

Part One

FINANCIAL REPORT FUNDAMENTALS

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FINANCIAL STATEMENT BASICS

**The Real Meat and Potatoes
of Financial Reports**

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To start this book it is important to understand that every for-profit business, nonprofit organization, governmental entity, and/or just about any type of “entity” you can think of need financial reports or financial statements (which represent the meat and potatoes of the financial reports). Without financial statements, managing the interests of these entities would be damn near impossible. Creditors such as banks, suppliers, landlords, and the like would not be able to assess the economic performance of the entity (and decide if credit should be extended). Management would not be able to determine how the entity is performing, including the rather novel concept of whether the entity is actually making or losing money (something the federal government doesn’t appear to have to worry about but we’ll leave this topic for another time). Investors would not be able to determine if their investments in the entity are actually worth anything. And completing and filing periodic tax returns to the slew of taxing authorities all entities must inevitably comply with would be challenging, to say the least.

Countless other examples of why financial statements are needed could be cited, so rather than burn an entire chapter on listing every potential scenario, let’s stay focused on two important acronyms as they apply to financial statements.

As we proceed through this book and assist the reader with understanding the basics of financial statements, a constant theme

Critical Terminology Alert—CART versus SWAG

CART stands for Complete, Accurate, Reliable, and Timely. This is how financial statements should be produced—in a complete, accurate, reliable, and timely manner. SWAG stands for Scientific Wild Ass Guess. And yes, let’s just say that more than a few companies have produced financial statements utilizing the ever-so-popular SWAG methodology.

is also presented in helping readers understand and identify when CART financial statements are being produced compared to applying the SWAG method. We note that you generally won’t find these acronyms listed in any official accounting literature, formal accounting guidance reference material, and so on, as these terms are centered more on how accounting is applied and conducted on “the street” as opposed to how accounting theory and principles are taught “in the classroom.” But whether CART or SWAG is applied, the same concept still holds as it relates to preparing financial statements and the consequences of not completing even the basics, as Twitter found out the hard way!

The Big Three—Financial Condition, Profit Performance, and Cash Flows

As previously noted, business managers, lenders, investors, governmental organizations, and the like (collectively referred to as the *parties* throughout this book) need to have a clear understanding of the financial condition of a business, both at a point in time and over a period of time. The primary objective of the big three financial statements summarized in this segment of the chapter is to achieve just this goal.

First Up, the Balance Sheet

Parties need to assess the *financial condition* of a business *at a point in time*. For this purpose they need a report that summarizes its assets (what the business owns) and liabilities or obligations (what the business owes), as well as the ownership interests in the residual of assets in excess of liabilities (which is commonly referred to as *owners' equity*). Understanding the financial condition of a business is best measured by number one on the list of the big three financial statements—*the balance sheet*.

Exhibit 1.1 presents a standard balance sheet for a business entity.

When first reviewing the balance sheet a number of items should jump out at the reader including the format used, the different groupings of assets, liabilities, and equity, the allocation of assets and liabilities between current and long-term, and other details. All of these concepts are discussed in Chapter 3, “Mastering the Balance Sheet,” but if there is one extremely important concept that must be understood with the balance sheet it is this—*the*

balance sheet must balance. That is, total assets must equal total liabilities plus shareholders' equity. If not, well I can only think of the line quoted by Tom Hanks who played astronaut Jim Lovell in the movie *Apollo 13*—“Houston, we have a problem.”

Next in Line, the Income Statement

Second up on our list of the big three financial statements is based on the simple concept of knowing (by the parties) whether a business has generated a profit or incurred a loss over *a period of time*. For this purpose, the business needs a report that summarizes sales or revenues against expenses or costs for a given period and the resulting profit generated or loss incurred. This financial statement is most commonly known as *the income statement* or similarly, the profit and loss statement (or *P&L* for short).

Exhibit 1.2 presents a typical income statement for the same business entity the balance sheet was presented in Exhibit 1.1.

Chapter 4, titled Understanding Profit, on understanding the income statement has been dedicated to breaking down the income statement in more detail but similar to the balance sheet, one important concept must be understood—*profit ≠ success and losses ≠ failure*. That is, generating a profit does not mean that the business is financially sound and is guaranteed success and conversely, incurring a loss does not mean the business is going to fail. Financial statements need to be understood in their entirety before a judgment can be passed on the long-term financial viability of the business.

