Winning Numbers

Accounting & Finance for Lawyers

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Law Offices of John E. Moore, III
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Faculty Fact Sheet

John E. Moore, III

Law Offices of John E. Moore, III
Vero Beach, Florida

John Moore is one of those people who you just enjoy spending time with. He is passionate about his life, his work and the help that he can provide to lawyers from all areas of practice. He is a high-energy, funny, smart and talented teacher.

His knowledge is practice-proven. John is a principal in the Law Offices of John E. Moore, III in Vero Beach, Florida, where he maintains an active estate planning practice. He is also an actively licensed CPA.

Moore's experience profile includes tenure with Arthur Andersen LLP, and service as an official of the U.S. Department of Housing & Urban Development and the Government National Mortgage Association, as well as time in private practice with a large law firm in Washington, D.C.

John's enthusiasm for the law reaches well beyond his office door. He was the 2010 recipient of the Florida Bar President's Pro Bono Service Award in the 19th Judicial District. He personally provided more than 1,500 hours of pro bono services, and oversaw about 1,000 hours on various projects.

Moore received his undergraduate degree from the **University of Notre Dame** and his law degree from the **University of Virginia**.

Curriculum

- **Winning Numbers:**
  Accounting & Finance for Lawyers *(6 hours)*
- **The Lawyer's Compass:**
  Character, Ethics and Trust in Modern Legal Practice *(6 hours)*

WINNING NUMBERS: ACCOUNTING AND FINANCE FOR LAWYERS™

by John E. Moore, III

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Invitation for Questions/Comments

If you have any questions, comments or suggestions, please do not hesitate to contact me. I welcome the opportunity to help you think through accounting issues or problems. And, I am always looking for ways to improve my presentation and materials.

Thanks for coming today! I look forward to hearing from you.

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SECTION 1: AN INTRODUCTION TO THE BASIC ACCOUNTING EQUATION AND THE FINANCIAL STATEMENTS

1.1 The Basic Accounting Equation

Quick analysis reveals a fundamental balance among the three components of an enterprise: its assets must equal the sum of its liabilities and its equity. Before its creation, the enterprise owns nothing, owes nothing and is owned by no one. At the beginning, then, the assets of an enterprise ($ 0) equal the sum of its liabilities and equity ($ 0 + $ 0). This balance will continue with each transaction consummated by the enterprise.

Owner's Initial Investment
$10,000 Cash = $10,000 Stock Certificate

Loan from Bank
$15,000 Cash = $5,000 Bank Debt + $10,000 Stock Certificate

Purchase of Gemstone
$14,000 Cash + $1,000 Gem = $5,000 Bank Debt + $10,000 Stock Certificate

Sale of Gemstone for $9,000
$23,000 Cash = $5,000 Debt + $10,000 Stock Certificate + $8,000 Profit

These relationships allow us to derive a relationship between the: (i) assets; (ii) liabilities and (iii) interests of an owner in an enterprise. This relationship is expressed in the form of an equation known as The Basic Accounting Equation:

The Basic Accounting Equation

Assets = Liabilities + Equity

1.2 Assets: A Definition

Analysis of changes in assets accounts for one-half of the work in applying the Basic Accounting Equation to a transaction. Statement of Financial Accounting Concepts ("SFAC") Number 6 defines an **asset** as:

> **"...[a] probable future economic benefit obtained or controlled by a particular entity as a result of past transactions or events."**

1.2.1 Assets: A Working Definition

A working definition of an asset might include the following**:**

(1) Things owned by the enterprise in the conventional sense of ownership; or

(2) Amounts owed to the enterprise as a result of past consideration exchanged.

1.2.2 Assets Do Not Include Many Items of Economic Value

It is important to note, however, that the accounting definition of asset often excludes items which would be considered additions to the economic value of the enterprise. The definition of asset excludes the possible things that might happen such as potential revenue from a new product.

1.2.3 GAAP: Looking Back vs. Looking Forward and The Historical Cost Principle

To a large degree, then, the presentation of assets on the balance sheet takes on a retrospective, rather than a prospective, view. Generally Accepted Accounting Principles ("GAAP") focus on the recordation of things that have occurred in the past and are, therefore, subject to objective valuation. This provides a significant limitation on the usefulness of financial statements prepared in accordance with GAAP.

This focus on objectivity gives rise to the **Historical Cost Principle** which mandates that assets be carried in the books and records of the entity without regard to their current value, unless the value of the asset has declined in which case the estimated decline must be recognized under the related **Lower of Cost or Market Principle**.

Other professions and disciplines focus on predicting the future value of the enterprise. Stock analysts, as an example, examine detailed operational information about an entity and its prospects to determine an estimate of stock value.

1.3 Liabilities: A Definition

SFAC Number 6 defines a **liability** as a:

> **"...probable future sacrifice of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."**

1.3.1 Liabilities: A Working Definition

A working definition of liabilities might include the following**:**

(1) **Amounts owed to third parties as a result of borrowing or other use of credit (for example, loans to the enterprise);**

(2) **Amounts which have been received in advance by the enterprise in exchange for its agreement to provide goods or services to be delivered in the future (for example, deposits received for future services); and**

(3) **Estimated future losses which will occur as a result of facts which are known to a reasonable degree of certainty today (for example, the estimated cost of satisfying a warranty obligation).**

1.3.2 A Purposeful Imbalance: The Conservatism Principle

There is an imbalance and bias in the definitions of assets and liabilities. The definition of asset will typically exclude the value of events that may occur in the future while the definition of liability requires the recognition of the existence of future expenses that are probable to occur.

This imbalance exists intentionally as a result of the **Conservatism Principle**. The Conservatism Principle stands as one of the foundational principles underlying Generally Accepted Accounting Principles.

The Conservatism Principle

Financial Statements prepared in accordance with Generally Accepted Accounting Principles will have the following standing four presumptive and inherent biases:

- Understate Revenues
- Overstate Expenses
- Understate Assets
- Overstate Liabilities

These biases become the ‘tie breakers’ in choosing between differing accounting principles. They are designed to protect the user of financial statement: third parties.

1.4 Equity: A Definition

The third main component of the Basic Accounting Equation represents the amounts which represent the investments of the owner in the enterprise over time. This term is referred to as “equity”.

1.4.1 Equity: A Working Definition

A working definition of equity might include the following:

(1) Formal investments by the owner (cash and assets); plus

(2) Net income of the owner which the owner has elected to leave in the business.

The profits of the enterprise belong to the owners of the enterprise. On an ongoing basis, the owners of the enterprise make decisions as to how to dispose of those profits. When the owners distribute profits (most commonly in the form of **dividends**, the investment by the owners is reduced. When the owners do not distribute profits as dividends but, instead, elect to reinvest those dividends in the ongoing enterprise of the business the economic effect is the same as though the owners increased their for investment in the enterprise.

1.4.2 Equity vs. Debt: Two Sources of Resources for the Enterprise

The Basic Accounting Equation stands for the proposition that the assets of a business can be provided from only two sources: liabilities and equity.

An enterprise can acquire an asset by borrowing the funds to be used to purchase the asset. In this case, the enterprise incurs a liability.

An enterprise could also ask the owners of the business to provide the funds to be used to acquire an asset to be used by the enterprise. In the first instance, this could be done by the owners addition of cash resources made by increasing their formal investment in the enterprise or by allowing the enterprise to retain profits which otherwise might be distributed to the owners.

Much effort is placed upon analyzing the relationship between the use of debt and equity in financing the operations of an enterprise. This topic will be revisited in the discussion of the Debt/Equity Ratio in Chapter 6.

1.4.3 Equity: Not Market Value

Equity represents the cumulative sum of: (i) the cumulative investments of the owners of an enterprise through their direct financial contribution and (ii) the cumulative profit (or loss) of the enterprise after reductions for distributions of those profits to the owners. In essence, it is a cumulative scorekeeping account.

The equity section of a balance sheet (an internal figure) does not approximate the fair market value of the ownership interests of the enterprise (an external figure). Market factors determine the fair market value of the ownership interests of the enterprise using a variety of assumptions about desired rates of return, relative risk of the investment, and the perceived economic prospects for the enterprise, among others.

1.5 Computing the Profits of the Entity: Matching Principle

Because the profits of a business belong to the owners, the owners have a vested interest in determining whether the enterprise is operating profitably. Remember: profits increase the benefits to owners while losses reduce those benefits.

Generally Accepted Accounting Principles provide a methodology for determining the net income of an enterprise. This process is based upon a series of ***estimates*** which are used to compute ***net income***. GAAP provides the basis for estimating net income as:

(1) Amounts received by, or which become owed to, the entity in exchange for goods sold, services rendered or assets transferred; ***less***

(2) The expenses incurred to generate the amounts received or new amounts owed.

In making this computation of profits, GAAP relies on the **Matching Principle**. In sum, the Matching Principle requires a more sophisticated approach to the computation of net income than is derived by merely focusing on the cash flows of the enterprise.

The Matching Principle

Net income determined in accordance with Generally Accepted Accounting Principles is determined by:

- Estimating the Revenues Earned During the Relevant Period (without regard to whether payment has, in fact, been received)

and *MATCHING*

- The Expenses Incurred to Generate Those Revenues (without regard to whether payment has, in fact, been made)

The Matching Principle does more than follow cash-in and cash-out. Instead, the Matching Principle implements the estimates required by ***accrual accounting*** which stands as the hallmark of accounting for profits under GAAP in contrast to the cash method.

1.5.1 Illustration of Inaccuracies of Cash Method of Accounting

Cash Method:

Year One		Year Two	
Event	Income Statement	Event	Income Statement
Dealer sells Car for $15,000	$15,000 Net Income	Dealer pays $12,000 for Car	$12,000 Net Loss

Accrual Method:

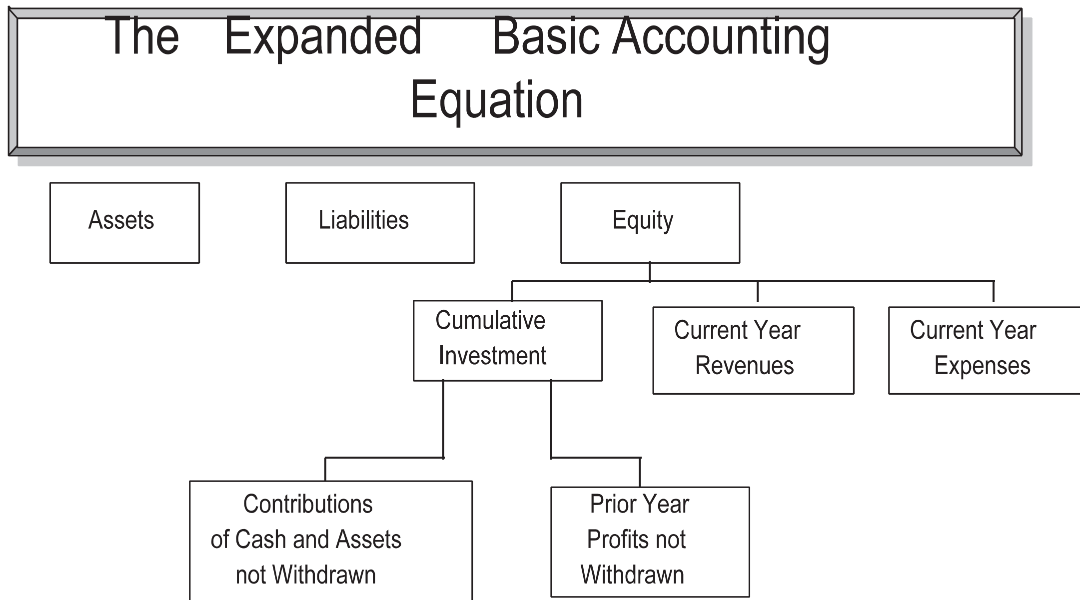
Year One		Year Two	
Event	Income Statement	Event	Income Statement
Dealer sells Car for $15,000	$15,000	NO EFFECT BECAUSE TRANSACTION TOOK PLACE IN YEAR ONE	
Cost of Car is "matched"	(12,000)		
Net Income	$ 3,000		

The accrual method of accounting for profits required under GAAP computes profits more accurately than a straight-forward analysis of cash inflows and outflows that take place under the cash method of accounting. The box above outlines an example which demonstrates the ability of the cash method to yield confusing results.

Large differences between the accrual method of accounting and the cash method of accounting will exist when the enterprise maintains highly varying levels of accounts receivable and inventories, or uses cash from operations to finance substantial improvements or repay debt. In these instances, cash is used in a manner in which expenses are not generally recorded creating a gap between accrual and cash net income.

1.6 Expansion of the Basic Accounting Equation; Introduction to the Financial Statements

We have learned two key elements of the accounting process so far. We now know the truth of the Basic Accounting Equation. We have also learned the distinctions between assets, liabilities and equity. Importantly, we explored how equity is comprised of: (i) owner investment (including cumulative profits), (ii) current year revenue and (iii)



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current year expense.

The chart above expands the Basic Accounting Equation to our new level of detail.

1.7 The Balance Sheet: A One-Day Snapshot

GEMSPROUT, Inc.
Balance Sheet
As of
December 31, 20X1

Assets:		
Current Assets		
Cash		$ 3,395,000
Marketable Securities		150,000
Accounts Receivable		1,030,000
Inventory		950,000
Prepaid Legal Expenses		5,000
Total current assets		5,530,000
Fixed Assets		
Building and Equipment	500,000	
Less: accumulated depreciation	(50,000)	
Net building and equipment		450,000
Land		250,000
Patent		50,000
Total fixed assets		750,000
Total assets		$ 6,280,000
		=========
Liabilities:		
Current Liabilities		
Accrued Expenses		$ 50,000
Accounts Payable		700,000
Total current liabilities		750,000
Long-term liabilities		
Chromedome Loan: Building and Equipment		375,000
Total long-term liabilities		375,000
Total liabilities		$ 1,125,000
Stockholders' Equity:		
Common Stock		$ 3,000,000
Retained Earnings		2,155,000
Total stockholders' equity		$ 5,155,000
Total liabilities and stockholders' equity		$ 6,280,000
		=========

1.8 The Income Statement: Summarizes Revenues and Expenses for a Stated Period of Time

The income statement summarizes the revenues and expenses recognized by the enterprise over the period of time for which it is prepared. The income statement presents the **results of operations**, or profitability, of the enterprise. The purpose of the income statement is to present the calculation of **net income**, the amount by which total revenues and gains exceed total expenses and losses for the period of time measured by the income statement. Of course, the income statements of some unfortunate enterprises display the **net loss** of the enterprise, when expenses and losses exceed revenues and gains for the period covered.

GEMSPROUT, Inc.
Statement of Income
For the year ended
December 31, 20X1

Sales		$ 2,600,000
Operating Expenses:		
Cost of Goods Sold	$750,000	
Depreciation Expense	50,000	
Maintenance Expense	20,000	
Total operating expenses		820,000
Operating income		1,780,000
Other income:		
Gain on sale of marketable securities		450,000
Other expenses:		
Interest expense	55,000	
Legal fees	20,000	
Total other expenses		75,000
Net income		$ 2,155,000
		=========

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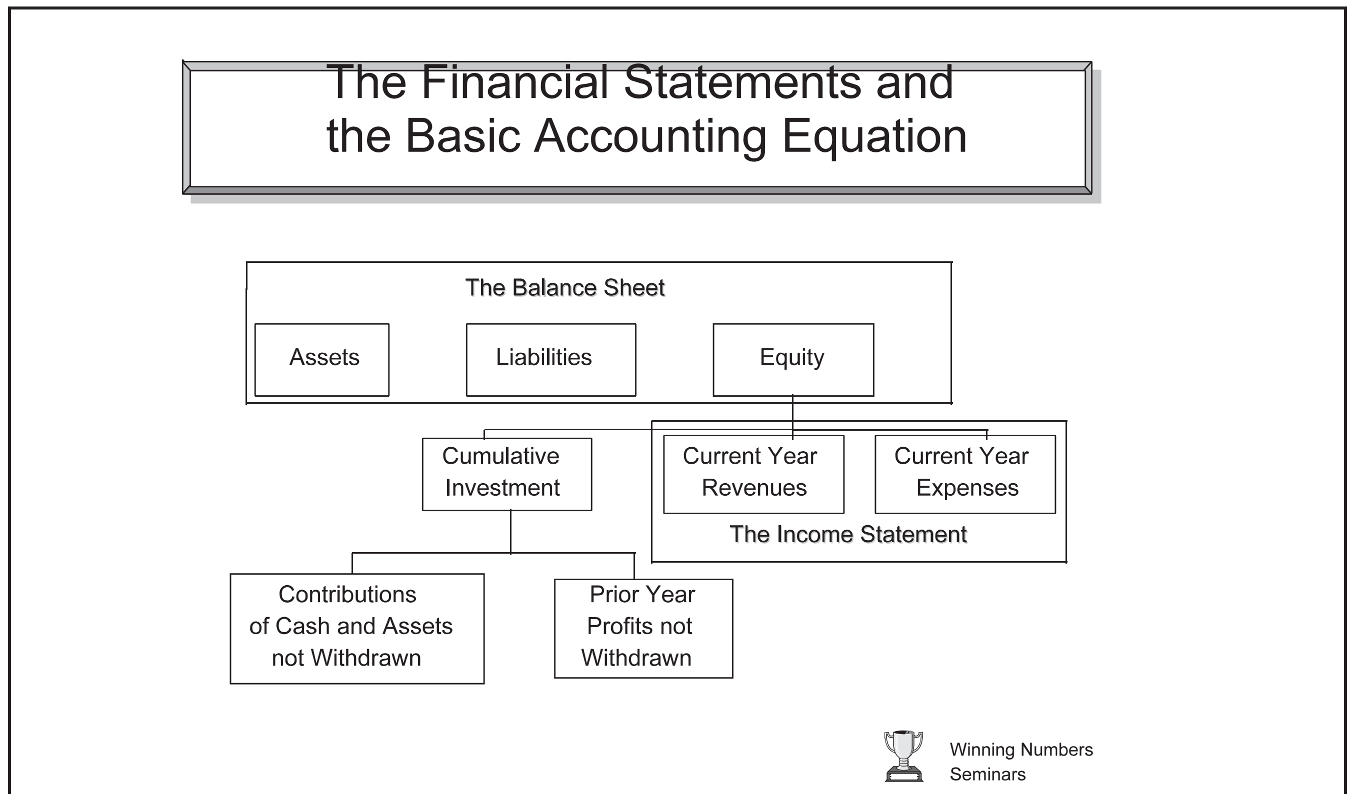
1.9 The Relationship Between the Balance Sheet, Income Statement and the Basic Accounting Equation



1.10 Interplay between Balance Sheet and Income Statement: Retained Earnings

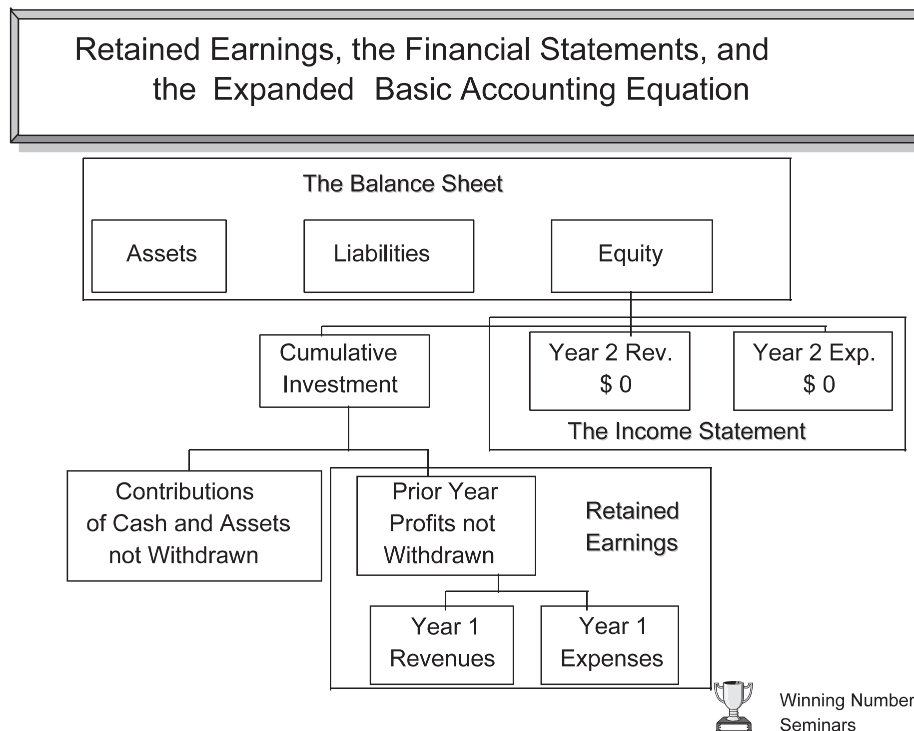
At the end of each accounting period, the entity calculates its net income by subtracting its expenses from its revenues. This net income of the enterprise is added to (or the net loss subtracted from) the previous accumulated, undistributed net income or losses of the enterprise. (A net loss, of course, would be subtracted from the undistributed net income or loss of the enterprise.)

This cumulative total of the net income or loss of the enterprise (net of any reductions for dividends returned to the owners) is referred to as **retained earnings**. As such, retained earnings comprises part of the equity of the enterprise; amounts carried in the retained earnings account are profits of the business which the owners have elected to "invest" in the business by not causing the business to make a distribution of such amounts.

Significantly, **retained earnings does not represent a sum of cash available to the enterprise**. All of the assets of the enterprise appear in the asset accounts listed on the balance sheet. Rather, retained earnings is a "scorekeeping" account which tracks the amount by which the owners' investment has been increased by cumulative net profits and decreased by the payment of dividends.

At the end of an accounting period, the retained earnings account captures the profit and loss activity of the enterprise. After the net income is added to (or net loss subtracted from) the retained earnings account at the end of the accounting period, the income statement accounts are reset to zero. This resetting process allows for the tracking of net income over a period of time to begin anew. Remember, the income statement summarizes activity over a period of time. Once that time period has concluded, the income statement resets to zero and begins tracking all over again.

The chart below illustrates the interplay between the balance sheet, the income statement and retained earnings. Illustrated below is the status of the financial statements at the beginning of the first day of a new accounting period (in this case, "Year Two"). In the box marked "The Income Statement", one can see that Year 2 Revenues and Year 2 Expenses are both zero which indicates that the tracking of revenues and expenses in Year 2 has yet to begin. In the box marked "RetainedEarnings", one can see that Year 1 Revenues and Year 1 Expenses (together, Year 1 Net Income) have been added to prior years' net income to arrive at the balance of retained earnings. (Note here that any distributions of profits taken out of the entity by the owners would have reduced the balance of the retained earnings account.)



1.11 The Statement of Cash Flows

The Statement of Cash Flows:

(1) Summarizes changes in the amount of cash and equivalents controlled by the entity;

(2) Analyzes the nature of cash flows by Dividing cash inflows and outflows into 3 categories:

- Cash Flows from Operating Activities:

  Cash generated and expended in the main business activities of the entity

- Cash Flows from Investing Activities:

  Cash generated and expended from the acquisition and disposition of investment assets

- Cash from Financing Activities:

  Cash generated and expended from raising and retiring debt and equity

The Statement of Cash Flows has, as its primary purpose, the reconciliation of the beginning of the year balance of cash assets with the end of the year balance of the cash assets. It does so by breaking the cash flows into the three categories described above.

The Statement of Cash Flows does not yield information concerning the profitability of the business. The Income Statement analyzes enterprise profitability. That being said, cash flow remains inherently important to the ability of a business enterprise to survive. Without adequate cash flow in the short term, businesses which could be profitable over the long-term may prove unable to operate long enough to realize those profits.

Appearing below is an example of the Statement of Cash Flows.

GEMSPROUT, Inc.
Statement of Cash Flows
For the years ended
December 31, 20X1 and 20X2

	20X1	20X2
Cash on hand at beginning of year	$ 0	$ 3,395,000
Cash flow from operating activities:		
Received from sales or on account	1,600,000	2,390,000
Payment of legal and maint. exp	(25,000)	(90,000)
Payments to inventory mixer	(25,000)	
Payments of accrued expenses		(50,000)
Payments of accounts payable		(1,100,000)
Purchase of inventory	(975,000)	
Net cash flow from operations	575,000	1,150,000
Cash flow from investing activities:		
Purchase of land and building	(750,000)	
Sale of marketable securities	600,000	1,400,000
Purchase of marketable securities	(300,000)	
Purchase of patent	(50,000)	
Loan to employee	(30,000)	
Net cash flow from investing activities	(530,000)	1,400,000
Cash flow from financing activities:		
Proceeds of bank borrowing	750,000	
Cash from sales of GEMSPROUT stock	3,000,000	500,000
Cash paid to reduce loan principal	(375,000)	
Cash used to pay loan interest	(25,000)	
Net cash flow from financing activities	$3,350,000	$ 500,000
Net increase (decrease) in cash	$3,395,000	$3,050,000
Cash on hand at end of year	$3,395,000	$6,445,000

See notes to the financial statements

1.12 The Notes to the Financial Statements

The Notes to the Financial Statements are required supplementary disclosures to the numerical information set forth in the Financial Statements. In some instances, descriptions of certain types of transactions are required to be presented in the Notes. In other instances, the enterprise will use the footnotes to present information which is external to the numerical presentation yet important to understanding the financial position and results of operations of the enterprise.

Many knowledgeable readers begin their review and analysis of Financial Statements by reading the Notes first. This is because the Notes can sometimes contain disclosures which are fundamental to assessing everything else in the Financial Statements. In certain instances, the only disclosures that will be made of critical items take place in the Notes. As an example, an entity which is facing a material contingent liability resulting from ongoing litigation will most likely only discuss the litigation in the Notes until the point in time when an adverse judgment is entered.

In general, the Notes will contain disclosures concerning:

- Business activities of the entity
- Significant accounting policies
- Description of significant relationships and transactions
- Asset Sales
- Realized reductions in the historical cost of assets
- Terms of significant liabilities
- Business combinations
- Disclosures concerning parent and subsidiary relationships
- Related party transactions
- Subsequent events
- Other items important to understanding the financial statements.

1.13 Statement of Stockholders' Equity

Most enterprises will include a reconciliation of changes in the various accounts comprising the equity section of the balance sheet in another statement entitled "Statement of Stockholder's Equity". The statement of equity is less significant than either the balance sheet or income statement Nonetheless, the statement of equity should be reviewed to discover whether additional equity interests were sold during the period, whether dividends or other distributions were made and whether any other adjustments to retained earnings occurred.

In addition, many market value adjustments which are not presented on the face of the Income Statement will now be included in the Statement of Stockholders' Equity.

SECTION 2: USING *10-Column Analysis*™ TO ANALYZE BUSINESS TRANSACTIONS

2.1 Introduction to *10-Column Analysis*™

The increase or decrease in each of the five elements of the Expanded Basic Accounting Equation yield a maximum of ten possible components to the equation. Most business transactions will affect only two or three of the components; rarely will one have to consider the effect of a transaction on four of the ten components of the equation.

Let us begin the construction of a graphical tool to assist us in the analysis of business transactions. With this tool, one can analyze any business transaction. We have already learned that each properly analyzed business transaction will balance the Expanded Basic Accounting Equation by analyzing the changes in its ten components. To review, those components are:

1. Increases in Assets
2. Decreases in Assets
3. Increases in Liabilities
4. Decreases in Liabilities
5. Increases in the Investment of Owners
6. Decreases in the Investment of Owners
7. Increases in Current Year Revenues
8. Decreases in Current Year Revenues
9. Increases in Current Year Expenses
10. Decreases in Current Year Expenses

Applying the Expanded Basic Accounting Equation to its components listed above, we should see that the sum of components 1 and 2 (Assets) equal the sum of components 3 and 4 (Liabilities) plus the sum of components 5 through 10 (Equity). The relationship between the 10 components and the Basic Accounting Equation is illustrated below.

Assets	=	Liabilities	+	Equity
(Components 1 & 2)	**=**	**(Components 3 & 4)**	**+**	**(Components 5 - 10)**

2.1.1. The ***10-Column Analysis*** ™ Worksheet©

The worksheet appearing below graphically reiterates the relationship between the 10 components of the Expanded Basic Accounting Equation. This worksheet will be used to analyze business transactions for changes in each of the 10 components. The process of analyzing a business transaction utilizing this tool is known as ***10-Column Analysis*** **™**.

Examination of this worksheet reveals several of its key features. First, each of the ten components of the Expanded Basic Accounting Equation is represented by its own column. These components are listed under a header which illustrates the Expanded Basic Accounting Equation. For example, Column (1) is labeled "Increase Assets" while Column (2) is labeled "Decrease Assets". These two columns summarize the possible options with respect to assets in the Expanded Basic Accounting Equation. Any changes in liabilities will be recorded in Columns (3) and (4). Changes in equity will be recorded in Columns (5) through (10): changes in owners' investments in Columns (5) and (6); increases or decreases in current year revenues are recorded in Columns (7) and (8), while increases and decreases in current year expenses in Columns (9) and (10).

In addition, a marker above Columns 7 through 10 indicate that entries in these columns will be affect the income statement of the enterprise. Columns 7 through 10 capture changes in current year revenues and current year expenses. If the net sum of the entries in the current year revenues columns (7 and 8) exceed the set sum of the entries in the current year expenses columns (9 and 10) the enterprise will show a net profit on its income statement for the period. The opposite situation indicates a net loss.

