Book V

Reporting on Your Financial Statements

Typical Product Business, Inc.
Statement of Financial Condition
at December 31, 2012 and 2013
(Dollar amounts in thousands)

Assets	2012	2013	Change
Cash	$2,275	$2,165	($110)
Accounts Receivable	$2,150	$2,600	$450
Inventory	$2,725	$3450	$725
Prepaid Expenses	$525	$600	$75
Current Assets	$7,675	$8,815	
Property Plant and Equipment	$11,175	$12,450	$1,275
Accumulated Depreciation	($5,640)	($6,415)	($775)
Net of Depreciation	$5,535	$6,035	
Total Assets	$13,210	$14,850	$1,640

Liabilities and Owners' Equity	2012	2013	Change
Accounts Payable	$640	$765	$125
Accrued Expenses Payable	$750	$900	$150
Income Tax Payable	$90	$115	$25
Short-term Notes Payable	$2,150	$2,250	$100
Current Liabilities	$3,630	$4,030	
Long-term Notes Payable	$3,850	$4,000	$150
Owners' Equity:			
Invested Capital	$3,100	$3,250	$150
Retained Earnings	$2,630	$3,570	$940
Total Owners' Equity	$5,730	$6,820	
Total Liabilities and Owners' Equity	$13,210	$14,850	$1,640

To gauge how profitable an investment is likely to be, visit www.dummies.com/extras/accountingaio for guidance on calculating present and future values.

In this book...

- Use the balance sheet to assess and report the financial condition of a business, as measured by its assets, liabilities, and equity.
- Produce a cash flow statement and summarize changes in stockholders' equity. Use the cash flow statement to explain how your business raised funds and how it used cash to generate profit. Use the stockholders' equity report to reveal changes in earnings, dividends, and company ownership.
- Read and interpret financial statements to evaluate a business's financial health. Assess your own business's financial fitness and size up other businesses you're thinking of doing business with.
- Make sense of explanatory notes and disclosures you're likely to find in a corporation's annual financial report. Reading this extra data may change your opinion about the company's plans for growth.
- Pick out valuable pieces of financial information from a company's report to its shareholders. You may find additional disclosures that clarify the company's financial performance.

Chapter 1

Presenting Financial Condition and Business Valuation

In This Chapter

- Valuing assets in balance sheets
- Using the balance sheet to estimate the value of a business
- Considering methods to value an entire business

The *balance sheet,* also called the *statement of financial condition,* gives a snapshot of a business's financial health at a point in time. It presents the assets of a business on the one hand and the liabilities and equity sources of the business on the other hand, reflecting the *balance sheet equation*:

Assets = Liabilities + Equity

This chapter considers how to *value* (estimate the monetary worth of) the assets and liabilities in the balance sheet. Traditionally, a business values assets at historical cost. In this chapter, you find out how to use other methods to value assets and how to compute a valuation for an entire business.

This chapter also explores the various uses for valuations and touches on the field of performing valuations as an occupation. You finish the chapter with a discussion of business valuations based on earnings and cash flow.

Clarifying the Values of Assets in Balance Sheets

The evidence is pretty strong that readers of financial reports aren't entirely clear about the dollar amounts reported for assets in a balance sheet. Other than cash — the value of which is clear — the amounts reported for assets in a balance sheet aren't at all obvious to non-accountants.

Of course, accountants should be clear about the valuation of every asset reported in the balance sheet. In preparing a year-end balance sheet, an accountant should do a valuation check on every asset. Recent authoritative pronouncements on financial accounting standards have been moving in this direction.

Accountants now must check at the end of the accounting year to see whether the value of any asset has been *impaired* (diminished in economic value to the business), and if so, write down (decrease) the book value of the asset. *Book value* is the cost of the asset less accumulated depreciation. Head over to Book III, Chapter 1 for more on depreciation.

Considering options for balance sheet valuation

If you need to value assets in the balance sheet, you may consider using historical cost, a value below cost, or a balance sheet value above cost:

- **Historical cost:** Most of the assets in a typical balance sheet are valued at *historical cost* (original cost). That value should be your starting point.
- **Impairment:** Accountants are required to write down impaired assets. The value of an impaired asset is typically *below* cost.
- **Increase in market value of asset:** In some cases, the value of the asset is *above* cost. Short-term investments in marketable securities held for sale may have an adjusted value above cost. The recorded values of nearly all other assets aren't written up (increased) to recognize appreciation in the replacement value or market value of the asset. One reason is because assets you use in your business (buildings, equipment) aren't held for sale. Also, these assets are likely to be used for many years. It's not your *intention* to sell assets you use in your business.

Looking at balance sheet valuation entries

The dollar amounts reported for assets in a balance sheet are the amounts that were recorded in the original journal entries made when recording the asset transactions. These journal entries could have been recorded last week, last month, last year, or 20 years ago for some assets. Here are some examples:

- The balance of the asset accounts receivable is from amounts entered in the asset account when credit sales were recorded. These sales are recent, probably within the few weeks before the end of the year.
- The balance in the inventory asset account is from the costs of manufacturing or purchasing products. These costs could be from the last two or three months.

- The costs of fixed assets reported in the property, plant, and equipment asset account in the balance sheet may go back five, ten, or more years — these economic resources are used for a long time.

Connecting balance sheet values and expenses

As you see earlier in this chapter, most balance sheet assets are valued at historical cost. The amount of cost used to value the asset depends partly on how expenses are treated.

Merchandisers (retailers) purchase inventory and sell those goods to the public. Inventory is an asset. Accounting rules dictate that the cost of inventory should be the price paid for the asset plus any other costs incurred to prepare the goods for sale. Those other costs may include shipping, storage, and even costs to build display racks.

The additional costs to prepare the good for sale are *not immediately expensed.* Instead, the costs are posted to inventory. Those costs become expenses when the inventory item is sold. At that point, all the costs are posted to cost of sales (or cost of goods sold).

If you buy jeans for your retail shop, for example, the shipping costs you pay to get the jeans to your shop are considered part of inventory. If you need to build displays racks by the front window, those costs are part of inventory, too. (For more about inventory, see Book II, Chapter 2.)

Another example to connect expenses with balance sheet values is the area of *leasehold improvements* — changes made to a leased space to meet a tenant's needs. Instead of immediately expensing this amount, accountants capitalize the cost as an asset. The asset is usually depreciated over the remaining life of the lease.

Assume you lease a factory building to a manufacturer. To accommodate truck shipments for the manufacturer/tenant, you need to widen the road approaching the factory. The spending on the road isn't immediately expensed. Instead, the cost is posted to an asset account called leasehold improvements. (See Book V, Chapter 4 for more about lease-related financial disclosures.)

Comparing two balance sheet valuations

Consider two different valuations for the same asset, and how the difference impacts the balance sheet. Refer to the balance sheet in Figure 1-1. The business uses the straight-line depreciation method, by which an equal amount of depreciation is allocated to each year of a fixed asset's estimated useful life (see Book III, Chapter 1 for more about depreciation methods).

Assets		Liabilities & Owners' Equity	
Cash	$1,500,000	Accounts Payable	$700,000
Accounts Receivable	$1,000,000	Accrued Expenses Payable	$600,000
Inventory	$1,800,000	Short-term Notes Payable	$1,500,000
Prepaid Expenses	$300,000	Total Current Liabilities	$2,800,000
Total Current Assets	$4,600,000		
		Long-term Notes Payable	$2,000,000
Property, Plant, & Equipment	$4,800,000		
Accumulated Depreciation	($1,400,000)	Owners' Equity	
Cost Less Depreciation	$3,400,000	Capital Stock (10,000 shares)	$1,000,000
		Retained Earnings	$2,200,000
		Total Owners' Equity	$3,200,000
Total Assets	$8,000,000	Total Liabilities & Owners' Equity	$8,000,000

Figure 1-1: Balance sheet for a company that uses straight-line depreciation.

Assume the business had used an accelerated depreciation method for its fixed assets instead. In this case, $700,000 more in depreciation would be expensed, using the accelerated method. The change in depreciation method results in several changes in the balance sheet, as shown in Figure 1-2:

Assets		Liabilities & Owners' Equity	
Cash	$1,500,000	Accounts Payable	$700,000
Accounts Receivable	$1,000,000	Accrued Expenses Payable	$600,000
Inventory	$1,800,000	Short-term Notes Payable	$1,500,000
Prepaid Expenses	$300,000	Total Current Liabilities	$2,800,000
Total Current Assets	$4,600,000		
		Long-term Notes Payable	$2,000,000
Property, Plant, & Equipment	$4,800,000	Owners' Equity:	
Accumulated Depreciation	($2,100,000)	Capital Stock (10,000 shares)	$1,000,000
Cost less Depreciation	$2,700,000	Retained Earnings	$1,500,000
		Total Owners' Equity	$2,500,000
Total Assets	$7,300,000	Total Liabilities & Owners' Equity	$7,300,000

Figure 1-2: Balance sheet for the same company, using accelerated depreciation.

- Depreciation expense over the years would be $700,000 higher. As a result, accumulated depreciation is $700,000 higher ($2,100,000 versus $1,400,000 in Figure 1-1).
- Using accelerated depreciation reduces the total value of assets. With that method, total assets are $7,300,000, compared with $8,000,000 total assets by using straight-line depreciation.
- The higher amounts of depreciation expense reduce cumulative net income by $700,000. Lower net income means that retained earnings is also lower ($1,500,000 versus $2,200,000 in Figure 1-1).

Introducing Business Valuation

The previous section shows how different valuation methods affect various items on the balance sheet, including inventory, leasehold improvements, and depreciation.

You can also use different valuation methods to estimate the dollar worth of the *entire* company. The following sections present the uses of business valuations and explain the Certified Valuation Analyst (CVA) designation for anyone interested in making a career of performing business valuations.

Grasping the practical applications of business valuations

Accountants don't perform business valuations simply to stick a dollar figure on a business. They do valuations for clients who need a general idea of how much money a business is worth in order to make well-informed decisions regarding that business. The following sections introduce a few of the more practical applications of business valuations.

Negotiating a business purchase

The most basic reason to place a dollar figure on a business is to help sellers or buyers determine what they think is a reasonable price for the business. Imagine if you were considering buying a pizza restaurant. You'd probably want to take a look at the ovens, equipment, and furniture — and consider how soon those fixed assets would need to be replaced. That analysis would help you determine what the business is truly worth to you, and how much you'd be willing to pay for it.

Securing a bank loan

Commercial loan officers work with loans to businesses. The loan officer is concerned about the company's ability to generate enough earnings to make the interest payments on the loan and repay the principal amount borrowed. If a valuation based on earnings shows the company's earnings are trending higher, the business is likely to be in a better position to make loan payments in the future. Say, for example, that your firm has a $2,000 monthly interest payment on a loan. The interest payment would be less of a burden if your earnings were $50,000 a month versus $5,000 a month. See the later section "Using future earnings and cash flow" to find out more about business valuations based on earnings.

Explaining a company's value to investors

Businesses often raise money by selling shares of the business to investors who want to know the value of what they're getting for their money. Unfortunately, the balance sheet may fail to reflect the true value of a particular asset or exclude the value of certain assets. For example, suppose a company purchases a time-saving machine that will eventually save it far more than the cost of that machine; the machine is worth more than the dollar amount the company paid for it. Assets that don't even appear on the balance sheet are customers or clients. A business may have strong long-term relationships with certain clients that generate significant sales and earnings, but the value can't be posted to the balance sheet as an asset. A business valuation takes this important asset into account.

Considering a CVA designation

The demand for business valuations and valuation analysis has resulted in a designation called a Certified Valuation Analyst (CVA). If you find business valuation fascinating and want to pursue it as a career, you may want to consider getting your CVA designation. The following sections show you how to get started and highlight other professions that do business valuations.

Visiting the NACVA website

The CVA designation is offered through the National Association of Certified Valuators and Analysts (NACVA), which you can find on the web at `www.nacva.com`. NACVA trains and certifies Certified Valuators and Analysts. The website explains that a primary requirement to become a CVA is to hold a valid license as a Certified Public Accountant.

Understanding other professionals and valuations

Many other professionals perform work that may be classified a business valuation, even though the work they produce isn't considered a certified

valuation. When a business is subject to litigation, an attorney may perform some analysis on a firm's balance sheet and income statement. If the owners of a firm are in a legal dispute about the value of each owner's share of the business, for example, an attorney may perform an analysis. Appraisers perform value analysis of commercial property to estimate its current worth.

Although other professionals may perform similar analysis, a CVA may be brought in to perform a certified valuation. Your accounting skills along with CVA training and designation ensure that you're up to the task.

Comparing Business Valuation Methods

Just as you can use different valuations to estimate the dollar value of assets listed on the balance sheet, you can use different methods to perform business valuations. And different methods lead to different conclusions. Keep in mind, however, that the values calculated for a valuation *may not* be the amounts listed on the balance sheet. A valuation may use concepts inconsistent with generally accepted accounting principles (GAAP). See Chapter 1 for more on GAAP and other accounting standards.

The question of whether determining the market value of a business is more of an art or a science is open to debate. One school of thought is that business valuation should be based on a complicated, multi-factor, formula-driven model — a scientific approach in which a business's dollar value can be quantified. The opposite camp argues that in buying a business you're buying a future stream of earnings, not merely a collection of assets. Their argument is that you're just as well off using a simple method, but this simple method requires forecasting future earnings, which is notoriously difficult, not to mention unreliable. Both sides agree on one point: The profit performance track record of the business (reported in its recent income statements) and its present financial condition (reported in its latest balance sheet) are absolutely essential for the valuation of a business. The debate concerns how you should analyze and use that information. The following sections present two common approaches to performing business valuations.

Replacing assets: Replacement value

One measurement of a business's worth in dollars is its *book value* — the cost of all assets less all accumulated depreciation. The following sections consider the cost of replacing assets used in a business.

