
How to Understand and Analyze Financial Statements

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How to Understand and Analyze Financial Statements

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AGENDA

9:00 am: Welcome and Introduction

9:05 am: Basic Concepts Underlying Financial Reporting

- Generally accepted accounting principles (GAAP) and non-GAAP reporting
- Levels of assurance provided in a financial statement
- Net income vs. cash flow
- Depreciable assets
- Capitalizing vs. expensing
- Inventory
- Other fundamental concepts

10:20 am: Stretch Break

10:30 am: The Financial Statements

- Accountants' report
- Balance Sheet
- Income Statement
- Statement of Cash Flows
- Notes to the Financial Statement

12:10 pm: Lunch Break

1:10 pm: Basic Financial Statement Analysis

- Short-term liquidity
- Long-term solvency
- Profitability
- Return on investment
- Commonly used ratios
- Other analysis issues

2:25 pm: Stretch Break

2:40 pm:

Common Manipulative Techniques

- How a financial statement can follow the rules and still be deceptive
- Circumstances where you are at most at risk of being misled
- How to spot the tipoffs of a problem

3:30 pm:

Adjourn

BIOGRAPHICAL INFORMATION

PROGRAM FACULTY

Douglas R. Smith has provided continuing education programs on accounting topics for state bar associations, law firms and corporate legal staff since 2001. He is a CPA and has served as a Chief Financial Officer and adjunct accounting faculty at the college level. Doug performed audit and consulting responsibilities for an international accounting and consulting firm, and is a member of the American Institute of CPAs.

How to Understand and Analyze Financial Statements



Presented by

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Newport, NC

How to Understand and Analyze
Financial Statements
For Lawyers

Presented by
Douglas Smith, CPA

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BASIC CONCEPTS

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

GAAP is the standard for professional financial statement preparation. It consists of official pronouncements of certain entities which are codified, and practices in the accounting profession. The entity that currently has responsibility for the aforementioned pronouncements is the Financial Accounting Standards Board. FASB is a private sector agency backed by the American Institute of Certified Public Accountants (AICPA).

FASB issues Statements of Financial Accounting Standards (called FASB's - fazbees) which are guidelines that are often subject to interpretation, or require judgments or estimates. Do not blindly accept an accountant's explanation that a particular treatment is required by a certain FASB without investigating it. There may be an argument for alternative treatment.

These pronouncements are added to as financial reporting needs require. They set the standard for *financial accounting*. That is the type of accounting designed to disclose financial condition (balance sheet), results of operations (income statement or profit and loss) and cash flows (statement of cash flows).

The Financial Accounting Standards referred to above, along with updates and interpretations by FASB, AICPA positions and other appropriate literature are now codified. This allows research of an accounting treatment by topic in this *Accounting Standards Codification*. When you see reference to an ASC number, it is citing this source.

Nothing requires a private company (not publicly traded) to follow GAAP in its financial reporting. Departures from GAAP may or may not be disclosed. Content of this Basic Concepts section should help you make inquiries as to whether any GAAP departures cause serious distortion in reported results.

The concepts in this section are general in nature and apply to all types of businesses; publicly traded corporations, closely held companies, LLCs, partnerships and proprietorships. Financial statement format may differ and terminology is not always consistent. However, by understanding the concepts you will be able to apply them to any presentation style you encounter. The basic concepts can also be applied to not-for-profit organizations, but keep in mind there are some differences in reporting practices and terminology for these entities.

The next section makes use of an important concept, *accrual* accounting. This is the key to understanding the difference between net income and cash flow.

Net income vs. cash flow

Under *accrual* accounting, revenue is recognized when it is **earned**, regardless of when payment is received. Expenses are recognized when **incurred**, regardless of when payment is made.

This provides a picture of the company's economic changes during a specific reporting period, even when transactions and their related movement of cash occur at a different time. For example, if goods are shipped and the customer is billed, sales revenue is recognized. At the same time, an asset (receivable) is created in the same amount. When the payment is received later, the receivable disappears. Likewise, if supplies are bought on credit, the expense is recognized, along with the related liability. When payment is made, it is settlement of the debt.

This earning of revenue and incurring of expense can happen during a different reporting period than the related cash receipt or payment. Thus, for a specified month, quarter or year the net income and cash flow of a company can be different.

Both net income and cash flow are important, but depending on the company, the two can be very different.

That is why a GAAP financial statement requires both an income statement and statement of cash flows.

A SIMPLER OPTION: NON-GAAP FINANCIAL STATEMENTS

Cash or modified cash basis

The simplest accounting system is **cash basis**. The financial statement will reflect only cash received and cash paid out. Cash basis works fine for some companies, mainly small and simple operations. Its advantage is its simplicity.

Under a cash basis, revenue is recognized on the financial statement only when cash is received, and expenses when cash is paid. If no cash has moved, revenue earned and expenses incurred, along with the related receivables and obligations to pay, will not appear on the cash basis financial statement.

A cash basis financial statement does not follow generally accepted accounting principles, because GAAP requires the use of accrual accounting.

It is common for companies or professional firms to use a hybrid accounting system that makes use of **cash basis for some transactions and accrual basis for others**. This can make sense in many cases. If the transactions recorded on the cash basis do not fluctuate significantly from one reporting period to the next, there could be minimal timing distortion of revenues and expenses using cash basis accounting. This is sometimes called modified cash basis.

Your question when this mixture of cash and accrual basis is present:

What specific transactions are recognized on a cash basis? If they do not fluctuate significantly from one reporting period to the next, there will be minimal distortion caused by using cash basis.

Tax basis of accounting

A common type of non-GAAP reporting you might encounter is a tax return, or financial statement prepared according to tax rules. Tax reporting has a different purpose than financial accounting rules under GAAP, cash or modified cash basis. Taxable income can be very different than earnings under a method of financial accounting.

Make use of a tax return, but do not use taxable income to determine the profitability of the company.

Pay attention to the section of the company tax return that reconciles taxable income to "book" income. There are some revenue and expense items that are timing differences; that is, are recognized in a different year for financial accounting purposes. Other differences between tax and financial accounting are permanent. That is, an expense of the company that is never recognized for tax purposes.

Many small businesses use tax-basis depreciation for their financial reporting because it saves the extra effort and expense of having two sets of depreciation records. Larger companies will usually keep a set of records for financial statement preparation that reflects the actual estimate of useful lives of assets and a set of records for tax reporting purposes. This is one item that in some companies can make a significant difference between GAAP net income and taxable income. Keep this in mind when you are given a tax return as the financial statement of a business.

Tax basis depreciation may be acceptable for GAAP financial statements if the methods and lives are not materially different than those for GAAP. Following are reasons tax depreciation (MACRS-Modified Accelerated Cost Recovery System) is likely to be materially different from GAAP.

- 1 – Immediate expense deduction for tax purposes
- 2 – Accelerated expensing for tax purposes
- 3 – Difference in useful lives of assets; accelerates depreciation for tax purposes.

Statutory basis of accounting

Statutory reporting is practiced by businesses that are required to report to regulatory authorities. It is usually designed for a particular purpose related to the type of regulator. An example is insurance company reports to a state insurance commissioner. This reporting is also not GAAP.

Contractual basis of accounting

An agreement between two parties might require a specific type of report that does not conform to GAAP. This would normally occur in order to have the report address a specific goal. As with a statutory basis, determine the extent to which you can make use of such a report.

LEVELS OF ASSURANCE

Your first question when viewing financials should usually be – how much reliance can you place on them? How much assurance are the accountants and the management of the company providing that you are seeing actual profit and financial condition?

Here's what to do first:

Look for an accountants' report. If it exists, it will be normally a single page disclosing the following:

- Level of assurance provided by the accountants
- Standard of accounting used – i.e., GAAP, cash, modified cash, tax, etc.

This part of the financial statement is required of most financial statements prepared by a CPA. If you do not have this, it does not mean there is anything wrong with the financials, but you are starting with less knowledge about them.

When there is an accountants' report provided by the CPA, there will be one of three levels of assurance.

1. Audited financial statement

An audit provides you with the highest level of assurance that you can receive from the accountants. The accountants' report, often called the audit opinion, will state one of the following opinions.

Unqualified opinion

Commonly called a "clean" opinion, it is the only type of opinion that does not indicate a problem for you be concerned about. The accountants will state that in their opinion that the financial statements "**present fairly in all material respects the financial position, results of operations and cash flows**" of the company. Although the accountants' opinion can include different disclosures, this is the wording of the opinion, which is you first and main concern.

An audit opinion does not contain any guarantees, and stops short of using terms such as "accurate."

Qualified opinion

The audit may disclose facts that cause the auditors to issue less than a clean opinion. This will normally be a *qualified opinion*. The written opinion will state that the financial statements are fairly stated “except for” a specified condition. This is not an unqualified opinion and should be a warning sign at least, and is usually a cause for serious concern about the finances of the company.

Sometimes, even though the financial statements might be fairly stated, accountants will determine that the ability of the company to continue in business is in doubt. This should be disclosed as part of the accountants’ opinion. This is called a *going concern* finding.

Less common are an adverse opinion, which states the financials are not fairly stated, and a disclaimer of opinion, where the accountants cannot form an opinion. This could be due to unavailable records.

2. *Reviewed financial statement*

A CPA review of a financial statement follows a specific set of standards, which are found in Statements of Standards for Accounting and Review Services promulgated by the American Institute of CPAs.

Unlike an audit, where extensive testing of balances and transactions is done, a review is limited to analytical procedures and inquiry. There is also no requirement to evaluate internal controls in the reviewed company, which is another significant difference in an audit and review. There is not a requirement to assess fraud risk in a review.

The review report will state that no material modifications are found that require adjustment to be in conformity with whatever accounting standard is being used (i.e., GAAP, modified cash, etc.). This is called the accountants’ conclusion, rather than opinion.

3. *Compiled financial statement*

The lowest level of assurance on a CPA-prepared financial statement is a *compilation*. The accountants’ report on a compiled financial statement is a disclaimer. It will state that no procedures were performed, and no assurance is given. In this case the accountants have been hired to only put the company’s information into financial statement form.

There are limited circumstances where a CPA prepared financial statement is not required to have any of the above three reports attached. There, of course, no assurance is being given by the accountant.

Regardless of the level of assurance you are receiving from an accounting firm, financial statements are the representation of the management of the company. Keep in mind that you are ultimately relying on the integrity of these individuals.

Accountant independence

In producing an audit or review, CPAs are required to be independent. That is, they have a responsibility to users of the financial statement on which they provided an opinion (audit) or conclusion (review). The accountants are not advocates for their client in these circumstances.

This requirement to remain independent of their client can cause conflict. For example, a client might pressure the auditor to issue a clean rather than qualified opinion. Signing an opinion by a CPA as an independent party is called the *attest* function.

Attestation along with its required independence can apply to engagements other than financial statements. You can ask for an opinion on any assertion or agreed upon procedure. A report will be issued similar to the audit report, with an opinion regarding fair statement of the assertion, and the accountants are held to the independence requirement. This assertion can be almost anything, but the CPA is not allowed to issue an opinion on future solvency of a company.

HISTORICAL COST PRINCIPLE

When you look at a balance sheet you will see the assets listed. This may be a detailed or very summarized balance sheet. If it is too summarized for you, detail should be available if you are in a position to ask. For example, if you see a line item for Fixed Assets for \$3,000,000, you might ask to see what assets make up that amount. In a financial statement with good disclosure, that might be seen in the notes.

Assets are shown on the balance sheet, with few exceptions, at *historical cost*, which is the amount the company paid for it. For depreciable assets, they are shown at historical cost less all past depreciation expense, called accumulated depreciation. The advantage of using historical cost is that it is verifiable and it is objective. The weakness of showing assets at historical cost is that the balance sheet does not tell you what these assets are worth. Especially regarding some assets, real estate for example, market value may not even be close to the historical cost less depreciation as shown on the balance sheet. If you are analyzing a financial statement for the purpose of determining market value of the assets, you may need to get appraisals of those assets.

There are notable exceptions to the historical cost principle. Generally, if an asset becomes impaired in value, it should be written down to the amount that it is worth after the impairment. By 'writing down' we mean that the book value as shown on the balance sheet is decreased and a loss is recorded that decreases net income. This is known as the *lower-of-cost-or-market rule*. In other words, if this rule is followed properly, the assets as you see them reported on the balance sheet will be stated at their original purchase price (less depreciation) or their current value, whichever is **lower**. If the value of an asset increases, we generally do not write it up; it remains on the books at historical cost. This rule is an attempt at conservatism in financial reporting.

There are exceptions to the lower-of-cost-or-market principle. Certain assets, such as securities available for trade, are marked up or down based on fluctuations in their market value. You may need to ask if any exceptions to LCM (lower-of-cost-or-market) exist.

DEPRECIABLE ASSETS

When an asset is purchased that will be used during the current and also future years, GAAP requires spreading the cost as an expense over its useful life. Thereby the cost of the asset is an expense as the asset is used up. This also matches the expense of the asset to the revenue it produces.

The device that is used to spread the cost of an asset over future accounting periods is *depreciation*.

The application of depreciation is not affected by the method of paying for the asset. If it is purchased with cash, debt or a combination of the two, that is recorded separately.

As each year passes, *depreciation expense* is an expense item on the income statement. Also, that same amount of depreciation increases *accumulated depreciation*, with reduces the value of the asset on the balance sheet (book value). The asset value as shown on the balance sheet will be cost less depreciation taken to date. That is called *book value*.

Fixed assets	\$1,000,000	
Less: Accumulated depreciation	300,000	\$700,000

Instead of presentation like the illustration above, you might see one line item on the balance sheet called Fixed Assets-Net for \$700,000.

The depreciated value of the asset on the balance sheet may or may not approximate market value. Therefore, we are not using depreciation to determine asset value, but to match cost to revenue.

The amount of depreciation taken may be the same each year. This is called straight-line depreciation. There are various forms of *accelerated depreciation* that load more depreciation in the early years of the asset life. This acceleration is justified when most of its utility is in the first years. Assets can also be depreciated based on actual usage. For example, a piece of machinery may be depreciated based on the number of units it produces during each year, compared to total expected output during its useful life.

Example of straight-line depreciation:

Vehicle: purchased on Jan. 1 for \$55,000
Estimated useful life: Five years
Estimated disposal value after five years: \$15,000

Straight-line depreciation expense each year: $\$8,000$ ($\$55,000 - \$15,000 = \$40,000 / 5$ years)

Net book value of the vehicle at December 31

Year 1 - $\$47,000$ ($\$55,000 - \$8,000$)

Year 2 - $\$39,000$ ($\$55,000 - \$16,000$)

Year 3 - $\$31,000$ ($\$55,000 - \$24,000$)

Year 4 - $\$23,000$ ($\$55,000 - \$32,000$)

Year 5 - $\$15,000$ ($\$55,000 - \$40,000$)

Book value is the amount you see at December 31 each of these years on the balance sheet.

At the end of the five-year period the book value is $\$15,000$, which is the cost less all depreciation taken. If we sell or trade the vehicle for more or less than our $\$15,000$ book value, we will recognize a gain or loss on the disposal. What we have done over the five years is recognize the expense of the vehicle as we used it.

Each of the four years when we record the $\$8,000$ decrease in book value of the vehicle, we also record an expense of the same amount. That expense reduces net income and is called depreciation expense. It is seen on the income statement.

A fixed asset is one that will be used in future periods. It is an expense as it is used up, not when it is purchased.

This concept of spreading the cost of an asset over its useful life to match its cost to the revenue it produces is also used with intangible assets. Intangible assets include intellectual property, technology, patents, copyrights and franchise fees. The terminology is different. *Amortization* is the name for “depreciation” of an intangible asset.

For natural resources like oil, gold and timber the term used for spreading the cost over the asset’s useful life is *depletion*. The value of the resource in the ground is estimated and the cost is shown as depletion expense as it is removed.

Depreciation is a major source of difference between financial accounting and tax reporting, as discussed in the Tax Basis section. For tax reporting purposes the number of years an asset is depreciated is set and is not the actual useful life. Also, most of the depreciation is recognized in the early part of the life of the asset (accelerated depreciation). Additionally, the purchase of a long-term asset may be expensed immediately, up to a limit. This loads expense into the early years of the life of an asset, which is a tax incentive for companies to invest in assets (reducing taxable income), but distorts true operating results if you are using a tax return to analyze the company’s profitability.

Depreciation is often the main difference between net income and cash flow in a commercial enterprise. There are situations where cash flow is emphasized in financial reports, such as real estate operations where the property is appreciating. There is no expectation of needing to replace the property, only provide maintenance. In such a situation it can make sense to look at

operating results without depreciation. Beware when this is done. If the depreciable assets will need to be replaced in the future, it is misleading to disregard depreciation.

CAPITALIZING VS. EXPENSING

We have just seen how to handle the expenditure for an asset that will be used over this and future years. We record an asset in the amount of the expenditure, and recognize expense as depreciation over its useful life.

Recording of the expenditure as an asset is called *capitalizing*. It defers the expense until later through depreciation.

If you are told that an item has been capitalized, it means no expense shows up immediately, but rather an asset is created. The later expense recognized will be depreciation or amortization.

Expenditures that are not capitalized are *expensed*, which means the entire amount shows up as an expense right now on the income statement. Thus, there is an immediate effect on net income.

It is normally obvious which items should be expensed and which should be capitalized, but that is not always the case. Sometimes it can be a somewhat subjective decision, and one that will have a direct effect on whether expenses are recognized now or later. Net income reported in the current period and in the future is affected by this decision. Abuse of this principle can also be used to intentionally manipulate earnings (Manipulation Section).

CONSERVATISM

In financial reporting conservatism means that judgements, estimates and reporting decisions are made to reflect the most unfavorable results rather than the most optimistic. This principle is not always employed, but you might hear the term used to describe a particular accounting treatment that has been used.

MATERIALITY

If an amount is so small that the user of a financial statement would not be affected by it, then it is considered immaterial. Immaterial misstatements are acceptable within GAAP. The size an item must be to qualify as immaterial is not defined anywhere, so be alert for abuses of this concept.

TIME VALUE OF MONEY

There are situations where a transaction occurs currently which causes cash to be exchanged in the future, either in a lump sum or a series of payments. The dollar received in the future is worth less than the dollar received now. One way to look at this is that cash, if received now, can be invested and will grow to a larger amount after the passage of time.

In order to recognize this difference in value, when such a transaction is recorded, the difference between the future value of the cash flow and the present value is determined. This is called *discounting* the amount to be paid or received in the future. To determine the amount of discount, an assumption must be made concerning an interest rate, called a discount rate, to use in the calculation. Your concern is the selection of a discount rate. It is a judgment call, and will directly affect the amount of present value calculated.

When a discount rate is being used in a time value of money calculation, your questions are:

- 1. What is the rate?**
- 2. How was it chosen?**

Choice of an appropriate rate will depend largely on the reason for the calculation being done. You may look to such factors as market borrowing rates for this company, general inflation expectations or required rate of return on invested capital.

This can affect liabilities if cash is to be paid in the future, and assets if cash is to be received in the future. You might also make use of this concept in litigation. For example, what is the present value of future lost profits? In family law, this concept is used to determine current value of future pension benefits. It can also be used in valuation of a business or professional practice.

Depending on the circumstances, you may need to determine either future value of a current payment or present value of future payment. For example, assume cash of \$200,000 annually will be exchanged each of the next ten years. The payer has a liability and the payee has an asset. Two million dollars will change hands, but since it will be paid over time it does not have the value of that amount received now. Here is where the present value calculation comes in.

If we apply a discount rate of six percent, the present value of those future payments is approximately \$1,472,000. Using a ten percent discount rate the present value is about \$1,229,000. This is a difference of about a quarter of a million dollars. This demonstrates your need to determine if the discount rate being used is reasonable in the circumstances.

THE FINANCIAL STATEMENTS

BALANCE SHEET

The balance sheet, also called Statement of Condition or Statement of Financial Position, shows the company's assets, liabilities and equity at **one point in time**. It is also cumulative of all activity since operation of the company began.

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

If a company has one asset, a building, and the building cost \$1,000,000, that is the total of the company's assets. If the owners of the company paid a \$200,000 down payment and borrowed the remainder from a bank, its balance sheet would look like this:

$$\begin{aligned} \text{ASSETS} &= \text{LIABILITIES} + \text{EQUITY} \\ \$1,000,000 &= \$800,000 + \$200,000 \end{aligned}$$

The owners (stockholders in the case of a corporation) have \$200,000 equity in the assets of the company. Creditors have the remainder of the equity. The balance sheet shows the assets and the source of them; one source being creditors and the other source being owners. Earnings left in the business are part of equity.

There is no one format for balance sheets. Some are much more summarized than others, but the accounting records of the company should have any detail you might need if you do not see it on the balance sheet.

Assets

The assets of the company are generally stated in order of liquidity. That is, the most easily converted into cash are listed first.

Assets that are to be converted into cash or used within one year (or one operating cycle, whichever is longer) are called *current assets*. These would include cash, marketable securities, accounts receivable and usually inventory.

Assets are stated at historical cost with some adjustments (see Historical Cost section). If your needs require you to know the market value of the assets you may need to have appraisals done.

Accounts receivable should be stated in the asset section of the balance sheet net of uncollectible amounts. These accounts are usually due from customers who buy on credit. The company doesn't know which accounts will be bad debts, but by estimating a percentage of accounts that will go bad, based usually on historical results, an allowance can be made for the bad debts associated with the accounts receivable shown on the balance sheet. This estimated

amount each reporting period is shown on the income statement as an expense. That results in the bad debt expense associated with this year's sales being matched to the year in which it is created. If estimates are not used, but receivables written off as they go bad, there will be likely misstatement of both net receivables, and bad debt expense

Goodwill is a term that is generally used to indicate a firm's place in the market that has been earned through building a customer base. For financial purposes, goodwill only appears on a balance sheet when it has been acquired. Goodwill is created when a company is purchased for a price in excess of the value of the acquiree's assets. The difference between the value of the assets purchased and the purchase price of the business is the intangible asset goodwill.

Prepaid expenses are treated as an asset if the items paid for will be used in future periods. When an expense is paid in advance, cash is decreased and the asset called prepaid expenses is increased, so total assets do not change. In future periods as the expense is actually incurred, the asset 'prepaid expenses' is used up. The asset is decreased as it is reported as expense on the income statement.

