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# Accounting & Financial Statements for Lawyers

**IWIRC Florida**  
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Presented by:  
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Moderator:  
Jill Kelso, Esq.

# Objectives

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This course is intended to familiarize attorneys with the principles of “the language of business” (i.e. Accounting) to facilitate productive communications between attorneys, their clients, and other business professionals.



# Agenda

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- Outline the basic concepts underlying financial reporting
- Identify the standard financial statements
- Compare various financial statements, understand how they fit together
- Discuss differences in reporting standards
- Describe accounting issues commonly encountered by attorneys and their clients

# Financial Statements

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## Why is this important?

- Understand your client
- Transactions
- Financial investigations
- Due diligence
- Valuations
- Mergers & Acquisitions
- Underwriting
- Financial restructuring



# Financial Statements

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- Income Statement

- Earned in period (month, year, YTD)
- Cash, accrual, modified
- Revenue – COGS – Operating Expenses = Profit
- COGS vs. Operating Expenses

Period

- Balance Sheet

- Point in time, snapshot
- Assets, liabilities, equity
- Groupings
- Accrual, cash, or modified

Point in time

- Cash Flow Statement

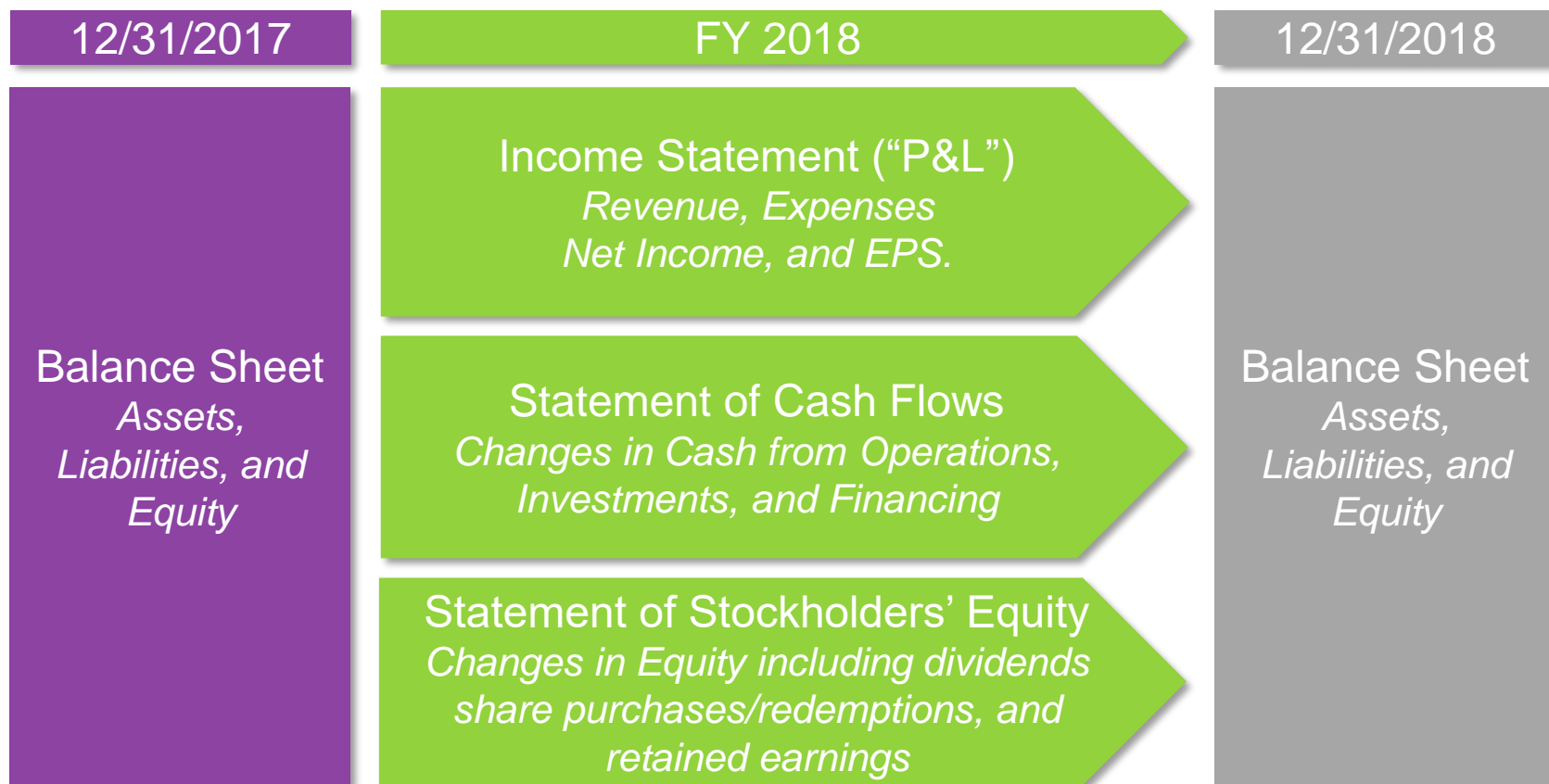
- Operating, Investing, and Financing activities
- Sources and Uses of Funds  
(e.g. Cash Generator or Cash Absorber)

