

TIPS *from* LauberCFOs

Credible Financial Statements Part 1

When bottom line results don't make sense from one period to the next, it is often a signal the company is not paying attention to simple accounting rules:

In this issue of "Tips from the CFO" we will tackle the topic of what is behind Credible Financial Statements. We will break the topic into two parts:

Part 1: Cash vs. Accrual
Revenue Recognition

Part 2: Matching revenues and Expenses
Miscellaneous Considerations

Why should we care?

- The purpose of financial statements is to give management and other interested parties an understanding of how the business is doing. If revenue is not recorded properly or there is not an appropriate matching of revenues with expenses, the financial statements will give a false picture which can lead to wrong decisions.
- While these "Tips from the CFO" are directed at small and mid-sized businesses, ignoring these simple concepts lead to the accounting scandals in recent years, misleading investors and costing billions of dollars.

Cash vs. Accrual

Cash basis financial statements

- These statements generally do not give a true picture of how a business is doing. In addition, for most entities they do not meet generally accepted accounting principles. They show when cash is

received without regard to when the product or service was delivered.

- These statements, often fail to match in the same reporting period, the expenses incurred to generate the revenue. As a result, cash basis statements do not reflect a true picture of the profit made at any point in time.
- Some companies (including many professional service organizations) choose this method of accounting because it may more closely match the income reported on their tax return. While this reasoning is understandable, other tools need to be in place to ensure a true reading is available of how the business is doing.

Accrual based financials

- This form of statement shows revenues and expenses recorded in the appropriate time period.
- Receivable, payable, prepaid and accrual accounts are used to account for the timing difference between recognition of revenue and expense and the actual receipt or disbursement of cash.
- Properly prepared accrual basis financial statements provide a much better picture of how a business is doing at any point in time.

Revenue Recognition

- The classic rule I learned in my Intro Accounting class was to recognize revenue when title to the goods transferred from seller to buyer. In most

cases this translates to recognition when the merchandise shipped.

- Service revenue is appropriately recognized in the period in which the service was performed.
- For projects that extend over more than one accounting period a consistent methodology should be used to allocate a portion of the total to each period corresponding with the associated costs recorded in that period.
- It can be appropriate, especially for smaller projects, to defer the income and expense and recognize in the month that the project is completed.
- Percentage of Completion is one methodology that compares the cost recorded to date on a project to the total estimated cost and records that percentage of the total expected revenue.
- Seldom if ever does appropriate revenue recognition correspond with receipt of progress payments.
- In most cases, the particular method used to recognize revenue is less important than picking one method and sticking with it consistently over time.

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