

CHAPTER 1

Understanding Financial Statements and Annual Reports



After reading this chapter, you will be able to

- Appreciate the history of accounting
- Understand the basics of the financial statements
- Understand cash-basis versus accrual-basis accounting
- Know how to obtain financial statements, Securities and Exchange Commission (SEC) filings, and annual reports
- Identify the main components of an annual report or 10K filing

Investors and owners have struggled with communicating and analyzing financial performance for centuries. Since the beginning of business activity—and with it, delegation of responsibility—the owner of the invested resources (perhaps a herd of goats) has sought to monitor and evaluate the stewardship of the operating manager (the shepherd). Accounting records have been found in Babylon, Assyria, and Sumeria that date back over 7,000 years. In these early records, scribes described business transactions using wedge-shaped cuneiform writing impressed on clay tablets. For privacy, a tablet was wrapped in a clay sheet, marked with a seal, and fired.

ESSENTIALS of Financial Analysis

Because there is a natural season to farming and herding, a natural beginning and a natural end, it was easy to analyze the results of activities: The value of the harvest was compared to the value of the seed and other resources, or the growth of the flock was noted after young were born, as in Exhibit 1.1. The same natural beginning and end to business activity was true when ancient sailors such as Columbus or Magellan embarked ventures to find new wealth in faraway places. Early accounting and financial analysis focused on determining the profit from each separate season or venture. Queen Isabella, for example, supplied ships and provisions, and Columbus sailed away. Years later, when he returned, the worth of the New World booty was compared to the cost of the initial provisions. The difference was profit.

Specific ventures, and agriculture and pastoral cycles have natural beginnings and ends. A list of all assets and liabilities was prepared at the beginning and end of the undertaking, and the change was profit or loss. Much the same method is used today, but modern businesses generally have no natural cycle. Barring business failure, modern businesses will go on forever. Plants operate day after day, year after year. Old plants wear out, new plants are built. Even now, some businesses have operated con-

EXHIBIT 1.1

Pastorale Accounting

Size of Herd

Beginning of spring		50 goats
End of summer		57 goats
Beginning goat herd	50 goats	
Ending goat herd	57 goats	—
Increased wealth (profit)		<u>7 goats</u>

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tinuously for hundreds of years. Investors, creditors, and others cannot wait for a modern business to naturally wind down before profit is calculated. To solve this problem, the arbitrary cycle of a fiscal year is imposed on business activity.

Many businesses have a busy season and a slow season. Where this is true, businesses may adopt a fiscal, or economic, year that starts and ends in the slow season, rather than using the calendar year with a year end at December 31. For example, Ethan Allen, a furniture manufacturer, and Robert Mondavi, a wine producer, both use a fiscal year that ends on June 30. PriceSmart, a membership shopping club operating in Central America, Asia, and the Caribbean, uses August 31. NetPhone uses a July 31 year end. Wal-Mart and Kmart have a January 31 year end.

Accounting is the language of business. It is the vehicle for communicating financial information about a company to many different groups of people: managers, owners, creditors, investors, customers, suppliers, government agencies, economists, and others. Each of these groups may have different uses for the information. Owners are concerned that the company produce a profit and increase their wealth. Creditors want to know that the company is liquid enough to make debt payments and solvent enough to repay the loan principle if the business fails. Managers want to be compensated for their work and have confidence their employer will provide job security. Customers and suppliers want to benefit from their ongoing business relationships. The government wants to ensure the public good, by collecting taxes and improving financial reporting. All these stakeholders can benefit and achieve their objectives if they have good accounting information.

Accounting is an ever-changing communicative system. All parties with a stake in the economic environment, upon which accounting reports, continually press for improvements in the information that accounting systems provide. This book presents many traditional as well as new ways of examining financial information that will facilitate the

**IN THE REAL WORLD**

Opaqueness versus Transparency

The events surrounding Enron's catastrophic bankruptcy have increased the focus on financial reporting by many companies. There has been much discussion on the issue of opaqueness versus transparency, which alludes to whether financial reporting actually is informative enough for decision makers. A lot of pressure has been brought to bear on companies to make their financial statements more transparent. For example, IBM had not disclosed that certain gains on sales of assets had been used to reduce the operating expenses on the income statement. After experiencing a stock price decline that resulted when the *New York Times* reported that IBM's "fourth-quarter earnings met expectations only because of a gain . . . from the sale of its optical transceiver business . . .", IBM decided to improve and increase its financial disclosures. However, John Joyce, IBM's chief financial officer (CFO), disagrees that such gains should be separately disclosed even though he is willing to disclose information about how IBM calculates its operating expenses. So, the push for transparency may result in more information in the notes to the financial statements even if not a change in the amounts on the financial statements themselves.

