




610: Financial & Accounting Issues for In-house Practitioners

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 Association of
Corporate Counsel

Financial & Accounting Issues for In-House Practitioners

Session - 610

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Session Overview

- **Today's Topics**
 - Reading and Understanding Financial Statements
 - Role of the Lawyer in Financial Statement Preparation
 - Selected Uses of Financial Statements
 - Financial Reporting and the SEC
 - Hot Topics in Accounting and Disclosure
- **Advance Materials**


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Session Overview

- **Context**
- Where were the lawyers?
- SEC Enforcement Staff initiative to hold “gatekeepers” accountable
- Lawyers charged in more than 30 enforcement actions in past two years
- Sarbanes-Oxley Act
 - Internal Financial and Disclosure Controls certification and reporting are a combination of legal and accounting processes
 - Office of Chief Counsel, not Office of Chief Accountant, overseeing the §404 reporting and attestation process
 - Not just public company issues

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Reading and Understanding Financial Statements

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Purpose

- Organizations report their financial position and results of operation through their financial statements.

- The purpose of this presentation is:
 1. Explain the financial statements
 2. Highlight key items on which to focus
 3. Briefly review an example

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What are Financial Statements?

● Financial Statement:

*A formal tabulation of names and amounts of money derived from accounting records that displays either financial position at a moment in time or one or more kinds of changes in financial position during a period of time.*¹

¹ Source is FASB concept Statement No. 5

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● Key concepts:

1. Formal tabulation from accounting records

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● Key concepts:

1. Formal tabulation from accounting records
2. Financial position at a moment in time.

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What are Financial Statements?

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*A formal tabulation of names and amounts of money derived from accounting records that displays either financial position at a moment in time or one or more kinds of **changes in financial position during a period of time.***¹

● Key concepts:

1. Formal tabulation from accounting records
2. Financial position at a moment in time.
3. Changes in financial position during a period of time

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Financial Statements


● There are two sections included in financial statements.

1. The four financial statements themselves
2. The Footnotes
 - Are an integral part of financial statements
 - As such, required to reference them on the face of each statement

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SEARS, ROEBUCK AND CO.			
Consolidated Statements of Income			
<i>millions, except per common share data</i>			
	2003	2002	2001
REVENUES			
Merchandise sales and services	\$ 36,372	\$ 35,698	\$ 35,755
Credit and financial products revenues	4,752	5,668	5,235
Total revenues	<u>41,124</u>	<u>41,366</u>	<u>40,990</u>
COSTS AND EXPENSES			
Cost of sales, buying and occupancy	26,231	25,646	26,234
Selling and administrative	9,111	9,249	8,892
Provision for uncollectible accounts	1,747	2,261	1,866
Depreciation and amortization	909	875	863
Interest, net	1,025	1,143	1,415
Loss on early retirement of debt, net	791	--	--
Special charges and impairments	112	111	542
Total costs and expenses	<u>39,926</u>	<u>39,285</u>	<u>39,812</u>
Operating income	1,198	2,081	1,178
Gain on sale of businesses	4,224	--	--
Other income, net	27	372	45
Income before income taxes, minority interest and cumulative effect of change in accounting principle	5,449	2,453	1,223
Income taxes	2,007	858	467
Minority interest	45	11	21
Income before cumulative effect of change in accounting principle	3,397	1,584	735
Cumulative effect of change in accounting for goodwill	--	(208)	--
NET INCOME	<u>\$ 3,397</u>	<u>\$ 1,376</u>	<u>\$ 735</u>
EARNINGS PER COMMON SHARE:			
BASIC			
Earnings per share before cumulative effect of change in accounting principle	\$ 11.95	\$ 4.99	\$ 2.25
Cumulative effect of change in accounting principle	--	(0.65)	--
Earnings per share	<u>\$ 11.95</u>	<u>\$ 4.34</u>	<u>\$ 2.25</u>
DILUTED			
Earnings per share before cumulative effect of change in accounting principle	\$ 11.86	\$ 4.94	\$ 2.24
Cumulative effect of change in accounting principle	--	(0.65)	--
Earnings per share	<u>\$ 11.86</u>	<u>\$ 4.29</u>	<u>\$ 2.24</u>

See accompanying notes. 



The Four Financial Statements

- There are four basic financials
 - One statement of position as of a point in time
 - Balance Sheet
 - Three statements of activity over a period of time (What happened since the last balance sheet date?).
 - Income Statement
 - Statement of Cash Flows
 - Statement of Shareholder's Equity

Which support and tie into the balance sheet

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Balance Sheet

- Balance sheet: Summary of an entity's assets and liabilities
 - + Assets → Resources owned by the entity
 - Liabilities → Obligations of the entity owed to third parties
 - = Shareholders' Equity → What is left over, which represents the owners' interest in the entity
- Assets and liabilities are presented in order of liquidity
 - The items nearest to cash are presented first
 - Present subtotals for current items (due within one year)
- Items to focus upon
 - Shareholders' equity - Is it positive?
 - Relationship between current assets and current liabilities


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SEARS, ROEBUCK AND CO.
Consolidated Balance Sheet

millions, except per share data

	2003	2002	2001
ASSETS			
Current assets			
Cash and cash equivalents	\$ 9,057	\$ 1,962	
Credit card receivables and equivalents	1,998	1,962	32,563
Less allowance for uncollectible accounts	422	585	1,832
Net credit card receivables	1,576	1,377	30,731
Other receivables and receivables	733	30,759	891
Merchandise inventories, net	5,335	863	5,115
Prepaid expenses and deferred charges	407	5,115	535
Deferred income taxes and deferred charges	708	535	749
Total current assets	18,196	749	39,983
Property and equipment			
Land	392		442
Buildings and improvements	7,151	442	6,930
Furniture, fixtures and equipment	4,972	6,930	5,050
Capitalized leases	609	5,050	557
Gross property and equipment	13,124	557	12,979
Less accumulated depreciation	6,336	12,979	6,069
Total property and equipment, net	6,788	6,069	6,910
Deferred income taxes	378		734
Goodwill	943	734	944
Tradenames and other intangible assets	710	944	704
Other assets	708	704	1,134
TOTAL ASSETS	\$ 27,723	\$ 1,134	\$ 50,409
TOTAL ASSETS	\$ 50,409	\$ 44,317	

