

## Taking the Entity's Temperature

What financial statements can tell about an enterprise

By Brenda M. Clarke

We all know of the relatively recent, devastating effects of the corruption and fraud in the financial reporting of industry giants such as Enron and WorldCom. These companies were able to defraud investors at a level not seen before in this country, primarily through the systematic manipulation of their financial reports. Although in most matrimonial matters we are not dealing with multibillion-dollar enterprises, it is still critically important to gain a general knowledge of how financial statements are created and what information can and cannot be obtained from these resources.

The primary objective of financial reporting is to communicate understandable information useful to the reader. To achieve this objective, the information must be accurate, timely, and in the proper format. The standard framework for guidelines and procedures in the United States for financial reporting is Generally Accepted Accounting Principles (GAAP), which includes mandatory standards, conventions, and rules that must be followed when reporting financial data for certain entities such as publicly held companies. In many instances, however, alternative methods of accounting will be utilized, including the cash basis and modified cash basis of accounting. (See "Basis of accounting," page 31.)

Regardless of the accounting method used, the financial statements of a company are the end product of the accounting process and include three primary reports:

- Balance sheet
- Income statement
- Cash-flow statement

These three reports can provide valuable information regarding the financial status of an organization. It is important to understand how these statements work together to paint a picture of the overall health and financial position of the enterprise. It also is important to understand how the presentation of the financial information can differ from one organization to the other.

### The balance sheet

Often referred to as the statement of assets, liabilities, and equity, or the statement of financial position, the balance sheet represents a company's economic status at a particular point in time. It is a "snapshot" of the company's financial condition as of a

certain date, usually the end of a month or year. Changes in the balance sheet from period to period can give a great deal of information about the enterprise.

The balance sheet equation consists of assets being equal to liabilities plus equity:

### Balance Sheet Equation

Assets	=	Liabilities	+	Equity
Economic resources		Amounts owed to creditors		Capital provided by shareholders

The economic resources of an enterprise can consist of both tangible and intangible assets. Assets are current and noncurrent items of value and include tangible items such as cash and cash equivalents, accounts receivable, inventory, fixed assets, and prepaid expenses. Intangible assets are items such as intellectual property and goodwill.

An organization's assets are presented on the balance sheet in order of their liquidity.

Current assets—cash or other assets that can be converted to cash within one year. Examples are cash, accounts receivable, inventory, and prepaid expenses.

Property and equipment—used in the operations of the business, shown at historical cost with a reduction for accumulated depreciation. Examples are machinery, equipment, office furniture, computers, and leasehold improvements.

Other assets—that don't fit into the first two categories. These often include intangible assets such as trademarks, patents, and purchased goodwill.

An important accounting convention relates to the carrying values for balance sheet assets and liabilities. GAAP require financial statement values to be recorded and carried at historical costs, which are the initial costs incurred when the items are first transacted.

In many instances, some of the economic resources of the enterprise will not be shown on the balance sheet, such as the value of an entity's proprietary processes, the value of customer lists and relationships, or the benefits of having an established, well-trained workforce in place.

### Liabilities

The liabilities of an enterprise can best be described as the claims against the assets of the enterprise. As is the case with assets, liabilities are segregated between current and noncurrent categories, with current being those liabilities that can be expected to be satisfied within one operating cycle, normally considered to be one year.

Current liabilities—amounts owed that will be paid within one year. Includes accounts payable, accrued payroll liabilities, and the portion of long-term debt that will be paid within one year.

Long-term debt—amounts owed that are not expected to be paid within one year.

The equity section of the balance sheet represents the claims of ownership against the assets of the enterprise. Equity is what is left after the satisfaction of third-party claims. The efficient deployment of assets to create equity is the challenge of every business enterprise. Understanding the relationship between the application of assets and use of liabilities to increase returns on equity is the essence of sound financial management.

Common and preferred stock—securities that represent ownership in a business enterprise. These are reported at their stated par value. If the par value is zero, this account may not appear on the balance sheet.

Additional paid in capital—the amount paid for common or preferred stock that is in excess of its stated par value.

Retained earnings—represents the earnings of a business enterprise that have not been distributed to the owners in the form of dividends or distributions.

Table 1 on page 30 is an example of a balance sheet of a professional service firm on December 31, 2007.

#### Income statement

The income statement is commonly referred to as the statement of operations, profit-and-loss statement, or statement of revenues and expenses. It conveys the performance of an enterprise over a specific period of time. The income statement of the company reflects the success of the enterprise in the inflow of revenue in relation to the outflow of expenses. Such information is essentially a roadmap between balance sheet dates.

Revenues (sales)—inflows of assets from the production and sale of goods, the rendering of services, or the performance of other activities that constitute the entity's primary operations.

Cost of goods sold—costs incurred that relate directly to the production of goods and services.

