BUSINESS FINANCIAL INFORMATION SECRETS

HOW A BUSINESS PRODUCES AND UTILIZES CRITICAL FINANCIAL INFORMATION

TAGE C. TRACY

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Preface

When we first entertained the idea of writing *Business Financial Information Secrets*, we were a bit apprehensive about the idea – but not for the reasons you might think. There is no question that the financial, accounting, and strategic business content and concepts covered in this book represent essential knowledge that business owners, executives, board members, managers, external analysts, lenders, investors, and similar parties must know and understand how to utilize as a strategic weapon in today's rapidly evolving and changing global economy. In fact, we have never been more bullish on the material presented in this book, along with our companion book, *How to Read a Financial Report*, ninth edition, as it represents "evergreen" business knowledge covering the subjects of business accounting, financing, capital management, and planning.

Rather, our concerns lay more with the macroeconomic and political environments that have, since the start of 2020, gripped and consumed the world, which has seen an unprecedented response by governments and central banks across the globe. To drive home our point, think about this fact for a moment: Since the birth of the United States of America's Central Bank, known as the Federal Reserve System (or simply the Fed) in 1913, it took approximately 95 years to accumulate approximately $1 trillion in assets on its balance sheet (and basically the same amount of currency). Over the past 12 years, from 2008 through 2020, the Fed's balance sheet has grown from roughly $1 trillion to approximately $7 trillion (7x growth) to combat two major economic corrections, including the Great Recession from 2008 through 2010 and the COVID-19 economic shock experienced starting in 2020. If this does not gain your attention (and concern), then layer on this fact as well: Total global debt was approximately $87 trillion at the end of the 2000 compared to a global GDP of roughly $50 trillion (representing a ratio of 174%). By the end of 2020, total global debt had risen to an unbelievable estimated figure of $277 trillion compared to an estimated global GDP of approximately $88 trillion for 2020 (representing a ratio of 315%). These trends are simply not sustainable, as the only real reason more and more debt can be absorbed is via historically low interest rates (now less than 1%

for most of the world's public debt issued by developed countries) combined with ultra-accommodative terms.

So why our apprehension, you may ask, as it would appear now more than ever that the material presented in this book represents critical knowledge? The answer lies in the fact that between Wall Street (via the Fed) and Washington (not to mention countries and their respective banks from around the world), the current mindset seems to be centered on giving away free money.

That is, if you believe the Fed and the federal government are on the right path by handing out free money via loans (if you can call them that) with no regard for whether a company, individual, public entity, and so on can repay the loan, then this book is not for you. There is no point in understanding critical financial information, reports, analyses, sources and uses of capital, cash flow, and so on, as with free money raining down like there is no tomorrow, why even bother? Just load up on debt, spend it rapidly in unproductive ventures, cry poor or blame someone else, and then request another loan (i.e., wash, rinse, repeat). Better yet, why even bother with having accountants, business analysts, financial officers, or even the IRS, as in this bizarre new world financial accountability is not required?

Okay, we know this is a certainly a reach and yes, we are being sarcastic, but given the current policies being implemented at both the monetary and fiscal levels, the question does have to be asked about the financial viability not just of businesses but, even more importantly, at the governmental and country levels as well. This is where we became enthralled with writing this book, as the concepts and material presented are even more important and relevant today than ever before for individuals, businesses, governments, and countries alike. Our position is simple in that proper accounting and financial reporting will always be an essential and critical function of every business operating in free markets and economies around the globe.

This book, along with *How to Read a Financial Report*, have been written to assist the reader in gaining the most complete and comprehensive understanding of how businesses produce, report, distribute, analyze, and use financial information. While *How to Read a Financial Report* is focused on external users and readers looking in (from the *outside in*), *Business Financial Information Secrets* is focused on internal producers and users of financial statements/information (from the *inside out*). A wide range of topics will be covered, specifically focused on the difference between externally prepared financial reports and statements and internally generated financial information, with additional attention placed on raising capital, managing cash and liquidity, and understanding how a business generates and consumes cash.

In summary, the material presented in this book does not represent a luxury (i.e., it is nice to understand this content), as for internal and external users of the financial information to succeed in today's business world, this book offers must-have knowledge. Further, and a concept that we harp on time and time again throughout this book, if you do not understand a business's cash flows and financial capital resources, you will most likely fail to understand its very bloodline that keeps it alive, in good times or bad. So fail here, and you are possibly placing the very existence of your business at risk.

