



Music by Numbers

presented by

**Alan Friedman, CPA
& Daniel Jobe**

Friedman, Kannenberg & Company, P.C.



TODAY'S OBJECTIVES...



- **“Dissect”** a Financial Statement
(Balance Sheet & Income Statement)
- Teach you **“how to read”** a F/S
- **“War Stories”** from 2 Music Retailers



**But first, let's test your knowledge
of financial terminology ...**



What does "F.S." stand for?

**This is the type of scaling
used on a bass guitar....
"Full Scale"**



Financial Terminology



What does “I.S.” stand for?

It's what comes on every keyboard...
“Internal Sounds”

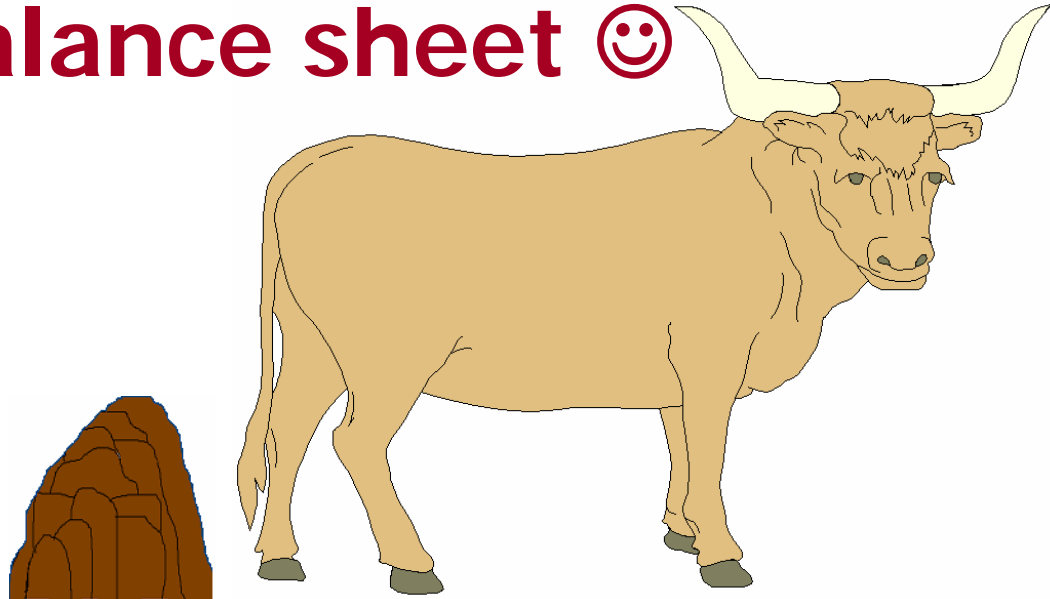


Financial Terminology



Finally, what is BS?

That's right...a balance sheet 😊



What comprises a “financial statement”



- **Balance Sheet**
- **Income Statement (a.k.a. “P&L”)**
- **Statement of Cash Flows**
- **Supporting Schedules (i.e. oper. expenses)**
- **Footnotes**
- **CPA firm letter (compilation, review, audit)**



What is a “balance sheet”?



EXCELLENCE MUSIC, INC. BALANCE SHEET DECEMBER 31, 2008

ASSETS

CURRENT ASSETS

Cash	\$ 25,000
Accounts receivable	200,000
Rental contracts receivable	875,000
Inventory	<u>1,200,000</u>

TOTAL CURRENT ASSETS 2,300,000

What is an "income statement"?



EXCELLENCE MUSIC, INC. STATEMENT OF INCOME AND RETAINED EARNINGS FOR THE YEAR ENDED DECEMBER 31, 2008

	<u>\$</u>	<u>%</u>
REVENUES		
Sales	\$ 1,000,000	54.1
Instrument rental income	750,000	40.5
Repair income	<u>100,000</u>	<u>5.4</u>
	1,850,000	100.0
 COST OF GOODS SOLD	 <u>800,000</u>	 <u>43.2</u>
	GROSS PROFIT <u>1,050,000</u>	<u>56.8</u>
 OPERATING EXPENSES		
Salaries - officers	30,000	1.6
Salaries - sales	200,000	10.8