Source: "IBM Plans to Expand Earnings Reports to Include More Details about Its Income," *The Wall Street Journal*, February 19, 2002.

user's making effective decisions. This chapter provides an overall view of the information typically provided in financial statements.

A Tour of the Financial Statements

We chose the financial statements of The Coca-Cola Company because they show the basics very well and because practically everyone has

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heard of Coke. The company includes four financial statements in its annual report, and they are shown in Exhibit 1.2. The names of the financial statements are

- Consolidated Statements of Income
- Consolidated Balance Sheets
- Consolidated Statements of Cash Flows
- Consolidated Statements of Share-Owners' Equity

Notice that the balance sheet covers two years and the other statements cover three years. All the titles listed above include the word “consolidated” because the statements include the accounts of The Coca-Cola Company (Coca-Cola) and all subsidiaries in which the company’s ownership interest enables it to exert control. A starting point for determin-

EXHIBIT 1.2

The Coca-Cola Company and Subsidiaries

Consolidated Statements of Income

Year Ended December 31,	2001	2000	1999
	(in millions, except per share data)		
NET OPERATING REVENUES	\$20,092	\$19,889	\$19,284
Cost of goods sold	6,044	6,204	6,009
GROSS PROFIT	14,048	13,685	13,275
Selling, administrative and general expenses	8,696	8,551	8,480
Other operating charges	—	1,443	813
OPERATING INCOME	5,352	3,691	3,982
Interest income	325	345	260
Interest expense	289	447	337

ESSENTIALS of Financial Analysis

EXHIBIT 1.2**THE COCA-COLA COMPANY AND SUBSIDIARIES CONTINUED**

Year Ended December 31,	2001	2000	1999
Equity income (loss)	152	(289)	(184)
Other income—net	39	99	98
Gains on issuances of stock by equity investees	91	—	—
INCOME BEFORE INCOME TAXES AND CUMULATIVE EFFECT OF ACCOUNTING CHANGE			
	5,670	3,399	3,819
Income taxes	1,691	1,222	1,388
INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE			
	3,979	2,177	2,431
Cumulative effect of accounting change, net of income taxes	(10)	—	—
NET INCOME	\$ 3,969	\$ 2,177	\$ 2,431
BASIC NET INCOME PER SHARE			
Before accounting change	\$ 1.60	\$.88	\$.98
Cumulative effect of accounting change	—	—	—
	\$ 1.60	\$.88	\$.98
DILUTED NET INCOME PER SHARE			
Before accounting change	\$ 1.60	\$.88	\$.98
Cumulative effect of accounting change	—	—	—
	\$ 1.60	\$.88	\$.98
AVERAGE SHARES OUTSTANDING	2,487	2,477	2,469
Dilutive effect of stock options	—	10	18
AVERAGE SHARES OUTSTANDING ASSUMING DILUTION	2,487	2,487	2,487

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EXHIBIT 1.2**THE COCA-COLA COMPANY AND SUBSIDIARIES CONTINUED**
Consolidated Balance Sheets**December 31,** **2001** **2000**

(in millions except share data)

ASSETS

CURRENT

Cash and cash equivalents	\$ 1,866	\$ 1,819
Marketable securities	68	73

	1,934	1,892
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Trade accounts receivable, less allowances

of \$59 in 2001 and \$62 in 2000	1,882	1,757
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Inventories	1,055	1,066
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Prepaid expenses and other assets	2,300	1,905
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TOTAL CURRENT ASSETS	7,171	6,620
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INVESTMENTS AND OTHER ASSETS

Equity method investments

Coca-Cola Enterprises Inc.	788	707
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Coca-Cola Amatil Limited	432	617
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Coca-Cola HBC S.A.	791	758
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Other, principally bottling companies	3,117	3,164
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Cost method investments, principally

bottling companies	294	519
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Other assets	2,792	2,364
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	8,214	8,129
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PROPERTY, PLANT AND EQUIPMENT

Land	217	225
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Buildings and improvements	1,812	1,642
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Machinery and equipment	4,881	4,547
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Containers	195	200
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	7,105	6,614
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Less allowances for depreciation	2,652	2,446
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ESSENTIALS of Financial Analysis