SEARS, ROEBUCK AND CO.		
Consolidated Balance Sheet		
<i>millions, except per share data</i>		
	2003	2002
LIABILITIES		
Current liabilities		
Short-term borrowings	\$ 1,033	\$ 4,525
Current portion of long-term debt and capitalized lease obligations	2,950	4,808
Merchandise payables	3,106	2,945
Income taxes payable	1,867	787
Other liabilities	2,950	3,753
Unearned revenues	1,244	1,199
Other taxes	609	580
Total current liabilities	13,759	18,597
Long-term debt and capitalized lease obligations	4,218	21,304
Pension and postretirement benefits	1,956	2,491
Minority interest and other liabilities	1,389	1,264
Total Liabilities	21,322	43,656
COMMITMENTS AND CONTINGENT LIABILITIES		
SHAREHOLDERS' EQUITY		
Common shares issued (\$.75 par value per share, 1,000 shares authorized, 230.4 and 316.7 shares outstanding, respectively)	323	323
Capital in excess of par value	3,519	3,505
Retained earnings	11,636	8,497
Treasury stock - at cost	(7,945)	(4,474)
Deferred ESOP expense	(26)	(42)
Accumulated other comprehensive loss	(1,106)	(1,056)
Total Shareholders' Equity	6,401	6,753
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 27,723	\$ 50,409



Shareholders' Equity

- It is also important to understand the sources of shareholder's equity
 - Monies paid by the shareholders vs.
 - Common stock, paid in capital
 - Amount earned and retained by the entity
 - Retained earnings

● For example, consider the June 30, 2004 Amazon.com Balance Sheet
(amounts in millions)

Assets	\$ 1,888
Liabilities	2,679
Equity	<u>\$ (791)</u>

Common stock and PIC	\$ 1,968
Retained earnings	(2,787)
Other	28
	<u>\$ (791)</u>



Income Statement

Income Statement:

- Summary of an entity's inflows (i.e. revenue) and the costs incurred (expenses) to generate them over a period of time.
- Left over is profit (loss)

Items to focus upon

- Operating income → Earnings generated by business operations
- Net income → Total earnings generated
- Earnings per share → Total earnings attributable to each share of stock
The higher the EPS, the higher the value of the stock (in theory).

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SEARS, ROEBUCK AND CO. Consolidated Statements of Income

millions, except per common share data

	2003	2002	2001
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NET INCOME	\$ 3,397	\$ 1,376	\$ 735
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See accompanying notes.



Statements of Cash Flows

- Cash flows:
 - Summary of the sources and uses of cash over a period of time.
- Purpose of the statement to report cash generated from (used by) each of these three activities
 - Operations
 - Investing
 - Financing

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SEARS, ROEBUCK AND CO. Consolidated Statements of Cash Flow

<i>millions</i>	2003	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 3,397	\$ 1,376	\$ 735
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation and amortization	909	875	863
Loss on early retirement of debt	791	--	--
Cumulative effect of a change in accounting for goodwill	--	208	--
Provision for uncollectible accounts	1,747	2,261	1,866
Special charges and impairments	112	111	542
Gain on sale of businesses	(4,224)	--	--
Gain on sales of property and investments	(12)	(347)	(21)
Income tax benefit on nonqualified stock options	25	24	14
Change in (net of dispositions and acquisitions):			
Deferred income taxes	648	(203)	(190)
Retained interest in transferred credit card receivables	--	--	(759)
Credit card receivables	524	(4,833)	(810)
Merchandise inventories	(158)	45	610
Other operating assets	(496)	(56)	61
Other operating liabilities	(739)	34	(596)
Net cash provided by (used in) operating activities	\$ 2,524	\$ (505)	\$ 2,315



SEARS, ROEBUCK AND CO.			
Consolidated Statements of Cash Flow			
<i>millions</i>	2003	2002	2001
CASH FLOWS FROM INVESTING ACTIVITIES			
Acquisition of businesses, net of cash acquired	(1,840)	--	--
Proceeds from sale of businesses	21,651	--	(1)
Proceeds from sales of property and investments	506	--	75
Purchases of property and equipment	(1,035)	568	59
Purchases of long-term investments	(925)	(1,035)	(1,126)
Net provided by cash (used in) investing activities	20,758	(2,322)	(1,088)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from long-term debt	6,565	4,051	795
Repayments of long-term debt	(3,257)	(6,565)	(4,051)
(Decrease) increase in short-term borrowings, primarily 90 days or less	(12,643)	(3,256)	(3,532)
Repayments of ESOP note receivable	964	(708)	1,295
Common shares repurchased	(3,519)	964	(708)
Common shares issued for employee stock plans	2	11	33
Dividends paid to shareholders	(427)	(625)	(333)
Net cash (used in) provided by financing activities	(16,212)	3,721	(1,008)
Effect of exchange rate changes on cash and cash equivalents	25	4	3
NET INCREASE IN CASH AND CASH EQUIVALENTS	7,095	898	222
BALANCE AT BEGINNING OF YEAR	1,962	1,064	842
BALANCE AT END OF YEAR	\$ 9,057	\$ 1,962	\$ 1,064
BALANCE AT BEGINNING OF YEAR	1,064	842	729
BALANCE AT END OF YEAR	\$ 1,962	\$ 1,064	\$ 842

See accompanying notes.



Statements of Shareholders' Equity

● Summary of the changes in each of the shareholders' equity accounts

● Usually presented in tabular format

● For Sears, most of the activity flows through retained earnings and Treasury stock.

