Financial Statements 101 - An Accounting Primer for Tax Attorneys

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Financial Statement Basics

Double-entry accounting – basic language of business

- at least two accounts are used to record every accounting activity
- record is referred to as an accounting “transaction”
- all transactions accumulated over a defined period of time serve as the very foundation for financial statements prepared under generally-accepted accounting principles
Financial Statement Basics

Example- Customer pays company for services:

Accounting Entry:

Cash increases   $1,000,000
Income increases $1,000,000
Financial Statement Basics

- Interrelationship between each of the financial statements presented under generally-accepted accounting principles

- Detailed reading of the financial statements, as well as the application of commonly-utilized analytical procedures tells a story about the company
Financial Statement Basics

Key tool for understanding the financial health and direction of a business

Properly prepared financial statements can inform the reader about a company’s ability to:

- Meet its obligations
- Generate a profit
- Provide a return to its owners / investors
Financial Statement Basics

Externally prepared financial statements (include a report rendered by an independent accountant) are designed to provide reader with greater assurance and clarity about the information contained within the financial report.

-GAAP = the body of rules and principles developed by the FASB for financial accounting and reporting.
Financial Statement Basics

Basic elements common to financial statements:

- Accountant’s report
- Required financial statements
- Required footnote disclosures
Financial Statement Basics

A complete financial statement presentation should include the following statements:

- Balance sheet
- Income statement
- Statement of stockholders equity
- Statement of cash flows
- Required footnote disclosures
Financial Statements Relation to the Passage of Time

**Balance Sheet**
Financial condition at a point in time

- **Beginning of Year** January 1, 2011

**Income Statement**
Summary of activity for period

**Statement of Cash Flows**
Summary of activity for period

**Statement of Stockholders Equity**
Summary of activity for period

- **End of Year** December 31, 2011

**Business Activity**

**Balance Sheet**
Financial condition at a point in time
Financial Statement Basics

Balance Sheet Format

**Assets:**
- What company owns
- What is owed to the company

**Liabilities:**
- What company owes

**PLUS**

**Equity**
- Shares issued by the company
- Earnings retained by the company
Financial Statement Basics

Balance Sheet- Assets

- Assets presented in order of liquidity, with current assets listed first, followed by noncurrent assets
- Current assets are consumed or converted into cash within one year
- Noncurrent assets have a life in excess of one year
- Assets may also be tangible or intangible
Financial Statement Basics

Balance Sheet- Liabilities

- Liabilities presented in order of their expected settlement
- Liabilities often have payment terms that make their settlement readily determinable
- Liabilities may have both a current and long term component that will be separated in the financial statements
Financial Statement Basics

Balance Sheet- Equity

- Excess of assets over liabilities is equity
- Equity is derived from invested capital plus accumulated and undistributed earnings
- Equity is divided among ownership units
- Different owners and ownership groups may have different rights of ownership
Financial Statement Basics

Income Statement

- Presents the results of the company’s revenue and expense transactions
- Covers a period of time rather than a point in time
Financial Statement Basics

Income Statement- summary of revenues and expenses

Revenue (sales)
- Cost of sales
  = Gross Profit
- Selling Expenses
- Administrative expenses
  = Income from operations
+/- Other income and expense
- Income taxes
  Income before extraordinary items
- Extraordinary items
  = Net income
Financial Statement Basics

Income Statement
- Each measure of income is useful for analysis purposes
- Accurate and consistent classification of revenue and expenses is important
Financial Statement Basics

Statement of Cash Flows

- Provides information regarding how the company generated and utilized cash
- Reports on a period of time
- Extremely powerful tool
Financial Statement Basics

Statement of Cash Flows- sources/uses of cash during the period

Net Income (income statement)
+/- Non-cash income/expenses____
= Cash from operations
+/- Cash from investing activities
+/- Cash from financing activities____
= Net increase/decrease in cash____

- Investing activities: purchase/sale of property & equipment, investments in securities, etc.

