AN INTRODUCTION TO FINANCIAL STATEMENTS FOR THE PRACTICING LAWYER

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INTRODUCTION

The purpose of this article is to acquaint the lawyer who advises small businessmen with financial statements. The accounting system and resultant financial statements are the backbone of the information system of the enterprise. Although much of the information may be historical in origin, its true value lies in its basis for future action. The lawyer representing a business client may have occasion to use financial statements when negotiating financial arrangements or other business transactions. Therefore, it is incumbent on the attorney representing a business to be familiar with its financial statements.

There are many full length books written on the subject of accounting and financial statements. It should be readily apparent, therefore, that detailed treatment of the subject cannot be given in an article of this length. The scope of this article is limited to a general discussion of the balance sheet, the income statement and the capital statement. Also various ratios which can be used in analyzing the financial condition of the business are discussed.

ACCOUNTING AND FINANCIAL STATEMENTS

Accounting and financial statements are used to appraise the relative operating success or failure of a business. In order to derive the maximum benefit from the financial statements, they should be as comprehensive as possible, prepared on a frequent basis, and employed in the decision-making processes of the enterprise. The financial statements can help the businessman determine proper costs, revenues and expenses from which he can insure maximum efficiency and thus maximize profits.

Financial statements summarizes transactions entered into by the business enterprise. They have a variety of internal and external uses. Internal uses include:

1) Historical data of the business;
2) Planning future operations based on past performance (e.g. debt or equity financing); and
3) The discovery of trends and their causes.

The principal external function is influence in the securing of outside financing from lenders, such as banks and other financial institutions. Outside financing sources will rely to a great extent upon the financial statements in making an investment decision.

The Balance Sheet

The purpose of the balance sheet is to disclose the financial position of the business at *a given point in time.* To put it another way, the balance sheet is a listing of the resources of a business and the interests of creditors and owners in those resources.

There can be several different forms of the balance sheet. The two major forms are the *account form* and the *report form.*

The account form uses a single page vertically divided into two equal parts or two separate pages. Assets are listed on the left while liabilities and net worth are listed on the right. Net worth may be referred to as owner's equity. This form of balance sheet conforms to the fundamental accounting equation: Assets (A) = Liabilities (L) Owner's equity (OE). An example of the account form of balance sheet is shown below.

Jones Hardware Store
Balance Sheet
December 31, 1956

Assets		Liabilities	
Cash	$25,000	Accounts Payable	$50,000
Merchandise	50,000	Owner's Equity	
Equipment	35,000	George Jones	35,000
	$110,000	Sally Jones	25,000
			$110,000

In the report form the Liability and Owner's Equity sections are placed just below the Asset section. The sum of Liabilities is deducted from the sum of the assets to yield the Owners Equity (OE).
Assets (A)—Liabilities = Owner's Equity (OE)

Jones Hardware Store
Balance Sheet
December 31, 1956

ASSETS		
Cash	$25,000	
Merchandise	50,000	
Equipment	35,000	
		$110,000
LIABILITIES		
Accounts Payable	$50,000	
Total Liabilities		$ 50,000
OWNER'S EQUITY		
George Jones	$35,000	
Sally Jones	25,000	
Total Liabilities and Owner's Equity		$110,000

Assets

The assets are generally divided into current assets and fixed assets. Current assets are usually listed on the balance sheet in order of their liquidity and may consist of the following items:

Cash—Bank deposits, currency, money orders or any medium of exchange that a bank will accept at face value on deposit;

Marketable securities—Temporary investments such as Treasury securities, commercial paper, Federal Agency issues or any investment in securities that can quick be converted into cash;

Notes receivable—Promissory notes to be paid within one year, usually representing a type of asset which may be readily convertible into cash;

Accounts receivable—Claims which arise from a sale of merchandise on account;

Inventory—Goods available for sale (merchandise) and materials which will be used in the creation of the merchandise;

Prepaid expenses—Payments made for services to be received in the future, i.e., insurance, taxes, rent.

