UNDERSTANDING FINANCIAL STATEMENTS

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UNDERSTANDING FINANCIAL STATEMENTS

I. Generally, there are two types of prepared financial statements, internally prepared or prepared by a CPA firm.

A. Internally prepared statements can be prepared by the owner of a business, the business's internal accounting staff or a bookkeeper. Internally prepared financials should be viewed with a certain degree of skepticism. Most often, internally prepared financial statements are not prepared following generally accepted accounting principles (GAAP), and can be far from it.

B. Internally prepared statements can be deficient in numerous areas.
1) Lack of consistency
2) Failure to present reconciled balances for cash or liabilities
3) Overstatement or understatement of inventory
4) Misstatement of the value of assets
5) Failure to properly record or classify revenues and expenses
6) Failure to disclose material facts

C. Financial statements prepared by a CPA firm can provide a level of assurance not present with internally prepared statements. CPA firms can issue three forms of financial statements: compilations, reviews or audits.

1) Compiled financial statements provide the least amount of assurance for CPA prepared financial statements, if any. The opening report language is: "We have compiled…" The compilation report states that the financial statements have not been reviewed or audited. There is hardly any assurance associated with a compilation report. A compilation engagement indicates that the CPA has merely put information, supplied by the client, into proper financial statement form without expressing any assurance or opinion. If an accountant becomes aware that information provided by the client is incorrect, incomplete or otherwise unsatisfactory, the accountant must discuss the issue(s) with the client and determine if a material misstatement will be caused if the information is unsatisfactory and used in preparing the compilation.

2) Reviewed financial statements provide a limited degree of assurance that the CPA is not aware of any material modifications that should be made to the financial statements. In a review engagement, the CPA is required to perform analytical procedures, inquiries and other procedures to obtain limited assurance on the statements. The user of the financial statements

is provided with a level of comfort on their accuracy. The opening report language is: "We have reviewed…"

3) Audited financial statements provide the highest level of assurance service the CPA can perform, and is intended to provide the user comfort on the accuracy of the financial statements. An audit requires the application of generally accepted auditing standards such as corroboration of amounts and disclosures and obtaining audit evidence through inquiry, physical inspection, observation, third-party confirmation, examination, analytical procedures and other procedures. Following an audit, without qualification, the auditor will opine that the financial statements are presented fairly, in all material aspects, in accordance with GAAP or the applicable financial framework required. The opening report language is: "We have audited…"

4) In each type of engagement, compilation, review or audit, it will be stated that company management is responsible for the financial statements.

D. What are generally accepted accounting principles (GAAP)? Generally accepted accounting principles are a culmination of specific principles, postulates and procedures developed to provide, when properly applied, financial information to users about the financial position, performance and changes in the financial position of an entity. GAAP employs the accounting of financial transactions using the accrual basis of accounting where elements of the financial statements are recognized prior to their being settled in cash transactions. Accrual basis accounting is more reflective of the economics of a transaction than a cash only basis. Accounts that would be disclosed on GAAP statements, but possibly omitted from cash basis statements would include:
   1) Accounts receivable and sales revenue
   2) Inventories and cost of goods sold
   3) Accounts payable
   4) Other liabilities and expenses.

E. There are non-GAAP compliant prepared financial statements using other methods of accounting. If the financial statements have not been prepared using GAAP, then they are referred to as OCBOA statements. OCBOA is an acronym for Other Comprehensive Basis of Accounting.

   1) The most commonly used accounting method for the preparation of financial statements is the cash basis. The cash basis of accounting is the recording of completed cash receipts and disbursements, with modifications for such items as depreciable assets.

2) Tax basis accounting, which is based on statutory rules and regulations, does not purport to represent GAAP. The potential "gotcha," or "got them"– tax returns are signed under the penalties of perjury.

3) A regulatory basis of accounting can require departure from GAAP. Examples would be utility, insurance or governmental accounting.

4) A contractual basis might be used to comply with an arrangement between the reporting entity and one or more third parties. There is a deviation from GAAP by agreement.

5) Be mindful of financial statements prepared using Conveniently Recognized Accounting Procedures, or CRAP, adopted by entities with something to hide or embellish. CRAP basis statements are very common in litigation matters and are most often internally prepared.

II. Balance sheet

A. This is the statement of assets, liabilities and equity, which is the basis for the basic accounting equation: Assets = Liabilities + Equity.