Pairing fixed asset accounts

Most companies pair each fixed asset account with its own accumulated depreciation account, both of which are included in the company's Chart of Accounts (see Book I, Chapter 2). Your office furniture asset account, for example, is paired with an account called accumulated depreciation- office furniture. The asset account less the accumulated depreciation equals the office furniture's book value. ***Note:*** Accounting systems commonly give each fixed asset account its own accumulated depreciation account; those account titles usually include a dash like the one in *accumulated depreciation- office furniture.*

Forecasting spending on fixed assets

Suppose you're in the market for a car repair shop. The big assets on the books are large pieces of equipment, such as hydraulic lifts for vehicles, and lots of other tools and equipment. All these items are listed as fixed assets on the balance sheet, each with its own accumulated depreciation account.

A potential buyer most likely wants to buy the business and use it to generate earnings over many years. Big considerations include when each asset needs to be replaced and how much the replacement asset will cost. The prospective buyer can scan the fixed asset listing and make a judgment on each asset. Assets with a large amount of cost posted to accumulated depreciation probably need to be replaced soon.

An analyst can estimate each asset's replacement cost and the year of replacement. That list represents the required cash flow to maintain the assets needed to operate the business. The listing's total dollar amount, plus the initial purchase price of the business, is the total investment required to buy and maintain the business. At that point, the investor can decide whether the business is worth the investment.

Using future earnings and cash flow

Although asset value provides a snapshot of a company's current value, it doesn't provide much insight into the company's potential future value. Taking into account the replacement value of assets, as explained in the previous section, is one way to project the company's future value. Another approach is to look at the company's ability to produce earnings and cash flow into the future. Several tools are available for measuring a company's potential profit.

Book III, Chapter 6 explains the difference between cash basis accounting and the accrual basis. Nearly all companies use the accrual method, which requires that they recognize revenue when it's earned rather than when they actually receive payment. The accrual method also posts expenses when they're incurred instead of waiting until the bills are actually paid. As a result, the earnings using the accrual method differ from the cash method.

Earnings first

Your first approach to determine future value may be potential earnings. Take a look at the firm's past financial performance. Next, consider how your industry knowledge could help increase sales. Mull over the firm's reputation and customer list.

Maybe you're considering buying an ad agency. The firm has a stable group of clients that have used the company for advertising for years. Your purchase price includes retention bonuses to motivate current key employees to stay with the company. Based on your long experience in the industry, you conclude that you can generate a 15 percent *profit margin* — or a 15-cent profit on every dollar in sales (see Book IV, Chapter 2 for more on profit measurements).

Every investment has an *opportunity cost* associated with it. Opportunity cost is cash you invest in the purchase that you can't use for *some other purpose.* Assume you invest $500,000 in a greeting card shop instead of investing the same amount in a convenience store. The profit earned by the convenience store owner is given up — that's the opportunity cost of investing in the greeting card shop.

Moving to cash flow

Earnings are important, but a better measure of a company's value may be the cash flow it generates. If you decide to invest in a company, you use cash. That cash has to come from somewhere. Consider these points:

- If you borrow funds, you stand to pay interest expense on the loan.
- Investors that issue stock expect a return on their investment, possibly in the form of a dividend.
- If you use cash from your existing company's operations, you'll have a tougher time meeting the cash flow needs of your business.

A business needs to recover its cash investment as soon as possible. Given these considerations, a potential buyer may look at future cash flows of the new business to determine a company's value.

Assume you're looking at a $600,000 investment in a bookstore. Based on your analysis, you determine that the business will generate $100,000 in cash inflow per year. The calculation you need to use is *payback period*:

Payback period = Initial investment ÷ Cash inflow per period

In this case, the payback period is 6 years ($600,000 ÷ $100,000). You can make a judgment as to whether or not 6 years is a reasonable period to

recover your original cash investment. See Book VIII, Chapter 4 for more about making purchase decisions.

Putting a present value on cash flows

Many analysts add a present value assumption into cash flow analysis because of *inflation,* which is broadly defined as a rise in the general level of prices for goods and services. In other words, today's dollar is likely to buy you more than a dollar will buy you five years from today.

Inflation impacts the value of the cash flows you receive from the business you purchase. The cash inflows should be adjusted to their *present value* (the current worth of a future sum of money). You should consider the present value of the cash flows you receive, because that amount represents the current purchasing power of those dollars.

Your annual cash inflows in the prior section total $100,000 per year. Assume a 3 percent inflation rate. You're interested in the present value of the payment received at the end of year 5. You need to multiply the cash inflow by a present value factor of 3 percent per period for 5 periods. You can find numerous versions of present value tables online.

When you find a table, the period "n" is 5 (five years). After you find the n value for 5, scroll over to the 3 percent column. The table should show 0.863 (depending on rounding in your table). You can multiply this present value factor by the cash inflow amount:

Present value of $100,000 at 3 percent, end of year 5
= $100,000 × 0.863 = $86,300

If you find a present value factor for all payments, you can compute the present value of all cash inflows. Use the sum of the cash inflows to judge the value of the business.

Chapter 2

Laying Out Cash Flows and Changes in Equity

In This Chapter

- Separating cash from profit
- Connecting the dots with the statement of cash flows
- Presenting cash flow by using the direct and indirect methods
- Summarizing changes in stockholders' equity

While accounting is all about the *accrual* method, which means revenue is recorded when it's earned and expenses are recorded when they're incurred, the missing piece of the puzzle is cash changing hands. For the users of financial statements to get a total picture of the health of the business, cash payments and receipts have to be reconciled with accrual transactions.

You accomplish this reconciliation by preparing a statement of cash flows. In this chapter, you find out about the three sections of the statement of cash flows — operating, investing, and financing — and what types of accounting information are reported in each. This chapter also brings you up to speed on the two acceptable ways to prepare the statement of cash flows — by using the direct or indirect method — and concludes with a brief explanation of the statement of changes in stockholders' equity.

Understanding the Difference between Cash and Profit

As explained in Book I, Chapter 4, the accrual method records revenue when it's earned, regardless of whether money changes hands. You also record expenses when you incur them, regardless of whether they're paid. Book I, Chapter 4 also introduces another accounting method — the cash method — which uses the criteria of cash changing hands to determine when revenue and expense transactions are recorded. The cash method is simply posting revenue and expenses by using your checkbook checks, debits, and deposits.

Recognizing accounting transactions doesn't hinge on cash being exchanged. As a result, you can expect to see a difference between a company's cash balances and profit shown on the income statement (see Book IV, Chapter 2). Not all costs are immediately expenses, and until a cost *is* an expense, it doesn't appear on the income statement. In the same way, not all cash receipts are immediately revenue. If a customer pays you in advance, you don't recognize revenue until you provide the product or service to the client. This section first shows you how noncash transactions influence a company's net income. It then illustrates the difference between costs and expenses.

Seeing how noncash transactions affect profit

The statement of cash flows homes in on the difference between two amounts:

- Ending balance in cash for the period
- Net income for the period

Differences exist because net income factors in revenue earned but not yet collected from customers and expenses incurred but not yet paid — rather than reflecting only transactions involving cash. In other words, net income is computed by using the accrual method of accounting. The accrual method means that a business is likely to have a balance in accounts receivable (for credit sales) and accounts payable (for purchases it hasn't yet paid for).

For example, suppose that in June a company deposits $2,000 into its checking account and writes checks to pay bills for $1,800. If you look only at the cash flowing in and out of the business, the company spent $200 less than it brought in, so it shows a profit of $200. But what if, in June, the company also used a credit card it doesn't intend to pay for until August to pay monthly bills in the amount of $1,000? Taking this transaction into account, the company actually spent more than it made, resulting in a loss of $800 ($2,000 in deposits less $2,800 in checks and credit card usage).

Distinguishing costs from expenses

When using the accrual method of accounting, one of the big distinctions you need to make and keep in mind is that costs aren't the same as expenses. Take a look at the differences:

- **Costs:** A *cost* is the money the company uses to produce or buy something — money that's not available to use anymore. Costs are a use of company cash, be it to purchase inventory, make investments, or pay back debt.

- **Expenses:** *Expenses* are costs directly *applied* to revenue-producing activities during a financial period. When spending is applied (or matched) with revenue, the spending becomes an expense. Book I, Chapter 4 explains the matching principle for revenue and expenses.

Suppose a company buys a shipment of aluminum for $25,000 cash in order to manufacture lawn mowers to sell to customers. The aluminum is a raw material, which appears on the balance sheet as an inventory account. When the company buys the aluminum, the price it pays, or promises to pay, is a *cost.* The company uses the aluminum to manufacture lawn mowers. When the lawnmower is sold, the cost of the aluminum used is reclassified as an *expense* (cost of goods sold). If the company uses half of the aluminum in production during the accounting period — and the lawn mowers produced are sold — the cost is $25,000, but the expense is only $12,500. The remaining $12,500 stays in inventory until it's needed to produce the product and the product is sold. Check out Book II, Chapter 2 for more on inventory.

The statement of cash flows is so important; it ties together the costs shown on the balance sheet with the expenses shown on the income statement.

Realizing the Purpose of the Statement of Cash Flows

The primary purpose of the statement of cash flows is to show a company's cash sources and uses during the financial period. Although cash can come from many different sources, such as customer payments, loans, and sales of assets, uses of cash directly trace back to costs. This information is interesting to the external users of the company's financial statements, who aren't privy to the day-to-day operations of the business, because it provides a basis for understanding how wisely a company manages its cash.

A company can be a real go-getter in the business world, but if cash is thrown around like chewing gum, the business may not be able to give prospective investors a reasonable return on their investment. Also, poor cash management may hinder a company's ability to make timely payments of principal and interest on a loan.

The statement of cash flows provides guidance for the following questions:

- **Does the company have the ability to generate positive cash flow in the future?** You don't want to invest in a one-hit wonder. Viewing a current statement of cash flows gives a hint as to the company's future prospects. Investors look for companies that can generate positive cash flow year after year.

- **Does the company have enough cash to make loan or dividend payments?** If you're a potential investor or lender for a corporation, letting the business use your money for free probably isn't very smart. You want to check out the statement of cash flows to see how the business manages its money and gauge the probability of the company having enough cash to satisfy its loan obligations and pay dividends.
- **Is the reason for the difference between net income and cash transactions indicative of a healthy business?** All cash is not created equal. Cash a company brings in from gross receipts is a lot more exciting to a potential investor than cash the company has left over because it sold some assets. After all, the business can own only a finite number of assets, while the sky's the limit for bringing in revenue from operations, assuming the business is managed well.

You ferret out this information by reviewing the different sections of the statement of cash flows. Each section ties back to how accounting transactions affect the income statement and balance sheet. So you're not looking at new information; instead, you're looking at the same information presented in a different way.

Walking through the Cash Flow Sections

A statement of cash flows has the following three sections:

- **Operating:** The sources and uses of cash in this section come from day-to-day business operations: cash received from sales to customers, and cash paid out for payroll, inventory, and other common costs.
- **Investing:** The investing section is all about buying and selling assets. This section shows sources and uses of cash from investment purchases and sales. The section also includes purchases and sales of property, plant, and equipment (PP&E).
- **Financing:** This section involves raising money to run a business and paying it back. This section includes cash inflows from loans and cash outflows for principal payments. It also includes equity related items (the sale of company stock and payment of dividends).

If some of these terms are unfamiliar to you, don't worry. By the time you finish reading the rest of this section, you'll be an old pro on cash flow.

Most of a company's cash transactions are in the operating section of the cash flow statement, because operations represent the common, day-to-day activity of the business. If you're reviewing cash activity, find the investing and financing transactions first. When you finish, any cash activity that remains unassigned should be posted to the operating section.

Figuring cash operating results

Generally accepted accounting principles (GAAP) has a guide to what shows up in the operating section: The operating section contains transactions not listed as investing or financing transactions. The following sections offer examples of operating sources and uses of cash. (See Book IV, Chapter 1 for details on GAAP.)

Operating sources of cash

Here are examples of operating sources of cash:

- **Cash receipts from the sale of goods or services:** This source is the cash that customers pay the company when the sale occurs. When the company collects cash from accounts receivable, that cash inflow is also from operations. For example, you go into Target and buy a new DVD player for $65. You fork over the cost of the purchase plus sales tax in cash. Target records this receipt as a source of cash.

  On the flip side, let's say that on October 12, you go into an appliance warehouse to buy a new washer and dryer. The warehouse is holding a "90 days same as cash" promotion, which means that as long as you cough up the cash for the washer and dryer within 90 days, you pay no interest. On October 12, the appliance warehouse has no cash source from you, and it won't have that source until you pay for your purchase on or before January 12. The appliance warehouse can't record the sale as a source of cash until it receives your payment.

- **Trading portfolio sales:** *Trading securities* are assets a business purchases to make a profit in the short term. The intention is to trade the securities (buy and sell them). Assume a business has spare cash lying around that it doesn't need access to in the immediate future. Rather than leaving the cash in the bank earning little or no interest, the company buys *highly liquid* (easily convertible to cash) stocks, bonds, or loans.

  The business tries to invest in something that won't drop in value during the holding period. Then, when the company sells the investment, the cash it receives goes on the statement of cash flows in the operating section rather than investing. The key here for operating section placement is that the investment is *short term.* See Book IV, Chapter 3 for more information about short-term investments.

- **Interest and dividends:** If the company makes loans to other businesses or individuals, any interest income it receives on those loans goes in the operating section. An example is a loan to a shareholder who is also an employee and needs cash beyond what she's receiving in her paycheck. This situation happens often in a closely held corporation.

  Also, some companies make loans to key vendors needing a short-term infusion of cash to keep their doors open. A company takes this step if it's in the company's best interest to keep an essential vendor in business.

After all, if you like to buy your widgets from Joe's Widget Shop and Joe goes out of business, you'll have to find another widget vendor, and maybe you won't like working with that vendor (or paying its prices) as much as you liked working with Joe.

