

Understanding Financial Statements

Wendy J. Rose
Partner, Financial Advisory Services
PricewaterhouseCoopers

Mary A. Woodford
Director, Financial Advisory Services
PricewaterhouseCoopers

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Kilpatrick Stockton LLP

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Coopers
& Lybrand

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100 Avenue of the Americas
New York, NY 10013

Welcome

Objectives:

- **Fundamentals of Financial Reporting**
- **Principles of Financial Statements**
- **Ratio Analysis**
- **Role of Independent Auditor**
- **Accountant's / Financial Advisor's Role in the Dispute Resolution Process**

Financial Reporting...

- **Not An Exact Science**
 - **Involves Estimations**
 - **Requires Judgment**

GAAP Hierarchy:

- Level I** —→
- FASB Statements
 - APB Opinions
 - AICPA Accounting Research Bulletins
 - FASB Interpretations
- Level II** —→
- AICPA Statements of Position
 - AICPA Industry Accounting Guides
 - AICPA Industry Audit Guides
 - FASB Technical Bulletins
- Level III** —→
- Consensus Positions of EITF
 - AcSEC Practice Bulletins
- Level IV** —→
- AICPA Accounting Interpretations
 - FASB Staff Questions & Answers
 - Widely Recognized & Prevalent Practices
- Level V** —→
- FASB Concept Statements
 - APB Statements
 - AICPA Issues Papers
 - International Accounting Standards
 - GASB Statements and Interpretations
 - GASB Technical Bulletins
 - Pronouncements of Professional Associations and Regulatory Agencies
 - AICPA Technical Practice Aids

Fundamental Principles and Conventions:

- **Going Concern Concept**
- **Historical Cost Measurement**
- **Estimation and Judgment**
- **Accrual Method of Accounting**
- **Matching Concept**
- **Revenue Recognition**
- **Expense Recognition**
- **Loss Contingencies**
- **Gain Contingencies**

