Attorney CLE Series

An Attorney's Guide to Understanding Financial Statements

A PRIMER FOR UNDERSTANDING, INTERPRETING AND ANALYZING FINANCIAL STATEMENTS

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GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena. His expertise in specific purpose valuations is well known, and he is a frequent speaker, regionally and nationally, on tax and valuation matters.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

Bob has written numerous articles for several area business publications and professional trade journals. He is a national instructor for both the American Institute of Certified Public Accountants and the National Association of Certified Valuators and Analysts and has served as an adjunct professor for Duquesne University's MBA program.

A member of the American and Pennsylvania Institutes of Certified Public Accountants, Bob previously chaired the Pittsburgh Committee on Taxation. He is also the past chair of the Education Board of the National Association of Certified Valuation Analysts as well as a former member of the organization's Executive Advisory Board, its highest Board.

He is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the Pittsburgh Chapter of the American Society of Appraisers. Bob has held numerous offices and directorships in various regional not-for-profit organizations. He received the 2003 Distinguished Public Service Award from the Pennsylvania Institute of Certified Public Accountants and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two children, Matthew and Alyssa.

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Steve has practiced in the public accounting field for 15 years. He has extensive experience in audit and accounting for both privately-held companies and not-for-profit entities. Steve serves a wide array of industries, including manufacturing, construction, real estate and technology development.

Steve brings experience in dealing with acquisitions and divestitures, due diligence procedures, contract accounting, and financial statement analysis. He also specializes in providing accounting and auditing services to not-for-profit organizations, including the enhanced auditing and reporting requirements for federal, state and local funding. Steve has provided guidance on revenue recognition, fund accounting and other issues pertinent to not-for-profit organizations.

After graduating from Grove City College with Highest Honors in Accounting, Steve joined Grossman Yanak & Ford LLP in 1995. As a CPA in Pennsylvania, Steve is a member of the Pennsylvania and American Institutes of Certified Public Accountants.

Steve's service to the community includes serving as treasurer for Shoulder to Shoulder Pittsburgh-San Jose, Inc., a not-for profit organization that provides medical and nutritional support to a rural area of Honduras. He is very involved as an elder in his church and serves as a member of the Budget, Finance and Stewardship committees. Steve is also the president of a local preschool.

He resides in Shaler Township with his wife, Heather, and their children, Noah and Laura.

Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory; tax planning and compliance; business valuation; and technology services. Led by five partners, the 20-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities in western Pennsylvania, eastern Ohio, northern West Virginia and New York.

Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client received the services of a skilled professional with a broad range of experience and knowledge that can be called upon to provide efficient, effective assistance.

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Please contact Mary Lou Harrison to schedule a date: 412-338-9300 or harrison@gyf.com

Table of Contents

I. *Introduction* 1

II. *Financial Statement Basics* 3

III. *Types of Accounting Services and Reports* 8

IV. *Financial Statement Disclosures* 14

V. *Financial Statement Analysis* 17

VI. *Financial Ratio Analysis* 22

VII. *Fraud and Financial Forensics* 31

VIII. *Conclusion* 36

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An Attorney's Guide to Understanding Financial Statements

Chapter I – *Introduction*

Understanding that the majority of legal cases conducted in civil court, as well as many in criminal court, turn on financial concepts and numeric information, it is critical that those involved in the legal representation of the parties to these actions possess the depth of knowledge required to attain the best possible resolution for their clients.

At the very heart of all financial information, from whatever source, is the discipline of accounting and the system of "double-entry" accounting within that discipline. Without question, double-entry accounting serves as the basic language of business. Developed as far back in time as the 13th century, the primary purpose of the concept of double-entry accounting has always been to reduce the likelihood of data entry errors in the accounting detail records.

The core aspect of double-entry accounting is, as the name suggests, that every accounting matter be recorded in the books of account with at least two entries. Using double-entry accounting means that at least two accounts are used to record every accounting activity. Properly used, double-entry accounting can tell a reader what is owned, what is owed, what is received or earned, and what is spent or disbursed.

When at least two accounts are used in a double-entry accounting system, the record is referred to as an accounting "transaction." Collectively, all transactions accumulated over a defined period of time serve as the very foundation for financial statements prepared under generally-accepted accounting principles. Ultimately, this same information (with certain statutory adjustments) provides the basis for a Company's income tax returns.

By way of analogy, if the financial statements are the finished product, such as an automobile, each of the transactions is just one of the many hundreds, if not thousands or millions, of particular parts that make up that finished product.

Mechanically, and as this program will demonstrate, there is an interrelationship between each of the financial statements presented under generally-accepted accounting principles. Thus, it is imperative that readers understand how a balance sheet relates to an income statement and changes in shareholder, partner or owner's equity. Moreover, all of these statements, then, are interrelated to the statement of cash flows.

Understanding the transitional aspects of accounting, as well as the composition and interrelationship of financial statements, is the first step in building a better interpretative skill set as to what this information means. This interpretative understanding, then will allow members of the legal community to better resolve issues and legal actions on behalf of their clients.

An Attorney's Guide to Understanding Financial Statements

Accounting, and the double-entry system to produce financial statements, tells a story. If all historical accounting is proper, a detailed reading of the financial statements, as well as the application of commonly-utilized analytical procedures can lead you easily to the story's plot.

On the other hand, if historical accounting is not proper, forensic principles, including review of detailed transactions and application of the same commonly-utilized analytical procedures (albeit, in a modified format) can often lead to that story's plot.

The goals of today's program are to provide you with a foundational understanding of financial accounting and the construction of financial statements prepared under generally-accepted accounting principles, as well as to teach you how to read financial statements and generally interpret what they mean.

Finally, the presentation will include an overview of those analytical procedures that seem to be the most commonly used by the financial community in interpreting financial statements.

Please feel free to contact any of today's presenters in the event that you have further questions or comments about today's program.

An Attorney's Guide to Understanding Financial Statements

Chapter II – *Financial Statement Basics*

Financial statements are a key tool for understanding the financial health and direction of a business. Being able to read and understand financial statements, therefore, is a valuable skill for any professional that seeks to better serve his or her business clients. Properly prepared financial statements can inform the reader about a company's ability to:

- Meet its obligations
- Generate a profit
- Provide a return to its owners / investors

However, developing an accurate picture of these business basics will usually require the reader to gather information from a variety of places throughout the financial report; not doing so may lead the reader to form inaccurate conclusions. The reader will also need to know how to analyze the financial information in light of historical trends, budgeted expectations, and comparable industry statistics.

There are no presentation requirements for internally-prepared financial statements, those prepared by the company for its own analysis and decision-making purposes. As a result, such financial statements may not include all of the information necessary for an outside reader to formulate accurate conclusions about the company. Externally prepared financial statements, which include a report rendered by an independent accountant, are designed to provide the reader with greater assurance and clarity regarding the information contained within the financial report. For this reason, the accounting industry has developed a host of rules and guidelines for externally prepared financial statements to attempt to clarify the financial story being presented.

The body of rules and principles that has been developed for financial reporting is referred to as generally accepted accounting principles, or **GAAP**. These principles are promulgated by the Financial Accounting Standards Board, or **FASB**, which is a non-governmental body that meets to research accounting issues and make revisions to GAAP as determined to be appropriate for the improvement of the financial reporting process.

While not all externally prepared financial statements look exactly the same, the following are the basic elements that are common to most of them (in order of presentation):

- Accountant's report (discussed in Chapter III)
- Required financial statements
- Required footnote disclosures (discussed in Chapter IV)
- Other supplementary information (optional)

An Attorney's Guide to Understanding Financial Statements

Required Financial Statements

Each financial statement is one piece of the company's overall financial puzzle. Without each piece, the picture will not be complete, and the user will not be able to accurately assess a company's ability to achieve its business objectives. A complete financial statement presentation should include the following statements:

- Balance sheet
- Income statement
- Statement of changes in equity
- Statement of cash flows

Balance Sheet

The balance sheet presents the assets, liabilities and equity of a company as of a point in time. This is usually the end of a company's fiscal year, but it could also be an interim date, such as a quarter or month end, or it may be as of the date of a particular event, such as the date of the company's formation or an acquisition date.