EXHIBIT 1.2**THE COCA-COLA COMPANY AND SUBSIDIARIES CONTINUED**

December 31,	2001	2000
	4,453	4,168
TRADEMARKS AND OTHER INTANGIBLE ASSETS	2,579	1,917
	\$ 22,417	\$ 20,834
LIABILITIES AND SHARE-OWNERS' EQUITY		
CURRENT		
Accounts payable and accrued expenses	\$ 3,673	\$ 3,905
Loans and notes payable	3,743	4,795
Current maturities of long-term debt	156	21
Accrued income taxes	851	600
TOTAL CURRENT LIABILITIES	8,429	9,321
LONG-TERM DEBT	1,219	835
OTHER LIABILITIES	961	1,004
DEFERRED INCOME TAXES	442	358
SHARE-OWNERS' EQUITY		
Common stock, \$.25 par value		
Authorized: 5,000,000,000 shares		
Issued: 3,491,465,016 shares in 2001;		
3,481,882,834 shares in 2000		
	873	870
Capital surplus	3,520	3,196
Reinvested earnings	23,443	21,265
Accumulated other comprehensive income and unearned compensation on restricted stock	(2,788)	(2,722)
	25,048	22,609

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EXHIBIT 1.2**THE COCA-COLA COMPANY AND SUBSIDIARIES CONTINUED**

December 31,	2001	2000
Less treasury stock, at cost (1,005,237,693 shares in 2001; 997,121,427 shares in 2000)	13,682	13,293
	11,366	9,316
	\$ 22,417	\$ 20,834

Consolidated Statements of Cash Flows

Year Ended December 31,	2001	2000	1999
			(in millions)
OPERATING ACTIVITIES			
Net income	\$ 3,969	\$ 2,177	\$ 2,431
Depreciation and amortization	803	773	792
Deferred income taxes	56	3	97
Equity income or loss, net of dividends	(54)	380	292
Foreign currency adjustments	(60)	196	(41)
Gains on issuances of stock by equity investees	(91)	—	—
Gains on sales of assets, including bottling interests	(85)	(127)	(49)
Other operating charges	—	916	799
Other items	34	119	119
Net change in operating assets and liabilities	(462)	(852)	(557)
Net cash provided by operating activities	4,110	3,585	3,883

ESSENTIALS of Financial Analysis

EXHIBIT 1.2**THE COCA-COLA COMPANY AND SUBSIDIARIES CONTINUED**

Year Ended December 31,	2001	2000	1999
INVESTING ACTIVITIES			
Acquisitions and investments, principally trademarks and bottling companies	(651)	(397)	(1,876)
Purchases of investments and other assets	(456)	(508)	(518)
Proceeds from disposals of investments and other assets	455	290	176
Purchases of property, plant and equipment	(769)	(733)	(1,069)
Proceeds from disposals of property, plant and equipment	91	45	45
Other investing activities	142	138	(179)
Net cash used in investing activities	(1,188)	(1,165)	(3,421)
FINANCING ACTIVITIES			
Issuances of debt	3,011	3,671	3,411
Payments of debt	(3,937)	(4,256)	(2,455)
Issuances of stock	164	331	168
Purchases of stock for treasury	(277)	(133)	(15)
Dividends	(1,791)	(1,685)	(1,580)
Net cash used in financing activities	(2,830)	(2,072)	(471)
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS			
	(45)	(140)	(28)
CASH AND CASH EQUIVALENTS			
Net increase (decrease) during the year	47	208	(37)
Balance at beginning of year	1,819	1,611	1,648
Balance at end of year	\$ 1,866	\$ 1,819	\$ 1,611

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ing control is when a company owns more than 50 percent of the voting stock of another company. Coca-Cola states in its “Management’s Discussion and Analysis” (MD&A) that “all majority-owned entities in which our Company’s control is considered other than temporary are consolidated.”

Starting with the income statement, the next section will give a brief explanation of each line item.

Income Statement

- *Net operating revenues.* Revenues earned performing fundamental business operations. Coca-Cola’s revenue recognition policy is to record revenue “when title passes to our bottling partners or our customers.”
- *Cost of goods sold.* The cost of the inventory that Coca-Cola sold to its bottling partners or customers
- *Gross profit.* The difference between sales (or operating) revenues and cost of goods sold
- *Selling, administrative, and general expenses.* Operating expenses in addition to cost of goods sold. The bulk of this category goes to marketing and advertising for Coca-Cola.
- *Other operating charges.* A category that may include nonrecurring expenses and costs like write-downs of asset values and settlements of lawsuits
- *Operating income.* Typically is the income from basic business operations and is also known as earnings before interest and taxes. For Coca-Cola, this is also before inclusion of items related to investments that Coca-Cola has made in other companies.
- *Interest income and interest expense.* Interest earned on investments and interest incurred for borrowing, like commercial paper debt

