Chapter 1

Discovering What Reports Reveal

In This Chapter

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

Financial reports give a snapshot of a company's worth at the end of a particular period, as well as a view of the company's operations and whether it made a profit. In the modern business world it's unthinkable that public, and some would say private, limited companies do not give the public some way to gauge their financial performance. Many stakeholders depend on this information.

Right now, nothing could possibly replace financial reports. Nothing could 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 people who work for a company wouldn't know how to make the company 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 help them make plans for future improvements.

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

Finding Out What Financial Reporting Is For

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

- **Assets:** The cash, amounts receivable from customers, stock awaiting sale, investments, buildings, land, tools, equipment, vehicles, copyrights, patents, and any other items needed to run a business that the company owns or has the use of.
- **Liabilities:** Money a company owes to outsiders, such as loans and unpaid bills.
- **Equity:** Shareholders' money invested in the company.
- **Sales:** Products or services sold to customers.
- **Costs and expenses:** Money spent to operate the business, such as money used for production, employee remuneration, and costs of operating the buildings and factories and supplies to run the offices.
- **Profit or loss:** The amount by which the revenue from sales exceeds (or is less than) the costs and expenses.
- **Cash flow:** The amount of money that flowed into and out of the business during the time period being reported.

REMEMBER

Without financial reporting, nobody would have any idea where a company stands financially. Sure, the managers of the company would know how much money the company had in its bank accounts but even they 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 company owes, or what the company owns. As an investor, if you don't know those details, you can't make an objective decision about whether the company is making money and whether it's worth investing in the future of the company.

Many people rely 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 get information about problem areas so they can make changes to improve the company's performance.
- **Employees:** Employees need to know how well they're meeting or exceeding their goals and to know where they need to improve. For example, if a salesperson has to make £30,000 in sales every month, they need a financial report at the end of each month to gauge how well they did in meeting that goal. If they believe that they met their goal, but the financial report doesn't show that they did, they'd have to provide details to defend their level of productivity. Most salespeople are paid according to the level of their sales. Without financial reports, there would be nothing to base their bonuses on.

  Employees also make career and pension decisions based on financial reports released by the company. If a company's financial reports are misleading or false, employees could lose most, if not all, of their pensions and their long-term financial futures could be at risk.

- **Creditors:** Suppliers need to understand a company's financial results to determine whether they should supply goods and services to the company. Banks and other lenders need to decide whether to risk lending more money to the company and to find out whether the company is meeting the minimum requirements of any existing loans. To find out how companies meet creditors' requirements, see Chapters 9 and 12.

  If a company's financial reports are false or misleading, banks might lend money at an interest rate that doesn't truly reflect the risks being taken. They could miss out on a better opportunity because they trusted the information released in the financial reports.
- **Investors:** Investors need information to judge whether or not the 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 make large losses. They may buy shares at inflated prices, risking the loss of capital as the truth comes out or missing out on better investment opportunities.
- **Government agencies:** These agencies need to be sure that the company is complying with regulations. They also need to be satisfied that the company is accurately informing the public about its financial position.
- **Analysts:** Analysts need information to develop analytical reviews for clients who are considering the company for investment or additional loans.
- **Financial reporters:** Financial reporters need to provide accurate coverage about a company's operations to the general public. Their commentaries help investors to be aware of the critical financial issues facing a company and any changes the company makes in its operations.
- **Competitors:** Every company's top people read the financial reports of their competitors. If these reports are based on false numbers, it distorts the financial playing field. 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.

Looking at Different Types of Reporting

Under UK company law, every company must prepare accounts for shareholders and file information on the public record at Companies House.

Small private companies will usually prepare one set of accounts for their shareholders but will file a simplified set of accounts known as abbreviated accounts at Companies House. In most cases, neither of these sets of accounts will need to be audited.

Medium-sized private companies require to have their accounts audited. Some minor concessions, to make things simpler, are available for the set of accounts which are filed.

Larger private companies receive no concessions.

Public limited companies, or PLCs, are not necessarily listed on the stock market. A PLC has the right to issue shares to the public but does not necessarily have to exercise that right. All PLCs are subject to more detailed reporting requirements than private companies but, except for listed entities, the extra requirements are minor.