Liabilities

Liabilities are amounts that are owed by the company to others. The Liabilities section of the balance sheet should present them with short-term obligations first. This is normally a sub-totaled section with the title Current Liabilities. A current liability is one that is due to be paid within one-year (or one operating cycle, if longer). Then you see the long-term liabilities, which are those that are due to be paid more than one year in the future. For example, a five-year loan from the bank would have a current portion for the principle amount due during the coming year (current liability), and a long-term portion for the remaining amount that will be paid in future years (long-term liability).

Liabilities are not necessarily payable in cash. From the section on accrual accounting, we saw that when payment is received in advance for services or goods to be provided later, we do not recognize revenue until the services or goods are provided; that is, when the revenue is *earned*. Between the time that the advance payment is received and the time the goods or services are provided, a liability appears on the balance sheet for the amount of the payment. The liability will usually carry the name *deferred revenue* or *unearned revenue*. As the services are being provided, the liability decreases and the amount of decreased liability will show as revenue on the company's income statement. For example, when a gift card is sold a liability is created, which becomes revenue when the card is redeemed.

Due to recent changes in lease accounting rules, most leases will result in an asset called right of use asset, and a liability for the lease payment obligation. This recognizes that many leases look economically like a sale with financing. (Leases are discussed separately).

A company may borrow money by taking out a loan from a bank or other lender, or it may issue bonds. All of these create liabilities on the balance sheet.

Bonds have a face value to be repaid on a particular date, and until that date a stated interest rate is paid on the face value. After bonds are issued there are market interest rate changes. The bonds are then sold at a premium or discount from their face value to reflect higher or lower prevailing rates than existed at the time of the bond issuance. If a bond carries a stated interest rate of 7%, and later the bond is sold when the market interest rate is 8%, then the 7% bond must be sold at a price that will make the periodic interest payments produce a return of 8%. The way this is done is by selling the bond at less than face value. If you see bonds being sold at 98 for example, this means that they are being sold at 98% of their face value. This will cause the interest paid to be a higher yield for the purchaser than if it was purchased at full face value. This is done when market interest rates have risen since the bond was issued.

The same principle works in reverse if rates have fallen. Bonds will be sold at a premium over face value in order to yield the new lower market interest rate. In summary, bond prices will vary inversely with changes in market interest rates.

Equity

The equity section of the balance sheet, which amounts to the difference between assets and liabilities, is sometimes called the book value of the company. This book value is not the market value of the company and not the market value of the owners' equity in the assets. That is because market value of the company is usually based on earnings or cash flow, and the assets are shown at historical cost rather than market value.

The most common changes to equity are from the following:

1. The owners' investments in the business.
In the case of a corporation this is accomplished through the issuance of stock. The principle is the same in any type of business entity. This increases total equity.
2. Net profit and net loss from the operations of the company.
The bottom-line result of the income statement goes to the equity section of the balance sheet as an increase or decrease in equity.
3. Withdrawals of profits by the owners.
In a corporation this is done by paying dividends. In other forms of entity, the effect on equity is the same but there is no declaration of a dividend.

On the balance sheet of a corporation, the sources of increase and decrease in equity are generally shown separately in the categories described below. In other forms of business such as LLCs, partnerships and proprietorships total equity will likely be summarized into one line as you see it on the balance sheet, but it is comprised of the same elements.

Equity section of the balance sheet:

Paid-in capital

This is the owners' investment referred to above. The line items will be called names such as capital stock, common stock, preferred stock and paid-in capital in excess of par value.

When you see *paid-in capital in excess of par value*, sometimes called contributed capital in excess of par value, that means the stock line item shows only the par value, and the remainder of the issue price shows as the excess. Some balance sheets combine these two.

Par value has legal implications that vary by state statute, and is sometimes referred to as legal capital. It has nothing to do with the issue price of stock or its value thereafter.

For example, if a new company issues 1000 shares of its \$1 par value stock for \$100 per share, its equity section could look as follows:

Common stock	\$ 1,000
Paid-in capital in excess of par value	<u>\$ 99,000</u>
Total paid-in capital	\$ 100,000

Retained earnings:

This is exactly what it says. It is the all of the earnings of the company since its beginning that have not been paid out in dividends (owner withdrawal in a non-corporate entity). This amount is not cash, but represents an interest in a portion of all of the assets of the company. Retained earnings is increased by net income, and decreased by net loss and dividends.

In an unincorporated business there is no capital stock and the term "retained earnings" is not often used. Both paid-in capital and retained earnings exist, but they are combined in owners' capital accounts. The concept is the same with any type of business, but the line items that you see on the balance sheet can have different names depending on the form of business.

Treasury stock:

Sometimes a corporation will go out into the market and buy back its own shares. These repurchased shares are called *treasury stock*. Although this stock has value, is not treated as an asset to the repurchasing company. Treasury stock shows in the equity section of the balance sheet as a **reduction** of equity. The cash payment for purchase of the stock reduces assets (cash) and reduces equity. Think of this as the company "unissuing" stock that it has previously issued. Equity has actually been shrunk by this stock repurchase.

INCOME STATEMENT

Also called profit & loss, statement of operations or similar names, measures economic changes for a specified period of time. Unlike the balance sheet, the income statement shows changes over a specified period of time.

For a service company the income statement is simply:

REVENUE
LESS: EXPENSES
EQUALS: INCOME FROM OPERATIONS
PLUS/LESS: NON-OPERATING REVENUES AND EXPENSES
LESS: INCOME TAX
EQUALS: NET INCOME

For a merchandising business, that is, one that buys or manufactures products for resale, there is another step in the income statement:

SALES
LESS: COST OF GOODS SOLD
EQUALS: GROSS PROFIT
LESS: OPERATING EXPENSES
EQUALS: INCOME FROM OPERATIONS
PLUS/ LESS: NON-OPERATING REVENUES AND EXPENSES
LESS: INCOME TAX
EQUALS: NET INCOME

Notice that non-operating revenues and expenses are shown “below the line”, that is, after income from operations. It is important to see income from operations separately because that is the profitability of the company in the course of its normal operations. Comparison of operations from year to year should be based on that line, because it shows profitability unaffected by changes in income tax rules, non-recurring items and activity outside of the core business of the company.

Examples of non-operating revenues and expenses are investment income and gain or loss on the sale of assets. If you view an income statement that does not separate non-operating revenues and expenses, identifying that separation might be necessary.

Judgements, methods and assumptions related to such things as inventory, depreciation and allowances for expenses incurred like bad debts will affect the amount and timing of reported earnings. Pay particular attention to those areas.

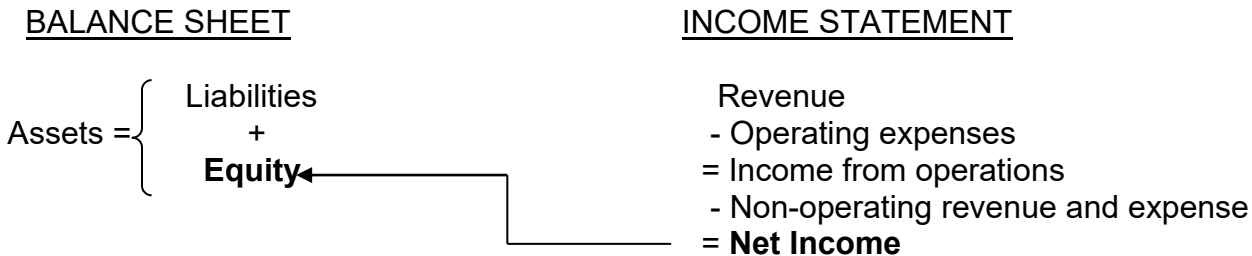
Most of the underlying information on methods and assumptions should be found in the notes to the financial statements. That doesn't exist, inquiry as to these items may be necessary for you to have sufficient confidence in the income statement.

If there are "paper gains or losses" such as change in value of available for sale investments or foreign currency gains or losses they are shown in a statement of Other Comprehensive Gains and Losses on a GAAP financial statement. That might be attached to the end of the income statement, or shown as a separate statement. Some of these items might later move to the income statement when they are realized (i.e., sold). Most non-GAAP financial statements will not include this element.

THE BALANCE SHEET / INCOME STATEMENT CONNECTION

Remember that the balance sheet is like a stop action photo of a particular point in time; that point being the close of business on financial statement date. The income statement measures changes during the reporting period, so at the beginning of the first day of each fiscal year, all revenue and expense accounts will start with a zero balance.

It works this way. In the process called *closing* at the end of the reporting period (year, quarter, month) all amounts in revenue and expense accounts, which make up the lines you see on the income statement, are zeroed out. The resulting difference between the revenue and expense items, which amounts to net income or loss, is transferred to *retained earnings* in the equity section of the balance sheet. In an unincorporated business the same thing happens, but there will probably not be a line called 'retained earnings'. Instead, you are likely to see an *owners' capital* or *members' equity* line that contains all increases and decreases to equity. In either case, net income or loss goes to *equity*. Now the system is ready to begin measuring the new period of time.



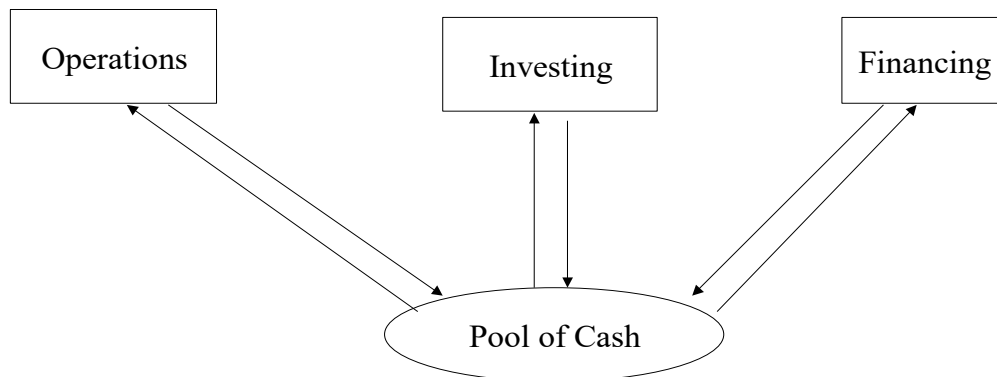
STATEMENT OF CASH FLOWS

The statement of cash flows shows us sources and uses of cash during the reporting period. Net income is a source of cash after the non-cash items like depreciation are taken out and other adjustments are made. Any activities that either provide cash or use cash are shown on this statement. This differs from the income statement in that we are not measuring all economic activity affecting earnings (i.e., accruals), but tracking the movement of cash.

Some financial statements of smaller companies will not include this statement. That is probably why it is not uncommon to hear small business owners ask the question “the income statement says that we made money, but where is it?” This statement tells you where the cash came from and where it went. Financial statements in accordance with GAAP must include this statement along with the balance sheet and income statement.

Sources and uses of cash fall into three categories, each of which should be shown separately on the statement of cash flows; operations, investing and financing. Operations includes most activity during the normal course of business. This section is usually presented as the net income from the income statement adjusted to cash flow. Investing activities include purchase of fixed assets as well as purchases and sales of investments. Financing activities include those that raise funds. Issuing of stock and borrowing are in this category, as is the payment of dividends and repayment of debt.

CASH FLOW



STATEMENT OF STOCKHOLDERS' EQUITY

This is simply a roll-forward of beginning total equity (i.e. end of last year's balance sheet) to the total equity at the end of the current year. As we saw earlier, the main items making up the change are net income or loss, new investment in the company by owners (issuing additional stock) and earnings distributed to owners.

GAAP requires the disclosure of changes in equity, but it does not have to be in the form of this statement. You might see the same information in the notes.

NOTES TO THE FINANCIAL STATEMENTS

A full set of financial statements will include notes. They are an integral part of the financial statement. If you are looking at an informally prepared financial statement and there are no notes, your inquiries about the statement might need to be more extensive.

Among the disclosures in the notes are:

- accounting policies of the company
- detail of amounts reported in the body of the statement when necessary
- items not shown in the body of the statement at all, such as contingencies.

ANALYSIS OF A FINANCIAL STATEMENT

There are no rules as to how you should always proceed when analyzing a company or firm. Depending on circumstances, your goals may not always be the same. Here you will see some of the most commonly used analytical tools that can be quickly and easily applied. These techniques will often lead you to the right questions to ask about the company, rather than provide conclusive answers.

Publicly traded companies publish their annual reports that include audited financial statements. Also, the public companies report to the Securities and Exchange Commission. The SEC 10-K is a good source of financial information that is more detailed than the annual reports.

For companies that are not publicly traded and not audited, apply the principles in the section on Levels of Assurance to determine the extent of your reliance on the financial statement. Then you are ready to apply analytical techniques, if useful for your purposes.

Comparisons are useful in analyzing a company. These fall into three categories:

1. Comparing different items within one financial statement of a particular year, month or quarter. For example, you might view compare sales to gross profit on the same income statement to see gross margin percentage.
2. Comparison of multiple years, quarters or months can help you isolate the cause of changes in profitability, see trends and formulate questions.
3. You can compare to industry averages, or possibly comparable companies. Beware of true comparability when trying this technique. Comparability includes such items as lines of business, size and possibly can be affected by geographic location.

When you are looking at more than one year's data, it may help you to identify trends. For example, are sales steadily increasing, steadily decreasing or sporadic? You can answer the same question about working capital, net income, expenses or any other financial statement component.

A useful tool for analysis is the *common-size* financial statement. On this statement you will see no dollar amounts. Each line item shows a percentage. For example, a common-size income statement would show you each item of revenue and expense as a percentage of total sales. This type of statement can be very useful in doing comparisons of a company's performance from one year to the next or to other companies and industry averages.

Varying emphasis can be placed on the following building blocks of analysis:

- Short-term liquidity
- Long-term solvency
- Profitability
- Return on investment

SHORT-TERM LIQUIDITY

Liquidity refers to that portion of a company's assets that consist of cash or items easily converted into cash. *Working capital* is one of the most important determinants of ability to meet obligations and continue operations. Working capital is sometimes defined as the difference between current assets and current liabilities. In other words, it is the amount of cash in excess of that which will be needed to meet payments due in the near future. Current assets are usually defined as those that are cash, will be converted to cash or used within one year. Current liabilities are those due within one year.

The relationship between current assets and current liabilities is called the *current ratio* (current assets/current liabilities). This ratio is useful because it can alert us to a cash problem and can be monitored over time to determine trends. A more severe test of this relationship is the quick ratio (quick assets/current liabilities). Quick assets are only those current assets that consist of cash and near cash items. For example, inventory is a current asset but often would not qualify as a quick asset.

There is no general rule as to what is a good current or quick ratio. Obviously, one wants to see more current assets than current liabilities, but other than that, the most useful things to do are:

- a) look for trends, i.e., a strengthening or deterioration of the ratio over several periods and
- b) comparison with industry averages. Care must be taken in comparing to other companies because true comparability may not exist. Look for companies that are alike in size and lines of business.

We are using the balance sheet, which represents one point in time. The real question is usually whether the company can produce needed cash in a timely way.

Even though a company may be profitable and have a large amount of total assets compared to its liabilities, if working capital problems exist it can jeopardize the company's existence. Under accrual accounting, revenue is recorded independently of the receipt and payment of cash. For example, a firm may be better at making sales than it is at collecting cash from customers, resulting in good sales and poor cash flow. A good glimpse at collection efficiency is provided by Accounts Receivable Turnover ratio and Average Days to Collect receivables (Ratio section).

Borrowing power does not directly show on the financial statement but it can help in analyzing liquidity. If a company has open lines of credit or other financing arrangements, that will represent available cash for temporary liquidity needs. In a full disclosure financial statement,

this type of available financing might be disclosed in the notes. In other situations, you only find out by asking.

LONG-TERM SOLVENCY

Capital Structure

The two categories of financing are:

1. Debt
2. Equity

This is sometimes referred to as the company's capital structure. The relationship between the totals of these two categories of financing tells you how leveraged the company is. Leverage is the use of debt to produce earnings.

This breakdown is readily seen on the balance sheet as total liabilities and total equity. Stated another way, this is the portion of the assets that are subject to creditors' claims, and how much of them are represented by equity of the owners of the company.

What is a good amount of leverage?

Many people are comforted by seeing more equity and less debt on a balance sheet, and that makes sense because it is an indicator of strength. But if a company has underutilized debt capacity, is that a cause for concern? It is sometimes argued that not using borrowing capability is costing a company money because of leveraging possibilities. If the borrowed funds can produce income greater than the cost of borrowing, then leverage has been used.

During times of inflation, fixed-rate debt can yield price-level gains. That is, the debt is paid back in cheaper dollars.

Earning power, or more specifically, cash flow, is crucial to long-term solvency. A company must have cash when it needs to meet obligations. Use the statement of cash flows, operations section, if it is available to determine the company's cash producing capability. You can also use the income statement, removing non-cash items like depreciation.

Forecasts and projections

There are situations where it is useful to look at expected future results of a company. This is when you might see financial forecasts. They can be helpful in a business sale, valuation, litigation and other matters.

Key to placing reliance on forecasts is the realism of the assumptions used. The numbers in the forecast will be produced as a result of assumptions about future revenues, expenses, industry and economic trends and financing activities. The forecast should use assumptions that can be backed up with logic. Beware of any forecast that does not state the assumptions used. For example, an assumption concerning the level of expected sales for a period might point to past

sales and predict an increase in orders due to the increased size and demand of some of its customers.

When viewing a financial forecast, see the assumptions first, and determine if they are realistic.

Forecasts most often estimate future profitability or cash flow. An existing business has historical data on which to base its forecast. In the case of a new business or new line of business, forecasting is more difficult, and should be treated with healthy skepticism.

PROFITABILITY AND EARNINGS

Net profit is a simple concept: REVENUE less EXPENSES = NET INCOME.

But the truth is there is more than one possible reported income amount. The reasons for this mainly fall into two categories:

1 - Accounting methods - there are different accounting methods which produce different results. The most common bases are cash, modified cash, accrual and tax. When a comparison is being done between companies, adjust for differences in accounting treatment. The most frequent areas where this makes a large difference are depreciation and inventory, but there are many others.

2 - Estimates and judgment calls that require allocation of revenues and expenses across current and future periods. The most common examples are:

Revenue recognition – the more complex the business transactions in which a company is engaged, the more this item comes into question. This is the decision that determines when revenue is reported.

Depreciation – estimated useful lives of assets, salvage value and choice of depreciation method determine the amount of reported depreciation expense each reporting period.

Asset write-downs (LCM) – the determination that certain assets have become impaired in value, and when such loss should be recognized.

Bad debts and other allowances – the extent to which expense incurred has been recognized.

Future liabilities and obligations – these can involve contingent liabilities and pension and benefit costs. Watch for reasonable application of time value calculations.

Non-operating gains and losses – these items should be properly separated from operating results.

Revenue

Revenue is usually the largest item on the income statement. Basic concerns about revenues are:

- What are the sources of revenue?
- How stable are these revenue sources?
- How and when is revenue recognized?

Stability of revenues is important to your evaluation of company results. Stability is usually indicated by a steady upward trend in the amount of revenues, as opposed to sporadic swings up and down. A simple trend analysis can be helpful, which can be a spreadsheet using percentage increases and decreases from a base year.

Make inquiries about other factors that can affect revenue stability, such as over-reliance on a small number of customers.

In a diversified company the various segments may have different rates of profitability. Reporting may be needed by segment. Be aware of allocation of overhead expenses among segments. The amount allocated to each segment requires judgement, and the way it is done helps to determine how total reported net income is divided among the segments. Such allocations should be consistent. For example, applying expenses based on percentage of sales or space used by the segment can make sense.

There are only limited FASB requirements regarding reporting by segment. It is left largely to the discretion of management. Therefore, such reporting is “soft” information, meaning it is highly subject to interpretation and manipulation by management.

Public companies are required by SEC to provide a management discussion and analysis. Your analysis of a privately held company requires inquiries of management for help in understanding unusual events affecting income and factors such as increases in material cost or labor costs.

Change in expense

When there is unexplained change in an expense, compare it to a related item if possible. For example advertising, and maintenance/repairs are common examples of such expenditures. Compare advertising to sales year to year. Maintenance and repairs can be compared to sales or total investment in property, plant and equipment. Research and development can be subject to timing choices but is harder to analyze. Since R&D may affect future performance, the absence of it can be important in some industries.

RETURN ON INVESTMENT

ROI is probably the most widely recognized measure of company performance. It can be used to make comparisons between types of investments and in business valuations.

For analysis purposes, the amount of profit is most useful when it is compared to the amount of invested capital. The profit shown as a return on investment helps in deciding where to invest.

There are several areas of analysis where ROI is useful. These include:

- Determining managerial effectiveness
- Analyzing profitability
- Earnings forecasting
- Evaluating capital investment

ROI uses key summary measures from both the income statement (profits) and the balance sheet (financing). It can show return to providers of debt financing (creditors) and equity financing (owners).

For forecasting, ROI adds discipline and realism. It fills this role by identifying overly optimistic or pessimistic forecasts.

In planning, ROI helps management evaluate investment alternatives for strategic decision making.

ROI is simply:

$$\frac{\text{INCOME}}{\text{INVESTED CAPITAL}}$$

But both income and invested capital can have different definitions. First determine which calculation is being used, or will best tell you what you need to know.

Invested capital can be defined as:

- Liabilities and equity (i.e., total assets)
- Equity capital (total equity on the balance sheet)
- Long-term debt plus equity capital (excludes current liabilities); also referred to as long-term capitalization.

If the total assets definition of invested capital is used, adjustment might have been made for:

Unproductive assets – the argument against removing this is that management is responsible for those assets too. It can sell them, for example.

Accumulated depreciation add-back – this is called the DuPont method. That corporation started the widespread use of this technique for internal management. The argument for this is that a) assets net of depreciation are not appropriate to use, because the assets are kept productive over their useful lives and b) if earnings are compared to an ever-decreasing asset base comparability will be reduced over the years. Both of these arguments are usually overridden by

the fact that not adding back depreciation is consistent with computing net income net of depreciation expense.

