Part I

Financial Accounting

1

Understanding Financial Statements

Les Livingstone

What Are Financial Statements? A Case Study

Gail was applying for a bank loan to start her new business: Nutrimin, a retail store selling nutritional supplements, vitamins, and herbal remedies. She described her concept to Hal, a loan officer at the bank.

Hal: How much money will you need to get started?

Gail: I estimate $80,000 for the beginning inventory, plus $36,000 for store signs, shelves, fixtures, counters, and cash registers, plus $24,000 working capital to cover operating expenses for about two months. That's a total of $140,000 for the start-up.

Hal: How are you planning to finance the investment of $140,000 for the start-up?

Gail: I can put in $100,000 from my savings, and I'd like to borrow the remaining $40,000 from the bank.

Hal: Suppose the bank lends you $40,000 on a one-year note, at 15% interest, secured by a lien on the inventory. Let's put together projected financial statements from the figures you gave me. Your beginning balance sheet would look like what you see on the computer screen:

Nutrimin

Projected Balance Sheet as of January 1, 20XX

Assets		**Liabilities and Equity**	
Cash	$ 24,000	Bank loan	$ 40,000
Inventory	80,000		
Current assets	104,000	Current liabilities	40,000
Fixed assets:		Equity:	
Equipment	36,000	Owner capital	100,000
Total assets	$140,000	Liabilities and equity	$140,000

The left side shows Nutrimin's investment in assets. It classifies the assets into "current" (which means turning into cash in a year or less) and "noncurrent" (not turning into cash within a year). The right side shows how the assets are to be financed: partly by the bank loan and partly by your equity as the owner.

Gail: Now I see why it's called a "balance sheet." The money invested in assets must equal the financing available—it's like two sides of the same coin. Also, I see why the assets and liabilities are classified as "current" and "noncurrent"—the bank wants to see if the assets turning into cash in a year or less will provide enough cash to repay the one-year bank loan. Well, in a year there should be cash of $104,000. That's enough cash to pay off more than twice the $40,000 amount of the loan. I guess that guarantees approval of my loan!

Hal: We're not quite there yet. We need some more information. First, tell me: How much do you expect your operating expenses will be?

Gail: For year 1, I estimate as follows:

Store rent	$36,000	
Phone and utilities	14,400	
Assistants' salaries	40,000	
Interest on the loan	6,000	(15% on $40,000)
Total	$96,400	

Hal: We also have to consider depreciation on the store equipment. It probably has a useful life of 10 years. So each year it depreciates 10% of its cost of $36,000. That is $3,600 a year for depreciation. So operating expenses must be increased by $3,600 a year from $96,400 to $100,000. Now, moving on, how much do you think your sales will be this year?

Gail: I'm confident that sales will be $720,000 or even a little better. The wholesale cost of the items sold will be $480,000, giving a markup of $240,000—which is 33⅓% on the projected sales of $720,000.

Hal: Excellent! Let's organize this information into a projected income statement. We start with the sales, and then deduct the cost of the items sold to arrive at the gross profit. From the gross profit we deduct your operating expenses, giving us the income before taxes. Finally we deduct the income tax expense in order to get the famous "bottom line," which is the net income. Here is the projected income statement shown on my computer screen:

Nutrimin

Projected Income Statement for the Year Ending December 31, 20XX

Sales		$720,000
Less cost of goods sold		480,000
Gross profit		240,000
Less expenses		
Salaries	$40,000	
Rent	36,000	
Phone and utilities	14,400	
Depreciation	3,600	
Interest	6,000	100,000
Income before taxes		140,000
Income tax expense (40%)		56,000
Net income		$ 84,000

Gail, this looks very good for your first year in a new business. Many business start-ups find it difficult to earn income in their first year. They do well just to limit their losses and stay in business. Of course, I'll need to carefully review all your sales and expense projections with you, in order to make sure that they are realistic. But first, do you have any questions about the projected income statement?

Gail: I understand the general idea. But what does "gross profit" mean?

