THE LITIGATION NEWSLETTER

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Chair's Letter

by: David C. Sarnacki

The financial issues that arise in litigation can be amazingly complex or amazingly simple. However, in most commercial litigation, the starting point in any case is understanding the financial statements. This issue of *The Litigation Newsletter* presents "Top Ten Lists" written as a primer to explain some of the underlying theory of financial statements. They also point out some of the situations where further "digging" might be required or additional questions asked. I am thankful that Glenn Sheets, a past Summer conference presenter and contributor to this newsletter, convinced his colleagues to assist us with this theme issue.

The contributing writers for this issue are all members of the Valuation and Litigation Advisory Group of Stout Risius Ross, Inc. (248-208-8800). With nearly 70 professionals, Stout Risius Ross provides services in investment banking, restructuring and turnaround management, and valuation and litigation support from offices in Detroit, Cleveland, and Chicago. The litigation services team is primarily responsible for consulting with parties involved in litigation by assisting with discovery, providing expert witness testimony, acting as a consultant to the attorneys involved, performing rebuttal analyses, and functioning as an advisor on the business and financial aspects of the case. In addition, the team assists in discovering, documenting, and researching issues associated with proximate cause, mitigation, and other aspects of a damages claim.

Our special thanks goes to each contributor:

Jeffrey Risius, CPA/ABV, CFA, ASA is the Managing Director of the Valuation and Litigation Advisory Group. With more than a dozen years of experience in this practice area, Jeff has testified and been involved in litigation matters involving valuation and financial issues. Jeff's many areas of experience include shareholder oppression suits, intellectual property disputes, divorce matters, and tax cases involving valuation issues. **Thomas Frazee, CPA/ABV** is a Manager and has provided expert witness testimony and participated in numerous valuation and litigation assignments. (Tom was particularly helpful in coordinating our efforts to provide this theme issue to you.) **Marcus Ewald** is a Senior Analyst, with extensive experience in the grocery, automotive, and high-tech sectors. **Ryan Thies** is an Analyst who focuses primarily on business valuation, statistical analyses and research issues. **Justin Cherfoli** is a Senior Analyst, with a strong background in auditing and business valuation, and experience in the automotive, medical, and technology industries.

Once again, I trust that you will profit from the practical advice in your Litigation Newsletter.

Introduction

Jeffrey Risius
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Marcus Ewald
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The Stout Risius Ross "Top Ten Lists" summarize some of the basics of financial statements, and include a few tips that may be useful when evaluating the economic aspects of a case or of an expert's testimony. These basics should not be construed as rules that never change. In fact, development of tax law and accounting theory/practice continue to impact this area of knowledge, and the methods of analyzing this information continue to improve.

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When someone refers to **Financial Statements**, they are usually referring to three primary documents: an income statement, balance sheet, and statement of cash flows. A fourth statement, which reconciles the company's beginning-of-period equity to its ending balance is also sometimes included. These financial statements are prepared to ***(1)*** provide an overview of the company's results of operations for some historic period of time and ***(2)*** show the recorded "value" of the company's assets and liabilities at one point in time.

The **income statement** (also known as the profit and loss statement or P&L) records the business' activity over a period of time (e.g., one year or one month). The numbers presented on this statement usually reflect the accounting or tax rules that are relevant (Generally Accepted Accounting Principles – GAAP, or other principles). These rules require the recording of transactions under certain circumstances, dictate how a cost should be recognized, etc.

The **balance sheet** is also prepared under these accounting principles. Its purpose is to depict the assets and liabilities of the company as of a certain point in time (as opposed to reporting the result of operations which occurred over the preceding period). The day after, or the day before the balance sheet was prepared, the business' financial "picture" may have been distinctly different; this is not reflected on the face of the balance sheet.

The **statement of cash flows** is designed to show a reader what the company did with its cash inflows and outflows. For instance, the company may have done a lot of work and shipped product, but never bothered to collect its receivables. The company may have used its cash to pay large dividends to it shareholders, rather than re-invest in additional equipment. Both of these practices would be reflected in the cash flow statement.

Notes to the financial statements are also provided to allow a reader the opportunity to more fully understand the business. These notes disclose additional information about the business, and the ways that the business records its accounting transactions.

Balance Sheet: Assets

The balance sheet should be viewed as the company's statement of financial position, as it presents the rights owned by the company (assets), claims against the company (liabilities), and the funds contributed to the company by its owners or generated internally and retained by the company (equity). The fundamental concept that exists in every balance sheet is illustrated by the following relationship:

Assets – Liabilities = Equity

A simplistic way to view a balance sheet, and this fundamental concept, is to think of a home purchased with a combination of a mortgage and cash. Let's assume the home, valued at $100,000, was purchased with 80% debt and 20% cash. The purchaser's balance sheet would include an asset (the house) worth $100,000. This balance sheet would also include a claim against that house, or a liability, for $80,000. The remaining amount, the "funds contributed by the owner," would be considered equity.

(1) **The definition of an asset**: Simply put, an asset is something of perceived value obtained

through the exchange of another asset (e.g., cash, a promise to pay, provision of services, etc). Within a company, the previous statement implies that assets may be purchased using cash, financed through an outside lender, or provided by the owners of the company. For example, when a law firm provides a service for its client (by providing professional advice), the firm generates an account receivable (i.e., an asset). In this instance, the future economic benefit (i.e., the account receivable) associated with the past transaction or event (i.e., the services performed) is the probable receipt of cash.

(2) **Classification of assets**: Within a balance sheet, assets are generally classified according to liquidity. That is, assets that are more readily convertible to cash, such as shares of IBM stock, are presented ahead of those assets that have inherently more time to liquidity, such as computer equipment. More specifically, assets that will be converted into cash or used within one year are classified as *current assets*. Generally, assets that do not meet the latter definition are presented as either *fixed assets* or *noncurrent assets* in a balance sheet.

(3) **Measurement of assets**: Generally speaking, assets may be presented in one of two ways: ***(1)*** at historical cost (or a variation thereof), or ***(2)*** at fair market value. While presenting assets at their fair market value would likely be accurate, it would be impractical from a reporting standpoint to estimate the fair market value of every asset owned by an entity each time the financial statements were issued. As such, for consistency and for ease of the user, there are several governing bodies that dictate what definition of value should be used for certain assets. That said, most assets are presented at historical cost, which is defined as the price paid to obtain the asset, plus any additional incidental costs (i.e., freight, installation, etc.). Other assets, typically those whose underlying value may be volatile and is easily measured, are presented at fair market value as of the balance sheet date.

Current Assets

(4) **Cash and cash equivalents**: Cash and cash equivalents are generally the first assets listed under the category of current assets due to their extreme liquidity. In order to be classified as a cash equivalent, two criteria must be met: ***(1)*** the asset must be easily convertible into cash, and ***(2)*** the asset must be very near to its maturity date (generally within 90 days) so that a significant change in value is improbable. Examples of cash equivalents include bank accounts, short-term Treasury securities, and commercial paper. Cash and cash equivalents are measured and recorded at fair market value.

(5) **Marketable securities**: This asset category includes (public) equity and trading securities. With the exception of fixed-income securities, which may be recorded at amortized cost, marketable securities are generally recorded at fair market value. Fluctuations in the value of the security (e.g., Priceline.com moving from $160/share to $2/share) may also be reflected in the company's income statement.

(6) **Accounts receivable**: As discussed previously, an account receivable is essentially a promise of payment by a customer for goods or services purchased in the past. Generally, an account receivable and a sale are recognized simultaneously upon the completion of services for (or the purchase of goods by) a customer. Because not every customer fulfills his promise of payment, there exists a contra-asset account, usually entitled "allowance for doubtful accounts." This account represents the amount of the entire account receivable balance that is deemed potentially uncollectible. The allowance account is frequently presented just below accounts receivable on the balance sheet. (Note: it is also common to present accounts receivable net of the allowance for doubtful accounts.) Accounts receivable are recorded at their expected realizable amount.

(7) **Inventory**: Inventory represents the assortment of purchased or produced goods that are or will

be available for sale to customers. While the notion of inventory as an asset is straightforward, the concept of measurement becomes increasingly complex when evaluating inventory, due to the numerous available methods of accounting for inventory. The two most common methods to value inventory are: ***(1)*** LIFO (last-in, first-out), and ***(2)*** FIFO (first-in, first-out). Simply stated, in using LIFO, the "cost" associated with the most recently purchased or produced inventory item is the assumed internal cost of the "next" item sold. In using FIFO, the assumed cost of the next item to be sold is represented by the cost of the "oldest" purchased or produced inventory item in stock.

Because inventory and cost of goods sold are closely related, the choice between these two methods not only affects the recorded value of the inventory on the balance sheet, but also the earnings of the company (as affected by the cost of goods sold.) To illustrate the effect of each method, consider an example in which inventory prices are rising, while the price paid by the customer is stagnant. Under LIFO, the most recently purchased or produced inventory item (the most expensive item) is the next item to be sold. Accordingly, the recorded value of the remaining inventory would be lower under LIFO than under FIFO. (Similarly, following that same example under LIFO, the cost of goods sold would be greater, causing the net income of the company to be lower.)

