

## Question-and-Answer Guide for Investors and Nonfinancial Managers

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# Raymond J. Lipay

# Understand Those Financial Reports

Question-and-Answer Guide  
for Investors and  
Nonfinancial Managers

RAYMOND J. LIPAY

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# Preface

If you own or intend to own stocks or bonds of one or more publicly listed corporations, you have an obligation to yourself to keep tabs on those companies that will be using your hard-earned invested dollars. Also, if you are a nonfinancial manager or executive who seeks advancement and opportunity within the corporate hierarchy in order to become an integral part of the organization, you want to gain more insight into your company's financial health and operating performance. The most readily available means for maintaining a vigilant eye on your investee and/or employer companies are the financial reports those companies issue for the benefit of their stockholders. Most important, you do not have to be a certified public accountant or a financial analyst to understand the meaning and significance of financial reports.

Nonfinancial persons often regard financial reports in the same way as they regard income tax returns. Too many numbers! Too technical! Confusing! The question and answer format of this book has been designed to soften such criticisms. Questions addressed in this book are those that might arise in the minds of present and potential corporate investors and managers when they turn the pages of a financial report. Answers have been designed in such a way as to enable a reader to appreciate, comprehend, and interpret the meaning and significance of the various types of financial reports issued by publicly listed corporations. In general, this book contains questions and related answers that should fulfill the needs of investors and nonfinancial managers, regardless of their level of knowledge concerning financial reports.

The guts of all financial reports are the financial statements, related notes, and other supplementary financial information that accompany those financial statements. This book will help to dispel any mystique that shrouds such financial data so that investors and nonfinancial managers may get the message behind the numbers. As a result, you will learn how to measure a corporation's performance, recognize red lights or warning signals concerning troubled situations, and interpret financial accounting and reporting terms as they are used throughout financial statement related data.

A special chapter is devoted to the audit reports that accompany financial statements. Their meaning and significance are explored.

Financial reports also contain financial and related narrative data that are not covered by audit reports. These include financial highlights, the president's letter, and the management report. The importance of these and other nonaudited items are covered in a separate chapter.

A unique feature of this book is a separate chapter on those financial reports filed by publicly listed companies with the Securities and Exchange Commission (SEC). The purpose of these reports and the ways they differ from the conventional annual and interim financial reports issued to stockholders are described.

In order to obtain a clear picture as to how financial reports are packaged and presented to shareholders, illustrations of financial statements, related notes, supplementary financial information, audit reports, and other related data are provided in designated chapters. These illustrations were taken from the 1982 annual reports of certain well-known publicly listed corporations. A glossary of 100 key terms and phrases that might be helpful in reading and analyzing financial reports is also provided as a reference aid at the end of this book.

For you as an investor, an understanding of financial reports issued by publicly listed corporations will provide you with a twofold advantage: (1) you will feel as though you are taking an active part in your investment, and (2) you will derive investor confidence in assessing your investment risk. For you as a nonfinancial manager, an understanding of financial reports issued by your employer corporation will enable you to be more aware of your company's past, present, and future. The question and answer format of this book will provide that essential understanding. Reading financial reports will then become a pleasure rather than a chore.

RAYMOND J. LIPAY

*New York*  
*November 1983*

# Understand Those Financial Reports

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## *Chapter One*

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# Overview of Financial Reports

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## INTRODUCTION

The majority of investors in publicly listed corporations are not directly involved or affiliated with their investee companies. Therefore, they cannot visualize on a day-to-day basis how those companies conduct their business operations. Financial reports help to resolve this obstacle by serving as the primary channel of communication between corporate management and owners (i.e., investors). Millions of dollars are spent annually by publicly listed corporations to produce and distribute financial reports in order to keep investors informed as to their investee companies' financial health and progress in an economic and competitive environment. This chapter covers the purpose and importance of financial reports, the basic types issued to stockholders, their overall content, and the frequency of their distribution.

## PURPOSE AND IMPORTANCE

- Q:** What is the purpose of financial reports?
- A:** Financial reports are documents used by corporations to report information concerning corporate management's stewardship function to stockholders and other interested parties, such as creditors, suppliers, and financial analysts. In this way users of financial reports are able to judge management's philosophy, performance, goals, and future prospects.
- Q:** How does information concerning management's stewardship function benefit investors?
- A:** Such information enables investors to assess the risks and returns of their investment dollars. In this way, investors can ascertain whether or not management is fulfilling its assigned responsibility, that is, managing and implementing the corporation's resources effectively.

**Q:** What types of companies issue financial reports?

**A:** Generally financial reports are issued by those companies that are considered to be publicly listed or publicly traded. In other words, such companies have their debt (i.e., bonds) or equity (i.e., stock) securities traded in a public market on a domestic stock exchange (e.g., the American Stock Exchange and the New York Stock Exchange) or in the domestic over-the-counter stock market. Publicly listed companies are also required to file their financial statements with the Securities and Exchange Commission (SEC), a regulatory agency of the federal government. Once a business enterprise issues its financial statements in preparation for the sale of any class of securities (i.e., bonds or debentures, preferred or common stock), that enterprise or company is considered to be a “publicly traded” or “publicly listed” company.

**Q:** As a potential shareholder, why should I look at financial reports when I can easily get a broker to advise me as to what companies I might invest in?

**A:** Investing in the securities of a particular company through a broker is like buying property through a real estate agent. Although a real estate agent will advise you to buy a particular piece of property that is within your financial means, you would generally inspect the property to determine its condition before actually purchasing it. The same should hold true for a purchase of a company’s securities. A careful reading of that company’s financial report prior to making an investment decision will give you some indication as to the company’s operating condition and financial health.

