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WEBINAR

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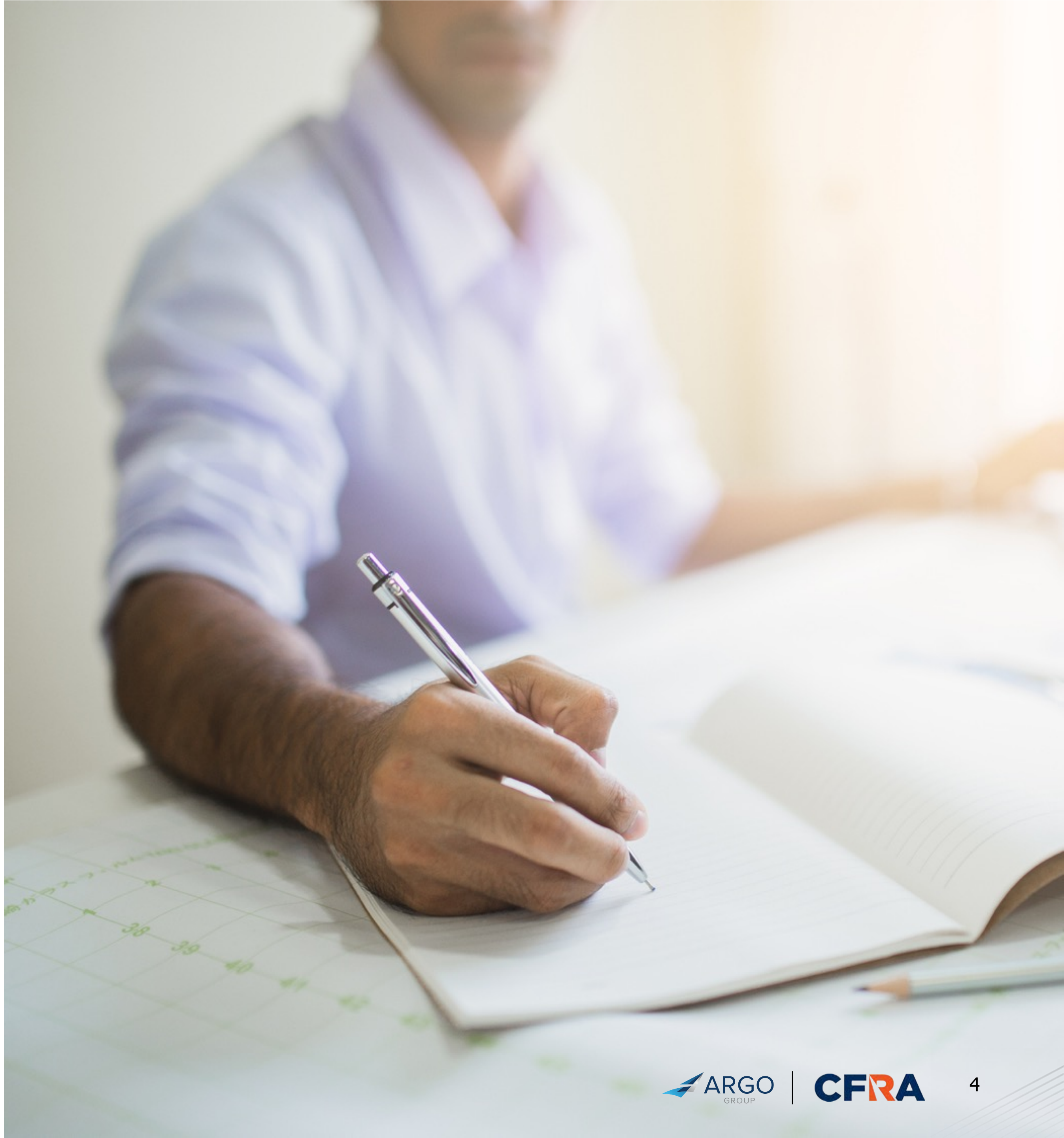
What to take away from this webinar

Understanding Accounting Concepts and Basic Red Flags

- To help you unlock what may be a black box called "accounting," by introducing some simple concepts and tools that can be applied in your day-to-day work
- Provide you with ratios and other analyses that will help in identifying the health of a business
- Help you identify risks and red flags in reviewing financial statements



Agenda

1. How are financial statements created?
    - What are accounts?
    - How do individual transactions get recorded in financial statements?
    - What are the different financial statement types?

