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Quality of Financial Position

The Balance Sheet and Beyond

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IQ Integrity & Quality

This is the third in a series of Deloitte & Touche publications intended to address the importance of integrity and quality to our capital markets system. Other IQ documents that may be of interest to you are:

- **IQ: Integrity and Quality**
- **IQ: Quality of Earnings**

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IQ

Quality of Financial Position

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INTEGRITY & QUALITY

Assessing the quality of a company's financial position is a complex process. There is no single financial statement that sets forth all of the quantitative and qualitative information reflecting financial position—you must move beyond the balance sheet and perform further analysis to get a complete picture. Although income statements and cash flow statements are important and do provide information relevant to financial position, the balance sheet is a basic "snapshot" of a company's financial position at a particular point in time and is a logical starting point for assessing a company's financial position. The balance sheet delineates the entity's resource structure, or major classes and amounts of assets, as well as its capital structure, or major classes and amounts of liabilities and equity.

Quality and Transparency of Financial Reporting

The transparency of the financial statements and the quality of the financial position are critical in evaluating a company. Following the enactment of the Sarbanes-Oxley Act of 2002, companies have a greater incentive for improving the quality and transparency of financial reporting. With the media, analysts, investors, and government leaders all challenging companies' integrity, there is a need for greater transparency in financial reporting, especially given the proliferation of complex, global business structures.

Management and audit committee members need to be champions of these changes; Deloitte & Touche is committed to this effort and will continue to play an active role in improving financial reporting. It is imperative that management and external auditors, with appropriate oversight from audit committees, continue to improve financial reporting and communication. One key is a better understanding of the assumptions used to establish significant accounting estimates and determine values. It is also important to understand the company's profile with regard to strategies, objectives, and risk tolerance, and to analyze whether on- or off-balance-sheet transactions involving the company are consistent with that profile. To do this, all parties must take the time to carefully examine the financial statements, including the notes and management's discussion and analysis.

Defining Quality

Many qualitative and quantitative factors that influence a company's financial position may not be obvious from its financial statements. Because there is no single definition of what constitutes a high-quality financial statement, many factors must be reviewed to gain a comprehensive understanding of the strength of a company's financial position. If it is properly prepared and accompanied by appropriate disclosure, the balance sheet gives insight into the following factors, which often differ by company and industry:

- **The company's degree of liquidity.** Does the company have enough cash, other liquid assets, or credit to pay its obligations promptly? Does the capital structure match the asset structure?

- **The nature of the business.** What are its inherent risks? Where is there subjectivity? Are the accounting principles and methods appropriate, conservative, or aggressive compared to others in its industry? Are judgments about the selection and method of application of accounting principles based on substance, rather than form?

- **The use of historical cost or fair value measurement methods.** How great a difference is there between the amounts resulting from the historical cost and fair value methods? To what extent have acquisitions caused a larger portion of the balance sheet to be stated at fair value?

- **The estimates and assumptions used in the financial statements.** Are the estimates and assumptions reasonable and supportable? Are they determined consistently? Do reserves based on management estimates represent a significant portion of liability or asset valuations?

- **The possibility of impairment.** Are the company's policies for evaluating impairment reasonable? Do any economic, performance, or industry trends raise questions regarding the ability to recover assets at their recorded amounts?

To truly understand a company's financial position, the following factors must be considered in addition to those directly evident in the balance sheet:

- **The use of off-balance-sheet arrangements.** Is there a complete understanding of all significant existing arrangements? Has the company employed structured finance transactions to specifically avoid debt on the balance sheet? How significant are commitments that, by definition, are not obligations on the balance sheet? Have all probable and estimable contingent liabilities been recorded?

- **The quality and effectiveness of internal controls.** Are there controls in place to safeguard assets and monitor account activities?

The purpose of this document is to assist management and audit committees in working collaboratively with their auditors, advisors, and stakeholders to better assess and communicate the financial position of their companies. It should be noted that although the terms "balance sheet" and "financial position" are often used interchangeably, the focus is on the company's financial position. The concept of financial position extends beyond the balance sheet to encompass a more comprehensive assessment of a company's economic resources, obligations, and equity.