- **Notes to the financial statements**

- Statement of Comprehensive Income (not covered here)
- Statement of Stockholders' Equity Report of net worth and equity activity

# Financial Statements

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# Basic Financial Statement Concepts

# Assets, Liabilities and Equity

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- **Assets:** probable future benefits as a result of a past transaction
  - **WHAT YOU OWN**
  
- **Liabilities:** probable future expenditures as a result of a past transaction
  - **WHAT YOU OWE**
  
- **Equity:** assets – liabilities
  
- Appear on the Balance Sheet (discussed later)



# Revenues, Expenses, Gross Profit, Net Income

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## Revenue

- Amounts earned from customers (e.g. Sales) before accounting for any expenses

## Expenses

- Expenditures or other costs associated with the entities operations for the period

## Gross Profit (a.k.a. Gross Margin/Gross Income)

- Sales – direct costs of producing that revenue (e.g. Cost of Goods Sold)

## Net Income

- Earnings after accounting for all expenses of the operation

Appear on the Income Statement (*discussed later*)

# Expenses, Capitalization, Depreciation/Amortization

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## Expenses

- Represent consumption of assets during a period

## Capital Assets

- Assets presumed be consumed over time (e.g. equipment, buildings, vehicles)

## Depreciation

- Estimates the consumption of tangible assets over their useful life.

## Amortization

- Similar to depreciation, estimates the consumption of intangible assets (Goodwill, Patents, customer lists)

# Accrual Accounting: Net Income vs. Cash Flow

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- **Cash basis accounting**
  - events are based on the collection and expenditure of cash, regardless when the underlying transaction took place.
  
- **Accrual basis accounting**
  - matches the income and expenses to the period they relate (regardless of when paid).

A company may have significant **Net Income**, but no (or even negative) **Cash Flow**.

# Generally Accepted Accounting Principles

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- Referred to as U.S. GAAP or just GAAP
- Always accrual basis
- GAAP is generally valued at historical basis (i.e. cost) rather than current or fair market value
  - Critical consideration
- Changes in GAAP increasing focus on fair value, creating potential valuation issues for many companies.

# Generally Accepted Accounting Principles

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## Goals of GAAP:

- Reduce opportunity for bias, misinterpretation, and ambiguity
- Make financial statements that can be compared between enterprises and between accounting periods
- Establish one set of accounting concepts, standards, and procedures to be used by all accountants and members of the financial community

# GAAP vs “non-GAAP” Reporting

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## Non-GAAP metrics

- EBITDA
- Free Cash Flow
- Revenue per \_\_\_\_\_ (insert metric here)

## “Ex-” Items

# Other GAAP Concepts

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## Other Basic Concepts

- Revenue recognition
- Bad debt reserves
- Warranty & returns reserves
- Asset impairments
- Accumulated depreciation
- Prepaid expenses
- Retained earnings

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# Components of Financial Statements



# Classification: Current v. Non-Current

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## “Current” Assets/Liabilities:

- Items which are expected to be collected, converted to cash, or paid within one (1) year:
  - Accounts Receivable
  - Accounts Payable

## Non-Current Assets/Liabilities:

- Items not expected to be collected, converted to cash, or paid within one (1) year:
  - Buildings
  - Long-Term Debt

*Important distinction in financial/ratio analysis.*

# Example Financial Statements

ACME Company, Inc. Income Statement For Year Ended December 31, 2010		
Sales	\$	3,500
Cost of Sales		1,500
SG&A		1,500
Net Income	<b>\$</b>	<b>500</b>
EPS	<b>\$</b>	<b>5.00</b>

ACME Company, Inc. Balance Sheet December 31, 2010		
<b><u>Assets</u></b>		
Cash	\$	500
Accounts Receivable		2,000
Inventory		1,000
PP&E		5,000
Other Assets		3,000
<b>Total Assets</b>	<b>\$</b>	<b>11,500</b>
<b><u>Liabilities</u></b>		
Accounts Payable	\$	1,000
<b><u>Stockholder's Equity</u></b>		
Common Stock	\$	100
APIC		9,900
Retained Earnings		500
<b>Total Stockholder's Equity</b>		<b>10,500</b>
<b>Total Liabilities &amp; Stockholder's Equity</b>	<b>\$</b>	<b>11,500</b>

