

# Composite Manufacturing Company: A Financial (Mis)Statement Case Study

## 1. INTRODUCTION<sup>1</sup>

Financial statements are a central feature of financial reporting and are the primary means of communicating accounting information to those both inside and outside a business enterprise.

The financial statements most frequently provided and/or must be provided in a public company's 10-K filing with the Securities and Exchange Commission ("SEC") are the:

- a. Balance Sheet (or Statement of Financial Position);
- b. Income Statement (or Statement of Earnings);
- c. Statement of Changes in Shareholders' Equity; and
- d. Statement of Cash Flows.

Accounting and auditing organizations establish the rules and guidelines used in accounting and financial reporting. These organizations include:

- a. Financial Accounting Standards Board ("FASB"): designated to establish financial accounting and reporting standards for the private sector.<sup>2</sup>
- b. Emerging Issues Task Force ("EITF"): designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched.<sup>3</sup>
- c. American Institute of Certified Public Accountants ("AICPA"): responsible for setting all audit standards and procedures that govern the audits of privately held companies.<sup>4</sup>

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<sup>1</sup> FASB Statement of Financial Accounting Concepts No. 1 – Objectives of Financial Reporting by Business Enterprises

<sup>2</sup> FASB. "Facts about FASB". <http://www.fasb.org/facts/>

<sup>3</sup> FASB. "Facts about FASB". <http://www.fasb.org/facts/>

<sup>4</sup> AICPA. "AICPA Mission and History".  
<http://www.aicpa.org/ABOUT/MISSIONANDHISTORY/Pages/MissionHistory.aspx>

- d. Auditing Standards Board (“ASB”): senior technical committee of the AICPA designated to issue auditing, attestation and quality control standards and guidance.<sup>5</sup>
- e. Financial Reporting Executive Committee (“FinREC”) (formerly known as the Accounting Standards Executive Committee): senior technical committee of the AICPA designed to determine the AICPA’s technical policies regarding financial reporting standards.<sup>6</sup>
- f. Public Company Accounting Oversight Board (“PCAOB”): established by Congress (through the Sarbanes-Oxley Act of 2002) to set auditing standards that govern the audits of publicly held companies.<sup>7</sup>
- g. Securities and Exchange Commission (previously defined as the “SEC”): has statutory authority to establish financial accounting and reporting standards for publicly held companies.<sup>8</sup>
- h. International Accounting Standards Board (“IASB”): responsible for setting the International Financial Reporting Standards and cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world.<sup>9</sup>
- i. Governmental Accounting Standards Board (“GASB”): responsible for establishing standards of accounting and financial reporting for U.S. state and local governments.<sup>10</sup>
- j. Federal Accounting Standards Advisory Board (“FASAB”): designated by the AICPA to establish accounting principles for federal entities.<sup>11</sup>

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<sup>5</sup> AICPA. Auditing, Attestation and Quality Control Standards Setting Activities - Operating Policies. [http://www.aicpa.org/Research/Standards/AuditAttest/ASB/DownloadableDocuments/ASB%20OPERATING%20POLICIES%20DOCUMENT%20\(2009-10\).pdf](http://www.aicpa.org/Research/Standards/AuditAttest/ASB/DownloadableDocuments/ASB%20OPERATING%20POLICIES%20DOCUMENT%20(2009-10).pdf)

<sup>6</sup> AICPA. “Financial Reporting Executive Committee”. <http://www.aicpa.org/interestareas/frc/accountingfinancialreporting/pages/finrec.aspx>

<sup>7</sup> PCAOB. “About the PCAOB”. <http://pcaobus.org/About/Pages/default.aspx>

<sup>8</sup> SEC. “The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity and Facilitates Capital Formation. <http://www.sec.gov/about/whatwedo.shtml>

<sup>9</sup> IFRS. “About the IFRS Foundation and the IASB”. <http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm>

<sup>10</sup> FASB. “Facts about FASB”. <http://www.fasb.org/facts/>

<sup>11</sup> FASAB. “Our Mission and Objectives”. <http://www.fasab.gov/about/mission-objectives/>

Accounting and auditing principles, standards and rules established by these organizations include:

- a. Generally Accepted Accounting Principles (“GAAP”): a broad set of standards that provide both broad and specific guidelines on how companies should compile and present information within the company’s financial statements.

The GAAP Hierarchy, as described below, is imposed on the reporting entities based on the understanding that management is responsible for selecting and applying the appropriate GAAP standards<sup>12,13</sup>:

- FASB SFAS’s and Interpretations, FASB Statement 133 Implementation Issues, FASB Staff Positions, and AICPA ARB’s and APB Opinions that are not superseded by actions of the FASB.
  - FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position.
  - AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB, consensus positions of the FASB EITF and the Topics discussed in Appendix D of EITF Abstracts (EITF D-Topics).
  - Implementation guides (Q&A) published by the FASB staff, AICPA Accounting Interpretations, AICPA Industry Audit and Accounting Guides and Statements not cleared by the FASB and practices that are widely recognized and prevalent either generally or in the industry.
- b. International Financial Reporting Standards (“IFRS”): set of accounting standards developed by the International Accounting Standards Board that is becoming the global standard for the preparation of public company financial statements.<sup>14</sup>
  - c. Generally Accepted Auditing Standards (“GAAS”): set of standards to provide a measure of audit quality and the objectives to be achieved in an audit. The AICPA approved and adopted the general, field work and reporting standards.<sup>15</sup>

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<sup>12</sup> SFAS No. 162 – The Hierarchy of Generally Accepted Accounting Principles

<sup>13</sup> Rules and interpretive releases of the SEC are sources of category 1 for SEC registrants.

<sup>14</sup> AICPA. “International Financial Reporting Standards (IFRS) — an AICPA Backgrounder”. [http://www.ifrs.com/pdf/IFRSUpdate\\_V8.pdf](http://www.ifrs.com/pdf/IFRSUpdate_V8.pdf)

<sup>15</sup> AICPA. AU Section 150 – Generally Accepted Auditing Standards

## 2. GAINING AN UNDERSTANDING OF FINANCIAL STATEMENTS

### *Balance Sheet (or Statement of Financial Position)*<sup>16</sup>

Purpose: report a company's financial position (including assets, liabilities and shareholders' equity) at a particular point in time.

Functions: outline an entity's resource structure (i.e. major classes and amounts of assets) and outline an entity's financing structure (i.e. major classes and amounts of liabilities and equity).

Uses: Assess an entity's financial flexibility, liquidity and risk.

### *Assets*

Assets have three essential characteristics<sup>17</sup>:

- a. Represent a probable future benefit that involves a capacity to contribute directly or indirectly to an entity's future net cash inflows.
- b. Entity can obtain this benefit and control others' access to the benefit.
- c. Transaction or other event giving rise to an entity's right (or control of) this benefit has already occurred.

Grouped on the balance sheet according to their "current" or "non-current" status and typically listed in order of liquidity, or the amount of time before a given asset is converted to cash (though, surprisingly, this is not a requirement of GAAP).

Typically, "current" assets are the first group of assets listed on the balance sheet because these assets are the most liquid (i.e. cash).

- a. "Current" assets are assets that will be converted to cash within 12 months of the balance sheet date or within the entity's operating cycle (whichever is longer).

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<sup>16</sup> FASB Statement of Financial Accounting Concepts No. 5 – Recognition and Measurement in Financial Statements of Business Enterprises

<sup>17</sup> FASB Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements (a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

“Property, Plant and Equipment” (referred to as “PP&E”) typically follows the “current” assets on the balance sheet.

- a. The PP&E account on the balance sheet represents a company’s investments in property, plant and equipment that is capitalized rather than fully expensed in the current period.
- b. PP&E is recorded on the balance sheet at historical cost, meaning the cost at which the company bought the PP&E.
- c. Since the entire cost of the PP&E is not expensed in the current period, the asset is depreciated over the life of the asset and expensed.
- d. Balance sheet illustrates the company’s depreciation for all capitalized PP&E in the “Accumulated Depreciation” account.
- e. Balance sheet reports the PP&E account net of “Accumulated Depreciation”.

“Non-current” assets are the last group of assets listed on the balance sheet because these assets are the least liquid (i.e. long-term investments).

- a. “Non-current” assets are assets that will not be converted to cash within 12 months of the balance sheet date or within the entity’s operating cycle (whichever is longer).
- b. “Non-current” assets are items that are expected to provide economic benefits to an entity for greater than one year.

### *Liabilities*

Liabilities have three essential characteristics<sup>18</sup>:

- a. Represent a present duty or responsibility to one or more other entities that entails settlement of an amount by probable future transfer or use of assets (either at a specified or determinable date, on occurrence of a specified event or on demand).
- b. This present duty or responsibility obligates a particular entity, leaving the entity little or no discretion to avoid the future sacrifice.
- c. The transaction or other event obligating the entity has already happened.

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<sup>18</sup> FASB Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements (a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

Grouped on the balance sheet according to their “current” or “non-current” status and typically listed in order of liquidity (which in regards to liabilities refers to how soon the obligations are expected to be satisfied or paid).

“Current” liabilities are the first group of liabilities listed on the balance sheet because these liabilities are expected to be satisfied or paid the soonest (i.e. current portion of long-term debt, such as monthly mortgage payments).

- a. “Current” liabilities are liabilities that are expected to be satisfied or paid within 12 months of the balance sheet date or within the entity’s operating cycle (whichever is longer).

“Non-current” liabilities are the second group of liabilities listed on the balance sheet because these liabilities are expected to be satisfied or paid the latest (i.e. long-term debt, such as the remaining balance of a mortgage).

- a. “Non-current” liabilities are liabilities that are not expected to be satisfied or paid within 12 months of the balance sheet date or within the entity’s operating cycle (whichever is longer).

### *Equity*<sup>19</sup>

Can be defined as “the residual interest in the assets of an entity that remains after deducting its liabilities”.

The amount of equity is increased or decreased by the entity’s operations and other events affecting the entity.

- a. For instance, a major distinguishing characteristic of equity is that it may be increased through investments of assets by owners, and decreased for distributions of assets to owners.
- b. Such investments by owners are referred to as “owners’ equity” (also commonly referred to as “shareholders” or “stakeholders” equity).
- c. Owners’ equity arises mainly from two sources:
  - Amounts invested by shareholders in the corporation (i.e. paid-in capital), and
  - Amounts earned by the corporation (i.e. retained earnings). Retained earnings represent the accumulated net income earned by the entity (but not yet paid to its shareholders) since its inception.