Gross profit—revenues less cost of goods sold.

Operating expenses—uses of assets in the operation of a business. These include general and administrative expenses, rent, officers' wages, legal and professional fees, etc.

Nonoperating income and expenses—these are income and expense items that are not directly related to the primary operating purpose of the business. Examples are investment income, interest expense, and unusual gains and losses.

A critical element in understanding how to comprehend the information conveyed in the balance sheets and income statements of any enterprise is to understand the linkage between these two primary statements. The income statement can be viewed as an

expanded picture of the changes in balance-sheet equity derived from business operations. Retained earnings is the summary of all net income less distributions of profit from the inception of the entity. The change in retained earnings on the balance sheet is essentially the net result of the entity's revenue less expenses between balance sheet dates, less the distributions of such net profits for the period. This is a complex concept to grasp, but it is the critical linkage between the activities reflected in the two primary financial statements.

Table 2 (at left) is a sample income statement. Note how the net income at the bottom of the report ties to the equity section of the balance sheet as presented above.

### Cash-flow statement

The statement of cash flows reports a company's sources and uses of cash. These sources and uses are broken down into three distinct categories:

**Operating activities**—cash from the operations of the business. Generally starts with net income for a particular period and is adjusted for noncash items such as depreciation and amortization.

**Investing activities**—cash from the purchase and sale of property and equipment. Also includes cash used for investments in other assets.

**Financing activities**—includes cash received from borrowing and repayment of debt. It includes the payment of dividends and distributions to shareholders and owners and the issuance and retirement of equity capital.

Table 3 (below), the statement of cash flows, starts with net income as reported in the income statement on page 30. The ending net cash also ties to the cash reported in the current asset section of the balance sheet at left.

### Basis of accounting

Small businesses have the option of reporting their financial statements on a cash basis or an accrual basis of accounting. The main difference between these two is when underlying economic activity is recorded in the general ledger and reflected within the financial statements.

In cash-based accounting, revenue is recognized when payment is received from the customer, not when the customer is invoiced. Expenses are recognized when cash is disbursed, not when a bill is received from the vendor. This basis of accounting is most popular for income tax reporting because it delays the recognition of income from accounts receivable until it is actually collected.

In accrual-based accounting, items of income and expense are recorded as earned or incurred, respectively, regardless of when cash trades hands. This method is preferable to the cash basis of accounting and is required under GAAP. It is preferred because it

complies with the “matching principle,” which states that income and expenses for a particular period should be matched, regardless of when the cash is received or disbursed.

Table 4 (on page 32) reveals the effect of using cash basis versus accrual basis accounting:

Another important basis of accounting is what is referred to as tax basis. Tax basis issues are important in the context of fixed-asset transactions, as well as in other areas, such as ownership investments in the enterprise.

### Financial statement analysis

An important part of any business analysis is a comparison of the financial performance of the subject company to benchmark data available in the marketplace. This data can be obtained from a number of sources and is usually segregated by industry. Ratio analysis compares the performance of a company to that of its peers by eliminating the element of size. Some of the categories of ratios are:

- Liquidity
- Profitability
- Leverage
- Activity
- Investment

**Liquidity**—These ratios measure a company’s ability to pay its short-term financial obligations. Normally, the higher the ratio, the better, as this indicates a company’s ability to fund operations while covering maturing debts. If too high, however, the company may have too much cash and should be making distributions, investing in operating assets, paying down long-term debt, etc. A low ratio can indicate a company’s difficulty paying its obligations.

The most commonly used liquidity ratio is the current ratio:

Current ratio = Current assets/Current liabilities

Generally a current ratio of 1.0 or greater is considered good, but this can vary by industry

**Profitability**—These ratios indicate how the company has operated over the past year. They demonstrate how successful the company was in generating profit and increasing shareholder value. These ratios are frequently used to gauge the effectiveness of management.

Operating profit margin = Earnings before interest and taxes/sales

Net profit margin = Earnings after taxes/sales

Return on assets = Earnings after taxes/total assets

**Leverage**—Also known as coverage ratios. These ratios measure the coverage for long-term lenders and investors. They provide information regarding the company's overall debt as well as its blend of debt to equity. These ratios can be used to determine the overall financial risk of a company.

Long-term debt-to-equity ratio = Long-term debt/shareholder's equity

Interest coverage = Earnings before interest and taxes/interest charges

**Activity**—These ratios measure the effectiveness of management to utilize the assets and other resources of the company. These ratios measure how well a company converts its assets into revenue.

Receivables turnover = Credit sales/accounts receivable

Asset turnover ratio = Sales/total average assets

**Investment**—Investors use these ratios to evaluate potential or existing investments in comparison with others to determine their value.

