

Beyond earnings: How reporters can decode financial statements

Financial Accounting & Analysis: An (Incredibly Dangerously Brief!) Introduction

Overview

Principal Financial Statements

Scale, Scale, Scale

Accounting Analysis

GAAP vs Non-GAAP

Some soft spots and red flags

Principal Financial Statements: Overview

Purpose of Financial Accounting

Financial accounting has evolved to a mechanism for communicating a firm's current standing and past performance.

Like all communication mechanisms, there are some rules for mapping “what is observed” to “what is said.” This is called Generally Accepted Accounting Principles (GAAP).

Like all communication mechanisms, it is imperfect.

Financial Accounting Foundation

The Fundamental Accounting Equation

$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Equity (E)}$$

or

$$\text{Claims of the firm} = \text{Claims on the firm}$$

Double entry bookkeeping rule – the accounting equation must always be satisfied after each transaction is recorded.

Financial Accounting Foundation

The Fundamental Accounting Equation

$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Equity (E)}$$

or

$$\text{Claims of the firm} = \text{Claims on the firm}$$

What pops out of the system?

Balance Sheet

Income Statement

The Balance Sheet

Represents *stocks* of assets, liabilities, and equities at a point in time.

Assets: claims or resources controlled by the firm (e.g., cash, receivables, inventory, equipment)

Liabilities: claims on the firm (e.g., payables, debt)

Equities: residual claimants of the firm (e.g., common stockholders). The book (i.e., balance sheet) value of equity is a frequently cited stat.

NVIDIA Corporation and Subsidiaries
Consolidated Balance Sheets
(In millions, except par value)

	<u>Jan 25, 2026</u>	<u>Jan 26, 2025</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 10,605	\$ 8,589
Marketable securities	51,951	34,621
Accounts receivable, net	38,466	23,065
Inventories	21,403	10,080
Prepaid expenses and other current assets	3,180	3,771
Total current assets	125,605	80,126
Property and equipment, net	10,383	6,283
Operating lease assets	2,867	1,793
Goodwill	20,832	5,188
Intangible assets, net	3,306	807
Deferred income tax assets	13,258	10,979
Non-marketable equity securities	22,251	3,387
Other assets	8,301	3,038
Total assets	<u>\$ 206,803</u>	<u>\$ 111,601</u>

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NVIDIA Corporation and Subsidiaries
Consolidated Balance Sheets
(In millions, except par value)

	Jan 25, 2026	Jan 26, 2025
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Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 9,812	\$ 6,310
Accrued and other current liabilities	21,352	11,737
Short-term debt	999	—
Total current liabilities	<u>32,163</u>	<u>18,047</u>
Long-term debt	7,469	8,463
Long-term operating lease liabilities	2,572	1,519
Other long-term liabilities	7,306	4,245
Total liabilities	<u>49,510</u>	<u>32,274</u>
Commitments and contingencies - see Note 12	—	—
Shareholders' equity:		
Preferred stock, \$0.001 par value; 2 shares authorized; none issued	—	—
Common stock, \$0.001 par value; 80,000 shares authorized; 24,304 shares issued and outstanding as of January 25, 2026; 24,477 shares issued and outstanding as of January 26, 2025	24	24
Additional paid-in capital	10,118	11,237
Accumulated other comprehensive income	178	28
Retained earnings	146,973	68,038
Total shareholders' equity	<u>157,293</u>	<u>79,327</u>
Total liabilities and shareholders' equity	<u>\$ 206,803</u>	<u>\$ 111,601</u>

Isn't the Balance Sheet Enough?

But what happened during the year?

Why did equity book value change?

The income statement seeks to provide some insight.

The Income Statement

Represents *flows* of net assets into/out of the firm during a period, largely due to its operations

Equity holder perspective – flows to/from equity

Flow of net assets is called net income (loss)

Net income for a period ultimately lands in the equity account called retained earnings on the balance sheet.

