It's the Financial Statements not the Standards ©

By

Keith S Kauffman, CPA (AZ), CFE

A quote from the Arizona Republic dated Thursday, May 10, 2007 made by Stuart Preston.

> "Cash is Cash. Everything else is accounting."

The next quote is from Albert Einstein.

> "Everything should be as simple as possible, but not simpler."

What do these quotes have to do with financial statements? In my opinion, they are the basis of what is wrong with the current financial statement presentation methods.

In order to improve financial reporting, the accounting profession continues to assess modifications to United States General Accepted Accounting Principles ("US GAAP") including convergence with international accounting standards. There are considerations to modifying the audit report to increase transparency. Congress has passed laws, Sarbanes-Oxley and Dodd Frank, to assist in the fight in improving financial reporting. In addition, auditing standards have been improved to assist auditors in ensuring financial statements do not contain material misstatements.

Even with changes to the accounting standards, improvements in the auditing standards, laws passed and attempts to increase transparency, financial statements as well as the audits of financial statements are becoming increasingly more complex, difficult to analyze and provide little, if no relevance, to an investor or the organization. Why?

I believe the resolution lies in the financial statements and not in the standards or laws.

When I began assessing ways to improve financial statements, I focused, as my colleagues have done, on changing US GAAP in order to improve financial statement presentation. As I continued my assessment, I had an epiphany. The focus should not be modifying US GAAP. It should be developing a new set of financial statements by altering the financial information being presented on the balance sheet, income statement and cash flow statement.

As I began developing this "new" set of financial statements, the primary purpose of the presentation began to emerge. The primary purpose of my new financial presentation was to show in a "simpler" manner the increases and decreases to cash and/or appearance of cash transactions (for example, a long-term loan to buy equipment) ("Cash") during the reporting period. In the simplest terms, answering the following questions; where did the Cash come from (Sources of Cash) and what was it used for (Uses of Cash)?

As I continued development, many other questions and ideas arose such as could the new financial reporting model be used by different entities (i.e. government, not-for-profit, private, public, etc.), different industries, internally in an organization (i.e. budgets) for a company, division, department, or team, and even be used to eliminate or significantly reduce financial statement fraud. The answer to all of these and more was yes it can.

Thus, I have created a new and vastly improved financial reporting method, Kauffman Financial Reporting Method ("KFRM").

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For the KFRM, I made the following decisions:

- Only Cash (or the appearance of cash) transactions will be recorded.
- Limit the categories on the Balance Sheet (explained later).
- There will be no estimates. For example, depreciation and amortization will no longer be calculated. In order to calculate depreciation and amortization each reporting period, it requires the asset to have an "estimated useful life". This will preclude it from being presented.
- Assets and liabilities will be recorded at historic cost (i.e. Fair Market Value ("FMV") presentation will not be allowed), except for one specific asset type. This asset type will be recorded at FMV only if specific conditions exist.
- Impairment Testing will no longer be required.

In the attached Exhibit A, the column labeled KFRM represents the format of the new financial reporting method. The company in Exhibit A is fictitious and does not represent any particular industry. The amounts are being used to explain and clarify the new financial reporting method. I have decided not to address the notes to the financials at this time as my focus is on the financial presentation.

I made adjustments to the change the presentation of the financial information from GAAP to KFRM. When the adjustments were completed, the result was a new way to present financial information:

- A Balance Sheet with only 6 categories, which are 1) Cash and Cash Equivalents; 2) Investments; 3) Long-Term Assets (for example, Property, Plant and Equipment); 4) Due To or From Related Parties; 5) Long-term Debt including Lines of Credit; and 6) Equity. Since the Balance sheet has been reduced to 6 primary areas, the attached table (see Exhibit B), although not fully inclusive, reflects where specific Balance Sheet categories will now be presented.
- The Statement of Income became the Statement of Sources and Uses.
- A new statement called the Statement of Retained Earnings Reconciliation would reconcile Net Income/(Loss) to Retained Earnings on the Balance Sheet. This statement begins with the Net Income/(Loss) and adds or subtracts various items which include, but are not limited to, gains and losses, debt forgiveness, FMV gain or loss, Goodwill, etc.
- The Statement of Cash Flows no longer exists.