Liquidity

Liquidity is one of the most important factors to consider in assessing a company's financial position, and may not be evident in the balance sheet. Liquid assets are cash and other assets that can be easily converted to cash; liquidity is the extent to which an entity can produce cash to meet its obligations. A high degree of liquidity indicates that a company is less likely to fail in the event of a downturn in its business or the economy. A company's growth rate can significantly alter the liquidity needs of the business. A balance sheet with strong liquidity ratios computed on the basis of historical amounts can give false comfort if the company is growing at a fast rate—for example, at 20 or 30 percent. A company needs to prove its ability to achieve profitable growth by emphasizing profits, revenues, and liquidity; no matter how much revenue it records, a company still needs cash to pay employees and suppliers and to meet its other obligations.

To achieve a strong financial position, many companies strive to match their capital structure with their asset structure; an example would be to finance short-term assets with short-term debt or with equity. Understanding the sources of short-term financing and the circumstances that may affect these sources of liquidity is important. If operating cash flows are the principal source of liquidity, consideration should be given to risks that could reduce the availability of those funds. These risks may include fluctuation in customer demand in response to rapid technological changes or the need for funds to reinvest in infrastructure, working capital, or capital expenditures. If commercial paper is a principal source of liquidity, it is important to know how the company could be affected by a downgrade in its debt rating or a deterioration of certain financial ratios or other measures of financial performance. Likewise, it is important to understand the constraints on a company's liquidity in terms of its contractual obligations, such as payments under debt and lease agreements, as well as off-balance-sheet commitments such as debt guarantees.

Although a high level of liquid assets is an indicator of financial flexibility, it comes at a price: cash and cash-equivalent assets often produce the lowest returns. Consequently, an entity with a large cash balance may be less profitable than a similar company that has all of its assets invested in profitable business activities.

To distinguish between companies that are truly improving liquidity and those that are seeking short-term advantage at the risk of long-term consequences, it is important to understand the business reasons for transactions. For some businesses or industries, certain transactions, such as sale-leasebacks, factoring of receivables, or transfers of assets to joint ventures, may be outside the ordinary course of business, whereas for other businesses or industries they are part of an ongoing business strategy.

Appendix I presents a series of questions that can assist in reviewing information included in a company's balance sheet.

When analyzing financial position, consideration should be given to norms in the company's industry. For example, most banks and credit card companies are in the business of borrowing and lending, and managing the interest differential between assets and liabilities is a fundamental profit driver. Accordingly, they are debt-heavy by nature. In these cases, one must consider industry-specific metrics of liquidity, such as the credit quality and duration of the loans. A metric of working capital may be appropriate for certain manufacturing or industrial operations, but inappropriate for public utilities that routinely operate with negative working capital.

Another example is a company that finances the sale of its products by extending long-term loans or lease financing to customers as inducements to buy those products. This business model tends to consume capital as inventory is reclassified to long-term assets in the form of receivables rather than being converted to cash. Although this approach is employed successfully by many businesses, it converts inventory risk to credit risk and requires capital in the form of long-term financing to fund the investment in the portfolio.

Consideration should also be given to a company's geographic locations and the risks and rewards related to certain countries. For example, the company's success in certain markets may rely on a particular government leader or access to raw materials and labor.

Restrictions imposed by debt agreements with external lenders are key pressures affecting a company's liquidity. Restrictions can take the form of debt service payments, financial covenants, and borrowing base provisions. Therefore, it is crucial for companies to factor in the effects of these restrictions when projecting liquidity in future periods.

Financial covenants allow lenders to monitor operations and provide remedies to lenders if a company's operations deteriorate. There are two basic types of covenants: qualitative and quantitative. Qualitative covenants ensure that the company maintains its operations in a responsible manner, and include items such as requiring the company to obtain an unqualified audit report. Quantitative covenants are typically financial ratios and other calculated measures of financial health which companies report to the lenders on a monthly or quarterly basis.

The violation of covenants may expose companies to certain risks. In some cases, lenders will waive a violation for a specific period. In others, lenders may seek to obtain fees for a waiver, restructure operations, or amend the debt agreement. These actions can prove to be very costly to companies, can ultimately result in a loss of management control, and may require the debt to be immediately payable.

Companies with large amounts of current assets (accounts receivable and inventory) sometimes borrow using asset-backed financing. Asset-backed financing gives companies the ability to borrow against the value of the assets, with restrictions as to the overall amount. Operating factors, such as sales fluctuations, receivable collections, production swings, and procurement practices, can cause substantial changes in the base available to borrow against.