# Example Financial Statements

<b>ACME Company, Inc.</b>		
<b>Statement of Cash Flows</b>		
<b>For Year Ended December 31, 2010</b>		
Cash flows from operating activities		
Net Income		500
Adjustments to reconcile net income to net cash provided by operating activities		
Increase in Accounts Receivable	(2,000)	
Increase in Inventory	(1,000)	
Increase in Other Assets	(3,000)	
Increase in Accounts Payable	1,000	(5,000)
		<hr/>
Net cash provided by operating activities		(4,500)
Cash flows from investing activities		
Purchase of PP&E	(5,000)	
		<hr/>
Net cash provided by investing activities		(5,000)
Cash flows from financing activities		
Sale of Common Stock	10,000	
		<hr/>
Net cash provided by financing activities		10,000
		<hr/>
Net increase in cash		500
Cash, at beginning of period		-
		<hr/>
Cash at end of period		500
		<hr/> <hr/>

# Common Size & Trends

<b>The Manufacturing Company</b>						
<b>Summary Income Statement</b>						
	<u>1999</u>		<u>2000</u>		<u>2001</u>	
	10/98 - 9/99		10/99 - 9/00		10/00 - 9/01	
	(12 Months)		(12 Months)		(12 Months)	
<b>Sales</b>	9,079,000	100.0%	15,724,000	100.0%	9,828,000	100.0%
<b>Cost of Goods Sold</b>	7,237,000	79.7%	14,410,000	91.6%	8,321,000	84.7%
<b>Gross Profit</b>	1,842,000	20.3%	1,314,000	8.4%	1,507,000	15.3%
<b>SGA</b>	1,505,000	16.6%	2,227,000	14.2%	1,981,000	20.2%
<b>Operating Income</b>	337,000	3.7%	(913,000)	-5.8%	(474,000)	-4.8%

# Budget-to-Actual Monitoring

Week	November												Total B	Total A
	11/6/01 B	11/6/01 A	11/13/01 B	11/13/01 A	11/20/01 B	11/20/01 A	11/27/01 B	11/27/01 A						
	44	44	45	45	46	46	47	47						
[1]														
(123) Stores	115	115	115	115	115	115	115	115						
(153) Sales	2,061,285	2,166,372	2,218,687	1,986,232	2,383,155	2,361,192	2,641,963	1,861,781	9,305,090	8,375,577				
(154) Cost of Goods Sold	1,174,932	1,356,784	1,264,652	1,616,256	1,358,398	1,242,865	1,505,919	961,614	5,303,901	5,177,519				
(155) Gross Profit	886,353	809,588	954,036	369,976	1,024,757	1,118,327	1,136,044	900,167	4,001,189	3,198,058				
(156) Store Payroll	250,705	272,627	250,705	257,435	310,079	296,299	250,705	245,718	1,062,195	1,072,079				
(157) Store Rent	703,913	279,801	-	12,824	-	-	-	693,122	703,913	985,747				
(158) Store Advertising	237,048	171,171	255,149	249,155	274,063	636,936	303,826	58,734	1,070,085	1,115,996				
(159) Store Other Expenses	229,613	28,638	141,187	145,795	142,832	24,995	145,420	20,461	659,051	219,889				
(160) Total Store Expenses	1,421,279	752,237	647,041	665,209	726,973	958,230	699,951	1,018,035	3,495,244	3,393,711				
(161) Store Level EBITDA	(534,927)	57,351	306,994	(295,233)	297,783	160,097	436,093	(117,868)	505,944	(195,653)				
(162) General & Administrative	154,592	158,124	240,000	164,968	140,000	158,350	163,000	135,340	697,592	616,782				
(163) Adjusted EBITDA	(689,519)	(100,773)	66,994	(460,201)	157,783	1,747	273,093	(253,208)	(191,648)	(812,435)				
(164) One-Time Expenses	302,622	2,825	-	-	-	-	-	42,471	302,622	45,296				
(165) EBITDA	(992,141)	(103,598)	66,994	(460,201)	157,783	1,747	273,093	(295,679)	(494,270)	(857,731)				
(166) Tax-Deductible Dep.	17,846	17,846	17,846	17,846	17,846	17,846	17,846	17,846	71,385	71,385				
(167) Tax-Deductible Amort	33,596	33,596	33,596	33,596	33,596	33,596	33,596	33,596	134,385	134,385				
(168) EBIT	(1,043,583)	(155,040)	15,552	(511,644)	106,341	(49,695)	221,651	(347,121)	(700,039)	(1,063,501)				
(169) Total Interest	-	-	-	-	-	-	-	-	-	-				
(170) EBT	(1,043,583)	(155,040)	15,552	(511,644)	106,341	(49,695)	221,651	(347,121)	(700,039)	(1,063,501)				
(171) Taxes Paid	-	-	-	-	-	-	-	-	-	-				
(172) Net Income	(1,043,583)	(155,040)	15,552	(511,644)	106,341	(49,695)	221,651	(347,121)	(700,039)	(1,063,501)				
DIP Balance		2,600,000		3,600,000		3,100,000		3,100,000		3,100,000				

