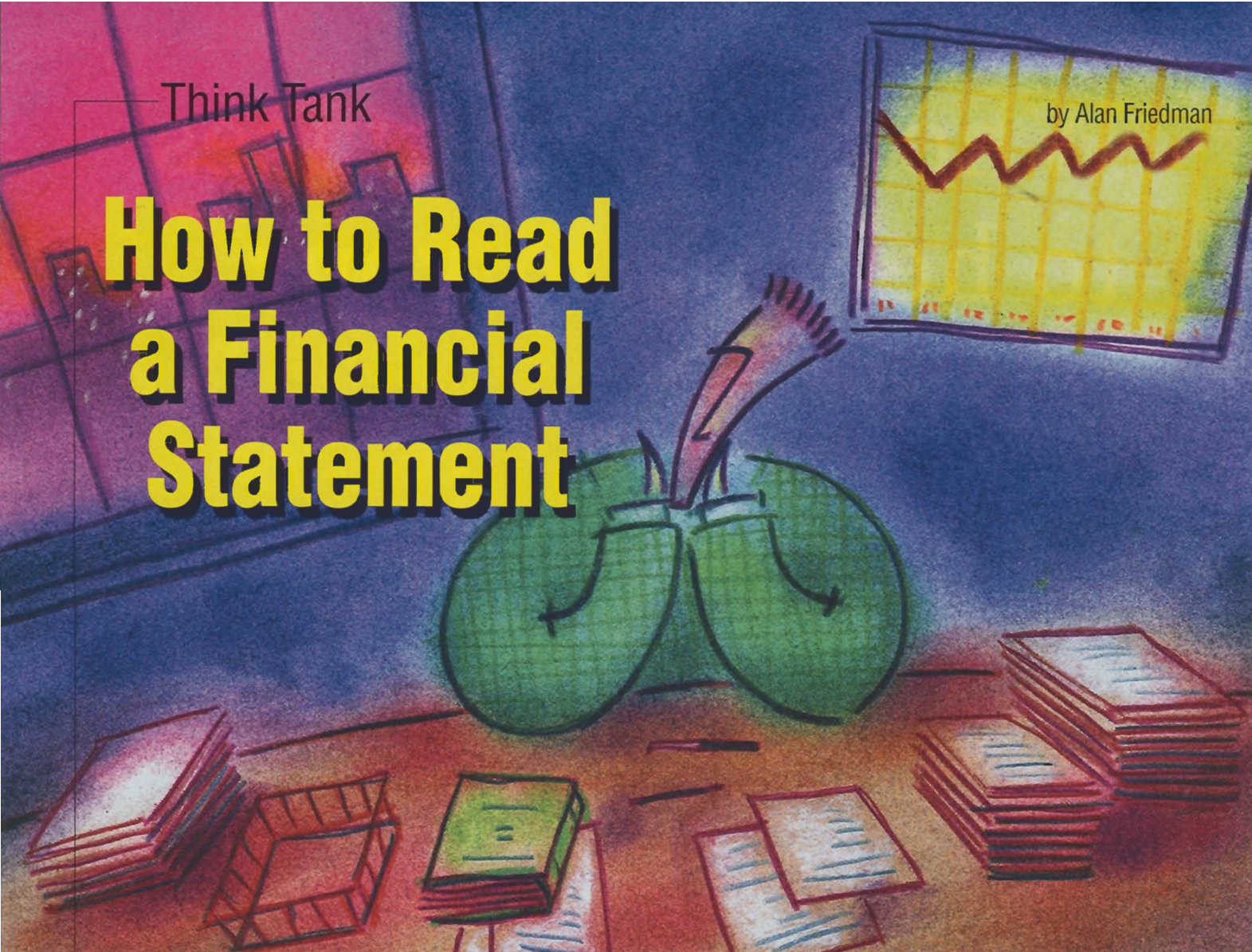


How to Read a Financial Statement



A company's financial statement is a picture of the business in action, where economics come to life. It traces the company's past, depicts its present and provides information useful to predicting its future. It is an especially important tool for the owners of that business. More than anything else, a financial statement provides an honest assessment of progress and a financial reflection of operational strength.

Many years ago, it was not as commonplace for management to submit financial statements to outside parties, such as banks, vendors and even shareholders. Shortly after the Civil War, a railroad—whose stock was listed on the New York Stock Exchange—was brief and to the point when asked to provide its financial statements: "We make no reports and publish no statements—and have done nothing of the sort for the last five years." Although by

no means typical, this statement illustrates the common attitude towards financial statements during the nineteenth century.