In some cases, noncompliance with lender requirements may be the first indication that a company is headed toward financial distress. Once a company is in financial distress, its business can deteriorate quickly. As such, companies should ensure that there are adequate processes in place to forecast cash flows, covenant compliance, and borrowing base levels. Any periods with projected liquidity deficiencies should be identified and addressed in advance.

Financial ratio analysis is another tool for assessing financial position and identifying liquidity benchmarks. To be meaningful, a company's financial ratios for a specific year must be compared to those from prior years to determine trends, and must be compared to industry norms and to those of competitors. Appendix II presents the most common financial ratios used to assess financial position, along with recent average ratios for several major industries.

The Nature of the Business

Understanding the nature of a company's business and the inherent risks and subjectivity related to it is important when analyzing financial position. The nature of a company's business depends on many factors, including the size of the company, where the company is in its life cycle, the geographic areas it operates in, and the competitive landscape in which it operates. Normally, there are factors that mitigate the risks, so it is important to understand a company's risk management policies and its strategies. Each company selects accounting policies based on what is appropriate for its business model, and decides how to apply those principles. These decisions can be described as having more or less inherent risk and more or less subjectivity.

The nature of a company's business often dictates the accounting methods under which it operates. Moreover, generally accepted accounting principles (GAAP) often allow alternative methods of accounting for a single transaction; it is an understanding of both the business and the basis for the selection that provides insight into the company's financial position.

The accounting policies footnote to the financial statements and management's discussion and analysis help summarize a company's accounting methods and assumptions. The SEC has recognized the importance of disclosing critical accounting policies as an aid to investors' understanding.[1]

The accompanying table provides examples of the degree of inherent risk and subjectivity related to the nature of a company's business and examples based on the application of alternative accounting principles. All of these factors, whether the result of management decisions or industry norms, shape a company's financial position and should be considered in assessing its quality.

1 See SEC Release Nos. 33-8098, 34-45907, Proposed Rule: Disclosure in Management's Discussion and Analysis about Application of Critical Accounting Policies.

LESS ← INHERENT RISK → MORE
← SUBJECTIVITY →

CHARACTERISTIC	ACCOUNT	CHARACTERISTIC
Diversified customer base; creditworthy customers; short-term receivables; fairly current balances	Accounts receivable	Concentration in a single or a few customers; customers with questionable credit; long-term receivables; older balances; related-party receivables
Consistently using a formula, with larger percentages applied to older aging categories based on collection history; using specific reserves for accounts in dispute or in situations where collectibility is in question	Accounts receivable – allowance for doubtful accounts	Reserve calculated based on judgment and historical write-offs; use of a flat percentage for all aging categories
Expensed as incurred, when permitted under GAAP	Prepaid expenses	Capitalizing and amortizing expenses whenever possible
Investment in securities that are more liquid; diversification; accepting lower yield in exchange for higher quality	Investment securities	Investment in securities that are less liquid; concentration of investments; seeking higher yield at greater risk
Used to mitigate business risk (e.g., clearly defined hedging and risk management policies monitored through effective controls, such as an interest rate swap used in a hedging relationship)	Derivatives	Used to create profit opportunity (e.g., speculative trading, such as an option on a volatile equity security)
Adequate supply of inventory on hand, resulting in a high turnover rate	Inventory	Excessive supply of inventory on hand, resulting in a low turnover rate
Consistently using a formula, with larger percentages applied to older aging categories based on sales history; using specific reserves for known circumstances where sales are uncertain	Inventory – allowance for obsolete inventory	Calculating the reserve based on judgment and historical write-offs using a flat percentage for all aging categories; this method will generally result in a lower reserve amount than other methods
Accelerated method; lower residual estimate; realistic useful lives for individual items based on historical data and known trends	Fixed assets – depreciation method	Straight-line method; greater residual estimate; generalized useful lives without historical basis or trends; minimal correlation between the method and the usage
Lower expected rate of return; lower assumed discount rate	Pension plan assets and obligations	Higher expected rate of return; higher assumed discount rate