In periods of rising prices:		
	Inventory Value	**Net Income**
FIFO	Typically more accurate	Higher
LIFO	Too low (only "old" costs are on Balance Sheet)	Better matching of revenue with current costs

Noncurrent Assets:

(8) **Gross fixed assets (a.k.a., Property, Plant & Equipment)**: Depending on the type of company, fixed assets may include anything from a desk chair to a 1500-ton stamping press. Typically on a balance sheet, similar fixed assets are grouped together for presentation purposes and are recorded at their historical cost. Examples include furniture and fixtures, buildings and improvements, and machinery and equipment. The future economic benefit associated with fixed assets such as these is twofold. In one sense, these assets could be sold at some point in the future. However, this is typically not the intention of a company purchasing fixed assets. Rather, the future economic benefit associated with fixed assets is the value created through their use in the operations of the company. Considering the stamping press mentioned above, each time that press stamps out a part that is sold to a customer, the company is realizing an economic benefit from that asset. Since this process occurs over a period of time, the economic benefit derived from the fixed asset diminishes over the life of the asset.

(9) **Accumulated depreciation**: Accumulated depreciation is a contra-asset account (i.e., an offset to gross fixed assets) that attempts to capture the diminished value of the fixed asset over time. As they are used, fixed assets are typically depreciated over their economic useful lives. While there are various methods available for depreciating assets, the most commonly used is the straight-line method, in which a fixed asset is depreciated evenly throughout its expected useful life. The important point to remember is that depreciation methods do not always reflect economic reality, and assets like real estate may appreciate over time (which is not reflected on the balance sheet).

(10) **Intangible assets**: While it is relatively easy to see the economic benefit associated with the assets described above, the benefit provided by intangible assets is typically less obvious. Intangible assets are defined as assets having a life

beyond one year; they generally lack physical substance, and frequently represent a right granted by the government or another company (i.e., patents, trademarks, and copyrights). Goodwill, a common intangible asset, may be described as the reason why customers continue to purchase from a certain company. Intangible assets may be purchased (and their cost, net of amortization, appears on the balance sheet.) They may also be created, in which case their value is not typically recorded on the balance sheet.

Tips:

- Many valuation- and transaction-related cases arise from disputes over the type and value of the assets owned by the company/transferred to the buyer.
- Recognizing the "rules" that are followed when recording assets on the balance sheet helps a financial statement reader to clearly identify and define the relevant assets.
- Evaluating the true level of a business' assets is also relevant for family law, bankruptcy, and judgment collections matters.

Balance Sheet: Liabilities

(1) **The definition of a liability**: Simply stated, liabilities represent promises to repay outside lenders and creditors in the future for assets or services provided to the entity by the lenders and creditors in the past. In most cases, liabilities are repaid by providing cash payments or services to the creditor. Liabilities generally arise as a result of the ongoing operations of a business (i.e., paying employees or vendors) or as a means of financing the operations of a company (i.e., debt, such as a bank line of credit or a bond payable).

A simple example of a liability arising from the typical operations of a manufacturing company is accounts payable. In order to manufacture goods, this company would likely have to purchase raw materials from various vendors. Upon receipt of the goods from the vendor, the manufacturing company would recognize a liability in the amount equal to the value of the assets received, plus any incidental costs in acquiring the assets (i.e., freight charges). This liability represents the manufacturing company's obligation to pay for the goods at some point in the future. (Note the manufacturing company would also recognize an asset (inventory) in the same amount upon receipt of the goods.)

(2) **Classification of liabilities**: Similar to assets, liabilities are recorded on the balance sheet according to liquidity. Specifically, liabilities that a company expects to settle within one year (of the balance sheet date) are classified as *current liabilities.* Obligations that are due beyond one year are classified as *long-term* or *noncurrent liabilities*. Various examples of current and noncurrent liabilities are discussed below.

(3) **Measurement of liabilities**: Liabilities are generally recorded on the balance sheet in an amount equal to the cost at which the transaction occurred (i.e., historical cost). Furthermore, in accrual accounting, liabilities are recognized when an asset has been impaired or a future obligation to pay has been incurred, and the amount of the impairment or obligation is estimable. While there are exceptions to recording liabilities at their historical cost (such as with bonds payable) liabilities are generally recorded on a balance sheet at their historical values.

Current Liabilities:

(4) **Accounts payable**: On a balance sheet, accounts payable may be further broken down into trade payables and other payables. The former represents obligations arising out of the normal operations of a company, while the latter may include items such as payables to employees for reimbursable expenses. These liabilities are generally recorded at historical cost. Similar to all liabilities, the repayment terms on accounts payable may fluctuate significantly from vendor to vendor; performing ratio analysis (described later) may provide additional insight on trends affecting the business.

(5) **Line of credit**: A line of credit is generally issued by a bank to a company as a means of funding the company's short-term operations by providing immediate access to cash upon demand. A liability arises each time funds are withdrawn. Additionally, there is generally a cap on the amount of money a company can borrow on their line of credit at any given time. Credit lines are typically collateralized with a company's assets or cash flow, and can be either open-ended or due at the end of a specified term. The interest rate at which the line of credit is granted and the amount available through the line of credit are directly related to the lender's perception of the risk of default by the borrowing entity.

(6) **Short-term debt obligations**: In general, debt is a liability or obligation in the form of bonds, loan notes, or mortgages owed to another party and required to be paid by a specified date (maturity). Debt instruments are generally issued with maturities greater than one year. However, the portion of the debt obligation that is due within one year is classified as short-term, and is presented separately in the liabilities section of the balance sheet as a current liability.

(7) **Accrued expenses**: Accrued expenses are liabilities that generally result from timing differences between the balance sheet date and the normal operating cycle of the specific company. The most common accrued expenses are for compensation-related liabilities. To illustrate this concept, consider a company that pays its employees every Friday for work performed during the week. If the balance sheet date happens to fall on a Wednesday, the company must recognize a liability for the compensation for the three days of work that will not be paid until Friday.

Noncurrent Liabilities:

(8) **Long-term debt obligations**: Within a balance sheet, debt obligations with greater than one year to maturity are presented as long-term liabilities. As mentioned previously, certain debt obligations (such as bonds payable) are not presented at historical cost; rather, they are presented at their net carrying value. The latter value is equal to the historical cost of the bond (i.e., its face value) plus or minus the amortized bond premium or discount (the difference between the face value and the actual selling price when issued).

Other current and noncurrent liabilities, not specifically discussed herein may include pensions and postretirement benefits, capital lease obligations, and deferred taxes and other charges.

(9) **Minority interest**: Another liability account frequently encountered when reviewing balance sheets (especially for larger companies) is minority interest. This account arises when a company owns less than 100% of a subsidiary, but has consolidated that subsidiary's results in the financial statements. The minority interest account represents the equity held by a subsidiary's other investors, but not on a market/fair market basis.

(10) **Contingent liabilities**: Liabilities that may require a company to make payments or provide services at some point in the future may not be explicitly recorded on the company's balance sheet due to the uncertainty of the liability or the inability to reasonably measure the future obligation. These liabilities are generally referred to as contingent liabilities and are typically disclosed in the "notes" of a company's financial statements. Contingent liabilities must be booked on a company's balance sheet when the actual obligation becomes probable and the amount of the obligation is reasonably estimable.

Tips:

- When examining the liability "side" of the balance sheet, special attention should be focused on ensuring that all liabilities required by GAAP to be recorded are recorded.
- Examine whether a company is using short-term liabilities (accounts payable) to fund long-term assets (new equipment). This frequently is a pre-warning of a potential liquidity problem.

- Look at a company's borrowing capacity; could it borrow to sustain a cash shortfall or is it so highly levered that it is in danger of violating its loan covenants? (This issue is frequently raised in lender liability and business start-up matters where proximate cause is a key concern).

Balance Sheet: Equity

Equity value is typically defined as the value of an ownership stake in a company. As such, equity capital pertains to a form of financing in which equity, or ownership, is sold to investors. When analyzing a company's financial statements, the equity value can be found on the company's balance sheet, where it is recorded as the "book value" (of equity). However, this book value of equity is not necessarily representative of the true market value of a company. Rather, further analysis into a company's assets, liabilities, and earnings capability is required in the derivation of true market value.

(1) **Historical costs**: The values of the assets and liabilities that are utilized in the calculation of book value are taken directly from the amounts on the balance sheet, which are generally recorded at historical cost. The recorded amounts are typically not restated, regardless of the extent to which they differ from their current, or economic, values. As such, the assets and liabilities generally remain on the balance sheet at historical cost. Situations where this may create misleading results include fully depreciated assets that are still operating and producing profitable products or recently purchased equipment that is suffering from technological obsolescence (e.g., every computer system you have ever bought!)