Hal: It's the usual accounting term for sales less the amount that your suppliers charged you for the goods that you sold to your customers. In other words, it represents your markup from the wholesale cost you paid for goods to the price for which you sold those goods to your customers. It is called "gross profit" because your operating expenses have to be deducted from it. In accounting, the word *gross* means "before deductions." For example, "gross sales" means sales before deducting goods returned by customers. Sales after deducting goods returned by customers are referred to as "net sales." In accounting, the word *net* means "after deductions." So, "gross profit" means income before deducting operating expenses. By the same token, "net income" means income after deducting operating expenses and income taxes. Now, moving along, we are ready to figure out your projected balance sheet at the end of your first year in business. But first, I need to ask you: How much cash do you plan to draw out of the business as your compensation?

Gail: My present job pays $76,000 a year. I'd like to keep the same standard of compensation in my new business this coming year.

Hal: Let's see how that works out after we've completed the projected balance sheet at the end of year 1. Here it is on my computer screen:

Nutrimin

Projected Balance Sheet as of December 31, 20XX

Assets			**Liabilities and Equity**	
Cash		$ 35,600	Bank loan	$ 40,000
Inventory		80,000		
Current assets		115,600	Current liabilities	40,000
Fixed assets:			Equity:	
Equipment	$36,000		Capital: Jan. 1	100,000
Less depreciation	3,600		Add net income	84,000
Net equipment	$32,400	32,400	Less drawings	(76,000)
			Capital: Dec. 31	108,000
Total assets		$148,000	Liabilities and equity	$148,000

Gail, let's go over this balance sheet together. It has changed, compared to the balance sheet as of January 1. On the "Liabilities and Equity" side of the balance sheet, the net income of $84,000 has increased capital to $184,000 (because earning income adds to the owner's capital), and deducting drawings of $76,000 has reduced capital to $108,000 (because drawings take capital out of the business). On the "Assets" side, notice that the equipment now has a year of depreciation deducted, which writes it down from the original $36,000 to a net (there's that word "net" again) $32,400 after depreciation. The equipment had an expected useful life of

10 years, now reduced to a remaining life of nine years. Last, but not least, notice that the cash has increased by only $11,600 from $24,000 at the beginning of the year to $35,600 at year-end. This leads to a problem: The bank loan of $40,000 is due for repayment on December 31. But there is only $35,600 of cash available on December 31. How can the loan be paid off when there is not enough cash to do so?

Gail: I see the problem. But I think it's bigger than just paying off the loan. The business will also need to keep about $25,000 cash on hand to cover two months' operating expenses and income taxes. So, with $40,000 to repay the loan, plus $25,000 for operating expenses, the cash requirements add up to $65,000. But there is only $35,600 cash on hand. This leaves a cash shortage of almost $30,000 ($65,000 less $35,600). Do you think that will force me to cut down my drawings by $30,000, from $76,000 to $46,000? Here I am, opening my own business, and it looks as if I have to go back to what I was earning five years ago!

Hal: That's one way to do it. But here's another way that you might like better. After your suppliers get to know you, and do business with you for a few months, you can ask them to open credit accounts for Nutrimin. If you get the customary 30-day credit terms, then your suppliers will be financing one month's inventory. That amounts to one-twelfth of your $480,000 annual cost of goods sold, or $40,000. This $40,000 will more than cover the cash shortage of $30,000.

Gail: That's a perfect solution! Now, can we see how the balance sheet would look in this case?

Hal: Sure. When you pay off the bank loan, it vanishes from the balance sheet. It is replaced by accounts payable of $40,000. Then the balance sheet looks like this:

Nutrimin

Projected Balance Sheet as of December 31, 20XX

Assets			**Liabilities and Equity**	
Cash		$ 35,600	Accounts payable	$ 40,000
Inventory		80,000		
Current assets		115,600	Current liabilities	40,000
Fixed assets:			Equity:	
Equipment	$36,000		Capital: Jan. 1	100,000
Less depreciation	3,600		Add net income	84,000
Net equipment	$32,400	32,400	Less drawings	(76,000)
			Capital: Dec. 31	108,000
Total assets		$148,000	Liabilities and equity	$148,000

Now the cash position looks a lot better. But it hasn't been entirely solved: there is still a gap between the accounts payable of $40,000 and the cash of $35,600. So, you will need to cut your drawings by about $5,000 in year 1. But that's still much better than the cut of $30,000 that had seemed necessary before. In year 2, the bank loan will be gone, so the interest expense of $6,000 will be saved. Then you can use $5,000 of this savings to restore your drawings back up to $76,000 again.