If ROI is determined using equity capital only as invested capital, the focus is on return to equity shareholders. This captures the effect of leverage (debt) on the shareholders' return. Preferred stock should be excluded because it receives a fixed return.

There are times when book value of the assets will be restated to market value, although this is not normally done. If the business is being purchased with market value being paid for the assets, then restatement is warranted. This restatement will change the ROI calculation.

Return on invested capital will be different for an individual investor than for the whole company when the investor purchased the stock at some price other than the original issue amount.

Since invested capital changes over the course of a year or other accounting period, average invested capital should be used if possible.

Next, income must be defined for calculation of ROI.

If invested capital is total debt and equity, then income before interest expense is used. That is because the interest is a payment to suppliers of debt capital. Use income before interest for return on assets and return on long-term debt plus equity, assuming interest is from long-term debt.

Income tax is sometimes excluded in order to measure management performance. However, it is a real expense and reduces income.

Following are ratios that aid in making the comparisons of items you will find on the financial statement. There are many ratios used in practice by those doing analyses. These are some of the most commonly used and helpful ones. Each shows a relationship between financial statement items. The relationships may include two income statement items, two balance sheet items or one of each.

Useful Ratios

Liquidity Ratios:

Current ratio

A firm meets its current obligations mainly by using its current assets. This ratio is used to assess the ability to meet these obligations.

$$\text{CURRENT RATIO} = \frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$$

Quick ratio

This ratio provides a more conservative assessment of a company's short-term liquidity. Only cash, receivables and marketable securities are considered, rather than all current assets as in the Current Ratio. Quick assets can be converted into cash almost immediately, while some current assets, like inventory, may not be converted to cash for some time.

$$\text{QUICK RATIO} = \frac{\text{QUICK ASSETS}}{\text{CURRENT LIABILITIES}}$$

Debt Management Ratios:

Debt to Equity ratio

Measurement of the proportion of capital provided by creditors relative to that provided by stockholders.

$$\text{DEBT TO EQUITY RATIO} = \frac{\text{TOTAL DEBT}}{\text{TOTAL EQUITY}}$$

Debt to Total Assets (Debt + Equity) Ratio

Measurement of the proportion of total capital provided by creditors. This ratio is most useful when equity is small or subject to substantial changes.

$$\text{DEBT TO TOTAL ASSETS RATIO} = \frac{\text{TOTAL DEBT}}{\text{TOTAL ASSETS}}$$

Operating ratios:

Accounts Receivable Turnover Ratio

Measurement of the length of time required to collect accounts receivable. The more time accounts receivable turns over each year, the more efficient are the credit granting and collection activities of the firm.

$$\text{ACCOUNTS RECEIVABLE TURNOVER} = \frac{\text{NET CREDIT SALES}}{\text{AVERAGE ACCOUNTS RECEIVABLE}}$$

Average Days to Collect Accounts Receivable

This is another way to scrutinize how well a company collects from its customers. It uses the turnover calculation above.

$$\text{AVERAGE DAYS TO COLLECT} = \frac{365 \text{ DAYS}}{\text{ACCOUNTS RECEIVABLE TURNOVER}}$$

Inventory Turnover Ratio

Inventory turnover is the purchase of inventory and then its resale to customers. This ratio measures the number of times inventory is turned over each year. The more times inventory is turned over, the more efficient the firm.

$$\text{INVENTORY TURNOVER} = \frac{\text{COST OF GOODS SOLD}}{\text{AVERAGE INVENTORY}}$$

Average Days to Sell Inventory

This converts the turnover calculation above to number of days.

$$\text{AVERAGE DAYS TO SELL INVENTORY} = \frac{365 \text{ DAYS}}{\text{INVENTORY TURNOVER}}$$

Profitability Ratios

By looking at revenue compared to the following items on the income statement you can isolate changes in profitability over time. This gives you specific areas to investigate further.

Gross Margin Ratio

The proportion of sales that is the excess of selling price over cost of goods sold (there is not total consistency in what is included in cost of goods sold). This gross margin percentage represents gross profit, which is used to pay operating and other expenses and to provide net profit.

$$\text{GROSS MARGIN RATIO} = \frac{\text{GROSS PROFIT}}{\text{NET SALES}}$$

Operating Income Ratio

Measures the profitability of a firm's main operations per sales dollar. Non-operating revenues and expenses are excluded. For example, gains or losses on sales of assets are not included because they are not part of the company's normal operations.

$$\text{OPERATING INCOME RATIO} = \frac{\text{OPERATING INCOME}}{\text{SALES}}$$

Net Income Ratio

Measurement of the portion of each sales dollar that is net income after all operating and non-operating revenues and expenses and income taxes.

$$\text{NET INCOME RATIO} = \frac{\text{NET INCOME}}{\text{SALES}}$$

Return on investment (ROI) ratios:

Return on Assets Ratio

Measurement of the profit earned through the use of all of its capital; i.e., the total of investment by both creditors and owners. The return on assets is determined for this purpose by adding back interest to net income. The reason interest is added back in is that it is a return to creditors for their capital contribution. The capital contribution made by creditors is included in average total assets, therefore net income must be determined on a comparable basis.

$$\text{RETURN ON ASSETS} = \frac{\text{NET INCOME} + \text{INTEREST (NET OF TAX)}}{\text{AVERAGE TOTAL ASSETS}}$$

Return on Equity Ratio

Measurement of the profit earned by a firm through the use of capital supplied by owners, including earnings left in the company. Capital that is supplied by creditors (liabilities) is not considered.

$$\text{RETURN ON EQUITY} = \frac{\text{NET INCOME}}{\text{AVERAGE EQUITY}}$$

Stockholder Ratios

Earnings Per Share

Measurement of the income available for common shareholders on a per-share basis. EPS is one of the most widely used analysis tools by investors. Net income is reduced by the amount of preferred dividends, because that amount is unavailable to common shareholders. Treasury shares are no longer outstanding, therefore they are not included in number of common shares.

EPS is termed “fully diluted” when the number of shares used in the calculation includes not only the number of outstanding shares, but also the number of common stock equivalents, such as warrants and options.

$$\text{EARNINGS PER SHARE} = \frac{\text{NET INCOME} - \text{PREFERRED DIVIDENDS}}{\text{AVERAGE NUMBER OF COMMON SHARES OUTSTANDING}}$$

Price Earnings Ratio

This ratio compares the price per share of a stock to the earnings per share. Very often “multiples” are referred to, which is the P/E ratio. This is the number of “times earnings” that the company’s stock is selling for.

$$\text{PRICE EARNINGS RATIO} = \frac{\text{MARKET PRICE PER SHARE}}{\text{EARNINGS PER SHARE}}$$

Other Measurements of Earnings

You cannot always rely on consistent use of terminology such as *income* and *earnings*. It is very common to encounter the use of measures of net income that are incomplete. That is, certain items of revenue or expense may be excluded. Most common is the exclusion of some expenses. There can be legitimate and useful reasons for this practice, but it can be misleading if you are not aware of method used. Determine first, what you are being given and second, whether that will meet your needs.

Following are popular techniques that are used for specific purposes. They do not follow any standards such as GAAP, or rule-making authority like FASB. There are also variations possible.

EBITDA

Earnings before interest, taxes, depreciation and amortization.

This is a useful measurement of the financial health of a company and its ability to meet its obligations. It is an attempt to expose a company's debt-free cash flow.

Starting with net income, the following is removed:

Interest – removal of this expense allows viewing company results without the effects of how much debt is used. This can be useful, for example, if there will be a potential new owner who will have different amount of debt. It also helps in comparing the company's results over time if the debt level has changed. In comparing with other companies or industry averages, EBITDA favors the more leveraged companies, because their higher interest cost is ignored.

Taxes – this refers to income taxes, not others like property tax. Viewing pre-tax results allows comparison with other companies that are in a different tax position. It also lets you see the company over time unaffected by changes in its tax position or the tax rules.

Depreciation and amortization – these are non-cash expenses, and their removal gets you closer to cash flow rather than GAAP net income.

EBITDA can be useful if you are aware of what it is and what it is not. Remember that it is not net income. It can be useful to see EBITDA beside a GAAP income statement. That informs you of the effect of the items not included in EBITDA.

PRO FORMA EARNINGS

Also called “normalized earnings”, “operating earnings,” “recurring earnings,” “earnings excluding special items,” or other similar language. Any of this terminology may be used in reference to net income that is incomplete, having items of revenue or expense removed from it. This type of reporting has its legitimate uses such as normalizing earnings in a business valuation. But the

danger is that, unlike EBITDA, often you are not given up-front disclosure of what has been removed from the net income calculation.

The needed question is, specifically what is excluded from reported earnings of this type. It is very useful to have a GAAP statement included. A pro forma report does not follow the guidelines of FASB or any other standard. The rules are simply made by whoever is preparing the report.

FREE CASH FLOW

Usually defined as cash flow after capital expenditures, free cash flow can be useful in viewing a company's cash-producing capability. Beware, though, because as with some other terms, there are variations of the definition. For example, only replacement capital expenditures may be used in the calculation, instead of all capital expenditures. If this concept is being used, you should ask if you should assume this definition. As defined above the formula is:

$$\text{FREE CASH FLOW} = \text{NOPAT} - \text{CAPITAL EXPENDITURES}$$

$$(\text{NOPAT} = \text{NET OPERATING PROFIT AFTER TAXES})$$

Other Financial Statement Issues

INVENTORY

Inventory refers to items that the company buys or manufactures for sale to its customers. On the balance sheet, inventory is shown as an asset at its cost. Inventory that is sold during the reporting period shows on the income statement as *cost of goods sold*. The terminology may differ. It may be called *cost of sales*, and it is deducted from sales on the income statement to show *gross profit* (as a percentage it is called *gross margin*).

Cost of goods sold would look on the income statement as follows:

	SALES
Less:	COST OF GOODS SOLD
Equals:	GROSS PROFIT (GROSS MARGIN)
Less:	OPERATING EXPENSES
Equals:	OPERATING INCOME

You can readily see that any change in the amount of cost of goods sold has a dollar-for-dollar effect on earnings.

Total inventory available for sale during the period is determined as follows:

	INVENTORY AT THE BEGINNING OF THE PERIOD
Plus:	INVENTORY PURCHASED DURING THE PERIOD
Equals:	TOTAL AVAILABLE INVENTORY

At the end of the accounting period, the total available inventory is either one of two things:

- It is either included in ending inventory as an asset on the balance sheet (it *has not* been sold), or
- It is included in cost of goods sold and reduces net income (it *has* been sold).

The allocation of inventory between sold and unsold is verified and adjusted by a periodic physical count of inventory. This count is critical, because any misstatement of it results in a dollar-for-dollar misstatement of expense (cost of goods sold). In other words, for every dollar inventory is misstated, net income is misstated by one dollar. This is because of the effect on cost of goods sold which is used in determining net income.

Inventory flow methods

Usually, an assumption must be made about inventory flow. Let's say you are in a business that has a fluctuating cost of inventory. You have purchased like items for resale; some that cost you \$100, some others for which you paid \$105 and some you got for \$107. All of these items are stored in a warehouse. When an item is sold, which did you sell? You may or may not know which ones you actually sold, but you make an assumption for financial reporting purposes. The method you choose for assuming your inventory flow will determine whether your cost of goods

sold for this item is \$100, \$105, \$107 or some other amount. You can see that how the method for handling inventory can impact reported results. Below are legitimate methods that are used, but the method used should be consistent. Any change in method should be disclosed, because that change may affect comparability between accounting periods.

First-in, First-out

Under FIFO the assumption is made that the first items purchased are the first items sold. The inventory shown on the balance sheet will be the most recent ones purchased. In our example the \$100 items would be the first ones sold and the \$107 would be remaining in ending inventory. During periods of rising prices FIFO causes the highest reported income because the older, lower costs make up cost of goods sold.

Last-in, First-out

LIFO assumes the opposite of FIFO. You are matching the most recent costs against income. During periods of rising prices LIFO causes the least reported income. Also, under LIFO, the amount of inventory on the balance sheet will likely be understated because the assumption is that the first, thus lower cost items are remaining in inventory.

Weighted average

This method simply averages the cost of all inventory items, weighted by the quantities purchased of each. Theoretically there's a lot to be said for this method, and it probably gives the truest picture of income and ending inventory. In many businesses however, averaging is not realistic because of the number of separate items purchased and the difficulty of individually tracking each one. The clerical cost must be weighed against advantages of the method used.

Specific identification

If a company is selling a very few high-ticket items, each item purchased and sold can be easily identified and the cost for the exact one sold can be used as cost of goods sold. Therefore, no arbitrary assumption has to be made. Also, the inventory amount shown as an asset is the cost of the specific item on hand. A yacht dealer, for example, would have no trouble using specific identification because of the few units sold.

BUSINESS COMBINATIONS

A corporation that owns a controlling interest (over 50%) in another must provide a consolidated financial statement. This report describes the parent and subsidiary corporations as if they were a single accounting entity.

Combinations can come about by:

- Stock in exchange for cash
- Assets in exchange for cash
- Stock for stock

A leveraged buyout uses debt to take a company private by buying out equity holders. The acquirers rely on future cash flows to service the increased debt and asset sales to reduce the debt. One advantage here is that interest is tax deductible while dividends paid to equity holders are not deductible. However, substitution of debt for equity is a riskier capital structure.

The accounting for consolidated net income each period eliminates inter-company transactions within the consolidated entity. For example, sales between parent and subsidiary and the related receivables and cash payments do not show on the consolidated income statement

At the time of the purchase, any excess of the purchase price over market value of the assets acquired is recorded as an asset called goodwill. Under current rules this goodwill remains unamortized on the balance sheet indefinitely. At such time as this goodwill is deemed to be impaired in value, it should be written down to its actual value.

Consolidation Requirement Without Majority Ownership

Equity Method

An investment in another company that is not over 50 percent, but is large enough to represent significant control (usually assumed to be at least 20 percent ownership), requires special accounting treatment. The investment is shown at cost, with subsequent proportionate shares of the investee's earnings and losses recognized as adjustments to the investment, and the investors share of investee income is recognized. This share of earnings will usually be seen as a separate item on the income statement.

Variable Interest Entities

A consolidation may be needed based on providing financial support rather than majority ownership. A variable interest entity is an off-balance sheet entity that may be required to be consolidated. A VIE is not self-supportive, i.e., it cannot finance its activities without outside support.

Common activities triggering this reporting treatment are loan guarantees, service fee arrangements, leasing transactions, shared operating expense agreements, certain inter-company debt, management of receivables, research and development activities and hedge activities to manage risk.

A variable interest in an entity is one that fluctuates with the value of the VIE's net assets. That variable interest does not need to be equity ownership. It can be any type of financial support, as in the examples above. The key is that the variable interest holder is in the position of an equity owner even without formal ownership.

To avoid the requirement to consolidate, it must be demonstrated that the entity has sufficient equity to finance its activities without outside support. There is a presumption that equity investment of less than ten percent of total assets is not sufficient for the entity to finance its own activities. Even if the equity level is higher than ten percent there is still a burden of meeting the self-sufficiency requirement.

An entity meeting the requirement of a “business” is not required to be evaluated to determine its status as a VIE.

A concern in litigation might arise when a VIE is consolidated. It could be argued that a VIE is not a separate legal entity for purposes of “piercing the corporate veil.”

These VIE consolidation requirements do not apply to personal financial statements.

CONTINGENT LIABILITIES

A set of circumstances that may cause a loss to occur is a contingent liability. Such a contingency will develop into an actual loss only upon the occurrence of some future event. The manner of reporting a contingency depends on an evaluation of the probability of an actual loss developing. Following are common conditions that may cause a contingent liability to be recognized:

- Pending litigation
- Collectability of receivables
- Product defects
- Property loss due to hazards

Depending on the evaluation of the likelihood of the contingency occurring, it will be reported as either

- 1) an accrued charge to income at the date of the financial statements - if the future event that will cause the loss is deemed probable to occur, and the amount of loss is known or reasonably estimable.
- 2) disclosed in the notes to the financial statements - if the probability of occurrence is reasonably possible but not probable
- 3) neither accrued nor disclosed - If the probability of occurrence is remote

RELATED PARTY TRANSACTIONS

Under GAAP there should be disclosure of related party transactions in the notes to the financial statements. When you have less than full disclosure this might need to be included in your

inquiries. A related party is one that can exercise significant control over policies of another entity.

Related parties can include management, owners and companies in which the entity has substantial investment, and others in a position to have influence. The point is to be aware of transactions that are not arm's length, and might not be reported at realistic amounts.

DEFERRED INCOME TAXES

Sometimes business activity currently reported generates a future tax benefit or liability. This can be caused by two types of situations:

1. Net operating losses – losses available for carryforward to future years represent a future tax benefit. That is an asset, called deferred tax. This might be a current asset, or long-term if the benefit is expected to be available beyond the next year.
2. Temporary timing differences in recognition of revenues and expenses. You are most likely to see timing differences in expenses. An example, which can be a significant amount for some companies, is accelerated depreciation used for tax purposes, with GAAP depreciation recognized on the financial statement. In later years of the asset life, there is tax liability because the expense was recognized in the early years for tax purposes, so that deduction is not available in later years. This generates a deferred tax liability.

There are also permanent differences in financial accounting and tax reporting, but these do not create a future tax asset or liability.

TROUBLED DEBT AND BANKRUPTCY

Troubled debt restructuring

Debt may be restructured in order to enhance the liquidity of the debtor. The rules for troubled debt restructure apply if financial difficulties led to the granting of a concession by a creditor. The main question to answer is whether income or loss was created.

First it must be determined whether the restructuring is a modification or an extinguishment of the debt. If modified, there are no substantially different terms. If the modification is a change in interest rate, it will be accounted for prospectively as a yield/interest expense adjustment.

Extinguishment of debt means that the debt is settled for cash or property, traded for equity, or exchanged for new debt with substantially different terms. "Substantially different" is defined as having a present value of new cash flow at least 10% more or less than the present value of the old cash flows. That status can also be affected by variable terms and conversion options.

Extinguishment will usually result in a gain or loss. It should be classified as non-operating gain or loss.

Bankruptcy

There may be a liquidation or reorganization.

Liquidation

Financial reporting for a company that is no longer a going concern follows a special set of practices.

Liquidation accounting is required when liquidation is imminent. This imminence is present when a plan is approved by the company or is imposed by other parties (i.e., involuntary bankruptcy). Financial statements should present assets at the expected cash net proceeds from liquidation. No assumption is made that there will be a legal release from debt. Disclosures about significant assumptions used to measure assets and liabilities should be disclosed.

Reorganization

A normal balance sheet, income statement and statement of cash flows are all presented, but should be labeled "Debtor-in-Possession" during a Chapter 11 reorganization.

On the balance sheet the liabilities should be separated by prepetition and post-petition. The prepetition liabilities are separated by those that are subject to compromise and not. Obligations classified as subject to compromise are prepetition liabilities that are not fully secured and have the possibility of not being paid at the full amount. These will include trade payables, unsecured debt and contract obligations. Liabilities classified on the balance sheet as not subject to compromise are prepetition obligations that are fully secured and are expected to be settled in full. Liabilities incurred in the post-petition period are presented as they ordinarily would be under GAAP. The assumption is that they will be paid by the debtor throughout the bankruptcy process.

On the income statement you should see expenses and provision for losses resulting from the reorganization separately as reorganization items. Revenue is less commonly a reorganization item.

On the statement of cash flows, reorganization items are shown separately in the operating, investing and financing categories, to the extent feasible.

The last step in successful emergence from Chapter 11 reorganization is the adoption of *fresh-start* accounting. This type of financial report establishes the opening balance sheet of the successor entity. Two accounting events are necessary: (1) recording the effects of the plan of reorganization and (2) revaluation of the assets and liabilities.

Fresh-start reporting should be used on emergence from Chapter 11 if:

1. The reorganization value of the assets of the emerging entity is less than the total of all post petition liabilities and allowed claims.

2. Holders of existing voting shares receive less than 50% of the voting shares of the emerging entity.

Entities that do not qualify for fresh-start reporting should report liabilities, if compromised by a confirmed plan, at the present value of amounts to be paid. If there is any forgiveness of debt it should be treated as extinguishment of debt.

MANIPULATIVE FINANCIAL REPORTING

The use of accounting techniques to affect financial statements can range in severity from fairly benign to aggressive to fraudulent. Especially beware of the areas in which accountants and management must make judgements that affect timing and amount of revenues and expenses. Most often you will be concerned with aggressive application of accounting principles where there is likely an argument that the reporting is within the guidelines.

Most manipulation will fall into one of only a few types, although it can look different depending on specific situations. We will discuss those types here in a general way so you can apply what you learn to any circumstance. The term *earnings management* is sometimes used to denote the use of accounting techniques to affect reported results.

Some of the reasons you may encounter earnings management are as follows:

- Preparation of a business for sale
- Concealment of true operating results in a marital dissolution
- Anticipation of management compensation based on short-term reported results or executives' concern about being terminated or demoted
- Avoidance of a loan covenant violation
- New management attempting to boost future results at the expense of the present
- Enhance shareholder value (public companies)
- Positioning for an initial public offering

Following are the areas in which earnings management will most likely occur. Either revenue or expenses (and the related liabilities) may be manipulated. First, we will look at revenues, then expenses.

REVENUE RECOGNITION

When a company will recognize revenue, or whether it will recognize revenue for a particular transaction is one of the main decisions many businesses make that will affect reported net income. By recognition of revenue, we mean that it is recorded so it will show up on the income statement and affect earnings.

For some companies, like those collecting cash at the time of the sale, recording revenue is not in question because revenue is earned and the cash is received at the same time. But for some companies it is different. Under the accrual basis of accounting, revenue is reported when earned, in order to show true results of operations. For some types of business that happens separately from the receipt of the related cash.

The concern is that revenue may be:

- Recognized in the wrong period
- Hidden (revenue is not reported)
- Fictitious (false revenue is reported)

Revenue recognized in the wrong reporting period

The most common manipulation here is premature recognition. This early reporting of revenue is most easily accomplished by a company that bills customers for sales and is paid later. The overriding question is whether the bill represents a bona fide sale for which cash will be received in a timely manner. If so, then revenue is earned and should show up on the financial statement.