# Statement of Stockholders' Equity

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Shows the change in shares, capital, and retained earnings over the period.

Formula:

$$\text{Beginning Equity} + \text{Changes in Capital} + \text{Net Income} - \text{Distributions} = \text{Ending Equity}$$

***Retained earnings:*** undistributed earnings and profits of a company

# Notes to the Financial Statements

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Notes are an integral part of the Financial Statements and provide important and detailed information about the company's operations including:

- Important accounting policies
- Significant litigation
- Related party transactions
- Hedging activities
- Contingencies

*Companies are sometimes described as “hiding” issues and information in the notes.*

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## Ratio Analysis



# Ratio Analysis

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## The Balance Sheet – Working Capital Ratio

- The relation between current assets and current liabilities shows the company's ability to meet its current obligations. Current assets are cash or assets which normally will be turned into cash within a year while current liabilities are short-term debts due and payable within a year.
- The excess of current assets over current liabilities is called working capital. Investors can assess the company's ability to meet current obligations by computing the working capital ratio.

Working Capital Ratio:  $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Working Capital Ratio:  $\frac{\$ 90,000}{\$ 35,000}$

# Ratio Analysis

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## The Balance Sheet – Net Assets to Debt

- The relation between net tangible assets and long-term debt outstanding gives some indication of the company's ability to borrow long-term money.
- Net tangible assets are total assets less all intangible assets, (i.e. those which cannot be touched, weighed or measured, such as goodwill, franchises, etc.), current liabilities, and any other liabilities ranking ahead of long-term debt.

Net Assets to Debt: 
$$\frac{\text{Total Assets} - \text{Intangible Assets} - \text{Current Liabilities}}{\text{Long-Term Debt Outstanding}}$$

Net Assets to Debt: 
$$\frac{\$ 200,000 - \$ 35,000}{\$ 40,000} = 4.13$$

# Ratio Analysis

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## The Balance Sheet – Capitalization Ratio

- The capitalization ratio or relationship between bonds, preferred shares and common shareholders' equity indicates the degree of leverage in the company. A company with a high % of borrowed money and/or preferred shares is said to be highly leveraged.
- Over the last several years, many new forms of quasi-debt and quasi-equity have been developed making this calculation more complex.

		<u>(000's)</u>	<u>%</u>
Long-term debt		\$ 40	24
Preferred shares		25	15
Common shares	25		
Retained earnings	<u>75</u>	<u>100</u>	<u>61</u>
Total Capitalization		\$ 165	100 %

# Ratio Analysis

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## The Income Statement – Interest Coverage Ratio

Interest Coverage: 
$$\frac{\text{Annual Net Operating Income}}{\text{Annual Long Term Debt Interest Expense}}$$

Interest Coverage: 
$$\frac{\$ 18,200}{\$ 3,200} = 5.7$$

## The Income Statement – Net Profit Margin vs. Gross Margin

- Varies widely between industries, but when compared to similar ratios of other companies within the same industry, it is a valid measure of management's efficiency.

Net Profit Margin: 
$$\frac{\text{Net Profit}}{\text{Sales}}$$

Net Profit Margin: 
$$\frac{\$ 9,000}{\$ 400,000} = 2.25\%$$

# Ratio Analysis

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## The Income Statement – Return on Common Shareholder’s Equity

- Test of management’s efficiency as it shows ability to utilize the shareholders’ investment.