In a way, there was little need for financial disclosure. Companies, such as banks and mills, were largely local enterprises with only a handful of owners, who were generally officers of the business. The condition of the business was one of the town's chief topics of conversation, as annual meetings could be attended by nearly every shareholder.

As times have changed, so has the need for more complete financial disclosure and standards for financial reporting. Businesses expanded and diversified, capital needs increased and owners spread beyond local boundaries. Shareholders, lenders and vendors who extended credit began to wonder what the business was doing with their money. Confusion would arise when a com-

pany reported profits but had little or no cash to fund growth, repay loans or distribute profits. These interested parties needed timely and reliable financial information in order to make informed investing and lending decisions. And so the age of financial statements and standards in financial disclosure had begun, pushed forward by forces like the New York Stock Exchange (NYSE), SEC (Securities & Exchange Commission), Financial Accounting Standards Board (FASB) and American Institute of Certified Public Accountants (AICPA).

Today, financial statements are the single-most important tool for assessing the financial viability of a company, whether a billion-dollar, publicly-held international conglomerate or a small, single-location music store owned by one person.

But financial statements can be confusing to even the most seasoned

business owner, banker or investor. Accordingly, I'll attempt to explain in simple terms how to read a financial statement without needing an accounting degree.

This first installment of a two-part series deals with the "balance sheet," while next month's will detail the "income statement." Together, these two statements make up the basic, yet most integral parts of a financial statement. Both articles will highlight the common components found in the financial statements of a typical music retailer. Next month's article will deal with other disclosures made in financial statements, as well as the different levels of assurance given by CPA firms who provide financial statement services.

Financial Statement Basics

Every financial statement contains a balance sheet and income statement. The balance sheet is a list of all the assets owned, liabilities owed and resulting equity of a given business. A balance sheet is a snapshot of the current position of a business on a single day in time (i.e. Dec. 31, 2002). An income statement, on the other hand, is a list of all the revenues earned, expenses incurred and resulting profit (or loss) of a given business. An income statement is a snapshot of the results of business operation for a period of time (i.e. the 12-month period Jan. 1 through Dec. 31, 2002).

There are other things found in a financial statement beyond the balance sheet and income statement. These additional disclosures might include a statement of cash flows, supplementary information and footnotes on significant accounting policies as well as a statement on the level of assurance given by a CPA firm. We'll talk more about these items in next month's article.

The Balance Sheet

Let's look at the comparative two-year balance sheet on the page 22 for our sample company, Harry's House of Horns, Inc. ("Harry's"), an incorporated school music dealer. Also included is the income state-

ment, as you'll begin to understand how interrelated both statements are to one another.

You'll notice the balance sheet includes certain assets under a classification called "current assets," if it's expected those assets will be converted to cash within one year. Similarly, the balance sheet includes certain liabilities under a classifica-

tion called "current liabilities," if it's expected those liabilities will be paid within one year. Accordingly, here are the most common items found on a music retailer's balance sheet:

Cash is money held in bank accounts, cash registers and on hand. Too little is dangerous because Harry could hit a sales slump and not generate enough cash to pay obligations

Harmonica Milestones

3,000 BC

First free-reed instruments developed in China, introduced to Europe in the 1600s.

1857

German clockmaker Matthias Hohner begins to manufacture harmonicas in his home.

1897

Hohner produces three million harmonicas — nearly tripling that figure by 1911.

1924

Hohner debuts chromatic and orchestral harmonicas.

1965

Harmonica becomes first musical instrument played in space — Astronaut Wally Schirra plays "Jingle Bells" on his Hohner Little Lady.

2003

HOHNER
XB-40

Revolutionary Hohner XB-40 Harmonica debuts at Anaheim Convention Center, NAMM Booth #3240... Don't miss it!

HOHNER



like payroll, taxes, bank loans and his accountant. Too much cash can be hurtful if it's sitting in a non-interest bearing account, while bank debt is accruing interest at high rates. When you look at Harry's cash balance of \$25,000 compared to total annual operating expenses—on the income statement—of \$1,253,000, you realize Harry doesn't have enough cash to pay even one month's expenses.

Accounts Receivable are amounts due from customers for goods delivered or services rendered not yet paid. Receivables should be reported after deducting an amount for any bad debts. Given that most of Harry's sales come from counter sales, a receivable balance of \$325,000 is an indication there may be some old (and possibly uncollectible) accounts that should be written off.