Probability

Probable



Likely to Occur

Reasonably Possible



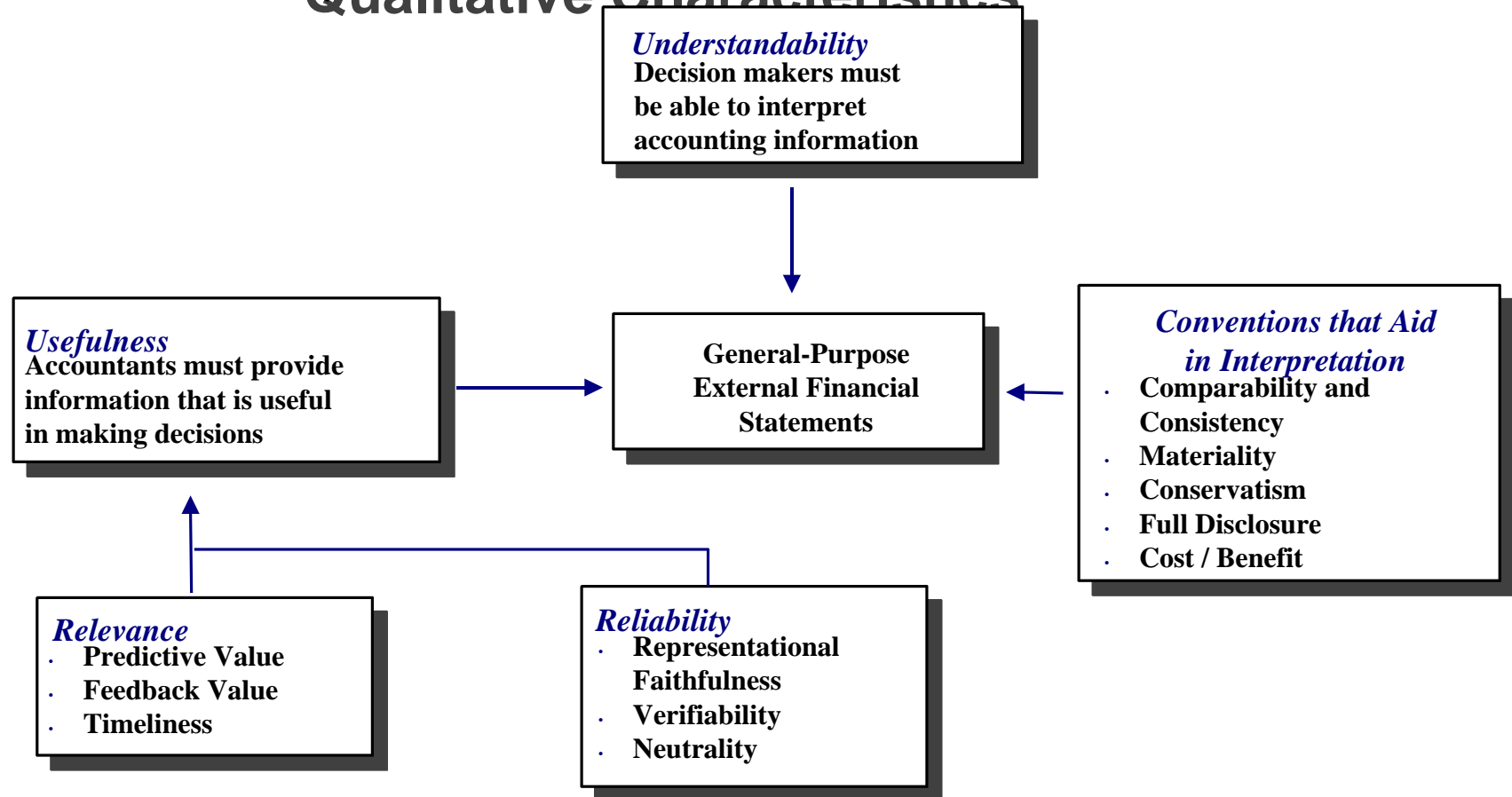
**More than Remote
& Less than Likely**

Remote

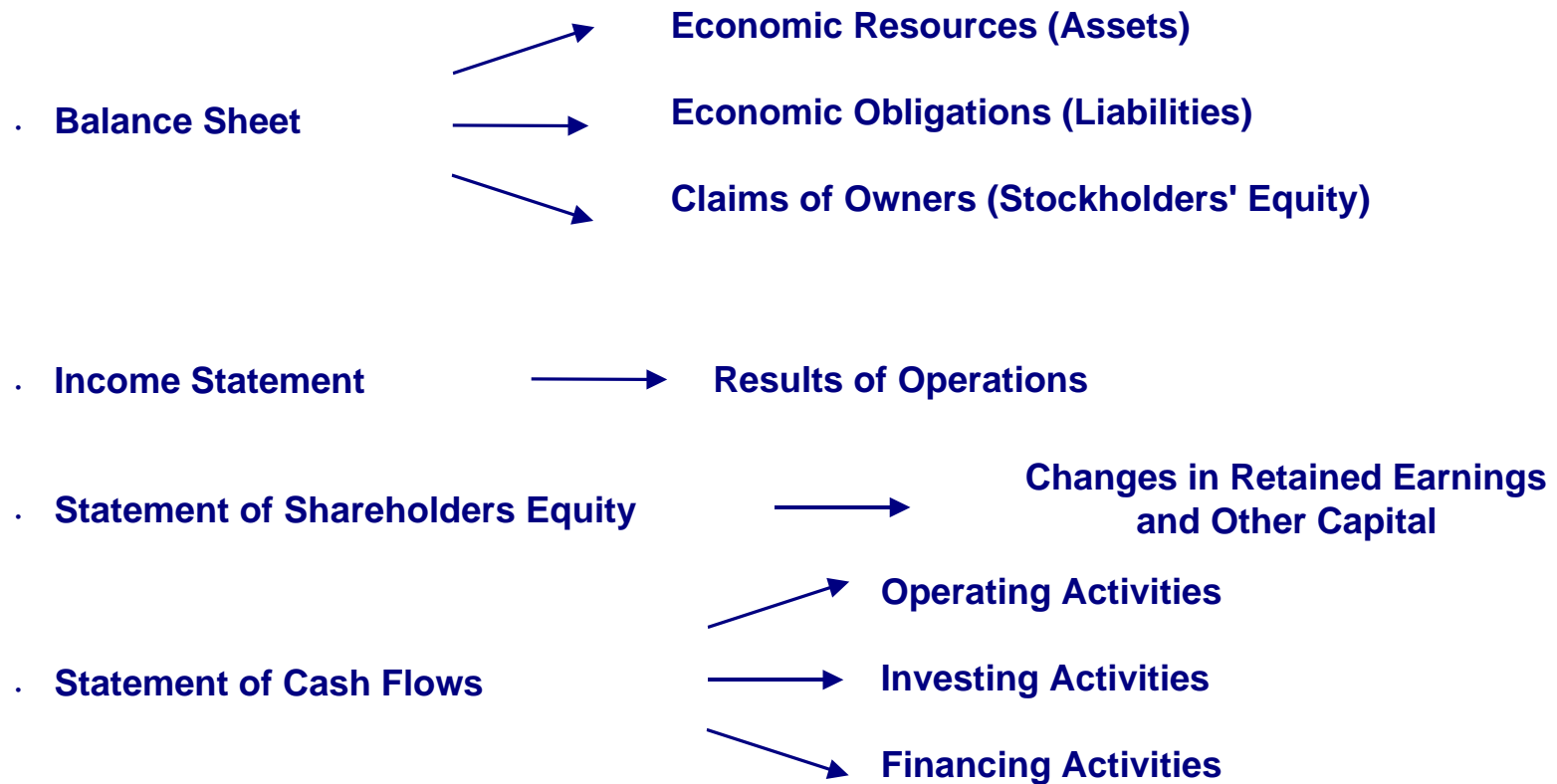


Not Likely to Occur

Qualitative Characteristics



Four Interrelated Financial Statements:



General Signal Corporation

Balance Sheet

Assets

December 31,

Current Assets (in millions)	<u>1996</u>	<u>1995</u>
Cash and cash equivalents	\$ 17.7	\$ 1.0
Accounts receivable	353.0	323.6
Inventories	240.6	234.7
Prepaid expenses and other current assets	19.8	30.1
Assets held for sale at estimated realizable value	4.9	60.4
Deferred income taxes	<u>55.9</u>	<u>71.6</u>
Total Current Assets	691.9	721.4

General Signal Corporation

Balance Sheet

Assets - Continued

Non-Current Assets (in millions)	<u>December 31,</u>	
	<u>1996</u>	<u>1995</u>
Property, plant and equipment	\$ 310.0	\$ 312.7
Intangible assets	381.3	406.0
Other assets	167.8	161.6