It should be noted that there exist certain exceptions to the standard of presenting assets at historical cost. For example, assets that are estimated to have been permanently impaired must be written down on the balance sheet. Since these impairments obviously also affect the market value of the asset, the balance sheet is more representative of market value than a simple historical cost presentation. Additionally, based on the classification of certain financial assets such as stocks and bonds, the assets may be recorded at market value on the balance sheet.

In addition to a company's assets, certain debt instruments may also require adjustments to accurately reflect true market value. The most common adjustment relates to the company's fixed debt obligations in a changing interest-rate environment. Consider the situation where a company has a fixed interest rate that is considerably below market interest rates. The company thus maintains an interest rate advantage, the present value of which can be calculated over the term of the obligation and used as a discount to the book value of the liability as reported on the balance sheet.

(2) **Intangible value:** Intangible assets relate to those assets that do not have material or physical substance, but that certainly contribute value to the business. This value is most notably realized by a company through increased earnings potential. This earnings potential is important, as equity investors are typically interested in future earnings when determining value. Essentially, intangible value exists to the extent that a company is producing a return over and above that required on its tangible assets.

Book equity as reported on the balance sheet does not inherently capture the value of a company's intangible assets. First, book value is backward looking in that it is based on historical costs and thus does not indicate future earnings potential. Second, a company may have many assets that are not recorded fully on the balance sheet. These include patents and trademarks, customer lists, superior technology, experienced management, and a skilled workforce, all of which contribute to intangible value.

(3) **Purchased goodwill**: A portion of a company's intangible asset value may actually be recorded on the balance sheet, typically in the form of <u>purchased</u> goodwill. Goodwill is recorded when a company acquires another company at a price above the value of its tangible assets. The difference between the purchase price and net

tangible asset value is recorded as goodwill and amortized over time.

(4) **Method of inventory accounting:** LIFO reserves are essentially an off-balance sheet asset. Special attention should be given to this reserve, as it is particularly relevant for certain industries. For example, an automobile dealership reporting inventory levels on a FIFO-based system will report a much higher book value than under a LIFO-based system, as the price of automobiles has increased steadily. (Note the dealership typically obtains financing based on the FIFO-based figure.)

(5) **Realization of accounts receivable:** When evaluating the true value of accounts receivable, several considerations are relevant.

- The company's past collection history can be considered. This can be performed through discussions with management and/or through the calculation of accounts receivable turnover ratios based on certain balance sheet and income statement accounts.
- A review of the company's accounts receivables aging schedule will indicate the number of accounts that are past due and thus less likely to be collected.
- The discounts paid by accounts receivable factoring firms can be considered. These firms will purchase a company's accounts receivable balances in exchange for the right to collect payment from the customers. However, considerable care should be exercised in utilizing this approach, as factoring firms may or may not assume the entire risk of collection, which affects the return that they expect to receive.
- Whether the company has established a reserve for uncollectible accounts that is already included within the accounts receivable balance on the balance sheet should be considered. This reserve provides an indication of management's expectations regarding the company's ability to collect its outstanding accounts.

(6) **Inventory**: In addition to accounts receivable, inventory levels may also require certain adjustments to derive market value from the amounts recorded on the balance sheet. For example, the company may have a certain amount of inventory that is either physically or technologically obsolete and thus worth less than the recorded amount. As a result, it is likely that a company will have to dispose of the inventory at a discount to its original cost. Similar to accounts receivable balances, it is important to determine if an inventory reserve has been included within the inventory amount existing on the balance sheet.

(7) **Off-balance sheet liabilities**: Although not explicitly recorded on the balance sheet, a company may have certain outstanding liabilities that must be considered. These liabilities are often contingent in nature and must be discussed with management to determine the likelihood of coming to fruition. These liabilities include, but are not limited to, lawsuits, guarantees, rent commitments, environmental costs, unfavorable purchase or supply agreements, or pension costs.

(8) **Additional information**: In addition to valuation-related issues, the equity section of the balance sheet should also be analyzed for additional information on:

- The number of shares outstanding;
- Whether there are any preferred shareholders;
- Whether shares were issued or repurchased in the current period; and
- The amount of the company's equity which was generated by operating profitably or which was contributed by the shareholders.

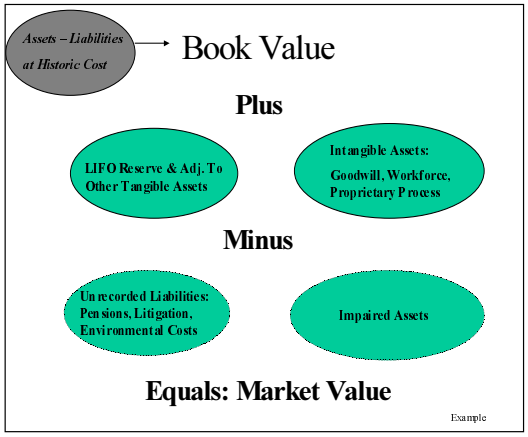
Valuation implications

(9) For each of the reasons outlined above, book value is not a true indicator of market value and should not be utilized in a valuation context. Evidence of this fact is easily obtained by comparing the book value of publicly traded companies with their

respective equity market capitalizations, as implied by the current share prices and the number of commonshares outstanding. These two measurements of value are rarely equal, and often vary to a great extent. Furthermore, numerous courts have ruled that book value is not a true indicator of the market value of the equity of a company.

Based thereon, legal counsel and valuation experts should take into account each of the factors above in converting the book value of a company's assets and liabilities to market value. For a company generating total returns that exceed those required on its tangible assets, the company generally has an element of intangible asset value, which is not captured on the balance sheet. In these situations, it is typically not prudent to rely upon the balance sheet as an indicator of true market value. Rather, it is necessary to perform an Income Approach or Market (valuation) Approach that will inherently capture such intangible value.

However, for companies that are not generating a sufficient return on their assets, or that are asset intensive, it is typical to perform an Underlying Asset Approach, which relies upon the assets and liabilities on a company's balance sheet as of the stated valuation date. Yet, even in this situation, it is important to adjust each of the balance sheet amounts to market value through consideration of the factors detailed above.



In conclusion, it is important to note that although it is not the best indicator of market value, the balance sheet should certainly not be ignored in a valuation context. The balance sheet provides useful information regarding the assets and liabilities owned by the company as of a certain date. Each of these accounts provides a starting point for the additional analysis that is required to develop a true market value. Furthermore, the book value of a company can at the very least provide a reasonableness check on the values determined through alternative approaches. In general, however, when book value does approximate market value, it is a mere coincidence.

Off-Balance Sheet Assets and Liabilities

The balance sheet is essentially an itemized list of the total assets and total liabilities of a company at any given point in time. These assets and liabilities are utilized in the presentation of the company's total net worth. Although such assets and liabilities are not typically presented at their current market values, they do provide an indication of a company's financial situation at a particular moment in time. However, when reviewing a company's balance sheet, it is important to note that certain assets and liabilities of a company may not be presented. These items are typically referred to as off-balance sheet assets and liabilities. Some of the most notable are outlined below.

(1) **Income tax losses**: Income tax losses result from the generation of operating losses by a company through the course of its continuing operations. These losses represent a benefit to the company in the form of available tax savings. This is due to the fact that tax losses can be applied to prior years' results in order to obtain refunds for taxes paid in these periods. Additionally, such losses can be carried forward to offset taxable income in future periods.

Depending on a company's intentions regarding the utilization of its tax losses, the associated benefit may or may not be presented on the balance sheet. However, the present value of such benefit can certainly be calculated and

should be considered in the determination of the company's total assets. An important point to consider is that the tax laws related tothe utilization of tax losses are complex. As a result,there may be annual limitations on the use of such losses for certain companies, particularly those that have undergone a change in ownership.

(2) **Pension costs**: Pension plans are agreements whereby employers agree to pay monetary benefits to their employees upon retirement. Such plans can either be defined contribution plans or defined benefit plans. For defined contribution plans, the employer does not promise a specific level of future benefits. Rather, the employer's contribution is contractually fixed, and the employee bears all investment risk associated with the assets contributed by the company. In such cases, the required contribution of a company is recorded as an annual cost on the income statement. Additionally, the balance sheet reflects either an asset or liability depending on the excess or shortfall of payments relative to the specified contribution. This type of plan is relatively simple to analyze.

However, under a defined benefit plan, the employer is obligated to pay a specific benefit upon an employee's retirement. In this case, the employer agrees to make whatever contributions necessary to meet the specified benefit, and to invest those assets. In so doing, it bears all investment risk. These characteristics increase the complexity of accounting for such plans. In general, companies are only required to include on their balance sheet a minimum liability calculated based on certain assumptions, including the discount rate attributable to the benefit obligation, the rate of increase in employees' compensation, the expected return on plan assets, expected retirement ages, etc.

Given the various assumptions, the actual liability could be significantly different than the minimum liability amount that is recorded on the balance sheet. The notes to the financial statements should be consulted to reconcile these items.

(3) **LIFO reserve**: Firms utilizing a LIFO system are required to disclose a LIFO reserve, which is the difference between the inventory amount on the balance sheet and the amount that would have been reported had the firm used FIFO. This reserve, which is presented in the footnotes to the financial statements, should be added to the company's inventory balance to determine a better estimate of its market value. Deferred taxes associated with this reserve should also be considered.