Let's dissect a "balance sheet"



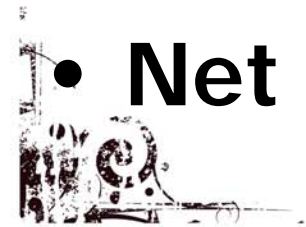
- **Current Assets**
- **Fixed Assets**
- **Rental Assets**
- **Other Assets**
- **Current Liabilities**
- **Long-term Liabilities**
- **Related party debt**
- **Owner's Equity**



Let's dissect an "Income Statement"



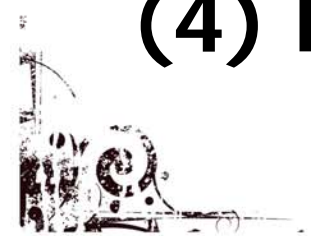
- Primary Operating Income (**i.e. sales**)
- Secondary Oper. Income (**i.e. rentals, lessons, repairs, tuning & delivery**)
- Operating Expenses (**a.k.a. "SG&A"**)
- Other (non-oper.) Expenses & Taxes
- Net Income (**a.k.a. "the bottom line"**)



What does a “balance sheet” tell us?



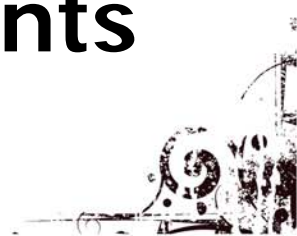
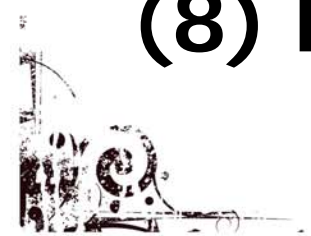
- (1) Liquidity**
- (2) Debt structure**
- (3) Owner's investment in business**
- (4) Net worth**



What does an “income statement” tell us?



- (5) Overall profitability**
- (6) Profitability by revenue activity**
- (7) Excessive operating expenses**
- (8) Non-op items, gain & loss events**



What does a B.S. and I.S. tell us “together”?



(9) Effectiveness of inventory mgt

(10) Return on rental pool investment

(11) Collectability of receivables

(12) Ability to service debts



#1 – Current Ratio = Liquidity

Current Ratio is one of the first metrics a bank considers when lending money. So, if bankers have a target, shouldn't you know what that target is?



#1 – Current Ratio = Liquidity



Excellence Music



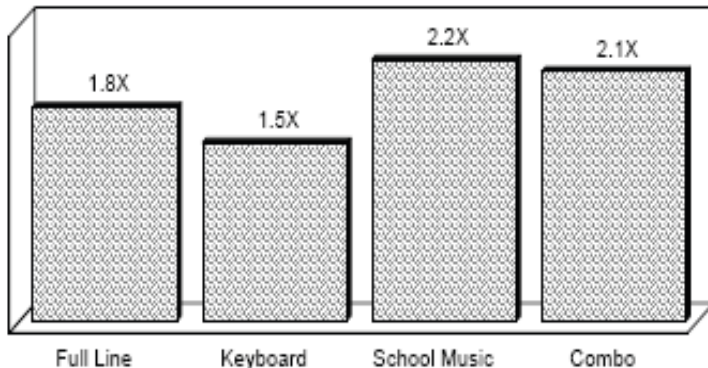
Bad Boys Music

CURRENT RATIO

Current Assets $\$ 2,300,000$
divided by Current Liabilities $\$ 2,025,000 = 1.14$

CURRENT RATIO

Current Assets $\$ 350,000$
divided by Current Liabilities $\$ 425,000 = 0.82$



Most bankers
want to see a
"Current Ratio"
of **2.00 to 1.00**
or better!

800 INDUSTRY
PERFORMANCE
REPORT

#2 – Debt Structure

A lack of long-term financing is like being a one-man band – you're carrying a heavy load all by yourself, you have no outside help, and in the end there's a limit to what you're able to do.