Dividends not charged to net income – they are charged directly to retained earnings.

NVIDIA Corporation and Subsidiaries
Consolidated Statements of Income
(In millions, except per share data)

	Year Ended		
	Jan 25, 2026	Jan 26, 2025	Jan 28, 2024
Revenue	\$ 215,938	\$ 130,497	\$ 60,922
Cost of revenue	62,475	32,639	16,621
Gross profit	153,463	97,858	44,301
Operating expenses			
Research and development	18,497	12,914	8,675
Sales, general and administrative	4,579	3,491	2,654
Total operating expenses	23,076	16,405	11,329
Operating income	130,387	81,453	32,972
Interest income	2,300	1,786	866
Interest expense	(259)	(247)	(257)
Other income, net	9,022	1,034	237
Total other income, net	11,063	2,573	846
Income before income tax	141,450	84,026	33,818
Income tax expense	21,383	11,146	4,058
Net income	\$ 120,067	\$ 72,880	\$ 29,760

Net Assets and Flows of Net Assets

Financial Statements are generally in conformity with Generally Accepted Accounting Principles (GAAP).

Those principles communicate measures of stocks and flows of net assets that are based upon **accrual accounting**.

Accrual accounting endeavors to record cash flows in the period they are earned/used to generate earnings, as opposed to when the cash is received/expended.

Accrual accounting is thought to better communicate the firm's performance/standing by providing more informative/relevant measures.

But Cash is King

GAAP requires accrual accounting (as opposed to cash basis accounting) so net assets and flows do not reflect cash **now**.

Revenues and expenses can be recorded before or after the associated cash flows.

An ability to generate/utilize cash, however, is critical for a business to service its debt, execute its investment strategy, etc.

Hence, a cash flow statement is also presented to highlight sources and uses of cash.

Statement of Cash Flows

The change in cash (i.e., the cash flow) is attributable to three activities: operating, investing, and financing

Operating section – **reconciles** from net income to measure of operating cash flows.

Investing section – lists cash flows from investing activities (e.g., buying and selling properties) and totals to investing cash flows.

Financing section – lists cash flows from financing activities (e.g., issues of debt or equity) and totals to financing cash flows.

NVIDIA Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(In millions)

	Year Ended		
	Jan 25, 2026	Jan 26, 2025	Jan 28, 2024
Cash flows from operating activities:			
Net income	\$ 120,067	\$ 72,880	\$ 29,760
Adjustments to reconcile net income to net cash provided by operating activities:			
Stock-based compensation expense	6,386	4,737	3,549
Depreciation and amortization	2,843	1,864	1,508
Gains on non-marketable equity securities and publicly-held equity securities, net	(8,918)	(1,030)	(238)
Deferred income taxes	(1,424)	(4,477)	(2,489)
Other	(287)	(502)	(278)
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(15,399)	(13,063)	(6,172)
Inventories	(11,324)	(4,781)	(98)
Prepaid expenses and other assets	577	(395)	(1,522)
Accounts payable	3,096	3,357	1,531
Accrued and other current liabilities	5,257	4,278	2,025
Other long-term liabilities	1,844	1,221	514
Net cash provided by operating activities	<u>102,718</u>	<u>64,089</u>	<u>28,090</u>

NVIDIA Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(In millions)

	Year Ended		
	Jan 25, 2026	Jan 26, 2025	Jan 28, 2024
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Cash flows from investing activities:			
Proceeds from sales of marketable securities	15,157	495	50
Proceeds from maturities of marketable securities	11,226	11,195	9,732
Proceeds from sales of non-marketable equity securities	84	171	1
Purchases of marketable securities	(40,616)	(26,575)	(18,211)
Purchases of non-marketable equity securities	(17,502)	(1,486)	(862)
Groq, Inc.	(13,000)	—	—
Purchases related to property and equipment and intangible assets	(6,042)	(3,236)	(1,069)
Acquisitions, net of cash acquired	(1,535)	(1,007)	(83)
Other	—	22	(124)
Net cash used in investing activities	<u>(52,228)</u>	<u>(20,421)</u>	<u>(10,566)</u>