(4) **Contingencies**: A contingency is defined as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss." Firms are required to accrue a loss, and record a balance sheet liability, when ***(1)*** it is probable that assets have been impaired or a liability has been incurred *and* ***(2)*** the amount of the loss can reasonablybe estimated. To the extent that neither of these conditions is met, a contingency will not be recorded on a company's balance sheet. Examples of common contingencies include environmental clean-up costs, litigation, debt guarantees, and unfavorable purchase or supply agreements. Depending on management's estimates regarding the probability of ultimately realizing certain contingencies, they may or may not be disclosed in the footnotes to the financial statements.

(5) **Intangible assets**: Intangible assets pertain to those assets that lack physical substance, but that significantly contribute to the value of a company. Typically the only intangible asset included on a company's balance sheet consists of (purchased) goodwill. Goodwill is generated through a company's acquisition of assets and is calculated as the amount by which the purchase price exceeds the book value of such assets. However, a company may have additional intangible assets, which consist of items such as an assembled workforce, trademarks, patents, customer lists, brand names, and technological knowledge. These assets are not typically presented on the balance sheet. Rather, their value is inherently captured through the earnings of the company and its ability to generate positive cash flow.

(6) **Operating leases**: Under the terms of an operating lease, a company agrees to rent property or equipment for only a portion of its economic life. The company does not own the property, nor does it maintain the option to purchase such property at the end of the lease term. Thus, the lessor retains primarily all of the risks of ownership. As a result, the lease obligation of the lessee is not reflected on its balance sheet. Rather, the lessee simply records its annual rental expense as an operating expense on its income statement. The footnotes to the financial statements, however, typically disclose a company's future obligations with respect to its operating leases.

(7) **Sales of accounts receivables**: Certain companies may finance their accounts receivables through the sale of such receivables to third-party investors (factors). By doing so, the companies can receive the cash from their receivables immediately. Thereafter, the company continues to service and collect its receivables; it simply passes them on to the factor upon receipt. The sale of these receivables is accounted for by reducing accounts receivables and increasing operating cash. Yet, the factor often has limited recourse, such that the selling company maintains responsibility for uncollectible receivables. Therefore, the company has a liability for the receivables that have been sold, but not yet collected. This potential liability/responsibility is not reflected on the balance sheet.

(8) **Take-or-pay and throughput agreements**: Take-or-pay contracts represent long-term commitments entered into by a company, whereby the company will agree to purchase a minimum quantity of a material over a specified time period. Natural resource companies often utilize throughput agreements with pipelines or processors to ensure that future distribution requirements are met. Each of these agreements (long-term supply contracts) represents a long-term commitment of a company that is not recorded on the balance sheet. However, the nature of the commitment and the minimum required payments are included in the footnotes to the financial statements.

(9) **Derivatives**: Companies operating in today's business environment face a number of risks associated with the sale of their products, including price risk, interest rate risk, and foreign currency risk. In order to manage such risks, companies are becoming increasingly involved in the use of hedging techniques to protect themselves against adverse movements in prices, interest rates, or foreign currency rates. Some of the most prevalent hedging instruments include futures contracts, options, forward commitments, interest rate swaps, and currency swaps. The increasing use of such instruments creates an additional level of complexity in analyzing a company's financial statements, in that hedging instruments may not be included directly on the balance sheet. Furthermore, unrealized gains and losses may also not be explicitly recorded. However, as with other off-balance sheet items, the footnotes to the financial statements will typically discuss the hedging instruments in further detail.

(10) **Backlog**: Although not recorded on the balance sheet, a company's backlog is a measurement of the work that has already been "signed up" for completion at future dates. If done properly, this work will generate future profits for the company. The receipt of such profits is more certain than business that has not yet been "signed up." Although official and unofficial backlogs are frequently considered by acquiring companies, their value is not reflected as an asset on the seller's balance sheet.

In summary, the balance sheet is an indication of the assets and liabilities owned by a company at a given point in time. However, the balance sheet is not all-inclusive. Rather, through a review of the notes to the financial statements, as well as discussions with management, additional assets or liabilities can be determined. These additional items should be considered within the context of certain litigation matters.

Revenue – It's all About Recognition

Revenue, sales, gross income, gross receipts – these terms are all used to describe the "top line" for a business. The "top line" is typically the first item that appears on the income statement, and it represents the cash inflow that a business receives (or expects to receive in the future) as a result of selling its products, services, or time. Not all cash inflows are reported as revenue. If an accounting firm sells its old computer system, the cash it receives is not reported as revenue; it is reported in other portions of the financial statements. Similarly, if a business receives a pre-payment/deposit on a service or product that has not yet been provided, the cash inflow is not recognized or recorded as revenue until it is actually earned (e.g., by providing the service or starting production of the product). There are many ways to measure, recognize, and record revenue. The method chosen is a function of the legal and business environment in which the organization operates.

(1) **Recognition when earned**: The activity which causes the seller to complete their "part of the deal" typically satisfies the requirement that the revenue is earned. For example, a landscaper who buys perennial flowers for planting does not earn any revenue until the plants are actually in the ground. Similarly, the manufacturer who completes 40% of the assembly work for a Big Blue Widget, has usually earned 40% of the revenue associated with that Widget. For a grocery retailer, the determination of when the revenue is earned is even easier – as each item is scanned through the checkout lane. The premature recognition of revenue is a frequent problem in cases involving accounting fraud/malpractice and merger/sale transactions.

(2) **Cash basis**: Under this method of accounting (frequently used by professional services firms, small businesses, and businesses with low levels of inventory), revenue is not recognized until the cash is "in the door", even if it was already earned. This may cause wide fluctuations in reported revenue and income as a big customer pays their bill (for work performed months earlier). This method simplifies recordkeeping, and frequently provides some tax benefits to a growing firm (which is able to defer the recognition of taxable income). This method is not a Generally Accepted Accounting Principle ("GAAP").

(3) **Accrual basis**: GAAP generally requires revenue to be recognized and reported on an accrual basis. The overriding goal of accrual basis accounting is to match the revenues received and the expenses incurred, and to record them in the same accounting period. This matching occurs even if no cash was received or expended. The recognition of revenue requires that the revenue be earned, and second, requires that the costs associated with producing that revenue also be recognized and reported on the income statement in the same period.

(4) **"Book" versus tax**: The IRS may require a business to recognize revenue, even when it has not yet been "earned" and recorded on the financial books. Accordingly, the revenue and profits reported on a tax return may differ from those reported on the "books" – the financial statement prepared under GAAP.

(5) **Documents**: Revenue is typically recognized after the completion of several steps. Each of these steps results in an accounting document that serves to provide a check-and-balance, as well as to provide evidence that the transaction occurred (e.g., the product was actually shipped and then received by the customer). These documents may include (in "order of appearance"), a request for quotation, a bid/quote, a purchase order or engagement letter, shipping documents, invoices, receipts or a check evidencing receipt of payment, and accounts receivable listings.

(6) **Inclusion of "special items"; e.g., freight, sales tax**: Many companies consider revenue to be best measured by including all of the receipts received from the sale of products or services. Other companies choose only to measure receipts for items to which they add or increase value. For example, a greeting card

retailer may exclude from revenue all of the sales taxes it collects. Although a customer pays $1.06 for a card, the revenue reported may be only $1.00; the six cents of sales tax was simply being collected and passed-through to the State. No value is added. Similarly, freight expense can also be handled as a pass-through item and not included in revenue because the seller is simply providing a convenient service to its customer; it bills the customer on behalf of the shipping company (without markup). The bottom line: when looking at reported revenue, be sure to understand what is being included.

(7) **Construction accounting**: The recognition of revenue for companies that perform contracting and construction services is particularly challenging. The most widely used methods of revenue recognition for this industry are the "completed contract" and "percentage of completion" methods. The reported financial results indicated by the two methods can be significantly different. In simple terms, the completed contract method does not result in the recognition of any revenue or profit until the contract is completely finished. For contracts that stretch over several years (or several financial reporting periods) this can be confusing when examining the income statement, seeing little revenue, and yet knowing the company is constantly busy performing work. The percentage of completion method allows revenue to be recognized as the work is completed (e.g., if 40% of the work is done, 40% of the revenue may be recognized). As a result, this method typically results in revenue and profits that are less volatile. The weakness of this method is that the contractor and accountant are forced to estimate what percentage of the project has been completed and the remaining costs, rather than simply waiting until the conclusion of the project.

(8) **Price inflation**: Although it might seem obvious, it is important to understand the importance of price inflation on a business' products and services and on the revenue they generate. Most industries (not including many technology sectors) experience some price inflation, but the level of inflation can vary dramatically. Gasoline stations have seen their revenue skyrocket over the last 18 months due to volatile and increasing oil prices. Car manufacturers have had slight price increases, but many continue to feel pricing pressure and have been forced to cut prices in certain models. When evaluating increases or decreases in revenue, be sure to understand what effect pricing is having; understanding pricing can also assist in understanding the business' "bottom line" (e.g., although gas station revenues may increase substantially, the profit levels per gallon may not, due to the increase in the retailer's cost of the product.)