EXHIBIT 1.1 — YEAR-END BALANCE SHEETS

Dollar Amounts in Thousands

	Last Year	This Year	Change		Last Year	This Year	Change
Cash	\$ 3,735	\$ 3,265	\$ (470)	Accounts Payable	\$ 2,675	\$ 3,320	\$ 645
Accounts Receivable	4,680	5,000	320	Accrued Expenses Payable	1,035	1,515	480
Inventory	7,515	8,450	935	Income Tax Payable	82	165	83
Prepaid Expenses	685	960	275	Short-Term Notes Payable	3,000	3,125	125
Current Assets	<u>\$16,615</u>	<u>\$17,675</u>		Current Liabilities	<u>\$ 6,792</u>	<u>\$ 8,125</u>	
Property, Plant, and Equipment	\$13,450	\$16,500	3,050	Long-Term Notes Payable	<u>\$ 3,750</u>	<u>\$ 4,250</u>	500
Accumulated Depreciation	(3,465)	(4,250)	(785)	Capital Stock—793,000 Shares and 500,000 Shares Respectively	\$ 7,950	\$ 8,125	175
Cost Less Depreciation	<u>\$ 9,985</u>	<u>\$12,250</u>		Retained Earnings	13,108	15,000	1,892
Intangible Assets	\$ 5,000	\$ 5,575	575	Stockholders' Equity	<u>\$21,058</u>	<u>\$23,125</u>	
Long-Term Operating Assets	<u>\$14,985</u>	<u>\$17,825</u>		Total Liabilities and Stockholders' Equity	<u>\$31,600</u>	<u>\$35,500</u>	<u>\$3,900</u>
Total Assets	<u>\$31,600</u>	<u>\$35,500</u>	<u>\$3,900</u>				

EXHIBIT 1.2—INCOME STATEMENT FOR YEAR*Dollar Amounts in Thousands*

Sales Revenue	\$52,000
Cost of Goods Sold Expense	<u>(33,800)</u>
Gross Profit	\$18,200
Selling, General, and Administrative Expenses	(12,480)
Depreciation Expense	<u>(785)</u>
Earnings before Interest and Income Tax	\$ 4,935
Interest Expense	<u>(545)</u>
Earnings before Income Tax	\$ 4,390
Income Tax Expense	<u>(1,748)</u>
Net Income	<u>\$ 2,642</u>

Bringing Up the Rear; the Statement of Cash Flows

And, finally the parties need a summary of its *cash flows for a period of time*. Similar to the income statement, cash flows are measured over a period of time (generally the same length of time as the income statement such as a month, quarter, or year) but unlike the income statement (which measures total sales or revenues against total expenses or costs to calculate the profit or loss), cash flows are best understood by distinguishing between where cash comes from (the sources) and where cash goes (the uses). This brings us to the last of the big three financial statements, which is ***the statement of cash flows***.

Exhibit 1.3 presents a typical statement of cash flows for the same business entity the balance sheet was presented in Exhibit 1.1 and income statement was presented in Exhibit 1.2.

EXHIBIT 1.3—STATEMENT OF CASH FLOWS FOR YEAR*Dollar Amounts in Thousands*

Cash Flow from Operating Activities			
Net Income (from Income Statement)		\$ 2,642	
Accounts Receivable Increase		(320)	
Inventory Increase		(935)	
Prepaid Expenses Increase		(275)	
Depreciation Expense		785	
Accounts Payable Increase		645	
Accrued Expenses Payable Increase		480	
Income Tax Payable Increase		<u>83</u>	<u>\$3,105</u>
Cash Flow from Investing Activities			
Expenditures for Property, Plant, and Equipment		\$(3,050)	
Expenditures for Intangible Assets		<u>(575)</u>	<u>(3,625)</u>
Cash Flow from Financing Activities			
Increase in Short-Term Debt		\$ 125	
Increase in Long-Term Debt		500	
Issuance of Additional Capital Stock Shares		175	
Distribution of Cash Dividends from Profit		<u>(750)</u>	<u>50</u>
Decrease in Cash During Year			\$ (470)
Cash Balance at Start of Year			<u>3,735</u>
Cash Balance at End of Year			<u>\$3,265</u>

In our business travels, there is no question that the statement of cash flows is without doubt the least understood of the big three financial statements but at the same time, the most important. Understanding how a business generates and consumes cash is discussed in more depth in Chapter 2 and as you start that chapter it is important to keep the most critical of concepts at the forefront of your thoughts as it relates to cash flows—*profit ≠ positive cash flow and a loss ≠ negative cash flow*.

For a perfect example of just how significant the difference can be between profit and cash flow, please refer to page 50 of Netflix's 2012 annual report (available online) and you see that for the fiscal year-end 2012, Netflix generated a profit of **\$17,152,000** or the company was “in the black” for the year (i.e., the color black in the financial community equates to positive earnings and the color red to losses). Now if you proceed to page 52, you see that Netflix actually had negative cash flow for the year of **\$217,762,000** (referred to as

the “Net increase [decrease] in cash and cash equivalents”). So for the same 12-month reporting period used for both the income statement and the statement of cash flows, one can see just how significant the divergence between the two figures can be (i.e., net profit versus negative cash flow). Netflix's results offer a perfect case study in why it is so important to understand all three of the financial statements to properly assess the economic performance of a business.