Fixed assets or plant and equipment are of a long-term nature. Generally, they are assets which produce income indirectly through their use in the operation of the enterprise. With the single exception of land, the usefulness of plant and equipment will gradually decline over time. This decline or expiration is called depreciation. Plant and equipment are generally carried on the balance sheet at their book value, which is the original cost less accumulated depreciation.

Liabilities

Liabilities are generally separated for balance sheet purposes into current and long-term. Current liabilities are generally debts that will be paid within one year, e.g. accounts payable or taxes payable. Long-term liabilities are debts which fall due more than one year from the date of the balance sheet.

Owner's Equity

Owner's equity may be expressed in several ways depending on the legal form of the business. For example, if the legal form is a partnership, owner's equity is the combined equity of the two or more persons forming the partnership. If the legal form is corporation, shareholder's equity will be expressed as stated capital, capital surplus and earned surplus.

Valuation of Accounts

Assets may not necessarily be valued at what would be realized in cash upon the sale. An accepted method for valuation of assets is as follows:

Cash—Face value.

Marketable securities—Cost or market value, whichever is lower.

Accounts & Notes Receivable—Net amount to be realized.

Inventories—Cost or market, whichever is lower.

Prepayments—Cost.

Plant Assets—Cost less accumulated depreciation.

The valuation of the liabilities can be stated as the definite amount owed to creditors according to contractual agreement.

The Income Statement

The income statment reflects the operation of a business *over a specific period* of time, whereas the balance sheet reflects the financial position *at a given* point in time. It measures the progress of the enterprise in carrying out the functions of the business, and it will show the revenue earned by the firm and the expenses incurred in generating the revenue. The income statement may also be referred to as the profit and loss (P&L) statement or the operating statement.

Revenue results from sale of merchandise, performance of services, rental of property or other income producing acitivities. No distinction is made between cash sales and credit sales as revenue is recognized at the time of sale.[1] Expenses are expenditures or liabilities incurred for the purchase of goods and services used for current income producing activities.

Costs are expenditures or liabilities incurred for assets which are not currently used. When such assets are used they become expenses which are expired costs.

There are two types of income statements; the single step form and the multiple step form.

In the single step form the sum of costs and expense are subtracted from the total revenue to yield net income. An example of this type of income statement is shown below.

Income		
Sales	$10,000	
Other Income	500	
Total Income		$10,500
Cost and Expenses		
Cost of Goods Sold	7,000	
Depreciation	1,000	
Interest Expense	500	
Federal Taxes on Income	500	
Total Cost & Expenses		9,000
Net Income		$ 1,500

In the multiple step form there are a number of groupings with intermediate balances. An example of this form is shown below.

1. At this juncture it might be helpful to distinguish between cash accounting and accrual accounting. Cash accounting is the measurement of income on a pure cash inflow and outflow basis. Accrual accounting measures income and expense at the time the right is earned or the obligation is incurred.

Sales		$120,000
Cost of Goods Sold		
Starting Inventory	$ 30,000	
Purchases	70,000	
Merchandise available for sale	100,000	
Less ending inventory	25,000	
Cost of Goods Sold		75,000
Gross Profits on Sales		45,000
Operating Expenses		
Selling Expenses		
Sales Salary Expense	9,000	
Depreciation Expense Store Equipment	1,500	
Store Supplies Expense	500	
Total Selling Expense	11,000	
General Expense		
Office Salary Expense	3,500	
Depreciation Expense Building	900	
Utility Expense	550	
Insurance Expense	480	
Taxes Expense	625	
Total General Expense	6,055	
Total Operating Expense	17,055	
Net Income from Operation	$27,945	

Capital Statement

The capital statement is a report of changes in the owner's equity section of the balance sheet which have occurred over a given time period. The balance sheet provides information concerning owner's equity at any single point in time; the income statement measures the increase or decrease in the owner's equity resulting from business operations, but neither gives a complete picture of changes in owner's equity.