As reported on the income statement, *dividends* are income paid to shareholders based on their proportional ownership of the corporation. For example, ABC Corp. owns 2,000 shares of XYZ, Inc. stock. ABC receives dividends from XYZ at $2 per share totaling $4,000 ($2 × 2,000 shares); this amount is posted to the operating section as a source of cash. You can find out more about the process behind declaring and paying dividends in Book IV, Chapter 5.

Operating uses of cash

Cash uses also show up in the operating section of a statement of cash flows. The cash outflows are kind of the flip side of the cash inflows. For example, accounts receivable from customers is an inflow, and accounts payable paid to vendors is an outflow.

Here are the operating cash outflows you're likely to encounter:

- **Satisfying accounts payable:** *Accounts payable* is the amount a company owes vendors for services and products purchased. When the original purchase takes place, no money changes hands between the customer and the supplier. Rather, the transaction contains a promise to pay within a certain amount of time.

  For example, suppose you order $500 of office supplies from Folders Office Supply, and Folders immediately invoices your company for $500. Your company doesn't record this amount as a cash outlay, because Folders wasn't paid yet; it merely has your promise to pay within 10 days (or 30 days, or whatever). This $500 becomes a cash outlay only after you sign and mail the payment check to Folders.

- **Trading portfolio purchases:** Just as sales of trading securities are a cash source, the amount of money the company pays to buy any trading security is a use of cash. No securities other than trading securities go in the operating section of the statement of cash flows. Again, the key here for operating section placement is that the investment is *short term.* See Book IV, Chapter 3 for more information about short-term investments.

- **Payments for other business expenses:** This category includes any cash outlays to buy inventory, pay employees, remit income taxes due, or pay any other suppliers (such as utility providers or the telephone company). You can find out more information about inventory purchases in Book II, Chapter 2.

- **Interest payments:** Any cash paid to lenders in the form of interest also goes in the operating section. The purpose or source of the loan doesn't make any difference. So interest paid to a related party, such

as a shareholder, for an *operating capital* loan (cash made available for day-to-day business functions) is treated the same as interest paid to a vehicle financing company for the note on the company car.

When a company borrows funds to operate, the cash inflow from the loan represents cash flow from financing. However, interest payments on the loan are an operating activity. Keep this difference in mind.

The main thrust of the operating section of the statement of cash flows is to reconcile the cash versus accrual treatment of income statement items. Because paying dividends to shareholders isn't a business expense, dividend payments don't show up on the income statement, so they're not an operating use of cash.

Showing cash investing transactions

Investing transactions involve the purchase and sale of noncurrent assets (see Book IV, Chapter 3). *Noncurrent assets* are assets the company anticipates owning for more than one year past the date of the balance sheet. Examples of noncurrent assets are long-term debt and equity investments; property, plant, and equipment; and intangible assets such as patents and copyrights.

What exactly are *debt and equity investments*?

- Common stock is an example of an *equity* investment. Equity refers to ownership in a company. Suppose you buy AT&T common stock. As a shareholder, you're an investor who gets paid back for the purchase of the stock only if you sell it to someone else.
- Bonds are *debt* investments. Corporations generally issue bonds to raise money for capital expenditures, operating expenses, and acquisitions. Because the investors are owed the principal amount they invest with the company, they're company creditors. For example, a municipality sells bonds to the public for the purpose of financing a new hospital. Bondholders receive interest payments at the bond's stated interest rate. When the bond matures, the company pays the bondholder the face amount of the bond.

Investing sources of cash

Investing transactions show up as sources of cash in the following ways:

- **Long-term debt sales and collection:** A company's investments in debt may fall into three categories: loans, held-to-maturity debt investments, and available-for-sale debt portfolios. Here's how they differ:
  - *Loans* are easy to understand; they're merely money the company loans to others that won't be repaid within 12 months of the balance sheet date. You know from your own personal debts (such

as car loans) that when you owe money, you periodically have to make payments on the principal portion of the loan. The same holds true with businesses. So any collection of principal on loans is a cash source for the company lending the money.

- *Held-to-maturity* debt investments are those the company anticipates holding onto until the debt matures. For example, ABC Corp. buys five-year bonds issued by the city of Orlando to build a new sports arena. When the bonds mature, the cash proceeds go in the investing section. See Book IV, Chapter 4 for details on bonds.
- *Available-for-sale* debt investments are one of those accounting topics defined by what they aren't rather than what they are. They don't fall into the held-to-maturity or trading category. However, as with the held-to-maturity investments, any cash the company receives from their sale or collection of principal at maturity reflects as a cash source in the investing section of the statement of cash flows.

- **Sales of equity investments:** If the company sells stock it owns in other corporations, the cash it receives is an investing source. So suppose your company owns 500 shares of ABC Corp. common stock, and you decide to sell all 500 shares. Any money you receive for the sale of your shares goes in the investing section.
- **Sales of property, plant, and equipment (PP&E) and intangibles:** The cash proceeds from any PP&E the corporation sells (such as cars, buildings, and equipment) is an investing source of cash. Ditto if the company sells an intangible asset such as a patent. (A *patent* provides licensing for inventions or other unique processes and designs.)

Investing uses of cash

Here are the potential uses of cash that appear in the investing section of the statement of cash flows:

- **Loans and debt purchases:** Any cash the company loans to another company is a cash outlay. So is any cash the company uses to buy bonds.
- **Purchase of equity investments:** This category includes any cash the company uses to buy stock in another corporation.
- **Purchase of PP&E:** If the business pays cash for any fixed asset acquisition or an intangible asset, this outlay of cash must appear in the investing section.

Accounting for financing activities

Financing activities show transactions with lenders such as long-term liabilities (paying or securing loans beyond a period of 12 months from the balance sheet date) and equity items (the sale of company stock and payment of dividends). Sound familiar from the investing section?

The one main financing cash source is *cash proceeds if a business issues its own stock or debt.* For example, ABC Corp. sells $3,000 of its own stock to XYZ, Inc. The cash ABC receives from XYZ for this transaction is a financing source of cash on ABC's statement of cash flows.

Short-term and long-term debt the company issues is included in the financing section. How long the creditor plans to hold the debt determines whether it's recorded on the creditor's books as short- or long-term debt.

Now, here are the uses of cash that would appear in the financing section of the statement of cash flows:

- **Treasury stock transactions:** *Treasury stocks* are shares of corporate stock that were previously sold and have since been bought back by the issuing corporation. The use of the cash is to buy back stock from shareholders. See Book IV, Chapter 5 for more information about treasury stock.
- **Cash dividend payments:** *Cash dividends* are earnings paid to shareholders based on the number of shares they own. Dividends can also come in the form of stock dividends, which don't involve cash changing hands. So remember, only cash dividends go in the financing section. You find more about cash and stock dividends, plus some info on stock splits (also a noncash transaction), in Book IV, Chapter 5.
- **Paying back debt:** Any principal payment a company makes on bonds or loans is a financing activity.

Recognizing Methods for Preparing the Statement of Cash Flows

Two methods are available to prepare a statement of cash flows: the indirect and direct methods. The Financial Accounting Standards Board (FASB; see Book IV, Chapter 1) prefers the direct method, while many businesses prefer the indirect method. Regardless of which method you use, the bottom-line cash balance is the same, and it has to equal the amount of cash you show on the balance sheet.

The last step in compiling the statement of cash flows is to verify that the ending balance in the cash flow statement equals the ending balance in the cash account on the balance sheet. If they don't agree, there must be a mistake or missing cash transactions in the cash flow statement. This is the process used for both the direct and indirect method.

The following figures show you what the statement of cash flows looks like when you use both the direct and indirect methods of preparation. Figure 2-1 is the statement of cash flows using the direct method, and Figure 2-2 is the statement of cash flows using the indirect method. As you look at both, note that the cash balance on 12/31/2015 is the same for both methods.

Statement of Cash Flows Direct Method For the Year Ending 12/31/2015	
Cash Flows from Operating Activities:	
Cash received from customers	58,523
Cash paid to suppliers	7,884
Employee compensation	2,139
Other operating expenses paid	1,548
Interest paid	675
Taxes paid	990
Net cash provided by operating activities	45,287
Cash Flows from Investing Activities:	
Proceeds from sale of equipment	25,000
Purchase of land	(60,000)
Net cash used for investing activities	(35,000)
Cash Flows from Financing Activities:	
New long-term borrowing	350
Payment of long-term debt	(200)
Purchase of treasury stock	(175)
Payment of dividends	(50)
Net cash used for financing activities	(75)
Increase (decrease) in cash	10,212
Cash balance, January 1, 2015	35,620
Cash balance, December 31, 2015	45,832
Reconciliation of Net Income and Net Cash Provided by Operating Activities:	
Net Income	
Add (deduct items) not affecting cash:	43,987
Depreciation expense	2,150
Gain on sale of equipment	(150)
Increase in accounts receivable	(3,500)
Increase in accounts payable	2,800
Net cash provided by operating activities	45,287

Figure 2-1: A direct method statement of cash flows.

Statement of Cash Flows Indirect Method For the Year Ending 12/31/2015	
Cash Flows from Operating Activities:	
Net income	
Add (deduct items) not affecting cash:	43,987
Depreciation expense	2,150
Gain on sale of equipment	(150)
Increase in accounts receivable	(3,500)
Increase in accounts payable	2,800
Net cash provided by operating activities	45,287
Cash Flows from Investing Activities:	
Proceeds from sale of equipment	25,000
Purchase of land	(60,000)
Net cash used for investing activities	(35,000)
Cash Flows from Financing Activities:	
New long-term borrowing	350
Payment of long-term debt	(200)
Purchase of treasury stock	(175)
Payment of dividends	(50)
Net cash used for financing activities	(75)
Increase (decrease) in cash	10,212
Cash balance, January 1, 2015	35,620
Cash balance, December 31, 2015	45,832

Figure 2-2: An indirect method statement of cash flows.

Using the direct method

The direct method of preparing the statement of cash flows shows the net cash from operating activities. This section shows all operating cash receipts and payments. Some examples of cash receipts you use for the direct method are cash collected from customers, as well as interest and dividends the company receives. Examples of cash payments are cash paid to employees and other suppliers and interest paid on notes payable or other loans (see Book IV, Chapter 4).

Here are three key facts to remember about the direct method:

- You present cash received and paid — not net income or loss as shown on the income statement (see Book IV, Chapter 2).
- Any differences between the direct versus the indirect method are located in the operating section of the statement of cash flows. The financing and investing sections are the same regardless of which method you use.

- The FASB prefers the direct method because it believes the direct method gives the users of the financial statements a more complete picture of the health of the business.

Starting indirectly with net income

When you use the indirect method of preparing the statement of cash flows, the operating section starts with net income from the income statement. You then adjust net income for any noncash items hitting the income statement. One typical adjustment is for depreciation, which is a noncash transaction (see Book III, Chapter 1).

Other common items requiring adjustment are gains and losses from the sale of assets (see Book IV, Chapter 2). This is because the gains or losses shown on the income statement for the sale will rarely if ever equal the cash a company receives. In other words, gain or loss is based on the difference between the asset's *net book value,* which is cost less accumulated depreciation, and the amount the item sold for — not how much cash the buyer hands over to the seller.

Assume a business has a machine it no longer uses. Because it no longer needs the machine, the business sells it to another company for $1,500. The cash received is $1,500, but what about gain or loss on disposal? Consider these facts:

- The company originally paid $3,000 to purchase and install the machine.
- The asset was *depreciated,* meaning that the asset's cost was gradually posted to depreciation expense over the machine's useful life. The total amount depreciated over time (accumulated depreciation) was $2,000. Check out Book III, Chapter 1 for more on depreciation.
- *Book value* for the machine on the date of sale was $1,000 ($3,000 cost – $2,000 accumulated depreciation).
- The company debits (increases) cash for $1,500 and debits (reduces) accumulated depreciation for $2,000. When the asset is sold, the accumulated depreciation account is adjusted to zero. Debits total $3,500.
- The asset is credited (reduced) by $3,000, which is the original cost.
- Gain on disposal is a credit for $500, which is the difference between $3,500 total debit and the $3,000 credit. After the gain is posted, total debits and credits both equal $3,500.

You see that the cash received ($1,500) differs from the gain on disposal ($500). These are the types of transactions that are reconciled in the statement of cash flows. The net income change ($500 gain) doesn't match the $1,500 cash inflow. Book IV, Chapter 2 goes into more detail in gains and losses.

Interpreting the Statement of Cash Flows

Users of the statement of cash flows are primarily interested in whether the company has positive cash flows from operations. As a general rule, a company should be covering its costs by the cash it brings in from the day-to-day running of the business, rather than from borrowed funds.

A potential investor or creditor wants to see that cash the company brings in through operations exceeds any cash brought in by selling assets or borrowing money. This is because selling assets or borrowing money can never be construed as a continuing event, such as bringing in cash from selling goods or services. Book IV, Chapter 2 explains this concept in more detail.

A company may issue stock or bonds in order to expand its operations. On a nonrecurring basis, that situation can be okay because successful expansion is a good thing for investors and creditors. Successful expansion leads to more sales and higher overall profits. However, unless cash from operations exceeds cash from other sources with some consistency, a company will be paying back debt with either more debt or equity being issued, which is decidedly not a good thing.

Here's how investors and lenders use the statement of cash flows:

- **Investor:** An investor wants to make sure the corporation has enough cash flow to pay an adequate return on investment. In other words, can the investor anticipate getting a cash dividend each year? Also important is using the statement of cash flows to evaluate how well the company is managing its cash because investors may eventually sell their shares of stock. If the company mismanages its cash to such a point that it goes out of business, there won't be any buyers for the company's stock — the stock may be worthless.
- **Creditor:** The creditor also has a vested interest in making sure the company has sound cash management. After all, in addition to the interest expense the debtor pays for the use of the loan, the creditor wants to make sure it also gets paid back the principal portion of the loan. It's never a good sign if a business is paying back debt by assuming more debt or issuing more equity.