The three financial statements for the company example introduced in this chapter are now presented here in Exhibits 1.1, 1.2, and 1.3. The format and content of these three financial statements apply to manufacturers, wholesalers, and retailers—businesses that make or buy *products* that are sold to their customers. Although the financial statements of service businesses that don't sell products differ somewhat, Exhibits 1.1, 1.2, and 1.3 illustrate the basic framework and content of balance sheets, income statements, and statements of cash flows for all businesses.

Additional Financial Statement Considerations and Concepts

So there you have it, the big three financial statements that represent the core financial information that is reported regularly by businesses to the parties. But before we dive into these financial statements and their subcomponents in great detail, it's worthwhile to cover some additional concepts, formats, and terminology associated with financial statements:

- ◆ Supplemental information: In almost all cases the financial statements need to be supplemented with additional information, which is presented in *footnotes*, *supporting schedules*, *audit reports*, and/or *other information*. One common supporting schedule—the *statement of changes in stockholders' (owners') equity*—accounts for increases and decreases in owners' equity over a period of time.
- ◆ Financial report versus financial statements: The broader term *financial report* refers to all of the above, plus any additional commentary from management, narrative explanations, graphics, and promotional content that accompany the financial statements and their footnotes and supporting schedules. The use of MDORs and MD&As (i.e., management discussion of operating results and management discussion and analysis) offer the company's executive management team with a window to highlight and/or summarize the performance of the business to assist the reader with gaining a better understanding of the financial results. In theory, this should be the primary purpose of an MDOR or MD&A but in practice, let's face it, these items provide management with an ideal window to "promote" the business.
- ◆ Alternative financial statement titles: Alternative titles for the balance sheet include "statement of financial condition" or "statement of financial position." An income statement may be titled "statement of operations," "earnings statement," or as previously noted, a P&L. For the purposes of this book, we stick with the names *balance sheet* and *income statement* to be consistent throughout the book. The statement of cash flows is almost always called just that.
- ◆ Plural: The term *financial statements*, in the plural, generally refers to a complete set that includes a balance sheet, an income statement, and a statement of cash flows. Informally, financial statements may be called just *financials*.
- ◆ Profit as a four letter word: The term *profit* is not popular in income statements (or elsewhere in financial reports). Not many companies use the term (although some do). Profit comes across to many people as greedy or mercenary. The term suggests an excess or a surplus over and above what's necessary. You may hear the term *profit and loss* or *P&L statement* for the income statement. But this title is not used in external financial reports released outside a business. Generally speaking, *net income* is used instead of profit.

- ♦ **Comparative information:** Many businesses present a two-year comparative income statement and statement of cash flows, either because they legally have to or they decide to do so. Comparative balance sheets may also be presented if desired. For external readers, having comparative information is generally favorable as it provides an easier method to evaluate and assess periodic financial results.
- ♦ **SEC required disclosures:** When companies are publicly traded, they must adhere to strict reporting standards governed by the SEC. Understanding all public reporting requirements is well beyond the scope of this book but the concept of just how extensive SEC disclosures are needs to be

mentioned to help readers sort through the mounds of information disclosed in a typical public company's annual shareholder report.

A perfect example of just how lengthy and extensive a company's complete annual financial report can be located in Yahoo's 2012 annual report. Of a total of 145 pages of material presented in the annual report, just five pages are allocated to the actual financial statements. The rest is allocated to primarily two functions—management promoting the business (to lead the report) and SEC disclosure requirements (covering the balance of the report).

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An Important Concept to Understand Throughout This Book

Over the past century (and longer) a recognized profession has developed, one of whose main functions is to prepare and report business financial statements—the *accounting profession*. A primary goal of the accounting profession has been to develop and enforce accounting and financial reporting standards that apply to all businesses. In other words, there is a “rule book” that businesses should obey in accounting for profit and in reporting profit, financial condition, and cash flows. Businesses are not free to make up their own individual accounting methods and financial reporting practices. The established rules and standards are collectively referred to as *generally accepted accounting principles* (or GAAP as previously noted), which continuously change, adapt, and evolve as business conditions change.

Tips, Tidbits, and Traps

A critical concept to understand is that GAAP represents more of an “Art” than an exact “Science.” That is, GAAP provides a certain amount of leeway in applying accounting principles by businesses that have similar business models yet use different financial and accounting strategies for reporting purposes. A common theme that is highlighted again and again through this book is just how *creative* (for lack of a better term) businesses can be when reporting financial results. Or as the old saying goes when an accountant gets asked what would seem to be a very simple question: What does $2 + 2$ equal? And the clever accountant’s response: Whatever you want it or need it to be!

But things are getting more complicated these days, that’s for sure. In the United States there are serious beginnings to adopt separate rules for private companies versus public companies, and for small companies versus larger companies. Furthermore, the efforts to develop international accounting and financial reporting standards keep slogging along, with mixed results so far. There will be a set of rules governing profit accounting and financial reporting for every business. However, exactly which set of rules will apply in the future to particular types of business is open to change.

In the book we generally assume that traditional GAAP standards apply, unless we say otherwise. We say more about the changing landscape of accounting and financial reporting standards in later chapters.

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