

RMA
New England Chapter
LOAN OFFICER RESIDENT SEMINAR
(LORS)

April 27, 2011

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AGENDA

- Level of Assurance/Opinion
- Financial Statement Overview
- Analyzing the Corporate Tax Returns
- Accounting Updates
- Evaluate the Quality of the Accounting Firms
- Know the CPA's Your Clients Utilize

I. Accountant's Opinion Letter – What Does It Mean?

- A. Audit
- B. Review
- C. Compilation
- D. Qualified Opinions
 - 1. Audit
 - a. Adverse
 - b. Subject To
 - c. Going Concern
 - 2. Review
 - a. Emphasis of a Matter
 - 3. Independence
 - a. Applicable to Reviews and Audits Only



Independent Auditor's Report

We have audited the accompanying balance sheets of ABC Construction, Inc. as of December 31, 2010 and 2009 and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. **Our responsibility is to express an opinion on these financial statements based on our audits.**

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. **An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.** An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Construction, Inc. as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The additional information, as described in the Table of Contents, is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. **The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.**

Accountant's Review Report

We have reviewed the accompanying balance sheets of the ABC Company, Inc., as of December 31, 2010 and 2009, and the related statements of income, stockholders' equity and cash flows for the years then ended. **A review includes primarily applying analytical procedures to management's financial data and making inquiries of Company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.**

Management is 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 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 reviews, 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.

Our reviews were made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America. The additional information, as described in the Table of Contents, is presented only for purposes of additional analysis and has been subjected to the inquiry and analytical procedures applied in the reviews of the basic financial statements, and we are not aware of any material modifications that should be made thereto.

Accountant's Compilation Report

We have compiled the accompanying balance sheet of ABC Construction, Inc. as of December 31, 2010 and 2009 and the related statements of income and retained earnings and cash flows for the years 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 these financial statements are in accordance with accounting principles generally accepted in the United States of America.**

Management is 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 (the owners) 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.**

Financial Statement Overview

- Balance Sheet – a “snap shot” of assets, liabilities & equity at a given time
- Income Statement – a “scorecard” of the Company’s performance for specific time period
- Cash Flows – the sources and uses of cash used/provided by the Company
- Footnote Disclosures – provide the “story” about the Company and financial data



- Cash
 - Internal controls a must
 - Misappropriation of funds is higher than ever
 - Timely bank reconciliations- key in this environment

- Accounts Receivable
 - Quality of the A/R
 - Analysis of over 90-day accounts
 - Major customer concentrations
 - Starts with a good billing cycle – plan, call, follow-up and call again

- Work-In-Process/Unbilled
 - Quality of unbilled/work-in-process
 - Challenge the reason for the unbilled asset
 - Indication of losses/project overruns
 - Impact of claims and/or unapproved change orders
 - % Complete
 - Soft asset – compare against equity



- Line-of-Credit/Debt
 - Compliance with loan covenants
 - Personal guarantees
 - Subordination agreements
- Debt to Equity-
 - Measures the amount of capital, including retained earnings you have compared to the amount of debt you have
 - Goal – 2:1

- Understated liabilities, including uncompensated absences, overbillings on projects and retainers
- Accruals/Reserves/Contingencies



ABC CONSTRUCTION, INC.

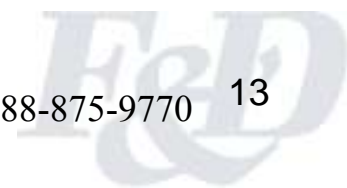
Statements of Income and Retained Earnings

For the years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Contract revenues earned	\$ 14,581,200	\$ 10,585,900
Cost of revenues earned	<u>12,874,900</u>	<u>9,473,200</u>
Gross profit	1,706,300	1,112,700
Selling, general and administrative expenses	<u>1,064,500</u>	<u>819,600</u>
Income from operations	<u>641,800</u>	<u>293,100</u>
Other income (expense):		
Interest income	8,800	7,300
Interest expense	<u>(124,700)</u>	<u>(116,800)</u>
	<u>(115,900)</u>	<u>(109,500)</u>
Income before income taxes	525,900	183,600
Federal and state income taxes:		
Current	51,000	12,300
Deferred	<u>140,000</u>	<u>50,100</u>
	<u>191,000</u>	<u>62,400</u>
Net income	334,900	121,200
Retained earnings at beginning of year	<u>456,900</u>	<u>335,700</u>
Retained earnings at end of year	<u>\$ 791,800</u>	<u>\$ 456,900</u>