#2 – Debt Structure



Excellence Music

CURRENT LIABILITIES

Accounts payable	\$ 1,500,000
Floor plan payable	300,000
Accrued taxes and expenses	75,000
Credit line payable	100,000
Current portion of long-term debt	<u>50,000</u>

TOTAL CURRENT LIABILITIES 2,025,000

LONG-TERM DEBT, less current portion 175,000



Bad Boys Music

RENTAL INSTRUMENTS

Band and orchestra rental instruments	1,000,000	
Less accumulated depreciation	<u>900,000</u>	<u>100,000</u>

CURRENT LIABILITIES

Accounts payable	\$ 200,000
Floor plan payable	50,000
Accrued taxes and expenses	25,000
Credit line payable	100,000
Current portion of long-term debt	<u>50,000</u>

TOTAL CURRENT LIABILITIES 425,000

LONG-TERM DEBT, less current portion 100,000

Item #3 – Owner's Investment



Owners investment...

Bankers (and your employees) think an owner's supply of cash is like an Alan Friedman guitar solo... "unending".



Item #3 – Owner's Investment



Excellence Music

DUE TO STOCKHOLDERS

100,000

STOCKHOLDERS' EQUITY

Common stock	\$ 50,000	
Retained earnings	<u>350,000</u>	<u>400,000</u>



Bad Boys Music

DUE TO STOCKHOLDERS

100,000

STOCKHOLDERS' EQUITY

Common stock	\$ 50,000	
Accumulated deficit	<u>25,000</u>	<u>75,000</u>

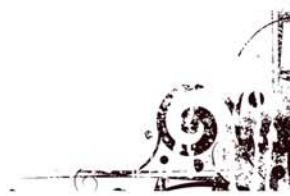
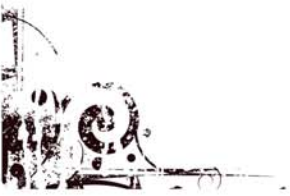
Bankers like to look to see how much an owner has invested in their business...or if this business is funding the losses for another business owned by a stockholder!

Item #4 – Net Worth (Equity)



Net Worth...

is an indication of how much (or little) a business is truly worth...sometimes...:>)



Item #4 – Net Worth (Equity)



Excellence Music

RENTAL INSTRUMENTS

Band and orchestra rental instruments	-	
Less accumulated depreciation	<u> </u>	<u> </u>

STOCKHOLDERS' EQUITY

Common stock	\$ 50,000	
Retained earnings	<u>350,000</u>	<u>400,000</u>



Bad Boys Music

RENTAL INSTRUMENTS

Band and orchestra rental instruments	1,000,000	
Less accumulated depreciation	<u>900,000</u>	<u>100,000</u>