Gail: That's good news. I'm beginning to see how useful projected financial statements are for business planning. Can we look at the revised projected balance sheet now?

Hal: Of course. Here it is:

Nutrimin

Projected Balance Sheet as of December 31, 20XX

Assets			**Liabilities and Equity**	
Cash		$ 40,600	Accounts payable	$ 40,000
Inventory		80,000		
Current assets		120,600	Current liabilities	40,000
Fixed assets:			Equity:	
Equipment	$36,000		Capital: Jan. 1	100,000
Less depreciation	3,600		Add net income	84,000
Net equipment	$32,400	32,400	Less drawings	(71,000)
			Capital: Dec. 31	113,000
Total assets		$153,000	Liabilities and equity	$153,000

As we see, cash is increased by $5,000 to $40,600—which is sufficient to pay the accounts payable of $40,000. Drawings are decreased by $5,000 to $71,000, which provided the $5,000 increase in cash.

Gail: Thanks. That makes sense. I really appreciate everything you've taught me about financial statements.

Hal: I'm happy to help. But there is one more financial statement to discuss. A full set of financial statements consists of more than the balance sheet and the income statement. It also includes a cash flow statement. Here is the projected cash flow statement:

Nutrimin

Projected Cash Flow Statement for the Year Ending December 31, 20XX

Sources of Cash		
From operations:		
Net income	$ 84,000	
Add depreciation	3,600	
Add increase in current liabilities	40,000	
Total cash from operations (a)	$127,600	
From financing:		
Drawings	$(71,000)	*Negative cash*
Bank loan repaid	(40,000)	*Negative cash*
Net cash from financing (b)	(111,000)	*Negative cash*
Total sources of cash (a + b)	$ 16,600	*($127,600 cash from operations less $111,000 negative cash from financing)*
Uses of Cash		
Total uses of cash	0	
Total sources less total uses of cash	$ 16,600	Net cash increase
Add cash at beginning of year	24,000	
Cash at end of year	$ 40,600	

Gail, do you have any questions about this cash flow statement?

Gail: Actually, it makes sense to me. I realize that there are only two sources that a business can tap in order to generate cash: internal (by earning income) and external (by obtaining cash from outside sources, such as bank loans). In our case the internal sources of cash are represented by the "Cash from Operations" section of the cash flow statement, and the external sources are represented by the "Cash from Financing" section of the cash flow statement. It happens that the "Cash from Financing" is negative, because no additional outside financing is received for the year 20XX, but cash payments are incurred for drawings and for repayment of the bank loan. I also understand that there are no "Uses of Cash" because no extra equipment was acquired. In addition, I can see that the total sources of cash less the total uses of cash must equal the net cash increase, which in turn is the cash at the end of the year less the cash at the beginning of the year. But I am puzzled by the "Cash from Operations" section of the cash flow statement. I can understand that earning income produces cash. However, why do we add back depreciation to the net income in order to calculate cash from operations?

Hal: This can be confusing, so let me try to explain as clearly as I can. Certainly net income increases cash, but first an adjustment has to be made in order to convert net income to a cash basis. Depreciation was deducted as an expense in figuring net income. So adding back depreciation to net income just reverses the charge for depreciation expense. We back it out because depreciation is *not* a cash outflow. Remember that depreciation represents just one year's use of the equipment. The cash outflow for purchasing the equipment was incurred back when the equipment was first acquired, and amounted to $36,000. The equipment cost of $36,000 is spread out over the 10-year life of the equipment at the rate of $3,600 per year, which we call depreciation expense. So, it would be double counting to recognize the $36,000 cash outflow for the equipment when it was originally acquired, and then to recognize it again a second time when it shows up as depreciation expense. We do not write a check to pay for depreciation each year, because it is not a cash outflow.