The primary statement would now be the Statement of Sources and Uses as it would reflect my primary purpose which is to show sources and uses of Cash during the financial reporting period.

The Statement of Sources and Uses will have three primary sections.

- The first section results in the Net Income (Loss) which looks much like a traditional Profit and Loss Statement. The main difference is the focus is placed on the Net Income (Loss) and not on a particular category of revenue or expense. For example, the line item labeled revenue could include sales taxes, deposits, advanced payments, and other items that relate to a sale or income.
- The next section is the Sources of Cash. This section includes Net Income and other items such as loans from financial institutions or related parties, proceeds from sale of equipment, etc.
- The final section is the Uses of Cash. This section includes Net Loss and other items such as dividends paid, debt service including interest, property, plant and equipment acquisitions, etc.

The end result on the Statement of Sources and Uses will tie to the Cash and Cash Equivalents line on the Balance Sheet.

As I developed the KFRM, I asked myself what purpose does the Statement of Sources and Uses serve as there is already a Statement of Cash Flows? The answer is the Statement of Sources and Uses is different in two major respects. First, the Statement of Sources and Uses will become the primary focus much like the Profit and Loss statement is today where as the Statement of Cash Flows is more of a reconciling statement. Second, the Statement of Sources and Uses is designed to be “simpler” for users of financial information to understand. The Statement of Cash Flows uses complicated accounting terminology and is not easy to read unless you understood the purpose of each of its sections.

Also, I considered the impacts on certain accounting methods which some of them have been outlined below:

- The Matching Principle. This is a primary concept of our current financial statement presentation model. The goal is to ensure revenue and expenses are being “Matched” in the appropriate reporting period. This was one of the largest mental hurdles I had to cross. The new method merely explains the sources and uses of funds during a given reporting period and is not to ensure revenue and expenses are being “Matched” in the appropriate reporting period.
- Revenue Recognition. This is a significant focus of the current financial statement presentation. My profession has spent and currently spends quite a lot of time devoted to this topic. This new method places substantially less emphasis on the revenue line item. The only revenue recorded will be the physical cash received from a sale. A sale that has not resulted in the exchange of Cash is not a sale for either the seller or buyer. For example, if ABC Company sells 1000 widgets and does not receive payment until a later date, the sale has not taken place until payment is received regardless if the buyer took ownership of the product. If ABC Company delivers product but only receives a deposit as partial payment, the deposit is revenue. If the deposit is refundable until the full performance on the contract, the deposit is still revenue. If the deposit is returned, the refund will be recorded as an expense at the date it is actually returned. If the entire transaction happens over two reporting periods, you report the proper transaction in the reporting period it happened. Thus, you could record the deposit in one reporting period and the refund of the deposit in the next reporting period. In the Notes, the sale can be described along with the amount of the deposit. If there is no deposit (i.e. no

cash exchanged), there is no Note to be included. Thus, selling inventory on credit or per a contractual obligation is not a sale under my method until Cash is actually exchanged.

- Inventory. Inventory in all of its forms (raw materials, products, etc) would no longer be recorded as an asset on the balance sheet. As “Inventory” is purchased it would be recorded as an expense under cost of goods sold on the Statement of Sources and Uses. I have heard the comment that there is value in the remaining inventory at the end of a reporting period. I will respond in two ways. First, the value is an estimate as there is usually a reserve recorded against inventory to adjust to the market value. As such, KFRM would not allow an estimate to be recorded. Thus, it should be recorded only at historic cost at the time of purchase. This leads to the second point that KFRM reflects what happens to the uses of Cash and a use of cash is the purchase of inventory. Whether the inventory is to be used in the current period or a future period is not relevant. This is one of the more clear examples of how KFRM will differ from the current reporting method.
- Acquisitions. This method will mostly likely cause a change in the amount of goodwill along with where goodwill is recorded. Under the KFRM, there cannot be negative goodwill. A buyer will not record accounts receivable or accounts payable. If the buyer acquires inventory, it will be recorded under cost of goods sold on the Statement of Sources and Uses. Any intangibles, such as patents and trademarks, will be recorded on the balance sheet as an investment. The purchase of long-term assets will be recorded at acquisition cost on the balance sheet. If the acquirer is assuming long-term debt or financing the acquisition, this will be recorded as long-term debt on the balance sheet. This method could alter goodwill, which will no longer be recorded on the balance sheet as an asset to be either tested for impairment or amortized. The purchased goodwill, if any, will be recorded under the Use section on the Statement of Sources and Uses and will be recorded as a reconciling item on the Statement of Retained Earnings Reconciliation. Thus, if an acquiring entity creates significant purchased goodwill, the goodwill will reduce retained earnings at the time of acquisition. In the Notes, the acquiring entity will need to detail the acquisition.
- Federal and State Income Taxes. The amounts recorded will only be what was paid or refunded. There will be no calculation for book/tax timing differences that result in a deferral amounts being recorded on the balance sheet.

