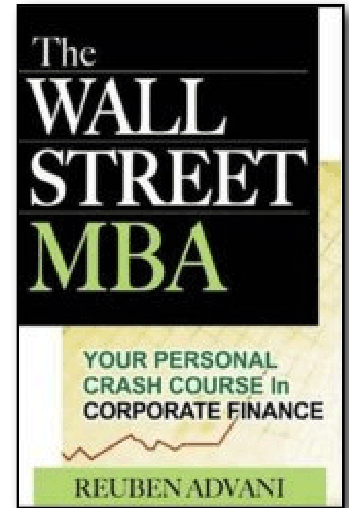

BOOK EXCERPT

Chapter 1:
Accounting Basics

Q: What's the definition of an accountant?

A: Someone who solves a problem you didn't know you had in a way you don't understand.

Normally, the mere mention of accounting is enough to send most of us into deep REM sleep. And that is for good reason. Accounting is boring. But like a lot of boring things in life, we still do it. Driving to work and getting our teeth cleaned are boring, but we still do it because we know each serves as a means to an end. Similarly, we learn accounting to assist us in tackling a number of business and personal challenges. A clear understanding of accounting, as well as the ability to apply the concepts, will lead to better decision-making in our business activities. From picking stocks to calculating our own net worth, these concepts are useful. Plus, if we can apply them correctly to real life vignettes and cases, they will be less boring, more fun and easy to read and digest.

In this chapter, we will discuss the following:

- Double Entry Accounting
- Cash vs. Accrual Accounting
- Creative Accounting
- Generally Accepted Accounting Principles (GAAP)
- Tax vs. Book Accounting
- Introduction to Financial Statements

Double Entry Accounting

In accounting, a system called double entry accounting is used. This system is similar in concept to something you may have studied back in grade school physics class. You might recall that for every action, there is an equal and opposite reaction. A similar principle applies in accounting. The principle is this: Money is transferred from a source account to a destination account. In other words, money is neither gained nor lost, it is simply transferred. So, when a transaction occurs on one side of the financial statements, there are one or more accompanying transactions that occur elsewhere in the financial statements.

Below are a few examples:

Example 1: A company purchases a product for later sale to its customers.
Result: The balance sheet would reflect a decrease in cash and an increase in inventory.

Example 2: A company sells products to its customers and receives payment by credit.
Result: The balance sheet would reflect an increase in accounts receivable and a decrease in inventory.

Example 3: A company borrows money.
Result: The balance sheet would reflect an increase in cash and an increase in debt.

Example 4: Finally, a company purchases a building with a combination of cash and a mortgage note.

Result: The balance sheet would reveal an increase under fixed assets (the purchase price of the building), a decrease of another asset, cash, and an increase on the liability side of the balance sheet, the mortgage note.

These concepts will become clear when the structure of the balance sheet is reviewed in more detail. For now, simply understand that financial transactions involve a dynamic interplay of accounts to create this balancing effect.

Cash vs. Accrual Accounting

In financial reporting, there are two basic methodologies for reporting transactions: the cash basis and the accrual basis.

Cash Accounting

The cash basis, as the term implies, records transactions when cash changes hands. Suppose you walk into a local hardware store and purchase a hammer for $10 cash and you take immediate possession. Under the cash basis, the store owner would record this transaction as a $10 sale because the cash was paid and the item delivered—the transaction was completed.

Cash basis reporting is not generally accepted in business, but it is allowed for tax purposes in certain businesses that meet the following conditions:

- The business does not sell products, meaning it is service-based and therefore has no inventory.
- The business keeps records for cash receipts and payments.
- The business has less than $5 million a year in sales.

For the vast majority of businesses, however, the cash basis is not acceptable. Generally, only small businesses with service-based sales can use cash basis reporting. Most other businesses use accrual basis reporting including all publicly traded companies.

Accrual Accounting

The accrual basis of accounting records transactions as they occur. The cash does not necessarily have to change hands but rather a transaction must have occurred. Suppose that in a similar transaction you go to the hardware store, you purchase your hammer, and you take possession of your hammer. However, you paid $10 on credit. Nonetheless, based on accrual accounting, the transaction is still recorded as a sale by the store owner.

Accrual basis reporting seeks to capture the overall economic activity of the firm. This is because in finance and accounting, there is a fundamental notion that businesses are assessed not so much on what they have on hand, but rather on their expectations or potential. In the universe of financial reporting, what you see is not always what you get. Based on accrual accounting, the expectation is that the company will indeed receive those payments at some point in the future, although the reality may produce entirely different outcomes. More specifically, companies book sales when goods are shipped, services are rendered, or a long-term contract is signed.

