THE COMPREHENSIVE GUIDE ON

HOW TO READ A FINANCIAL REPORT

+ WEBSITE

EXPANDED EDITION WITH EXTENSIVE WEBSITE MATERIAL

Wringing vital signs out of the numbers

John A. Tracy *and* Tage C. Tracy

WILEY

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THE COMPREHENSIVE GUIDE ON HOW TO READ A FINANCIAL REPORT

WRINGING VITAL SIGNS OUT OF THE NUMBERS

Eighth Edition

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PREFACE

When TOP (i.e., the Old Pro, aka John A. Tracy) and myself were approached by John Wiley & Sons about expanding and enhancing *How to Read a Financial Report*, at first I was taken aback. I mean honestly, how does one improve on a book that has been in publication for more than 30 years, has sold 300,000-plus copies (and counting), is now in its eighth edition, and is widely referenced as ***the*** benchmark when it comes to helping readers from all walks of life clearly and concisely understand the complex world of financial reports? Then it occurred to me that attempting to improve the book was not the goal but rather the idea was to expand or enhance the book in an effort to achieve three primary goals.

First, to transition the material and subject matter into a format that is more user friendly from an “e” (electronic or digital) perspective. A number of features have been incorporated to improve the interactivity of the material by incorporating hotlinks on important subject matter; referencing current events of significance; highlighting critical concepts, terminology, and tips; and building in a web-based TMK, or test my knowledge section, to provide positive feedback on key material in a real-time fashion.

Second, to empower the readers and extend their knowledge of financial reports and statements to identify potential problems, inconsistencies, errors, and irregularities within the financial information presented. The idea is to move beyond simply understanding the basics of financial reports and statements into the world of analysis and further, to what a company’s financial results really mean or indicate. Or to quote Jack Nicholson from the movie *A Few Good Men*, to ensure that you will be able to “handle the truth.”

Third, to take you, the reader, on a journey through a case study that is not just designed to test your knowledge of financial reports and statements but more importantly, to walk you through the life of two similar companies, the fates that await them after operating for a number of years (good and bad), and the role that accounting played in their successes and failures. Or in other words, to highlight a critical concept within company financial reports and statements—that accounting is more of an art than science.

Thus, the reference to "the comprehensive guide" was born, as this really captures the essence of this book, a more comprehensive guide to reading and understanding financial reports. In addition, this edition catches up with the major changes in financial reporting since the previous edition of *How to Read a Financial Report*, and addresses a fast-moving topic toward incorporating different financial reporting standards for private and small businesses compared to large, publicly traded companies. But I note that although numerous changes were made with the comprehensive version, the basic architecture and structure of the book remains unchanged, which at its heart is centered on two concepts that are of intense importance in today's highly uncertain economic environment:

1. Understanding the connections between the big three financial statements, and that all are of equal importance and relay a valuable message about the financial health of a company.

2. Highlighting the importance of cash flows, which is the hallmark of the book.

The basic framework of the book has proved successful for more than 33 years and I would be a fool to mess with this success formula (not to mention feeling the wrath of my father who undoubtedly would "cut me out of the will" for the umpteenth time).

All of the exhibits in the book have been prepared in Excel worksheets. To request a copy of the workbook file of all the exhibits, please contact me at my e-mail address: tagetracy@cox.net. We express our sincere thanks to all of you who have sent compliments about the book over the years. The royalties from sales of the book are nice, but the bouquets from readers are icing on the cake.

This book has taken a good deal of “thinking outside of the box,” which was highly dependent on a strong working partnership between the authors and the publisher. I thank most sincerely the many people at John Wiley & Sons who have worked with my father on the previous editions of the book, for more than three decades now. In addition, I’d be remiss without mentioning Tula Batanchiev and Judy Howarth, who were critical drivers in developing this comprehensive version of the book. They’ve been a pleasure to work with on this version and throughout the process have maintained an open, creative, and visionary mind-set, all essential when working with this type of project. There is no doubt that they’ve made the new version much better than if we had been left on our own. Books are the collaboration of good editors and good authors. We had good editors; you’ll have to be the judge how good the authors are.

In closing, this is now the fourth book I’ve had the opportunity to work with my father on since 2003. Each book has been a remarkable journey and adventure that simply put, I could not have ever imagined taking without his support, guidance, and yes, frequent ribbing and jabs (and when you move through the books, you’ll notice we attempt to incorporate humor and poke fun at ourselves, as well as the accounting profession). But the bottom line (no pun intended with this book’s subject matter) is, if it weren’t for the man I call TOP, I would have never had the opportunity to become an author. Again, I’m forever grateful for the opportunity and dedicate this book to a man who still to this day continues, after more than 50 years of being a father, to open new doors for me each and every day.