Each of the columns has been marked "+" (positive) or "-" (negative) in the space immediately above the column. This indication which will assist in maintaining the balance of the Expanded Basic Accounting Equation. Use of the positive and negative markings will be discussed below.

At the top of the worksheet is a device referred to as the "Proof Tool". In this area of the worksheet, the user can prove that the Expanded Basic Accounting Equation remains in balance after recording a transaction. By summing all of the items entered in the respective columns, and adding the column sums together as indicated, use of the Proof Tool will verify that the Expanded Basic Accounting Equation remains balanced after recording the transaction.

The far left column of the worksheet provides space for the entry of a description of each of the transactional elements. Numbers representing the dollar amounts of the transactional elements will be entered into one of the 10 columns representing the 10 components of the Expanded Basic Accounting Equation.

10-Column Analysis™ Worksheet©

```
Proof of   {  $                  =   $                                                                                      }
The Basic  {  $                  =   $                    +   $                                                             }
Accounting {[ $        - $     ] = [ $        - $       ] + [ $        - $        + $        - $        - $        + $      ] }
Equation   {[ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10) }

            [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                    [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

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2.2 Two Rules In Applying ***10-Column Analysis***™

There are two simple rules to follow in using the ***10-Column Analysis***™ Worksheet©.

1. **The transaction, as entered in the Worksheet, must maintain the balance of the Expanded Basic Accounting Equation.**

We have seen that every business transaction maintains the balance of the Expanded Basic Accounting Equation. Transactions will fit into one of two categories:

(1) Equal entries can be made on opposite sides of the equation.

An example of this would be a transaction that increases assets [recorded in Column (1)] on one side of the equation and an increase in liabilities [recorded in Column (3)] on the other side of the equation. In this transaction, the equation stays in balance because assets (on one side of the equation) and liabilities (on the other) each increased by an equal amount.

(2) Equal amounts be entered into offsetting components on the same side of the equation.

An increase in assets recorded in Column (1) can be offset by a decrease in assets in Column (2). The equation stays in balance here because there has been no net change in assets; total assets remain the same and are still equal to the sum of liabilities and equity.

Both of these types of transactions require the entry of numbers in at least two columns. More complicated transactions may result in more than two entries, but, in each case, the effects of the entries will be to keep the Expanded Basic Accounting Equation in balance.

2. **The numerical entries for a particular transaction in columns marked with a "+" must equal the numerical values of entries for that transaction in columns marked with a "-".**

10-Column Analysis™ is designed to make it easy to balance the Expanded Basic Accounting Equation. Each of the 10 columns is marked with a "+" or a "-" indicating the effect of entering a number in that column. Maintaining the balance of the Expanded Basic Accounting Equation requires only that the sum of items entered into columns marked with a "+" equal the sum of items marked with a "-".

There is no numerical significance to the positive and negative signs. (If you like, you can think of these as apples and oranges, hot and cold, etc.) Instead, the positive and negative designations are merely a tool to be used in analyzing a transaction.

An example may help illustrate the use of the "+" and "-" markings. Assume you have concluded that a transaction results in the receipt of $100,000 in cash by the entity. You have correctly entered $100,000 in Column (1) "Increased Assets". Column (1) is marked with a "+" sign. You will maintain the balance of the Expanded Basic Accounting Equation by entering a total of $100,000 in columns marked with a "-" sign. In this example, you could enter up to $100,000 in Columns (2), (3), (5), (7) or (10). The correct entry would, of course, depend upon the nature of the transaction. If cash was received because the entity took out a loan (increasing a liability), you should enter the $100,000 in Column (3) "Increased Liabilities". If the cash were provided by the investment of an owner, the entry would be made in Column (5), "Increase Owners' Investments". In either case, entry of $100,000 in a "-" column would result in maintaining the balance of the Expanded Basic Accounting Equation.

You can utilize the +/- tool in reverse as a means to check the accuracy of a transaction already recorded in the Worksheet. After you have completed recording any transaction, add the numbers in columns marked "+". The Expanded Basic Accounting Equation will remain in balance if this number is equal to the sum of the items in columns marked "-".

2.3 The Four Steps in ***10-Column Analysis***™

There are 4 steps to be followed in conducting the analysis of any transaction in ***10-Column Analysis***™.

2.3.1 Analyze the Transaction

One must review the effect of the transaction on each of the 10 components to the Expanded Basic Accounting Equation as described above. One should ask, for example, "How does this transaction effect the assets of the entity?" or "Are revenues increased as a result of this transaction?"

Correct identification of the impact of the transaction on the components of the Expanded Basic Accounting Equation is critical to successful use of ***10-Column Analysis***™.

2.3.2 Enter the Data in the ***10-Column Analysis***™ Worksheet©

Once one has identified the components of the Expanded Basic Accounting Equation that will be impacted in the transaction, one must compute the amounts to be entered into the columns which represent each component.

Many times this will be a straightforward process; in other instances it will require the user to call upon knowledge of business practice and accounting convention. (The examples in this Chapter are designed to minimize the amount of external knowledge required.)

2.3.3 Complete the Proof Tool

At the top of the ***10-Column Analysis***™ **Worksheet**© appears a device known as the Proof Tool. The Proof Tool summarizes the results of a transaction and shows that the Expanded Basic Accounting Equation remains in balance after entering the transaction into the Worksheet.

To use the Proof Tool one must: (i) sum all of the entries in each respective column and (ii) add the column totals together as indicated in the Proof Tool. For example, the sum of the amounts entered in Column 2 are subtracted from the amounts entered in Column 1; and the sum of the amounts entered in Column 4 are subtracted from the amounts entered in Column 3. The change in equity is computed by adding and subtracting the totals of the amounts contained in Columns 5 through 10 as indicated.

Working the Proof Tool to the end will prove that the sum of the changes in assets equals the sum of the changes of liabilities and equity. Put another way, the Proof Tool proves that the Expanded Basic Accounting Equation has remained in balance.

2.3.4 Compare "+"'s and "-"'s

One of the fundamental rules of ***10-Column Analysis*™** requires that the amounts entered in columns which are headed by a "+" equal the amounts entered into columns which are headed by a "-".

As a final step in implementing ***10-Column Analysis*™**, one should check to ensure that this condition has been satisfied.

2.4 The Relationship Between ***10-Column Analysis***™ and "Debits and Credits"

In formal accounting, the terms "debit" and "credit" are use to describe the offsetting components of any transactional analysis. As useful as these terms are, the terms themselves can be confusing. These terms are not used in ***10-Column Analysis***™ as they are not necessary to building a fundamental understanding of accounting and the financial statements.

For the benefit of purists, "+" entries in the ***10-Column Analysis***™ Worksheet© would be considered "debit" entries; "-" entries are "credit" entries for formal accounting

purposes.

2.5 Application of ***10-Column Analysis***™

The examples that follow apply ***10-Column Analysis***™ to a series of business transactions related to the formation and first year of operations of GEMSPROUT, Inc., a start-up, high-tech, high-flying, biomedical company.

GEMSPROUT is the brainchild of a thirty-year-old accountant who awoke one morning to find that repeated removal of his standard-issue green eye shade had resulted in significant hair loss. Unmarried and desperately worried that potential mates would find his starkly vacant scalp unattractive, GEMSPROUT founder, Preston Gem, began a search of scientific literature to find a cure for male pattern baldness.

In applying ***10-Column Analysis***™ throughout these exercises, the reader should analyze the transaction in the space provided under the description of each transaction. Each transactions is followed by a completed worksheet and written explanation and guidance to assist in the analysis.

2.5.1 ***10-Column Analysis***™: Initial Cash Investment by Owner

Gem quickly discovered an article on the potential benefits of aloe vera and peanut butter as a topical scalp cream in Follicle, the Journal of the American Academy of Hair and Scalp Research. Now excited, Gem used his own "Form a Corporation Kit" to incorporate GEMSPROUT, Inc. in Nevada on January 1, 20X1.

Gem became the sole stockholder of GEMSPROUT after he withdrew his life savings of $3,000,000 and placed them on deposit in a bank account in the corporate name of GEMSPROUT and issued himself stock certificate number 1. Apply ***10-Column Analysis™*** to the transaction described above.

10-Column Analysis™ Worksheet©

```
Proof of     {    $                    =   $                                                              }
The Basic    {    $                    =   $                   +   $                                      }
Accounting   {  [ $       - $       ] = [ $       - $       ] + [ $       - $       + $       - $       - $       + $       ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                               [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {    $3,000,000          =   $3,000,000                                                                       }
The Basic  {    $3,000,000          =   $0                  +   $3,000,000                                               }
Accounting {  [ $3,000,000- $     ] = [ $       - $       ] + [ $3,000,000 - $     + $       - $       - $       + $      ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                    [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets CASH	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Cash deposited	3,000,000									
	Stock issued					3,000,000					

The cash contributed by Gem becomes an asset of GEMSPROUT and is recorded in Column (1) "Increased Assets" - CASH. The cash represents an investment by the owner in the enterprise and is correctly entered in Column (5) "Increased Owners' Investment".

The Proof reveals that the sum of the increases in assets ($3,000,000) are equal to the sum of increases in liabilities ($0) and equity ($3,000,000) recorded in this transaction.

Total positives (Column (1): $3,000,000) equal total negatives (Column (5): $3,000,000).

2.5.2 ***10-Column Analysis***™: Purchase of an Asset Using Cash

Gem contacts the author of the Follicle article extolling the potential benefits of the aloe vera and peanut butter concoction. The author, Edward du Hickey, informs Gem that the patent on the aloe/peanut butter scalp cream is owned by a reclusive former German monk, Father H.R. Crown.

Gem contracts Herr Crown and arranges to purchase the patent for $50,000. Apply ***10-Column Analysis***™ to the purchase of the patent for cash.

10-Column Analysis™ Worksheet©

```
Proof of    {     $                   =   $                                                                              }
The Basic   {     $                   =   $                +   $                                                         }
Accounting  {   [ $       - $       ] = [ $       - $       ] + [ $        - $       + $       - $       - $       + $       ]}
Equation    {   [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity*************************]
                                                                                [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of     {    $0                     =   $0                                                                                                 }
The Basic    {    $0                     =   $0                  +   $0                                                                         }
Accounting   {  [ $50,000 - $50,000 ] = [ $        - $       ] + [ $        - $       + $       - $       - $       + $      ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                      [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets PATENT	- (2) Decr. Assets CASH	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Cash paid to Crown		50,000								
	Patent received	50,000									

The patent purchased from Herr Crown becomes an asset of GEMSPROUT; after the purchase, GEMSPROUT controls all the rights and benefits to the patent. Purchase of the patent is recorded in Column (1) "Increased Assets" - PATENT. The cash paid to Herr Crown reduces the amount of cash on hand, decreasing the cash asset. This payment is recorded in Column (2) "Decreased Assets" - CASH.

In this transaction, one asset, $50,000 in cash, was exchanged for another, a patent, which is recorded in the books and records of GEMSPROUT at $50,000, the cost to acquire the asset. There has been no change in total assets in this transaction. The Proof reveals that assets ($0) are equal to the sum of liabilities ($0) and equity ($0) recorded in this transaction. Total positives (Column (1): $50,000) equal total negatives (Column (2): $50,000).

This example illustrates the operation of the historical cost principle. Assets purchased by an entity are recorded at an amount equal to the consideration given by the enterprise to acquire the asset. In this case, the patent may eventually prove to have value far in excess of the $50,000 paid. But, when GEMSPROUT and Crown concluded the arms-length negotiation for the sale of the patent, the value agreed to was $50,000.

2.5.3 ***10-Column Analysis***™: Purchase of an Asset by Incurring a Liability

Gem decides that GEMSPROUT will manufacture its aloe/peanut butter scalp cream in its own factory. He contacts his commercial real estate broker, Jim Clean, who immediately shows Gem a recently deserted paint manufacturing and mixing facility in Shining Top, Tennessee. Mr. Clean tells Gem that the Shining Top facility is owned by The Chromedome Bank which is willing to finance GEMSPROUT's purchase on favorable terms. Gem and Chromedome negotiate the bald terms of the transaction, leaving the detailed negotiations to their attorneys. After much scratching of heads, GEMSPROUT purchases the building and equipment from Chromedome in exchange for GEMSPROUT's execution of an interest-bearing note with an original principal balance of $750,000. Of the $750,000, an appraiser estimated that $500,000 is attributable to the cost of building and equipment and $250,000 is attributable to the cost of the land. Apply ***10-Column Analysis™*** to the purchase of the building and equipment by GEMSPROUT.

10-Column Analysis™ Worksheet©

```
Proof of    {    $                  =   $                                                                   }
The Basic   {    $                  =   $              +   $                                                }
Accounting  {  [ $       - $      ] = [ $       - $      ] + [ $        - $      + $      - $      - $      + $      ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [************************Equity*************************]
                                                                            [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of    {    $750,000            =   $750,000                                                                          }
The Basic   {    $750,000            =   $750,000            +   $0                                                        }
Accounting  {  [ $750,000- $       ] = [ $750,000- $       ] + [ $         - $        + $        - $        - $        + $      ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                               [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab. LOANS	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	B & E recorded	500,000									
	Land recorded	250,000									
	Loan agt. executed			750,000							

The building and equipment become an asset of GEMSPROUT when the title is conveyed to GEMSPROUT by the Chromedome Bank, presumably at the same time GEMSPROUT agrees to pay the Bank $750,000 (plus interest) over time. In this transaction, acquisition of the land, building and equipment increases total assets by $750,000. These assets are recorded in an amount equal to the principal of the loan in Column (1). The agreement to repay the Chromedome Bank, a liability, is recorded in an equal amount in Column (3) - "Increased Liabilities".

Total assets and total liabilities have each increased by $750,000 as a result of this transaction. The Proof Tool shows total assets (on the left side of the equation) increasing by 750,000, equal to the increase in total liabilities (on the opposite side of the equation).

Total positives (Column (1): $750,000) equal total negatives (Column (3): $750,000).

2.5.4 ***10-Column Analysis***™: Creation of a Prepaid Asset

Gem realizes that his venture will soon require top-flight legal help. He contacts his college roommate, I.L. Cheatham, now a name partner in the prestigious Las Vegas law firm of Houmani, Weighs, Ken-Wee, Cheatham and Howe.

Cheatham informs Gem that his firm will require a $25,000 retainer to begin the lawyer/client relationship. Cheatham emphasizes that the $25,000 will be held by his firm and applied as payment to the first $25,000 of services rendered by the firm. Additional work in excess of the $25,000 paid in advance will be billed to GEMSPROUT. Gem reluctantly agrees to this arrangement and sends $25,000 to Cheatham. Apply ***10-Column Analysis™*** to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of   {    $                  =   $                                                                                  }
The Basic  {    $                  =   $                  +   $                                                           }
Accounting {  [ $       - $       ] = [ $       - $       ] + [ $        - $       + $       - $       - $       + $       ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [*************************Equity*************************]
                                                                                  [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {     $0                    =   $0                                                                                        }
The Basic  {     $0                    =   $0                 +   $                                                                  }
Accounting {   [ $25,000 - $25,000 ] = [ $        - $       ] + [ $         - $        + $        - $        - $        + $       ]}
Equation   {   [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                        [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets PREPAIDS	- (2) Decr. Assets CASH	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Firm to serve	25,000									
	Cash sent to firm		25,000								

This transaction is an exchange of assets. One asset of GEMSPROUT, cash, has been given to a third party, the law firm. In return, GEMSPROUT received another asset, the right to receive legal services in the future, from the law firm. This type of asset is called a "prepaid expense" or a "prepaid asset".

The payment to the law firm does not represent a current year expense of GEMSPROUT. The matching principle requires revenues to be compared to the expenses used to generate those revenues in order to compute net income for a particular time period. In the case of the prepaid legal expenses, the expense will not be recorded until legal services are actually used by GEMSPROUT. Once services are used they become an expense of GEMSPROUT for the period in which the services are used.

GEMSPROUT records the exchange of assets in Column 1 (an increase in Prepaid Assets - Legal Expenses) of $25,000 and in Column 2 (a decrease in Cash). The Proof reveals that Total Assets have not changed as a result of the transaction. Total positives (Column (1): $25,000) equal total negatives (Column (2): $25,000).

2.5.5 ***10-Column Analysis***™: Purchase of Inventory with Cash

Gem discovers that Nutri-Healtho-World, a nationwide chain of stores selling only hydroponically-grown health food and organic cosmetics, is about to enter bankruptcy. Armed with this knowledge, Gem proceeds to negotiate for the purchase of: (i) two tanker trucks full of aloe vera and (ii) a railroad car filled with peanut butter destined for the Nutri-Healtho-World warehouse.

Gem wires $975,000 (treated as a cash payment) to Nutri-Healtho-World and the trucks and railroad car are diverted to Shining Top. Apply ***10-Column Analysis***™ to the purchase of inventory by Gem.

10-Column Analysis™ Worksheet©

```
Proof of    {    $                   =   $                                                                         }
The Basic   {    $                   =   $                 +   $                                                   }
Accounting  {  [ $       - $       ] = [ $       - $       ] + [ $        - $       + $       - $       - $       + $       ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)]}

               [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                           [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {    $0                   =   $0                                                                                    }
The Basic  {    $0                   =   $0                  +   $0                                                            }
Accounting {  [ $975,000- $975,000] = [ $        - $       ] + [ $        - $        + $        - $        - $        + $       ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                     [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets INVENTORY	- (2) Decr. Assets CASH	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Inventory acquired	975,000									
	Cash sent out		975,000								

In this transaction, GEMSPROUT exchanges one asset, cash, for another asset, inventory. (Inventory is the term used to describe materials on hand for conversion into finished products, as well as the finished products themselves.) The aloe vera and peanut butter will be held by GEMSPROUT until they are mixed and converted into a finished product.

The amounts associated with the purchase of the inventory are not yet expenses of GEMSPROUT. Under the matching principle, the costs to purchase and improve the inventory will be accumulated by GEMSPROUT in an asset account until the inventory is sold. When sold, the costs associated with the inventory are then transferred from the asset account into an expense account. This expense is then matched against the revenue which arises from the sale of the inventory to compute the profit on the sale.

Assume, for example, that none of the inventory is sold in the first year of GEMSPROUT's operations, but that all of the inventory is sold in the second year. The matching principle would require that all costs associated with the acquisition and improvement of the inventory be shown as an asset of GEMSPROUT until the second year. In the second year, all of the costs associated with the acquisition and improvement of the inventory would be recognized as an expense and matched against the revenue earned from selling the inventory in the second year to determine the net profit of GEMSPROUT in the second year.

Total assets remain unchanged as a result of the transaction. GEMSPROUT's inventory increased by $975,000 [the cost of the inventory recorded in Column (1)], while GEMSPROUT's cash balance declined [Column (2)] by an equal amount.

Total positives (Column (1): $975,000) equal total negatives (Column (2): $975,000).

2.5.6 ***10-Column Analysis***™: Increasing Cost of Inventory by Adding Value

Gem proves totally inept at mixing the aloe and peanut butter according to the formula set forth in Crown's patent. Gem wires Crown an emergency message asking if Crown can assist GEMSPROUT in the commercial preparation of its scalp cream. (By the way, Gem has decided to call the product "Aloepena" after Gem's love of those spicy peppers that add the zing to Mexican food and grow hair on the chest. Crown, free of his former vow of poverty, notifies Gem that his going rate is $25,000 for the one day's work which will be needed to conduct the delicate mixing procedure. Gem accepts. Crown arrives and mixes the aloe vera and peanut butter. Apply ***10-Column Analysis***™ to the transaction described above.

10-Column Analysis™ Worksheet©

```
Proof of   {    $                  =   $                                                                       }
The Basic  {    $                  =   $                +   $                                                  }
Accounting {  [ $       - $      ] = [ $       - $      ] + [ $        - $      + $       - $       - $      + $      ] }
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10) }

              [*******Assets******] = [****Liabilities****] + [************************Equity*************************]
                                                                                [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {    $0                  =   $0                                                                        }
The Basic  {    $0                  =   $0                 +   $0                                                 }
Accounting {  [ $25,000 - $25,000 ] = [ $       - $       ] + [ $       - $       + $       - $       - $       + $       ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5) - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                              [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets INVENTORY	- (2) Decr. Assets CASH	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Costs incr invntry	25,000									
	Cash paid to Crown		25,000								

This example is difficult. The payment of $25,000 is made to Crown for his assistance in mixing the inventory. The mixing brings the aloe vera and peanut butter together to make a finished product. Crown's work improves the inventory. Under the matching principle, the costs associated with the acquisition and improvement of the inventory must be accumulated so that those costs can be matched against the revenue generated by the sale of the inventory. If these costs were not accumulated and matched, large errors in the calculation of net income would result.

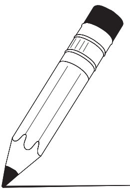
The payment to Crown differs in substance from the payments made to employees to clean the offices in the previous example. Crown has directly enhanced the value of the inventory by mixing the aloe vera and the peanut butter. The prisoners working to clean the offices were providing general maintenance support to GEMSPROUT's operations; their work did not directly involve the inventory.

The increase in the accumulated costs of the inventory are reflected by increasing assets (Column (1)) by $25,000. The payment to Crown reduces assets, cash, by an equal amount (Column (2)).

Total positives (Column (1): $25,000) equal total negatives (Column (2): $25,000).

Intuition argues that there are many types of expenditures which at least indirectly support the improvement of inventory. The key to proper matching is identifying those expenditures with a substantial relationship to the inventory. Costs which are directly related to the inventory warrant addition to the accumulated costs of the inventory; costs only incidentally related to the inventory as recognized immediately as expenses. Cost accounting concentrates on identifying and accumulating those costs which have a direct relationship to the inventory. A cost accounting system would estimate, for example, the cost of electricity used to power machines which make inventory. These electrical costs would be added to the recorded cost of the inventory. The accumulated costs are carried as assets of the entity until the inventory is sold. Upon sale, the costs of the inventory are then matched against the revenues from the sale in determining net income.

The allocation of costs to inventory requires a great deal of judgment. Subtle differences in the substance of transactions can alter their accounting treatment. Assume, for example, that GEMSPROUT hired Crown to train its employees in the mixing procedures. These training costs are more directly related to the employees than to the inventory. In most cases, the cost of training would be recognized immediately as current year expense rather than as an increase in the cost of the inventory to be matched against later revenue.



2.5.7 ***10-Column Analysis***™: Sale of Inventory at a Profit for Cash

Dee Pilatory, President of NAIR, Inc., reads of GEMSPROUT's new product while waiting to see his scalp replacement physician for treatment following a tragic accident. (Pilatory is seeking to reverse the tragic effect caused when 2 gallons of an experimental strength Nair was substituted for Gatorade which was then inadvertently dumped on his head following a recent victory of the Nair, Inc. softball team.)

Gem charges Pilatory $1,600,000, which Pilatory pays in cash upon shipment of the Aloepena. In return, Pilatory receives one-half of the existing inventory of Aloepena. Apply ***10-Column Analysis***™ to the purchase by Pilatory.

10-Column Analysis™ Worksheet©

```
Proof of   {    $                  =   $                                                                          }
The Basic  {    $                  =   $                +   $                                                     }
Accounting {  [ $       - $      ] = [ $       - $      ] + [ $        - $       + $       - $       - $       + $       ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [************************Equity*************************]
                                                                                   [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of    {    $1,100,000          =    $1,100,000                                                                                  }
The Basic   {    $1,100,000          =    $0                 +    $1,100,000                                                          }
Accounting  {   [$1,600,000-$500,000] = [ $       - $       ] + [ $        - $       +$1,600,000 - $     - $500,000+ $      ]}
Equation    {   [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                          [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets CASH	- (2) Decr. Assets INVENTORY	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns. SALES	+ (8) Decr. Revns.	+ (9) Incr. Exps. "COGS"	- (10) Decr. Exps.
	Cash received	1,600,000									
	Revenue recgnized							1,600,000			
	Inventory removed		500,000								
	Costs matched									500,000	

This transaction consists of two parts: (1) the receipt of $1,600,000 in cash from Pilatory as revenue received for the Aloepena sold and (2) matching the expense of the inventory transferred to Pilatory in the transaction against that revenue.

Recording the first step is straightforward. GEMSPROUT received $1,600,000 in cash from the sale of Aloepena. The cash increases assets (Column (1)). The payment received from Pilatory relates to the sale of products during the current period and is, therefore, recorded in Column (7), "Increased Revenues".

The second step requires some calculation. To this point GEMSPROUT has accumulated the following inventory costs:

Costs to Acquire Aloe and Peanut Butter (Example 2.5.5)	$ 975,000
Cost of Hiring Crown to Mix the Inventory (Example 2.5.6)	25,000
Total Accumulated Inventory Costs	$1,000,000
	=========

Pilatory has purchased one-half of the existing inventory of Aloepena. In order to match the expense of producing one-half the inventory against the revenue from the sale of that inventory, GEMSPROUT must transfer one-half of the accumulated costs of the inventory from assets to expense. This is done by decreasing assets (Column (2)) by $500,000 (one-half of the $1,000,000 in accumulated costs) while increasing expenses (Column (9)) by an equal amount. (The expense recognized in known as the "Cost of Goods Sold" or "COGS"). The transfer converts one-half of the amounts expended on the inventory before sale from their asset classification. These expenditures become expenses which are matched against the revenue earned on the sale.

At the conclusion of the transaction, GEMSPROUT would have an inventory asset equal to $500,000. This represents the remaining accumulated costs related to the unsold inventory as illustrated below.

Costs to Acquire Aloe and Peanut Butter (Example 2.5.5)	$ 975,000
Cost of Hiring Crown to Mix the Inventory (Example 2.5.6)	25,000
Total Accumulated Inventory Costs before Pilatory sale	$1,000,000
Less: Costs Attributable to Inventory Sold to Pilatory	(500,000)
Costs Attributable to the Inventory Remaining After Sale	$ 500,000
	=========

As a final check, total positives of $2,100,000 (Column (1): $1,600,000 + Column (9): $500,000) equal total negatives of $2,100,000 (Column (7): $1,600,000 + Column (2): $500,000).

2.5.8 ***10-Column Analysis***™: Utilization of Prepaid Expense

GEMSPROUT receives a statement from Houmani, Weighs indicating that the firm has performed $20,000 worth of legal work. As was the arrangement, Houmani, Weighs offsets fees charged for the services performed against the advance payment made by GEMSPROUT. Apply ***10-Column Analysis***™ to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of    {    $                  =   $                                                                              }
The Basic   {    $                  =   $                +   $                                                         }
Accounting  {  [ $       - $      ] = [ $       - $      ] + [ $       - $       + $       - $       - $       + $      ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                      [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {     $(20,000)           =   $(20,000)                                                                                      }
The Basic  {     $(20,000)           =   $0                  +   $(20,000)                                                              }
Accounting {   [ $0       - $20,000 ] = [ $        - $      ] + [ $        - $       + $       - $       - $20,000 + $      ]}
Equation   {   [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets PREPAIDS	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps. LEGAL	- (10) Decr. Exps.
	Expense recgnized									20,000	
	Asset reduced		20,000								

Houmani, Weighs has informed GEMSPROUT that it has provided $20,000 worth of legal services in the current period. In Example 2.5.4, GEMSPROUT paid $25,000 to the law firm which would then bill the first $25,000 of charges against the prepaid amount. This arrangement resulted in GEMSPROUT creating an asset in the amount of $25,000.

Now that Houmani, Weighs has provided the services, the matching principle requires that $20,000 be transferred to current year expenses. This is accomplished by reducing assets (Column (2)) and increasing expenses (Column (7)) by the $20,000 which has been used in the current year.

Total positives (Column (7): $20,000) equal total negatives (Column (2): $20,000).

As a result of this transaction, the asset recorded by GEMSPROUT will be reduced to $5,000. A balance sheet prepared after recording the expense would reflect prepaid legal expenses as an asset with a $5,000 balance.

2.5.9 ***10-Column Analysis***™: Reduction of Debt with Cash; Payment of Expense with Cash

Elated at the success of preliminary Pilatory purchase, on July 1, 20X1, GEMSPROUT elects to make an early payment on GEMSPROUT's note at the Chromedome Bank. Chromedome notifies GEMSPROUT that it will accept the $375,000 early principal payment only if GEMSPROUT also pays the $25,000 in interest on the outstanding balance since purchase. Apply ***10-Column Analysis™*** to this payment of principal and interest.

10-Column Analysis™ Worksheet©

```
Proof of     {    $                 =   $                                                                        }
The Basic    {    $                 =   $               +   $                                                    }
Accounting   {  [ $        - $       ] = [ $        - $       ] + [ $        - $       + $       - $       - $       + $       ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                           [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {    $                  =   $                                                                                    }
The Basic  {    $                  =   $                 +   $                                                              }
Accounting {  [ $       - $      ] = [ $       - $      ] + [ $        - $       + $       - $       - $       + $       ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                               [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets CASH	- (3) Incr. Liab.	+ (4) Decr. Liab. LOANS	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps. INTEREST	- (10) Decr. Exps.
	Cash paid		375,000								
	Principal reduced				375,000						
	Cash paid		25,000								
	Interest expense									25,000	

This example consists of two components. In the first, $375,000 of cash is paid to the Chromedome Bank to reduce the principal balance of the loan. This is reflected by a decrease of assets (Column (2)) in this amount coupled with an equivalent decrease in liabilities (Column (4)).
The second component covers the payment of interest on the note. In this example, GEMSPROUT pays $25,000 in cash for interest due. The payment of interest represents an expense and, for this example, we have assumed that no previous liability was established for the interest due. (Example 2.5.16, 2.5.16) contains a more detailed description of how the transaction would have been recorded if a liability related to the interest due had been previously established.) The payment of interest reduces assets (Column (2)) and increases expenses (Column (9)) by $25,000.

