

# Contents at a Glance

---

<b><i>Introduction</i></b> .....	<b>1</b>
<b><i>Part I: Getting Down to Financial Reporting Basics</i></b> .....	<b>7</b>
Chapter 1: Opening the Cornucopia of Reports .....	9
Chapter 2: Recognizing Business Types and Their Tax Rules .....	21
Chapter 3: Public or Private: How Company Structure Affects the Books.....	29
Chapter 4: Digging into Accounting Basics .....	43
<b><i>Part II: Checking Out the Big Show: Annual Reports</i></b> ....	<b>59</b>
Chapter 5: Exploring the Anatomy of an Annual Report .....	61
Chapter 6: Balancing Assets against Liabilities and Equity .....	75
Chapter 7: Using the Income Statement.....	91
Chapter 8: The Statement of Cash Flows .....	107
Chapter 9: Scouring the Notes to the Financial Statements.....	121
Chapter 10: Considering Consolidated Financial Statements .....	139
<b><i>Part III: Analyzing the Numbers</i></b> .....	<b>151</b>
Chapter 11: Testing the Profits and Market Value.....	153
Chapter 12: Looking at Liquidity.....	171
Chapter 13: Making Sure the Company Has Cash to Carry On .....	181
<b><i>Part IV: Understanding How Companies Optimize Operations</i></b> .....	<b>193</b>
Chapter 14: How Reports Help with Basic Budgeting .....	195
Chapter 15: Turning Up Clues in Turnover and Assets .....	205
Chapter 16: Examining Cash Inflow and Outflow .....	217
Chapter 17: How Companies Keep the Cash Flowing.....	227

<b><i>Part V: The Many Ways Companies Answer to Others</i></b> .....	<b>235</b>
Chapter 18: Finding Out How Companies Find Errors: The Auditing Process.....	237
Chapter 19: Digging into Government Regulations .....	247
Chapter 20: Creating a Global Financial Reporting Standard.....	259
Chapter 21: Checking Out the Analyst-Corporation Connection.....	269
Chapter 22: How Companies Communicate with Shareholders .....	281
Chapter 23: Keeping Score When Companies Play Games with Numbers .....	295
<b><i>Part VI: The Part of Tens</i></b> .....	<b>317</b>
Chapter 24: Ten Financial Scandals That Rocked the World .....	319
Chapter 25: Ten Signs That a Company's in Trouble.....	329
<b><i>Glossary</i></b> .....	<b>335</b>
<b><i>Index</i></b> .....	<b>343</b>

# Table of Contents

---

## ***Introduction* ..... 1**

About This Book .....	2
Conventions Used in This Book.....	2
What You're Not to Read.....	2
Foolish Assumptions.....	3
How This Book Is Organized .....	3
Part I: Getting Down to Financial Reporting Basics .....	4
Part II: Checking Out the Big Show: Annual Reports.....	4
Part III: Analyzing the Numbers .....	4
Part IV: Understanding How Companies Optimize Operations .....	4
Part V: The Many Ways Companies Answer to Others.....	5
Part VI: The Part of Tens.....	5
Icons Used in This Book .....	5
Where to Go from Here.....	6

## ***Part I: Getting Down to Financial Reporting Basics* ..... 7**

### **Chapter 1: Opening the Cornucopia of Reports. . . . . 9**

Figuring Out Financial Reporting.....	9
Preparing the reports.....	10
Why financial reporting counts (and who's counting) .....	11
Checking Out Types of Reporting .....	12
Keeping everyone informed .....	13
Following the rules: Government requirements .....	14
Going global.....	15
Staying within the walls of the company: Internal reporting.....	15
Dissecting the Annual Report to Shareholders .....	17
Breaking down the parts.....	17
The meat of the matter .....	18
How the number crunchers are kept in line.....	19

### **Chapter 2: Recognizing Business Types and Their Tax Rules. . . . . 21**

Flying Solo: Sole Proprietorships .....	21
Keeping taxes personal.....	22
Reviewing requirements for reporting.....	22
Joining Forces: Partnerships.....	23
Partnering up on taxes .....	23
Meeting reporting requirements.....	24
Seeking Protection with Limited Liability Companies .....	24
Taking stock of taxes .....	24
Reviewing reporting requirements.....	25



Shielding Your Assets: S and C Corporations ..... 25  
    Paying taxes the corporate way..... 26  
    Getting familiar with reporting requirements ..... 27

