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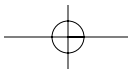
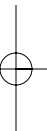
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**Financial  
Reporting  
Outside  
and Inside  
a Business**

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# Getting Down to Business

Every business has three primary financial tasks that determine the success or failure of the enterprise and by which its managers are judged:

- *Making profit*—avoiding loss and achieving profit goals by making sales or earning other income and by controlling expenses
- *Cash flow*—generating cash from profit and securing cash from other sources and putting the cash inflow to good use
- *Financial health*—deciding on the financial structure for the entity and controlling its financial condition and solvency



*To continue in existence for any period of time, a business has to make profit, generate cash flow, and stay solvent.*

Accomplishing these financial objectives depends on doing all the other management functions well. Business managers earn their keep by developing new products and services, expanding markets, improving productivity, anticipating changes, adapting to new technology, clarifying the business model, thinking out clear strategies, hiring and motivating people, making tough choices, solving problems, and arbitrating conflicts of interests between different constituencies (e.g.,

## FINANCIAL REPORTING

customers who want lower prices versus employees who want higher wages). Managers should act ethically, comply with a myriad of laws, be responsible members of society, and not harm our natural environment—all the while making profit, generating cash flow, and avoiding insolvency.



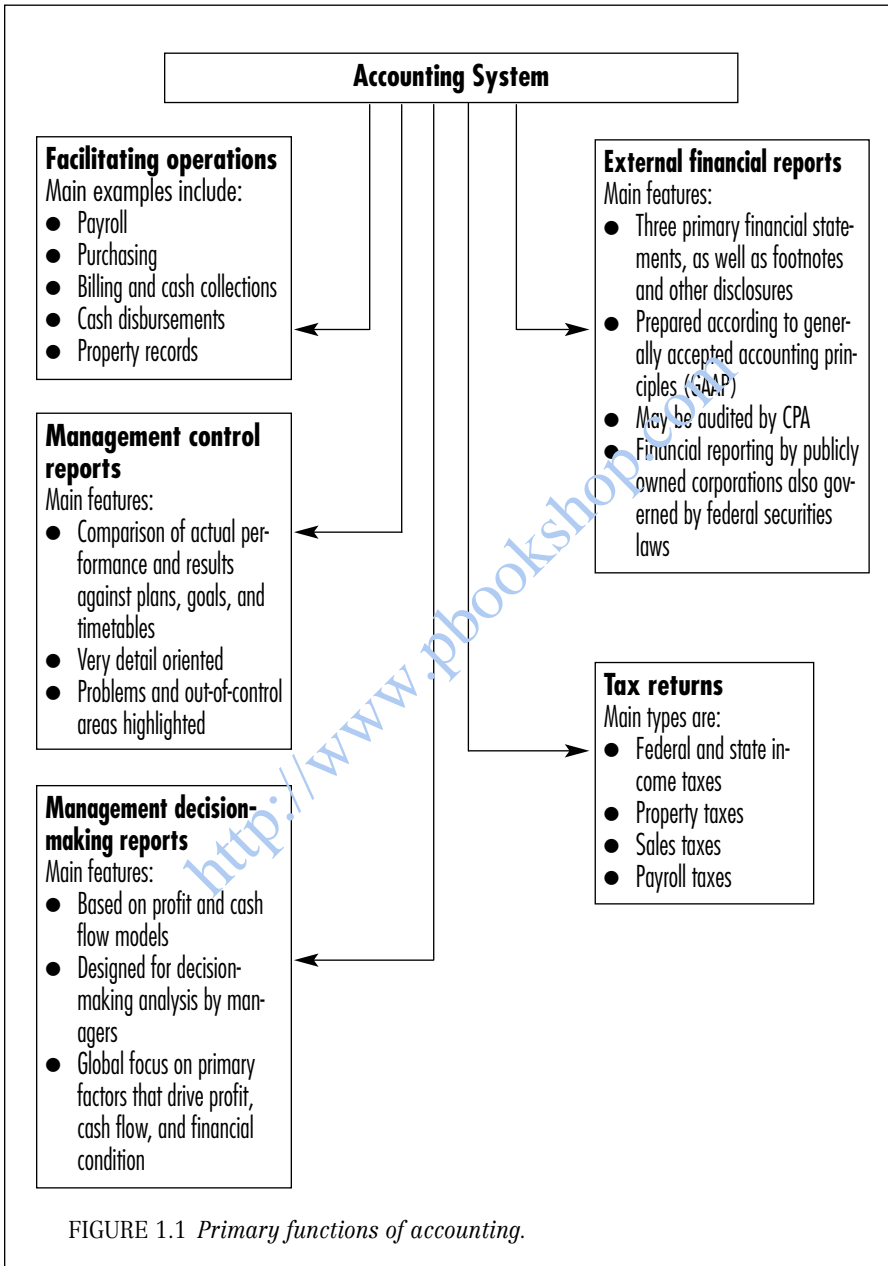
### ACCOUNTING INSIDE AND OUT

Ask people to describe accounting and the most common answer you'll get is that accounting involves a lot of record keeping and bookkeeping. Which is true. The accounting system of a business is designed to capture and record all its transactions, operations, activities, and other developments that have financial consequences. An accounting system generates many documents, forms, and reports. Even a small business has hundreds of accounts, which are needed to keep track of its sales and expenses, its assets and liabilities, and of course its cash flows. Accounting systems today are computer-based. The accounts of a business are kept on the hard disks of computers, which should be backed up frequently, of course.