Deferred income taxes	<u>0.0</u>	<u>11.5</u>
Total Non-Current Assets	859.1	<u>891.8</u>
Total Assets	<u>\$1,551.0</u>	\$1,613.2

General Signal Corporation

Balance Sheet

Liabilities and Shareholders' Equity

Current Liabilities (in millions)	<u>December 31,</u>	
	<u>1996</u>	<u>1995</u>
Short term borrowings and current portion of long-term debt	\$ 5.6	\$ 9.0
Accounts payable	187.3	158.1
Accrued expenses	214.6	233.8
Income taxes	<u>31.7</u>	<u>31.2</u>
Total Current Liabilities	439.2	432.1

General Signal Corporation

Balance Sheet

Liabilities and Shareholders' Equity - Continued

Long-Term Liabilities (in millions)	<u>December 31,</u>	
	<u>1996</u>	<u>1995</u>
Long-term Debt, Less Current Portion	\$ 201.3	\$ 428.6
Accrued Post-Retirement Benefits	133.2	146.9
Deferred Income Taxes	17.3	0.0
Other Liabilities	<u>16.2</u>	<u>27.5</u>
Total Long-Term Liabilities	368.0	603.0
Total Liabilities	<u><u>807.2</u></u>	<u><u>1,035.1</u></u>

