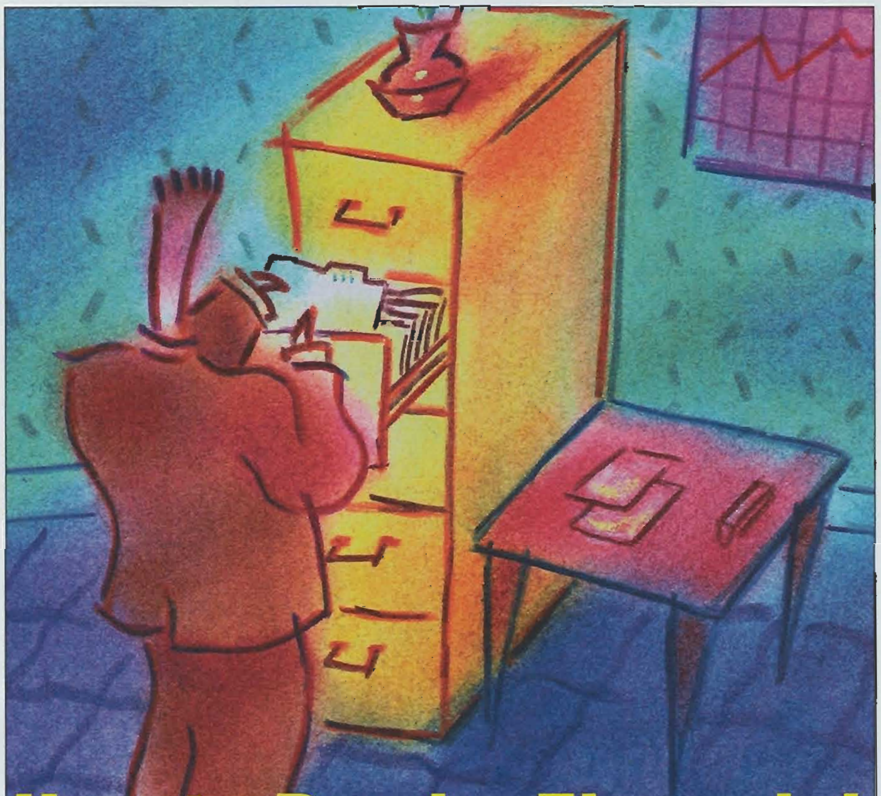
by Alan Friedman



How to Read a Financial Statement (Part II)

In last month's *Think Tank* article, we looked at why financial statements are the single-most important tool used to assess the financial performance of a company. It also gave some basic guidance on how to interpret or "read" a financial statement, starting with details about the "balance sheet."

This second installment will highlight the common components found on the "income statement" of a typical music retailer, with some important commentary along the way. It will also address other disclosures commonly found in financial statements, as well as the different levels of assurance given by CPA firms who provide financial statement services. Try not to get too excited.

One More Time

Let's briefly make the distinction between the 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 as of a single day in time (i.e. Dec. 31, 2002). The income statement, on the other hand, is a list of all the revenues earned, expenses incurred and resulting profit (or loss) for a period of time (i.e. the year ending Dec. 31, 2002).

The Income Statement

Now take a look at the two-year comparative income statement on page 28 for our sample company, Harry's House of Horns, Inc., an incorporated school music dealer. Like last time, both the balance sheet and income statement are included, given how interrelated they both are to one another.

You'll immediately notice something unique to music retailing: Harry's income statement reports "sales" revenue separately from other operating revenue (like rental, repair and music instruction income). I rarely see this done correctly, as many music retailers and their accountants will either lump all revenue sources into "sales" or report these revenues at the bottom of the income statement under "Other Income (Expense)." Either way, it's wrong. Following are a few reasons why.

By including all sources of revenue in sales, you're overstating your gross profit and gross profit percent. Gross profit is a measure of "sales" profitability, not "rental" or "repair" profitability. That's why I rarely pay attention to a retailer's boast of a 46-percent gross profit margin. When you remove these other revenues (and their related costs if they're erroneously included in "cost of goods sold"), gross profit percents tend to drop to more realistic levels, like 25 to 40 percent.