At this point, it is critical to understand the differences between cash and accrual accounting. Suppose ABC Software announces a $500,000 licensing agreement. Under this agreement, ABC will receive payments of $100,000 each year for the next five years. Based on the accrual method, what would revenues reflect at the end of this year?

If you answered $500,000, you are absolutely correct, because under the accrual method, ABC would book the full amount—the contract is signed and the services, in theory, are rendered. This assumes that there is no follow-up servicing, so the software is delivered in its entirety. Under the cash method, how would this result differ?

If you answered ABC would book $100,000, you are correct once again, because they would record only what was collected. In sum, ABC collected $100,000, and that is what was recorded.

Creative Accounting

As you can well imagine, accrual accounting creates many opportunities for fraud and manipulation. The vague rules governing revenue recognition, along with numerous intangible items, create exciting yet often misleading opportunities for "creative accounting." The best example of this on an industry-wide basis has to do with telecommunications companies using network swaps in the late 1990's to artificially inflate revenues. At the time, loose accounting standards in a nascent industry opened the door to deceptive methods of financial disclosure. The end result of this practice, sadly, was not unlike many of the cases we cover in this book: billions of dollars of hard-earned investor funds evaporated overnight.

For years, large telecom companies were plagued by steadily declining margins in wholesale network bandwidth. At the same, they faced mounting pressure to reveal strong earnings to Wall Street analysts. To alleviate these problems, telecom companies began the practice of swapping network bandwidth with other industry players while both parties booked the sale. This was done using what was called Indefeasible Rights of Use contracts (IRU's), which are long-term contracts for use of bandwidth. Using these contracts, telecom companies would engage in a practice known as "round-tripping" whereby two companies would simultaneously engage in a purchase and sale of an IRU contract with each party recognizing the revenue portion. Using this technique, one party would book the entire revenue amount resulting from the sale of the IRU contract. The same company would structure a reciprocal deal with its counterpart so that it was simultaneously purchasing a similar bandwith contract. In the end, no assets were transferred but both parties booked a sale. The net effect of this transaction would be zero because they were effectively exchanging the same bandwidth. However, using accrual basis accounting, they were able to book this revenue.

So how did they get away with this? When each side recorded the sale, they booked the full amount of the contract as per standards of accrual accounting. However, in the buyback, each side spread the purchase price (amortized) of buying access over the course of the deal, which at times meant 25 years or more. Alternatively, they might have booked the buyback as a capital expenditure, which would not affect the income statement and in turn have no effect on earnings. This method of accounting was advocated by Arthur Anderson's Professional Standards Group which became widely regarded as the arbiter of accounting rules in the industry. As the pressure to meet Wall Street's earnings expectations increased, so did this practice, which was certain to boost earnings. In fact, one famous deal involved two industry leaders, Global Crossing and 360networks. Global Crossing hoped to exchange $150 million of its capacity for $200 million of 360networks'capacity. In the process, both sides would book revenue, although Global Crossing, not as much. As such, 360networks agreed to purchase more at some future date to offset the current shortfall.

Such deals were commonplace and went unchecked for years. As share prices soared, the level of scrutiny on accounting procedures sank. But when such deals failed to compensate for earnings shortfalls, accounting regulators took a closer look at these practices and more importantly, the surrounding disclosures.

GAAP

The American Institute of Certified Public Accountants (AICPA) is a professional organization of practicing Certified Public Accountants (CPA's). The recommendations of this organization have been vital to the development of the overall principals that we use in financial reporting and are known as Generally Accepted Accounting Principles, or GAAP. GAAP is for the most part considered to be based on the standards and interpretations of the Financial Accounting Standards Board, discussed below. When you read financial statements, assume that they are GAAP-based, unless otherwise stated.

If you have been following the news, you know that these methods are far from perfect. There are all types of loopholes that companies may capitalize on and for that reason, we have seen numerous instances of accounting fraud over the last several years. GAAP is not without its shortcomings, but it is the overriding set of principles used when producing financial statements.

Who Does What?

A good deal of confusion arises over who is in charge of what when it comes to accounting and financial reporting. Essentially, the prime overseers of corporate accounting regulations and guidelines are the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).

FASB. The Financial Accounting Standards Board (FASB) serves as an overseeing body whose mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." FASB is to accounting what the Supreme Court is to the law: the top governing body that issues standards and interpretations that form the basis of all GAAP legislation. Through a series of processes and sub-committees, FASB is granted the role of determining what is acceptable in financial reporting. FASB's not perfect, but it's the best that we've got.