(9) **Installment sales**: A business may recognize revenue over time if a sale is completed on an installment basis. This method of recognition is widely used in real estate transactions, and may allow the seller to receive tax benefits by deferring the recognition of income associated with the sale. One of the main points to consider is whether the risk of ownership has been transferred from the seller to the buyer; if it has, the installment sale treatment may be less applicable.

(10) **Ratio analysis**: The amount of a company's sales can affect many of the financial statement relationships that are examined by lenders, financial analysts, and investors. "Ratio analysis" is an analytic method of looking at the relationships between various accounts presented in the financial statements. This type of analysis allows for the comparison of results over time, between companies of different sizes, and simplifies some of the examination that is required. The revenue numbers are considered in ratios that examine asset turnover (what level of assets are required to generate a certain level of sales) and margins (as a percentage of sales, what level of profit falls to the "bottom line"). These types of ratios are also considered and calculated in loan covenants that attempt to measure a company's strength (and ability to pay back its debts).

Tips

- Understanding when and how revenue is recognized is crucial to understanding a business' future income potential.

- A clear definition of revenue and how it should be measured is one of the most important terms to define and understand in any legal agreement dealing with the sale of an asset/company, or the payment of future contingent amounts (e.g., commission agreements, earn-out provisions, etc.). It is also probably the most important number to understand when dealing with construction bidding and contracts.
- Although it is the "top line" on most income statements, revenue is the real driver of the business' "bottom line".

Cost of Sales and Operating Expenses

While revenue indicates the amount of cash flow that is initially being brought into a company, cost of sales and operating expenses determine that portion of the cash flow that is ultimately retained as net income. In other words, these items are responsible for determining the profitability of the company.

(1) **Cost of sales** consists of those items directly incurred in the production of a company's revenues. For manufacturing entities, these items generally consist of the materials and labor costs associated with the production process. Additionally, an allocation for overhead expenses is also typically included within cost of sales. Subtracting a company's cost of sales from its revenue results in gross margin.

Revenue	**$100**
Minus Cost of Sales	*$60*
Gross Margin	**$40**
Minus Operating Expenses	*$15*
Operating Income	**$25**

(2) Given the determination of gross margin, companies then must deduct **operating expenses** to arrive at operating income. Operating expenses consist of the general and administrative costs that are not directly associated with the production of the company's products. Typical items include executive and administrative salaries, rent and utilities, payroll taxes and benefits, office supplies, advertising, professional fees, and other miscellaneous items. Although the calculation of operating income may appear fairly straightforward, there are many accounting conventions that companies may utilize in the recording of the above expenses. Given these different accounting conventions, the ability to compare the results between companies may be diminished.

(3) **Allocation of expenses**: Certain items, such as depreciation and rent expense, are typically allocated between cost of sales and operating expenses. For example, in terms of rent expense, that portion of rent attributable to a company's manufacturing facilities will be allocated to cost of sales, while the portion associated with office space will be allocated to operating expenses. However, each company may allocate certain other expenses to cost of sales in different manners. As a result, the gross margins of companies, even within the same industry, may differ as a direct result of these different allocation procedures. Of course, when analyzing a company's bottom line, after accounting for both cost of sales and operating expenses, differences due to allocation are eliminated.

(4) **Capitalization of expenses**: For certain purchases, a company has the option of either capitalizing (recording it on the balance sheet) the item or expensing it on its income statement. This decision often occurs with software and new technology development, supplier launch costs (automotive), and certain costs associated with installing new equipment or moving. If the company opts to expense an item, the full cost of the purchase is included immediately on the current period's income statement, thus reducing profitability by the amount of the purchase.

However, a company may also capitalize the expense. In so doing, the purchase is recorded as an asset on the balance sheet and depreciated or amortized over time based upon the estimated useful life, with no initial income statement effect. Rather, the purchase is reflected on the income statement (and spread out over multiple periods) as annual depreciation or amortization expense.

Therefore, companies that expense a purchase will experience lower levels of profitability in the year of the purchase, as compared to those companies capitalizing the purchase. However, since those companies that capitalized the expense will experience annual depreciation or amortization costs thereafter, their profitability levels will be lower beyond the initial year. Thus, the choice to capitalize or expense an item is essentially a decision as to when to recognize the cost of the item.

(5) **Method of inventory accounting**: The chosen inventory costing method is integral in the determination of a company's net income. When a company sells its inventory, it also recognizes a cost of sales amount associated with the respective sale, as detailed in the inventory equation below:

Cost of sales = Beginning inventory
+ Net purchases – Ending inventory

Knowing three of these variables allows for the determination of the fourth. Beginning or ending inventory numbers are frequently established by a physical count; purchases can be verified by examining the cash outflows and accounts payable over the period. While inventory can be counted, the determination of its value requires the application of an inventory costing method. The two most widely used methods are first-in, first-out ("FIFO") and last-in, first-out ("LIFO"), and since they affect at least one of the variables listed on the right side of the equation, they also affect cost of sales.

Under a FIFO-based system, the cost of sales that is recognized and matched to sales revenue is the cost that the company incurred to produce the oldest item currently in inventory. Conversely, a LIFO-based system assumes that the cost to produce the most recent item is most appropriate.

The inventory level and cost of sales will differ if a company chooses LIFO versus FIFO. However, they can be reconciled. If a LIFO-based system is utilized, the difference between FIFO- and LIFO-based inventory levels is recorded in the notes to the financial statements as a LIFO reserve. Special attention should be given to this reserve, as it is particularly relevant for industries with higher inventory levels and changing prices. For example, an automobile dealership reporting inventory levels on a FIFO-based system will report a much higher book value than under a LIFO-based system, as car prices have risen.

(6) **Owning versus leasing**: A company can choose to finance its fixed assets in several different manners, each of which has a different effect on the financial statements. First, the company may finance its facilities with operating leases. In this case, there is no balance sheet effect, as the company does not own the assets. It simply incurs an annual rent expense that is included on the income statement. On the other hand, the company may choose to purchase and own its building and equipment (frequently by obtaining bank financing). Given this decision, the purchase is typically capitalized, and the building and equipment are included on the balance sheet at cost. These assets are then depreciated over time, with the annual depreciation expense affecting the income statement over the economic life of the asset. The company that owns its assets does not incur rent expense; it may have interest expense associated with any related indebtedness. The "charge" for its fixed assets, therefore, is reflected in its annual depreciation expense. Due to this fact, analysts often analyze different companies' profitability prior to both depreciation and rent expense in order to eliminate the effects of this financing decision.

(7) **Capital leases**: In addition to owning or leasing its fixed assets, an alternative form of financing available to companies is a "capital" lease, an arrangement where the title to the asset may not change hands, but the risks of ownership are essentially transferred to the lessee. Unlike operating leases, capital leases are reflected on the balance sheet. The cost of the asset covered under the capital lease is included on the balance sheet as a net fixed asset and depreciated. Additionally, the obligation (future lease payments) owed to the lessor is included as a liability, similar to the treatment of interest-bearing debt.

Capital leases also affect a company's income statement; interest expense incurred (associated with using the asset and paying for it over time through lease payments) is recorded as an expense. Additionally, the company recognizes annual depreciation expense on assets covered under the capital lease. Typically, in the initial periods of the lease term, the combined interest and depreciation expense exceeds the rental payments that would be incurred on the same asset under an operating lease. As time passes, this trend reverses, such that total aggregate expense under either a capital or operating lease is equal over the lease period.

	Operating Lease	Capital Lease/ or Ownership
Asset on Bal. Sheet	No	Yes
Liability on Bal. Sheet	No	Yes / Maybe
Depreciation Expense	No	Yes
Interest Expense	No	Yes / Maybe
Rent Expense	Yes	No

(8) **Officers' compensation**: The compensation paid to a company's officers, including base salaries and bonuses, often represents a significant portion of a company's operating expenses. Many closely held private companies pay their officers, who are also often shareholders in the company, greater compensation than non-shareholders with identical responsibilities. Additionally, many family-owned businesses will pay compensation to family members that are not integrally involved in the business. As a result, in order to view companies on a comparative basis, the income statement should be adjusted to reflect the amount that would be paid to the officers by a typical industry participant. Certain studies and surveys conducted by various organizations are available for this purpose. It should be noted that the propensity for companies to pay their officers above-market compensation is most prevalent where the officers have voting control of the company.

(9) **Rent expense**: As discussed above, a company's financial statements may differ from competitors in its industry as a result of the decision to own or lease its fixed assets. Additionally, many companies will lease their facilities or equipment from a entity related via common ownership. These related entities are often owned by the company's shareholders and may charge above-market rents to the operating company. These above-market rents are a form of additional shareholder compensation/return. As with excess officers' compensation, the rent expense on a company's income statement should be adjusted to a market level prior to comparison with other companies.

