AMERICAN BANKRUPTCY INSTITUTE

2018 Hon. Steven W. Rhodes Consumer Bankruptcy Conference

Understanding Financial Information for Small Businesses

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UNDERSTANDING FINANCIAL INFORMATION FOR SMALL BUSINESS

I. MAKING SURE YOU AND YOUR CLIENT UNDERSTAND THE COMPANY'S FINANCIAL STATEMENTS

In the age of QuickBooks and similar programs, most small business debtors are capable of providing their bankruptcy attorney with a Balance Sheet and Income Statement that has numbers filled into to all the appropriate columns. Hitting print is easy enough, but many times the financial statements that result are not accurate. This is because many small business debtors suffer from the problem of "Garbage In; Garbage Out". This occurs when the debtor's book keeping is inadequate, or was inadequate in the past, and as a result the numbers that are being input into QuickBooks or a similar program are incomplete or inaccurate – leading to the production of inaccurate financial statements. To compound the problem, some small business owners have a limited understanding of how financial statements work making it difficult for them to identify inaccurate information or understand the significance of the numbers. As a result, it is critical that bankruptcy counsel go through the numbers with the debtor to determine whether the numbers are accurate and whether the debtor understands them.

To start, bankruptcy counsel needs to identify who is responsible for the debtor's book keeping. How long has that person been in their position and what is their level of sophistication with regard to imputing and interpreting the company's financial information? I recently had a small manufacturing client that came to me a few months after its corporate controller had abruptly quit and mailed in his keys. The employee who had taken over the company's books was readily capable of printing out financial reports that appeared to have all the required information. However, when I started really working through the numbers and asking questions about how the numbers were derived, I learned that (i) the debtor's owners did not understand the numbers and were often unsure of their accuracy, (ii) the company had not taken an inventory for many years and the value of the company's inventory was overvalued by hundreds of thousands of dollars, (iii) some of the owner's personal expenses were identified on the company's expense report, (iv) the company did not know what its actual COGs or profit margin for its different products. Many of these problems surfaced because the owners had completely relied on debtor's previous corporate controller to manage the finances and never took the time to review, investigate and understand the debtor's own financial reports. When the controller abruptly left, the debtor found itself sitting on a mountain of debt with several years' worth of inaccurate or incomplete financial information in its system and no reliable picture of where it stood.

In my experience, it has been the process of sitting down and going through debtor's financial statements with the client that has allowed me to help the client start to actually understand its business and identify the reasons the company is in bankruptcy. Are payroll costs out of control? Is the space they are renting too expensive or too large? Is the company turning a profit but bogged down with legacy debt from prior years of losses? Does the company have a losing contract that they need to reject? Does the company have a losing product that they need to quit selling? Is the owner taking too much out of the company in owner draws? Is the company seasonal and failing to budget or cut expenses during its slow

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period? These are the kinds of questions that a line-by-line analysis of the Balance Sheet, Income Statement and Cash Flow Statement will allow you to explore with your client so you can truly understand what has caused the client's financial problem and how the bankruptcy process may be able to help.

II. GENERAL OVERVIEW OF FINANCIAL STATMENTS

There are three basic financial reports that you should be familiar with: the Balance Sheet, Income Statement, and Statement of Cash Flows.

A. Balance Sheet Basics:

Most attorneys are not financial wizards. In fact, many of us became attorneys to avoid the numbers. However, when advising your clients on their financial matters, you will need to have an understanding of the numbers. I actually find that this is helpful in business bankruptcy matters, as well as personal bankruptcy matters in which the debtor is an entrepreneur business owner.

The BALANCE sheet simply tells us what a business OWNS and what it OWES.

