Finance 101 – Understanding your Financial Statements

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Financial Statement Basics
Financial Statement Levels of Assurance

- Audit
- Review
- Compilation
Financial Statement Levels of Assurance

- **Audit**
  - Independent auditor expresses an opinion, or if circumstances require, disclaims an opinion, regarding the fairness with which the financial statements present the financial position, the results of operations & changes in financial position, in accordance with generally accepted accounting principles (GAAP)
  - Highest level of assurance

- **Review**
  - Accountant expresses limited assurance that no material modifications should be made to the statements for them to be in conformity with GAAP
  - Limited assurance
Financial Statement Levels of Assurance

- Compilation
  - Compiled statements are management’s representations presented in the form of financial statements, but the accountant has not undertaken any efforts to express assurance on the financial statements
Financial Statement Levels of Assurance

- Audit vs. Review:
  - Lender or other 3rd party users of financial statements often specifies level of service
  - Auditor’s Report vs. Accountant’s Report
  - CPA must be independent in both
  - Financial statements are management’s responsibility in both
  - Audits are more costly due to more in-depth procedures
Financial Statement Levels of Assurance

- Audit vs. Review:
  - Audit
    - Confirm cash, accounts receivable, notes payable, etc.
    - Observation of inventory
    - Fraud risk assessment (interviews, test of controls, walk-thrus, etc.)
    - Communication of internal control matters identified (SAS 115)
  - Review
    - Inquiries of client
    - Analytical procedures
    - Not required to document fraud risk assessment
Financial Statement Basics

- **Matching Principle**
  - Recognize expenses in the same accounting period when the related revenues are recognized

- **Cash Basis vs. Accrual**
  - Cash – revenue recognized when cash is received & expenses when cash is paid
  - Accrual – Revenues when earned, such as product is shipped or services provided, & expenses when revenue is recognized

- **Historical Cost vs. Market Value**
  - Balance sheet items are recorded at original cost, such as fixed assets, & do not necessarily reflect the current value
Exercise 1 – Basic Financial Statements
Financial Statements

- Balance Sheet
- Statement of Income
- Statement of Changes in Stockholders’ Equity
- Statement of Cash Flows
- Notes
- Supplementary Information
Financial Statements

- **Balance Sheet or Statement of Financial Position**
  - Reports assets, liabilities & stockholders’ equity as of a specific date
  - Reflects what is owned, owed & amounts invested by shareholders
  - Accesses liquidity & financial flexibility
  - Classified as current vs. non-current in order of liquidity
  - Balance sheet limitations include:
    - Items recorded at cost & not necessarily at market value
    - Some items must be estimated
    - Omits items of financial value to the Company
Financial Statements

- **Income Statement**
  - Measures earning performance for a given period of time
  - Net income is available to stockholders or retained for future investment in the Company
  - Depicts a Company’s ability to generate earnings over the long term
  - Drives Company’s stock price
  - Classification of expenses by function, such as cost of goods sold, selling & general administrative
  - Also separation of operating vs non-operating activities
Financial Statements

- **Cash Flows Statements**
  - Used to reconcile the cash account – *how did the Company generate cash & how did it use its cash?*
  - Classified into three different activities:
    - **Operating:**
      - Income Statement items - net income (loss) plus any non-cash items, such as depreciation/amortization, & adjustments for changes in current assets/liabilities
    - **Investing:**
      - Typically long-term asset item - acquiring/disposing of investments & fixed assets
    - **Financing:**
      - Typically both liability & equity-related items - borrowing/repaying debt & buying/selling stock, paying dividends
Financial Statements

- **Income Statement vs. Cash Flows Statement**
  
  *The Income Statement measures a Company’s profitability, the Cash Flow Statement represents its ability to pay vendors, creditors, employees & stockholders!*
Exercise 2 – Financial Ratios
Financial Ratios

- **Ratio Analysis**
  - Compare period to period
  - Compare Company to Company
  - Spot trends impacting your Company

- **Types of Ratios**
  - Solvency or Liquidity
  - Efficiency
  - Profitability
  - Commons Size
ESOP-Specific Disclosures for Plan Sponsor’s Financial Statements
ESOP Footnote Disclosures

- Footnote Disclosures
  - Description of the plan including how contributions are determined, employee groups covered & the nature/effect of matters affecting comparability of info for all periods covered
  - If the ESOP is leveraged, the Company should disclose the basis for releasing shares & how dividends on allocated/unallocated shares are used
  - Accounting policies followed for ESOP transactions, which includes the method of measuring compensation, classification of dividends & treatment of ESOP shares for earnings per share computations
  - Amount of compensation cost recognized during the period
ESOP Footnote Disclosures

- Footnote Disclosures
  - Number of allocated shares, committed-to-be-released shares & suspense shares held by the ESOP at the balance sheet date
  - Fair value of unearned ESOP shares at the balance sheet date
  - Existence & nature of any repurchase obligation, including fair value of the shares allocated as of the balance sheet date that are subject to repurchase obligation
  - Amount & treatment in the EPS computation of tax benefits related to dividends paid to an ESOP
Questions
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References

- U.S. GAAP Accounting Standards Codification (ASC) 718-40: ESOP Stock Ownership Plans

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