

Accounting: The Basis of Business Decisions?

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Has your telecommunications company ever been asked to provide your financial information to a third party? Of course it has. Are those third parties just being nosy or is there a sound reason for wanting to see your financial statements? Being an accountant by trade, I can assure you that your financial statements speak volumes about how your company is doing.

The title of the text book for my first business course was *Accounting: The Basis of Business Decisions*. My teacher wanted to emphasize that accounting information was the starting point for good financial choices and good management control. But as I took more courses, I also learned that financial information is how companies are evaluated and how companies let the outside world know how they are doing. As you all know, third parties, such as insurance underwriters, use a company's financial information to make assessments about it.

The starting point for a third party's financial analysis of a company is its audited financial statements (AFS). AFS include the balance sheet, income statement, statement of cash flows and explanatory notes. An audit is performed by external, qualified, independent certified public accounts, licensed by their state, who follow generally accepted professional standards. The auditors issue their opinion with the AFS. The desired result is an "unqualified" opinion, which means that the auditor did not find anything in the company's financial presentation or control environment that would cause them to "qualify" or reserve their opinion. AFS almost always

are presented with the information from the current year and the previous year so that the user can make comparisons between the two.

With the AFS in hand, the underwriter can begin his financial analysis of the company. The balance sheet presents a snapshot of the company's financial position as of a certain date, usually the company's fiscal year-end. The balance sheet is divided into three principle components: assets, liabilities and equity. Simply put, assets are the tools or resources of a company, liabilities are



what it owes and equity is what it owns. The underwriter will test certain ratios on the balance sheet, like the current ratio (current assets over current liabilities, which is a measure of liquidity) and working capital (current assets less ▶▶▶

current liabilities). The analyst also will use the balance sheet to check the leverage ratio by dividing total liabilities by total assets.

Inventory turnover is tested by dividing the accounts receivable number on the balance sheet by 365. Most of the companies I've seen don't hold inventory, so this is really a test of receivable recovery and the nature of collections.

The balance sheet is the income statement that reports the company's activity. It's like a snapshot—it only hints at what has happened and what's going on. It is usually for the entire fiscal year, and in its most basic form, is divided into three main sections: revenue, expenses and taxes. Other comprehensive income such as unrealized gains on investments and foreign currency exchange adjustments are generally reported net of tax effect on the income statement. Extraordinary

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Underwriters use net income to measure profitability through the profit margin (net income divided by revenue), the return on assets (net income divided by total assets) and the return on equity (net income divided by total equity). Some analysts seek a different measure of operations to gauge profitability by using earnings before interest payments and taxes (EBIT) and EBIT less depreciation and amortization (EBITDA). Other exotic measurements such as free cash flow can be used, depending on the needs of the analyst. For stock companies, one of the best-known measures of profitability is earnings per share (net income divided by the number of outstanding shares).

The income statement also allows the analyst to measure the relationship between revenue and expenses. For example, expenses divided by revenue or a component of revenue will show the



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impact of each expense line item on revenue. This is useful for comparisons between the years and highlights direct expenses and overhead.

The statement of cash flow lets the user of the AFS see how cash was used by the company during the reporting period. There are two forms of the cash flow statement: direct and indirect. Direct presentations also must include the indirect presentation, so more often than not, most AFS only have the indirect presentation. That presentation has four parts: cash from or used in operations, cash from or used in investing activity, cash from or used in financing activity and a reconciliation of beginning cash to ending cash. The operations part begins with net income and adds back non-cash operating transactions like depreciation, and then adds or subtracts the changes in most balance sheet line



items from the prior year to the current balance sheet date. The investing activity part focuses on purchased and sales of fixed assets and marketable securities, and the financing activity part shows money received from loans and stock offerings or money used to repay loan principle. The sum of the three parts is cash generated (or used) during the year.

While the three main AFS are invaluable for financial analysis, the notes to the financial statements are just as important. The notes explain operations and the basis of accounting, and contain specific information required by generally accepted accounting principles and auditing standards.

Of course, financial analysts might also look for information from various other sources to rate a company. Reports from management to shareholders such as the annual reports, reports from rating agencies like Dun & Bradstreet and industry data from government agencies are all used to augment knowledge of the company and shed light on operations. But at the heart of financial analysis are the AFS—the basis for business decisions. ■

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