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<sup>19</sup> FASB Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements (a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

d. Owners' equity may also be comprised of other equity components such as:

- Common stock;
- Treasury stock; and
- Deferred compensation

### *Recording Assets and Liabilities*<sup>20</sup>

Assets and liabilities are recorded in one of six ways:

a. Historical cost (proceeds)

- For assets, the amount of cash (or cash equivalent) paid to acquire an asset, which is generally adjusted after acquisition for amortization or other allocations (fixed assets and most inventories are reported at their historical cost).
- For liabilities, the amount of cash (or cash equivalent) received when an obligation is incurred and may be adjusted after acquisition for amortization or other allocations (liabilities that involve obligations to provide goods or services to customers are generally reported at historical proceeds)

b. Current cost

- The amount of cash (or cash equivalent) that would have to be paid if the same or an equivalent asset were acquired currently (some inventories are reported at their current cost).

c. Current market value

- The amount of cash (or cash equivalent) that could be obtained by selling an asset in liquidation (some investments in marketable securities are reported at their current market value, as are assets that are expected to be sold at prices lower than their carrying amounts).
- In the case of marketable securities, fair market value may be identical to the current market value (as there are directly observable market transactions of similar assets).
- However, fair value is the amount at which the asset could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party, other than in a liquidation sale

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<sup>20</sup> FASB Statement of Financial Accounting Concepts No. 5 – Recognition and Measurement in Financial Statements of Business Enterprises

d. Fair market value<sup>21</sup>

- The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date; the fair value may be the same as the current market value (i.e., marketable securities).
- However, fair market value also applies to assets and liabilities for which there is little, if any, market activity for the asset or liability at the measurement date; the fair market value is based on the reporting entity's own assumptions about the market.

e. Net realizable (settlement) value

- For assets, the non-discounted amount of cash (or cash equivalent) into which an asset is expected to be converted in due course of business less any direct costs necessary to make that conversion (short-term receivables and some inventories are reported at their net realizable value).
- For liabilities, the non-discounted amount of cash (or cash equivalent) expected to be paid to liquidate an obligation in the due course of business including any direct costs necessary to make that payment (liabilities that involve known or estimated amounts of money payable at unknown future dates (for example, warranty obligations) are generally reported at their net settlement value).

f. Present (or discounted) value of future cash flows

- For assets, the present or discounted value of future cash inflows into which an asset is expected to be converted in the due course of business less present values of cash outflows necessary to obtain those inflows (long-term receivables are reported at their present value (discounted at the implicit or historical rate).
- For liabilities, the present or discounted value of future cash outflows which is expected to be required to satisfy a liability in the due course of business (long-term payables are reported at their present value (discounted at the implicit or historical rate).

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<sup>21</sup> FASB Statement of Financial Accounting Standards No. 157 – Fair Value Measurements

In addition, situations often arise that cause a significant decline (i.e. impairment) of the benefits produced by an asset (for example, a building being destroyed by a natural disaster before it has been fully depreciated).

- a. When an asset has been deemed impaired, the carrying value of that asset should either be fully or partially written off (depending on the particular circumstances and/or applicable specific accounting rules)

Furthermore, some uncertainties in the accounting process give rise to “contingencies” in relation to assets and liabilities.

- a. Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (“SFAS 5”) defines gain and loss contingencies as:
  - “An existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur”
- b. SFAS 5 established the requirement of accruing for an estimated loss from a loss contingency by a charge to income if the following two conditions are met:
  - Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements; and
  - The amount of the loss can be reasonably estimated.
- c. SFAS 5 also describes how gain contingencies should be handled. It states that:
  - “Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization. Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization”

### ***Income Statement (or Statement of Earnings)***<sup>22,23</sup>

Purpose: summarize the profit (or loss) generating activities of an entity that occurred during a particular period of time – (not as of a particular *point* in time, like the balance sheet).

Functions: reflects the extent to which (and the ways in which) the equity of an entity increased or decreased from all sources other than transactions with owners during a period.

Uses: It is generally viewed as the most useful to predict the future profitability of a company.

### ***Operating Income (Expenses)***

Consist of items (revenues, cost of sales and other income(expenses)) generated during the ordinary course of business.

Subtracting cost of goods sold and the operating expenses from net sales results in operating income for the stated period.

### ***Revenues***

Actual or expected cash inflows (or the equivalent) of an entity or settlements of its liabilities (or a combination of both) arising from delivering or producing goods, rendering services or other activities that constitute the entity's ongoing major or central operations. Examples of types of revenues include:

- a. Sales;
- b. Deliveries;
- c. Fees;
- d. Interest;
- e. Dividends;
- f. Rent; and
- g. Royalties

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<sup>22</sup> Spiceland, J. David, James F. Sepe and Lawrence A. Tomassini. Intermediate Accounting. McGraw-Hill, 2003. pp. 168-170.

<sup>23</sup> FASB Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements (a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

Various assets are increased by revenues. Examples include:

- a. Cash;
- b. Claims against customers or clients (i.e. accounts receivable); and
- c. Investments (i.e. from the reinvestment of interest and dividend revenue)

### *Expenses*

Actual or expected cash outflows (or the equivalent) from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's ongoing major or central operations. Examples of types of expenses include:

- a. Cost of goods sold;
- b. Cost of services provided;
- c. Interest;
- d. Rent; and
- e. Salaries and wages

The assets that flow out (or are used by) or the liabilities that are incurred may include:

- a. Cash;
- b. Units of product delivered or produced;
- c. Employees' services used;
- d. Utilities; and
- e. Taxes on current income

## *Gains (Losses)*

Increases (decreases) in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity (i.e. those that are not considered an entities ongoing major or central operation) except those that result from revenues (expenses) or investments by (distributions to) owners. Examples of types of gains (losses) include:

- a. The net results of comparing the proceeds and costs from incidental transactions with other entities, such as:
  - sales of investments in marketable securities;
  - dispositions of used equipment; and
  - settlements of liabilities at other than their carrying amounts
- b. Nonreciprocal transfers between entities that are not its owners, such as:
  - gifts or donations (could also be operating expenses depending on the circumstances);
  - legal settlements and/or awards;
  - thefts; and
  - assessments of fines, penalties or damages by courts
- c. Holding assets or liabilities while their values change, such as:
  - price changes that cause inventory items to be written down from cost to market;
  - changes in market prices of investments in marketable equity securities accounted for at market values or at the lower of cost and market; and
  - changes in foreign currency exchange rates
- d. Other environmental factors, such as:
  - damage to or destruction of property by natural catastrophes; and
  - damage from fire

Gains and losses may be described or classified as “operating” or “non-operating” depending on their relation to an entity’s major ongoing or central operations.

### *Non-Operating Items*

May include revenue, expense, gain and loss items that are not generated during the entity’s ordinary course of business. Adding and subtracting these items results in “earnings before income taxes.” Subtracting the taxes associated with these earnings results in “income from operations.”

### *Separately Reported Items*<sup>24</sup>

These items include revenues, expenses, gains and losses generated by (or related to) discontinued operations, extraordinary items and the cumulative effect of changes in accounting principles. Before net income (or net earnings) can be calculated, these additional items must be taken into account.

#### a. Discontinued Operations

- Business segments (1) whose operations have been (or will be) eliminated from the ongoing operations of the business; and (2) with which the entity will no longer have any significant continuing involvement with after disposal.
- Discontinued operations are listed separately in the income statement because their income stream will soon end. Such information is very useful to investors and creditors when predicting a company’s future income generating capabilities.

#### b. Extraordinary Items

- Include unusual events that have a material effect on the current year’s income and are highly unlikely to occur again in the future.
- To be “extraordinary,” the item must be both unusual in nature and infrequent in occurrence.

#### c. Cumulative Effect of a Change in Accounting Principle

- Most often these changes are either in the method of accounting for inventory (i.e. change from FIFO to LIFO) and/or in the method of depreciation (i.e. straight-line to double-declining balance).

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<sup>24</sup> Spiceland, J. David, James F. Sepe and Lawrence A. Tomassini. Intermediate Accounting. McGraw-Hill, 2003. pp. 182-192.

- Such changes can have a material effect on earnings and create inconsistencies when comparing the current year earnings to prior years. As a result, these changes need to be clearly noted.

### *Example of a Change in Accounting Principle*

The effect that the change of an accounting principle can have can be clearly demonstrated when looking at a depreciation example. Assume a machine with a book value of \$100,000 and a salvage value of \$0 is depreciated over five years using the straight-line method, resulting in the following charge to a Company's earnings:

$$5 \text{ years} = \$100,000 / 5 = \$20,000 \text{ per year}$$

Therefore, depreciation expense would be incurred as follows:

Year 1: \$20,000

Year 2: \$20,000

At the end of 2 years, the net book value of the machine is \$60,000 (\$100,000 original book value less \$20,000 depreciation expense in year 1 less \$20,000 depreciation expense in year 2).

However, using the double-declining balance method results in a difference:

$$5 \text{ years} = 20\% \text{ per year} \times 200\% = 40\% \text{ per year}$$

Therefore, depreciation expense would be incurred as follows:

Year 1: \$100,000 x 40% = \$40,000

Year 2: \$60,000 x 40% = \$24,000

At the end of 2 years, the net book value of the machine is \$36,000 (\$100,000 original book value less \$40,000 depreciation expense in year 1 less \$24,000 depreciation expense in year 2).

Therefore, changing from the straight-line method to the double-declining balance method of depreciation results in a cumulative difference of \$24,000 in depreciation expense during this two year period (\$40,000 using the straight-line method versus \$64,000 using the double-declining balance method), impacting both the expenditures contained in the income statement and the values of the assets contained on the balance sheet.

### *Net Earnings*<sup>25</sup>

The amount of income that flows through from the income statement to retained earnings in the balance sheet. These earnings are then used to finance the company's growth and/or pay distributions or dividends to stockholders. Net earnings can be determined after taking into account income from operations, other income and separately reported items (as discussed above).

### *Comprehensive Income*<sup>26</sup>

A broad measure of the effects of transactions and other events on an entity, comprising all recognized changes in equity of the entity during a period from transactions and other events except those resulting from investments by owners and distributions to owners.

Net Earnings and comprehensive income have the same broad components (revenues, expenses, gains, and losses) but are not the same because certain classes of gains and losses are included in comprehensive income but are excluded from net earnings.

Combining these "other comprehensive income (loss)" items with net earnings results in "comprehensive income". Examples of these items include:

- a. Effects of certain accounting adjustments of earlier periods that are recognized in the current period
- b. Certain holding gains and losses arising from changes in market values of investments in marketable securities classified as noncurrent assets; and
- c. Foreign currency translation adjustments

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<sup>25</sup> FASB Statement of Financial Accounting Concepts No. 5 – Recognition and Measurement in Financial Statements of Business Enterprises

<sup>26</sup> FASB Statement of Financial Accounting Concepts No. 5 – Recognition and Measurement in Financial Statements of Business Enterprises

### ***Statement of Changes in Shareholders' Equity***<sup>27,28</sup>

Purpose: discloses the sources of the changes in the various permanent shareholders' equity accounts that occurred during a period.

