | \$ 3,704 |
| Adjustments to reconcile net income including noncontrolling interests to net cash provided by operating activities: | | | |
| Depreciation and amortization | 1,781 | 1,645 | 1,492 |
| Non-cash lease expense | 286 | 194 | — |
| Stock-based compensation | 665 | 619 | 595 |
| Other non-cash operating activities, net | 85 | 42 | 9 |
| Deferred income taxes | 59 | 104 | 147 |
| Changes in operating assets and liabilities: | | | |
| Merchandise inventories | (1,892) | (791) | (536) |
| Accounts payable | 1,838 | 2,261 | 322 |
| Other operating assets and liabilities, net | 1,057 | 728 | 623 |
| Net cash provided by operating activities | 8,958 | 8,861 | 6,356 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | | |
| Purchases of short-term investments | (1,331) | (1,626) | (1,094) |
| Maturities and sales of short-term investments | 1,446 | 1,678 | 1,231 |
| Additions to property and equipment | (3,588) | (2,810) | (2,998) |
| Acquisitions | — | (1,163) | — |
| Other investing activities, net | (62) | 30 | (4) |
| Net cash used in investing activities | (3,535) | (3,891) | (2,865) |

$$CFFO - Capex = FCF$$

$$\sim \$9B - \sim \$3.6B = \$5.4B$$

*Costco generated ~\$3.6 billion in free cash flow in 2021

Cash flow statement (CFFF example)

How much cash did was raised through debt/equity or paid out to shareholders via buybacks + dividends?

COSTCO WHOLESALE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
 (amounts in millions)

| | 52 Weeks Ended August 29, 2021 | 52 Weeks Ended August 30, 2020 | 52 Weeks Ended September 1, 2019 |
|---|--------------------------------------|--------------------------------------|--|
| CASH FLOWS FROM FINANCING ACTIVITIES | | | |
| Change in bank payments outstanding | 188 | 137 | 210 |
| Proceeds from short-term borrowings | 41 | — | — |
| Proceeds from issuance of long-term debt | — | 3,992 | 298 |
| Repayments of long-term debt | (94) | (3,200) | (89) |
| Tax withholdings on stock-based awards | (312) | (330) | (272) |
| Repurchases of common stock | (496) | (196) | (247) |
| Cash dividend payments | (5,748) | (1,479) | (1,038) |
| Other financing activities, net | (67) | (71) | (9) |
| Net cash used in financing activities | (6,488) | (1,147) | (1,147) |

*Costco earned ~\$5B in net income in 2021, while dividends were ~\$5.7B

Balance sheet

| | August 29, 2021 | August 30, 2020 |
|---|--------------------|--------------------|
| EQUITY | | |
| Preferred stock \$0.01 par value; 100,000,000 shares authorized; no shares issued and outstanding | — | — |
| Common stock \$0.01 par value; 900,000,000 shares authorized; 441,825,000 and 441,255,000 shares issued and outstanding | 4 | 4 |
| Additional paid-in capital | 7,031 | 6,698 |
| Accumulated other comprehensive loss | (1,137) | (1,297) |
| Retained earnings | 11,666 | 12,879 |
| Total Costco stockholders' equity | 17,564 | 18,284 |
| Noncontrolling interests | 514 | 421 |
| TOTAL EQUITY | 18,078 | 18,705 |
| TOTAL LIABILITIES AND EQUITY | \$ 59,268 | \$ 55,556 |

*We now know that Costco's decrease in retained earnings is because their dividends in 2021 exceeded net income

How do the 3 statements link?

Net Income / Retained Earnings (NI – Dividends):

- > Net income feeds into retained earnings and is the starting point for cash flow from operations

PP&E, Depreciation, and Capex

- > Depreciation is subtracted from PP&E and capital investments are added to the PP&E account on BS

Net Change in Cash

- > The total net change in cash is added to the BS cash from the prior period to get to cash in the next period

How do the 3 statements link?

Balance Sheet

| | |
|---------------|-----------------------------|
| Assets | Liabilities |
| | Shareholder's Equity |

