Why Product Managers Need to be Able to Read 10-K Statements

DEVELOPMENTCORPORATE

Contents

Financial Literacy Intro

One of the key themes I have reinforced over my 15 year career in product management is basic financial literacy. Product managers need to be able to locate, read, and interpret basic financial filings like Annual Reports (10-Ks), quarterly filings (10-Qs) and Proxy Statements (Def 14As). There is a ton of information that customers and competitors who are public companies must disclose. This information can make or break a sales deal or competitive steal away campaign.

Here's a simple case in point. A company I worked for had a long standing relationship with a customer where they provided a value added outsourced solution that generated over $1.5 million/year in revenues. After a change in management, the customer decided to re-examine their investment in the outsourced solution. A new executive wanted to bring the solution in house. To do so, this company would need to invest over $750,000 in equipment and software, plus set up a group of employees to do the processing/value added services the service provider had been doing. If they brought the business in house they believed they could save $500K a year.

The sales person on this deal was petrified that the customer was going to take the solution in house. As a result he thought of offering to cut the monthly fees by 50% so that the customer would not even consider taking the solution in house. This company had a history of 'writing down' existing business in a bid to preserve revenue.

Fortunately a product manager on the deal pricing committee did a little research on the customer. Even though it was a large company with greater than $200 million in revenues, it had some serious financial challenges. At the time they were 'considering' in-sourcing the solution the company only had $5 million in cash on their balance sheet and a limited revolving credit facility. The product manager learned this fact by reviewing the customer's 10-Qs and 10-Ks. The customer also had certain minimum EBITDA and cash flow targets they had to meet to be in compliance with the covenants of their loan agreements. Once the sales team realized that the company would have to invest about 20% of their existing cash balance to make the project work, they came to the conclusion that they were not serious about in-sourcing. Instead they were really looking to get a massive price reduction. Armed with this knowledge they were able to structure a win-win deal for all parties that did not result in a 50% revenue reduction. In this case, the product manager was able to save the company hundreds of thousands of dollars in lost revenue.

The balance of this post will focus on some basic elements of 10-K Annual Reports.

10-K Overview

A Form 10-K is an annual report required by the U.S. Securities and Exchange Commission (SEC), that gives a comprehensive summary of a company's financial performance. Although similarly named, the annual report on Form 10-K is distinct from the often glossy "annual report to shareholders," which a company must send to its shareholders when it holds an annual meeting to elect directors (though some companies combine the annual report and the 10-K into one document). The 10-K includes information such as company history, organizational

structure, executive compensation, equity, subsidiaries, an audited financial statements, among other information.

You can find 10-Ks at the SEC's EDGAR website where it maintains copies of all filings. You can search by company name or ticker symbol. Canada offers a similar system for Canadian public companies called SEDAR. You can access it here.

A 10-K consists of a number of standard components- 4 parts and 15 schedules. An annotated table of contents is included at the end of this post.

For discussion purposes I am going to reference a 10-K filed by a former employer of mine – EasyLink Services. This report covers a timeframe after I left the company. You can access the complete filing here.

Here are some relevant parts of the filing that would be of interest to product managers:

Fiscal Year

On the cover of the filing, EasyLink's fiscal year is listed. Most company's fiscal years run from January through December. EasyLink's runs from August 1 – July 30. Companies sometimes use non-calendar fiscal years to differentiate themselves from other companies. Another company I worked for fiscal year ran from October 1 to September 1 to mirror the U.S. Federal government's fiscal year.

Understanding customer fiscal year ends is critical. Most large purchases (>$150,000) need to be budgeted. Annual budgets are usually developed in the third fiscal quarter, finalized in the fourth quarter, and 'released' in the first quarter. Trying to pitch an unplanned major purchase in the third or fourth quarter can be tough. You should be aware of any budgetary roadblocks that could slow down the purchase process.

When studying competitors, understanding their fiscal year is also important. Typically, most financial plans have revenue plans that are 'backloaded' – in other words the fourth quarter tends to be the largest of all quarters. Sales people will bust their backs to exceed quota and get into the accelerator portion of the compensation plans. They will tend to offer higher discounts or better pricing late in the fiscal year to maximize their compensation.