Looking Quickly at the Statement of Changes in Stockholders Equity

Larger businesses generally have more complicated ownership structures than smaller and medium-sized companies. Larger businesses are most often organized as a corporation in contrast to other forms of legal structures. (See Book VI, Chapter 2 for more about the legal structure of a business.)

Corporations can issue more than one class of stock shares, and many do. One class, *preferred stock,* has certain perks that the other class, called *common stock,* doesn't. Also, a corporation may have both voting and non-voting stock shares. And corporations can buy back their own stock shares (*treasury stock*) for a variety of reasons. Book IV, Chapter 5 addresses these transactions.

The point is that many businesses, especially larger public companies, engage in activities that change their owners' equity components. These owners' equity activities tend to get lost from view in a comparative balance sheet and in the statement of cash flows. Yet the activities can be important. Therefore, the business prepares a separate statement of changes in stockholders' equity covering the same period as its income statements. The statement of changes in stockholders' equity is where you find certain technical gains and losses that increase or decrease owners' equity but that are *not* reported in the income statement. You have to read this summary of changes in the owners' equity accounts to find out whether the business had any such gains or losses. Look in a column headed *comprehensive income* for these gains and losses, which are very technical.

The general format of the statement of changes in stockholders' equity includes columns for each class of stock, additional paid in capital, treasury stock, retained earnings, and the comprehensive income element of owners' equity. Professional stock analysts have to pore over these statements. Average financial report readers probably quickly turn the page when they see this statement. But it's worth a quick glance if nothing else.

Many financial reports include a statement of changes in stockholders' equity in addition to their three primary financial statements. It's not really a full-fledged financial statement. Rather, it serves as a columnar footnote for the various owners' equity accounts in the balance sheet. For more about changes in owners' equity, see Book IV, Chapter 5.

Chapter 3

Analyzing Financial Statements

In This Chapter

- Evaluating a business's financial health
- Categorizing business transactions
- Connecting revenue and expenses with their assets and liabilities
- Focusing on profitability and activity measures
- Preparing vertical and horizontal analyses

Stakeholders in a business are naturally curious about the financial condition of a company, as reported in its financial statements. Stakeholders include everyone who may be affected by the financial success or failure of the business — owners, investors, lenders, the CEO and other executives, managers, employees, and even vendors.

This chapter offers practical tips to help investors, lenders, or anyone who has a financial stake in a business glean important insights from financial statements. These tips also help anyone else with an interest in the financial condition of a business.

Judging Solvency and Liquidity

Solvency and liquidity both measure the ability of an entity to pay its debts. Solvency has a long-term focus, while liquidity addresses short-term payments.

Solvency refers to the ability of a business to pay its liabilities on time. Solvency measures whether or not a company is viable — a business that can generate sufficient cash flow to operate over the long-term (multiple years).

Liquidity, on the other hand, refers to the ability of a business to keep its cash balance and cash flows at adequate levels so that operations aren't disrupted

by cash shortfalls. When considering liquidity, the focus is on the next six months or the next year. For more on this important topic, check out *Cash Flow For Dummies* by Tage C. Tracy and John A. Tracy (Wiley).

Understanding the risks of late payments

Delays in paying liabilities on time can cause serious problems for a business. Customers may shy away from doing business with a company that has financial problems. Vendors may not be willing to sell the company product because of the risk of not being paid. Customers and vendors may hear about a company's financial issues through media reports (newspaper, TV, web).

In extreme cases, a business can be thrown into *involuntary bankruptcy.* In a bankruptcy, a court-appointed trustee may take substantial control over the business and its decisions about debt payment. Even the threat of bankruptcy can cause serious disruptions in the normal operations of a business.

Recognizing current assets and liabilities

Short-term, or *current,* assets include:

- Cash
- Marketable securities that can be immediately converted into cash
- Assets expected to be converted into cash within one year

The *operating cycle* is the process of converting current assets (largely inventory and accounts receivable) into cash. The term *operating cycle* refers to the repetitive process of putting cash into inventory, holding products in inventory until they're sold, selling products on credit (which generates accounts receivable), and collecting the receivables in cash. In other words, the operating cycle is the "from cash — through inventory and accounts receivable — back to cash" sequence. The operating cycles of businesses vary from a few weeks to several months, depending on how long inventory is held before being sold and how long it takes to collect cash from sales made on credit.

Short-term, or *current,* liabilities include non-interest-bearing liabilities that arise from the operating (sales and expense) activities of the business. A typical business keeps many accounts for these liabilities — a separate account for each vendor, for instance. In an external balance sheet you usually find only three or four operating liabilities. It's assumed that the reader knows

that these operating liabilities don't bear interest (unless the liability is seriously overdue and the creditor has started charging interest because of the delay in paying the liability).

The balance sheet example shown in Figure 3-1 discloses three operating liabilities: accounts payable, accrued expenses payable, and income tax payable. The terminology for these short-term operating liabilities varies from business to business.

Typical Product Business, Inc.
Statement of Financial Condition
at December 31, 2015 and 2016
(Dollar amounts in thousands)

Assets	2015	2016	Change
Cash	$2,275	$2,165	($110)
Accounts Receivable	$2,150	$2,600	$450
Inventory	$2,725	$3,450	$725
Prepaid Expenses	$525	$600	$75
Current Assets	$7,675	$8,815	
Property Plant and Equipment	$11,175	$12,450	$1,275
Accumulated Depreciation	($5,640)	($6,415)	($775)
Net of Depreciation	$5,535	$6,035	
Total Assets	$13,210	$14,850	$1,640

Liabilities and Owners' Equity	2015	2016	Change
Accounts Payable	$640	$765	$125
Accrued Expenses Payable	$750	$900	$150
Income Tax Payable	$90	$115	$25
Short-term Notes Payable	$2,150	$2,250	$100
Current Liabilities	$3,630	$4,030	
Long-term Notes Payable	$3,850	$4,000	$150
Owners' Equity:			
Invested Capital	$3,100	$3,250	$150
Retained Earnings	$2,630	$3,570	$940
Total Owners' Equity	$5,730	$6,820	
Total Liabilities and Owners' Equity	$13,210	$14,850	$1,640

Figure 3-1: Typical comparative balance sheet for a product business at the end of its two most recent years (in vertical, or portrait format).

In addition to operating liabilities, interest-bearing notes payable that have maturity dates one year or less from the balance sheet date are included in the current liabilities section (see short-term notes payable in Figure 3-1). The current liabilities section may also include certain other liabilities that must be paid in the short run (which are too varied and technical to discuss here).

Notice the following points in Figure 3-1 (dollar amounts refer to year-end 2015):

- The first four asset accounts (cash, accounts receivable, inventory, and prepaid expenses) are added to give the $8,815,000 subtotal for *current assets*.
- The first four liability accounts (accounts payable, accrued expenses payable, income tax payable, and short-term notes payable) are added to give the $4.03 million subtotal for *current liabilities*.
- The total interest-bearing debt of the business is separated between $2.25 million in *short-term* notes payable (those due in one year or sooner) and $4 million in *long-term* notes payable (those due after one year).

Brushing up on current and quick ratios

If current liabilities become too high relative to current assets — which constitute the first line of defense for paying current liabilities — managers should move quickly to resolve the problem. A perceived shortage of current assets relative to current liabilities could sound the sirens in the minds of the company's creditors and owners. The current and quick ratios measure this risk.

Making a judgment about the ratios you compute depends on your industry. However, a current ratio of at least 1.0 is considered a minimum expectation for company liquidity (see the earlier section on liquidity). At that ratio, you have at least $1 in current assets to pay each dollar of current liabilities.

Business managers know that acceptable ratios also depend on general practices in the industry for short-term borrowing. Some businesses do well with current ratios less than 2.0 and quick ratios less than 1.0; so take these benchmarks with a grain of salt. Lower ratios don't necessarily mean that the business won't be able to pay its short-term (current) liabilities on time.

Applying the current ratio

Current assets are the first source of money to pay current liabilities when these liabilities come due. Remember that current assets consist of cash and assets that will be converted into cash in the short run. Ideally, a company will use current assets as a payment source, rather than additional borrowing or other financing.

To size up current assets against total current liabilities, the *current ratio* is calculated. Using information from the company's balance sheet (refer to Figure 3-1), you compute its year-end 2015 *current ratio* as follows:

$8,815,000 current assets ÷ $4,030,000 current liabilities = 2.2 current ratio

Generally, businesses don't provide their current ratio on the face of their balance sheets or in the footnotes to their financial statements — they leave it to the reader to calculate this number. On the other hand, many businesses present a financial highlights section in their financial report, which often includes several financial ratios.

Moving to the quick ratio

The *quick ratio* is more restrictive than the current ratio. Only cash and assets that can be immediately converted into cash are included, which excludes inventory. In some businesses, it may take many months to sell inventory. Here is the adjusted asset number you use for the quick ratio (refer to Figure 3-1):

$8,815,000 current assets – $3,450,000 inventory = $5,365,000 assets for quick ratio

You compute the quick ratio as follows:

$5,365,000 assets for quick ratio ÷ $4,030,000 current liabilities = 1.3 quick ratio

Wrapping up with working capital

The same data used to calculate current and quick ratios is used to compute *working capital.* Here's the formula:

Working capital = Current assets – Current liabilities

A current ratio of at least 1.0 is considered reasonable for liquidity purposes. That's because the ratio displays at least $1 in current assets for each dollar of current liabilities.

Assume that current assets and current liabilities each total $1,500,000. The current ratio is 1.0 ($1,500,000 ÷ $1,500,000). Put the same data in the working capital formula. Working capital would be zero ($1,500,000 less $1,500,000). *Negative* working capital would mean that current assets are less than current liabilities. So, the minimum expectation of 1.0 for a current ratio is the same as a $0 working capital calculation.

Understanding That Transactions Drive the Balance Sheet

A balance sheet is a snapshot of the financial condition of a business at an instant in time. If the *fiscal,* or accounting, year of a business ends on December 31, its balance sheet is prepared at the close of business at midnight December 31. (A company should end its fiscal year at the close of its natural business year or at the close of a calendar quarter — September 30, for example.) This freeze-frame nature of a balance sheet may make it appear that a balance sheet is static. Nothing is further from the truth. A business doesn't shut down to prepare its balance sheet. The financial condition of a business is in constant motion because the activities of the business go on nonstop.

Analyzing three types of balance sheet transactions

Transactions change the makeup of a company's balance sheet — that is, its assets, liabilities, and owners' equity. The transactions of a business fall into three basic types. Notice that these three types match up with the three categories of cash flow in the statement of cash flows (see Chapter 2):

- **Operating activities:** This category refers to making sales and incurring expenses, and also includes accompanying transactions that relate to the recording of sales and expenses. For example, a business records sales revenue when sales are made on credit, and then, later, records cash collections from customers. The transaction of collecting cash is the indispensable follow-up to making the sale on credit. For another example, a business purchases products that are placed in its *inventory* (its stock of products awaiting sale), at which time it records an entry for the purchase. The *expense* (the cost of goods sold) isn't recorded until the products are actually sold to customers. Keep in mind that the term *operating activities* includes the associated transactions that precede or are subsequent to the recording of sales and expense transactions.
- **Investing activities:** This term refers to making investments in assets and (eventually) disposing of the assets when the business no longer needs them. The primary examples of investing activities for businesses that sell products and services are *capital expenditures.* A capital expenditure is an amount spent to modernize, expand, or replace the long-term operating assets of a business. A business may also invest in *financial assets,* such as bonds and stocks or other types of debt and equity instruments. Purchases and sales of financial assets are also included in this category of transactions.
- **Financing activities:** These activities include securing money from debt and equity sources of capital, returning capital to these sources, and

distributing profit to owners. For instance, when a business pays cash dividends to its stockholders the distribution is treated as a financing transaction. The decision whether or not to distribute some of its profit depends on whether the earnings generated are needed to operate the business. If the company distributes earnings by paying a dividend, the equity section of the balance sheet is reduced. (See Book VIII, Chapter 1 for more about accounting for financing activities.)

Reviewing changes in balance sheet accounts

Figure 3-2 presents a summary of changes in assets, liabilities, and owners' equity during the year. Notice the middle three columns in Figure 3-2, for each of the three basic types of business transactions discussed in the prior section. One column is for changes caused by its revenue and expenses and their connected transactions during the year, which collectively are called *operating activities.* The second column is for changes caused by its *investing activities* during the year. The third column is for the changes caused by its *financing activities.*

Typical Product Business, Inc.
Statement of Changes in Assets, Liabilities, and Owners' Equity
For Year Ended December 31, 2015
(Dollar amounts in thousands)

Assets	Beginning Balances	Operating Activities	Investing Activities	Financing Activities	Ending Balances
Cash	$2,275	$1,515	($1,275)	($350)	$2,165
Accounts Receivable	$2,150	$450			$2,600
Inventory	$2,725	$725			$3,450
Prepaid Expenses	$525	$75			$600
Property Plant and Equipment	$11,175		$1,275		$12,450
Accumulated Depreciation	($5,640)	($775)			($6,415)
Totals	$13,210	$1,990	$0	($350)	$14,850
Liabilities and Owners' Equity					
Accounts Payable	$640	$125			$765
Accrued Expenses Payable	$750	$150			$900
Income Tax Payable	$90	$25			$115
Short-term Notes Payable	$2,150			$100	$2,250
Long-term Notes Payable	$3,850			$150	$4,000
Owners' Equity - Invested Capital	$3,100			$150	$3,250
Owners' Equity - Retained Earnings	$2,630	$1,690		($750)	$3,570
Totals	$13,210	$1,990		($350)	$14,850

Figure 3-2: Summary of changes in assets, liabilities, and owners' equity during the year according to basic types of transactions.