Premature billing:

In a practice called *channel stuffing*, a company can ship goods and send bills in excess of what is needed for final customers. The bills sent represent sales in excess of the cash that will be received in payment. The specifics of how this scheme can look vary greatly, but it often involves the granting of liberal right of return, incentives to take product early, or shipping to high credit risk customers without allowing for the increase in bad debt allowance.

Revenue should only be booked to the extent that cash is expected to be collected in the normal time frame for that company. It is not sufficient that a shipment is made and a bill sent, but title and risk of loss must be passed to the buyer.

Long-term contracts -

Another area where the recognition of revenue can be rather easily manipulated is where there is a long-term contract involved. Under the percentage-of-completion method, revenue is recognized based on work completed. Examples are construction, long-term consulting agreements and computer and software services. Here revenue should be recognized to the extent the obligations under the contract have been fulfilled. The task is to make your best determination as to the portion of the contract that has actually been performed, compared to amount billed to the customer. If payment under the contract is based on passage of time alone, this does not apply.

Bundled sale -

A "bundled" sale includes sale of a product, a service contract and possibly financing. The allocation of the price among the components of the sale determines whether revenue is booked by the seller immediately or over time. As in the case of all allocations, a determination should be made as to its reasonableness.

Recognize deferred vs. current revenue -

When advance payment has been received for goods or services to be furnished in the future, that revenue should be deferred as a liability until it is earned.

To detect revenue recognition in the wrong period:

- Understand the company's revenue recognition policy and whether it actually follows its stated policy
- Tipoff - Watch change in accounts receivable over time compared to sales. When receivables increase at a faster rate than sales, it can indicate premature or fictitious sales on the books. Ultimately these receivables may be eliminated by a bad debt write-off, so look for any unusually large write-offs in excess of allowances previously made for bad debts.

- Inquire as to any side letters or other informal agreements which affect the terms of a sale. This can reveal channel stuffing when, for example, there is a liberal right of return granted.
- Look for significant changes in revenue, especially a sudden variance. This does not in itself mean anything is wrong, but if there is not an explanation it gives you a likely time period to investigate.
- Inquire as to the existence of related party transactions. These can be sham deals or done under unusual terms.
- Watch cash flow compared to accrual based net income. Although a lag in cash flow is normal, the cash from operations should be reasonable compared to net income over time.

HIDDEN REVENUE

Cash sales are the easiest to hide. Retailers, restaurants and casino operations do business that way. Cash is easy to move and cannot usually be traced. Internal control for this type of company is often difficult, and to be effective it must include extensive monitoring of cash.

To detect unreported sales:

- Compare changes in sales with changes in variable costs. Variable costs are those that fluctuate along with the level of business activity. The correlation is not always proportionate but should be reasonable.
- Understand the normal gross margin percentage of the company. You may get this from its historical financial statements or, absent that, substitute industry average data. Applying the gross margin percentage to the cost of goods sold will provide you with a reasonable amount of reported sales. You can then compare that with sales on the financial statement for reasonableness.
- Often a good indication of true sales can be determined from third party purchases, i.e., water consumption in coin laundries, pizza boxes, tire disposal fees, etc. this is similar to considering variable costs, but here you are scrutinizing quantities of product used or specific payments.
- When the results can justify the cost, traffic can be clocked in some businesses.
- Observe the pattern of cash deposits recorded on the company books. Are they too consistent, too inconsistent or more sporadic than the actual business activity?

FICTITIOUS SALES

This is a less common form of financial manipulation, but it happens. There is simply an entry made into the books to increase sales. To keep this from being obvious an offsetting entry will be

made, usually to accounts receivable. Thereby it will look like credit sales. Also accounting software normally requires an offsetting entry.

Detecting fictitious sales:

- Watch for change in accounts receivable that outruns increase in sales over time, just as with early revenue recognition.
- Identify large or unusual accounts receivable write-offs, such as charging off debt from companies who are still credit customers.

ACCRUED EXPENSES (ALLOWANCES, RESERVES)

Sometimes an expense is incurred but not paid, and for some types of expense, the exact amount is not always known. In order to measure the profitability of the company for a specific time period, this economic change needs to be reflected in the financial statement for that period. As always, when this expense is recorded, two items on the financial statements are affected. First, the expense is recorded at its actual or estimated amount. This shows up on the income statement and reduces net income. At the same time, since payment not been made, a liability in the same amount is entered. This appears on the balance sheet.

Later when the expense is actually paid, cash is reduced and the liability is removed. Your concern is twofold:

- (1) the timing, i.e., whether the allowance shows up in the period in which it was actually incurred
- (2) the amount, i.e., if the amount is estimated, is the allowance overstated or understated.

The reason this concept is open to abuse is that both the timing and the amount can be subjective. This makes you reliant on the estimates and judgement applied by management and accountants.

Common examples of the type of expense that shows up this way are bad debts, returns, warranty costs, downsizing costs and acquisition costs. The most common is bad debt expense, and for some companies it is a large enough factor that just tweaking it can have significant earnings effect. Firms that bill customers for later payment are an example, as are financial institutions.

The deliberate understatement of bad debts, for example, related to the current period's sales will overstate net income. In future periods, when actual bad debts are written off in excess of amounts allowed for, that increased expense will reduce earnings in that period. Therefore, net income has been overstated in the current period and will be understated in the future. If those bad debts in excess of the allowance are not written off, the bad debt expense will not show on

the income statement, so income will remain overstated and assets (accounts receivable) will also be overstated.

These allowances can be deliberately overstated as well as understated. Overstatement has the effect of overstating current expense, which allows understatement in future periods. This shifts some current earnings into the future. One reason this is done is *smoothing income*. That means storing profits for future recognition, thereby giving the appearance of steady growth rather than sporadic performance.

One way a company can appear to have a healthy increase in profitability is by drastically lowering its credit standards. This will usually increase sales and it can be a legitimate way to achieve the increase. However, watch for such a loosening of credit standards without a corresponding increase in bad debt expense allowance. If the allowance for the increased expense is not recognized, those bad debts will be written off in future periods. So, by not allowing properly for the expense, some of the expense is pushed into future periods. In other words, sales will have been reported for which no cash will ever be received.

The total assets of some companies, such as financial institutions, are comprised mainly of receivables. When those amounts owed are allowed to deteriorate over time, it can cause a large one-time write-down of receivables. Although the decrease in value happens over time, the total loss may show in one year and can come as a surprise to shareholders and creditors.

Allowances and the related expense recognition are also used for warranty costs, insurance claim reserve, downsizing expense, returns and any other estimated expense that has been incurred but not yet paid.

Often no estimate of the amount of an expense is necessary, because that amount is known. Examples of expenses that commonly need to be accrued for which the amount is known are payroll costs and interest expense. In these cases, your only concern is that the expense is actually recognized.

The term for recognizing expenses which have not been paid, whether the amount is estimated or not, is *accruing* the expense.

Sometimes a company pays an expense in advance. Under accrual accounting, expenses should appear on the financial statement when incurred, so the advance payment is not an expense. It is shown as an asset on the balance sheet. The line item will be called Prepaid Expenses, or something similar.

As the expense is incurred, the balance sheet asset disappears, and expense shows up on the income statement in like amount.

Common examples of prepaid expense are insurance, property tax and club memberships.

To detect abuses in the area of allowances, reserves and accruals:

- Inquire as to the method and assumptions for allowing for bad debts and other estimated expenses. Pay special attention to changes in the assumptions.
- Compare the change in the amount of accrued expense recognized over several reporting periods with related items on the financial statement. For example, an increase in accounts receivable disproportionate to increase in credit sales can indicate recorded sales for which there will be no cash received.
- View back-up detail of financial statement line items if it is available. For example, the back-up for bad debt expense and receivables would be an *aging*, which shows the individual customers and how long their debt has been outstanding. This can help you determine the quality of the amounts reported on the financial statement.

ASSET IMPAIRMENT WRITE-DOWNS

Most assets are stated at cost (with adjustments, as discussed separately). They should be analyzed regularly for impairment in value. All assets including receivables, inventory, goodwill property and others are affected by this principle. A reduction in book value (amount shown on the balance sheet) should be made for any impairment in value (see Lower-of-cost-or-market).

There are two financial statement effects of this action. First, the asset is written down to its actual value, and second, a loss appears on the income statement.

When an asset is written down for impairment in value, you are concerned with its

(1) Timing

Are the write-downs being made when impairment is discovered, or in a time period too early or too late? Timely recognition of this type of loss depends on regular monitoring of assets for impairment.

(2) Amount

Is the amount of impairment being recognized too large or too small?

Recognition of impairment that is too large or too early will overstate current earnings, because the loss is understated or not recognized. This can be done as a form of smoothing income (discussed in accruals and allowances). Anytime there is an incentive to store current earnings for use later, and the company has assets subject to impairment, beware of this tactic.

The opposite can also happen. The asset impairment recognition might be too little or too late. The incentive here would be to maximize current earnings, even at the expense of future reported results. It is not unusual for a company to put off the write-down of assets and related income statement loss. Even though it is not a reduction in cash flow, a write-down can affect public company stock price or management bonus in any company. Another incentive might be to maintain certain financial statement ratios to be in compliance with a loan covenant.

Detecting improper application of write-down principles:

- Identify assets that are subject to rapid impairment in value, especially technology and intellectual property that can become obsolete quickly.
- Inquire as to inventory counting and valuation procedures.
- Determine whether the company periodically examines assets for changes in value.

CAPITALIZING VS. EXPENSING

The decision on whether to capitalize or expense an expenditure will affect reported net income and total assets. There can sometimes be legitimate differences of opinion on whether an item is an expense of the current period or should be capitalized as an asset, with its cost being spread out over future years.

When management classifies current period expenses as the purchase of assets, the effect is to increase the current period's net income. It defers the expense into future periods through depreciation and amortization. The opposite scenario can take place. Expensing items in the current period that should be capitalized will depress reported results this year and overstate results in the future.

Detecting aggressive capitalization policies:

- Inquire as to the company's capitalization policies
- View specific assets capitalized during the period in question to determine that they should not have been expensed. Pay particular attention to start-up costs, software development costs, marketing and advertising.
- Investigate large expenses (i.e., should they be capitalized)?
- Look for unexplained increase in fixed assets (i.e., are maintenance and repairs being capitalized?)
- Look for operating expense decline vs. sales (i.e., are operating expenses being capitalized?)

INVENTORY MANIPULATION

A form of expense manipulation that affects cost of goods sold on the income statement is the misstatement of inventory count or bad valuation of goods. The mechanics of this technique is explained in the Analysis section.

An overvaluation of unsold inventory on the balance sheet will result in equal overstatement of earnings. That is because of the resulting understatement of cost of goods sold expense. The opposite effect can be achieved by understating unsold inventory.

Your best protection against deception in this area is verification of a reliable inventory count. If that is not present, evaluate the method used to determine the inventory amount.

CONTINGENCIES AND OFF-BALANCE-SHEET LIABILITIES

A possible off-balance sheet liability is an obligation for future payment that may or may not happen. This is a *contingent liability*. The contingency may or may not materialize, and FASB provides standards on treatment of contingencies. It may be:

1. disclosed in the notes to the statements
2. booked as an estimated amount due
3. not shown at all

Factors such as likelihood of being paid and ability to establish an amount determine GAAP disclosure requirements. Private company financial statements often will not follow GAAP, so you may not see this disclosure. In these cases, it may need to be part of your inquiries. Pending lawsuits are a common type of contingent liability.

Obligations under a lease that qualifies as a short-term operating lease might not appear as a liability. Historically, all operating leases (i.e., a lease that does not look like a sale economically) were always off-balance sheet liabilities. Under new lease reporting standards, most of these liabilities will be part of the balance sheet.

Detecting contingencies and off-balance sheet liabilities:

-See attorney's billings for activity related to legal action or partnership agreements

-Inquire as to any operating lease agreements

-See payments made after balance sheet date that would indicate liabilities that existed on that date but were unreported. This is referred to as a subsequent event analysis.

GENERAL CONSIDERATIONS IN DETECTING EARNINGS MANAGEMENT

Ask about accounting policies, especially in areas where there is subjectivity, i.e., assumptions or estimates are made or judgement is applied.

Keep in mind the financial statement line items that are related and observe the relative changes over time. Ratio analysis (see Analysis section) can be useful in accomplishing this.

Beware of the use of intermediary companies. Related or controlled companies can be used to park profits or losses outside a company. This can be accomplished by using controlled customers or suppliers. A company sells or buys with the intermediary at artificial pricing, which then sells or buys with real customers. The replacement of several customers or vendors with a large one is a tip off.

Recognize the limitations of using less than complete financial statements. This is common in closely held companies. For example, without a cash flow statement, verifying the legitimacy of reported accrual-based income is much more difficult. Sometimes you must conclude that the reports do not reveal what you need to know about a company.

When asking for financial statements, try to obtain enough history to be able to recognize trends and abrupt changes. Usually at least three years is needed. Go further back if possible. In addition to year-end statements, ask for *interim financial* statements. These are prepared periodically during the year, such as quarterly or monthly. The reason they can help is that most of the clean-up work is usually done on the year end financials. That is often legitimate, but you will be looking for significant changes at year end that are unexplained. Another way to look at changes that were made to get the balances “right” is by viewing adjusting entries at financial statement date.

COMMON ACCOUNTING AND FINANCIAL TERMINOLOGY

Accounting Standards Codification (ASC)

The current source for generally accepted accounting principles. Included within ASC are the prior Statements of Financial Accounting Standards (SFAS), updates and interpretations from the Financial Accounting Standards Board, American Institute of CPAs positions and other literature. All of these are arranged by topic, which facilitates research.

Accrual basis of accounting

Under the accrual basis, income is recognized when it is earned and expenses are recognized when they are incurred, regardless of when cash is received or spent. For example, when a sale is made on credit, income is recognized at the time of the sale even though no cash has yet changed hands.

Assets

Everything that the business owns, including items such as cash, inventory, accounts receivable, equipment, vehicles and intangibles. These items are reported on the balance sheet at historical cost less depreciation (there are limited exceptions). There can be significant differences between the amount of total assets as seen on the balance sheet and the market value of those assets.

Balance Sheet

The assets, liabilities and equity of a company or organization as of a particular date are stated on the balance sheet. Also called a Statement of Financial Condition, it indicates the financial condition of the firm at financial statement date. The concept of the balance sheet remains the same regardless of the form of business or not-for-profit organization, although terminology will change.

The balance sheet can be shown this way:

$$\text{ASSETS} = \text{LIABILITIES} + \text{EQUITY}$$

Capital lease

A lease which has the characteristics of a purchase of an asset using debt. The asset leased and the related lease liability are reported on the balance sheet.

Capital structure (capitalization)

The sources of long-term financing of a company. There are two categories, debt and equity.

Capitalization

The recording of an expenditure as an asset rather than an expense. The asset is then "expensed" over future periods as it is used. The methods for spreading this cost are depreciation, amortization and depletion depending on the type of asset involved.

Carve-out

A financial statement of what a stand-alone business would look like in a divestiture

Cash basis of accounting

Under the cash basis, income is recognized when cash is received and expenses are recognized when cash is paid out. This is simpler to handle than the accrual basis of accounting, but since it is based on cash flow rather than income measurement, significant misstatements of income and financial condition can occur.

Common-size financial statements

A financial statement that shows percentages rather than dollar amounts. For example, a common-size income statement can show each line item of income and expense as a percentage of total sales.

Consolidated financial statements

Statements presenting combined information about more than one interrelated corporation that form a single accounting entity.

Contra asset

A balance sheet item that is subtracted from the cost of an asset. For example, accumulated depreciation is subtracted from depreciable assets.

Contribution margin

The difference between sales and variable costs of a product or service. This is the amount available to cover fixed costs and profit.

Cost of capital

The rate of return required by those providing both debt and equity capital.

Cost of goods sold

The purchase or production price of goods sold to customers during an accounting period. Cost of goods sold is calculated as follows:

BEGINNING INVENTORY
Plus: PURCHASES
= GOODS AVAILABLE FOR SALE
Less: ENDING INVENTORY
= COST OF GOODS SOLD

Cost of Goods Sold shows up on the income statement this way:

SALES
Less: COST OF GOODS SOLD
= GROSS PROFIT
Less: OPERATING EXPENSES
= NET INCOME

Current asset

An asset that will be used or converted into cash within one year or one operating cycle, whichever is longer.

Current liability

An obligation that will require payment of cash or goods or services within one year or one operating cycle, whichever is longer.

Cumulative dividend

A characteristic of some preferred stocks whereby any preferred dividends in arrears must be paid before any dividends can be paid to common shareholders.

Debit/Credit

Avoid using these terms to mean an increase or decrease. In accounting usage, they only refer to the left and right sides of a double entry accounting system. A debit to an account will sometimes represent an increase to that account and sometimes it will represent a decrease. The same is true of the term "credit". In a discussion among accountants and non-accountants the use of these terms can create confusion.

Deferred revenue (unearned revenue)

Liability that is created by receiving advance payment for goods or services to be delivered in the future.

Depreciation

Depreciation is a device that is used to spread the cost of an asset over its useful life. In accounting usage depreciation is not used for the purpose of determining market value of a partially used asset. Rather it is the way in which the cost of the asset is matched to the periods in which it produces income.

Derivative

A financial instrument that derives its value from an underlying security, commodity or interest rate. There is no ownership of the asset, but there is an obligation to buy or sell the asset at a future date, or an obligation to pay or right to receive payment depending on whether the market price of the asset goes up or down. These instruments are used to hedge against losses.

Financial accounting

Financial reporting for the purpose of reporting earnings (results of operations), financial condition and cash flows. These are the financial statements that are not only used by management, but

they are for external use also (i.e., they are furnished to parties outside the company). Financial reporting rules will not always coincide with tax reporting, statutory reporting, contractual or managerial accounting.

Financial Accounting Standards Board (FASB)

This is the rulemaking body for the accounting profession, created by the American Institute of Certified Public Accountants. Their pronouncements are called Financial Accounting Standards. They are codified in Accounting Standards Codification (ASC), and are the basis for generally accepted accounting principles (GAAP).

First-in, First-out (FIFO)

Inventory costing method based on the assumption that the first inventory items purchased are the first ones sold.

Fixed assets

Those assets that are of a long-term nature, such as equipment, buildings and vehicles.

Fixed costs

These are costs that do not fluctuate with rising and falling levels of sales. For example, the rent of a facility remains the same regardless of changes in sales activity.

Generally accepted accounting principles (GAAP)

The rules that govern the preparation of financial statements. The primary authority for these rules is the Financial Accounting Standards Board (FASB).

Goodwill

That portion of valuation of a business that is in excess of the value of the assets. It only shows as a balance sheet asset when it is acquired.

Gross profit (Gross margin)

Sales less the cost of purchasing or producing the products sold. Operating and other expenses are deducted from gross profit to determine net income. Expressed as a percentage, it is gross margin.

Hedge

A risk management strategy whereby financial instruments (derivatives) are used to insure against negative events, such as foreign currency translation changes, interest rate changes and debtor default.

Hybrid basis of accounting

An accounting system that includes elements of both the cash basis and accrual basis of accounting.

Income Statement

The income statement measures net income or loss over a period of time. Depending on the basis of accounting used, the stated income may vary considerably. Be sure that you know the

accounting basis used and which abuses to look for. See *cash basis of accounting, accrual basis of accounting and hybrid basis of accounting*.

Last-in, First-out (LIFO)

Inventory costing method based on the assumption that the last items purchased were the first ones sold.

Leverage

The use of capital secured from creditors that produces more income than that needed to cover the interest on the debt.

Liabilities

Obligations to creditors and others. The most common liabilities are those requiring the repayment of debt in cash, but also included are services or products for which payment has been received but have not been delivered.

Liquidity

The availability of cash for a company to meet its short-term financial obligations.

Lower-of-cost-or-market principle

The principle requiring that assets on the balance sheet be reduced from their original cost to their current market value when their market value falls below cost.

Managerial accounting

Internal financial reporting and analysis for management. Since these reports do not go out to the public, the financial accounting rules do not apply. However, there are techniques that are commonly used to manage and plan.

Minority interest

Ownership of less than 50% of the shares of a corporation. Also called non-controlling interest.

Operating control

Ownership, individual or collective, of over 50% of the voting shares of a corporation. These majority owners can hire, fire, determine dividend policy and make all the operating decisions for the corporation.

Operating lease

Under a lease treated this way, no asset or liability is recorded, as is done under a capital lease. The amounts of the lease payments show as an expense each period on the income statement. There is no direct balance sheet effect. This is the most common off-balance sheet liability.

Primary beneficiary

An entity that provides support for a variable interest entity and receives most of the benefit or loss from the VIE.

Private Company Council (PCC)

The standard setting body for the accounting standards for small and medium sized privately held companies

Pro forma

A financial statement prepared on an “as if” basis. For example, a pro forma statement might be prepared showing next year’s financial condition and results of operations based on assumptions of the amounts of sales, expenses, etc. Historical reporting called proforma will have some element(s) left out. An example would be proforma results that exclude marketing costs. It is critical to get a specific answer regarding what is missing from a proforma historical report.

Retained earnings

Net profits that are kept accumulating in the business rather than being paid out to owners as dividends. These profits are not generally held as cash. Instead, they have been used to purchase assets in the course of normal operations. Therefore, retained earnings does not represent cash, but the owners’ interest in all balance sheet assets. A corporate balance shows retained earnings as a line item. The same concept exists in other forms of entity (LLC, partnership, proprietorship) but is usually included in a total equity line item.

Small and Medium Enterprise (SME) Accounting

An alternative to GAAP for smaller, simpler companies. It was produced by American Institute of CPAs, and may be compiled, reviewed or audited. It combines attributes of other standards, i.e. GAAP, cash basis and tax basis.

Specific Identification

Inventory costing method that is based on identifying each specific inventory item sold rather than making an arbitrary inventory flow assumption such as LIFO or FIFO.

Spin-off

Separation of a subsidiary from its parent with no change in equity ownership. Shares in the new separate company are issued to the original stockholders.

Statement of Cash Flows

A financial statement that details sources of funds and uses of funds.

Statement of Stockholders’ Equity

A statement which shows the changes in stockholders’ equity from one period to the next. These changes will include sales of stock, dividends, net profit net loss and other less common changes categorized as other comprehensive gain or loss.