	<u>Retained Earnings</u>	<u>Treasury Stock</u>
Beg. balance	\$ 8,497	\$ (4,474)
Net income	3,397	--
Dividends	(258)	--
Options exercised	--	202
Stock Buyback	--	(3,673)
Ending balance	<u>\$ 11,636</u>	<u>\$ (7,945)</u>

SEARS, ROEBUCK AND CO.								
Consolidated Statements of Shareholders' Equity								
<i>dollars in millions</i> <i>shares in thousands</i>	Common Shares Outstanding	Common Shares Issued	Capital in Excess of Par Value	Retained Earnings	Treasury Stock	Deferred ESOP Expense	Accumulated Other Comprehen- sive Loss	Total Share- holders' Equity
Balance, end of year 2002	316,734	\$ 323	\$ 3,505	\$ 8,497	\$ (4,474)	\$ (42)	\$ (1,056)	\$ 6,753
Net income				3,397				3,397
Total other comprehensive loss							(50)	(50)
Total comprehensive income								3,347
Dividends declared to shareholders (\$0.92 per share)				(258)				(258)
Stock options exercised and other changes	5,295		14		202			216
Shares repurchased	(91,653)				(3,673)			(3,673)
ESOP expense recognized						16		16
Balance, end of year 2003	<u>230,376</u>	<u>\$ 323</u>	<u>\$ 3,519</u>	<u>\$ 11,636</u>	<u>\$ (7,945)</u>	<u>\$ (26)</u>	<u>\$ (1,106)</u>	<u>\$ 6,401</u>



Footnotes to the Financial Statements


● Purpose:

to provide supplemental information about the financial condition of a company without which the financial statements can not be fully understood.

● Three types of footnotes

1. Describe accounting rules used
2. Provide detail on specific item on financial statements
3. Disclose information not shown on financial statements


● Commitments and Contingencies



**Role of the Lawyer
in Financial
Statement
Preparation**

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Commitments and Contingencies

- **Commitment:** contractual agreements that will have a significant financial impact on the company in the future
 - Ex. operating leases

- **Loss contingency:** potential liability, with the amount of loss to be determined by a future event
 - Ex. Claim giving rise to potential lawsuit
 - Must analyze for:
 - Accrual
 - Disclosure
 - No action
 - Applies if case is material to the company

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Accrual of Loss Contingencies

- Accrual required under FAS 5 if:
 - Information available prior to financial statements' issuance indicates it is **probable** that an asset has been impaired or liability incurred; and
 - The amount of loss can be **reasonably estimated**

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Disclosure of Loss Contingencies

- Disclosure required under FAS 5 if:
 - Information available prior to financial statements' issuance indicates it is **probable** or **reasonably possible** that an asset has been impaired or liability incurred
 - Disclosure included in the notes to the financial statements
 - Note: the amount of loss **does not** have to be reasonably estimated for **disclosure** to be required

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Loss Contingencies: Key Definitions

- **Probable:** future event(s) are likely to occur
- **Reasonably possible:** the chance of the future event(s) occurring is more than remote, but less than likely
- **Remote:** the chance of the future events occurring is slight

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Loss Contingency Analysis

Likelihood of Event?	Reasonably Estimable?	Action?
Probable	Yes	Accrue
Probable	No	Disclose
Reasonably possible	Either	Disclose
Remote	N/A	None

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Loss Contingencies: Action Steps

- Establish a company policy that quantifies the likely outcome based on the key definitions; for example:
 - Probable = greater than 65% likelihood of occurring
 - Reasonably possible = 10% to 65% likelihood of occurring
 - Remote = less than 10% likelihood of occurring

- Key: Apply the policy consistently – in good times and bad

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Selected Uses of Financial Statements

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Selected Uses of Financial Statements

- **Analysis of Business Performance**
- **Credit Arrangements**
- **Mergers and Acquisitions**

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Analysis of Business Performance

Overview

- Financial statements and notes can and should be used to provide insight into the financial strength and earnings capacity of a business
- Requires an examination of the relationship between accounts - not just individual line items
- A relatively small group of ratios and comparisons are typically the object of most readers' attention

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Analysis of Business Performance

- **Nature of analysis depends on reader's perspective**
 - Short-term noteholder concerned with company's ability to pay current obligations
 - Long-term debtholder might look to historical and projected earnings and cash flow
 - Stockholders would share the long-term debtholders perspective, but probably with more concern for earnings and growth trends
 - Management is concerned with all of the above, plus it needs financial information to make operating decisions
- **Let's look at some of the financial ratios most often computed to analyze a business**

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Analysis of Business Performance

Ratios to Measure Return on Investment

- Return on Equity
- Return on Assets

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Ratios to Measure Return on Investment

Return on Equity

Sears, Roebuck and Co.		Consolidated Statement of Income	
millions		2003	
REVENUES			
Merchandise sales and services	\$	36,372	
Credit and financial products revenues		4,762	
Total revenues		41,134	
COSTS AND EXPENSES			
Cost of sales, buying and occupancy		26,231	
Selling and administrative		9,111	
Provision for uncollectible accounts		1,747	
Depreciation and amortization		909	
Interest, net		1,025	
Loss on early retirement of debt, net		793	
Special charges and impairments		112	
Total costs and expenses		39,526	
Operating income		1,198	
Gain on sale of businesses		4,224	
Other income, net		27	
Income before income taxes, minority interest and cumulative effect of change in accounting principle		5,449	
Income taxes		2,007	
Minority interest		45	
Income before cumulative effect of change in accounting principle		3,397	
Cumulative effect of change in accounting for goodwill		-	
NET INCOME		\$ 3,397	

Sears, Roebuck and Co.		Consolidated Balance Sheets	
millions		2003	
SHAREHOLDERS' EQUITY			
Common shares issued (\$0.75 par value per share, 1,000 shares authorized, 230.4 and 316.7 shares outstanding, respectively)	\$	323	\$ 323
Capital in excess of par value		3,519	3,505
Retained earnings		11,636	8,497
Treasury stock - at cost		-7,945	-4,474
Deferred ESOP expense		-26	-42
Accumulated other comprehensive loss		-1,106	-1,056
Total Shareholders' Equity	\$	6,401	\$ 6,753

$$\frac{\$3,397 \text{ (Net Income)}}{\$6,401 + \$6,753 \div 2 \text{ (Average Shareholders' Equity)}} = 51.6\%$$