Functions: reconciles the various components of shareholders' equity on the balance sheet for the beginning of the period with the same items at the end of the period.

Uses: since the individual profit-generating transactions that cause retained earnings to change are included in the income statement, this statement only shows the net effect of these transactions on retained earnings.

Changes in Shareholders' Equity typically include:

- a. Issuance and/or re-purchase of stock (i.e. treasury stock);
- b. Payment of dividends;
- c. Unrealized holding gains and losses; and
- d. Foreign currency translation gains and losses

### ***Statement of Cash Flows***<sup>29</sup>

Purpose: directly and/or indirectly reflects an entity's cash receipts classified by major sources and its cash payments classified by major uses during a period – (not as of a particular *point* in time, like the balance sheet).

Functions: answers the question, “where does the money come from and where does the money go?” It provides information on all cash receipts and disbursements that occurred during the operating period.

Uses: provides information pertaining to:

- a. an entity's activities in generating cash through operations to repay debt, distribute dividends or reinvest to maintain or expand operating capacity;
- b. an entity's financing activities, both debt and equity; and

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<sup>27</sup> Spiceland, J. David, James F. Sepe and Lawrence A. Tomassini. Intermediate Accounting. McGraw-Hill, 2003. pp. 88-89, 170.

<sup>28</sup> According to Section 210.3-04 (Changes in stockholders' equity and noncontrolling interests) of Title 17: Commodity and Securities Exchanges issued by the SEC, the Statement of Changes in Shareholders' Equity may be provided either in a note or as a separate statement.

<sup>29</sup> FASB Statement of Financial Accounting Concepts No. 5 – Recognition and Measurement in Financial Statements of Business Enterprises

- c. an entity's investing or spending of cash.

The Statement of Cash Flows reflects the cash available, while an income statement reflects the "profit" earned during a period. Profit is not cash in the bank.

While many companies choose not to prepare a Statement of Cash Flows, the SEC requires all publicly traded companies to disclose their Statement of Cash Flows.

The FASB issued the standards for cash flow reporting as Statement No. 95 in November 1987. This required that the Statement of Cash Flows classify cash receipts and payments according to their source: operations, investing or financing.

By combining and analyzing the activity in these three categories, investors and creditors can gain an insight into a company's ability to generate long and short-term cash flows, its ability to pay long and short-term debt as well as its current cash standing.

### *Operating Activities*

Cash inflows and outflows associated with the transactions that resulted in operating income in the income statement.

Many analysts believe that if cash flow from operating activities is not consistent and substantial, the company has or will have economic issues.

Operating cash flow can reveal trends in the operations of a business that are otherwise commingled with and/or disguised by non-cash items, such as depreciation, or non-recurring events, such as litigation.

### *Investing Activities*

Cash inflows and outflows associated with the acquisition/disposition of long-term assets used in the business and of non-operating investments.

### *Financing Activities*

Cash inflows and outflows resulting from transactions with the businesses creditors and owners.

## *Financial Statement Disclosures*<sup>30</sup>

Disclosure of information about the items in financial statements may be provided by notes, parenthetically on the face of financial statements, by supplementary information or by other means.

Disclosure information serves to explain or highlight information recognized in the financial statements.

Disclosure information is essential to understanding the information recognized in financial statements and is considered an integral part of financial statements prepared in accordance with GAAP.

- a. However, financial statement disclosures are not a substitute for recognition in financial statements for items that meet recognition criteria.
- b. Generally, the most useful information about assets, liabilities, revenues, expenses and other items of financial statements should be recognized in the financial statements.

Disclosure information may include (but is not limited to):

- a. Significant accounting policies;
- b. Detailed contents of expense categories, such as cost of goods sold;
- c. Alternative measures for assets or liabilities;
- d. The effects of changing prices;
- e. Cash flow information;
- f. Information regarding contingencies;
- g. Earnings per share data;
- h. Contingencies; and
- i. Related party transactions

Each user of accounting information will uniquely perceive the relative value to be attached to each quality of that information.

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<sup>30</sup> FASB Statement of Financial Accounting Concepts No. 6 – Elements of Financial Statements (a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

Statements of Financial Accounting Standards (previously defined as “SFAS”) issued by the FASB establish standards prescribing disclosure practices for particular items or events.

In order to justify requiring a particular disclosure, the perceived benefits of that disclosure must exceed the costs associated with it.

### ***Fraudulent Financial Statements***<sup>31</sup>

Schemes involving the intentional misstatement or omission of material information in the organization’s financial statements. Examples include:

- a. Recording fictitious revenues;
- b. Concealing liabilities or expenses; and
- c. Artificially inflating reported assets

Having an understanding of financial statement analysis can help prevent such schemes from occurring and reduce the incurrence of significant losses.

According to the Association of Certified Fraud Examiners’ (“ACFE”) 2010 Report to the Nation on Occupational Fraud and Abuse, financial statement fraud was the least commonly reported form of fraud.

Financial statement fraud cases represented less than 5% of all reported cases, with asset misappropriation and corruption representing the remaining 95%.

While financial statement fraud is not nearly as common as other forms of fraud, its impact tends to cause considerably more damage.

- a. On average, the median loss of a financial statement fraud is \$4,000,000.
- b. This is 16 times as high as losses from asset misappropriation and 25 times as high as losses from corruption.

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<sup>31</sup> Extracted (in part) from the 2010 Report to the Nations on Occupational Fraud and Abuse, published by the Association of Certified Fraud Examiners (ACFE). The report, in its entirety, is available online at <http://www.acfe.com/rtn/rtn-2010.pdf>.

Fraudulent financial statements differ from other forms of occupational fraud in that the typical goal of such a scheme is not to directly enrich the perpetrator, but rather to mislead investors, owners, management and/or other third parties as to the profitability of an organization.

The losses resulting from financial statement fraud are often measured in terms of lost market capitalization or lost shareholder value rather than the direct loss of financial assets.

The lost shareholder value resulting from financial statement fraud can have crippling effects on even the largest companies (such as in the cases of Enron and WorldCom) and have deep impacts on the organization's shareholders.

### 3. FINANCIAL SHENANIGANS

Howard M. Schilit, Ph.D., CPA coined the term “financial shenanigans” and identified fifteen major financial shenanigans<sup>32</sup>.

#### *Earnings Manipulation Shenanigans*

##### *Earnings Manipulation Shenanigan #1 – Recording Revenues Too Soon*

- Recording revenue before completing any obligations under contract.
- Recording revenue far in excess of work completed on a contract.
- Recording revenue when future services remain to be provided.
- Receivables (especially long-term and unbilled) growing faster than sales.
- Changes in revenue recognition assumptions of liberalizing customer collection terms.
- Seller offering extremely generous extended payment terms.

##### *Earnings Manipulation Shenanigan #2 – Recording Bogus Revenue*

- Recording sales that lack economic substance.
- Use of an inappropriate or unusual revenue recognition approach.
- Recording revenue on receipts from non-revenue producing transactions.
- Recording revenue from transactions that lack a reasonable arm’s-length process.
- Recording cash received from a lender, business partner, or vendor as revenue.
- Unusual decreases or increases in liability reserve accounts.

##### *Earnings Manipulation Shenanigan #3 - Boosting Income Using One-Time or Unsustainable Activities*

- Boosting profits using one-time events.
- Including investment income or gains as part of revenue.
- Routinely recording restructuring charges.

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<sup>32</sup> Schilit, Howard M. Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports, 3<sup>rd</sup> Edition. McGraw-Hill, 2010.

Commingling future product sales with buying a business.

Shifting losses to discontinued operations.

*Earnings Manipulation Shenanigan #4 - Shifting Current Expenses to a Later or Earlier Period*

Changes in capitalization policy or accelerated capitalization of costs.

Amortizing or depreciating costs too slowly.

Failing to write down or write off impaired assets.

Decline in bad debt/obsolescence expense or reserves related to bad debt.

*Earnings Manipulation Shenanigan #5 - Employing Other Techniques to Hide Expenses and Losses*

Failing to record an expense from a current transaction.

Failing to record an expense for a necessary accrual or reversing a past expense.

Declining accruals, reserves, or “soft liability” accounts.

Failing to highlight off-balance sheet obligations.

Failure to accrue loss reserves.

### *Earnings Manipulation Shenanigan #6 - Shifting Current Income to a Later Period*

Creating reserves and releasing them into income in a later period.

Recording current-period sales in a later period.

Sudden and unexplained declines in deferred revenue.

Unexpectedly consistent earnings during a volatile time.

Improperly holding back revenue just before an acquisition closes.

### *Earnings Manipulation Shenanigan #7 - Shifting Future Expenses to an Earlier Period*

Accelerating discretionary expenses into the current period.

Large write-offs accompanying the arrival of a new CEO.

Unusually smooth earnings during volatile times.

Repeated restructuring charges that serve to convert ordinary expenses to a one-time expense.

Improperly writing off in-process R&D costs from an acquisition.

### *Cash Flow Shenanigans*

#### *Cash Flow Shenanigan #1 - Shifting Financing Cash Inflows to the Operating Section*

Recording bogus cash flow from operations (CFFO) from a normal bank borrowing.

Boosting CFFO by selling receivables before the collection date.

Disclosures about selling receivables with recourse.

Providing less disclosure than in prior period.

Changes in the wording of key disclosure items in the financial reports.

*Cash Flow Shenanigan #2 - Shifting Normal Operating Cash Outflows to the Investing Section*

Inflating operating cash flow (OCF) with boomerang transactions.

Improper capitalization of normal operating costs.

Investing outflows that sound like normal costs of business.

Purchasing patents, contracts, and development –stage technologies.

Changes in the wording of key disclosure items in the financial reports.

*Cash Flow Shenanigan #3 - Inflating Cash Flow Using Acquisitions or Disposals*

Inheriting operating cash inflows in a normal business acquisition.

Declining free cash flow while CFFO appears to be strong.

Acquiring contracts or customers rather than developing them internally.

New categories appearing on the Statement of Cash Flows.

Selling a business, but keeping the related receivables.

*Cash Flow Shenanigan #4 - Boosting Operating Cash Flow Using Unsustainable Activities*

Boosting CFFO by paying vendors more slowly.

Accounts payable increasing faster than cost of goods sold.

Increases in other payables accounts.

Dramatic improvements in CFFO.

CFFO benefit from one-time items.

## ***Key Metric Shenanigans***

### ***Key Metric Shenanigan #1 - Misleading Metrics That Overstate Performance***

Changing the definition of a key metric.