The primary purpose of an accounting system is to accumulate a complete, accurate, and up-to-date base of data and information needed to perform essential functions for a business. Figure 1.1 presents a broad overview of the internal and external functions of business accounting. Note the Janus, or two-faced, nature of an accounting system that looks in two different directions—internal and external, or inside and outside the business.

In addition to facilitating day-to-day operating activities, the accounting department of a business has the responsibility of preparing two different kinds of *internal reports*—very detailed reports for management control and much more condensed reports for decision making. Likewise, the accounting department prepares two different kinds of *external reports*—financial reports for owners and lenders and tax returns for tax authorities. Accountants have a relatively free hand in designing control and decision-making reports for managers. In sharp contrast, external reporting is *compliance-driven*. External financial reports must comply with authoritative standards and established accounting rules. And, as I'm sure you know, tax returns must comply with tax laws.

## GETTING DOWN TO BUSINESS



## FINANCIAL REPORTING



### INTERNAL FUNCTIONS OF ACCOUNTING

In addition to the day-to-day operational demands (preparing payroll checks, paying bills on time, sending out invoices to customers, etc.), Figure 1.1 reveals two other internal functions of accounting: the preparation of management control reports and reports for management decision making. Management control demands attention to a very large number of details; quite literally, thousands of things can go wrong. Management decision making, in contrast, focuses attention on relatively few key factors. Decision making looks at the forest, not the trees. For decision-making purposes, managers need accounting reports that are condensed and global in nature—that present the big picture. These reports should resonate with the business model and should be structured according to the profit and cash flow models of the business.

In passing, I should mention that accounting information seldom comprises the whole set of information needed for decision making and control. Managers use many, many other sources of information—competitors' sales prices, delivery problems with suppliers, employee morale, and so on. Nonaccounting data comes from a wide diversity of sources, including shopping the competition, sales force reports, market research studies, personnel department records, and so on. For example, customer files are very important, and they usually include both accounting data (past sales history) and nonaccounting data (sales reps assigned to each customer).



### EXTERNAL FUNCTIONS OF ACCOUNTING

Accountants have two primary external reporting responsibilities: the preparation of tax returns and external financial reports (see Figure 1.1 again). Exceedingly complex and constantly changing laws, rules, and forms govern state and federal income taxes, payroll taxes, property taxes, and sales taxes. Accountants have their hands full just keeping up with tax regulations and forms. Accountants also have to stay abreast of changing accounting standards to prepare external financial reports.

## External Financial Reports

In the next chapter I present an overview of external financial reports. Please bear in mind that this book does not examine in any great detail the external financial reports of business.\* This book is mainly concerned with internal reports to managers and how managers analyze the information in these reports for making decisions and for controlling the financial performance of the business. Only a few brief comments about external financial reporting of particular importance to managers are mentioned here.

The financial statements of a business that are the core of the external financial reports sent to its shareowners and lenders must conform with *generally accepted accounting principles* (GAAP). These are the authoritative guidelines, rules, and standards that govern external financial reporting to the outside investors and creditors of a business. The main purpose of having financial statements audited by an independent CPA firm is to test whether the statements have been prepared according to GAAP. If there are material departures from these ground rules of financial statement accounting and disclosure, the CPA auditor says so in the audit opinion on the financial statements.

External financial reports include footnotes that are an integral addendum to the financial statements. Footnotes are needed because the external financial report is directed to outside investors and creditors of the business who are not directly involved in the day-to-day affairs of the business. Managers should already know most of the information disclosed in footnotes. If managers prefer to have certain footnotes included in their internal accounting reports, the footnotes should be included—probably in much more detail and covering more sensitive matters than footnotes presented in external financial reports.

An external financial report includes three primary financial statements: One summarizes the profit-making activities of the business for the period; one summarizes the cash inflows and outflows for the same period; and one summarizes the assets of the business at the end of the period that are balanced by the claims against, and sources of, the assets.

\*Without too much modesty, I can recommend my book, *How to Read a Financial Report*, 5th ed. (New York: John Wiley & Sons, 1999).

## FINANCIAL REPORTING

The three primary financial statements do not come with built-in analysis. Rather, the financial statements provide an organized source of information. It's up to the users to extract the vital signals and messages from the statements. As I explain later, managers need much more information than are reported in the external financial statements.