Total positives of $400,000 (Column (4): $375,000 + Column (9): $25,000) equal total negatives of $400,000 recorded in Column (2).

2.5.10 ***10-Column Analysis***™: Purchase of an Asset for Cash

Gem engages famed business consultants Robin Leach, formerly host of Lifestyles of the Rich and Famous and Michael Jordan, eager to ease the boredom of retirement, to meet at Shining Top to review corporate strategy. Leach and Jordan recommend that GEMSPROUT diversify its lines of business noting that, despite Aloepena's advance billing, no new hair has yet to grow on Pilatory's head.

Leach recommends a purchase of the common stock of Mr. Jay's Hair Weave, Inc., a new company specializing in "really great looking hairpieces". GEMSPROUT buys 100,000 shares of Mr. Jay's Hair Weave for $300,000 through Gem's broker, Scott Ticker. Apply ***10-Column Analysis***™ to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of     {    $                    =   $                                                                                  }
The Basic    {    $                    =   $                +   $                                                             }
Accounting   {  [ $        - $       ] = [ $        - $       ] + [ $         - $       + $       - $       - $       + $       ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                          [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {   $0                     =   $0                                                                                          }
The Basic  {   $0                     =   $0                    +   $0                                                                }
Accounting {  [$ 300,000-$ 300,000] = [ $        - $        ] + [ $        - $        + $        - $        - $        + $        ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                     [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets MKT. SEC.	- (2) Decr. Assets CASH	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Cash paid		300,000								
	Stock received	300,000									

This transaction represents a simple exchange of one type of asset, cash, for another, marketable securities. The decrease in cash is recorded in Column (2) while the increase in marketable securities is recorded in Column (1).

Total positives (Column (1): $300,000) equal total negatives (Column (2): $300,000).

2.5.11 ***10-Column Analysis***™: Loan by the Enterprise

Herr Crown has elected to leave the monastery after perfecting use of the Phloebee hair cutting device to give the ideal "surfer cut". Crown solicits GEMSPROUT to lend Herr Crown $30,000 to begin a chain of mobile hair salons that will bring the latest in *haute couture* hair fashions to junior high schools throughout the United States.

In keeping with the newly formulated diversification policy, GEMSPROUT lends Herr Crown the requested $30,000. Apply ***10-Column Analysis***™ to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of    {    $                   =   $                                                                         }
The Basic   {    $                   =   $                 +   $                                                   }
Accounting  {  [ $       - $       ] = [ $       - $       ] + [ $       - $       + $       - $       - $       + $       ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5) - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)]}

               [*******Assets******] = [****Liabilities****] + [************************Equity*************************]
                                                                               [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {    $0                   =   $0                                                                               }
The Basic  {    $0                   =   $0                    +   $0                                                     }
Accounting {  [ $ 30,000- $ 30,000] = [ $        - $        ] + [ $        - $        + $        - $        - $        + $        ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

              [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                   [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Cash to employee		30,000								
	Receivable estblshed	30,000									

This transaction is another example of an exchange of assets. GEMSPROUT has given up cash in exchange for another asset, in this case, the right to receive payment from Crown. This type of asset is known generally as a **receivable**.

The exchange of assets is recorded in Columns (1) and (2).

Total positives ($30,000: Column (1)) equal total negatives ($30,000: Column (2)).

2.5.12 ***10-Column Analysis***™: Gain on Sale of an Asset

This just in....the price of Mr. Jay's Hair Weave stock skyrockets on news reports that 98 out of 100 women surveyed prefer hairpieces to natural hair....GEMSPROUT sells 50,000 shares (one-half of its original purchase) at $12 per share. Apply ***10-Column Analysis***™ to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of     {    $                   =   $                                                                              }
The Basic    {    $                   =   $                 +   $                                                        }
Accounting   {  [ $       - $       ] = [ $       - $       ] + [ $        - $       + $       - $       - $       + $       ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                             [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of     {     $450,000            =   $450,000                                                                      }
The Basic    {     $450,000            =   $0                  +   $450,000                                              }
Accounting   {  [ $600,000- $150,000] = [ $        - $       ] + [ $        - $        + $450,000- $        - $        + $      ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                    [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets CASH	- (2) Decr. Assets MKT. SEC.	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns. GAIN	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Cash received	600,000									
	Stock transfer		150,000								
	Gain on sale							450,000			

The key to completing this example lies in understanding how to compute a gain on the sale of an asset. In Example 2.5.10, GEMSPROUT purchased 100,000 shares of Mr. Jay's Hair Weave stock for $300,000. In this transaction, GEMSPROUT sells one-half of that stock (50,000 shares) for $12 a share. GEMSPROUT thus has generated cash proceeds from the sale of $600,000.

In computing the gain on the sale, GEMSPROUT must match the costs to acquire the shares sold against the revenue received from the sale. Because one-half of the shares have been sold, one-half of the cost must be recognized in the transaction. In this case, one-half of the original cost of $300,000 is $150,000. Thus, the gain on sale is computed as follows:

Total Proceeds from Sale	$600,000
Less: Cost of Stock Sold (1/2 x $300,000)	150,000
Gain on Sale	$450,000
	=======

The cash received increases assets (Column (1)); the cost of stock transferred is reflected in Column (2) and the gain on sale is recorded in Column (7) as an increase in revenues.

Total positives of $600,000 (Column (1): $600,000) equal total negatives (Column (2): $150,000 + Column (7): $450,000).

At the end of this transaction, GEMSPROUT would continue to hold marketable securities with a cost of $150,000. Application of the lower of cost or market principle bars the recognition of increases in value of assets above the cost paid to acquire the asset. In this instance, even though the market currently values the Mr. Jay's common stock at four times its original purchase price, GEMSPROUT would continue to carry the 50,000 remaining shares on its balance sheet at their recorded historical cost.

One may wonder why the $150,000 related to the cost of the stock was not reflected as an expense in the current period and offset against revenues of $600,000 to arrive resulting in the income statement recording a net profit of $450,000 as a result of this transaction. The answer lies in the distinction between sales of inventory (which are part of the normal course of business) and the sales of other assets (which are considered incidental to the primary business activity of this entity). When assets which are incidental to the primary business of an entity are sold, as is the case here, the gain or loss on the sale of the assets is recorded on a net, rather than on a gross, basis.

2.5.13 ***10-Column Analysis***™: Sale of Inventory at a Profit on Credit

Word of Aloepena's new use spreads like wildfire throughout the world. World heavyweight champion, George Foreman, known big eater and grilling machine spokesperson, contacts GEMSPROUT in an attempt to corner the market in Aloepena's newest fad use: cholesterol-reducing all-over body lotion, designed to eliminate the cumulative effects of a steady diet of grilled peanut butter and banana sandwiches.

Gem sells the perky, paunchy, pugilist one-half of the remaining inventory in exchange for his promise to pay $1,000,000 immediately after his title defense against "Iron Bars" Mike Tyoneon in 30 days. Apply ***10-Column Analysis***™ to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of    {   $                  =  $                                                                   }
The Basic   {   $                  =  $               +  $                                                }
Accounting  { [ $       - $       ] = [ $       - $       ] + [ $        - $       + $       - $       - $       + $       ]}
Equation    { [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

[*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of     {    $                    =   $                                                                                }
The Basic    {    $                    =   $                  +   $                                                         }
Accounting   {  [ $       - $       ] = [ $       - $       ] + [ $         - $        + $        - $        - $        + $       ]}
Equation     {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)   - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                     [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets RECEIVBLE	- (2) Decr. Assets INVENTORY	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns. SALES	+ (8) Decr. Revns.	+ (9) Incr. Exps. COGS	- (10) Decr. Exps.
	Receivable establshd	1,000,000									
	Revenue recgnized							1,000,000			
	Inventory removed		250,000								
	Expense matched									250,000	

This example is almost identical to 2.5.7. This transaction also consists of two parts: (1) the receipt of a promise from Fourman to pay $1,000,000 in 30 days as revenue received for the Aloepena sold and (2) matching the expense of the inventory transferred to the two in the transaction against that revenue.

Recording the first step is straightforward. GEMSPROUT recognized a $1,000,000 account receivable from the sale of Aloepena to Fourman. The recognition of this assets increases assets (Column (1)). When the receivable is collected from the duo, the receivable will be eliminated (Column (2)) and the cash recorded as received (Column(1)). The promise received from the duo relates to the sale of products during the current period and is, therefore, recorded in Column (7), "Increased Revenues".

As before, the costs attributable to the inventory sold must be calculated. Immediately prior to the sale, GEMSPROUT had accumulated the following inventory costs:

Costs to Acquire Aloe and Peanut Butter (Example 2.5.5)	$ 975,000
Cost of Hiring Crown to Mix the Inventory (Example 2.5.6)	25,000
Total Accumulated Inventory Costs before Pilatory sale	$1,000,000
Less: Costs Attributable to Inventory Sold to Pilatory	(500,000)
Costs Accumulated in the Inventory After Pilatory Sale	$ 500,000
	==========

Fourman has purchased one-half of the remaining inventory of Aloepena. In order to match the expense of producing the inventory sold against the revenue from the sale of that inventory, GEMSPROUT must record the transfer of one-half of the remaining accumulated costs of the inventory from assets to expense. This is done by decreasing assets (Column (2)) by $250,000 (one-half of the $500,000 in remaining accumulated costs) while increasing expenses (Column (9)) by an equal amount.

At the conclusion of the transaction, GEMSPROUT would have an inventory asset equal to $250,000. This represents the remaining accumulated costs related to the unsold inventory as illustrated below.

Costs to Acquire Aloe and Peanut Butter (Example 2.5.5)	$ 975,000
Cost of Hiring Crown to Mix the Inventory (Example 2.5.6)	25,000
Total Accumulated Inventory Costs before Pilatory sale	$1,000,000
Less: Costs Attributable to Inventory Sold to Pilatory	(500,000)
Costs Accumulated in the Inventory After Pilatory Sale	$ 500,000
Less: Costs Attributable to Inventory Sold to Fourman	(250,000)
Costs Accumulated in the Inventory After Fourman Sale	$ 250,000
	=========

Total positives of $1,250,000 (Column (1): $1,000,000 + Column (9): $250,000) equal total negatives of $1,250,000 (Column (7): $1,000,000 + Column (2): $250,000).

2.5.14 ***10-Column Analysis***™: Purchase of an Asset Using Trade Credit

Having completed the Foreman sale and with Nutri-Healtho-World out of business, GEMSPROUT began searching for new sources of aloe and peanut butter to begin rebuilding its dwindling inventory. Through connections, Gem arranges a meeting with top executives of the Jergens Skin Cream Company and Jif Peanut Butter, Inc. Jergens and Jif join jollily in a joint venture and offer to supply pre-mixed, but unprocessed, inventory.

Gem likes the idea and decides to purchase $700,000 worth of the combined product, giving the "J/J JV" GEMSPROUT's promise to pay in 30 days. Apply ***10-Column Analysis***™ to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of    {    $                  =   $                                                                            }
The Basic   {    $                  =   $                 +   $                                                      }
Accounting  {  [ $        - $     ] = [ $        - $    ] + [ $        - $      + $      - $      - $      + $      ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

[*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                 [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of    {     $700,000            =   $700,000                                                                          }
The Basic   {     $700,000            =   $700,000           +   $0                                                         }
Accounting  {   [ $700,000- $       ] = [ $700,000- $      ] + [ $        - $       + $       - $       - $       + $      ]}
Equation    {   [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                        [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Inventory received	700,000									
	Acct. pay. incurred			700,000							

This example focuses on how an entity can use liabilities to acquire assets. In this transaction, GEMSPROUT agrees to pay the J/J JV $700,000 in 30 days in exchange for receiving $700,000 worth of aloe and peanut butter today. This type of liability is known as an account payable. Accounts payable are a form or credit available from suppliers. In this case, GEMSPROUT has increased its assets by increasing the amount owed to suppliers of its inventory. The increase in assets is recorded in Column (1); the increase in liabilities in Column (3).

Total positives (Column (1): $700,000) equal total negatives (Column (3): $700,000).

The additional inventory will be added to the accumulated costs remaining after the Fourman sale as illustrated below.

Costs to Acquire Aloe and Peanut Butter (Example 2.5.5)	$ 975,000
Cost of Hiring Crown to Mix the Inventory (Example 2.5.6)	25,000
Total Accumulated Inventory Costs before Pilatory sale	$1,000,000
Less: Costs Attributable to Inventory Sold to Pilatory	(500,000)
Costs Accumulated in the Inventory After Pilatory Sale	$ 500,000
Less: Costs Attributable to Inventory Sold to Fourman	(250,000)
Costs Accumulated in the Inventory After Fourman Sale	250,000
Plus: Costs to Acquire J/J JV Inventory	700,000
Total Costs in Inventory	$ 950,000
	=========

This ending balance will appear on the balance sheet of GEMSPROUT prepared after the conclusion of the sale.

2.5.15 ***10-Column Analysis***™: Depreciation of An Asset

Upon completion of the first year of operation, GEMSPROUT recognizes that it must allocate the cost of its Shining Top facility to expense this year. Gem's analysis indicates that the building has an expected life of ten years and allocates one-tenth of the cost to expense in the first year. Apply ***10-Column Analysis™*** to this transaction.

10-Column Analysis™ Worksheet©

```
Proof of   {    $                   =   $                                                                              }
The Basic  {    $                   =   $                 +   $                                                        }
Accounting { [ $       - $       ] = [ $       - $       ] + [ $        - $       + $       - $       - $       + $      ]}
Equation   { [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

             [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

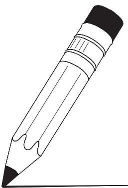
```
Proof of   {     $(50,000)            =   $(50,000)                                                                                       }
The Basic  {     $(50,000)            =   $0                  +   $(50,000)                                                               }
Accounting {   [ $0      - $50,000 ] = [ $       - $       ] + [ $        - $       + $       - $       - $50,000 + $      ]}
Equation   {   [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [*************************Equity**************************]
                                                                                  [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Accum. deprec.		50,000								
	Expense recorded									50,000	

This example focuses on the process of matching expenses to revenue over time. In this example, GEMSPROUT must allocate the cost of its Shining Top factory over the estimated useful life of the factory. You may recall that $500,000 of the $750,000 acquisition cost was allocated to the building and equipment. Under the straight-line method of depreciation, the cost of the building and equipment would be allocated on a pro-rata fashion for each year in which the equipment was used. In this case, 1/10th of the cost

Total positives (Column (1): $700,000) equal total negatives (Column (3): $700,000).



2.5.16 ***10-Column Analysis***™: Accrual of Year End Expenses

The corporate offices at the Shining Top facility need serious cleaning. Gem hires his first employees from a local prison work-release program on December 15 and does not pay them before the end of the year. The total amount owed to the prisoners equals $20,000. In addition to the addition of employees GEMSPROUT has come into possession of the following information:

1. The Chromedome Bank informs GEMSPROUT that interest of $30,000 on the $375,000 has accrued since the July 1 payment. (This note bears interest at 16% per annum).
2. Houmani, Weighs informs GEMSPROUT that GEMSPROUT has not consumed any used any additional legal services since the date of the last invoice.

Apply ***10-Column Analysis***™ to these facts.

10-Column Analysis™ Worksheet©

```
Proof of    {    $                  =   $                                                                         }
The Basic   {    $                  =   $             +   $                                                       }
Accounting  {  [ $       - $      ] = [ $       - $      ] + [ $        - $       + $       - $       - $       + $      ]}
Equation    {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

               [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                          [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab.	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.

Solution:

10-Column Analysis™ Worksheet©

```
Proof of   {    $0                 =   $0                                                                        }
The Basic  {    $0                 =   $50,000            +   $(50,000)                                            }
Accounting {  [ $0      - $0      ] = [ $50,000 - $       ] + [ $         - $       + $       - $       - $50,000 + $      ]}
Equation   {  [ Sum (1) - Sum (2) ] = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)]}

              [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                                [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets	- (3) Incr. Liab. A/P	+ (4) Decr. Liab.	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
	Maint. Exp accrued									20,000	
	Int. Exp. accrued									30,000	
	Accr. Ex. created			50,000							

This exercise illustrates the process by which an entity estimates expenses at the end of a fiscal year in conjunction with the preparation of its financial statements. The expenses here (interest and maintenance) must be recognized by the entity during 1993 because the entity received the benefits of the services during that year. Put another way, these expenses were incurred during 1993 and must be matched against the revenues generated during 1993 in order to correctly determine the net income for the year.

Most employers pay their employees after the employees have provided their services to the employer. As such, unless a pay day coincides with the end of a fiscal year, the employer owes the employee for services already rendered. Interest expense is recognized in a similar fashion: the entity will estimate the amount of interest it owes on amounts outstanding when preparing a balance sheet. A balance sheet prepared after the expense is incurred, but before the expense is paid, must reflect a liability for the amount owed to the employee. These expenses which arise as a result of payments being made after the date of a balance sheet (for expenses which are incurred before the date of the balance sheet) are known as **accrued expenses**. It is important to note that a balance sheet prepared as of the end of 1994 will include accrued expenses of $50,000 reflecting that maintenance services and interest expense were incurred during 1994, even though GEMSPROUT will not pay for those services until 1995.

The entire accrual process in illustrated by the two entries shown below. The first entry establishes the accrued expenses (as in the example immediately above). This entry brings the estimated liabilities current as of the balance sheet date. In the second entry below, is the payment of the liability after it is recorded. (This would occur during the calendar year following the date of the balance sheet.) In the second entry, assets are reduced by $50,000 as cash is paid to the employees and cash is paid to the Chromedome Bank. The liability for accrued expenses is reduced as GEMSPROUT no longer owes the employees the funds and is current on its interest payments to the Bank. Note that no additional expense is recognized in the second entry: the expense was recognized in 1994 when the accrued liability was created.

10-Column Analysis™ Worksheet©

```
Proof of     {    $(50,000)            =   $(50,000)                                                                     }
The Basic    {    $(50,000)            =   $0                    +   $(50,000)                                           }
Accounting   {  [ $        - $50,000 ] = [ $50,000 - $50,000 ] + [ $        - $       + $       - $       - $50,000 + $       ]}
Equation     {  [ Sum (1) - Sum (2) ]  = [ Sum (3) - Sum (4) ] + [ Sum (5)  - Sum (6) + Sum (7) - Sum (8) - Sum (9) + Sum (10)}

                [*******Assets******] = [****Liabilities****] + [************************Equity**************************]
                                                                              [xxxxxxxxxxx Income Statement xxxxxxxxxx]
```

Ex. No.	Descr.	+ (1) Incr. Assets	- (2) Decr. Assets CASH	- (3) Incr. Liab. ACCR.LIAB	+ (4) Decr. Liab. ACCR.LIAB	- (5) Incr. Owners' Invest.	+ (6) Decr. Owners' Invest.	- (7) Incr. Revns.	+ (8) Decr. Revns.	+ (9) Incr. Exps.	- (10) Decr. Exps.
YR 1	Liability recorded			50,000							
	Expense recognized									50,000	
YR 2	Cash paid		50,000								
	Liability reduced				50,000						

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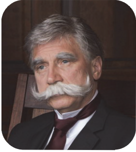

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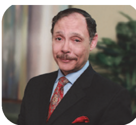

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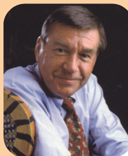

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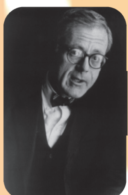

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SECTION 3: DRAFTING TIPS, *Lawyer's Alerts*, and Practical Illustrations

3.1 The Financial Statements

3.1.1 DRAFTING TIP: "As of" vs. "For the period ending"

When drafting documents dealing with balance sheets, income statements and Statements of cash flows, it is important to be aware of the proper descriptions of these documents. Because a balance sheet is prepared as of the close of business on a particular day, it is appropriate to refer to a balance sheet as being prepared "**as of**" the preparation date. The income statement and statement of cash flows are prepared to summarize the results of transactions for a period of time: typically monthly, quarterly, or annually. It is appropriate, therefore, to refer to these statements as being prepared "**for the period ended**" on the appropriate date.

3.1.2 DRAFTING TIP: Income Statement vs. Statement of Operations

The term "**income statement**" implies that the entity has, in fact, earned net income during the accounting period. For purposes of Section 1, we have assumed that net income exists when the revenues of the entity exceed its expenses. When the entity has incurred a net loss, it would be misleading to use the term "income statement" to refer to the financial statement which sets forth the results of operations of the entity. Instead, when an entity is reporting a net loss, it calls this statement a **statement of operations** and not an income statement.

3.1.3 DRAFTING TIP: Correct Names of the Financial Statements

When referring to the financial statements of a for-profit entity the following names should be used:

Balance Sheet:	Balance Sheet; Statement of Financial Condition (typical for financial institutions)
Income Statement:	Income Statement (if net income is shown); Statement of Operations (if a net loss is shown) and **NOT Cash Flow Statement**
Statement of Cash Flows:	Statement of Cash Flows
Footnotes:	Notes to the Financial Statements
Statement of Equity:	Statement of Stockholders' /Owner's/ Owners'/ Partners' Equity, as appropriate

3.1.4 DRAFTING TIP: Current Assets

The term "**current assets**" is used to describe those assets which are cash, or

will be converted into cash within one year, or one accounting cycle, whichever is shorter. The use of an accounting cycle to define current assets is extremely rare.

Current assets generally include:

- Cash
- Marketable securities
- Accounts receivable
- Inventories
- Prepaid expenses.

Current assets are categorized separately from non-current assets in the balance sheet. The definition of current assets is critical to the calculation of the "current ratio".

3.1.5 DRAFTING TIP: Current Liabilities

The term "current liabilities" is used to describe those liabilities which will be satisfied within one year, or one accounting cycle, whichever is shorter.

Current liabilities include:

- Accounts payable;

- Accrued liabilities;

- Short-term borrowings (i.e., maturities of less than one year); and

- The portion of long-term borrowings which are due within the year.

Current liabilities appear in a separate category from long-term liabilities on the balance sheet. The definition of current liabilities is critical to the calculation of the "current ratio".

3.1.6 DRAFTING TIP: Working Capital

The term “working capital” refers to the difference between current assets and current liabilities. It is a measure of the liquidity of the enterprise.

Working capital serves as a measure of the enterprise to withstand cash flow problems. Large amounts of working capital compared to ongoing expenses suggest that the enterprise has the financial ability to withstand revenue downturns.

The ratio of working capital to sales measures the efficiency with which the enterprise uses its assets to generate sales. The general rule is the lower the fraction, the more efficiently the enterprise is operating. That being said, operating with insufficient working capital will have a very low fractional relationship between its working capital and sales. As such, it is important to compare this relationship with industry standard measures.

3.1.7 DRAFTING TIP: Consolidated vs. Consolidating vs. Stand-alone Financial Statements

Consolidated financial statements are prepared to summarize the assets, liabilities and equity of a group of businesses which are commonly owned. Consolidated financials, as they are known, reflect the sum of the various line item accounts of the subsidiary financial statements in one line item account. All transactions between members of the group (**intercompany transactions**) are eliminated from the calculation of amounts shown in the consolidated financial statements.

A **consolidating** financial statement is a multi-column worksheet which shows the details of the component financial statements which comprise the consolidated financials. Separate financial statements will be shown for each enterprise which is a part of the consolidated group. The consolidating statement is extremely useful in identifying the profitability and solvency of the various entities which comprise a diversified enterprise.

An entity which is part of a commonly owned group may also present **stand-alone** financial statements. Stand-alone statements present the balance sheet, income statement and statement of cash flows for the subject entity alone. A lawyer dealing with stand-alone financials should pay careful attention to the method used to allocate expenses common to the group (such as the expenses of operating the controlling entity or **holding company**) to the entity which is presented alone. Typically, stand-alone statements will contain footnotes which explain the allocations made.

3.1.8 *Lawyer's Alert*: What If I Can't Obtain Current Financial Statements?

Because the financial condition of an entity can change very rapidly it is always best to obtain the most recent Financial Statements which are available. In most businesses, however, there is a justifiable delay between the end of the accounting period and the preparation of the Financial Statements which cover that time period. The time between the end of the period the preparation of the statements is used to summarize information, correct inaccuracies in the accounting records, prepare the necessary accruals of expenses and income, to conduct an audit (if the statements are to be audited) and to finalize the form of the statements.

The information which will appear in the financial statements is available, at least in its raw form from several other sources. The **general ledger** of the business is the main set of accounting records of the business. The general ledger (or G/L, as it is often called) will list all of the Income Statement and Balance Sheet accounts and will contain details of the transactions comprising the account balances. By obtaining the general ledger, one can make generally prepare a reasonably accurate set of Financial Statements. The same information is available from a **trial balance**. A trial balance lists all of the accounts and their ending balances but omits the details of the transactions comprising the account balances. A trial balance is usually prepared by the enterprise and delivered to the auditors as the first step in the audit process.

The general ledger and trial balance can serve as a substitute for financial statements if none are available. Both of these tools are limited in that they may not

contain the normal **adjusting entries** which are made by the entity as part of the Financial Statement preparation process. On the other hand, in many instances, it is useful to obtain the raw data contained in the general ledger or trial balance for comparison to the final Financial Statements. This type of comparison will focus on the adjustments made to the raw transactional data and may highlight manipulative activity by the entity in preparing the Financial Statements.

3.1.9 *Lawyer's Alert*: When Reviewing Financial Statements, Always Ask for the Audit Workpapers!

Whenever financial statements play a part in any legal matter, the careful lawyer will ask to review or will subpoena the workpapers prepared by an accountant in conducting an audit, review or compilation of the financial statements. In most states, there is no client/accountant privilege; none exists under federal law. These documents contain a significant amounts of worthwhile analysis of the facts and circumstances underlying the financial statements. More importantly, in many instances the workpapers will tell the reader what has not been included in the financial statements.

3.1.10 *Lawyer's Alert*: Other Reports and Documents Prepared in an Audit: Must Reading!!!

There are several other documents and reports, all of which are included in accountant's workpapers, that a careful lawyer will want to examine in the course of looking at financial statements. In particular, one may wish to review:

- **Summary of Unadjusted Differences**

  This document goes by a variety of different names. It contains all of the adjustments which were proposed by various members of the audit team which were not included in the financial statements.

- **Management Representation Letter**

  This letter contains various representations by management concerning the accuracy of the financial statements. Use it to bind management to the numbers in the financial statements.

- **Management Letter**

  This document is prepared by the accountants and suggests a variety of improvements to the financial and operating environment of the enterprise. This is a fruitful area for plaintiff's attorneys because accountants generally try to be as inclusive in these recommendations as possible.

- **Report on Internal Controls**

  This is a report prepared by the accountants as part of every audit. In this report, the accountants set forth their conclusions about the internal financial controls

and control environment of the entity. Another fruitful area of examination for plaintiff's counsel.

3.1.11 *Lawyer's Alert*: Understand the Nature of the Accountant-Client Relationship; Accountant-Client Privilege

As attorneys, we are familiar with the provisions of Rule 1.3 of the Model Code of Professional Responsibility which requires us to represent clients with zealous advocacy.

Accountants play an entirely different role in the business affairs of their clients. The primary responsibility of the Certified Public Accountant is to attest to the accuracy of information set forth in the financial statements. In this role, they act as agents of the Public (hence the name, Certified *Public* Accountant). This objective role requires accountants who perform attest services to maintain their **independence** from the business affairs of their clients.

Numerous interpretations exist to aid accountants in determining whether they are, in fact, independent. These interpretations create the following general rules which will give the reader a general idea of what is required for accountants to maintain independence from their attest clients:

- Attest accountants cannot serve on the Board of Directors of an attest client;

- Attest accountants cannot, except in very limited circumstances, borrow money from their clients;

- Attest accountants cannot own equity positions in their clients or enter into joint ventures with their clients; and

- Attest accountants cannot be owed money from a prior year engagement when performing services on a current basis.

In general, there is no accountant-client privilege under common or federal law. This, of course, is consistent with the objective, public role given to accountants under the federal securities reporting system. That notwithstanding, there is a limited accountant-client which exists under the Internal Revenue Code. Some states have enacted non-evidentiary accountant-client privilege statutes which require that an accountant generally preserve as confidential information received from a client; these statutes do not, however, protect an accountant from disclosing that information at a trial. Some states have enacted evidentiary accountant-client privilege statutes which differ from the federal standard. In these instances, recasting the matter as a federal law violation can circumvent the limitations of the state evidentiary standard.

The attorney-client privilege can sometimes be extended from the attorney to an accountant. As a general matter, the accountant must be engaged by the attorney and deliver work product to the attorney.

An excellent article in the Journal of Accountancy summarizes these issues. A

link to that article appears below.

http://www.journalofaccountancy.com/Issues/2004/Apr/AttorneyClientPrivilegeCpasAndTheEFrontier.htm

3.1.12 DRAFTING TIP: Representations Concerning the General Accuracy of the Financial Statements

Lawyers will often be responsible for drafting contractual representations and language concerning the accuracy of financial statements. The following adjectives are often used in attempting to describe the financial statements: ***true, complete, correct, accurate, free from error or omission, not misleading***. You may be able to negotiate the use of these adjectives to describe financial statements which are submitted to your client. When you are drafting a representation concerning your client's financial statements **insist** on limiting the representation made to the following:

> ***The financial statements of [the entity] present fairly, in all material respects, the financial condition of [the entity] as of the dates stated and the results of operations and statements of cash flows [of the entity] for the periods indicated in conformity with generally accepted accounting principles.***

Why? This representation is an adaptation of the language which accountants use to describe the opinion which they, the experts, are able to render after examination of the financial statements. You should argue that your client should not be held to a higher standard than that which professionals are able to ascertain. "After all, " you will ask, "if we have a question about the financial statements, we will have to get the accountants to audit them, and this is all they will be able to conclude."