Inconsistencies between the earnings release and 10-Q.

Pretending that one-time gains are recurring in nature.

Pretending that recurring charges are nonrecurring in nature.

Divergence in trend between same-store sales and revenue per store.

### ***Key Metric Shenanigan #2 - Distorting Balance Sheet Metrics to Avoid Showing Deterioration***

Distorting accounts receivable metrics to hide revenue problems.

Failing to prominently disclose the sale of accounts receivable.

Increase in receivables other than accounts receivables.

Converting accounts receivable into notes.

Stopping the reporting of certain key metrics.

#### 4. ANALYZING FINANCIAL STATEMENTS<sup>33</sup>

Methods used to analyze the financial statements generally falls into the following categories:

- a. Vertical trend analysis (i.e. common size analysis) (see page C1)
- b. Horizontal trend analysis (see Net Sales Growth activity ratio on page C4)
- c. Ratio analysis (see page C4)
- d. Reasonableness testing
- e. Analysis of the Statement of Cash Flows
- f. Data mining
- g. Detailed Forensic Accounting

##### *Vertical Trend Analysis*

Compares each item contained in the financial statements to a common base item. For instance:

- a. Expressing all items contained in the balance sheet as a percentage of total assets (or total liabilities and equity); and
- b. Expressing all items contained in the income statement as a percentage of sales

The relationships between these items are then compared, both within the accounting period and with historical periods and/or industry data.

Performing this analysis can assist in:

- a. Providing insight into which items contained in the financial statements are key drivers of the entity's operations;
- b. Highlighting unusual trends and/or relationships; and
- c. Drawing conclusions about an entity's past and present performance; and
- d. Providing useful information to compare one entity to others within its industry to assist in evaluating performance

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<sup>33</sup> Golden, Thomas W., Steven L. Skalak and Mona M. Clayton. A Guide To Forensic Accounting Investigation. John Wiley & Sons, Inc. 2006. pp. 368-70.

### ***Horizontal Trend Analysis***

Compares each item contained in the financial statements in one period to the same items in a prior or future period and can calculate the percentage change between the two selected periods.

This method of analysis is used to highlight (and understand) the percentage of change of individual financial statement items over periods of time.

Performing this analysis can assist in:

- a. Identifying unusual trends in both an entity's key drivers (such as sales) and in particular expenses;
- b. Identifying areas and/or specific items to be further pursued; and
- c. Providing useful information to compare one entity to others within its industry to assist in evaluating performance

### ***Ratio Analysis***

Assesses and/or measures the relationships among different financial statement items and between these items and non-financial information.

Performing this analysis can assist in:

- a. Highlighting relationships between financial statement items;
- b. Highlighting unexpected changes in single and/or multiple items; and
- c. Providing useful information to compare one entity to others within its industry to assist in evaluating performance

These ratios can then be compared on a historical basis within the entity or against an industry benchmark.

- a. Risk Management Association ("RMA") compiles comparative historical data on a number of industries (Annual Statement Studies).
  - This data is organized by Standard Industrial Codes ("SIC").

b. Integra Information© provides business valuation and analysis data on a number of industries<sup>34</sup>.

- This data represents the financial performance of over 4.5 million privately held businesses organized by NAICS code.
- Integra provides detailed industry financial benchmarks spanning over 900 industries.
- Integra's data provides users with financial statements and over 70 financial ratios to assist in analysis.

Examples of types of, and specific, ratios include:

a. Liquidity Ratios

- Measure the quality and adequacy of current assets to meet current obligations.
- The inability to meet current obligations is one of the first indicators of financial distress.

b. Profitability Ratios

- Designed to assist in the evaluation of management performance.
- Indicates what profit the company is generating on the mix of assets currently employed by the company .

c. Leverage Ratios

- Measure a company's vulnerability to business downturns.
- Companies with higher leverage ratios are more susceptible to business downturns.
- Should be considered in light of the average requirements of the particular industry.

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<sup>34</sup> Integra Information. <http://www.microbilt.com/financial-benchmarking.aspx>

### ***Reasonableness Testing***

This method of analysis benchmarks the results recorded in the financial statements against an independently calculated expectation. For example:

- a. One might calculate the expected amount of interest expense for a period based on industry data.
- b. He/she would then compare the expected amount of interest expense with the amount actually incurred during that period.

Performing this analysis can assist in highlighting unusual and/or unexpected amounts and/or fluctuations.

### ***Analysis of the Statement of Cash Flows***

When does a company have enough cash?

When it has enough cash to pay short-term liabilities such as:

- payroll, benefits and taxes;
- vendors and creditors;
- short-term or portion of long-term debt current loan repayments; and
- necessary capital asset investments

When does a company have too much cash?

When the company has high cash balances on its balance sheet (high liquidity ratios).

Since cash does not generate additional profits or benefit shareholders, a company can use excess cash reserves to:

- a. Reinvest in the business to generate future cash returns;
- b. Invest in short-term interest bearing investments;
- c. Pay down debt; and
- d. Distribute dividends

## Common Cash Flow Analysis Tools/Ratios

### Free Cash Flow (“FCF”)

The cash a company is able to generate after laying out the money required to maintain or expand its asset base.

The FCF available to a company is calculated as:

$$\begin{array}{r} \text{Net Income} \\ + \text{Amortization/Depreciation} \\ - \text{Changes in Working Capital} \\ - \text{Capital Expenditures} \\ \hline \\ = \text{Free Cash Flow} \\ \hline \hline \end{array}$$

(or FCF = Operating Cash Flow – Capital Expenditures)

A negative FCF indicates that the company may be making large investments in the company’s infrastructure and/or capital assets, which may over time result in higher profits.

FCF allows a company to pursue additional business opportunities that may increase shareholder value.

FCF is also frequently used to value businesses.

### ***Data Mining***

Consists of queries or searches performed within accounts (or other data) to identify anomalies within the accounts/data. Examples of data mining analysis include:

- Listing a group of accounts by size
- Identifying and reviewing all new suppliers
- Identifying gaps in check numbers
- Identifying duplicate invoice numbers or payments
- Testing transactions for proper cutoff dates
- Comparing recent prices with actual inventory costs

**Composite  
Manufacturing  
Company**

**Year Ended  
December 31, 2016**

**A Financial  
(Mis)Statement  
Case Study**



## **Composite Manufacturing Co.**

### **What the Company is about . . .**

1. Composite Manufacturing Co. ("Composite") is an innovator in the solar lighting field. The Company's principal product is the "SUNPIPE" - a super-reflective, maintenance-free natural light system that allows daylight to illuminate your home or office.
2. Daylight is reflected down the "SUNPIPE" to a translucent ceiling fixture, which uniformly diffuses natural light throughout your home or office. The SUNPIPE's revolutionary design efficiently reflects energy-free daylight from dusk to dawn at a fraction of the cost of a traditional light.
3. Two brothers – Big Jim and Little Jim – own the Company equally. Big Jim, the older brother, is responsible for a significantly disproportionate share of corporate functions. He currently oversees the credit, finance, sales, quality control and human resource departments. Big Jim has performed these duties since the unexpected death of their father in 2003.
4. Little Jim is the plant manager and is in-charge of production. The brothers have received the same salary and distributions notwithstanding different involvement in the day-to-day operations of Composite.
5. 2016 was a successful year for the Company. Major divestitures were completed and significant restructuring and reorganization projects were accomplished. Corporate goals concerning earnings, returns and cash flows were exceeded. The Company entered 2017 positioned well to support a continued strong financial performance.
6. The brothers have made several unsuccessful applications to financial institutions to obtain additional financing. Family members that they approached are willing to invest but do not have ready capital. The brothers have approached your client, a non-family member, to obtain a capital infusion in exchange for a minority interest in the Company.



**COMPOSITE MANUFACTURING CO.  
MANAGEMENT FINANCIAL STATEMENTS  
WITH  
SUPPLEMENTARY INFORMATION  
YEARS ENDED DECEMBER 31, 2016 AND 2015**

**COMPOSITE MANUFACTURING CO.  
YEARS ENDED DECEMBER 31, 2016 AND 2015**

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**COMPOSITE MANUFACTURING CO.  
BALANCE SHEETS  
DECEMBER 31, 2016 AND 2015**

**ASSETS**

	<u>2016</u>	<u>2015</u>
<b>CURRENT ASSETS:</b>		
Cash	\$ 14,000	\$ 331,000
Accounts receivable - trade (net of allowance for estimated uncollectible accounts of \$15,000 for 2016 and 2015)	1,149,000	1,125,000
Inventory (Notes 1 and 2)	3,416,000	2,636,000
Due from affiliate (Note 3)	246,000	181,000
Other current assets	<u>302,000</u>	<u>42,000</u>
<b>TOTAL CURRENT ASSETS</b>	<b>5,127,000</b>	<b>4,315,000</b>
<b>PROPERTY, PLANT AND EQUIPMENT, at cost, less accumulated depreciation and amortization (Notes 4 and 5)</b>	<b>766,000</b>	<b>680,000</b>
<b>OTHER ASSETS</b>	<u><b>107,000</b></u>	<u><b>59,000</b></u>
<b>TOTAL ASSETS</b>	<u><b>\$6,000,000</b></u>	<u><b>\$5,054,000</b></u>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

<b>CURRENT LIABILITIES:</b>		
Accounts payable - trade	\$ 461,000	\$ 494,000
Current portion of long-term debt (Note 5)	1,566,000	1,141,000
Accrued expenses	<u>334,000</u>	<u>291,000</u>
<b>TOTAL CURRENT LIABILITIES</b>	<b>2,361,000</b>	<b>1,926,000</b>
<b>LONG-TERM DEBT (Note 5)</b>	<u><b>645,000</b></u>	<u><b>606,000</b></u>
<b>TOTAL LIABILITIES</b>	<u><b>3,006,000</b></u>	<u><b>2,532,000</b></u>
<b>COMMITMENTS (Note 6)</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock, \$50 par value, 500 shares authorized, 49.5 shares issued and outstanding	2,000	2,000
Retained earnings	<u>2,992,000</u>	<u>2,520,000</u>
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<u><b>2,994,000</b></u>	<u><b>2,522,000</b></u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<u><b>\$6,000,000</b></u>	<u><b>\$5,054,000</b></u>