And to leave you with one final thought before you dive headfirst into the book, a simple reference to a quote from a movie might help explain the current economic environment and risks present. In the movie *Jurassic Park*, Dr. Allan Grant realized that the power of life (in the form of dinosaurs finding a way to reproduce) was far greater than the control over "unauthorized" breeding trying to be administered by the fictitious corporation known as InGen. As he so eloquently noted (by confirming that Dr. Ian Malcom was also correct in his assessment), "life found a way." In the same respect, free markets will eventually find a way to function in an economically viable manner and be allowed to correct, adjust, and survive, as the central control being administered over the markets (by both the Fed and the federal government) will eventually give way to what will most likely be an extremely violent and painful correction – all in the name of Adam Smith's theory on markets and the invisible hand.

SECRET

That is, invisible forces will act in such a powerful way that the laws of supply, demand, and individual pressures will result in the natural flow of resources, capital, and price discovery (beyond anything the central planners can control).

We absolutely believe that this will be the case as, with most of the world's global economy now based on some form of capitalism, it will only be a matter of time before natural economic market forces find a way to not only survive but thrive moving forward. This book is designed to make sure you have at least a fundamental understanding of the basic principles of business financial information, what is needed, where it comes from, when it is needed, how it is used, and why it is so important!

Note: We have prepared all of the exhibits in this book as Excel worksheets, which can be requested via email, free of charge, by reaching out to tagetracy@cox.net**.**

Acknowledgments and Dedication

We would like to express our utmost thanks to John Wiley & Sons, Inc., (commonly referred to as Wiley) for their continued support of our quest to produce and distribute relevant, timely, and critical accounting, financial, and business planning content to assist readers around the globe. Wiley has been a trusted partner to me and my father for over 30 years, during which time 15 books (including updated editions and this current title) have been published in over a dozen different languages. Wiley's current team, led by Kevin Harreld and Susan Cerra, have been a pleasure to work with as their level of professionalism, experience, and knowledge in this space is unmatched. This rings especially true at the time of this publication given the significant economic, political, social, environmental, and global health challenges facing basically all businesses throughout the world.

Taking the lead role in authoring this book, I would like to dedicate this project to, first, my parents: my dad, who turned a spry 86 years old in late 2020, and my mom, who passed away in 2017. I cannot tell you how much invaluable guidance my dad has provided on the topic of writing books as he encouraged me to take over the family business a decade or so ago, and how many thanks I owe my mom for saving my ass by editing numerous college papers drafted decades past (a job thankfully taken over by Wiley's editing department). But the real thanks to my parents resides in providing me with the proper moral compass and ethics on which I have operated my own business for the past 25+ years and coauthored numerous books. In an era when economic, business, and political trust is in such short supply, I can only look back to the foundation my parents laid for me with profound gratitude.

And second, it would be extremely selfish of me not to offer my sincere and deepest thanks and love to my immediate family, including my wife and partner in crime Kristin, our eldest son Mitchel (next in line to take over the family business), our daughter Katrina (and her new husband Nicolas Small), and our youngest son Tanner (and his new wife Meredith Cahill).

Their impact on my career and understanding of the importance of effectively discussing and communicating subjects of extreme importance in a clear, concise, and easy-to-understand manner is a lesson they have taught me every day of my life, and which I will never forget.

Along this same line, I would like to extend an extra-special thanks to my wife of 35+ years, who has somehow put up with an old bean counter and business professional like myself, always willing to lend an ear and pretend to enjoy learning more about such lively and entertaining topics as accounting and finance. Maybe she was actually interested (doubtful) or maybe she just needed a bit of conversation to help her fall asleep at night (probably, as this is a running joke between the two of us), but whatever the case, she has always supported my endeavors, no matter how challenging, time-consuming, or "out there," with zero doubt and 100% confidence. Could anyone ask for a better wife, partner, or friend?