Time value of money

The concept that the value of receipt or payment of one dollar today is different than receipt or payment of the same dollar later.

Treasury stock

Previously issued stock that is repurchased by the issuing corporation. It is seen on the balance sheet as a reduction in equity.

Unearned revenue (Deferred revenue)

See deferred revenue.

Unrealized gain or loss

A change in the market value of an investment that occurs prior to its sale.

Variable costs

These costs rise and fall based on changes in sales volume. It is possible for a cost to be semi-variable. That is, it will be influenced by change in sales, but not in a proportionate way.

Variable interest entity (VIE)

An entity that cannot fund its own operation, receives its main support from an outside entity and often must be consolidated into that entity for reporting purposes.

Warrant

A long-term stock option. These can be coupled with debt to gain a more favorable interest rate.

Weighted average method

Inventory costing method based on average cost of items purchased weighted by the number of each item that is purchased.

Appendix

Review Report
GAAP Departure

Independent Accountant's Review Report

To the Stockholders
Bounty Ventures, Inc.

We have reviewed the accompanying balance sheet of Bounty Ventures, Inc. as of December 31, 2021 and the related statements of income, retained earnings and cash flows for the year then ended. A review includes primarily applying analytical procedures to owners' financial data and making inquiries of company owners. 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, we do not express such an opinion.

Owners are responsible for the presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note 2 to the financial statements, accounting principles generally accepted in the United States of America require that fixed assets be depreciated over their estimated useful lives. Management has informed us that the company has recorded depreciation using the Modified Accelerated Cost Recovery System required for income tax purposes, which does not result in an allocation of depreciation to expense over the estimated useful lives of the fixed assets. The effects of this departure from accounting principles generally accepted in the United States of America on financial position and results of operations have not been determined.

King & Company, LLP

Compilation Report

Accountant's Compilation Report

To the Stockholders
Bounty Ventures, Inc.

We have compiled the accompanying statement of assets and liabilities – income tax basis of Bounty Ventures, Inc. as of December 31, 2021, and the related statements of revenues and expenses – income tax basis for the year then ended. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with the income tax basis of accounting.

Owners are responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

King & Company, LLP

Lookout Traders, LLC
Balance Sheet – Modified Cash Basis
December 31, 2021

ASSETS	
Cash	\$18,600
Short-term Investments	53,100
Accounts Receivable	181,200
Inventory	219,600
Prepaid Expenses	4,400
Other	3,600
 Total Current Assets	 480,500
 Leasehold Improvements	 11,800
Vehicles	87,300
Furniture & Fixtures	48,700
Buildings	265,000
Land	85,000
Accumulated Depreciation	(99,500)
 Fixed Assets (Net)	 398,300
 Total Assets	 <u>\$878,800</u>
LIABILITIES & EQUITY	
Accounts payable	\$66,500
Note payable-bank	88,600
Current Portion of long-term debt	28,100
Deferred Revenue	16,100
Accrued liabilities	18,400
 Total Current Liabilities	 217,700
 Loans payable	 101,300
Mortgage	198,600
 Total Long-Term Liabilities	 299,900
 Total Liabilities	 517,600
 <i>Members' Equity</i>	 361,200
 Total Liabilities & Equity	 <u>\$878,800</u>

Lookout Traders, LLC
Income Statement – Modified Cash Basis
For the Year Ended December 31, 2021

Sales	\$1,754,200
Cost of Goods Sold	(901,200)
Gross Profit	853,000
Consulting Revenue	71,500
Total Gross Profit and Consulting Revenue	924,500
Operating Expenses	
Salaries	446,750
Payroll taxes	52,300
Interest	33,200
Depreciation	22,100
Advertising	11,300
Utilities	4,800
Office supplies	5,500
Bad debts	3,300
Vehicle expense	8,900
Travel and entertainment	7,200
Property taxes	3,500
Other	1,600
Total Operating Expenses	640,500
Income from Operations	284,000
Investment Income	3,400
Income Taxes	(82,900)
Restructuring Charge	(44,000)
Net Income	<u>\$200,550</u>

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors
Natural Grocers by Vitamin Cottage, Inc.:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Natural Grocers by Vitamin Cottage, Inc. and subsidiaries (the Company) as of September 30, 2021 and 2020, the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended September 30, 2021, and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of September 30, 2021 and 2020, and the results of its operations and its cash flows for each of the years in the three-year period ended September 30, 2021, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of September 30, 2021, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated December 9, 2021 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Change in Accounting Principle

As discussed in Note 2 to the consolidated financial statements, the Company has changed its method of accounting for leases as of October 1, 2019 due to the adoption of ASU 2016-02, *Leases*.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the consolidated financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the consolidated financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of a critical audit matter does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Impairment of Long-Lived Assets

As discussed in Notes 2 and 7 to the consolidated financial statements, the Company reviews its long-lived assets for possible impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be recoverable. The Company assesses the recoverability of the assets at an asset group level (with each store representing an individual asset group) by determining whether the carrying value of such assets can be recovered through projected undiscounted future cash flows over the assets' respective remaining lives. As of September 30, 2021, the Company's long-lived assets included property and equipment, operating lease assets, and finance lease assets of \$151.4 million, \$316.4 million, and \$39.4 million, respectively.

We identified the assessment of the recoverability of long-lived assets associated with certain store locations, including property and equipment, operating lease assets, and finance lease assets, as a critical audit matter. A high degree of auditor judgment was applied in evaluating certain inputs to the assessment. These inputs included forecasted sales and forecasted operating expenses as a percentage of forecasted sales attributable to individual asset groups, for which there was limited observable market information.

The following are the primary procedures we performed to address this critical audit matter. We evaluated the design and tested the operating effectiveness of certain internal controls related to the Company's process to assess the recoverability of long-lived assets, including controls related to development of the inputs of forecasted sales and forecasted operating expenses as a percentage of forecasted sales. We performed sensitivity analyses to assess the impact of changes in forecasted sales and forecasted operating expenses as a percentage of forecasted sales on the recoverability analysis. We evaluated management's ability to effectively forecast sales and operating expenses as a percentage of sales by comparing actual results to management's historical forecasts. We evaluated the reasonableness of forecasted sales and forecasted operating expenses as a percentage of forecasted sales by comparing the inputs to available industry reports, historical financial data, and budgets.

/s/ KPMG LLP

We have served as the Company's auditor since 2010.

Denver, Colorado
December 9, 2021

Report of Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors
Natural Grocers by Vitamin Cottage, Inc.:

Opinion on Internal Control Over Financial Reporting

We have audited Natural Grocers by Vitamin Cottage, Inc. and subsidiaries' (the Company) internal control over financial reporting as of September 30, 2021, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2021, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of September 30, 2021 and 2020, the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended September 30, 2021, and the related notes (collectively, the consolidated financial statements), and our report dated December 9, 2021 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP

Denver, Colorado
December 9, 2021

NATURAL GROCERS BY VITAMIN COTTAGE, INC.

Consolidated Balance Sheets
(Dollars in thousands, except per share data)

	September 30,	
	2021	2020
Assets		
Current assets:		
Cash and cash equivalents	\$ 23,678	28,534
Accounts receivable, net	8,489	8,519
Merchandise inventory	100,546	100,175
Prepaid expenses and other current assets	2,914	6,185
Total current assets	135,627	143,413
Property and equipment, net	151,399	147,929
Other assets:		
Operating lease assets, net	316,388	339,239
Finance lease assets, net	39,367	40,096
Deposits and other assets	530	616
Goodwill and other intangible assets, net	11,768	10,499
Total other assets	368,053	390,450
Total assets	\$ 655,079	681,792
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 68,949	69,163
Accrued expenses	26,589	24,995
Term loan facility, current portion	1,750	—
Operating lease obligations, current portion	33,308	32,156
Finance lease obligations, current portion	3,176	2,836
Total current liabilities	133,772	129,150
Long-term liabilities:		
Term loan facility, net of current portion	21,938	—
Operating lease obligations, net of current portion	301,895	325,641
Finance lease obligations, net of current portion	39,450	39,506
Deferred income tax liabilities, net	15,293	14,429
Total long-term liabilities	378,576	379,576
Total liabilities	512,348	508,726
Commitments (Notes 11 and 18)		
Stockholders' equity:		
Common stock, \$0.001 par value. 50,000,000 shares authorized, 22,620,417 and 22,546,765 shares issued at 2021 and 2020, respectively	23	23
Additional paid-in capital	57,289	56,752
Retained earnings	85,419	116,291
Total stockholders' equity	142,731	173,066
Total liabilities and stockholders' equity	\$ 655,079	681,792

See accompanying notes to consolidated financial statements.

NATURAL GROCERS BY VITAMIN COTTAGE, INC.

Consolidated Statements of Income
(Dollars in thousands, except per share data)

	Year ended September 30,		
	2021	2020	2019
Net sales	\$ 1,055,516	1,036,842	903,582
Cost of goods sold and occupancy costs	763,328	753,701	664,829
Gross profit	292,188	283,141	238,753
Store expenses	234,586	227,069	197,792
Administrative expenses	28,355	26,780	22,837
Pre-opening expenses	920	1,543	1,358
Operating income	28,327	27,749	16,766
Interest expense, net	(2,271)	(2,048)	(4,952)
Income before income taxes	26,056	25,701	11,814
Provision for income taxes	(5,475)	(5,692)	(2,398)
Net income	\$ 20,581	20,009	9,416
Net income per share of common stock:			
Basic	\$ 0.91	0.89	0.42
Diluted	\$ 0.91	0.89	0.42
Weighted average number of shares of common stock outstanding:			
Basic	22,591,816	22,501,779	22,424,328
Diluted	22,711,003	22,577,646	22,554,603

See accompanying notes to consolidated financial statements.

NATURAL GROCERS BY VITAMIN COTTAGE, INC.
Consolidated Statements of Cash Flows
(Dollars in thousands)

	Year ended September 30,		
	2021	2020	2019
Operating activities:			
Net income	\$ 20,581	20,009	9,416
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	29,633	31,193	28,977
Impairment of long-lived assets and store closing costs	1,155	612	380
Loss (gain) on disposal of property and equipment	209	(42)	(131)
Share-based compensation	877	1,129	1,185
Deferred income tax expense	864	3,742	3,973
Non-cash interest expense	24	12	13
Changes in operating assets and liabilities			
Decrease (increase) in:			
Accounts receivable, net	30	(3,418)	(315)
Income tax receivable	3,004	2,350	(5,174)
Merchandise inventory	(371)	(3,996)	(1,951)
Prepaid expenses and other assets	(141)	(762)	42
Operating lease asset	31,090	30,206	—
(Decrease) increase in:			
Operating lease liability	(32,030)	(30,569)	—
Accounts payable	(2,639)	10,103	1,024
Accrued expenses	1,594	5,934	1,211
Deferred compensation	—	—	(688)
Deferred rent and leasehold incentives	—	—	(580)
Net cash provided by operating activities	<u>53,880</u>	<u>66,503</u>	<u>37,382</u>
Investing activities:			
Acquisition of property and equipment	(26,350)	(26,752)	(30,030)
Acquisition of other intangibles	(1,937)	(2,832)	(2,703)
Proceeds from sale of property and equipment	89	—	836
Proceeds from property insurance settlements	443	27	32
Net cash used in investing activities	<u>(27,755)</u>	<u>(29,557)</u>	<u>(31,865)</u>
Financing activities:			
Borrowings under revolving facility	65,900	236,100	405,900
Repayments under revolving facility	(65,900)	(241,792)	(413,400)
Borrowings under term loan facility	35,000	—	—
Repayments under term loan facility	(11,313)	—	—
Capital and financing lease obligations payments	—	—	(780)
Finance lease obligation payments	(2,823)	(2,271)	—
Dividends to shareholders	(51,453)	(6,301)	—
Loan fees paid	(52)	(25)	—
Payments on withholding tax for restricted stock unit vesting	(340)	(337)	(421)
Net cash used in financing activities	<u>(30,981)</u>	<u>(14,626)</u>	<u>(8,701)</u>
Net (decrease) increase in cash and cash equivalents	<u>(4,856)</u>	<u>22,320</u>	<u>(3,184)</u>
Cash and cash equivalents, beginning of year	<u>28,534</u>	<u>6,214</u>	<u>9,398</u>
Cash and cash equivalents, end of year	<u>\$ 23,678</u>	<u>28,534</u>	<u>6,214</u>
Supplemental disclosures of cash flow information:			
Cash paid for interest	\$ 370	354	787
Cash paid for interest on finance or capital and financing lease obligations, net of capitalized interest of \$194, \$102 and \$268, respectively	1,782	1,690	4,148
Income taxes paid	6,747	3,305	4,734
Deferred compensation paid	—	—	700
Supplemental disclosures of non-cash investing and financing activities:			
Acquisition of property and equipment not yet paid	\$ 4,770	2,407	6,289
Acquisition of other intangibles not yet paid	319	255	476
Proceeds from sale of property and equipment not yet received	—	42	6
Property acquired through capital and capital financing lease obligations	—	—	12,156
Property acquired through operating lease obligations	9,216	13,204	—
Property acquired through finance lease obligations	3,025	11,625	—

See accompanying notes to consolidated financial statements

NATURAL GROCERS BY VITAMIN COTTAGE, INC.

Consolidated Statements of Changes in Stockholders' Equity
 Fiscal Years Ended September 30, 2021, 2020 and 2019
 (Dollars in thousands, except per share data)

	Common stock –\$0.001 par value		Additional paid-in capital	Retained earnings	Treasury stock	Total stockholders' equity
	Shares outstanding	Amount				
Balances September 30, 2018	22,373,382	\$ 23	\$ 56,236	\$ 91,507	\$ (1,040)	\$ 146,726
Net income	—	—	—	9,416	—	9,416
Share-based compensation	89,675	—	83	—	681	764
Balances September 30, 2019	22,463,057	23	56,319	100,923	(359)	156,906
Net income	—	—	—	20,009	—	20,009
Share-based compensation	47,222	—	433	—	359	792
Issuance of common stock	36,486	—	—	—	—	—
Topic 842 transition impact	—	—	—	1,660	—	1,660
Cash dividends	—	—	—	(6,301)	—	(6,301)
Balances September 30, 2020	22,546,765	23	56,752	116,291	—	173,066
Net income	—	—	—	20,581	—	20,581
Share-based compensation	—	—	537	—	—	537
Issuance of common stock	73,652	—	—	—	—	—
Cash dividends	—	—	—	(51,453)	—	(51,453)
Balances September 30, 2021	<u>22,620,417</u>	<u>\$ 23</u>	<u>\$ 57,289</u>	<u>\$ 85,419</u>	<u>\$ —</u>	<u>\$ 142,731</u>

See accompanying notes to consolidated financial statements.

NATURAL GROCERS BY VITAMIN COTTAGE, INC.

Notes to Consolidated Financial Statements September 30, 2021 and 2020

1. Organization

Nature of Business

Natural Grocers by Vitamin Cottage, Inc. (Natural Grocers or the holding company) and its consolidated subsidiaries (collectively, the Company) operate retail stores that specialize in natural and organic groceries and dietary supplements. The Company operates its retail stores under its trademark *Natural Grocers by Vitamin Cottage*® with 162 stores as of September 30, 2021, including 41 stores in Colorado, 25 in Texas, 14 in Oregon, 12 in Arizona, nine in Utah, eight in Kansas, seven in Missouri, six each in Iowa, New Mexico and Oklahoma, four each in Idaho, Montana and Washington, three each in Arkansas, Nebraska, Nevada and North Dakota, two in Wyoming, and one in Minnesota and Louisiana. The Company also has a bulk food repackaging facility and distribution center in Colorado. The Company had 162 and 159 stores as of September 30, 2021 and 2020, respectively.

2. Basis of Presentation and Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include all the accounts of the holding company's wholly owned subsidiaries, Vitamin Cottage Natural Food Markets, Inc. (the operating company) and Vitamin Cottage Two Ltd. Liability Company (VC2). All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Management reviews its estimates on an ongoing basis, including those related to valuation of inventories, useful lives of long-lived assets for depreciation and amortization, impairment of finite-lived intangible, long-lived assets, and goodwill, lease assumptions, allowances for self-insurance reserves, deferred tax assets and liabilities and litigation based on currently available information. Changes in facts and circumstances may result in revised estimates and actual results could differ from those estimates.

Segment Information

The Company has one reporting segment, natural and organic retail stores.

Other Comprehensive Income

The Company has no other comprehensive income.

Cash and Cash Equivalents

Cash and cash equivalents include currency on hand, demand deposits with banks, money market funds and credit and debit card transactions which typically settle within three business days. The Company considers all highly liquid investments with a remaining maturity of 90 days or less when acquired to be cash equivalents.

Accounts Receivable

Accounts receivable consists primarily of receivables from vendors for certain promotional programs, magazine advertising and other miscellaneous receivables and are presented net of any allowances for doubtful accounts. Accounts receivable also includes receivables from Landlords for tenant improvement allowances. Vendor receivable balances are generally presented on a gross basis separate from any related payable due. Allowance for doubtful accounts is calculated based on historical experience and application of the specific identification method. Allowance for doubtful accounts totaled \$0.1 million as of each of September 30, 2021 and 2020.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist primarily of investments in cash and cash equivalents. The Company's cash and cash equivalent account balances, which are held in major financial institutions, exceeded the Federal Deposit Insurance Corporation's federally insured limits by approximately \$22.6 million as of September 30, 2021.

Vendor Concentration

For the years ended September 30, 2021 and 2020, purchases from the Company's largest vendor and its subsidiaries represented approximately 67% and 66%, respectively, of all product purchases made during such periods. However, the Company believes that, if necessary, alternate vendors could supply similar products in adequate quantities to avoid material disruptions to operations.

Merchandise Inventory

Merchandise inventory consists of goods held for sale. The cost of inventory includes certain costs associated with the preparation of inventory for sale, including inventory overhead costs. Merchandise inventory is carried at the lower of cost or net realizable value. Cost is determined using the weighted average cost method.

Long-Lived Assets

Depreciable long-lived assets primarily consist of leasehold and building improvements, which are stated at historical cost less accumulated depreciation. Depreciation is provided using the straight-line method over the useful life of the relevant asset. For land improvements and leasehold and building improvements, depreciation is recorded over the shorter of the assets' useful lives or the lease terms. Maintenance, repairs and renewals that neither add to the value of the property nor appreciably prolong its life are charged to expense as incurred. Gains and losses on disposition of property and equipment are included in store expenses in the year of disposition, and primarily relate to store relocations.

The Company capitalizes interest, if applicable, as part of the historical costs of buildings and leasehold and building improvements.

Impairment of Finite-Lived Intangible and Long-Lived Assets

We assess our long-lived assets, principally property and equipment, lease right of use assets and purchased intangible assets subject to amortization, for possible impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. These events or changes primarily include a significant change in current period performance combined with a history of losses and a projection of continuing losses, or a decision to close or relocate a store. If the carrying value of such assets over their respective remaining lives is not recoverable through projected undiscounted future cash flows, impairment is recognized for any excess of the carrying value over the estimated fair value of the asset group. The fair value of the asset group is estimated based on either: (i) discounted future cash flows using a market participant's discount rate; or (ii) an appropriate third-party market appraisal or other valuation technique.

The Company considers factors such as historic and forecasted operating results, trends and future prospects, current market value, significant industry trends and other economic and regulatory factors in performing these analyses. As of September 30, 2021 and 2020, the Company had property and equipment assets of \$151.4 million and \$147.9 million, respectively, operating lease assets of \$316.4 million and \$339.2 million, respectively, finance lease assets of \$39.4 million and \$40.1 million, respectively, and purchased intangible assets subject to amortization of \$6.1 million and \$4.9 million, respectively. The Company recorded impairment charges related to long-lived assets of \$1.1 million, \$0.6 million and \$0.4 million in fiscal years 2021, 2020 and 2019, respectively.

Goodwill and Intangible Assets

Intangible assets primarily consist of goodwill and trademarks. Goodwill and the *Vitamin Cottage* trademark have indefinite lives and are not amortized; rather, they are tested for impairment at least annually. Intangible assets with definite lives are amortized over their estimated useful lives. The Company evaluates the reasonableness of the useful lives of these intangibles at least annually.

The Company's annual impairment testing of goodwill is performed as of July 1. In performing the Company's analysis of goodwill, the Company first evaluates qualitative factors, including relevant events and circumstances, to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. In January 2017, the FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment," Topic 350, "Intangibles – Goodwill and Other" (ASU 2017-04). Early adoption is permitted and the Company early adopted for the year ended September 30, 2020. The amendments in ASU 2017-04 simplify the accounting for goodwill impairment for all entities by requiring impairment charges to be based on the first step in the current two-step impairment test. An impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value should be recognized; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. As of September 30, 2021, the Company has recorded no impairment charges related to goodwill.

The Company capitalizes certain costs incurred with developing or obtaining internal-use software. Capitalized software costs are included in intangible assets in the consolidated balance sheets and are amortized over the estimated useful lives of the software. Software costs that do not meet capitalization criteria are expensed as incurred.

Deferred Financing Costs

Certain costs incurred with borrowings or establishment of credit facilities are deferred. These costs are amortized over the life of the credit facility using the straight-line method.

Leases

The Company leases retail stores, a bulk food repackaging facility and distribution center and administrative offices under long-term operating or finance leases. These leases include scheduled increases in minimum rents and renewal provisions at the option of the Company. The lease term for accounting purposes commences with the date the Company takes possession of the space and ends on the later of the primary lease term or the expiration of any renewal periods that are deemed to be reasonably assured at the inception of the lease.

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, "Leases (Topic 842)" in February 2016 and subsequently issued related ASUs in 2018 and 2019 (collectively, "ASC 842"). ASC 842 requires lessees to recognize a right-of-use asset and corresponding lease liability for all leases with terms greater than 12 months. Under ASC 842, recognition, measurement and presentation of lease expenses depend on whether the lease is classified as a finance or operating lease.

The Company adopted ASC 842 on October 1, 2019, the first day of fiscal year 2020, using the modified retrospective transition approach.

