Chapter 1

Opening the Cornucopia of Reports

In This Chapter

- Reviewing the importance of financial reports
- Exploring the different types of financial reporting
- Discovering the key financial statements

Financial reports give a snapshot of a company's value at the end of a particular period, as well as a view of the company's operations and whether it made a profit. The business world couldn't function without financial reports. Yes, fewer scandals would be exposed because companies wouldn't be tempted to paint false but pretty financial pictures, but you'd still need a way to gauge a firm's financial health.

At this point in time, nothing's available that can possibly replace financial reports. Nothing can be substituted that'd give investors, financial institutions, and government agencies the information they need to make decisions about a company. And without financial reports, the folks who work for a company wouldn't know how to make it more efficient and profitable because they wouldn't have a summary of its financial activities during previous business periods. These financial summaries help companies look at their successes and failures and help them make plans for future improvements.

This chapter introduces you to the many facets of financial reports and how internal and external players use them to evaluate a company's financial health.

Figuring Out Financial Reporting

Financial reporting gives readers a summary of what happens in a company based purely on the numbers. The numbers that tell the tale include the following:

- **Assets:** The cash, marketable securities, buildings, land, tools, equipment, vehicles, copyrights, patents, and any other items needed to run a business that a company holds.
- **Liabilities:** Money a company owes to outsiders, such as loans, bonds, and unpaid bills.
- **Equity:** Money invested in the company.
- **Sales:** Products or services that customers purchase.
- **Costs and expenses:** Money spent to operate a business, such as expenditures for production, compensation for employees, operation of buildings and factories, or supplies to run the offices.
- **Profit or loss:** The amount of money a company earns or loses.
- **Cash flow:** The amount of money that flows into and out of a business during the time period being reported.

Without financial reporting, you'd have no idea where a company stands financially. Sure, you'd know how much money the business has in its bank accounts, but you wouldn't know how much is still due to come in from customers, how much inventory is being held in the warehouse and on the shelf, how much the firm owes, or even how much the firm owns. As an investor, if you don't know these details, you can't possibly make an objective decision about whether the company is making money and whether it's worth investing in the company's future.

Preparing the reports

A company's accounting department is the key source of its financial reports. This department is responsible for monitoring the numbers and putting together the reports. The numbers are the products of a process called *double-entry accounting,* which requires a company to record resources and the assets it uses to get those resources. For example, if you buy a chair, you must spend another asset, such as cash. An entry in the double-entry accounting system shows both sides of that transaction — the cash account is reduced by the chair's price, and the furniture account value is increased by the chair's price.

This crucial method of accounting gives companies the ability to record and track business activity in a standardized way. Accounting methods are constantly updated to reflect the business environment as financial transactions become more complex. To find out more about double-entry accounting, turn to Chapter 4.

Why financial reporting counts (and who's counting)

Many people count on the information companies present in financial reports. Here are some key groups of readers and why they need accurate information:

- **Executives and managers:** They need information to know how well the company is doing financially and to find out about problem areas so they can make changes to improve the company's performance.
- **Employees:** They need to know how well they're meeting or exceeding their goals and where they need to improve. For example, if a salesperson has to make $50,000 in sales during the month, he needs a financial report at the end of the month to gauge how well he did in meeting that goal. If he believes that he met his goal but the financial report doesn't show that he did, he'd have to provide details to defend his production levels. Most salespeople are paid according to their sales production. Without financial reports, they'd have no idea what their compensation is based on.

  Employees also make career and retirement-investment decisions based on the company's financial reports. If the reports are misleading or false, employees could lose most, if not all, of their 401(k) retirement savings, and their long-term financial futures could be at risk.
- **Creditors:** They need to understand a company's financial results to determine whether they should risk lending more money to the company and to find out whether the firm is meeting the minimum requirements of any loan programs that are already in place. To find out how creditors gauge whether a business meets their requirements, see Chapters 9 and 12.

  If a firm's financial reports are false or misleading, creditors may loan money at an interest rate that doesn't truly reflect the risks they're taking. And by trusting the misleading information, they may miss out on a better opportunity.
- **Investors:** They need information to judge whether a company is a good investment. If investors think that a company is on a growth path because of the financial information it reports but those reports turn out to be false, investors can pay, big time. They may buy stock at inflated prices and risk the loss of capital as the truth comes out, or miss out on better investing opportunities.
- **Government agencies:** These agencies need to be sure that companies comply with regulations set at the state and federal levels. They also need to be certain that companies accurately inform the public about their financial position.