Tage C. Tracy

About the Author

Tage C. Tracy (pronounced "Tog"/Scandinavian descent) has, over the past 25+ years, operated a financial consulting firm focused on offering CFO/executive-level support and planning services to private companies on a fractional basis. These services include providing guidance and support with raising debt and equity capital, completing complex financial analysis, supporting risk management assessments, guiding accounting system designs and structuring, and being an integral part of the strategic business planning management functions. Tage specializes in providing these services to businesses operating at four distinct stages: (1) startups and business launches, (2) rapid growth, ramp, and expansion management, (3) strategic exit and acquisition preparedness and management, and (4) turnarounds, challenged environments, and survival techniques.

Tage is also an active author and has been the lead or coauthor with a total of seven books, including this most recent title, *Business Financial Information Secrets*. The other books Tage has coauthored (with his father, John A. Tracy) include *How to Read a Financial Report,* ninth edition, *How to Read a Financial Report* – Comprehensive Version, *Cash Flow for Dummies, Small Business Financial Management Kit for Dummies*, previous editions of *How to Read a Financial Report*, and *How to Manage Profit and Cash Flow*.

Tage received his baccalaureate in accounting in 1985 from the University of Colorado at Boulder with honors. Tage began his career with Coopers & Lybrand (today PricewaterhouseCoopers) and obtained his CPA certificate in the state of Colorado in 1987 (now inactive). Tage can be reached on his website http://financemakescents.com/ or directly at tagetracy@cox.net.

PART ONE

The *What, When, and Where* of Producing Best-in-Class Financial Information

CHAPTER 1

The Big Three Financial Statements

STARTING WITH A QUICK BACKSTORY

As we launch into the content and concepts presented throughout this book, I would like to begin by referring to a book my father and I coauthored, titled *How to Read a Financial Report* (now in its ninth edition). This book, first written by my father and published by Wiley over 30 years ago, has stood the test of time and represents one of the top "go-to" technical accounting and financial references used by businesses, colleges, and organizations around the world. The book has so much useful information that you will find several overlaps and references to key financial and accounting concepts discussed in this book. However, there are also significant differences between these books that at heart are centered in the following two items:

- First, our book *How to Read a Financial Report* is centered on the premise of an external party (e.g., an investor, lender, etc.) evaluating or analyzing an organization from the outside looking in. That is, all the financial and accounting information produced has been done with the understanding that the audience will be external, independent third parties who are not privy to the organization's internal operations and related financial information and data. This represents a critical difference between this book and *How to Read a Financial Report* that will become evident moving through the material. The content of this book has been structured to look at financial and accounting information from the inside out with a heavy emphasis on business management (as opposed to adhering to guidelines, rules, and regulations established by external bodies or organizations such as the SEC).

- Second, *How to Read a Financial Report* is presented from more of a technical/accounting perspective or, for lack of a better term, a bit more black-and-white (as it relates to providing an understanding of accounting and financial concepts and how the big three financial statements are interconnected). This book is based on more of an internal business approach where, while it adheres to general or standard accounting rules and guidelines, its primary purpose is to assist with socializing accounting concepts, financial analyses and reporting strategies, and business planning from an internal operating or strategic perspective. Or, as I told my dad (a retired professor emeritus from the University of Colorado), "That is how you teach it in the classroom, but this is how it is done on the street."

So, with this said, let's launch into our first topic on the big three financial statements, as there is no better place to start, making sure you have a clear understanding of the role and importance of the balance sheet, income statement (aka profit-and-loss, or P&L), and statement of cash flows. Large or small, for-profit or non-profit, corporations, LLCs, partnerships, or sole proprietorships, governments, or private businesses, legal or illegal, it doesn't really matter, as this basic concept is always present. That is, all operating entities need to produce complete, accurate, reliable, and timely financial statements on which to base sound business decision-making.

THE FINANCIAL REPORTING BEDROCK

It should go without saying that business managers, company lenders and investors, regulatory agencies, and countless other parties need to clearly and concisely understand an organization's financial performance and results in a timely manner. This is common sense, no doubt, but you would be absolutely amazed at how often this basic concept is overlooked or, for lack of a better term, neglected, by even the senior-most executive management teams. Maybe it is a result of ignorance, not having enough time, or just being lazy, but as we start our discussion on the big three financial statements, it should become abundantly clear just how important all three primary financial statements are and the key role each one plays.

