CORPORATE LAW FORUM: ACCOUNTING BASICS FOR LAWYERS

What In-House Counsel Need to Know About Financial Statements and Current Accounting Issues

Tuesday, March 31, 2015
Bernie Woolfley – bwoolfley@navigant.com – 202.973.4543

Bernie is a Managing Director in Navigant’s Washington, D.C. office’s Disputes and Investigations practice. He has over 20 years of experience as a forensic accountant and consultant. He assists companies (and their Boards of Directors), law firms and federal agencies in performing investigations of various types of fraud and corruption (in both domestic and international settings) and the review of accounting activities in the context of both internal investigations and litigation. He is a Certified Public Accountant and a Certified Fraud Examiner.

Kevin Davis – kdavis@navigant.com - 202.481.7340

Kevin is a Director in Navigant’s Washington, D.C. office’s Disputes and Investigations practice. He has over 25 years of experience as an accountant, auditor and consultant. Kevin provides services on GAAP, financial reporting, SEC, and GAAS/auditing issues, and advises audit committees, company executives and legal counsel relating to independent financial investigations and litigation matters. Prior to joining Navigant, Kevin spent over 18 years with two international accounting firms. He is a Certified Public Accountant.
UNDERSTANDING FINANCIAL STATEMENTS
ACCOUNTING METHODS

Cash Basis

- Recognizes revenues when a company receives cash.
- Recognizes expenses when a company makes cash disbursements.
- Primarily used by small businesses.

VS.

Accrual Basis

- Revenues are recorded when earned and expenses are recorded when incurred. Expenses are “matched” to associated revenue.
- It is irrelevant when cash is received or paid.
- Generally Accepted Accounting Principles (GAAP) require the use of the accrual basis of accounting.
The balance sheet is represented by the accounting equation, which is a snapshot at a particular point in time.

<table>
<thead>
<tr>
<th>Assets</th>
<th>=</th>
<th>Liabilities</th>
<th>+</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>• An economic resource that is expected to benefit the business in the future.</td>
<td></td>
<td>• It is something the business owes and represents the creditor’s claim on the business assets.</td>
<td></td>
<td>• The stockholders claim to the assets of the business are called equity.</td>
</tr>
<tr>
<td>• It is something that has value, and the business owns or has control of.</td>
<td></td>
<td>• Ex. Accounts payable, notes payable, salaries payable</td>
<td></td>
<td>• Equity represents the amount of assets that are left over after the company has paid its’ liabilities. It is the company’s net worth.</td>
</tr>
<tr>
<td>• Ex. Cash, merchandise inventory, furniture</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The balance sheet is represented by the accounting equation, which is a snapshot at a particular point in time.
BALANCE SHEET

ASSETS
» Current Assets:
  › Cash & Securities
  › Receivables
  › Inventories
» Non-Current Assets:
  › Tangible Assets
    — Buildings & Plants
    — Land
    — Equipment
  › Intangible Assets
    — Goodwill
    — Intellectual Property

LIABILITIES & EQUITY
» Current Liabilities
  › Payables
  › Accrued Expenses
  › Short-term debt
  › Unearned Revenue
» Long-term Liabilities
  › Long-term debt
  › Other long-term liabilities
» Shareholders’ Equity
  › Stock
  › Retained Earnings

Assets = Liabilities + Owner’s Equity
Assets and Liabilities are valued (based upon a variety of factors) at either cost or fair value. Important to note that changes in valuation methodologies can have a significant impact on values.

Depreciation/Amortization is the process by which a company gradually records the loss in value of fixed or intangible asset. The corresponding expense related to this loss is recorded as an expense over the useful life of the asset.

Balance Sheets often distinguish between “current” (i.e. reasonably expected to be converted into cash within the next year) and “long-term”.

A number of balance sheet accounts require estimation and/or application of judgment:

- Allowance for uncollectible accounts
- Goodwill
- Useful lives of assets
- Contingencies
- Pension Liabilities
Summarizes the operating activities of the company over a particular period of time.