LESS ← INHERENT RISK / SUBJECTIVITY → MORE		
CHARACTERISTIC	**ACCOUNT**	**CHARACTERISTIC**
Conservative future cash flow and fair value assumptions; realistic remaining useful lives	Impairment – fixed assets; intangibles	Aggressive future cash flow and fair value assumptions; unrealistic remaining useful lives
Reserves calculated by third parties (e.g., self-insurance reserve estimated by actuaries)	Other accruals – litigation, environmental, warranties	Reserves calculated by management using a historical basis
Reserve calculation based on history, known problems in the portfolio, the quality of the portfolio, and current economic conditions	Loan loss accruals	Reserve based on management judgment and comparison with peers
Fair-value-based method of accounting for stock options	Compensatory stock option plans	Intrinsic-value-based method of accounting for stock options
Minimal debt covenants; absence of other-than-customary default triggers or cross-default provisions	Long-term debt	Highly restrictive debt covenants, particularly those based on multiple financial ratios; accelerated debt payments in the event of a credit downgrade, default, or other event trigger; redemption required at a significant premium as a result of certain events (e.g., change of control)
Non-redeemable preferred stock with a fixed dividend rate; convertible preferred stock into fixed number of common shares	Equity – preferred stock	Preferred stock containing a fixed maturity date or mandatory redemption feature which is not within the control of the issuer; nonredeemable preferred stock (no maturity date) that contains a cash/put feature
Settlement in a fixed number of shares	Put/call features (on preferred stock, warrants, etc.)	Settlement in cash (would result in derivative accounting); contingent on defined events
Traditional, simplistic financial structures; traditional two-step securitization structure used for monetizing traditional asset classes (e.g., auto loans, mortgages, credit cards)	Special-purpose entities	Nontraditional, complex structures; monetizing nontraditional asset classes (e.g., inventory, fixed assets); use of minimal outside equity in the structures to achieve off-balance-sheet treatment
Conservative estimated future tax effects attributable to temporary differences and carry-forwards	Deferred tax liability or asset	Aggressive estimated future tax effects attributable to temporary differences and carry-forwards

Proximity of Book Values to Economic Fair Values

Accounting standard-setters are moving toward creating a fair value balance sheet in their efforts to support quality of financial position. This increased use of fair value accounting rather than historical cost accounting on the balance sheet has added another important dimension to the assessment of a company's financial position. It is not only derivatives that require a close look, but also the valuation of stock options, warrants, securitization gains, and a variety of other mark-to-market issues. The quality of the fair value estimates is influenced by the reasonableness of the assumptions used and the quality of the experts and the models on which the estimates rely. Valuations that are easily determined and readily realized, such as in an active market, are more reliable than those that rely on private valuation approaches based on models. Private valuations are necessary for contracts that may be indexed to measures of weather; commodities process; or quoted prices of service capacity, such as energy storage and bandwidth contracts. For example, the value of a 10-year Treasury bond can be determined from public sources, but the value of a 20-year energy contract needs to be benchmarked against a model reflecting similar contracts. Modeling has inherent uncertainties, for example, in the case of a 20-year energy contract there may be relatively few trades of similar instruments.

Despite attempts to increase the amount of fair value reporting on the balance sheet, there are still many assets and liabilities that are valued based on historical costs that are significantly different than fair values. An example is land, which may have increased in value since the time of its purchase. The most common means of bringing this value onto the balance sheet is to sell the asset and make it liquid, or to revalue it in an acquisition. Consequently, it is important to know if there have been any recent acquisitions, which would increase the proximity of fair value and historical cost.

In assessing financial position, consideration should also be given to any changes in fair value attributable to altered valuation techniques. For example, it is important to understand how the company manages the risks related to changes in credit quality or market fluctuations of underlying, linked, or indexed assets or liabilities, especially when those assets are illiquid or susceptible to material uncertainties in valuation.

Considerable attention is being given to fair value accounting. A recent accounting pronouncement requires companies to reassess their recorded goodwill and other intangibles and the useful lives of these assets to achieve closer alignment with fair values. Additionally, the book values of many assets on the balance sheet differ from the values that would be recorded by the purchaser if the company were sold. Accounting principles require the writedown of overvalued assets, but there is no provision to increase many undervalued assets. Understanding the fair value of a company's assets and liabilities as compared to their recorded value provides insight into the company's financial position.

Estimates and Assumptions

There are areas of judgment that require management to make and record estimates in their financial statements. Among these areas are estimates of pension, health care, and post-retirement medical assets and liabilities. Judgment is also involved in determining allowances and reserves for a variety of items, including the collectibility of receivables and loans; the utility, value, or obsolescence of inventory; the realization of deferred tax assets; and environmental, plant closing, warranty, and self-insurance reserves. These assets and liabilities are subject to estimates of recoverability or valuation, and it is important to understand the quality of the underlying estimates and the assumptions used in developing them. It is also important to understand the portion of the estimates that is based on management's assumptions. The use of third-party specialists can improve the quality of estimates and assumptions, especially in the areas of pension and benefit plan valuations, derivatives valuations, and litigation and environmental reserves.

