A Guide to Financial Statements

What will be required based upon what you want to accomplish

Do you believe that one type of financial statement is as good as another? If you do, look at your franchise’s menu display. If one choice satisfied everyone, you wouldn’t need that menu, but you want to be able to tailor everyone’s orders to their individual tastes.

There’s a parallel in financial statements. While most financial statements are built upon the same accounting principles -- for example, balance sheets list assets and liabilities -- how statements are reviewed can vary greatly. If you’re preparing financial statements solely for your use, that’s not a big deal. But if you’ve been asked to provide financial statements as part of a loan application or a potential acquisition, the type of statement can make or break the deal.

The role of financial statements

Financial statements provide a snapshot of key business measures that can be compared with previous or future statements to get a sense of the health of a business. A franchise owner can use statements to manage the business and inform important decisions. A lender can use statements as a tool to evaluate the health of the business and develop a sense of the risk involved in making a loan. A prospective buyer of a franchise can use statements in developing a fair market value for the business.

Most business owners will rely on an outside source, such as a certified public accountant (CPA) to prepare statements for them on a regular basis.

Before we get into the types of financial statements, let’s look at some basic definitions:

What is assurance? A CPA has a legal and ethical obligation when it comes to evaluating financial statements. The term CPAs use to describe this is “assurance.” The more steps taken to verify the accuracy of a company’s financial statements, the greater the degree of assurance.

For example, if your CPA develops financial statements based solely on records that you hand over and doesn’t take any steps to confirm that the records are accurate, he or she will add a notice saying that no assurance has been provided. On the other hand, if the CPA completes a thorough audit of your company’s records, he or she will include a statement to that effect.

What are misstatements? Simply put, a misstatement occurs when something in a financial statement doesn’t match up with the underlying facts. A material misstatement is a situation in which the misstatement is major enough that it might mislead someone using the statement to make a decision. Misstatements are typically the result of errors, but can also suggest fraud.

Now let’s look at three primary options when it comes to preparing financial statements, and when each type might be the most appropriate choice.

Unaudited Statements

As the name suggests, unaudited statements are financial statements that have not received a formal audit from an outside party such as a CPA. There are two different types of unaudited statements: Compiled and Reviewed.
Compiled Statements

• Typically used with small loans or when there is considerable collateral
• Does not include assurance from the CPA
• CPA must disclose any lack of independence from the business
• CPA does not provide a formal opinion of the statements

With compiled statements, the CPA simply takes the information from the franchise owner and develops the requested financial statements. The CPA doesn't verify the accuracy of the information or provide any analysis, although he or she does have to consider whether any material misstatements appear to be present. If the CPA has some sort of connection to the business (for example, he or she owns a share), that must be disclosed. The first page of the report will note that the CPA did not audit the statements and therefore cannot provide assurance or an opinion about them.

Compiled statements may be used when the amount of credit being extended is fairly small, or when a loan is guaranteed by substantial collateral, so the risk to the lender is minimal.

Reviewed Statements

• Typically required when businesses seek loans or other financing
• Provides more assurance than compiled statements
• CPA must verify his/her independence
• Not as detailed as an audit

The most basic level of assurance comes with reviewed statements. As the name suggests, the CPA reviews the statements and the information used to develop them to provide limited assurance that they appear to be accurate. Reviewed statements do not involve testing the company's records, evaluating internal controls, or determining the risk of fraud.

The CPA must have a good understanding of the accounting practices and standards that are used in the industry, and enough knowledge about the specific business and its accounting practices that he or she would be able to recognize any material misstatements. If the CPA is not truly independent from the business, he or she is ethically unable to perform this type of review.

Reviewed statements are requested when a franchise owner is seeking larger amounts of credit or is being considered for a more complex form of financing. A franchise owner may also request this type of statement when making an important business decision.

Audited Statements

• Typically required for large financing, investments, or mergers/acquisitions
• Provide highest level of assurance
• CPA must verify his/her independence
• CPA will review your internal controls

The statements with the highest level of assurance are referred to as audited. The CPA who prepares the statements will devote a substantial amount of time to analyzing the information and performing specific procedures to verify its accuracy, which may include everything from a physical inventory to confirming specific transactions with other parties that were involved.
While no CPA can promise absolute accuracy, a formal audit provides what’s known as reasonable assurance that the statements are accurate and free of material misstatements. As with reviewed statements, if the CPA does not meet standards for independence, he or she cannot perform the audit.

Audited statements are generally required when a franchise operator is seeking large amounts of credit or a complicated financing approach. In addition, prospective investors, partners, or acquirers typically prefer the independent confirmation that an audit provides.

**Which is right for you?**
Determining whether you need compiled, reviewed, or audited statements depends largely upon what those statements will be used for. If you’re having the statements prepared because a lender is determining whether to give you financing, you’ll probably need statements that are reviewed or audited. The best way to determine what’s right is to ask whoever requested the statements.

**In search of financing?**
If you’re thinking about financial statements because you have business plans that may require outside financing, it also pays to perform some research into financing sources. While some franchise restaurant owners may think borrowing is as simple as calling your local commercial banker, those who have pursued financing will tell you it’s not always that easy. Why? Franchises are unique businesses, with different valuation factors than many business bankers are unfamiliar. That can make getting a loan complex, delay the process, or result in not qualifying for as much money as your franchise business deserves because of the bank’s lending limits.

An alternative you may wish to consider is a specialty lender that is accustomed to working with franchise owners. This type of lender understands how a business like yours operates, so they can approach the underwriting with realistic expectations and an appreciation for inherent risks. In addition, as private companies, specialty lenders are not restricted by federal limits.
Many franchise operators turn to specialty lenders that are accustomed to working with franchise owners. They understand how a business like yours operates.

About First Franchise Capital Corporation®
Looking for a lender that understands and focuses exclusively on serving franchise restaurant operators? First Franchise Capital Corporation provides cash flow and asset-based loans to franchise restaurant owners throughout the U.S. We believe strong relationships with our clients lead to personalized service and customized finance solutions to finance equipment, real estate, business acquisitions, and more. Our team of specialists delivers a personalized client approach to ensure your satisfaction and success.

First Franchise Capital Corporation can customize a loan for your needs and situation, from $200,000 to $30 million. The goal is to help you finance growth with minimal out-of-pocket cost by leveraging the power of your assets and cash flow. Learn more by contacting us at 844-395-8249 or www.firstfranchisecapital.com.

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