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Expenses</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Earnings that result from the delivery of goods or services to customers.</td>
<td>• The costs of selling goods or services. Expenses are the opposite of revenues and therefore, decrease equity.</td>
<td>• The difference between revenues and expenses.</td>
</tr>
<tr>
<td>• Equity is increased by revenues.</td>
<td>• Ex. Rent expense, salaries expense, advertising expense, utilities expense</td>
<td>• At the end of each period, net income is closed to equity. If the difference is positive (income), it will increase equity. If the difference is negative (loss), it will decrease equity.</td>
</tr>
</tbody>
</table>
INCOME STATEMENT

» Revenues
  › Net Sales
  › Rental Revenue
  › Other Revenue

» Expenses
  › Cost of Goods Sold
  › Operating Expenses

» Non-Recurring Events
  › Discontinued Operations
  › Accounting Changes

<table>
<thead>
<tr>
<th>Total Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Cost of Goods Sold</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Gross Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Operating Expenses</td>
</tr>
<tr>
<td>+ Other Revenue</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income From Operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Income Tax</td>
</tr>
<tr>
<td>+/- Non-Recurring Events</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Income</th>
</tr>
</thead>
</table>
Revenue is realizable and earned when:

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- Seller’s price to buyer is fixed
- Collectability is reasonable assured

Expense is recognized when probable and estimable

Matching Principle – Requires a company to match expenses with related revenues in order to report a company’s profitability during a specified period of time.

The Net Income or Loss that is ultimately recorded by a company is reflected in the owner’s equity section of the balance sheet.
The balance sheet and income statement have a series of different accounts (e.g. cash, fixed assets, payables, expenses, etc.) There is no limit to the number of accounts a company can have (e.g. fixed assets may have an account for “cars”, “boats”, “property”, etc.)

Under double-entry accounting, every financial transaction is recorded by making a change in one account (a debit) and an equal but opposite change in another account (a credit). Examples:

- **Purchasing a car:** impacts your “cash account” and the “assets account”
- **Cleaning Services:** impacts your “cash account” and the “office expense account”

Accounting relies upon “debits” and “credits” to determine whether you’re increasing the balance in an account or decreasing the balance in the account.

<table>
<thead>
<tr>
<th>Expenses</th>
<th>Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>Liabilities/Owner’s Equity</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase (+)</td>
<td>Decrease (-)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease (-)</td>
<td>Increase (+)</td>
</tr>
</tbody>
</table>
STATEMENT OF CASH FLOWS

» Summarizes the information concerning the cash inflows (receipts) and cash outflows (payments) for a specified period of time.

» Classifies all transactions affecting cash into one of three categories:

**Operating Activities**
- Cash related to transactions impacting net income

**Investing Activities**
- Cash related to acquisition and sale of long-term assets and non-operating investment assets

**Financing Activities**
- Cash related to transactions with creditors and owners

» Income is opinion, cash flow is fact
FINANCIAL STATEMENTS – KEY POINTS

Notes to the Financial Statements

» Required in all issued financial statements as an integral part of the statements.
» Indicate the actual accounting methods the company uses.
» Disclose additional relevant information needed to keep statements from being misleading.
» “If you haven’t read the notes…”

Role of Management

» Management is responsible for the complete and accurate preparation of all financial statements.
» Management is also responsible for developing a system of internal controls over financial reporting.
The SEC has authority under the securities laws of the United States to set accounting standards to be followed by public companies and the power to enforce those standards. Practically since its inception, the SEC has looked to the private sector for leadership in establishing and improving the accounting methods used to prepare financial statements.

The body currently performing this function is the Financial Accounting Standards Board (FASB), which has the power to set, but not enforce, accounting standards to be used by public companies.

### SEC Reporting Requirements for Public Companies

- **10-K**
  - Annual report required by the SEC of nearly all publicly held corporations

- **10-Q**
  - Quarterly report including unaudited financial statements that provides a continual view of a company’s financial position

- **8-K**
  - “Current report” used to report any material events or corporate changes which are of importance to investors
The actual determining of appropriate accounting treatment is based upon a compiled set of rules and regulations that have been set forth by the Financial Accounting Standards Board. These rules and regulations are generally referred to as Generally Accepted Accounting Principles (GAAP). Over the years, there have been numerous sources of authoritative accounting guidance.