Poway, California Tage C. Tracy

August 2013

PART ONE

FINANCIAL REPORT FUNDAMENTALS

CHAPTER 1

FINANCIAL STATEMENT BASICS

THE REAL MEAT AND POTATOES OF FINANCIAL REPORTS

To start this book it is important to understand that every for-profit business, nonprofit organization, governmental entity, and/or just about any type of “entity” you can think of need financial reports or financial statements (which represent the meat and potatoes of the financial reports). Without financial statements, managing the interests of these entities would be damn near impossible. Creditors such as banks, suppliers, landlords, and the like would not be able to assess the economic performance of the entity (and decide if credit should be extended). Management would not be able to determine how the entity is performing, including the rather novel concept of whether the entity is actually making or losing money (something the federal government doesn’t appear to have to worry about but we’ll leave this topic for another time). Investors would not be able to determine if their investments in the entity are actually worth anything. And completing and filing periodic tax returns to the slew of taxing authorities all entities must inevitably comply with would be challenging, to say the least.

Countless other examples of why financial statements are needed could be cited, so rather than burn an entire chapter on listing every potential scenario, let’s stay focused on two important acronyms as they apply to financial statements.

As we proceed through this book and assist the reader with understanding the basics of financial statements, a constant theme is also presented in helping readers understand and identify when CART financial statements are being produced compared to applying the SWAG method. We note that you generally won’t find these acronyms listed in any official accounting literature, formal accounting guidance reference material, and so on, as these terms are centered more on how accounting is applied and conducted on “the street” as opposed to how accounting theory and principles are taught “in the classroom.” But whether CART or SWAG is applied, the same concept still holds as it relates to preparing financial statements and the consequences of not completing even the basics, as Twitter found out the hard way!

Critical Terminology Alert—CART versus SWAG

CART stands for Complete, Accurate, Reliable, and Timely. This is how financial statements should be produced—in a complete, accurate, reliable, and timely manner. SWAG stands for Scientific Wild Ass Guess. And yes, let’s just say that more than a few companies have produced financial statements utilizing the ever-so-popular SWAG methodology.

The Big Three—Financial Condition, Profit Performance, and Cash Flows

As previously noted, business managers, lenders, investors, governmental organizations, and the like (collectively referred to as the *parties* throughout this book) need to have a clear understanding of the financial condition of a business, both at a point in time and over a period of time. The primary objective of the big three financial statements summarized in this segment of the chapter is to achieve just this goal.

First Up, the Balance Sheet

Parties need to assess the *financial condition* of a business *at a point in time*. For this purpose they need a report that summarizes its assets (what the business owns) and liabilities or obligations (what the business owes), as well as the ownership interests in the residual of assets in excess of liabilities (which is commonly referred to as *owners' equity*). Understanding the financial condition of a business is best measured by number one on the list of the big three financial statements—***the balance sheet***.

Exhibit 1.1 presents a standard balance sheet for a business entity.

EXHIBIT 1.1—YEAR-END BALANCE SHEETS

Dollar Amounts in Thousands

	Last Year	This Year	Change		Last Year	This Year	Change
Cash	$ 3,735	$ 3,265	$ (470)	Accounts Payable	$ 2,675	$ 3,320	$ 645
Accounts Receivable	4,680	5,000	320	Accrued Expenses Payable	1,035	1,515	480
Inventory	7,515	8,450	935	Income Tax Payable	82	165	83
Prepaid Expenses	685	960	275	Short-Term Notes Payable	3,000	3,125	125
Current Assets	$16,615	$17,675		**Current Liabilities**	$ 6,792	$ 8,125	
Property, Plant, and Equipment	$13,450	$16,500	3,050	**Long-Term Notes Payable**	$ 3,750	$ 4,250	500
Accumulated Depreciation	(3,465)	(4,250)	(785)				
Cost Less Depreciation	$ 9,985	$12,250		Capital Stock–793,000 Shares and 800,000 Shares Respectively	$ 7,950	$ 8,125	175
Intangible Assets	$ 5,000	$ 5,575	575	Retained Earnings	13,108	15,000	1,892
Long-Term Operating Assets	$14,985	$17,825		**Stockholders' Equity**	$21,058	$23,125	
Total Assets	$31,600	$35,500	$3,900	**Total Liabilities and Stockholders' Equity**	$31,600	$35,500	$3,900

