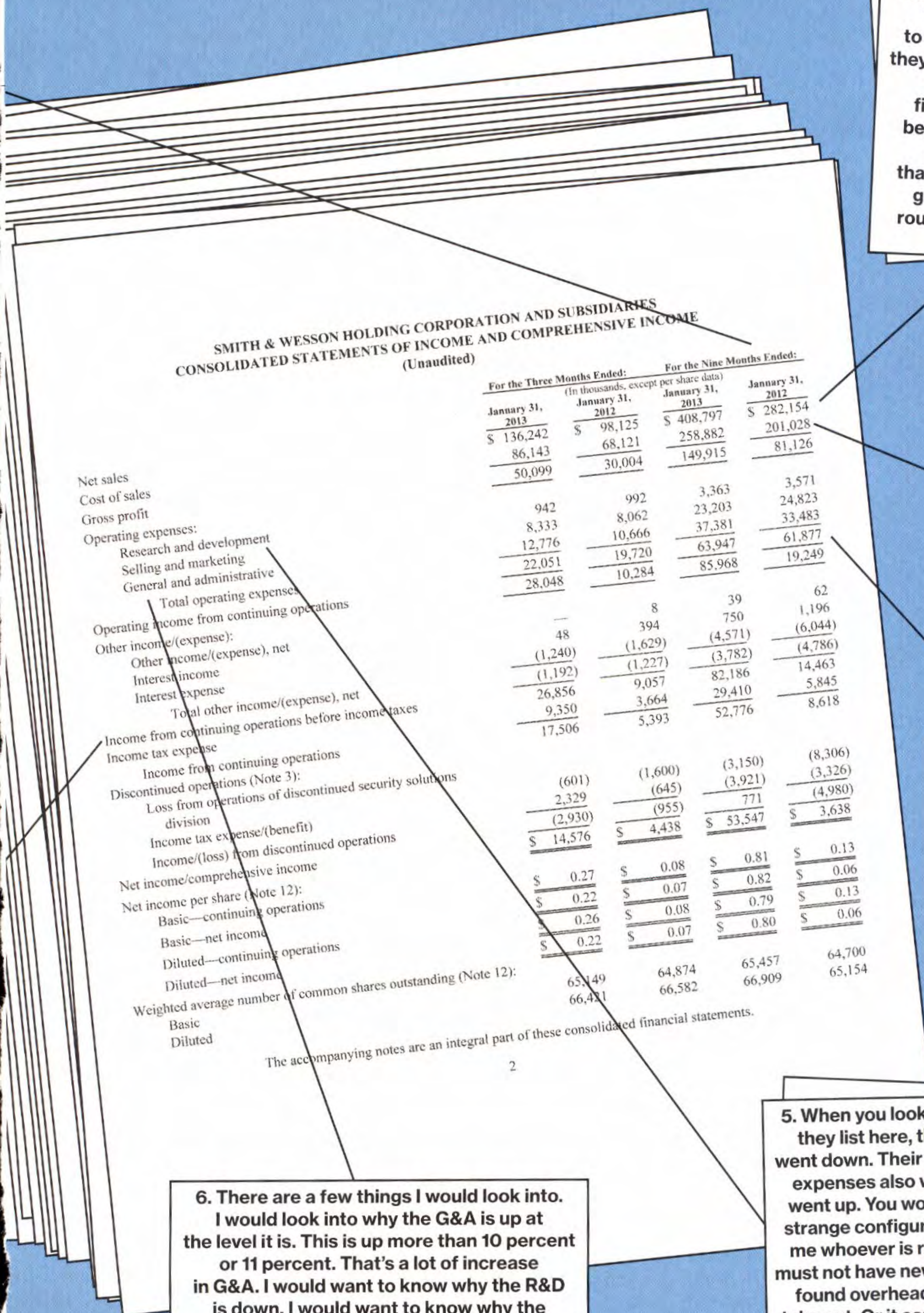
How To

Read A Financial Statement

Mark Hurd

We covered over the company name, Smith & Wesson, on the statements and asked Hurd how he would review them