Operating Leases

Operating lease liabilities represent the present value of lease payments not yet paid. Operating lease assets represent the Company's right to use an underlying asset and are based upon the operating lease liabilities adjusted for prepayments or accrued lease payments, initial direct costs, lease incentives and impairment of operating lease assets. The rent payment pursuant to the lease agreement is recorded as a reduction in the operating lease liability and as a reduction in the right of use asset and as single lease expense over the term of the remaining lease.

Finance Leases

Finance lease liabilities represent the present value of lease payments not yet paid. Finance lease assets represent the Company's right to use an underlying asset and are based upon the lease liabilities adjusted for prepayments or accrued lease payments, initial direct costs, lease incentives and impairment of lease assets. The Company does not record single lease expense for the rental payments under finance leases, but rather payments under the finance lease obligations are recognized as a reduction of the finance lease obligation and as interest expense. The right of use asset is depreciated over the term of the related lease.

Leases –prior to adoption of ASC 842

Operating Leases

Prior to the adoption of ASC 842 in fiscal year 2020, the Company accounted for operating leases with rent holidays and escalating payment terms by recognizing the associated expense on a straight-line basis over the lease term, and the difference between the average rental amount charged to expense and amounts payable under the leases are included in deferred rent. For certain leases, the Company has received cash from landlords to compensate for costs incurred by the Company in making the store locations ready for operation (leasehold incentives). Leasehold incentives received from a landlord were deferred and recognized on a straight-line basis as a reduction to rent expense over the lease term.

Capital Financing Leases

From time to time, the Company enters into leases with developers for build-to-suit store locations. Upon lease execution, the Company analyzed its involvement during the construction period. As a result of defined forms of lessee involvement, the Company could be deemed the “owner” for accounting purposes during the construction period, and may be required to capitalize the project costs on its balance sheet. If the project costs were capitalized, the Company performed a sale-leaseback analysis upon completion of the construction to determine if the Company should remove the assets from its balance sheet. If the asset should not be removed from the balance sheet, the fair market value of the building remained recognized as an asset on the balance sheet, along with a corresponding capital lease financing obligation equal to the fair market value of the building less any amount the Company contributed towards construction. The Company did not record rent expense for the rental payments under capital financing leases, but rather payments under the capital financing lease obligations were recognized as a reduction of the capital lease financing obligation and as interest expense. The capital financing lease assets were depreciated on a straight-line basis over the estimated useful life of the asset.

Capital Leases

Occasionally, the Company entered into leases that were deemed to be capital leases. For these leases, the Company capitalized the lower of the present value of the minimum lease payments or the fair value of the leased asset at inception and recorded a corresponding capital lease obligation. The Company did not record rent expense for the rental payments under capital leases, but rather payments under the capital lease obligations were recognized as a reduction of the capital lease obligation and as interest expense. The capital lease asset was depreciated on a straight-line basis over the term of the related lease.

Self-Insurance

The Company is self-insured for certain losses relating to employee medical and dental benefits and workers compensation. Stop-loss coverage has been purchased to limit exposure to any significant level of claims. Self-insured losses are accrued based upon the Company’s estimates of the aggregate claims incurred but not reported using historical experience. The estimated accruals for these liabilities could be significantly affected if future occurrences and claims differ from historical trends.

Revenue Recognition

Revenue is recognized at the point of sale, net of in-house coupons, discounts and returns. Sales taxes are not included in sales. The Company charges sales tax on all taxable customer purchases and remits these taxes monthly to the appropriate taxing jurisdiction. The Company records a contract liability within accrued expenses when it sells the Company’s gift cards and records a sale when a customer redeems the gift card.

Cost of Goods Sold and Occupancy Costs

Cost of goods sold and occupancy costs includes the cost of inventory sold during the period net of discounts and allowances, as well as, distribution, shipping and handling costs, store occupancy costs and costs of the bulk food repackaging facility and distribution center. The amount shown is net of various rebates from third-party vendors in the form of quantity discounts and payments. Vendor consideration associated with product discounts is recorded as a reduction in the cost of the product. Store occupancy costs include rent, common area maintenance and real estate taxes. Store occupancy costs do not include any rent amounts for the store leases classified as finance leases (previously classified as capital and financing lease obligations).

Store Expenses

Store expenses consist of store-level expenses such as salaries, benefits and share-based compensation, supplies, utilities, depreciation, gain or loss on disposal of assets, long-lived asset impairment charges, store closing costs and other related expenses associated with operations support. Store expenses also include purchasing support services and advertising and marketing costs.

Administrative Expenses

Administrative expenses consist of salaries, benefits and share-based compensation, occupancy costs, depreciation, office supplies, hardware and software expenses, professional services expenses and other general and administrative expenses.

Pre-Opening Expenses

Costs associated with the opening of new stores or relocating/remodeling existing stores are expensed as incurred.

Advertising and Marketing

Advertising and marketing costs are expensed as incurred and are included in store expenses and pre-opening expenses in the consolidated statements of income. Total advertising and marketing expenses for the years ended September 30, 2021, 2020 and 2019 were \$6.3 million, \$6.6 million and \$8.2 million, respectively, net of vendor reimbursements of \$5.4 million, \$4.5 million and \$4.6 million for the years ended September 30, 2021, 2020 and 2019, respectively.

Share-Based Compensation

The Company adopted the 2012 Omnibus Incentive Plan in connection with its initial public offering on July 25, 2012. Restricted stock units are granted at the market price of the Company's common stock on the date of grant and expensed over the applicable vesting period.

The excess tax benefits for recognized compensation costs are reported as a credit to income tax expense and as operating cash outflows when such excess tax benefits are realized by a reduction to current taxes payable.

Income Taxes

The Company accounts for income taxes using the asset and liability method. This method requires recognition of deferred tax assets and liabilities for expected future tax consequences of temporary differences that currently exist between the tax basis and financial reporting basis of the Company's assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates in the respective jurisdictions in which the Company operates.

The Company considers the need to establish valuation allowances to reduce deferred income tax assets to the amounts the Company believes are more likely than not to be recovered.

The Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. Although the Company believes that its estimates are reasonable, actual results could differ from these estimates. In addition, the Company is subject to periodic audits and examinations by the Internal Revenue Service (IRS) and other state and local taxing authorities.

Any interest or penalties incurred related to income taxes are expensed as incurred and treated as permanent differences for tax purposes.

U.S. Tax Reform

On March 27, 2020, the Coronavirus Aid, Relief and Economic Security Act (the CARES Act) was signed into law. Intended to provide economic relief to those impacted by the COVID-19 pandemic, the CARES Act, among other things, includes provisions addressing the carryback of net operating losses for specific periods, temporary modifications to the limitations placed on the tax deductibility of net interest expenses, and technical amendments for qualified improvement property (QIP).

As a result of the technical amendments made by the CARES Act to QIP, the Company accelerated tax depreciation expenses of approximately \$9.3 million for the year ended September 30, 2019, representing primarily temporary book-to-tax timing differences for income tax purposes. The impacts of the CARES Act are recorded as components within the Company's deferred income tax liabilities and income tax receivable on the Company's consolidated balance sheets.

Recently Adopted Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, "Leases (Topic 842)" in February 2016 and subsequently issued related ASUs in 2018 and 2019 (collectively, "ASC 842"). ASC 842 requires lessees to recognize a right-of-use asset and corresponding lease liability for all leases with terms greater than 12 months. Under ASC 842, recognition, measurement and presentation of lease expenses depend on whether the lease is classified as a finance or operating lease.

The Company adopted ASC 842 on October 1, 2019, the first day of fiscal year 2020, using the modified retrospective transition approach. In addition, the Company elected the package of practical expedients permitted under the transition guidance within the new standard, which, among other things, permits companies not to reassess prior conclusions on lease identification, lease classification and initial direct costs. The Company did not elect the hindsight practical expedient.

The adoption of ASC 842 resulted in the recognition of operating lease assets and operating lease liabilities of \$359.6 million and \$377.8 million, respectively, as of October 1, 2019. Included in the measurement of the new lease assets is the reclassification of certain balances, including those historically recorded as deferred rent and leasehold incentives.

Additionally, the Company recognized a cumulative effect adjustment, which increased retained earnings by \$1.7 million for the year ended September 30, 2020. This adjustment was primarily driven by the derecognition of \$41.9 million of lease obligations and \$40.2 million of net assets related to leases that had been classified as capital financing lease obligations under the former failed-sale leaseback guidance. These leases were reclassified as operating or finance leases as of October 1, 2019, the transition date. See Note 11 for additional information related to the Company's lease accounting policy.

In June 2018, the FASB issued ASU 2018-07, "Compensation-Stock Compensation," Topic 718, "Improvements to Non-employee Share-Based Payment Accounting" (ASU 2018-07) as part of its Simplification Initiative to reduce complexity when accounting for share-based payments to non-employees. ASU 2018-07 expands the scope of Topic 718 to more closely align share-based payment transactions for acquiring goods and services from non-employees with the accounting for share-based payments to employees, with certain exceptions. The provisions of ASU 2018-07 were effective for the Company's first quarter of the fiscal year ending September 30, 2020, with early adoption permitted. The adoption of this ASU did not have an impact on the Company's consolidated financial statements for the year ended September 30, 2020.

In January 2017, the FASB issued ASU 2017-04, "Simplifying the Test for Goodwill Impairment," Topic 350, "Intangibles – Goodwill and Other" (ASU 2017-04). The amendments in ASU 2017-04 simplify the accounting for goodwill impairment for all entities by requiring impairment charges to be based on the first step in the current two-step impairment test. An impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value should be recognized; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments should be applied on a prospective basis. ASU 2019-10 delayed the effective date of this ASU to align with the effective date of ASU 2016-13 (referred to above). Because the Company is a smaller reporting company, the provisions of ASU 2017-04 will be effective for the Company's first quarter of the fiscal year ending September 30, 2024. Early adoption is permitted and the Company early adopted for the year ended September 30, 2020. ASU 2017-04 did not have an impact on the Company's consolidated financial statements for the year ended September 30, 2020.

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, "Revenue from Contracts with Customers," Topic 606, "Revenue from Contracts with Customers" (ASU 2014-09). ASU 2014-09 provides guidance for revenue recognition and replaced most existing revenue recognition guidance in GAAP. ASU 2014-09's core principle is that a company recognizes revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled for the transfer of those goods or services. The Company adopted this ASU and related amendments on October 1, 2018, using the modified retrospective approach. Additionally, upon adoption of this ASU, the Company elected the following practical expedients:

- ASU 2016-09, pursuant to which the incremental costs of obtaining a contract are recognized as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.
- ASU 2016-12, pursuant to which sales taxes and other similar taxes collected from customers are presented net of sales.
- ASU 2016-20, pursuant to which the transaction price allocated to performance obligations is not disclosed when the related contract has a duration of one year or less.

The adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements for the year ended September 30, 2019.

Recent Accounting Pronouncements

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments - Credit Losses," Topic 326, "Measurement of Credit Losses on Financial Instruments" (ASU 2016-13), subsequently amended by various standard updates. ASU 2016-13 replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information when determining credit loss estimates. ASU 2016-13 also requires financial assets to be measured net of expected credit losses at the time of initial recognition. ASU 2019-10, issued in November 2019, delayed the effective date of ASU 2016-13 for smaller reporting companies such as the Company. The provisions of ASU 2016-13 will be effective for the Company's first quarter of the fiscal year ending September 30, 2024. Early adoption is permitted. The Company is currently evaluating the impact that the adoption of these provisions will have on its consolidated financial statements.

In December 2019, the FASB issued ASU 2019-12, "Income Taxes," Topic 740, "Simplifying the Accounting for Income Taxes" (ASU 2019-12). The new guidance simplifies the accounting for income taxes by removing certain exceptions to the general principles and also simplifies areas such as franchise taxes, step-up in tax basis goodwill, separate entity financial statements and interim recognition of enactment of tax laws or rate changes. The provisions of ASU 2019-12 will be effective for the Company's first quarter of the fiscal year ending September 30, 2022 with early adoption permitted. The Company does not anticipate that the adoption of these provisions will have a material impact on its consolidated financial statements.

In March 2020, the FASB issued ASU 2020-04, "Reference Rate Reform," Topic 848, "Facilitation of the Effects of Reference Rate Reform on Financial Reporting" (ASU 2020-04). The new guidance provides optional expedients and exceptions for applying GAAP to contracts, hedging relationships and other transactions affected by reference rate reform if certain criteria are met. The guidance applies only to contracts, hedging relationships and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform. The interest rate currently payable under the Company's Credit Facility is based on LIBOR, but recent amendments provide for a LIBOR successor rate once LIBOR is discontinued. The amendments in this update only apply to modifications made prior to December 31, 2022. The Company does not anticipate that this ASU will have a material impact on its consolidated financial statements.

3. Revenue Recognition

The nature of the goods the Company transfers to customers at the point of sale consists of merchandise purchased for resale. In these transactions, the Company acts as a principal and recognizes revenue (net sales) from the sale of goods when control of the promised goods is transferred to the customer. Control refers to the ability of the customer to direct the use of, and obtain substantially all the remaining benefits from, the transferred goods.

The Company's performance obligations are satisfied upon the transfer of goods to the customer (at the point of sale), and payment from the customer is also due at that time. Transaction prices are considered fixed. Discounts provided to customers at the point of sale are recognized as a reduction in revenue as the goods are sold. Revenue excludes sales and usage-based taxes collected.

Proceeds from the sales of the Company's gift cards are recorded as a liability at the time of sale and recognized as revenue when the gift cards are redeemed by the customer and the performance obligation is satisfied by the Company.

As of each September 30, 2021 and September 30, 2020, the balance of contract liabilities related to unredeemed gift cards was \$1.5 million and \$1.3 million, respectively. Revenue for the fiscal year ended September 30, 2021 includes \$0.7 million that was included in the contract liability balance of unredeemed gift cards at September 30, 2020.

The following table disaggregates the Company's revenue by product category for the fiscal years ended September 30, 2021, 2020 and 2019, dollars in thousands:

	Year ended September 30,					
	2021		2020		2019	
Grocery	\$ 731,894	69%	720,185	69	619,825	69
Dietary supplements	220,000	21	213,182	21	188,913	21
Body care, pet care and other	103,622	10	103,475	10	94,844	10
	<u>\$ 1,055,516</u>	<u>100%</u>	<u>1,036,842</u>	<u>100</u>	<u>903,582</u>	<u>100</u>

4. Earnings Per Share

Basic earnings per share excludes dilution and is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if the Company's granted but unvested restricted stock units were to vest, resulting in the issuance of common stock that would then share in the earnings of the Company. The following table presents the Company's basic and diluted earnings per share for the years ended September 30, 2021, 2020 and 2019, dollars in thousands, except per share data:

	Year ended September 30,		
	2021	2020	2019
Net income	\$ 20,581	20,009	9,416
Weighted average number of shares of common stock outstanding	22,591,816	22,501,779	22,424,328
Effect of dilutive securities	119,187	75,867	130,275
Weighted average number of shares of common stock outstanding including the effect of dilutive securities	<u>22,711,003</u>	<u>22,577,646</u>	<u>22,554,603</u>
Basic earnings per share	\$ 0.91	0.89	0.42
Diluted earnings per share	\$ 0.91	0.89	0.42

There were 166,362, 94,497 and 56,510 non-vested restricted stock units for the years ended September 30, 2021, 2020 and 2019, respectively, excluded from the calculation as they are antidilutive.

The Company paid a quarterly cash dividend of \$0.07 per share of common stock in each quarter of fiscal year 2021 and 2020. The Company paid a special cash dividend of \$2.00 per share of common stock in December 2020. The Company did not declare or pay any dividends in the year ended September 30, 2019.

As of September 30, 2021, the Company had 50,000,000 shares of common stock authorized, of which 22,620,417 shares were issued and outstanding, as well as 10,000,000 shares of preferred common stock authorized, of which none was issued and outstanding.

5. Fair Value Measurements

The Company records its financial assets and liabilities at fair value in accordance with the framework for measuring fair value. The framework establishes a fair value hierarchy that distinguishes between assumptions based on market data (observable inputs) and market participant's assumptions (unobservable inputs). Non-financial assets, such as goodwill and long-lived assets, are accounted for at fair value on a non-recurring basis. These items are tested for impairment on the occurrence of a triggering event or, in the case of goodwill, at least on an annual basis.

During fiscal year 2021, long-lived assets, including Right of Use Assets, with a carrying value of \$3.3 million were written down to their fair value of \$2.1 million, resulting in asset impairment charges of \$1.1 million. During fiscal year 2020, long-lived assets with a carrying value of \$1.1 million were written down to their fair value of \$0.5 million, resulting in asset impairment charges of \$0.6 million. During fiscal year 2019, long-lived assets with a carrying value of \$0.8 million were written down to their fair value of \$0.4 million, resulting in asset impairment charges of \$0.4 million. The carrying amounts of the Company's financial assets and liabilities, including cash and cash equivalents, accounts receivable, accounts payable and other accrued expenses, approximate fair value because of the short maturity of those assets and liabilities.

6. Property and Equipment

The Company had the following property and equipment balances as of September 30, 2021 and 2020, dollars in thousands:

	Useful lives (in years)	As of September 30,	
		2021	2020
Construction in process	n/a	\$ 2,268	6,717
Land	n/a	6,062	1,390
Buildings	16 - 40	34,531	26,732
Land improvements	1 - 24	1,782	1,575
Leasehold and building improvements	1 - 25	159,800	153,438
Fixtures and equipment	5 - 7	145,754	139,965
Computer hardware and software	3 - 5	25,068	23,628
		375,265	353,445
Less accumulated depreciation and amortization		(223,866)	(205,516)
Property and equipment, net		\$ 151,399	147,929

Total costs capitalized for qualifying construction projects of leasehold and building improvements included \$0.5 million and \$0.4 million the years ended September 30, 2021 and 2020, respectively, related to internal staff compensation. Depreciation expense related to capitalized internal staff compensation was \$0.6 million for each of the years ended September 30, 2021, 2020, and 2019. Interest costs of \$0.2 million, \$0.1 million and \$0.3 million were capitalized for the years ended September 30, 2021, 2020 and 2019, respectively.

Depreciation and amortization expense for the years ended September 30, 2021, 2020 and 2019 is summarized as follows, dollars in thousands:

	Year ended September 30,		
	2021	2020	2019
Depreciation and amortization expense included in cost of goods sold and occupancy costs	\$ 873	793	736
Depreciation and amortization expense included in store expenses	27,542	29,225	27,150
Depreciation and amortization expense included in administrative expenses	1,218	1,175	1,091
Total depreciation and amortization expenses	\$ 29,633	31,193	28,977

7. Impairment of Long-Lived Assets

Long-lived assets, such as property and equipment, lease right of use assets and purchased intangible assets subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. The Company assesses the recoverability of the assets at an individual store level which we consider to be the lowest level in the organization for which independent identifiable cash flows are available. If the carrying value of such assets over their respective remaining lives is not recoverable through projected undiscounted future cash flows, impairment is recognized. The amount of impairment is measured based on projected discounted future cash flows using a market participant's discount rate. The Company considers factors such as historic and forecasted operating results, trends and future prospects, current market value, significant industry trends and other economic and regulatory factors in performing these analyses.

As of September 30, 2021 and 2020, the Company had property and equipment assets of \$151.4 million and \$147.9, respectively, and lease right-of-use assets of \$355.8 million and \$379.3, respectively. In the fourth quarter of fiscal years 2021 and 2020, the Company concluded, as a result of its review of potential long-lived asset impairment, that certain long-lived assets were impaired. The Company recorded impairments of \$1.1 million, \$0.6 million and \$0.4 million for the years ended September 30, 2021, 2020 and 2019, respectively. Such charges are reflected within store expenses on the consolidated statement of income for the years ended September 30, 2021 and 2020.

8. Goodwill and Other Intangible Assets

Goodwill and other intangible assets as of September 30, 2021 and 2020, are summarized as follows, dollars in thousands:

	Useful lives (in years)	As of September 30,	
		2021	2020
Amortizable intangible assets:			
Other intangibles	0.5 - 3	\$ 3,754	3,634
Less accumulated amortization		(3,139)	(2,378)
Amortizable intangible assets, net		615	1,256
Other intangibles in process		5,507	3,625
Trademark	Indefinite	389	389
Deferred financing costs, net ⁽¹⁾		59	31
Total other intangibles, net		6,570	5,301
Goodwill	Indefinite	5,198	5,198
Total goodwill and other intangibles, net		\$ 11,768	10,499

⁽¹⁾ Certain prior year amounts have been reclassified for consistency with current year presentation.

Amortization expense was \$0.8, \$0.8 and \$0.5 million for the years ended September 30, 2021, 2020 and 2019, respectively.

Capitalized costs for internal-use software development were \$2.0 million and \$2.6 million for the years ended September 30, 2021 and 2020, respectively, primarily due to capitalization of expenses related to external consultants.

9. Accrued Expenses

The composition of accrued expenses as of September 30, 2021 and 2020, is summarized as follows, dollars in thousands:

	As of September 30,	
	2021	2020
Payroll and employee-related expenses	\$ 13,243	13,569
Accrued property, sales and use tax payable	8,322	7,912
Accrued marketing expenses	713	407
Deferred revenue related to gift card sales	2,157	1,819
Other	2,154	1,288
Total accrued expenses	\$ 26,589	24,995

10. Long-Term Debt

Credit Facility

The Company is a party to a Credit Facility, entered into on January 28, 2016 and subsequently amended, consisting of a \$50.0 million revolving loan facility (the Revolving Facility) and a \$35.0 million term loan facility (the Term Loan Facility, and together with the Revolving Facility, the Credit Facility). The operating company is the borrower under the Credit Facility and its obligations under the Credit Facility are guaranteed by the holding company and VC2. The Credit Facility is secured by a lien on substantially all of the Company's assets. The revolving commitment amount under the Revolving Facility is \$50.0 million, including a \$5.0 million sublimit for standby letters of credit. The Company has the right to borrow, prepay and re-borrow amounts under the Revolving Facility at any time prior to the maturity date without premium or penalty. The Credit Facility matures on November 13, 2024. Base rate loans under the Credit Facility bear interest at a fluctuating base rate, as determined by the lenders' administrative agent based on the most recent compliance certificate of the operating company and stated at the highest of (i) the federal funds rate plus 0.50%, (ii) the prime rate, and (iii) the Eurodollar rate plus 1.00%, less the lender spread based upon the Company's consolidated leverage ratio. Eurodollar rate borrowings under the Credit Facility bear interest based on the London Interbank Offered Rate, or its successor (LIBOR), for the interest period plus the lender spread based upon the Company's consolidated leverage ratio. The unused commitment fee is based upon the Company's consolidated leverage ratio. The Company will repay principal amounts outstanding under the Term Loan Facility in equal installments of approximately \$0.4 million on the last day of each fiscal quarter, beginning on March 31, 2021 and ending on September 30, 2024, with the remaining principal amount payable on the maturity date. Amounts repaid on the Term Loan Facility may not be reborrowed.