Before we dive into a more detailed analysis of each of the big three financial statements, a quick overview of each financial statement and the related purpose is warranted:

- ***The balance sheet:*** The financial condition of a business is communicated in an accounting report called the *balance sheet*. In its simplest form, the balance sheet reports the assets owned by a business, the liabilities owed by the business (to third parties), and the net ownership equity (assets minus liabilities), all at a point in time.
- ***The income statement (AKA the Profit & Loss or just the P&L):*** The financial performance of a business that reports and measures its profit- or loss-making activities is presented in an accounting report called the *income statement*. In its simplest form, the income statement reports sales, costs of goods sold, operating expenses, other expenses or income, and finally, whether a net profit or loss was generated and covers a period of time (e.g., 12-month period of 1/1/20 through 12/31/20).
- ***The statement of cash flows:*** Finally, the last of the big three financial statements, and often the most important (but least understood), is the *statement of cash flows*. In its simplest form, this financial statement reports a business's sources (i.e., how a business generates cash), uses (i.e., how a company consumes cash), and net change in cash. Similar to the income statement, the statement of cash flows covers a time period which is almost always consistent with the time period reported in the income statement.

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

Finally, as you work your way through the book, please remember these definitions for frequently used terms and concepts:

- ***Financial information:*** The term *financial information* is used throughout the entire book and in its broadest sense includes basically all types of financial reports, financial statements, data, analyses, evaluations, assessments, and so on. For ease of reference and consistency, we simply use the term *financial information* in an all-encompassing meaning, apart from Chapter 2, where we present a discussion on the role and importance of preparing external financial reports and statements (which represent a selection or fraction of internally generated financial information).
- ***Businesses:*** As previously noted, all types of businesses, organizations, not-for-profits, government entities, and so on should produce financial statements on a periodic basis. Again, for ease of reference and consistency, when we refer to a *business* throughout the book, it is assumed to include any one of the entities identified.
- ***Financial statements:*** The term *financial statements*, in the plural, generally refers to a complete set that includes a balance sheet, an income statement, and a statement of cash flows as well as often implying that multiple years of financial statements will be presented. Informally, financial statements are called just "financials." In almost all cases the financial statements need to be supplemented with additional information, which is presented in *footnotes* and *supporting schedules*. One supporting schedule is very common – the *statement of changes in stockholders' (owners') equity*.

THE INCOME STATEMENT, AKA PROFIT AND LOSS (P&L)

First up, we will begin with the income statement, as, for most parties, this is the financial statement that is not only looked to first to quickly assess total sales generated (which is a common measurement of the "size" of a business) and whether a business made any money (i.e., a profit), but, maybe more importantly, is the financial statement that tends to be the most easily understood. Exhibit 1.1 provides an example of a standard externally presented income statement.

The income statement is read in a step-down manner, like walking down a set of stairs. At the top of the staircase, sales revenue is reported first.

EXHIBIT 1.1 Audited Income Statement

QW Example Tech., Inc.
Audited Financial Statements
For the Fiscal Year Ending
12/31/2020

Income Statement For the Twelve-Month Period Ending (all numbers in thousands)	FYE 12/31/2019	FYE 12/31/2020
Sales Revenue, Net	$53,747	$72,198
Costs of Goods Sold	($24,259)	($27,541)
Gross Profit	$29,488	$44,657
Operating Expenses:		
Selling, Marketing, & Promotional	$9,406	$13,357
Corporate General & Administrative	$7,500	$9,000
Research, Development, & Design	$10,749	$12,996
Depreciation & Amortization Expense	$1,814	$2,421
Total Operating Expenses	$29,469	$37,774
Operating Income (Loss)	$19	$6,883
Other Expenses (Income):		
Other Expenses, Income, & Discontinued Ops	$250	$2,000
Interest Expense	$150	$400
Total Other Expenses (Income)	$400	$2,400
Net Profit (Loss) before Income Taxes	($381)	$4,483
Income Tax Expense (benefit)	($133)	$1,569
Net Profit (Loss)	($248)	$2,914

Sales revenue (AKA the "top line") is always reported first with costs of goods sold then reported to calculate gross profit.

Operating expenses are reported after gross profits and capture general company business expenses.

Finally, after all expenses are reported the company reports its net profit (or loss) often referred to as the "bottom line."

Confidential - Property of QW Example Tech., Inc.

