CHAPTER 7

FINANCIAL REPORTING

0701 GENERAL. Financial statements are a key feature in financial reporting. They are a principal means of communicating accounting information to those outside an activity. Although financial statements may also contain information from sources other than accounting records, accounting systems are generally organized on the basis of the elements of financial statements (assets, liabilities, revenues, expenses, etc.) and provide the bulk of the information for financial statements. Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions--for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.

070101. Objectives. Financial reporting should provide information about:

A. The activity's economic resources, obligations, and owner's equity;

B. The activity's financial performance during a period;

C. How the activity obtains and spends cash;

D. How the activity discharged its stewardship responsibility.

070102. Other Requirements. In addition to providing explanations and interpretations to assist users of financial reports, financial reports contain program and personnel information required by DoD, Congress, and other users.

070103. Financial Statements. The principal financial statements used to convey information to users are the statement of financial position or balance sheet, statement of operations or income and expense statement, and the statement of cash flows. These reports provide information on the financial performance and condition of the NAFI as follows:

1. The statement of financial position (or balance sheet) provides information about an activity's economic resources, obligations, and equity. That information helps users identify the activity's financial strengths and weaknesses and assess its liquidity and solvency.

2. The statement of financial position (or income and expense statement) provides information about the activity's financial performance during a specified period of time.

3. The statement of cash flows details the amount of cash received and cash dispersed for the accounting period. The beginning balance is the beginning of the period cash and the ending balance is the end of period cash.

070104. Responsibilities.

A. DoD Components. The DoD Components are responsible for the fair presentation in the financial statements of financial position, results of operation, and the program and personnel information included. In addition, the DoD Components are responsible for compliance with NAF program laws and regulations.

B. DFAS. DFAS is responsible for compiling all the necessary information from the nonappropriated and appropriated fund accounting and payroll systems, and preparation of financial statements and reports. The integrity of those systems and the accuracy of the data produced are also DFAS responsibilities. When requested, DFAS will provide other management information as needed to satisfy management or regulatory requirements.

070105. Cash Basis of Accounting. Financial statements, reports, and other information from activities authorized to use the cash basis of accounting shall be prepared in accordance with generally accepted accounting principles. The statements differ from those described above.

070106. Footnotes to financial statements. Footnotes are an integral part of the financial statements and should be used when more information is needed. Footnotes normally are not required other than on the year-end service-level consolidated statements. Accountants are required to disclose in the financial statements all relevant economic information pertaining to the business entity. When the actual dollar amounts on the financial statements do not provide sufficient information for decision makers, accountants supplement the financial statements with more detailed data in the form of footnotes. An example of a footnote is a special event that dramatically effects the financial statements. The footnote will help managers compare the operating results of the current business period with the operating results of previous periods. Fund equity adjustments and significant business closures are other prime examples of occurrences which require footnotes.

0702 REPORTING TO THE IRS.

070201. General. All records relating to payments to individuals and firms must be retained for at least four years and be available for IRS review if required. CONUS offices should consult their local IRS office when forms, publications, or assistance are needed. Overseas offices should contact the Internal Revenue Service, Assistant Commissioner (International), 950 L'Enfant Plaza South S.W., Washington, DC 20024, to get the address and telephone number of the nearest IRS representative. IRS representatives, in CONUS and overseas, are available to provide instructions concerning IRS procedures for return preparation and filing, and depositing employment tax payments. Overseas offices should use the following to request forms and publications: Forms Distribution Center, PO Box 25866, Richmond, VA 23289, or Forms Distribution Center, Rancho Corboda, CA 95743-0001.

070202. Contract Payments. Cumulative payments made under service contracts of $600 or more to anyone other than a corporation during a calendar year will be reported. The items to be reported are the total amount paid and the name, address, and social security number of the individual. For businesses, report the amount paid, the business name, business address, and business tax identification number. NAFI contracts with entertainers are considered service contracts. If a single payment to an individual is less than $600 but total payments made during the calendar year to the same individual reach $600, the report must be filed. The report (the return) will be provided to the individual or firm and to the IRS on IRS Form 1099 MISC. The individual or firm should receive a copy of the Form 1099 MISC by January 31 of the year following the calendar year of payment. This requirement also applies to individuals who, in addition to being NAFI employees, have contracts with the NAFI for non-personal services. A separate Form 1099 MISC will be prepared for each individual or firm to whom total payments of $600 or more are made. An IRS Form 1096 is used to transmit the IRS copy of the Form 1099s to the IRS. These forms must be forwarded to the IRS by February 28 each year. Refer to IRS publications for preparation instructions and filing requirements.