- **Analysts:** They need information to develop analytical reviews for clients who are considering the company for investments or additional loan funds.
- **Financial reporters:** They need to provide accurate coverage of a company's operations to the general public, which helps make investors aware of the critical financial issues facing the company and any changes the company makes in its operations.
- **Competitors:** Every company's bigwigs read their competitors' financial reports. If these reports are based on false numbers, the financial playing field gets distorted. A well-run company could make a bad decision to keep up with the false numbers of a competitor and end up reducing its own profitability.

Companies don't produce financial reports only for public consumption. Many financial reports are prepared for internal use only. These internal reports help managers

- Find out which of the business's operations are producing a profit and which are operating at a loss.
- Determine which departments or divisions should receive additional resources to encourage growth.
- Identify unsuccessful departments or divisions and make needed changes to turn the troubled section around or kill the project.
- Determine staffing and inventory levels needed to respond to customer demand.
- Review customer accounts to identify slow-paying or nonpaying customers in order to devise collection methods and to develop guidelines for when a customer should be cut off from future orders.
- Prepare production schedules and review production levels.

These are just a few of the many uses companies have for their internal financial reports. The list is endless and is limited only by the imagination of the executives and managers who want to find ways to use the numbers to make business decisions. I talk more about using internal reports to optimize results in Chapters 14, 15, and 16.

Checking Out Types of Reporting

Not every company needs to prepare financial statements, but any company seeking to raise cash through stock sales or by borrowing funds certainly does. How public these statements must be depends on the business's structure.

Most businesses are *private companies,* which share these statements only with a small group of stakeholders: managers, investors, suppliers, vendors, and the financial institutions that they do business with. As long as a company doesn't sell shares of stock to the general public, it doesn't have to make its financial statements public. I talk more about the reporting rules for private companies in Chapter 2.

REMEMBER

Public companies, which sell stock on the open market, must file a series of reports with the Securities and Exchange Commission (SEC) each year if they have at least 500 investors or at least $10 million in assets. Smaller companies that have incorporated and sold stock must report to the state in which they incorporated, but they aren't required to file with the SEC. You can find more details about the SEC's reporting requirements for public companies in Chapters 3 and 19.

Even if a firm doesn't need to make its financial reports public, if it wants to raise cash outside a very small circle of friends, it has to prepare financial statements and have a certified public accountant (CPA) *audit* them, or certify that the financial statements meet the requirements of the generally accepted accounting principles (or GAAP, which you can find out more about in the section "How the number crunchers are kept in line," later in this chapter). Few banks consider loaning large sums of money to businesses without audited financial statements. Investors who aren't involved in the daily management of a business also usually require audited financial statements.

Keeping everyone informed

One big change in a company's operations after it decides to publicly sell stock is that it must report publicly on both a quarterly and annual basis to its stockholders. Companies send these reports directly to their stockholders, to analysts, and to the major financial institutions that help fund their operations through loans or bonds. The reports often include glossy pictures and pleasingly designed graphics at the beginning, keeping the less eye-pleasing financial reports that meet the SEC's requirements in the back.

Quarterly reports

Companies must release *quarterly reports* within 45 days after the quarter ends. Companies with holdings over $75 million must file more quickly. In addition to the three key financial statements — the *balance sheet,* the *income statement,* and the *statement of cash flows* (check out the upcoming section "The meat of the matter" for details on these documents) — the company must state whether a CPA has audited (see Chapter 18) or reviewed (a much less intensive look at the data) the numbers. A report reviewed rather than audited by a CPA holds less weight.

Annual reports

Most small companies must file their *annual reports* within 90 days of the end of their fiscal year. Companies with over $75 million in assets must file their reports within 60 days. The annual report includes the information presented in the quarterly reports and much more, including a full business description, details about the management team and its compensation, and details about any filings done during the year.

Most major companies put a lot of money into producing glossy reports filled with information and pictures designed to make a good impression on the public. The marketing or public relations department, rather than the financial or accounting department, writes much of the summary information. Too often, annual reports are puff pieces that carefully hide any negative information in the *notes to the financial statements,* which is the section that offers additional details about the numbers provided in those statements (see Chapter 9). Read between the lines — especially the tiny print at the back of the report — to get some critical information about the accounting methods used, any pending lawsuits, or other information that may negatively impact results in the future.

Following the rules: Government requirements

Reports for the government are more extensive than the glossy reports sent to shareholders (see the preceding section). Companies must file many types of forms with the SEC, but I focus on only three of them in this book:

- **The 10-K:** This form is the annual report that provides a comprehensive overview of a company's business and financial activities.