While there is a lot that goes into a balance sheet, there are a few things that every practitioner should be aware of:

1. The balance sheet is simply a snapshot. Every balance sheet will have a date on it and that date represents the date on which the snapshot was taken. The balance sheet will represent the financial standing of the company as of that particular day. It tells us where the company ended up (as opposed to how it has done over time).
2. This financial statement tells us whether the company is solvent – i.e. are its assets at least equal to its liabilities? If the company were liquidated tomorrow, would there be anything left for the owners? A good balance sheet can provide a rough indicator of where the company stands with respect to solvency.
3. The balance sheet reveals whether the company has enough cash and other assets to pay its bills during the time immediately following the date on the balance sheet. Reviewing the balance sheet can tell you if the company can afford to pay its short-term obligations.
4. We discussed earlier that the balance sheet tells us what the company OWNS – otherwise known as it assets. The balance sheet gives us an idea of what those assets consist of whether it is cash, short-term investments, inventory or money that is owed to the company by other people. This portion of the balance sheet gives you a good idea of how quickly the assets may be converted to cash.
5. The balance sheet also tells us who the company owes based on the various categories of creditors the company may have.
6. Finally, the balance sheet gives us a snapshot of how much of the asset value is actually owned by the Owners.

B. Income Statement:

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This financial report is also known as a statement of earnings, statement of operations, the profit-and-loss statement or simply the P&L. Unlike the balance sheet, the income statement is not a snapshot as of a particular date; instead, it tells us whether the company was profitable over a specific period of time.

While useful, the income statement often misleads the business owner into thinking that the business is healthy when it may not be. If you only look at the income statement, it may appear that client has money to spend when it actually does not. To better understand this, think about the basic elements of a contract – offer, acceptance, and consideration. The income statement only tracks the offer and acceptance portion. It is not about cash (consideration). The income statement does not show the actual consideration coming in and out of the business bank account.

The income statement provides you with a) the value of everything (goods or services) that a business has sold over a period of time; b) the total cost of selling those goods or services (regardless of whether the business has paid for them); and c) tells whether the company is generating any income on the sale of the goods and/or services.

NOTE: The discussion above assumes that the company uses the accrual method of accounting.

C. Statement of Cash Flows:

"We were always focused on our profit and loss statement. But cash flow was not a regularly discussed topic. It was as if we were driving along, watching only the speedometer, when in fact we were running out of gas." – Michael Dell

This statement is true for many small and mid-size business owners. In many cases, it is the cause for their bankruptcy filings. We have all heard about the companies that "grew broke" even though their income statements showed a profit. Simply put, every attorney advising a small business needs to know the cash position of the client.

Cash is what you have in the bank and the statement of cash flows tells exactly how much the company deposited into their bank account, how much the checks were written for, and the difference during a specific time period. It tells a business owner if it can make a capital investment in equipment today and still make payroll next week.

This statement tells us how well you are turning the income statement profits and turning it into cash. While beyond the scope of our discussion here, if a client provides a cash flow statement, you will want to be sure it is a DIRECT statement as opposed to an INDIRECT statement of cash flows. The direct statement is similar to a checkbook whereas the indirect statement can include things like depreciation that don't really provide the true cash information.

The cash flow statement should tell you:

1. Whether the cash from business operations is positive or negative.

2. How much cash was invested in the business (either borrowed or invested), and what was paid out to lenders and investors.
3. Whether the cash brought in was more or less than the cash paid out.

II. THE DIFFERENCE BETWEEN ACCRUAL AND CASH-METHOD ACCOUNTING:

Most businesses use the accrual method of accounting. Without going into all of the details and nuances of the accounting method, you should understand this distinction: the accrual method measures the income and expenses at the time they are incurred, regardless of whether the consideration (cash) has changed hands. The CASH method only recognizes the income or expense after the income is received or the expense is paid.

One of the biggest challenges with the cash-basis accounting is that it doesn't show you whether the sales are actually profitable. Furthermore, even though it is labeled as "cash-basis" it doesn't actually give a complete picture of the cash in and out of the business bank account.

As a general rule, if you operate a sole proprietorship or small business, especially a service-related business that does not carry inventory, you'll be able to use cash accounting as long as your gross annual revenue does not exceed $1 million. Otherwise, you must use accrual accounting. If your company is a partnership or a C-corporation, with average gross revenue exceeding $5 million per year, you must also use accrual-basis accounting.