ABC CONSTRUCTION, INC.
Schedules of Cost of Revenues Earned
For the years ended December 31, 2010 and 2009

	2010	2009
Direct costs:		
Subcontractors	\$ 5,987,600	\$ 4,413,700
Materials	5,120,900	3,774,300
Direct labor	<u>1,242,800</u>	<u>896,300</u>
	<u>12,351,300</u>	<u>9,084,300</u>
Indirect costs:		
Insurance	86,400	60,500
Indirect salaries	129,600	98,700
Employee benefits	109,300	87,400
Payroll taxes	130,400	94,500
Depreciation	11,200	8,600
Motor vehicle expense	<u>56,700</u>	<u>39,200</u>
	<u>523,600</u>	<u>388,900</u>
	<u>\$ 12,874,900</u>	<u>\$ 9,473,200</u>



ABC CONSTRUCTION, INC.

Schedules of Selling, General and Administrative Expenses

For the years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Officer's salary	\$ 335,900	\$ 230,000
Office salaries	203,000	231,900
Travel	89,200	33,700
Profit sharing	60,000	25,000
Professional services	47,200	36,400
Telephone	46,700	37,800
Repairs and maintenance	43,400	35,400
Employee benefits	34,200	26,200
Office supplies	27,800	21,700
Insurance	24,700	18,000
Advertising	24,100	24,000
Vehicle expense	22,600	15,200
Dues and subscriptions	17,800	12,300
Rent	16,800	14,700
Payroll taxes	16,600	11,400
Postage and shipping	15,900	11,900
Contributions	12,300	5,500
Rubbish removal	4,800	3,400
Depreciation	2,800	12,300
Officer's life insurance	2,700	3,400
Miscellaneous	16,000	9,400
	<u>\$ 1,064,500</u>	<u>\$ 819,600</u>

- Income Statement
 - Revenues

 - Cost of revenues – measure gross profit margin
 - Supplemental schedules

 - Operating expenses
 - Group into categories such as indirect labor, facilities, communications, etc.
 - Supplemental schedules

 - Other income / expense
 - Interest and misc. items

 - Income tax expense



ABC CONSTRUCTION, INC.

Statements of Cash Flows

For the years ended December 31, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Net income	\$ 334,900	\$ 121,200
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	14,000	20,900
Changes in operating assets and liabilities:		
(Increase) decrease in contract receivables	(727,600)	3,800
(Increase) in costs and estimated earnings in excess of billings on uncompleted contracts	(86,900)	(128,700)
Decrease in inventory		10,000
Decrease in prepaid expenses and other current assets	11,000	39,800
(Increase) in other assets	(14,600)	(7,600)
Increase (decrease) in accounts payable	489,100	(133,700)
Increase in billings in excess of costs and estimated earnings on uncompleted contracts	42,500	67,900
Increase (decrease) in accrued expenses and other current liabilities	260,700	(167,700)
Net cash provided by (used in) operating activities	<u>323,100</u>	<u>(174,100)</u>
Cash flows from investing activities -		
Purchase of property and equipment	(31,100)	(10,300)
Net cash used in investing activities	<u>(31,100)</u>	<u>(10,300)</u>
Cash flows from financing activities:		
Net change in demand note payable, bank	(155,000)	141,800
Principal (payments on) proceeds from debt	(13,100)	(21,200)
Net cash (used in) provided by financing activities	<u>(168,100)</u>	<u>120,600</u>
Net increase (decrease) in cash	123,900	(63,800)
Cash at beginning of year	<u>86,200</u>	<u>150,000</u>
Cash at end of year	<u>\$ 210,100</u>	<u>\$ 86,200</u>

- Cash flows from
 - operating activities – collecting A/R + paying liabilities
 - financing activities – debt borrowings/payments, stock redemption
 - investing activities – capital spending
- Using cash flows to measure EBITDA
(Earnings before interest, taxes, depreciation, amortization)



LISTING OF GENERAL FOOTNOTES APPLICABLE TO MOST BUSINESSES:

A. Description of Organization and its customer base

- *ABC Construction Company is a general contractor that provides commercial construction services primarily in Massachusetts.*

B. Significant Accounting Policies

- Consolidation Policy
- Basis of accounting

Only when different from GAAP.

- Cash Equivalents

Describe instruments considered cash.

- Estimates

Management uses estimates and assumptions in preparing financial statements in conformity with generally accepted accounting principles in the United States of America. Those estimates and assumptions affect the reported amounts of revenues and expenses. Actual results could vary from the estimates that were used.