2. How are financial statements analyzed?
    - What are some of the key ratios?
    - How do ratios help in financial statement analysis?

3. What specific accounting issues arise most often?
    - Revenue recognition
    - Acquisition accounting
    - Reserves and accruals

Financial Statements

Objectives of Accounting

Accounting: An Information System

- Useful information for making business and economic decisions
- Information about financial position, earnings and cash flows during a period
- How an enterprise has discharged its stewardship responsibility to owners

Types of Financial Statements

Results of Operations →	Income Statement
Financial Position →	Balance Sheet
Funds Flow →	Statement of Cash Flows

Balance Sheet

ASSETS		
	Cash	$2,030
	Short Term Investments	614
	Inventory	1,796
	Other Current Assets	589
Total Current Assets		5,029
	Property, Plant and Equipment, Net	3,197
	Other Noncurrent Assets	318
Total Assets		$8,544
LIABILITIES		
	Current Maturities of Long-Term Debt	325
	Accounts Payable	1,109
	Other liabilities	838
Total Current Liabilities		2,272
	Long-term Debt	188
	Other Noncurrent Liabilities	910
SHAREHOLDERS' EQUITY		
	Common Stock	55
	Additional Paid-in Capital	2,631
	Retained Earnings	8,646
	AOCI	77
	Treasury Stock	(6,235)
Total Liabilities and Shareholder's Equity		$8,544

Assets. Probable future ***economic benefits*** obtained or controlled by a particular entity as a result of past transactions or events.

Examples:
- Inventories
- Property, plant and equipment
- Acquired patents
- Costs incurred to develop new products?

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Liabilities. Probable future ***sacrifices of economic benefits*** arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Examples:
- Debt
- Amount owed to suppliers and employees
- Leases
- Contingent obligations?
- Reserves
- Trade payables

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Equity. Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

Examples:

- Contributed capital – common stock
- Accumulated undistributed earnings

Audience Insights

When a company acquires another company and pays premium over the book value, where is this displayed?

a. Assets
b. Liabilities
c. Shareholders' equity
d. It is not displayed on the balance sheet

Audience Insights

When a company acquires another company and pays premium over the book value where is this displayed?

a. Assets

Income Statement

Net Revenues	$15,943
Cost of Goods Sold	(10,294)
Gross Profit	5,649
Operating Expenses	(4,475)
Net Interest Income	91
Income Before Income Taxes	1,264
Provision for Income Taxes	(486)
Net Income	$778
Earnings per share – basic	$0.94
Earnings per share - diluted	$0.93

Revenues. Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both.)

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Revenue recognition example:

Scenario A): Company X sells security cameras for $10 each, and sold 100 cameras during the quarter, all on the last day.

Scenario B): The company offers a 30-day return period. Based on past experience, the return rate is 1-2%.

Scenario C): In addition, the selling price includes training and installation.

Audience Insights

In Scenario B), how much revenue should be recognized during the quarter if the return rate is estimated to be 1%?

a. $1000
b. $0
c. $990

Audience Insights

In Scenario B), how much revenue should be recognized during the quarter if the return rate is estimated to be 1%?

c. $990

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Expenses. Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both).

Examples:
- Salaries
- Cost of material in goods sold
- Depreciation and amortization
- Payment for a computer?

Audience Insights

Where should you look if you want to determine a company's "top-line" growth?

a. Gross profit
b. Net revenues
c. Net income
d. None of the above

Audience Insights

Where should you look if you want to determine a company's "top-line" growth?

b. Net revenues

Example Journal Entries

1. Borrow cash $100

Cash	100	
Debt		100

2. Acquire $80 merchandise inventory

Inventory	80	
Accounts payable		80

3. Sell $70 worth of merchandise for $120 on credit

Accounts receivable	120	
Revenue		120
Cost of goods sold	70	
Inventory		70

4. Pay sales clerk and utilities bill $30

Selling and general expenses	30	
Cash		30

The Accounting Equation:

Assets	**=**	**Liabilities**	**+**	**Shareholders' Eq**
Cash 70		A/P 80		Rev 120
A/R 120		Debt 100		CGS 70
Inv. 10				Op Exp 30
				Net Inc 20
Assets 200		**Liabilities 180**		**Retained Earnings 20**

Statement of Cash Flows

Direct Method

Operating cash flow (payment for salary & utility)	(30)
Investing cash flow	-
Financing cash flow	100
Net change in cash	70
Cash, beg	0
Cash, end	70

Indirect Method

Net Income	20
Increase in AR	(120)
Increase in Inv	(10)
Increase in AP	80
Op cash flow	(30)

Analyzing Financial Statements

Ratio Analysis

BENCHMARKING

- Comparing a single company's ratios to an industry average or to the ratios of comparable companies

COMPARATIVE ANALYSIS

- Analyzing a single company's financial statements and ratios over time

Examples of Most Used Ratios: Revenue Quality Indicators

Days Sales Outstanding (DSO) = (receivables ÷ revenue) × days in quarter

- Rising DSO could mean:
  - Extending credit period to boost sales
  - Late period sales to meet target
  - Revenue that may not be collectible

Deferred revenue in days = (deferred revenue ÷ revenue) × days in quarter

- Declining deferred could mean:
  - More aggressive revenue recognition that results in pulling future revenue into the current period
  - Failure to replenish the revenue pipeline

Examples of Most Used Ratios: Earnings Quality Indicators

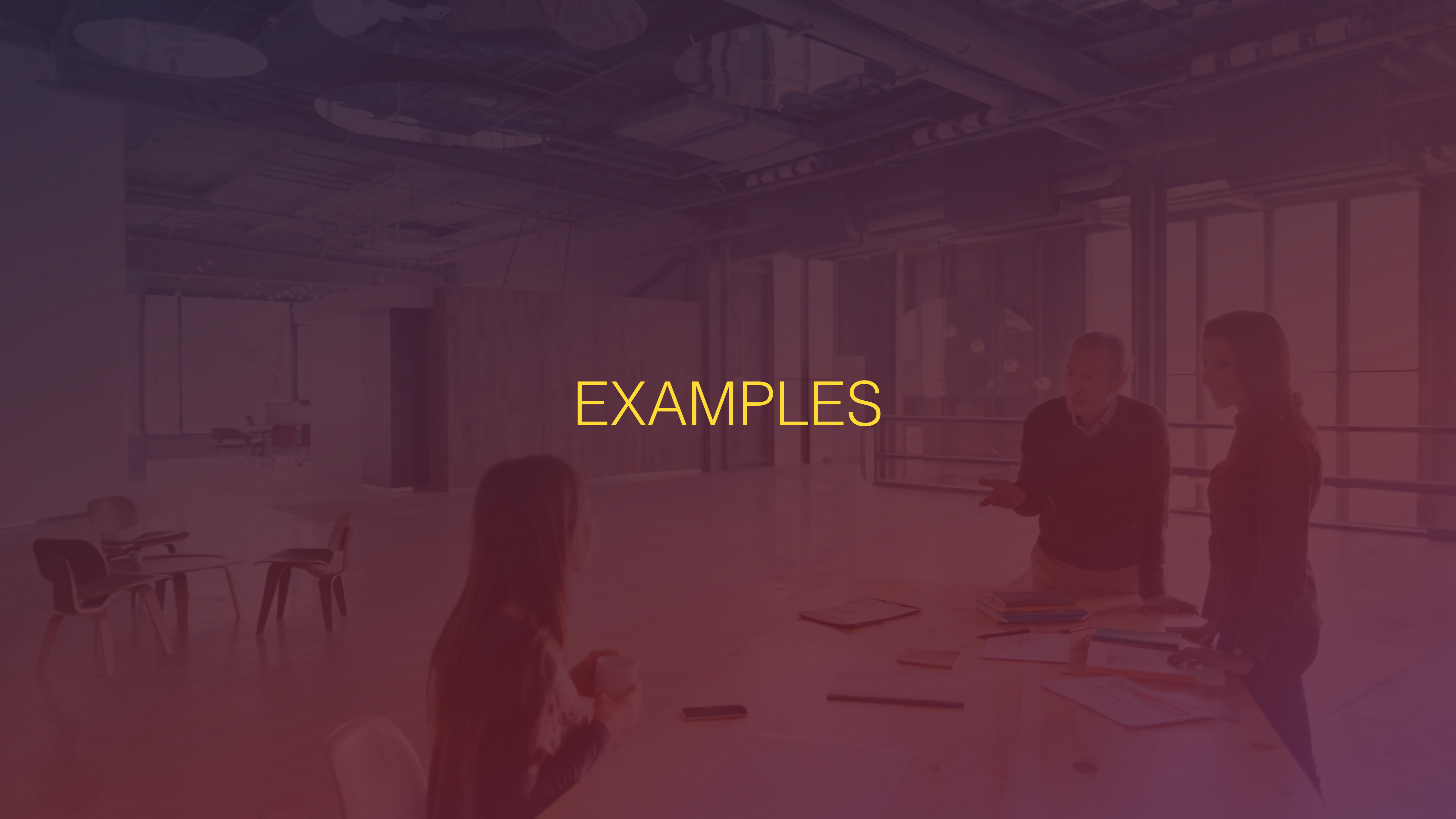
- **Inventory:** Excess could lead to margin pressure
  - Inventory in days = (inventory ÷ cost of goods sold) x days in quarter
  - Inventory as percentage of expected future sales