Gail: Thanks. Now I understand that depreciation is not a cash outflow. But I don't see why we also added back the increase in current liabilities to the net income in order to calculate cash from operations. Can you explain that to me?

Hal: Of course. The increase in current liabilities is caused by an increase in accounts payable. Accounts payable is amounts owed to our suppliers for our purchases of goods for resale in our business. Purchasing goods for resale from our suppliers on credit is not a cash outflow. The cash outflow occurs only when the goods are actually paid for by writing out checks to our suppliers. That is why we added back the increase in current liabilities to the net income in order to calculate cash from operations. In the future, the increase in current liabilities will, in fact, be paid in cash. But that will take place in the future, and is not a cash outflow in this year. Going back to the cash flow statement, notice that it ties in neatly with our balance sheet amount for cash. It shows how the cash at the beginning of the year plus the net cash increase equals the cash at the end of the year.

Gail: Now I get it. Am I right that you are going to review my projections and then I'll hear from you about my loan application?

Hal: Yes, I'll be back to you in a few days. By the way, would you like a printout of the projected financial statements to take with you?

Gail: Yes, please. I really appreciate your putting them together and explaining them to me. I picked up some financial skills that will be very useful to me as an aspiring entrepreneur.

Points to Remember about Financial Statements

When Gail arrived home, she carefully reviewed the projected financial statements, and then made notes about what she had learned.

1. The basic form of the balance sheet is Assets = Liabilities + Owner Equity.
2. Assets are the expenditures made for items such as inventory and equipment that are needed to operate the business. The liabilities and owner equity reflect the funds that financed the expenditures for the assets.
3. Balance sheets show the financial position of a business at a given moment of time.
4. Balance sheets change as transactions are recorded.
5. Every transaction is an exchange, and both sides of each transaction are recorded. For example, when a bank loan is made, there is an increase in cash, which is matched by an increase in a liability entitled "Bank loan." When a bank loan is repaid, there is a decrease in cash, which is matched by a decrease in a liability entitled "Bank loan." After every transaction, the balance sheet stays in balance.
6. Income increases owner equity, and drawings decrease owner equity.
7. The income statement shows how the income for the period was earned.
8. The basic form of the income statement is:
   a. Sales − Cost of Goods Sold = Gross Income.
   b. Gross Income − Expenses = Net Income.
9. The income statement is simply a detailed explanation of the increase in owner equity represented by net income. It shows how the owner equity increased from the beginning of the year to the end of the year on account of the net income.
10. Net income contributes to cash from operations, after it has been adjusted to a cash basis.
11. Not all expenses are cash outflows: for instance, depreciation.
12. Changes in current assets (except cash) and current liabilities are not cash outflows or inflows, respectively, in the period under consideration. They represent future, rather than present, cash flows.
13. Cash can be generated internally by operations, or externally from outside sources such as lenders (or equity investors).
14. The cash flow statement is simply a detailed explanation of how cash at the start developed into cash at the end by virtue of cash inflows, generated internally and externally, less cash outflows.

15. As previously noted:
    a. The income statement is an elaboration of the change in owner equity in the balance sheet caused by earning income.
    b. The cash flow statement is an elaboration of the balance sheet change in beginning and ending cash.

    Therefore, all three financial statements are interrelated, or, to use the technical term, "articulated." They are mutually consistent, and that is why they are referred to as a "set" of financial statements. The three-piece set consists of a balance sheet, income statement, and cash flow statement.
16. A set of financial statements can convey much valuable information about the enterprise to anyone who knows how to analyze financial statements. This information goes to the core of the organization's business strategy and the effectiveness of its management.