General Signal Corporation

Balance Sheet

Liabilities and Shareholders' Equity - Continued

Shareholders' Equity (in millions)	December 31,	
	<u>1996</u>	<u>1995</u>
Common stock	\$ 78.2	\$ 77.9
Additional paid-in capital	337.1	304.2
Retained earnings	667.4	582.9
Cumulative translation adjustments	(1.4)	(3.9)
Common stock in treasury	<u>(337.5)</u>	<u>(383.0)</u>
Total Shareholders' Equity	743.8	578.1
Total Liabilities and Shareholders' Equity	<u><u>\$1,551.0</u></u>	<u><u>\$1,613.2</u></u>

General Signal Corporation

Income Statement

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Net sales	<u>\$ 2,065.0</u>	<u>\$ 1,863.2</u>	<u>\$ 1,527.7</u>
Cost of sales	1,435.7	1,308.0	1,109.5
Selling, general and admin. expenses	406.2	354.4	292.3
Gain on disposition	(20.8)	0.0	0.0
Transaction and consolidation charge	0.0	20.1	0.0
Merger break-up fee and other	<u>0.0</u>	<u>0.0</u>	<u>(46.2)</u>
Total operating costs and expenses	<u>1,821.1</u>	<u>1,682.5</u>	<u>1,355.6</u>
Operating Earnings	243.9	180.7	172.1

General Signal Corporation

Income Statement - Continued

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Operating earnings	\$ 243.9	\$ 180.7	\$ 172.1
Interest expense, net	<u>21.5</u>	<u>24.3</u>	<u>11.8</u>
Earnings before taxes	222.4	156.4	160.3
Income taxes	<u>89.0</u>	<u>56.3</u>	<u>56.2</u>
Earnings From Continuing Operations	133.4	100.1	104.1

General Signal Corporation

Income Statement - Continued

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Earnings from continuing operations	\$ 133.4	\$ 100.1	\$ 104.1
Earnings (Loss) from discontinued Operations, net of tax			
Operations	0.0	0.0	2.4
Disposal	<u>0.0</u>	<u>(64.0)</u>	<u>(25.8)</u>
NET INCOME	<u><u>\$133.4</u></u>	<u><u>\$36.1</u></u>	<u><u>\$80.7</u></u>

General Signal Corporation

Statement of Cash Flows

Cash Flow From Operating Activities

Year Ending December 31,

	<u>1996</u>	<u>1995</u>	<u>1994</u>
Earnings from continuing operations	\$ 133.4	\$ 100.1	\$ 104.1
Adjustments to reconcile earnings to net cash			
Gain on disposition	(20.8)	0.0	0.0
Asset write down and other charges	19.7	0.0	0.0
Transaction and consolidation charges	0.0	20.1	0.0
Deferred income taxes	43.7	32.0	36.8
Depreciation and amortization	69.2	62.8	48.4
Pension credits	(8.8)	(9.3)	(9.7)
Other, net	<u>5.5</u>	<u>4.4</u>	<u>2.2</u>
Total Adjustments to Reconcile Earnings to Net Cash	108.5	110.0	77.7

General Signal Corporation

Statement of Cash Flows

Cash Flow From Operating Activities - Continued

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Earnings from continuing operations	\$ 133.4	\$ 100.1	\$ 104.1
Changes in assets and liabilities			
Accounts receivable	(30.8)	(15.4)	(25.2)
Inventories	(10.4)	21.4	(26.8)
Prepaid expenses and other current assets	11.0	18.1	(1.0)
Accounts payable	28.8	(14.2)	29.5
Accrued expenses and other	(49.0)	(71.6)	(50.5)
Income taxes	<u>0.2</u>	<u>12.3</u>	<u>7.9</u>
Total Changes in Assets and Liabilities	(50.2)	(49.4)	(66.1)