When first reviewing the balance sheet a number of items should jump out at the reader including the format used, the different groupings of assets, liabilities, and equity, the allocation of assets and liabilities between current and long-term, and other details. All of these concepts are discussed in Chapter 3, “Mastering the Balance Sheet,” but if there is one extremely important concept that must be understood with the balance sheet it is this—***the balance sheet must balance.*** That is, total assets must equal total liabilities plus shareholders’ equity. If not, well I can only think of the line quoted by Tom Hanks who played astronaut Jim Lovell in the movie *Apollo 13*—“Houston, we have a problem.”

Next in Line, the Income Statement

Second up on our list of the big three financial statements is based on the simple concept of knowing (by the parties) whether a business has generated a profit or incurred a loss over *a period of time*. For this purpose, the business needs a report that summarizes sales or revenues against expenses or costs for a given period and the resulting profit generated or loss incurred. This financial statement is most commonly known as ***the income statement*** or similarly, the profit and loss statement (or *P&L* for short).

Exhibit 1.2 presents a typical income statement for the same business entity the balance sheet was presented in Exhibit 1.1.

EXHIBIT 1.2—INCOME STATEMENT FOR YEAR

Dollar Amounts in Thousands

Sales Revenue	$52,000
Cost of Goods Sold Expense	(33,800)
Gross Profit	$18,200
Selling, General, and Administrative Expenses	(12,480)
Depreciation Expense	(785)
Earnings before Interest and Income Tax	$ 4,935
Interest Expense	(545)
Earnings before Income Tax	$ 4,390
Income Tax Expense	(1,748)
Net Income	$ 2,642

Chapter 4, titled Understanding Profit, on understanding the income statement has been dedicated to breaking down the income statement in more detail but similar to the balance sheet, one important concept must be understood—***profit ≠ success and losses ≠ failure***. That is, generating a profit does not mean that the business is financially sound and is guaranteed success and conversely, incurring a loss does not mean the business is going to fail. Financial statements need to be understood in their entirety before a judgment can be passed on the long-term financial viability of the business.

Bringing Up the Rear, the Statement of Cash Flows

And, finally the parties need a summary of its *cash flows for a period of time*. Similar to the income statement, cash flows are measured over a period of time (generally the same length of time as the income statement such as a month, quarter, or year) but unlike the income statement (which measures total sales or revenues against total expenses or costs to calculate the profit or loss), cash flows are best understood by distinguishing between where cash comes from (the sources) and where cash goes (the uses). This brings us to the last of the big three financial statements, which is ***the statement of cash flows***.

Exhibit 1.3 presents a typical statement of cash flows for the same business entity the balance sheet was presented in Exhibit 1.1 and income statement was presented in Exhibit 1.2.

EXHIBIT 1.3—STATEMENT OF CASH FLOWS FOR YEAR

Dollar Amounts in Thousands

Cash Flow from Operating Activities		
Net Income (from Income Statement)	$ 2,642	
Accounts Receivable Increase	(320)	
Inventory Increase	(935)	
Prepaid Expenses Increase	(275)	
Depreciation Expense	785	
Accounts Payable Increase	645	
Accrued Expenses Payable Increase	480	
Income Tax Payable Increase	83	$3,105

Cash Flow from Investing Activities		
Expenditures for Property, Plant, and Equipment	$(3,050)	
Expenditures for Intangible Assets	(575)	(3,625)
Cash Flow from Financing Activities		
Increase in Short-Term Debt	$ 125	
Increase in Long-Term Debt	500	
Issuance of Additional Capital Stock Shares	175	
Distribution of Cash Dividends from Profit	(750)	50
Decrease in Cash During Year		$ (470)
Cash Balance at Start of Year		3,735
Cash Balance at End of Year		$3,265

In our business travels, there is no question that the statement of cash flows is without doubt the least understood of the big three financial statements but at the same time, the most important. Understanding how a business generates and consumes cash is discussed in more depth in Chapter 2 and as you start that chapter it is important to keep the most critical of concepts at the forefront of your thoughts as it relates to cash flows–***profit ≠ positive cash flow and a loss ≠ negative cash flow***.

For a perfect example of just how significant the difference can be between profit and cash flow, please refer to page 50 of Netflix's 2012 annual report (available online) and you see that for the fiscal year-end 2012, Netflix generated a profit of **$17,152,000** or the company was "in the black"