**COMPOSITE MANUFACTURING CO.**  
**STATEMENTS OF EARNINGS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

	<u>2016</u>	<u>2015</u>
<b>NET SALES</b>	<b>\$9,513,000</b>	<b>\$8,898,000</b>
<b>COST OF GOODS SOLD</b>	<b><u>6,121,000</u></b>	<b><u>5,711,000</u></b>
<b>GROSS PROFIT</b>	<b><u>3,392,000</u></b>	<b><u>3,187,000</u></b>
<b>OPERATING EXPENSES:</b>		
Shipping	126,000	80,000
Selling	436,000	446,000
General and administrative	<u>1,829,000</u>	<u>1,604,000</u>
<b>TOTAL OPERATING EXPENSES</b>	<b><u>2,391,000</u></b>	<b><u>2,130,000</u></b>
<b>OPERATING INCOME</b>	<b><u>1,001,000</u></b>	<b><u>1,057,000</u></b>
<b>OTHER EXPENSE:</b>		
Interest expense	171,000	149,000
Litigation (Note 7)	200,000	-
Loss on sale of fixed asset	<u>-</u>	<u>2,000</u>
<b>TOTAL OTHER EXPENSE</b>	<b><u>371,000</u></b>	<b><u>151,000</u></b>
<b>EARNINGS BEFORE STATE INCOME TAXES</b>	<b>630,000</b>	<b>906,000</b>
<b>PROVISION FOR STATE INCOME TAXES</b>	<b><u>13,000</u></b>	<b><u>20,000</u></b>
<b>INCOME FROM OPERATIONS</b>	<b>617,000</b>	<b>886,000</b>
<b>DISCONTINUED OPERATIONS:</b>		
Income from operations of discontinued division (less applicable income taxes of \$18,000)	90,000	-
Gain on disposal of division (less applicable income taxes of \$24,000)	<u>50,000</u>	<u>-</u>
<b>Earnings before extraordinary item and cumulative effect of a change in accounting principle</b>	<b>757,000</b>	<b>886,000</b>
<b>EXTRAORDINARY ITEM - Gain on early extinguishment of debt (less applicable income tax benefit of \$15,800)</b>	<b>80,000</b>	<b>-</b>
<b>Cumulative effect on prior years of accounting change (less applicable income taxes of \$7,680)</b>	<b><u>17,000</u></b>	<b><u>-</u></b>
<b>NET EARNINGS</b>	<b><u>\$ 854,000</u></b>	<b><u>\$ 886,000</u></b>

**COMPOSITE MANUFACTURING CO.**  
**STATEMENTS OF RETAINED EARNINGS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

	<u>2016</u>	<u>2015</u>
<b>BALANCE, BEGINNING OF THE YEAR</b>	<b>\$2,520,000</b>	<b>\$2,146,000</b>
<b>NET EARNINGS</b>	<b>854,000</b>	<b>886,000</b>
<b>DISTRIBUTIONS TO STOCKHOLDERS</b>	<b><u>(382,000)</u></b>	<b><u>(512,000)</u></b>
<b>BALANCE, END OF THE YEAR</b>	<b><u>\$2,992,000</u></b>	<b><u>\$2,520,000</u></b>

**COMPOSITE MANUFACTURING CO.**  
**STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

	<u>2016</u>	<u>2015</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net earnings	\$854,000	\$886,000
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	70,000	49,000
Provision for uncollectible accounts	-	3,000
Litigation (Note 7)	200,000	-
Loss on sale of fixed asset	-	2,000
(Increase) decrease in cash surrender value - officers' life insurance	(7,000)	3,000
(Increase) decrease in:		
Accounts receivable - trade	(24,000)	(55,000)
Inventory	(780,000)	(232,000)
Other current assets	(260,000)	(3,000)
Other assets	(41,000)	-
Increase (decrease) in:		
Accounts payable	(33,000)	130,000
Accrued expenses	<u>43,000</u>	<u>26,000</u>
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<u>22,000</u>	<u>809,000</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of equipment	(156,000)	(413,000)
Proceeds from sale of fixed asset	<u>-</u>	<u>9,000</u>
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<u>(156,000)</u>	<u>(404,000)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds on installment notes	-	230,000
Proceeds from revolving line of credit	375,000	85,000
Principal payments on installment notes	(41,000)	(37,000)
Principal payments on revolving line of credit	-	(434,000)
Net payments to affiliate	(65,000)	(235,000)
Payment of obligation to former employee pursuant to litigation	(70,000)	-
Distributions to stockholders	<u>(382,000)</u>	<u>(512,000)</u>
<b>NET CASH USED IN FINANCING ACTIVITIES</b>	<u>(183,000)</u>	<u>(903,000)</u>
<b>NET DECREASE IN CASH</b>	(317,000)	(498,000)
<b>CASH, BEGINNING OF THE YEAR</b>	<u>331,000</u>	<u>829,000</u>
<b>CASH, END OF THE YEAR</b>	<u>\$ 14,000</u>	<u>\$331,000</u>
<b>SUPPLEMENTAL DISCLOSURES:</b>		
Noncash operating and financing transactions:		
Obligation to former employee pursuant to litigation (Note 7)	\$200,000	\$ -
Interest paid	168,000	137,000
Income taxes paid	17,000	22,000

**COMPOSITE MANUFACTURING CO.**  
**NOTES TO FINANCIAL STATEMENTS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**Note 1 - Summary of significant accounting policies and business of the Company**

**Business of the Company**

The Company manufactures and sells super reflective natural lights systems within the United States and the European Economic Community.

**Estimates**

The preparation of the Company's financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

**Inventory**

Inventory is valued at the lower of cost or market (net realizable value). Cost is determined assuming a first-in, first-out flow of physical inventory.

**Property, plant and equipment**

Property, plant and equipment are stated at cost.

Depreciation and amortization are provided utilizing straight-line and a variety of accelerated methods over estimated useful lives ranging from 5 to 40 years for buildings, 15 to 31.5 years for leasehold improvements, and 5 to 12 years for all other property and equipment.

**Income taxes**

The Company elected to be taxed as an "S" corporation under the Internal Revenue Code effective January 1, 1994. In lieu of corporate federal tax, the stockholders of an "S" corporation are taxed on their proportionate share of the corporation's income. However, the corporation is required to pay certain state income taxes.

**COMPOSITE MANUFACTURING CO.**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**Note 2 - Inventory**

Inventory consists of the following:

	<u>2016</u>	<u>2015</u>
Raw materials	\$ 539,000	\$ 412,000
Work in process	-	51,000
Finished goods	<u>2,877,000</u>	<u>2,173,000</u>
<b>Total</b>	<b><u>\$3,416,000</u></b>	<b><u>\$2,636,000</u></b>

**Note 3 - Related-party transactions**

Receivables from to an affiliated company, which is controlled by the Company's stockholders, fluctuate from day to day.

See Note 6 for lease with related party.

**Note 4 - Property, plant and equipment**

Property, plant and equipment consists of:

	<u>2016</u>	<u>2015</u>
Land	\$ 44,000	\$ 43,000
Land improvements	40,000	40,000
Building	899,000	892,000
Leasehold improvements	109,000	109,000
Machinery and equipment	364,000	355,000
Furniture and fixtures	112,000	108,000
Computer equipment	40,000	103,000
Automobiles	<u>147,000</u>	<u>61,000</u>
<b>Total cost</b>	<b>1,755,000</b>	<b>1,711,000</b>
<b>Less accumulated depreciation and amortization</b>	<b><u>989,000</u></b>	<b><u>1,031,000</u></b>
<b>Net property, plant and equipment</b>	<b><u>\$ 766,000</u></b>	<b><u>\$ 680,000</u></b>

**COMPOSITE MANUFACTURING CO.**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**Note 5 - Long-term debt**

Long-term debt consists of:

	<u>2016</u>	<u>2015</u>
Revolving line of credit, interest payable monthly at prime with the principal due on October 1, 2016 plus accrued interest, collateralized by substantially all of the assets of the Company, guaranteed by the stockholders.	\$1,476,000	\$1,101,000
Installment note, payable in monthly installments of \$3,386 plus interest at prime with a final balloon payment of \$446,924, plus interest, due November 1, 2016, collateralized by substantially all of the assets of the Company, guaranteed by the stockholders.	605,000	646,000
Obligation to former employee pursuant to litigation, payable in installments of \$50,000, \$40,000 and \$40,000 on April 1, 2017, January 5, 2018 and January 5, 2019, respectively. (Note 7)	<u>130,000</u>	<u>-</u>
<b>Total long-term debt</b>	<b>2,211,000</b>	<b>1,747,000</b>
<b>Less current portion</b>	<b><u>1,566,000</u></b>	<b><u>1,141,000</u></b>
<b>Long-term debt</b>	<b><u>\$ 645,000</u></b>	<b><u>\$ 606,000</u></b>

Annual maturities of long-term debt are as follows:

2017	\$655,000
2018	40,000
2019	40,000
2020	<u>1,476,000</u>
<b>Total</b>	<b><u>\$2,211,000</u></b>

**COMPOSITE MANUFACTURING CO.**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**Note 6 - Commitments**

The Company leases its warehouse facilities in Miami, Florida, from an entity controlled by the Company's stockholders on a month-by-month basis. Rent expense aggregated \$105,394 and \$100,963 for the years ended December 31, 2016 and 2015, respectively.

The Company had entered into an agreement to sublease a portion of its warehouse. The terms of the lease required monthly payments of \$3,600 from May 1, 1999 through April 30, 2019. The sublease rental income is reflected as a reduction of rent expense.

The Company maintains three Letters of Credit with a bank, aggregating approximately \$411,000. The purpose of the letters, which are being held on behalf of an affiliated company, is to help finance future operations. The letters are guaranteed by the stockholders of the Company.

During 2015, the Company entered into agreements to lease new computer hardware and software. The terms of these leases require monthly payments of \$3,069 from February 1, 2015 through February 1, 2019. The expense related to these leases aggregated \$33,759 in 2016.

**Note 7 - Litigation**

During 2016, the Company became a defendant in a lawsuit filed by a former employee for breach of contract. Subsequent to December 31, 2016, an out-of-court settlement was reached which required the Company to forgive indebtedness of \$70,000 from the former employee and to make payments of \$50,000, \$40,000 and \$40,000 on April 1, 2017, January 5, 2018 and January 5, 2019, respectively. The forgiveness of debt and the obligation for the remaining payments subsequent to December 31, 2015 have been reflected in these financial statements.

**Note 8 - Employee benefit plan**

The Company maintains a contributory qualified employees profit-sharing plan which provides for an annual contribution, to be determined each year by the Board of Directors of the Company, provided that no company contribution for any fiscal year shall exceed the deduction allowed for federal income tax purposes.

Funds contributed to the Company's plan are deposited with trustees. The profit-sharing plan contribution aggregated \$215,770 and \$197,650 for 2016 and 2015, respectively.

