

# Accredited Business Advisor (ABA) Part I

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## Preparatory Course

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Kelen has remained actively involved in CPA exam content development for the past eight years and has authored over a thousand multiple choice questions for various sections of the exam, attending workshops with the AICPA across the country each year. He also serves as an Editorial Advisor for the AICPA's "Journal of Accountancy" as well as both an author and technical reviewer for Continuing Professional Education (CPE) courses published by the AICPA. He also authors CPE courses and serves as a technical reviewer and revision editor for Wolters Kluwer (CCH Group) and WebCE as well as contributing to CPE course development for SmartPros. He also authors CPE courses for PDH Academy.

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Lynn Fountain has over 38 years of experience spanning public accounting, corporate accounting and consulting. 20 years of her experience has been working in the areas of internal and external auditing and risk management. She is a subject matter expert in multiple fields including internal audit, ethics, fraud evaluations, Sarbanes-Oxley, enterprise risk management, governance, financial management and compliance. Lynn has held two Chief Audit Executive (CAE) positions for international companies.

In one of her roles as CAE, she assisted in the investigation of a multi-million-dollar fraud scheme perpetrated by a vendor that spanned 7 years and implicated 20 employees. The fraud was formally investigated by the FBI and resulted in 5 indictments estimating a \$1.3M fraud loss.

Ms. Fountain is currently engaged in her own consulting and training practice. She is a highly sought-after trainer and international speaker. In addition, Ms. Fountain has assisted numerous companies with enterprise risk management frameworks, internal audit processes and financial accounting. She also serves as a discussion leader for the AICPA for numerous classes finance, accounting and risk management topics.

Ms. Fountain is the author of three separate technical books. Her first book released in 2015 by the Institute of Internal Auditors Foundation is entitled "Raise the Red Flag – The Internal Auditors Guide to Fraud Evaluations". Her second book "Leading the Internal Audit Function" was released in October 2015 by Taylor & Francis Publications. This book serves as the initial launch for a series of leading practice internal audit and information technology publications. Her third book "Ethics and the Internal Auditor's Dilemma" was released in December 2016.

Ms. Fountain obtained her BSBA from Pittsburg State University and her MBA from Washburn University in Kansas. She has her CPA, CGMA, CRMA credentials.



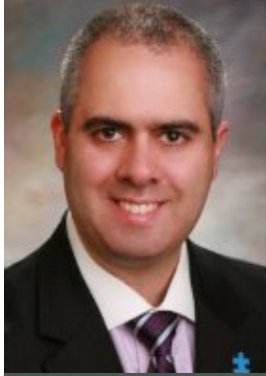
**Robert K. Minniti**

Dr. Minniti is the President and Owner of Minniti CPA, LLC. Dr. Minniti is a Certified Public Accountant, Certified Forensic Accountant, Certified Fraud Examiner, Certified Valuation Analyst, Certified in Financial Forensics, Master Analyst in Financial Forensics, Chartered Global Management Accountant, and is a licensed private investigator in the state of Arizona.

Dr. Minniti received his doctoral degree in business administration from Walden University, received his MBA degree and Graduate Certificate in Accounting from DeVry University's Keller Graduate School of Management, and received his Bachelor of Science in Business Administration degree from the University of Phoenix. Dr. Minniti taught graduate and undergraduate courses in forensic accounting at DeVry University, Grand Canyon University, Kaplan University, Northwestern University, and the University of Phoenix. He designed graduate and undergraduate courses for Grand Canyon University, Northwestern University, and Anthem College.

He is a writer and public speaker. He has experience in forensic accounting, fraud examinations, financial audits, internal audits, compliance audits, real estate valuations, business valuations, internal control development, business continuation planning, risk management, cyber security, privacy laws, data security, Sarbanes-Oxley compliance work and business consulting. In addition to his practice Dr. Minniti is an instructor teaching continuing professional education classes for a variety of providers and CPA Societies.

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## Salvatore Collemi

Salvatore A. Collemi, CPA is the Managing Member and Founder of Collemi Consulting and Advisory Services, LLC where he relies on over two decades of global business experience to guide U.S. and International public accounting firms, litigation attorneys, valuation experts, the C-suite and related institutions that support the profession in order to promote and enhance audit quality.

His practice provides outsourced high-level strategic and technical accounting & auditing guidance. Services include a full range of U.S. and International accounting & auditing consultations, technical reviews of financial statements and workpapers, AICPA Peer Review & PCAOB Inspection preparation, perform internal inspections, customized CPE training, independence & ethics consultations, etc. Salvatore is also a keynote speaker at company retreats and conferences. His past work experience at the U.S. Securities and Exchange Commission and the AICPA, combined with his previous roles as external auditor and technical partner to both national and international public accounting firms, gives him a keen understanding into the mindset of both regulators and standard-setters that he shares with his clients.

As a recognized subject matter expert on International Financial Reporting Standards (IFRS), Salvatore was named by the AICPA as an official participant in the development and review of IFRS questions for the Uniform CPA Examination and served as the IFRS Expert-at-Large for the AICPA Board of Examiners Content Committee from 2011-2014. Salvatore also served as AICPA liaison to the International Federation of Accountants (IFAC) Transnational Auditors Committee and Global Peer Review Subcommittee to assist in the development of their international quality assurance review program.