070203. Gambling/Bingo Winnings. IRS reporting requirements for gambling and bingo winnings are tied to individual games. Winnings are not accumulated from game to game as contract payments are. Each game stands alone for IRS reporting requirements. Whenever cash, merchandise, or a combination thereof with a total value of $1200 or more is awarded to a person for winning a single bingo game or other gambling activity, an IRS Form W-2G (Statement for Certain Gambling Winnings) is prepared. Individuals should receive their copies of the W-2G either at the time payment is made or not later than January 31 of the following year. An IRS Form 1096 is used to transmit the IRS copy of the W-2Gs to the IRS. These forms must be forwarded to the IRS by February 28 of the following year. Refer to IRS publications for preparation instructions and filing requirements.

0703 RATIOS. If requested, DFAS can provide as an example the following ratios.

070301. Working Capital Ratios. The ratio analysis or working capital can be used by management as a means of checking upon the efficiency with which working capital is being applied. Important ratios for working capital management analysis are the working capital and inventory turnover ratios and the turnover or average collection period for accounts receivable. The behavior of ratios, over a series of accounting periods, is indicative of trends which may signal the need for adjustments in the future. Some of the working capital ratios which may be computed are described below.

070302. Current Ratio. The relationship between current assets and current liabilities is called the current ratio. This ratio measures the ability to pay short term debts and is computed by dividing the total of current assets by the total of current liabilities. Marketable securities, receivables, and inventories may decline in value and there is no certainty as to when they will be converted into cash. On the other hand, current liabilities must be paid at their face value and at specific dates. It is desirable, therefore, that current assets always be materially in excess of current liabilities. The excess of current assets over current liabilities is also frequently used as an index of current financial condition. It is referred to as working capital or net current assets. There is general rule that a current ratio of 1.5:1 is satisfactory. Like most generalities this one is subject to modification in certain specific cases. A ratio that is smaller would indicate that debts may be too high. On the other hand, if the current ratio is too large this means more current assets should be converted to other useful purposes.

070303. Acid-Test Ratio. This ratio is the sum of cash, receivables, and marketable securities (called quick assets) divided by current liabilities. The acid-test ratio is a supplemental measure of liquidity. A ratio of 1:1 indicates that for every dollar of current debt there is available one dollar of quick assets to meet current liabilities. As a general rule, the acid-test ratio should be no less than 1:1. While it is generally desirable that the acid-test be high and improving, it is possible for it to be too high for the good of the business. Cash and most receivables are not earning interest and the return on most temporary investments is not large. Neither too little nor too much working capital is desirable. One of the arts of business management is the ability to determine and maintain the optimum amount of each type of asset.

070304. Ratio of Net Sales to Assets. The ratio of net sales to assets is a measure of the effectiveness of the utilization of assets. Assume that two similar activities have equal amounts of assets but that the sales of one are double the amount of the sales of the other. Obviously, the former is making better use of its assets. In computing the ratio, any long-term investments should be excluded from total assets as they make no contribution to sales. The units of product sold may also be used in place of the dollar amount of sales, if sales can be stated in a common unit. Assets used in determining the ratio may be the total at the end of the year, the average at the beginning and end of the year, or the average of monthly totals.

070305. Accounts Receivable Turnover. The relationship between credit charge sales and accounts receivable is stated as the accounts receivable turnover. It is calculated by dividing net charge sales by the average accounts receivable. The average of the monthly balances of accounts receivable should be used in the computation, as it gives recognition to seasonal fluctuations. When such data are not available it is necessary to use the average of the balances at the beginning and end of the year. Accounts receivable yield no revenue hence it is desirable to keep the amount invested in them at a minimum and the number of turnovers as high as possible. Prompt collection reduces the amount of loss from bad debts. The composition of accounts receivable changes continually during the business cycle. Accounts receivable are increased when charge sales are made and decreased when collections are received. Increases or decreases in the volume of sales will also affect the amount of outstanding accounts. Another method of expressing the result is to divide 365 (days) by the receivable turnover figure to get the average number of days that the receivables were on the books.

070306. Merchandise Inventory Turnover. Most of the observations about receivables discussed in the preceding subsection are also applicable to merchandise inventory. Inventory in excess of the needs of the business ties up funds that could be used in other ways to better advantage and may increase the amount of insurance, storage, and other related expenses. There is also added risk of loss through price declines and deterioration or obsolescence of the merchandise. The merchandise inventory turnover rate is computed by dividing the cost of goods sold by the average cost price value of the inventory. If monthly data are not available, it is necessary to use the average of the inventories at the beginning and end of the year. This measures the efficiency of inventory control. A ratio of 1 to 1 is generally acceptable for food and bar operations. For all other sales operations, however NAFI management may establish other goals.