Business Overview.

In Item 1. Business on page 1 of the filing Easylink briefly describes their business. This section is basically the start of their corporate messaging platform. It is how they simply explain their business. This section also describes how EasyLink segments its business into two broad categories. It also describes two significant acquisitions EasyLink had completed.

Products and Services

On page 2, EasyLink provides a basic description of their products and services.

Departmental Overviews

On page 3 EasyLink describes their product development, customer and technical support, and sales and marketing organizations. In terms of product development they note that in fiscal 2011 they spent $12.7 million in product development. This represents only 10% of revenues. High growth companies often spend 25%-30% of their revenues on product development.

Customers

On page 4, EasyLink discloses that they have approximately 30,000 customers. Many of our customers may generally terminate our services with 30 days notice without penalty, unless their agreement contains a minimum revenue commitment that would require payment by the customer of any unused shortfall amount upon termination. Translation – most customers are month to month which would be easier to steal away than customers that had multi-year contracts with monthly or annual minimums. EasyLink noted than no single customer accounted for more than 10% of revenues. When companies disclose that their revenues are concentrated in a few customers, that is a sign that if your firm can steal away one or more of those customers, you can inflict significant financial pain on your competitor.

Seasonality & Backlog

EasyLink notes "Our revenues experience modest changes due to seasonality, and we have no material backlog in sales orders or the provisioning of customer orders. We traditionally experience lower than average usage in the fiscal first and second quarters as we move into the summer and holiday months." Translation is that their third and fourth quarters are not too backloaded.

Competition

On pages 3-4 EasyLink describes who they consider to be their major competitors to be.

Employees

On page 5 EasyLink states "As of July 31, 2011, we had approximately 541 employees worldwide, all of which were full-time employees. Of these employees 340 were located in the U.S. and 201 were located internationally. None of our employees are covered by a collective bargaining agreement. We consider our relations with our employees to be good." Some companies even break down headcount by major department.

Headcount numbers are very important. You can use them to calculate some common metrics such as average revenue/head, average expense/head, and average profit/head. You can use these metrics to compare your firm against theirs as well as your competitors.

Item 1A. Risk Factors

All 10-Ks contain a section that details, from the company's perspective, risks and uncertainties that could impact their financial performance and stock price. Many of these items are pro-forma, you will see them in most 10-Ks. You should be alert to anything that is not cited by other companies in the industry. EasyLink's risk factors start on page 6 and run through page 12.

Item 2. Properties

On page 12 Easylink describes the properties and locations they use for their business.

Item 3. Litigation

On pages 12 and 13 EasyLink describes six lawsuits they are party to. It is not unusual for companies to be involved in lawsuits. If the company believes that they have a significant risk of losing a lawsuit, they will establish a reserve to cover any settlement. If the suit settles with no financial impact, the company will release the reserve and provide a temporary one time bump in profits and earnings.

Accounts Receivable and Allowance For Doubtful Accounts

On page 19, EasyLink describes their accounts receivable and doubtful accounts. "The net carrying values of accounts receivable were $29.8 million and $11.5 million as of July 31, 2011 and 2010, respectively. Inclusive in the values were allowance for doubtful accounts of $2.9 million and $1.7 million, respectively. In addition, the bad debt expense for Fiscal 2011 and Fiscal 2010 was $1.4 million and $0.8 million, respectively. This level of accounts receivable and doubtful accounts are reasonable given the scale of EasyLink's revenues is fine. Another useful metric is DSO – Days Sales Outstanding. DSO = total accounts receivable / (total sales/365). A DSO of less than 45 days is ideal.