There are two sets of financial statements, the income statement and the balance sheet, and they work in concert. If you want to get to the health of a company, you have to look at both. What we have here is an income statement. It's going to take you through things like revenue and expenses and tell you about the profitability of the company. That profitability generally turns into cash flow and brings you to the balance sheet. ¶ The more years of financial data you can get, the better, because **you get to see a flow**. You look at things like revenue, and you look at expenses, and you can start to ask, "What happened year to year?" and start looking at the deltas between the numbers. That's one methodology for looking at a business. ¶ Another is to simply take the expenses and say, **"If you've got $1 of revenue and 80¢ of expenses and your profit is 20¢, just tell me what you spend the 80¢ on."** How much on sales? How much on overhead? How much of it do you spend on R&D? ¶ Instead of taking a line-by-line view, take a look at the relationship between expenses to revenue and gross margin to revenue. It will tell you a lot about the choices the company is making about where to invest. ¶ This all comes with a note of caution. Even when you start to analyze these lines for their incremental ups or downs, you may not get clarity. **People see a sales expense go up and assume that means there are more salespeople** or more selling effort like advertising. Well, frankly, that may not be true, because inside sales expenses there could be other costs that are categorized in sales expenses, but they're not giving you sales effort in the marketplace. Like office overhead or IT upgrades for the sales team, for example. It's the same thing with R&D. People think R&D being up or down is some surrogate for the amount of innovation in a company. Not necessarily so: There are things that go on in the R&D line that could be overhead or some other kind of spending that's not valuable, such as duplicative real estate or human resources costs inherited as part of an acquisition. ¶ There are a lot of people who don't want to spend time on this type of stuff, **but the great thing about numbers is they typically don't mislead you**. They don't purposely lie to you. If you interrogate them, they'll reveal things to you, so you have to be able to have enough different looks at them that you can get absolute clarity. ¶ Clearly, what we have here is a manufacturer. They have a large cost of sales, so they're building a product of some type. They're not a services company. I would guess they sell their products through some sort of channel. So because they have big [general and administrative] costs, and G&A exceeds their sales and marketing, my inclination would be they must sell at retail or sell through some sort of aggregator process. They have a small relative R&D bill. When you look at this from an R&D perspective, they're spending less than 1 percent, so this must be a conveyor-belt-oriented branded product. **It's some sort of hard good.** ¶ But again, even with those two statements you may never get a complete picture. As I'm here to tell you, many people even inside have a hard time getting all the detail you'd like to get a full view of the health of the company. **Then the thing always when you're running these companies is the quality of the people driving this income statement.** ¶ The nice thing about the income statement is that if you understand the strategy, the income statement is the X-ray that shows the health of the patient. ● *Hurd is president of Oracle and former CEO of Hewlett-Packard. As told to Ashlee Vance*



SMITH & WESSON HOLDING CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(Unaudited)

	For the Three Months Ended: January 31, 2013	For the Three Months Ended: January 31, 2012	For the Nine Months Ended: January 31, 2013	For the Nine Months Ended: January 31, 2012
	(In thousands, except per share data)			
Net sales	$ 136,242	$ 98,125	$ 408,797	$ 282,154
Cost of sales	86,143	68,121	258,882	201,028
Gross profit	50,099	30,004	149,915	81,126
Operating expenses:				
Research and development	942	992	3,363	3,571
Selling and marketing	8,333	8,062	23,203	24,823
General and administrative	12,776	10,666	37,381	33,483
Total operating expenses	22,051	19,720	63,947	61,877
Operating income from continuing operations	28,048	10,284	85,968	19,249
Other income/(expense):				
Other income/(expense), net	—	8	39	62
Interest income	48	394	750	1,196
Interest expense	(1,240)	(1,629)	(4,571)	(6,044)
Total other income/(expense), net	(1,192)	(1,227)	(3,782)	(4,786)
Income from continuing operations before income taxes	26,856	9,057	82,186	14,463
Income tax expense	9,350	3,664	29,410	5,845
Income from continuing operations	17,506	5,393	52,776	8,618
Discontinued operations (Note 3):				
Loss from operations of discontinued security solutions division	(601)	(1,600)	(3,150)	(8,306)
Income tax expense/(benefit)	2,329	(645)	(3,921)	(3,326)
Income/(loss) from discontinued operations	(2,930)	(955)	771	(4,980)
Net income/comprehensive income	$ 14,576	$ 4,438	$ 53,547	$ 3,638
Net income per share (Note 12):				
Basic—continuing operations	$ 0.27	$ 0.08	$ 0.81	$ 0.13
Basic—net income	$ 0.22	$ 0.07	$ 0.82	$ 0.06
Diluted—continuing operations	$ 0.26	$ 0.08	$ 0.79	$ 0.13
Diluted—net income	$ 0.22	$ 0.07	$ 0.80	$ 0.06
Weighted average number of common shares outstanding (Note 12):				
Basic	65,149	64,874	65,457	64,700
Diluted	66,421	66,582	66,909	65,154

The accompanying notes are an integral part of these consolidated financial statements.

2

2. I would start by looking at the first line, called net sales. When you look at that line, the movement from $282 million to $408 million means they've had a substantive rise in sales. My first reaction would be, with no other data available to me, that's good. So they've grown $126 million roughly speaking year over year.

3. Their cost of sales did not go up nearly as much as their revenue, which is also good. Their cost of sales went up $57 million, so as you can tell here, their profitability, or operating gross profit, went up substantively.

4. It's a very nice-looking performance. They sold a lot more stuff with virtually no increase in operating expenses. That they spent $61 million, and then barely $2 million more of expenses, but increased their revenue by $126 million is impressive.

5. When you look inside the expenses they list here, their R&D expenses went down. Their selling and marketing expenses also went down and G&A went up. You would think of that as a strange configuration because it tells me whoever is running the company must not have new ideas. It may be they found overhead inside their R&D to take out. Or it could be that they're not investing substantively more in R&D. I would say they've obviously found inefficiencies in sales or they've been able to add a lot of revenue for the existing pipeline they've had.

6. There are a few things I would look into. I would look into why the G&A is up at the level it is. This is up more than 10 percent or 11 percent. That's a lot of increase in G&A. I would want to know why the R&D is down. I would want to know why the sales expense was down. But if you just asked me the hygiene of this piece of paper, yes, I would say this is a very good-looking P&L.