Inventory consists of musical instruments and products that are available for sale. Inventory should be reported at the lower of its cost (including freight-in) or its market value if it has dropped below cost. There are three mistakes many retailers make with respect to inventory:

1. They include the cost of musical instruments intended for rent in inventory. This is wrong. Rental instruments should be separately stated as a "fixed asset" category, and depreciated accordingly. Incorrectly including them in inventory distorts inventory turns and confuses bankers in selecting the right borrowing facility to finance these instruments;

2. They fail to include inventory acquired under floor-plan financing arrangements. Just because a retailer doesn't have to pay for certain inventory until it's sold doesn't mean they don't have an obligation to pay for it. Erroneously excluding floor-planned items from inventory distorts inventory turns and misleads the financial-statement reader about the amount of debt the business is carrying;

3. They simply carry too much inventory. By dividing the average inventory of \$1.1 million (beginning and ending inventory divided by 2) into \$1.5 million of cost of goods sold, we calculate Harry's inventory

Balance Sheet

HARRY'S HOUSE OF HORNS, INC. BALANCE SHEETS DECEMBER 31, 2002 and 2001			
ASSETS		2002	2001
CURRENT ASSETS			
Cash		\$ 25,000	\$ 50,000
Accounts receivable		325,000	250,000
Inventory		1,200,000	1,000,000
Prepaid expenses		25,000	25,000
TOTAL CURRENT ASSETS		1,575,000	1,325,000
FIXED ASSETS			
Store furniture, fixtures and equipment		125,000	125,000
Vehicles		50,000	50,000
Leasehold improvements		100,000	100,000
		275,000	275,000
Less accumulated depreciation		250,000	200,000
		25,000	75,000
RENTAL ASSETS			
Musical instruments and equipment		900,000	750,000
Less accumulated depreciation		400,000	300,000
		500,000	450,000
OTHER ASSETS			
		25,000	25,000
		\$ 2,125,000	\$ 1,875,000
LIABILITIES AND STOCKHOLDER'S EQUITY			
CURRENT LIABILITIES			
Accounts payable		\$ 900,000	\$ 750,000
Floor plan payable		450,000	300,000
Accrued taxes and expense		65,000	50,000
Credit line payable		100,000	100,000
Current portion of long-term debt		80,000	80,000
TOTAL CURRENT LIABILITIES		1,595,000	1,280,000
LONG-TERM DEBT, less current portion		240,000	320,000
STOCKHOLDER'S EQUITY			
Common stock		10,000	10,000
Additional paid in capital		100,000	100,000
Retained earnings		180,000	165,000
		290,000	275,000
		\$ 2,125,000	\$ 1,875,000

Income Statement

HARRY'S HOUSE OF HORNS, INC. STATEMENTS OF INCOME AND RETAINED EARNINGS FOR THE YEARS ENDED DECEMBER 31, 2002 and 2001					
	2002	%	2001	%	
NET SALES	\$ 2,200,000	100.0	\$ 1,800,000	100.0	
COST OF GOODS SOLD	1,500,000	68.2	1,200,000	66.7	
GROSS PROFIT	700,000	31.8	600,000	33.3	
OTHER OPERATING INCOME (EXPENSE)					
Rental income, net of \$250,000 and \$200,000 of depreciation	500,000	22.7	400,000	22.2	
Repair income, net of \$175,000 and \$150,000 of repair costs	75,000	3.4	50,000	2.8	
Lesson income, net of \$75,000 and \$50,000 of teacher costs	50,000	2.3	40,000	2.2	
Other operating income	25,000	1.1	10,000	0.6	
TOTAL OPERATING PROFIT	650,000	29.5	500,000	27.8	
OPERATING EXPENSES					
Salaries - officers	40,000	1.8	40,000	2.2	
Salaries - sales	395,000	18.0	300,000	16.7	
Salaries - administrative	100,000	4.5	75,000	4.2	
Advertising and promotion	250,000	11.4	200,000	11.1	
Rent	100,000	4.5	100,000	5.6	
Taxes	55,000	2.5	45,000	2.5	
Depreciation	50,000	2.3	50,000	2.8	
Insurance	45,000	2.0	40,000	2.2	
Freight-out, postage and shipping	40,000	1.8	35,000	1.9	
Utilities	35,000	1.6	30,000	1.7	
Bank and merchant card fees	23,000	1.5	27,000	1.5	
Supplies	30,000	1.4	25,000	1.4	
Telephone	30,000	1.4	23,000	1.3	
Professional fees	25,000	1.1	21,000	1.2	
Office expense	20,000	0.9	19,000	1.1	
Travel and entertainment	5,000	0.2	5,000	0.3	
INCOME FROM OPERATIONS	1,253,000	57.0	1,035,000	57.5	
OTHER INCOME (EXPENSE)					
Interest income	1,000	0.0	2,000	0.1	
Gain on disposal of fixed assets	2,000	0.1	3,000	0.2	
Interest expense	(80,000)	(3.6)	(60,000)	(3.3)	
NET INCOME BEFORE TAXES	20,000	0.9	10,000	0.6	
PROVISION FOR INCOME TAXES	5,000	0.2	2,000	0.1	
NET INCOME (LOSS)	15,000	0.7	8,000	0.4	
BEGINNING RETAINED EARNINGS	165,000		157,000		
ENDING RETAINED EARNINGS	\$ 180,000		\$ 165,000		

turn of 1.4 times. Harry should be achieving at least two turns and striving for three turns a year. Carrying too much inventory is causing cash shortages, which translates into lower gross profit margins, higher interest costs, lower profits and ultimately low owner compensation.

