
ARMING YOU WITH ESSENTIAL KNOWLEDGE

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In past editions of this book, Chapter 1 dove right into the critical concept of gaining a clear understanding of how businesses produce and consume cash. In fact, we opened with this all-important statement:

Savvy business managers, owners, lenders, investors, and analysts pay a significant amount of attention to cash flows. Cash flows represent the heartbeat and pulse of every business, and without producing a steady heartbeat and healthy pulse of positive cash flows, a business would soon most likely end up on life support—or worse yet, die.

For this edition, I felt that I should begin by providing an explanation of the primary differences between what constitutes a *financial report* and the purpose and role of *financial statements*. While I touch on the elements of preparing *financial reports*, the primary focus of this book is how to read and understand *financial statements*, which make up the nerve center of the financial report. (Do not fret, as I will get to the critical concept of cash flows in Chapter 2 and again in Chapter 5.)

What Is a Financial Report?

To start, it would be helpful to clarify the difference between the purpose and function of financial statements and a company's financial reports. In this context, I am referring to publicly traded companies and other large businesses that are required, by regulatory bodies such as the SEC, or by third parties such as a large lender, to issue quarterly or annual financial reports. An important concept to keep in mind is that financial statements represent a part (albeit a critical part) of a company's financial report. Looking at it differently, it would be extremely difficult to produce a financial report without including financial statements, but financial statements can be produced and presented to third parties without a full financial report. In effect, financial statements by themselves are a financial report.

It is important to keep in mind that while a company's financial statements represent the backbone for analyzing and evaluating its financial performance, financial reports include extensive additional financial, business, legal, and regulatory material that accompany the financial statements. The actual financial statements may take up anywhere from three to six pages of an external business financial report, while the complete financial report may often exceed 100 pages (thanks to management providing their discussion and assessment of operating results, along with the required footnotes that accompany audited financial statements).

Although this book is about how to read and understand financial statements, understanding what additional content and data is most often included in financial reports, and why, makes sense because I focus on two primary tranches of additional information: management discretionary disclosures and financial statement footnotes (including supporting schedules). I describe these as follows:

1. Management discussion of operating results (MDOR):

The MDOR, sometimes referred to as the MD&A (management discussion and analysis), is a section of a business's financial report that is generally reserved for management to provide an assessment or overview of key operating results, market trends, industry data, strategies, and so on that management believes would be beneficial to external parties to help them more fully understand the operating results of a business. The MDOR is usually located at the front of the financial report that is prepared periodically and externally distributed. Quite often, it starts with a shareholder or investor letter prepared by the company's board chair or CEO. There is no doubt that the MDOR can provide useful information to external parties, but it should be noted that, generally speaking, the information in the MDOR has not been audited by an independent CPA firm.

Rather, it contains information that is presented by a company's management team. Translation: The MDOR tends to include a broader range of business information that has been internally prepared by the company and incorporates more opinions and perspectives than audited financial statements, which tend to stay factual in nature.

- 2. Financial statement footnotes and supporting schedules:** In contrast to MDOR disclosures, financial statement footnotes and supporting schedules (sometimes referred to as supplemental reports) are part of the audited financial statements, prepared by an independent CPA firm with support from company financial executives and legal counsel. Often, these are located toward the back of the externally prepared financial report, just after the financial statements. The goal of financial statement footnotes is to provide additional clarity, support, and detail to validate and substantiate the information provided in the financial statements. For example, if a company has established a reserve for a potential liability due to uncertain legal actions brought against the company, the footnote will help shed additional light on the nature of the legal action and potential damages. Financial statement footnotes tend to avoid presenting management opinions and are more likely to stick to the facts. Yet, even here, I must point out an irony in the accounting and financial reporting world; that is, while the purpose of audited financial statements and associated footnotes is to present external financial reports that are prepared by independent, third-party CPAs and are factual in nature,

almost all audited financial statements and associated footnotes rely heavily on the use of estimates when calculating operating results. This concept underscores the importance of remembering that accounting is often just as much an art as a science! In short, footnotes and supporting schedules represent an essential part of every CPA-prepared or CPA-audited financial report. Financial statements would be naked without their footnotes.

In summary, it is important to remember that this chapter refers to financial information as presented in *external* financial reports—those that circulate outside the business. These financial reports and communications are designed mainly for use by outside business shareowners, analysts, company lenders, governmental agencies, and the like, with the business shareowners, executive management team, and creditors (e.g., lenders, strategic partners and vendors, etc.) representing the three primary *stakeholders* in the business. Internal business executives, managers, and staff have access to significantly more information than that released in the company's external financial reports. This information is incredibly detailed in nature and is usually highly confidential, so external disclosure is tightly guarded. A more thorough discussion on internally generated business financial information appears in our sister book, *How to Write a Financial Report*, and is supported by the words of wisdom bestowed on us by Warren Buffett: When analyzing financial information, “the devil is in the details.” It goes without saying that invaluable internal financial information is both highly sought after and closely guarded, given its importance.