Measures the annual percentage yield on the investment made by your shareholders



Ratios to Measure Return on Investment

Return on Assets

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NET INCOME		\$ 3,397	

Sears, Roebuck and Co.		Consolidated Balance Sheets	
millions		2003	
ASSETS			
Current assets			
Cash and cash equivalents	\$	9,027	\$ 1,062
Credit card receivables		1,981	32,242
Less allowance for uncollectible accounts		-42	-1,232
Net credit card receivables		1,986	30,710
Other receivables		753	694
Merchandise inventories, net		5,345	5,115
Prepaid expenses and deferred charges		407	520
Deferred income taxes		750	744
Total current assets		18,196	39,055
Property and equipment			
Land		362	842
Buildings and improvements		7,461	6,863
Furniture, fixtures and equipment		4,972	5,050
Capitalized leases		620	672
Other property and equipment		13,241	12,979
Less accumulated depreciation		6,330	6,026
Total property and equipment, net		6,788	6,915
Deferred income taxes		376	724
Goodwill		863	864
Trademarks and other intangible assets		710	714
Other non-current assets		11	11
Total Assets		\$ 27,723	\$ 49,491

$$\frac{\$3,397 \text{ (Net Income)}}{\$27,723 + \$50,409 \div 2 \text{ (Average Total Assets)}} = 8.7\%$$

- Measures the annual percentage yield on the gross investment in the business financed by your shareholders and your creditors combined.
- The relationship between the returns on assets and on equity is indicative of the effect of the business' financial leverage -- if the leverage is positive (debt is high), the return on equity will be higher than the return on assets. Put another way, the business uses debt financing to increase returns to stockholders.

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Analysis of Business Performance

Ratios to Measure Liquidity and Safety

- Debt to Equity Ratio
- Interest Coverage Ratio
- Tangible Net Worth
- Net Working Capital
- Current Ratio

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Ratios to Measure Liquidity and Safety

Debt to Equity Ratio

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Consolidated Balance Sheet	
millions	
2003	
LIABILITIES	
Current liabilities	
Short-term borrowings	\$ 1,033
Current portion of long-term debt and capitalized lease obligations	2,950
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Long-term debt and capitalized lease obligations	4,218
Pension and postretirement benefits	1,956
Minority interest and other liabilities	1,389
Total Liabilities	\$ 21,322

Sears, Roebuck and Co.	
Consolidated Balance Sheet	
millions	
2003	
SHAREHOLDERS' EQUITY	
Common shares issued (\$.75 par value per share, 1,000 shares authorized, 230.4 and 316.7 shares outstanding, respectively)	\$ 323
Capital in excess of par value	3,519
Retained earnings	11,636
Treasury stock - at cost	-7,945
Deferred ESOP expense	-26
Accumulated other comprehensive loss	-1,106
Total Shareholders' Equity	\$ 6,401

$$\frac{\$21,322 \text{ (Total Liabilities)}}{\$ 6,401 \text{ (Total Shareholders' Equity)}} = 3.33x$$

Indicates the mix of funding provided by shareholders (owners) and creditors. The greater the number, the "more leveraged" is the company.

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Ratios to Measure Liquidity and Safety

Interest Coverage Ratio

Sears, Roebuck and Co.	
Consolidated Statement of Income	
millions	
2003	
REVENUES	
Merchandise sales and services	\$ 36,372
Credit and financial products revenues	4,752
Total revenues	41,124
COSTS AND EXPENSES	
Cost of sales, buying and occupancy	26,231
Selling and administrative	9,111
Provision for uncollectible accounts	1,747
Depreciation and amortization	900
Interest, net	1,025
Loss on early retirement of debt, net	791
Special charges and impairments	112
Total costs and expenses	39,926
Operating income	1,198
Gain on sale of businesses	4,224
Other income, net	27
Income before income taxes, minority interest and cumulative effect of change in accounting principle	5,449
Income taxes	2,007
Minority interest	45
Income before cumulative effect of change in accounting principle	3,397
Cumulative effect of change in accounting for goodwill	-
NET INCOME	\$ 3,397

$$\frac{\$5,449 + \$1,025 \text{ (Income before Interest and Taxes)}}{\$1,025 \text{ (Interest Expense)}} = 6.32x$$

Measures the ability of a company to cover its interest obligations. Sometimes you'll see a variation that also factors in scheduled principal payments.

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Ratios to Measure Liquidity and Safety

Tangible Net Worth

Sears, Roebuck and Co.	
Consolidated Balance Sheet	
millions	
2003	
SHAREHOLDERS' EQUITY	
Common shares issued (\$ 7.75 par value per share, 1,000 shares authorized, 230.4 and 316.7 shares outstanding, respectively)	\$ 323
Capital in excess of par value	3,519
Retained earnings	11,636
Treasury stock, at cost	-7,945
Deferred ESOP expense	-26
Accumulated other comprehensive loss	-1,106
Total Shareholders' Equity	\$ 6,401

Sears, Roebuck and Co.	
Consolidated Balance Sheet	
millions	
2003	
ASSETS	
Current assets	
Cash and cash equivalents	\$ 9,057
Credit card receivables	1,998
Less allowance for uncollectible accounts	42
Net credit card receivables	1,956
Other receivables	733
Merchandise inventories, net	5,335
Prepaid expenses and deferred charges	407
Deferred income taxes	708
Total current assets	16,196
Property and equipment	
Land	392
Buildings and improvements	7,151
Furniture, fixtures and equipment	4,972
Capitalized leases	609
Gross property and equipment	13,124
Less accumulated depreciation	6,336
Total property and equipment, net	6,788
Deferred income taxes	378
Goodwill	943
Trademarks and other intangible assets	710
Other assets	708
TOTAL ASSETS	\$ 27,723

$$\$6,401 \text{ (Total Shareholders' Equity)} - \$1,653 \text{ (Goodwill, Tradenames and Other Intangible Assets, Prepaid Expenses and Deferred Assets)} = \$4,748 \text{ (Tangible Net Worth)}$$

