LEARNING MADE EASY

4th Edition

Reading Financial Reports for dummies

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Read between the lines and interpret the fine print

Understand the accounting that builds a report

Make smart, data-supported business decisions

Lita Epstein, MBA

Finance Wizard

Reading Financial Reports

4th Edition

by Lita Epstein, MBA

for dummies
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Reading Financial Reports For Dummies®

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Introduction

When I open an annual financial report today, one of the first questions I ask myself is, "Can I believe the numbers I'm seeing?" I never used to think that way. I used to think that any corporate financial report audited by a certified public accountant truly was prepared with the public's interests in mind.

The financial scandals of the late 1990s and early 2000s destroyed my confidence in those numbers, as they did for millions of other U.S. investors who lost billions in the stock market crash that followed those scandals. Sure, a stock bubble (a period of rising stock prices that stems from a buying frenzy) had burst, but financial reports that hid companies' financial problems fueled the bubble and helped companies put on a bright, smiling face for the public. After these financial reporting scandals came to light, more than 1,800 public companies had to restate their earnings. Yet in almost a repeat of the scandals, the mortgage mess of 2007 showed how financial institutions were still using the same tricks of keeping key financial information off the books to hide financial troubles.

I still wonder what government regulators and public accountants were thinking and doing during these fiascos. How did the system break down so dramatically and so quickly? Although a few voices raised red flags, their pleas were drowned out by the euphoria of the building stock market bubble of the early 1990s and the housing market bubble of the mid-2000s.

These financial scandals occurred partly because Wall Street measures success based on a company's quarterly results. Many analysts on Wall Street are more concerned about whether a company meets its quarterly expectations than they are about a company's long-term prospects for future growth. Companies that fail to meet their quarterly expectations find their stock quickly beaten down on the market. To avoid the fall, companies massage their numbers. This shortsighted race to meet the numbers each quarter is a big reason these scandals happen in the first place.

Since the scandals broke, legislators have enacted new laws and regulations to attempt to correct the problems. In this book, I discuss these regulations and show you how to read financial reports with an ounce of skepticism and a set of tools that can help you determine whether the numbers make sense. I help you see how companies can play games with their numbers and show you how to analyze the numbers in a financial report so you can determine a company's true financial health.

About This Book

This book provides detailed information on how to read a financial report's key statements — the balance sheet, the income statement, and the statement of cash flows — as well as how to discover and scour a report's other important parts.

When you finish reading this book, you'll understand what makes up the parts of financial statements and how to read between their lines, using the fine print to increase your understanding of a company's financial position. You'll also be familiar with the company outsiders who are responsible for certifying the accuracy of financial reports, and you'll know how the rules have changed since the corporate scandals broke. Although I can't promise that you'll be able to detect every type of fraud, I can promise that your antennae will be up and you'll be more aware of how to spot possible problems.

And most important, you'll get a good understanding of how to use these reports to make informed decisions about whether a company is a sound investment. If you work inside a company, you'll have a better understanding of how to use the reports to manage your company or your department for success.

Conventions Used in This Book

I use the words *corporation* and *company* almost interchangeably. Just so we're on the same page, all corporations are companies, but not all companies are corporations. The key difference between them is whether a company has gone through *incorporation,* which is the rather complicated legal process by which a company gets a state charter to operate as a business. To find out more about company structure and incorporation, see Chapter 2.

To help you practice the tools I show you in this book, I use the annual reports of the two largest toy companies, Mattel and Hasbro, and dissect their reports throughout various chapters. You can download a full copy of the reports by visiting the investor relations section of the companies’ websites: `www.hasbro.com` and `www.mattel.com`.

What You're Not to Read

Many of the topics I discuss in this book are, by nature, technical — dealing with finances can hardly be otherwise. But in some cases, I provide details that offer more than the basic stuff you need to know to understand the big picture. Because these explanations may not be up your alley, I mark them with a Technical

Stuff icon (see the upcoming section “Icons Used in This Book”) and invite you to skip them without even the slightest regret. Even if you skip them, you still get all the information you need. On the other hand, if you savor every financial detail or fancy yourself the bravest of all financial report readers, then dig in!

I've also added some sidebars to give you more detail about a topic or some financial history. You can skip those, too, and still be able to understand how to read financial reports.

Foolish Assumptions

To write this book, I made some basic assumptions about who you are. I assume that you

- Want to know more about the information in financial reports and how you can use it.
- Want to know the basics of financial reporting.
- Need to gather some analytical tools to more effectively use financial reports for your own investing or career goals.
- Need a better understanding of the financial reports you receive from the company you work for to analyze the results of your department or division.
- Want to get a better handle on what goes into financial reports, how they're developed, and how to use the information to measure the financial success of your own company.