On July 1, 2009, the FASB issued the codification of U.S. GAAP. The Codification is now the sole source of authoritative governmental entities. SEC rules and interpretive releases are also authoritative for SEC registrants.

International Financial Reporting Standards (IFRS) are the standards created by the International Accounting Standards Board (IASB) for use in a variety of international countries.

- Currently, over 110 countries required the use of IFRS when preparing financial statements.
- The SEC is evaluating the adoption of IFRS for registered companies
Accountants performing audits of public companies must adhere to the standards of the Public Company Accounting Oversight Board (PCAOB). The PCAOB was created by the Sarbanes Oxley Act of 2002 (SOX) to oversee the audits of public companies and broker-dealers.

Accountants performing audits of non-public companies must adhere to the auditing standards set forth by the AICPA Auditing Standards Board (ASB).

The combined rules established by the PCAOB and the ASB are generally referred to as Generally Accepted Auditing Standards (GAAS).

The standards set by the PCAOB are considered more rigorous than those of the ASB because, among other things, they include enhanced standards on quality control, ethics and independence.

The general, field work and reporting standards set by the ASB currently provide the framework for an audit performed on either public or non-public companies.
WHY ANALYZE FINANCIAL STATEMENTS?

» To make informed decisions regarding the financial condition of an organization.

- **Liquidity**: Availability of cash to meet obligations
- **Solvency**: Ability to meet debts when they are due
- **Profitability**: Excess of revenues over expenses

**Viability** – To ensure that a Company Can Continue as a Going Concern
ANALYZING PROFITABILITY AND KEY METRICS

» Earnings Per Share = Net Income / Weighted Average Number of Shares Outstanding
» EBITDA = Earnings Before Interest, Taxes, Depreciation and Amortization
» Gross Profit = Sales – Cost of Goods Sold
» Gross Profit Margin = Gross Profit / Sales
» Net Profit Margin = Net Income / Sales
» Operating Expenses to Sales = Operating Expenses / Sales
» Return on Total Assets = Net Income / Total Assets
» Return on Equity = Net Income / Stockholders’ Equity
» Asset Turnover = Revenue / Average Assets for the Period
ACCOUNTING RELATED STRATEGIES USED TO MANAGE EARNINGS
EARNINGS MANAGEMENT

» Higher net income
  › Acceleration of revenue recognition
  › Reduction of expense
  › Deferral of expenses until later period

» Lower net income
  › Manage market expectations related to growth
  › Mostly done by recognizing expenses currently through reserves that could be released in the future to increase bottom-line earnings
FOCUS OF EARNINGS MANAGEMENT

» Transactions which require judgment
  › Accounting decisions based on the application of principles to the facts and circumstances of the transaction

» Transactions within the organization that are outside the direct prevue of accounting
  › Sales teams negotiating deals and contracts

» Large number of transactions below a threshold requiring review by accounting personnel
Most people would assume that revenue recognition is very straight-forward.

“When I receive cash or deliver goods/service, I should recognize revenue.”

Revenue is recognized when earned, when the risk of ownership has changed hands.
Accounting literature sets forth four criteria that must be met -

- Persuasive evidence of an arrangement exists;
- Delivery has occurred or services have been rendered;
- The seller’s price to the buyer is fixed or determinable; and
- Collectability is reasonably assured.
REVENUE RECOGNITION ISSUES

» Sham Sales
  › Employees falsify records
  › Sales of goods that are shipped to another company location
  › Side arrangement exists to return goods

» Round-tripping activity
  › Sale of product or service to a customer
  › Provide funds to the customer through another transaction in order for customer to pay for good or service
REVENUE RECOGNITION ISSUES

» Improper cutoff of sales activity
  › Accounting records “held open” beyond period end date
  › Allows for sales activity after calendar period end to be counted in the prior quarter or year
  › Also occurs with the “back-dating” of contracts

» Distributor relationships
  › “Sale” made to a distributor
  › Revenue is recognized when terms, written or oral, limit financial risk to the distributor
  › When is final sale to the customer?
Timing on long-term contracts (i.e., percentage of completion contract)

Revenue is recognized in proportion to the expected expenses to be incurred, with profit margin factored in.