Note: Figure 3-2 doesn't include subtotals for current assets and liabilities. (The formal balance sheet for this business is presented in Figure 3-1.) The summary of changes in assets, liabilities, and owners' equity isn't a required financial statement for external users (stakeholders). The purpose of Figure 3-2 is to demonstrate how the three major types of transactions change the assets, liabilities, and owners' equity accounts during the year.

Tying in profit

Figure 3-2 lists a $1.69 million increase in owners' equity–retained earnings account. See the operating activities column. The increase represents net income earned for the year.

The operating activities column in Figure 3-2 is worth lingering over for a few moments because the financial outcomes of making profit appear in this column. Most people see a profit number, such as the $1.69 million in this example, and stop thinking any further about the financial outcomes of making the profit. This is like going to a movie because you like its title, but you don't know anything about the plot and characters. You probably noticed that the $1,515,000 increase in cash in this column differs from the $1,690,000 net income figure for the year. The cash effect of making profit (which includes the associated transactions connected with sales and expenses) almost always differs from the net income amount for the year. Book V, Chapter 2 explains this difference.

Managing balance sheet activity

The summary of changes presented in Figure 3-2 gives a sense of the balance sheet in motion, or how the business got from the start of the year to the end of the year. Having a good sense of how transactions propel the balance sheet is important. A summary of balance sheet changes, such as those shown in Figure 3-2, can be helpful to business managers who plan and control changes in the assets and liabilities of the business. They need a clear understanding of how the three basic types of transactions change assets and liabilities. Also, Figure 3-2 provides a useful platform for the statement of cash flows explained in Book V, Chapter 2.

Measuring Profitability

In addition to having a handle on how well a company covers its current debt with current assets, just about all financial statement users want to be able to evaluate the relative robustness of a company's income over a series of years or financial periods. Looking at a company's performance over a long period of time is called *trend analysis.*

This section explains how trend analysis works and why it's so important when evaluating profitability. It then moves on to explain two profitability measures: return on investment and return on equity.

Understanding trend analysis

A single profitability measure standing alone doesn't really tell you much about a company or how it's performing compared to its competitors. This is true for two reasons:

- **The company may have had an exceptionally good or bad year.** Unless a company's performance is static from year to year, looking at only one year of financial statement results is misleading. The statement user sees an inaccurate vision of the company's performance over time.

  Consider a personal example. Suppose you win $50,000 in the lottery this year, making your total income (after adding in your earnings from your part-time job) $62,000. The next year and the year after that, you don't have any winning lottery tickets (darn it!), and your average income is $33,000 per year. Clearly, looking at your income for only the year you won the lottery gives an inaccurate indication of your typical annual income, because that year's income includes an unusual, nonrepeating event.

- **Under generally accepted accounting principles (GAAP), companies are allowed to use various methods to estimate some expenses.** If a financial statement user is trying to compare Company A to Company B by applying a single set of profitability ratios, he's not going to see the whole picture.

  For example, two equally profitable companies using different inventory valuation methods (see Book VIII, Chapter 2) may report big differences in net income. The same holds true for depreciation of long-term assets, discussed in Book III, Chapter 1. Different options are also available for booking an estimate for *bad debt* expense, which is the money the company reckons it won't be able to collect from credit customers (see Book III, Chapter 6). Many more differences may arise by using allowable GAAP methods, but you get the picture.

  Trend analysis gives much more meaningful information to the financial statement user because differences in accounting methods tend to smooth out over time. For example, although the method a company uses for depreciation affects the amount of depreciation expense by year, it never affects original cost. In other words, an asset costing $1,000 can never be depreciated for more than $1,000. After the asset is fully depreciated, total depreciation expense is the same, regardless of the method used. Analyzing ratios over a period of several years should be somewhat consistent, which permits the financial statement user to do some useful trend comparisons.

Using trend analysis means looking at profitability ratios over a number of years. Doing so is usually more helpful to the financial statement user than any single ratio is because everything is relative. Seeing how profitability ratios go up and down (when comparing current performance to past performance and when comparing the company with other companies in the same industry) is more meaningful than just looking at one stand-alone ratio. Most investors consider at least five years — sometimes up to ten.

Focusing on return on investment

Return on investment (ROI) is a measuring tool investors use to see how well their investment in a particular company is faring — and to help them make that important decision to sell a stock and move on or to stick with it. Potential investors also use ROI when trying to make a decision among different companies in which to plunk their spare cash.

Investors want to see how well company management is using the company assets to make money. This information gives the investor some idea of the competency of management and the relative profitability of a business when compared to others the investor is considering.

Investors can calculate ROI, which is expressed as a percentage, a few different ways. All the methods involve using some form of comparing income to assets. Here are two common methods:

- **Net income divided by average total assets:** *Net income* (see Book VIII, Chapter 1) is the bottom-line total of what's left over after you deduct all business expenses and losses from all revenue and gains for the same financial period. *Assets* are all the resources a company owns. So if a company has net income of $100,000 and average total assets of $2,700,000, its ROI is 3.7 percent ($100,000 ÷ $2,700,000).

  

  To determine the average of any account, add the account balance at the beginning of the financial period to the ending balance and divide that figure by two. So, if total liabilities are $50,000 on January 1 and $75,000 on December 31, average total liabilities is $125,000 ÷ 2 = $62,500.

- **Operating income divided by average operating assets:** This form of ROI calculation starts with income before income taxes and interest and divides it by average *operating assets,* which are long-lived assets such as property, plant, and equipment. So if a company's operating income is $82,000 and its average operating assets are $1,200,000, ROI using this method is 6.83 percent ($82,000 ÷ $1,200,000).

In real life, it doesn't make any difference which method an investor uses. As long as the chosen method is used consistently, trend analysis using any ROI method will give the investor a significant resource for making a decision as to which company to invest in.

Homing in on return on equity

As explained in the prior section, return on investment measures how well you generate profits from company assets. *Return on equity* (ROE) measures the profit earned for each dollar invested in a company's stock. You figure it by dividing net income by average *owners' equity* (see Book IV, Chapter 5), which is what's left over in the business after all liabilities are subtracted from all assets.

The higher the ROE ratio, the more efficient management is at utilizing its equity base. This measurement is important to stockholders and potential investors because it compares earnings to owners' investments (equity). Because this calculation takes into account *retained earnings* — the company's cumulative net income less dividends — it gives the investors much-needed data as to how effectively their capital is being used. Having net income grow in relation to increases in equity presents a picture of a well-run business.

Take a walk through a quick calculation. If a company's net income is $35,000 and the average owners' equity is $250,000, ROE is 14 percent ($35,000 ÷ $250,000). Once again, to make wise investment decisions, users of this information look at ROE as it trends over a series of years and compare it to the ROE of other companies.

Exploring Activity Measures

This section discusses *activity measures* that quantify the relationship between a company's assets and sales. Accounting textbooks usually mention a few activity measures. This section discusses the ones most commonly used: those that measure accounts receivable and inventory activity.

For many companies, accounts receivable and inventory represent the largest account balances in the balance sheet. As a result, performing analysis on these accounts is an important indicator of financial performance.

Ratio analysis that studies activity shows you how well a company is using its assets to make money. This calculation is an expansion of the return on investment (ROI) measurement. The premise is that how well a company uses its assets to generate revenue goes a long way toward telling the tale of its overall profitability. Presumably, a business that's effectively and efficiently operated, which activity measures show, will generally be more successful than its less effective and efficient competitors.

Asset turnover analysis shows how well you use assets to generate sales. A higher ratio means more sales per dollar of assets, which is the goal. In other

words, efficiently turning over assets indicates a well-run business. The basic formula to calculate asset turnover is this:

Asset turnover = Sales ÷ Average assets

The two most important current assets for the majority of businesses are accounts receivable and inventory. The following sections explain each turnover ratio.

Accounts receivable turnover

Accounts receivable turnover shows the average number of times accounts receivable is turned over during the financial period. In this case, turned over means how often a receivable is posted to the books and then received in cash. Here's the formula:

Accounts receivable turnover = Net credit sales ÷ Average accounts receivable

Net credit sales represent sales made on credit, less any sales returns and discounts. See Book I, Chapter 3 for more detail on receivables. Average accounts receivable is simply the beginning receivable balance for the period plus the ending receivable balance divided by two. See "Focusing on return on investment," earlier in this chapter for instructions on how to compute an average balance.

The sooner a company collects receivables from its customers, the sooner the cash is available to take care of the needs of the business. This turnover rate is a big deal, because the more cash the company brings in from operations, the less it has to borrow for timely payment of its liabilities.

Here's an example of how to figure accounts receivable turnover: Village Shipping has net credit sales of $35,000 for the year. Accounts receivable (A/R) was $2,500 at January 1 and $1,500 at December 31. The average A/R is ($2,500 + $1,500) ÷ 2 = $2,000. The accounts receivable turnover is $35,000 ÷ $2,000 = 17.5, or 17.5 times.

Another often-used accounts receivable activity measure is *the average collection period for accounts receivable,* also called *day's sales outstanding.* This measure calculates the average number of days that credit sales remain in accounts receivable — a valuable aid in helping companies develop credit and collection policies. The average collection period for accounts receivable is figured by dividing accounts receivable as of the last day of the financial period by the average day's sales (all sales in the financial period divided by

365 days or 366 days in a leap year). This calculation assumes that a business is open each day of the year. It may not be realistic, but it allows the formula to be compared among businesses.

Inventory turnover

Inventory turnover shows how efficiently the company is handling inventory management and replenishment. The less inventory a company keeps on hand, the lower the costs are to store and hold it, thus lowering the cost of inventory having to be financed with debt or by selling equity to investors.

However, keep in mind that running out of inventory hurts business. Low inventory levels can cause lost sales and late deliveries and perhaps strain the company's relationship with its customers. Also, running low on inventory may cause the company to panic and buy the same inventory for a higher price to get it *right now.* Too much of that sort of mismanagement can play havoc with the bottom line.

Here's the formula for inventory turnover:

Inventory turnover = Cost of goods sold ÷ Average inventory value

You calculate average inventory the same way you compute the average for accounts receivable in the prior section. If cost of goods sold are $35,000, and average inventory is $8,500, inventory turnover is $35,000 ÷ $8,500 = 4.12, or 4.12 times.

Comparing Horizontal and Vertical Analysis

A good way to do some ratio and trend analysis work is to prepare both horizontal and vertical analyses of the income statement. Both analyses involve comparing income statement accounts to each other in dollars and in percentages.

Understanding horizontal and vertical analysis is essential for managerial accounting, because these types of analyses are useful to *internal* users of the financial statements (such as company management), as well as to external users. If analysis reveals any unexpected differences in income statement accounts, management and accounting staff at the company should isolate the reasons and take action to fix the problem(s).

You can do the same types of analyses for balance sheet accounts. For a horizontal analysis, you compare like accounts to each other over periods of time — for example, accounts receivable (A/R) in 2014 to A/R in 2015. To prepare a vertical analysis, you select an account of interest (comparable to total revenue) and express other balance sheet accounts as a percentage. For example, you may show merchandise inventory or accounts receivable as a percentage of total assets.

Using horizontal analysis

Horizontal analysis compares account balances and ratios over different time periods. For example, you compare a company's sales in 2014 to its sales in 2015.

Figure 3-3 is an example of how to prepare a horizontal analysis for two years. For useful trend analysis, you need to use more years (most investors use five), but this example gives you all the info you need to prepare a horizontal analysis for an unlimited number of years.

Village Shipping Inc. Income Statement Horizontal Analysis For the years ending December 31, 2014 and December 31, 2015	2014	2015	% Change 2015 from 2014
Sales	500,000	475,000	-5.00%
Cost of goods sold	269,000	265,000	-1.49%
Gross profit	231,000	210,000	-9.09%
Wages	163,000	154,000	-5.52%
Repairs	4,150	5,800	39.76%
Rent	12,000	13,000	8.33%
Taxes	17,930	16,940	-5.52%
Office expenses	587	1,023	14.14%
Total expenses	197,667	190,763	-3.49%
Net Income	33,333	19,237	-42.29%

Figure 3-3: Income statement horizontal analysis for 2014 and 2015.

The analysis computes the percentage change in each income statement account at the far right. The first number you might consider is the change in profit. Net income declined by 42.29 percent. Consider these two numbers and how they contributed to the decline:

- Repairs expense increased by 39.76 percent
- Sales declined by 5 percent

To isolate the reason for the net income decline, look at the change in *total dollars,* as well as the percentage change. The repair expense is the largest percentage change — an increase in costs. But note that the dollar amount of change is only $1,650 ($4,150 to $5,800). On the other hand, the sales decline was $25,000 ($500,000 to $475,000). The decrease in sales has a bigger impact on the net income decline, when dollars are considered.

Implementing vertical analysis

Vertical analysis restates each amount in the income statement as a percentage of sales. This analysis gives the company a heads up if cost of goods sold or any other expense appears to be too high when compared to sales. Reviewing these comparisons allows management and accounting staff at the company to isolate the reasons and take action to fix the problem(s).

Figure 3-4 is an example of how to prepare a vertical analysis for two years. As with the horizontal analysis, you need to use more years for any meaningful trend analysis. This figure compares the difference in accounts from 2014 to 2015, showing each account as a percentage of sales for each year listed.

Village Shipping Inc.
Income Statement Vertical Analysis
For the years ending December 31, 2014 and December 31, 2015

	2014		2015	
Sales	500,000	100.00%	475,000	100.00%
Cost of goods sold	269,000	53.80%	265,000	55.79%
Gross profit	231,000	46.20%	210,000	44.21%
Wages	163,000	32.60%	154,000	32.42%
Repairs	4,150	0.83%	5,800	1.22%
Rent	12,000	2.40%	13,000	2.74%
Taxes	17,930	3.59%	16,940	3.57%
Office expenses	587	0.12%	1,023	0.22%
Total expenses	197,667	39.53%	190,763	40.16%
Net Income	33,333	6.67%	19,237	4.05%

Figure 3-4: Income statement vertical analysis for 2014 and 2015.