Measures true net proceeds a company could be expected to receive from a liquidation

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Ratios to Measure Liquidity and Safety

Net Working Capital

Sears, Roebuck and Co. Consolidated Balance Sheet		Sears, Roebuck and Co. Consolidated Balance Sheet	
millions		millions	
	2003		2003
ASSETS			
Current assets			
Cash and cash equivalents	\$ 9,057		
Credit card receivables	1,990		
Less allowance for uncollectible accounts	42		
Net credit card receivables	1,956		
Other receivables	733		
Merchandise inventories, net	5,335		
Prepaid expenses and deferred charges	407		
Deferred income taxes	795		
Total current assets	\$ 18,196		

Sears, Roebuck and Co. Consolidated Balance Sheet		Sears, Roebuck and Co. Consolidated Balance Sheet	
millions		millions	
	2003		2003
LIABILITIES			
Current liabilities			
Short-term borrowings	\$ 1,033		
Current portion of long-term debt and capitalized lease obligations	2,950		
Merchandise payables	3,106		
Income taxes payable	1,867		
Other liabilities	2,950		
Unearned revenues	1,244		
Other taxes	609		
Total current liabilities	\$ 13,759		

$$\begin{aligned}
 & \$18,196 \text{ (Current Assets)} \\
 & - 13,759 \text{ (Current Liabilities)} \\
 & \hline
 & \$ 4,437 \text{ (Net Working Capital)}
 \end{aligned}$$

A measure of the shorter-term, more liquid assets available to meet short-term obligations, serve as a cushion against unforeseen needs for resources and take advantage of new opportunities

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Ratios to Measure Liquidity and Safety

Current Ratio

Sears, Roebuck and Co. Consolidated Balance Sheet		Sears, Roebuck and Co. Consolidated Balance Sheet	
millions		millions	
	2003		2003
ASSETS			
Current assets			
Cash and cash equivalents	\$ 9,057		
Credit card receivables	1,990		
Less allowance for uncollectible accounts	42		
Net credit card receivables	1,956		
Other receivables	733		
Merchandise inventories, net	5,335		
Prepaid expenses and deferred charges	407		
Deferred income taxes	795		
Total current assets	\$ 18,196		

Sears, Roebuck and Co. Consolidated Balance Sheet		Sears, Roebuck and Co. Consolidated Balance Sheet	
millions		millions	
	2003		2003
LIABILITIES			
Current liabilities			
Short-term borrowings	\$ 1,033		
Current portion of long-term debt and capitalized lease obligations	2,950		
Merchandise payables	3,106		
Income taxes payable	1,867		
Other liabilities	2,950		
Unearned revenues	1,244		
Other taxes	609		
Total current liabilities	\$ 13,759		

$$\frac{\$18,196 \text{ (Current Assets)}}{\$13,759 \text{ (Current Liabilities)}} = 1.32 \times$$

- Another measure of the ability to pay current liabilities as they mature. A ratio of 1:1 or greater corresponds to positive net working capital.
- What's appropriate for a company depends to a large extent on its industry. Companies with small inventory and easily collectible accounts receivable can operate safely with a lower current ratio than companies that have a greater proportion of their current assets in inventory and sell their products on credit.

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Analysis of Business Performance

Ratios to Measure Operating Efficiency

- Inventory Turnover
- Operating Profit Margin
- Average Collection Period (Days' Sales)
- Receivables Turnover
- Number of Days' Sales in Inventory
- Gross Profit Margin

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Ratios to Measure Operating Efficiency

Inventory Turnover

	2002	2003
ASSETS		
Cash and cash equivalents	\$ 44	\$ 87
Accounts receivable, net (includes amounts due from Motorola of \$89 in 2002 and \$43 in 2003)	418	327
Inventories	804	693
Deferred income taxes	26	20
Other current assets	112	228
Assets held-for-sale	15	334
Total current assets	1,419	1,689
Property, plant and equipment, net	3,226	2,357
Investments	101	126
Other assets	379	277
Total assets	\$ 5,125	\$ 4,449

	2002	2003
Net sales (includes sales to Motorola of \$1,080 in 2001, \$1,143 in 2002 and \$961 in 2003)	\$ 5,001	\$ 4,864
Cost of sales	3,763	3,451
Cross margin	1,238	1,413
Selling, general and administrative	604	649
Research and development	993	1,005
Reorganization of businesses	1,156	63
Operating earnings (loss)	(1,515)	(304)
Other income (expense):		
Interest expense, net	(163)	(114)
Gains on sales of investments and businesses, net	15	106
Other	(16)	(7)
Total other income (expense)	(166)	(15)
Loss before income taxes	(1,681)	(319)
Income tax expense	86	47
Net loss	\$ (1,767)	\$ (366)

$$\frac{\$3,451 \text{ (Cost of Sales)}}{\$804 + \$693 \div 2 \text{ (Average Inventory)}} = 4.6 \text{ times}$$

An alternative measure of how quickly inventory is sold and how efficiently it is managed

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Ratios to Measure Operating Efficiency

Operating Profit Margin

Sears, Roebuck and Co.	
Consolidated Statement of Income	
(in millions)	
	2003
REVENUES	
Merchandise sales and services	\$ 39,372
Other revenues	2,752
Total revenues	41,124
COSTS AND EXPENSES	
Cost of sales, buying and occupancy	26,233
Selling and administrative	9,111
Provision for uncollectible accounts	1,747
Depreciation and amortization	909
Interest, net	1,025
Income tax expense of other net	73
Total costs and expenses	39,938
Operating income	1,198
Gain on sale of businesses	4,224
Other income, net	27
Income before income taxes, minority interest and cumulative effect of change in accounting principle	5,449
Income taxes	2,007
Minority interest	45
Income before cumulative effect of change in accounting principle	3,397
Cumulative effect of change in accounting for goodwill	--
NET INCOME	\$ 3,397

$$\frac{\$1,198 \text{ (Operating Income)}}{\$41,124 \text{ (Total Revenues)}} = 2.9\%$$

