How To Speak Accountant
by Michael Goldman

Corporate lawyers keep companies out of trouble by anticipating and helping to circumvent problems. This cannot be done in a vacuum - the practice of Corporate Law is a team-oriented activity. Too often a team of very talented lawyers, accountants, operations managers, sales managers and marketers is assembled but doesn't gel. When they don't function as a team the reason is often that they misunderstand each other - they come in with different underlying assumptions, different perspectives, and even different definitions of the same words or terms. As a result, communication suffers and valuable information does not get adequately conveyed to all team members.

Adequate communication has never been more necessary than it is today. Today's business cycle is short, unpredictable, and fierce. There are a lot of factors outside of our control that are having more and more influence on the performance and valuations of our companies. These include the actions of multiple levels of government, currency valuations, cost and availability of capital, technology, resource availability, etc. It is more important than ever to fully understand your business dynamics - the key drivers, the relationships, the timings and flows, and the causes and effects.

This is the first in a series of articles that will help you understand your business better by discussing how accounting information is prepared, how to determine the assumptions and biases underlying the numbers, how to determine what the numbers in front of you mean, and what to do with them once you have them.

We will explore how financial statements can affect your decision making as well as how your decision making, in turn, will affect the numbers. You will come to understand that the financial statements are much more than the end result of your accountant's all-nighters. In the right hands, financial statements and other financial information are key pieces of data that fuel an overall thought process, the end result of which is to identify business strengths and problems, predict what may occur in regards to that business, make and execute decisions, and then begin evaluating again.

The Language of Accounting

Most business people and professionals speak in their own language. Lawyers use paragraph numbers of laws or regulations as short-hand for entire trains of thought. Doctors have long multi-syllable names for practically everything. Sales people often rattle off product codes, speaking in item numbers instead of product names. Arguably the most frustrating language of all in the business tower of babble is that of the accountants and financial people. Nobody feels stupid asking a doctor to translate his Latin into English or a lawyer to describe the section of code they just referenced. What makes finance so intimidating is that its basic language is numbers - innocent looking numbers, numbers just like those everyone learned how to manipulate in grade school.

Accountants present their numbers in the "generally accepted" format and mistakenly act like that makes them generally understood. That attitude in turn often prevents others in the organization from asking the questions that need to be asked in order to understand what the numbers are trying to communicate. It doesn't have to be that way. With a little bit of guidance, anybody with a basic understanding of business can understand financial statements and other financial information.

On rare occasions you can get lucky and take a tour through a business and spot something on the assembly line or shipping dock, and be able to instantly diagnose a business' problems. If nothing you see gives you that instant epiphany, your next steps are to talk with management and dig into the numbers. And, even if that instant insight into the dynamics of the business does quickly appear to you, you will still want to verify it, and that verification will most likely involve numbers.

Numbers are not mystical. They are a symbolic representation of thought, just as words and sentences are. Numbers in business share the following characteristics:

- The numbers are all driven by the activity in the business. The preparation of financial information should be an iterative process - the numbers on the financial statements are one way of measuring what is happening in a company (just as are discussions with employees, surveying customers, physical measures, etc.). These measurements should be used to help influence further activity in the business, which will in turn influence future financial statements. The numbers cannot exist independently of the factors that are driving them.

- Financial information is presented in standard formats - Balance Sheets, Income Statements, Statements of Cash Flow, etc. Usually there are notes and management discussions to further elaborate on important components of the statements.

- The numbers on the financial statements got there via an accounting system. Every accounting system has strengths and limitations that both influence and determine the quality and usefulness of the information presented on the financial statements. The system of internal controls over the accounting system also influences the quality of the information presented, as well as the susceptibility to fraud or unintentional misstatements.