Along with the impacts, I realized weaknesses in the reporting method I am proposing:

- Unrecorded Liabilities. They will not be recorded under this method. Although this appears obvious, it is a weakness and worth addressing. How would a user of financial information know or be aware of the amount of unrecorded liabilities if they are not presented on the balance sheet. If an issuer had $100,000 of unrecorded liabilities, would this knowledge benefit the user of the financial information? The answer lies in the overall strength of the financial information. All financial statement presentations have strengths and weaknesses, but to use an accounting term, it is the financial statements “taken as a whole” that provides the overall strength or weakness of the financial statement presentation. I believe the KFRM is far stronger than the current method and will more than compensate for this apparent weakness.
- Financial Ratios. Another weakness, as many of them would have to be abandon as tools for analytical and comparative purposes. They would have almost no meaning under this new method. Although I have not addressed this or contemplated it, there is a possibility that new ratios could be

developed. In recent years during these economic difficulties, I have noticed the use of these ratios to be less important and cash to be the primary focus.

- Fraudulent Reporting. As a Certified Fraud Examiner, I have asked myself could this method lend itself to new types of fraudulent presentation. I must concede it is possible. For example, selling a widget and acquiring large deposit only to return that deposit in the next reporting period. What this method forces is the actual receipt of the large deposit and its eventual return. I have found that recording entries to create inventory or receivables is significantly easier than asking a company or individual to physically part with a substantial amount of cash hoping that it will be returned at a subsequent period. I do not believe you could ever totally eliminate financial statement fraud. However, the KFRM may significantly reduce its impact and/or prevalence.

This new method has numerous other benefits. I will list some of them below including ones I have mentioned earlier:

- Budgets or forecasts – As many of these are on a cash basis anyway.
- External interim reporting to banks or government agencies.
- Owners/Executives of companies will find the presentation easier to understand. Thus, possibly leading to better decision making.
- Departments/Divisions/Teams – the method can be applied from consolidations to the most granular level of an organization.
- Industry – the method can be used in any industry.
- Government/Not-for-Profit – These organizations would not require a separate reporting method. This method is more than sufficient.
- Tax Structure – C-corp., S-corp., LLC, LP, etc. can all use this method.
- Tax Auditors – can use as a tool for investigation.
- Easier to prepare and audit.
- Fraud investigations.
- Bankruptcy reporting.
- Transparency.
- And many others.

The ultimate question is how would a user of such financial information be better informed than under the current method. The answer is in the simplification. I believe users of financial statements have trouble understanding the current financial statement presentation method. The current presentation method as we have already experienced is easy to manipulate and is difficult to interpret. Using the Statement of Sources and Uses, a user could clearly identify where cash came from and what it was used for instead of trying to understand how to interpret net income or net loss under the current method. I see the audit and interim reporting under the KFRM becoming an invaluable tool to assist owners, officers, boards, investors, lenders, management, employees, etc. in decision making related to an organization.

Where do we go from here?

If needed, the creation of a new financial accounting board to formalize the KFRM and accounting standards and work with the AICPA regarding new or modified auditing standards.