**Chapter 3: Public or Private: How Company Structure Affects the Books ..... 29**

Investigating Private Companies ..... 29  
    Checking out the benefits ..... 30  
    Defining disadvantages ..... 31  
    Figuring out reporting ..... 32  
Understanding Public Companies ..... 33  
    Examining the perks ..... 35  
    Looking at the negative side..... 35  
    Filing and more filing: Government and shareholder reports ..... 36  
A Whole New World: How a Company Goes from Private to Public..... 39  
    Teaming up with an investment banker ..... 40  
    Making a public offering..... 41

**Chapter 4: Digging into Accounting Basics ..... 43**

Making Sense of Accounting Methods ..... 43  
    Cash-basis accounting..... 43  
    Accrual accounting..... 44  
    Why method matters..... 44  
Understanding Debits and Credits ..... 46  
    Double-entry accounting..... 47  
    Profit and loss statements ..... 47  
    The effect of debits and credits on sales ..... 48  
    Digging into depreciation and amortization..... 49  
Checking Out the Chart of Accounts..... 50  
    Asset accounts ..... 51  
    Liability accounts..... 53  
    Equity accounts ..... 54  
    Revenue accounts..... 55  
    Expense accounts ..... 56  
Differentiating Profit Types ..... 57  
    Gross profit ..... 57  
    Operating profit..... 58  
    Net profit..... 58

***Part II: Checking Out the Big Show: Annual Reports..... 59***

**Chapter 5: Exploring the Anatomy of an Annual Report ..... 61**

Everything but the Numbers ..... 62  
    Debunking the letter to shareholders ..... 62  
    Making sense of the corporate message..... 63  
    Meeting the people in charge..... 64

Finding basic shareholder information..... 64  
 Getting the skinny from management ..... 64  
 Bringing the auditors’ answers to light..... 68  
 Presenting the Financial Picture..... 71  
 Summarizing the Financial Data ..... 72  
     Finding the highlights..... 72  
     Reading the notes ..... 73

**Chapter 6: Balancing Assets against Liabilities and Equity . . . . . 75**

Understanding the Balance Equation ..... 75  
 Introducing the Balance Sheet..... 76  
     Digging into dates ..... 76  
     Nailing down the numbers..... 78  
     Figuring out format..... 78  
 Ogling Assets..... 80  
     Current assets ..... 80  
     Long-term assets..... 83  
     Accumulated depreciation ..... 86  
 Looking at Liabilities ..... 87  
     Current liabilities ..... 87  
     Long-term liabilities..... 88  
 Navigating the Equity Maze..... 89  
     Stock..... 89  
     Retained earnings ..... 90  
     Capital ..... 90  
     Drawing ..... 90

**Chapter 7: Using the Income Statement. . . . . 91**

Introducing the Income Statement..... 92  
     Digging into dates ..... 93  
     Figuring out format..... 93  
 Delving into the Tricky Business of Revenues..... 96  
     Defining revenue ..... 96  
     Adjusting sales ..... 97  
     Considering cost of goods sold..... 99  
     Gauging gross profit ..... 100  
 Acknowledging Expenses ..... 101  
 Sorting Out the Profit and Loss Types..... 103  
     EBITDA ..... 103  
     Nonoperating income or expense..... 104  
     Net profit or loss ..... 105  
 Calculating Earnings per Share..... 105

**Chapter 8: The Statement of Cash Flows . . . . . 107**

Digging into the Statement of Cash Flows ..... 107  
     The parts..... 108  
     The formats ..... 109

Checking Out Operating Activities .....	111
Depreciation .....	111
Inventory.....	112
Accounts receivable.....	112
Accounts payable .....	113
Summing up the cash-flow-from-activities section.....	113
Investigating Investing Activities.....	114
Understanding Financing Activities .....	115
Issuing stock.....	115
Buying back stock.....	115
Paying dividends.....	116
Incurring new debt .....	116
Paying off debt .....	117
Recognizing the Special Line Items .....	117
Discontinued operations.....	117
Foreign currency exchange .....	118
Adding It All Up.....	118

## **Chapter 9: Scouring the Notes to the Financial Statements . . . . . 121**

Deciphering the Small Print .....	122
Accounting Policies Note: Laying Out the Rules of the Road .....	122
Depreciation .....	123
Revenue.....	124
Expenses .....	124
Figuring Out Financial Borrowings and Other Commitments.....	126
Long-term obligations .....	126
Short-term debt.....	129
Lease obligations .....	130
Mergers and Acquisitions: Noteworthy Information .....	131
Pondering Pension and Retirement Benefits .....	132
Breaking Down Business Breakdowns.....	133
Reviewing Significant Events.....	135
Finding the Red Flags .....	136
Finding out about valuing assets and liabilities.....	137
Considering changes in accounting policies.....	137
Decoding obligations to retirees and future retirees.....	138