**Supplementary Information**

**COMPOSITE MANUFACTURING CO.**  
**SUPPLEMENTARY INFORMATION - BALANCE SHEETS**  
**DECEMBER 31, 2016 AND 2015**

**OTHER CURRENT ASSETS**

	<u>2016</u>	<u>2015</u>
Prepaid expenses	\$ 47,000	\$ 42,000
State grant receivable	<u>255,000</u>	<u>-</u>
<b>TOTAL OTHER CURRENT ASSETS</b>	<b><u>\$302,000</u></b>	<b><u>\$ 42,000</u></b>

**OTHER ASSETS**

Computer programming costs (net of accumulated amortization of \$3,664)	\$ 51,000	\$ -
Cash surrender value - officers' life insurance	44,000	37,000
Rent security deposits	5,000	5,000
Covenant not-to-compete (net of accumulated amortization of \$46,667 and \$36,667 in 2016 and 2015, respectively)	3,000	13,000
Goodwill (net of accumulated amortization of \$583 and \$458 in 2016 and 2015, respectively)	<u>4,000</u>	<u>4,000</u>
<b>TOTAL OTHER ASSETS</b>	<b><u>\$107,000</u></b>	<b><u>\$ 59,000</u></b>

**ACCRUED EXPENSES**

Real estate taxes	\$ 70,000	\$ 61,000
State income taxes	5,000	10,000
Payroll	12,000	10,000
Profit-sharing contributions	215,000	197,000
Interest	15,000	12,000
Rent	<u>17,000</u>	<u>1,000</u>
<b>TOTAL ACCRUED EXPENSES</b>	<b><u>\$334,000</u></b>	<b><u>\$291,000</u></b>

**COMPOSITE MANUFACTURING CO.**  
**SUPPLEMENTARY INFORMATION - STATEMENTS OF EARNINGS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**COST OF GOODS SOLD**

	<u>2016</u>	<u>2015</u>	<u>Increase (Decrease)</u>	<u>Percent Change</u>
<b>COST OF MATERIALS</b>	<b><u>\$4,333,000</u></b>	<b><u>\$4,219,000</u></b>	<b><u>\$114,000</u></b>	<b><u>2.70%</u></b>
<b>FREIGHT IN</b>	<b><u>311,000</u></b>	<b><u>245,000</u></b>	<b><u>66,000</u></b>	<b><u>26.94</u></b>
<b>DIRECT LABOR</b>	<b><u>714,000</u></b>	<b><u>657,000</u></b>	<b><u>57,000</u></b>	<b><u>8.68</u></b>
<b>INDUSTRIAL SERVICES</b>	<b><u>459,000</u></b>	<b><u>298,000</u></b>	<b><u>161,000</u></b>	<b><u>54.03</u></b>
<b>MANUFACTURING OVERHEAD:</b>				
Rent	83,000	57,000	26,000	45.61
Shop supplies and expense	14,000	24,000	(10,000)	(41.67)
Utilities	32,000	28,000	4,000	14.29
Repairs	24,000	37,000	(13,000)	(35.14)
Depreciation	46,000	35,000	11,000	31.43
Payroll taxes	48,000	44,000	4,000	9.09
Group insurance	<u>57,000</u>	<u>67,000</u>	<u>(10,000)</u>	<u>(14.93)</u>
	<b><u>304,000</u></b>	<b><u>292,000</u></b>	<b><u>12,000</u></b>	<b><u>4.11</u></b>
<b>TOTAL COST OF GOODS SOLD</b>	<b><u>\$6,121,000</u></b>	<b><u>\$5,711,000</u></b>	<b><u>\$410,000</u></b>	<b><u>7.18%</u></b>

**COMPOSITE MANUFACTURING CO.**  
**SUPPLEMENTARY INFORMATION - STATEMENTS OF EARNINGS**  
**YEARS ENDED DECEMBER 31, 2016 AND 2015**

**SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

	<u>2016</u>	<u>2015</u>	<u>Increase (Decrease)</u>	<u>Percent Change</u>
<b>SELLING EXPENSES:</b>				
Sales commissions	\$ 14,000	\$ 14,000	\$ -	-
Travel and entertainment	131,000	110,000	21,000	19.09%
Advertising and promotion	203,000	245,000	(42,000)	(17.14)
Freight on sales	77,000	61,000	16,000	26.23
Provision for uncollectible accounts	-	3,000	(3,000)	(100.00)
Trade shows	<u>11,000</u>	<u>13,000</u>	<u>(2,000)</u>	<u>(15.38)</u>
<b>TOTAL SELLING EXPENSES</b>	<b><u>\$ 436,000</u></b>	<b><u>\$ 446,000</u></b>	<b><u>\$ (10,000)</u></b>	<b><u>(2.24%)</u></b>
<b>GENERAL AND ADMINISTRATIVE EXPENSES:</b>				
Executive salaries	\$ 467,000	\$ 410,000	\$ 57,000	13.90%
Office salaries	517,000	468,000	49,000	10.47
Office expense, stationery and supplies	24,000	11,000	13,000	118.18
Telephone	49,000	49,000	-	-
Postage	22,000	16,000	6,000	37.50
Dues and subscriptions	29,000	17,000	12,000	70.59
Professional fees	48,000	47,000	1,000	2.13
Computer supplies	26,000	12,000	14,000	116.67
Insurance:				
General	74,000	68,000	6,000	8.82
Group	57,000	67,000	(10,000)	(14.93)
Officers' life	8,000	18,000	(10,000)	(55.56)
Depreciation	11,000	4,000	7,000	175.00
Automobile expense	21,000	24,000	(3,000)	(12.50)
First aid	3,000	4,000	(1,000)	(25.00)
Real estate taxes	73,000	60,000	13,000	21.67
Payroll taxes	73,000	66,000	7,000	10.61
Computer services	64,000	7,000	57,000	814.29
Research and development	20,000	7,000	13,000	185.71
Profit-sharing contribution	215,000	197,000	18,000	9.14
Charitable contributions	5,000	3,000	2,000	66.67
Amortization	13,000	10,000	3,000	30.00
Miscellaneous	<u>10,000</u>	<u>39,000</u>	<u>(29,000)</u>	<u>(74.36)</u>
<b>TOTAL GENERAL AND ADMINISTRATIVE EXPENSES</b>	<b><u>\$1,829,000</u></b>	<b><u>\$1,604,000</u></b>	<b><u>\$225,000</u></b>	<b><u>14.03%</u></b>

## **Composite Manufacturing Co.**

### **Additional analysis reveals . . .**

#### **Page 1 of 2**

1. The Company shipped \$246,000 of its systems to its affiliated company on December 15, 2016. The systems were returned in January 2017. Composite included the \$246,000 as an amount due from affiliate and in net sales at December 31, 2016.
2. The Company settled a lawsuit against a competitor for patent infringement and included the \$500,000 in 2016 sales revenues.
3. The Company had record sales in December 2016. On further analysis, it was learned that sales for the last week of the year included \$167,000 of light systems shipped to Sunpipes 'R Us. Composite had never dealt with this distributor before. Sunpipes 'R Us have taken the light systems "on consignment" and need not pay for them until they are sold to customers.
4. The Company applied to the State of Illinois for a grant for development of the sunpipe systems for federal, state and city government buildings. The State of Illinois Grant Board received the application for \$255,000 and processed the Company's request as such. Upon receiving a copy of the application, the Company recorded the amount as a sale in December 2016 and as another current asset.
5. Composite's bookkeeper has embezzled approximately \$100,000 from the Company during 2016 by paying her credit card statements. She forged the owner's signatures on the checks and destroyed the checks when she opened the bank statements each month. The bookkeeper charged her credit card expenses to travel and entertainment, advertising and promotion and cost of goods sold in the same proportions as she charged the owner's credit card expenses.

## **Composite Manufacturing Co.**

### **Additional analysis reveals . . .**

#### **Page 2 of 2**

6. Composite's inventory at December 31, 2016 includes \$100,000 of old model sunpipes that are technologically obsolete and can not be readily sold. The Company is also concerned that the old model products do not meet EPA emission guidelines.
7. Composite's product liability attorneys believe that a contingent liability exists for claims arising from the explosion of translucent ceiling fixtures connected to the sunpipe. The brothers vigorously deny that the Company has any such liability as the parts came from the Company's suppliers. It is expected that the costs of settling these lawsuits will exceed insurance coverage by \$500,000.
8. Composite is awaiting rulings from the Illinois EPA and the Federal EPA regarding fines and clean up costs at a site owned by the Company. The Company had stored and disposed of industrial solvents at that location. The Environmental Protection Agencies believe that the clean up will cost between \$1,500,000 and \$3,000,000. Big Jim is adamant that it will cost the Company no more than \$500,000 or \$1,000,000 to clean up the site. Further, he has not made any record of these liabilities in the books of Composite as the Company will pay the amounts as and when they are incurred.

**Exhibit I**

Composite Manufacturing Co.

Page 1 of 4

## Selected Historical Financial Data

BALANCE SHEET	Year Ended Dec 31, 2016		Year Ended Dec 31, 2015	
	Unaudited	%	Unaudited	%
<b>ASSETS</b>				
Current Assets:				
Cash and equivalents	\$14,000	0.2%	\$331,000	6.5%
Accounts receivable (trade)	1,149,000	19.2%	1,125,000	22.3%
Inventories	3,416,000	56.9%	2,636,000	52.2%
Due from affiliate	246,000	4.1%	181,000	3.6%
Other current assets	302,000	5.0%	42,000	0.8%
Total Current Assets	<u>5,127,000</u>	<u>85.5%</u>	<u>4,315,000</u>	<u>85.4%</u>
Property and Equipment (cost):				
Land and improvements	84,000	1.4%	83,000	1.6%
Machinery and equipment	364,000	6.1%	355,000	7.0%
Furniture and fixtures	112,000	1.9%	108,000	2.1%
Automobiles	147,000	2.5%	61,000	1.2%
Computer equipment	40,000	0.7%	103,000	2.0%
Building	899,000	15.0%	892,000	17.6%
Leasehold improvements	109,000	1.8%	109,000	2.2%
	<u>1,755,000</u>	<u>29.3%</u>	<u>1,711,000</u>	<u>33.9%</u>
Less: Accumulated Depreciation	<u>(989,000)</u>	<u>-16.5%</u>	<u>(1,031,000)</u>	<u>-20.4%</u>
Net property and equipment	<u>766,000</u>	<u>12.8%</u>	<u>680,000</u>	<u>13.5%</u>
Non-Current Assets:				
Other assets	<u>107,000</u>	<u>1.8%</u>	<u>59,000</u>	<u>1.2%</u>
Total Non-Current Assets	<u>107,000</u>	<u>1.8%</u>	<u>59,000</u>	<u>1.2%</u>
<b>TOTAL ASSETS</b>	<u><u>\$6,000,000</u></u>	<u><u>100%</u></u>	<u><u>\$5,054,000</u></u>	<u><u>100%</u></u>
<b>LIABILITIES</b>				
Current Liabilities:				
Accounts payable (trade)	\$461,000	7.7%	\$494,000	9.8%
Current portion of long-term debt	1,566,000	26.1%	1,141,000	22.6%
Accrued expenses	334,000	5.6%	291,000	5.8%
Total Current Liabilities	<u>2,361,000</u>	<u>39.4%</u>	<u>1,926,000</u>	<u>38.1%</u>
Long-Term Liabilities:				
Long-term debt	<u>645,000</u>	<u>10.8%</u>	<u>606,000</u>	<u>12.0%</u>
<b>TOTAL LIABILITIES</b>	<u><u>3,006,000</u></u>	<u><u>50.1%</u></u>	<u><u>2,532,000</u></u>	<u><u>50.1%</u></u>
<b>STOCKHOLDERS' EQUITY</b>				
Common Stock	2,000	0.0%	2,000	0.0%
Retained earnings, end of year	<u>2,992,000</u>	<u>49.9%</u>	<u>2,520,000</u>	<u>49.9%</u>
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<u><u>2,994,000</u></u>	<u><u>49.9%</u></u>	<u><u>2,522,000</u></u>	<u><u>49.9%</u></u>
<b>TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY</b>	<u><u>\$6,000,000</u></u>	<u><u>100%</u></u>	<u><u>\$5,054,000</u></u>	<u><u>100%</u></u>