- **Cost capitalization:** Increase could boost current margins
  - Example: Capitalized cost ÷ R&D expense or revenue

- **Estimated expenses:** Decline may indicate understated operating expenses
  - Bad debt allowance ÷ gross receivables
  - Warranty reserve ÷ revenue, or warranty expense ÷ actual claims
  - Inventory reserve ÷ gross inventory

Focus on Disclosure:

- Change in accounting policies, e.g., revenue recognition policy
- Change in accounting estimates: e.g., sales returns or rebates, useful lives, bad debt
- One-off gains and their impact on key metrics
- Comparison with peers



EXAMPLES

Boosts to Reported Revenue

- Transition to more aggressive revenue recognition policies and practices
  - End of period "buzzer" sales
  - Extended payment terms / increased customer financing
  - Change in revenue timing: e.g., upfront versus overtime
- Revenues recorded from pure book-keeping entries
  - Percentage of completion project adjustments
  - Change in provision estimates
  - "Grossing up" revenue (principal versus agent recognition)
- Revenues that lack economic substance
  - Recording revenues when the customer is not obligated to pay
  - Concurrent negotiation of sales and supply agreements
  - Giving customers something of value as a quid pro quo

Revenue Recognition: Under Armour

Late Period Sales

In 2015, UAA was trying to maintain high growth rate. In Q4, DSO increased to 53 days (our DSO calculation excluded direct sales from company stores and online, which typically have negligible receivables).

($ millions)	Q4/2013	Q1/2014	Q2/2014	Q3/2014	Q4/2014	Q1/2015	Q2/2015	Q3/2015	Q4/2015
Sales	682.8	641.6	609.7	937.9	895.5	804.9	783.6	1,204.1	1,170.7
% Direct	39%	26%	31%	26%	38%	25%	32%	26%	36%
Sales x Direct	416.5	474.8	420.7	694.1	555.0	603.7	532.8	891.0	749.2
Receivables	210.0	331.3	269.1	449.2	279.8	395.9	353.4	551.2	433.6
DSO x Direct	46	63	58	60	46	59	60	57	53
YoY	-11.4%	-1.1%	-4.4%	-0.6%	+0.0%	-6.0%	+3.7%	-4.4%	+14.8%

DSO, excluding direct sales, increased 7 days as of 4Q15.

Revenue Recognition: Under Armour

Why did DSO increase? In a call with CFRA, UAA explained the DSO increase:

- Receivables up due to timing of shipments.
- UAA shipped product to customers earlier than last year – so that those customers could set their floors for the consumer in time for the spring launch.
- DSO not expected to remain elevated in 2016.

Companies often imply that late-period sales just happens on its own. In our experience, when there is high end-of-period revenue, it is often effectuated by the company.

Revenue Recognition: Under Armour

So did DSO in 2016 revert back to more normal levels as promised?