## **Chapter 10: Considering Consolidated Financial Statements . . . . . 139**

Getting a Grip on Consolidation .....	139
Looking at Methods of Buying Up Companies.....	144
Reading Consolidated Financial Statements.....	146
Looking to the Notes .....	148
Mergers and acquisitions .....	149
Goodwill .....	149
Liquidations or discontinued operations .....	150

***Part III: Analyzing the Numbers*..... 151**

**Chapter 11: Testing the Profits and Market Value .....153**

- The Price/Earnings Ratio..... 154
  - Figuring out earnings per share..... 154
  - Calculating the P/E ratio ..... 155
  - Practicing the P/E ratio calculation..... 156
  - Using the P/E ratio to judge company market value (stock price)..... 157
  - Understanding variation among ratios ..... 159
- The Dividend Payout Ratio..... 160
  - Determining dividend payout..... 160
  - Digging into companies' profits with dividends ..... 161
- Return on Sales ..... 163
  - Figuring out ROS ..... 163
  - Reaching the truth about profits with ROS ..... 164
- Return on Assets..... 164
  - Doing some dividing to get ROA ..... 165
  - Ranking companies with the help of ROA ..... 165
- Return on Equity..... 165
  - Calculating ROE..... 166
  - Reacting to companies with ROEs assistance..... 166
- The Big Three: Margins..... 167
  - Dissecting gross margin..... 167
  - Investigating operating margin ..... 168
  - Catching the leftover money: Net profit margin ..... 169

**Chapter 12: Looking at Liquidity .....171**

- Finding the Current Ratio ..... 172
  - Calculating the current ratio ..... 172
  - What do the numbers mean? ..... 173
- Determining the Quick Ratio ..... 173
  - Calculating the quick ratio..... 173
  - What do the numbers mean? ..... 174
- Investigating the Interest Coverage Ratio ..... 175
  - Calculating the interest coverage ratio..... 175
  - What do the numbers mean? ..... 176
- Comparing Debt to Shareholders' Equity..... 176
  - Calculating debt to shareholders' equity ..... 177
  - What do the numbers mean? ..... 178
- Determining Debt-to-Capital Ratio ..... 178
  - Calculating the debt-to-capital ratio..... 178
  - What do the numbers mean? ..... 180

**Chapter 13: Making Sure the Company Has Cash to Carry On . . . . 181**

Measuring Income Success .....	181
Calculating free cash flow .....	182
Figuring out cash return on sales ratio.....	184
Checking Out Debt.....	185
Determining current cash debt coverage ratio.....	186
Computing cash debt coverage ratio .....	188
Calculating Cash Flow Coverage.....	190
Finding out the cash flow coverage ratio.....	190
Hasbro .....	192
What do the numbers mean? .....	192

**Part IV: Understanding How Companies  
Optimize Operations ..... 193****Chapter 14: How Reports Help with Basic Budgeting. . . . . 195**

Peering into the Budgeting Process .....	196
Who does what.....	196
Setting goals .....	197
Building Budgets.....	199
Providing Monthly Budget Reports.....	201
Using Internal Reports .....	203

**Chapter 15: Turning Up Clues in Turnover and Assets . . . . . 205**

Exploring Inventory Valuation Methods.....	206
Applying Three Inventory Valuation Methods .....	208
Average costing.....	209
FIFO.....	210
LIFO.....	210
Comparing inventory methods and financial statements .....	211
Determining Inventory Turnover .....	211
Calculating inventory turnover.....	212
What do the numbers mean? .....	213
Investigating Fixed Assets Turnover.....	214
Calculating fixed assets turnover .....	214
What do the numbers mean? .....	215
Tracking Total Asset Turnover.....	215
Calculating total asset turnover.....	215
What do the numbers mean? .....	216

**Chapter 16: Examining Cash Inflow and Outflow . . . . . 217**

Assessing Accounts Receivable Turnover .....	217
Calculating accounts receivable turnover.....	218
What do the numbers mean? .....	219