Use specific representations to cover specific amounts in the statements. As an example, you client may want specific assurance as to the amount of the accounts receivable that will be collected following closing. In that instance, you would want to draft a representation in which the Buyer represents how much of the accounts receivable will be collected following closing, rather than relying on a general statement regarding the accuracy of the financial statements.

3.1.13 *Lawyer's Alert*: Understanding the Nature of GAAP

GAAP form the basis by which financial statements are prepared in the United States. GAAP has evolved over time much in the same way as did the common law. The name itself, Generally Accepted Accounting Principles, paints the picture of the evolution of these principles from general usage among enterprises into the more formal system which exists today.

As a general matter, many themes underlie the concepts inherent in GAAP. These include a broad preference to substance over form. GAAP intends to ensure the comparability of financial reporting between entities as well as among entities over time.

It is also important to note that GAAP often allows choices between various acceptable accounting method without mandating which choice an entity must make. As an example, there are broad principles associated with the accounting for inventories; several distinct methods (LIFO, FIFO, Specific Identification) exist as possible choices within GAAP. And, while the general rule would require the entity to elect the accounting method which best fits the Conservatism Principle, entities still retain a wide degree of discretion, subject to regulatory authority.

By statute, the Securities and Exchange Commission has the legal authority to prescribe the accounting principles and methods used by publicly held companies to prepare their financial statements. For the largest part, the SEC historically delegated this responsibility to a non-profit entity known as the Financial Accounting Standards Board (or "FASB"). Current SEC accounting practices are document in the SEC Division of Corporation Finance reporting manual located at:

http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml

SEC pronouncements constitute authoritative GAAP for SEC Registrants.

The FASB traditionally provided guidance in the form of documents known as Statements of Financial Accounting Standards ("SFAS"). Recently, the FASB undertook to codify the various FASB pronouncements. These pronouncements form a body of authoritative GAAP principles. This codification, the FASB Accounting Standards Codification is available free of charge at:

http://www.fasb.org/store/subscriptions/fasb/registered

Futher authoritative pronouncements will take the form of modifications to the Codification, rather than individual pronouncements.

The range of topics on which the FASB has made pronouncements does not include the entire range of financial reporting issues. As such, a large part of the accounting rules still reside in non-authoritative principles which are "generally accepted" and generally known. The American Institute of Certified Public Accountants assists the profession by developing specialized guides to the accounting issues which exist in particular industries.

Within the United States, differing bodies have the authority or responsibility for establishing GAAP in certain specialized settings. These include:

- Federal Accounting Standards Advisory Board ("FASAB") which has promulgated a series of statements as SFFAS to establish authoritative GAAP for federal government entities; and

- Government Accounting Standards Board ("GASB") which establishes financial reporting policies for state and local governments.

International accounting standards, known as International Financial Reporting Standards (or "IFRS"), are followed by enterprises in more than 100 countries, but not

the United States or Canada. The International Accounting Standards Board promulgates IFRS.

At the present time, accounting standard setting bodies around the world are working to bring accounting standards into global harmony. In February 2006, the FASB and IASB issued a statement pledging to work toward the goal of converging accounting standards into a single, world-wide system by 2008. This convergence effort remains uncompleted. A very useful comparison between IFRS and GAAP can be found at:

http://www.ifrsaccounting.com/irfs-gaap.html

3.2 ACCOUNTING FOR CASH AND SECURITIES

Cash includes cash amounts on deposit and cash equivalent investments. Cash and marketable securities are both considered current assets because they are extremely liquid.

Marketable securities are recorded initially at their cost. The lower of cost or market convention generally applies to the accounting for marketable securities. If the price of marketable securities declines, a loss is shown (recognized) in the income statement, even if the securities have not yet been sold. If the price of the securities which have declined in value later increases, gains can be shown but only to the extent which restores the asset to its original historical cost. The securities can never be shown on the balance sheet at a price higher than their initial cost. Therefore, increases in value above historical cost cannot be recognized until the security is sold. The accounting for marketable securities now takes into account the possibility that an entity can either: (i) trade securities or (ii) intend to hold securities (typically bonds) until maturity. In the case of a trading portfolio, the appreciation and depreciation of the portfolio, as measured by fair value, is typically reflected in the income statement. In the case of securities which the entity intends to hold to maturity, the lower of cost or market principle will generally not apply.

Lower of cost or market accounting is based upon the Conservatism Principle (which requires losses to be recognized as soon as they are known) and the historical cost principle (which requires assets to be recorded at historical cost and not adjusted for increases in market value).

The accounting for long-term investments in equity securities depends upon the size of the investment. The cost method (lower of cost or market) is used for investments of less than 20% of the outstanding equity of the investee enterprise. The equity method is used for investments of between 20% and 50%. Under the equity method, a share of the profit or loss of the investee enterprise equal to the portion of the enterprise owned is included in the income statement of the investing enterprise. If an entity owns 50% or more of another entity, consolidation applies. The balance sheets and income statements of the two entities are combined with an allowance made if the investor enterprise owns less than 100% of the investee.

3.2.1 Practical Illustration: Accounting for Securities: Write-Downs and Mark-to-Market

A topic which has received much attention in recent years has been ‘mark-to-market’ accounting. Understanding this topic requires a good understanding of the traditional approach to accounting for assets, as well as the pressures that exist to modify this historical approach.

3.2.1.1 Historical Cost Under Traditional GAAP Accounting

Under traditional GAAP rules, an asset is recorded on the balance sheet at its historical cost. This historical cost, which can be objectively verified through examination of the transaction giving rise to the purchase, serves as the initial basis of presentation of the asset on the balance sheet.

GAAP generally has provided that upon preparation of the balance sheet, the enterprise must apply the lower of cost or market principle to each of its assets. If it appears that the value of an asset has declined below historical cost, the enterprise will reduce the carrying value of the asset to less than than historical cost.

This process is known as a “write down”. When an asset is written down, there is a decrease in assets which is offset by the recognition of an expense (which reduces equity). The decrease in assets is offset by the decrease in equity; the expense associated with the decline in asset value would generally reduce net income.

If the asset later increases in value from a point below historical cost, the value of the asset can be increased through a “write up” of the asset. The write-up, however, can only restore the carrying cost of the asset to equal its historical cost; there is no provision, for increasing the carrying cost beyond historical cost.

International Financial Reporting Standards and Historical Cost

In general, International Financial Reporting Standards take a much broader view of asset valuation by giving entities the option to report on an historical cost or constant purchasing power (“CIPPA”) model. In sum, the CIPPA model contemplates that entities may elect to report assets on a constant purchasing power unit basis as a means of countering the adverse effects of hyper-inflaton on the accuracy of financial statements.

3.2.1.2 FAS 115: Historical Cost Gives Way to Fair Value (Mark-to-Market)

For many types of assets and settings, historical cost yields little useful information in the financial statements. As an example, for enterprises which are engaged in the trading of assets, market value measures asset value far more relevantly than would the historical cost approach.

The term ‘mark-to-market’ arose to describe the process of determining the market value of trading assets. The accounting literature prefers to describe mark-to-market accounting as **reporting assets at fair value**.

Statement of Financial Accounting Standards 115, issued in May 1993, brought

market value concepts into the world of GAAP by establishing new standards for the accounting for securities. FAS 115 divided securities into three categories with three separate sets of accounting rules:

- Debt securities for which the entity has the positive intent and ability to hold until the securities mature are classified as **held-to-maturity** securities and effectively are presented on an historical cost basis.

- Debt and equity securities that are purchased with the intention of sale in the short term are classified as **trading** securities. These assets are reported at fair value ("marked-to-market"). Unrealized gains and losses on trading securities are included in the income statement.

- Any other securities are categorized as **available-for-sale**. These assets are also reported at fair value. However, unrealized gains and losses on securities which are available for sale are not reported in the income statement. Instead, these gains or losses are reported as a separate component ("Other Comprehensive Income") on the Statement of Stockholders' Equity. In essence, these gains or losses will increase (or decrease) equity directly without impacting the computation of net income as presented in the income statement.

3.2.1.3 FAS 157: Fair Value Clarified

Statement of Financial Accounting Standards 157 became effective for fiscal years beginning after November 15, 2007.

FAS 157 took several steps to aid in the implementation of the fair value concepts included in FAS 115. defined "fair value" as "...the price that would be received to sell an asset or paid to transfer a liability in an orderly fashion between market participants at the measurement date." In this way, fair value is defined as an exit price: the price to dispose of an asset, rather than to acquire an asset. FAS 115 also established a hierarchy of information to be used in establishing fair value.

Key to FAS 157's view of fair value is the concept that fair value of assets should be determined by reference to a market not a computer pricing model.

Fair Value Accounting Breaks Down: The Market Crash of 2008

During the dramatic market events of the fall of 2008, entities were struggling to find any type of buyer or market for many types of securities. Market conditions dramatically impacted the market prices for mult-class securities which were backed by sub-prime mortgage loans ("Sub-prime MBS"). In some cases, enterprises holding trading securities could not find any market for some types of securities which raises the question, "What is a security worth when it cannot be sold?"

In some cases, application of fair value accounting caused holders of Sub-prime MBS to reflect large losses on these **trading securities** in their income statements. These losses caused markets and regulators to question the long-term viability of the holders of the Sub-prime MBS. In this way, "mark-to-market" accounting was felt by many to be contributing to the financial crisis.

In October 2008, Congress required the SEC to study the effects of mark-to-market accounting. In December 2008, the SEC declined to ease the mark-to-market rules for public reporting entities. By contrast, the Financial Accounting Standards Board issued an official update to FAS 157 that eases the mark-to-market rules when the market is unsteady or inactive.

3.2.1.4 FAS 159: Fair Value Expanded

Statement of Financial Accounting Standards 159 expanded the use of fair value reporting by allowing entities to elect to report the fair value of certain financial instruments on an instrument-by-instrument basis.

3.3. ACCOUNTING FOR ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

Accounts receivable are amounts due to an enterprise from third parties. These items typically arise as a result of the revenue generating activities of the enterprise. Receivables are generally carried on the balance sheet at cost, reduced by an allowance account which reflects an estimate of the portion of the total amounts owed which will not be collected. The allowance account, which reduces the amount at which accounts receivable are carried on the balance sheet, is created by recognizing an expense. (This expense matches the estimate the losses associated with future failures to pay the enterprise arising from sales made during the accounting period against revenues recorded as a result of those sales. In this way, credit losses from current sales are subtracted from the revenues from those sales in computing the net income arising from those sales.) When an enterprise determines that a receivable will not be collected, it writes-off the receivable against the allowance. No further expense is recorded at the time the enterprise writes-off the account because the expense was previously recognized.

Prepaid expenses are assets which result from payments made by the enterprise to third parties for goods or services which will be received or used by the enterprise in later periods. The expense associated with the use of the asset is matched against revenues in the period in which the prepaid asset is expended.

3.3.1 Practical Illustration: Provision for Bad Debts Creates the Allowance for Doubtful Accounts

Solar Motors has recorded sales on account to dealers in the amount of $5,000,000. This would be reflected on the balance sheet and income statement of Solar as shown below.

Balance Sheet		*Income Statement*	
Assets:		*Revenues:*	
Accounts Receivable	*$5,000,000*	*Sales*	*$5,000,000*

Solar estimates that it will experience credit losses of $65,000 associated with the credit sales previously recorded. Solar records a provision for bad debts in this amount; this entry also increases the allowance for doubtful accounts. Following the recording of this expense, Solar's balance sheet and income statement would appear as below.

Balance Sheet		*Income Statement*	
Assets:		*Revenues:*	
Accounts Receivable	*$5,000,000*	*Sales*	*$5,000,000*
less: allowance for		***************	
doubtful accounts	*(65,000)*	*Expenses:*	
Net accounts receivable	*4,935,000*		
	=========	*Provision for Bad Debts*	*65,000*

As the example illustrates the recognition of the $65,000 expense. This expense will reduce net income by $65,000. At the same time, recognition of the expense increases the balance of the allowance for doubtful accounts from $0 to $65,000. This $65,000 is then subtracted from gross accounts receivable to arrive at the net balance of accounts receivable, $4,935,000. This net balance is then added to the balances of the other asset accounts to determine total assets.

3.3.2 DRAFTING TIP: Allowance for Doubtful Accounts versus Provision for Bad Debts

It is important to remember the difference between the **allowance for doubtful accounts** and the **provision for bad debts**. The allowance for doubtful accounts is a contra-asset account which appears on the balance sheet. The balance of the allowance is subtracted from gross accounts receivable to arrive at net accounts receivable. The provision for bad debts is an expense account which appears on the income statement. As an expense account, the provision (along with the other expenses) is subtracted from items of revenue to compute the net income of the entity. The careful lawyer will ensure that these terms are used correctly when drafting legal documents dealing with accounts receivable.

3.3.3 Practical Illustration: Operation of the Allowance for Doubtful Accounts when an Account is Written Off

Solar Motors had previously established its allowance for doubtful accounts as illustrated below.

Balance Sheet		*Income Statement*	
Assets:		*Revenues:*	
Accounts Receivable	*$5,000,000*	*Sales*	*$5,000,000*
less: allowance for doubtful accounts	*(65,000)*	*Expenses:*	
Net accounts receivable	*4,935,000*	*Provision for Bad Debts*	*65,000*

Solar has now determined that one account, with a balance of $10,000, will not be collected. The relevant portions of the balance sheet and income statement after this write-off are shown below.

Balance Sheet		*Income Statement*
Assets:		
Accounts receivable	*$4,990,000*	*No effect from the write-off because the loss from uncollectibility was previously recognized when provision was made*
less: allowance for doubtful accounts	*(55,000)*	
Net accounts receivable	*4,935,000*	

The net balance of accounts receivable, $4,935,000, did not change after the write-off. Nor was there any income statement impact. The effect of the write-off was confined to the balance sheet where: (i) the balance of outstanding accounts receivable was reduced by $10,000 and (ii) the balance of the allowance was reduced by an equal amount.

3.3.4 *Lawyer's Alert*: Be Careful of Accounts Receivable Balances

When evaluating accounts receivables balances, first determine whether the entity is using the **percentage of sales** or the **percentage of receivables** method to estimate the provision for bad debts and the allowance for doubtful accounts. Use of the percentage of sales method emphasizes the importance of correctly determining net income over maintaining an accurate balance of accounts receivable on the balance sheet. Use of the percentage of receivables method stresses balance sheet accuracy.

In drafting documents which deal with the transfer and future collectibility of accounts receivable, it is important to understand which method (percentage of sales or percentage of allowance) has been used in establishing the allowance for doubtful accounts. If the balance sheet value of accounts receivable is significant to the transaction, and the allowance has been computed using the percentage of sales method, it is important to recalculate the allowance based on a percentage of the outstanding receivables. An accounts receivable aging can assist in providing further

information concerning the current status of accounts receivable. By matching "apples with apples", all parties to the transaction can share a common understanding of the current status of the accounts receivable.

3.3.5 DRAFTING TIP: Accounts Receivable Vs. Prepaid Expenses Vs. Deposits

Accounts receivable are often confused with prepaid expenses. Accounts receivable represent amounts of money which are owed to the enterprise, usually as a result of sales activity. **Prepaid expenses**, in contrast, are amounts expended by the entity for goods or services which will be used in the future. Insurance premiums paid in advance for future coverage are a good example of a prepaid expense.

Prepaid expenses, in turn, are often confused with **deposits**. A deposit is an amount paid by an entity to a third-party which the third party holds with an agreement to return to the amount upon the satisfaction of certain conditions. An enterprise entering a long-term commercial lease may, for example, give its landlord a large deposit upon signing of the lease. This deposit will be returned to the enterprise if, at the end of the lease period, the space is returned to the landlord in satisfactory condition.

Because a deposit is generally placed as security, and is not intended to prepay an expense, deposits generally are not converted into expense over time. Rather, the deposit is maintained as an asset of the enterprise until such time as the conditions associated with the deposit are satisfied. If, in the future, some portion of the deposit is retained by the holder (i.e., not returned to the entity), the withheld amount becomes an expense of the enterprise.

3.3.6 Practical Illustration: Accounts Receivable Aging Report

Whenever analyzing accounts receivable, one should obtain an aging report such as the one illustrated below.

GEMSPEED, Inc.
Accounts Receivable Aging Report

Customer	Account Balance	0 to 30 Days	30 to 60 Days	60 to 90 Days	More than 90 Days
BOOZE-n-CRUISE	4500	3000	500	1000	
EXXIN, Inc.	1200				1200
Granatelli, Inc.	750	750			
Moore Auto	2000	500	1500		
ZEKES, Inc.	3000	2750	250		
	-----	-----	-----	-----	-----
Total	11450	7000	2250	1000	1200
	=====	=====	=====	=====	=====

The above report presents a brief taste of an accounts receivable aging report. In the above report, GEMSPEED has recorded $11,450 in accounts receivable. Of this amount, $7,000 (or 61.14%) is less than 30 days old; $2,250 (19.65%) has been outstanding between 30 and 60 days; $1,000 (8.78%) has been outstanding for more than 60 but less than 90 days, while $1,200 (10.48%) has been outstanding more than 90 days.

In analyzing GEMSPEED accounts receivable, one could compare aging reports prepared over time to look for trends. Increasing percentages of accounts receivable in the far right columns (60 to 90; More Than 90) would be considered problematic as it would indicate increasing problems in collecting accounts receivable.

In the above example, the amounts owed by EXXIM, Inc. should trouble GEMSPEED. The balance owed by EXXIM has been outstanding for more than 90 days. EXXIM may have decided not to pay the amounts due. Further investigation of the circumstances surrounding this account would appear necessary.
In addition, one would want to explore the relationship with BOOZE-n-CRUISE. If BOOZE-n-CRUISE is a regular customer with an a payment history which indicates that balances tend to decrease over time, the information above is not troubling. If, however, BOOZE-n-CRUISE has routinely paid all of its bills on time, increasing amounts in the 30 to 60 and 60 to 90 columns could be a sign of looming danger.

3.3.7 DRAFTING TIP: Drafting Representations Concerning Accounts Receivable

A representation in a contract or settlement agreement may state, for example, that:

> "...all accounts receivable on the Balance Sheet as of December 31, 20X1 will be **collected.**"

This statement implies that the gross amount of accounts receivable recorded by the enterprise, without regard to any allowance created to reflect the uncollectible portion of the receivables, will ultimately be paid to the enterprise. An aggressive interpretation of this representation would hold that collection of any amount less than the gross amount of receivables recorded would violate the representation. Damages for violation of this representation would presumably be measured by the difference between the amount collected and the gross receivables recorded on the December 31, 20X1 Balance Sheet.

A different representation could state:

> "all accounts receivable on the Balance Sheet as of December 31, 20X1 are **collectible.**"

This representation implies that the accounts receivable arise from valid transactions, that the third party from whom the money will be collected has no defense to the collection of the receivable and that the enterprise has no reason to believe that the third party will not pay. This does not necessarily mean that the gross amount of the receivables will be collected. An aggressive interpretation would hold that this representation makes no promise about the amount which will be collected, only that there is no reason to believe that collection will not occur.

The more thorough representation is one that makes several statements concerning the accounts receivable. The following representation, for example, presents several independent statements concerning receivables.

> ***"All accounts receivable shown on the Balance Sheet exist as the result of valid transactions. Seller does not know of any defenses to the collection of any of the accounts receivable. Seller has no reason to believe that the accounts receivable, net of the allowance for doubtful accounts shown on the Balance Sheet, will not be collected in the ordinary course of business. Seller [represents that $xxx,xxx of the receivables will be collected within x months of the date of sale] or [does not represent that any of the receivables will, in fact, be collected].***

3.4 ACCOUNTING FOR INVENTORY

There are four significant steps to the accounting for inventories.

In the first step, the entity must ensure that it has properly identified the universe of goods which it owns. This requires examination of transactions involving the inventory to ensure that goods in transit, goods held on consignment, goods sold pursuant to right of return, and goods under financing arrangements are properly recorded. In general, if the seller holds legal title to the inventory it is included, unless the passing of legal title is pursuant to a transaction which makes it likely that the goods will return to the seller.

In the second step, production costs (labor, materials and overhead) must be carefully examined to identify those costs which can be included in the cost of inventory units. Direct costs, those which are directly related to the product such as labor and materials, are included in the cost of inventory units. The entity will also study its production process to identify indirect costs. Indirect costs are those costs which are part of the production process but not part of the product itself (such as the cost of electricity to operate a factory). Indirect costs are also included in the cost of the inventory.

The third step occurs once the cost of the inventory units is established. Various flow assumptions (specific identification, LIFO, FIFO, weighted average) are applied to determine which units available for sale during the period were (i) sold, and included in the cost of goods sold reflected on the income statement, or (ii) remained part of ending inventory as of the balance sheet date.

In the fourth step, ending inventory is measured as of the balance sheet date and is valued at the lower of cost or market. Any write-down of inventory needed to reduce the cost of inventory to market value is added to the cost of goods sold.

3.4.1 Practical Illustration: Inventory Accounting Explained

Accounting for inventories generally follows three steps.

In the first step, costs are analyzed to determine whether they can be included in the cost of inventory.

- If the costs are related, directly or indirectly, to production, the costs are included in the cost of inventory goods available for sale.

- If the costs are related to the main operating activities of the enterprise, costs are included in operating expenses.

- If the costs do not fit into either of the two prior categories, they are included in other expenses.

In the second step, the costs allocated to inventory are allocated either to:

- Cost of goods sold, in which case the costs are recognized as an expense on the income statement.

- Ending Inventory, in which case the costs are categorized as an asset on the balance sheet. The costs reside here until the units represented by the costs are sold and the costs become expenses to be matched, under the Matching Principle, against the revenue generated by such sales.

In the third step, the inventory is tested against the lower of cost or market principle. If the net realizable value of the inventory is less than its recorded cost, the inventory is written down to its net realizable value.

3.4.2 Practical Illustration: Illustration of the Specific Identification Method of Accounting for Inventory Costs

Assume that ACME, Inc. has a beginning inventory on January 1, 20X1 of 3 units valued at $10 each. (This information is available in the footnotes to ACME's Balance Sheet as of December 31, 20X0 and will appear as the inventory figure on the December 31, 20X0 Balance Sheet.)

Assume also that ACME has manufactured or purchased 10 units during 20X1 at the following costs:

Units 1, 2 and 3	$10
Units 4, 5, 6 and 7	$15
Units 8, 9 and 10	$20

ACME maintains a perpetual inventory system and specifically identifies its inventory. ACME knows from its records that units 2, 6, 9 and 10 are in the ending inventory at December 31, 20X1. The value of ACME's ending inventory as of December 31, 20X1 is computed as follows:

Unit 2	$10
Unit 6	15
Units 9 and 10 (2 @ $20)	40

	$65
	===

ACME's cost of goods sold for the year ended December 31, 20X1 is computed as follows:

Beginning inventory		$30
Plus: Purchases (or goods manufactured)		
Units 1, 2 and 3	$30	
Units 4, 5, 6 and 7	60	
Units 8, 9 and 10	60	

Total purchases (or goods manufactured)		150

Cost of goods available for sale		$180
Less: ending inventory		(65)

Cost of goods sold		$115
		===

3.4.3 Practical Illustration: Illustration of the FIFO (First-in, first-out) Method of Accounting for Inventory Costs

Assume ACME, Inc. has a beginning inventory on January 1, 20X1 of 3 units valued at $10 each. (This information is available in the footnotes to ACME's Balance Sheet as of December 31, 20X0 and appears as the inventory figure on the December 31, 20X0 Balance Sheet.) Assume also that ACME has manufactured or purchased 10 units during 20X1 at the following costs:

Units 1, 2 and 3	$10
Units 4, 5, 6 and 7	$15
Units 8, 9 and 10	$20

ACME maintains a periodic inventory system and uses the FIFO system. ACME knows from its records that it sold 9 units during the year. ACME performs an inventory count at the close of business on December 31, 20X1 and finds that it has 4 units of inventory on hand.

Using FIFO, ACME assumes that the first units manufactured or purchased are the first units sold. Use of FIFO, therefore, reveals that the 4 units in the ending inventory are the 4 units manufactured or purchased most recently. The value of ACME's ending inventory as of December 31, 20X1 is computed as follows:

Units 8, 9 and 10 (3 @ $20)	$60
Unit 7	15

	$75
	===

ACME's cost of goods sold for the year ended December 31, 20X1 is computed as follows:

Beginning inventory		**$30**
Plus: Purchases (or goods manufactured)		
Units 1, 2 and 3	**$30**	
Units 4, 5, 6 and 7	**60**	
Units 8, 9 and 10	**60**	

Total purchases (or goods manufactured)		**150**

Cost of goods available for sale		**$180**
Less: ending inventory		**(75)**

Cost of goods sold		**$105**
		===

3.4.4 Practical Illustration: Summary of the Effects of Application of FIFO vs. LIFO in a Period of Rising Prices

The chart on the following page illustrates the effects of the use of FIFO and LIFO in periods of rising prices. As one can see, this is a classic example of how application of two different accounting methods, both of which are acceptable, can yield substantially different balance sheet and income statement results.

3.4.5 *Lawyer's Alert*: Beware of the Differences Between Lifo and Fifo

During periods of rising prices, use of LIFO emphasizes the correct portrayal of net income while the use of FIFO emphasizes the accurate portrayal of the value of the inventory on the Balance Sheet. Lawyers should be cognizant of these differences.

Assume that a lawyer is representing a client who has agreed to purchase a business during a period of rising prices for an amount equal to a specified multiple of historical net income. Assume further that the purchased business uses FIFO. The purchaser's lawyer may wish to ask that the net income used to compute the purchase price be computed using LIFO. This request would be based on the importance of correctly determining net income. Use of LIFO in these circumstances would result in the lowest net income and the lowest purchase price.

The lawyer for the seller may wish to negotiate for a change in the method of calculating the purchase price. The seller's lawyer would emphasize the accuracy of FIFO in arguing for a purchase price based on asset values, which are more accurately predictable than purchase prices based on assumed future net income.

Alternatively, if there is a wide variance between FIFO and LIFO, both lawyers may wish to move the valuation to one based on gross sales, which is not affected by choice of inventory method.

SUMMARY OF
LIFO AND FIFO ASSUMPTIONS

ACME had 3 units in its beginning inventory at the start of the year and 10 units were produced during the year. The costs of each type of unit are set forth below. 13 units were, therefore, available for sale during the year. ACME's physical inventory confirmed that there were 4 units on hand at the end of the fiscal year. 9 units (13 available less 4 in ending inventory) were, therefore, sold during the year.

	Cost	FIFO Cost of Goods Sold	FIFO Ending Inv-entory	LIFO Cost of Goods Sold	LIFO Ending Inv-entory
B.I. # 1	$10	10			10
B.I. # 2	10	10			10
B.I. # 3	10	10			10
Production # 1	10	10			10
Production # 2	10	10		10	
Production # 3	10	10		10	
Production # 4	15	15		15	
Production # 5	15	15		15	
Production # 6	15	15		15	
Production # 7	15		15	15	
Production # 8	20		20	20	
Production # 9	20		20	20	
Production #10	20		20	20	
	----	---	---	---	---
Available	$ 180				
	===				
Totals		$105	$75	$140	$40
		===	===	===	===

In this example, the Cost of Goods Sold under the FIFO method is $35 lower than the Cost of Goods Sold under the LIFO method ($105 under FIFO vs. $140 under LIFO). Therefore, net income under the FIFO method will be $35 higher than net income under the LIFO method. At the same time, the ending inventory under the FIFO method is $35 higher than under the LIFO method ($75 vs. $40). The balance sheet which displays the results of the FIFO method will display an ending inventory which is $35 than that computed under the LIFO method.

3.5 ACCOUNTING FOR FIXED AND INTANGIBLE ASSETS

Fixed assets are generally productive assets held for long-term use by the enterprise. Fixed assets are recorded initially at historical cost which includes the costs to put the asset into service. The matching principle dictates that the costs of fixed assets must be allocated into expenses over time to match the revenues generated by the fixed assets. This process is known as depreciation. There are several acceptable depreciation methods. The straight-line methods allocates costs evenly over the periods in which the asset is used. Accelerated depreciation methods allocate greater depreciation expense to the early years of use and lesser depreciation to the later years. The choice among acceptable methods is left to the entity.

Significant improvements to fixed assets will be capitalized (i.e., added to the cost of the fixed asset and depreciated over time). Immaterial items, those which will not affect the interpretation of the financial statements, will be recorded as expenses in the current period. Materiality is determined by reference both to the absolute level of amount and how changes in amount will affect financial statement interpretation.

Intangible assets are those assets which are not identifiable within other categories but which have value to the enterprise. Intangible assets include patents, copyrights, trademarks, goodwill and other similar items. Like fixed assets, the costs of intangible assets are allocated to expense over time to match revenues generated from the intangible assets. Goodwill can only arise where an entity purchases a business from another and pays more for the business than the sum of the fair market values of the assets. In this case, the difference between the purchase price and the aggregate fair market value of the assets is recorded as goodwill.

```
The Depreciation Formula:

Cost of asset  -  Residual value
--------------------------------  = Depreciation expense
         Useful life
```

3.5.1 Practical Illustration: The Depreciation Formula

The chart on the preceding page illustrates the mathematical concept underlying straight-line depreciation. With accelerated depreciation methods, a portion of the depreciable base (the numerator of the equation) is allocated to expense each year.