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- *Equity income or loss.* This is Coca-Cola's share of the income earned by companies that Coca-Cola has bought enough stock in to be able to influence their management practices.
- *Other income.* Can include atypical events like when a subsidiary merges with another company and decreases the parent's (i.e., Coca-Cola's) ownership interest in the combined activity.
- *Gains on issuances of stock by equity investees.* An equity investee is a company that Coca-Cola owns stock in. The investee issued more stock to a third party, Coca-Cola's investment value increased, so Coca-Cola had a gain.
- *Income taxes.* The income tax effect of every item preceding this line
- *Income before cumulative effect of accounting change.* Also known as income from continuing operations; operations that are discontinued or are being discontinued are shown separately
- *Cumulative effect of accounting change, net of income taxes.* When a company changes how it accounts for something, it may be necessary to report the impact on net income in prior years as if the company had always used the new method. In Coca-Cola's case, the company adapted a new requirement for reporting derivatives and hedging activities.
- *Net income.* The "bottom line"!
- *Basic net income per share.* Commonly known as earnings per share (EPS). This is net income divided by the average number of common shares outstanding (a company may disclose the number of shares here, as Coca-Cola does, or in the notes)
- *Diluted net income per share.* Reported only if not greater than basic EPS. Diluted EPS shows how much reduction would occur if additional common shares were issued through conversion of other securities or exercise of stock options.

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Balance Sheet

- *Assets.* Resources that a company has legal control of
- *Current assets.* Cash and other assets likely to be converted to cash or consumed within a year; usually includes the following five components
 1. *Cash and cash equivalents.* The latter are marketable and highly liquid securities with short-term maturities (say, no more than three months). May include CDs and money market funds
 2. *Marketable securities.* May include any investment in the stocks or bonds of another entity (probably small enough to not involve influence or control)
 3. *Trade accounts receivable.* Receivables that result from credit sales to customers, reduced by an amount that is likely to be uncollectible
 4. *Inventories.* Contains merchandise inventory for a retail company; raw materials, supplies, work-in-process, and finished goods inventories for a manufacturing company. Companies disclose in the notes what inventory method(s) are used (e.g., first-in, first-out [FIFO] or last-in, first-out [LIFO] or average)
 5. *Prepaid expenses and other assets.* Includes resources paid for but not consumed yet, like prepaid rent, prepaid insurance, prepaid advertising, and supplies
- *Equity method investments.* For Coca-Cola, this includes “investments in companies in which we have the ability to exercise significant influence [traditionally 20%–50%] over operating and financial policies, including certain investments where there is a temporary majority interest.” The equity method involves recognizing a share of the net earnings of investee companies (subsidiaries) in the income of the investor (Coca-Cola)

ESSENTIALS of Financial Analysis

- *Cost method investments.* These are also investments in other companies but of a lesser percentage so as not to have influence (less than 20 percent). These investments are carried at cost or fair market value.
- *Other assets.* For Coca-Cola, this includes investments in infrastructure programs with bottlers and advance payments to customers for distribution rights; in general, this category contains all assets that do not fit into the other categories.
- *Property, plant and equipment.* Typically, tangible, long-term plant assets (useful for more than a year); some plant assets (not land) are depreciated.
- *Trademarks and other intangible assets.* May also include patents, copyrights, goodwill, and other resources that have no physical existence.
- *Liabilities and share-owners' equity.* Represent the sources of all those assets on the other side of the balance sheet (e.g., the sources being either creditors [liabilities] or owners [owners' equity])
- *Current liabilities.* Obligations that will be settled within a year, usually, by payment from current assets
- *Accounts payable and accrued expenses.* Obligations to parties that have provided goods or services to the company. May include liabilities for purchases, wages and salaries, taxes, and advertising
- *Loans and notes payable.* If current, probably includes commercial paper from banks in the United States and outstanding amounts from a line of credit
- *Current maturities of long-term debt.* The portion of a company's long-term debt (typically, notes and bonds) that is due in the coming year
- *Accrued income taxes.* Taxes associated with profits already earned but on which the payment is avoided in the current year
- *Long-term debt.* Includes interest-bearing debt that is due beyond a year (typically, notes and bonds)

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- *Deferred income taxes.* Deferred taxes can arise when the tax expense (based on accounting income) is different from the taxes payable (based on taxable income); accounting income can differ significantly from taxable income.
- *Share-owners' equity.* Represents the property of owners; the amount of the assets that owners have claim to
- *Common stock.* The total par value of common stock issued to date
- *Capital surplus.* The amount of the proceeds, received from original stock issuances, in excess of the par value (i.e., by the end of 2001 Coca-Cola had received \$4,393 million from issuing common stock made up of \$873 million par value plus \$3,520 million excess). Par value and excess (or surplus) together represent the contributed capital (contributed by owners).
- *Reinvested earnings.* The cumulative amount of net income reinvested in the company (also called *retained earnings*) after any dividends have been distributed to owners
- *Accumulated other comprehensive income, etc.* Includes other changes in shareholders' equity that are *not* on the income statement and *not* a result of transactions with owners in their capacity as owners (this component is discussed further in Chapter 2)
- *Treasury stock.* Represents the cost incurred by a company in buying back its own, formerly outstanding, stock