While Gail was making her notes, Hal was carefully analyzing the Nutrimin projected financial statements in order to make his recommendation to the bank's loan committee about the Nutrimin loan application. He paid special attention to the cash flow statement, keeping handy the bank's guidelines on cash flow analysis, which included issues such as the following:

- Is cash from operations positive? Is it growing over time? Is it keeping pace with growth in sales? If not, why not?
- Are cash withdrawals by owners only a small portion of cash from operations? If cash withdrawals by owners are a large share of cash from operations, then the business is conceivably being milked of cash, and may not be able to finance its future growth.
- Of the total sources of cash, how much is being internally generated by operations versus obtained from outside sources? Normally, it is wiser to rely more on internally generated cash for growth than on external financing.
- Of the outside financing, how much is derived from equity investors and how much is borrowed money? Normally, it is preferable to rely more on equity than on debt financing.
- What kinds of assets is the company acquiring with the cash being expended? Is it likely that that these asset expenditures will be profitable? How long will it take for these assets to repay their cost, and then to earn a reasonable return?

Hal reflected carefully on these issues, and then finalized his recommendation, which was to approve the loan. It turned out that the bank's loan committee accepted Hal's recommendation, and even went further. They authorized Hal to tell Gail that—if she met all of her responsibilities in regard to the loan throughout the year—the bank would renew the loan at the end of the year and even increase the amount. Hal called Gail with the good news. Their conversation included the following dialogue:

Hal: In order to renew the loan, the bank will ask you for new projected financial statements for the subsequent year. Also, the loan agreement will want you to submit financial statements for the year just past—that is, not projected, but actual financial statements. The bank will require that these actual financial statements have been reviewed by an independent CPA.

Gail: Let me be sure I understand: Projected financial statements are forward-looking, whereas actual financial statements are backward-looking. Is that correct?

Hal: Yes, that's right.

Gail: Next, what is an independent CPA?

Hal: As you probably know, a CPA is a certified public accountant, a professional trained in finance and accounting, and licensed by the state. *Independent* means a CPA who is not an employee of yours, or a relative. It means someone in public practice in a CPA firm. In other words, it is someone outside, objective and unbiased.

Gail: And what does *reviewed* mean?

Hal: Good question. CPAs offer three levels of service relating to financial statements:

1. An *audit* is a thorough in-depth examination of the financial statements and tests of the supporting records. The result is an audit report, which states whether the financial statements are free of material misstatements (whether caused by error or by fraud). A "clean" audit report provides assurance that the financial statements are free of material misstatements. A "modified" report gives no such assurance, and is cause for concern. Financial professionals always read the auditor's report first, before even looking at any financial statement, in order to see if the report is clean. If it is not clean, there is no assurance that the financial statements are free of material misstatements. The auditor is a watchdog, and this watchdog barks by issuing a modified audit report. By law, all companies that have publicly traded securities must have their financial statements audited, as a protection to investors, creditors, and other financial statement users. Private companies are not required by law to have audits. But sometimes audits are required for private companies by agreement with particular investors or creditors. An audit provides the highest level of assurance that a CPA can provide. Audits are also the most expensive level of service. There are less expensive and less thorough levels of service, such as the following.
2. A *review* is a less extensive, and less expensive, level of financial statement inspection by a CPA. Since it is less extensive and less expensive, it provides a lower level of assurance that the financial statements are free of material misstatements.
3. Finally, there is the lowest level of service, which is called a *compilation*, where the outside CPA puts together the financial statements from the client company's books and records but does not examine them in much depth. A compilation provides the least assurance and is the least expensive level of service.

So the bank is asking you for the middle level of assurance when it requires a review by an independent CPA. Banks usually require a review from borrowers that are smaller private businesses.

Gail: Thanks. That makes it very clear.

We now leave Gail and Hal to their successful loan transaction, and move on.

Financial Statements: Who Uses Them and Why

Here is a brief list of who uses financial statements and why. This list gives only 14 examples, and is by no means complete.