  Firms must file this report within 90 days after the end of the fiscal year (companies with more than $75 million in assets must file within 60 days). In addition to the information included in the glossy annual reports sent to shareholders (see the preceding section), investors can find more detailed information about company history, organizational structure, equity holdings, subsidiaries, employee stock-purchase and savings plans, incorporation, legal proceedings, controls and procedures, executive compensation, accounting fees and services, and changes or disagreements with accountants about financial disclosures.

- **The 10-Q:** This form is the quarterly report that describes key financial information about the prior three months. Most companies must file this report within 45 days of the end of the quarter (firms with more than $75 million in assets must file within 40 days). In addition to the information sent directly to shareholders, this form includes details about the company's market risk, controls and procedures, legal proceedings, and defaults on payments.

- **The 8-K:** This form is a periodic report that accounts for any major events that may impact a company's financial position. Examples of major events include the acquisition of another company, the sale of a company or division, bankruptcy, the resignation of directors, or a change in the fiscal year. When a major event occurs, the company must file a report with the SEC within four days of the event.

You can access reports filed with the SEC online at Edgar, which is run by the SEC. To use Edgar, go to `www.sec.gov/edgar.shtml`.

Going global

More and more companies operate across country borders. For years, each country had its own set of rules for preparing financial reports to meet government regulations. Global companies had to keep separate sets of books and report results under different sets of rules in each country in which they operated.

By 2008, more than 100 countries agreed to accept the International Financial Reporting Standards (IFRS; see Chapter 20) developed by the London-based International Accounting Standards Board (IASB). Beginning in 2002, the U.S. agreed to look at ways to converge the IFRS and the U.S. GAAP (see Chapter 18). The U.S. is on track to allow companies to file required reports using either U.S. GAAP or IFRS by 2011.

Staying within the walls of the company: Internal reporting

Not all an accounting department's financial reporting is done for public consumption. In fact, companies usually produce many more internal reports than external ones to keep management informed. Firms can design their internal reports in whatever way makes sense to their operations.

Each department head usually receives a report from the top managers showing the department's expenses and revenue and whether it's meeting its budget. If the department's numbers vary significantly from the amount that was budgeted, the report indicates red flags. The department head usually needs to investigate the differences and report what the department is doing to correct any problems. Even if the difference is increased revenue (which can be good news), the manager still needs to know why the difference exists, because an error in the data input could have occurred. I talk more about reports and budgeting in Chapter 14.

Reports on inventory are critical, not only for managing the products on hand but also for knowing when to order new inventory. I talk more about inventory controls and financial reporting in Chapter 15.

Tracking cash is vital to the day-to-day operations of any company. The frequency of a company's cash reporting depends on the volatility of its cash status — the more volatile the cash, the more likely the company needs frequent reporting to be sure that it has cash on hand to pay its bills. Some large firms actually provide cash reporting to their managers daily. I talk more about cash reporting in Chapters 16 and 17; Chapter 16 focuses on incoming cash, and Chapter 17 deals with outgoing cash.

Finding the roots of financial reporting

Accounting practices can be traced back to the Renaissance, but financial reporting wasn't recognized as a necessity until centuries later.

- **1494:** Italian monk Luca Pacioli became known as the "father of accounting" for his book *Everything about Arithmetic, Geometry and Proportions,* which includes a section on double-entry accounting (see Chapter 4). Pacioli warned his readers that an accountant shouldn't go to sleep at night until his debits equal his credits.
- **1700–1800:** For-profit corporations started to appear in Europe as early as the 18th century. In 1800, only about 330 corporations operated in the U.S.
- **1800s:** As public ownership of stock increased, regulators realized that some standardized distribution of information to investors was a priority. The New York Stock Exchange was the first to jump into the fray, and in 1853, it began requiring companies listed on the exchange to provide statements of shares outstanding and capital resources.
- **1929:** Before the stock market crash, equity investing became a passion. People borrowed money to get into the market, paying higher and higher prices for stock. Sound familiar? Not too different from what occurred just before the 2000 crash of technology and Internet stocks.
- **1933–1934:** Congress created the SEC and gave it authority to develop financial accounting and reporting standards and rules that would deter companies from distributing misleading information.
- **1973:** The Financial Accounting Standards Board (FASB) was created to establish standards for financial accounting and reporting. The SEC recognized the generally accepted accounting principles (GAAP) as the official reporting standards for federal securities laws.
- **1984:** The FASB formed the Emerging Issues Task Force, which keeps an eye on changes in business operations and sets standards before new practices become entrenched.
- **2002:** The FASB began work with the International Accounting Standards Board (IASB) to converge international financial reporting systems.