Some areas require more judgment than others; for example, pension accounting relies on the assumptions of management and plan actuaries. Companies sponsor pension plans and incur pension obligations—the assumed future obligation to retired employees. In the long term, pension plan assets and investment returns reduce those liabilities. In the short term, if the fund's returns are projected to exceed the expected liability and associated costs, the company's pension contribution can be reduced, which can boost earnings. The higher the expected rate of return the lower the company's pension expense, resulting in greater earnings.

The assumptions underlying the estimates should be monitored from period to period and should also be reviewed against estimates and assumptions used by comparable companies in the industry.

Impairment

Understanding the possibility of impairment is also key to the quality of a company's financial position. The company should have reasonable policies in place to assess an asset's impairment, if any. The assumptions used in predicting future cash flows should be reasonable and supportable. Additionally, companies should consider economic, performance, or industry trends that may call into question the recoverability of assets at their recorded values. During the past decade, many companies bought and sold assets which resulted in values largely accounted for as "intangible" or "goodwill"; recently, many of these values have been written down through impairment losses as a result of subsequent declines in the values associated with these transactions.

Off-Balance-Sheet Arrangements

An understanding of off-balance-sheet financing is helpful in assessing a company's financial position. These arrangements may include special-purpose entities, leasing transactions, debt guarantees, co-borrowing arrangements, securitizations, and other contingent obligations that may not require recognition on the balance sheet. An analysis of financial position should encompass factors that are likely to affect the company's ability to continue using those off-balance-sheet financing arrangements. In addition, arrangements should be analyzed for their business purposes and activities, their economic substance, the key terms and conditions of any commitments, the initial and ongoing relationships with the company and its affiliates, and the potential risk resulting from the company's contractual commitments related to the arrangement.

The risk associated with special-purpose entities (SPEs) has been highlighted by recent accounting failures. An SPE is typically created for a single purpose, such as to serve as the lessor in a leasing transaction, to acquire or construct operating assets while keeping the assets and related debt off the balance sheet, or to act as a counterparty to a financial instrument contract. If undertaken for valid business reasons and accounted for properly, SPEs can be beneficial to a company, such as a securitization SPE for mutual funds. It is important to understand the business reason for undertaking these types of transactions, as well as the structure of the arrangement, because companies may employ structured-finance transactions to specifically avoid debt on the balance sheet. Companies often guarantee the debt associated with these off-balance-sheet entities, creating the potential for additional liabilities that are not reflected on the balance sheet. Consequently, an assessment of a company's debt position should consider this debt in the complete aggregation of the company's obligations. As a result, appropriate disclosure takes on greater importance to the readers of financial statements.

Management and audit committees should also be aware of commitments, contingencies and uncertainties that are known, but are not required to be recognized in the balance sheet. For example, commitments such as operating leases may be significant, but are not obligations recorded in the balance sheet. Other examples are tobacco companies or companies that use asbestos in their products, which are likely to have much higher litigation risk than most businesses, or a company that has used hazardous materials in its production process, which may have environmental risks related to a closed plant. Although accounting rules state that contingencies should be recorded only when the loss is probable and estimable, it is important to consider the adequacy of the disclosures as well as consistent monitoring of these risks to identify losses that would need to be recorded in the near future.

In addition to the off-balance-sheet liabilities discussed previously, many companies have extensive unrecorded assets, such as trained employees, loyal customers, popular brand names, fully depreciated plant and equipment, and intellectual property. Assets that spell the difference between success and failure for many companies include research and development, employee know-how, trademarks, brand names, patents, and alliances with suppliers and distributors. The value of these assets bears little or no relationship to the amounts reflected on the balance sheet. Even with recent steps toward fair value accounting, the value of these unrecorded assets will materialize only when the entity is sold.

Internal Controls

Controls should be pervasive throughout an organization and should be visible to management, accounting professionals, and others who regularly conduct business with the company. This issue has taken on greater prominence now that the Sarbanes-Oxley Act requires CEOs and CFOs to certify that they have responsibility for establishing and maintaining internal controls. Control can come in many forms, including the knowledge of the accounting staff, the efforts of the internal accounting function and corporate risk officers, proven computer systems, and external audits and reviews. Control is most easily accomplished for balance-sheet accounts. Many of these accounts can be reconciled and verified by third parties, such as bank balances and accounts receivable, or physically counted, such as inventory and fixed assets.