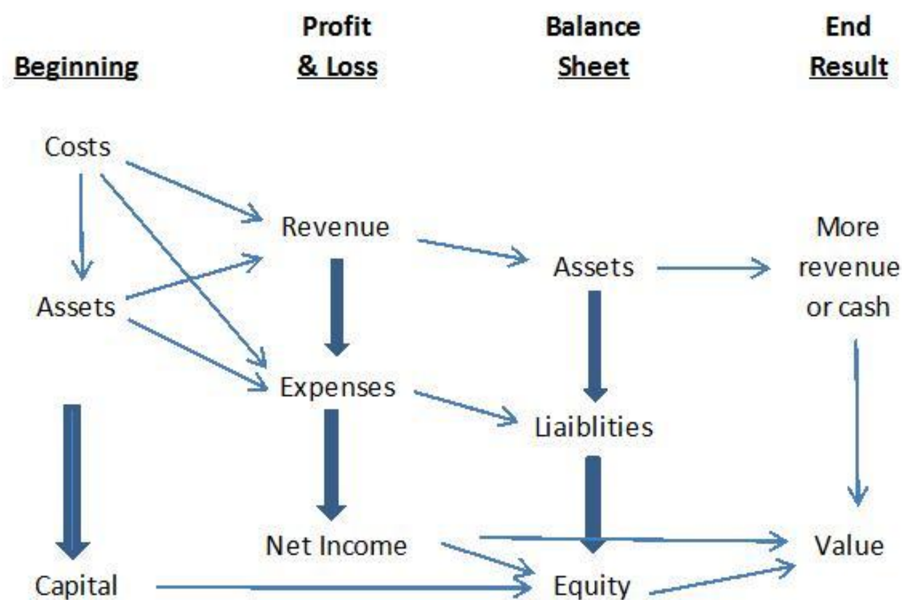
- There are many ways to analyze the numbers on financial statements, including ratio analysis, trend analysis, horizontal analysis, vertical analysis, variance analysis, common-size analysis, etc. Again, these are all just shorthand for different patterns of thought. A good analysis will raise a lot of questions and indications of what to further investigate in terms of what is driving the numbers to be what they are.

- There are many different uses for the same sets of financial statements. These include making investment decisions, paying taxes, diagnosing and solving problems, settling legal disputes, finding fraud, raising capital, impressing your relatives, etc.

The Big Picture

In order to be able to use financial statements, it is important to understand both the basics about business cycles and how financial statements reflect a business cycle. Putting aside beginning entrepreneurial functions such as recognizing an opportunity, making business plans, etc., a company really begins in earnest when it starts acquiring assets and incurring costs. From there it generates revenue and incurs the necessary expenses that need to be spent to realize those revenues. Revenues beget more assets and expenses beget liabilities. Ultimately the assets, the revenue-generating capability, the accumulated equity, etc. become value.

Before exploring financial statements in more detail, it is important to understand each of the terms in the picture below:



An asset is an item or resource with economic value. It has value because it can ultimately be converted to cash. If you own stock in a fast growing and hugely profitable company but were totally prohibited from selling it, collecting dividends, gifting it, or otherwise converting it to cash, that stock is not an asset.

Assets can be tangible or intangible, and the value of a specific asset can be different based on different situations or uses (valuation issues will be discussed in future installments). Assets are also classified by accountants into current or long-term, depending on how soon they are likely to be converted to cash.

Costs may or may not be assets. Cost is a measure of effort, material, resources, time, risks incurred, opportunity forgone, and other trade-offs made in order to get something. If the cost has measurable monetary value that satisfy accounting criteria, the accountant will classify it as either an asset or an

expense, depending on its useful life, its amount, and other factors. Some costs are very real and may ultimately produce value, but do not qualify for inclusion in financial statements - an example would be all the uncompensated time spent writing articles instead of doing billable activity or being with family members.

A business incurs costs before it can generate revenue. Even a very simple business, such as opening a post-office box and inducing people to send money to it, incurs the costs of the post-office box, the advertising of the address, etc. Before a lawyer can hang her shingle and begin taking money from clients, she has incurred the costs of her education which include her tuition, the forgone time that she could have spent earning money at another job, etc.

Hopefully the costs that are incurred will eventually generate revenue. Revenue (also known as "sales") is the dollar amount that a customer pays for goods or services provided as the result of a transaction. Inherited money, gifts, and money found on the sidewalk are all wonderful things but they are not revenue. "Revenue recognition" refers to the time when accountants determine that revenue has been earned.

Recognition depends not only on having a high likelihood of being paid, but also on when the goods have been delivered or the services have been provided. These are not as straight-forward questions as they may seem. Some companies recognize revenue when their customer pays for the goods, some when the customer receives the goods, some when the goods are first shipped, some when the goods are merely moved from one part of the warehouse to another, and some when the customer simply signs a contract to buy the goods.

Expenses are costs incurred in the effort to generate revenue. The effort doesn't have to be successful, but there must be an identifiable effort made. Whether an expenditure qualifies as an expense of your business depends in part on what your business is. A new pair of skates is a business expense to a person in the business of selling hockey lessons, but probably not to a person in the business of printing signs. Any cost of doing business resulting in revenue-generating activities generates either an asset or an expense, but it must be related to the business' effort to generate revenue to be able to make it onto the financial statements.

The difference between an asset and an expense is often a function of time (expected life) and amount (significant or not) - if you buy an umbrella to keep dry while you conduct business that is an expense because the amount is small and the life is usually short. If you install a new roof to keep you dry that is most likely an asset.