(10) **Nonrecurring expenses**: A final consideration in the analysis of a company's financial statements is the identification of nonrecurring expenses. These types of expenses relate to one-time items that are not expected to be incurred in the future. Common examples of these items include legal settlements, restructuring costs, gains or losses on disposal of certain assets, bad debt expenses, and inventory obsolescence charges. Each of these items has the effect of distorting the income statement in the period in

which it is incurred. As a result, such effects should be removed when comparing results between companies.

Tips:

- The accounting conventions selected by a company should be considered when comparing operating results between companies.
- Understand the "quality" of the earnings. Are they inflated due to aggressive accounting assumptions?
- Lender liability issues frequently consider definitional issues associated with technical covenants, the types of capital used by the company (e.g., leases), and the accounting treatment of expense items.
- Minority-interest shareholders may not be receiving the same type or level of economic benefits as a controlling shareholder. Look for related-party transactions in evaluating this, especially in shareholder dispute/oppression claims, fraud investigations, and tax disputes.

Taxation – Read My Lips

Taxation issues are nearly always relevant in litigious matters. Lawsuits related to poor tax planning, IRS disputes, and accountant malpractice are examples of matters where knowledge of the Internal Revenue Code ("IRC") is one of the main focuses of the case. Even more prevalent are the tax considerations that go into calculating damages and in structuring the award or settlement for the benefit of a plaintiff or defendant. The focus of this article will be on the income tax issues that typically arise in a litigious context, as opposed to developments in tax law or other topics.

(1) **Basis in Law**: The tax treatment of any event is determined by the IRC. This (voluminous) set of instructions is updated via legislative actions. One of the biggest updates occurred in 1986, under the Tax Reform Act of 1986. Generally, new presidential administrations trigger changes in the Code, as certain positions are amended. In addition to the Code, the IRS puts forth various documents designed to interpret the Code and to provide guidance to taxpayers and tax professionals. This guidance comes in the form of Treasury Regulations (IRS interpretations of the IRC), private letter rulings (issued at the request of a taxpayer for that taxpayer's specific question/issue), and taxpayer advice memorandums (released to the public). Additionally case law, as determined through the Tax Court, and through various Federal Courts, also help to shape the actual application of the Code to the transactions occurring each day in the market.

(2) **Layout of returns**: Personal income tax returns are fairly straightforward. The first page of a Form 1040 lists all of the taxable income of the individual. (Non-taxable income is typically not included on the Form). Subsequent pages of the individual tax return will contain the supporting detail and calculations for these items. For most of the items on these returns, the IRS receives third-party verification of the amount paid to the individual (e.g., an employer will also submit a copy of the employees W-2, supporting the amount of wages paid). This check-and-balance reduces the risk of underreporting of income. On corporate or partnership returns, information on both the revenue and expenses of the entity are listed, as well as information on the entity's assets, liabilities, and ownership.

(3) **Taxable income versus "book" income**: In many situations, the IRC/tax treatment of various income and expense items differs from Generally Accepted Accounting Principles ("GAAP"). For example, the IRC is much more closely aligned with cash-basis accounting, especially for smaller businesses, while GAAP generally requires accrual-basis accounting. To reconcile the revenue, expenses, and income reported on a business's tax return to its GAAP-basis financial statements, the Schedule M-1 is shown (typically on Page 3 of the corporate tax return, Form 1120). This schedule is useful in understanding non-deductible expenses, and in illustrating the (potentially wide) disparities

between a company's reported results and its taxable activity.

(4) **Ordinary income**: A taxpayer generally reports two "types" of income: ordinary and capital. Ordinary income is generally taxed at higher tax rates (for individual taxpayers), and includes items such as wages, interest, and dividends. Business entities recognize ordinary income from their "ordinary" business transactions. A car dealer has ordinary income (or loss) for each vehicle they sell. Most taxable deductions are used to offset ordinary income.

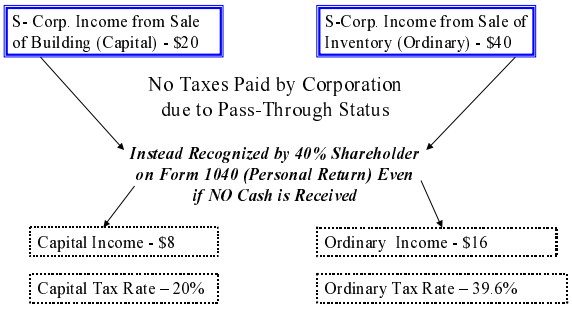
(5) **Capital gain income**: This type of income is generally derived from the sale of a capital asset. For the individual, this could include the sale of marketable securities. For a business, this would include the sale of assets that can be depreciated, goodwill, and other long-lived assets. Treatment of income as capital income primarily benefits individual taxpayers, as the income is taxed at lower tax rates than ordinary income (generally for assets held for more than one year). This advantage is one of the most crucial aspects of structuring transactions that involve the sale of assets or stock (e.g., shareholder disputes, transaction advisory malpractice, family law matters).

(6) **Basis in an asset**: Capital gain income is typically recognized only upon the realization of the gain (e.g., the sale of the asset). In determining the amount of the gain, the "basis" in the asset is subtracted from the sale proceeds. Basis is generally determined by examining the original acquisition cost (not fair market value), subtracting any depreciation already taken on the asset, and adjusting for any additional investments. An investor (individual or business) can have a basis in an individual asset (e.g., a commercial building) or a company's stock (e.g., shares of a closely held business). The basis in an asset affects the amount of gain that will be recognized; it may also affect the actual market value of the asset if a buyer is concerned about the deferred or built-in capital gain that they may be acquiring.

(7) **Corporate taxes**: Under the IRC a C-Corporation is taxed as an entity, and will pay taxes based on its reported net income. Taxes are assessed using a graduated scale, ranging from 15% to 38% of marginal income. Capital and ordinary income is typically taxed at the same rates.

(8) **Pass-through entities:** The legal organization of a pass-through entity (S-Corporations, partnerships, limited liability corporations) allows special tax treatment under the IRC. The primary benefit is that no business entity-level taxes are assessed against the entity; its expenses and/or income passes through to the shareholders and is reported on their individual returns. This pass-through occurs even if the entity does not actually distribute any of the income to its shareholders. For any given shareholder, the calculation of basis, the amount of economic benefits actually received, and the value of an ownership interest can be a challenging process.

Pass-Through Entities



(9) **Taxability of damages**: With the exception of certain personal injury cases, the majority of litigation matters require a consideration of the taxability of the damage award/settlement. This consideration should be made for both the plaintiff and the defendant; typically it is difficult to structure the conclusion in a manner that is favorable for both parties. The defendant

typically desires to make payments that will be tax-deductible (the sooner the better), in essence using Uncle Sam to "subsidize" the award (by immediately reducing taxable income, and the associated taxes paid). The plaintiff may prefer to receive the money over time so that the immediate tax liability is lower. They may also want to receive the award as payment for a capital asset, so that it may be taxed at the lower capital gains rates (especially relevant for individuals and pass-through entities).

(10) **Relevant for valuation**: The applicability of the IRC can affect both the amount of income that a business can expect to receive, as well as the valuation of that business' income. Fair market value has been defined in numerous tax cases related to estate and gift tax disputes, transactions between related parties, purchase price allocation that occurs after a business merger, and many run-of-the-mill tax disputes. One of the most widely cited examples of the impact of tax law on valuation conclusions relates to the application of valuation discounts. Valuation discounts for a minority interest (e.g., a shareholder unable to legally control the actions of a business entity/asset) are widely applied in estate tax matters.

A number of other taxes can be considered (e.g., social security, state income taxes) in approaching a case. The points mentioned above are just an overview of the myriad of issues that should be considered when drafting a complaint, evaluating potential damages, negotiating a settlement, and structuring the outcome.

Statement of Cash Flows – Cash is King

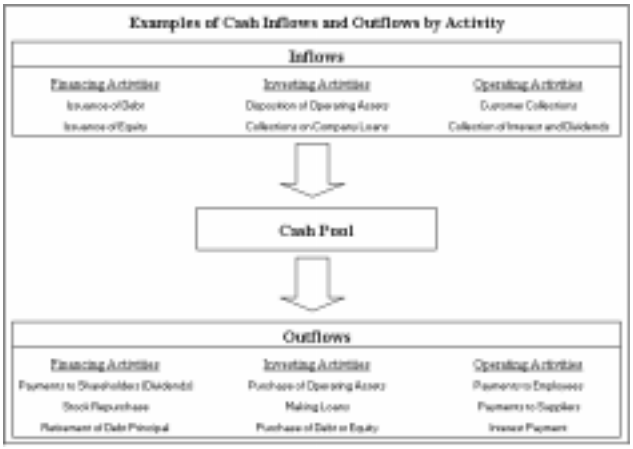
The inclusion of a statement of cash flows indicates that a company is using an accrual basis of accounting. Under accrual accounting, revenues and expenses are recognized when they are earned or incurred, not when the cash is collected or disbursed. Consequently, the income and expense items on the income statement rarely correspond exactly to cash flows.