Dissecting the Annual Report to Shareholders

The annual report gives more details about a company's business and financial activities than any other report. This document is primarily for shareholders, although any member of the general public can request a copy. Glossy pictures and graphics fill the front of the report, highlighting what the company wants you to know. After that, you find the full details about the company's business and financial operations; most companies include the full 10-K that they file with the SEC.

Breaking down the parts

The annual report is broken into the following parts (I summarize the key points of each of these parts in Chapter 5):

- **Highlights:** These are a narrative summary of the previous year's activities and general information about the company, its history, its products, and its business lines.
- **Letter from the president or chief executive officer (CEO):** This is a letter directed to the shareholders that discusses the company's key successes or explains any major failures.
- **Auditors' report:** This is a report that tells you whether the numbers are accurate or whether you should have any concerns about the future operation of the business.
- **Management's discussion and analysis:** In this part, you find a management discussion of the financial results and other factors that impact the company's operations.
- **Financial statements:** The key financial statements are the balance sheet, income statement, and statement of cash flows. In the financial statements, you find the actual financial results for the year. For details about this part of the report, check out the following section, "The meat of the matter."
- **Notes to the financial statements:** In the notes, you find details about how the numbers were derived. I talk more about the role of the notes in Chapter 9.
- **Other information:** In this part, you find information about the company's key executives and managers, officers, board members, locations, and new facilities that have opened in the past year.

The meat of the matter

No doubt, the most critical part of the annual report for those who want to know how well a company did financially is the financial statements section, which includes the balance sheet, the income statement, and the statement of cash flows.

The balance sheet

The *balance sheet* gives a snapshot of the company's financial condition. On a balance sheet, you find assets, liabilities, and equity. The balance sheet got its name because the total assets must equal the total liabilities plus the total equities so that the value of the company is in balance. Here's the equation:

Assets = Liabilities + Equities

Assets are shown on the left side of a balance sheet, and liabilities and equities are on the right side. Assets are broken down into *current assets* (holdings that the company will use in the next 12 months, such as cash and savings) and *long-term assets* (holdings that the company will use longer than a 12-month period, such as buildings, land, and equipment).

Liabilities are broken down into *current liabilities* (payments on bills or debts that are due in the next 12 months) and *long-term liabilities* (payments on debt that are due after the next 12 months).

The equities portion of the balance sheet can be called *owner's equity* (when an individual or partners closely hold a company) or *shareholders' equity* (when shares of stock have been sold to raise cash). I talk more about what information goes into a balance sheet in Chapter 6.

The income statement

The *income statement,* also known as the *profit and loss statement (P&L),* gets the most attention from investors. This statement shows a summary of the financial activities of one quarter or an entire year. Many companies prepare P&Ls on a monthly basis for internal use. Investors always focus on the exciting parts of the statement: revenue, net income, and earnings per share of stock.

In the income statement, you also find out how much the company is spending to produce or purchase the products or services it sells, how much the company costs to operate, how much it pays in interest, and how much it pays in income tax. To find out more about the information you can find on an income statement, go to Chapter 7.

The statement of cash flows

The *statement of cash flows* is relatively new to the financial reporting game. The SEC didn't require companies to file it with the other financial reports until 1988. Basically, the statement of cash flows is similar to the income statement in that it reports a company's performance over time. But instead of focusing on profit or loss, it focuses on how cash flows through the business. This statement has three sections: cash from operations, cash from investing, and cash from financing. I talk more about the statement of cash flows in Chapter 8.

How the number crunchers are kept in line

Every public company's internal accounting team and external audit team must answer to government entities. The primary government entity responsible for overseeing corporate reporting is the SEC. Reports filed with the SEC are reviewed by its staff. If SEC employees have any questions or want additional information, they notify the company after the reports are reviewed.

REMEMBER

Financial statements filed with the SEC and for public consumption must adhere to the *generally accepted accounting principles* (GAAP). To meet the demands of these rules, financial reporting must be relevant, reliable, consistent, and presented in a way that allows the report reader to compare the results to prior years, as well as to other companies' financial results. To find out more about GAAP, turn to Chapter 18.

With GAAP in place, you may wonder why so many accounting scandals have hit the front pages of newspapers around the country for the past few years. Filing statements according to GAAP has become a game for many companies. Unfortunately, investors and regulators find that companies don't always engage in transactions for the economic benefit of the shareholders but sometimes do so to make their reports look better and to meet the quarterly expectations of Wall Street. Many times, companies look financially stronger than they actually are. For example, as scandals have come to light, companies have been found to overstate income, equity, and cash flows while understating debt. I talk more about reporting problems in Chapter 23.