Cash Flow Statement

- *Operating activities.* Activities related to the fundamental business operation of the company (i.e., buying and selling goods and/or services)
- *Net income.* When the operating section of the cash flow statement begins with net income, then it has been prepared by reconciling net income to cash provided by operating activities.

ESSENTIALS of Financial Analysis

- *Depreciation and amortization.* These noncash expenses reduce net income but do not affect cash, so they are added back to net income in order to arrive at cash from operations.
- *Net change in operating assets and liabilities.* For Coca-Cola this net change is explained in a note.

In general, the adjustments explained in the note are related to increases and decreases in current assets and current liabilities (here called operating assets and liabilities). To explain just one of those changes, let's think about credit sales. Credit sales increase sales revenues (and therefore increase net income) but do not affect cash (the company receives an account receivable instead of getting cash), so the increase in accounts receivable should be deducted from net income to arrive at cash from operations.

- *Investing activities.* Activities generally related to the purchase and sale of long-term assets. Coca-Cola bought and sold various property, plant and equipment assets and acquired bottling companies and trademarks.
- *Financing activities.* Activities generally related to obtaining financial resources from the credit market and stock market (or paying off debt or paying dividends)
- *Effect of exchange rate changes on cash and cash equivalents.* Because Coca-Cola operates in a global environment, it is exposed to the risk of changes in foreign currency exchange rates. To reduce this risk, the company engages in foreign currency hedging. These hedging activities are described in the notes.

Share-owners' Equity Statement

The format of this statement looks complicated, but it basically is formatted to show all the changes in all the equity accounts over a three-year period. One year picks up where the previous year leaves off. The section on the year 2001 follows.

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- *Comprehensive income.* Changes in share-owners' equity that are not part of net income or due to transactions with owners
- *Net income.* The amount of income as shown on the income statement. Notice that it is added to reinvested earnings (see also *dividends*, the last component in this list).
- *Translation adjustments.* Contains the dollar effect of changes in foreign currency exchange rates
- *Cumulative effect of SFAS No. 133.* Shows the effect of adapting Statement of Financial Accounting Standards (SFAS) No. 133 on January 1, 2001. This SFAS requires companies to show the fair value of derivative instruments as either assets or liabilities on the balance sheet. Derivative instruments are generally used to reduce exposure to risk.
- *Net gain (loss) on derivatives.* Contains gains and losses on hedges. Derivative instruments are supposed to be classified as a fair-value hedge, a cash-flow hedge, or a hedge of net investment in a foreign operation (depending on the exposure being hedged). For Coca-Cola, the \$92 reported here is mostly related to a foreign currency cash-flow hedge.
- *Net change in unrealized gain (loss) on securities.* This contains the effect of a changing fair market value for securities classified as available for sale
- *Minimum pension liability.* This represents, in Coca-Cola's case, a decrease in comprehensive income due to having to increase a liability related to pension plans.
- *Stock issued to employees exercising stock options.* Represents the cash raised by selling stock to employees at a specified option price
- *Restricted stock.* Restricted stock plans are for certain officers and key employees of the company. These are adjustments to equity accounts that may or may not have affected the income statement, but did not directly result in a cash flow.

**TIPS & TECHNIQUES**

Financial Performance Measurement Project

At press time, the most recent update on the Financial Accounting Standards Board's (FASB) Web site pertaining to its financial performance project read, in part, as follows:

Project Objectives

The primary objectives of the project are (1) to improve the quality of information displayed in financial statements so that investors, creditors, and others can better evaluate an enterprise's financial performance and (2) to ascertain that sufficient information is contained in the financial statements to permit calculation of key financial measures used by investors and creditors. Several of the respondents to the August Proposal suggested that this project, although limited to the display of items and measures in financial statements, is especially timely because the proliferation of alternative and inconsistent financial performance measures is undermining high-quality financial reporting, which is essential to well-informed investment decisions and efficient capital markets.

The project will focus on form and content, classification and aggregation, and display of specified items and summarized amounts on the face of all basic financial statements, interim as well as annual. That includes determining whether to require the display of certain items determined to be key measures or necessary for the calculation of key measures. The project will not address management discussion and analysis or the reporting of so-called pro forma earnings in press releases or other communications outside financial statements and does not include segment information or matters of recognition or measurement of items in financial statements.