Measures the profitability of operations and revenue growth

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Ratios to Measure Operating Efficiency

Average Collection Period (Days' Sales)

Freeselect Semiconductor, Inc. and Subsidiaries		
Combined Balance Sheets		
(in millions)		
	2002	2003
ASSETS		
Cash and cash equivalents	\$ 44	\$ 87
Accounts receivable, net <small>includes amounts due from Motorola of \$59 in 2002 and \$43 in 2003</small>	418	327
Inventories	304	893
Deferred income taxes	26	20
Other current assets	112	228
Assets held-for-sale	15	334
Total current assets	1,419	1,689
Property, plant and equipment, net	3,226	2,357
Investments	101	126
Other assets	379	277
Total assets	\$ 5,125	\$ 4,449

Freeselect Semiconductor, Inc. and Subsidiaries		
Combined Statements of Operations		
(in millions)		
	2002	2003
Net sales (includes sales to Motorola of \$1,080 in 2001, \$1,419 in 2002 and \$561 in 2003)	\$ 4,001	\$ 4,954
Cost of sales	3,753	3,525
Gross margin	1,238	1,413
Selling, general and administrative	604	649
Research and development	993	1,005
Reorganization of businesses	1,190	61
Operating earnings (loss)	(1,516)	(304)
Other income (expense):		
Interest expense, net	(163)	(114)
Gain on sales of investments and businesses, net	43	308
Other	(18)	(7)
Total other income (expense)	(168)	(15)
Loss before income taxes	(1,684)	(319)
Income tax expense	86	47
Net loss	\$ (1,767)	\$ (380)

$$\frac{\$418 + \$327 + 2 \text{ (Average Accounts Receivable)}}{\$4,864 \div 365 \text{ (Average Daily Sales)}} = 27.95 \text{ days}$$

Measures average number of days' sales uncollected in accounts receivable, providing an idea of how successful the company is in collecting amounts due from its customers

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Ratios to Measure Operating Efficiency

Receivables Turnover

Freescale Semiconductor, Inc. and Subsidiaries Combined Balance Sheets		
(In millions)	2002	2003
ASSETS		
Cash and cash equivalents	\$ 44	\$ 87
Accounts receivable, net (Includes amounts due from Motorola of \$89 in 2002 and \$43 in 2003)	418	327
Prepaid expenses	44	49
Deferred income taxes	26	20
Other current assets	112	228
Assets held-for-sale	15	334
Total current assets	1,419	1,689
Property, plant and equipment, net	3,226	2,357
Investments	101	126
Other assets	379	277
Total assets	\$ 5,125	\$ 4,443

Freescale Semiconductor, Inc. and Subsidiaries Combined Statements of Operations		
(In millions)	2002	2003
Net sales (includes sales to Motorola of \$1,080 in 2001, \$1,143 in 2002 and \$981 in 2003)	\$ 5,001	\$ 4,864
Cost of sales	3,763	3,451
Gross margin	1,238	1,413
Selling, general and administrative	604	649
Research and development	993	1,005
Reorganization of businesses	1,156	63
Operating earnings (loss)	(1,515)	(304)
Other income (expense):		
Interest expense, net	(163)	(114)
Gains on sales of investments and businesses, net	15	106
Other	(18)	(7)
Total other income (expense)	(166)	(15)
Loss before income taxes	(1,681)	(319)
Income tax expense	86	47
Net loss	\$ (1,767)	\$ (366)

$$\frac{\$4,864 \text{ (Total Sales)}}{\$418 + \$327 \div 2 \text{ (Average Accounts Receivable)}} = 13.06 \text{ times}$$

An alternative measure of the efficiency of a company's collection efforts. If a company makes sales for cash, "total credit sales" should be substituted for "total sales."

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Ratios to Measure Operating Efficiency

Number of Days' Sales in Inventory

Freescale Semiconductor, Inc. and Subsidiaries Combined Balance Sheets		
(In millions)	2002	2003
ASSETS		
Cash and cash equivalents	\$ 44	\$ 87
Accounts receivable, net (Includes amounts due from Motorola of \$89 in 2002 and \$43 in 2003)	418	327
Inventories	604	693
Deferred income taxes	26	20
Other current assets	112	228
Assets held-for-sale	15	334
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Interest expense, net	(163)	(114)
Gains on sales of investments and businesses, net	15	106
Other	(18)	(7)
Total other income (expense)	(166)	(15)
Loss before income taxes	(1,681)	(319)
Income tax expense	86	47
Net loss	\$ (1,767)	\$ (366)

$$\frac{\$804 + \$693 \div 2 \text{ (Average Inventory)}}{\$3,451 + 365 \text{ (Average Cost of Sales)}} = 79.2 \text{ days}$$

An indicator of the amount of inventory maintained relative to the average number of days sales that would be filled. This measure can be used to assess the efficiency of a company's distribution system.

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Ratios to Measure Operating Efficiency

Gross Profit Margin

Sears, Roebuck and Co.		
Consolidated Statement of Income		
millions		2003
REVENUES		
Merchandise sales and services	\$	36,372
Credit and financial products revenues		4,752
Total revenues		41,124
COSTS AND EXPENSES		
Cost of goods sold		26,231
Provision for uncollectible accounts		1,747
Depreciation and amortization		909
Interest, net		1,025
Loss on early retirement of debt, net		791
Special charges and impairments		112
Total costs and expenses		39,926
Operating income		1,198
Gain on sale of businesses		4,224
Other income, net		27
Income before income taxes, minority interest and cumulative effect of change in accounting principle		5,449
Income taxes		2,007
Minority interest		45
Income before cumulative effect of change in accounting principle		3,397
Cumulative effect of change in accounting for goodwill		--
NET INCOME	\$	3,397

$$\frac{\$41,124 - \$26,231}{\$41,124} = 36.2\%$$
 (Total Revenues less Cost of Goods Sold) / (Total Revenues)

Measures the profitability of the company at the product level. An indicator of the profitability of revenue growth