Financial Information and the Big Three Financial Statements

It should be obvious that business managers, company lenders, investors, regulatory agencies, and countless other parties need to clearly understand an entity's financial performance, in a timely manner. This is common sense, no doubt, but you would be absolutely amazed at how often this basic concept is overlooked or, for lack of a better term, neglected by even the senior most internal company executive management teams.

Expanding on this thought, I would like to further note that all, yes *all*, businesses, organizations, non-for-profits, and governments (referred to as “entities” throughout this chapter), in one fashion or another, *should* produce reliable financial information on which business and economic decisions are made. Here again, this should be common sense, but I selectively used the term *should* because not all entities actually produce reliable financial information. Do not ask us how these entities prepare tax returns, execute financial management tasks, or make business and economic decisions, but in the spirit of full transparency, assuming all entities actually maintain accounting systems and produce reliable financial information can be a fatal error.

Focusing on entities that produce reliable financial information, I would like to note that financial information comes in all shapes, sizes, and forms ranging from something as small as preparing a flash report that summarizes the sales performance of a sales representative in a specific geographic region to something

as large as Apple, Inc. producing its annual report for shareholders and other external readers to peruse.

The primary means of communicating an entity's financial information to external parties is via its *financial statements*, the preparation of which is one of the main functions performed by accountants. In a sense, accountants act as the financial scorekeepers of the entity as it is their job to ensure that complete, accurate, reliable, and timely (i.e., CART) financial statements are produced.

Financial statements are sent regularly by an entity to both internal and external parties including lenders, investors, financial analysts, regulatory bodies, internal management—and anyone else with a legitimate interest in the business for that matter. The entity's financial statements should include three primary statements including the *balance sheet*, which communicates the entity's financial condition at a point in time; the *income statement*, which reports the entity's profit-motivated activities over a period of time (e.g., for a full calendar year or 12 months); and the *statement of cash flows*, which reports how an entity produces and consumes cash over the same period of time as the income statement. Collectively, I refer to these as the *big three* financial statements.

You will notice that I use that darn word *should* again, as quite often you will come across less sophisticated and private entities that elect to omit the statement of cash flows from its financial information. Maybe it is a result of ignorance, not having enough

time, or just being lazy, but as I begin our discussion on the big three financial statements, it should become abundantly clear just how important all three primary financial statements are and the key role each one plays. Here I provide an expanded explanation of each of the big three financial statements:

- ♦ **The balance sheet:** The financial condition of a business is communicated in an accounting report called the *balance sheet*. In its simplest form, the balance sheet reports the assets owned by a business, the liabilities owed by the business (to third parties), and the net ownership equity (assets minus liabilities), all at a point in time.
- ♦ **The income statement (or P&L):** The financial performance of a business that reports and measures its profit- or loss-making activities is presented in an accounting report called the *income statement*. In its simplest form, the income statement reports sales revenue, costs of goods sold, operating expenses, other expenses or income, and finally, whether a net profit or loss was generated and covers a period of time (e.g., 12-month period of 1/1/24 through 12/31/24).
- ♦ **The statement of cash flows:** Finally, the last of the big three financial statements, and often the most important (but least understood), is the *statement of cash flows*. In its simplest form, this financial statement reports a business's cash sources (i.e., how it generates cash), uses (i.e., how it consumes cash), and

net change. Similar to the income statement, the statement of cash flows covers a time period which is almost always consistent with the time period reported in the income statement.

It should be noted that alternative titles for these financial statements are common. For the balance sheet, alternatives include “statement of financial condition” or “statement of financial position.” An income statement may be titled “statement of operations” or “earnings statement” as well as the “profit and loss” or, more simply, the P&L. For consistency, I stick with the names *balance sheet* and *income statement*. The statement of cash flows is almost always called just that (but sometimes referred to as a *cash flow statement*).

Finally, I would like to mention that in almost all cases when financial statements are distributed to external parties, the financial statements are supplemented with additional information in the footnotes and supporting schedules. One quite common supporting schedule is the *statement of changes in stockholders' (owners') equity*. The broader term *financial report* refers to all this, plus any additional commentary from management, narrative explanations, graphics, and promotional content that accompany the financial statements, footnotes, and supporting schedules. Distribution of the financial reports of a private business may be restricted to its top-level managers, its shareholders, and major creditors. Federal laws require publicly owned businesses to make their financial reports publicly available.