## Selected Historical Financial Data

INCOME STATEMENT	Year Ended Dec 31, 2016		Year Ended Dec 31, 2015	
	Unaudited	%	Unaudited	%
Net Sales	\$9,513,000	100%	\$8,898,000	100%
Cost of Sales	<u>6,121,000</u>	<u>64.3%</u>	<u>5,711,000</u>	<u>64.2%</u>
Gross Profit	3,392,000	35.7%	3,187,000	35.8%
Shipping	126,000	1.3%	80,000	0.9%
Selling	436,000	4.6%	446,000	5.0%
General and Administrative Expenses	<u>1,829,000</u>	<u>19.2%</u>	<u>1,604,000</u>	<u>18.0%</u>
Total Operating Expenses	2,391,000	25.1%	2,130,000	23.9%
Income from Operations	1,001,000	10.5%	1,057,000	11.9%
Other Income (Expenses):				
Interest Expense	(171,000)	-1.8%	(149,000)	-1.7%
Litigation	(200,000)	-2.1%	-	0.0%
Loss on Sale of Fixed Assets	-	0.0%	(2,000)	0.0%
Total Other Income (Expenses)	<u>(371,000)</u>	<u>-3.9%</u>	<u>(151,000)</u>	<u>-1.7%</u>
Income (Loss) Before Income Taxes	630,000	6.6%	906,000	10.2%
Provision for State Income Taxes	<u>(13,000)</u>	<u>-0.1%</u>	<u>(20,000)</u>	<u>-0.2%</u>
Income After Taxes	617,000	6.5%	886,000	10.0%
Discontinued Operations:				
Income from Operations of Discontinued Division, net of taxes	90,000	0.9%	-	0.0%
Gain on Disposal of Division, net of taxes	<u>50,000</u>	<u>0.5%</u>	<u>-</u>	<u>0.0%</u>
Earnings Before Extraordinary Item and Cumulative Effect of Change in Accounting Principle	757,000	8.0%	886,000	10.0%
Extraordinary Item:				
Gain on Early Retirement of Debt, net of taxes	80,000	0.8%	-	0.0%
Cumulative Effect of Accounting Change	<u>17,000</u>	<u>0.2%</u>	<u>-</u>	<u>0.0%</u>
Net Earnings	854,000	<u>9.0%</u>	886,000	<u>10.0%</u>
Retained Earnings, Beginning	2,520,000		2,146,000	
Distributions	<u>(382,000)</u>		<u>(512,000)</u>	
Retained Earnings, Ending	<u>\$2,992,000</u>		<u>\$2,520,000</u>	

**Exhibit I**

Composite Manufacturing Co.

**Page 3 of 4**

## Selected Historical Financial Data

CASH FLOW STATEMENT	Year Ended Dec 31, 2016 Unaudited	Year Ended Dec 31, 2015 Unaudited
Cash Flows From Operating Activities:		
Net Income (Loss)	\$854,000	\$886,000
Plus:		
Bad debts	-	3,000
Loss on disposition of equipment	-	2,000
Litigation	200,000	
Depreciation & amortization	70,000	49,000
Total Adjustments	<u>1,124,000</u>	<u>940,000</u>
Changes in Working Capital:		
(Incr.) Decr. in cash surrender value - officers life insurance	(7,000)	3,000
(Incr.) Decr. in accounts receivables (trade)	(24,000)	(55,000)
(Incr.) Decr. in inventories	(780,000)	(232,000)
(Incr.) Decr. in other current assets	(260,000)	(3,000)
(Incr.) Decr. in other assets	(41,000)	-
Incr. (Decr.) in accounts payable (trade)	(33,000)	130,000
Incr. (Decr.) in accrued expenses	43,000	26,000
Total Adjustments	<u>(1,102,000)</u>	<u>(131,000)</u>
Net Cash Flows From (For) Operating Activities	22,000	809,000
Cash Flows From Investing Activities:		
Purchase of property and equipment	(156,000)	(413,000)
Proceeds from sale of property and equipment	<u>0</u>	<u>9,000</u>
Net Cash Flows From (For) Investing Activities	(156,000)	(404,000)
Cash Flows from Financing Activities:		
Net advances (repayments) - revolving loan agreement	375,000	(349,000)
Net advances (repayments) - installment notes	(41,000)	193,000
Payment of obligation to former employee pursuant to litigation	(70,000)	-
Net advances to affiliate	(65,000)	(235,000)
Distributions to stockholders	(382,000)	(512,000)
Net Cash Flows From (For) Financing Activities	<u>(183,000)</u>	<u>(903,000)</u>
Net Increase (Decrease) in Cash and Equivalents	(317,000)	(498,000)
Cash and Equivalents, Beginning	<u>331,000</u>	<u>829,000</u>
Cash and Equivalents, End	<u>\$14,000</u>	<u>\$331,000</u>

## Selected Historical Financial Data

SELECTED FINANCIAL RATIOS	Year Ended Dec 31, 2016	Year Ended Dec 31, 2015	2015 RMA (n) Sales \$5-10 MM
<b><u>LIQUIDITY</u></b>			
Gross Working Capital (a)	2,766,000	2,389,000	na
as a percent of net sales	29.1%	26.8%	22.6%
Net Working Capital (b)	4,318,000	3,199,000	na
as a percent of net sales	45.4%	36.0%	15.9%
Current Ratio (c)	2.2	2.2	2.9
Quick Ratio (d)	0.5	0.8	1.5
Cash Ratio (e)	0.0	0.2	0.7
<b><u>ACTIVITY</u></b>			
Net Sales Growth	6.9%	1.1%	-7.2%
Receivables Turnover (f)	8.3	7.9	9.7
Days Receivables Outstanding	44.1	46.1	37.6
Inventory Turnover (g)	1.8	2.2	3.7
Inventory Turnover In Days	203.7	168.5	98.6
Payables Turnover (h)	13.3	11.6	12.4
Days Payable Outstanding	27.5	31.6	29.4
Total Asset Turnover	1.6	1.8	1.6
<b><u>PROFITABILITY</u></b>			
Earnings Before Taxes (EBT)	630,000	906,000	na
EBT as a percent of net sales	6.6%	10.2%	7.7%
Earnings Before Interest & Taxes.	801,000	1,055,000	na
EBIT as a percent of net sales	8.4%	11.9%	na
Earnings Before Taxes, Depr., & Amort.	700,000	955,000	na
EBTDA as a percent of net sales	7.4%	10.7%	na
Return on Assets (i)	10.5%	17.9%	18.5%
Return on Equity (j)	21.0%	35.9%	na
<b><u>LEVERAGE</u></b>			
Funded Debt (k)	2,211,000	1,747,000	na
Funded Debt/Invested Capital (l)	42.5%	40.9%	na
EBIT/Interest Expense	4.7	7.1	na
Debt to Equity (m)	1.0	1.0	1.0

(a) Equals current assets less current liabilities.

(b) Equals current assets (excluding cash and cash equivalents) less current liabilities (excluding notes payable to banks)

(c) Equals current assets divided by current liabilities.

(d) Equals cash and equivalents and trade receivables divided by current liabilities.

(e) Equals cash and equivalents divided by current liabilities.

(f) Equals net sales divided by trade receivables.

(g) Equals total cost of goods sold divided by inventory.

(h) Equals total cost of goods sold divided by payables.

(i) Equals pre-tax income divided by total assets.

(j) Equals pre-tax income divided by total stockholders' equity. RMA average excludes intangibles from denominator.

(k) Equals long-term debt plus current portion of long-term debt

(l) Equals funded debt divided by total stockholders' equity plus funded debt

(m) Equals total liabilities divided by tangible net worth (total assets less total liabilities and intangible assets)

(n) Manufacturing (Residential Electric Lighting Fixture Manufacturing) SIC 3645, NAICS 335121.

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Balance Sheet and Income Statement Adjustments

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- (1) The Company shipped \$246,000 of its systems to its affiliate on December 15, 2016. The systems were returned in January 2017. The Company included the \$246,000 in the amount Due from Affiliate and in Net Sales at year-end. This amount is being eliminated to reflect the fair market value of the Due from Affiliate and Net Sales.
- (2) The Company settled a lawsuit against a competitor for patent infringement and included the \$500,000 in 2016 revenues. This nonrecurring revenue distorts annual trends and, therefore, is eliminated to present normalized earnings patterns and trends.
- (3) The Company shipped \$167,000 of light systems to Sunpipes 'R Us in December 2016. Sunpipes 'R Us has taken the light systems on consignment and, therefore, has no obligation to pay for the products until they are ultimately sold.
- (4) The Company applied to the State of Illinois for a grant for development of the sun pipe systems for Federal, state and city government buildings. The State of Illinois Grant Board received the application in the amount of \$255,000 and processed the Company's request. Upon receiving a copy of the application, the Company recorded the amount as a sale and as an Other Current Asset. Receipt of this amount is speculative and should be recorded as income only when the grant is awarded and funded.
- (5) The Company's bookkeeper embezzled approximately \$100,000 by using Company funds to pay her credit card statements. She allocated the expenses to travel and entertainment expenses (25% - selling expenses), advertising and promotion expenses (25% - general and administration expenses) and cost of goods sold (50%) in the same proportions as the credit card expenses of the shareholders.
- (6) Inventory Obsolescence - This amount reduces the value of the inventory by \$100,000 to restate inventory to fair market value. The amount of the writedown represents inventory that is technologically obsolete .
- (7) A contingent liability exists for products liability claims arising from the explosion of translucent ceiling fixtures connected to the Sunpipe. It is expected that the cost of settling those lawsuits will exceed the Company's insurance coverage by \$500,000.
- (8) The Company is also awaiting rulings from the Illinois EPA and Federal EPA regarding fines and cleanup costs at a site owned by the Company. The Company had stored and disposed of industrial solvents at that location. Management estimates the liability to be in the range of \$500,000 to \$1,000,000. Preliminary estimates from both agencies range between \$1,500,000 and \$3,000,000. The costs to clean up the contaminated property is estimated at \$1,500,000.