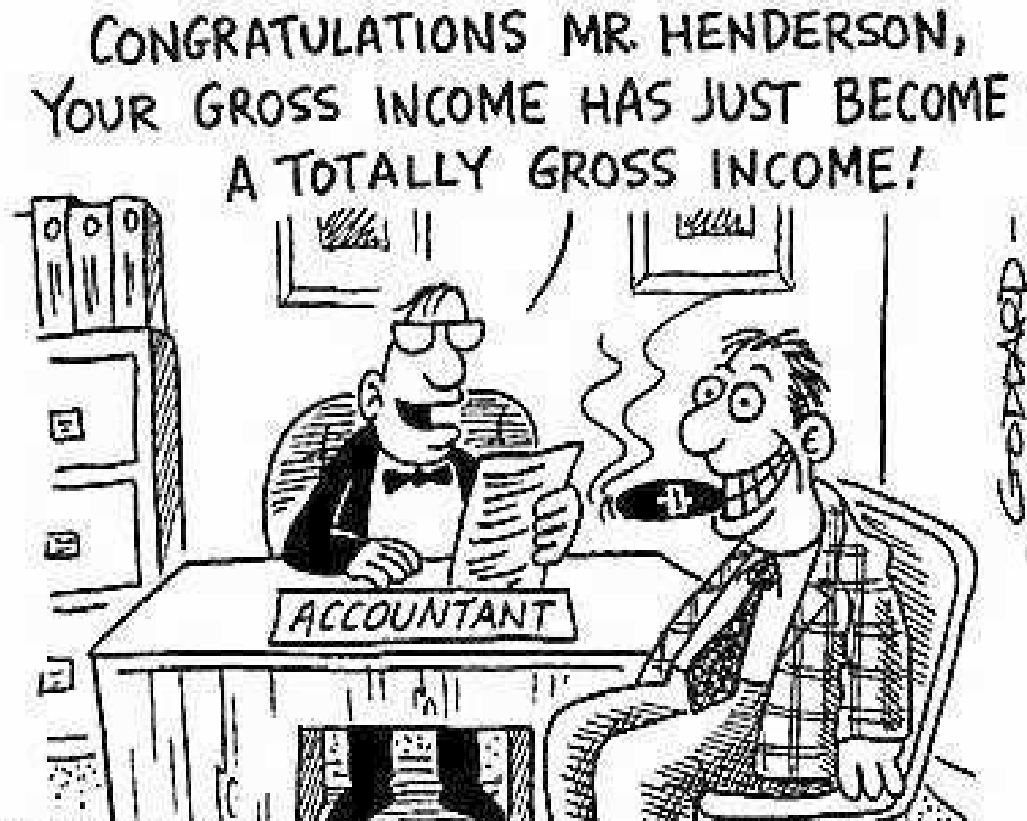
STOCKHOLDERS' EQUITY

Common stock	\$ 50,000	
Accumulated deficit	<u>25,000</u>	<u>75,000</u>

Being prepared to explain the items on your balance sheet can make a huge difference when obtaining bank financing.

#5 – Overall Profitability

The **Income Statement** is your “fake book”



#5 – Overall Profitability



Excellence Music

INCOME FROM OPERATIONS	105,000	5.7
OTHER EXPENSE		
Interest	<u>50,000</u>	<u>2.7</u>
INCOME BEFORE INCOME TAXES	<u>55,000</u>	<u>3.0</u>
INCOME TAXES	<u>-</u>	<u>-</u>
NET INCOME	<u><u>55,000</u></u>	<u><u>3.0</u></u>



Bad Boys Music

INCOME FROM OPERATIONS	(15,000)	(1.5)
OTHER EXPENSE		
Interest	<u>30,000</u>	<u>3.0</u>
LOSS BEFORE INCOME TAXES	<u>(45,000)</u>	<u>(4.5)</u>
INCOME TAXES	<u>-</u>	<u>-</u>
NET LOSS	<u><u>(45,000)</u></u>	<u><u>(4.5)</u></u>

#6 – Departmental Profitability



Tracking departmental profitability...is like paying attention to the horn section in your band – you'll be able to hear and correct someone playing out of tune.



#6 – Departmental Profitability



Excellence Music

	<u>\$</u>	<u>%</u>
REVENUES		
Sales	\$ 1,000,000	54.1
Instrument rental income	750,000	40.5
Repair income	<u>100,000</u>	<u>5.4</u>
	1,850,000	100.0
COST OF GOODS SOLD	<u>800,000</u>	<u>43.2</u>
GROSS PROFIT	<u>1,050,000</u>	<u>56.8</u>



Bad Boys Music

	<u>\$</u>	<u>%</u>
SALES	\$ 1,000,000	100.0
COST OF GOODS SOLD	<u>625,000</u>	<u>62.5</u>
GROSS PROFIT	375,000	37.5
OTHER OPERATING PROFIT		
Net instrument rental income (\$750,000 income, less \$350,000 of depreciation)	400,000	40.0
Net repair income (\$150,000, less \$135,000 of repair wages & parts)	<u>15,000</u>	<u>1.5</u>
TOTAL OPERATING PROFIT	<u>790,000</u>	<u>79.0</u>

#7 – Managing Operating Expenses

Operating expenses...
need to be managed
at all levels.

(Including your employee's smoke breaks)



#7 – Managing Operating Expenses



music
FOR PROGRESSIVE MUSIC RETAILERS

IDEAS

MANAGEMENT BY GREG BILINGS

29 Ways to Cut Costs

I'm sorry, but there are really only two ways to maintain a profit: increase revenue or reduce expenses. Those of us in the musical instrument business love to focus on sales. Unfortunately, the current economic conditions make increasing sales difficult. But there are many things we can change on the other side of the ledger, and the present circumstances provide both the motivation and the justification to make productivity improvements and budget cuts — big and small.