For more information about Salvatore, visit Collemi Consulting & Advisory Services, LLC and LinkedIn.

# Chapter 21

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## FINANCIAL STATEMENT ANALYSIS

### LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Understand the difference between financial reporting and general purpose financial statements
- Describe comparative financial statements and their use
- Evaluate various financial statement ratios and examine how to interpret ratio results
- Understand the limitations associated with using financial statement ratios

## FINANCIAL REPORTING VERSUS GENERAL PURPOSE FINANCIAL STATEMENTS

The terms *financial report* and *financial statement* are sometimes used interchangeably, but they have very separate and distinct meanings.

- *Financial report* is an umbrella term used for several types of reports provided to management about the financial health of a company. Financial reports gather important financial information for distribution to the public (typically, this information includes financial statements such as balance sheet, income statement, statement of cash flow, etc.). These statements are all included under the umbrella term *financial reports*. Financial reports also include specific reporting that may analyze the financial health of an organization through ratio evaluation or trend analysis. All financial statements are financial reports, but not all financial reports are financial statements.
- Financial statements fall under the financial report umbrella. Financial statements provide specific information about the financial position of an organization (including assets, liabilities, shareholder equity, cash flow, and results of operations). They are typically in a table format that has references to footnotes that explain specific details.

## COMPARATIVE FINANCIAL STATEMENTS

Comparative financial statements are a complete set of financial statements issued by an organization that reveal information for more than one reporting period (e.g., two years, three years, etc.). Management may refer to a *financial package*. A financial package may include statements such as the balance sheet, income statement, and cash flow statement, which all may provide information for multiple periods. Comparative financial statements are useful in many ways including, the following:

- Investors and management can analyze the financial performance of an organization over multiple periods. This allows the professional to easily examine and look at trends that may be occurring in the business.
- Comparative information can also relate to specific comparison of various information such as expenses to revenues or assets to liabilities. Also, ratios can be calculated for several periods from the various statements and used for trend analysis. This information is also used in assessing the health of the organization.
- Comparative financial information may also be used by management during their strategic planning processes to assist in evaluating past and projecting future performance.

A comparative financial statement will typically include several periods of activity shown in columns. This allows for easy analysis and comparison. Following is a simplified example of a comparative balance sheet.



## ABC Inc.

## Comparative Balance Sheet

	As of 12/31/20X3	As of 12/31/20X2	As of 12/31/20X1
<u>Current Assets</u>			
Cash	XXX	XXX	XXX
Accounts Receivable	XXX	XXX	XXX
Inventory	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total Current Assets</b>	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
Fixed Assets	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total Assets</b>	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<u>Current Liabilities</u>			
Accounts Payable	XXX	XXX	XXX
Accrued Expenses	XXX	XXX	XXX
Short-Term Debt	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total Current Liabilities</b>	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
Long-Term Debt	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>
<b>Total Liabilities</b>	<u>XXX</u>	<u>XXX</u>	XXX
<b>Shareholder's Equity</b>	XXX	XXX	XXX
<b>Total Liabilities and Shareholder's Equity</b>	<u>XXX</u>	<u>XXX</u>	<u>XXX</u>

Comparative financial statements are important to the process of financial analysis. Financial analysis may include evaluating businesses' specific assets, liabilities, revenues, expenses, or other financial statement information. It can also include evaluating projects, budgets, and other finance-related transactions to determine their performance and suitability to the organization's objectives. One type of financial analysis is to evaluate whether an organization is stable, solvent, liquid, or profitable enough to warrant future investment. These types of analysis may include:

- Internal financial analysis, which helps managers come to business decisions through evaluation of historical trends
- External financial analysis, which helps shareholders and stakeholders evaluate potential for investing

When speaking of financial analysis, professionals often use various financial ratios to compare and analyze information incorporating the various financial statements. Ratios are important elements to assist in understanding the organization's activities, but it is also important to understand that ratios do not necessarily tell the whole story. Often, an individual ratio is of more use when evaluated in-line with other ratios or trend information. In any event, for ratios to be useful and meaningful, they must be:

- Calculated using reliable, accurate financial information
- Calculated consistently from period to period

- Used in comparison to internal benchmarks
- Used in comparison to other companies in your industry
- Viewed both at a single point in time and as an indication of broad trends and issues over time
- Carefully interpreted in the proper context, considering there are many other important factors and indicators involved in assessing performance

## UNDERSTANDING RATIOS BY EVALUATING THE CONCEPTS OF MATH EQUATIONS

Often, professionals get so caught up in “calculating” ratios and memorizing formulas that they lose sight of the meaning behind the numbers. One of the biggest challenges with ratios is determining whether an increase or a decrease in the ratio is a good thing or a bad thing. The answer relates to fundamental math principles and what happens when the numerator or denominator (or both) change. Let’s review some basic math concepts.