Exhibit A

ABC Company
Balance Sheet
As of (Date)

	GAAP	Adjustments	KFRM
Assets			
Cash and Cash Equivalents	$ 470,000	$ -	$ 470,000
Accounts Receivable	2,000,000	(2,000,000)	-
Deposits and Prepaid Expenses	100,000	(100,000)	-
Inventory	3,000,000	(3,000,000)	-
	5,570,000	(5,100,000)	470,000
Property Plant and Equipment (Cost)	5,000,000	850,000	5,850,000
Goodwill	1,250,000	(1,250,000)	-
Investments	75,000	-	75,000
	$ 11,895,000	$ (5,500,000)	$ 6,395,000
Liabilities and Equity			
Accounts Payable & Accruals	$ 2,000,000	$ (2,000,000)	$ -
Long-term Debt - current portion	500,000	-	500,000
Income Tax Payable	125,000	(125,000)	-
	2,625,000	(2,125,000)	500,000
Due to Shareholder	1,000,000	-	1,000,000
Long-term Debt	1,600,000	-	1,600,000
	5,225,000	(2,125,000)	3,100,000
Capital	1,000	-	1,000
Retained Earnings (Deficit)	6,669,000	(3,375,000)	3,294,000
	6,670,000	(3,375,000)	3,295,000
	$ 11,895,000	$ (5,500,000)	$ 6,395,000
	-	-	-

ABC Company

Statement of Sources and Uses

For the Period (Date)

	GAAP	Adjustments	KFRM
Revenue	$ 20,000,000	$ (1,000,000)	$ 19,000,000
Cost of Sales			
Beginning Inventory	2,500,000	(2,500,000)	-
Purchases	14,000,000	-	14,000,000
	16,500,000	(2,500,000)	14,000,000
Ending Inventory	3,000,000	(3,000,000)	-
	13,500,000	500,000	14,000,000
Gross Profit	6,500,000	(1,500,000)	5,000,000
Operating Expenses			
Salaries, Wages, Benefits and Taxes	2,750,000	(300,000)	2,450,000
Depreciation and Amortization	350,000	(350,000)	-
Rent Expense	400,000	-	400,000
Interest Expense	250,000	(250,000)	-
Professional Fees	375,000	-	375,000
General and Administrative	1,000,000	5,000	1,005,000
Total Operating Expenses	5,125,000	(895,000)	4,230,000
Net Income from Operations	1,375,000	(605,000)	770,000
Gain (Loss) on Sale of Property	50,000	(50,000)	-
Net Income Before Taxes	1,425,000	(655,000)	770,000
Income Tax Expense (Benefit)	(125,000)	125,000	-
Net Income	**$ 1,300,000**	**$ (530,000)**	**$ 770,000**
<u>Sources:</u>			
Net Income from Operations			770,000
Procceds from Sale of Property			250,000
Acquisition of Long-term Debt			2,100,000
Advances from Shareholder			-
Total Sources			**3,120,000**
<u>Uses:</u>			
Net Loss from Operations			-
Acquisition of PP&E			(3,000,000)
Purchased Goodwill			(1,300,000)
Repayments to Shareholder			(250,000)
Debt Service - Due to Shareholder			(25,000)
Debt Service - Long term Debt			(225,000)
Dividends Paid			-
Total Uses			**(4,800,000)**
Net Increase (Decrease) in Cash and Cash Equivalents			**(1,680,000)**
Cash and Cash Equivalents - Beginning of Year			2,150,000
Cash and Cash Equivalents - End of Year			**$ 470,000**

ABC Company
Statement of Retained Earnings Reconciliation
For the Period (Date)

	GAAP	Adjustments	KFRM
Net Income (Loss)	$ 1,300,000	$ (530,000)	$ 770,000
Reconciling Items:			
Gain (Loss) On Sale of Property	-	50,000	50,000
Unrealized Gain (Loss) on Investment	-	-	-
(Purchased Goodwill)	-	(1,300,000)	(1,300,000)
Interest Expense	-	(250,000)	(250,000)
	-	(1,500,000)	(1,500,000)
Net Income (Loss) Before Tax Refunds (Payments)	1,300,000	(2,030,000)	(730,000)
Income Tax Refunds (Payments)	-	-	-
Net Income (Loss)	1,300,000	(2,030,000)	(730,000)
Retained Earnings (Deficit) - Beginning of Year	5,369,000	(1,345,000)	4,024,000
Dividends Paid	-	-	-
Retained Earnings (Deficit) - End of Year	$ 6,669,000	$ (3,375,000)	$ 3,294,000

ABC Company
Statement of Cash Flows
For the Period (Date)