The Credit Facility requires compliance with certain customary operational and financial covenants, including a leverage ratio. The Credit Facility also contains certain other customary limitations on the Company's ability to incur additional debt, guarantee other obligations, grant liens on assets and make investments or acquisitions, among other limitations. Additionally, the Credit Facility prohibits the payment of cash dividends to the holding company from the operating company without the administrative agent's consent, provided that so long as no default or event of default exists or would arise as a result thereof, the operating company may pay cash dividends to the holding company in an amount sufficient to allow the holding company to:

(i) pay various audit, accounting, tax, securities, indemnification, reimbursement, insurance and other reasonable expenses incurred in the ordinary course of business and (ii) repurchase shares of common stock and pay dividends on the Company's common stock in an aggregate amount not to exceed \$10.0 million during any fiscal year.

The Company had no amounts outstanding under the Revolving Facility as of September 30, 2021 and 2020. The Company had \$23.7 million of outstanding borrowings under the Term Loan Facility as of September 30, 2021. As of September 30, 2021 and September 30, 2020, the Company had undrawn, issued and outstanding letters of credit of \$1.0 million and \$1.3 million, respectively, which were reserved against the amount available for borrowing under the terms of the Revolving Facility. The Company had \$49.0 million and \$48.7 million available for borrowing under the Revolving Facility as of September 30, 2021 and September 30, 2020, respectively.

On November 13, 2019, the Company amended the Credit Facility to extend the maturity date to November 13, 2024 and permit the operating company to pay cash dividends to Natural Grocers in an amount sufficient to allow Natural Grocers to repurchase shares of common stock and pay dividends on its common stock in an aggregate amount not to exceed \$10.0 million during any fiscal year. On November 18, 2020, the Company entered into the Fourth Amendment to the Credit Facility to provide for the Term Loan Facility and to permit payment of a one-time dividend of up to \$50.0 million no later than December 31, 2020.

Lease Obligations

The Company had 20 and 19 leases that were classified as finance leases as of September 30, 2021 and 2020, respectively. No rent expense is recorded for these finance leases; rather, rental payments under such leases are recognized as a reduction of the lease obligation and as interest expense. The interest rate on finance lease obligations is determined at the inception of the lease.

Interest

The Company incurred gross interest expense of \$2.5 million, \$2.2 million and \$5.2 million in the years ended September 30, 2021, 2020 and 2019, respectively. Interest expense for the year ended September 30, 2021 and 2020 relates primarily to interest on finance lease obligations. Interest expense for the years ended September 30, 2019 relates primarily to interest on capital and financing lease obligations. The Company capitalized interest of \$0.2 million, \$0.1 million and \$0.3 million for the years ended September 30, 2021, 2020 and 2019, respectively.

11. Lease Commitments

The Company leases most of its stores, a bulk food repackaging facility and distribution center and its administrative offices. The Company determines if an arrangement is a lease or contains a lease at inception. Lease terms generally range from 10 to 25 years, with scheduled increases in minimum rent payments.

The FASB issued ASU 2016-02, "Leases (Topic 842)" in February 2016 and subsequently issued related ASUs in 2018 and 2019 (collectively, "ASC 842"). ASC 842 requires lessees to recognize a right-of-use asset and corresponding lease liability for all leases with terms greater than 12 months. Under ASC 842, recognition, measurement and presentation of lease expenses depend on whether the lease is classified as a finance or operating lease. The Company adopted ASC 842 on October 1, 2019, the first day of fiscal year 2020, using the modified retrospective transition approach.

Operating lease liabilities represent the present value of lease payments not yet paid. Operating lease assets represent the Company's right to use an underlying asset and are based upon the operating lease liabilities adjusted for prepayments or accrued lease payments, initial direct costs, lease incentives and impairment of operating lease assets.

Most leases include one or more options to renew, with renewal terms normally expressed in periods of five-year increments. The exercise of lease renewal options is at the Company's sole discretion. The lease term includes the initial contractual term as well as any options to extend the lease when it is reasonably certain that the Company will exercise that option.

Variable payments related to pass-through costs for maintenance, taxes and insurance or adjustments based on an index such as Consumer Price Index are not included in the measurement of the lease liability or asset and are expensed as incurred.

As most of the Company's lease agreements do not provide an implicit discount rate, the Company uses an estimated incremental borrowing rate, which is derived from third-party lenders, to determine the present value of lease payments. We use other observable market data to evaluate the appropriateness of the rate derived from the lenders. The estimated incremental borrowing rate is based on the borrowing rate for a secured loan with a term similar to the expected term of the lease.

Leases are recorded at the commencement date (the date the underlying asset becomes available for use) for the present value of lease payments, less tenant improvement allowances received or receivable. Leases with a term of 12 months or less (short-term leases) are not presented on the balance sheet. The Company's short-term leases relate primarily to embedded leases. The Company has elected to account for the lease and non-lease components as a single lease component for all current classes of leases.

The Company's lease agreements do not contain any material residual value guarantees or material restrictive covenants. The Company subleases certain real estate or portions thereof to third parties. Such subleases have all been classified as operating leases. Remaining lease terms extend through fiscal year 2030. Although some sublease arrangements provide renewal options, the exercise of sublease renewal options is at the sole discretion of the subtenant. The Company recognizes sublease income on a straight-line basis.

The Company has four operating leases and one finance lease with Chalet Properties, LLC (Chalet), one operating lease with the Isely Family Land Trust LLC (Land Trust) and one operating lease with FTVC, LLC, each of which is a related party (see Note 14). The leases began at various times with the earliest commencing in November 1999, continue for various terms through July 2040 and include various options to renew. The terms and rental rates of these leases are similar to leases that would be entered into with nonrelated parties and are at prevailing market rental rates. These leases account for \$7.6 million of right-of-use assets and \$7.9 million of lease liabilities included in the disclosures below. Cash rent paid pursuant to the related party leases was \$1.3 million, \$1.3 million and \$1.5 million for the years ended September 30, 2021, 2020 and 2019, respectively.

The components of total lease cost for the year ended September 30, 2021 and 2020 are as follows, dollars in thousands:

Lease cost	Classification	Year ended September 30,	
		2021	2020
Operating lease cost:			
	Cost of goods sold and occupancy costs	\$ 42,652	42,634
	Store expenses	319	319
	Administrative expenses	305	311
	Pre-opening expenses	233	154
Finance lease cost:			
Depreciation of right-of-use assets	Store expenses ⁽¹⁾	3,686	3,139
Interest on lease liabilities	Interest expense, net ⁽¹⁾	1,953	1,698
Short-term lease cost	Store expenses	326	2,016
Variable lease cost	Cost of goods sold and occupancy costs ⁽²⁾	5,611	5,367
Sublease income	Store expenses	(313)	(368)
Total lease cost		\$ 54,772	55,270

1 Immaterial balances related to stores not yet open are included in pre-opening expenses.

2 Immaterial balances related to the corporate headquarters and distribution center are included in administrative expenses and store expenses, respectively.

Additional information related to the Company's leases for the year ended September 30, 2021 and 2020 are as follows, dollars in thousands:

	Year ended September 30,	
	2021	2020
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 44,473	44,281
Operating cash flows from finance leases	1,976	1,792
Financing cash flows from finance leases	2,823	2,271
Right-of-use assets obtained in exchange for new lease liabilities:		
Operating leases	9,216	13,204
Finance leases	3,025	11,625

Additional information related to the Company's leases as of September 30, 2021 and 2020 were as follows:

	September 30,	
	2021	2020
Weighted-average remaining lease term (in years):		
Operating leases	11.1	11.7
Finance leases	11.9	12.5
Weighted-average discount rate:		
Operating leases	3.6%	3.6
Finance leases	5.0%	5.1

In addition, during the year ended September 30, 2020, the Company purchased one store building that had previously been leased. This resulted in: (i) a \$2.5 million reduction in operating lease liability and (ii) the reclassification of \$2.4 million of corresponding operating right-of-use asset to property and equipment.

Future lease payments under non-cancellable leases as of September 30, 2021 were as follows, dollars in thousands:

Fiscal Year	Operating leases	Finance leases	Total
2022	\$ 44,717	5,080	49,797
2023	43,946	5,176	49,122
2024	42,120	5,242	47,362
2025	40,417	5,252	45,669
2026	37,202	5,295	42,497
Thereafter	201,831	30,157	231,988
Total future undiscounted lease payments	410,233	56,202	466,435
Less imputed interest	(75,030)	(13,576)	(88,606)
Total reported lease liability	335,203	42,626	377,829
Less current portion	(33,308)	(3,176)	(36,484)
Noncurrent lease liability	\$ 301,895	39,450	341,345

The table above excludes \$28.2 million of legally binding minimum lease payments for leases that had been executed as of September 30, 2021 but whose terms had not yet commenced.

Future minimum rental commitments and sublease rental income under the terms of the Company's operating and finance leases were as follows as of September 30, 2021, dollars in thousands:

Fiscal Year	Third parties	Related parties	Sublease rental income	Total leases
2022	\$ 48,457	1,341	(353)	49,445
2023	47,781	1,341	(343)	48,779
2024	46,021	1,341	(275)	47,087
2025	44,323	1,346	(274)	45,395
2026	41,428	1,069	(273)	42,224
Thereafter	229,303	2,684	(339)	231,648
Total payments	\$ 457,313	9,122	(1,857)	464,578

Future minimum rental commitments under the terms of the Company's related party leases include \$3.4 million pursuant to a finance lease and \$5.7 million pursuant to operating leases as of September 30, 2021.

Prior to the Company's adoption of ASC 842 as of October 1, 2019, the Company's leases were designated as either capital, financing or operating. Consistent with the guidance provided in ASC 842, previously designated capital lease obligations are now classified as finance leases, while previously designated capital lease finance obligations have been derecognized and reclassified as operating or finance leases. The designation of operating leases remains substantially unchanged under ASC 842.

Total rent expense, including common area expenses and warehouse rent, for the years ended September 30, 2021, 2020, and 2019 totaled \$55.3 million, \$54.6 million and \$51.6 million, respectively, which is included in cost of goods sold and occupancy costs and administrative expenses in the consolidated statements of income. In addition, \$0.2 million, \$0.2 million and \$0.3 million is included in pre-opening expense associated with rent expense for stores prior to their opening date for the years ended September 30, 2021, 2020 and 2019, respectively.

12. Share-Based Compensation

The Company adopted the 2012 Omnibus Incentive Plan (as amended, the Plan) on July 17, 2012. Restricted stock unit awards granted pursuant to the Plan, if they vest, will be settled in new shares of the Company's common stock or shares of common stock held in treasury. At the adoption of the Plan, there were 1,090,151 shares of common stock available for issuance or delivery under the Plan. In March 2019, the Company's stockholders approved a proposal to amend the Plan to: (i) increase the number of shares of common stock reserved for issuance thereunder by 600,000 shares and (ii) extend its term by five years. As of September 30, 2021, 407,746 shares of common stock remain available for grants under the Plan. The Plan provides for awards of options, stock appreciation rights, stock grants, restricted stock units, other share-based awards and cash-based incentive awards to officers, members of the Board and certain employees who are not named executive officers and consultants. As of September 30, 2021, restricted stock units had been granted under the Plan, at no out-of-pocket cost to officers, Board members and key employees. These restricted stock units vest subject to requisite service requirements, immediately in part or annually in installments over a one-to-five-year period. The award recipients are not entitled to cash dividends or to vote with regard to non-vested restricted stock units, and the units are subject to forfeiture during the vesting period. Restricted stock units are granted at the market price of the Company's stock on the date of grant and are expensed on a straight-line basis over the vesting period.

The shares of non-vested restricted stock units as of September 30, 2021 were as follows:

	Shares	Weighted average grant date fair value
Non-vested as of September 30, 2019	316,356	\$ 10.18
Granted	124,239	8.93
Forfeited	(40,052)	10.53
Vested	(115,286)	11.22
Non-vested as of September 30, 2020	285,257	9.17
Granted	225,660	11.22
Forfeited	(22,974)	8.87
Vested	(99,804)	9.18
Non-vested as of September 30, 2021	388,139	10.38

During the year ended September 30, 2021, the Company awarded stock grants totaling 4,000 shares of the Company's common stock to 40 employees who were not named executive officers. Such shares were fully vested on the grant date.

Share-based compensation expense for restricted stock unit awards to certain employees who are not named executive officers was \$0.5 million, \$0.8 million and \$0.8 million for the years ended September 30, 2021, 2020 and 2019, respectively. Share-based compensation expense for restricted stock unit awards to one named executive officer was \$0.2 million, \$0.2 million and \$0.2 million for the years ended September 30, 2021, 2020 and 2019, respectively.

Each independent member of the Board receives an annual grant of restricted stock units equal to \$60,000 (based on the closing price of common stock on the New York Stock Exchange on the date of grant). Such grants are made each year on the date of the Company's annual meeting of stockholders, or on a pro rata basis in the case of a mid-year appointment. Share-based compensation expense for the Company's awards to its Board members was \$0.2 million for each of the years ended September 30, 2021, 2020 and 2019.

The Company recorded total share-based compensation expense before income taxes of \$0.9 million, \$1.1 million and \$1.2 million in the years ended September 30, 2021, 2020 and 2019, respectively. The share-based compensation expense is included in cost of goods sold and occupancy costs, store expenses or administrative expenses in the consolidated statements of income consistent with the manner in which the applicable officer, Board member or key employee's compensation expense is presented. The Company realized a tax benefit from share-based compensation of \$0.1 million in the year ended September 30, 2021, and did not realize a tax benefit from share-based compensation expense in the years ended September 30, 2020 and 2019.

As of September 30, 2021, there was \$2.5 million of unrecognized share-based compensation expense related to non-vested restricted stock units, net of estimated forfeitures, which the Company anticipates will be recognized over a weighted average period of approximately three years.

13. Stockholders' Equity

Share Repurchases

In May 2016, the Board of Directors (the Board) authorized a two-year share repurchase program pursuant to which the Company may repurchase up to \$10.0 million in shares of the Company's common stock. The Board subsequently extended the share repurchase program, which will terminate on May 31, 2022. Repurchases under the Company's share repurchase program may be made from time to time at management's discretion on the open market or through privately negotiated transactions in compliance with Rule 10b-18 under the Securities Exchange Act of 1934, as amended (the Exchange Act), subject to market conditions, applicable legal requirements and other relevant factors. Repurchases of common stock may also be made under a Rule 10b5-1 plan, which permits common stock to be repurchased when the Company might otherwise be precluded from doing so under insider trading laws. The share repurchase program does not obligate the Company to purchase any particular amount of common stock and may be suspended, modified or discontinued by the Company without prior notice.

The Company did not repurchase any shares during the years ended September 30, 2021 and 2020. The dollar value of the shares of the Company's common stock that may yet be repurchased under the share repurchase program is \$8.3 million.

During fiscal year 2021, the Company reissued no treasury shares. During fiscal year 2020, the Company reissued 47,222 treasury shares at a cost of \$0.4 million to satisfy the issuance of common stock pursuant to the vesting of certain restricted stock unit awards and the award of stock grants. At September 30, 2021 and 2020 the Company held no shares in treasury.

14. Related Party Transactions

The Company has ongoing relationships with related parties as noted:

Chalet Properties, LLC: The Company has four operating leases and one finance lease (see Note 11) with Chalet. Chalet is owned by the Company's four non-independent Board members, Kemper Isely, Zephyr Isely, Heather Isely and Elizabeth Isely, and other family members. Rent paid to Chalet was \$1.0 million for the year ended September 30, 2021 and 2020, and \$1.2 million for the year ended September 30, 2019.

Isely Family Land Trust LLC: The Company has one operating lease (see Note 11) with Land Trust. The Land Trust is owned by the Isely Children's Trust and by the Margaret A. Isely Family Trust. Rent paid to the Land Trust was \$0.3 million for each of the years ended September 30, 2021, 2020 and 2019.

FTVC LLC: The Company has one operating lease (see Note 11) for a store location with FTVC LLC, which is owned by the Company's four non-independent Board members and other related family members. Rent paid to FTVC LLC was less than \$0.1 million for each of the years ended September 30, 2021, 2020 and 2019.

15. Income Taxes

The following are the components of the provision for income taxes as of September 30, 2021, 2020 and 2019, respectively, dollars in thousands:

	Year ended September 30,		
	2021	2020	2019
Current federal income tax expense (benefit)	\$ 3,859	1,317	(1,981)
Current state income tax expense	752	633	406
Total current income tax expense (benefit)	4,611	1,950	(1,575)
Deferred federal income tax expense	836	3,157	3,760
Deferred state income tax expense	28	585	213
Total deferred income tax expense	864	3,742	3,973
Total provision for income taxes	\$ 5,475	5,692	2,398

The differences between the United States federal statutory income tax rate and the Company's effective tax rate are as follows:

	Year ended September 30,		
	2021	2020	2019
Statutory tax rate	21.0%	21.0	21.0
State income taxes, net of federal income tax expense	3.6	4.0	3.7
Enhanced food deduction	(0.5)	(0.6)	(1.3)
Deferred tax liability adjustment	0.8	(0.3)	(0.5)
Other, net	(3.9)	(2.0)	(2.6)
Effective tax rate	21.0%	22.1	20.3

The Company's effective tax rate was 21.0% in the year ended September 30, 2021 compared to 22.1% in the year ended September 30, 2020. The Company's effective tax rate increased from 20.3% in the year ended September 30, 2019 to 22.1% in the year ended September 30, 2020 primarily due to a cost segregation study performed resulting in a tax benefit of approximately \$0.5 million for the year ended September 30, 2019. The Company had a similar tax benefit as a result of the accelerated depreciation allowed under the CARES Act related to Qualified Improvement Property for the year ended September 30, 2020. However, due to higher pre-tax income in the year ended September 30, 2020, this resulted in a lower impact on the effective rate.

Deferred taxes have been classified on the consolidated balance sheets as follows, dollars in thousands:

	As of September 30,	
	2021	2020
Long-term assets	\$ —	—
Long-term liabilities	(15,293)	(14,429)
Net deferred tax liabilities	\$ (15,293)	(14,429)

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities are as follows, dollars in thousands:

	As of September 30,	
	2021	2020
Deferred tax assets		
Goodwill	\$ 238	475
Trademarks	613	623
Finance lease obligations	10,443	10,453
Operating lease obligations	82,119	87,947
Accrued paid time off	682	771
Other	649	821
Gross deferred tax assets	<u>94,744</u>	<u>101,090</u>
Deferred tax liabilities		
Property and equipment	(20,477)	(19,929)
Finance lease assets	(9,645)	(9,855)
Operating lease assets	(77,867)	(83,508)
Leasehold improvements	(1,652)	(1,900)
Subleases	—	(99)
Other	(396)	(228)
Gross deferred tax liabilities	<u>(110,037)</u>	<u>(115,519)</u>
Net deferred tax liabilities	<u>\$ (15,293)</u>	<u>(14,429)</u>

The Company believes that it is more likely than not that it will fully realize all deferred tax assets in the form of future deductions based on the nature of the deductible temporary differences and expected future taxable income.

The Company did not utilize federal income tax carryforwards or federal tax credit carryforwards in the year ended September 30, 2021. The Company utilized approximately \$0.2 million in tax effected federal income tax carryforwards and approximately \$0.4 million in federal tax credit carryforwards in the year ended September 30, 2020. The Company utilized less than \$0.1 million in tax effected state income tax carryforwards in the years ended September 30, 2021 and 2020.

The Company did not have any uncertain tax positions as of September 30, 2021 and 2020.

The Company files income tax returns with federal, state and local tax authorities. With limited exceptions, the Company is no longer subject to federal income tax examinations for fiscal years 2017 and prior and is no longer subject to state and local income tax examinations for fiscal years 2016 and prior.

16. Defined Contribution Plan

The Company has a defined contribution retirement plan (the Retirement Plan) covering substantially all employees who meet certain eligibility requirements as to age and length of service. The Retirement Plan incorporates the salary deferral provisions of Section 401(k) of the Internal Revenue Code of 1986, as amended (the Code). Employees may defer up to the annual maximum limit prescribed by the Code. The Company, on a discretionary basis, may match up to 25% of participant contributions up to a maximum annual employer match of \$2,500. During the year ended September 30, 2021, the Company accrued \$0.9 million for matching contributions to be paid out after the plan year ending December 31, 2021. In January 2021, the Company funded matching contributions of \$1.2 million to participants' accounts for the plan year ended December 31, 2020.

817. Segment Reporting

The Company has one reporting segment, natural and organic retail stores. The Company's revenue is derived from the sale of natural and organic products at its stores. All existing operations are domestic.

18. Commitments and Contingencies

Self-Insurance

The Company is self-insured for certain losses relating to employee medical and dental benefits and workers compensation, subject to a stop loss policy. The self-insurance liability related to claims under the Company's health benefit plans is determined based on analysis of actual claims. The amounts related to these claims are included as a component of payroll and employee-related expenses in accrued expenses. Liabilities associated with the risks that are retained by the Company are estimated, in part, by considering historical claims experience, demographic factors and other actuarial assumptions. While the Company believes that its assumptions are appropriate, the estimated accrual for these liabilities could be significantly affected if future occurrences and claims materially differ from these assumptions and historical trends.