For example, suppose you're about ready to lower sales prices 10 percent because you think sales volume will increase more than enough to make this a smart move. You'd better know which profit and cash flow analysis tools to use to test the impact of this decision on your business. The external profit report does not provide the information you need. Rather, you need the type of internal profit report explained in Chapter 3 to analyze just how much sales volume would have to increase in order to increase profit. You might be surprised by how much sales volume would have to increase. If you think sales volume would have to increase by only 10 percent, you are dead wrong!

### A WORD ABOUT ACCOUNTING METHODS

GAAP have been developed to standardize accounting methods for measuring net income (bottom-line profit), for presenting financial condition and cash flow information, and to provide financial disclosure standards for reporting to external investors and lenders to business. Over the years GAAP have come a long way, but have not yet resulted in complete uniformity and consistency from one business to the next, or even among companies in the same industry. Businesses can choose from among different but equally acceptable accounting methods, which can cause a material difference in the profit (net income) reported for the year and in the values of certain assets, liabilities, and owners' equity accounts reported in the financial statements of a business.

Profit depends on how it's measured—in particular, on which accounting methods have been selected and how the methods are applied in practice. I'm reminded of the old baseball joke here: There's an argument between the batter and the catcher about whether the pitch was a ball or a strike. Back and forth the two go, until finally the umpire settles it by saying "It ain't nothing until I call it." Likewise, someone has to decide how to "call" profit for the period; profit depends on how the

## GETTING DOWN TO BUSINESS

“strike zone” is determined, and this depends heavily on which particular accounting methods are selected to measure profit.

External financial reports are the primary means of communication to fulfill the *stewardship fiduciary function* of management—that is, to render a periodic accounting of what has been done with the capital entrusted to management. The creditors and shareowners of a business are the sources of, as well as having claims on, the assets of the business. Therefore, they are entitled to a periodic accounting by their stewards (*agents* is the more popular term these days).



Please keep in mind that managers have a fiduciary responsibility to the outside world. They are responsible for the fairness and truthfulness of the financial statements. There’s no doubt that top management has the primary responsibility for the business’s financial statements—this cannot be shifted or “outsourced” to the CPA auditor of its financial statements. Nor can legal counsel to the business be blamed if top management issues misleading financial statements, unless they were a party to a conspiracy to commit fraud.

Because external financial reports are public in nature, disclosure is limited, especially in the profit performance report of a business. Disclosure standards permit the business to withhold information that creditors and external investors probably would like to know. The theory of this, I believe, is that such disclosure would reveal too much information and cause the business to lose some of its competitive advantages. The internal accounting profit report presented in the next chapter contains confidential information that the business wouldn’t want to reveal in its external financial report to the outside world.

Publicly owned corporations are required to include a *management discussion and analysis* (MD&A) section in their annual financial reports to stockholders, which deals with the broad factors and main reasons for the company’s profit performance. Generally speaking, these sections are not too specific and deal with broad issues and developments over the year.

### END POINT

The book analyzes how to make profit. So it seems a good idea in conclusion to say a few words in defense of the profit

## FINANCIAL REPORTING

motive. Profit stimulates innovation; it's the reward for taking risks; it's the return on capital invested in business; it's compensation for hard work and long hours; it motivates efficiency; it weeds out products and services no longer in demand; it keeps pressure on companies to maintain their quality of customer service and products.

In short, the profit system delivers the highest standard of living in the world. Despite all this, it's no secret that many in government, the church, and society at large have a deep-seated distrust of our profit-motivated, free enterprise, and open market system—and not entirely without reason.

It would be naive to ignore the abuses and failings of the profit system and not to take notice of the ruthless profit-at-any-cost behavior of some unscrupulous business managers. Unfortunately, you don't have to look very far to find examples of dishonest advertising, unsafe products, employees being cheated out of their pensions, dangerous working conditions, or deliberate violation of laws and regulations.

Too many companies travel the low moral and ethical road. A form of Gresham's law\* seems to be at work. Dirty practices tend to drive out clean practices, the result being a sinking to the lowest level of tolerable behavior. Which is very sad. No wonder profit is a dirty word to so many. No wonder business gets bad press. Ethical standards should be above and ahead of what the law requires.

Many businesses have adopted a formal code of ethics for all employees in the organization. It goes without saying that managers should set the example for full-faith compliance with the code of ethics. If managers cut corners, what do they expect employees to do? If managers pay only lip service to the code of ethics, employees will not take the code seriously.

\*You may recall that Sir Thomas Gresham was a sixteenth-century economist who is generally credited with the important observation that, given two types of money circulating in the economy, the one perceived as more dear or of higher quality will be kept back and spent last; the cheaper or lower-quality money will be offered first in economic exchange. Thus, the cheaper money will drive out the higher-quality money. Even though we have only one currency in the American economy, you may have noticed that most of us tend to pass the currency that is in the worst shape first and hold back the bills that are in better condition.