- Q1 2016: DSO up 7 days YoY.
- Q2 2016: DSO up 2 days YoY.
- Q3 2016: DSO up 5 days YoY. In the 10-Q, UAA said the increase was "due to the timing of shipments driven by current period sales being more heavily weighted to the end of the period."
- Revenue beat consensus by 1% in Q1 & Q3. Met consensus in Q2. Stretching to make the numbers?

Revenue Recognition: Under Armour

Nov. 4, 2019: *WSJ* reported that DOJ/SEC is investigating UAA's accounting.
Nov. 15, 2019: *WSJ* article offered more details:

Former employees described efforts in 2016 to sustain the 20% quarterly growth rate, even as retailers failed to sell some of the company's sweatshirts, T-shirts and other apparel. "**It was a pretty common practice to pull forward orders from the month after the quarter to ship within the quarter in order to hit the number** or close the gap," a former sales executive said.

When retailers declined to take products before their requested ship date, Under Armour sometimes adjusted the terms of the contract to offer a discount or extend the period in which retailers could pay for the products, this former executive and other employees said. "**Problem is once this starts it doesn't seem to stop," the sales executive said. "We found ourselves pulling forward every quarter**."...

To help meet its quarterly targets, Under Armour in 2016 **shipped new inventory intended for its own factory stores to off-price seller TJX** Co s., the former merchandise executive said. That **allowed Under Armour to immediately book the goods as revenue** instead of having to wait for a customer to buy the item at its own stores.

This executive and another former employee said Under Armour was **careful to avoid shipping too much inventory to TJX so that it wouldn't have to disclose that the discounter was among its major customers** in its securities filings.

(emphasis added)

Acquisition Accounting

- The acquirer must fair value the assets and liabilities of the acquired company at the time of acquisition, known as purchase price allocation (PPA).
- Favorable fair value adjustments may boost post-acquisition revenue and/or earnings.

Tricks of the trade used in PPA

Writing Down Acquired Assets

- Receivables
- Inventory
- PP&E

Writing Up Acquired Liabilities

- Provisions
- Accrued liabilities
- Contract liabilities

Contingent Consideration Reversals

- Magnitude
- Well disclosed?

Inflated Acquired Provisions Lead to Reversals: Lenovo

- Lenovo has a provision for environmental restoration, which it says are "estimated costs of environmentally sound disposal of waste electrical and electronic equipment upon return from end-customers."
- Always review roll-forward schedules of provisions!

(Millions of US$)	FY12 Mar	FY13 Mar	FY14 Mar
Provision for Environmental Restoration, Beginning Balance	15	86	56
Exchange Adjustment	(2)	(7)	(3)
Provisions Made (Expense)	11	12	9
Amounts Utilized	(5)	(3)	(5)
Unused Amounts Reversed	(1)	(32)	(37)
Acquisition of Subsidiaries	68	-	-
Provision for Environmental Restoration, Ending Balance	86	56	20

Lenovo recorded $68 million in acquired provisions for its environmental restoration reserve.

Lenovo subsequently reversed most of it into earnings.

Source: Company reports

Acquisition of Unfavorable Contracts/Contract Liabilities: Triumph Group (TGI)

- TGI is an Aerospace and Defense company in the U.S.
- Cash flow statement showed significant **non-cash earnings benefits** from "Amortization of acquired contract liability".

	Year ended March 31,		
	2018	2017	2016
Operating Activities			
Net loss	$ (425,391)	$ (42,952)	$ (1,047,960)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:			
Depreciation and amortization	158,368	176,946	177,755
Impairment of intangible assets	535,227	266,298	874,361
Amortization of acquired contract liability	(125,148)	(121,004)	(132,363)
Loss on divestiture and assets held for sale	30,741	19,124	—
Curtailments, settlements and early retirement incentives	(25,722)	—	(1,244)
Other amortization included in interest expense	11,677	5,553	3,904
(Recovery) provision for doubtful accounts receivable	(242)	202	1,996
(Benefit) provision for deferred income taxes	(43,108)	9,480	(118,302)
Share-based compensation	7,949	7,922	2,657
Changes in other current assets and liabilities, excluding the effects of acquisitions:			
Accounts receivable	(105,104)	112,196	73,083
Inventories	(163,417)	(272,653)	293,517
Prepaid expenses and other current assets	(4,239)	11,756	(6,958)
Accounts payable, accrued expenses and income taxes payable	(43,696)	211,560	53,914
Accrued pension and other postretirement benefits	(88,464)	(100,012)	(87,559)
Other	(8,325)	(2,894)	(2,938)
Net cash (used in) provided by operating activities	(288,894)	281,522	83,863

Source: TGI's March 2018 10-K.