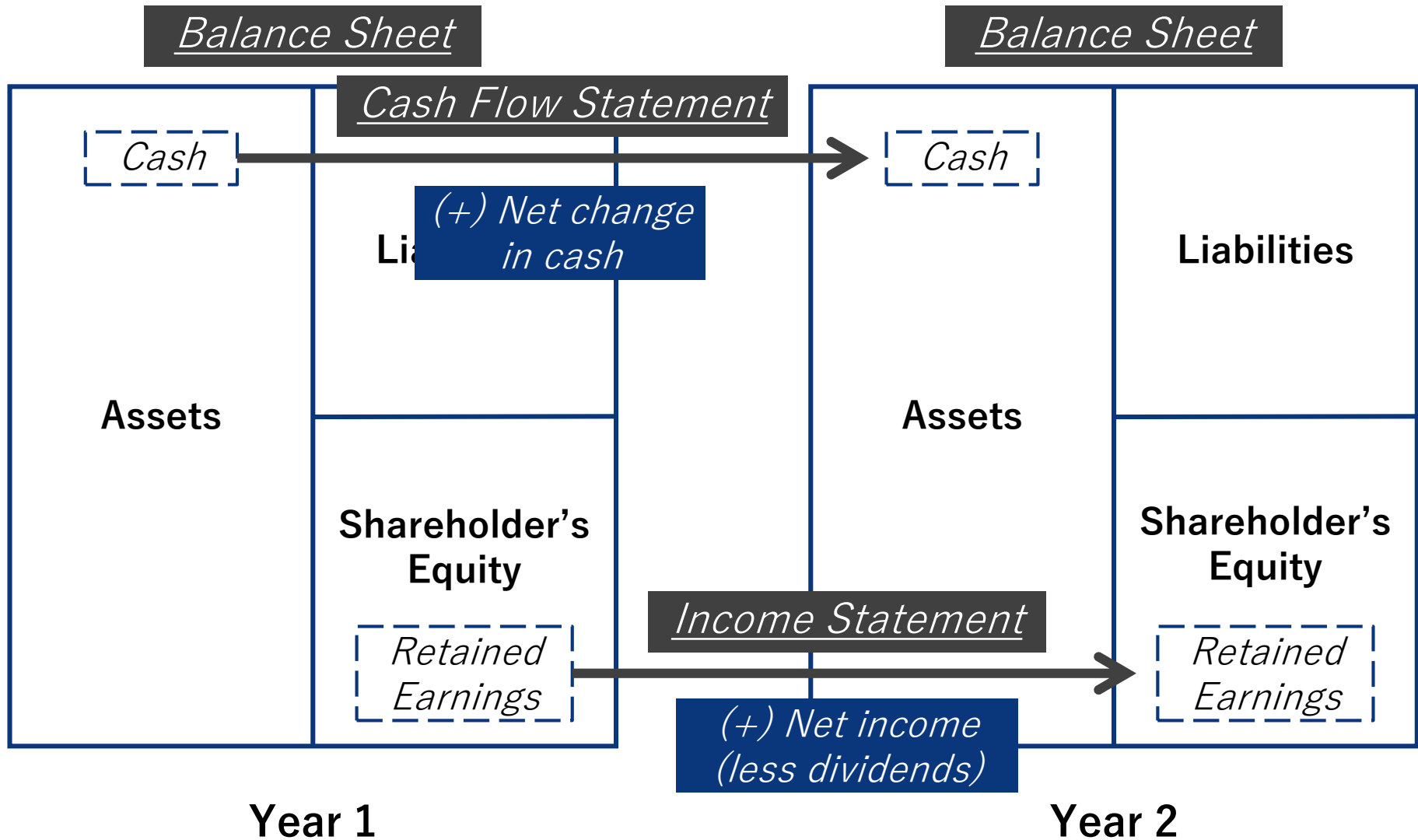
Year 1

Balance Sheet

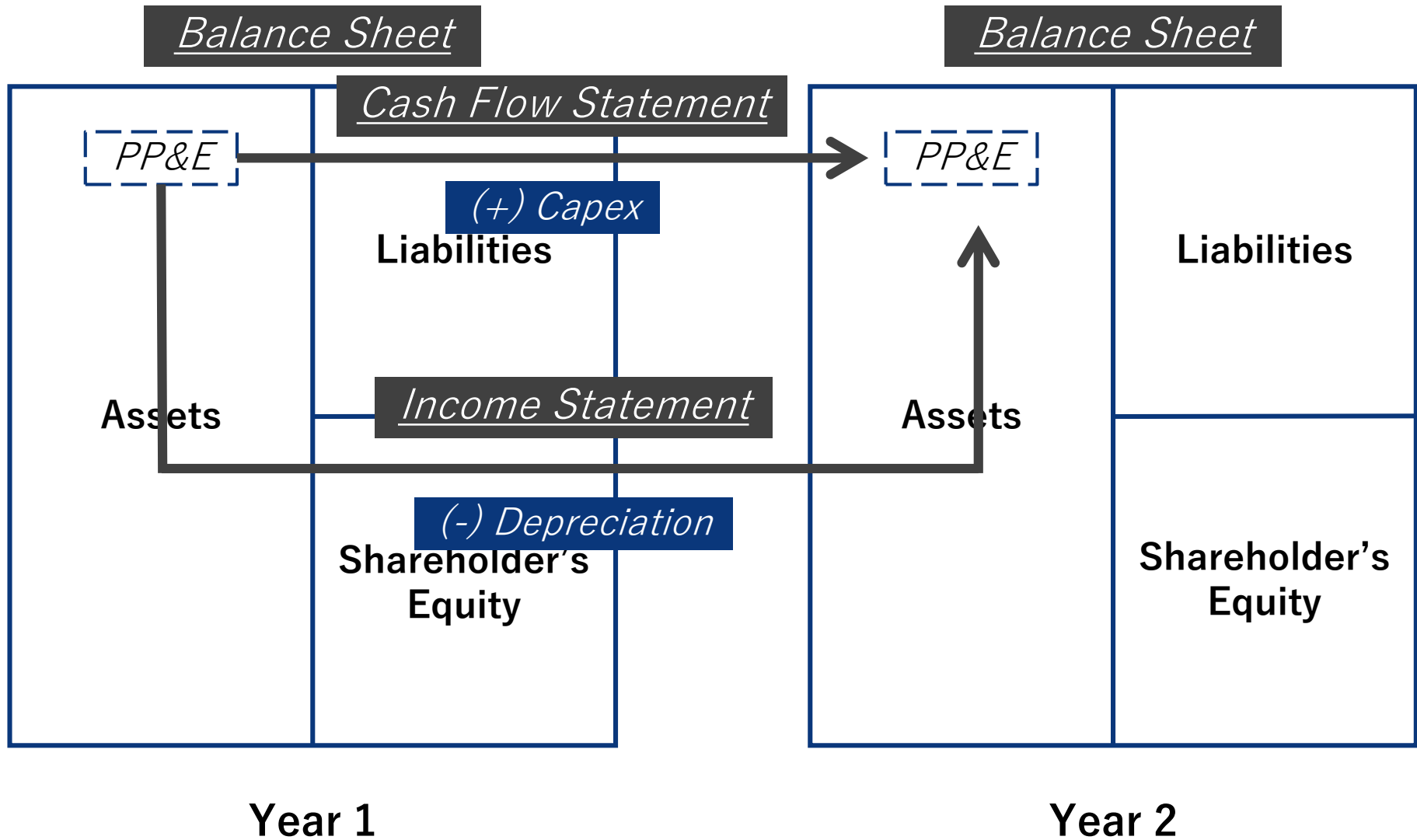
| | |
|---------------|-----------------------------|
| Assets | Liabilities |
| | Shareholder's Equity |