The outcome of this project might be right around the corner. Go to www.fasb.org to find out what changes may occur and when.

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- Tax benefit from employees' stock option and restricted stock plans
- Restricted stock and other stocks plans, less cancellations
- Amortization of restricted stock
- Unearned restricted stock adjustment
- *Purchase of stock for the treasury.* Represents payment to existing stockholders to buy back their Coca-Cola stock
- *Dividends.* Payments to shareholders (the only other thing, besides net income, to affect Reinvested Earnings)



IN THE REAL WORLD

Changes in GAAP

If earnings appear to improve from one period to the next, it may not necessarily reflect better success in operations. Sometimes earnings are affected by a change in the accounting methods a company uses or a change in what generally accepted accounting principles (GAAP) or the SEC will allow. For example, the oil industry will be affected by a change that the SEC allowed in February 2002. Before February, energy companies had to recognize the full decline of the price of gas as a charge against earnings. In February, the SEC allowed Houston Exploration Company to reduce that charge by the benefit gained from a cash flow hedge. For example, if the price of gas goes from \$2.00 to \$1.00 per gallon but a hedge agreement guarantees the company will receive no less than \$1.50, then the charge against earnings will be at \$.50 per gallon rather than the full decline of \$1.00. As a result, earnings are higher after the new accounting guidance but the cash flow itself is not affected. The lesson is: Take good news (higher earnings) with a grain of salt.

Source: "Accounting Change May Boost Earnings at Oil Firms if Hedging Gains Are Figured," *The Wall Street Journal*, March 20, 2002.

A Quick Review of Cash-Basis versus Accrual-Basis Accounting

The balance sheet is given its name because the left and right sides balance each other. Assets on the left should always equal the sum of the liabilities and owners' equity on the right

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

Furthermore, owners' equity contains the retained earnings balance that accumulates by adding the net income to it at the end of every period. So the accounting equation shown above can be expanded as follows:



IN THE REAL WORLD

The Importance of Notes to the Financial Statements

One aspect of financial analysis should include a study of what short sellers look at in their decision making. Short selling involves borrowing stock to sell when its price is high and buying it back to return it when its price is lower. The short seller benefits from the decline of stock value. Examining what makes a short seller pessimistic about a company can be a valuable tool. For example, short seller James Chanos was alerted by a fairly complicated-sounding note entitled "Related Party Transactions," which mentioned that an Enron officer was a "managing member" of another company with which Enron had engaged in transactions. Related-party transactions, especially if they are not clearly disclosed, could make one wonder if there are conflicts of interest wherein the company itself is not being well served and the substance of transactions may not be what they seem.

Source: "Enron Short Seller Detected Red Flags in Regulatory Filings," *The Wall Street Journal*, November 5, 2001, C1.

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Cash + Other assets = Liabilities + Owners' equity + Revenues – Expenses

Basing a spreadsheet on the above equation (notice that assets are split into cash and other assets) helps to show how the traditional accounting system has come to be known as a double-entry system (it is like Newton's Third Law of Motion, which says that every action must have an equal and opposite reaction). The following spreadsheet shows many possible ways to affect an accounting system and still balance.

We are assuming that cash must be involved in order to show what transactions can possibly be entered in a cash-basis-only system (see Exhibit 1.3).



IN THE REAL WORLD

Write-Offs

The traditional approach to write-offs was to get them out in the open, then ignore them, and even sometimes watch the company's stock price go up—figuring that the worst was over. Research has shown that this may no longer be appropriate. Write-offs in 2001 for companies in the Standard & Poor's 500 stock index totaled more than in the previous half decade. Simultaneously, bankruptcies increased. Multex.com and *The Wall Street Journal* examined statistics for 1996–2001 for public companies with market capitalization of at least \$1 billion and found that the group with the largest charges relative to revenue saw their stock prices decline by 9.4 percent within 90 days. Companies with the smallest charges had a median gain of 1.48 percent. According to Marc Gerstein, director of investment research at Multex.com, "If you want to weed out stocks to look at for investment purposes, companies with unusually large write-offs are a good place to start."

Source: "Stock Gurus Disregard Most Big Write-offs, but They Often Hold Vital Clues to Outlook," *The Wall Street Journal*, December 31, 2001.