3.5.2 DRAFTING TIP: Historical cost vs. book value vs. fair market value

Three different terms can be used in referring to the economic value associated with a fixed asset. The cost or historical cost is the amount at which the asset is recorded in the financial records of the enterprise without reduction by depreciation or other cost allocation. An enterprise is required, under the historical cost principle, to maintain the value of its assets at cost. This amount will stay constant over time unless substantial improvements are made to the asset. Substantial improvements may be considered additions, which are generally capitalized and added to the historical cost of the asset.

The book value of the asset is equal to the historical cost less any recognized depreciation or other cost allocation. Book value represents the systematic estimate of the declining value of the asset. This decline in value is matched against revenues through the depreciation process. The book value is equal to the recorded historical cost reduced by any associated: valuation reduction (marketable securities), depreciation (fixed assets), depletion (a material asset such as an oil well), or amortization (intangible assets).

The fair market value of the asset is what the asset would bring if sold in an arms-length transaction with a third party. While book value is intended to approximate fair market value, no relationship exists between the two. In some cases, such as a quickly appreciating building, fair market value will exceed historical cost. (Conservatism bars recognition of this increase in value until sale of the property to a third party.) Ironically, because a building is considered a depreciable asset, the enterprise will recognize depreciation expense each year with respect to the building. The book value of the building will be lower than its historical cost which is, typically, lower than the fair market value of the building.

3.5.3 Practical Illustration: Illustration of Interplay between Historical Cost, Accumulated Depreciation and Book Value

Assume that ACME, Inc. owns three large fixed assets, a truck (purchased for $40,000), a factory (purchased for $200,000; $50,000 of capital improvements added two years later; the factory has been appraised at $2,000,000) and a large piece of equipment (purchased 40 years ago for $20,000 and fully depreciated). The table below indicates how the book value of the assets would be computed and the amount which would be displayed on the Balance Sheet in the asset category "Fixed Assets".

Item	Historical **Cost**	Accumulated **Depreciation**	Book **Value**
Truck	$40,000	$15,000	$25,000
Factory	$250,000	$75,000	$175,000
Equipment	$20,000	$20,000	$0
Total	$310,000	$110,000	$200,000

The following line item might appear on ACME's Balance Sheet:

Fixed assets (net of accumulated depreciation) $ 200,000

An alternative presentation would show:

Fixed assets	$ 310,000
Less: accumulated depreciation	(110,000)
	200,000

There are several items to note here. (1) Although the appraised value of the factory far exceeds its historical cost, the historical costs principle mandates that the factory be carried in the accounting records and presented in the Balance Sheet at cost. The market value of the factory ($2,000,000) far exceeds the book value, $175,000. (2) The older equipment, even though fully depreciated remains "on the books" until disposed of. (3) The fixed assets are presented on the Balance Sheet at book value (i.e., net of accumulated depreciation).

3.5.4 *Lawyer's Alert*: MATERIALITY

The concept of materiality appears throughout the application of accounting principles to business transactions. As a general rule, differences which are immaterial to the results of operations or financial condition of an enterprise are often overlooked. For example, where the application of an unaccepted accounting method in lieu of an accepted accounting method will not result in a material difference in the Income Statement or Balance Sheet, an enterprise can use either method. Auditors typically will spend very little time reviewing items which, if omitted from the Financial Statements, would not cause a material difference in the information presented.

What, then, is considered material? "10 percent of net income" is an often cited, and inadequate, definition of materiality. A better definition of material would be this: an transaction is material if recording (or not recording) the transaction would yield a significantly different interpretation of the Financial Statements of an enterprise. Materiality must be considered in two ways:

1. Numerical materiality: effect on the presentation of the Income Statement and the Balance Sheet. Generally, transactions with little effect on the Income Statement or the Balance Sheet will not be considered material. No set threshold for determining income statement materiality exists. Materiality is usually expressed as a percentage of: (i) a category of accounts on such as current assets or operating expenses or (ii) a total item such as total assets or net income.

Assume that BETA, Inc. has net income of $3,020,000, total assets of $15,000,000 but current assets of only $200,000. Now assume that BETA is considering whether to expense or capitalize a $50,000 repair to a machine. This repair would extend the useful life of the asset and reduce depreciation expense in the current year by $10,000, if capitalized. If expensed net income would be reduced by the $50,000 cost of the repair. BETA would choose, in most circumstances, to expense this repair, because capitalization, the technically correct alternative, does not result in a numerically material difference. The difference in net income between the two choices in $40,000, or 1% of net income, a small amount. Capitalizing the asset would create a $50,000 asset and increase total assets by only less than 1%.

2. Contextual materiality: effect on other disclosures in the Financial Statements. Transactions which may be numerically immaterial may become significant because of the secondary effects on contractual or regulatory relationships which may result from recording the transaction. These secondary effects are often described in the Notes to the Financial Statements. In extremely adverse cases, the secondary effects may cause an auditor to qualify its opinion on the Financial Statements of the enterprise. Many lending agreements, for example, rely on information generated from the Financial Statements to determine whether the borrower has defaulted under the agreement. It is not uncommon for these agreements to specify that the enterprise

must maintain a certain level of profitability or a current ratio above a certain level.

Assume that BETA, strapped for cash because of its low level of current assets, is extremely dependent upon a line of credit for the liquidity necessary to continue its operations. Assume further that the lending agreement covering the line of credit requires that BETA earn net income each year of at least $3,000,000.

The decision concerning the accounting for the repair transaction that was numerically immaterial, now becomes material in context. Capitalization would allow BETA to meet the net income condition of the lending agreement; expensing the repair would lead to a violation of the lending agreement. Even though the difference in net income under either approach is not numerically significant, this transaction becomes material because of the effect of the transaction on BETA's compliance with the terms of the critical lending agreement. The $2,970,000 net income earned by BETA after expensing the repair does not meet the net income condition of the lending agreement. Failure to meet the conditions of the agreement will place BETA in default under the agreement. This default status would allow the bank to accelerate, or demand immediate payment of, all amounts borrowed under the line of credit. Because BETA does not have sufficient liquid assets to repay the line of credit, acceleration of the debt could threaten BETA's ability to continue operations. Failure to meet the net income condition, and its effects on BETA's operations, would be disclosed in the Notes to the Financial Statements and could lead to an explanatory paragraph in the auditor's opinion.

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The staff is aware that certain registrants, over time, have developed quantitative thresholds as "rules of thumb" to assist in the preparation of their financial statements, and that auditors also have used these thresholds in their evaluation of whether items might be considered material to users of a registrant's financial statements. One rule of thumb in particular suggests that the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.

The use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that – without considering all relevant circumstances – a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material.

The staff has no objection to such a "rule of thumb" as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute for a full analysis of all relevant considerations.

Materiality concerns the significance of an item to users of a registrant's financial statements. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important.

In its Statement of Financial Accounting Concepts No. 2, the FASB stated the essence of the concept of materiality as follows:

> ***The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.***

This formulation in the accounting literature is in substance identical to the formulation used by the courts in interpreting the federal securities laws. The Supreme Court has held that a fact is material if there is – a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. Under the governing principles, an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances," as the accounting literature puts it, or the "total mix" of information, in the words of the Supreme Court. In the context of a misstatement of a financial statement item, while the "total mix" includes the size in numerical or percentage terms of the misstatement, it also includes the factual context in which the user of financial statements would view the financial statement item.

The shorthand in the accounting and auditing literature for this analysis is that financial management and the auditor must consider both "quantitative" and "qualitative" factors in assessing an item's materiality.

3.5.5 Practical Illustration: Goodwill

The following example illustrates how goodwill can only arise in a transaction in which an entity pays more than the total fair market value of the assets of the acquired entity to purchase another entity.

Amalgamated Industries as agreed to acquire all of the assets of Conglomerated Industries in a transaction which will be accounted for as a purchase. Amalgamated has agreed to pay $ 5,000,000 for the assets. Further information on the assets of Conglomerated which will be purchased appears below.

Asset	Fair Market Value
Building	$ 1,000,000
Patent	2,000,000
Securities	500,000

	$ 3,500,000
	=========

The $5,000,000 purchase price exceeds the current fair market value of the assets. Rather than allocating to each asset a portion of the purchase price which exceeds its fair market value, Conglomerated will record the following assets on its books as a result of the purchase.

Asset	Recorded Cost to Conglomerated
Building	$ 1,000,000
Patent	2,000,000
Securities	500,000
Goodwill	1,500,000

	$ 5,000,000
	=========

3.6 ACCOUNTING FOR LIABILITIES

Accounts payable are liabilities of the enterprise which arise when goods or services are obtained on credit.

Notes payable are created when the enterprise borrows money. (The portion of the note to be paid within one year is considered a current asset.)

Accrued expenses are liabilities for expenses incurred during the current income statement period (such as payroll expenses) that will be paid in the next period. Accrued expenses are created to match expenses to revenues.

A deferred liability is established with respect to amounts paid to the enterprise which have not yet been earned by providing services or delivering goods.

Long-term debt obligations of the enterprise are recorded at face value and increased or decreased by any premium or discount which resulted from the issuance of debt at other than market rates. The premium is added to, and the discount subtracted from, interest expense over the life of the obligation.

Contingent liabilities will be recognized by the enterprise where: (1) it is reasonably likely that the contingency will occur and (2) the amount of loss from the contingency can be reasonably established. When these conditions cannot be satisfied, the possible existence of a contingency is disclosed in the footnotes.

A deferred tax liability is established with respect to future amounts of tax which will be paid as a result of differences between taxable income and accounting income. A current tax liability is established to reflect amounts which will be paid to tax authorities.

Current liabilities are those which are payable within one year of the balance sheet date.

3.6.1 DRAFTING TIP: CURRENT LIABILITIES

The term "current liabilities" is used to describe those liabilities which will be satisfied within one year, or one accounting cycle, whichever is shorter.

Current liabilities include:

- Accounts payable;
- Accrued liabilities;
- Short-term borrowings; and
- The portion of long-term borrowings which are due within the year

Current liabilities appear in a separate category from long-term liabilities on the balance sheet. The definition of current liabilities is critical to the calculation of the "current ratio".

3.6.2 Practical Illustration: Illustration of the Accrual of Expenses

The following chart illustrates the timing of events and the accounting actions taken with respect to accrued expenses. Accrued expenses are those items of expense, other than accounts payable and recorded contingent liabilities, which have been incurred during an accounting period, but which have not yet been paid. Accrued expenses are typically items of a repetitive nature which occur in the ordinary course of business. Accrual of expenses is at the heart of the matching principle which requires that revenues be matched against the expenses incurred to generate those revenues in determining net income for an accounting period.

```
Timing of events:

Services provided ----> Balance Sheet ---> Expense is paid
                          prepared

Accounting treatment:

Expense incurred ---> Expense recognized & ---> Payment
                       Liability created         reduces
                                                Liability
```

The following constitute the most typical accrued expenses. When an accrual is made for these expenses, amounts have been incurred before the end of the accounting period even though not paid until after the end of the accounting period.

-Interest:	Interest at the agreed upon rate between the date of last interest accrual and the end of the income statement period.
-Payroll:	Payroll and related tax liabilities between end of last payroll period and the end of the income statement period.
-Utilities:	Estimated amount of utilities utilized, but unbilled, as of the end of the income statement period. (Past usage rates may be used.)
-Property taxes:	Estimated property tax for year pro-rated for the number of months in the income statement period.

3.6.3 Practical Illustration: Resolution of Contingent Liabilities in the Financial Statements

The following chart illustrates the resolution of contingent liabilities in the financial statements of an entity.

	Likelihood of occurrence of contingent event		
	Probable	Reasonably Likely	Remote
Reasonable estimate of loss	Record liability at estimate	Footnote disclosure	No disclosure
Estimated range of loss	Record liability at low estimate w/ disclosure	Footnote disclosure	No disclosure
No reasonable est.	Footnote disclosure	Footnote disclosure	No disclosure

Before an entity must record a contingent liability in its financial statements, (i) the contingent event the occurrence of which is probable and (ii) the loss from the contingency must be reasonably estimable.

3.6.4 *Lawyer's Alert:* Beware of Recorded Liabilities for Income Taxes

There is a significant possibility that the amount shown on the balance sheet as the current portion of income taxes payable will not correspond to the amount which will actually be due to the IRS upon submission of the relevant tax return. This potential difference arises because:

- The enterprise may accrue its income taxes payable using a simple formula (i.e. 30% of net income) which does not necessarily bear any relation to the amount which will be owed to the taxing authorities. Items which are used solely in computing taxable income and liability such as operating loss carryforwards (which reduce tax liability) and depreciation recapture (which increases taxable income) are not tracked as part of the normal financial accounting system. The effects of these items will not be included in any simplistic estimation procedure.

- The accrual is made before the tax return is finalized. Even if the accrual is tied specifically to the tax return liability, major adjustments can occur in tax returns as a result of recharacterization of income or expense items in the final stages of preparation.

- Materiality is invoked in dealing with income taxes payable. In a typical audit situation, accountants who practice as auditors will review the estimate of income tax liability developed by the enterprise. Auditors generally require their estimates to be accurate within a material range. However, the precise figure which will be paid to the IRS (or other taxing agencies) will usually be determined by accountants other than those who performed the audit long after audited financial statements are issued.

Lawyers should be aware that representations that "...the amounts shown on the Balance Sheet as liabilities for income taxes will be sufficient to pay all taxes due on income" are often not true. Therefore, if the tax liability shown is significant, or if failure to comply with the representation will have significant impact, the lawyer should seek the advice of a tax professional with particular knowledge of the enterprise. If a representation is to be made concerning income taxes payable, the liability can probably be more accurately described as a reasonable estimate of the amount which will be owed, based on knowledge at the time of the representation.

3.7 ACCOUNTING FOR EQUITY

Although the nomenclature varies with the type of entity, equity consists of the ownership interests of the enterprise.

Common stock is the controlling equity interest in a corporation and common stockholders typically control the overall management of the affairs of the corporation. Common stock is recorded at the par or stated value, if any, with amounts in excess of par or stated value treated as additional paid-in capital.

Preferred stock is a hybrid: it has characteristics of both debt and equity, but is treated as an equity interest.

Retained earnings are the cumulative profits of the enterprise which have not been distributed to the owners in the form of dividends. State law generally permits the payment of dividends if the corporation has positive retained earnings and the payment of the dividend will not render the corporation insolvent. The treatment of dividends of stock of the enterprise given to stockholders depends upon the size of the dividend being paid. Negative retained earnings can be eliminated through a quasi-reorganization, under certain circumstances.

3.7.1 DRAFTING TIP: Terminology Applied to Common Stock

Authorized: a corporation is authorized to issue the number of shares of common stock specified in the Articles of Incorporation. The Articles may be amended to increase the number of authorized shares. Authorization is merely a legal status. No value is transferred to the corporation in exchange for the shares until they are issued.

Issued: shares which have been sold are deemed issued. A share of stock will be considered issued even if owned by the corporation in the form of treasury stock (see below).

Unissued: shares which have been authorized, but which have not been issued, are deemed to be unissued shares. The sum of issued and unissued shares should equal the number of authorized shares.

Outstanding: shares which are owned by third parties are considered outstanding shares. All outstanding shares have considered to be issued, but not all issued shares are outstanding as the corporation can own treasury stock.

Treasury Stock: stock which has been previously issued by the corporation, but which has been repurchased by the corporation, is known as treasury stock. Treasury stock is not considered outstanding. However, if treasury stock is sold or otherwise transferred to a

third-party, it will be considered outstanding once again.

Retired or Cancelled: a corporation may elect to retire or cancel treasury stock. Although state corporation statutes vary, retirement or cancellation typically reduces the number of issued shares. Upon retirement or cancellation, any amount maintained in a par or stated value account with respect to retired shares is transferred to the additional paid-in capital account.

Subscribed: a corporation may undertake subscriptions for the purchase of its common stock. In a subscription, a third party agrees to purchase stock by paying for the stock over time. The subscription contract creates an asset, subscriptions receivable, for the issuing corporation as it represents the right to receive money from the subscriber in exchange for its stock. Subscribed stock remains unissued until the payments called for by the subscription agreement are made at which time the subscribed stock is considered issued. The amount of any subscribed stock will be disclosed in the financial statements.

3.7.2 DRAFTING TIP: Preferred Stock

The following terminology is applied to preferred stock.

Cumulative: When preferred stock carries a cumulative right, any dividends not paid are accumulated. The passed dividends, and the current year preferred dividend, must be paid in future years before dividends can be paid to common stockholders. Most preferred stock will carry cumulative rights. Unpaid cumulative dividends (dividends in arrears) are not a liability of the corporation until declared by the board of directors. The enterprise will typically make footnote disclosure of any dividends in arrears which exist as of the balance sheet date.

Convertible: some preferred stockholders are given a right to convert their preferred stock into common stock. This convertibility feature will generally specify a common stock price (the conversion price), or a ratio (the conversion ratio), of preferred to common shares, to be used in converting the face value of preferred into common stock. Holders of the preferred stock will look to the market value of the common stock to determine whether conversion from preferred to common would be profitable.

Participating: some preferred stock will carry a right to share in the profits of the enterprise with the common stock. This participation feature will specify the respective rights of the preferred and common stock holders with respect to the receipt of dividends beyond the normal dividend specified for the preferred stock. Fully participating preferred stock shares equally with common stock in any dividends to be paid to common stockholders.

Call Feature: some preferred stock will be callable by the issuing enterprise. When preferred stock is called, the holders are required to surrender their preferred stock in exchange for a pre-agreed payment to be made for their preferred shares. This call price

will typically be slightly higher than the face value of the preferred stock. All dividends in arrears must be paid to preferred stockholders upon call of their preferred stock.

Redeemable Preferred: preferred stock can also be redeemable by the issuing enterprise. Unlike a call right, the issuing enterprise does not control the events governing redemption. Preferred stock holders can, for example, possess the right to force the enterprise to redeem the preferred stock and pay all dividends in arrears after a certain point in time or if a certain number of dividends have been passed. These redeemability features will be set out in the terms of the preferred stock. By definition, events external to the enterprise can result in the enterprise becoming obligated to repurchase redeemable preferred stock. This special contingent obligation requires special footnote and balance sheet disclosure to inform readers of the financial statements of the upcoming obligations of the enterprise to expend resources to redeem preferred stock.

3.7.3 *Lawyer's Alert*: Beware of Adjustments to Retained Earnings

Because the results of operations must appear in the income statement, the adjustment of retained earnings is limited to the correction of mistakes or errors in accounting made in prior years. These prior period adjustments are made to correct: (i) mathematical mistakes; (iii) mistakes made in application of the accounting principles being applied by the enterprise at the time and (iii) the misuse or oversight of facts which existed at the time the balance sheet was prepared. The effect of changing from the use of an unacceptable accounting principle to the use of an acceptable principle is considered the correction of an error and is treated as a prior period adjustment. The effect of changes between acceptable accounting principles, however, are included in the calculation of net income in the year in which the change is made. No other adjustments to retained earnings should occur in the normal course.

3.7.4 Practical Illustration: Effects of Par Value on Corporate Equity Accounts

Lawyers should be aware of how various proposed capital structures will affect the balance sheet presentation of the various equity accounts. In many cases, the lawyer incorporating the corporation will advise the corporate founders of the various capital structures available.

Assume that ACME, Inc. issues 15,000 shares of its common stock at a price of $10 per share.

Par value:

If the state corporation statute under which ACME is incorporated requires the use of $1 par value, the equity section of ACME's balance sheet would show:

Common stock	*$ 15,000*
Paid-in capital in excess of par	*135,000*

Stated value:

ACME's board of directors has determined that it will use a stated value of $0.50 per share. The equity section of ACME's balance sheet would show:

Common Stock	*$ 7,500*
Additional paid-in capital	*142,500*

No par or stated value:

Pursuant to the relevant statute, ACME's board elects to assign no par value or stated value to the common stock. The equity section of ACME's Balance Sheet would show:

Common Stock	*$ 150,000*

3.7.5 DRAFTING TIP: Retained Earnings

Retained earnings, despite its name, does not represent a "pot of cash" which has been set aside for future use by the corporation. All cash and other assets owned by the enterprise will appear as assets on the Balance Sheet. Retained earnings is a cumulative measure of the profits or losses of the enterprise which have not been distributed to the shareholders or owners as a dividend. (In one sense, retained earnings is a "plug figure" which balances the Basic Accounting Equation after accounting for all of the assets, liabilities and other equity accounts.) In drafting documents, a lawyer should never refer to retained earnings as an item owned by an enterprise or an item to be transferred upon sale!

3.8 ACCOUNTING FOR REVENUES AND OTHER INCOME

Revenues are amounts received by an enterprise from its main operating activity. Revenues are distinct from gains and other income which arise from activities which are incidental to the operation of the enterprise. The determination of whether a particular inflow represents revenue will depend, therefore, on the main activity of the enterprise. Revenue is recognized (included in the computation of net income) when earned even if amounts will not be paid until later. Recognition can occur when (i) the earnings process is complete and (ii) an exchange has taken place. Revenue is typically recognized at the time of sale, provided all contingencies are resolved or can be reasonably estimated. In certain cases (such as long-term contracts), revenue can be recognized in advance of the completion of the contract if the revenue and profit can be reasonably estimated. When the collection of future payments is uncertain, the installment method may be used to record revenues as cash is received.

Two forms of other income are common. Gains or losses on the sale of an asset are computed by comparing total proceeds in the sale transaction to the book value of the asset. Income will be accrued when earned even if not yet paid. Interest income, for example, often is earned and recognized in the income statement before it is received by the enterprise.

3.8.1 DRAFTING TIP: Revenues Vs. Income Vs. Gains

In drafting and negotiating, it is important to be aware of the distinction between revenues, income and gains. Revenues are generally the gross amounts earned from the main, ongoing activity of an enterprise before consideration of expenses. Income, in contrast, generally refers to an amount of revenue which has been reduced by associated expenses. A gain is the amount by which the proceeds of the sale of an asset exceed the recorded cost of the asset, and are considered a subset of revenues.

3.8.2 DRAFTING TIP: Realization Vs. Recognition

These two similar sounding accounting terms have important differences in meaning of which lawyers should be aware.

Realization refers to the process of consummating a transaction between the enterprise and a third party. A gain or loss, for example, is said to be "realized" when the relevant sales transaction is completed.

Recognition refers to the inclusion of the effects of a transaction in the accounting records of the enterprise. Some unrealized items, such as declines in the market values of assets owned by the enterprise, are recognized (i.e., included in the financial statements) before the loss on the sale of the assets is realized.

When drafting language to refer to amounts received by the corporation, the attorney should use the term "realized". If, for example, a contract is to call for the payment of a certain percentage of gross receipts from sales of a product, the relevant language might read:

> ***X shall pay to Y five percent (5%) of all amounts realized from the sale of Product Z.***

The term "recognized" should be used only to refer to the timing of the inclusion of the items in question in the financial statements. A contract might provide, for example, that a payment is to be made once the effects of a transaction are known and reflected in the financial statements. A relevant provision might read:

> ***All payments with respect to the transfer of the building to Amalgamated shall be made upon recognition of the sale in the financial statements of Conglomerated. If the transfer is not recognized as a sale or other equivalent treatment, the payment shall be made no later than January 1, 20X1.***

Revenue Recognition Principle

The Revenue Recognition Principle (along with Matching, Conservatism, Historical Cost) provides a fundamental element underlying GAAP.

The Revenue Recognition Principle stands for the proposition that any entity may not recognize revenue until: (i) the earnings process is complete and (ii) an exchange has taken place.

In an inventory-based economy, knowing when to recognize revenue was relatively easy. If the goods were delivered and accepted, both elements of the test were met.

In a service based economy, the questions become more difficult. How much revenue is recognized on a five-year warranty contract when the entire fee is prepaid in the first year?

Consider the following: Enron was recognizing revenue on ten-year power supply contracts in the year the contract was signed. Appropriate or not?

3.8.3 Practical Illustration: Illustration of Revenue vs. Other Income

Whether an item will be classified as revenue or as other income depends upon the nature of the primary business activity of the entity. Interest earned by a bank, for example, constitutes revenue because earning interest on loaned funds is the primary business activity of a bank. Interest earned on consumer accounts by a retail department store would, most likely, be classified as other income because selling retail merchandise, not loaning funds to customers, is the primary business purpose of the retail store.

3.8.4 *Lawyer's Alert*: The No-Sale Sale

In certain instances, the owners of an asset may be faced with the need to generate net income in excess of that being produced by the normal operations of the enterprise. This may occur because the entity has not met profit targets, needs to generate profits which will be added to capital (equity) required by regulation, desires to keep its net income increasing over time or a myriad of other reasons.

In a typical case the holder of a highly appreciated asset which needs to generate a substantial profit in the current period. The asset will appear in the balance sheet at its book value: historical cost less accumulated depreciation plus improvements. Upon sale, the entity will record a gain equal to the difference between the consideration received and the book value. Although the gain on the sale of the asset would not typically be included in the operating income of the enterprise, it would be included in the net income of the enterprise. Sale of the asset contributes to the objective of increasing current year net income.

In a subset of asset sale cases, the owning entity will desire to retain control over the asset over time while still having the transaction qualify for sale treatment. In these cases, the selling entity will provide for terms of sale which will allow them varying levels of ability to retain control of the asset. In the extreme case, the buyer will be required to resell the asset to the owner after a fixed period of time; in these cases, there is almost always an arrangement by which the seller can continue to enjoy the beneficial use of the asset during the intervening "non-ownership" period.

In this extreme case, it is easy to see that the entity has not "sold" the asset at all. Instead, the entity has created a financing vehicle by which it obtains the "sales proceeds" as a loan which will be repaid on the repurchase of the asset in the future. In one sense, the transaction is a "No-Sale Sale": the seller wants sales treatment for accounting purposes while effectively retaining ownership of the asset. The lender ("buyer") has received the best possible security interest" outright ownership of the legal title. This transaction will not be treated as a sale on the books of the selling entity; rather, the cash received (increasing assets) will be treated as establishing a liability (increasing liabilities) for the amount of the sales proceeds.

As in many areas, the extreme cases are easy. In reality, the amount of control possessed by the selling entity will vary from case to case. The closer the seller comes to retaining the bulk of the benefits of beneficial ownership of the asset, the less likely it is that the seller will be able to treat the transaction as a sale.

3.8.5 DRAFTING TIP: Consult the Accountant!

When drafting documents which deal with revenue recognition (and other issues), the wise attorney will ask the client's auditor to review at least the concepts involved in the sales transaction, if not the documents themselves. Although some auditors may be reluctant to commit to an opinion on the spot, the attorney will at least garner an idea of how close the transaction in question comes to failing to qualify for revenue recognition.

Lawyers should be aware that small changes in documents can have serious effects on the eligibility of the transaction for sales treatment. In the heat of negotiation, several minor, but cumulatively important, points may be ceded to the purchaser of the property. If there is a question about whether these commitments will disqualify the transaction from sales treatment, the lawyer should defer final agreement until the ramifications of such agreements are known.

This advice applies equally to other situations as well. If an accounting question arises during a transaction, in many cases, it is better to receive the benefit of the auditor's thinking while there is still time available to address any concerns raised. Failure to do so may result in some unpleasant surprises for the attorney, and the client, when it is time for the auditor to render an opinion on the financial statements.

3.8.6 Practical Illustration: Illustration of the Installment Method

The following chart illustrates accounting for revenue under the installment method. The installment method is not permissible for financial accounting and is not a generally accepted accounting principle. Installment accounting is allowed, however, for certain federal income tax purposes.

Assume that ACME, Inc. sells a specialized industrial machine which generates a taxable gain on the sale (exclusive of depreciation recapture, see Chapter 7) of $750,000. The buyer buying the asset will pay $1,200,000 for the asset in three installments of $400,000, $200,000 and $600,000, with the first installment payable upon delivery of the asset on December 1, 20X1.

Under the installment method, the percentage of the taxable gain reported on the sale is equal to the percentage of total proceeds received during that year. The following table sets forth the computation of gain recognized during the respective years.

Year	Proceeds received	Total Proceeds	% of Total Proceeds	Total Gain	Gain Recognized
1991	$400,000	$1,200,000	33.33%	$750,000	$250,000
1992	200,000	1,200,000	16.67%	750,000	125,000
1993	600,000	1,200,000	50.00%	750,000	375,000
	$1,200,000				$750,000

3.8.7 Practical Illustration: Computation of the Gain or Loss on the Sale of an Asset

The following chart illustrates the computation of gain (or the loss) on the sale of an asset.

```
Assume that ACME, Inc. owns a machine with the following
characteristics and history:

          Historical      Accumulated      Book
             Cost         Depreciation     Value
         ============    ==============   ========
           $300,000        $175,000       $125,000

1.  Assume the asset is sold for $150,000.  The gain on
the sale would be computed as follows:

                 Proceeds from sale:  $ 150,000
                 less: book value      (125,000)
                                       ---------
                 Gain on sale         $  25,000
                                       =========

2.  Assume the asset is sold for $50,000.  The loss on the
sale would be computed as follows:

                 Proceeds from sale:  $  50,000
                 less: book value      (125,000)
                                       ---------
                 Loss on sale         $ (75,000)
                                       =========
```

3.9 ACCOUNTING FOR OPERATING EXPENSES, LOSSES AND OTHER EXPENSES

An expense occurs when assets are used up or liabilities are incurred in carrying out the central operations of the enterprise. Losses arise from other decreases in assets and equity or increases in liabilities. Operating expenses are those which relate directly to the business of the enterprise.