- REVENUE RECOGNITION
- Fair Value
- Allowance for Doubtful Accounts - Only method allowed under GAAP
- Income Taxes - Describe methods of computing current and deferred income taxes
- Commitments and Contingencies – Pending or threatening litigation
- Concentrations in Customers or Suppliers - Customers and suppliers over 10% of total
- Cash concentrations – disclosure for uninsured balances ($> \$250,000$)



- Variable Interest Entities – FIN 46
- Notes Payable and Lines of Credit - terms, guarantees, and covenant violations
- Long-term Debt - same as Notes Payables plus 5 year maturities
- Operating Lease Obligations - terms and 5 year maturities
- Pension & Profit Sharing Plans - terms of plans and actuarial calculations (if any)
- General Economic Conditions – customer deferrals, delays, or cancellations could have an adverse impact on our future operating results

Analyzing the Corporate Tax Returns

- **See Handout**
 - **Break out session (10 minutes)**



Accounting Update

•IFRS

The development of International Financial Reporting Standards due to the globalization of business and finance. This worldwide growth has led to a greater need of comparability across all fields.

•Accounting Standards Codification

The FASB will become the single authoritative source of GAAP (restructures the current technical guidance).

•Future Lease Accounting Changes

The classification of leases as either capital or operating leases on financial statements, has led to the omission of relevant information such as the rights of obligations of both parties in a lease. FASB and the IASB have initiated a project that will change this approach and recognize leases in the statement of financial position. They are beginning to draft amendments to the *FASB Accounting Standards* and *IFRS*.

•Future Revenue Recognition Changes

Current GAAP concepts have resulted in different requirements for different industries which has led to different accounting methods for economically similar transactions.

IFRS provides less guidance on revenue recognition and the standards they have in place are difficult to understand and apply to complex transactions.

FASB and the IASAB have initiated a joint project to develop a common revenue standard for both GAAP and IFRS. This standard would remove inconsistencies in existing practices, provide a framework for addressing different issues, improve comparability across entities/industries, and simplify the preparation of financial statements.

Evaluating The Quality Of The Accounting Firm

Are All CPA's Alike?

A. AICPA Membership

1. Peer Review Standards

- a. Every third year required
- b. Receive a copy of the most recent peer review letter
- c. Can obtain a copy from State Society and AICPA



Are All CPA's Alike?

B. Reputation of Firm

1. Check with the local CPA Society
2. Check with local business people

Are All CPA's Alike?

C. Firm's Knowledge of Industry

1. Membership in Trade Associations
2. Number of clients in the industry
3. Articles/Publications/Seminars



Know The CPA's Your Clients Utilize

- A. Face to Face Contact
- B. Experience Impacting Clients' Profitability
- C. Understand How Often They Interact with their Clients
- D. If You Call Them During The Year, Do They Understand the Clients' Finances at Interim Periods?
- E. Do They Force the Discipline of an Annual Budgeting Process Upon their Clients?
- F. Do They Systematically Prepare a Management Letter Every Year?
- G. Understand the CPA's Commitment or Responsibility for your Clients' Profitability.
- H. Do They Utilize Industry Benchmarks and Their Understanding of the Industry to Help Clients?

Questions and Answers

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PRESENTER BIO'S



Edward J. Callahan

Director of Construction Services

Mr. Callahan is Director of the Construction Services Group at Feeley & Driscoll, P.C. Ed has over 25 years of experience in public accounting, specializing in accounting/tax and business planning issues as they apply to contractors and suppliers. His other areas of expertise include: information management systems (job cost, accounting, and -estimating), operational and financial analysis, workers compensation planning, surety bonding, and banking -assistance. Ed is a Certified Construction Industry Financial Professional (CCIFP). He is also Treasurer of the ACE Mentor Program of Massachusetts. Mr. Callahan holds a BS degree in business administration from the University of Massachusetts (Amherst) and an MS in taxation from Bentley College. In 2005 he received the Accounting Alumni Award from the University of Massachusetts.



Christopher P. Hines

Director

Mr. Hines has over 13 years of experience in public and private accounting. Mr. Hines' background is comprised of auditing and business consulting for clients in the construction, engineering, and professional services industries. His areas of specialization include management of audit engagements, overhead audits for governmental and state agencies, strategic planning and business consulting, corporation tax planning and operational and financial analysis. Mr. Hines has a B.S. in Accounting from the University of Massachusetts and is a candidate for the Masters in Taxation from Bentley University.