ESSENTIALS of Financial Analysis

EXHIBIT 1.3

Cash-Basis Accounting

	Balance Sheet			Income Statement	
	Cash +	Other Assets =	Liabilities +	Owners' Equity +	Revenue - Expenses
1.	+	-			
2.	+		+		
3.	+			+	
4.	+				+
5.	-				-
6.	-			-	
7.	-		-		
8.	-	+			

Examples of explanations for the transactions include:

- 1.** If cash increases and another asset decreases, the transaction could have been a sale of equipment for cash.
- 2.** An increase in both cash and a liability could signify that the company borrowed money from the bank or received payment for work contracted to be performed later.
- 3.** An increase in cash and owners' equity would result from a company issuing its stock to investors.
- 4.** An increase in cash and revenues would result from a cash sale to a customer.
- 5.** A decrease in cash and also in the expense column (which really means that expenses increased) would result if a company paid its rent for the month.
- 6.** A decrease in cash and in owners' equity results when a company pays out cash dividends.

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7. A decrease in cash and liabilities results when a company pays off debt.
8. A decrease in cash and an increase in other assets results when a company buys inventory to hold for sale later.

Now, let's examine the transactions that can be recorded under the accrual basis of accounting (see Exhibit 1.4). Notice that none of the following transactions affect cash.

Examples of explanations for the transactions include:

1. Noncash assets could increase and liabilities increase if a company enters into a long-term capital lease of, for example, equipment.

EXHIBIT 1.4

Accrual-Basis Accounting

	Balance Sheet			Income Statement		
	Cash +	Other Assets =	Liabilities +	Owners' Equity +	Revenue -	Expenses
1.		+				
2.	+			+		
3.		+			+	
4.	-					-
5.		-			-	
6.			+			-
7.			+	-		
8.			-	+		
9.			-		+	
10.				+		-
11.				+ and -		

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2. Noncash assets could increase and owners' equity increase if a company issues stock in exchange for land.
3. Noncash assets could increase and revenues increase for a credit sale (the asset would be accounts receivable).



IN THE REAL WORLD

A Tool for Financial Analysis:

XBRL: Extensible Business Reporting Language

- *What is it?* Software that will be added to accounting and financial reporting software so that financial information can be better accessed and used.
- *How does it work?* XBRL code will be used to tag and automatically translate all business information so that the data can be searched, identified, linked, and analyzed.
- *What will it accomplish?* XBRL will enable financial information users to perform fast and accurate searches of business data. They will be able to "tailor the search for multiple companies' data and export [it] easily into a spreadsheet for further analysis; since each piece of information is identified with a tag, comparisons and calculations can be automated."*
- *Who will benefit?* Anyone who prepares or uses business data: organizations, auditors, bankers, shareholders, and investors.

*"Finally, Business Talks the Same Language," *Journal of Accountancy*, August 2000, 24-30.

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- 4.** Noncash assets would decrease when they are depreciated and an expense recorded (depreciation expense).
- 5.** Noncash assets decrease and owners' equity decreases when certain investments (classified as available for sale) are written down to market value and the unrealized loss reported as a deduction to owners' equity.
- 6.** A liability (like wages or taxes payable) increases and an expense is recorded (wages or tax expense) when accruals are recorded at the end of an accounting period.
- 7.** A liability increases and owners' equity decreases when a dividend is declared (the dividend does not have to be paid yet to be recorded).
- 8.** A liability is decreased and owners' equity increased when convertible bonds are converted to stocks and the stock issued.
- 9.** A liability decreases and revenues increase when a company performs a service that enables it to earn the payment received some time ago (or when time goes by and the rental payment received last month has now been earned).
- 10.** Owners' equity increases and expenses are recorded if an employee is paid with stock instead of cash for services performed.
- 11.** An increase and decrease occur completely within the owners' equity accounts when a stock dividend is distributed.

Notice that quite a few transactions can affect the income statement (revenues and expenses) without affecting cash at all. So there is a lot of room for judgment since noncash transactions have to be recorded at fair market value and market value can be more or less objectively determinable, depending on the circumstances.

Following are some useful Web sites for obtaining and understanding financial statements.

**TIPS AND TECHNIQUES**

Beware Companies' Promotion of Their Own Stock

Recent events demonstrate that companies have a vested interest in promoting their own stock and boosting the perceived chances at growth in value. For example, some Enron employees reported that they had been asked to sit in a trading room and make it look like they were busy trading when the financial analysts came through on tour. In addition, some financial analysts report that when they say anything about a company's financial situation that might put that company in a bad light, their access to the company is sometimes affected and former contacts become irate and/or inaccessible. So it is apparent that companies want to look as good as possible.