As an illustration, assume that Firm X starts the fiscal year with $50,000 in capital. This capital includes the initial capital investment, subsequent investments, and retained earnings from previous years. During the next fiscal year, the owner of Firm X withdraws $20,000 of his capital and the firm has a net income of $40,000. The balance sheet for the next fiscal year would reflect owner's equity of $70,000, but would not indicate the reasons for the change. Nor would the income statement indicate the reasons for the change because it is confined to showing how the net income figure of $40,000 was achieved.

The capital statement, however, details the changes in ownership equity by reconciling the beginning balance with the ending balance.

CAPITAL STATEMENT

December 31, 1965

Capital, January 1, 1965		$50,000
Net income for the year	$40,000	
Less Withdrawals	20,000	
Increase in capital		20,000
Capital, December 31, 1965		$70,000

In a partnership, the capital statement would appear much as the statement above but might be labeled "Statement of Partners' Capital Accounts." In a corporation, such statements are normally called "Statement of Retained Earnings" and may include such items as dividends to stockholders short-term debt by relying on quick assets of cash and accounts receivable without relying on the sale of inventories is important. It is generally a desirable practice for a business to maintain a quick asset ratio of 1:1, but before making a judgment, one must look at the industry average, the firm's trend and the general economic conditions.

The ratio is generally expressed as:

$$\text{Quick Asset Ratio} = \frac{\text{Current Monetary Assets}}{\text{Current Liabilities}}$$

Other solvency ratios which are also important are the "activity ratios". One activity ratio which the businessman should be cognizant of is the "accounts receivable turnover". The small businessman may be faced with the situation of having minimum working capital with which to operate his business. He can ill afford to have funds tied up in accounts receivable for an abnormally prolonged period. The cash made available by prompt collection may be used to meet obligations as they come due. Prompt collection will also reduce the amount of loss from bad debts.

The "accounts receivable ratio" is calculated by dividing net sales by the average accounts receivable in order to determine how often the accounts receivable turn over during a year. The more frequent the turn over the greater the cash flow. The average accounts receivable may be obtained by averaging the monthly balances or by averaging the balances at the beginning and end of the year.

Many firms must wait for receipt of payment from credit sales which may cause temporary cash shortages. In order to determine the accounts which are slow in paying, an aging of all accounts receivable will provide more detailed information. Each account outstanding should be broken down into categories of less than 30 days, 30 to 60 days, 60 to 90 days, and over 90 days.

Analysis of Financial Statements

Although each of the statements discussed earlier will reveal something about the financial condition of the enterprise, a clearer picture can be obtained by developing certain relationships between items on the statements. Comparative analysis of the balance sheet and income statement can

be performed either horizontally or vertically. Horizontal analysis involves comparison of the same item or groups of items on a series of statements. For instance, a comparison of the current assets for several financial periods is an example of horizontal analysis. Vertical analysis is the comparison of items on the same statement, such as a comparison of the current assets to current liabilities.

In general, the financial relationships developed from these statements fall into three categories:

1. Solvency of the business.
2. Profitability of the business.
3. Stability of the business.

Solvency Relationships

Solvency relationships are ratios which provide information about the ability of the business to meet its short-term debt. A particularly useful solvency ratio is that of liquidity. The information required to compute the liquidity ratio comes from the balance sheet. This ratio is computed by dividing current assets by current liabilities. It is commonly referred to as the "current ratio" or the "working capital ratio." This ratio will roughly indicate the ability of the business to pay current obligations as they come due. It is expressed generally:

$$\text{Liquidity Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

Although there is no specific standard which constitutes a satisfactory liquidity ratio, a businessman should be aware of what the average liquidity ratio is for his type of business.[2] The trend in the liquidity ratio can also provide indications of improvement or lack thereof in the financial position of the enterprise.

A more rigorous measure of the ability of the business to meet current obligations is the "quick" or "acid test ratio". This calculation is performed by deducting inventory from current assets and dividing the remainder by current liabilities. Inventories are typically the least liquid of current assets and, as such, are the assets on which losses are most likely to occur in the event of liquidation. Therefore, the ability to service the date of billing. As a general rule, the collectibility of an account which is over 60 days past due may be questionable. The same procedure can be used for a firm's accounts payable when a cash shortage limits the amount which may be used to meet obligations at any given time. This is generally referred to as "stretching accounts payable".