Focus, and where judgment occurs, is on the total cost to complete the contract relative to costs incurred at point in time.

As budget increases and percentage of completion possibly reverses, revenue to be recognized may be reduced.
EXPENSE RECOGNITION ISSUES

» Focus on earnings management is not when a payment is made, but rather when judgment is required
» Manipulation of expense recognition

› Allowance against future benefits of an asset
  — Allowance for doubtful accounts – Accounts receivable
  — Loan loss reserve – Mortgage notes

› Timing of an accrual for future activity
  — Legal reserve
  — Allowance for loss on completion of future contractual activity

› Capitalization of expense transaction as assets (i.e., property and equipment)
  — Numerous transactions just below an approval level so as to reduce review of actual activity
OTHER EARNINGS MANAGEMENT ISSUES

» Leases
  › Capitalize v. Expense

» Goodwill
  › Time of acquisition
  › Annual/interim assessment of realizability

» Acquisition Accounting
  › Judgment of valuation on assets
QUARTER-END AND YEAR-END ACCOUNTING CLOSE PROCESS
» What are the accountants doing?

› Preparation of initial draft of financial statements
› Consolidation of business units, segments, international operations
› Ensure intercompany activity is eliminated
› Assess the valuation and realizability of assets
› Budget-to-actual and comparison with prior quarter activity to assess significant fluctuations and business trends
› Finalization of documents requested by external auditors
› Preparation and completion of required financial statements, disclosures, and regulatory documents, as necessary
WHY SHOULD YOU CARE?

» Illegal acts and inappropriate accounting conclusions are often made at the end of a reporting period when company personnel and/or accountants are attempting to “hit” certain targets.

» Pressure from company executives to see specific results even though actual activity may not have produced those results.

» If earnings management did occur, it would be inappropriate for management to sign-off on required quarterly and year-end financial certifications.
IMPLEMENTING THE NEW REVENUE RECOGNITION STANDARDS
On May 28, 2014, the FASB and the IASB issued converged guidance on recognizing revenue in contracts with customers. The new guidance is a major achievement in the Boards’ joint efforts to improve this important area of financial reporting. The FASB and IASB believes that the new guidance will:

- Remove inconsistencies and weaknesses in the current revenue recognition standards
- Provide a robust framework for addressing revenue issues consistently across industries
- Improve comparability of revenue recognition practices
- Increase the disclosure requirements
- In the long run, reduce the complexity around the preparation of financial statements
- Often referred to as Topic 606
• The current effective date for this standard requires companies to use the new standards for annual reporting periods beginning after December 15, 2016 for public entities (and December 15, 2017 for all other entities). However, there is real likelihood that there may be a one year delay in implementing this new standard.

• Unlike earlier efforts at revenue recognition, this is an attempt at “one size fits all”. Unlike many other standards (which are rules based), these standards are much more subjective and represent a series of guidelines.

• Companies will face a challenge in implementing the new standard. Even though the “implementation date” is a way off, there is pressure now to start preparing systems for these new changes.

• SEC requires historical earnings information for three years. As such, 2015/2016 will represent the first periods truly covered by this standard.
WHY SHOULD YOU CARE?

» Revenue affects everyone.

» These new standards have the potential (in some industries) to be very subjective. Some of the key factors may have to be estimated and, as such, are open to manipulation.

» The new standards are very focused on understanding contracts with outside customers. Even if the “standard” contracts are correctly addressed, non-standard contracts (and other types of one-off agreements) have a potential risk of being misstated if the appropriate resources are not brought to bear to evaluate them under the new standards.

» This is an issue of documentation – there will have to be processes to ensure that key estimates made during the implementation of these standards will have to be documented.