NVIDIA Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(In millions)

	Year Ended		
	Jan 25, 2026	Jan 26, 2025	Jan 28, 2024
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Cash flows from financing activities:			
Proceeds related to employee stock plans	644	490	403
Payments related to repurchases of common stock	(40,086)	(33,706)	(9,533)
Payments related to employee stock plan taxes	(7,948)	(6,930)	(2,783)
Dividends paid	(974)	(834)	(395)
Principal payments on property and equipment and intangible assets	(101)	(129)	(74)
Repayment of debt	—	(1,250)	(1,250)
Other	(9)	—	(1)
Net cash used in financing activities	<u>(48,474)</u>	<u>(42,359)</u>	<u>(13,633)</u>
Change in cash and cash equivalents	2,016	1,309	3,891
Cash and cash equivalents at beginning of period	8,589	7,280	3,389
Cash and cash equivalents at end of period	<u>\$ 10,605</u>	<u>\$ 8,589</u>	<u>\$ 7,280</u>

Principal Financial Statements Overview: Summary

Balance Sheet – *stocks* of assets, liabilities, and equities at a point in time

Income Statement – *flows* of net assets into/out of the firm during a period, largely due to its operations

Cash Flow Statement – *flows* of cash into/out of the firm during the period

Using Financial Statements Well: Two Tips

Financial statements are used to assess performance, inform predictions, and/or aid decision-making.

Using them well is challenging.

Here are two tips to keep in mind

Scale, Scale, Scale

Ed and Mary gave their two daughters, Barb and Betty, some startup funds for their new business ventures. One year later, Barb returned home with \$110 and Betty returned home with \$210.

From a purely financial perspective, which daughter made Mary and Ed most proud?

Scale, Scale, Scale

In depends on how many start-up funds each daughter was granted – the scale of the financing they received matters.

Many common financial statement **ratios** are employed because they adjust for scale.

Scale adjustments permit:

- Comparisons across firms

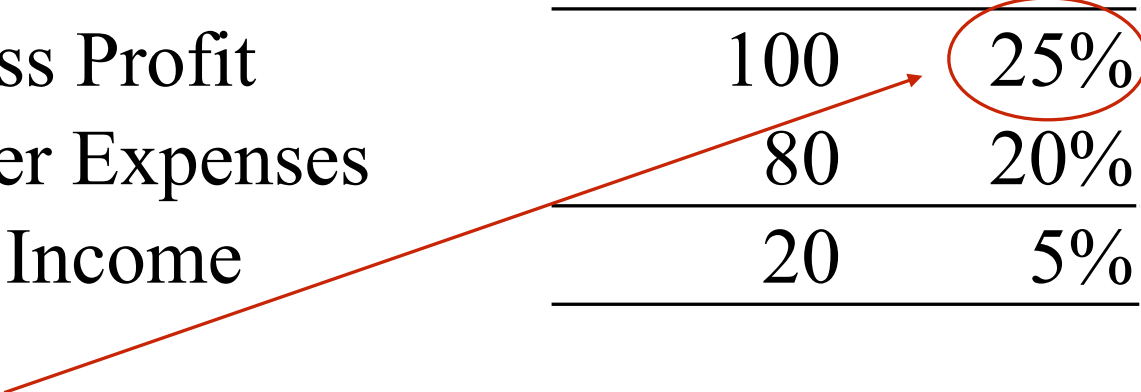
- Comparisons of a firm with itself over time

Ratio Analysis – Two Examples

A Profitability Assessment Ratio

A Simple Income Statement

Sales/Revenues	400	100%
Cost of Goods Sold	300	75%
Gross Profit	100	25%
Other Expenses	80	20%
Net Income	20	5%



Gross Profit Margin: One Profitability Assessment Ratio

A Profitability Assessment Ratio

$$\text{Gross Profit Margin} = \frac{\text{Sales} - \text{Cost of Sales}}{\text{Sales}}$$

Captures a firm's mark-up, which is necessary to cover operating costs and (hopefully) leave a profit for the firm.