**Exhibit II**

Composite Manufacturing Co.

Page 2 of 4

## Adjusted Income Statement

INCOME STATEMENT	Year Ended Dec 31, 2016 Unaudited	Adjustments	Adjusted Income Statement
		(\$246,000) (1)	
		(500,000) (2)	
		(167,000) (3)	
Net Sales	\$9,513,000	(255,000) (4)	\$8,345,000
		(167,000) (3)	
Cost of Sales	<u>6,121,000</u>	<u>(50,000) (5)</u>	<u>5,904,000</u>
Gross Profit	3,392,000	(951,000)	2,441,000
Shipping	126,000		126,000
Selling	436,000	(25,000) (5)	411,000
General and Administrative Expenses	<u>1,829,000</u>	<u>(25,000) (5)</u>	<u>1,804,000</u>
Total Operating Expenses	<u>2,391,000</u>	<u>(50,000)</u>	<u>2,341,000</u>
Income from Operations	1,001,000	(901,000)	100,000
<b>Other Income (Expenses):</b>			
Interest Expense	(171,000)		(171,000)
Litigation	(200,000)		(200,000)
Lawsuit settlement	-	500,000 (2)	500,000
Embezzlement loss	-	(100,000) (5)	(100,000)
Loss on Inventory Restatement	-	(100,000) (6)	(100,000)
		(500,000) (7)	
Loss on Contingency Liability		(1,500,000) (8)	(2,000,000)
Loss on Sale of Fixed Assets	-		
Total Other Income (Expenses)	<u>(371,000)</u>	<u>(1,700,000)</u>	<u>(2,071,000)</u>
Income (Loss) Before Income Taxes	630,000	(2,601,000)	(1,971,000)
Provision for State Income Taxes	<u>(13,000)</u>	<u>39,015</u>	<u>26,015</u>
Income After Taxes	<u><u>\$617,000</u></u>	<u><u>(\$2,561,985)</u></u>	<u><u>(\$1,944,985)</u></u>

**Exhibit II**

Composite Manufacturing Co.

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## Adjusted Balance Sheet

BALANCE SHEET	Year Ended Dec 31, 2016 Unaudited	Adjustments		Adjusted Balance Sheet
<b>ASSETS</b>				
Current Assets:				
Cash and equivalents	\$14,000			\$14,000
Accounts receivable (trade)	1,149,000	(167,000)	(3)	982,000
		167,000	(3)	
Inventories	3,416,000	(100,000)	(6)	3,483,000
Due from affiliate	246,000	(246,000)	(1)	0
Other current assets	302,000	(255,000)	(4)	47,000
Total Current Assets	<u>5,127,000</u>	<u>(601,000)</u>		<u>4,526,000</u>
Property and Equipment (cost):				
Land and improvements	84,000			84,000
Machinery and equipment	364,000			364,000
Furniture and fixtures	112,000			112,000
Automobiles	147,000			147,000
Computer equipment	40,000			40,000
Building	899,000			899,000
Leasehold improvements	109,000			109,000
	<u>1,755,000</u>	<u>0</u>		<u>1,755,000</u>
Less: Accumulated Depreciation	<u>(989,000)</u>			<u>(989,000)</u>
Net property and equipment	<u>766,000</u>	<u>0</u>		<u>766,000</u>
Non-Current Assets:				
Other assets	107,000			107,000
Total Non-Current Assets	<u>107,000</u>	<u>0</u>		<u>107,000</u>
<b>TOTAL ASSETS</b>	<u><b>\$6,000,000</b></u>	<u><b>(\$601,000)</b></u>		<u><b>\$5,399,000</b></u>
<b>LIABILITIES</b>				
Current Liabilities:				
Accounts payable (trade)	\$461,000			\$461,000
Current portion of long-term debt	1,566,000			1,566,000
Accrued expenses	334,000			334,000
Total Current Liabilities	<u>2,361,000</u>	<u>0</u>		<u>2,361,000</u>
Long-Term Liabilities:				
Long-term debt	645,000			645,000
		500,000	(7)	
Contingencies	0	1,500,000	(8)	2,000,000
<b>TOTAL LIABILITIES</b>	<u><b>3,006,000</b></u>	<u><b>2,000,000</b></u>		<u><b>5,006,000</b></u>
<b>STOCKHOLDERS' EQUITY</b>				
Common Stock	2,000			2,000
Retained earnings, end of year	2,992,000	(2,601,000)		391,000
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<u><b>\$6,000,000</b></u>	<u><b>(\$601,000)</b></u>		<u><b>\$5,399,000</b></u>

## Selected Historical Financial Data

SELECTED FINANCIAL RATIOS (ADJUSTED)	Year Ended	Adjusted Ratios	2015 RMA (n) Sales \$5-10 MM
	Dec 31, 2016 As Reported		
<b>LIQUIDITY</b>			
Gross Working Capital (a)	2,766,000	2,165,000	na
as a percent of net sales	29.1%	25.9%	22.6%
Net Working Capital (b)	4,318,000	3,717,000	na
as a percent of net sales	45.4%	44.5%	15.9%
Current Ratio (c)	2.2	1.9	2.9
Quick Ratio (d)	0.5	0.4	1.5
Cash Ratio (e)	0.0	0.0	0.7
<b>ACTIVITY</b>			
Net Sales Growth	6.9%	-6.2%	-7.2%
Receivables Turnover (f)	8.3	8.5	9.7
Days Receivables Outstanding	44.1	43.0	37.6
Inventory Turnover (g)	1.8	1.7	3.7
Inventory Turnover In Days	203.7	215.3	98.6
Payables Turnover (h)	13.3	12.8	12.4
Days Payable Outstanding	27.5	28.5	29.4
Total Asset Turnover	1.6	1.5	1.6
<b>PROFITABILITY</b>			
Earnings Before Taxes (EBT)	630,000	(1,971,000)	na
EBT as a percent of net sales	6.6%	-23.6%	7.7%
Earnings Before Interest & Taxes.	801,000	(1,800,000)	na
EBIT as a percent of net sales	8.4%	-21.6%	na
Earnings Before Taxes, Depr., & Amort.	700,000	(1,901,000)	na
EBTDA as a percent of net sales	7.4%	-22.8%	na
Return on Assets (i)	10.5%	-36.5%	18.5%
Return on Equity (j)	21.0%	-501.5%	na
<b>LEVERAGE</b>			
Funded Debt (k)	2,211,000	2,211,000	na
Funded Debt/Invested Capital (l)	42.5%	84.9%	na
EBIT/Interest Expense	4.7	(10.5)	na
Debt to Equity (m)	1.0	12.7	1.0

(a) Current assets less current liabilities.

(b) Current assets (excluding cash and cash equivalents) less current liabilities (excluding notes payable to banks)

(c) Current assets divided by current liabilities.

(d) Equals cash and equivalents and trade receivables divided by current liabilities.

(e) Equals cash and equivalents divided by current liabilities.

(f) Equals net sales divided by trade receivables.

(g) Equals total cost of goods sold divided by inventory.

(h) Equals total cost of goods sold divided by payables.

(i) Equals pre-tax income divided by total assets.

(j) Equals pre-tax income divided by total stockholders' equity. RMA average excludes intangibles from denominator.

(k) Equals long-term debt plus current portion of long-term debt

(l) Equals funded debt divided by total stockholders' equity plus funded debt

(m) Equals total liabilities divided by tangible net worth (total assets less total liabilities and intangible assets)

(n) Manufacturing (Residential Electric Lighting Fixture Manufacturing) SIC 3645, NAICS 335121.

## Adjusting Journal Entries

Account Name	Debit	Credit
(1) Sales	\$246,000	
Due from affiliate		\$246,000
<i>To adjust sales revenue and the Due from Affiliate account for items returned after year end.</i>		
<i>Earnings Manipulation Shenanigan #1 - Recording Revenues Too Soon.</i>		
(2) Sales	\$500,000	
Lawsuit Settlement		\$500,000
<i>To adjust sales revenue for nonrecurring revenue received from a lawsuit settlement.</i>		
<i>Earnings Manipulation Shenanigan #3 - Boosting Income Using One-Time or Unsustainable Activities.</i>		
(3) Sales	\$167,000	
Inventory	\$167,000	
Accounts Receivable (Trade)		\$167,000
Cost of Sales		\$167,000
<i>To reverse revenue and accounts receivable recorded prematurely in relation to a consignment sale.</i>		
<i>Earnings Manipulation Shenanigan #1 - Recording Revenues Too Soon.</i>		
(4) Sales	\$255,000	
Other Current Assets		\$255,000
<i>To reverse revenue and an asset recorded prematurely in relation to a State of Illinois grant application.</i>		
<i>Earnings Manipulation Shenanigan #1 - Recording Revenues Too Soon.</i>		
(5) Embezzlement Loss	\$100,000	
Cost of Sales		\$50,000
Selling Expenses		\$25,000
General and Administrative Expenses		\$25,000
<i>To reclassify fraudulent expenses recorded by the Company's bookkeeper.</i>		
(6) Loss on Inventory Restatement	\$100,000	
Inventories		\$100,000
<i>To adjust the fair market value of inventory to account for technologically obsolete items.</i>		
<i>Key Metric Shenanigan #2 - Distorting Balance Sheet Metrics to Avoid Showing Deterioration.</i>		
(7) Loss on Contingent Liability	\$500,000	
Contingencies		\$500,000
<i>To account for a contingent liability arising from product liability claims.</i>		
<i>Earnings Manipulation Shenanigan #4 - Shifting Current Expenses to a Later Period</i>		
(8) Loss on Contingent Liability	\$1,500,000	
Contingencies		\$1,500,000
<i>To account for a contingent liability arising from environmental fines and cleanup costs.</i>		
<i>Earnings Manipulation Shenanigan #4 - Shifting Current Expenses to a Later Period</i>		