1. Existing equity investors and lenders, to monitor their investments and to evaluate the performance of management.
2. Prospective equity investors and lenders, to decide whether to invest.
3. Investment analysts, money managers, and stockbrokers to make buy/sell/hold recommendations to their clients.
4. Rating agencies (such as Moody's Investors Service, Standard & Poor's, and Fitch Ratings), to assign credit ratings, or Dun & Bradstreet, to obtain business information reports.
5. Major customers and suppliers, to evaluate the financial strength and staying power of the company as a dependable resource for their business.
6. Labor unions, to gauge how much of a pay increase a company is able to afford in upcoming labor negotiations.
7. The board of directors, to review the performance of management.
8. Management, to assess its own performance.
9. Corporate raiders, to seek hidden value in companies with underpriced stock.
10. Competitors, to benchmark their own financial results.
11. Potential competitors, to assess how profitable it may be to enter an industry.
12. Government agencies responsible for taxing, regulating, or investigating the company.
13. Politicians, lobbyists, issue groups, consumer advocates, environmentalists, think tanks, foundations, media reporters, and others who are supporting or opposing any particular issue.
14. Actual or potential joint venture partners, franchisors or franchisees, and other business interests that have a reason to be informed about the company and its financial situation.

This brief list shows how many people use and rely on financial statements for a large variety of business purposes. It shows how important financial statements are in business.

It also shows how essential it is to master the understanding, analysis, and use of financial statements in order to be successful in the business world.

Financial Statement Format

Financial statements have a standard format. This format is similar whether an enterprise is as small as Nutrimin or as large as a major corporation. For example, a recent set of financial statements for a large public corporation can be summarized (in millions of dollars) as follows:

Income Statement

Years Ended June 30	XXX1	XXX2	XXX3
Revenue	$15,262	$19,747	$22,956
Cost of revenue	2,460	2,814	3,002
Research and development	2,601	2,970	3,775
Other expenses	3,787	4,035	5,242
Total expenses	$ 8,848	$ 9,819	$12,019
Operating income	$ 6,414	$ 9,928	$10,937
Investment income	703	1,963	3,338
Income before income taxes	7,117	11,891	14,275
Income taxes	2,627	4,106	4,854
Net income	$ 4,490	$ 7,785	$ 9,421

Note what this income statement tells us:

- Revenue increased each year, by $4,485 in XXX2 and by $3,209 in XXX3. These increases are good news, but note that the amount of increase has dropped in year XXX3.
- Total expenses have also increased each year, but by a smaller amount than revenue.
- As a result, net income increased each year, by $3,295 in XXX2 and by $1,636 in XXX3. Again, this is good news, but note that the amount of increase has dropped in year XXX3.

Cash Flow Statement

Years Ended June 30	XXX1	XXX2	XXX3
Operations			
Net income	$ 4,490	$ 7,785	$ 9,421
Adjustments to convert net income to a cash basis	3,943	5,352	4,540
Cash from operations	$ 8,433	$ 13,137	$ 13,961
Financing			
Stock repurchased, net	$(1,509)	$ (1,600)	$ (2,651)
Stock warrants sold	538	766	472
Preferred stock dividends	(28)	(28)	(13)
Cash from financing	$ (999)	$ (862)	$ (2,192)
Investing			
Additions to property and equipment	$ (656)	$ (583)	$ (879)
Net additions to Investments	(6,616)	(10,608)	(11,048)
Net cash invested	$(7,272)	$(11,191)	$(11,927)
Net change in cash	162	1,084	(158)

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Note what this cash flow statement tells us:

- Cash from operations increased each year, by $4,704 in XXX2 and by $824 in XXX3. These increases are good news, but note that the amount of increase has dropped in year XXX3.
- Cash from financing is negative each year. The corporation has not increased its outside financing, but rather has reduced it—mainly by repurchasing its own stock.
- Net cash invested increased each year, by $3,919 in XXX2 and by $736 in XXX3. Again, this is good news, because investment is needed to grow the company. But note that the amount of increase has dropped in year XXX3.
- Cash from operations has been sufficient to provide for the company's investment needs, and even to reduce outside financing. That shows a company with sufficient growth and profitability to keep investing for further growth. It generates sufficient cash from operations to cover all investment needs while also reducing outside financing.