Both investors and company insiders who aren't familiar with the ins and outs of financial reports can benefit from the information and tools I include in this book.

Icons Used in This Book

Throughout the book, I use icons to flag parts of the text that you'll want to notice. Here's a list of the icons and what they mean.

TIP This icon points out ideas for improving your financial report reading skills and directs you to some useful financial resources.

REMEMBER This icon highlights information you definitely want to remember.

WARNING This icon points out a critical piece of information that can help you identify the dangers and perils in financial reports. I also use this icon to emphasize information you definitely don't want to skip or skim when reading a financial report.

TECHNICAL STUFF This icon highlights information that may explain the numbers in more detail than you care to know. Don't worry; you can skip these points without missing the big picture!

Throughout the book, I give examples from financial reports of real companies, particularly Mattel and Hasbro. I highlight these examples with the icon you see here.

Beyond the Book

In addition to the material in the print or e-book you're reading right now, this product comes with some access-anywhere goodies on the web. You'll probably need reminders about the key parts of an annual report or the best financial analysis formulas to use. To view the Cheat Sheet, go to `www.dummies.com` and type “Reading Financial Reports For Dummies Cheat Sheet” in the search box.

Where to Go from Here

You can start reading anywhere in this book, but if you're totally new to financial reports, you definitely want to start with Part 1 so you can get a good handle on the basics before delving into the financial information. If you already know the basics, turn to Part 2 to begin dissecting the parts of a financial report. And to get started on the road to analyzing the numbers, turn to Part 3. If your priority is tools for optimizing company operation, you may want to begin with Part 4. Turn right to Part 5 if you want to know more about company outsiders involved in the financial reporting process.

Part 1

Getting Started with Financial Reports

IN THIS PART ...

Explore the types of financial reports and get to know the key financial statements.

Discover business types and their tax rules, including sole proprietorships, partnerships, and limited liability companies.

Differentiate between public and private companies, and understand what it means when a company decides to go public.

Understand accounting basics — enough to understand different kinds of profit, and to distinguish debits from credits.

Chapter 1

Opening the Cornucopia of Reports

IN THIS CHAPTER

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

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

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

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

Figuring Out Financial Reporting

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

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

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

Preparing the reports

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

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

Seeing why financial reporting counts (and who's counting)

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

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

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

how creditors gauge whether a business meets their requirements, see Chapters 9 and 12.

If a firm's financial reports are false or misleading, creditors may loan money at an interest rate that doesn't truly reflect the risks they're taking. And by trusting the misleading information, they may miss out on a better opportunity.

- **Investors:** They need information to judge whether a company is a good investment. If investors think that a company is on a growth path because of the financial information it reports, but those reports turn out to be false, investors can pay, big time. They may buy stock at inflated prices and risk the loss of capital as the truth comes out, or they may miss out on better investing opportunities.
- **Government agencies:** These agencies need to be sure that companies comply with regulations set at the state and federal levels. They also need to be certain that companies accurately inform the public about their financial position.
- **Analysts:** They need information to develop analytical reviews for clients who are considering the company for investments or additional loan funds.
- **Financial reporters:** They need to provide accurate coverage of a company's operations to the general public, which helps make investors aware of the critical financial issues facing the company and any changes the company makes in its operations.
- **Competitors:** Every company's bigwigs read their competitors' financial reports. If these reports are based on false numbers, the financial playing field gets distorted. A well-run company could make a bad decision to keep up with the false numbers of a competitor and end up reducing its own profitability.

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

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

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

Checking Out Types of Reporting

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

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

REMEMBER *Public companies,* which sell stock on the open market, must file a series of reports with the Securities and Exchange Commission (SEC) each year if they have at least 500 investors or at least $10 million in assets. Smaller companies that have incorporated and sold stock must report to the state in which they incorporated, but they aren't required to file with the SEC. You can find more details about the SEC's reporting requirements for public companies in Chapters 3 and 18.

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

Keeping everyone informed

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

Quarterly reports

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

Annual reports

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

REMEMBER Most major companies put a lot of money into producing glossy reports filled with information and pictures designed to make a good impression on the public. The marketing or public relations department, not the financial or accounting department, writes much of the summary information. Too often, annual reports are puff pieces that carefully hide any negative information in the *notes to the financial statements,* which is the section that offers additional details about the numbers provided in those statements (see Chapter 9). Read between the lines — especially the tiny print at the back of the report — to get some critical information about the accounting methods used, any pending lawsuits, or other information that may negatively impact results in the future.

Following the rules: Government requirements

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

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

  Firms must file this report within 90 days of the end of the fiscal year (companies with more than $75