Price-to-earnings ratio = Stock price/earnings per share

Another procedure to evaluate a business enterprise is through the use of a common size analysis. This is a process whereby each item on the balance sheet and income statement is restated as a percentage of a given base. Balance sheet items are usually restated on a basis of total assets and income statement items on a basis of total revenue.

Table 5 (on page 33), Common Size Analysis, is helpful to evaluate the materiality of each item and the change in these items over different periods. It also is helpful when comparing the subject company to others that may or may not be the same size.

Types of reports

An independent Certified Public Accountant (CPA) can provide three levels of services related to the financial reporting of a business enterprise. These are a compilation, review, and an audit.

A compilation provides the lowest level of assurance. A compilation engagement is the most common for small closely held businesses because it is the least expensive and requires less time because of fewer procedures. A compilation consists of assembling the financial data from the company's accounting records and presenting it in the form of financial statements. The financial information is strictly the representation of management, and the accountant is not required to perform any procedures to verify or corroborate the financial-statement information provided by the client. The accountant is required to read the compiled financial statements and consider whether they are in appropriate form and free from obvious material errors.

A review is an evaluation of a company's financial statements using management inquiries, analytical procedures, and a knowledge of the industry. The scope of a review is less than an audit, but it provides "limited assurance" that nothing came to the accountant's attention requiring modification. A review engagement requires all of the procedures necessary for a compilation engagement plus other procedures that enable the accountant to provide limited assurance on the financial statements.

An audit engagement provides the highest level of assurance about the reliability of a company's financial statements. This service is a critical review and verification of financial data. An audit results in a professional opinion from the CPA, attesting to the accuracy of the financial statements and the representations they contain. In addition, the CPA is required to obtain reasonable assurance that the audited financial statements are not materially misstated due to fraud.

#### Financial analysis in divorce

Attorneys and accountants rely heavily on financial reports when calculating maintenance, child support, and marital asset divisions in a divorce setting. In smaller closely held businesses, the ability to manipulate the financial reports is present and often undertaken by business owners. The ability to read between the lines and perform a proper analysis and assessment of the quality of the financial statements is essential, particularly in the family-law setting.

Following are some tips and areas to pay particularly close attention to when analyzing the quality of financial reports:

- Compare the company's financial statements to the corporate income tax returns. Tax returns must be signed by the business owner and often give a higher level of assurance that the items reported are accurate.
- Look at interest and investment income. Is this appropriate for the level of cash and marketable securities reported on the balance sheet?

- Review bank reconciliation reports and cutoff dates. Does it appear that little or no deposits were made in December? Were the expenses in December higher than other months? Proper cutoffs can have a dramatic effect on both income and valuation purposes.
- Increased shareholder loans or receivables. Do changes in this account make sense and is the asset or liability properly divulged with the other financial disclosures?
- Acquisition of new debt. Request financial statements and pro-forma financial statements submitted with new loan requests to search for discrepancies or projections.
- Increases in fixed assets. Do these reveal discretionary purchases, which is one way to funnel funds into possible nonoperating or nonnecessary assets?
- Prepaid expenses. In cash-basis financial statements, the prepayment of expenses can decrease income and cash flow, thereby lowering entity value.
- Changes in operating expenses. Investigate changes in rent, legal fees, and other operating expenses to see if any of these key expense accounts have changed significantly from year to year.
- Changes in officer or key employee salaries. Is the amount being paid in line with the level of service being provided? Is it fairly consistent from year to year? In some cases, key employees may be given bonuses, additional expense allowances, new cars, or other perquisites as an attempt to lower firm income and cash flow.
- Changes in cost of goods sold. This account tends to be a “catch-all” and a perfect place to hide nonoperating and nonbusiness expenditures. Perform a common size analysis on the income statement to confirm that the overall percentage of cost of goods sold is in line with the prior year.
- Nonoperating, appreciating assets. Does the company own any artwork, real estate, investments in other companies, or marketable securities? These assets are reported at their original cost, and their appreciation is not reflected on financial statements.
- Allowance for bad debt. Is this reasonable? Is it comparable to other competitors in the industry? Has the company employed new collection techniques that may render this estimate incorrect?
- Discretionary costs. Look for lavish expenditures, sporting events, travel, and entertainment. Are these necessary for the operation of the business? Are they comparable to prior years and other similar businesses?

- Off-balance-sheet assets and liabilities. For some companies, the value of an enterprise is not fairly represented in financial statements. For example, in a startup company, the entity may show negative cash-flow, but the value may lie in the research and development of new processes, patents, trademarks, etc. Are investments in real estate and other personal property, such as artwork and collectibles, worthy of further investigation?

This brief overview of the fundamental concepts related to the primary financial statements of any business enterprise is designed to provide insight into how to utilize this information for matrimonial law engagements. Family-law attorneys should seek professional counsel as warranted.

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