If you offer any credit to your customers and let them pay you later for the purchases, or if your business makes any purchases on credit, you must use accrual accounting. If you manufacture a product, buy goods for resale, sell merchandise or report any inventory that your business has on hand at the end of each year for taxes, the IRS requires you to use accrual accounting.[1]

EXHIBITS

The following examples are attached for your review and discussion:

a. Examples of Financial Statements (Balance Sheet, Income Statement, Statement of Cash Flows, Schedule of Operating Expenses)
b. Independent Auditor's Report
c. Independent Accountant's Report
d. Accountant's Compilation Report

[1] https://bizfluent.com/info-8750129-irs-require-accrual-basis.html. While generally true, there are exceptions to the rule.

EXHIBITS

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[COMPANY]

Financial Statements

December 31, 2017

Accountants' Compilation Report

To The Board of Directors
[Company]
[City], [State]

Management is responsible for the accompanying financial statements of [Company] (a Corporation), which comprise the Balance Sheet as of December 31, 2017, and the related Statements of Income and Retained Earnings and Statements of Cash Flows for the years ended December 31, 2017 and 2016 in accordance with accounting principles generally accepted in the United States of America. We have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

Management elected to omit substantially all the disclosures ordinarily included in financial statements prepared in accordance with the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the Company’s financial position and results of operations. Accordingly, the financial statements are not designed for those who are not informed about such matters.

Accounting principles generally accepted in the United States of America require that fixed assets be depreciated on a straight-line basis over their estimated useful lives. The Company has computed depreciation on all fixed assets in accordance with the Modified Accelerated Cost Recover System required for federal income tax purposes, which does not allocate depreciation to expense over the estimated useful lives of the assets. Management has not determined the effect of this departure on the financial statements.

Accounting principles generally accepted in the Unites States of America require management to assess whether the Company has a controlling interest in any entities in which the Company has a variable interest in order to determine if those entities should be consolidated. Management has not performed the required assessment and therefore, if there are variable interest entities for which the Company is the primary beneficiary, has not consolidated those entities. Although the effects on the financial statements of the failure to perform the required assessment have not been determined, many elements in the financial statements would have been materially affected and management determined that the Company is the primary beneficiary of any variable interest entities.

The accompanying supplementary information contained in the Schedules of Operating Expenses is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information is the responsibility of management. The supplementary information was subject to our compilation engagement. We have not audited or reviewed the supplementary information and do not express an opinion, a conclusion, nor provide any assurance on such information.

[Date]

[COMPANY]

BALANCE SHEET
December 31, 2017

ASSETS

Current Assets		
Cash in Bank	######	
Employee Advance	######	
Prepaid Federal Income Tax	######	
Prepaid Michigan Income Tax	######	
Total Current Assets		######
Property and Equipment		
Equipment	######	
Furniture and Fixtures	######	
Total	######	
Less: Accumulated Depreciation	######	
Net Property and Equipment		######
Other Assets		
Investment	######	
Software, net of Accumulated Amortization	######	
Total Other Assets		######
TOTAL ASSETS		######

See Accountants' Compilation Report

[COMPANY]

BALANCE SHEET
December 31, 2017

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities		
Credit Card Payable	######	
Line of Credit	######	
Accrued Retirement Plan	######	
Total Current Liabilities		######
Shareholders' Equity		
Common Stock, $1 par value, 60,000 shares authorized and 3,000 shares issued and outstanding	######	
Retained Earnings	######	
Total Shareholders' Equity		######
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY		######

See Accountants' Compilation Report

[COMPANY]

STATEMENTS OF INCOME AND RETAINED EARNINGS
For the Twelve Months Ended December 31, 2017 and 2016

	2017		2016	
	Amount	%	Amount	%
Revenues				
Revenue	#######	########	#######	########
Other Revenue	#######	########	#######	########
Total Revenues	#######	########	#######	########
Operating Expenses	#######	########	#######	########
Income (Loss) from Operations	#######	########	#######	########
Other Income (Expense)				
Interest Income	#######	########	#######	########
Nondeductible Expense	#######	########	#######	########
Interest Expense	#######	########	#######	########
Total Other Income (Expense)	#######	########	#######	########
Income (Loss) Before Federal Income Tax	#######	########	#######	########
Federal Income Tax	#######	########	#######	########
NET INCOME	#######	########	#######	########
Retained Earnings, Beginning	#######		#######	
RETAINED EARNINGS, ENDING	#######		#######	

See Accountants' Compilation Report

[COMPANY]