There has been a lot of talk these days about accountability. For the next 10 minutes, let's turn our attention to austerity. Managing expenses is not as much fun as planning a big sales event. We have to let go of things we hold dear, deal with thorny little issues and even admit we've made mistakes. However, the benefits are immediate and long-lasting. Changes in our expense structure benefit cash flow and the income statement right away, but they also position us to be more efficient and effective as we prepare for the inevitable next wave of growth. I like to think of it as polishing the stone.

Having realistic expectations is the key to fiscal management success. If there was one easy way to chop \$50,000 from your expenses, you probably would have thought of it by now. But there might just be 30 ways to save \$200 a month, which adds \$48,000 per year to your bottom line. Even if you only find half that much, it could be the difference between profit and loss in a difficult year.

So, here's my list. None of these are theoretical. Many are brutal. Your humble writer only recommends cost-savings he has actually used himself.

Tried-and-true ways to cut expenses, maintain profits in a tough economy

OCCUPANCY

1. Call your electric company, and have an energy audit. It's free and easy. An expert will visit your store and use sophisticated computer modeling to make a series of energy consumption sug-

gestions. If you do the audit and (probably) all of those supplies aren't getting to your store. Buy generic brands in bulk at Sam's Club or Costco, and don't buy unnecessary junk like candy for a bowl on the receptionist's desk. Use these companies' Web shopping lists to keep employees in the store and to reduce impulse purchases. When it comes to supplies, use them up, wear them out and improve. Expect 50-percent savings in the first year.

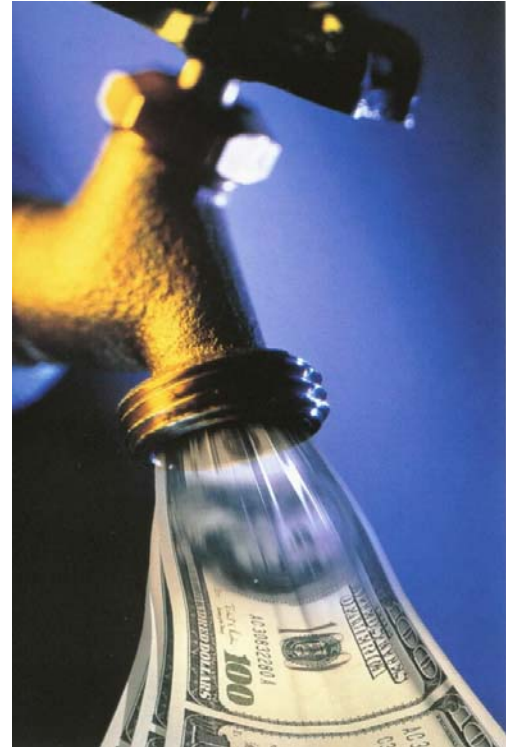
4. Audit your telephone bill. Are you paying more than a nickel a minute for long distance or 800 service? Are the incoming 800 calls generating business? Are 57-minute calls to your employer's hometown area code showing up on the bill? Look for odd fees like caller ID on your fax line. Do you need all those lines? Could VoIP (Voice over Internet Protocol) work for you? Are your employees using 411 at \$1.25 a call? Encourage employees to use their cell phones for all outgoing calls.

5. Get competitive bidding on all your insurance policies at least every other year. A new insurance agent will always find ways to save

Manage expenses at their most basic level, then review them as a "percentage of sales" to make sure you are in-line with industry averages.

#8 – Non-Operating items

“You could be running a profitable operation, but losing money due to a lack of capital or non-recurring events.”



#8 – Non-Operating items

INCOME FROM OPERATIONS	(15,000)	(1.5)
------------------------	----------	-------

OTHER EXPENSE		
---------------	--	--

Interest		
----------	--	--

<u>30,000</u>	<u>3.0</u>
---------------	------------

LOSS BEFORE INCOME TAXES		
--------------------------	--	--

(45,000)	(4.5)
----------	-------

INCOME TAXES		
--------------	--	--

<u>-</u>	<u>-</u>
----------	----------

NET LOSS		
----------	--	--

<u>(45,000)</u>	<u>(4.5)</u>
-----------------	--------------

RETAINED EARNINGS		
-------------------	--	--

<u>70,000</u>	
---------------	--

ENDING RETAINED EARNINGS	\$ <u>25,000</u>
--------------------------	------------------

#9 – Inventory Management



Inventory... Do you need a tornado to come through to clean up your inventory, or is your inventory as forceful as a tornado?