Fundamental to the accounting for expenses is understanding the tension between creation of an asset and recognition of an expense. If an item is to have value over time, an asset should be created and the portion of that asset which is utilized in any one accounting period should be allocated into expense during that period. This assumes, of course, that the item will have value in the future periods. If this assumption is not correct, the amounts should be recognized immediately as an expense.

Research and development costs are expensed when occurred. The costs of developing software are expensed until the technical feasibility of the project is proven; after that point costs are capitalized. The expenses of a start up enterprise are accounted for normally (i.e., they are expensed as incurred and not capitalized) and the financial statements are marked to indicate the start-up nature of the enterprise. The interest expense incurred in the construction of a long-term asset by the enterprise are added to the cost of the asset rather than recognized as an expense.

3.9.1 DRAFTING TIP: Cost vs. Expense vs. Loss

The similar sounding terms cost, expense,and loss have very different meanings. A cost is an amount expended which will be recognized in the income statement in the future. Amounts expended to improve inventory, for example, are considered costs.

Statement of Financial Accounting Concepts No. 6 ("SFAC No. 6") defines expenses as "...outflows or other using up of assets or incurring of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."

SFAC No. 6 defines losses as "...decreases in assets or equity or increases in liabilities which occur as a result of other aspects of the business of the enterprise."

3.10 SPECIAL INCOME STATEMENT CONSIDERATIONS

Several items are of special enough significance to warrant special presentation in the income statement. Gross profit is difference between net sales and the cost of goods sold. Operating income is the difference between net revenue and operating expenses of the enterprise. Net income before taxes is shown separately on the income statement to highlight the effect of taxes on net income. The gain or loss which results from the discontinuance of a major segment of a business are shown separately. The positive or negative effects of extraordinary items (which are unusual in nature and infrequent in occurrence) are shown separately. The effects of a change in accounting principle (as distinguished from the correction of an accounting error) are shown on the face of the income statement. These items will not necessarily incur in every income statement, but, when they do occur, special accounting rules apply.

3.10.1 Practical Illustration: Structure of the Income Statement

```
      Sales
    - Returns
      -------
    = Net sales
    - Cost of goods sold
      ------------------
    = Gross profit
    - Operating expenses
      ------------------
    = Operating income
    + Other income
    - Other expenses
      ------------------
    = Net income before taxes
  +/- Provision for income taxes
      --------------------------
      Net income from continuing operations
  +/- Gain or (loss) from discontinued
       operations
      --------------------------------------
      Net income before extraordinary items,
       and cumulative effect of change
       in accounting principle
  +/- Extraordinary items
      --------------------------------------
      Net income before cumulative effect of
       change in accounting principle
  +/- Cumulative effect of change in
       accounting principle
      --------------------------------------
      Net income
      ======================================
```

3.10.2 DRAFTING TIP: Gross Profit

Gross profit is the difference between net sales and the cost of goods sold. The cost of goods sold includes only those costs which are directly associated with the production of the goods which were sold by the enterprise during the period. Gross profit, therefore, is the measure of the profitability of the enterprise most closely associated with the production and sale of products. Put another way, gross profit is the profit remaining after accounting for the costs incurred to manufacture or acquire the product. Gross profit does not include the costs to market or distribute the product.

3.10.3 DRAFTING TIP: Operating Income

In establishing the form of the income statement, many enterprises will separate revenues and expenses into two categories: (i) operating expenses (i.e., those related to the operations of the enterprise which are presumably controllable by managers) and (ii) other revenues and expenses (i.e., those revenues and expenses which arise because of outside events or decisions related to the capital structure of the entity.) (These distinctions were discussed at length in Section 3.9.)

Operating income is the difference between net revenues and operating expenses of the entity.

3.10.4 DRAFTING TIP: Income from Discontinued Operations

A diversified enterprise may, on occasion, elect to terminate a major **segment of business**. When this occurs, the income statement effects of the termination are displayed separately on the income statement. A gain or loss entitled "**Gain or loss from discontinued operations**" is presented on the income statement separately from the other income statement items.

Separate presentation allows the reader of the financial statement to focus on **income from continuing operations**, the income which was generated in the most recent period from the operations which will continue in the next period. Similarly, the gain or loss from the disposition transaction will be segregated in the income statement. Sale of a segment at a significant gain or loss will, therefore, not taint the reader's understanding of the profit earned by the enterprise from its operations during the period.

3.10.5 DRAFTING TIP: Extraordinary Items

Some events which occur during the period are of such an unusual nature that their effects on the profitability of the enterprise must be disclosed separately. These events, known as **extraordinary items**, must satisfy both of two criteria. The event must first be **unusual in nature**. An event is unusual in nature if it is considered highly abnormal and not related to the ordinary business activity of the enterprise. The event must also be

infrequent in occurrence. An event occurs infrequently if it is not expected to occur again in the foreseeable future, given the location and financial circumstances of the enterprise.

Extraordinary items can be both positive and negative. When drafting a provision in an agreement one must be careful to consider the potential impact of extraordinary items on the net income of an entity. Care should be taken to draft provisions which specify whether the effects of extraordinary items should be included in the calculation of net income for purposes of the particular agreement.

3.10.6 DRAFTING TIP: Drafting Language Describing Net Income

Many types of transactions will require the lawyer to draft language to describe the net income of the enterprise. Business are typically sold for amounts equal to some pre-agreed multiple of net income of the enterprise in the period prior to sale. Alternatively, a partner leaving a partnership may be entitled to a payment equal to a certain percentage of net income for a certain number of years. A bonus paid to an employee might be based on a sliding scale of percentage of net income earned by the enterprise.

In each case the lawyer should consider the following:

1. **Ability of adverse parties to manipulate net income**.

Formulas based on net income are subject to manipulation because of the large number of estimates, judgments and variables which are present in computing net income. In the example above, for example, the partners could reduce the net income by paying themselves larger salaries. Instead of trying to draft limits on every judgment (such as no more than a 6% increase in expenses shall be allowed), it may be better to draft a formula based on a revenue concept. In the partnership example, the withdrawing partner might ask for a percentage of the gross revenues of the partnership over time. By choosing to base the formula on revenues, an item determined by dealings with third parties, the lawyer is reducing the ability of the continuing managers to manipulate the net income figure.

2. **Which expenses should be included?**

If a net income formula is used, the lawyer will want to make clear whether net income as computed in the formula will include: (i) the effects of changes in accounting principles; (ii) extraordinary items, (iii) gains or losses from discontinued operations and (iv) income taxes. Failure to specify which, if any, of these items will be included in the computation of net income for formula purposes could result in significantly differing results.

3. **Are bonuses based on net income computed before or after payment of the bonus?**

This is an obscure and often overlooked point. Assume that a contract specifies that a $20,000 bonus will be paid if net income exceeds $100,000. Assume that net income

computed without regard to the bonus comes to $110,000. Has the bonus been earned? If net income is defined as being computed after the bonus is paid, net income would be $90,000 and the bonus would not be earned. If net income is defined as being computed before the bonus is paid, net income would be equal to $110,000 and the $20,000 bonus would be earned. Precision in definition here is critical.

4. **Do not fall victim to the trap of using the phrase "net income as determined in accordance with generally accepted accounting principles applied on a consistent basis"!**

The term "generally accepted accounting principles" (or "GAAP") describes an entire body of accounting knowledge, much as the term "common law" describes a large portion of American legal precedent. Inherent in GAAP is: (i) the ability of the entity to choose between acceptable accounting methods and (ii) the ability of the entity to make and revise estimates used in applying those methods.

There are three important things to remember when drafting language concerning GAAP. First, GAAP changes. Like the law, generally accepted accounting principles are not static. What is generally accepted one year may not be the next. The change between methods could adversely affect your client. Second, an entity generally may choose from a variety of acceptable methods in applying GAAP. Thirdly, there are a wide number of choices and judgments inherent when applying GAAP. All of the estimates used in preparing the financial statements (useful lives, percentage of collectible receivables) and discretionary items (such as salary levels) can all be changed in a manner adverse to your client's interest while applying GAAP on a consistent basis. Gains or loss on the sale of significant assets, provisions for income taxes, extraordinary items, changes in accounting principles and the gain or loss on discontinued operations are all items which can positively or negatively affect net income. The effects of these items may or may not be included in your client's idea of net income for purposes of this transaction or settlement.

Use of the phrase "net income as determined under generally accepted accounting principles" is easy and will certainly make the drafting lawyer appear knowledgeable. However, use of this general description throws the calculation of net income open to all of the possible changes in estimates, principles and circumstances described above which can positively and negatively affect net income.

Instead of relying on the general statement, consult with your client as to those items which are of critical importance in determining the profitability of the subject entity and as to the appropriate accounting methods which should be used to account for each. Then, draft a provision which specifies the accounting methods to be used to account for specific items and have the provision reviewed by an accountant. List the estimates to be used in computing net income. (You may wish to consider drafting a provision that provides that any change in accounting method or estimate must be approved by your client in advance.) The drafting lawyer should also consider whether gains on sales of assets, provisions for income taxes, extraordinary items, changes in accounting principles and the gain or loss on discontinued operations should be included in net income for purposes of this transaction.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
1. Increasing current assets by classification of long-term assets as current assets	Reclassifying long-term assets as current assets, based on a parallel change in "investment intent" by management. Management may also create current asset accounts by subdividing long-term assets into both a short- and long-term component (e.g., short-term and long-term prepaid expenses short-term and long-term accounts receivable.) Alternatively, entire classifications of assets may be transferred between categories.	Transfers like this will often occur as an adjusting entry made after the balance sheet date. General ledger entries in the months following the balance sheet date should be examined. Key to appropriateness is factual support: will the amounts classified as current actually come due within one year? Look hard at changes based upon placing assets under contracts for sale: typically performance by the other side is contingent and, therefore, the contract is easily cancellable.	Overstates current assets. Understates long-term assets by an equal amount.	None.	These transfers are often made to improve the "current ratio", which often must be maintained at a minimum level to comply with covenants in debt agreements. Current assets are those which are cash, or will become cash, within 12 months of the balance sheet date, or, rarely, within one business cycle.
2. Overstating gross accounts receivable.	Creation of false sales which generate false accounts receivable.	Confirmation letters sent to third parties who are asked to confirm that they owe money in the amount stated and have no offsetting claim against entity. (This is a routine part of an audit examination.)	Overstates total assets by overstating accounts receivable.	Overstates net income by overstating revenues.	Statistical sampling is used in audits to validate accounts receivable balances. An audit is not designed to detect fraud. Fraud detection usually requires expanding the scope of testing normally performed as part of the audit.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
3. Overstating net accounts receivable	Understating allowance for doubtful accounts by using a smaller (i) percentage of A/R or (ii) percentage of sales estimate of uncollectibility than that required by the facts.	Testing collectibility of A/R (see Item 1) and examination of reasonability of management's estimate. Auditors will also examine estimate in light of historical experience.	Overstates total assets by understating allowance for doubtful accounts which overstates net accounts receivable.	Overstates net income by understating provision for doubtful accounts.	Manipulation here often cloaked in terms of "management judgment." Look to see if changes in circumstances warrant departure from historical approach.
4. Understanding net accounts receivable.	Overstating allowance for doubtful accounts by using either a larger (i) percentage of A/R or (ii) a percentage of Sales as an estimate of uncollectibility than that required by the facts.	See Item 2.	Understates total assets by overstating allowance for doubtful accounts which understates net accounts receivable.	Understates net income by overstating provision for doubtful accounts.	Reverse of Item 3. Often used to manipulate net income when net income used to calculate amounts owed by the entity to a third party (e.g., buyer of business will pay seller 15% of entity's net income for 10 years).
5. Overstating value of marketable securities.	Use of incorrect market values for marketable securities.	Comparison of values used against published values (e.g., Wall Street Journal price quotations).	Overstates total assets by overstating net marketable securities.	Overstates net income by understating unrealized losses on marketable securities.	By inflating the values of marketable securities, the entity avoids recording a loss on the securities and, by doing so, increases net income. This is of particular importance in markets in which the entity is a major participant (e.g., Enron).
6. Overstating value of non-marketable securities.	Use of aggressive valuation techniques for non-marketable securities. Beware of estimates of value prepared by internal staff.	Thorough examination of appraisal or other basis for estimate. Look for objective evidence such as recent sales of the security in question.	Overstate total assets by overstating marketable securities.	Overstates net income by understating unrealized losses on non-marketable securities.	Valuation of closely-held securities is a common problem. If amount is material, close attention should be paid to valuation method. Can affect both short-and long-term portfolio.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
7. Transfer of securities from short-term to long-term portfolio without change in investment intent.	Management will note a change in investment intent (i.e., from short-term to long-term) with respect to a particular security. Balance of short-term securities account reduced in amount equal to increase in long-term account through an entry made on general ledger.	General ledger will reflect transfer. Significant transfers also detectable by comparison of current to prior years' financial statements.	Overstates total assets by overstating long-term securities.	Overstates net income by understating unrealized losses on securities.	Used to avoid recognition of declines in value which do not constitute material impairment of asset value. All declines must be recognized in short-term portfolio; only material impairments recognized in long-term portfolio.
8. Inappropriate use of equity method of accounting for an investment in another entity.	Management will apply equity method to investments of less than 20% or more than 50% of outstanding stock of the subject.	General ledger will reveal equity accounting in use. Look for accounts entitled "Equity Investments in XYZ, Inc." (B/S) or Income/Loss from XYZ, Inc. (I/S). Footnotes should state equity owned by entity.	Can both overstate and understate long-term securities and total assets.	Can both overstate and understate net income.	Rare. The equity method is generally required for investments of between 20% and 50% of the equity of another entity. Investments of 50% or more require consolidation.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
9. Overstating ending inventory.	Creation of false purchases of inventory. Entity overstates count (or value) of ending inventory at year-end.	Examination and confirmation of accounts payable. (See Item 1, below). Auditors design complicated review process to ensure: (i) accuracy of inventory count by random testing of items counted by entity; (ii) that items of inventory have values stated; (iii) computational accuracy of inventory tabulation.	Overstate total assets in year of manipulation by overstating ending inventory. Overstating net income by understating cost of good sold.	Overstates net income in year of manipulation by understating cost of goods sold. Overstates total assets in year of manipulation by overstating ending inventory.	Ending inventory Year 1, by definition, becomes beginning inventory in Year2. Unless fraud is committed again in Year 2, the overstatement of net income in Year 1 will be offset by understatement in Year 2. Very common form of fraud.
10. Overstatement of capitalized costs of fixed assets.	Management elects to include items in the cost of a fixed asset which should be recognized as a current year expense.	Examination of costs included in fixed assets and their appropriateness. Only those costs directly related to bringing the asset into service should be included.	Overstates net income in early years by converting expenses to assets. Overall effect over time is $0 because increased costs will be recognized (through depreciation) over life of the asset.	Overstates total assets by overstating gross fixed assets.	This is one of many examples in which net income is increased by claiming that expenses are, in fact, assets.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
11. Lengthening depreciable lives of assets without factual basis for doing so.	Management lengthens estimate of depreciable lives of assets in computing depreciation expense. Usual claim is that initial estimates (or past practice) were incorrect in light of changed circumstances.	Comparison of depreciation computed in current year to depreciation in prior year. Compare lives used by entity to lives used by comparable entities on similar assets.	Understates accumulated depreciation, overstates net fixed assets and overstates total assets.	Overstates net income by understating depreciation expense.	Very common!
12. Shortening depreciable lives of assets without factual basis for doing so.	Management shortens estimate of depreciable lives of assets.	Comparison of depreciation computed in current year to depreciation in prior years. Compare lives used by entity to lives used by comparable entities.	Overstates accumulated depreciation, understates net fixed assets and overstates total assets.	Understates net income by overstating depreciation expense.	In actual practice this clause is often justified because of asset obsolescence. Reverse of Item 11.
13. Failure to write-off obsolete fixed assets or inventory.	Management elects to leave the cost of non-functioning fixed assets or non-saleable inventory on the balance sheet.	List of fixed assets should be reviewed to ensure that each is still in working order and used in operations. Inventory should be carried at no more than its net realized value.	Overstates fixed assets by understating accumulated depreciation; net effect is to overstate total assets. Overstates ending inventory and total assets.	Overstates net income by understating depreciation expense. Understates net income by understating cost of goods sold.	Timing of white-offs can be significant. In some cases, a entity having a “bad” year will search for items to write-off to “bite the bullet” in a single year. More common, however, is failure to write-off assets which are no longer useful.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
14. Recognition of goodwill in absence of purchase of an ongoing business.	Management will make as an entry into the general ledger creating "goodwill" as an asset and increasing either owner's equity or a revenue account.	Examination of financial statements reveals a "goodwill" account; examination of past transactions shows no purchase of an ongoing business.	Overstates total assets.	Effect depends on how goodwill was established. If a revenue account is used, net income will be overstated. If an equity account is used, no I/S effect.	Goodwill arises only when one entity purchases the ongoing operations of another (or a group of assets) at a price which exceeds the fair market value of the assets (less any liabilities assumed). It is common for many small business owners to show goodwill in an amount equal to the difference of total assets and what they think the business is worth.
15. Failure to amortize intangible assets over their economic lives.	Management elects to amortize intangible assets (e.g., patents, copyrights, contractual rights bargained for separately) over legal life when, in fact, asset only has value over a shorter period of time: its economic life.	Examination of lives used in amortization as compared to an objective estimate of economic life of asset. In most cases, the substance of the legal relationships (copyrights, contracts) and technology (patents) must be understood before a reasonable estimate can be made.	Overstates total assets by understating accumulated amortization of intangible assets.	Overstates net income by understating amortization expense.	This is often a topic of discussion and negotiation between management and auditors due to subjective nature of estimates of economic life.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
16. Failure to record accounts payable.	Management will not record invoices for goods received or services rendered near year end. By doing so, management avoids accrual of expenses.	Confirmation letters sent to usual suppliers and service provides to compare amounts they claim they are owed to accounts payable balance recorded on books of entity. Transactions in first weeks of Year 2 are examined to verify that they should not have been recorded in Year 1. Pay particular attention to amounts paid early in Year 2.	Understates total liabilities by understating accounts payable.	Overstates net income by an amount equal to the expense which should have been accrued.	This is closely related to Item 17.
17. Failure to identify and record accrued expenses.	Management simply omits the calculation of items of exercise incurred, but not paid for, in Year 1. Examples of items here include: rent, payroll, taxes, insurance, and interest.	Examination of entries in general ledger to ensure common accrued items are covered and calculated correctly. "Closing the books" checklists prepared by the entity should be examined for compliance and completeness. Review payments early in Year 2 to determine if any payments related to expenses which were incurred and should have been accrued in 1992.	Understates total liabilities by understating accounts payable.	Overstates net income by understating expense which should have been accrued.	

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
18. Failure to record contingent liabilities.	Management: (i) omits identification of potential contingent liabilities; (ii) fails to make reasonable estimates of potential exposure; or (iii) underestimates probability of contingency.	Difficult to detect because detection requires "proof of a negative" (i.e.. there are no claims outstanding). Management should be questioned about potential claims. Auditors will obtain signed representations in "client representation letter" that all claims have been identified. Auditors will also typically contact all lawyers paid by the entity has used and ask them to identify claims. Be sure to examine audit work papers dealing with contingent liabilities. Look for a memo summarizing "FASB 5" analysis.	If liability should be accrued, total liabilities understated by amount of accrual. If disclosure is the only step required, no B/S effect.	If liability should be accrued, net income is overstated by amount of accrual. If disclosure is the only step required, no I/S effect.	Creation of liability requires: (i) likely probability of event occurring and (ii) reasonable estimate of loss being made.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
19. Recording amounts received as revenues when work remains to be done: failure to establish deferred liabilities.	Management records amounts received for future services as revenue rather than as a liability.	Comparison of amounts received from customers against production/shipping schedules or billing summaries. Examination of contracts for terms and conditions which remain unfulfilled after collection of amounts from customers.	Understates total liabilities by understating deferred liabilities.	Overstates net income by overstating revenue	When an entity collects money in advance of work being performed, the transaction should result in an increase in assets and in liabilities. No revenue should be recognized until goods are delivered (and contingencies resolved) or services are rendered.
20. Extraordinary reduction of current liabilities.	Management elects to make substantial payments of current liabilities in close proximity to a balance sheet date.	Examination of cash payments journal (or the cash accounts) reveals heavy pay down of current liabilities near a balance sheet date.	Reduces both current assets and current liabilities.	None.	This step is taken to bring about compliance with restrictive comments which establish a minimum "current ratio" which must be maintained. Every dollar of current liabilities paid with a dollar of current assets will increase the current ratio. While this is permissible, it is manipulative if done deliberately and repeatedly without a business purpose.

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
21. Failure to properly classify long-term and current portion of notes payable.	Management does not appropriately evaluate (or omit evaluation) of terms of long-term payables to determine amount classified as short-term. Current liabilities are those which fall due without one year of the balance sheet date.	The terms and payment schedules of all long-term lending relationships must be examined as of each balance sheet date. Particular attention should be paid to minimum financial ratios which must be maintained (see Item 20). Examine documents to determine if any defaults create ability by lender to accelerate. If lender can accelerate, the liability is current unless lender agrees to forbear.	Understates current liabilities; overstates long-term liabilities. No effect on total liabilities.	None.	Beware of scheduled balloon payments which will become due during the next 12 months. These may not appear on the schedule of regular payments. Also be wary of entities which renegotiate lending arrangements on an annual basis to provide for extensions slightly in excess of 1 year. Liabilities handled this way indicate very heavy reliance on borrowing.
22. Depreciation of land.	The costs associated with the purchase of land underlying a building are included in the depreciable base of the building. These costs are then depreciated. Land is not depreciable.	All purchases of fixed assets involving buildings shall be examined to determine if an appropriate allocation of costs has been made between building and land.	Understates net fixed assets by overstating accumulated depreciation. This results in understating total assets.	Understates net income by overstating depreciation expense.	Rare event

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
23. Classifying debt as equity.	Certain financial instruments have characteristics of both debt and equity. Manipulation can occur when instruments, that are, in substance, borrowing obligations of the entity are classified instead as equity. Example: “preferred stock” which calls for mandatory payment of dividends approximating a market rate of interest, which is secured and which does not vote.	Terms of financial instruments classified as equity must be examined to ensure they have a preponderance of equity characteristics: (i) dividends payable only when declared; (ii) voting rights; (iii) generally, no security interest in particular assets; (iv) no guarantee by principals of entity.	Understates total liabilities; overstates equity.	May overstate net income by understating interest expense.	A trick used to improve the debt/equity ratio which is often included as a minimum requirement in loan agreements.
24. Inappropriate reductions of retained earnings to avoid recognition of expense in current period.	Management elects to reduce retained earnings rather than current year expense typically associated with events which occurred in earlier periods (i.e., discovery of significant impairment of an asset which occurred in a prior period.	Look for changes in retained earnings between periods which do not equal the sum of net income and any dividends paid. Should appear in footnotes in statement of equity.	Reduces equity and can reduce total assets.	Overstates net income by reducing expenses.	The only appropriate adjustments to retained earnings are for: • Correction of mathematical errors. • Switch from an unacceptable accounting method. • Complete recapitalization of an entity.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
25. Inappropriate recapitalization.	Management elects to eliminate a retained deficit (i.e., negative retained earnings). This is accomplished by: (i) writing up asset values to fair market value and (ii) reducing the retained deficit to zero or creating a positive balance in retained earnings account.	Obvious maneuver easily defected by comparing current retained earnings to prior years. Must be described in footnotes.	Asset values increased to appropriate fair market values.	Increased depreciable asset values will result in increased depreciation expense and decreased net income.	Valid recapitalizations are rare in that they are typically associated with a major change in corporate history such as a complete buy-out, major disposition, ect.
26. Premature recognition of revenue.	Management elects to recognize revenue in advance of the entity fulfilling all of the requirements of earning revenue. Example: Money collected for work to be done in the future should not be recognized as revenue until work is completed. Instead a liability entitled "deferred revenue" should be established.	Examine footnote disclosure of the nature of continuing obligations of the entity. Consider nature of business: are amounts typically collected in advance of performance (e.g., insurers; magazines; professional firms.)	Understates liabilities by failing to recognize deferred revenue liability.	Overstates net income by overstating revenue recognized.	Common modern service sector fraud. Look for significant production commitments and examine contractual relationships to gauge completion progress. If entity maintains an asset account entitled "Deposits received" or "Customer deposits" investigate relationship between amount received and future goods/services to be delivered. Beware of use of "Percentage of completion" method of revenue recognition. Only applicable in limited circumstances.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
27. Recognition of revenue as a result of a "No Sale" sale.	Management will enter into a "sales agreement" by which the entity "sells" assets to a third party, agreeing to repurchase the assets at a time in the future. The agreement will typically provide for interim payments which approximate interest in the "sales proceeds" received.	Examination of terms and conditions of large asset sales as found in legal documents and footnotes.	It depends. If the recorded receivable is in excess of the book value of the asset sold, assets will be overstated. If not, this is an asset neutral approach.	Overstates net income by recognizing revenue which should not have been recognized because the asset was not sold.	Often occurs in sale/leaseback situations where seller retains right to possession of asset at end of the lease term.
28. Revenue Manipulation through Rebates and Return Programs	The enterprise will offer rebates and return programs that enable customers to unwind transactions. Enterprise reports sales in one period; unwinds sales in later periods.	Examining critically the underlying terms of the financial arrangements between the parties. Ensuring that the auditor is aware of all documents that establish the relationship between the parties. Look for pattern of post-transaction adjustments.	Overstates assets, by creating a receivable for amounts which are subject to reversal.	Overstates net income by claiming revenue that has not yet been earned.	This practice is becoming more and more common.
29.Reclassification of expenses from operating to non-operating categories (and vice-versa).	Management re-categorizes the presentation of certain expense accounts from one category to the other.	Comparison of current period financials to: (i) prior period financials and (ii) industry practice. Examination of footnotes. Beware: this device often involved the movement of sub-accounts between "other" or "general and administrative" accounts in both operating and non-operating expenses.	None.	None.	This device is used for a variety of reasons. Executive bonuses for example, may be computed as a percentage operating income thereby creating an incentive to reduce operating expenses. These charges may be appropriately affected to improve comparison between the subject and other industry members.

WINNING NUMBERS: FRAUD AND MANIPULATION CHECKLIST

Item	Accomplished By	Detected By	B/S Effect	I/S Effect	Other
30. Moving Items Off the Books, including liabilities and money losing activities	Carving out activities from the financial statements by failing to include their effects in the consolidated financial statements.	Close examination of contractual relationships to ensure that substance over form theme under GAAP is adhered to.	Usually done to overstate assets or understate liabilities.	Usually done to overstate income or understate expenses.	The general rule: the enterprise must account for those items which will impact its assets, liabilities, revenues and expenses. If the enterprise is involved, ask how the accounting is done.
31. Unnecessary complexity that tends to hide fraudulent activity.	The enterprise will devise a long series of transactions to yield a particular accounting result.				Complexity never adds value. As a result, one must wonder what complexity adds to the profit activities of the enterprise. "Tax reasons" will many times be cited as justifying complexity. Remember, though, tax features a substance over form theme.
32. Change of accounting method without any apparent reason.	The enterprise changes an accounting method or accounting estimate, presumably to increase the accuracy of financial reporting.				Blatant manipulation. Look for a series of "coincidental" changes all of which tend to violate the Conservatism Principle.

WINNING NUMBERS 10-STEP STATEMENT ANALYSIS CHECKLIST©

The ***WINNING NUMBERS 10-Step Statement Analysis Checklist©*** summarizes the analytical work involved in analyzing any financial statement. The Worksheet reviews the substance of *10-Step Statement Analysis* by presenting Steps 1 through 10 in sequence with reminders to the analyst on how to calculate each of the respective *Keys to the Financial Statements*. These 10 steps include:

1. Get the Big Picture

In this step, one reviews the financial statements for a quick view of liquidity and profitability.

In the first instance the analyst answers the question, "Can the Entity Pay Its Bills? by reviewing:

- **The Current Ratio**
- **Cash Flow from Operations**

Next the analyst asks, "Is this Entity Operating Profitably" by looking at:

- **Operating Income**
- **Net Income**

2. Read the Footnotes; Verify Type of Opinion

The analyst reviews the footnotes to the financial statements in a search for items of signficance. One should review the form of opinion accompanying the financial statements to understand the level of scrutiny, if any, applied by the attesting accountant.

3. Convert Into Standard Format/Obtain Industry Comparative Data

Some of the most interesting comparisons will result from analysis of the subject financial statements against those of its industry competitors. In Step 4, the analyst ensures the comparability of data and prepares for later analysis.

4. Do the Scan

The analyst reviews comparative years' information to highlight items of significant change between years. This review helps identify items to which the analyst will devote more significant attention in later steps.

5. Analyze Component Percentages of Income Statement and Balance Sheet Items.

In this step, the analyst reviews the subject income statement on an item by item basis to further highlight changes. This is compared to the industry average. Balance sheet review may be undertaken.

