RATIONAL NUMBERS

i to pi "Please be rational"

pi to i "Oh get real!"

Many aspects of a business are qualitative. Topics like the markets that a business serves or the differentiation offered by the products are both examples of topics that are at least partially subjective.

Numbers can provide a very different perspective. Our next series of newsletters will discuss different aspects of financial statements, and how to rapidly use numbers to reach some fairly significant conclusions about the operations of companies.

This newsletter will introduce the areas that will be covered greater detail in coming months.

Our objective of these newsletters is to help non-financial people understand financial statements better, and faster. We also hope that our work will also help folks from the finance or investment world better understand the viewpoints of people actually working to run enterprises. We'll define some of the jargon that is thrown around, and give real examples from public companies. If you would have any specific questions that you'd like answered in this upcoming series, please let us know and we'll work to answer them in the newsletters.

CUTTING TO THE CHASE

After the Telecom bubble burst, many very expensive assets, including sophisticated wafer fabrication plants were made available for purchase. These assets were routinely considered as acquisition candidates. Within the industry-leading companies, teams were routinely designated to look at the site and come back with acquisition recommendations.

A group of us traveled to the East coast to visit a prestigious wafer fab. All of us were given an overview presentation. This presentation told us of the great value of the fab and its poor alignment with the strategic direction of the parent corporation. Further, it highlighted advanced technology, the elite staff and strong revenue forecasts, as further evidence of the worth of the asset.

At this point, the management team of the wafer fab told us they were providing two detailed presentations to be conducted simultaneously. The first presentation was to focus on technology and products, while the second would focus on business and financials. Most of the group wanted to hear about the technology and products, so I went with the sole financial guy to hear about the numbers.

The financial guy that accompanied me was a very astute numbers guy, but not particularly blessed with great people skills. We sat down and were handed our packet of numbers as the speaker began his introductory comments. Within seconds, the numbers guy blurted out a very direct question… "Is this one of those companies that has a million dollars of landscaping in the reception area?"

It turns out that the company did have quite elaborate offices, and that indeed that site had very beautiful indoor landscaping. The room became very quiet and the speaker was visibly shaken. Ironically, the numbers guy continued to look at the financial data and seemed to miss the social chaos.

Many people found the comment to be simply rude, but it illustrates how quickly accurate conclusions can be drawn about a company. The site did indeed have a pattern of excess spending, and the rest of the financial presentation showed a strong resistance to the types of cost containment strategies that might lead to the site becoming a viable business.

There is no magic in financial numbers, and learning some of the algebraic relationships of key metrics is relatively straightforward. Our next set of newsletters will talk about various financial metrics that can be used to quickly develop a working understanding of a business.

Key Point: *Financial statements can quickly give deep insights into a company.*

DIFFERENT SETS OF NUMBERS

Three main financial documents for a company are:

The Profit and Loss (P&L) statement

The Balance Sheet

The Statement of Cash Flows

This newsletter will describe these three documents in qualitative terms. In coming months, we'll spend time on each financial statement, giving specific examples how to use these documents.

THE P&L STATEMENT

This discussion should start with a cautionary note about the P&L statement. It is the easiest of the three documents to understand. Ironically, particularly in technology companies, many mistakes are made in the use of the P&L statement.

The P&L statement describes the revenue, and costs associated with that revenue during a period of time, commonly a month, a quarter or a year. The P&L statement starts with the revenue, or "top-line", of the company. The costs of the company are subtracted. The revenue of the company, minus the costs, is recorded at the bottom (hence the term "bottom-line"). If the revenue is greater than the costs of the revenue, the bottom-line is positive and the company is profitable.

The P&L statement describes many different types of costs, including the costs to produce the product, costs to market and distribute the product, costs for development of future products and general costs for the administration of the company.

In the next newsletter, we'll cover the P&L statement and touch on topics including fixed and variable costs, flow-through, different business models, EBIT & EBITDA, what GAAP and pro-forma means and other mystical financial terms.

THE BALANCE SHEET

The balance sheet is a statement of the assets and liabilities of a company at a fixed point in time. It is a more difficult statement to understand, but in many ways it is the best barometer of the overall health of the business. The Balance Sheet is comprised of three major sections that comprise an algebraic equation: assets equal liabilities plus equity.

Assets include cash and cash equivalents, manufacturing plants, equipment, investments, inventories, and monies that the company is owed. In addition, it can include goodwill and other intangible assets, items that could not actually ever be "sold", per se, but that have some value implied by a prior financial transaction (If you read that sentence and understand it, you've spent way too much time reading about accounting principles--go out and get some fresh air…)

Liabilities include debts the company owes to other companies, payroll owed to employees, loans to investors or banks, and obligations that the company has anticipated but has not yet incurred.

The final category of the Balance Sheet is Equity. Equity includes things such as shareholder equity, retained earnings and paid-in capital.

In the second newsletter of this series, we'll discuss the different categories of the Balance Sheet and relate them to the P&L Statement to better understand the operational efficiency of the company. In addition, we will discuss the judgment calls that management teams make in determining the value of items on the balance sheet, how changes on the Balance

Sheet are reflected in the P&L statement, and items that can be considered in either the Liability or Equity portion of the Balance Sheet. The focus will be to help the reader understand what constitutes a strong Balance Sheet and what weaknesses can be detected in a company by examining the Balance Sheet.

STATEMENT OF CASH FLOWS

For most people, the Statement of Cash Flows is the most difficult financial document to understand. It is ironic that the only statement that really deals with cold, hard cash is the most difficult to understand, whereas both the P&L Statement and the Balance Sheet, both of which have many items that are only loosely related to hard cash, are easier to grasp.

In most simple terms, the Statement of Cash Flows explains the flow of cash (and cash equivalents) into and out of the company based upon the P&L statement and changes in the Balance Sheet.

While it is a bit difficult to understand, the information contained in the Statement of Cash Flows is critically important: it shows how the company generates or consumes cash. It answers many fundamental questions about the company: Is the company viable? Can the company meet payroll? Does it raise the money from additional stock sales, thereby diluting shareholders? Does it generate operational cash?

To answer these questions in a sensible fashion, the Statement of Cash Flows is divided into three areas: operational activities, investing activities and financing activities.

Our final newsletter dealing with numbers will look at the Statement of Cash Flows, by section, so that a little bit of the mystery is lifted.

Cheers,

The InSite Team

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