Balance Sheet

Years Ended June 30	**XXX2**	**XXX3**
Current Assets		
Cash and equivalents	$ 4,975	$ 4,846
Short-term investments	12,261	18,952
Accounts receivable	2,245	3,250
Other	2,221	3,260
Total current assets	$21,702	$30,308
Property and equipment, net	$ 1,611	$ 1,903
Investments	15,312	19,939
Total fixed assets	$16,923	$21,842
Total assets	$38,625	$52,150
Current Liabilities		
Accounts payable	$ 874	$ 1,083
Other	7,928	8,672
Total current liabilities	8,802	9,755
Noncurrent liabilities	1,385	1,027
Total liabilities	$10,187	$10,782
Preferred stock	$ 980	
Common stock	13,844	$23,195
Retained earnings	13,614	18,173
Total equity	$28,438	$41,368
Total liabilities and equity	$38,625	$52,150

Note what this balance sheet tells us:

- This company grew its total assets by $13,525, from $38,625 to $52,150.
- But total liabilities increased only by $595, from $10,187 to $10,782.

- Therefore net assets grew by $13,525 less $595, which is $12,930.
- This $12,930 is the same amount by which total equity increased from $28,438 to $41,368, because, as we know: Total Assets = Total Liabilities + Owner Equity.

You may have observed that there are only two years of balance sheets but three years of income statements and cash flow statements. This is because these public company financial statements were obtained from filings with the U.S. Securities and Exchange Commission (SEC), and the SEC requirements for corporate annual report filings are two years of balance sheets, plus three years of income statements and cash flow statements.

These corporate financial statements contain numbers very much larger than those for Nutrimin. But there is no difference in the general format of these two sets of financial statements.

Guide to SEC Filings

The SEC requires all public companies in the United States to disclose certain financial information in filings with the SEC, which can be viewed online. The main filings include:

- *Form 8-K.* Disclosure of significant financial events—for example, resignation or termination of auditor, a new borrowing of material amount, a material merger or acquisition, or a material divestment.
- *Form 10-Q.* Quarterly financial statements.
- *Form 10-K.* Annual report for the fiscal year. Typical Table of Contents:

  Item 1. Brief Description of Company Business

  Item 1A. Risk Factors

  Item 1B. Unresolved Staff Comments

  Item 2. Properties

  Item 3. Legal Proceedings

  Item 4. Submission of Matters to a Vote of Security Holders

  Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer, Purchases of Equity Securities

  Item 6. Selected Financial Data

  Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (often abbreviated as MD&A)

  Item 7A. Quantitative and Qualitative Disclosures about Market Risk

  Item 8. Financial Statements and Supplementary Data

  Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

  Item 9A. Controls and Procedures

  Item 9B. Other Information

  Item 10. Directors and Executive Officers of the Registrant

  Item 11. Executive Compensation

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Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13. Certain Relationships and Related Transactions

Item 14. Principal Accountant Fees and Services

Item 15. Exhibits and Financial Statement Schedules

The Notes to the Financial Statements

In addition to the three financial statements, there are the notes to the financial statements, which are regarded as an integral part of the three statements. (See Exhibit 1.1.)

Financial Accounting Standards

It is no accident that financial statements have a standard format. There are financial accounting standards that require uniformity in financial statement presentation, in order that financial statements can be compared:

- From period to period for the same organization.
- From organization to organization for the same period.

This comparability is essential because accounting is the language of business, so it is important that all businesses use the same language. How is this uniformity established?

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards in financial accounting

Exhibit 1.1 Notes to financial statements.

The Notes provide detailed information about the items in the financial statements and also supplementary information. This detailed and supplementary information is of substantial value and importance. It includes details such as the following:

1. Summary of Significant Accounting Policies
2. Recent Accounting Developments
3. Acquisition of Certain Assets
4. Commitments
5. Accrued Liabilities
6. Revolving Credit Facility
7. Long-Term Debt
8. Leases
9. Project Early Departure
10. Derivative and Financial Instruments
11. Comprehensive Income
12. Common Stock
13. Stock Plans
14. Employee Retirement Plans
15. Income Taxes
16. Net Income per Share
17. Contingencies

and reporting. Those standards govern the preparation of financial reports, and are known as generally accepted accounting principles (GAAP). They are officially recognized as authoritative by the Securities and Exchange Commission (SEC) (Financial Reporting Release No. 1, Section 101, and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants (AICPA) (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). The main purpose of GAAP is to make financial statements uniform and comparable in form and content from organization to organization and from period to period. Such standards are essential to the efficient functioning of the economy, because investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information.