The assets are those items that are owned by the company. They can be tangible (or physical) assets, such as cash, inventory or property or intangible, such as intellectual property, customer lists and trademarks. They are also described in terms of their ability to be converted into cash. Assets that are expected to be converted into cash or consumed during the business's operating cycle (typically one year) are called **current assets**. Common current assets include cash, accounts receivable, inventory, and prepaid expenses. Other assets may take a longer time to consume or convert into cash and are called **noncurrent assets**. This category would generally include fixed assets such as real estate and personal property, intangible assets, notes receivable, and pension-related assets.

The nature and classification of assets is important for financial statement analysis (as discussed later). Thus, the balance sheet should be presented in order of liquidity, with current assets listed first, followed by noncurrent assets. For example, cash, generally being the most liquid asset, is usually the top line of the balance sheet. Many balance sheets will present a subtotal for current assets, although this is not a requirement under GAAP.

Liabilities are those amounts that are owed by the company. The settlement of a liability may be through the payment of cash, the forfeiture of a non-cash asset, or the exchange of the liability for another liability. Similar to assets, liabilities are differentiated by the timing of when they will be settled. Liabilities that are expected to be settled during the business cycle (typically within one year) are considered to be **current liabilities**. Common current liabilities include accounts payable, accrued payroll and other expenses, deferred revenue and tax liabilities. Long-term liabilities are those that will not be settled within one year. Notes payable, capital leases and pension obligations are common examples of long-term liabilities. It is important to note, however, that these liabilities may have a component that will be settled within one year, and that component is considered to be a current liability. Scheduled monthly debt repayments on a mortgage that are due within one year would be a current liability even though the remaining balance of the mortgage is a long-term liability.

This differentiation is important because, like assets, liabilities are presented in order of their expected settlement. Accounts payable may be the most current liability, as vendor payment terms are typically within thirty days. A subtotal for current liabilities is often presented, though not required.

The excess of assets over liabilities is the company's equity. Equity is usually comprised of ownership units, such as stock for corporations, membership units for limited liability companies or capital accounts for partnerships. The ownership structure can be very complex. A corporation may issue preferred stock and common stock. Each class of stock can be assigned different voting rights, dividend rights and liquidation preferences. In addition, stock options or warrants may exist and have a multi-year vesting period. Corporations may also choose to buy back their own stock. These shares may be retired and canceled or held in treasury by the company for future reissuance (**treasury stock**).

Partnerships and limited liability companies also have a lot of flexibility in establishing their capital structure and ownership rights. These terms will be specified in their operating agreements.

A company may have more liabilities than assets and, in such case, have a deficiency rather than equity. This will generally occur when a company has experienced losses from operations. A company should present a capital deficiency on the balance sheet even though the owners may not be obligated to fund the shortfall (such as in a limited liability company).

Income Statement

The income statement presents the results of the company's revenue and expense transactions. It covers a period of time (most often one year) rather than a point in time, like the balance sheet.

The income statement is basically a process of reduction. It begins with the company's total revenue from sales and subtracts its cost of goods sold to arrive at gross profit. Cost of goods sold includes those costs directly related to the product or service that is being sold and can vary depending on the industry. For a manufacturer, cost of goods may include significant costs for materials and production facilities and equipment, as well as production labor. For a service company, direct service labor may be the main component and materials costs may be less significant.

An Attorney's Guide to Understanding Financial Statements

From gross profit, other operating expenses are subtracted to arrive at income from operations. Operating expenses include all costs related to and attributable to the company's on-going operations.

Other income and expenses are then factored into the income statement. These items are not a part of the company's operating process. Gains and losses from the sale of fixed assets, interest expense, miscellaneous revenue that is ancillary to the company's business, and any unusual and infrequent income or expense items not attributable to operations are included in this section. While some of these items may be common and recurring, such as interest expense, they are not considered to relate directly to the operating process and are therefore excluded from operating income.

Income taxes, if they are applicable to the type of entity being presented, are also subtracted as a separate income statement line item to arrive at net income from operations, which may be the bottom line of the income statement. A company may also have discontinued operations (discussed below), extraordinary items, or comprehensive income. In these cases, additional lines would be presented at the end of the income statement to further adjust net income (from continuing operations) to overall comprehensive income.

Statement of Changes in Equity

A company's components of, and changes in, its equity must also be presented. The components of equity can be presented either in the balance sheet, a separate statement of equity, or in the footnotes. As noted above, the equity structure can range from very simple to very complex. A separate statement of changes in equity is often preferred when there is a complex equity structure or numerous equity transactions. In addition to any net income or loss generated during the year, other equity transactions may include issuing additional shares of stock, repurchasing stock into the treasury, paying dividends, issuing stock options or warrants or reflecting a change in accounting principles.

A company's equity may also include a noncontrolling interest in the equity of a subsidiary. This will occur when consolidated financial statements are presented for a parent company and one or more subsidiaries that are under the control of the parent. Control is usually, but not exclusively, achieved through voting power. The noncontrolling interest represents the equity attributable to the other owners of the subsidiary based on their ownership percentages and rights. This equity does not belong to the parent company; thus, it is segregated from the other components of the parent company's equity.

Statement of Cash Flows

The statement of cash flows provides the financial statement user with information regarding how the company generated and utilized cash. Similar to the income statement, the statement of cash flows reports on a period of time, such as one year. It categorizes all activities into three categories: operating, investing and financing.

An Attorney's Guide to Understanding Financial Statements

Operating activities relate to the company's ongoing current operations and is generally computed as the company's net income adjusted for transactions that are either noncash in nature or have not yet been settled in cash. Depreciation expense is commonly a significant noncash adjustment between net income and operating cash flows. Changes in current asset and current liability balances also affect operating cash, as these balances do not become cash activity until they are settled (for instance when receivables are collected or when inventory is sold).

Investing activities relate to the use of cash for long-term investment and are typically associated with the company's noncurrent assets. Purchasing or selling property and equipment (with the exception of real estate companies), issuing notes receivable and purchasing or selling investments (with the exception of investment companies) are all investing activities.

Financing activities relate to transactions involving lenders or owners and are typically associated with the company's long-term debt obligations or equity. Borrowings and repayments of debt, proceeds from the issuance of stock, and dividend payments are examples of financing activities.

Companies may engage in investing or financing transactions that are noncash and would not be included in the statement of cash flows. These transactions are reported below the statement. Examples include the financed purchase of property through the issuance of a note payable to the bank, or the conversion of debt into equity.

Together, these financial statements comprise the central component of a company's financial report and will provide a reader with information that will form the basis for making financial decisions about the company. They work in harmony to recount the performance of a company, present an inventory of what belongs to the company, and describe how the ownership of the company is structured. As will be shown in the following chapters, there is more information contained in other areas of the financial report that is critical to a proper assessment of the company's financial health, as well as common tools to analyze the information.

An Attorney's Guide to Understanding Financial Statements

Chapter III – *Types of Accounting Services and Reports*

The accountant's report frames the reader's perspective for the remainder of the report. Knowing what level of service has been performed by the independent accountant informs the reader as to the level of assurance that can be placed on the financial report. Thus, it is placed at the beginning, ahead of any of the financial content.

The accountant's report identifies the subject matter (i.e. the entity or groups of entities in the case of a consolidation or combination) and specifies the period of time covered by the report. It also describes the nature of the service performed by the accountant and the responsibilities of both management and the accountant with respect to the financial statements. Lastly, it expresses an opinion and describes any limitations on that opinion (as discussed below). If applicable, it will also refer to any supplementary information included in the financial report.

While there are numerous accounting services that are offered by CPA firms, there are three general levels of service with respect to financial reports that can be provided by independent accountants:

- Audit
- Review
- Compilation

Audits

The objective of an audit is the expression of an opinion by the auditor that the financial statements (and related footnote disclosures) are reasonably stated in all material respects. The auditor's opinion covers both the financial statements and the footnote disclosures (and may also cover any supplementary information). An audit opinion is based on the concepts of materiality and reasonable (as opposed to absolute) assurance.

Materiality is based on the auditor's judgment and is defined in FASB Statements of Financial Accounting Concepts, No. 2, *Qualitative Characteristics of Accounting Information* as:

> *"the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."*

Materiality is based on both quantitative and qualitative factors. When the results of an audit indicate that the financial statements and disclosures do present fairly, in all material respects, the company's financial condition, the audit opinion is **unqualified**. The audit is generally planned and performed with the expectation of rendering an unqualified opinion. The aforementioned standard audit report is an example of an unqualified opinion.