Results of Operations

Results of operations is one of the most significant sections in the 10-K. It describes overall revenue and expenses, and the commentary describes what has driven increases and decreases. Consider this table:

	July 31,	Ended July		
	7/31/2011	7/31/2010	Variance $	Variance %
Service revenues, net:				
On Demand				
Fax Services	94,580	33,253	61,327	184%
DCM Services	1,950	1,990	(40)	-2%
Production Email	16,336	4,652	11,684	251%
Notification	8,558	-		
Other Services	5,329	860	4,469	520%
Total On Demand	126,753	40,755	85,998	211%
Supply Chain				
EDI Services	31,786	32,840	(1,054)	-3%
Telex Services	6,227	7,848	(1,621)	-21%
Total Supply Chain	38,013	40,688	(2,675)	-7%
Total Service revenues, net:	164,766	81,443	83,323	102%
Cost of services:				
On Demand	47,565	12,297	35,268	287%
Supply Chain	9,287	10,252	(965)	-9%
Total Cost of services	56,852	22,549	34,303	152%
Gross profit:				
On Demand	79,188	28,458	50,730	178%
	48%	35%	13%	38%
Supply Chain	28,726	30,436	-1,710	-6%
	51%	135%		
Total Gross profit	107,914	58,894	49,020	83%
	65%	72%		
Product development and enhancement	12,150	7,275	4,875	67%
Selling and marketing	23,302	12,560	10,742	86%
General and administrative	46,698	27,822	18,876	68%
Acquisition and integration related	3,326	-		
Total Operating expenses	85,476	47,657	37,819	79%
Other expenses	(5,068)	(1,346)	(3,722)	277%

EasyLink is unusual in that report results of operations by product/service line. You can see trends in revenues, gross margin, and operating expense. EasyLink's legacy product lines (EDI & Telex) show slight year-over-year declines, while their other product/service lines show significant growth via its acquisition of the Xpedite business. It is important to note that only 10 months of Xpedite's revenues were included in FY2011 since the acquisition closed in October 2010. Having insight into product/service line revenues is a gold mine. You can determine the health and future potential from the trends.

Statement of Operations (aka Income Statement or Profit/Loss Statement) have four major sections. The first deals with revenues – the funds received by the company for the sale of products and services. Revenue that is reported is subject to revenue recognition rules. These are complex regulations that can impact the scale of revenues reported in a given fiscal year. If you have insomnia one night, check out ASC 606, Revenue From Contracts With Customers. The second section deals with the cost of good/services sold. COGs are the costs associated with the production of goods or services. Check this link out for more details. Gross Margin or Gross Profit is equal to Revenue minus Cost of Goods/Services sold. Companies in the same industry will have similar gross margins. The next section deals with operating expenses. Operating expenses represent the ongoing cost for running a product, business, or system. Typically they include sales, marketing, research, development, and general and administrative expenses. Again, companies in the same industry will have operating expenses as a similar percentage of revenues as other peers. The last section covers other expenses such as interest payments on debts and taxes.

Report of Independent Registered Accounting Firm

The audit report from EasyLink's auditors Friedman LLP is on page F-2. Public companies are required to have an independent audit each year. This ensures that the financial statements and other management commentary are complete and accurate. They also certify that internal controls are sufficient to meet the requirements of Sarbanes Oxley.

Two things to look for in the auditor's report. First, if the auditor issues a 'qualified' opinion -- in other words the auditor has issues with how the company has presented or accounted for certain financial information. Another red flag is if they find deficiencies in the company's internal controls.

Financial Statements

10-Ks include full financial statements for the fiscal year. We have already discussed Results from Operations (aka Income Statement or Profit & Loss statement), let's move onto two other statements – the Balance Sheet and Cash Flow Statement.

Balance Sheet

The balance sheet presents a snapshot in time of a firm's assets, liabilities, and stockholder equity. In the EasyLink example, most of the changes from 2010 to 2011 were driven by the acquisition of Xpedite.