Legal

In January 2020, a former assistant store manager filed a purported class action lawsuit in the United States District Court for the District of Colorado on behalf of current and former assistant store managers alleging that the Company violated the Fair Labor Standards Act ("FLSA") and Colorado labor laws by misclassifying the assistant store managers as exempt. The alleged violations relate to failure to pay for overtime work. In November 2020, the court granted plaintiffs' motion for conditional certification with regard to the FLSA claim. In September 2021, the court ordered 56 opt-in plaintiffs to individual arbitration, leaving 101 FLSA plaintiffs in the FLSA collective action. The litigation is currently in the discovery stage. The plaintiffs did not quantify any alleged damages. The Company believes these claims are without merit and intends to defend the matter vigorously. Given the preliminary stage of the case and the legal standards that must be met for, among other things, class certification, the Company is unable to reasonably estimate at this time the possible range of loss, if any, that may result from this action.

The Company is otherwise periodically involved in various legal proceedings that are incidental to the conduct of its business, including but not limited to employment discrimination claims, customer injury claims and investigations. When the potential liability from a matter can be estimated and the loss is considered probable, the Company records the estimated loss. Due to uncertainties related to the resolution of lawsuits, investigations and claims, the ultimate outcome may differ from the estimates. Although the Company cannot predict with certainty the ultimate resolution of any lawsuits, investigations and claims asserted against it, management does not believe any currently pending legal proceeding to which the Company is a party will have a material adverse effect on its financial statements.

GAAP

Generally Accepted Accounting Principles

1

FASB

Financial Accounting Standards Board

2

ASC

Accounting Standards Codification

3

Accrual Basis

- Recognize revenue when earned
- Recognize expenses when incurred

4

Non-GAAP

(Special Purpose Frameworks)

- Cash / Modified cash basis

5

Non-GAAP

(Special Purpose Frameworks)

- Cash / Modified cash basis
- Tax basis

6

Non-GAAP

(Special Purpose Frameworks)

- Cash / Modified cash basis
- Tax basis
- Statutory basis

7

Non-GAAP

(Special Purpose Frameworks)

- Cash / Modified cash basis
- Tax basis
- Statutory basis
- Contractual basis

8

AUDIT

Unqualified (“clean”) opinion

“.... presents fairly, in all material respects...”

9

REVIEW

Limited assurance

Independence required

10

COMPILATION

No assurance

No independence required

11

Depreciation

Vehicle purchased: January 1, 2022

Price: \$ 55,000

Estimated useful life: Five years

Estimated disposal value: \$15,000

Depreciation expense each year: \$8,000

12

*Depreciation Expense
(Reduces Net Income)*

Year 2022 \$8,000

Year 2023: \$8,000

Year 2024: \$8,000

Year 2025: \$8,000

Year 2026: \$8,000

Total expense: \$40,000

13

Net Book Value of Vehicle

December 31, 2022 \$ 47,000

December 31, 2023 \$ 39,000

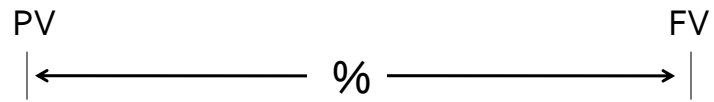
December 31, 2024 \$ 31,000

December 31, 2025 \$ 23,000

December 31, 2026 \$ 15,000

14

Time Value of Money



15

Balance Sheet

ASSETS = LIABILITIES
+ EQUITY

One point in time

16

Income Statement

(Service Business)

Revenue

- Operating expenses

= Income from Operations

+ / - Non-operating revenue & expense

= Net Income

17

Income Statement

(Merchandising Business)

Revenue

- Cost of goods sold

= Gross profit

- Operating expenses

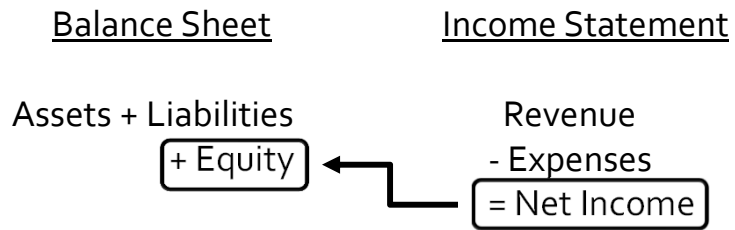
= Income from Operations

+ / - Non-operating revenue & expense

= Net Income

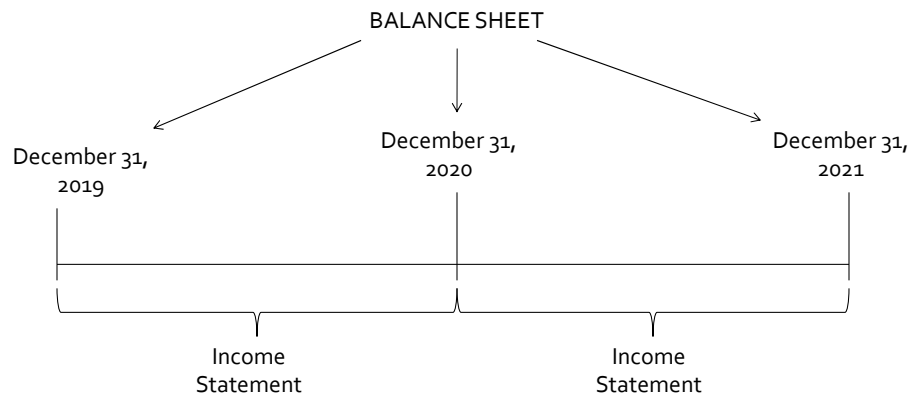
18

The Balance Sheet / Income Statement Connection



19

The Balance Sheet / Income Statement Connection



20

Investment by Owners (Stock Issue)

$$\begin{array}{rclcl} \underline{\text{ASSETS}} & = & \underline{\text{LIABILITIES}} & + & \underline{\text{EQUITY}} \\ + \$ 100,000 & & & & + \$ 100,000 \end{array}$$

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

21

Borrowing

$$\begin{array}{rclcl} \underline{\text{ASSETS}} & = & \underline{\text{LIABILITIES}} & + & \underline{\text{EQUITY}} \\ + \$ 100,000 & & + \$ 100,000 & & \end{array}$$

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

22

Asset Purchase for Cash

ASSETS = LIABILITIES + EQUITY

- \$ 10,000

+ \$ 10,000

REVENUE - EXPENSES = NET INCOME

23

Asset Purchase – Cash and Financing

ASSETS = LIABILITIES + EQUITY

+ \$10,000

+ \$ 8,000


- \$ 2,000

REVENUE - EXPENSES = NET INCOME

24

Cash Sales

$$\begin{array}{r} \underline{\text{ASSETS}} \\ + \$10,000 \\ \hline \end{array} = \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}}$$

$$\begin{array}{r} \underline{\text{REVENUE}} \\ + \$10,000 \end{array} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$


25

Credit Sale Inventory

$$\begin{array}{r} \underline{\text{ASSETS}} \\ + \$10,000 \\ - \$6,000 \\ \hline \end{array} = \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}}$$

$$\begin{array}{r} \underline{\text{REVENUE}} \\ + \$10,000 \end{array} - \begin{array}{r} \underline{\text{EXPENSES}} \\ + \$6,000 \end{array} = \underline{\text{NET INCOME}}$$

26

Cash Expense

$$\begin{array}{r} \underline{\text{ASSETS}} \\ - \$2,000 \end{array} = \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}}$$

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

+ \$2,000

27

Expense on Credit

$$\underline{\text{ASSETS}} = \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}}$$

+ \$2,000

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

+ \$2,000

28

Depreciation Expense Each Period

$$\begin{array}{r} \underline{\text{ASSETS}} \\ - \$12,000 \end{array} = \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}}$$

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

+ \$12,000

29

Receipt of Prepayment for Goods or Services

$$\begin{array}{r} \underline{\text{ASSETS}} \\ + \$20,000 \end{array} = \begin{array}{r} \underline{\text{LIABILITIES}} \\ + \$20,000 \end{array} + \underline{\text{EQUITY}}$$

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

30

Performance of Prepaid Goods or Services

$$\begin{array}{r} \underline{\text{ASSETS}} \\ - \$5,000 \end{array} = \begin{array}{r} \underline{\text{LIABILITIES}} \\ - \$5,000 \end{array} + \underline{\text{EQUITY}}$$

$$\begin{array}{r} \underline{\text{REVENUE}} \\ + \$5,000 \end{array} - \begin{array}{r} \underline{\text{EXPENSES}} \\ + \$5,000 \end{array} = \underline{\text{NET INCOME}}$$

31

Bad Debt Expense

$$\begin{array}{r} \underline{\text{ASSETS}} \\ - \$3,000 \end{array} = \begin{array}{r} \underline{\text{LIABILITIES}} \\ - \$3,000 \end{array} + \underline{\text{EQUITY}}$$

$$\underline{\text{REVENUE}} - \begin{array}{r} \underline{\text{EXPENSES}} \\ + \$3,000 \end{array} = \underline{\text{NET INCOME}}$$

32

Loan Payment

$$\begin{array}{rcl} \underline{\text{ASSETS}} & = & \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}} \\ - \$2,000 & & - \$1,600 \end{array}$$

$$\begin{array}{rcl} \underline{\text{REVENUE}} & - & \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}} \\ & & + \$ 400 \end{array}$$

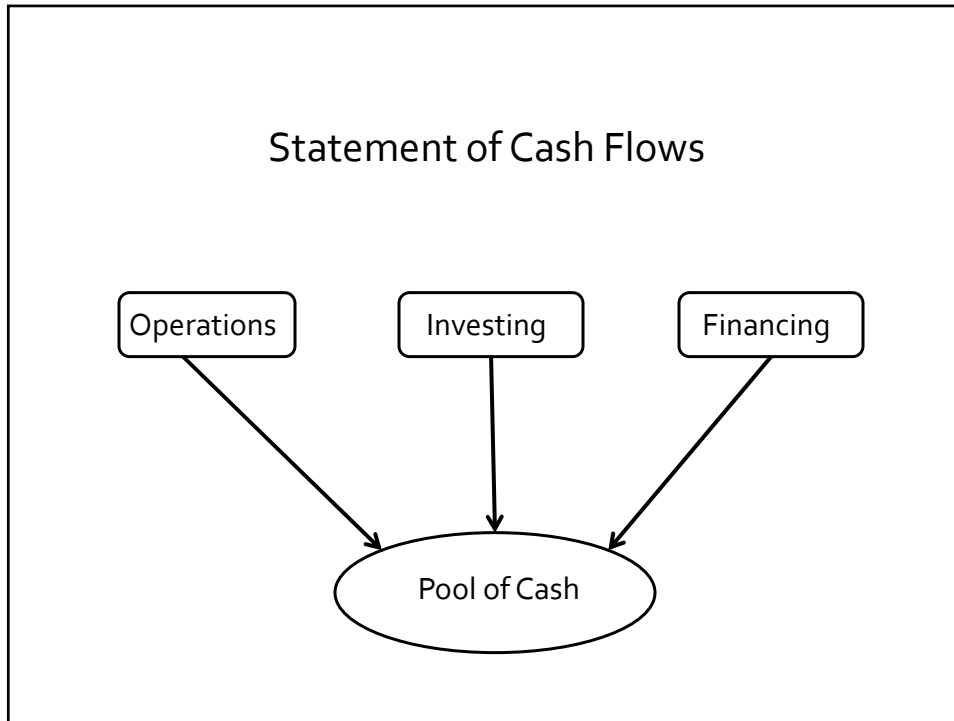
33

Profit Distribution to Owners (Dividend)

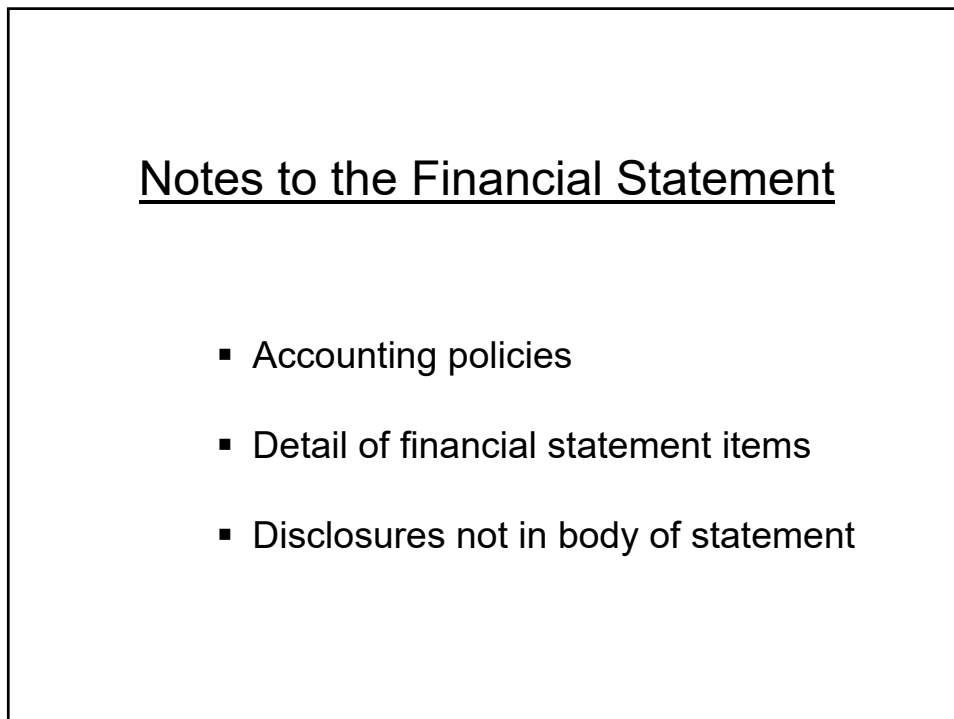
$$\begin{array}{rcl} \underline{\text{ASSETS}} & = & \underline{\text{LIABILITIES}} + \underline{\text{EQUITY}} \\ - \$20,000 & & - \$20,000 \end{array}$$

$$\underline{\text{REVENUE}} - \underline{\text{EXPENSES}} = \underline{\text{NET INCOME}}$$

34



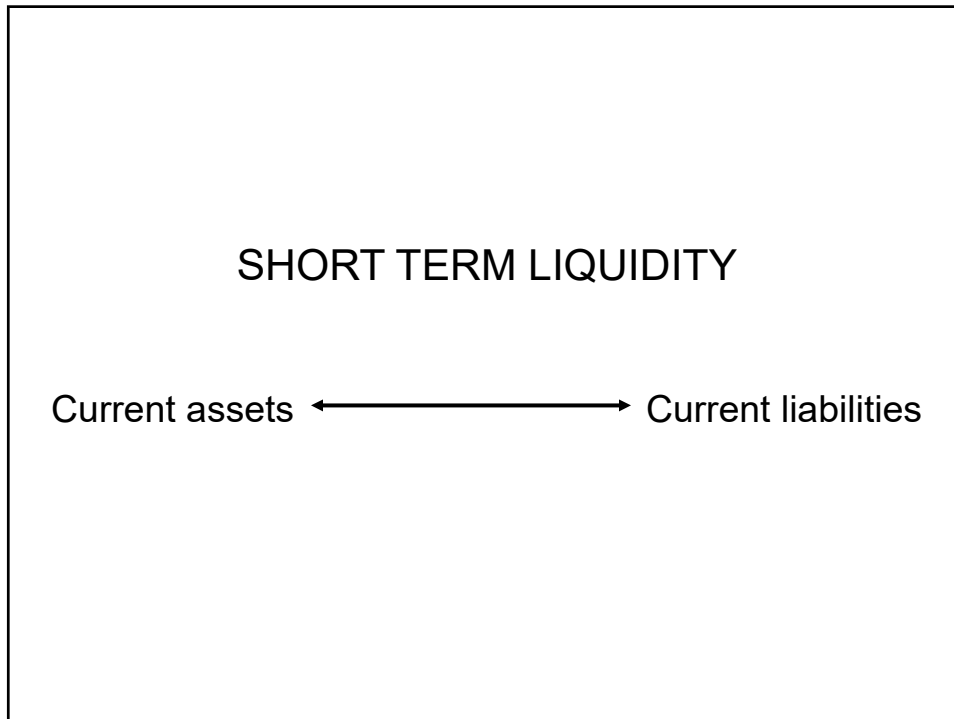
35



36

	Fiscal Year		
	2020	2019	2018
Revenues:			
Restaurant sales	93.9%	94.3%	94.5%
Franchise income	4.2%	3.8%	4.0%
Other operating income	1.9%	1.9%	1.5%
Total revenues	100.0%	100.0%	100.0%
Costs and expenses:			
Food and beverage costs (percentage of restaurant sales)	29.1%	28.9%	28.1%
Restaurant operating expenses (percentage of restaurant sales)	57.7%	48.6%	48.3%
Marketing and advertising	2.5%	3.3%	3.7%
General and administrative costs	12.0%	7.4%	8.2%
Depreciation and amortization expenses	7.9%	4.6%	4.1%
Pre-opening costs	0.6%	0.4%	0.4%
Gain on lease modifications	(0.1%)	—	—
Loss on impairment	6.0%	—	—
Total costs and expenses	110.3%	88.8%	88.6%
Operating income (loss)	(10.3%)	11.2%	11.4%
Other income (expense):			
Interest expense, net	(1.7%)	(0.5%)	(0.4%)
Other	0.0%	0.0%	(0.0%)
Income (loss) from continuing operations before income tax expense	(12.0%)	10.7%	11.0%
Income tax expense (benefit)	(2.9%)	1.7%	1.8%
Income (loss) from continuing operations	(9.1%)	9.0%	9.2%
Income (loss) from discontinued operations, net of income taxes	—	—	0.0%
Net income	(9.1%)	9.0%	9.2%

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LONG TERM SOLVENCY

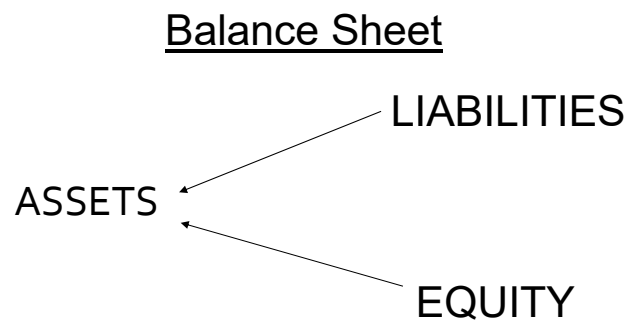
See:

- Leverage
- Ability to produce cash
(historic and forecasts)

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CAPITAL STRUCTURE

How leveraged is the company?



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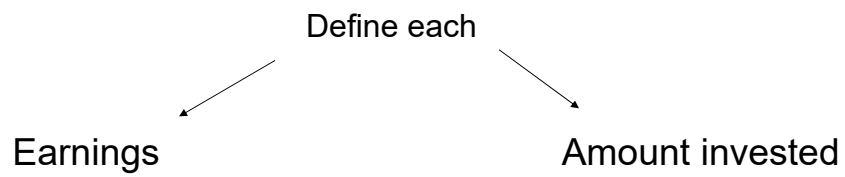
PROFITABILITY

See:

- Accounting methods
- Estimates / judgment

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RETURN ON INVESTMENT (ROI)



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LIQUIDITY

Current Ratio

= Current Assets / Current Liabilities

2021

135,627 / 133,772

= **1.01**

2020

143,413 / 129,150

= **1.11**

43

DEBT MANAGEMENT

Debt to Equity

= Total Debt / Total Equity

2021

512,348 / 142,731

= **3.59**

2020

508,726 / 173,066

= **2.94**

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PROFITABILITY

Gross Profit Ratio

Gross profit / Sales

<u>2021</u>	<u>2020</u>	<u>2019</u>
292,188 / 1,055,516	283,141 / 1,036,842	238,753 / 903,582
= .28	.27	.26

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PROFITABILITY

Operating income ratio

Operating income / Sales

<u>2021</u>	<u>2020</u>	<u>2019</u>
28,327 / 1,055,516	27,749 / 1,036,842	16,766 / 903,582
= .03	.03	.02

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PROFITABILITY

Net Income Ratio

Net Income / Sales

<u>2021</u>	<u>2020</u>	<u>2019</u>
20,581 / 1,055,516	20,009 / 1,036,842	9,416 / 903,582
= .02	= .02	= .01

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RETURN ON INVESTMENT (ROI)

Return on Assets

= Net income (loss)+ Interest expense / Average Total Assets

(20,581 + 2,271) / 668,436

= .03

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RETURN ON INVESTMENT (ROI)

Return on Equity

= Net income (loss) / Average Equity

20,581 / 157,899

= .13

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EBITDA

Earnings before interest, taxes,
depreciation and amortization

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Pro forma

(Normalized earnings, recurring earnings, etc.)

Ask:
What is omitted or assumed?

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Inventory Count Effect On Net Income

Beginning Inventory
+ Purchases

= Inventory Available for Sale

Ending Inventory
ASSET

Cost of Goods Sold
EXPENSE

52

Business combinations

Small ownership – Balance sheet asset

Significant influence – Equity method

Over 50% ownership - Consolidation

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Contingent liabilities

- Accrue expense and liability
- Disclose in notes
- Neither accrue nor disclose

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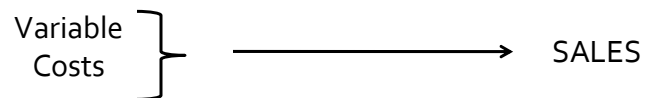
Sales with later billing

- Bona fide sale?
- Cash expected in timely manner?

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Revenue Reasonableness Test

Cash Business



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Income Statement

Cash Business

? → Sales
Know this \$ → - Cost of goods sold
Know this % → = Gross profit
- Operating expenses
= Income from Operations
+/- Non-operating revenues and expenses
= Net income

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ACCRUALS

To accrue expense, loss incurred and related liabilities

Bad debts

Warranty costs

Loss on acquisition

Cost of downsizing

Claim loss (insurance companies)

Stock option incentive accruals

Restructuring costs

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ALLOWANCES & RESERVES

To accrue expenses incurred and related liabilities

Look for:

1. Reserve exists if appropriate
2. Too small or too large?
3. Significant change from prior periods

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Asset impairment write-downs

Too little or too late

Accelerates earnings

Too early or too large

Defers earnings

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Capitalizing vs. expensing

Watch unusual changes:

Fixed assets – Balance sheet

Operating expenses – Income statement

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Intermediary company

Look for:

- Several customers replaced by one large customer
- Several vendors replaced by one large vendor

Inquire:

Any controlled entity not consolidated?

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