Then, as you proceed down each step, a deduction of one or more expenses is reported. The first step deducts the cost of goods (products) sold from the sales revenue of goods sold, which gives *gross profit* (also called *gross margin* – one of the few places you see the term *profit* in income statements). This measure of profit is called *gross* because many other expenses are not yet deducted.

Next, a broad category of general business expenses, often referred to as *operating expenses* or *selling, general, and administrative expenses*, are reported in the P&L. In our income statement example (Exhibit 1.1) you see four different operating expenses presented, including selling, marketing, and promotional; corporate general and administrative; followed by research, development, and design; and finally depreciation and amortization expense. When preparing external income statements, there is no set rule as to how many expenses must be presented but generally speaking, you will find that most external income statements attempt to avoid providing too much detail and limit the list to eight or less (unless the business had a very unusual year and elects to provide additional disclosures).

In our example, the reason we have chosen to disclose three specific expense "buckets" separately is for their importance.

- First, in today's hyper-technology-driven economy, investors are keenly focused on just how much a business spends on research, development, and design (an extremely important function). Since our sample company is a technology-based business, this expense bucket makes sense to report separately.
- Second, selling, marketing, and promotional expense is also highlighted to reflect the importance of just how much a business must spend to secure or capture customers and, ultimately, drive sales revenue. Marketing, promotional, and selling expenses often are separated from general and administration expenses, given their significance (from a dollar perspective) and importance in driving sales revenue.
- Third, you will notice that in our income statement example, we have elected to report depreciation and amortization expense (unique non-cash expenses) as a separate line item. The reason for this is that as we move through the book and highlight the importance of understanding the statement of cash flows, it is very convenient to segregate noncash expenses such as depreciation and amortization expense as a separate line item in the income statement. It should be noted that businesses may or may not report depreciation or amortization expense on a separate line in their income statements based on the concept of materiality (discussed in Chapter 5). We have elected to report depreciation and amortization as a unique expense to better help our readers understand its impact on earnings, cash flow, and the balance sheet.

The level of detail for expenses in income statements is flexible and is really dependent on the desires of the company's management team to report what they believe is the right balance of providing too much detail versus not enough. From a financial reporting standards perspective, the guidelines are somewhat loose on this point and left open for different levels of opinions.

Finally, we reach the bottom portion of the income statement where other expenses and income are reported. Interest expense on debt is deducted as well as other non-recurring-type expenses (e.g., in this case, a large loss was incurred for a discontinued operation), which generates earnings before income tax. The last step is to deduct income tax expense, which gives net income, the bottom line in the income statement. Undoubtedly, you have heard the term *bottom line* (but this slang is not used in financial statements), as well as *top line*, which refers to total sales revenue. Other terminology you should be aware of includes being in the "black" (generating a profit) or the "red" (incurring a loss).

Note: Publicly owned businesses are required to report earnings per share (EPS), which basically is annual net income divided by the number of capital stock shares or similar investment units. Privately owned businesses don't have to report EPS, but this figure may be useful to their stockholders.

To conclude our introduction with the income statement, three items should be kept in mind.

First, the income statement presented in Exhibit 1.1 has been structured for external presentation (as opposed to internal business analysis). We dive into the key differences and importance of income statements prepared for external versus internal parties in Chapter 2.

Second, it is important to note that of the big three financial statements, the income statement is the one that tends to be the most easily and often manipulated or subject to misstatement. The reason for this is that many parties tend to focus first (and only) on this financial statement (making it the main attraction), as well as that these same parties are often not nearly as well versed in understanding the balance sheet and statement of cash flows.

Third, you will see multiple references to this all-important advice (throughout the book) which simply states – ***Understand the income statement, trust the balance sheet, but most importantly, rely on the statement of cash flows.*** As you work through the financial statements and this book, the importance of the state of cash flows will become increasingly clear.

THE BALANCE SHEET

The financial statement that is second in line is the balance sheet, which in its simplest form presents the *financial condition* of a business at a point in time (e.g., as of the fiscal year ending 12/31/20). Unlike the income statement, which presents a business's financial performance over a period of time, the balance sheet reports and summarizes a business's assets and liabilities, as well as the ownership interests in the residual of assets in excess of liabilities (referred to as owners' equity).