	GAAP	Adjustments	KFRM
Cash Flows from Operating Activities			
Net Income (Loss)	$ 1,300,000	$ (1,300,000)	-
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and Amortization	350,000	(350,000)	-
Gain on Sale of Property	(50,000)	50,000	-
Changes in assets and liabilities:			
Accounts Receivable	(1,000,000)	1,000,000	-
Deposits and Prepaid Expenses	(5,000)	5,000	-
Inventory	(500,000)	500,000	-
Accounts Payable & Accruals	300,000	(300,000)	-
Income Tax Payable	125,000	(125,000)	-
Net cash provided by (used in) operating activities	520,000	(520,000)	-
Cash Flows from Investing Activities			
Acquisition of PP&E	(3,000,000)	3,000,000	-
Purchased Goodwill	(1,300,000)	1,300,000	-
Procceds from Sale of Property	250,000	(250,000)	-
Net cash provided by (used in) investing activities	(4,050,000)	4,050,000	-
Cash Flows from Financing Activities			
Advances from (Repayments to) Shareholder	(250,000)	250,000	-
Acquisition of (Repayment of) Long-term Debt	2,100,000	(2,100,000)	-
Net cash provided by (used in) financing activities	1,850,000	(1,850,000)	-
Net Increase (Decrease)	(1,680,000)	1,680,000	-
Cash and Cash Equivalents - Beginning of Year	2,150,000	(2,150,000)	-
Cash and Cash Equivalents - End of Year	**$ 470,000**	**$ (470,000)**	**$ -**

Exhibit B

Category	Statement	Under KFRM
Cash and Cash Equivalents	Balance Sheet	Asset
Accounts Receivable	Not Recorded	Not Applicable
Inventory	Statement of Sources and Uses	Cost of Goods Sold
Prepaid Expenses	Statement of Sources and Uses	Expense under Net Income (Loss) from Operations
Deposits (Paid)	Statement of Sources and Uses	Expense under Net Income (Loss) from Operations
Due from Shareholder/ Stockholder/ Related Party	Balance Sheet	Asset
Income Taxes Receivable (when received)	Statement of Sources and Uses and Statement of Retained Earnings Reconciliation	Source of funds on the Statement of Sources and Uses and Income Tax Benefit on the Statement of Retained Earnings Reconciliation
Property, Plant and Equipment (Defined by Management)	Balance Sheet	Asset
Accumulated Depreciation and Amortization	Not Recorded	Not Applicable
Furniture, Fixtures and Equipment (Defined By Management)	Statement of Sources and Uses	Expense under Net Income (Loss) from Operations
Investments (i.e. investments in other entities, stocks, intangibles purchased, notes receivable, etc.)**	Balance Sheet	Asset
Deferred Tax Asset/Liability	Not Recorded	Not Applicable
Goodwill	Purchase Goodwill (only) - Statement of Sources and Uses & Statement of Retained Earnings Reconciliation	Statement of Sources and Uses – Use. Statement of Retained Earning Reconciliation - Reconciling item
Bank Overdraft	Balance Sheet	Liability
Lines of Credit	Balance Sheet	Liability
Accounts Payable	Not Recorded	Not Applicable
Accrual Liabilities	Not Recorded	Not Applicable
Other Payables (i.e. Sales Taxes Payable, Rebates (Paid), etc.)	Statement of Sources and Uses	Expense included in Net Income (Loss) from Operations
Deposit or Advance (Received)	Statement of Sources and Uses	Revenue included in Net Income (Loss) from Operations
Income Taxes Payable (when paid)	Statement of Sources and Uses and Statement of Retained Earnings Reconciliation	Use of funds on the Statement of Sources and Uses and Income Tax Expense on the Statement of Retained Earnings Reconciliation
Long-Term Debt	Balance Sheet	Liability
Due to Shareholder/ Stockholder/ Related Party	Balance Sheet	Liability
Capital/ Stock/ Additional Paid-in-Capital/ Treasury Stock	Balance Sheet	Equity
Dividends Paid	Statement of Sources and Uses and Statement of Retained Earnings Reconciliation	Use of funds on the Statement of Sources and Uses and Dividends on the Statement of Retained Earnings Reconciliation
Retained Earnings	Balance Sheet	Equity

** As stated earlier, the only asset I would allow a FMV presentation is an investment with a readily determinable and recognizable value on the Balance Sheet date. For example, a security traded on an open market exchange. Appraisals or similar methods will not be allowed.