- Financing activities: debt borrowings/repayments, contribution/withdrawal of equity, payment of dividends, etc.
Financial Statement Basics

Statement of Stockholders Equity

- A company’s components of, and changes in, its equity must also be presented – either in the balance sheet, a separate statement of equity or in the footnotes.
- A separate statement of changes in equity is often preferred when there is a complex equity structure or numerous equity transactions.
Financial Statement Basics

Types of Accounting Reports

Compilation
- Lowest level of service, no assurance from accountant
- Can be prepared by accountants who are not independent
- No disclosures required

Review
- Better than a compilation, less assurance than an audit
- Accountants do not verify financial statement assertions, only that they appear reasonable
- No “opinion” rendered by the accountant
Financial Statement Basics

Types of Accounting Reports

Audit
- Highest level of assurance (no absolute- materially reasonable)
- Accountant expresses “opinion”- goal is that the financials are reasonably stated and given an “unqualified opinion”
- If there are exceptions in the financials that that cannot be assured, report can state “except for” and note the qualification. Considered a “qualified” opinion
- If no opinion can be rendered, a “disclaimer of opinion” is issued. Provides no assurance to readers of the financials.
Financial Statement Notes

Footnotes (generally referred to as Notes) provide explanatory information to supplement the raw numbers, frame the reader’s perspective and clarify areas that may be ambiguous.
Financial Statement Notes

Key Notes include:

- Description of the company
- Significant accounting policies
- Estimates, contingencies and commitments
- Related party transactions
- Income taxes
Financial Statement Notes

Description of the company

-Legal structure of the company, where/when it was organized and its tax filing status (e.g., corporation, S corporation, partnership, etc.)

-Should also describe nature of company’s operations including its product lines and their significance to the overall company
Financial Statement Notes

Significant accounting policies
- Revenue recognition
- Method of valuing inventory
- Capitalization/depreciation policies for long-lived assets
- Method of estimating allowance for doubtful receivables
- Treatment of research and development costs
- Treatment of shipping, advertising and warranty costs
- Assets valued at historical cost or fair market value
Financial Statement Notes

Estimates, contingencies and commitments

- Some financial statement amounts are estimates and are susceptible to future refinement as additional facts and circumstances are presented.
- Other items are contingent upon the occurrence of future events or are so uncertain as to amount that they cannot be recorded in the financial statements.
- Financial statements must also disclose significant future commitments.
Financial Statement Notes

Related party transactions

- Loans (either to or from the company)
- Leases (especially real estate leases)
- Purchase of materials
- Sales of goods
- Management fees or other administrative charges
Financial Statement Notes

Income Taxes

- Current income taxes
- Deferred tax assets/(liabilities)
- Net operating loss
- Effective tax rate
- Management’s view on the future use of attributes (valuation allowances)
- FIN 48 (ASC 740) disclosure
- Tax Audits
Deferred income taxes result from differences between taxable income and accounting income (i.e., timing differences):

- Depreciation and Amortization
- Deferred compensation
- Prepaid income
- Warranty costs
Financial Statement Notes

Other

- Property and Equipment
- Debt
- Acquisitions/dispositions
Financial Statement Ratios

Financial statements inform investment decisions by allowing reader to determine whether a company can:

- Meet its obligations
- Generate a profit
- Provide a return to its owners

Financial statement ratios allow an investor to analyze the raw data presented in financial statements

Acceptable ratios vary widely by industry
Financial Statement Ratios: Analyzing Return on Investment

Return on Equity:
—Measures annual percentage yield (APY) on owners’ investment
—Ratio =
  • Net Income (income statement) ÷
  • Average Stockholders Equity (balance sheet)

Return on Assets:
—Measures APY on owners’ plus creditors’ investment
—Ratio =
  • Net Income (income statement) ÷
  • Average Total Assets (balance sheet)