There are three markets for trading shares in the UK. The full market is subject to very detailed listing rules which are considered briefly below and in more detail in Chapter 3. AIM (Alternative Investment Market) provides a lighter touch for companies seeking a listing for the first time. As AIM companies grow, they may progress to the full market. The third market is known as the Plus market (formerly OFEX) which exists to permit arranged (matched) deals between buyers and sellers as distinct from the open market dealings in shares for companies on the AIM or full markets.

All public companies and private companies (other than small private companies) require an audit by a firm of registered auditors which are firms of accountants regulated by the various professional bodies. More details about auditors and the audit are included in Chapter 18.

Keeping everyone informed

One big change to a company's operations after it decides to sell shares to the public is that the company must report publicly on a regular basis to its shareholders and the major financial institutions that help fund their operations through loans or bonds. As well as an annual report, listed companies in the UK currently need to produce the following:

- Interim reports (currently at the 6 month stage).
- Preliminary announcements (these are advance notices of the profit and other key information which will appear in the annual accounts).
- Notification of material events such as indications that the profit is going to fall significantly short of the previously announced expectations. These notifications would also include other matters such as proposed take overs, mergers, and so on.
- Notification of major changes in shareholdings.

Most major companies put a lot of money into producing glossy reports filled with information and pictures to make a good impression on the public. The marketing or public relations department, rather than the financial or accounting departments, 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 detail about the figures provided in those statements (see Chapter 9). Find out how to 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 could negatively impact results in the future.

You can access reports filed with Companies House online at the Companies House Web site `www.companieshouse.gov.uk`.

Staying within the walls of the company: Internal reporting

Not all the finance department's reporting is done for public consumption. In fact, companies usually produce many more internal reports than external ones to keep management informed. Companies can design their internal reports in whatever way makes sense to their operations.

These internal reports help managers to:

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

Each department head usually receives a report from the top managers showing the department's expenses and revenues, sometimes called sales or turnover, and whether it's meeting its budget. If the department's numbers vary significantly from budget, the report indicates red flags. The department head usually needs to investigate the differences, or variations on budget, and report what the department is doing to correct any problems. Even if the difference is increased revenue (which can be good news), the manager still needs to know why the difference exists because an error in the data input may have occurred. We talk more about reports and budgeting in Chapter 14.

Reports on inventory are critical not only for managing the products in hand, but also for knowing when to order more inventory. We talk more about inventory controls and financial reporting in Chapter 15.

Tracking cash is vital to the day-to-day operations of any company. Some large companies actually provide cash reporting to their managers daily. The frequency of a company's reporting depends on the volatility of its cash status. The more volatile the cash, the more the company needs frequent reporting to make sure that it has cash in hand to pay its bills. We talk more about cash reporting in Chapters 16 and 17; Chapter 16 focuses on incoming cash, and Chapter 17 deals with outgoing cash.

These are just a few of the many uses companies have for their internal financial reports. The list is endless and is limited only by the imaginations of the executives and managers who want to find ways to use the numbers to make better business decisions. We talk more about using internal reports to optimise results in Chapters 14, 15, and 16.

Preparing the reports

The finance department is the key source of 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 bookkeeping,* which requires a company to record resources and the assets it used to get those resources. For example, if you buy a chair you must spend another asset probably cash. An entry in the double-entry system would show both sides of that transaction. The cash account would be reduced by the cost of the chair and the furniture account value would be increased by the cost of that chair.

This crucial method of accounting gives companies the ability to record and track business activity in a standardised way. The principles of double-entry bookkeeping have stood the test of time, remaining unchanged for centuries but accounting standards are constantly updated to reflect the business environment as financial transactions become more complex. To find out more about double-entry bookkeeping, turn to Chapter 4.

Dissecting the Annual Report for Shareholders

The annual report gives more detail about the company's business and financial activities than any other report. This report is primarily for shareholders, although any member of the general public can request a copy or look at it online. Glossy pictures and graphics fill the front of the report, highlighting what the company wants you to know. After that, you find the full details about the company's business and financial operations.

The annual report is broken into the following parts (We summarise the key points of each of these parts in Chapter 5):

- **Mission statement:** Many companies put their statement of intent, or their mission statement, on the front cover, or in a key position on the first page. This succinct statement explains the company's key vision and strategy.
- **Financial highlights:** The inside cover and first page normally contain the company's view of their financial performance last year compared to the year before. This comparison is interesting, but carefully selected, information.
- **The chairman's statement:** This is always a key description of the intentions of the company. Whilst predicting what will be in any particular statement is impossible, in this section the chairman is expected to pick out the critical issues in the recent past and in the future.
- **Reports of the chief executive and directors:** These reports contain a number of matters required by law as well as describing the principal activities of the company.