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Mergers and Acquisitions

- Effects of Sarbanes-Oxley
- Post-closing Adjustments
- Earn Outs

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Effects of Sarbanes-Oxley

Effects on Process

- Due diligence clearly expanded
 - Especially internal financial and disclosure controls and procedures
- Anticipation of future certifications by CEO and CFO of acquirer
 - Timing of transaction potentially affected by status of target company's controls and procedures
 - Integration issues
 - Timing relative to next required CEO and CFO certifications
- Representations, closing conditions or termination rights based on Sarbanes-Oxley requirements

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Effects of Sarbanes-Oxley

Representations and Warranties

- Financial statements "fairly present in accordance with GAAP" not sufficient for CEO/CFO certifications. Thus, financial statement representations may expand to parallel certification language and cover internal financial and disclosure controls and procedures
- Representations regarding timely and complete SEC filings should include timely and unqualified Section 302 and 906 certifications (and soon Section 404 reports and attestations)
- Examples follow

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Effects of Sarbanes-Oxley

Representation about Financial Controls

- The Company maintains accurate books and records reflecting its assets and liabilities and maintains proper and adequate internal accounting controls over financial reporting that provide assurance that (1) transactions are executed with management's authorization, (2) transactions are recorded as necessary to permit preparation of the consolidated financial statements of the company and to maintain accountability for the Company's consolidated assets, (3) access to the Company's assets is permitted only in accordance with management's authorization, (4) the reporting of the Company's assets is compared with existing assets at regular intervals, and (5) accounts, notes and other receivables and inventory are recorded accurately, and proper and adequate procedures are implemented to collect them on a timely basis.

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Effects of Sarbanes-Oxley

Representation about Certifications

- The Company has on a timely basis filed all certifications and statements required by Rule 13a-14 or 15d-14 under the Exchange Act and furnished all certifications and statements required by 18 U.S.C. Section 1350 (Section 906 of the Sarbanes-Oxley Act) with respect to any report referred to in Section ___ of this Agreement [reference is to representation about SEC periodic reports]. Such certifications contain no qualifications or exceptions to the matters certified therein and have not been modified or withdrawn. Neither the Company nor any of its officers has received notice from any Government Entity questioning or challenging the accuracy, completeness, form or manner of filing or submission of such certifications.

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Effects of Sarbanes-Oxley

Representation about Disclosure Controls

- The Company maintains disclosure controls and procedures required by Rule 13a-15 or 15d-15 under the Exchange Act. Such controls and procedures are effective to ensure that all material information concerning the Company and its subsidiaries is made known on a timely basis to the individuals responsible for the preparation of the Company's filings with the SEC and other public disclosure documents. Schedule ___ to the Company Disclosure Letter lists, and the Company has delivered to Buyer, all written descriptions of, and all policies, manuals and other documents promulgating, such disclosure controls and procedures.

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Effects of Sarbanes-Oxley

Closing Conditions

- What is effect of failure to provide a clean certification under Section 302 or 906?
- What is effect if violation of Sarbanes-Oxley Act is discovered between signing and closing?
 - Deem them material expressly?
 - Provide express, separate condition that no such violation has occurred?
- Absent agreement about materiality of violation, would violation be MAC or MAE or failure of bring-down?

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Post-Closing Adjustments

- Clearly define items upon which possible adjustments will be based
- Consider specificity with which application of GAAP “consistently applied” is provided for
- Control of adjustment process
- Dispute resolution mechanism
- Excellent article in September 2004 Issue of ACC Docket - *The Pitfalls of Purchase Price Adjustment Provisions* by Jeffrey Isaacs, VP and Corporate Counsel, Prudential Financial, Inc., and Stephen Wiseman, Partner, King & Spalding

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Earn-Outs

- Typically part of acquisitions of privately-owned businesses where former owners/management will continue to run the business
- There have been a small number of public deals over the years that have included earn-out provisions
- Practice Pointers
 - Clearly define the financial performance criteria
 - Consider handling of extraordinary circumstances
 - Spell out procedure for determining accomplishment of performance measures
 - Spell out dispute resolution procedures

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Financial Reporting and the SEC

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The in-house bar association.™



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SEC Regulations



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The Regulations

- **Regulation S-K:** *disclosure* requirements governing the *content* of '34 Act reports (periodic reports, proxy solicitations, registration statements and other SEC filings)
 - Current emphasis on real-time disclosure

- **Regulation S-X:** requirements for the form and content of *financial information* in SEC filings

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Form 10-K

- Filed annually after fiscal year end
- Financial elements:
 - Audited financial statements and notes, including independent auditor's opinion under Reg S-X
 - Management's discussion and analysis of financial statements (MD&A)
 - Disclosure about market risks
- Other key elements:
 - Description of material legal proceedings
 - Description of properties and business
 - Disclosure of audit committee financial expert
 - Disclosure of code of ethics
- Certifications: required from CEO and CFO
 - Additional Section 404 certification required for accelerated filers in 2004

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Form 10-Q

- Filed quarterly (3x per year)
- Financial elements:
 - Interim financial statements and notes
 - typically unaudited
 - MD&A
 - Disclosure about market risks
- Other key elements:
 - Material legal proceedings
 - Material changes in securities
 - Results of matters submitted to stockholder vote
- Certifications required (CEO and CFO)

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8-K Reports

Accelerated and expanded disclosure under new rules effective August 23, 2004:

- Filings required in 4 business days
 - Emphasis on real-time disclosure
 - SEC had considered 2 business day requirement
- Items triggering disclosure increased to 19
- Format changed; items organized by topic
- Release at <http://www.sec.gov/rules/final/33-8400.htm>

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New 8-K Items

- Business and Operations
 - 1.01 Entry into a material definitive agreement
 - 1.02 Termination of a material definitive agreement
 - 1.03 Bankruptcy or receivership
- Financial Information
 - 2.01 Completion of asset acquisition or disposition
 - 2.02 Results of operations and financial condition
 - 2.03 Creation of financial obligation under an off-balance sheet arrangement
 - 2.04 Triggering events that accelerate or increase a direct financial obligation under an off-balance sheet arrangement