General Signal Corporation
Statement of Cash Flows
Cash Flow From Operating Activities - Continued

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Earnings from continuing operations	\$ 133.4	\$ 100.1	\$ 104.1
Total adjustments to reconcile earnings from continuing operation to net cash	108.5	110.0	77.7
Total changes in assets and liabilities	<u>(50.2)</u>	<u>(49.4)</u>	<u>66.1</u>
Net Cash from Operating Activities	<u><u>191.7</u></u>	<u><u>160.7</u></u>	<u><u>115.7</u></u>

General Signal Corporation
Statement of Cash Flows
Cash Flow From Investing Activities

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Divestitures	\$ 94.4	\$ 53.4	\$ 26.2
Capital expenditures	(59.3)	(49.0)	(74.8)
Acquisitions, net of cash acquired	0.0	(272.4)	(83.3)
Other, net	<u>(2.8)</u>	<u>15.3</u>	<u>0.5</u>
Net Cash from Investing Activities	<u><u>32.3</u></u>	<u><u>(252.7)</u></u>	<u><u>(131.4)</u></u>

General Signal Corporation

Statement of Cash Flows

Cash Flow From Financing Activities

	Year Ending December 31,		
	<u>1996</u>	<u>1995</u>	<u>1994</u>
Issuance of long-term debt	\$ 115.3	\$ 273.2	\$ 77.9
Redemption of long-term debt	(288.5)	(134.0)	(7.0)
Purchase of common stock	(1.2)	(18.0)	(18.5)
Issuance of common stock	14.7	17.1	4.9
Dividends paid	<u>(47.6)</u>	<u>(45.6)</u>	<u>(42.6)</u>
Net Cash from Financing Activities	<u><u>(207.3)</u></u>	<u><u>92.7</u></u>	<u><u>14.7</u></u>

General Signal Corporation
Statement of Cash Flow

Year Ending December 31,

	<u>1996</u>	<u>1995</u>	<u>1994</u>
Net cash from operating activities	\$ 191.7	\$ 160.7	\$ 115.7
Net cash from investing activities	32.3	(252.7)	(131.4)
Net cash from financing activities	<u>(207.3)</u>	<u>92.7</u>	<u>14.7</u>
Net changes in cash and cash equivalents	16.7	0.7	(1.0)
Cash at beginning of year	<u>1.0</u>	<u>0.3</u>	<u>1.3</u>
Cash at End of Year	<u><u>\$17.7</u></u>	<u><u>\$1.0</u></u>	<u><u>\$0.3</u></u>