Special attention should be given to unusual transactions that may not be subject to normal control procedures. These include the sale of assets outside the ordinary course of business, mergers, acquisitions, significant or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a segment of the business. Audit committees and investors should develop an understanding of the business value brought to companies by these transactions. Appropriate disclosure, particularly of these types of transactions, also demonstrates a willingness to embrace transparency and may suggest to readers that a higher degree of control exists. Furthermore, documentation of transactions should be contemporaneous, not delayed until a question arises. In some cases, documentation is required to obtain certain accounting treatment; for example, a written policy must be in place before a derivative instrument is entered into to obtain hedge accounting.

Communication between the internal audit function and the audit committee is another important element of control. The internal auditors can be a set of "eyes and ears" for the audit committee, objectively investigating areas that are of greatest concern.

Closing Thoughts

As the media, government, investors, and others continue to focus their attention on the strength and credibility of the financial statements of public companies, those of us who share responsibility for the financial reporting process should work together to improve the investing public's confidence. Additionally, the Securities and Exchange Commission recently proposed new rules that will significantly increase the disclosures included in a company's management's discussion and analysis and reiterate that disclosures should be in "plain English." The SEC's intention is to further the idea that financial statements should be comprehensible to those who have a reasonable understanding of business and economic activities and who are willing to study the information with reasonable diligence. There are many factors to consider when assessing a company's financial position, and management, audit committees, and auditors need to be aware of these considerations to properly fulfill their responsibilities in protecting the investing public and bringing transparency to financial statements.

Appendix I **Questions to Consider in Assessing Financial Position**

The following questions provide a framework for dialogue among the audit committee, management, and the external auditors regarding the quality of a company's financial position. There are many factors to consider when assessing financial position and these questions are for directional purposes only. Effective internal controls are an important element and should be pervasive in all of these areas.

This list is not meant to be comprehensive, nor are all questions applicable in all situations. It is suggested that audit committee members also review the questions for assessing the quality of earnings included in *Integrity and Quality: Quality of Earnings*, the second in Deloitte & Touche's series of IQ publications. In preparing to review a company's financial statements, you should consider whether you need to address questions specific to that company or its industry. Remember that the answer to any one question does not constitute an assessment of the quality of the company's financial position; audit committee members should weigh the answers in the aggregate, draw their own conclusions, and suggest actions they deem appropriate.

General

- Are the accounting principles selected by management in line with those of peers in the industry?
- What are the most significant estimates made by management in the current financial report? What was the range of possible amounts for those estimates?
- If the proposed external or internal audit adjustments had been recorded, collectively or individually, what impact would they have had on the company's financial position?
- Do the management's discussion and analysis and footnote disclosures clearly and adequately explain significant accounting policies and estimates and any significant changes to such?
- Are there any significant assets or liabilities that are recorded at fair value? If so, which ones? What method was used to determine the fair value? What impact did the recording of fair value have on the overall financial position?

Related Parties

- Has management identified all related parties and related-party transactions, including special-purpose entities and any off-balance-sheet transactions?
- Is there sufficient information available to thoroughly understand and evaluate the relationship of the parties to the transaction?
- Do the parties have substance and the ability to carry out the transaction?

Accounts Receivable

- Are accounts receivable increasing significantly faster than revenue?
- Are accounts receivable generated by a few significant customers?
- Are any significant customers experiencing financial difficulties or viability issues? If so, are the related amounts reserved adequately?
- Are seasonal factors contributing to changes in the turnover of accounts receivable?
- Are aging categories becoming older?
- Are discount incentives having an unfavorable impact on future sales?
- Is the composition of the customer base changing significantly?
- Have unusual payment terms or other forms of financing been extended to any customer? If so, why and how much?
- Have receivables been factored? If so, what was the business reason for the factoring?
- Are there unusual trends in the allowance for doubtful accounts receivable?

Inventory

- Is there an unusual relationship between inventory and sales (e.g., sales are decreasing but inventory is increasing)?
- Are there events or changes in demand or price indicating that carrying amounts of inventory may be too high?
- Are adjustments resulting from physical inventories significant?
- Are the books adjusted or are differences dismissed after taking a physical inventory?
- Are inventory obsolescence, returns, and warranty reserves adequate?
- Are purchase commitments appropriate relative to the growth in sales?
- Is there any unusual shipping at or near period-end?