Too low relative to norms for the firm's strategy suggests insufficient demand/wrong supply.

Too high relative to norms for the firm's strategy suggests that some sales have been foregone.

A Profitability Assessment Ratio

$$\text{Gross Profit Margin} = \frac{\text{Sales} - \text{Cost of Sales}}{\text{Sales}}$$

Rank, from highest to lowest, the expected gross margins for the following firms:

Nordstroms

Target

Walmart

An Operating Efficiency Ratio

Inventory management is critical for firms that sell products (e.g., retail and manufacturing).

Did the firm buy/make the right stuff?

Is the firm carrying the right amount of the right stuff?

How does a financial statement user assess inventory management?

Inventory turnover ratios aid in that assessment.

An Operating Efficiency Ratio

$$\text{Inventory Turnover} = \frac{\text{Cost of Sales}}{\text{Inventory}}$$

Captures how fast inventory gets into and out of the door.

Too low relative to norms for the firm's strategy suggests the wrong stuff has been acquired or that too much is being acquired given demand.

Too high relative to norms for the firm's strategy suggests the suggests some sales have been foregone.

An Operating Efficiency Ratio

$$\text{Inventory Turnover} = \frac{\text{Cost of Sales}}{\text{Inventory}}$$

Rank, from highest to lowest, the expected inventory turnover for the following firms:

Nordstroms

Target

Walmart

A Plethora of Ratios

There are a many, many ratios employed – ROE, ROA, A/R Turns, Days Receivables, Debt to Equity, Times Interest Earned, ... and on and on

There are no correct definitions

Good sources of some definitions – Investopedia or ask AI

Tip 1: Scale, Scale, Scale

Financial statement data is used to make *relative* comparisons.

- Compare a firm with itself over time

- Compare a firm with other firms in its industry

Tip 1: Scale the data to make apples to apples comparisons.

Accounting Analysis

Accounting Analysis

Bill was concerned that he might have failed his final exam. He was returning from checking his score when he crossed paths with his friend Mark.

Mark: How did your exam go?

Bill: I got a 70.

Mark: That's great!

Accounting Analysis

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Mark: How did your exam go?

Bill: I got a 70.

Mark: That's great!

Bill: Out of 200.

Moral: You cannot interpret a performance measure without a clear understanding of how that measure is defined.

Accounting Analysis

So how definitive is GAAP?

Let's consider revenue recognition ...

Revenue Recognition: The Rule

Revenue is recognized when a contractual performance obligation to a customer is satisfied.

A performance obligation is satisfied when control of the goods or services have been transferred to the customer.

An Example

iHealth is an online health insurance marketplace, which connects individuals with health insurance providers. iHealth is paid like an insurance agent so it receives commissions from an insurance company when an iHealth client signs up for that company's insurance plan. The commissions are typically paid annually in the first year a client enrolls in a plan, and then annually or monthly in subsequent years assuming the client reenrolls in the plan through iHealth.

An Example

Assume Joe Senior is successfully enrolled in a insurer's plan on 12/7/20X1 by iHealth. iHealth receives a \$120 commission payment on 1/20/20X2. iHealth expects to receive \$84 in the middle of January of each subsequent year assuming the customer continues to renew the plan through iHealth's marketplace. iHealth's anticipates that customers, on average, stay with a plan for about four years.

How much revenue should iHealth recognize in income for the year ended 12/31/20X1?

How much revenue should iHealth recognize in income for the year ended 12/31/20X2?

eHealth – What do they do?

“For Medicare-related, individual and family and ancillary health insurance plans, our services are complete once a submitted application is approved by the relevant health insurance carrier.”