An Attorney's Guide to Understanding Financial Statements

There may be times when an unqualified opinion cannot be rendered. This will occur when there is either:

- a known material misstatement of the financials
- a scope limitation preventing a material aspect of the audit from being performed

When such a situation arises, the auditor's report will state the nature of the qualification and render an opinion on the financial statements, with the exception of the noted qualification. This is referred to as a **qualified** opinion, and can generally be quickly detected by the words "except for" in the report.

It is important to understand the reasons for a qualified opinion. A company may deliberately present a material misstatement of the financial statements for cost-benefit reasons. For example, a company may choose to not separately identify and segregate certain intangible assets and instead present them all as goodwill. This is not in accordance with generally accepted accounting principles; however, the company may believe that this information is not particularly relevant to the known users of the financial statements.

An auditor also may encounter a situation in which a material component of the financial statements cannot be audited. For example, a business may have an operation or business line that processes a significant amount of cash transactions at remote locations. The internal controls and supporting documentation may not be sufficient for the auditor to gain the needed level of assurance over these transactions.

When the auditor is unable to render an opinion on the financial statements at all, a **disclaimer** of opinion can be issued. However, this is very rare as it provides no assurance to the readers of the financial statements. In such cases, it is likely that the audit will simply be ceased.

The following is an example of a standard unqualified audit opinion:

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Stockholders
of ABC Company

We have audited the accompanying balance sheets of ABC Company (a Pennsylvania corporation) as of December 31, 2010 and 2009, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Firm's Signature]

Pittsburgh, Pennsylvania

May 18, 2011

Reviews

Reviews involve fewer procedures than audits and do not seek to verify the assertions made by management, only to consider the reasonableness of those assertions. Therefore, reviews provide less assurance than audits. Reviews employ analytical procedures and inquiries of management and other company personnel to identify areas of the financial statements that may be materially misstated. However, there is no verification of financial statements amounts to source documents or other standard forms of audit evidence.

An accountant's report on reviewed financial statements cannot be classified as qualified or unqualified because the accountant is not rendering an opinion on the financial statements. However, these reports can still include a reference to a departure from generally accepted accounting principles and will contain the same "except for" language as in a qualified audit report.

The following is an example of a standard review report:

INDEPENDENT ACCOUNTANT'S REVIEW REPORT

To the Board of Directors and Stockholders
of ABC Company

I (We) have reviewed the accompanying balance sheets of ABC Company (a corporation) as of December 31, 2010 and 2009, and the related statements of income, retained earnings and cash flows for the years then ended. A review includes primarily applying analytical procedures to management's financial data and making inquiries of Company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

An Attorney's Guide to Understanding Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

[Firm's Signature]

Pittsburgh, Pennsylvania

May 18, 2011

Compilations

Compilations are the lowest level of service provided by external accountants. In a compilation, the accountant is presenting the company's financial information in accordance with the required presentation requirements established for external financial statements. However, the accountant provides no assurance on the accuracy of the financial statements being presented. A compilation is a useful service when the company's management does not have the internal resources to prepare full disclosure financial statements for internal or external purposes, but the readers of the financial statements have a strong awareness of the business and are not seeking external assurance.

Unlike audits and reviews, compilations can be performed by accountants that are not independent of the company. If this is the case, the lack of independence must be noted in the accountant's report. Also, unlike audits and reviews, a compilation report may choose to omit all required footnote disclosures and present only the basic financial statements.

The following is an example of a standard compilation report (by an independent accountant):

INDEPENDENT ACCOUNTANT'S COMPILATION REPORT

To the Board of Directors
of XYZ Company

An Attorney's Guide to Understanding Financial Statements

We have compiled the accompanying balance sheets of ABC Company (a corporation) as of December 31, 2010 and 2009, and the related statements of income and retained earnings and cash flows for the years then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether these financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

[Firm's Signature]

Pittsburgh, Pennsylvania

May 18, 2011

Why Audits Provide Greater Assurance

External users of financial statements will very often prefer to have an audit performed over a review or a compilation. This is because the audit process is designed to provide greater assurance regarding the accuracy of the financial statements and disclosures, which directly impacts a user's ability to rely on those financial statements for decision-making.

One reason for this increased assurance is the risk assessment process. An audit requires the auditor to consider risks, both internal and external, to the company's financial reporting system. Through this process, the auditor gains a more in-depth understanding of the business and is in a better position to identify potential misstatements. The risk assessment process also considers the company's internal control structure. The internal control system is the body of policies and procedures that govern the company's financial reporting process. A breakdown in either the design or the implementation of internal control can increase the risk of a material misstatement of the financial statements.

An Attorney's Guide to Understanding Financial Statements

The following is a partial listing of typical risks considered by the auditor during the planning of an audit:

- Complexity of structure, issues related to management group, and effectiveness of governance
- Known or likely legal matters
- Issues related to the business's industry and regulatory environment
- Effect of general economic conditions
- Impact of political or social environment
- Nature and diversity of the business's revenue sources – product lines and customers
- Production process – availability of labor and materials, competition, product quality
- Extent and design of information technology
- Susceptibility of assets to impairment or unrecorded liabilities
- Extent of estimates in the financial statements
- Other significant changes in the business – product lines, key personnel, business relationships
- Intended users of the financial statements
- Business strategies and objectives; performance measurements

Another reason why audits provide greater assurance is because the auditor is performing and documenting substantive tests of the company's financial information. Once the auditor has assessed the risk of material misstatement, as described above, audit tests are then designed and performed to respond to the identified risks. This testing will be done through a variety of means as determined by the auditor's judgment including, confirmation with third parties, vouching of transactions, physical observation by the auditor, predictive analytical tests, and other procedures. The collective evidence gathered during the audit is evaluated in light of the risks initially identified as well as new information that arose during the audit. The results are then reported to the appropriate levels of management.

Reviews and compilations can be very meaningful in appropriate circumstances, and can be cost-effective approaches to developing quality financial reports. Still, they cannot provide the same level of assurance to a financial statement user as an audit.

Much of the audit process design and implementation is subject to the auditor's judgment. Thus, it is important that the selection of an auditor consider the auditor's level of general experience as well as industry-specific expertise, and that the auditor is diligent in the design and performance of the audit.

An Attorney's Guide to Understanding Financial Statements

Chapter IV – *Financial Statement Disclosures*

A complete financial report must include certain required disclosures to supplement the basic information presented in the financial statements. Many of these disclosures are contained in footnotes that accompany the financial statements and are an integral part of the financial report. The footnotes provide explanatory information to supplement the raw numbers in the financial statement, frame the reader's perspective and clarify areas that may be ambiguous to the reader.

Description of the Company

Proper analysis of a company's financial health begins with a basic understanding of the company itself. The first footnote should identify the legal structure of the company, where and when it was organized and its tax status. This could inform a reader as to where a company is in its lifecycle as well as the legal environment in which it is operating. This footnote should also describe the nature of the company's operations including its product lines and their significance.

Also, if the company is experiencing significant financial difficulties and there is substantial doubt about its ability to continue operating for one year beyond the balance sheet date, the footnotes may also describe the nature of the difficulties and management's plan to alleviate the condition. This is referred to as a going concern disclosure.

Significant Accounting Policies

The first or second footnote should also describe the company's significant accounting policies. Financial statement readers should be especially aware of changes in a company's accounting policies, as such changes could affect comparability of the financial statements. Policy changes must be justified by management as resulting in better accounting practices; companies are not permitted to simply change accounting policies at their discretion.

The disclosure of accounting policies may be lengthy and cover a wide range of financial statement areas. Perhaps the most significant accounting policy for most companies is revenue recognition. There are many means of recognizing revenue depending on the industry and the nature of the sales transaction, and this can have a tremendous impact on the financial statements. It is so significant that auditors are required to consider as a part of audit planning how the company could commit fraud through inappropriate revenue recognition. Other significant accounting policies may include:

- Method of valuing inventory
- Capitalization and depreciation policies for long-lived assets
- Method of estimating allowance for doubtful receivables
- Treatment of research and development costs
- Treatment of shipping, advertising and warranty costs
- Whether certain assets are valued at historical cost or fair market value

An Attorney's Guide to Understanding Financial Statements

Estimates, Contingencies and Commitments

The basic financial statements provide the reader with descriptions and amounts, but what if there are other unrecorded amounts, or what if the amounts presented are likely to change? These are important questions in obtaining the overall financial picture needed for informed decision-making.