Leverage Ratios

Associated with the solvency ratios are the "leverage ratios." These ratios measure the extent to which the enterprise has been financed by debt, and the relation of debt to owner's equity in the enterprise.

2. Two excellent sources for industry ratios and averages is Robert Morris Associates and Dun & Bradstreet. These publications are usually available in most libraries.

These sets of ratios are important because they provide an indication of the margin of safety for creditors and the ability of the enterprise to withstand a downturn in the business operation. If the claims of creditors are large in proportion to the owner's equity, or alternatively, if the "debt-to-asset ratio" is high, it will be more difficult to raise additional capital or to receive favorable credit terms from suppliers.

Every functioning enterprise is a risk venture, not only for the proprietor, but also for the investors and creditors. This risk is translated into interest rates and/or credit terms for the business. The higher the debt-to asset ratio, the greater the risk that banks and other creditors will *not* have their loans retired as scheduled, and thus the more unfavorable the conditions under which credit will be extended to the business.

The debt-to-asset ratio or "debt ratio" as it is commonly called, is derived by dividing total debt by total assets. Ordinarily, total debt is synonymous with liabilities. Total assets are current and fixed assets.

Profitability Relationships

"Profitability relationships" are helpful in determining how effectively the business is using the resources at its command. These ratios presume a proper balance between sales and various asset accounts. A good example of a profitability ratio is "profit margin to sales." This is the ratio of net profits after taxes to sales.

A second useful profitability ratio is "rate of return on net worth." This may be of particular value since the businessman may want to consider alternate investments for his capital and whether to finance the business using his own money or that of other investors. For example, if the businessman is earning 4 percent from the business on his investment, he might be better off to close down the business and put the money in a bank where he can earn 6 percent. The rate of return on net worth ratio is computed by dividing net profit after taxes by net worth.

Funds Flow Analysis

Another financial technique which can be informative is "funds flow analysis" or "sources and uses of funds." By comparing the net changes in each balance sheet account for two different periods, it is possible to calculate the sources of funds that flow into the business and how such funds were used during that period.

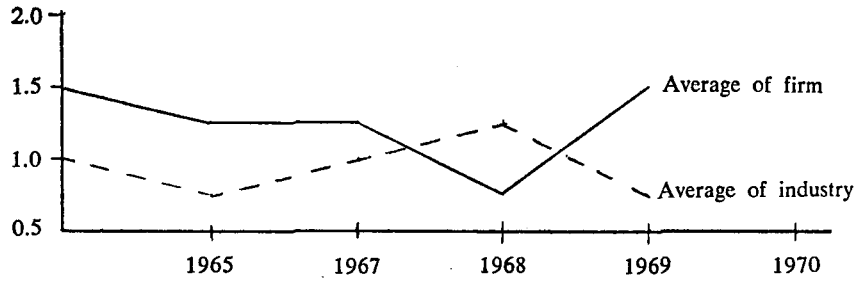
Other Ratios

There are many other ratios that can be used in analyzing the financial condition of the business. Ratios are not only helpful in pointing out weaknesses in the enterprise, but can also be of value in planning future operations. It should be kept in mind that there is no magic in ratios. They are analytical tools and should be used as such. Appendix A contains a list of ratios which the small businesman might look into. The Appendix contains a list of ratios (some of which are discussed above) which may be of help in analysing the financial strengths of a business.

Trend Analysis

Plotting a ratio over sveral reporting periods will reveal certain trends and help illuminate the strengths and weakness of the business. Also plotting a ratio against industry averages will help determine the company's position in relation to its competition. An example of such a trend analysis is shown below

TREND ANALYSIS-ACID TEST RATIO



CONCLUSION

This article is only a first approach to financial statements. An understanding of their function is an indispensable tool for the attorney who represents small business enterprises.