⋮

“For Medicare-related, individual and family and ancillary health insurance plans, ... we recognize commission revenue based upon the total estimated lifetime commissions we expect to receive for selling the plan after the carrier approves an application, net of an estimated constraint. We refer to these as estimated and constrained LTVs for the plan.”

Tip 2: Don't Assume

Firms apply GAAP how they apply GAAP

Firms disclose how they apply GAAP

If you project your view of GAAP onto their statements, you might be disappointed.

Tip 2: Read firm discloses about their accounting practices. When do they recognize revenues? When do they recognize expenses?

Beyond Earnings: What Earnings?

There is GAAP Earnings – Firm's have to Disclose

There is non-GAAP Earnings – Firm's Disclose

There is Street Earnings – Analyst Measures

Non-GAAP Earnings

Non-GAAP Earnings

Most firms now offer non-GAAP measures of performance.

These metrics are supposed to be reflective of the core business and/or performance that will recur in the future.

SEC now requires:

- Non-GAAP cannot be elevated above GAAP

- Require reconciliation of GAAP to non-GAAP

Non-GAAP Earnings

Non-GAAP means not GAAP. It is defined by management.

Non-GAAP is not generally audited, but management is still responsible for adhering to their own definitions.

As a user, you need to assess those definitions.

Issues with Non-GAAP Earnings Measures

Usually excludes share-based compensation (because it is non-cash). Is that conceptually right?

Usually excludes one-time expenses/losses (because they are non-recurring). Are they really non-recurring? Are they consistent in their application?

Usually excludes one-time revenues/gains: Did they get them all? Are they consistent in their application?

A final aside: non-GAAP earnings almost always exceeds GAAP earnings. Surprised?

Non-GAAP Earnings

Research suggests that non-GAAP or Street earnings better explain stock returns in “recent” years (post 1992).

Does that necessarily mean that managers have employed non-GAAP measures to sway market perceptions?

Non-GAAP Earnings

Research suggests that non-GAAP or Street earnings better explain stock returns in “recent” years (post 1992).

Does that necessarily mean that managers have employed non-GAAP measures to sway market perceptions?

Perhaps not – Management focuses on what investors focus on ... they just give investors what they want.

Non-GAAP Earnings

Subsequent research suggests that the “non recurring” expenses excluded from non-GAAP earnings are associated with lower future cash flows (they are recurring?) and with lower future risk adjusted stock returns.

Does this research necessarily suggest that managers are fooling the market?

Some Soft Spots and Red Flags

Some Soft Spots and Red Flags

Incentives matter: managers make questionable accounting decisions when have strong incentives tied to financial accounting numbers.

When managers make questionable accounting decisions they most commonly do so to

- recognize revenue early

- recognize expenses late

- keep debt/debt-like claims off the balance sheet

Some Soft Spots and Red Flags

When firms recognize revenues early you will usually observe:

build up of large “receivable-like” asset balances

operating cash flows lagging accounting earnings

example: eHealth has very large commissions receivable balances.

Some Soft Spots and Red Flags

When firms recognize expenses late you will usually observe:

build up of large asset balances like inventory, PP&E, prepaids, capitalized “X”

operating cash flows lagging accounting earnings

Some Soft Spots and Red Flags

When firms keep debt off the balance sheet you will see:

nothing in the principal financial statements

but there will be some murky looking disclosures

An Example: Meta Data Center Deal

Non-Marketable Equity Investments Under Equity Method

In October 2025, we entered into an arrangement to co-develop a data center campus in Louisiana (the Venture). This Venture provides strategic optionality and flexibility, enabling us to effectively meet future infrastructure capacity needs as AI markets and technologies develop.

At Venture formation, we contributed \$4.30 billion of held-for-sale assets, net of liabilities, and we received a one-time distribution of \$2.55 billion. We hold a 20% membership interest in the Venture, which is accounted for under the equity method included within non-marketable equity investments on the consolidated balance sheets. We provide construction management, administrative and property management services to the Venture. The parties have committed to fund their respective pro rata share of approximately \$27 billion in total estimated development costs.