In tandem, ROE and ROA tell investors whether management has employed assets and leverage effectively
Financial Statement Ratios: Measuring Safety and Liquidity

Net Working Capital
— Measures short-term liquidity and reserves
— Ratio =
  • Current Assets (balance sheet) –
  • Current Liabilities (balance sheet)

Debt Service Ratio
— Measures ability to pay debts and make current principal payments as they come due
— Ratio =
  • Income Before Interest & Taxes (income statement) ÷
  • (Interest Expense (income statement) + Scheduled Debt Repayments (statement of cash flows))
Financial Statement Ratios: Evaluating Efficiency

Inventory Turnover
— Measures how quickly inventory is sold
— Ratio =
  • Cost of Goods Sold (income statement) ÷
  • Average Inventory (balance sheet)

Average Collections Period
— Measures days the average receivable remains outstanding
— Ratio =
  • Average Accounts Receivable (balance sheet) ÷
  • Average Daily Sales (sales ÷ 365) (income statement)
Financial Statements in Litigation

- Tax accrual workpapers (“TAW”)
- Evidence issues
- Substantive Issues
Tax Accrual Workpapers

“Tax accrual workpapers” is defined in Internal Revenue Manual 4.10.20.2:

[T]hose audit workpapers, whether prepared by the taxpayer, the taxpayer’s accountant, or the independent auditor, that relate to the tax reserve for current, deferred and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to footnotes disclosing those tax reserves on audited financial statements. These workpapers reflect an estimate of a company’s tax liabilities and may also be referred to as the tax pool analysis, tax liability contingency analysis, tax cushion analysis, or tax contingency reserve analysis.
Tax Accrual Workpapers: Policy of Restraint

Taxpayers sensitive to disclosure because TAW present IRS a road map to a taxpayers’ latent and disclosed tax issues

—Legal arguments in support and against
—Likelihood of settlement

Policy of Restraint. IRM 4.10.20.3.1(2)

—IRS requests TAW only
  • in “unusual circumstances,” such as when then IRS needs discreet fact information that has proven otherwise unavailable
  • taxpayer involved in listed transactions
Tax Accrual Workpapers:  
Attorney-client or IRC 7525 privilege?

Is the purpose seeking legal advice or performing accounting work?

– Dual purpose advice *not subject* to attorney-client privilege. *See United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999)

Has the privilege been waived? *See United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982)
Tax Accrual Workpapers: Work Product Privilege?


Authored by the taxpayer or advisors

– Current Circuit split
  • United States v. Textron, 577 F.3d 21 (1st Cir. 2009)
  • United States v. Deloitte LLP, 610 F.3d 129 (D.C. Cir. 2010)

– Interesting questions
  • Dual purpose documents?
  • Incorporation of mental impressions?
Tax Controversy Uses For Financial Statements

Government will often request financial statements during administrative process or litigation.

Statements and notes may be useful for issue spotting in a variety of areas, e.g.,

- Economic substance
- Debt/equity
- Basis for expert valuations
- Transfer pricing (particularly related party notes)
- Characterization of payments
Tax Controversy Uses For Financial Statements

By the same token, financial statements can be offered affirmatively to prove facts

—Imprimatur of independent auditor lends credulity

—Efficient summary of underlying data and documents

—Hearsay issues?
  • Possibly Rule 803(6) business records. *See In re Ollag Construction Equipment Corp.*, 665 F.2d 43 (2nd Cir. 1981)
  • Double hearsay? What sources inform the financial statements?
Use of Financial Statement for Tax Lawyers

Tax due diligence for transactions

- Countries and states with operations
- Type of entity or entities
- Accounting policies and procedures
- Prior acquisitions and dispositions
- General tax posture
Tax Due Diligence

FIN 48 (ASC 740) Reserves

- Understand technical issues related to each exposure
- Managements view on “more-likely-than-not” tax exposures
- Determine open tax years
- Determine positions taken and reasoning
- Determine method of quantification
- Location of accrued interest expense
- Estimate timing of payouts
Tax Due Diligence