B. The balance sheet shows what assets are owned and who owns them. To the extent creditors have claims on assets, the assets are owned by the creditors, not the equity holders.

1) Balance sheets are created as of a certain date, such as December 31, 20xx, not For the Year Ended December 31, 20xx. The balance sheet is a snapshot as of a point in time.

2) Assets are generally shown at cost, not fair market value. Occasionally, marketable securities will be shown at FMV.

a.) Inventory valuation methods can have a material impact on the determination of net income. There are numerous acceptable inventory pricing methods.
i. Last in, first out or LIFO
ii. First in, first out or FIFO
iii. Average cost
iv. Direct costing
v. Base stock method

C. Current assets are things a company would expect to convert into cash within one year. Total current assets might include cash, marketable securities, accounts receivable, inventories, work-in-progress, and prepaid expenses.

D. Current liabilities are claims against a company that are expected to be paid within one year. Total current liabilities might include accounts payable to vendors, sales tax payable, payroll taxes payable, customer advances, accrued interest, income tax payable or the current portion of long-term debt and capital leases.

E. Working capital is the difference between the current assets total and the current liabilities total. Working capital is an indication of an entities ability to pay its bills currently or timely.

F. Fixed or depreciable assets are those assets that are not held for sale and generally have a life expectancy of more than one year. The cost of the assets are recovered through depreciation expense.

G. Other assets, shown at the bottom of the balance sheet, can represent a variety of items, including intangibles such goodwill, patents, copyrights and deferred taxes. Under GAAP, these intangible assets are required to be measured at year end at "fair value." This is not fair market value. Other assets can also include non-productive assets and misfits.

H. Long-term debt, leases and contingencies are reportable at the value due to the creditor. The lower portion of the liabilities section generally shows the long-term debt, capital leases and other obligations that will not be a demand on current assets during the following twelve-month period. Contingent liabilities may be noted in this section of the balance sheet but not recognized and recorded.

I. The equity section of the balance sheet represents the owners' claim on the net assets of the business. The presentation differs with the type of entity reporting its financial position. A proprietorship will show owner's equity, a partnership will show partner capital, and a corporation will show the investment by owners and retained earnings. The equity section of a corporation can also show treasury stock held by the company.

III. Income statement

A. The income statement shows how much revenue is earned over a specific time period and the related costs and expenses associated with earning the revenue.

B. Income statements generally report income or loss on a quarterly or annual basis. An income statement is like a motion picture, in that it reports activity on a cumulative basis for the period shown. An income statement should indicate the period covered with a heading stating "for the quarter ended" or "for the year ended."

C. As the indicator of profitability, the income statement should, at least, indicate the total revenues, cost of sales, other expense and net income or loss for the period.

IV. The statement of cash flows is an integral part of the financial statements and might colloquially be called "Show Me the Money." Another slang term for the statement is "Where Did the Cash Come From and Where Did It Go."

A. The cash flow statement reports a company's inflows and outflows of cash and shows the increase or decrease in cash over the time period being reported.

B. The changes reported in the statement tie balance sheet and income statement together.

C. The statement of cash flows is an important tool for analysts.

V. The notes accompanying financial statements can provide the details required in having a complete financial understanding of a company, at least as far as the financial statements will permit.

A. The notes disclose pertinent information regarding numerous elements within the financials, including such things as accounting policies and practices, detailed information regarding long-term debt, pension plan commitments and stock options for management.

B. Notes to the financial statements must be present for the financial statements to be in conformity with GAAP.

C. The notes to the financial statements are rarely, if ever, provided with internally prepared financials. When provided, the notes may explain some of the following:

- Summary of significant accounting policies
    - Basis of accounting
    - Nature of operations
    - Use of estimates
    - Cash and cash equivalents
    - Inventory
    - Property and equipment
    - Revenue and cost recognition
    - Evaluation of subsequent events
- Transactions with related parties
- Property, equipment and depreciation
- Financing activities
    - Lines of credit
    - Notes payable

Lease obligations payable
Surety bonds
Contingencies
Backlog
Measurement of fair value
Discontinued operations
Retirement plan arrangements
Employee benefits
Income taxes
Intangible assets and goodwill
Litigation and legal matters

D. The income can be presented under various names, including income statements, statement of profit and loss, statement of operations and statement of revenues and expenses. They all represent the same statement.