We also entered into lease agreements with the Venture for the use of properties on the data center campus, which will commence in 2029. The aggregate initial lease commitment is approximately \$12.31 billion, with each property having an initial four-year lease term and options to renew for a total lease period of up to 20 years. In addition, we have provided residual value guarantees (RVG) with an aggregate threshold of approximately \$28 billion that decreases over time. If we decide to terminate or not renew a lease, and if certain other conditions are met, our maximum RVG payment would equal any shortfall between the fair value at that time and the RVG threshold for that property. As of December 31, 2025, RVG payments are not probable and therefore, no liability has been recorded.

We do not have the power to direct the activities that most significantly impact the Venture's economic performance. Therefore, we are not the primary beneficiary and do not consolidate the variable interest entity (VIE). Our maximum exposure to loss related to the Venture was \$45.95 billion as of December 31, 2025, consisting of \$1.83 billion carrying value of our equity investment, the lease commitments, our estimated future fundings, and the maximum RVG threshold.

An Example: Meta Data Center Deal

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My interpretation:

Meta and outside parties are financing a data center campus, which they call the Venture.

Meta provided initial financing of 1.75 billion.

Outside investors provided 2.55 billion.

The total development expected to cost (an additional?) 27 billion

Meta is managing construction and will be managing the campus

An Example: Meta Data Center Deal

We also entered into lease agreements with the Venture for the use of properties on the data center campus, which will commence in 2029. The aggregate initial lease commitment is approximately \$12.31 billion, with each property having an initial four-year lease term and options to renew for a total lease period of up to 20 years. In addition, we have provided residual value guarantees (RVG) with an aggregate threshold of approximately \$28 billion that decreases over time. If we decide to terminate or not renew a lease, and if certain other conditions are met, our maximum RVG payment would equal any shortfall between the fair value at that time and the RVG threshold for that property. As of December 31, 2025, RVG payments are not probable and therefore, no liability has been recorded.

My interpretation:

When the campus is complete, Meta will lease it.

Initial 4 year lease with total payment commitment of 12.31 billion

Can renew the lease for additional terms up to 20 years in total

If Meta does not renew, they have provided a residual value guarantee (RVG) of \$28 billion, which decreases over time as they renew.

No liability recorded for RVG.

An Example: Meta Data Center Deal

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My interpretation:

The structure of the Venture is not a typical corporate entity – it is a variable interest entity (VIE).

If Meta controls (is the primary beneficiary of) the Venture, Meta would consolidate it meaning that the plant and equipment of the Venture would be on Meta's balance sheet and the claims of other investors in the entity would likely be liability claims on Meta's balance sheet.

But Meta is not the primary beneficiary because ... I dunno.

An Example: Meta Data Center Deal

Once the data center is up and running, what will Meta likely reflect on its books besides its 20% interest in the data center?

4 years of minimum lease payments

nothing for the initial \$28 billion residual value guarantee if they don't renew after 4 years

nothing for the lease payments that would arise if they do renew after 4 years

An Example: Meta Data Center Deal

And their maximum exposure to loss associated with the data center is about \$46 billion ... far more than what they will reflect on their balance sheet.

Could Meta have simply borrowed funds from the other investors and developed the Venture?

Sure, but there would be a lot more on Meta's balance sheet – a lot more plant and equipment and a lot more debt.

Does Meta want to look like, say, a utility company?

Some Soft Spots and Red Flags

A final red flag:

A failure to disclose is a disclosure ...

Firms usually disclose how they account for things. If they do not, or they do so poorly, the things are more likely to be bad.

Summary

Principal Financial Statements

Scale, Scale, Scale

Accounting Analysis

GAAP vs Non-GAAP

Some soft spots and red flags

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Thank You!