Some financial statement amounts are indeed susceptible to future refinement as additional facts and circumstances are presented. For example, a company may have a very strong historical record of collecting its accounts receivable and, in the absence of any contrary evidence, has provided for a nominal allowance for doubtful accounts. One week after releasing its financial statements, its largest customer files for bankruptcy and the company estimates that it will receive $.30 per dollar. The initial allowance reflected by the company may have been disclosed as a significant estimate to caution the reader. Further, the customer relationship itself, if significant enough, may have been disclosed due to the inherent risk associated with any customer concentration.

Other amounts are so uncertain that they cannot be recorded in the financial statements. For example, a company is the defendant in a lawsuit and expects to lose the suit. However, the company, with the assistance of its legal representation, is unable to estimate the amount that will be payable upon conclusion of the legal matter. This situation would be required to be disclosed in the footnotes; however, the company would be correct in not recording a liability in the financial statements due to its inability to make a reasonable estimate of the amount.

Financial reports must also disclose significant future commitments. A common example of such a commitment is an operating lease. The amount owed by the company for each future year must be disclosed in the footnotes; however, these amounts are not recorded as liabilities as of the balance sheet date. Another example of an unrecorded obligation is a long-term supply agreement with a vendor, in which the company has committed to purchasing certain quantities of materials at predetermined prices.

Related Party Transactions

Companies often engage in related party transactions. Nonpublic companies with small, closely-knit ownership groups may be more likely to conduct this type of activity. This is important information for a financial statement user because these transactions may not be consummated at fair market value and can therefore create a dependency or benefit that would not exist under different circumstances.

The Financial Accounting Standards Board defines ***related parties*** as including:

a. *Affiliates of the entity*

b. *Entities for which investments in their equity securities would be required...to be accounted for by the equity method by the investing entity*

c. *Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management*

d. *Principal owners of the entity and members of their immediate families*

e. *Management of the entity and members of their immediate families*

f. *Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests*

g. *Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.*

<u>Typical related party transactions include</u>:

- Loans (either to or from the company)
- Leases (especially real estate leases)
- Purchases of materials
- Sales of goods
- Management fees or other administrative charges

A financial statement reader should be aware of related party relationships and transactions. Loans may be less likely to adhere to prescribed repayment terms. Purchases and sales, as well as the negotiated prices, may fluctuate from year to year depending on other external factors.

The financial statement disclosures are an integral part of the financial report. The disclosures may span dozens of pages to provide detail information regarding the company's accounting practices, the significance of estimates and risks within the financial statements, and its rights and obligations underlying the company's assets, liabilities and equity. While it may take a reader much longer to digest the contents of the footnote disclosures than the financial statements themselves, an accurate assessment of a company's financial health would not be possible without them.

An Attorney's Guide to Understanding Financial Statements

Chapter V – *Financial Statement Analysis*

Once the pieces of the financial puzzle are gathered, one can begin the process of assembling them into a meaningful picture of the company's financial health. Financial statement users will need to consider not only the amounts of assets, liabilities and earnings, but look at the underlying detail of those balances to understand the strength, quality and risks imbedded in the financial statements. The information needed to assess the nature of the individual assets and liabilities and the quality of the earnings and cash flows can often be obtained from the footnote disclosures, as well as through the use of ratio analysis and other analytical tools (covered in Chapter VI).

Assets

The strength of a company's balance sheet begins with the nature of its assets. Investors and lenders are interested in how readily the company's assets can be converted into cash. Generally, cash and receivables are considered to be highly liquid assets; however, the reader should not make that assumption in all circumstances. Instead, he or she should read the footnotes to determine whether there are any restrictions on the use of significant cash balances.

Receivables may include trade accounts from its normal operations, receivables from related parties, secured notes receivable and other miscellaneous receivables, as well as an allowance for potentially uncollectable accounts. Each of these categories may carry different risk considerations with respect to the timing of collectability and the potentiality for default. Thus, it is important to know the nature of the receivables and the industry to fully assess the liquidity and risk associated with receivables. Companies must disclose the components of its receivables; however, this detail information might only be presented in the footnotes to the financial statements.

Inventory often also consists of many details that are only known through a careful study of the footnotes. The method of recording inventory (such as first-in first-out, last-in first-out, average cost, or standard cost) will impact both the carrying value of inventory on the balance sheet and the cost of sales and, ultimately, the net income reflected in the income statement. The composition of inventory among raw materials and finished good, and the provision of a reserve for obsolete or unsalable inventory, are important considerations in the quality of a company's overall inventory balance. Finished goods that are ready for sale may be more liquid and carry less risk than raw materials that still need to undergo the production process.

The same considerations apply to noncurrent assets. Real and personal property may be recorded at cost or at fair market value, which may be significantly different, and are subject to estimates of useful life and impairment, if applicable. Fair market value may improve the balance sheet by increasing the carrying value of assets, but it introduces more subjectivity and volatility into the balance sheet value.

An Attorney's Guide to Understanding Financial Statements

Intangible assets, including goodwill resulting from an acquisition, may be the most subjective of a company's assets, and depending on the nature of the specific assets and the marketplace, they may also be the least liquid of the company's assets. If these are significant to the balance sheet, the reader will need to know the basis for amortizing these assets and to what extent impairment reserves have been reflected.

Liabilities

A financial statement reader's analysis of liabilities should consider two primary attributes: when the liability will need to be settled and how much estimation is imbedded in the liability's balance. A company's financial strength generally improves to the extent that it is able to defer its liabilities to future dates. A company whose liabilities are primarily accounts payable due in the next month has tighter cash flow demands than a company with a sizable long-term note payable to the bank over 15 years.

Also, greater reliance can be placed on a liability that is fixed in nature versus one that is subject to estimation. Consider an accrued liability for real estate taxes, which can be determined based on stated tax rates, versus an accrued liability for estimated environmental remediation costs, which could fluctuate depending on the level of effort needed to remediate the effected area.

A reader should also consider whether there are unrecorded liabilities that impact the financial analysis. For example, operating leases represent future obligations that are not included in the balance sheet; however, significant lease obligations should be disclosed in the footnotes. Also, the company may have contingent liabilities associated with future uncertainties. A potential loss depending on the outcome of a litigation matter may be considered contingent liabilities. Although these are not recognized in the balance sheet and may never come to pass, a financial analysis of the company would not be complete with considering the potential effects of such items.

Quality of Earnings

The income statement should also be analyzed in detail by looking at the key components that drive net income. Increased sales volume, gross profit and operating income are positive indicators of strong earnings. However, if the net income is generated by a nonrecurring transaction unrelated to the company's normal operations, such as a gain on the sale of a large piece of equipment, this would have less value to a financial reader.

Also, a company may have a long-term supply arrangement with a customer that is generating a significant amount of the company's sales. A reader would want to know how significant this customer activity is in relation to the overall financial statements as well as when this agreement will expire. Any concentration of activity with one customer is a long-term risk factor.

An Attorney's Guide to Understanding Financial Statements

Going Concern

Financial statement readers should be alert for disclosures regarding the company's ability to continue as a going concern (that is, a company that continues to operate) for a period of one year beyond the date of the balance sheet. Doubts regarding a company's ability to continue operating may be fueled by the following financial characteristics:

- Recurring losses for a period of years
- An excess of current liabilities over current assets
- A deficiency (negative amount) of equity
- Industry-specific events, such as changes in technology or regulations

The first footnote will describe the events or circumstances that cause doubt regarding the company's ability to continue as a going concern. If that doubt has been alleviated by management's plans for future operations, that plan will be disclosed as well.

Comparability

Most financial reports are presented on a dual-year basis, meaning that information for the two most recent reporting periods is presented together. Generally, the periods are side by side in order to facilitate a reader's ability to compare the two reporting periods. For the balance sheet, this comparison will be as of two points in time, for instance December 31, 2010 and December 31, 2009. For the income statement and cash flow statement, the presentation will compare two periods of time, most often a year.