VI. A. Did you cover everything in that subpoena?

XYZ, INC.

BALANCE SHEET

December 31, 2018

ASSETS			LIABILITIES		
Current assets:			Current liabilities:		
Cash	$	1,413,184	Accounts payable	$	1,168,657
Accounts receivable, net of allowance of $69,715		4,099,832	Accrued expenses		1,603,300
Inventories		562,443	Current maturities of bank long-term debt		443,682
Prepaid expenses		43,437	Current maturities of former shareholder long-term debt		71,837
Total current assets		6,118,896	Total current liabilities		3,287,476
Property and equipment:			Non-current liabilities:		
Land		913,248	Long-term bank debt, net of current maturities		6,631,478
Buildings and improvements		6,490,526	Long-term debt to former shareholder, net of current maturities		1,487,351
Production equipment		7,574,589	Total non-current liabilities		8,118,829
Furniture and fixtures		451,312	Total liabilities		11,406,305
Automotive equipment		284,582			
		15,714,257			
Less accumulated depreciation and amortization		(4,682,056)			
Net property and equipment		11,032,201			
Other assets:			STOCKHOLDERS' EQUITY		
Intangible assets, net of accumulated amortization of $375,483		2,467,002	Common stock, $.01 par; 10,000,000 shares authorized, 45,420 issued		454
Deposits		676,018	Capital in excess of par		1,958,190
Note receivable		26,902	Retained earnings		9,770,824
Cash value of life insurance		18,130	Treasury stock, at cost		(2,796,624)
Total other assets		3,188,052	Total stockholders' equity		8,932,844
	$	20,339,149		$	20,339,149

See accompanying notes and accountants' review report.

XYZ, INC.

INCOME STATEMENT

For the year ended December 31, 2018

Sales	$	26,734,004
Cost of sales:		
Paper, material and sublet work		7,682,396
Payrolls and related expenses		11,686,045
Equipment and related expenses		2,244,825
Total cost of sales		21,613,266
Gross profit		5,120,738
Operating expenses:		
Compensation		677,422
Rents		333,512
Interest		458,107
Depreciation and amortization		321,798
Utilities		144,211
Other operating expenses		267,449
Total operating expenses		2,202,499
Income from operations		2,918,239
Other income (expense)		115,202
Net Income before taxes	$	3,033,441

See accompanying notes and accountants' review report.

XYZ, INC.

STATEMENT OF STOCKHOLDERS' EQUITY

For the year ended December 31, 2018

	Common Stock		Capital in Excess	Retained	Treasury Stock	
	Shares	Amount	of Par	Earnings	Shares	Amount
Balance, December 31, 2017	#####	$ 454	$ 1,617,744	$ 7,750,962	(41,799)	$ (2,809,492)
Net income for the year	-	-	-	3,033,441	-	-
Dividends paid	-	-	-	(1,013,579)	-	-
Sale of treasury stock	-	-	340,446	-	-	12,868
Balance, December 31, 2018	#####	$ 454	$ 1,958,190	$ 9,770,824	(41,799)	$ (2,796,624)

See accompanying notes and accountants' review report.

XYZ, INC.

STATEMENT OF CASH FLOWS

For the year ended December 31, 2018

Cash flows from operating activities:		
Net income	$	3,033,441
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization		1,376,325
(Gain) loss on disposition of assets		(15,094)
(Increase) decrease in:		
Trade accounts receivable		(892,606)
Inventories		(334,194)
Prepaids and other assets		(673,166)
Increase (decrease) in:		
Accounts payable		464,841
Accrued expenses		483,062
Net cash provided by operating activities		3,442,609
Cash flows from investing activities:		
Acquisition of goodwill		(2,185,909)
Acquisitions of equipment		(2,120,260)
Proceeds from sale of equipment, net		46,959
Proceeds from note payments received		3,926
Net cash used by investing activities		(4,255,284)
Cash flows from financing activities:		
Dividends paid		(1,013,579)
Proceeds from long-term bank debt		2,400,000
Principal payments on long-term debt		(347,935)
Sale of treasury stock, net		353,314
Net cash used by financing activities		1,391,800
Net increase (decrease) in cash		579,125
Cash, beginning of year		834,059
Cash, end of year	$	1,413,184