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# How CPAs Analyze Financial Statements in Dissolution Cases

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What do forensic accountants look for when they review financial statements of a business provided to them by counsel? What are the signs that there are irregularities taking place? What are the typical types of financial statements?

There are three standards and three types of financial statements. The three standards are audits, reviews and compilations. The three types are balance sheets, income statements, and statements of cash flows (these sometimes have other names). This article will explain the standards, the types, and then the techniques used to analyze them. Keep in mind that these standards and types apply to financial statements prepared under generally accepted accounting principles (GAAP); the forensic accountant then studies these financial statements and conducts certain testing that will be described below, and he may report his findings to a court in a format that does not conform to the above standards and types.

## Standards of Financial Statements

The first matter that is examined is what is called the standard of accountants' services rendered in preparation of the financial statement. Generally, the higher the standard by the company's CPA's, the lower will be the intensity of analysis by the forensic accountants. One therefore looks to see what standard of financial statement is being presented and who prepared them. *An audited* financial statement is one that is tested to the greatest degree by the company's CPA's; a *reviewed* financial is tested to some degree, and a *compilation* does not have to be tested at all.

A compilation (a compiled financial statement) can simply be a presentation in the proper form of financial statement of financial information taken directly from the company's records without any further analysis. In other words, to prepare a compiled financial statement, an accountant can simply look at a company's general ledger or other financial information, accept the company's numbers as being accurate. The accountant then simply collects the company's numbers and puts them together on a piece of paper that is in the correct format of classical financial statements. There is no requirement to actually analyze the numbers to see that they are accurate. There are many accountants who prepare compilations with much better quality than this - they demand backup for many of the numbers and do other work, but that is not required for a compilation.

The second standard of financial statement is a *review*, and an accountant who prepares a reviewed financial statement is required to perform various analytical testing of the numbers so that the amounts appear reasonable.

The third standard is an *audit*, where the accountant performs a much greater level of testing of the numbers.

To illustrate the differences between the three standards, a company that sells goods on credit will have accounts receivable. To prepare a *compilation*, an accountant need only call up the company's controller/bookkeeper and ask what is the amount of the accounts receivable. Whatever the controller/bookkeeper tells him goes on the financial statement as the amount of the accounts receivable. To prepare a review, the accountant will probably look at the company's accounts receivable printouts, will compare this year's amounts with prior year's amounts, will compare this year's amount of accounts receivables with this year's sales, do the same for the prior year, and thereby try to see if the amount of accounts receivable appears reasonable. To prepare an *audit*, he will not only do what is done at a review level, but will actually send out letters to many of the customers asking them to write him back confirming that the amounts that the company said are owed are actually owed.

Therefore, in a dissolution matter, if a forensic accountant is given financial statements to analyze, he first tries to ascertain the quality of the statements. He will perform much more analysis if he is given compilations than if he were given audited financial statements. He would also look at the firm preparing the financial statements.

## Types of Financial Statements

A balance sheet (many firms call it a statement of financial condition) has two groups of numbers, both of which equal each other: they "balance." The first group of numbers identify the assets of the company. The assets are reported on a cost basis, so that if, for example, a building was purchased many years ago for $500,000, and is worth two million dollars today, the balance sheet would show a building with a cost of $500,000. (The forensic accountant would then adjust the balance sheet to reflect that the current value is two million.) The second group identifies the liabilities and capital. The theory is that assets are acquired by either borrowing money or by investing money, and so the assets equal the sum of the borrowings and the invested capital. Looking at it a little differently, if one were to subtract the liabilities from the assets, one would arrive at the amount identified as "capital."

**ASSETS = LIABILITIES + CAPITAL**

**ASSETS - LIABILITIES = CAPITAL**

To determine the net worth of the company, one looks at the capital amount; this represents the net assets that are left after paying off, or deducting, the liabilities. The capital on a financial statement would be what is called "the book value" of the company, and it represents the net worth of the company using historical costs. After appraisal adjustments by the forensic accountant, the capital would represent the real net worth, using current fair market values.

An income statement identifies the gross income or receipts of a business and then the expenses incurred, arriving at a number that represents the "net income" of the business.

A statement of cash flows identifies the financial history of the company from a cash basis point of view. It will also show how the cash flowed during the period - what was borrowed, what was invested, etc.

A balance sheet presents the financial condition of the company at a certain date - usually the last day of the fiscal year. An income statement and a statement of cash flows present a financial history of a period of time, usually for the current fiscal year. Thus, a set of financial statements for a typical company will be a balance sheet dated the last day of the year, and an income statement and statement of cash flows for the *period* of the past year.

## What Does the Forensic Accountant Do with the Financial Statements?

As discussed above, the forensic accountant first tries to determine the overall quality of the financial statement so that he can ascertain how much analysis would be necessary. In addition, the forensic accountant's analysis is often towards a different objective than that of the CPA firm that prepared the financial statements. Assuming that additional analysis would be necessary, these are some of the steps that would be taken.