Fixed Assets and Intangibles

- Were physical counts of fixed assets performed and reconciled to the general ledger?
- Was there a change in the depreciation or amortization method and/or life of fixed assets or intangibles? If so, what gave rise to that change?
- Are capitalization and depreciation policies consistent with those of competitors?
- Are actual capital expenditures significantly different from budgeted amounts and is adequate cash flow and/or financing in place for planned capital expenditures?
- Were tests performed to detect impairment of long-lived assets, including goodwill? Were there any indications of impairment based on the tests or on other conditions? If appropriate, were write-downs taken?
- Are the assumptions underlying the calculation of the fair value of hard-to-value assets reasonable and based on current information? Are they based on assumptions that are difficult to determine, such as occurrences over long periods? Do the disclosures adequately portray the methods for calculating fair value and the related degree of uncertainty?
- Does the company lease significant fixed assets? If so, what is the business reason?
- Are there any sales or leaseback transactions?

Debt Covenants

- Is or has the company been in violation of debt covenants, possibly requiring disclosure and reclassification of long-term debt to a current liability?
- How close was the company in meeting or violating its covenants this period and what is projected over the next four quarters?
- How much additional borrowing capacity does the company have under its existing debt agreements and how much is projected over the next four quarters?
- How much excess cash flow did the company have this period and how much is projected over the next four quarters?
- Are there any cross-default provisions that could be triggered by a single debt covenant violation?
- Are there debt covenants relating to unspecified "material adverse changes"?

Deferred Taxes

- Have there been cumulative losses in recent years or other conditions that may require a valuation allowance for net deferred tax assets?

Pensions and Other Post-Retirement Benefits

- Is the expected rate of return on pension plan assets appropriate?
- Do fluctuations in asset values, changes in interest rates, and projected increases in health care costs necessitate revision of the accounting estimates related to benefit plans?

Accruals and Liabilities

- Are there unusual trends in accruals?
- Did estimates related to the calculation of accruals (e.g., warranty, environment, merger, restructuring, etc.) change in the current period? If so, why?
- Have all probable and estimable contingent liabilities been recorded?
- Have circumstances in the current period resulted in overaccruals as of the balance sheet date? If so, have the accruals been reduced as appropriate?

Guarantees and Commitments

- Does the company have sufficient cash or undrawn credit to meet its guarantee commitments?
- Are guarantees related to core businesses?
- Is the company exposed to credit/default risk due to financial problems or bankruptcy from a significant entity with which it does business, such as a supplier/customer, service provider, lessor/lessee, debtor, financial guarantor, investor/investee, joint venture partner, derivative counterparty, and/or trading partner?
- Does the company have significant purchase commitments and/or obligations?

Equity Securities and Investments

- Has there been an "other than temporary" decline in investment securities classified as held to maturity or available for sale, or in equity- or cost-basis investments, requiring loss recognition?
- Is there a need to disclose an early warning sign related to a decline that has been experienced but not yet deemed other than temporary?
- If the company has international investments, does it have the ability to repatriate those funds?

Employee Stock Options

- Has the company made changes to its options plans, such as repricing or extending the term of outstanding options, that require expense recognition and disclosure?
- Is the company considering changing its method of accounting for stock options?

Derivatives

- Is there an appropriate, documented risk management policy and derivative/hedging strategy in place, and if so, is it being followed?
- Is the economic effectiveness of the company's hedging strategy being evaluated on a quarterly basis?
- Is there an appropriate risk management infrastructure in place and adequate technical resources to account for derivatives?
- Are complex derivative instruments being used?
- How are derivative positions valued?
- Are processes in place to ensure that the assumptions used in a mark-to-market model are reasonable?
- Is the company required to post collateral for its derivative positions and how is this monitored?
- How is counterparty credit risk evaluated?

Off-Balance-Sheet Accounting – General

- Are assets and liabilities appropriately included in or excluded from the balance sheet? If excluded, why are they excluded?
- Has management reviewed significant recorded (i.e., on-balance-sheet) transactions that may give rise to off-balance-sheet commitments and contingencies?
- Were transactions engineered to achieve off-balance-sheet treatment?
- What is the underlying economic or business reason for the arrangement?
- Has management evaluated its exposure to credit and other losses from off-balance-sheet transactions and, where appropriate, provided for losses arising from these transactions?
- What factors could cause the obligation to move onto the balance sheet?
- If the transaction had been with a non-related party, would it have been structured the same way? Would the transaction have taken place?
- Is there off-balance-sheet debt? What is the operating or business reason for having off-balance-sheet debt?