Liabilities are obligations to pay money, goods, or services to someone else. Examples include accounts payable, taxes, accrued expenses, and deposits you are holding. Liabilities can be contingent (i.e. one associated with a threatened union vote or new government regulation) but they do not get put on financial statements unless they are the result of a transaction or past event. Liabilities most often are the result of expenses or costs that have been incurred but not yet paid for.

On the Statement of Profit and Loss, the difference between the revenues recognized and the expenses incurred in realizing those revenues is profit, or "net income". On the Balance Sheet, the difference between assets and liabilities is equity . Equity can also be calculated independently of assets and liabilities by taking the capital contributions of the owners and adding (subtracting) the cumulative net income (losses). Equity is where it all comes together.

In older, simpler times when the dollar was stable, assets were mostly tangible, transactions were straight-forward, and the amounts of liabilities were easy to determine, Equity was also called "Book Value". Book Value was the first and often only place an investor or judge went when she wanted to know the health or value of a company.

In today's more complex world of intangible assets, volatile markets, political uncertainty, technological change, creative transaction structures, complicated tax and legal environment, etc. financial statements at best provide hints at the estimation of a company's performance, health, and value. To really know a company, you have to get into the guts of the assumptions and processes used to generate its financial statements, to know both what is there and what isn't there, and to assess what it all means.

The Pixels Within the Big Picture

According to Wikipedia, a pixel is the smallest addressable element in a digital picture. The word *pixel* is based on a contraction of *pix* ("pictures") and *el* (for "element"). Wikipedia goes on to explain "many common operations can be implemented by uniformly applying the same operation to each pixel independently. Other arrangements of pixels are also possible, with some sampling patterns even changing the shape of each pixel across the image. For this reason, care must be taken when acquiring an image on one device and displaying it on another, or when converting image data from one pixel format to another."

Each of a business' many transactions or activities get classified as one of those elements - assets, revenues, expenses, liabilities, etc. Just like pixels, the same transaction can have very different looks depending on the context - an expense in one company may be an asset in another, for example, or the exact same asset can be carried at very different values in two different companies. Just like a digital photograph needs rules on how to display the pixels, accounting has rules on how to handle the different transactions that occur in business. Before jumping into the Balance Sheet (next installment), it is important to understand the concepts that provide the context for all financial statements.

Financial statements are usually prepared under Generally Accepted Accounting Principles, or GAAP. Note the word "usually". For non-public companies GAAP is not required if the basis of alternative presentation is disclosed. Some alternate basis of presentation are the Income Tax basis or the Cash Basis. Statements prepared under the Income Tax Basis use the accounting regulations determined by the IRS, while statements prepared under GAAP use the conceptual framework determined by the American financial community (and, since Enron, the US Government). Cash Basis statements are

exactly what they sound like - accounting that is prepared like a giant bank ledger, tracking nothing but the cash that flowed in and the cash that flowed out. There can be very significant differences between each of these different basis of presentation.

GAAP is the most commonly used basis of financial statement presentation. The basic tenets of GAAP are:

Reporting Entity - Individuals, sole proprietors, corporations, partnerships, trusts, and Limited Liability Companies are all entities that have their own accounting. Accounting and financial statements cannot be commingled across entities - each financial statement has to purely represent a single entity. Financial statements of numerous related entities often get consolidated together, but at bedrock every economic entity has its own set of financial statements.

Reporting Period - Every financial statement is prepared for a defined reporting period; a month, quarter, year, or something else. Balance Sheets always have an "as of" date - the date at which the assets and liabilities are tabulated. Income Statements represent profit and loss activities for a specified period of time, such as "the month ending 2/28/10" or "the year ending 12/31/10". This sounds simple, but there are actually different definitions of common terms such as "year" or "month" in the accounting world. Some companies report their financial results based on a 52-week year rather than on a calendar year. Many retailers use a 4-5-4 quarterly calendar, where two of the months consist of 4 weeks each and the middle month of the quarter is a 5-week "month".

Going Concern - Financial statements assume that the entity will continue normal operations for at least for another year. This is important because of the assumptions used in preparing the statements. Remember, for example, that one of the key differences between an asset and an expense is the useful remaining life of the expenditure - if it will last less than a year it is an expense, if more than a year it is probably an asset. If the entire entity isn't likely to survive the year, all of its assets will probably end up in the liquidation heap for far less than they cost, so continuing to report them at the higher value would be misleading. This is why when companies are not in compliance on their loan agreements either the bank needs to waive the breach or it needs to be resolved. Until the threat of foreclosure and liquidation passes, the company cannot be considered a going concern and the balance sheet will need to be revalued from what its current state.