Second, rental, repair and lesson income are meaningful sources of "operating" income and, accordingly, don't belong with "non-operating" income, like interest income and gains from the sale of fixed assets. Revenues from instrument rentals, short-term equipment rental, repairs, piano tuning, delivery service, music instruction and clinics—to name a few—should be reported before operating expenses (which are also called "selling, general and administrative" expenses).

Lastly, the improper reporting of these revenues prevents you from being able to accurately compare your store's financial performance to that of your peers, via important resources like the *NAMM Cost of Doing Business Survey & Report*.

Accordingly, here are the most common items and placement on a music retailer's income statement:

Net Sales is the gross revenue earned from selling musical instruments and product. It is net of any sales discounts, allowances and returns. While it is an indication of revenue activity, it is not an indication of profitability. You'll see why in a minute.

Cost of Goods Sold is the cost (including freight-in) of musical instruments and products sold to generate the sales revenue just mentioned. It is not the cost of inventory purchased, but the cost of inventory sold during the period of time covered by the income statement.

Gross Profit is simply net sales less cost of goods sold. In other words, gross profit is what Harry earned solely from sales activity. You'll notice Harry's gross profit percent decreased from 33.3 percent in 2001 to 31.8 percent in 2002.

Yes, Harry worked harder selling stuff (as annual sales went up from $1.8 million to $2.2 million), but he did it less profitably. Guess what—who cares! I've seen music retailers fail at 40 percent gross profit, and I've seen retailers flourish at 15 percent gross profit. What matters most is the "gross profit dollars" generated (the true measure of sales profitability) and whether it was enough to cover operating overhead expenses.

That's not to say these indicators aren't of any importance. It's just that in the real world of stiff competition and falling margins, music retailers should focus more on generating gross profit "dollars," not gross sales or gross profit percent. One calculation that I like to make is Gross Margin Return on Inventory (GMROI). By dividing Harry's average inventory of $1.1 million into his gross profit of $700,000, we arrive at a GMROI of $0.64—or 64 cents of profit for every dollar invested in inventory. In other words, it's pitiful.

Harry needs to increase his GMROI to at least $1.50 or better. He can do this by either selling more profitably (which is difficult), reducing inventory levels (which is much easier) or a little of both. These are just some of the important messages conveyed by a good financial statement.

Other Operating Income is any income, other than sales, that is an integral part of the operations of a music store. As previously mentioned, these other sources of income (rentals, repairs, music lessons, etc.) should be reported "net" of their related costs. For example, rental income should be reported net of depreciation expense; repairs should be reported net of repairs parts and wages; and music lessons should be reported net of labor costs for teachers. By doing so, the financial statement reader can immediately see if Harry is making any money from each of these activities.

Interestingly, I've noticed two trends with regard to other operating income. First, it always comes as a big surprise to music storeowners when they learn how profitable (or unprofitable) these other operating profit activities are when properly reported. Second, profit from these other operating income activities is starting to surpass profit from sales activity. Hence the reason why some regional "school music" dealers are on a mission to grow their business by a national expansion of their instrument rental programs and services.

Total Operating Profit is the combined net operating profit from all sales and other operating income activities.

Operating Expenses are the selling, general and administrative expenses incurred by all music stores. The most significant of these expenses to keep an eye on are (officer, sales and administrative) salaries, rent/occupancy costs and advertising expenses. These are the most likely expenses to grow out of control.

The most recent copy of *NAMM's Cost of Doing Business Report* will provide a keen insight as to the appropriate level of spending for these expenses, as it reports them as a percent of sales for all types, size and geographical location of music stores.

Income from Operations is the net operating income Harry has earned after taking into account all operating expenses, but before non-operating income and expense.

Other Income (Expense) are non-operating (or non-business related) income items, like interest and dividend income, finance income and gains from the sale of fixed assets, as well as non-operating expense items, like interest and financing charges or losses on stock investments made by the business.