The SEC. After the stock market crash of 1929, a number of changes took place to ensure that such an event would never happen again. As such, the Securities and Exchange Commission (SEC) was formed as an independent regulatory agency of the U.S. government. The SEC now regulates all publicly traded companies by making sure that they:

- file annual audited financial statements with the SEC
- follow accounting standards and practices as recommended by the SEC
- identify accounting and reporting problems for FASB to address

International Accounting Standards

In the United States, accounting rules prescribed by GAAP are followed. Other countries, however, tend to use and apply their own standards. This difference in accounting standards affects everything from the treatment of depreciation and amortization to the actual structure of the financial statements. Between some countries, such differences are minor. For example, differences between the U.S. and U.K versions of GAAP are apparent in the treatment of asset acquisition and the tax treatment of extraordinary income items. But overall, the two formats are in relative conformity with one another. Larger differences emerge when comparing accounting standards in the U.S. with those of some Asian countries. And, as cross-border mergers and/or strategic alliances become more common, such differences can create untold hassles in accounting for such deals. For example, a U.S. based corporation that acquires an Indian based counterpart will have to account for differences in taxes, intangible expense items, asset value techniques, etc. In large transactions, these differences can create millions of dollars worth of accounting hassles.

There have been movements to create a worldwide standard of accounting, but as long as each country is confident that they are employing the best standards, such movements will probably continue with few results. But who knows? The best that we can do for now is to attempt to understand the basic tenets of accounting and buddy up to distinguished CPAs with years of international experience. And if you're having trouble with that, might I suggest *How to Win Friends and Influence Others* by Dale Carnegie as some supplementary reading.

Tax Accounting vs. Book Accounting

Very often, companies will create two sets of financial statements. One is reserved for tax reporting while the other for investor reporting. This enables the company to present its best performance numbers while minimizing its tax burden. In other words, this is the "have your cake and eat it too" option. Tax accounting is aimed at making sure that income and deductions reported on tax returns are in compliance with IRS rules and regulations. Book accounting, on the other hand, pertains to reporting on the company's financial statements and is usually in line with GAAP standards, but may not always be in line with tax standards.

Such reporting creates a fair amount of confusion for analysts and investors alike. In fact, companies that tend to maintain tight control over their financial statements and follow very loose reporting standards will tend to capitalize on the differences between tax and book accounting. Companies will often attempt the balancing act of trying to maximize returns for investors while trying to minimize their tax liabilities for tax purposes. So, in essence, it is acceptable for a company to use book accounting for investor purposes while using tax accounting for tax purposes. Companies that practice this approach must reconcile these differences based on an IRS tax schedule so that any changes or differences that exist between the two disclosures are documented.

Introduction to Financial Statements

Years ago, I was cramming for a high school English final. The exam was to be based on a number of books from the Victorian era, few of which had any relevance in my quest for a Firebird Trans Am. As I fully intended to devote more time to grooming my mullet and as little time as possible to studying Dickens, I devised a revolutionary study technique. In order to cover several books in a short time, I opted to read every third chapter of each book. In doing this, I could read three books in the time it would take most people to read one. Pretty clever, right? Armed with my new technique and a heck of a lot of confidence, I poured through the classics in record time and on exam day I pulled a solid A-. A few years later I tried this technique in college and failed miserably.

The moral to this story is simply this: you can read a few chapters of a book and get a feel for the plot, the characters, and central theme. But you will never truly understand a story until you have read all of the chapters, word for word, and more importantly, understand how they relate to one another.

A similar principle holds true when it comes to financial statements. You should study the balance sheet, income statement, and cash flow statement for a company but more than anything, you should understand the links between these statements. Only then will you begin to understand the story behind the company. Unfortunately, due to the obvious time constraints of high-powered brokers and investors, many on Wall Street use my every third chapter methodology, which may explain why the world has lost confidence in Wall Street.

The next several chapters are devoted to specific financial statements: how to read, analyze, and project them. We will cover the balance sheet, the income statement, and the cash flow statement, seeking understanding of what each statement is comprised of, how each is used, and most importantly, how the three statements relate to each other to provide a big picture analysis. From there, we will learn the best ways to analyze these statements using trend and ratio analysis. Before we do that, take a look at how these statements are disclosed and what generally accompanies them.