By comparing two, or ideally more, years against each other, financial statement users can identify positive or negative trends in the company's earnings, liquidity or other performance measures. The income statements may be used to identify top-line changes in sales volume or bottom-line net income. The balance sheets may be used to determine whether the company is investing more or less in its inventory from year to year. The cash flow statements may be used to assess the company's typical debt retirement obligations or history of dividend payments.

The reader must be aware of circumstances that may affect the comparability of multiple years' financial statements. Occasionally these items may be discernible directly on the financial statements, such as new line items. However, a careful read of the footnote disclosures may reveal other events that were unusual or nonrecurring. A well-prepared financial report will refer to these footnote disclosures from within the financial statements in order to facilitate the reader's understanding of all pertinent information. Examples of some typical events that affect comparability are listed on the following pages.

An Attorney's Guide to Understanding Financial Statements

Reclassifications

A reclassification is a change to previously issued financial statements for the express purpose of improving the comparability of the two years being presented. A company may change how certain account balances or transactions are classified in order to improve its financial reporting relative to generally accepted accounting principles. The prior year financial statements will then be adjusted as well in order to maintain comparability of the two reporting periods. However, the reclassification only covers reporting periods that are included in the financial report; thus, if a user is attempting to compare and analyze a longer period of time, he or she may have difficulty in applying a similar reclassification to the older financial information.

New or Discontinued Operations

Business operations evolve over time. New or discontinued operations affect the comparability of financial statements in which one period reflects the operations of a particular business line or segment, but another period does not. Discontinued operations that result from the sale or closure of a business segment are segregated from normal operations and presented below income from operations in order to improve comparability and report income from ongoing operations. The balance sheet, though, will still include assets and liabilities related to the discontinued operations. In a similar fashion, any newly acquired business lines would impact the financial statement presentation for periods after the acquisition.

Unusual or Infrequent Transactions

A company may experience a significant transaction in one reporting period that is not encountered in other reporting periods. For instance, a legal settlement may result in substantial income in the year in which the settlement is negotiated. As a result, the company may report favorable earnings when, in reality, the results of ongoing operations has been declining for a number of years.

Some unusual or infrequent transactions are not directly related to operations and can be identified on the income statement as a component of other income or expense. Examples of such transactions include legal awards or settlements, gains or losses on the sale of long-term assets, restructuring costs, and impairments of tangible or intangible assets. Financial statement readers may use an intermediary measure of income, such as income from continuing operations, in order to exclude the effects of these items.

Other significant transactions may be a part of operations for the reporting period. Severance costs, research and development costs, legal costs, and start-up costs are just a few of the many types of operating expenses that could fluctuate significantly from year to year based on a wide range of factors. While the footnotes may provide information as to the underlying situations resulting in performance variations, this would most likely occur in the course of fulfilling some other disclosure requirement; there is no requirement to describe the nature of fluctuations in performance, except in the case of going concern questions.

Putting together the information contained in the financial statements can give a financial statement reader insight into the financial health of the company. This information, combined with other information available from statistical analyses and industry comparisons (covered in Chapter VI), will enable the user to make better-informed decisions.

An Attorney's Guide to Understanding Financial Statements

Chapter VI – *Financial Ratio Analysis*

Financial ratio analysis is the evaluation and interpretation of a company's financial data using standard financial ratios or accounting ratios to determine a company's financial condition.[1] Simply stated, a ratio is a mathematical relation between one quantity and another. There are numerous ratios that can be calculated for a company; selecting the appropriate ratios will depend on the purpose of the exercise (i.e. determining credit worthiness) and the type of company.

When performing financial analysis, calculating ratios can be a useful tool. However, a ratio by itself is meaningless until it is compared to prior years' experience, projections, and industry averages as well as other ratios. Ratio analysis provides a benchmark to measure performance of a company and identify potential problems.

Ratios can be classified as follows:

Coverage – is the measure of a company's ability to satisfy particular obligations.

Return – is a measure of the net benefit relative to a resource expended.

Turnover – is a measure of the gross benefit relative to a resource expended.

Component Percentage – is the ratio of one financial statement component to another.

Operating performance and the financial condition of a company can be evaluated through financial ratios including liquidity ratios, activity ratios, financial leverage ratios and profitability ratios.

Liquidity Ratios: Short-Term Solvency

Liquidity ratios indicate the ease of converting certain assets into cash. These ratios are of particular interest to those extending short-term credit to a company. Assets that may be converted into cash in a short time period are referred to as liquid assets and are listed on the financial statements as current assets. The amount by which current assets exceed current liabilities is referred to as net working capital. The following are the most common liquidity ratios.

The ***current ratio*** is a measure of short-run solvency – the ability of a company to meet its debt requirements as they come due. Current liabilities are used as the denominator of the ratio as they are considered to represent the most urgent debts requiring payment within one year or operating cycle.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} \quad \frac{1{,}796{,}421}{644{,}233} = 2.79$$

[1] Modernanalyst.com Business Analysis Glossary

An Attorney's Guide to Understanding Financial Statements

The minimum acceptable current ratio is 1:1, however this relationship does not allow much margin for safety relative to possible inventory shrinkage or uncollectable accounts receivable.

A ***quick ratio,*** or ***acid test ratio,*** is a more rigorous test of short-term solvency than the current ratio because the numerator eliminates inventory, which is considered the least liquid current asset and most likely source of loss.

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}} \qquad \frac{1{,}004{,}080}{644{,}233} = 1.56$$

An acid test of 1:1 is considered satisfactory unless the majority of the "quick assets" are in accounts receivable, and the pattern of collections lag behind the schedule for payment of current liabilities.

The ***cash ratio*** is the most conservative liquidity ratio, as it excludes all current assets except the most liquid: cash and equivalents.

$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Marketable Securities}}{\text{Current Liabilities}} \qquad \frac{193{,}658}{644{,}233} = 0.30$$

The cash ratio is an indication of a company's ability to satisfy its current liabilities in the event immediate payment was demanded. Generally, the higher the aforementioned liquidity ratios, the better able a company is to satisfy its immediate obligations. A company with a long operating cycle[2] may have more need to have liquid assets than one with a short operating cycle. Longer operating cycles indicate that cash is tied up in inventory and receivables for a longer length of time.

Working capital is measured in dollars rather than as a ratio. It is calculated by subtracting total current liabilities from total current assets. Bankers focus on net working capital over time to determine a company's ability to weather financial crises. Loans are often tied to minimum working capital requirements. Companies want to not only demonstrate positive working capital, but also minimize the amount of working capital requirements for efficiency.

Activity Ratios

Activity ratios are measures of how well assets are employed. They can be used to evaluate the benefits produced by specific assets, including accounts receivable and inventory. A company invests in an asset (i.e. inventory or equipment) and then uses the asset to generate revenue. The greater the turnover, the more effective a company is at producing benefits from its investment.

2 Operating cycle is defined as the duration between the time cash is invested in goods and services (i.e. inventory) to the time that investment produces cash.

An Attorney's Guide to Understanding Financial Statements

Accounts receivable turnover indicates how many times, on average, accounts receivable are collected during the year.

$$\text{AR Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}} \qquad \frac{6{,}799{,}900}{605{,}686} = 11.23$$

The turnover represents the average number of days required to convert receivables to cash. The ratio is calculated using net accounts receivable (net of the allowance for doubtful accounts) and net sales. The average collection period helps to gauge the ability of the company to collect from its customers. It also helps to provide information regarding a company's credit policies, as the ratio is typically compared to the company's stated credit policies.

Inventory turnover indicates how many times inventory is created and sold during a period. It measures how efficiently a company manages and sells inventory.

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \qquad \frac{4{,}483{,}081}{938{,}657} = 4.78$$

Generally, a high turnover indicates efficient inventory management. The faster inventory sells, the fewer funds are tied up in inventory. However, a high turnover can indicate under-stocking and lost orders, a decrease in prices or shortage of raw materials. Additionally, the type of industry is also important in assessing inventory turnover. Produce retailers would be expected to have high inventory turnover as opposed to retailers of high-end equipment.