General Signal Corporation

Statement of Shareholders' Equity

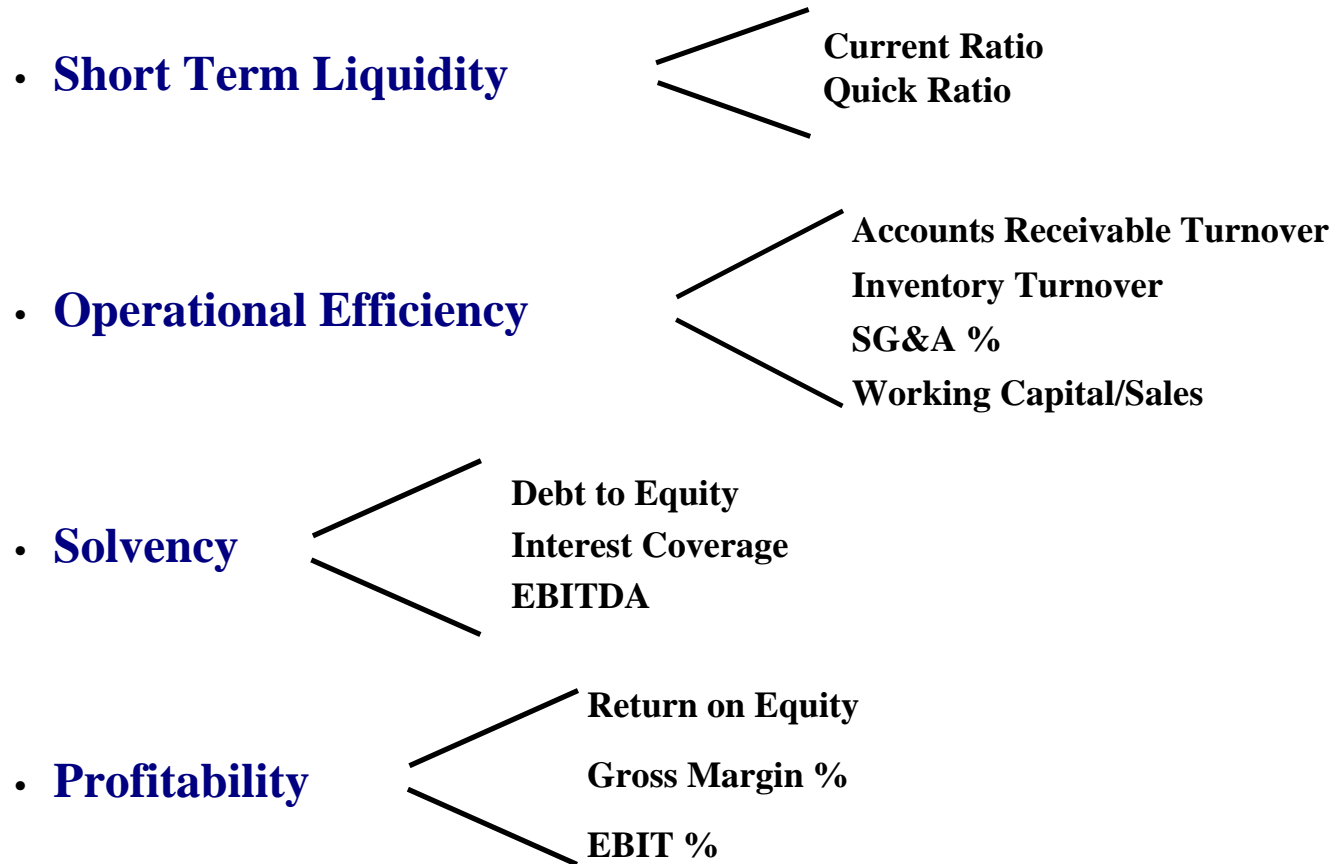
	Common Stock	Additional Paid-In Capital	Retained Earnings	Cumulative Translation Adjustments	Common Stock In Treasury
Balance at December 31, 1993	\$77.1	\$272.0	\$583.1	\$(8.5)	\$(398.5)
Net earnings	----	----	80.7	----	----
Dividends declared	----	----	----	----	----
Purchase of common stock	----	----	(43.3)	----	(18.5)
Exercise of stock options and stock ownership plan funding	0.3	9.1	----	----	(2.0)
Translation adjustments	----	----	----	(3.6)	----
Balance at December 31, 1994	<u><u>\$77.4</u></u>	<u><u>\$281.1</u></u>	<u><u>\$620.5</u></u>	<u><u>\$(12.1)</u></u>	<u><u>\$(419.0)</u></u>

Footnotes to Financial Statements:

- **Accounting Policies**
- **Unusual Charges or Events / Extraordinary Items**
- **Commitments & Contingencies**
- **Obligations**
- **Discontinued Operations**
- **Subsequent Events**



Key Relationships



Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{CR} = \frac{691.9}{439.2} = 1.58$$

- ∪ **Most Widely Used Measure of Liquidity**
- ∪ **Extent to Which Current Assets Cover Current Liabilities**
- ∪ **Useful for Determining Trends**

Quick Ratio

$$\frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}}$$

$$\text{QR} = \frac{(691.9 - 240.6)}{439.2} = 1.03$$

- Used to Test the Ability to Pay Short Term Obligations
- Indicates Efficient Use of Short Term Assets