  A recent development in the directors' report now requires the directors to state that they are not aware of any information of which the auditors are unaware (Yes! That is exactly what it says). A review of the business, including financial and non-financial key performance indicators, is also required to be included in the directors' report as a substitute for the information which would have been required in the OFR (see below).
- **Review of operations – also known as the operating and financial review (OFR):** This section has always been an important voluntary statement from which we can derive the company's strategy. The detection of the overall strategy should not be too difficult.

  Recently, the government got in a right pickle when it decided to make the OFR compulsory but then changed its mind soon after in order to cut red tape. In the meantime the Accounting Standards Board had written rules for the OFR and many companies had done so much work in gathering the necessary information that they went ahead and published their OFR's on a voluntary basis!

- **Directors' responsibilities:** This section covers a number of issues including the responsibilities of the directors in relation to the publishing of financial information.
- **Auditors report:** This statement is also nearly a standard with few particular variations. It's here to record the fact that the auditors have done their job, how they did the job, and what their considered opinion is of the prepared accounts.
- **The financial statement:** For those who want to know how well the company has done financially, the financial statement is the most critical part of the annual report as it includes the balance sheet, the income statement (also known as the profit and loss account), and the cash-flow statement.
    - The *balance sheet* gives a snapshot of a company's financial condition. On a balance sheet, you find assets, liabilities, and equity. The balance sheet got its name because the total assets must equal the total liabilities plus total equity (which in itself is a liability of the company). For more on the balance sheet, see Chapter 6.
    - The *income statement,* also known as the *profit and loss account* (P&L), gets the most attention from investors. This statement shows a summary of the financial activities of an entire year or any other period. Many companies prepare income statements on a monthly basis for internal use. Investors always focus on the exciting parts of the statement: sales revenue, net income, and earnings per share. To find out more about the information you can find in an income statement, go to Chapter 7.
    - The *cash-flow statement* is relatively new to the financial reporting game. The Accounting Standards Board didn't require companies to publish it with the other financial reports until 1991 – previous to that there was a requirement for a rather convoluted document known as the 'Source and Application of Funds'. Basically, the cash-flow statement is similar to the income statement in that it reports a company's performance over time. But instead of focusing on profit or loss, it focuses on how cash flowed through the business. This statement has three sections: cash from operations, cash from investing, and cash from financing. We talk more about the statement of cash flows in Chapter 8.

Understanding How the Number Crunchers Are Kept in Line

Every public company's internal accounting team, as well as its external auditors, must answer to government. The primary government entity responsible for overseeing corporate reporting and making sure that reporting is accurate is the Financial Reporting Council (FRC). Reports filed with Companies House may be reviewed by the Financial Reporting Review Panel which is a subsidiary body of the FRC. The Review Panel will also investigate complaints from members of the public concerning financial reports.

Another subsidiary body of the FRC is the Accounting Standards Board (ASB) which, as its name suggests, is responsible for setting accounting standards in the UK. The ASB's power has been reduced in recent years since UK listed companies are now required to prepare their consolidated accounts in accordance with International Accounting Standards as adopted by the European Community. There is much more about this regulatory hiatus in Chapter 18.

Finally, auditors of listed companies are visited by the Audit Inspection Unit – yet another public body answerable to the FRC. We now have the answer to the question 'Who audits the auditors?'

Financial statements filed at Companies House must adhere to Generally Accepted Accounting Principles (GAAP). To meet the demands of these rules, financial reporting must be understandable, relevant, reliable, and comparable with the financial reports of other similar entities. To find out more about GAAP, turn to Chapter 18.

You may wonder why so many accounting scandals have hit the front pages of newspapers around the country for the past few years with GAAP in place. Filing statements according to GAAP rules has become a game for many companies. Unfortunately, investors and regulators find that companies don't always engage in transactions for the economic benefit of the shareholders but to make their reports look better and to meet the expectations of the City. Many times, companies look financially stronger than they actually are. For example, as scandals have come to light, companies have been found to overstate income, equity, and cash flows while understating debt. We talk more about reporting problems in Chapter 21.