First, one would prepare a spreadsheet listing the balance sheets for the past five years, if available, and then another spreadsheet listing the income statements for the same period, and a third spreadsheet listing the cash flows, if available. One would then study each spreadsheet, looking for unusual items or developing patterns, or changes in patterns. A usual example is that the legal fees of a business will be consistent from year to year, either in dollar amounts or as a percentage of sales, and then, in the year of divorce, the legal fees will increase dramatically. One would then predict that the personal legal fees for the divorce are being paid by the business and are being deducted as a business expense by the business. One then would obtain the paid legal bills from the business to ascertain if the legal costs are all business expense, or if they are what we call “perquisites”. If they are all business in nature, one may discover that they are due to a new lawsuit that may significantly affect the value of the business.

Similarly, one would look at the history of the gross profit percentages of the company. Imagine a company that sells the same items from year to year, and reports that in years one and two, the cost of the goods that are sold cost 40% of the sales price, for a gross profit of 60%. In year three, the cost of goods sold is reported to be 30%, for a gross profit of 70%. In year four, the costs are reported to be 45%, for a gross profit of 55%, as shown below:

| | **Year I** | **Year 2** | **Year 3** | **Year 4** |
|---|---|---|---|---|
| Sales | 100% | 100% | 100% | 100% |
| Cost of sales | 40% | 40% | 30% | 45% |
| Gross profit | 60% | 60% | 70% | 55% |

This chaotic pattern indicates that further analysis is needed to see if the inventory numbers are incorrect, or if there are unreported sales, or if the financial statements are simply unreliable.

There are certain expenses which are usually business in nature, and they are a good indicator of the sales level. For a company that manufactures shampoos, for example, a major expense would be utilities, since water is a key ingredient of shampoos. If the utility expense is increasing from year to year while sales are decreasing, and if there has not been any significant utility rate increase, one would assume that sales are being underreported. One would then look for other evidence to support that assumption. An expense as mundane as paper supplies may provide a clue to activity that is not being reflected on the financial statements.

Close attention should be paid to payroll. There should be a direct correspondence between sales and payroll expense, so that if there is a recession and sales drop, there should be a drop at some point in payroll. There may be a time lag, but the pattern should appear. The opposite would be true if sales increase significantly over previous levels. If sales are flat and payroll is increasing, it may be because management is hiring new people to either develop new business or in anticipation of greater sales - in either case, spousal support that is based on the current situation may not be as favorable as it might be if the projected new sales takes place. On the other hand, the increased payroll may be due simply to a desire to hide income from one's spouse, and so the business manager is now issuing payroll checks to his new girlfriend or to his friends and relatives, none of whom is working at the business. A review with the out-spouse of payroll tax returns and the endorsements of payroll checks may help uncover this maneuver.

For smaller businesses, a review of the payroll and the payroll tax expense may show that the payroll taxes paid are insufficient. It may be that the employees are being treated as independent contractors, and if that is improper, there may be a large contingent tax liability to deal with in the valuation. It will also show that the company takes a very aggressive position regarding taxes, and this attitude may reflect its position regarding perquisites.

A study of the history of the balance sheets may show that inventory is constantly shrinking, year to year. If sales are increasing during the same period, one would delve more deeply, because usually, as sales increase, more inventory is needed to be on hand to service those sales.

The balance sheets may show increasing borrowing from banks or shareholders. If the income statement shows that during the same period, sales and net income were increasing, one would study the matter to see why there is a need to keep borrowing when profits are rising. Further, if there are new loans, there are probably new loan applications filed with the bank. A subpoena of the bank's records will show if the same tax returns and financial statements that were given to the bank were also given to the spouse during the dissolution proceedings. The loan application may also contain a new personal financial statement prepared by the person operating the business. Quite often, that person will claim to his spouse that his income is very low and that his assets are minimal; the personal financial statement submitted to the bank often shows a different picture. It may reflect income and assets that the other spouse was not aware of. One then has to conduct further analysis to determine the true reality.

The balance sheets may report certain assets which require special treatment. There may be an asset called “covenant not to compete”. This usually represents the portion of the cost of a business that was allocated to a covenant, usually for tax reasons. Thus, if a magazine publisher purchased a magazine for two million dollars, he might report the purchase as one million for a covenant not to compete and one million for the subscription list. Both of these assets could be amortized; *i.e.* deducted, for tax purposes.

If one were to encounter assets such as these, one should obtain all of the details regarding the underlying transactions so that those details could be used in a current valuation. If, for example, the magazine publisher publishes five magazines like the one that he purchased for two million, it would be a good starting point in valuing the company to compare and contrast each of his other magazines to the one purchased for two million dollars.

There might be assets - such as patents - which may indicate enormous financial potential. The asset may be reflected on the books at a small amount, for that might be all that was incurred to develop that patent. But the patent could be very valuable by itself if it were to be sold, or it could be an indication that the company is moving into a lucrative direction, or into a new type of business. All of this must be considered when valuing the company.

Finally, there are liabilities that should be examined closely. Many businesses report a liability called deferred income taxes, which represents a theoretical liability to pay taxes that might never actualize. The footnotes to the financial statements may mention contingent liabilities, such as ongoing lawsuits, which should be evaluated as to their probability.

In summary, a study of the financial statements of a business can itself provide important insights regarding the company and the amount of discovery that will be needed.