Short Term Liquidity

	McDonald's	Wendy's	Pizza Inn
Current Ratio	.52	1.62	1.33
Quick Ratio	.48	1.46	1.08

Short Term Liquidity

	McDonald's	Wendy's	Pizza Inn	Industry Average
Current Ratio	.52	1.62	1.33	.50
Quick Ratio	.48	1.46	1.08	.40

Accounts Receivable Turnover

$$\frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

$$\text{ART} = \frac{2,065}{((353.0 + 323.6)/2)} = 6.10$$

- Measures Asset Utilization
- Low Ratio May Indicate Collection Problems

Inventory Turnover

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{IT} = \frac{1,435.7}{((240.6 + 234.7)/2)} = 6.04$$

- **Indicates Operational Efficiency of Management**
- **Low Ratio May Indicate Excess, Obsolete Inventory**
- **Attention Should Be Paid to Trends**

Selling, General & Administrative Percentage

$$\frac{\text{Selling + General + Administrative Expenses}}{\text{Sales}}$$

$$\text{SGA\%} = \frac{406.2}{2,065} = 19.7\%$$

- **Indicates the Efficiency of Management**
- **Used to Analyze Fixed Costs Compared to Sales**

Working Capital / Sales

$$\frac{\text{Current Assets} - \text{Current Liabilities}}{\text{Sales}}$$

$$\text{WCS} = \frac{(691.9 - 240.6)}{2,065} = .12$$

- Indicates the Portion of Revenues Tied Up in Current Assets
- Used to Evaluate Efficiency of Sales

Sammy the Gorilla

	<u>Before</u> <u>Adjustment</u>	<u>Recommended</u> <u>Adjustment</u>	<u>12/31/96</u>
Video Games	\$1.0	\$(.3)	\$.7
Plastic Gorillas	.1	0	.1
Board Games	<u>.3</u>	<u>(.05)</u>	<u>.25</u>
Total	<u>\$1.4</u>	<u>\$(.35)</u>	<u>\$1.05</u>

Sammy the Gorilla

	<u>Before Adjustment</u>	<u>Recommended Adjustment</u>	<u>12/31/96</u>
Marketing Rights	\$4.0	\$(4.0)	\$0

Valdez Company

Issue 1: \$4.2 million expended in 1996

Current Assets



\$4.2

Storage Tanks, PPE



\$4.2

Valdez Company

Issue 2: \$70 - \$250 million estimate

Retained Earnings



\$70

Accrued Liability



\$70

Operational Efficiency

	McDonald's	Wendy's	Pizza Inn
A/R Turnover	25.31	36.91	11.81
Inventory Turnover	39.92	32.31	30.93
SG&A %	12.79%	7.19%	7.71%
Work. Cap./ Sales	-9.66%	6.81%	3.63%

Debt to Equity

$$\frac{\text{Total Debt}}{\text{Average Stockholders' Equity}}$$

$$\text{DE} = \frac{(5.6 + 201.3)}{((743.8 + 578.1)/2)} = .31$$

- Indicates Proportion of Debt to Total Equity
- High Ratio May Indicate Need to Restructure Debt

Interest Coverage

$$\frac{\text{Income before Interest \& Taxes}}{\text{Interest Expense on Debt}}$$

$$\text{IC} = \frac{243.9}{21.5} = 11.34$$

- **Indicates Ability to Service Debt**
- **Low Ratio May Indicate Potential Default**
- **Interest Coverage Should Be Analyzed in Conjunction with Debt to Equity Ratio**

Earnings Before Interest, Taxes, Depreciation & Amortization

$$\frac{\text{Net Income} + \text{Interest} + \text{Taxes} + \text{Depreciation} + \text{Amortization}}{\text{Sales}}$$

$$\text{EBITDA} = \frac{(133.4 + 21.5 + 89 + 32.2 + 13.2)}{2,065} = 14\%$$

- **Indicates the Efficiency of Operations**
- **Useful in Evaluating Solvency and Cash Flows**