(1) **Background**: The statement of cash flows presents information related to inflows and outflows of a company's cash and cash equivalents over a specified period of time, such as a fiscal year. Prior to 1987, companies often provided what was referred to as a *statement of changes in financial position.* Rather than dealing exclusively with cash and cash equivalents, this statement presented changes in accounts that were generically referred to as *funds.* The term funds was defined by the company's management team and, while it frequently corresponded to cash and cash equivalents, it was not uncommonly considered to be working capital (current assets less current liabilities). In 1987 the Financial Accounting Standards Board (FASB) issued a statement that detailed the purpose of the statement of cash flows, and defined cash equivalents as short-term, highly liquid investments that are readily convertible into known amounts of cash. Typically, only investments with maturities of three months or less are considered to be cash equivalents.

Classification of Cash Flows

Cash inflows and outflows are divided into three activity-based categories: financing activities, investing activities, and operating activities.

(2) **Financing activities** include the acquisition of financial resources required to fund the operation of the business, and the repayment of these resources to the owners and other stakeholders. Examples of actions that are classified as financing activities include the issuance of common stock, issuance of corporate debt, repurchase of outstanding shares, payment of debt principal (interest payments are classified as an operating activity), and payment of dividends. These activities generally affect balance sheet accounts related to long-term liabilities and owners' equity, and show the type of capital the company is using to fund its operations and growth. Growing companies typically have large cash inflows from financing activities.



(3) **Operating activities** include all transactions not considered to be financing or investing in nature. Generally, operating cash flows result from the sale of goods and services. The primary source of operating cash inflow is the collection of revenue from the company's customers. Cash disbursements for supplies, labor, and other costs of goods sold represent the most significant source of operating cash outflows. As stated previously, cash payments of interest are classified under operating activities. Similarly, taxes are presented with operating activities even though they are also affected by investing and financing actions. The effects of operating activities are usually reflected in the current asset and current liability accounts on the company's balance sheet. Depending on the type of business, the degree of capital employed, and the growth levels, operating activities may generate cash or use cash.

Direct vs. Indirect Approach for Operating Activities

(5) There are two ways a statement of cash flows may be presented: the direct approach and the indirect approach. The following major sources of operating cash flows must be explicitly presented under the **direct approach**:

- Cash collections from customers;
- Receipt of interest and dividends;
- Other operating cash inflows;
- Cash paid to suppliers of goods and services, including employees;
- Interest paid;
- Income taxes paid; and
- Other operating cash outflows.

(6) In contrast, under the **indirect approach**, net income as presented on the income statement is reconciled to the net cash flow from operations by adjusting for noncash income and expenses present on the income statement (e.g., depreciation) and cash inflows and outflows not contained therein. The indirect approach is much more common in practice. The presentation of financing and investing cash flows is generally unaffected by the approach used. In addition, companies that use the direct approach must reconcile net income to operating cash flow in a supplementary schedule. Consequently, companies that use the direct approach in effect present the indirect approach as well.

Interpreting the Statement of Cash Flows

(7) The statement of cash flows provides a significant amount of information that is not available or not readily apparent from the income statement and balance sheet. Because those statements are prepared on an accrual basis, it is not possible to follow the flow of cash into and out of a company without the statement of cash flows. Also, breaking down the inflows and outflows into different categories simplifies interpretation and can help highlight important aspects of a company's financial health.

(8) Net income as reported on the income statement is among the most important barometers of a company's performance. However, many of the income and expense items relate, at least in part, to accruals or noncash items. For instance, revenue as reported on the income statement is not typically equal to cash collections from customers, as changes in the level of accounts receivable will influence cash collections. Depreciation and amortization are common examples of noncash items that appear as

expenses on the income statement but do not effect the company's cash position. The statement of cash flows provides information that can be used to answer important questions about a company, such as why a profitable company (from a net income standpoint) is perennially short on cash, or alternatively, how a company that has a negative bottom line might be generating substantial positive operating cash flow.

(9) Important information related to a company's investing and financing activities can also be found on the statement of cash flows. The level of investment in productive assets is of primary importance. A company that is not making sufficient investments in capital equipment may not be able to support increases in sales volume. Alternatively, a company that is purchasing a substantial amount of machinery and equipment but is not expecting a proportionate increase in sales might have excess capacity in the future. In addition to capital expenditures, the cash flow statement provides information related to the investments a company is making in non-operating assets, and the proceeds from the sale of any investments. Finally, the statement of cash flows specifies if and how a company raised or paid down financing during the period. If capital was raised through the issuance of stock or debt, or if the company used cash to pay down outstanding loans or repurchase equity, the results of these actions will be shown on the statement of cash flows.

(10) It is important to assess whether or not a company is producing sufficient cash flow from operations to sustain future growth, as it is not possible for a company to generate positive cash flows from investing and financing activities indefinitely. Also, the quality of a company's earnings can be determined from the statement of cash flows. A company's financial flexibility can be assessed by determining if it has sufficient solvency (the ability to pay maturing debts) and liquidity (the ability to raise additional capital) to meet the challenges presented by unexpected business changes such as an unforeseen decline in sales or increase in labor costs.

Notes to the Financial Statements – Read 'Em and Weep

In order to better explain the fundamentals of the "notes to the financial statements," it is important to first understand the general purpose of the four principal financial statements. The objectives of financial reporting (i.e., presentation of the four basic financial statements), are:

- To provide information that is useful in making rational investment, credit, and similar decisions;
- To help users assess the timing and uncertainty of cash flows; and
- To provide information on economic resources, and the claims and changes therein.

However, since the presentation of the four principal financial statements is primarily in a numerical format, further explanations are often required for users to gain the thorough understanding described above. This coincides with the "full disclosure principle" generally adhered to in the preparation of a company's financial statements. This principle states that the accountant (or other preparer) should include sufficient information to permit a knowledgeable reader to make an informed judgment regarding the financial position of the company to which the financial statements are ascribed. The purpose of the notes to the financial statements is to fulfill this obligation; that is, to augment the information contained in the financial statements in order to provide to the user a better understanding of the company's financial position.

(1) **The purpose of the notes** is to provide additional information regarding a specific company and its financial statements that will enable a reader to better understand the financial position of the company. The footnotes are intended to enable the users to better estimate the timing, the amounts, and the uncertainties of the estimates provided in the financial statements. This supplementary information includes data regarding the accounting methods used by the company, assumptions made by management in preparation of the financial statements, and information

about certain estimates made by the company that are included in the financial statements. In a company's annual report, the footnotes are generally found immediately following the presentation of the company's four principal financial statements, which usually concludes with the statement of cash flows or the statement of stockholders' equity.

(2) **Typical order of the footnotes:** The following presents a generic representation of the notes to the financial statements that may be found in a company's annual report. The order and the description of the notes to the financial statements presented may vary considerably across different companies.

Note 1:	Overview/Organization of the Business
Note 2:	Significant Accounting Policies
Note 3:	Inventories
Note 4:	Other Current Assets
Note 5:	Property, Plant, and Equipment
Note 6:	Other Long-Term Assets
Note 7:	Debt Obligations
Note 8:	Income Taxes
Note 9:	Extraordinary and other Non-core Items
Note 10:	Employee Stock Ownership Plan or Employee Benefits
Note 11:	Litigious Liabilities
Note 12:	Concentrations of Credit Risk
Note 13:	Earnings Per Share Data
Note 14:	Segment Financial Data
Note 15:	Subsequent Events

The following items describe some frequently sought-after information that can be found in the footnotes to a company's financial statements:

(3) **How a company is organized:** A brief description of the operations and the organization (i.e., if the company is a C-corporation) of a business is usually included as the first note to the financial statements.

(4) **Mergers, sales, or acquisitions:** Information regarding recent mergers, sales, divestitures, and/or acquisitions is generally detailed in a footnote to the financial statements. This footnote, typically presented immediately following the significant accounting policies footnote, provides insight to the user of the financial statements on the historical and future financial impact on the company of these transactions, the accounting treatments accorded to the acquired assets/business, and the valuation analysis of the acquiring company.

(5) **The method of accounting for inventory:** The method of accounting for inventory (i.e., FIFO vs. LIFO) within a company is frequently (albeit briefly) described in the footnote entitled, "significant accounting policies." Often, there is a more detailed description of the finished goods, raw material, and work-in-process levels, and a calculation of the difference between LIFO and FIFO (the LIFO reserve) included in the inventory footnote. This footnote may also include information regarding slow-moving or potentially obsolete inventory.

(6) **Segregation of a company's fixed assets:** Typically, a company's balance sheet presents only a summary of the entity's net fixed assets. Many times, users of the financial statements are interested in viewing what types of fixed assets a company owns, such as land, buildings, or machinery and equipment. This type of information, as well as the accumulated depreciation attributed to the fixed assets, the estimated useful lives of the assets, and the associated depreciation method (e.g., straight-line or accelerated) is provided in the property, plant, and equipment (or fixed assets) footnote.