Historical Cost - Financial Statements are a measurement of either an entity's financial position (balance sheet) or its profitability. In order to measure something, you need a unit of measure. Units of measure must be objective and consistent in order for them to have any meaning. Unless we are in a period of severe inflation or currency upheaval, the dollar is generally considered to be an acceptable unit of measure. Those of us old enough to remember early 1970's prices (so many of the things we used in daily life back then sold for under a dollar that all typewriter keyboards had a cents symbol) may disagree with this, but in the world of accountants the dollar is still a stable unit of measure.

It's not just the dollar that is the unit of measure for accountants - it is the dollars that you actually paid for an item. This is known as "historical cost". A building bought for $1,000,000 twenty years ago

may have a liquidation (fire sale) value today of $700,000, a replacement cost (if you had to rebuild it) value of $3,000,000, and a market value (what you could receive in an unhurried arms-length transaction) of $2,000,000. To the mind of an accountant , the only truly objective measure of value is what you paid for an item, less depreciation. In this case, $1,000,000, less the 20 years of accumulated depreciation. It doesn't matter that neither the amount you paid 20 years ago nor the rate at which you've been depreciating the building have any economic relation to anything going on today. Objectivity is considered more important than that much more subjective standard," being right".

There are exceptions to the Historical Cost principle. When the market value of an asset declines below its cost, the value should be written down to the Lower of Cost or Market. This is a one-way street - if the value increases, it cannot be written back up on the statements. Some investment assets may be continually marked to market price, depending on the business reason for holding the asset and the type of business holding it. Companies dealing in foreign currencies have translation issues. All deviations from historical cost must be disclosed in the notes or other disclosures required for GAAP financial statements.

Consistency - Comparability between entities, or between one reporting period and another for the same entity, can only be achieved if the accounting is done consistently. While different companies in the same industry may apply very different accounting methods, it is essential that any particular entity apply the same accounting methods in all similar transactions.

Matching - Under GAAP, revenue and all of its related costs must be reported in the same time period. For example, a company's employees are entitled to earn bonus and vacation time as they work. A company that is at its seasonal peak may not allow vacations to actually be taken during the period being reported on, but is required to accrue the cost of those vacations and bonuses as they are earned. This is different from the Cash Basis of accounting, where no accruals are made and the entire expense of the vacations and bonus is realized when they are paid. Under the Income Tax Basis, you may end up with a third result, depending on whether the employees are owners or "highly compensated" and how soon after the close of the accounting year the bonuses are paid.

The GAAP requirement to match related costs and revenues makes the Profit and Loss Statement more usable, but often leads to accrued liabilities, pre-paid expenses, deferred revenues, and other unnatural items on the entity's balance sheet. For example, if you pay your insurance policy once a year at the beginning of the year, this becomes a pre-paid expense that gets amortized each month until your insurance coverage expires.

Realization of Revenue - The realization of revenue principle is supposed to enforce consistency and objectivity, but is ripe for abuse. Under GAAP, revenue is not realized (recorded) until an exchange has occurred and the earning process is virtually complete. At least some of the revenue is not allowed to be realized if there are significant contingencies, warranties, or other obligations still to be performed, unless you are allowed to use certain other accounting rules such as the Percentage of Completion method or End of Production accounting. In contrast, under the Cash Basis you simply

recognize revenue when you actually get paid, and under the Income Tax Basis you recognize revenue in the manner that gets the government "their money" as quickly as possible.

Many frauds, usually overstatement of revenue, are committed by tinkering with the definitions of the various terms that define Realization of Revenue. Some companies declare their product to be shipped when the product leaves the building, some when the UPS label is printed, others when the product crosses a certain line in the warehouse. Determining what contingencies or what warranty obligations still exist can also be subjective. Understanding when revenue actually gets realized is one of the most important elements to understanding a company.

Other concepts that are important to the accountant include:

- Materiality - the opposite of "too big to fail", if it is small enough it doesn't matter.
- Objectivity - two different people looking at the same data would reach essentially the same result
- Conservatism - when in doubt, choose the outcome least likely to overstate assets or income
- Industry Practice - it makes sense and is allowable for different industries to recognize those differences and have accounting practices that may be unique to them (but common amongst all companies in the industry).

Someone who has just read all of the above, or the first two chapters of any accounting text, would be excused for thinking that accounting is objective, clear-cut, and simply a matter of following some rules that every accountant knows and agrees to. If that were the case, forensic accounting would not be the fastest growing part of the accounting profession. Even simple precepts can become murky in their execution.   Upcoming installments will delve into the financial statements and show how much subjectivity and leeway there actually is