Special-Purpose Entities

- Have the following been identified related to SPEs?
    - All structuring transactions and any side agreements or amendments to the original documents
    - The nature of relationships with third parties that transfer assets or liabilities to and/or from the SPE
    - All parties that have an ability to control asset acquisition
    - All parties with continuing involvement, including those with the ability to change service providers and those with subordinated interests
    - The party that served as primary arranger of debt placement and/or that performed a supporting role
    - All parties that receive residual economics and fees for services, including information about the structuring of those fees
- Do the voting interests in the SPE convey a controlling financial interest?
- Does management assess every party that has a relationship with an SPE as of each reporting date to determine whether it provides significant financial support to the SPE and is, therefore, the SPE's primary beneficiary?

Appendix II **Summary of Balance-Sheet Ratios**

Ratio analysis is a common form of financial statement analysis, and can be used in conjunction with other tools to evaluate the past, current, and projected conditions and performance of companies. Ratio analysis provides relative measures of the company's performance and can indicate clues to the underlying financial condition. To be meaningful, a financial ratio for a specific year must be compared to those from prior years to determine trends, and must also be compared to industry norms and those of competitors.

Industry averages are available from a number of sources. Some of the most-used sources are:

- Dun & Bradstreet: Computes 14 ratios for each of 125 lines of business; the ratios are published in *Industry Norms and Key Business Ratios.*
- Robert Morris Associates: This association of bank loan officers publishes *Annual Statement Studies*, which includes 16 ratios that are computed for more than 300 lines of business, as well as a percentage distribution of items on the balance sheet and income statement.
- Prentice Hall: Publishes the *Almanac of Business and Industrial Financial Ratios*, which lists 24 key financial ratios for 180 industries based on Internal Revenue Service data.

For the purpose of comparison, we have included a table of average financial ratios for a variety of high-level industries. This information also illustrates differences across industries; for example, the average quick ratio for a technology company is 2.32, but this ratio is only 0.50 for a utility company. The ratio analysis involving a particular company should be compared to benchmarking data for similar companies at a more detailed level. The publications listed previously give specific sub-industry statistics that are also categorized based on company size.

	Manufacturing	Utilities	Consumer Business	Technology	Transportation	Financial
Current Ratio* = Current Assets/Current Liabilities	**2.13**	**0.83**	**1.39**	**2.83**	**1.34**	**N/A**
Quick Ratio* = Current Assets – Inventory/Current Liabilities	**1.33**	**0.50**	**0.81**	**2.32**	**1.04**	**N/A**
Interest Coverage = Income + Interest Expense/Interest Expense	**5.69**	**4.78**	**6.74**	**8.87**	**12.34**	**N/A**
Inventory Turnover* = Cost of Goods Sold/Average Inventory	**8.77**	**22.69**	**16.23**	**19.30**	**19.75**	**N/A**
Receivables Turnover* = Net Credit Sales/Average Net Receivables	**5.65**	**8.81**	**15.80**	**6.96**	**13.41**	**2.10**
Asset Turnover = Net Sales/Average Total Assets	**1.14**	**0.52**	**1.21**	**0.76**	**1.09**	**0.10**
Long-Term Debt to Equity = Long-Term Debt/Equity	**2.50**	**1.40**	**0.77**	**0.25**	**0.61**	**0.20**
Total Debt to Equity = Total Debt/Equity	**2.64**	**1.70**	**0.92**	**0.33**	**0.64**	**0.30**
Return on Assets = Net Income/Average Assets	**4.82**	**3.05**	**5.11**	**3.90**	**6.09**	**0.30**
Return on Equity = Net Income/Average Equity	**8.12**	**11.29**	**11.04**	**8.77**	**14.47**	**6.20**

Source: OneSource, Ratio Comparisons Report as of October 4, 2002 for the consumer cyclical, utilities, services, technology, and transportation sectors, respectively. In the case of financial services, data is from OneSource, Annual Ratio Report as of December 31, 2001, and reflects one representative company.

* Signifies liquidity ratio, which is a measurement used to calculate the degree of a company's liquidity.

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