ASSETS				
Current assets:	7/31/2011	7/31/210	$ Variance	% Variance
Cash and cash equivalents	30,178	20,475	9,703	47%
Accounts receivable, net of allowance for doubtful accounts and allowance for sales returns and	29,752	11,481	18,271	159%
Prepaid expenses and other current assets	3,956	1,865	2,091	112%
Deferred income taxes	3,709	6,598	(2,889)	-44%
Total current assets	67,595	40,419	27,176	67%
Property and equipment, net	10,127	5,521	4,606	83%
Goodwill	73,494	34,455	39,039	113%
Other intangible assets, net	68,615	15,874	52,741	332%
Deferred income taxes, net	22,507	7,588	14,919	197%
Other assets	721	629	92	15%
Total assets	243,059	104,486	138,573	133%
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities:				
Accounts payable	5,527	2,310	3,217	139%
Notes payable	28,088	15,258	12,830	84%
Accrued expenses	19,051	8,740	10,311	118%
Deferred revenue and other current liabilities	3,360	1,497	1,863	124%
Total current liabilities	56,026	27,805	28,221	101%
Notes payable, net of current portion	80,174	9,684	70,490	728%
Deferred income taxes, net	6,940	-	6,940	
Other liabilities	814	285	529	186%
Total liabilities	143,954	37,774	106,180	281%
Additional paid-in capital	137,467	132,799	4,668	4%
Treasury stock, 1,000 shares at July 31, 2011 and 2010	(2,122)	(2,122)	-	0%
Accumulated other comprehensive loss	(2,789)	(5,797)	3,008	-52%
Accumulated deficit	(33,775)	(58,471)	24,696	-42%
Total stockholders' equity	99,105	66,712	32,393	49%
Total liabilities and stockholders' equity	243,059	104,486	138,573	133%

There are some things to look for. First is working capital. Working Capital is equal to current assets minus current liabilities. In EasyLink's case they have about $11.5 million in working capital. EasyLink spends about $11.8 million a month in cost of goods sold and operating expenses. So if revenue suddenly stopped coming in, they would have about a month's runway before running out of cash. Another metric to look at is Days Sales Outstanding (DSO). DSO = total accounts receivable / (total sales/365). This is an indication of how quickly EasyLink's customers pay their invoices. EasyLink's DSO is about 51 days. If DSO > 90 days it should raise a red flag.

You can also determine how much debt a company is carrying. Debt is covered in two places – notes payable in current liabilities + notes payable in long term liabilities. Notes payable in current liabilities is the portion of the total debt that is due within the period reported for the Balance Sheet.

Another metric to consider is deferred revenue. Deferred revenue is money received for goods or services which have not yet been delivered. An example is software maintenance. A customer pays an annual fee for maintenance (support & bug fixes). The company can only recognize one twelfth of the maintenance each month, the revenue is deferred. If the deferred revenue number is very high in comparison to total revenues it is a sign that the company is using the cash it received for other purposes, such as to fund operating losses.

Cash Flow Statement

A cash flow statement is intended to

1. Provide information on a firm's liquidity and solvency and its ability to change cash flows in future circumstances
2. Provide additional information for evaluating changes in assets, liabilities and equity
3. Improve the comparability of different firms' operating performance by eliminating the effects of different accounting methods
4. Indicate the amount, timing and probability of future cash flows

The cash flow statement is partitioned into three segments, namely:

1. cash flow resulting from operating activities;
2. cash flow resulting from investing activities;
3. cash flow resulting from financing activities.

From a product manager's perspective the main use of a cash flow statement is to understand whether a company is generating cash from operations or burning cash.

Consider EasyLink's cash flow statement below. You can see that in 2011 they generated over $28 million in cash from operations, and at year end they had a cash balance of over $20 million. In early stage or venture backed companies you will often see that they are burning cash. For example, Uber lost $304 million in the first quarter of 2018.

Year Ended July 31,	31-Jul	31-Jul	$ Variance	% Variance
	2011	2010		
Cash flows from operating activities:				
Net income	24,696	17,093	7,603	44%
Adjustments to reconcile net income (loss) to net cash provided by				
Depreciation and amortization	13,533	8,057	5,476	68%
Bad debt expense	1,411	795	616	77%
other non-cash interest expense	1,020	535	485	91%
assets		144	(144)	-100%
Deferred income taxes, net	(12,433)	(12,604)	171	-1%
Non-cash charges for equity instruments issued for compensation and services	1,635	1,054	581	55%
Changes in assets and liabilities:			-	
Accounts receivable	(3,399)	(877)	(2,522)	288%
Prepaid expenses and other assets	(48)	5,774	(5,822)	-101%
Accounts payable	596	(396)	992	-251%
Accrued expenses	2,152	2,373	(221)	-9%
Deferred revenue and other current liabilities	1,163	(771)	1,934	-251%
Other long term liabilities	(511)	(408)	(103)	25%
Net cash provided by operating activities	**29,815**	**20,759**	9,056	44%
Cash flows from investing activities:				
acquisitions, net of cash acquired	(102,143)			
Purchases of property and equipment	(3,722)	(1,090)	(2,632)	241%
Net cash from investment	-	1	(1)	
Net cash used in investing activities	**(105,865)**	**(1,089)**	(104,776)	9621%
Cash flows from financing activities:			-	
Net borrowings from issuance of notes payable	122,000	5,000	117,000	2340%
Payments of notes payable and debt extinguishment	(39,899)	(7,600)	(32,299)	425%
Proceeds from exercises of employee stock options and restricted stock, net of tax	3,139	(6,577)	9,716	-148%
Payment of dividends on preferred stock	(200)	(858)	658	77%