6. Calculate Profitability Ratios

The analyst calculates a series of ratios which will help draw conclusions concerning the profitability of the subject entity. These include:

- **Return on Assets**
- **Return on Sales**
- **Return on Equity**

7. Calculate Solvency/Liquidity Ratios

The analyst calculates a series of ratios which will help draw conclusions concerning the solvency and liquidity of the subject entity. These include:

- **Current Ratio**
- **Quick Ratio**
- **Debt to Equity Ratio**
- **Fixed Assets to Equity Ratio**

8. Calculate Efficiency Ratios

The analyst calculates a series of ratios which will help draw conclusions concerning the operating efficiency of the subject entity. These include:

- **Receivables Collection Period**
- **Inventory Turnover**
- **Assets to Sales**
- **Equity to Sales**
- **Accounts Payable to Sales**

9. Calculate Investment Performance Ratios

The analyst calculates a series of ratios which will help draw conclusions about the performance of an ownership interest in the entity as an investment opportunity.

- **Price/Earnings Ratio**
- **Earnings per Share**
- **Return on Investment**
- **Market Value of Entity**

10. Draw Conclusions

The final step in the checklist consists of a summary of findings from the other steps. The analyst prepares a summary which includes:

- **Items of significance**
- **Items for further review**
- **Qualitative analysis of profitability, solvency and operating efficiency of the entity**

STEP 1. GET THE BIG PICTURE

A. CAN THE ENTITY PAY ITS BILLS?

1. Compute the Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{Current Ratio}$$

- ***Generally the higher the Current Ratio the more likely it is that the entity will meet its obligations as they come due. Look for trends over time in collection of receivables, turnover of inventory. Slowing receivables collection and decreased inventory turnover indicate declining quality of current assets. Look also for differences highlighted by the quick, or acid-test, ratio. A Current Ratio above industry norms and a Quick Ratio below industry norms indicate an over dependence on inventory as a source of current assets.***

YEAR 1	YEAR 2	INDUSTRY AVG.
____________	____________	____________

2. Examine Cash Flow from Operations

Cash Flow from Operations appears as a sub-total line item on the Statement of Cash Flows

- *Positive Cash Flow from Operations indicates that the ongoing business activities of the enterprise are generating cash increasing the ability of the enterprise to pay its bills over time. Cash Flow from Operations should be compared to ending balance of cash on the Balance Sheet to gauge the magnitude of the cash generated or the shortfall created by operations.*

YEAR 1	YEAR 2
+/-	+/-

B. IS THIS BUSINESS OPERATING PROFITABLY?

Net Income and Operating Income appear
as line items on the the Income Statement

- *Net Income indicates that the entity is operating profitably on an overall basis. Operating Income indicates that the ongoing, regular activities of the entity are profitable. Substantial differences are attributable to items which are not part of daily operations such as gain or loss on sale of assets, interest income and expense and unusual items.*

	YEAR 1	YEAR 2	INDUSTRY AVG.
Net Income	___________	___________	___________
Operating Income	___________	___________	___________

STEP 2: READ THE NOTES; CONFIRM TYPE OF OPINION

Review Significant Accounting Policies (x when completed) _______

Review Description of Business Activity (x when completed) _______

Review Terms of Significant Liabilities (x when completed) _______

	Year 1	Year 2
Significant contingent liabilities?	Y/N	Y/N
Sales of equity interests during the period?	Y/N	Y/N
Effects of assets sales on net income? (Circle One)	-/0/+	-/0/+
Effects of related party transactions on Net Income?	-/0/+	-/0/+
Effects of significant acquisitions/dispositions?	-/0/+	-/0/+

Other items noted in the Notes:

1.
2.
3.
4.

Circle Type of Attest Service Below:

Audit Review Compilation Other

STEP 3: OBTAIN INDUSTRY STANDARD INFORMATION; CONVERT ENTITY FINANCIALS INTO COMPARATIVE FORMAT

In this step, the analyst obtains industry comparative financial statements, if possible. This information is available commercially, often for particular businesses, from credit information providers such as Dun and Bradstreet and Standard and Poors. Industry wide information is published quarterly by the Department of Commerce in a publication known as the Quarterly Financial Report.

It is most helpful to the analyst if information has already been compiled on the subject entity by the credit rating agency. Dun and Bradstreet, for example, offers a variety of financial and credit information on specific companies and industries that will prove very useful to you in analyzing financial statements. Dun and Bradstreet can be reached at 1-877-753-1444 *or www.dnb.com.*

STEP 4: DO THE SCAN

In this step, the analyst reviews comparative columns in the Income Statement and Balance Sheet to uncover those line items which have changed signficantly between the comparative periods. List the items which changed significantly between Year 1 and 2:

Item	Change
Income Statement:	
1.____	Increase/Decrease
2.____	Increase/Decrease
3.____	Increase/Decrease
4.____	Increase/Decrease
5.____	Increase/Decrease
Balance Sheet:	
1.____	Increase/Decrease
2.____	Increase/Decrease
3.____	Increase/Decrease
4.____	Increase/Decrease
Statement of Cash Flows:	
1.____	Increase/Decrease
2.____	Increase/Decrease

STEP 5: ANALYZE COMPONENT PERCENTAGES OF FINANCIAL STTEMENTS

	Year 1	Year 2	Ind. Avg.
As a percentage of Total Assets:			
Cash	________%	________%	________%
Marketable Securities	________%	________%	________%
Accounts Receivable (net)	________%	________%	________%
Inventory	________%	________%	________%
Prepaid Assets	________%	________%	________%
Other Current Assets	________%	________%	________%
TOTAL CURRENT ASSETS	________%	________%	________%
Fixed Assets (net)	________%	________%	________%
Other Assets	________%	________%	________%
____________________________	________%	________%	________%
____________________________	________%	________%	________%
____________________________	________%	________%	________%
____________________________	________%	________%	________%

As a percentage of Total Liabilities:

	Year 1	Year 2	Ind. Avg.
Accrued Expenses	________%	________%	________%
Accounts Payable	________%	________%	________%
Current portion of long-term debt	________%	________%	________%
Income taxes payable	________%	________%	________%
Other Current liabilities	________%	________%	________%
TOTAL CURRENT LIABILITIES	________%	________%	________%
Deferred Income	________%	________%	________%
Long-term debt	________%	________%	________%
Other liabilities	________%	________%	________%

B. List each operating expense; calculate the percentage of net revenues reflected by each operating expense.

	Year 1	Year 2	Ind. Avg.
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%
________________________	________%	________%	________%

STEP 6. CALCULATE PROFITABILITY RATIOS

1. Compute Return on Assets

$$\frac{\text{Net Income}}{\text{Total Assets}} = \text{Return on Assets}$$

- *This ratio gives an indication of how efficiently an entity uses its assets to generate net income. A higher return on assets indicates greater efficiency.*

YEAR 1	YEAR 2	INDUSTRY AVG.
____________	____________	____________

2. Compute Return on Sales

$$\frac{\text{Net Income}}{\text{Net Sales}} = \text{Return on Sales}$$

- *This ratio gives an indication of the profitability of the entity by revealing the portion of each dollar of sales remains after all expenses are paid. A higher return on assets indicates a more profitable entity.*

YEAR 1	YEAR 2	INDUSTRY AVG.
____________	____________	____________

3. Compute Return on Equity

$$\frac{\text{Net Income}}{\text{Net Equity}} = \text{Return on Equity}$$

- ***This ratio gives an indication of how efficiently an entity utilizes the equity provided to it by its owners. Entities that have higher debt to equity ratios should generate higher returns on equity than others.***

YEAR 1	YEAR 2	INDUSTRY AVG.
____________	____________	____________
____________	____________	____________

STEP 7. CALCULATE SOLVENCY/LIQUIDITY RATIOS

1. Compute the Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \text{Current Ratio}$$

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

See Step 1 for detailed discussion of the Current Ratio

2. Compute the Quick Ratio

$$\frac{\text{Cash + A/R + [Marketable Secur.]}}{\text{Current Liabilities}} = \text{Quick Ratio}$$

- ***The Quick Ratio measures the relationship between the most liquid assets of the enterprise and current liabilities. Quick assets include cash and accounts receivable. Where significant, marketable securities will also be included. The Quick Ratio should be evaluated in light of the Current Ratio. Large differences are attributable to the amounts of inventory and prepaid assets which are included in the computation of the Current Ratio, but which are not considered quick assets.***

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

3. Compute the Debt to Equity Ratio

$$\frac{\textbf{Total Liabilities}}{\textbf{Total Equity}} = \textbf{Debt to Equity Ratio}$$

- *The higher the Debt/Equity Ratio, the more the entity is dependent upon borrowed funds to finance its operations. Higher Debt/Equity ratios generally mean higher amounts of interest to be paid and higher risk that a downturn in operations may affect creditors ability to collect amounts due. The wisdom of maintaining a high Debt/Equity depends on the ability of the enterprise to earn with borrowed funds. If the Return on Assets is greater than the interest rate charged to borrow, the enterprise is using debt effectively to finance additional profitable operations.*

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	____________	____________

4. Compute the Fixed Assets to Equity Ratio

$$\frac{\textbf{Total Fixed Assets}}{\textbf{Total Equity}} = \textbf{Fixed Assets to Equity}$$

- *This ratio indicates the extent to which the entity has used its equity capital to purchase fixed assets. To a certain extent, this ratio indicates the likelihood that equity holders can be repaid their full equity investment in a liquidation scenario. Generally, a lower ratio is more desirable.*

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	____________	____________

STEP 8. CALCULATE EFFICIENCY RATIOS

1. Compute the Receivables Collection Period

$$\frac{\text{Accounts Receivable}}{\text{Credit Sales}} \times 365 = \text{Collection Period}$$

- *The Receivables Collection Period indicates the number of days required, on average, to collect an account receivable. The shorter the period, the more efficiently the entity collects its accounts receivable. If information on Credit Sales is not available, Net Sales can used.*

YEAR 1	YEAR 2	IND. AVG.
___________	____________	____________
____________	______________	______________

2. Compute Inventory Turnover

$$\frac{\text{Sales}}{\text{Inventory}} = \text{Inventory Turnover}$$

- ***Inventory turnover indicates how efficiently an entity utilizes its inventory to generate profits and cash flow. Generally, a higher inventory turnover is better, but too much inventory turnover can indicate that not enough inventory is kept on hand which can also adversely affect profits.***

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	____________	____________

3. Compute Assets to Sales

$$\frac{\text{Total Assets}}{\text{Net Sales}} = \text{Assets to Sales}$$

- *An entity which generates a low assets to sales ratio is utilizing its assets effectively to generate sales revenue. In evaluating this ratio, one should also pay attention to return on sales, to avoid the problem of 'going broke on volume'.*

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

4. Compute Accounts Payable to Sales

$$\frac{\text{Accounts Payable}}{\text{Sales}} = \text{Accounts Payable to Sales}$$

- *This ratio gives an idea of how much the entity uses low cost "trade credit" to finance its operations. Too much dependence on trade credit can be a problem, if relationships with suppliers are abused and credit becomes unavailable.*

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

STEP 9. CALCULATE INVESTMENT PERFORMANCE MEASURES

1. Compute Price/Earnings Ratio

$$\frac{\textbf{Market Price per Share}}{\textbf{Earnings per Share}} = \textbf{Price/Earnings Ratio}$$

- *The Price/Earnings ratio is one of the key market statistics. The higher the ratio, the greater the expectations of the market for the future prospects of the entity. The "P/E Ratio" should be compared to other members of the same industry in order to understand the relative position of the entity as compared to its peers.*

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

2. Compute Earnings Per Share

$$\frac{\textbf{Net Income}}{\textbf{Number of Common Shares Outstanding}} = \textbf{Earnings per Share}$$

- ***Earnings per share is another closely followed statistic. "EPS" is not comparable between entities because each entity sets its own capital structure, particularly the number of common shares outstanding. Earnings per share can, however, be compared to prior years' earnings per share to see how the profitability of the entity is changing over time. Fully diluted earnings per share is a concept which assumes that all convertible debt instruments have been converted to common shares.***

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

3. Compute Return on Investment

$$\frac{\textbf{Cash dividend + Change in Mkt. Value}}{\textbf{Initial Investment}} = \textbf{ROI}$$

- ***Return on Investment is the key measure of investment performance of the entity. This figure is compared by investors to other investments available in the marketplace to evaluate the attractiveness of an investment in the common stock of this entity.***

YEAR 1	YEAR 2	INDUSTRY AVG.
___________	___________	___________

4. Compute Market Value of Entity

$$\frac{\text{Average Net Income of Entity}}{\text{Industry Capitalization Rate}} = \text{Market Value}$$

-OR-

EBITDA x Multiple = Market Value

- *This formula provides a short-hand way to calculate the market value of any entity. In this formula average net income is divided by an capitalization rate which is determined by reference to the risk inherent in an investment in the industry. By way of reference, federally insured securities are the lowest risk investments in the market. The current rate paid on those securities sets a floor for capitalization rates; yield on "junk bonds" might set the ceiling. The correct industry capitalization rate is one which compensates for the risk inherent in this investment.*

- *EBITDA is an acronym for Earnings Before Interest, Taxes, Depreciation and Amortization and is designed to be a uniform calculation of estimated cash flow that can be relied upon in computing market value.*

  It is computed by increasing GAAP net income by the expenses in the income statement associated with: (i) interest expense; (ii) income taxes; (iii) depreciation expense and (iv) amortization expense. Adding back non-cash items (depreciation and amortization) helps to convert GAAP net income into a cash basis number. Adding back interest expense smooths the differences in reported profits between entities that utilize differing amounts of debt (which has expense) and equity (which does not) in their capital structures. Adding back income tax expense helps eliminate both historical differences (such as expense reductions associated with past tax losses) and regional differences in tax structure.

STEP 10. DRAW CONCLUSIONS

1. Items of Significance

A.____

B.____

C.____

D.____

E.____

2. Items for Further Review

A.____

B.____

C.____

D.____

E.____

3. Qualitative Analysis

A. Profitability

1.	Return on Assets	--/-/0/+/++
2.	Return on Sales	--/-/0/+/++
3.	Return on Equity	--/-/0/+/++

B. Solvency/Liquidity

1.	Current Ratio	--/-/0/+/++
2.	Quick Ratio	--/-/0/+/++
3.	Debt to Equity Ratio	--/-/0/+/++
4.	Fixed Assets/Equity Ratio	--/-/0/+/++

C. Efficiency Ratios

1.	Receivables Collection	--/-/0/+/++
2.	Inventory Turnover	--/-/0/+/++
3.	Assets to Sales	--/-/0/+/++
4.	Accounts Payable to Sales	--/-/0/+/++

WINNING NUMBERS

FIVE-MINUTE FINANCIAL STATEMENT ANALYSIS SHORTCUT

1. **Order DNB Credit Advisor Report**

2. **Get the Big Picture**

3. **Do the Scan**

4. **Compute the Following Ratios**

   a. **Debt/Equity**
   b. **Return on Sales**
   c. **Return on Equity**

5. **Read the Notes to the Financial Statements**

NAUTILUS RESTAURANT, INC.
STATEMENT OF INCOME
FOR THE YEARS ENDED
DECEMBER 31,

	20X1	20X2	IND. AVG.
Sales	$ 1,325,000	$ 1,450,000	$ 1,203,416
Less: Cost of Food	572,000	835,000	605,318
Gross Profit	753,000	615,000	598,098
Payroll	198,750	174,000	
Depreciation	13,000	23,000	
Utilities	145,000	174,000	
Advertising	217,500	116,000	
Maintenance	14,500	36,250	
Total Operating Expenses	588,750	523,250	473,098
Operating Income	164,250	91,750	125,000
Interest Expense	9,000	18,000	
Charitable Gifts	50,000	25,000	
Legal Expenses	25,000	7,750	
Extraordinary Item	20,625	-	
Total Other Expenses	104,625	50,750	85,287
Net Income	59,625	41,000	39,713

NAUTILUS RESTAURANT, INC.
BALANCE SHEET
AS OF
DECEMBER 31,

	20X1	20X2	IND. AVG.
Cash	$ 57,500	$ 62,000	$ 55,184
Accounts Receivable	16,200	33,000	14,318
Notes Receivable	-	-	2,685
Inventory	18,000	36,000	22,074
Other Current Assets	14,000	20,000	16,406
Total Current Assets	105,700	151,000	110,667
Fixed Assets	148,000	263,204	118,422
Other Non-Current Assets	55,000	53,000	69,204
Total Assets	308,700	467,204	298,293
Accounts Payable	27,800	47,700	28,636
Current Portion of Long-term debt	3,000	15,000	298
Notes Payable	6,000	3,000	10,440
Other Current Liabilities	51,000	46,500	49,815
Total Current Liabilities	87,800	112,200	89,189
Other Long-term debt	85,000	161,104	66,818
Deferred Liabilities			597
Total Liabilities	172,800	273,304	156,604
Stockholders' Equity	135,900	193,900	141,689
Total Liabilities and Equity	308,700	467,204	298,293

SECTION 6: PRESENT VALUE ANALYSIS

6.1 Discounting: Computing the Value Today of Amounts to be Received in the Future

Compounding involves computing the amount which will be present in the future as a result of an investment made today. In contrast, **discounting** involves the calculation of what a dollar to be received in the future is worth today.

Assume that $1,000 is invested in a bank certificate of deposit on January 1, 20X1. The certificate pays 10% interest which is compounded annually. The following time line illustrates the effects of compounding of interest.

```
$1,000 --------------> $1,100 -------------> $1,210 -------------> $1,331

1/1/X1                 1/1/X2                 1/1/X3               1/1/X4

  [Interest earned $100]  [Interest earned $110]   [Interest earned $121]
     ($1000 x 0.10)           ($1100 x 0.10)           ($1200 x 0.10)
```

Assume that $1,000 is invested in a bank certificate of deposit on January 1, 20X1. The certificate pays 10% interest which is compounded semi-annually. The following time line illustrates the effects of compounding of interest.

```
$1,000 ------------> $1,050 -----------> $1,102.50 -----------> $1,157.63

1/1/X1               7/1/X1                1/1/X2                7/1/X2

[Interest earned $100]  [Interest earned $52.50]  [Interest earned $55.13]
 ($1000 x 0.10 x 6/12)   ($1050 x 0.10 x 6/12)    ($1102.50 x 0.10 x 6/12)
```

Discounting is the reverse of compounding. Discounting assumes that dollars received in the future are worth less than dollars received now because interest could be made on a dollar possessed today. Discounting, then, can be viewed as answering the question: what is a dollar received in the future worth to me today? In other words, discounting gives the **present value** of $1 to be received some time in the future.

The table below reverses the initial time line which demonstrated the concept of compounding. The table illustrates that $1,331 received three years from now is equal in

value to $1,000 received today, if one assumes that the $1,000 could be invested over that time at a 10% interest rate.

Assume that on January 1, 20X1 someone agrees to pay you $1,331 at the end of three years. How much is this right worth to you on January 1, 20X1. The following time line illustrates the concept of discounting.

```
$1,000 <------------ $1,100 <--------------- $1,210 <-------------- $1,331

1/1/X1               1/1/X2                   1/1/X3                 1/1/X4

[Interest earned:  $100] [Interest earned: $110] [Interest earned: $121]
   ($1000 x 0.10)            ($1100 x 0.10)          ($1200 x 0.10)
```

The table below, the discounted value table, provides a short-hand vehicle for computing the value of discounted cash flows.

1) Identify the relevant interest rate. (The rate which you could invest the money at if you had the money now.)

2) Determine the number of periods into the future when the money will be received.

3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant number of discounting periods to find the discounting factor.

4) Multiply the discounting factor found at the intersection by the amount to be received in the future to determine what that amount is worth to you today.

The table below contains a portion of the discounting table and an example of its use.

DISCOUNTED OR PRESENT VALUE OF $1

Number of periods	*3%*	*6 %*	*8 %*	*10 %*	*16 %*
	Annual interest rate				
1	.97087	.94349	.92593	.90909	.86207
2	.94260	.89000	.85734	.82645	.74316
3	.91514	.83962	.79383	.75131	.64066
4	.88849	.79209	.73503	.68301	.55229
5	.86261	.74726	.68057	.62092	.47611

Assume that your employer offers to pay you a $2,000 bonus two years from now and that you can earn 8% on your invested money during the interim period. What is that bonus worth to you today?

1) Identify the relevant interest rate. (The rate which you could invest the money at if you had the money now.)

8 %

2) Determine the number of periods into the future when the money will be received.

2

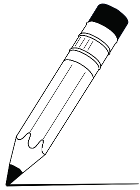
3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant number of discounting periods to find the discounting factor.

.85734

4) Multiply the discounting factor found at the intersection by the amount to be received in the future to determine what that amount is worth to you today.

.85734 x $2,000 = $1724.68

Take notice of two interesting factors revealed from the Discounting Table. The factors decrease as you go down any of the interest columns. This reiterates the time value of money. A dollar received today is worth more than a dollar received two years from now which is worth more than a dollar received five years from now. Also notice that the factors decrease as you read across the table for any particular discounting period. This reinforces the strength of interest rates. The more one can earn on invested money, the greater the time value of money and the greater the discount which must be applied if the money is not available to you to invest!



6.1.1 Exercise: What is the Present Value of a Lump Sum to be Received (or Paid) in the Future?

GEMSPEED has been involved in a trademark infringement lawsuit with GUMMY LUBE, INC. which offers a product that restores the freshness to chewing gum within 30 minutes. GUMMY LUBE has offered GEMSPEED two settlement options: (1) receive $500,000 today or (2) receive $750,000 three years from now.

1) Assume GEMSPEED can earn 6 % on its invested funds. Which offer should GEMSPEED accept?

2) Assume GEMSPEED can earn 16 % on its invested funds. Which offer should GEMSPEED accept?

DISCOUNTED OR PRESENT VALUE OF $1

Annual interest rate

Number of periods	*3*%	*6* %	*8* %	*10* %	*16* %
1	.97087	.94349	.92593	.90909	.86207
2	.94260	.89000	.85734	.82645	.74316
3	.91514	.83962	.79383	.75131	.64066
4	.88849	.79209	.73503	.68301	.55229
5	.86261	.74726	.68057	.62092	.47611

Work area:

Solution:

Problem 1) GEMSPEED can accept $500,000 today or $750,000 three years from now. GEMSPEED can earn 6% on its invested funds in the interim. Which offer should GEMSPEED accept?

1) Identify the relevant interest rate. (The rate which GEMSPEED could invest the money at if you had the money now.)

6 %

2) Determine the number of periods into the future when the money will be received.

3

3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant number of discounting periods to find the discounting factor.

.83962

4) Multiply the discounting factor found at the intersection by the amount to be received in the future to determine what that amount is worth to GEMSPEED today.

.83962 x $750,000 = $ 629,715.00

(GEMSPEED should accept the offer to be paid the $750,000 in three years. This assumes, of course, that GEMSPEED can adequately ensure that the funds will be paid in three years!)

Problem 2) Same options but now GEMSPEED can earn 16% on its invested funds in the interim. Which offer should GEMSPEED accept?

1) Identify the relevant interest rate. (The rate which GEMSPEED could invest the money at if you had the money now.)

16 %

2) Determine the number of periods into the future when the money will be received.

3

3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant number of discounting periods to find the discounting factor.

.64066

4) Multiply the discounting factor found at the intersection by the amount to be received in the future to determine what that amount is worth to GEMSPEED today.

.64066 x $750,000 = $ 480,495.00

(GEMSPEED should accept the offer to be paid the $500,000 now).

6.1.2 Discounting Multiple Cash Flows

The Discounting Table can also be used to calculate the present value of multiple cash flows which are received over a several year period. In these cases a separate discounting factor is applied to determine the present value of each cash flow. These present values are then added together to determine the present value of the multiple cash flows. In essence, a scenario with multiple cash flows is simply a series of single cash flow discounting problems which are added together to get a total present value.

The Discounting Table can be used to calculate the present value of multiple future cash flows by performing the following steps.

1) Identify the relevant interest rate. (The rate which the money could be invested if the money were on hand today.)

2) Determine the discounting period in which each cash flow will be received.

3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant discounting period to find the discounting factor to be used to discount each of the multiple cash flows.

4) Multiply the discounting factor found at the intersection by the future cash flow to determine the present value of that particular cash flow.

5) Add the present values together to compute the total present value of the cash flows.

The following table contains a portion of the Discounting Table and an example of how to apply the discounting table to multiple cash flows.

DISCOUNTED OR PRESENT VALUE OF $1

Number of periods	*Annual interest rate* 3%	6 %	8 %	10 %	16 %
1	.97087	.94349	.92593	.90909	.86207
2	.94260	.89000	.85734	.82645	.74316
3	.91514	.83962	.79383	.75131	.64066
4	.88849	.79209	.73503	.68301	.55229
5	.86261	.74726	.68057	.62092	.47611

Assume that your insurance company offers to settle a claim by paying you $80,000 in the following manner: $15,000 at the end of one year, $25,000 at the end of the second year and $40,000 at the end of the third year. Also assume that you can earn 8 % on your invested money. What is this arrangement worth to you today?

1) Identify the relevant interest rate. (The rate which the money could be invested if the money were on hand today.)

8 %

2) Determine the discounting period in which each cash flow will be received.

Year 1	$15,000
Year 2	25,000
Year 3	40,000

3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant discounting period to find the discounting factor to be used to discount each of the multiple cash flows.

Year 1	.92593
Year 2	.85734
Year 3	.79383

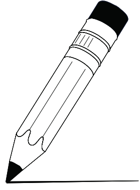
4) Multiply the discounting factor found at the intersection by the future cash flow to determine the present value of that particular cash flow.

Year 1	$15,000	x	.92593	=	$13,888.95
Year 2	25,000	x	.85734	=	21,433.50
Year 3	40,000	x	.79383	=	31,753.20

5) Add the present values together to compute the total present value of the cash flows.

$13,888.95
21,433.50
31,753.20

$67,075.65
==========



6.1.3 Exercise: What is the Present Value of a Series of Payments to be Received (or Paid) in the Future?

GUMMY LUBE has revised its previous settlement offer and presented GEMSPEED with two settlement options: (1) receive $600,000 today or (2) receive $300,000 one year from now; $250,000 two years from now and $175,000 three years from now.

1) Assume GEMSPEED can earn 8 % on its invested funds. Which offer should GEMSPEED accept?

DISCOUNTED OR PRESENT VALUE OF $1

Number of periods	Annual interest rate 3%	6 %	8 %	10 %	16 %
1	.97087	.94349	.92593	.90909	.86207
2	.94260	.89000	.85734	.82645	.74316
3	.91514	.83962	.79383	.75131	.64066
4	.88849	.79209	.73503	.68301	.55229
5	.86261	.74726	.68057	.62092	.47611

Work area:

Solution:

Problem 1) GEMSPEED can accept $600,000 today or $300,000 one year from today, $250,000 two years from today and $175,000 three years from today. Under Scenario A, GEMSPEED can earn 6% on its invested funds in the interim, while under Scenario B GEMSPEED can earn 16 %. Which offer should GEMSPEED accept?

1) Identify the relevant interest rate. (The rate which the money could be invested if the money were on hand today.)

Scenario A: 6 % Scenario B: 16 %

2) Determine the discounting period in which each cash flow will be received.

Year 1	$300,000
Year 2	250,000
Year 3	175,000

3) Enter the table in the relevant interest rate column and proceed to the intersection of that column with the relevant discounting period to find the discounting factor to be used to discount each of the multiple cash flows.

	Scenario A	Scenario B
Year 1	.94349	.86207
Year 2	.89000	.74316
Year 3	.83962	.64066

4) Multiply the discounting factor found at the intersection by the future cash flow to determine the present value of that particular cash flow.

Scenario A:	Scenario B:
$300,000 x .94349 = $283,047.00	$300,000 x .86207 = $258,621.00
250,000 x .89000 = 222,500.00	250,000 x .74316 = 185,790.00
175,000 x .83962 = 146,933.50	175,000 x .64066 = 112,115.50

5) Add the present values together to compute the total present value of the cash flows.

Scenario A:	Scenario B:
$283,047.00	$258,621.00
222,500.00	185,790.00
146,933.50	112,115.50
----------	----------
$652,480.50	$556,526.50
==========	==========

Conclusion: Under Scenario A, GEMSPEED should accept the stream of payments. Under Scenario B, however, the interest that would be lost is so significant that GEMSPEED should accept the $600,000 upfront payment and invest it at the 16% rate!