Effective Tax Rate

- Why isn’t it 38%-40%
- Material permanent items
- State rate
- Foreign rate
- Consideration of the post-closing rate (i.e., cash repatriation)
Tax Due Diligence

Current and deferred income taxes

- Any cash tax benefits in future years (i.e., material DTAs)
- Attributes and valuation allowances
- What is the estimated taxable income for the current year (i.e., estimated current provision)
- Taxes receivable and payable
Tax Due Diligence

Material transactions

- Acquisitions, dispositions, internal restructurings, equity issuances, redemptions, and debt financings
- Impact on use of tax attributes
- Valuation of taxable transactions
- Deferred intercompany transaction triggers
Tax Due Diligence

Tax Examinations

- Closed, ongoing, and pending examinations
- US, non-US, state, and local
- All types of tax (e.g., income, franchise, capital-based, asset-based, sales, use, property, and employment)
- Quantify potential exposures and compare to accruals
- Determine open tax years
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

What is FAS 109?

-Standard that requires the recognition of expense/income for book/tax accounting differences.
  • Total tax expense based on pre-tax book income
  • Whether tax expense is classified as “current” (actual tax liability in CY) or “deferred” (future expense/benefit) is what must be calculated

-Applies to Federal, foreign, state and local taxes based on income.
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

Example:

**Year 1**
Pre-tax book (financial statement) income: $1,000,000
Tax Rate (federal and state): 35%
Tax Expense for Financial Statements: $350,000

Book depreciation expense: $250,000
Tax depreciation expense: ($500,000)
Difference (favorable): ($250,000)

Taxable income: $750,000
Tax Rate (federal and state): 35%
Current Tax Expense: $262,500

Deferred Tax Expense (Benefit): $87,500
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

Example:

**Year 2**

Pre-tax book (financial statement) income: $1,000,000
Tax Rate (federal and state): 35%
Tax Expense for Financial Statements: $350,000

Book depreciation expense: $250,000
Tax depreciation expense: $0
Difference (unfavorable): $250,000

Taxable income: $1,250,000
Tax Rate (federal and state): 35%
Current Tax Expense: $437,500

Deferred Tax Expense (Benefit): ($87,500)
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

Valuation Allowances

- Companies must evaluate the likelihood that they will realize deferred tax assets

- If it is “more likely than not” that the company will not realize their deferred tax assets, they are required to record a valuation allowance against the deferred tax asset and therefore not record the deferred tax benefit (income)
  - Affects book tax expense
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

Valuation Allowance Example:

**Year 1**
Pre-tax book income (loss): ($1,000,000)
Tax Rate (federal and state): 35%
Tax expense (benefit) for Financial Statements: ($ 350,000)

Taxable income: ($ 1,000,000)
Tax Rate (federal and state): 35%
Current Tax Expense (cannot go below $0): $ 0
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

Valuation Allowance Example:

**Year 1**
Book/Tax Difference NOL Carryover: ($1,000,000)

Tax Rate (federal and state): 35%
Deferred Tax Expense (Benefit): ($ 350,000)

Accounting Journal Entry:

DR Deferred Tax Asset* $ 350,000
CR Tax Benefit $350,000

*Asset because we expect to utilize $350,000 of NOL carryovers in future years to offset taxable income
Accounting for Income Taxes
FAS 109 (FASB ASC 740)

Valuation Allowance Example:

What if we don’t expect to utilize the NOL??

• Could have a partial or full valuation allowance

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Tax Asset</td>
<td>$ 350,000</td>
</tr>
<tr>
<td>Valuation Allowance</td>
<td>($350,000)</td>
</tr>
<tr>
<td>Net Asset</td>
<td>$ 0</td>
</tr>
</tbody>
</table>

-No deferred tax asset/expense recorded since no taxable income recorded