

TIPS *from* LauberCFOs

Credible Financial Statements Part 2

This issue of "Tips from the CFO" is the 2nd of 2 parts in which we tackle the topic what is behind Credible Financial Statements.

Part 1: Cash vs. Accrual
Revenue Recognition

Part 2: Matching revenues and Expenses
Miscellaneous Considerations

Matching Revenue and Expenses

To start, let's break expenses into three groups:

Expenses related directly to the product or service. Examples would be material, labor, purchased costs related to a specific job, commissions, etc.

- In most cases these costs will be recorded in the period that the title to the product passes or the service is delivered to the customer.
- If costs are incurred in a period prior to delivery, these costs are typically recorded in an Asset / Work in Process inventory account until delivery when they would be expensed to Cost of Sales.
- Inventory balances should be adjusted monthly based on the accounting method used, even if only an estimate.
- If the amount included in inventory at the end of a month is based on a physical count, care must be used to ensure that all inventory counted has been recorded on the books (i.e. in accounts payable) in the current or a prior period or a misstatement will result.

Expenses that can be reasonably allocated to the above direct costs. Examples would be taxes and benefits related to the direct wages, other manufacturing overhead allocated based on material, labor or machine time.

- These costs should flow to the income statement in the same period as their related direct costs.

Period costs such as administrative wages, rent, utilities, insurance, office supplies, depreciation, interest, etc.

- These costs are typically expensed on the income statement in the month incurred.
- For monthly charges such as leases and utilities it is important to consistently record one each month as expense.
- Wages should be recorded in the same period that the associated revenue is recorded. For example, if revenue is recorded through the last day of the month which happens to end on Wednesday, 3/5th (Mon., Tues., Wed.) of that week's payroll should also be recorded as an expense. A Liability / Accrual account is used to record this amount at month end.
- If the amount invoiced relates to several months, i.e. property insurance premium, the total amount would be recorded in an Asset / Prepaid account. In each subsequent month, the amount appropriate to cover one month is removed from the prepaid and expensed on the income statement.

- If the amount is billed annually at the end of the year, i.e. real estate or personal property taxes, an estimate of 1/12th of the annual amount is expensed each month on the income statement and recorded in a Liability / Accrual account.
- 1/12th of the estimated annual amount of Depreciation and Amortization should be recorded each month.
- For some items like Bad Debt Expense, it is reasonable to expect that some expense will be incurred during the year without being able to identify in which month. In these cases it is appropriate to expense 1/12th of the estimated annual amount each month with the offsetting amount recorded in a Reserve account on the Balance Sheet.

Miscellaneous Considerations:

- Always make sure any adjustments the auditor makes to the prior year statements are properly reflected in the current year financials.
- Do not make adjustments to prior months after closing and reporting on them. Make any necessary corrections to the current month.

Restating prior months will diminish the credibility of interim reports and make it difficult to know if you are looking at the correct version.

- In most cases, timely closings are more important than precisely accurate numbers. Use of estimates and best judgments is better than delaying the information in the name of correctness.
- Unusual or unanticipated expenses or write-offs should be recognized in the period they occur.
- Accruals should be adjusted monthly or as often as estimates change.
- Depreciation expense should be adjusted during the year to reflect asset additions and disposals.
- It is appropriate to accrue year end bonuses or donations over the course of the year.
- Obsolete or unusable inventory or fixed assets should be written down to realizable value when it is determined they are no longer useful to the business.
- The value of intangible assets like patents, trademarks and good will should be written off over their expected useful life rather than lives required by tax law.

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