Fixed asset turnover indicates the ability of the company's management to employ its fixed assets to generate revenue.

$$\text{Fixed Asset Turnover} = \frac{\text{Net Sales}}{\text{Fixed Assets}} \qquad \frac{6{,}799{,}900}{380{,}412} = 17.88$$

This ratio is important for capital-intensive businesses, such as manufacturers with significant investments in long-lived assets. Generally, the higher the ratio, the smaller the investment required to generate sales; and thus, the company is more profitable.

Total asset turnover indicates the extent that a company's investment in total assets results in sales.

$$\text{Total Asset Turnover} = \frac{\text{Net Sales}}{\text{Total Assets}} \qquad \frac{6{,}799{,}900}{6{,}561{,}178} = 1.04$$

An Attorney's Guide to Understanding Financial Statements

As with the fixed asset ratio, the higher the ratio the smaller the investment required to generate sales; and thus, the company is more profitable. When asset turnover ratios are low relative to the industry or company's historical ratios, either the investment in assets is too great and/or sales are sluggish. However, a low ratio could be explained by an extensive plant modernization.

Leverage Ratios: Debt Financing and Coverage

Companies can finance their assets through equity, debt or a mix of both. Financial risk is the extent that debt financing is used relative to equity. The amount and proportion of debt in a company's capital structure is extremely important due to the trade off between risk and return. The higher the proportion of debt, the greater the degree of risk because creditors have priority and must be satisfied before any benefits are available to owners in the event of bankruptcy. The use of debt involves risk because of the fixed commitment (in the form of interest and principal repayment) debt carries. Failure to satisfy the fixed charges associated with debt could ultimately result in bankruptcy. Additionally, when a company has a high debt load, it will have difficulty obtaining additional debt financing if or when needed, or credit will be extended at very high interest rates. Note that excess leverage by banks is widely believed to have contributed to the global financial crisis.

When a company properly uses debt there is potential for increased benefits to the shareholders. If operating earnings exceed fixed charges associated with debt, the returns to shareholders are increased through financial leverage.

Leverage ratios are used to assess how much financial risk a company holds. Component percentages compare a company's debt with either its total capital (debt plus equity) or its equity capital. Coverage ratios reflect a company's ability to satisfy fixed obligations including interest, principal repayment or lease payments.

The ***debt ratio*** indicates the proportion of assets that are financed with debt (including both short and long-term debt). This ratio is simply:

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}} \qquad \frac{3{,}121{,}744}{6{,}561{,}178} = 0.48$$

The debt ratio can be further refined to include only long-term debt rather than total debt.

$$\text{Long-term Debt to Total Assets} = \frac{\text{Long-term Debt}}{\text{Total Assets}} \qquad \frac{3{,}114{,}416}{6{,}561{,}178} = 0.47$$

Note that debt ratios depend on the classification of long-term leases and on the classification of some items as long-term debt and equity.

An Attorney's Guide to Understanding Financial Statements

The ***debt to equity ratio*** indicates the relative uses of debt and equity as sources of capital to finance the company's assets. This ratio is typically evaluated using book values of the capital sources. The problem with analyzing risk of a company through a financial ratio that uses book value of equity is that there is little to no relationship between the book value and its market value. The book value of equity on the financial statements of a company consists of the proceeds of all the stock issued since incorporation less any treasury stock (which is stock repurchased by the company) and the accumulation of all the historical earnings of the company less any dividends paid since inception. Historical earnings are recorded in accordance with accounting principles, which may not reflect the true economics of transactions. The market value of equity is the value of equity as perceived by an investor and will include consideration of both tangible and intangible assets. If market value of equity is known it can be replaced for book value in the following equation:

$$\text{Total Debt to Equity} = \frac{\text{Total Debt}}{\text{Total Shareholders' Equity}} \qquad \frac{3{,}121{,}744}{2{,}169{,}196} = 1.44$$

In addition to leverage ratios there are a number of financial leverage ratios that capture the ability of a company to satisfy its debt obligations. The two most common ratios are the times interest coverage ratio and the fixed charge coverage ratio.

The ***times interest coverage ratio*** (also referred to as the interest coverage ratio) compares the earnings of a company that are available to meet the interest on debt obligations.

$$\text{Times Interest Coverage} = \frac{\text{Earnings Before Interest and Taxes}}{\text{Interest}} \qquad \frac{776{,}121}{569{,}997} = 1.36$$

In order for a company to benefit from debt financing, the fixed interest payments that accompany the debt must be more than satisfied by operating earnings. The more times a company can cover its annual interest expense from operating earnings, the better the position for the equity holders.

The ***fixed charge coverage ratio*** is a broader measure of coverage capability as it includes any fixed charges such as lease payments. The ratios can also include preferred dividends as a fixed charge.

$$\text{Fixed Charge Coverage} = \frac{\text{Earnings Before Interest and Taxes + Lease Payments}}{\text{Interest + Lease Payments}} \qquad \frac{776{,}121 + 121{,}152}{569{,}997 + 121{,}152} = 1.30$$

The fixed charge coverage ratio is important for companies that operate extensively with leasing arrangements, either operating or capital leases. You will see coverage ratios used in debt covenants to help protect creditors.

An Attorney's Guide to Understanding Financial Statements

Profitability Ratios

Profitability ratios compare components of income with sales, which in essence measures the success of a company to translate sales dollars into profits at different stages of measurement.

The ***gross profit margin*** ("GP" or "GPM") is a measure of the gross profits earned on sales. The gross profit margin shows the relationship between sales and the cost of products sold and measures the ability of a company both to control costs of inventory or manufacturing of products and to pass along price increases through sales to customers.

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Net Sales}} \qquad \frac{2{,}316{,}819}{6{,}799{,}900} = 0.34$$

Calculation of this ratio will depend on the type of company. For example, service firms will likely not have cost of goods sold and therefore no gross profit margin.

The ***operating profit margin*** is the ratio of operating profit, which is also known as EBIT (earnings before interest and taxes) to sales. The operating profit margin is a measure of overall operating efficiency and incorporates all of the expenses associated with ordinary business activity.

$$\text{Operating Profit Margin} = \frac{\text{Operating Income}}{\text{Net Sales}} \qquad \frac{776{,}121}{6{,}799{,}900} = 0.11$$

The ***net profit margin*** measures profitability after consideration of all revenue and expense including interest, taxes and non-operating items.

$$\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}} \qquad \frac{(130{,}081)}{6{,}799{,}900} = (0.02)$$

Another important perspective on operating performance is the relationship between cash generated from operations and sales, as it is cash rather than accrual-based earnings that a company needs to service debt, pay dividends and invest in capital assets. The ***cash flow margin*** is the measures the ability to translate sales into cash.

$$\text{Cash Flow Margin} = \frac{\text{Cash Flow from Operating Activities}}{\text{Net Sales}} \qquad \frac{424{,}909}{6{,}799{,}900} = 0.06$$

An Attorney's Guide to Understanding Financial Statements

Return on total assets ("ROA") or ***return on investment*** ("ROI") is a measure of how effectively a company's assets are being used to generate profits.

$$\text{Return on Assets} = \frac{\text{Net Earnings}}{\text{Total Assets}} \qquad \frac{(130{,}081)}{6{,}561{,}178} = (0.02)$$

Return on equity is the bottom line measure for the shareholders of a company. It measures the profits earned for each dollar invested in the company's stock.

$$\text{Return on Equity} = \frac{\text{Net Earnings}}{\text{Shareholders' Equity}} \qquad \frac{(130{,}081)}{2{,}169{,}196} = (0.06)$$

Businesses that generate high returns relative to their shareholders' equity pay their shareholders handsomely and create substantial assets for every dollar invested. These businesses are typically self-funding and require little to no additional debt or equity investments.

To quickly gauge whether a company is an asset creator or a cash consumer, an analyst will look at the return on equity it generates. By relating the earnings to shareholder equity, an investor can quickly see how much cash comes from existing assets. If the return on equity is 20 percent, for instance, then 20 cents of assets are created for every dollar originally invested. As additional cash investments increase on the asset side of the balance sheet, the return on equity reflects whether additional dollars invested are dollars of return from previous investments.