070307. Turnover of Working Capital. A close relationship exists between sales and working capital. As sales volume increases, the investment in inventories and receivables increases and therefore, a larger amount of working capital is necessary. The turnover of working capital reflects the extent to which the business is operating on a small or large amount of working capital in relation to sales. This turnover or ratio is composite of number of relationships (inventories, receivables, current liabilities, etc.). These various component elements should be analyzed individually to account for changes from period to period. The turnover of working capital is computed by dividing the net sales for the year by the average working capital.

070308. Net Income Ratio. This measures the rate of return on revenue. A percentage of 5-10 percent is generally acceptable.

070309. Return on Assets Ratio. This measures the NAFIs ability to generate revenue with its existing assets. The ratio is computed by dividing net income by the average total assets. Average total assets are beginning total assets plus ending total assets divided by 2.

070310. Return on Fund Equity. This measures the NAFI's ability to use leverage by earning a higher rate of return than is paid for the funds used to operate. The ratio is computed by dividing net income by the average fund equity.

070311. Other Ratios.

A. Fixed Asset Turnover.

B. Accounts Receivable Aging.

C. Working Capital to Total Assets.

D. Return on Tangible Assets.

0704 COMPARATIVE ANALYSIS OF FINANCIAL STATEMENTS.

070401. General. Comparative analysis consists of a study of relationships and trends to determine whether or not the financial position and results of operations and the financial progress of the business are satisfactory or unsatisfactory. The objective of any analytical method used to analyze a financial statement is to simplify or reduce the data under review to more understandable terms. The analyst first computes and organizes data and then analyzes and interprets them. Analytical data are not ends in themselves, they must be assimilated intelligently to aid in decision making by management. The frequency with which analytical data are furnished is of the utmost importance. It is not enough for management to know at the end of a year, or even a quarter, that costs are increasing more rapidly than revenues. The accountant must often use interim cost standards, ratios, or other devices, in presenting income statement data. Moreover, they must devise adequate methods of accruing items which may not be finally determined until the end of the fiscal year or later, but which are of vital importance in their effect on income.

070402. Analytical Methods and Techniques. Analytical methods and techniques used in analyzing financial statements include the following:

A. Comparative balance sheets, income statements, and statements of retained earnings or net worth showing:

1. Absolute data (dollar amounts).

2. Increases and decreases in absolute data in terms of dollar amounts.

3. Increases and decreases in absolute data in terms of percentages.

4. Comparisons expressed in ratios.

5. Percentages of total.

B. Statement of sources and uses of working capital.

C. Trend ratios of selected and/or related financial and operating data. A trend analysis should be made for each NAFI's financial statement. The analysis of the balance sheet should compare actual to actual and the percentage of increase or decrease be shown. The analysis of the income statement for each activity should compare actual to actual and actual to the budgeted amounts. As with the balance sheet analysis, differences will be shown as a percentage. The analysis should be made by each activity for items such as; sales, cost of goods sold, labor expenses, net income, and all other revenue and expense items with a material financial effect on the activity.

D. Common-size percentages - balance sheets, income statements and individual sections of these statements.

E. Ratios expressing the relationships of items selected from the balance sheet, the income statement or both statements.

F. Statement of variation in net income or gross margin.

070403. Comparative Statements

A. General. Any fact, by itself has limited significance. There must be other related facts to give the first one increased meaning. The validity of this observation is easily demonstrated in the case of information about a business. For example, learning that last year's net income of a certain activity was $68,514 is to learn very little. Does that amount of net income indicate a successful year or a poor one? Does the amount present an improvement over or a decline from the year before? Is the amount large or small in relation to sales? - to assets? - to equity? How does it compare with similar activities? Other facts must be known if the information about last year's income is to have any real meaning. The same can be said of any other single bit of information about a business.

B. Types of Comparison. The financial statements can be much more informative and meaningful if they are analyzed on a comparative basis. Four types of comparison may be possible:

1. Comparison of the latest financial statements and relationships between various elements with the statements and relationships of one or more previous periods.

2. Comparison of the statements and financial relationships of the fund with data for other similar activities.

3. Comparison of statements and financial relationships of two or more divisions or branches of the same activity.

4. Comparison of information in the statements with pre-set plans or goals (normally in the form of budgets).

C. Horizontal Analysis. A comparison of the amounts for the same item in the financial statements of two or more periods is called horizontal analysis. The term is applied because the analysis, which suggests probabilities, weaknesses, or strengths, includes data from year to year rather than as of one date or period of time as a whole. The comparison is facilitated if the amount of any change and its relative size are shown. In computing the percent of change, the amount for the earlier year serves as the base. In general, the percentage of change is of greater interest than the actual amounts.

D. Vertical Analysis. The amount of each item in a statement can be expressed as a percentage of the total. This is termed vertical analysis. A maximum of information is provided if statements relating to two or more periods are vertically analyzed and the results compared or contrasted.