Provision for Income Taxes is the taxes expected to be incurred by the business for the period covered by the income statement. But keep in mind that you generally will only see a provision for income taxes on a "C" corporation's financial statements. Subchapter "S" corporations, partnerships, limited liability companies and sole proprietorships are entities that pay no tax; their taxable income "flows through" onto their owner's individual income tax returns where taxes are then paid.

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 $60,000 of teacher costs	50,000	2.3	40,000	2.2
Other operating income	25,000	1.1	10,000	0.6
	650,000	29.5	500,000	27.8
TOTAL OPERATING PROFIT	1,350,000	61.4	1,100,000	61.1
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	33,000	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
	1,253,000	57.0	1,035,000	57.5
INCOME FROM OPERATIONS	97,000	4.4	65,000	3.6
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	

Net Income (Loss) is the true "bottom line" of profit or loss incurred for the period covered by the income statement. Is this the sole measure of net profitability? Definitely not. Given that officer compensation is often a deduction on the income statement, it's important to look at net income, officer compensation and benefits to determine the company's true profitability.

Beginning and Ending Retained Earnings is the accumulated amount of net profits left in the business since its inception. As profitable as your company may be, banks and other creditors don't want to see you pulling out all the profits each year. They like to see this amount grow as it indicates the owner's willingness to invest profits back in the business, which helps secure the bank's position on assets for funds they've lent to the business. By the way, it's no coincidence that ending retained earnings is on both the income statement and the balance sheet. It's what makes the balance sheet "balance" and the financial statements relate to one another.

Other Disclosures

Financial statements are the responsibility of a company's management. However, lenders, suppliers and stockholders may require management to engage an independent CPA firm to provide a certain level of assurance by either compiling, reviewing or auditing management's financial statements. Accordingly, a set of financial statements may contain an accountant's compilation, review or audit report, a statement of cash flows, supplementary schedules and/or detailed footnotes in addition to the balance sheet and income statement. These additional disclosures are designed to give the financial statement reader greater assurance and in-depth information so that they can make informed judgments about the company, as well as wiser investing and lending decisions.

Now you know why Enron, MCI/Worldcom and other recent newsmakers have had such a widespread and detrimental impact on both the accounting profession and the investment community.

The Accountants Black Eye

Management may lack the motive, but certainly have the ability, to manipulate profits in order to entice investors to invest or lenders to lend. That's why lenders, suppliers and stockholders often want, or require, financial statements that have been audited (the highest level of assurance) by an independent CPA firm. Unfortunately, when that audit firm either chooses to ignore or fails to detect management's "cooking of the books," the effect is more far-reaching than the faulty financial statements themselves. Many people get hurt as employees lose jobs, loans go bad, investments are lost, retirements disappear, vendors get screwed and confidence in auditing firms erodes. What angers me most is the resulting public perception that there is a lack of integrity in the entire accounting profession.

In reality, the many accountants I've met and known have dedicated their professional lives to the principals of integrity, quality, due care, independence and objectivity. It's a shame that the moral failures of a very few high-profile low-lifes have (temporarily) marred our honorable professional. But as the saying goes, "the cream will rise to the top."

Some Final Thoughts

Who would have thought that financial statements would dominate the news in 2002. But given the importance and power contained in the message they send, it's imperative that business owners, financial management and accountants alike exercise due care when preparing these reports.

I often wonder what the financial statements of industry leaders like MARS, Manny's and Thoroughbred Music looked like the day before they went out of business. Wow, that would have made a great "Part III." Maybe some other time.

After five years and more than 40 *Think Tank* articles on a variety of financial topics, I've finally run out of ideas. So the gang at Music Inc. came up with the brilliant idea to have me write responses to your financial questions—a sort of "Dear Abbey" for the music product community.

So prepare yourself for the new "Ask Alan" column and send me those questions that keep you up at night. You can e-mail me at askalan@musicincmag.com.

And thanks to Music Inc. for this new endeavor—just when I was about to trade my PC with Excel for a Mac with ProTools. Bastards! *—A.F.*

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