Taking a Close Look at Customer Accounts ..... 220

Finding the Accounts Payable Ratio ..... 222

    Calculating the ratio ..... 222

    What do the numbers mean? ..... 223

Determining the Number of Days in Accounts Payable..... 223

    Calculating the ratio ..... 223

    What do the numbers mean? ..... 224

Deciding Whether Discount Offers Make Good Financial Sense ..... 225

    Calculating the annual interest rate ..... 225

    What do the numbers mean? ..... 226

**Chapter 17: How Companies Keep the Cash Flowing . . . . . 227**

    Slowing Down Bill Payments ..... 227

    Speeding Up Collecting Accounts Receivables..... 228

    Borrowing on Receivables..... 230

    Reducing Inventory ..... 231

    Getting Cash More Quickly..... 232

***Part V: The Many Ways Companies Answer to Others . . . . . 235***

**Chapter 18: Finding Out How Companies Find Errors: The Auditing Process . . . . . 237**

    Inspecting Audits and Auditors ..... 237

        Looking for mistakes ..... 238

        Meeting Mr. or Ms. Auditor ..... 238

    Examining Records: The Role of the Auditor..... 239

        Preliminary review..... 240

        Fieldwork ..... 240

        Audit report ..... 242

    Filling the GAAP ..... 242

        Accounting standards: Four important qualities..... 243

        Changing principles: More work for the FASB ..... 244

**Chapter 19: Digging into Government Regulations . . . . . 247**

    Checking Out the 10-Q ..... 248

        Financial information ..... 248

        Other critical matters..... 249

    Introducing the 10-K..... 250

        Business operations ..... 250

        Financial data ..... 250

        Information about directors and executives ..... 252

        The extras ..... 252

    Investigating Internal Controls ..... 253

Uncovering the Ways Companies Keep in Compliance.....	254
Digging into Board Operations .....	256
The nominating process .....	256
Contacting board members.....	257
Finding Out about Insider Ownership.....	258

## **Chapter 20: Creating a Global Financial Reporting Standard . . . . .259**

Why Develop a Worldwide Financial Standard?.....	259
Key Moves to Reshape Global Financial Reporting .....	260
Who Benefits from a Global Standard and How?.....	261
Investors .....	261
Capital Markets .....	262
Companies .....	262
Exploring Key Differences between GAAP and IFRS .....	262
Accounting framework.....	263
Financial statements.....	263
Revenue recognition.....	265
Assets .....	265
Inventory.....	266
Related-party transactions-disclosures .....	266
Discontinued operations.....	267
Impairment charges.....	267

## **Chapter 21: Checking Out the Analyst-Corporation Connection . . . .269**

Typecasting the Analysts .....	269
Buy-side analysts .....	270
Sell-side analysts.....	271
Independent analysts .....	273
Bond analysts .....	274
Regarding Bond Rating Agencies.....	274
Delving into Stock Rating.....	276
Taking a Look at How Companies Talk to Analysts .....	277
Analyst calls.....	277
Press releases.....	278
Road shows.....	279

## **Chapter 22: How Companies Communicate with Shareholders . . . .281**

Making the Most of Meetings .....	282
Checking Out How the Board Runs the Company.....	283
Watching the directors .....	283
Speaking out at meetings .....	284
Moving away from duking it out .....	285
Sorting through Reports .....	286
Catching Up on Corporate Actions .....	287
Culling Information from Analyst Calls.....	288
Listening between the lines.....	289
Knowing when to expect analyst calls .....	292

Staying Up to Date Using Company Web Sites.....	292
Regarding Reinvestment Plans .....	293
Dividend-reinvestment plans .....	293
Direct-stock-purchase plans.....	294

### **Chapter 23: Keeping Score When Companies**

#### **Play Games with Numbers . . . . . 295**

Getting to the Bottom of Creative Accounting .....	296
Defining the scope of the problem .....	296
Recipes for cooked books.....	297
Unearthing the Games Played with Earnings.....	298
Reading between the revenue lines.....	299
Detecting creative revenue accounting .....	303
Exploring Exploitations of Expenses.....	305
Advertising expenses .....	306
Research and development costs.....	306
Patents and licenses.....	307
Asset impairment.....	308
Restructuring charges.....	309
Finding Funny Business in Assets and Liabilities.....	309
Recognizing overstated assets.....	310
Looking for undervalued liabilities.....	312
Playing Detective with Cash Flow.....	314
Discontinued operations.....	314
Income taxes paid.....	315

## ***Part VI: The Part of Tens..... 317***

### **Chapter 24: Ten Financial Scandals That Rocked the World. . . . . 319**

Enron.....	320
Citigroup.....	321
Adelphia.....	321
WorldCom/MCI .....	322
Sunbeam .....	323
Tyco.....	323
Waste Management .....	324
Bristol-Meyers Squibb.....	325
Halliburton .....	325
Arthur Andersen.....	326

### **Chapter 25: Ten Signs That a Company's in Trouble . . . . . 329**

Lower Liquidity.....	329
Low Cash Flow .....	330
Disappearing Profit Margins.....	330
Revenue Game-Playing.....	331

Too Much Debt .....	332
Unrealistic Values for Assets and Liabilities.....	332
A Change in Accounting Methods .....	332
Questionable Mergers and Acquisitions .....	333
Slow Inventory Turnover.....	334
Slow-Paying Customers.....	334
<b><i>Glossary</i></b> .....	<b>335</b>
<b><i>Index</i></b> .....	<b>343</b>