Compounding Interest Rate

Number of Periods	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	17%	18%	19%	
1	1.01000	1.02000	1.03000	1.04000	1.05000	1.06000	1.07000	1.08000	1.09000	1.10000	1.11000	1.12000	1.13000	1.14000	1.15000	1.16000	1.17000	1.18000	1.19000	1
2	1.02010	1.04040	1.06090	1.08160	1.10250	1.12360	1.14490	1.16640	1.18810	1.21000	1.23210	1.25440	1.27690	1.29960	1.32250	1.34560	1.36890	1.39240	1.41610	1
3	1.03030	1.06121	1.09273	1.12486	1.15763	1.19102	1.22504	1.25971	1.29503	1.33100	1.36763	1.40493	1.44290	1.48154	1.52088	1.56090	1.60161	1.64303	1.68516	1
4	1.04060	1.08243	1.12551	1.16986	1.21551	1.26248	1.31080	1.36049	1.41158	1.46410	1.51807	1.57352	1.63047	1.68896	1.74901	1.81064	1.87389	1.93878	2.00534	2
5	1.05101	1.10408	1.15927	1.21665	1.27628	1.33823	1.40255	1.46933	1.53862	1.61051	1.68506	1.76234	1.84244	1.92541	2.01136	2.10034	2.19245	2.28776	2.38635	2
6	1.06152	1.12616	1.19405	1.26532	1.34010	1.41852	1.50073	1.58687	1.67710	1.77156	1.87041	1.97382	2.08195	2.19497	2.31306	2.43640	2.56516	2.69955	2.83976	2
7	1.07214	1.14869	1.22987	1.31593	1.40710	1.50363	1.60578	1.71382	1.82804	1.94872	2.07616	2.21068	2.35261	2.50227	2.66002	2.82622	3.00124	3.18547	3.37932	3
8	1.08286	1.17166	1.26677	1.36857	1.47746	1.59385	1.71819	1.85093	1.99256	2.14359	2.30454	2.47596	2.65844	2.85259	3.05902	3.27841	3.51145	3.75886	4.02139	4
9	1.09369	1.19509	1.30477	1.42331	1.55133	1.68948	1.83846	1.99900	2.17189	2.35795	2.55804	2.77308	3.00404	3.25195	3.51788	3.80296	4.10840	4.43545	4.78545	5
10	1.10462	1.21899	1.34392	1.48024	1.62889	1.79085	1.96715	2.15892	2.36736	2.59374	2.83942	3.10585	3.39457	3.70722	4.04556	4.41144	4.80683	5.23384	5.69468	6
11	1.11567	1.24337	1.38423	1.53945	1.71034	1.89830	2.10485	2.33164	2.58043	2.85312	3.15176	3.47855	3.83586	4.22623	4.65239	5.11726	5.62399	6.17593	6.77667	7
12	1.12683	1.26824	1.42576	1.60103	1.79586	2.01220	2.25219	2.51817	2.81266	3.13843	3.49845	3.89598	4.33452	4.81790	5.35025	5.93603	6.58007	7.28759	8.06424	8
13	1.13809	1.29361	1.46853	1.66507	1.88565	2.13293	2.40985	2.71962	3.06580	3.45227	3.88328	4.36349	4.89801	5.49241	6.15279	6.88579	7.69868	8.59936	9.59645	10
14	1.14947	1.31948	1.51259	1.73168	1.97993	2.26090	2.57853	2.93719	3.34173	3.79750	4.31044	4.88711	5.53475	6.26135	7.07571	7.98752	9.00745	10.14724	11.41977	12
15	1.16097	1.34587	1.55797	1.80094	2.07893	2.39656	2.75903	3.17217	3.64248	4.17725	4.78459	5.47357	6.25427	7.13794	8.13706	9.26552	10.53872	11.97375	13.58953	15
16	1.17258	1.37279	1.60471	1.87298	2.18287	2.54035	2.95216	3.42594	3.97031	4.59497	5.31089	6.13039	7.06733	8.13725	9.35762	10.74800	12.33030	14.12902	16.17154	18
17	1.18430	1.40024	1.65285	1.94790	2.29202	2.69277	3.15882	3.70002	4.32763	5.05447	5.89509	6.86604	7.98608	9.27646	10.76126	12.46768	14.42646	16.67225	19.24413	22
18	1.19615	1.42825	1.70243	2.02582	2.40662	2.85434	3.37993	3.99602	4.71712	5.55992	6.54355	7.68997	9.02427	10.57517	12.37545	14.46251	16.87895	19.67325	22.90052	26
19	1.20811	1.45681	1.75351	2.10685	2.52695	3.02560	3.61653	4.31570	5.14166	6.11591	7.26334	8.61276	10.19742	12.05569	14.23177	16.77652	19.74838	23.21444	27.25162	31
20	1.22019	1.48595	1.80611	2.19112	2.65330	3.20714	3.86968	4.66096	5.60441	6.72750	8.06231	9.64629	11.52309	13.74349	16.36654	19.46076	23.10560	27.39303	32.42942	38

Discounting Interest Rate

Number of Periods	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	11%	12%	13%	14%	15%	16%	17%	18%	19%	
1	0.99010	0.98039	0.97087	0.96154	0.95238	0.94340	0.93458	0.92593	0.91743	0.90909	0.90090	0.89286	0.88496	0.87719	0.86957	0.86207	0.85470	0.84746	0.84034	0
2	0.98030	0.96117	0.94260	0.92456	0.90703	0.89000	0.87344	0.85734	0.84168	0.82645	0.81162	0.79719	0.78315	0.76947	0.75614	0.74316	0.73051	0.71818	0.70616	0
3	0.97059	0.94232	0.91514	0.88900	0.86384	0.83962	0.81630	0.79383	0.77218	0.75131	0.73119	0.71178	0.69305	0.67497	0.65752	0.64066	0.62437	0.60863	0.59342	0
4	0.96098	0.92385	0.88849	0.85480	0.82270	0.79209	0.76290	0.73503	0.70843	0.68301	0.65873	0.63552	0.61332	0.59208	0.57175	0.55229	0.53365	0.51579	0.49867	0
5	0.95147	0.90573	0.86261	0.82193	0.78353	0.74726	0.71299	0.68058	0.64993	0.62092	0.59345	0.56743	0.54276	0.51937	0.49718	0.47611	0.45611	0.43711	0.41905	0
6	0.94205	0.88797	0.83748	0.79031	0.74622	0.70496	0.66634	0.63017	0.59627	0.56447	0.53464	0.50663	0.48032	0.45559	0.43233	0.41044	0.38984	0.37043	0.35214	0
7	0.93272	0.87056	0.81309	0.75992	0.71068	0.66506	0.62275	0.58349	0.54703	0.51316	0.48166	0.45235	0.42506	0.39964	0.37594	0.35383	0.33320	0.31393	0.29592	0
8	0.92348	0.85349	0.78941	0.73069	0.67684	0.62741	0.58201	0.54027	0.50187	0.46651	0.43393	0.40388	0.37616	0.35056	0.32690	0.30503	0.28478	0.26604	0.24867	0
9	0.91434	0.83676	0.76642	0.70259	0.64461	0.59190	0.54393	0.50025	0.46043	0.42410	0.39092	0.36061	0.33288	0.30751	0.28426	0.26295	0.24340	0.22546	0.20897	0
10	0.90529	0.82035	0.74409	0.67556	0.61391	0.55839	0.50835	0.46319	0.42241	0.38554	0.35218	0.32197	0.29459	0.26974	0.24718	0.22668	0.20804	0.19106	0.17560	0
11	0.89632	0.80426	0.72242	0.64958	0.58468	0.52679	0.47509	0.42888	0.38753	0.35049	0.31728	0.28748	0.26070	0.23662	0.21494	0.19542	0.17781	0.16192	0.14757	0
12	0.88745	0.78849	0.70138	0.62460	0.55684	0.49697	0.44401	0.39711	0.35553	0.31863	0.28584	0.25668	0.23071	0.20756	0.18691	0.16846	0.15197	0.13722	0.12400	0
13	0.87866	0.77303	0.68095	0.60057	0.53032	0.46884	0.41496	0.36770	0.32618	0.28966	0.25751	0.22917	0.20416	0.18207	0.16253	0.14523	0.12989	0.11629	0.10421	0
14	0.86996	0.75788	0.66112	0.57748	0.50507	0.44230	0.38782	0.34046	0.29925	0.26333	0.23199	0.20462	0.18068	0.15971	0.14133	0.12520	0.11102	0.09855	0.08757	0
15	0.86135	0.74301	0.64186	0.55526	0.48102	0.41727	0.36245	0.31524	0.27454	0.23939	0.20900	0.18270	0.15989	0.14010	0.12289	0.10793	0.09489	0.08352	0.07359	0
16	0.85282	0.72845	0.62317	0.53391	0.45811	0.39365	0.33873	0.29189	0.25187	0.21763	0.18829	0.16312	0.14150	0.12289	0.10686	0.09304	0.08110	0.07078	0.06184	0
17	0.84438	0.71416	0.60502	0.51337	0.43630	0.37136	0.31657	0.27027	0.23107	0.19784	0.16963	0.14564	0.12522	0.10780	0.09293	0.08021	0.06932	0.05998	0.05196	0
18	0.83602	0.70016	0.58739	0.49363	0.41552	0.35034	0.29586	0.25025	0.21199	0.17986	0.15282	0.13004	0.11081	0.09456	0.08081	0.06914	0.05925	0.05083	0.04367	0
19	0.82774	0.68643	0.57029	0.47464	0.39573	0.33051	0.27651	0.23171	0.19449	0.16351	0.13768	0.11611	0.09806	0.08295	0.07027	0.05961	0.05064	0.04308	0.03670	0
20	0.81954	0.67297	0.55368	0.45639	0.37689	0.31180	0.25842	0.21455	0.17843	0.14864	0.12403	0.10367	0.08678	0.07276	0.06110	0.05139	0.04328	0.03651	0.03084	0

SECTION 7: ACCOUNTANTS' REPORTS

7.1 Practical Illustration: Standard Form of Audit Opinion

The following illustrates the standard from of accountants' report on financial statements which have been audited.

Looke, Good and Hard, C.P.A.'s
123 Able Street
Any town, USA

To the Board of Directors of XYZ, Inc.:

We have audited the accompanying balance sheet of XYZ, Inc. as of December 31, 20XX and the related statements of income, retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express on opinion on these financial statements based on our audit.

We conducted our audit in conformance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. 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 audit provides 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 XYZ, Inc. as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles in the United States.

[Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules presented are for the purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.]

[Signature]
[Date]

The audit represents the highest level of examination that an accountant can provide. Note the following items of significance in the standard form of report (the language of which is dictated by accounting standards):

1. **The financial statements are prepared by management not the accountants.**

   The report points out that the financial statements are the responsibility of management, not the accountants. This is technically correct: management prepares the statements and the accountants audit them. In reality, the accountants prepare the statements for management sign-off.

2. **The report stresses that an audit relies upon examinations on a test basis (statistical sampling).**

   Not every transaction undertaken by an entity is reviewed in an audit.

3. **Inherent in an audit is the concept of materiality.**

   This point is closely tied to Point 2, above. Auditors concentrate on those items which will have a significant impact on the financial statements. The materiality threshold forms the basis for the desire to obtain the auditors' workpapers when examining or litigating over financial statements. Although an item might not be material (and therefore not included in the financial statements), the auditors may have discovered evidence of a pattern of fraudulent misdealing. Along a similar vein, these workpapers may document management "talking out of both sides of its mouth" by characterizing a transaction one way to the auditors and another to stockholders or creditors.

4. **All standard audits are conducted in accordance with Generally Accepted Auditing Standards and are designed to examine statements for their compliance with Generally Accepted Accounting Principles.**

   Generally Accepted Auditing Standards are the rules by which auditors conduct audits. These rules are promulgated by the AICPA (for non-public reporting enterprise) and the Public Company Accounting Oversight Board (established by the Sarbanes-Oxley Act of 2002) to oversee the auditors of public companies.

   A good overview of GAAS is available at:

   http://www.aicpa.org/download/members/div/auditstd/au-00150.pdf

5. **The date of the report is the date on which the auditors end their field work. It is not the date the report was delivered.**

6. **As a general matter, if financial statements are to be relied upon in a significant transaction, it is best to obtain (or require) an audit of the statements to be performed!**

The Ten Auditing Standards

General Standards

1. The auditor must have adequate technical training and proficiency to perform the audit.

2. The auditor must maintain independence in mental attitude in all matters relating to the audit.

3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The auditor must adequately plan the work and must properly supervise any assistants.

2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

3. The auditor must obtain sufficient appropriate1 audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

7.2 Practical Illustration: Standard Form of Review Report

The following illustrates the standard from of accountants' report on financial statements which have been reviewed. A review is an intermediate form of examination which does not have the same scope of review as does an audit. A review should not be utilized when thrid party reliance on the financial statements is required.

Looke, Good and Hard, C.P.A.'s
123 Able Street
Anytown, USA

To the Board of Directors of XYZ, Inc.:

We have reviewed the accompanying balance sheet of XYZ, Inc. as of December 31, 20XX and the related statements of income, retained earnings and cash flows for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information contained in these financial statements is the representation of the management of XYZ, Inc.

A review consists primarily of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, 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 generally accepted accounting principles.

[Signature]
[Date]

7.3 Practical Illustration: Standard Form of Compilation Report

The following illustrates the standard from of accountants' report on financial statements which have been compiled. A compilation is the lowest form of service an accountant can provide. Compilations, as described in the report, involve little more than summarizing financial information provided by mangement into financial statement format. Compiled financial statements should be used for internal purposes only.

Looke, Good and Hard, C.P.A.'s
123 Able Street
Anytown, USA

To the Board of Directors of XYZ, Inc.:

We have compiled the accompanying balance sheet of XYZ, Inc. as of December 31, 20XX and the related statements of income, retained earnings and cash flows for the year then ended, in accordance with standards established by the American Institute of Certified Public Accountants. All information contained in these financial statements is the representation of the management of XYZ, Inc.

A compilation is limited to presenting, in the form of financial statements, information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

[Signature]
[Date]

7.4 Practical Illustration: The Assembly

Some states have authorized a new level of service which resides below the compilation on the ladder of service. This lowest level of service is known as an “assembly”. Its premise is that the accountant merely assembled in the information in the financial statements without providing any report or comment. Most statutes provide that an assembly, by definition, occurs for the benefit of management and, therefore, cannot be relied upon by a third party. These limitations were designed to enable accountants to provide some form of financial statement service without risk of liability to third parties who may come in contact with the financial statements examined by the accountant.

Invitation for Questions/Comments

If you have any questions, comments or suggestions, please do not hesitate to contact me. I welcome the opportunity to help you think through accounting issues or problems. And, I am always looking for ways to improve my presentation and materials.

Thanks for coming today! I look forward to hearing from you.

JOHN E. MOORE
Law Offices of John E. Moore, III
3240 Cardinal Drive, Suite 200
Vero Beach, FL 32963
(772) 234-8344 (o)
jmoore@moorelawvero.com

The Ten Auditing Standards

General Standards

1. The auditor must have adequate technical training and proficiency to perform the audit.

2. The auditor must maintain independence in mental attitude in all matters relating to the audit.

3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The auditor must adequately plan the work and must properly supervise any assistants.

2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

3. The auditor must obtain sufficient appropriate1 audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

AICPA's Financial Reporting Framework for Small- and Medium-Sized Entities:

Frequently Asked Questions

1. What is the Financial Reporting Framework for Small- and Medium-Sized Entities?

All financial statements are prepared in accordance with a financial reporting framework. The term *financial reporting framework* is defined as a set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements. Examples of financial reporting frameworks are generally accepted accounting principles (GAAP) in the United States of America, International Financial Reporting Standards (IFRSs), and special purpose frameworks (also known as other comprehensive bases of accounting [OCBOA]).

The Financial Reporting Framework for Small- and Medium-sized Entities (FRF for SMEs) is a self-contained special purpose framework intended for use by privately held small-to-medium-sized entities (SMEs) in preparing their financial statements. The FRF for SMEs draws upon a blend of traditional methods of accounting with some accrual income tax methods. The framework is being developed by a working group of CPA professionals and AICPA staff who have years of experience serving smaller-to-medium-sized private entities. The FRF for SMEs has been exposed for public comment to solicit broad stakeholder input. The AICPA expects to issue the final framework in the first half of 2013.

2. What is a SME?

SMEs pervade the business world in virtually every jurisdiction, from the largest economies to the smallest. In terms of sheer numbers the segment is sizeable. Estimates put the number of SMEs in the United States at approximately 20 million.[1] They are active in every industry group and involved in providing goods and services in a wide-ranging set of activities. There is no standard definition of a SME in the United States and the AICPA does not define the term either.

3. Why would SMEs use the FRF for SMEs?

The FRF for SMEs will be a less complicated and less costly system of accounting for SMEs that are not required to produce U.S. GAAP-based financial statements. The FRF for SMEs will be a cost-beneficial solution for owner-managers and others who need financial statements that are prepared in a consistent and reliable manner in accordance with a framework that has undergone public comment and professional scrutiny. The accounting principles composing the FRF for SMEs are intended to be the most appropriate for the preparation of SME financial statements based on the needs of the financial statement users and cost-benefit considerations. Accounting principles in the FRF for SMEs will be responsive to the well documented issues and concerns stakeholders currently encounter when preparing financial statements for SMEs.

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[1] "IFRS for SMEs in Your Pocket," Deloitte, April 2010.

4. What type of entities is the FRF for SMEs intended for?

The FRF for SMEs is being developed for smaller- to medium-sized, owner-managed, for-profit entities that need reliable financial statements where internal or external users have direct access to the owner-manager and GAAP financial statements are not required. The FRF for SMEs may be used by entities in most industry groups and by unincorporated and incorporated entities.

It would be an impossible task to define conclusively the characteristics of a typical entity that would use and benefit from the FRF for SMEs. The FRF for SMEs is intended for owner-managers who rely on a set of financial statements to confirm their assessments of performance, and of what they own and what they owe, and to understand their cash flows. Often, their financial statements support applications for bank financing, when the banker does not base a lending decision solely on the financial statements but also on available collateral or other evaluation mechanisms not related to the financial statements. A majority of these owner-managers have no expectations of going public.

The AICPA has no authority to require the use of the FRF for SMEs for any entity. Therefore, the FRF for SMEs will have no effective date and an owner-manager can decide to use the FRF for SMEs once it is released. An owner-manager should make that decision in conjunction with those who may use the entity's financial statements.

5. What is meant by owner-managed entity? Is the FRF for SMEs only intended for owner-managed entities?

Owner-managed entities are closely held companies where the people who own a controlling ownership interest in the entity are substantially the same set of people who run the company—in contrast with public companies where the ownership and management are clearly separated. Owner-managed businesses represent the majority of all businesses in the United States. Often, owner-managed entities do not have a qualified CPA on staff. Rather, the owner-managers or bookkeepers maintain the entities' books and records.

The term *owner-managed* was selected to help describe the typical entity that would benefit from using the FRF for SMEs. The AICPA does not intend to scope out entities that may not be owner managed from using the FRF for SMEs. Entities that have operational management who are not the owners may find that the FRF for SMEs is an ideal choice for their financial reporting needs and circumstances.

6. Are there any entities prohibited from using the FRF for SMEs?

The AICPA cannot preclude an entity from preparing its financial statements under the FRF for SMEs. The FRF for SMEs is intended to be used by small- and medium-sized for-profit entities. Typically, the FRF for SMEs would be used by owner-managers who rely on a set of financial statements to confirm their assessments of performance, and of what they own and what they owe and the entity's cash flows.

7. What is a special purpose framework?

Special purpose frameworks include cash basis, modified cash basis, tax basis, regulatory basis, contractual basis, and other bases of accounting that utilize a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements. Special purpose frameworks, with the exception of the contractual basis of accounting, are commonly referred to as OCBOA.

By far, the tax and modified cash bases are the most frequently used special purpose frameworks today. Historically, there have been no definitive requirements for special purpose framework financial statements. Nonauthoritative guidance on special purpose framework financial statements can be found in the AICPA's Technical Questions and Answers, which are available in *Technical Practice Aids*.

8. How does the FRF for SMEs differ from other special purpose frameworks like the tax and cash bases of accounting?

Unlike the tax or cash bases of accounting, the FRF for SMEs will undergo public exposure and professional scrutiny and contain explicit and comprehensive accounting principles. These features result in a reliable and consistently applied financial framework.

9. Is the FRF for SMEs authoritative?

No. The FRF for SMEs is a type of special purpose framework that is being developed by the AICPA's FRF for SMEs task force and AICPA staff and will be exposed to public comment and professional scrutiny. The FRF for SMEs will not be approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the Financial Accounting Standards Board and will have no official or authoritative status.

10. Can a non-CPA prepare financial statements using the FRF for SMEs?

Yes. Non-CPAs may prepare financial statements using available financial frameworks including the FRF for SMEs, cash, tax, and even GAAP bases of accounting.

11. How do CPAs report on financial statements prepared under the FRF for SMEs?

CPA practitioners performing audit, review, or compilation engagements on financial statements prepared under the FRF for SMEs will follow the same standards as they do today when reporting on other special purpose framework financial statements. The AICPA will be providing audit, review, and compilation report examples to assist CPAs in reporting on financial statements prepared under the FRF for SMEs.

12. Is there industry-specific guidance in the FRF for SMEs?

The FRF for SMEs is a principles-based framework that can be used by incorporated and unincorporated entities across industries. Specific industry-specific guidance will therefore not be included in the FRF for SMEs.

13. How will the FRF for SMEs be maintained in the future?

A key feature of the FRF for SMEs is that it will be a stable framework that will not undergo frequent changes.
Notwithstanding, the FRF for SMEs will be nimble and responsive to significant developments in financial reporting.

14. How is the FRF for SMEs less complicated and less costly?

The FRF for SMEs will be constructed of accounting principles that are especially suited and relevant to a typical SME. Examples include the following:

- The FRF for SMEs will use historical cost as its measurement basis and depart from the increased use of fair value.
- The FRF for SMEs will not require complicated accounting for derivatives, hedging activities, or stock compensation.

Moreover, the FRF for SMEs disclosure requirements will be greatly reduced, providing users of financial statements with the relevant information they need while recognizing that those users can obtain additional information from management if they desire.

15. How is the FRF for SMEs more relevant for SMEs?

The FRF for SMEs is designed specifically to suit the needs of small- and medium-size entities and their stakeholders. Familiar traditional accounting and accrual income tax accounting principles will comprise the FRF for SMEs and only financial reporting topics that are pertinent and have meaning to most SMEs and their financial statement users will be included. For example, there will be no concept of comprehensive income in the FRF for SMEs. The FRF for SMEs assists owner-managers and other SME stakeholders in focusing on the performance of the SME, its assets, liabilities, and cash flows.

16. AU-C Section 800 (AU Section 623) states that if special purpose framework financial statements include items that are the same or similar to those in GAAP financial statements, similar informative disclosures are appropriate. Because the FRF for SMEs is a special purpose framework in accordance with AU-C Section 800, will those "similar informative disclosure" requirements apply?

Yes, the provisions of AU-C section 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* (AICPA, *Professional Standards*), will apply to financial statements prepared under the FRF for SMEs. The AICPA task force and staff developing the framework believe that the disclosure requirements contained in the FRF for SMEs will meet the "similar informative disclosures" requirement of AU-C section 800.

17. Will lenders/financial institutions accept financial statements prepared under the FRF for SMEs?

Owner-managers and their CPA practitioners will need to consult with lenders and other key external stakeholders about the use of the FRF for SMEs. With substantial relevance and cost-benefit factors, the AICPA believes that the lending community will accept financial statements prepared under the FRF for SMEs. Lenders are often very flexible in accommodating various financial frameworks for smaller entities. For example, many lenders today permit financial statements prepared using the cash or income tax basis of accounting from their customers. More important to lenders is the consistent application of the accounting principles underlying the financial statements. The FRF for SMEs will consist of traditional accounting principles and accrual income tax accounting methods that are very familiar to lenders and have served the lending community well for many years.

The FRF for SMEs is intended to be utilized by entities whose lenders base their decisions principally on reliable operations and cash flows. The FRF for SMEs will appeal to such lenders because it will be a reliable financial framework, providing relevant information, will be easier to understand, will contain explicit and comprehensive accounting principles, and will be subjected to professional scrutiny. Moreover, the FRF for SMEs will be a cost-beneficial financial reporting option for the lenders' customers.

18. How does the FRF for SMEs fit in with the Financial Accounting Foundation's Private Company Council and standard setting in the United States?

The AICPA and the Financial Accounting Foundation (FAF) are both committed to the private company financial reporting constituency; however, the objectives of these two efforts are different. The new FAF Private Company Council will focus on modifications to U.S. GAAP for private companies that need or are required to have financial statements prepared in accordance with GAAP. The FRF for SMEs is a concise, highly relevant framework for owner-managers of SMEs and their external stakeholders where U.S. GAAP financial statements are not required or necessary.

19. Why do we need the FRF for SMEs now that the new Private Company Council has been established?

For decades the AICPA has wanted private companies and their financial statement users to have the information that suits their unique needs and is cost beneficial to them. The new Private Company Council and the FASB will be working toward that goal and the AICPA is committed to the new council's success. But that solution only helps private companies that need U.S. GAAP financial statements. The fact is, many SMEs do not need GAAP financial statements and their financial reporting needs can be better addressed by a less complicated and more relevant financial framework like the FRF for SMEs.

20. Why not promote the use of IFRS for SMEs rather than develop a new framework?

The International Accounting Standards Board has been recognized by the AICPA as an international accounting standard setting body and, as a result, the IFRS for SMEs may be an alternative for those SMEs needing GAAP financial statements.
Although there will be some similarities between the FRF for SMEs and the IFRS for SMEs, the AICPA believes that the FRF for SMEs will be more understandable and more useful at this time because it is specifically written for U.S. entities. Additionally, the FRF for SMEs will reduce differences between the FRF for SMEs and the U.S. tax code. For example, last in, first out inventory is not permitted by the IFRS for SMEs whereas it will be permitted by the FRF for SMEs.

21. Is developing the FRF for SMEs a way for the AICPA to become an accounting standard setter?

No. The FRF for SMEs is a nonauthoritative financial reporting framework that can be used voluntarily by entities that do not need GAAP financial statements. The AICPA has no authority to compel or preclude the use of the FRF for SMEs. The FAF supports the AICPA's development of the FRF for SMEs, calling it "important and complementary."

22. Is the FRF for SMEs inferior or superior to GAAP?

The FRF for SMEs is neither inferior nor superior to GAAP. The issue is about what is the most suitable financial reporting framework for an entity. Many SMEs do not need GAAP financial statements and the FRF for SMEs may be the right choice to satisfy their financial reporting needs and those of their stakeholders.

23. What is the long-term future of the FRF for SMEs in light of the growing convergence of U.S. financial reporting standards with IFRS and global accounting trends?

The AICPA expects that the FRF for SMEs will be a very useful financial reporting system in the United States as owner-managers of SMEs, their accountants, and their external stakeholders recognize its benefits. The FRF for SMEs is a financial reporting framework for those entities that do not need GAAP. As such, the convergence of U.S. GAAP with IFRS does not directly impact the FRF for SMEs. As the U.S. financial reporting environment continues to evolve in response to global forces, such as convergence and adoption of IFRS and the emergence of the IFRS for SMEs, the FRF for SMEs will remain a relevant framework and key element in that evolving environment.

24. What are the implications for peer reviewers related to the FRF for SMEs?

The responsibilities related to a peer review will be no different from what they are today when a peer review is conducted of an audit, review, or compilation of financial statements prepared in accordance with a special purpose framework. A peer reviewer will need to be familiar with the performance and reporting standards of the Statements on Auditing Standards or the Statements on Standards for Accounting and Review Services, as well as the FRF for SMEs. The peer reviewer must apply professional judgment to determine if the recognition, measurement, presentation, and disclosure principles followed are appropriate in determining whether the CPA's report is correct.

25. Will the Uniform CPA Examination include questions pertaining to the FRF for SMEs?

Those responsible for the preparation of the CPA Exam will monitor usage of the FRF for SMEs, as they would do for other financial reporting frameworks. If FRF for SMEs usage becomes prevalent, questions about the FRF for SMEs could eventually be included in the CPA Exam.

26. Will the AICPA provide implementation guidance and tools to assist financial statement preparers, CPA practitioners, and financial statement users in learning about and applying the FRF for SMEs?

Yes. Implementation guidance, in the form of application examples, illustrative financial statements, a disclosure checklist, and similar tools will be offered by the AICPA to complement the FRF for SMEs. In addition, toolkits will be available to help CPA firms introduce and explain the FRF for SMEs and its advantages to clients and financial statement users.

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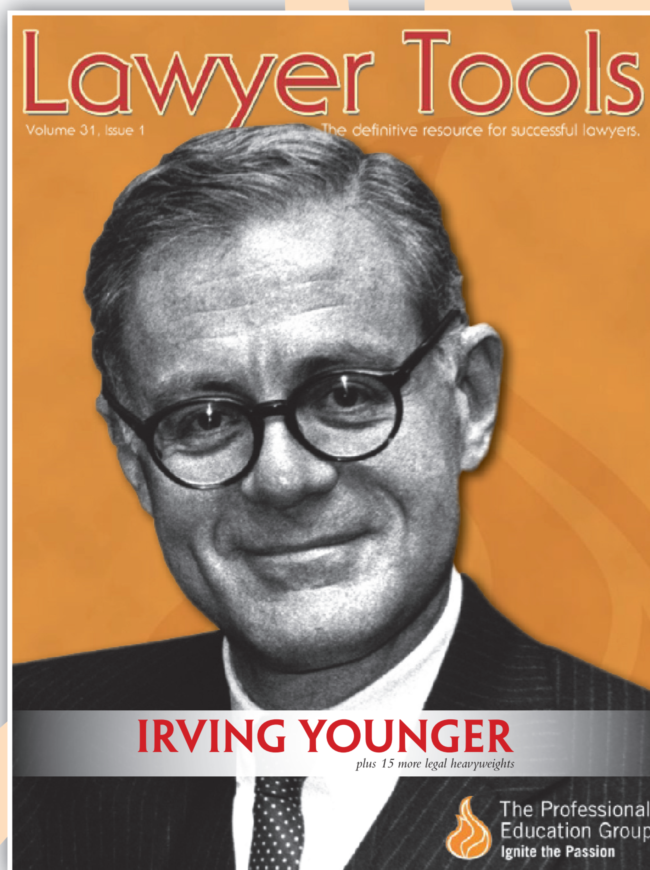

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