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New 8-K Items

- Financial Information, cont.
 - 2.05 Costs associated with exit or disposal activities
 - 2.06 Material impairments
- Securities and Trading Markets
 - 3.01 Notice of delisting; transfer of listing; noncompliance with listing standard
 - 3.02 Unregistered sale of equity securities
 - 3.03 Material modification of rights of security holders

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New 8-K Items

- Accountants and Financial Statements
 - 4.01 Changes in accountant
 - 4.02 Non-reliance on previously issued financial statements or audit report or completed interim review
- Corporate Governance and Management
 - 5.01 Changes in control of company
 - 5.02 Changes in directors or executive officers
 - 5.03 Changes to charter or bylaws; change in fiscal year
 - 5.04 Temporary suspension of trading under employee benefits plan
 - 5.05 Changes to, or waiver to, code of ethics

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New 8-K Items

- Section 6 – reserved
- Regulation FD
 - 7.01 Regulation FD disclosure
- Other events
 - 8.01 Other events
- Financial Statements and exhibits
 - 9.01 Financial statements and exhibits
- 19 Items, plus Rule 12b-20:
 - Any additional information necessary to make disclosure not misleading

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Compliance with New 8-K Rules

- Disclosure Response Team: Develop a task force to ensure compliance with new requirements
 - Members: Legal, IR, Corporate Communications, Finance, Accounting
 - Make assignments for each item
- Develop a policy for materiality
 - 6 of the 8 new items require materiality analysis
 - Keep the threshold low and decision-making centralized
- Don't forget – Rule 12b-20

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Disclosure Controls and Procedures

- Procedures designed to ensure that disclosure in public reports complies with SEC rules
- Includes:
 - Internal controls
 - Operations and legal control procedures
- Disclosure Committee
 - Role – ever expanding
 - Composition – legal, finance, internal audit, IR

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Disclosure Committee: Action Steps

- Consider developing Disclosure Committee Charter
- Determine committee composition – legal, accounting, internal audit, IR, risk management and others as necessary
- Determine reporting relationship – majority report to CEO and CFO
- Develop policy for documentation – consider minutes with resolutions only (not items considered for disclosure)
- Develop plan for disclosure analysis of real-time issues (8-Ks)
- Consider use of internal certifications/questionnaires
- Evaluate effectiveness: interviews, questionnaires

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Focus Area: MD&A

- Management's explanation of operating and financial matters
- Disclose trends, events or uncertainties known to management that would have a material impact on financials
 - Should not just textualize the financials; instead provide more analysis than discussion of financials
 - Describe what matters to management – especially the uncertainties and concerns; what keeps management up at night?

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MD&A: Action Steps

- Preparatory work
 - Reread SEC Release 33-8350 (December 2003)
 - Review analyst reports, questions on analyst calls, disclosure on press releases and website, competitor comment letters and public disclosures
- Meet with Disclosure Committee
 - Focus on negative trends and uncertainties
 - Focus on *why* the business results have been impacted, instead of just *what* the impact has been
 - Inquire about any financial measures management uses to assess performance; should they be included?

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Hot Topics in Accounting and Disclosure

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The in-house bar association.SM



Regulation FD – The Rule

- When a public company discloses:
 - material non-public information
 - to any securities market professionals or securities holders,

- The company must disclose the information publicly.

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Regulation FD - Key Elements

- Material nonpublic information – no bright line test
 - Would a reasonable investor consider the facts disclosed important in a decision to buy, sell or hold securities?
 - Does the information alter the total mix of information available about the company?
 - Materiality will be judged in hindsight; market movement after disclosure is strong evidence of materiality

- Disclosure to securities market professionals or holders
 - Principal exceptions – employees, customers, suppliers, press, strategic partners and any person who agrees to maintain confidentiality of information

- Public disclosure – press release, 8-K, pre-announced webcast

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Application of Regulation FD

Siebel Systems (SEC Civil Action, June 2004)

Prior Violation: Siebel made \$250k settlement for 2002 actions

Current Civil Action:

- Approximately 3 weeks after company publicly announced negative outlook, CFO made positive statements regarding company outlook at two private sessions with investors/analysts
- Stock price rose 8% the next day; trading volume almost doubled
- Action also alleges violation of Rule 13a-15 (disclosure controls and procedures); First case

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Application of Regulation FD

- Motorola (21(a) Report, November 2002)
- Company issued mid-quarter press release announcing it does not expect to meet its previously announced financial projections due to “significant weakness in first quarter order input”
 - Subsequent private phone calls to analysts:
 - Reminder that “significant” = 25% or more

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Reg FD: Confirmation of Guidance

SEC: reaffirmation of prior guidance in the second half of a quarter or after intervening events = “new” material guidance, subject to Reg FD

Strict application:

- Statement that you restated guidance on a certain date will be perceived as a confirmation
- Likely that reaffirmation of other material information (e.g. market share changes, sales expectations) would also be perceived as confirmation subject to Reg FD

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SEC Comment Letters

SEC comment letters and issuer responses available to the public on www.sec.gov

- Applies to all filings after August 1, 2004
- Letters will not be released until at least 45 days after SEC completes review of filing
- May request confidential treatment

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SEC Comment Letters

- Letters were previously available through FOIA requests
- New availability allows for benchmarking without specific FOIA request
- Approach to comments by SEC staff – any anticipated changes?

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FASB Initiatives

- No new standards issued during fiscal 2004
- Outstanding exposure drafts:
 - Proposed interpretation regarding accounting for Conditional Asset Retirement Obligations
 - Proposed Statement of Financial Accounting Standards regarding inventory costs
 - Proposed Statement on Accounting for Share-Based Payments (stock options and stock purchase plans)

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Other FASB Projects - Int'l Convergence

- FASB continues to work with the IASB on several projects, including:
 - Business Combinations
 - Revenue Recognition
 - Short-term international convergence
 - ✓ Fix those little differences that are collectively major
 - 8 Accounting changes
 - 8 Inventory
 - 8 EPS
 - 8 Classifying liabilities
 - 8 Income taxes
 - 8 Change in depreciation