Acquisition of Unfavorable Contracts/Contract Liabilities: Triumph Group (TGI)

TGI previously made multiple acquisitions. One such acquisition was the Hydraulic Actuation business from GE Aviation, which TGI acquired for $75.6 million.

		June 27, 2014
Cash	$	4,608
Accounts receivable		35,582
Inventory		48,469
Property and equipment		29,781
Goodwill		161,160
Intangible assets		32,496
Deferred taxes		62,731
Other assets		2,023
Total assets	$	376,850
Accounts payable	$	17,830
Accrued expenses		52,935
Acquired contract liabilities		230,476
Total liabilities	$	301,241

Purchase price allocation PPA) for this acquisition shows $230.5 million in estimated fair value of acquired contract liabilities.

Source: TGI's March 2015 10-K.

Acquisition of Unfavorable Contracts/Contract Liabilities: Triumph Group (TGI)

What are these acquired contract liabilities?

In connection with several of our acquisitions, we assumed existing long-term contracts. Based on our review of these contracts, we concluded that the terms of certain contracts to be either more or less favorable than could be realized in market transactions as of the date of the acquisition. As a result, we recognized acquired contract liabilities, net of acquired contract assets as of the acquisition date of each respective acquisition, based on the present value of the difference between the contractual cash flows of the executory contracts and the estimated cash flows had the contracts been executed at the acquisition date. The liabilities principally relate to long-term contracts that were initially executed several years prior to the respective acquisition (see Note 3 for further discussion).

The Company measured these net liabilities under the measurement provisions of ASC 820, *Fair Value Measurement* , which is based on the price to transfer the obligation to a market participant at the measurement date, assuming that the net liabilities will remain outstanding in the marketplace. Fair value estimates are based on a complex series of judgments about future events and uncertainties and rely heavily on estimates and assumptions. The judgments used to determine the estimated fair value assigned to each long-term contracts can materially impact our results of operations.

- TGI records a liability if it deems that the acquired contract is unfavorable to what could be realized in current market.
- Liability amortized as a **benefit to revenue** to offset the theoretical unfavorable amount.

Source: TGI's March 2018 10-K.

Acquisition of Unfavorable Contracts/Contract Liabilities: Triumph Group (TGI)

Major caveat: Significant judgment required in these estimates:

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An aggressive management team could inflate these liabilities, which would set themselves up for sizeable (non-cash) earnings going forward.

Source: TGI's March 2018 10-K.

Acquisition of Unfavorable Contracts/Contract Liabilities: Triumph Group (TGI)