Financial statement users and analysts should be aware of where this bias may creep into a company's financial reporting. Deanna Burgess has analyzed the graphs in a sample of annual reports and found that about a fifth of them had vertical-scale alterations that have the potential to mislead the reader into thinking that the changes, shown in the data graphed, are more significant than they really are. Vertical scale alterations are present when the origin is something other than zero. It is important to be aware of this because Burgess found that people's perceptions were affected by even the slightest alteration: "Virtually no amount of graphical manipulation was acceptable; any alteration in the vertical scale caused a sizable difference in readers' perceptions."

Source: Deanna Oxender Burgess, "Graphical Sleight of Hand," *Journal of Accountancy*, February 2002, 45-51.

Web Sites for Further Research

Financial Statements—General

- www.sec.gov
- www.freeEdgar.com
- www.pwcglobal.com

Financial Statements—Individual Companies

- The Coca-Cola Company: www.coca-cola.com
- Pfizer: www.pfizer.com
- The Dow Chemical Company: www.dow.com
- Corning Incorporated: www.corning.com
- BankOne Corporation: www.bankone.com
- General Electric Company: www.ge.com/annual01

Industry Averages, Industry Information and Financial Analysis, and Information About Stock Markets

- <http://cbs.marketwatch.com/news>
- www.usadata.com—stock quotes, research, and the like
- www.esignal.com—stock quotes and the like
- <http://sdsmarketwatch.com>
- <http://invest-faq.com>
- www.geoinvest.com—stock market information, free stock research
- www.nelnet.com—links to more than 2,700 investment managers from websites worldwide
- www.dtonline.com
- www.1stresearch.com—industry profiles: overview, trends, and so on

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- www.justquotes.com—current and historical stock prices and much more
- www.ibbotson.com—industry information on cost of capital and risk
- www.options-iri.com—provides insights about the market
- www.oio.com—stock quotes, volatility charts, market news
- www.dogsofthedow.com—stock selection information, stock histories from 1996 to the present
- www.spglobal.com
- www.cnnfn.com
- www.dowjones.com
- www.nbc.com
- www.morningstar.com—market news, analyst research
- www.schwab.com—market news, charts
- www.smartmoney.com—quotes, market updates
- www.fool.com—investment news, stock quotes and research, and the like
- www.multex.com—contains market research
- <http://yahoo.marketguide.com>
- <http://www.financialweb.com>
- <http://moneycentral.msn.com/investor/invsub/results/compare.asp>
- <http://www.corporateinformation.com>

Education

- www.free-ed.net
- <http://library.thinkquest.org/3088/>—EduStock.com: Edustock is an educational Web page designed to teach young and old alike what the stock market is and how it can work for them.

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- <http://www.investsmart.com.au/home/default.asp>—InvestSmart.com
- <http://TeachMeFinance.com>
- www.tiaa-cref.org/library/dictionary—dictionary of financial terms
- www.financiallearning.com
- www.investorguide.com
- www.fool.com—for The Motley Fool

General Business Information and Current Business Events

- www.wsj.com
- www.fortune.com
- www.ustoday.com
- www.nytimes.com
- www.apoline.com
- www.reuters.com

Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS)

- www.aicpa.org
- www.fasb.org
- www.gasb.org
- www.cpa2biz.com

Advice for Advisers

- www.investmentadvisor.com

ESSENTIALS of Financial Analysis

**General Knowledge and Background in
Financial Matters**

- http://ourworld.compuserve.com/homepages/Bonehead_Finance
- www.fool.com
- www.bernardsvill.org/invest.htm
- <http://smartmoney.com>
- www.ozsoft.com
- <http://moneycentral.msn.com>
- www.featuresource.com—business articles

Search Engines and Sites to Find Other Sites

- www.yahoo.com
- <http://lii.org>
- www.webbieworld.com—features picks for popular sites in many categories, including business
- www.google.com

E-business Sites

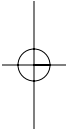
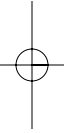
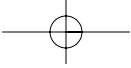
- www.dci.com—lots of information about information technology
- www.bcg.com—look at BCG Publications for information on e-commerce
- www.website101.com
- www.lexmercatoria.org
- www.gbd.org
- www.zdnet.com/enterprise/e-business

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Summary

Organizations have many ways to communicate information about themselves. Different decision makers have different ideas about what they want to know about an organization. However, when it comes to deciding whether to let an organization use your money, it is the financial information that is most needed. And that financial information comes in many forms. The fortunate thing is that financial reporting does follow GAAP, enabling one to evaluate and compare companies. In addition, there are numerous analytical techniques one can use to gain further insight into what the numbers mean. This book covers many of those traditional analytical techniques as well as some relatively new ones.

<http://www.pbookshop.com>



<http://www.pbookshop.com>