Return on Common Shareholders’ Equity:  $\frac{\text{Net Income} - \text{Preferred Dividends}}{\text{Common Shareholders’ Equity}}$

Return on Common Shareholders’ Equity:  $\frac{\$ 9,000 - 1,750}{100,000} \times 100\%$

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Legal Matters

# Legal Matters Involving Accounting

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- Contract disputes
- Mergers & Acquisitions transactions/disputes
  - Especially involving earn-out or post-closing adjustments
- Securities matters
  - Shareholder suits, securities law violations, disclosure issues, securities fraud, etc.
- Shareholder oppression disputes
  - Often involve demonstrating or disproving the financial/business motivation behind management/director actions.
- FCPA violations and international trade issues
- Tax disputes
- Alter-ego, asset tracing, and funding judgments

# Situations to be Alert for Accounting Issues

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- Contracts or debt covenants that reference **GAAP, IFRS**, or any other comprehensive basis of accounting
- Large company purchasing a small company (frequent source of problems)
- Transactions involving significant **inventory** (especially if few or no reserves)
- Transactions involving significant outstanding **receivables** (possible aging issue)
- **Revenue recognition** issues (e.g. companies who use distributors)
- Companies with significant **warranty** obligations or **product returns**
- International transactions (**FCPA violations/trade regulations**)



# Other Accounting/Financial Related Issues

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- Damages, lost profits, lost wages, lost value
- Taxes:
  - Different forms of business entity will result in different tax treatment (Federal and state)
- M&A
- GAAP is often very different than “market” value
- Capital structure issues
  - Debt covenants, equity issues, dilution, technical defaults and impact on company financial statements
- Bankruptcy
  - Evaluation of debtor balance sheet, pre-filing activity and proposed restructuring plans

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# Any Questions?

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# Thank you!

If you would like a copy of this deck,  
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# Biographies

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**Carol Fox**  
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**Carol Fox** is a CPA with over 30 years of private and public accounting experience. For over nineteen years, her practice has focused on providing forensic and investigative services to debtors, creditors, Federal bankruptcy trustees, committees and examiners, court-appointed fiduciaries, the Securities and Exchange Commission, the Department of Justice and financial institutions.

Ms. Fox enjoys a diverse and dynamic practice. She has provided extensive restructuring and bankruptcy for distressed situations in the healthcare, life sciences, mining, education, e-commerce, and real estate sectors. In addition, she has led high profile investigations of investment schemes, fraud investigations, internal corporate investigations, due diligence assignments and matters involving business disputes and quantification of damages.

Ms. Fox is a Subchapter V Trustee for the Southern District of Florida, is currently serving as Chapter 11 Trustee for the Eastern District of Kentucky and as state court receiver. Additionally, she has testified as an expert witness on numerous occasions in federal and state court including testifying as an expert for the Department of Justice in the chapter 11 bankruptcy of *Peabody Energy, et al.*

Ms. Fox graduated from the University of Florida with a Bachelor of Science degree in Accounting. She is a CPA,\* CIRA (Certified Insolvency and Restructuring Advisor) and CFE (Certified Fraud Examiner) and has addressed numerous professional organizations on issues relating to bankruptcy, forensic accounting and distressed healthcare. In 2019, Carol was recognized as a Top U.S.A. Woman Dealmaker by the Global M&A Network. Currently, she serves on IWIRC-Florida's Board of Directors, representing the South Florida chapter.

# Biographies

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**Jill E. Kelso**  
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**Jill Ellen Kelso** is a Trial Attorney and the Appellate Coordinator for the United States Trustee, Region 21, in Orlando, Florida. After graduating *cum laude* from the University of Florida College of Law, Jill served as a Law Clerk to the Honorable Steven H. Friedman in the U.S. Bankruptcy Court for the Southern District of Florida. In 2003, Jill joined the Bankruptcy and Creditors' Rights Practice Group at a national law firm, where she represented secured creditors, creditors' committees, corporate debtors, receivers, and trustees in Chapter 7, 11 and 13 bankruptcy cases and related adversary proceedings, receiverships, and other state and federal court matters. In 2009, Jill began representing the U.S. Trustee in supervising the administration of bankruptcy cases and trustees in the Orlando and Jacksonville Divisions of the Middle District of Florida. In 2014, Jill was selected as the Appellate Coordinator for Region 21 to represent the U.S. Trustee in bankruptcy appeals in a number of jurisdictions.

Jill currently serves on the Board of Directors for the Orlando Chapter of the Federal Bar Association, the Florida Network of the International Women's Insolvency & Restructuring Confederation, and the George C. Young American Inn of Court. She is also a member of the Central Florida Bankruptcy Law Association (CFBLA) and the Jacksonville Bankruptcy Bar Association. She is a past president of CFBLA and the Bankruptcy Law Educational Series Foundation, Inc., and previously served on the Board of Directors for the Middle District of Florida *Pro Se* Bankruptcy Legal Assistance Clinic, Inc. and the Bankruptcy Court's Steering Committee.