Fixed Assets are tangible property that have a useful business life longer than one-year, including land, buildings, furniture, displays, vehicles, office equipment and computers, tools, machinery as well as leasehold improvements. Except for land, these assets have a limited useful life. Accordingly, a deduction in the form of depreciation is taken from the original cost in order to record the proper amount of expense each year.

Because these assets are generally not sold and therefore aren't converted to cash, management must be careful deciding what to spend on fixed assets. That's why both the cost of fixed assets and its related accumulated depreciation are shown separately (as opposed to "net" of one another) on the balance sheet. This lets the financial statement reader determine how much was spent on fixed assets each year.

Harry didn't buy any new fixed assets this year and most of his assets have been fully depreciated. This may indicate some aging assets that must be replaced in coming years.

Instrument Rental Assets are the instruments that are held out for rent and have a useful business life longer than one year. I like to see them broken out separately on a balance sheet, instead of lumped in with other fixed assets.

Similar to fixed assets, these instruments should be depreciated over their useful life. However, unlike some fixed assets that may have a useful life of five to seven years, rental assets may have a useful life of as little as three years or that exceed 10 years. Their useful life should be determined by the kind of contract they are rented under ("rent-to-own" versus "rent-to-rent"), rather than by how long they last before falling apart.

Why depreciate a saxophone over

10 years if it's rented under a 36-month "rent-to-own" contract where the title will eventually pass to the customer? To do so would overstate "net" rental income by understating depreciation expense. By the same token, why would you depreciate a clarinet over three years if it's rented under a "rent-to-rent" contract and the title will never pass to the customer? To do so would understate "net" rental income by overstating depreciation expense. A rental asset's "useful life" is ultimately determined by how long it's useful to the music store, not the customer.

Other Assets are non-current assets such as rent deposits, organization costs, goodwill and other intangible assets.

Accounts Payable is the money owed to vendors who have supplied goods or services to the business. By dividing Harry's average accounts payable of \$825,000 into his cost of goods sold of \$1.5 million, we can begin to assess how quickly Harry is paying his vendors—every 200 days (not good). When you add the floor plan payable to the equation, the picture gets much worse.

Floor Plan Payable is the money owed to vendors who have supplied inventory under a special "pay-as-sold" financing arrangement. I like to see this amount separately reported instead of lumped in with trade payables, as it lets one know how much inventory is subject to potentially high-interest carrying charges if not timely sold.

Accrued Taxes & Expenses are unpaid wages, commissions, taxes, payroll deductions and interest as of the balance sheet date.

Lines of Credit Payable & Current Portion of Long-Term Debt indicates the amount of bank debt due in the next 12 months. Although lines of credit are essentially the same thing, they are segregated from other installment debt as they are generally payable on demand and subject to special provisions that require they be paid off during the course of the year.

Long-Term Debt is the amount of installment debt that must be paid in

future years. It is usually comprised of different loans taken out at different times at varying interest rates.

Common Stock & Additional Paid In Capital are corporate "equity" accounts that show the amount invested in the company by its shareholders through the sale of stock. Partnerships, limited liability companies and sole proprietorships show the same invested funds, but call their accounts "Partners' Capital," "Members' Capital" and "Owner's Capital," respectively.

Retained Earnings is another corporate "equity" account reflecting the accumulated earnings reinvested in the business. Bare in mind you won't find retained earnings separately reported on the financial statements of partnerships, limited liability companies and sole proprietorships; it's merely included in the entity's capital account.

Some Final Thoughts

Balance sheets are simple mathematics. If you add up what you own (the assets) and subtract what you owe (the liabilities), you'll arrive at the equity in the business. In theory, if you sell your assets and pay your debts, you'll walk away with the equity in the business. However, in the real world, you could have obsolete inventory, bad debts, rental assets worth more than their net book value and contingent liabilities; all requiring adjustments to arrive at a more realistic value.

It takes practice to learn how to read a financial statement and understand what it's really telling you. But when mastered, you'll make informed decisions that will help insure the continued viability of your business.

Next month, we tackle the ever-popular "income statement."



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