» Subsequent changes to initial estimates will also have to be justified and documented. A single change in one estimate may have a ripple effect through the entire revenue process and runs the risk of drawing scrutiny from regulators and outsiders.
UNDERSTANDING THE RISKS WITHIN THE ACCOUNTING FUNCTION
WHO DO YOUR ACCOUNTANTS REALLY REPORT TO?

- Employees in the corporate accounting function usually report up through senior members of the executive team (e.g. CFO, Director of Finance). However, accountants operating in individual product units or in foreign countries may report to business unit leaders who can control their compensation, etc.

- Having accountants report to business unit leaders increases the risk that the independence of your accounting team may be compromised and may limit their ability to report on inappropriate conduct.

- While there may always be “dotted-line” reporting structures, the true authority (ability to hire/fire, compensation, etc.) for the supervision of accounting personnel should, in most cases, remain outside of the operational or business units of a company.

- Coordination and communications among accountants in different units/countries should be encouraged. This helps with the sharing of knowledge and a more consistent application of accounting policy.
By the nature of their work, accountants access, use and store huge volumes of both current and historical data. This data usually extends across long periods of time and across subsidiaries, product lines, etc.

Accountants also deal with significant volumes of confidential and employee related data.

While many accountants store data on secure network servers, others often use their personal hard drives and, as such, there maybe a greater risk of loss associated with an accountants computer.

Many accountants don’t necessarily perceive that a company’s data retention policies apply to them and, as such, retain a significant amount of data that might be in violation of your own data retention rules.
A perception exists among some GCs/senior executives that corporate accountants have the ability to see into books and records of international operating units, etc. While this is usually true for larger companies, for many mid-size companies (including those that are publically traded) this may not be the case.

International units may operate on stand-alone systems that track transactions locally with no reporting of those transactions to the corporate level. In those cases, summary results of operations are “uploaded” to corporate on a periodic (monthly/quarterly) basis. These results are then incorporated through the corporate consolidation process.

If your US based accounting team cannot see the transactional level data for a specific countries operations, it is more difficult to perform the necessary oversight on those operations. In these cases, you need to identify ways to perform that oversight function through detailed inquiry, internal audit testing, etc.
Internal Audit usually centers on targeted testing that is focused on ensuring compliance with some established process or financial requirement (e.g. compliance with regulatory requirements, contractual terms, accounting policies, etc.). In some cases, this work may also focus on testing internal controls or some specific subset of transactions.

An internal audit usually doesn’t rise to the level of a full financial statement audit or an audit focused on detecting fraud. As such, the mere fact that internal audit “performed a review” may not be sufficient basis for concluding that the operations in a specific country or area are acceptable.

Before a GC can place any reliance on the work of an internal auditor, it is essential that he/she understands the exact scope of the audit and the nature of the procedures that were performed.
The Independent auditor is required to meet with the Audit Committee on a regular basis (usually upon completion of the annual audit). Those discussions should include (among other things):

- The auditors assessment of the quality (not just acceptability) of the accounting principles used
- The nature of significant risks and exposures
- Adequacy of disclosures
- Any audit adjustments note or proposed by the auditors (and whether they were “passed” or implemented in the financial statements).

The disclosure is relatively standard and (usually) is not reflective of issues that need current attention. But, it is helpful for the GC to understand these discourses (and the context in which they were made) so as to better identify potential risks or issues that could arise in the future.
ACCOUNTANTS AS DETECTORS OF FRAUD

» More junior accountants (and, in many cases, accountants in other countries) perceive themselves as more processors than investigators.

» In some cases, the accountants may focus on the timely processing of data based upon their interpretation of the rules and they may not necessarily focus on looking for “red flags” in transactions or in identifying potentially inappropriate conduct.

» Accountants need to be trained and empowered to look for red flags in the transactions they process. There also needs to be a support structure through which they can express their concerns about unusual transactions without fear of the consequences related to doing so.

» In the same way that many accounting functions value individuals who are CPAs, the company should also place value on having an appropriate number of individuals with the CFF (Certified in Financial Forensics) and CFE (Certified Fraud Examiners) designations.
QUESTIONS?