#9 – Inventory Management



Excellence Music



Bad Boys Music

GROSS MARGIN RETURN ON INVENTORY (GMROI)

Gross Profit	\$	<u>1,050,000</u>	
divided by Inventory	\$	1,200,000	= \$ 0.88

GROSS MARGIN RETURN ON INVENTORY (GMROI)

Gross Profit	\$	<u>375,000</u>	
divided by Inventory	\$	300,000	= \$ 1.25

Most retailing experts (across all industries) suggest
a GMROI target of **\$1.50 or better**

#10 – Return on your Rental Instrument Pool



Not paying attention to your **Rental Pools** is like letting a bunch of drummers play their own drum solos at a tent sale ...all at the same time.



#10 – Return on Rental Pool Asset



Excellence Music

RENTAL POOL PRODUCTIVITY

Net instrument rental income	\$ 750,000
add back current depreciation	<u>none</u>
Gross Rental Income	\$ 750,000
Gross Rental Asset	<u>unknown</u>
Return on Rental Asset	<u>#VALUE!</u>



Bad Boys Music

RENTAL POOL PRODUCTIVITY

Net instrument rental income	\$ 400,000
add back current depreciation	<u>\$ 350,000</u>
Gross Rental Income	\$ 750,000
Gross Rental Asset	<u>\$ 1,000,000</u>
Return on Rental Asset	<u>0.75</u>

This tells you how long it takes to recover the cost on your rental pool
(12 months divided by .75 = **16 months**)

#11 – Collectability of Receivables

Receivables...

Don't fall into the collection trap – selling an item on credit doesn't guarantee you'll be paid for it!



#11 – Collectability of Receivables



Excellence Music

CURRENT ASSETS

Cash	\$ 25,000
Accounts receivable	200,000
Rental contracts receivable	875,000
Inventory	<u>1,200,000</u>
TOTAL CURRENT ASSETS	2,300,000



Bad Boys Music

CURRENT ASSETS

Cash	\$ 5,000
Accounts receivable	20,000
Rental contracts receivable	25,000
Inventory	<u>300,000</u>
TOTAL CURRENT ASSETS	350,000

Banks normally discount the value of receivables because of their fear they can't be collected!

#12 – Debt Service Coverage



While you may be profitable, you could still be crushed under the weight of a burdensome debt service!!



#12 – Debt Service Coverage



Excellence Music

DEBT SERVICE COVERAGE

Income (loss) from operations	\$	105,000
add back current depreciation	\$	<u>25,000</u>
Cash from operations	\$	130,000
Total long term debt payments	\$	<u>90,000</u>
Debt Service Coverage		<u>1.44</u>



Bad Boys Music

DEBT SERVICE COVERAGE

Income (loss) from operations	\$	(15,000)
add back current depreciation	\$	<u>375,000</u>
Cash from operations	\$	360,000
Total long term debt payments	\$	<u>60,000</u>
Debt Service Coverage		<u>6.00</u>

Most banks like a **1.5 to 1** debt service coverage ratio!

So, who's the better retailer?



Excellence Music



or



Bad Boys Music

Let's meet 2 financially astute music retailers...



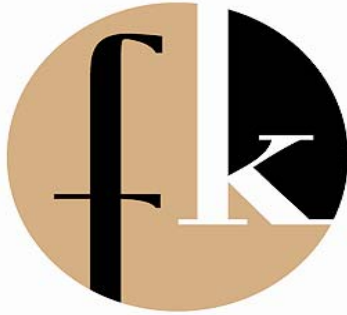
Lori Gates, CPA,
Controller



Joel Menchey,
President



Need more help?



friedman kannenberg

and company pc

Contact **Jen Lowe** after this seminar
to set up a meeting time

ATTACK!



NAMM[®] 
idea center

Enjoy the show!