Common Public Filings

Financial statements are filed periodically with the SEC by all public companies. Below is a summary guide to the more common filings:

- **10-K**. This covers the company's annual performance and is due 90 days after the end of fiscal year. It contains:
  - Income Statement
  - Balance Sheet Balance Sheet
  - Cash Flow Statement
  - Footnotes to the Financial Statements
  - Management Discussion and Analysis
  - Auditor's Report
- **Annual report.** Essentially, a condensed version of the 10-K with more emphasis placed on marketing the company to investors through colorful charts and pictures.
- **Proxy Statement.** Offered around the time of the annual meeting and covers the following:
  - Management compensation
  - Management stock options
  - Related party transactions
  - Auditor changes
- **10-Q.** An unaudited statement of the company's quarterly performance, due 45 days after quarter ends. The 10-Q includes many performance reports, similar to those found in a 10-K.
- **Form 8-K.** Due 15 days after any material event (any major change in ownership or capital structure) and 5 days after an auditor change.
- **Form 144.** A registration document that discloses when insiders buy or sell stock.

Financial Statement Report

So what is generally found in the standard financial statement reports such as the 10-K and 10-Q? Aside from the balance sheet, income statement, and cash flow statement, companies will offer important accompanying disclosures. This documentation would include management's discussion and analysis, the management's report, the auditor's report, and the explanatory notes and supplementary information. These sections disclose any extraordinary items, any exceptional treatment of certain items, and generally any item that might merit further explanation. Below, we detail each of these individual reports:

Management's Discussion and Analysis

Commonly referred to as the MD&A report, this company-generated analysis offers a strategic overview of the company's performance during the prior year, as well as anticipated changes in the coming year. Normally, this occupies a few pages at the beginning of every annual report or 10-K for publicly traded companies. The MD&A report is usually a worthwhile read, as it provides hints as to the company's plans, goals, and expectations for the coming year.

Management's Report

Typically, a supplement to the MD&A report, the Management's Report details the responsibilities of individual managers in preparing the financial reports. In the wake of the big accounting scandals such as Enron, WorldCom, and Parmalat, it is important to understand who is specifically responsible for the actual preparation of these financial statements.

The Auditor's Report

In the past, this served as a relatively generic standard seal of approval issued by a company's auditors. However, in the aftermath of the big corporate accounting scandals and the adoption of the Sarbanes-Oxley Act, we have witnessed a new standard in corporate audits. Auditors will now explicitly disclose any red flags in their report.

Explanatory Notes and Supplementary Information

If there's one thing you take away from this section, it should be simply to read the footnotes. There's no possible way that I can stress enough the importance of these supplementary notes. To truly grasp the importance of this, read on.

Read the footnotes! Back in the 1950s, a gentleman by the name of John Rigas was working as a movie house usher in a small town in Western Pennsylvania known as Coudersport. If you have ever been to Coudersport, you know it is something right out of a Norman Rockwell painting. Behind the colorful five and dime store facades and below the cobblestone streets lie the remnants of a cable empire. At the time, Mr. Rigas, something of a visionary, read about the new technology of cable television and decided that the good people of Coudersport should have it. So with a $300 investment, he commenced building his empire. Within a decade he had wired most of the town. Over the next four decades, he built a national empire that was now collectively managed by himself and his sons. By the late 1990's, Adelphia had become a Wall Street darling and the fifth largest cable provider in the U.S. All of this changed during one quarterly earnings conference call in 2002. This occurred after the Enron scandal surfaced and at a time when Wall Street analysts began asking more pressing questions. And on this particular call, one analyst asked a question about a footnote pertaining to company loans to the Rigas family. The footnote stated: "Certain subsidiaries of the company are co-borrowers with certain companies owned by the Rigas family." The question was followed by a vague response and the hasty conclusion of the call.

The stock price collapsed on the news, and over the next several days, a truly remarkable story unfolded, a story that documented instances of the Rigas family borrowing excessively from the Adelphia company bank account. This publicly traded company was essentially treated as the founders' own personal bank account. Amongst other things, they used funds from the company to pay for the construction of a golf course, a private jet, and even shares of Adelphia—not in the company name but the family name. That, along with clever accounting that included capitalizing millions of dollars in costs that should have been expensed, contributed to the eventual demise of the company. And what was ostensibly a conflict of interest was later determined by the courts to be a clear case of fraud.

The moral to this story is simply this: read the footnotes. Because within that tiny footnote was enough information to turn a multi-billion dollar company into a penny stock. Read the footnotes.

You have been reading the first chapter of The Wall Street MBA, Your Personal Crash Course in Corporate Finance (McGraw-Hill, 2006), by Reuben Advani, president of Telestrat Education, Inc. For information about the variety of essential business skills continuing education courses we offer to attorneys, CPAs, Insurance Agents, and general business professionals, visit **http://www.OneDayMBA.org**.