Other Exhibits

Companies usually list of other interesting documents they have filed with the SEC. Starting on page 27, you can find a list of these filings. Want to see copies of the employment agreements for key executives? They are there. Looking at the incentive compensation portion of an employment agreement can give you an idea of what motivates executives to do, or not do, certain things. Want to see the lease agreement for a new office? It's there as well. Other filings include the definitive agreements for mergers and acquisitions and the documents associated with debt financing. One interesting fact found in debt documents are known as 'covenants'. Covenants describe certain terms and conditions that th company must abide to. They include items such as minimum EBITDA targets, restrictions on future acquisitions, and how excess cash generated by the business above pre-agreed targets must be used to pay down existing debt.

Index to standard 10-K

Part 1

Item 1 – Business

This describes the business of the company: who and what the company does, what subsidiaries it owns, and what markets it operates in. It may also include recent events, competition, regulations, and labor issues. (Some industries are heavily regulated, have complex labor requirements, which have significant effects on the business.) Other topics in this section may include special operating costs, seasonal factors, or insurance matters.

Item 1A – Risk Factors

Here, the company lays anything that could go wrong, likely external effects, possible future failures to meet obligations, and other risks disclosed to adequately warn investors and potential investors.

Item 1B – Unresolved Staff Comments

Requires the company to explain certain comments it has received from the SEC staff on previously filed reports that have not been resolved after an extended period of time. Check here to see whether the SEC has raised any questions about the company's statements that have not been resolved.

Item 2 – Properties

This section lays out the significant properties, physical assets, of the company. This only includes physical types of property, not intellectual or intangible property.

Item 3 – Legal Proceedings

Here, the company discloses any significant pending lawsuit or other legal proceeding. References to these proceedings could also be disclosed in the Risks section or other parts of the report.

Item 4 – Mine Safety Disclosures

This section requires some companies to provide information about mine safety violations or other regulatory matters.

Part 2

Item 5 – Market

Gives highs and lows of stock, in a simple statement. Market for Registrant's Common Equity, related stockholder matters and issuer purchases of equity securities.

Item 6 – Consolidated Financial Data

In this section Financial Data showing consolidated records for the legal entity as well as subsidiary companies.

Item 7 – Management's Discussion and Analysis of Financial Condition and Results of Operations

Here, management discusses the operations of the company in detail by usually comparing the current period versus prior period. These comparisons provide a reader an overview of the operational issues of what causes such increases or decreases in the business.

Item 7A – Quantitative and Qualitative Disclosures about Market Risks

Forward Looking Statements

Forward-looking statement is the disclaimer that projections as to future performance are not guaranteed, and things could go otherwise.

Item 8 – Financial Statements

Independent Auditor's Report

Consolidated Statements of Operation

Consolidated Balance Sheets

Other accounting reports and notes

Here, also, is the going concern opinion. This is the opinion of the auditor as to the viability of the company. Look for "unqualified opinion" expressed by auditor. This means the auditor had no hesitations or reservations about the state of the company, and the opinion is without any qualifications (unconditional).

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

Item 9A. Controls and Procedures

Item 9B. Other Information

Part 3

Item 10. Directors, Executive Officers and Corporate Governance

Item 11. Executive Compensation

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13. Certain Relationships and Related Transactions, and Director Independence

Item 14. Principal Accounting Fees and Services

Part 4

Item 15. Exhibits, Financial Statement Schedules Signatures