Solvency

	McDonald's	Wendy's	Pizza Inn
Debt/ Equity	.67	.22	1.15
Interest Coverage	7.69	38.41	7.77

Solvency

	McDonald's	Wendy's	Pizza Inn	Industry Average
Debt/ Equity	.67	.22	1.15	2.9
Interest Coverage	7.69	38.41	7.77	3.2

Return on Equity

Net Income after Taxes - Preferred Dividends

Average Common Stockholders' Equity

$$\text{R.E.....} = \frac{(133.4 - 0)}{((743.8 + 578.1)/2)} = 20.18\%$$

- **Measures Return to Common Stockholders on Their Investment**
- **Measures Profitability**
- **Indicates Degree of Financial Leverage when Compared to Return on Assets**

Gross Margin Percentage

$$\frac{\text{Sales} - \text{Cost of Sales}}{\text{Sales}}$$

$$\text{GM\%} = \frac{(2,065 - 1435.7)}{2,065} = 30.5\%$$

- **High Percentage Indicates Profitability**
- **Measures Profit Availability to Cover Fixed Costs**
- **Attention Should Be Paid to Trends**

Earnings Before Interest & Taxes Percentage

$$\frac{\text{Pretax Income}}{\text{Sales}}$$

$$\text{EBIT \%} = \frac{222.4}{2,065} = 10.8\%$$

- Indicates Overall Profitability of Company
- Compare to Trends in Industry

Profitability

McDonald's

Wendy's

Pizza Inn

Return on
Equity

18.97%

16.63%

50.40%

Gross Margin
%

76.17%

48.52%

21.84%

EBIT/
Sales

21.06%

13.43%

8.53%

Independent Accountant/Auditor
Three Levels of Service

- **Compilation**
- **Review**
- **Audit**

Comparative Analysis:

	<u>Compilation</u>	<u>Review</u>	<u>Audit</u>
1. GAAP Assurance	None	Limited	Full
2. Entities	Nonpublic	Nonpublic	Public
3. Gaap Disclosures	Not Full	Full	Full
4. Independence	Not Required	Required	Required
5. Control Structure / Risk	Not Required	Not Required	Not Required
6. Inquiry Procedures	Not Required Unless Questionable Information	Inquiry, Analytical Procedures, and Investigation	Inquiry, Analytical Procedures, Independent Observations, Confirmations, Inspections and Testing of Transactions

Assessments of the Independent Auditor:

- **Recorded Transactions are Reported in the Financial Statements**
- **Reported Assets & Liabilities Exist**
- **Reported Assets Are Fairly Reported and Reflect True Obligations**
- **Assets, Liabilities, Revenues, Expenses, Cash Flows, etc. are Appropriately Valued**
- **Financial Statements are Properly Classified, Described and Disclosed in Conformity with GAAP**

Types of Audit Opinions

- **Unqualified Opinion**
- **Explanatory Language**
- **Qualified Opinion**
- **Adverse**
- **Disclaimer of Opinion**

SAS 82

Consideration of Fraud in a Financial Statement Audit

- **Describes fraud and its characteristics**
- **Requires auditor to assess risk of material misstatement due to fraud**
- **Guidance on how an auditor should respond to the results of the assessment**
- **Addresses related documentation requirements**

Fraudulent Financial Reporting Risk Factors

- **Management's characteristics and influence over the control environment.**
- **Industry Conditions**
- **Operating characteristics and financial stability.**

Accountant's / Financial Advisor's Role in the Dispute Resolution Process

- **Combine financial and industry experiences with knowledge of the litigation process and environment.**
- **Assist attorneys to draft financial and accounting related document requests.**
- **Assist attorneys to prepare deposition questions and attend depositions.**
- **Prepare or rebut damage claims.**
- **Serve as expert witness.**
- **Serve as consultant.**
- **Prepare demonstrative exhibits.**
- **Serve as a mediator or arbitrator.**