At the bottom of the analysis, note that net income, as a percentage of sales, declined by 2.62 percentage points (6.67 percent to 4.05 percent). As a dollar amount, net income declined by $14,096 ($33,333 to $19,237). As mentioned in the prior section, management should consider both the percentage change and the dollar amount change.

Using Common Size Financial Statements

One way to visually zero in on potential problems and missteps taking place within a business is to prepare and study common size financial statements. *Common size financial statements* get rid of the dollars and cents, reflecting account balances as percentages. For example, with the vertical analysis of income statement items, all income statement items are shown as a dollar amount and percentage of total sales. With a common size income statement, you omit any references to the dollar figures.

The big deal about common size financial statements is that the distraction of the dollar amounts is taken away. Cleaning up the statements this way allows the user to compare different companies in the same industry in a more equitable manner.

For example, just because one company has higher total revenue than another doesn't necessarily make it a better company to invest in or loan money to. Showing accounts as a percentage of another account of interest rather than a dollar amount really allows you to see the big picture of how the business is doing rather than obsessing about the difference in dollar amounts.

Chapter 4

Reading Explanatory Notes and Disclosures

In This Chapter

- Touching on corporate governance
- Studying the characteristics of a corporation
- Finding out more about a company by reading its notes and disclosures
- Figuring out who is responsible for full disclosure

This chapter begins with a quick overview of corporate governance and ends by shedding light on the explanatory notes and other information found in most corporate annual reports. For a complete picture of corporate annual reports, see Chapter 5. Annual reports educate the shareholders about corporate operations for the past year.

Also in this chapter, you find out how a business becomes a corporation, and you review the four characteristics of a corporation: continuity, easy transferability of shares, centralized management, and (the biggie) limited liability.

The complete list of notes and disclosures that may appear on a corporate annual report is quite long, so this chapter can't cover them all. Instead, it focuses on the most common explanatory notes and disclosures popping up on corporate annual reports.

Realizing How Corporations Should Govern Themselves

Simply put, *corporate governance* is the framework under which a corporation operates. At its core, this framework involves establishing financial *controls* (policies and procedures that govern how the company's finances are handled),

showing accountability to the shareholders, and making sure corporate management acts in the best interest of the shareholders and the community in which it operates. Financial controls and accountability are covered in depth in the upcoming section "Reviewing Common Explanatory Notes."

Part of a corporation's self-regulation includes fully disclosing information on its financial statements. Hence the focus on corporate governance in a chapter about financial statement notes and disclosures.

The subject of corporate governance could fill an entire book. But here are just a couple examples of ways that corporations need to self-regulate:

- **Acting in the best interests of the shareholders:** The corporation should operate so that the shareholders can expect a reasonable rate of return. For example, the corporation doesn't pay excessive bonuses to corporate officers that reduce cash flow to such a point the business can't effectively operate.
- **Being sensitive to environmental concerns:** The corporation shouldn't pollute or cause health issues through its business waste or other by-products for those living in the communities in which the business operates.

Identifying Corporate Characteristics

Many people have only a murky understanding of how a business becomes a corporation and what being a corporation means. This section quickly walks you through the process and explains the characteristics of a corporation to provide a broader context for understanding corporate governance and financial statement disclosures.

Incorporation — the process of turning a regular old business into a corporation — is governed by state statute. If a company wants to set up shop as a corporation, it must play by the rules of the state in which it operates. For more about incorporating, see Book VI, Chapter 1.

In most states, the incorporation process kicks off when the company files a *corporate charter* or *articles of incorporation* with the Secretary of State. This document contains all pertinent facts about the new corporation, including its name, address, and information about the type and number of stock shares it's authorized to issue. The corporation must name a *registered agent*: the person the Secretary of State contacts with questions about the corporation. After the charter is accepted by the Secretary of State, parties interested in purchasing shares of stock in the business hold a meeting. These new shareholders then elect a board of directors, and the corporation is off and running!

This is a very simplified version of the incorporation process, which can vary by state. An initial public offering (IPO) — when a company offers shares of common stock to the public for the first time — is much more complicated than the previous paragraph may lead you to believe.

Every corporation has four characteristics:

- **Limited liability:** This term means that investors in a corporation normally can't be pursued for corporate debt. If a vendor, a lender, or some other entity to which it owes money sues the corporation, the individual investors are generally off the hook.

  However, you may encounter exceptions to this general rule, which hinge on the corporation managing itself according to state statute. Also, the federal government and state departments of revenue can go after shareholders or corporate officers for certain types of unpaid taxes. One example is the *trust fund* portion of the payroll taxes, which includes the employee portion of federal withholding tax, Federal Insurance Contributions Act (FICA) tax, and Medicare.

- **Easy transferability of shares:** This characteristic means that if a person has the money, he can purchase shares of stock in a corporation — with the expectation of selling the shares in the future if he needs the money. However, for *closely held* corporations (those with few shareholders), this characteristic doesn't quite ring true. If you're the majority shareholder in a private corporation, you don't have to sell shares to just anyone.

  Easy transferability of shares applies more to the purchase and sale of shares of publicly traded stock. Publicly traded stocks trade on exchanges, which are set up to connect buyers and sellers. For example, if you want to buy shares of AT&T stock, you don't have to get permission from good ole' Ma Bell. You just call up your friendly neighborhood stockbroker — or go online. In either case, you make the trade through an exchange.

- **Centralized management:** The management of a corporation shouldn't be divided among many different groups. For the corporation to function at full efficiency, shareholders give up the right to chime in on every decision it makes. The shareholders elect the board of directors, who oversee the corporate operations and choose officers to handle the day-to-day business operations.

- **Continuity:** Until the corporation is formally dissolved, it's assumed to have unlimited life, continuing out into perpetuity. The members of the board of directors can change, corporate officers can change, or there can be a different mix of shareholders, but the corporation just rolls on and on.

Reviewing Common Explanatory Notes

As noted earlier in this chapter, one aspect of corporate self-governance is giving financial statement users the complete information they need in order to accurately gauge the company's performance and financial health. Some of that information comes in the form of explanatory notes.

Leveling the playing field among financial statements

Explanatory notes are discussions of items accompanying the financial statements; they contain important disclosures that aren't presented in the financial statements themselves. The financial statements are the income statement (see Book IV, Chapter 2), balance sheet (see Book IV, Chapters 3 to 5 and Book V, Chapter 1), and statement of cash flows (see Book V, Chapter 2).

Another term for an explanatory note is *footnote* or just *note*. This chapter uses all three terms so you get used to seeing them used interchangeably.

Such notes are essential to fulfill the needs of the external users of the financial statements: people like you who may be interested in investing in the business, banks thinking about loaning the company money, or governmental agencies making sure the company has complied with reporting or taxation issues. External users don't work for the company, so they aren't privy to the day-to-day accounting transactions taking place within the business.

Information that can't easily be gleaned from reviewing the financial statements has to be spelled out in notes and disclosures, which explain how or why a company handles a transaction a certain way. Full disclosure allows external users to understand what's going on at the company and creates a level playing field so an external user can compare the financial statements of one company with those of another company.

Such notes are part of the corporate annual report (see Chapter 5), which provides shareholders with both financial and nonfinancial information about the company's operations in past years.

The notes come after the financial statements in the corporate annual report and are ordered to mirror the presentation of the financial statements. In other words, notes for income statement accounts come first, followed by balance sheet notes, and then items reflecting on the statement of cash flows.

The U.S. Securities and Exchange Commission (SEC), introduced in Book IV, Chapter 1, requires certain explanatory notes specifically for publicly traded companies. However, as a best practice, many preparers of financial statements for private companies follow SEC guidelines.

Explaining significant accounting policies

This section explains the explanatory notes commonly addressed in financial accounting textbooks. Most of these subjects are presented elsewhere in this book in more detail, so you get just a brief overview here and a reference to let you know where you can find more info.

Keep in mind that each of these explanatory notes is just a light-bite (truncated) version. Depending on the company and the complexity of the underlying accounting transaction, explanatory notes can be long and boring to wade through for all but the most diligent and experienced investor. Each type of note is accompanied by a simple version of what you see in real life.

The first order of business when a company prepares its explanatory notes is to describe in general the business and its significant accounting policies. Some businesses break the two broad topics into different notes. The first could be called "Basis for Presentation" and the second "Accounting Policies." Alternatively, the company could have just one note called "Summary of Business and Accounting Policies."

Taking this first step creates a fairer presentation of the financial statements. Information about accounting policies helps financial readers to better interpret the statements. A footnote is needed for each significant accounting choice the company makes.

At the very least, the explanatory notes should include what depreciation methods are in use, how a company values its ending inventory, its basis of consolidation, how it accounts for income taxes, information about employee benefits, and accounting for intangible assets. The following sections touch on each of these subjects in turn.

Note also that explanatory notes may explain the time period and payments due on a capital lease. Leases aren't covered in detail in this book, but keep in mind that you may see leases in the notes section.

Reviewing depreciation and inventory valuation methods

Depreciation (see Book III, Chapter 1) consists of spreading the cost of a long-term asset over its useful life, which may be years after the purchase. *Inventory valuation methods* detail how a business may value its ending inventory (see Book VIII, Chapter 2).

The methods a company opts to use for both depreciation expense and inventory valuation can cause wild fluctuations for the amount of assets shown on the balance sheet and the amount of net income (or loss) shown on the income statement. Because of this fluctuation, the financial statement user needs to know which methods the company uses in order to more fairly compare one company's financial statement figures to another's. Differences in net income could merely be a function of depreciation or valuation methodology — a fact the user would be unaware of without the footnote.

Assuming that depreciation and inventory are addressed in note 1, here's a truncated example of how such a note looks:

> NOTE: SUMMARY OF BUSINESS AND ACCOUNTING POLICIES
>
> We compute inventory on a first-in, first-out basis. The valuation of inventory requires we estimate the value of obsolete or damaged inventory.
>
> We compute depreciation for financial reporting purposes using the straight-line method, generally using a useful life of 2 to 5 years for all machinery and equipment.

Consolidating financial statements

Consolidation is what happens when companies merge or when a larger company (called a parent company) acquires one or more smaller ones (subsidiaries). In the context of generally accepted accounting principles (GAAP), *consolidation* refers to the aggregation of financial statements of two or more companies so those statements can be presented as a whole. In this section of the footnotes, the company confirms the fact that the consolidated financial statements do indeed contain the financial information for all its subsidiaries. Any deviations from including all subsidiaries must be explained.

Here's a truncated example of a note addressing consolidation:

> NOTE: SUMMARY OF BUSINESS AND ACCOUNTING POLICIES
>
> Our consolidated financial statements include our parent account and all wholly owned subsidiaries. Intercompany transactions have been eliminated, and we use the *equity method,* which means we report the value based on our proportionate ownership, to account for investments in which we own common stock.

Accounting for income taxes

Financial statements prepared by using GAAP and those prepared for tax purposes differ. The former are created by using what's called *book* accounting, and the latter are created by using *tax* accounting. Temporary and permanent differences can exist between the book and tax figures. Keep reading for a brief explanation of each difference.

Here's an example of a permanent difference: Using book accounting, assume a business can expense 100 percent of meals and entertainment costs it incurs in the normal course of business. For tax purposes, however, it can expense at most 50 percent of that same cost. This is a permanent difference because under the Internal Revenue tax code, the business is never able to expense 100 percent. The difference between book and tax expenses is permanent.

The most common temporary difference relates to depreciation. Assume that, for book purposes, a company uses straight-line depreciation and for tax purposes a more accelerated method. In the short run, there will be a difference in depreciation expense. Eventually, over time, the amount of depreciation the company expenses for an asset will balance out so that under either method the total amount of depreciation is the same. The difference in depreciation expense is only temporary.

The company must address the differences between book and tax, called *deferred tax assets and liabilities,* in the footnotes to the financial statements. Here's a truncated example of how such a note may look:

> NOTE: TAXES
>
> Income before taxes was $7.68M, and the provision for federal taxes was $2.78M, an effective tax rate of 36.2 percent. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting versus for tax reporting purposes.

Spelling out employee benefits

Details about the company's expense and unpaid liability for employees' retirement and pension plans are also spelled out in the footnotes. The obligation of the business to pay for postretirement health and medical costs of retired employees must also be addressed.

Accounting for employee benefits is a somewhat advanced accounting topic. Just remember that employee benefits require an explanatory note, and you'll be fine.

Here's a truncated example of how such a note looks:

> NOTE: RETIREMENT BENEFIT PLANS
>
> We provide tax-qualified profit sharing retirement plans for the benefit of our eligible employees, former employees, and retired employees. As of December 31, 2015, approximately 80% of our profit sharing fund was invested in equities with the rest in fixed-income funds. We have independent external investment managers.

Walking through intangibles

Intangible assets aren't physical in nature as is a desk or computer. Two common examples of intangibles are *patents,* which license inventions or other unique processes and designs, and *trademarks,* which are unique signs, symbols, or names that the company uses. (See Book IV, Chapter 3 for more information about intangibles.) Besides explaining the different intangible assets the company owns via an explanatory note, the business also needs to explain how it has determined the intangible asset's value posted to the balance sheet.

Here's a truncated example of how such a note looks:

> NOTE: INTANGIBLE ASSETS
>
> We classify intangible assets with other long-term assets. As of December 31, 2015, our intangible assets consisted of the following: patents, copyrights, and goodwill. They are generally amortized on a straight-line basis. We perform a yearly review to determine whether useful life is properly estimated, and to determine whether the value of the intangible asset has been impaired.

Looking for important event disclosures

A company must also provide information in its annual report explaining the following topics: accounting changes, business combinations, contingencies, events happening after the balance sheet date, and segment reporting.

The topic of event disclosure is usually discussed separately from the topic of explanatory notes that accompany financial statements. But keep in mind that event disclosure information goes in the footnotes to the financial statements right along with the accounting method information described in the previous section.