(7) **Debt obligations:** Information pertaining to a company's debt obligations is generally included in a footnote to the financial statements. This footnote can provide very useful information regarding the future liquidity of a company. While the financial statements present debt obligations due within one year and total debt obligations with maturities greater than one year, the financial statements may not present all of the necessary information needed in evaluating the future

viability of a company. For example, a balance sheet may show that a company has $20 million of long-term debt. What the balance sheet does not show (and what the footnote would show) is that there exists a $15 million balloon payment looming two years from the balance sheet date. Such information may be crucial in evaluating a company's future viability. Another important disclosure typically found in the debt footnote is information regarding a company's debt covenants and interest rates, which may restrict the company's future purchase of assets or distribution of cash flows.

(8) **Subsequent events:** Regulatory authorities have established guidelines for companies insofar as they report major events occurring subsequent to the financial statement date (but before their issuance) that may impact the decisions made by users of the financial statements. Such disclosures are typically presented in a footnote entitled, "subsequent events." Examples of items that may be included in this footnote are initial public offerings, acquisitions, litigation, and stock-splits.

(9) **Pro-forma adjustments:** For companies that are involved in acquiring and divesting businesses, comparison of financial data from year to year can be very difficult; the company that exists today doesn't look like it did the year before (or own the same assets). To allow some level of analysis, companies may provide pro-forma adjustments to reflect what the company would have looked like if it had owned the acquired/sold business for the entire period of time presented. These calculations and associated discussions are contained in the footnotes. (Additionally, many companies prepare pro-forma financials when selling a company. These projected statements are the seller's view of what the company would look like if it were purchased by an outside party.)

(10) **Unrecorded assets and liabilities:** The notes frequently contain discussions on many of the "off-balance sheet" assets and liabilities discussed earlier. Required disclosures include the amount of lease payments (operating and capital) required to be made over the next five years, stock options grants and exercises, how the pension liabilities of the company were calculated, and descriptions of derivatives, guarantees or other contingent liabilities that exist but are not recorded on the balance sheet.

Tips:

- While the notes to the financial statements may vary drastically across companies, the purpose remains the same; to better assist users of financial statements in assessing the financial position of the company in question.
- Look for the management discussion and analysis notes; they are included with many financial statements prepared for companies regulated by the SEC and explain the company's operations and financial results
- All of the information on a specific topic may not be contained in one footnote. Read them in their entirety; pieces of the puzzle will fall together more quickly.

Ratio Analysis – A Tool for Comparability

Ratio analysis involves the comparison of two or more line items in a company's financial statements. Commonly computed ratios can be divided into four general categories: liquidity ratios, activity ratios, leverage ratios, and return ratios.

- Liquidity ratios deal with a company's ability to meet short-term obligations by comparing various elements of current assets and current liabilities.
- Activity ratios, often referred to as turnover ratios, indicate how efficiently a company is managing certain accounts.
- Leverage ratios consider the capital structure of the company, comparing debt and equity levels.

- Return ratios investigate the income characteristics of the company, and the returns earned by investors. Common examples of each type of ratio are presented below.

Liquidity Ratios

(1) The **current ratio** is perhaps the most commonly referred to liquidity ratio. The current ratio compares current assets to current liabilities to determine if the company will be able to meet short-term obligations with current assets.

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

A low current ratio might suggest that a company would have a difficult time meeting upcoming financial obligations, and may be forced into bankruptcy. However, a current ratio that is too high might indicate that the company is not managing assets efficiently, perhaps by not collecting accounts receivable from customers quickly enough or by paying down accounts payable before they should.

(2) Another common liquidity ratio is the **quick ratio**. While the current ratio treats all current assets the same, some current assets (e.g., inventory) are much less liquid than cash or marketable securities. For this reason, the quick ratio eliminates inventory and sometimes other relatively illiquid current assets from the calculation.

$$\text{Quick Ration} = \frac{\text{Current Assets-Inventory}}{\text{Current Liabilities}}$$

A quick ratio of greater than one is typically considered good, as it indicates that the company would be able to meet all short-term obligations with highly liquid current assets.

Activity Ratios: Activity ratios provide information about the timing of revenue and expense recognition and the related cash flows. These ratios typically focus on accounts receivable, accounts payable, and inventory.

(3) **Accounts receivable (AR) turnover** is a measure of the company's sales that is tied up in accounts receivable. This is of interest to management as it affects cash collection. In general, companies would prefer to keep accounts receivable to a minimum, as this increases the frequency of cash collection.

$$\text{Accounts Receivable Turnover} = \frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

Dividing the annual accounts receivable turnover into 365 days yields the "days" in AR. For instance, if the accounts receivable turnover for a company were 8.11, this would imply 45 days in AR (365 days per year / 8.11 turns per year). In other words, cash equal to the sales for a 45-day period is tied up in accounts receivable. It is useful to compare AR activity (such as days in AR) to a company's targets, historical levels, and contractual terms with customers to ensure receivables are being collected in a timely manner.

(4) Similar to AR turnover, **accounts payable (AP) turnover** is also a commonly calculated ratio. Just as companies tend to want to collect their receivables quickly, they also tend to want to stretch payment of their payables out for as long as possible.

$$\text{Accounts Payable Turnover} = \frac{\text{Cost of Goods Sales}}{\text{Average Accounts Payable}}$$

Here, sales is replaced by cost of goods sold, since this is the income statement account associated with accounts payable. As with AR, dividing the number of days in the year, by AP turnover, yields days in AP. Again, it is recommended that trends in AP turnover be identified and that a company's results be compared to stated terms from suppliers to determine if management is managing accounts payable efficiently.

(5) The third common activity ratio is **inventory turnover**. This ratio indicates how long it takes the company to create and sell its inventory.

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

There are costs associated with holding inventory and a company would generally prefer to sell inventory as quickly as possible, generating a higher inventory turnover rate. However, an inventory turnover number that is too high might indicate that the company is carrying too little inventory and would be unable to keep up with demand.

Leverage Ratios: Leverage ratios analyze the riskiness of a company by providing information about the debt levels in a company's capital structure. As the level of debt increases, a company becomes relatively more risky as financial leverage magnifies both gains and losses. Commonly used leverage ratios are debt to equity and the times interest earned ratio.

(6) As the name implies, the **debt to equity ratio** compares a company's debt to stockholders' equity. The debt to equity ratio is similar to the debt to total capital ratio and the debt to total asset ratio (the latter two being equivalent).

$$\text{Debt to Equity} = \frac{\text{Total Debt}}{\text{Stockholders' Equity}}$$

$$\text{Debt to Total Capital} = \frac{\text{Total Debt}}{\text{Debt + Equity (or Assets)}}$$

Each of the above mentioned ratios measure a company's current debt load to gauge the risk profile of the company. Comparing debt to equity ratios with other companies in an industry may indicate that a company is under- or over-leveraged and should perhaps consider either raising more debt financing or paying down existing obligations.

(7) The **times interest earned ratio** measures a company's ability to make interest payments on outstanding debt.

$$\text{Times Interest Earned Ratio} = \frac{\text{Earnings Before Interest and Taxes}}{\text{Interest Expense}}$$

The higher this ratio, the more easily the company will be able to make interest payments out of income from operations. While a high level is typically considered desirable, if the times interest earned ratio is abnormally high, it might indicate that the company is under-leveraged and could raise the equity shareholder's returns by borrowing additional capital.

Return Ratios: In the end, the primary goal of management is to maximize shareholder wealth. Consequently, return ratios are important to current and potential investors (debt and equity). Popular return ratios include the return on assets (ROA) and return on equity (ROE) ratios.

(8) **Return on assets** considers net income and the assets used to generate that income.

$$\text{Return On Assets} = \frac{\text{Net Income}}{\text{Average Total Assests}}$$

An unusually low ROA, as compared to a company's historical results or to other market participants, suggests that management is poorly managing the company's productive assets. It may be possible to use those assets more efficiently through actions such as changing product mix, disposing of underused assets, or introducing new product lines.

(9) Similar to return on assets, **return on equity** compares net income to the investment the company's owners have in the company.

Since preferred dividends are paid before common dividends, the amount of any preferred dividends must be subtracted from net income to determine what is available to the common equity holders. Like ROA, it is useful to compare ROE to other companies in the same industry. If a company's ROE is significantly below that of other, similar companies, it may be an indication that the company is being managed poorly or that the company's capital structure (level of debt versus equity) is inappropriate.

Tips:

- Use ratio analysis to compare companies that differ in size or that conduct business in different industries (to a point); be careful comparing ratios of companies that use different accounting methods.
- Ratios are used by creditors, lenders, and transaction advisors to assess the financial health of a company. Accordingly, ratios are frequently referenced in the documents prepared by those parties.
- Ratios can be very misleading if a company's balance sheet fluctuates over the course of the year (or the period presented). If a transaction that changes the balance sheet is recorded just prior to the balance sheet date, this may skew the ratio analysis.
- Most ratios somehow consider the balance sheet and the assets or liabilities it presents. In situations where the recorded balance sheet amount does not equal true economic value, the calculated ratio, based on historic cost, may be misleading. This is especially true for the ROA and ROE ratios.

Notes

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