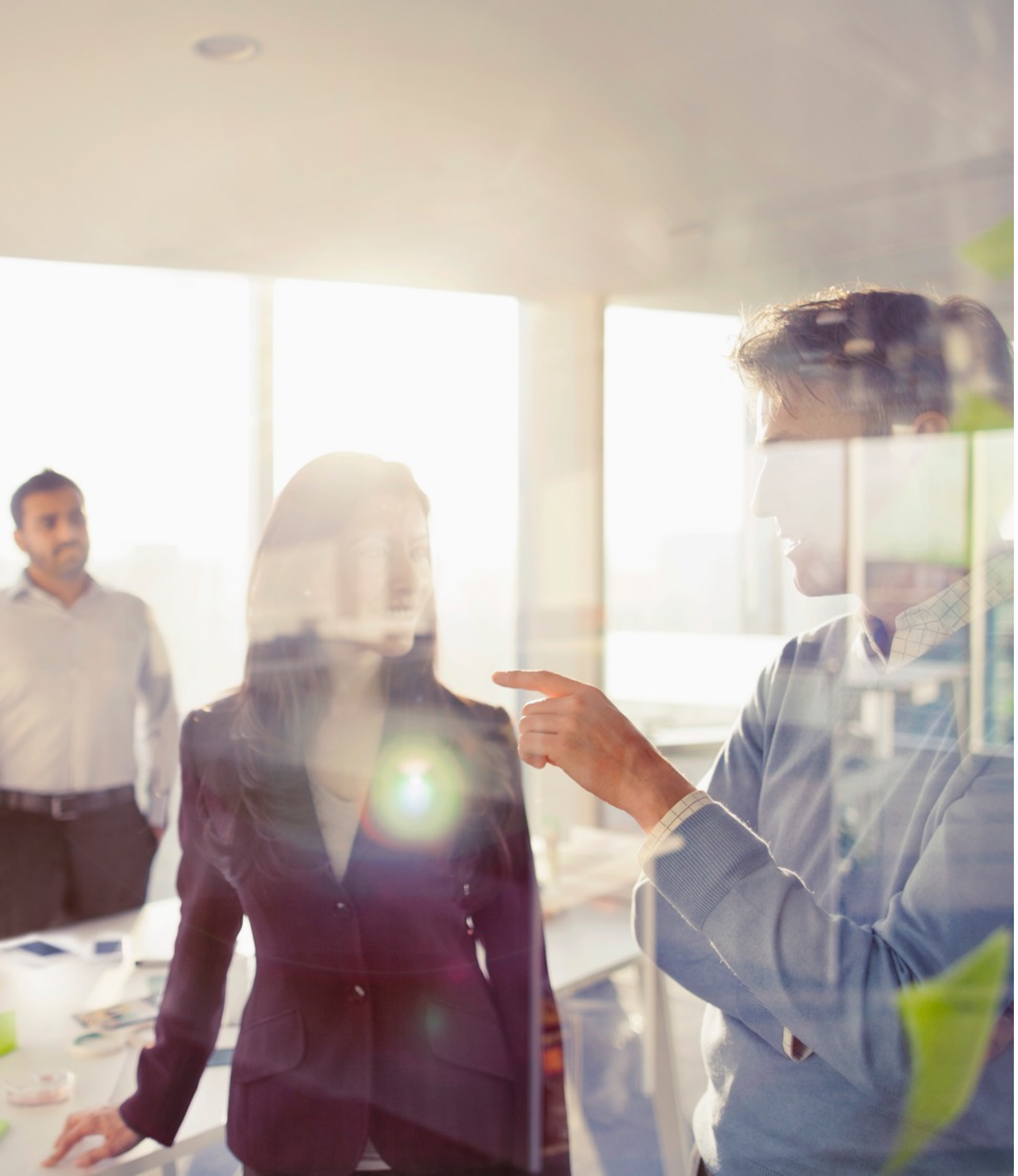
Amortization of contract assets amounted to 57% of Adj. Op Income in FY18!

(Millions of US$)	FY16 Mar	FY17 Mar	FY18 Mar
Amortization of Contract Liabilities	132.4	121.0	125.1
Adjusted Operating Income- non-GAAP	464.0	431.3	220.9
Amortization/Adjusted Operating Income- non-GAAP	29%	28%	57%

This earnings stream will decline over time as the liability falls, shifting from an earnings tailwind to a headwind:

Included in the net sales of the Integrated Systems and Aerospace Structures is the non-cash amortization of acquired contract liabilities recognized as fair value adjustments through purchase accounting from various acquisitions. The Company recognized net amortization of contract liabilities of $125,148 , $121,004 and $132,363 in the fiscal years ended March 31, 2018, 2017 and 2016 , respectively, and such amounts have been included in revenues in results of operations. The balance of the liability as of March 31, 2018 , is $274,167 and, based on the expected delivery schedule of the underlying contracts, the Company estimates annual amortization of the liability as follows: 2019 — $68,782 ; 2020 — $63,241 ; 2021 — $59,098 ; 2022 — $32,021 ; 2023 — $25,071 ; Thereafter $25,954 .

Source: TGI's March 2018 10-K.



One last piece of advice

Reporting numbers are based on judgements and don't tell the whole story.

QUESTION & ANSWER

What questions do you have?

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