Z-Score

Z-scores are used to predict corporate defaults. The Z-score uses multiple corporate income and balance sheet values to measure the financial health of a company. The ratio weights five financial ratios and sums those amounts to determine the actual Z-score of the subject company. The five ratios used in the calculation are the working capital to total assets ratio, retained earnings to total assets ratio, earnings before interest and taxes (EBIT) to total assets ratio, book value of equity to total liabilities ratio, and sales to total assets ratio.

These five ratios are used as they each are significant in predicting the likelihood of default and capture a different credit-relevant aspect of a company's operations. The Z-score calculation varies depending on whether the subject company is in a manufacturing or nonmanufacturing industry.

An Attorney's Guide to Understanding Financial Statements

In the case of a manufacturing company, the Z-score calculation, complete with the weightings of the ratios, is as follows:

.717 x (working capital/total assets) + .847 x (retained earnings/total assets) + .310 x (EBIT/total assets) + .420 x (book value of equity/total liabilities) + .998 x (sales/total assets)

The Z-score for non-manufacturing companies is calculated as follows:

6.56 x (working capital/total assets) + 3.26 x (retained earnings/total assets) + 6.72 x (EBIT/total assets) + 1.05 x (book value of equity/total liabilities)

The Z-score is not intended to predict when a company will file a formal declaration of bankruptcy but instead its purpose is to measure how closely a company resembles other companies that have filed for bankruptcy. While this ratio should not be the sole form of analysis used to gauge a Company's financial health, it can be a solid indicator of corporate financial distress.

A Z-score of 2.9 or greater is preferred while a score of less than 1.23 indicates significant risk of bankruptcy for a manufacturing company. For non-manufacturing companies, a Z-score of 2.6 or greater is preferred while a score of less than 1.1 indicates significant risk of bankruptcy.

The financial ratios of our sample company as used throughout this material are included in the Appendix.

Financial ratio analysis, as a quantitative approach, may appear easy to learn and apply, however there are some common mistakes in application that should be noted:

- Failing to use an average or weighed average when applicable can distort ratios. For example when computing accounts receivable turnover if the average accounts receivable balance is $250,000, the ending balance is $500,000 and credit sales for the year are $4 million; the days sales outstanding would be 22.5 days based on the average balance, as opposed to 45 days based on the ending balance.

- Most sources of industry information do not always disclose the accounting methods used by the companies contained in the figures or ratios that are compiled by the source, which could negatively affect the comparability of such information. Further the basis of a comparative analysis may be impacted by the nature of the business, its size, geographic location, business practices and other factors that may differentiate the subject company from the industry as a whole.

- If a historical analysis covers an insufficient number of years, certain trends and performance measures could be misinterpreted. For example, if the analysis only covers a two-year period in which a company invests in substantial capital improvements, any ratio using total assets or net income will be impacted by the capital investment.

Any exercise in selecting, calculating and interpreting financial ratios can be a difficult process to undertake. However, done properly, reviewing and analyzing financial ratios can assist in determining the strengths and weaknesses of a company, as well as identifying areas warranting additional inquiry or investigation.

An Attorney's Guide to Understanding Financial Statements

Chapter VII – *Fraud and Financial Forensics*

In the wake of the avalanche of corporate accounting scandals, the demand for experts in financial forensics has never been greater. As a result of the massive number of cases involving financial impropriety, there have been many studies undertaken to gain an understanding of the situations and circumstances under which these acts take place. Most of the scandals involved accusations of "creative accounting." In a study published in the *Journal of Accounting and Economics*, it was noted that CEOs have more to benefit from financial misrepresentations, and CFOs are typically pressured by CEOs to engage in questionable accounting practices. In the infamous case of Enron, one of its first executives to plead guilty to fraud and money laundering was the firm's CFO, Andrew Fastow.

The misdeeds by executives and employees of both public and private companies involve, in many instances, complex methods for overstating revenue, understating expenses, overstating asset values and underreporting liabilities, as well as misusing or misdirecting funds.

In reaction to the financial reporting scandals of the early 2000s Congress passed *The Sarbanes-Oxley Act of 2002* ("The Act"). The Act called for the creation of the Public Company Accounting Oversight Board, a private-sector, non-profit corporation to oversee auditors of publicly traded companies "in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports." It vests the board with four main responsibilities: (1) registering accounting firms that audit public companies trading in U.S. securities markets; (2) inspecting registered accounting firms; (3) establishing standards for auditing, quality control, ethics, and independence for registered accounting firms; and (4) investigating and disciplining registered accounting firms, and people associated with them, for violations of law or professional standards.

The Act places requirements and prohibitions on accounting firms. It makes it unlawful for firms not registered with the board to audit public companies and, among other things, it:

1. requires auditors to report all critical accounting policies and practices to the firm's audit committee (§ 204);
2. requires lead audit and reviewing partners to rotate off an audit every five years and subjects them to a five-year time-out period after the rotation (§ 203);
3. prohibits public accounting firms from providing certain non-audit services such as bookkeeping or appraisal without pre-approval from the board (§ 201);
4. requires public accounting firms to establish an audit committee (§ 301);
5. requires chief executive officers (CEOs) and chief financial officers (CFOs) to certify that financial statements accurately and fairly represent the financial condition and operations of the company and subjects them to criminal penalties for intentional false certification (§ 302);

6. prohibits firms from making loans to any of their directors or executives (§ 402);
7. requires public companies to establish an internal control system for tracking and auditing financial processes and further requires an external auditor's report on management's assertions about that system (§ 404);
8. requires rapid disclosure of material changes in the financial conditions of a public firm (§ 409);
9. provides comprehensive whistleblower protections (§ 806); and
10. makes it a crime for any person to destroy, alter, or conceal any document to prevent its use in official legal proceedings (§ 1102).

Fraud Examples

Fraudulent financial reporting is often perpetrated through the improper recognition of revenue, either through premature recognition or through completely fabricated sales transactions. Consider the case of CompTronix Corp. In order to hide the loss of a major customer, it boosted its gross profit by recording increases to its inventory and reducing its cost of goods sold. It relieved the inventory by creating false sales invoices for a portion of the inventory and by transferring another portion of it to fixed assets, where it would be easier to conceal. Both the reduction in the cost of sales and the false sales invoices resulted in increases to the company's profit. CompTronix then wrote checks to cover the false invoices that were created to support the increases in equipment. However, CompTronix deposited these checks into its own bank account and recorded the deposits as collections on the accounts receivable that resulted from the false sales invoices. This process allowed the company to increase its gross profit and improve its balance sheet, while simultaneously generating increased bank activity and producing documents to support the false transactions.

Companies can also improve the results of operations by capitalizing expenditures as assets that should be recorded as expenses under GAAP. The line between when items should be capitalized versus expensed is often unclear, and companies may elect to be aggressive in capitalizing items that they perceive to have a future benefit. Fine Host Corp. began capitalizing costs incurred to acquire customer contracts in 1994. By 1997, the amount of such costs had escalated from $200,000 to $14,000,000, and represented 22% of total assets. The company had become increasingly aggressive in its capitalization approach to the point where it was including overhead costs and had initiated other expense-avoiding tactics, which resulted in a restatement of its earnings for 1994-1997.

Management may also attempt to delay recognition of certain expenses by understating liabilities. A simple way to accomplish this is through liabilities that are subject to a great deal of estimation, such as a warranty obligation. Warranty obligations relate to anticipated amounts of rework that the company will be required to provide in the future for products that have already been sold. This obligation is usually based on historical levels of rework, but the introduction of new products or changes in the manufacturing process may make these estimates more difficult to assess. Management may seek to be overly aggressive with these estimates in order to understate liabilities and increase the company's profit. This is a dangerous tactic because the expense would then need to be reflected when the rework is actually performed, merely delaying the inevitable. Management can also use these liabilities to smooth earnings from one year to the next by being more or less aggressive with the estimates depending on the company's operating performance, thereby either giving earnings an extra boost or holding back in an otherwise strong year.

These examples illustrate the magnitude of misstatement that can be quickly accomplished through manipulation of the financial statements. The objective of this type of fraud is usually to directly or indirectly financially benefit key management by improving the operating results of the company. There have been published studies that indicate that earnings manipulation occurs so as "…to influence stock market perceptions, to increase management compensation, to reduce the likelihood of violating lending agreements, and to avoid regulatory intervention."