STATEMENTS OF CASH FLOWS
For the Twelve Months Ended December 31, 2017 and 2016

	2017 Amount	2016 Amount
Operating Activities		
Net Income	#######	#######
Adjustments to reconcile Net Income		
to net cash provided by operations:		
Prepaid Federal Tax	#######	#######
Employee Advances	#######	#######
Credit Card Payable	#######	#######
Accrued Taxes and Expenses	#######	#######
Net cash provided by Operating Activities	#######	#######
Investing Activities		
Equipment	#######	#######
Accumulated Amortization	#######	#######
Accumulated Depreciation	#######	#######
Investment	#######	#######
Net cash provided by Investing Activities	#######	#######
Financing Activities		
Line of Credit	#######	#######
Net cash provided by Financial Activities	#######	#######
Net cash increase for period	#######	#######
Cash at beginning of period	#######	#######
Cash at end of period	#######	#######

See Accountants' Compilation Report

SUPPLEMENTARY INFORMATION

[COMPANY]

SCHEDULES OF OPERATING EXPENSES
For the Twelve Months Ended December 31, 2017 and 2016

	2017		2016	
	Amount	%	Amount	%
Advertising	#######	#######	#######	#######
Amortization	#######	#######	#######	#######
Auto Expense	#######	#######	#######	#######
Bank Charges and Service Fees	#######	#######	#######	#######
Billing, Collection and Administrative	#######	#######	#######	#######
Books and Journals	#######	#######	#######	#######
Casual Labor	#######	#######	#######	#######
Computer Consulting and Expense	#######	#######	#######	#######
Contributions	#######	#######	#######	#######
Depreciation	#######	#######	#######	#######
Equipment Lease	#######	#######	#######	#######
Gifts and Promotion	#######	#######	#######	#######
Insurance - Health	#######	#######	#######	#######
Insurance - Life	#######	#######	#######	#######
Insurance - Other	#######	#######	#######	#######
Legal and Accounting	#######	#######	#######	#######
Maintenance and Repairs	#######	#######	#######	#######
Medical Supplies	#######	#######	#######	#######
Meetings and Seminars	#######	#######	#######	#######
Office Expense	#######	#######	#######	#######
Professional Dues and Fees	#######	#######	#######	#######
Rent	#######	#######	#######	#######
Retirement Plan	#######	#######	#######	#######
Retirement Plan Fee	#######	#######	#######	#######
Taxes - Other	#######	#######	#######	#######
Taxes - Payroll	#######	#######	#######	#######
Telephone	#######	#######	#######	#######
Travel	#######	#######	#######	#######
Uniforms	#######	#######	#######	#######
Wages - Officers	#######	#######	#######	#######
Wages - Others	#######	#######	#######	#######
TOTAL OPERATING EXPENSES	#######	#######	#######	#######

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7

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Stockholders
of [Name of Company]

We have audited the accompanying financial statements of [Name of Company] (a [State of Incorporation] corporation), which comprise the balance sheets as of [Date(s)] , and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [Name of Company] as of [Date(s)] , and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

[Firm's Signature]

[Location of Firm (City, State)]

[Report Date]

INDEPENDENT ACCOUNTANT'S REVIEW REPORT

To Management
XYZ Company
City, State

I (We) have reviewed the accompanying financial statements of XYZ Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income and retained earnings and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant's Responsibility

My (Our) responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. Those standards require me (us) to perform procedures to obtain limited assurance as a basis for reporting whether I am (we are) aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. I (We) believe that the results of my (our) procedures provide a reasonable basis for my (our) conclusion.

Accountant's Conclusion

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[ ]
Firm's Signature
[ ]
City, State
[ ]
Report Date

Accountants' Compilation

To Management
XYZ Company
City, State

Management is responsible for the accompanying financial statements of XYZ Company (a corporation), which comprise the balance sheet as of December 31, 20XX, and the related statements of income and retained earnings and cash flows for the year then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. I (We) have performed a compilation engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the AICPA. I (We) did not audit or review the financial statements nor was I (were we) required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, I (we) do not express an opinion, a conclusion, nor provide any form of assurance on these financial statements.

[ ]
Firm's Signature
[ ]
City, State
[ ]
Report Date