The Securities and Exchange Commission has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the SEC's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

From GAAP to IFRS

While GAAP has served the United States for many years, other countries have developed their own accounting standards. With increasing globalization it becomes more important to be able to read, understand, and compare financial statements for firms in many different countries. In order to do so it is necessary for the various financial accounting standards of different countries to be replaced with a single set of worldwide financial accounting standards. That development is currently proceeding under the name of International Financial Reporting Standards (IFRS).

Adoption of IFRS has already taken place in more than 100 countries, including the European Union. In addition, China, Japan, India, and Canada are all committed to following the EU's lead in 2011. The SEC is planning to phase IFRS into the U.S. system as a replacement for GAAP in stages over the next few years. This is not a simple task, and will encounter substantial difficulties and require major adjustments. In essence, GAAP and IFRS are based on very different and conflicting concepts.

GAAP is a vast collection of rules that set out in detail how financial information must be compiled and disclosed in financial statements. In brief, GAAP is rule-based. In contrast, IFRS is much less detailed and much less specific. It lays out broad general principles, and leaves the specific details to the discretion of users, so long as they keep within the broad general principles. In brief, IFRS is principles-based rather than rules-based. As a result, there are many disagreements and disputes between proponents of GAAP and proponents of IFRS. However, while the resolutions of these disputes remain unclear, one thing seems absolutely certain: In a few years IFRS will replace U.S. GAAP.

Summary and Conclusions

Financial statements contain critically important business information, and are used for many different purposes by many different parties inside the business and outside of the business. Clearly, all successful businesspeople should have a good basic understanding of financial statements and of the main financial ratios, such as profit margin, asset

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turnover, return on assets, and return on equity. Beyond the present chapter, this book contains further information and explanations relating to financial statements:

Chapter 2: Analyzing Financial Statements

Chapter 3: Analyzing Business Earnings

Chapter 10: The Integrity of Financial Reporting

Downloadable Resources for this chapter available at www.wiley.com/go/portablembainfinance

Understanding Financial Statements Balance Sheet: Liabilities + Equity

Internet Links

You can access an excellent 45-minute tutorial on understanding financial statements at www.baruch.cuny.edu/tutorials/statements/.

Here are short videos about each of the financial statements:

"What Is a Balance Sheet?"
www.youtube.com/watch?v=v_EpPu5tiXY&feature=related

"What Is an Income Statement?"
www.youtube.com/watch?v=KqNEvgT71l8& feature=related

"What Is a Cash Flow Statement?"
www.youtube.com/watch?v=-eietCf5nNI& feature=related

The following Web site provides a great deal of information on financial statements and related topics, plus many useful links: http://CPAclass.com/arp/.

Guidance on understanding financial statements from IBM Corporation is available at www.ibm.com/investor/tools/guides.phtml.

Notes and exercises on financial and managerial accounting are at www.middlecity.com/index.shtml.

For Further Reading

Horngren, Charles T., Gary L. Sundem, John A. Elliott, and Donna Philbrick, *Introduction to Financial Accounting*, Charles T. Horngren Series in Accounting (Upper Saddle River, NJ: Prentice-Hall, 2005).

Ingram, Robert W., and Thomas L. Albright, *Financial Accounting: Information for Decisions* (Florence, KY: South-Western College Publishing, 2007).

Stickney, Clyde P., and Roman L. Weil, *Financial Accounting: An Introduction to Concepts, Methods and Uses* (Florence, KY: South-Western College Publishing, 2006).

Weygandt, Jerry J., Donald E. Kieso, and Paul D. Kimmel, *Accounting Principles*, 7th ed., with PepsiCo Annual Report (Hoboken, NJ: John Wiley & Sons, 2004).

Wild, John J., *Financial Accounting: Information for Decisions*, 4th ed. (New York: McGraw-Hill, 2006).