Accounting changes

A company may have up to three types of accounting changes to report: a change in accounting principle, a change in an accounting estimate, or a change in a reporting entity. Narrative descriptions about accounting changes go in the explanatory notes to the financial statements very early in the game — usually in the first or second note.

Following is an explanation of each type of accounting change:

- **Accounting principles** guide the way the company records its accounting transactions. Under GAAP, a company is usually allowed different ways to account for transactions; for example, GAAP allows companies to use different depreciation methods to expense the cost of long-lived assets.

  

  For financial statements, changes in accounting principle have to be shown by retrospective application to all affected prior periods (unless doing so isn't practical). This process involves three steps:

  - Adjust the carrying amounts of affected assets and liability accounts for the cumulative effect of the change.
  - Take any offset (difference in amounts) to beginning retained earnings. In other words, the difference in carrying amounts either increases or decreases beginning retained earnings.
  - If the financial report shows multiple years for comparison, show the effect of the new accounting principle in each of the reported years.

- **Accounting estimates** are numbers a company enters into the financial records to reflect its best guesses as to how certain transactions will eventually shake out. For example, going back to the depreciation example, consider the estimate for *salvage value,* which is how much a company assumes it will be able to get for a long-lived asset when the time comes to dispose of it. If something happens to make you believe your original estimate of salvage value was wrong and you change it, that's a change in accounting estimate.

  

  A change in accounting estimate has to be recognized currently and prospectively. For example, if salvage value is recalculated, the current and future financial statements show the salvage value as corrected. No change is made to prior period financial statements.

- **Reporting entities** reflect which business combinations are shown on the financial statements, also known as *consolidated* financial statements. When a business owns more than 50 percent of another business, the investor business is called a *parent* and the investee is the *subsidiary.* If something changes in the way the subsidiaries show up on the financial statements, that's a change in reporting entity.

  

  Changes in reporting entities are shown retrospectively to the financial statements of all prior periods. This means you have to show the dollar amount effect of the change of reporting entities in the balances of all related assets and liabilities. Any offsetting amount goes to the beginning balance of retained earnings.

Business combinations

Accounting textbooks typically cover basic *business combinations,* which include these three:

- **Mergers:** Two or more companies combine into a single entity. Mergers are usually regarded as friendly combinations — not hostile takeovers.
- **Acquisitions:** One company acquires another business. The business doing the acquiring takes over, and in essence the *target* (acquired) company ceases to exist. Acquisitions usually aren't quite as friendly as mergers.
- **Dispositions:** A company transfers, sells, or otherwise gets rid of a portion of its business. For example, a shoe manufacturer makes dress shoes, slippers, and tennis shoes and decides to sell its slipper division to another company.

If a company involves itself in any of these three activities during the financial reporting period, it has to explain the transaction and spell out the effect of the business combination on the financial statements. Business combination information goes in the explanatory notes to the financial statements very early in the game; it first crops up in the first or second note, and then it's addressed as needed in subsequent notes.

If a company is involved in a disposition, GAAP dictates that it disclose not only the facts and circumstances surrounding the disposition but also any anticipated operational losses from getting rid of a portion of its business. The losses are calculated *net of tax,* which means you factor in any increase or decrease in tax due because of the disposition. The company must also show any loss or gain on the sale of that portion of the business (also net of tax) on the income statement. These results are pulled out and reported separately because they won't continue into the future. This activity is typically posted to an account called income (or loss) from discontinued operations.

Contingencies

A *contingent liability* exists when an existing circumstance may cause a loss in the future depending on other events that have yet to happen (and, indeed, may never happen). For example, the company is involved in an income tax dispute. Disclosing this contingent liability is a requirement if the company will owe a substantial amount of additional tax penalties and interest should the unresolved examination end up in the government's favor. See Book IV, Chapter 4 for a general discussion about contingencies.

Here's a truncated example of a contingency note:

NOTE: COMMITMENTS AND CONTINGENCIES

> As of December 31, 2015, we were contingently liable for guarantees of indebtedness owed by third parties in the amount of $3 million. These guarantees relate to third-party vendors and customers and have arisen through the normal course of business. The amount represents the maximum future payments that we could be responsible to make under the guarantees; however, we do not consider it probable that we will be required to satisfy these guarantees.

A contingent liability needs to be reported not only as a disclosure via a footnote to the financial statements but also in the financial statements if it's probable and the amount of loss can be reasonably estimated. This disclosure specifically states that the company doesn't consider the loss contingency probable, so footnote disclosure without inclusion in the financial statements is all that's required for this example.

Events happening after the balance sheet date

The company also must address any subsequent events happening after the close of the accounting period but before the financial statements are released. Like contingent liabilities, depending on their nature, subsequent events may just need a disclosure in the footnotes to the financial statements, or they may require both a disclosure and an adjustment to the figures on the financial statements to reflect the dollar amount effect of the subsequent event.

How the company handles the event happening after the balance sheet date depends on whether the event is classified as a Type I or Type II event:

- **Type I events:** These events affect the company's accounting estimates reflecting on the books but not confirmed as of the balance sheet date. (See the earlier section "Accounting changes" for an explanation of accounting estimates.) A good example is the estimate for uncollectible accounts. This estimate exists on the books at the balance sheet date, but the company can't be sure of the resolution of the estimate until a subsequent event occurs, such as a customer filing for bankruptcy. At that point, the company confirms that the amount is actually uncollectible.

  If the confirming event (such as the bankruptcy) occurs after the balance sheet date but before the financial statements are finalized, the company has to adjust its financial statements. Footnote disclosure can be used to explain the event as well.

- **Type II events:** These events aren't on the books at all before the balance sheet date and have no direct effect on the financial statements under audit. The purchase or sale of a division of the company is a classic example of a Type II event.

  These events are also called *nonrecognized events.* This means that if they're material, they have to be disclosed in footnotes to the financial statements, but the financial statements don't have to be adjusted.

Here's a truncated example of a note on an event taking place after the balance sheet date:

> NOTE: SUBSEQUENT EVENT
>
> On February 1, 2015, we entered into an agreement to sell our ownership interests in our ABC division to XYZ Manufacturing for approximately $5 million in cash. The transaction is subject to certain regulatory approvals. We expect the transaction to close in the 4th quarter of 2015.

Segment reports

Business segments are components operating within a company. For example, a clothing manufacturer makes dresses, blouses, pants, and sweaters; these are all business segments. If a business has various segments, it must disclose info about each segment — such as its type, geographic location, and major customer base — so that the users of the financial statements have sufficient information. Here's a truncated example of how such a note looks:

> NOTE: SEGMENT REPORTING
>
> As of December 31, 2015, our organizational structure consisted of the following operating segments: North America and Europe. Our North American segments derive the majority of their revenue from the sale of finished clothing. Our European segment derives the majority of its revenue from the sale of fabric and notions to other European companies.

Putting the Onus on the Preparer

The explanatory notes and disclosures, like the financial statements themselves, are the responsibility of the company's management and its accounting staff. Management and the internal accounting staff prepare the explanatory notes and disclosures by using the applicable American Institute of Certified Public Accountants (AICPA) disclosure checklist. All GAAP guides contain a comprehensive appendix listing the full AICPA disclosure checklist.

After management prepares the financial statements and explanatory notes and disclosure information, the company often hires an independent certified public accountant (CPA) to evaluate management's work. The CPA is *independent,* which means she has no special relationship to or financial interest in the company. The CPA may or may not be required to be independent, depending on the work the CPA performs for the client.

CPAs perform three major types of financial statement work:

- **Audits:** *Auditing* is the process of investigating information that's prepared by someone else, usually company management and the accountants the company employs, in order to determine whether the financial statements are fairly stated. CPAs performing audits must investigate the assertions that a company makes on its financial statements, including any notes and disclosures.

  Financial statement assertions often relate to how the company conducts business, such as how it makes and spends money and how it records financial information about its property, plant, and equipment; its long-term liabilities and equity; and its cash and investments.

  An audit provides a reasonable level of *positive assurance,* which means the financial statements are free of material errors and are stated in accordance with GAAP. An audit does not, however, provide an absolute guarantee that the financial statements contain no errors. Also, an audit isn't designed or performed to detect all fraud.

  Although accountants employed by the business prepare the financial statements (including the notes and disclosures), only an independent CPA can audit them. If auditing is a subject that interests you, check out *Auditing For Dummies* by Maire Loughran (Wiley).

- **Reviews:** When a CPA conducts a *review,* she looks at the company's documents and provides *negative assurance,* which means the CPA finds no reason to believe the information prepared by company management is incorrect. For example, the CPA looks over the company's financial statements, noting whether they're of proper appearance. For example, do the statements contain appropriate explanatory notes and disclosures per the AICPA disclosure checklist? Do they conform to GAAP? Reviews are usually performed for privately owned companies when the users of the financial statements require some sort of assurance about the financial statements' assertions but don't require a full-blown audit.

- **Compilations:** If a CPA is hired to do a compilation, she can compile financial statements (using information provided by company management) that omit footnote disclosures required by GAAP or that use another *comprehensive basis of accounting,* such as cash-basis accounting (see Book III, Chapter 6). Preparing the statements this way is okay as long as omitting the explanatory notes and disclosures is clearly indicated in the report without intent to mislead users.

  When footnote disclosures have been omitted, CPAs add a paragraph to the compilation report stating that management has elected to omit disclosures. This paragraph lets the user know that if the financial statements did contain the explanatory notes or disclosures, that information may affect their conclusions.

Here's an example of the language used when a company is omitting compilation disclosures:

> Management has elected to omit substantially all the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the users' conclusions about the company's financial position, results of operations, and its cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Chapter 5

Studying the Report to the Shareholders

In This Chapter

- Staying private or going public: Why annual reports differ among companies
- Identifying the three purposes of a corporate annual report
- Recognizing common sections in an annual report
- Analyzing Form 10-K

Most of the chapters in Books IV and V are devoted to explaining how to prepare financial statements (the income statement, balance sheet, and statement of cash flows). But what happens to these statements after they're done? Do they just get filed away in case anyone asks to see them?

Absolutely not! The financial statements become the heart of a company's annual report to its shareholders. An *annual report* is a document that the company can share with its current owners, potential investors, creditors, the media, and so on; it can be an important public relations tool that shows the outside world how the company is doing. For many companies, the report is also a regulatory requirement.

This chapter explains the ins and outs of a corporate annual report, including the three key purposes it serves. Here you also find out about Form 10-K, an annual filing that the U.S. Securities and Exchange Commission (SEC) requires from most publicly traded companies.

Why Private and Public Companies Treat Annual Reports Differently

A corporate annual report (which may also be called the *annual report* or the *annual report to shareholders*) may look different depending on whether the company in question is private or public.

The corporate annual report for a *private* company — one whose stock isn't traded on the open market — is usually a bare-bones document that gives users just the mandatory information about how the company performed in the past year. You don't find many bells and whistles in a private company's report. That's because most private companies are *closely held* (they have a small number of owners), so they aren't too concerned about how a larger audience will react to the report. On the other hand, a public company's report is often loaded with bells and whistles, such as marketing material designed to tout the company to potential investors and creditors.

Another key difference between the annual reports of private and public companies is that private companies don't always have their financial statements audited, while public companies do. A private company usually has its financial statements audited only if doing so is required to fulfill a business purpose. (Perhaps a creditor or an insurer providing *bonding* — compensation to customers in case the company doesn't fulfill its obligations — requires an audit.)

As explained later in this chapter, public companies' financial statements must always be audited in order to fulfill regulatory requirements. What does it mean for the statements to be audited? After the company creates the statements, it employs an independent certified public accountant (CPA) to gather sufficient information to express an opinion on whether the statements are materially correct. (In other words, they don't contain any misstatements that could significantly impact the decisions made by the financial statement users.) See Book IX for a more detailed explanation of auditing.

Only after a public company's financial statements are audited can they be included in the company's annual report to the shareholders.

This chapter focuses on the annual reports that large public companies prepare to show you what the most elaborate reports look like. You can access the corporate annual report for just about any publicly traded corporation online. Go to the home page of any company in which you have an interest. Look for an "Investor" link on the home page, and click it. *Voilà!* Chances are you're looking at the annual report. If you can't easily find the "Investor" link, don't spin your wheels. Just search the web by using the key phrase "[Company name] corporate annual report." You'll likely locate it easily.

Fulfilling Three Purposes

This section spells out the three distinct goals of the annual report for a public corporation: to promote the company, to display its financial performance and goals, and to meet regulatory requirements.

Something to keep in mind: Going forward, large public corporations will undoubtedly turn more and more toward electronic media to distribute their annual reports. Doing so is a cost-saver and demonstrates a corporation's commitment to using resources wisely.

Serving a marketing and PR function

A substantial portion of a corporate annual report is devoted to the company's bragging about what it has accomplished during the preceding year and where it expects to go in the coming year. The language can be full of hyperbole and puffery. The purpose of this marketing and public relations material is to keep existing shareholders pumped up about the wisdom of their investment and to attract new shareholders to the fold.

Stating financial performance and goals

Less flashy but of decidedly more interest to serious investors are the sections addressing the corporation's financial performance in the past year. The information in these sections indicates how closely the company came to hitting projected revenue figures. Additionally, the company addresses how it intends to improve financial performance going forward.

Here are some examples of financial goals:

- Increasing revenue by expanding into global markets.
- Becoming regarded as a premier employer.
- Managing operations for the greatest effectiveness.
- Increasing brand awareness. *Brand awareness* is a fancy way of saying the company wants to make sure consumers recognize the company and its signature products. The purpose of brand awareness is also tied to making the company's products preferred over similar ones marketed by the competition.

Meeting regulatory requirements

Most large companies would produce an annual report even if the U.S. government didn't require them to. That's because an annual report is such a crucial marketing and PR tool. However, because publicly traded companies must adhere to stringent regulatory requirements, not issuing an annual report isn't an option.