**Q:** Now that I own shares in a particular company, why should I read the financial reports issued by that company? My broker will advise me as to whether I should continue to maintain the investment or sell out.

**A:** That’s true! However, investing in a public company is similar to

being a landlord of rental property. As a landlord, you would make periodic visits to the rented property to see that everything is in working order. In like manner, as an investor (or partial owner) of a company you should be inclined to “check up” periodically on your investment. Financial reports provide an opportunity for this periodic “checkup” on your investment.

## TYPES OF FINANCIAL REPORTS

**Q:** What are the most common forms of financial reports issued by publicly traded companies?

**A:** The two most common types are annual reports and interim reports. Annual reports present financial information covering an operating cycle of a corporation’s business, which is generally one full year. Interim reports present financial information covering three months, or a quarter of a year, for example, January 1, 19X2 through March 31, 19X2. Two other types of financial reports issued by publicly traded companies that must be filed with the SEC are:

1. SEC Form 10-K, an expanded version of the annual report.
2. SEC Form 10-Q, an expanded version of the interim report.

Although SEC Forms 10-K and 10-Q are similar in most respects to annual and interim reports issued to stockholders, both forms contain additional financial and nonfinancial information that might interest readers of financial reports.

**Q:** When comparing annual with interim reports, which is more important in terms of credibility?

**A:** Annual reports might be considered more important in terms of credibility because the financial statements included within annual reports are audited or examined by independent certified

public accountants (CPAs). Although financial information included within interim reports is not audited or examined by CPAs, interim reports are important to investors because the information contained therein is part of a total and continual flow of information to the investment community.

- Q:** Should an investor refer to both interim and annual financial reports, or is the information provided within annual reports sufficient for keeping tabs on an investee company?
- A:** An investor should have access to both interim and annual reports of an investee company. Although the annual report provides information regarding a company's history and operating performance throughout the past year, interim reports can serve as a timely progress report to an investor regarding investee company activities during the course of a year.

## CONTENT OF FINANCIAL REPORTS

### Basic Information

- Q:** What kinds of information does a typical annual report include?
- A:** An annual report typically includes such data as:

*Description of the company's business (products or services).  
Objectives, philosophy, and strategy of the business.  
Explanations of current developments that might affect the business, such as conditions existing within the industry, legislative and foreign policies that affect the operation of the company, the labor-management situation, and economic conditions that affect the company (e.g., inflation).  
An indication of the company's future outlook.*

*Programs the company has undertaken to fulfill its social responsibility (e.g., environmental protection or aid for the handicapped).*

*The company's financial results for the current and preceding years.*

### Method of Presentation

**Q:** How is all of this information presented within an annual report?

**A:** Annual report information is presented through a combination of the following:

*Narrative material, such as a letter from the company's president to its shareholders, company description and statement of philosophy.*

*Pictures of operating locations, plants, and offices.*

*Highlights or review of financial results.*

*Charts and graphs that illustrate certain financial results by product lines and/or service, as well as trends over past years.*

*Audited financial statements and other supplementary financial information.*

### Charts and Graphs

**Q:** How important are the colorful and often impressive charts and graphs in annual reports?

**A:** Graphics alone are not important as a means of understanding a company's activities in order to assess investment risk. Graphics are important only when they are an integral part of the entire company story. In other words, elaborate artwork should complement the narrative and financial information.

### Overall Review of Annual Report

**Q:** Since there appears to be a great deal of information within an annual report, how might a prospective investor obtain an overall view of a company's operations from reading the report?

**A:** In order to obtain an overall or "summary-type" review of a particular company, a prospective investor might look at:

*The president's letter.*

*Financial highlights or review section.*

*Selected financial data.*

*Management's discussion and analysis of financial condition and results of operations.*

*Report of management.*

**Q:** Would the above information be adequate for a prospective investor to make an investment decision?

**A:** Not necessarily, because such information is unaudited. When making an investment decision, a prospective investor should rely primarily on the audited financial statements contained within an annual report.

### Audited Versus Unaudited Financial Information

**Q:** Why should a prospective investor rely on the audited financial statements rather than the unaudited information? What is the basic difference?

**A:** The unaudited information (e.g., president's letter, financial highlights) is usually not verified or examined by a party outside the particular company. On the other hand, audited financial statements are examined by CPAs who are independent of the



company that issues such statements. As a result, the annual report will contain an independent auditor's report, which will indicate that:

*Certain auditing steps were undertaken to verify the items contained in the financial statements, and to make certain that these steps met standards of practice approved by the public accounting profession.*

*The financial statements covered by the independent auditor's report have been prepared by the company's management in conformity with generally accepted accounting principles.*

In other words, if the annual report contains financial statements that have been audited or examined by public accountants who are independent of the company in question, a prospective investor can be reasonably assured that the figures within those financial statements have a certain degree of credibility.

**Q:** What is the general purpose of these audited financial statements, and what are they comprised of?

**A:** Audited financial statements represent a progress report and a summation of the current financial condition of a business. They serve as a measure of management's past performance and are presented in conformity with generally accepted accounting principles on a comparative basis with prior years. Audited financial statements found in annual reports include:

*Balance sheet.*

*Income statement or statement of earnings.*

*Accumulated retained earnings statement, which may often be combined with the income statement, or a statement of changes in stockholders' equity.*

*Statement of changes in financial position.*

*Footnotes, which clarify and explain certain items in the actual financial statements.*