Year 2

How do the 3 statements link?



How do the 3 statements link?



How do the 3 statements link?

Example: What does the balance sheet look like in 2021?

| Balance Sheet | 2020 | 2021 |
|-------------------------------------|------------|----------|
| Assets | | |
| Cash | 50 | ? |
| PP&E | 150 | ? |
| Total assets | 200 | ? |
| Liabilities | | |
| Debt | 10 | ? |
| Total liabilities | 10 | ? |
| Equity | | |
| Equity capital | 190 | ? |
| Retained earnings | 0 | ? |
| Shareholder's equity | 190 | ? |
| Total liabilities and equity | 200 | ? |

| Income Statement | 2021 |
|--------------------|-----------|
| Revenue | 100 |
| Depreciation | 10 |
| Operating expenses | 20 |
| EBIT | 70 |
| Interest expense | 1 |
| Tax expense | 9 |
| Net Income | 60 |

| Cash Flow Statement | 2021 |
|---------------------------|-----------|
| CFFO (Operating) | |
| Net Income | 60 |
| Depreciation | 10 |
| CFFI (Investing) | |
| Capex | -50 |
| CFFF (Financing) | |
| Dividends paid | -10 |
| Net Change in Cash | 10 |

How do the 3 statements link?

Example: What does the balance sheet look like in 2021?

| Balance Sheet | 2020 | 2021 |
|-------------------------------------|------------|------------|
| Assets | | |
| Cash | 50 | 60 |
| PP&E | 150 | 190 |
| Total assets | 200 | 250 |
| Liabilities | | |
| Debt | 10 | 10 |
| Total liabilities | 10 | 10 |
| Equity | | |
| Equity capital | 190 | 190 |
| Retained earnings | 0 | 50 |
| Shareholder's equity | 190 | 240 |
| Total liabilities and equity | 200 | 250 |

| Income Statement | 2021 |
|--------------------|-----------|
| Revenue | 100 |
| Depreciation | 10 |
| Operating expenses | 20 |
| EBIT | 70 |
| Interest expense | 1 |
| Tax expense | 9 |
| Net Income | 60 |

| Cash Flow Statement | 2021 |
|---------------------------|-----------|
| CFFO (Operating) | |
| Net Income | 60 |
| Depreciation | 10 |
| CFFI (Investing) | |
| Capex | -50 |
| CFFF (Financing) | |
| Dividends paid | -10 |
| Net Change in Cash | 10 |

“ You have to understand accounting and you have to understand the nuances of accounting. It’s the language of business and it’s an imperfect language, but unless you are willing to put in the effort to learn accounting – how to read and interpret financial statements – you really shouldn’t select stocks yourself.

WARREN BUFFETT

Chairman of Berkshire Hathaway

Key terms

- **COGS** – Cost of goods sold
- **D&A** – Depreciation and amortization
- **R&D** – Research and development
- **SG&A** – Selling, general, and administrative costs
- **OpEx** – Operating expenses
- **EBIT** – Earnings before interest and taxes (operating income)
- **EBITDA** – Earnings before interest, taxes, depreciation, and amortization (“bullshit earnings” – Charlie Munger)
- **NOPAT** – Net operating profit after tax
- **CFFO** – Cash flow from operations
- **FCF** – Free cash flow
- **CapEx** – Capital expenditures