First, the term *numerator* relates to the top number in a fraction, and *denominator* relates to the bottom number in a fraction. From a pure math perspective, when you divide the numerator by the denominator, you come up with a fraction. The higher the denominator is than the numerator, the smaller the fraction will be. The smaller the denominator is than the numerator, the larger the fraction. You can use the same analysis for the numerator and just invert the results. (The smaller the numerator is than the denominator, the smaller the fraction. The larger the numerator is than the denominator, the larger the fraction). Let’s look at some examples:

Numerator Change		
Fraction	Percent	Comment
2/3	.66	Here you can see the denominator of 3 stays constant, but the numerator decreased from 2 to 1. As a result, the fraction became a smaller percent.
1/3	.33	
3/8	.375	Here the denominator of 8 is constant, but the numerator increased from 3 to 5. As a result, the fraction became larger.
5/8	.625	
Denominator Change		
Fraction	Percent	Comment
1/4	.25	In this instance, the numerator of 1 stays constant, but the denominator was changed from 4 to 2. This resulted in an increase in the fraction.
1/2	.50	
1/2	.50	This example is the inverse of the above. The numerator is left at 1, but the denominator changed from 2 to 4. This resulted in a decrease in the fraction.
1/4	.25	

So what if the numerator and denominator both change? If this is the case, the professional would analyze which number had the largest change. If the denominator changed more (percentage wise) than the numerator, then the analysis described above of the denominator being larger than the numerator is relevant. If the numerator changed more (percentage wise) than the denominator, then the analysis described above of the numerator being larger than the denominator is relevant.

How does this help us in financial ratio analysis? The basic math concepts must be considered and applied to how balances on the financial statements increase and decrease. To understand the impact, go back to basic financial statement and accounting concepts of what constitutes a debit (increase) and what constitutes a credit (decrease). As an example, let’s review accounts that impact the balance sheet:

## REVIEW QUESTIONS

1. Per GAAP, what are the three primary financial statements required to be prepared by organizations?
  - a. Income statement, statement of cash flow, statement of equity
  - b. Balance sheet, statement of equity, income statement
  - c. Balance sheet, income statement, statement of cash flow
  - d. Income statement, management discussion and analysis, balance sheet
  
2. What is the proper definition of *intangible assets*?
  - a. Goods available for sale as well as raw materials used to produce those goods
  - b. Money owed by customers to the entity for goods or services delivered on credit but not yet paid for by the customer
  - c. Assets purchased for long-term use by an organization that are not likely to be converted quickly into cash
  - d. An asset that is not physical in nature
  
3. Which of the following categories of liabilities would be considered a short-term liability?
  - a. Bonds payable
  - b. Accounts payable
  - c. Deferred tax liabilities
  - d. Capital leases
  
4. Which category of stock entitles the holder to a fixed dividend?
  - a. Common stock
  - b. Preferred stock
  - c. Treasury stock
  - d. Retained earnings

## ANSWERS TO REVIEW QUESTIONS

**1. a. Incorrect.** A partnership cannot be made up of only one person. The UPA provides governance and key regulations for business partnerships in several U.S. states.

**b. Correct.** Based on the Uniform Partnership Act, a partnership is "...an association of two or more persons to carry on as co-owners a business for profit." More than likely, this definition aligns with your general understanding of what a partnership represents.

**c. Incorrect.** While a partnership can be made up of three or more persons, this is not the minimum number of persons that must be involved with a partnership. Instead, the minimum number is lower.

**d. Incorrect.** Partnerships can take one of several forms. The easiest types of partnerships to form, and therefore the most popular ones, are the general partnership and the limited partnership. While a partnership can be made up of four or more persons, this is not the minimum number of persons that must be involved with a partnership.

**2. a. Incorrect.** The UPA was most recently released in 1997, but this is not the year in which it was last amended. It was amended at a later date.

**b. Correct.** The first UPA was released in 1914. The UPA has been revised, amended, and updated over the years.

**c. Incorrect.** This is not when the UPA was last amended. The UPA governs general partnerships, and also governs limited partnerships except where the limited partnership statute is inconsistent.

**d. Incorrect.** This is not when the UPA was last amended. As noted in the prefatory note in the UPA, the UPA has been adopted in every state in the United States other than Louisiana and has been the subject of remarkably few amendments in those states over the past 80 years.

**3. a. Incorrect.** Limited partners are not personally responsible for the debts of the partnership. This is one of the distinct advantages with a limited partnership arrangement. The limited partners have, however, invested the majority of the partnership's equity and capital, and usually have the first claim to the partnership's profits and losses, although the amount is normally limited.

**b. Incorrect.** This is not one of the types of partners within a partnership. Instead, partnerships often have either general partners or limited partners.

**c. Incorrect.** This is not one of the types of partners within a partnership. Partnerships can take one of several forms. The easiest types of partnerships to form and therefore the most popular ones are the general partnership and the limited partnership.

**d. Correct.** The general partner must take primary responsibility for the day-to-day management of the business. The general partner is also responsible for the majority of the risk of failure in the event that the partnership fails. Limited partners' risk of loss is limited to the amount they have invested in the partnership.