Companies that issue publicly traded securities — as well as companies that meet certain other criteria — have to file annual reports with the U.S. Securities and Exchange Commission (SEC). The specific report required by the SEC is called *Form 10-K.* The final section of this chapter explains which companies have to file this form and what exactly it entails.

To avoid having to create two separate types of annual reports, some companies include in their reports to shareholders all the information that the SEC requires be included in Form 10-K. SEC and other regulatory bodies are addressed in Book IV, Chapter 1.

Reading the Annual Report to Shareholders

This section takes you through the sections that you most often find in a corporate annual report. With the exception of the audited financial statements, the sections are put together in an effort to draw the external reader into the inner workings of the business in an attempt to raise the users' comfort with and confidence in the company. Audited financial statements, on the other hand, require a specific presentation.

Writing the narrative for a corporate annual report is an art. Many times, the report is contracted out to professionals rather than produced in-house, although the company's chief executive or managing director always has a say in the format of the report.

Keep in mind that this section contains just a brief overview of what you may expect to see in a corporate annual report. Especially if a company is large, it may include a plethora of additional information.

If you have the time, check out *Reading Financial Reports For Dummies* by Lita Epstein (Wiley). While the following sections touch on the fundamentals, this book walks you through reviewing financial reports from A to Z.

Meeting the chair of the board of directors

Most casual investors in a corporation have absolutely no idea who the chairperson of the board of directors is or what that person does. Although the duties of the chairperson are similar from company to company, the individual holding the position is unique to the particular company.

The chairman of the board of directors is the head honcho who oversees the board of directors (and is usually elected by the other members of the board). The board of directors consists of individuals elected by the shareholders to guide the company based on the firm's mission or vision.

The board of directors doesn't handle the day-to-day activities of any business; that's management's job. However, approving the hiring of upper management personnel, such as the chief executive officer (CEO), is a function of the board of directors.

In the corporate annual report, you meet the chairman via a letter whose salutation is something like "Dear Fellow Shareholder." The letter gives the company's top management team a chance to review all the accomplishments the company achieved during the preceding year. The letter also summarizes goals for the future. It ends by thanking the shareholders for their support and offering a firm promise to work tirelessly to continue earning the trust of the shareholders and growing their value in the company stock.

Highlighting key financial data

In the beginning of the annual review, the company gives the shareholders a condensed version of how well the company performed during the preceding year. This condensed info provides the more casual readers with what the company perceives as the main points of interest. At the least, this section contains a summary of operations, earnings per share data, and balance sheet data:

- **Summary of operations:** This summary shows the company's bottom line net income for at least three years (and preferably five to ten years). *Net income* is the excess of revenue and gains over expenses and losses during a financial period.
- **Earnings per share (EPS):** This calculation shows the net income per outstanding share of common stock. Read on for an explanation of this formula. Many investors focus on this figure, comparing it to their other investments and to other companies' EPS in the same industry. For example, an investor may compare the EPS of The Coca-Cola Company to the EPS of PepsiCo to gauge the value of one company's stock over the other, given that these companies are in the same industry.

Three calculations you may see in an annual review are basic EPS, diluted EPS, and cash dividends (see Book IV, Chapter 5 for additional details on all three). Here's an example of each:

- **Basic EPS:** To figure basic EPS, take net income for the financial period and divide it by the weighted average number of shares of common stock outstanding. The weighted average factors in the fluctuations of stock outstanding during the entire year instead of just taking stock outstanding at January 1 and stock outstanding at December 31 and dividing it by two.

  If ABC Corp. has net income of $100,000, and the weighted average number of shares of common stock outstanding is 21,833, basic EPS is $100,000 ÷ 21,833 = $4.58.

- **Diluted EPS:** If the company has issued stock options or convertible debt or convertible preferred stock that the investor has the option to convert into common stock, the company has to show diluted EPS, which is a complicated calculation. (*Stock options* are benefits allowing employees to purchase a certain number of shares of company stock at a pre-determined date and price.)

  Diluted EPS calculates earnings per share by estimating how many shares could theoretically exist after all stock options and convertible securities have been exercised into common stock shares. So if ABC Corp.'s weighted average of common stock outstanding after adding in these extras is 24,989, its diluted EPS is $100,000 ÷ 24,989 = $4.00.

- **Cash dividends:** This calculation is the amount per share paid to shareholders of record. The company must have earnings to pay a dividend, because dividends are a payment of earnings. The board of directors determines the dividend paid, if any, to shareholders of record.

- **Balance sheet data:** This section shows selected figures from the balance sheet in which the company believes the shareholders have an interest. For example, the company may show *total assets,* which are all assets (current and long-term) that the company owns as of the balance sheet date. The company may also show *long-term debt,* which is any debt the company won't have paid off within 12 months of the balance sheet date.

Even though these figures are compressed, they're based upon — and must reconcile with — the audited financial statements.

Figure 5-1 shows an example of this condensed financial data.

Year Ended December 31,	2015	2014	2013
Summary of Operations:			
Net operating revenues	$100,000	$ 98,000	$105,000
Earnings Per Share:			
Basic	$ 4.58	$ 4.75	$ 3.89
Diluted	4.00	4.25	3.97
Cash dividends	1.75	1.62	1.24
Balance Sheet Data:			
Total assets	$ 35,271	$ 33,620	$ 39,587
Long-term debt	5,060	3,782	1,318

Figure 5-1: Select financial information.

Touting company achievements

In this section, which has a distinct public relations purpose, the company expands upon any facts the chairman of the board discusses in his letter to the shareholders. For example, this section may break out how the company has increased growth *per capita,* which is the average per person living in an area the company serves. Per capita growth could mean that the company sold more products to existing consumers or expanded its sales base into new markets or countries. Companies want to emphasize that they're attracting new customers while still maintaining a bond with existing customers.

Looking into the future

In its annual report, a company also addresses where it sees itself in the future — both short-term and long-term. Although the business may not provide specific financial targets (like total sales or new customers), it gives the reader its strategy for moving forward. Doing so addresses any concerns that an investor may have that the business is a *going concern:* that it will be able to stay in business for at least 12 months beyond the balance sheet date, generating or raising enough cash to pay its operating expenses and make appropriate payments on debt.

Obviously, investors aren't going to get all fired up about their ownership in the company stock if they believe the company will be around for only a couple more years. Therefore, annual reviews normally give a three-to-five-year plan on growth methodology. Often, companies associate their growth predictions with social and economic transitions — for example, changes in population demographics such as aging and income.

Getting to know key management and board members

This section of the annual report introduces other members of the board of directors, the management team for each division of the company, and committee members (such as members of the audit committee). Most likely, the report includes pictures of all of them posed at the company headquarters.

Walking through Form 10-K

The U.S. Securities and Exchange Commission (SEC) requires that all companies registered with it annually file Form 10-K shortly after the end of the company's fiscal year. The SEC also requires that Form 10-Q must be filed each fiscal quarter. Companies that have a certain class of securities, a certain level of assets or number of holders, and/or which are publicly traded must register with the SEC:

- **Class of securities:** Any company issuing securities traded publicly on a stock exchange or in the *over-the-counter market* (where dealers buy from and sell to interested investors for their own accounts via the phone or computer) must register with the SEC.
- **Assets or holders:** Any company with more than $10 million in assets and 500 or more holders of any class of equity, such as common or preferred stock, must register as well.
- **Publicly traded:** Any company whose equity (stock) or debt (bonds) is publicly sold pursuant to a registration statement must register with the SEC.

  A *registration statement* is filed with the SEC when a company wants to issue securities to the public. It includes a full and fair disclosure of the securities being issued, info about the company and what it does, the company's financial position, and what the company plans to do with the proceeds from the issuance. The company submitting the filing is referred to as the *registrant.*

Registration with the SEC doesn't mean the SEC is giving the company a stamp of approval. It merely means the company has provided all documents required for registration.

Form 10-K consists of a facing page and four additional parts: business, market/financial, management/corporate governance, and exhibits/financial statement schedules. The following sections explain each part in turn.

Facing page: Identifying the affected company

The facing page of Form 10-K gives basic info about the company (the SEC registrant), including its name, address, telephone number, and the fiscal year in question. It also lists the title and class of securities (equity and debt) that are registered with the SEC and the number of shares outstanding. Some more advanced information appears on the facing page as well, such as whether the company is required to file certain reports or has done so voluntarily.

Part I: Finding out more about the registrant

Part I contains information about the company, including an overview of what the company does and any risk factors surrounding it. An example of a *risk factor* may be heightened competition hurting the core business or a significant depletion of the raw materials needed to make its products.

This section requires the following additional info:

- The year the company organized
- Its form of organization
- Any bankruptcy proceedings, business combinations, or changes in the method of conducting its business

For example, the registrant may state, "We were incorporated in February 1945 under the laws of the State of Delaware and succeeded to the business of a New York corporation."

The Part I information can be incorporated by reference from the annual report to the stockholders if that report contains the required disclosures. If the company opts to do this, it must cross-reference Form 10-K to the annual report showing what was incorporated and from which pages in the annual report. For example, the company could write, "See page 10 of the 2015 annual report for this information."

Part II: Revealing the company's financial performance

Part II is really the meat of Form 10-K because it reveals a company's financial performance in the past year. This part features information about

where the company's stock is traded, analysis and discussion from company management, and the audited financial statements.

Market information and financial highlights

In Part II, the company tells the SEC in which market the company's common stock lists and trades. Two U.S. examples are the New York Stock Exchange and NASDAQ.

The company also lists the high and low common stock market prices and dividends declared for the year in question. More than likely, the company will also include its key financial data from the annual report to stockholders. (See the earlier section "Highlighting key financial data.")

Management discussion and analysis

Part II also includes a management discussion and analysis section. Normally, management recaps business operations and discusses significant financial trends within the company during the past couple years. For example, for a fast-food restaurant, management would probably discuss how government regulations to combat obesity are expected to affect the business.

Audited financial statements

The audited financial statements, critical accounting policies, estimates, and explanatory notes and disclosures also appear in Part II. *Accounting policies* include how a company recognizes revenue and expenses and where these figures show up on the financial statements. An example of an *estimate* is the *allowance for uncollectible accounts,* which is what the company anticipates it won't be able to collect from customers who have purchased on credit; see Book IV, Chapter 3. For additional guidance on explanatory notes and disclosures, see Chapter 4.

Auditing is the process of systemically gathering enough evidence to support the facts a company is showing in the financial statements. The results of an audit are communicated to all interested users in a format that they can both understand and use for their intended purposes.

The goal of a financial statement audit is for the auditor to form an opinion regarding whether the financial statements are or aren't free of material misstatement. Auditors aren't responsible for preparing the financial statements they're auditing. In fact, they *can't* prepare them; to do so would violate the concept of independence.

Therefore, the items under audit are company management's responsibility. In other words, the financial statements contain *management assertions* — management's assurance that the information provided is materially correct. A company accountant uses these assertions to produce the financial statements.

After conducting the audit of the financial statements, the auditor can express one of four basic options:

- **Unqualified:** An *unqualified* opinion is the best the client can get! It means that the audit has been conducted in accordance with generally accepted auditing standards (GAAS) *and* that the financial statements conform with generally accepted accounting principles (GAAP) in all material aspects.
- **Qualified:** An auditor may have to issue a qualified opinion when the company doesn't use GAAP consistently, or circumstances may have prevented the auditor from getting enough evidence to be able to issue an unqualified opinion. When the end user (a potential investor, for example) sees this opinion, she knows she can't rely on the information in the financial report as much as she could if the auditor offered an unqualified opinion. Qualified opinions are referred to as "except for" opinions, because the language in the audit report often uses the phrase "except for" to explain why the report is qualified.
- **Adverse:** As you can probably guess, an adverse opinion isn't good! The auditor issues an *adverse* opinion if the financial statements don't present the client's financial position, results of operations, and cash flows in conformity with GAAP. This type of opinion is issued only when the financial statements contain material departures from GAAP. (Book IV, Chapter 1 defines materiality and how it applies to financial statements. For now, just realize that what is material for one business may not be material for another.)
- **Disclaimer of opinion:** This happens when the auditor can't form an opinion on a client's financial statements. For example, a disclaimer may be issued in cases when the auditor isn't independent.

Book IX, Chapter 1 displays a standard unqualified audit opinion. That report gives you some idea of the language used.

Part III: Identifying management and corporate governance

Yippee! You've successfully navigated the more detailed parts of Form 10-K. Heading toward the finish line, next up is a discussion of management and governance. In this short section, the company lists its directors and executive officers — most likely with a reference back to Part I of Form 10-K (if that section has already provided sufficient information).

For example, Part III may read as follows: "See Item X in Part I of this report for information regarding executive officers of the corporation." Otherwise, the company lists here each individual's name, title/office, and any other relevant information (such as whether the individual is associated with another unrelated organization).

Now, what about corporate governance? Some of the issues corporate governance addresses are ethical business behavior, responsibility for the community in which the company operates, and equitable treatment of the shareholders. For example, corporate governance demands full and fair disclosure associated with the financial statements so investors can make informed decisions. For a manufacturing company, this section may note that it takes care not to pollute the drinking water of adjacent cities with illegal dumping of factory runoff.

Most companies state that they have a Code of Business Conduct for both employee and nonemployee directors. If the code isn't included in Form 10-K, the form will at least provide information as to where on the company website this information resides. See Chapter 4 for more about corporate governance.

Part IV: Exhibits, financial statement schedules, and signature

This section merely lists the documents that are part of Form 10-K and gives the exhibit number where each document can be found. This section can go on interminably, listing such exhibits as "Exhibit No. 6.8.5: 2005 Stock Option Plan of the Company: amended and restated through December 31, 2015." Pretty exciting stuff!

Finally, the last page contains the signature of the chairman of the board of directors, the chief executive officer, the chief financial officer, the principal accounting officer, all directors, and the *attorney-in-fact* (the individual holding power of attorney) attesting to the fact the report doesn't contain any untrue statement of a material fact or omit any necessary material facts.