Misappropriation of Assets

Only a limited number of personnel have the necessary access to perpetrate fraudulent financial statement reporting, but others may actually have a more direct access to the company's assets and be able to benefit at the expense of the company through the misappropriation of these assets. While fraudulent financial reporting is significantly more costly, with a median loss of $1.7 million per incident, the median loss for misappropriation of assets is still a hefty $100 thousand per incident and is more common.

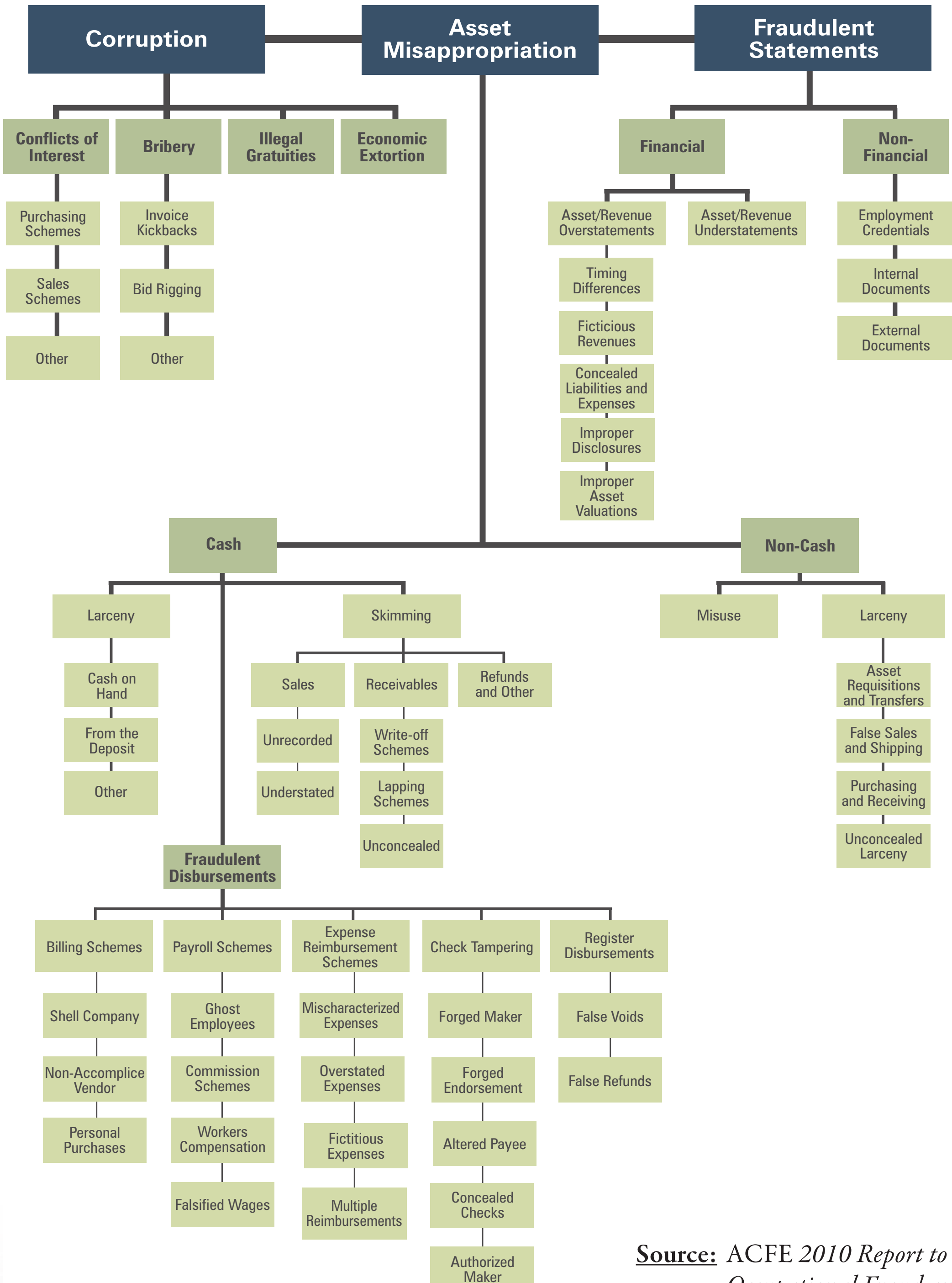
Often, the misappropriation of company assets is achieved through the company's normal disbursement process. An employee may be able to create a fictitious vendor and submit false invoices to the company from the fictitious vendor. This would require the ability to be involved in both the invoice approval process as well as the cash disbursement process. In smaller companies, though, this may not be difficult to achieve if there are limited numbers of employees and each one has a wide range of access rights for expediency. Even in large companies, employees can sometimes find cracks in the internal control system due to a breakdown in communication among departments.

Payroll is another large area of cash disbursements within most companies, and there are many variations of the process of generating improper payroll claims. An employee with access to the payroll system may create false employees, with the intention of the company paying these fictitious employees and having the money deposited into the perpetrator's bank account. Pay rates can also be adjusted within the payroll system in order to fraudulently increase an employee's pay. An employee with no payroll access may still be able to submit false expense reports or time sheets.

The following diagram presents the different classifications of fraud. Within each section, there are numerous schemes designed to circumvent the internal control system and conceal the fraudulent effects.

An Attorney's Guide to Understanding Financial Statements

Occupational Fraud and Abuse Classification System



Source: ACFE *2010 Report to the Nations on Occupational Fraud and Abuse*, pg. 7

An Attorney's Guide to Understanding Financial Statements

Forensic Accounting

Like the Sarbanes-Oxley Act, the field of financial forensics has emerged in response to the prevalence of high-profile financial scandals. Financial statement users may have relied on financial statement audits to detect the existence of fraud; yet many of these cases involved complex schemes that successfully eluded both management and the auditors. Auditing standards do require the auditor to consider fraud in planning the audit and to design procedures to detect material fraud, but the objective of an audit is not to detect fraud; it is the expression of an opinion on the overall financial statements with reasonable assurance.

Forensic accounting brings together the skills of accounting, auditing and investigation in an effort to prevent and detect fraudulent activity. It provides a more focused investigation into known or suspected fraud within a company. It employs auditing techniques but generally expands them to cover a larger amount of the transaction population than is required for an audit. In some cases, the investigation may test 100% of the relevant transactions.

The goals of a forensic accounting investigation will generally be a determination of what transpired, how it was accomplished, and what the loss was to the company. This information is communicated to the governing committee and can be much less formal than an audit report. The results and findings may be used for civil litigation or even criminal prosecution. These investigations may also lead to internal modifications to the company's hierarchy, roles and responsibilities, internal control procedures, as well as support for the termination of specific individuals.

Much time and effort is being invested into the improvement of the auditing practice and forensic accounting to prevent and detect fraud. Forensic accounting will continue to evolve as it builds on additional case study and as the public becomes increasingly intolerant of these financial abuses.

An Attorney's Guide to Understanding Financial Statements

Chapter VIII – *Conclusion*

Understanding the language spoken by accountants and other members of the financial community offers many opportunities for members of the legal profession to better serve your clients. If properly understood, financial statements will tell the story of the financial performance of a company. Further, being aware of what users of financial information consider to be important performance indicators, as well as how certain actions of management impact those performance indicators, is critical to interpreting a set of financial statements.

Insights gained from financial statement analysis can be used to evaluate credit risk and determine a company's worth. Having knowledge of the construction of financial statements and how they are analyzed will assist members of the legal community in developing appropriate inquiries of clients and their financial advisors.

Finally, during a time when financial impropriety is prevalent, being aware of the methods used in overstating revenue and asset values; understanding expenses and liabilities; as well as misusing funds can be very beneficial. However, as explained herein, these cases involve complex schemes that have successfully eluded both company management and their independent auditors. In the event that this type of act is suspected, engaging the services of a financial expert to work closely with legal counsel is a good first step.

The intent of today's program was to provide an introduction to understanding and interpreting financial statements. It would be impossible to address any aspect in depth. However, we hope that our session today has provided some information that will prove helpful to your practice.

Should you have any questions regarding this material or are presented with a case that may require the skills of a financial expert, please feel free to contact Bob Grossman or Steven Heere, both of whom welcome the opportunity to assist you and your clients.