Let's Speak the Proper Language

One element people often overlook when reading financial reports and financial statements is that you must learn to speak “accountantnesse” or “financesse.” That is, accountants and financial professionals often use a variety of specific terms and acronyms to describe financial information. While I do not expect you to become an expert overnight, mastering the following basic list of standard financial terminology should be helpful in your quest to learn how to read a financial report (ensuring that you are well versed with financial lingo). Here are some basic terms and acronyms for you to digest:

- ◆ Top line: A company's net sales revenue generated over a period of time (e.g., for a 12-month period).
- ◆ COGS or COSR: Pronounced like it is spelled; stands for costs of goods sold (for a product-based business) and costs of sales revenue (for a service-based or hybrid service- and product-based business). COGS or COSR tend to vary directly (or in a linear fashion) with the top-line sales revenue.
- ◆ Gross profit and margin: Sometimes used interchangeably, gross profit equals your top line less your COGS or COSR. The gross margin (a percentage calculation) is determined by dividing your gross profit by the top line.
- ◆ Op Ex: A rather broad term that is short for operating expenses, which may include selling, general, administrative, corporate overhead, and other related expenses. Unlike COGS or COSR, Op Ex tends to be fixed in nature and will not vary directly with the top-line sales revenue.
- ◆ SG&A: Selling, general, and administrative expenses. Companies may distinguish between Op Ex and SG&A to assist parties with understanding the expense structure of its operations in more detail.
- ◆ Bottom line: A company's net profit or loss after all expenses have been deducted from net sales revenue. Being “in the black” indicates that a net profit is present and being “in the red” indicates that a net loss was generated.
- ◆ Breakeven: The operating level where a company generates zero in profit or loss as it “broke even.” Additionally, it is the amount of sales revenue that needs to be generated to cover all COGS/COSR and Op Ex.
- ◆ Contribution margin: You may hear companies reference the term *contribution margin*. What this generally refers to is the profit generated by a specific operating unit or division of a company (but not for the company as a whole). Most larger

companies have multiple operating units or divisions, so the profit (or loss) of each operating unit or division is calculated to determine how much that specific unit or division “contributed” to the overall performance of the entire company.

- ◆ Cap Ex: While Op Ex is associated with the income statement, Cap Ex stands for capital expenditures and is a calculation of how much a company invested in tangible or intangible assets during a given period (for equipment, machinery, new buildings, investments in intangible assets, etc.).
- ◆ YTD, QTD, MTD: These are simple and stand for year to date, quarter to date, or month to date. For example, a flash report may present QTD sales for the period of 10/1/24 through 11/15/24 (so management can evaluate sales levels through the middle of a quarter).
- ◆ FYE and QE: These two items stand for fiscal year-end and quarter-end. Most companies utilize a fiscal year-end that is

consistent with a calendar year-end of 12/31/xx (which would make their quarter-ends 3/31/xx, 6/30/xx, 9/30/xx, and 12/31/xx). Please note that several companies utilize FYEs that are different than a calendar year-end to match their business cycle with that of a specific industry. For example, companies that cater to the education industry may use a FYE of 6/30/xx to coincide with the typical operating year for schools or colleges (which tend to run from 7/1/xx through 6/30/xx).

Not only will you find referrals to these terms and acronyms throughout the book, but you will also quickly discover that in the real world, these terms and acronyms are used frequently. The better armed you are with this knowledge, the more credibility you will carry when you end up having to swim with the financial sharks out in the dog-eat-dog world of global capitalism.

A Final Word before You Dive into the Rest of the Book

The primary goals of including this new chapter into the book were threefold. First, I want to start our discussion with a concise explanation of the difference between financial reports and financial statements. Second, I hope to clearly identify the importance of the big three financial statements. Third, I want to arm you with some additional terminology to help you gain a better understanding of the world in which accountants and financial professionals live. If you can master these three objectives out of the gate, you will find that you already have a leg up when diving into financial reports and financial statements.

Moving ahead, I will first turn our attention toward providing you invaluable insight and knowledge on how to actually read financial statements (the heart and soul of the financial report)

to better understand critical connections between the big three financial statements, which are covered in depth in Part Two. This is followed by real-life tools and reference material on how to analyze financial statements, (as covered in Part Three), to evaluate the operating performance and financial health of a business. I also sprinkle in a couple of chapters on how companies can game (for lack of a better term) the presentation of operating results in financial statements through the use of financial engineering, and I've included a chapter on identifying potential financial fraud, a topic that is of utmost importance given the recent implosions of FTX in 2023 and Wirecard in 2020 (companies that operated in the cryptocurrency and fintech spaces, respectively).

