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Small Business

Rediscovering the Balance Sheet

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The June 7, 1976 issue of *Business Week* is must reading for every owner and manager of a small business. Even though the article, "Focus on Balance Sheet Reform," deals primarily with the problems of big corporations, the comments and conclusions apply to small businesses to the same, if not greater, degree. Lenders have always been more thorough in their review of the financial statements of closely-held entities than those of large publicly-held corporations — and all the points raised in the article will be brought to the fore by every banker in reviewing credit applications and renewal negotiations of small businesses.

The Need for Capital

Unlike publicly-held corporations which can raise needed cash by offering equity issues for sale to the public, small businesses usually have only two sources to which to look when money is needed for working capital or expansion — the owners of the company and the banker. In most cases, it will be the latter who supplies the necessary funds.

With the renewed interest in the balance sheet the owner or manager of a small business must be well prepared to answer questions that have not been asked for a while. There was a time when the income statement was considered more important — despite the fact that the effects of inflation were, in many cases, responsible for the nice increases in earnings. Most bankers still insisted on scrutinizing repayment ability, but even that consideration was tainted by the psychological effect of comparative income statements which showed progressively increasing earnings.

"Leverage" became a laudable attribute until interest rates climbed to the point where the debt became a millstone around the neck. Even though reasonable leverage is still a most desirable position for the company, it can get a lender into a lot of trouble very fast. Therefore, bankers are getting back to basics and looking very closely at ratios on the balance sheet. And they are going a few steps further into the new direction — asking questions that help bring certain balance sheet items into line with economic reality.

Some Joy — Some Grief

Adjusting the balance sheet for the effects of inflation is bound to have some pleasant results in some areas, but also to cause some real grief in other areas. Since the underlying idea is REFORM, any changes made in balance sheet accounts have to find their way into the income statement, and it will be there that most of the grief comes about.

In going over the various accounts on the balance sheet it is apparent why cash is usually listed first. It is probably the only item that will always be expressed in current-value dollars at the balance sheet date. Besides being the "anchor" of just about any transaction, it is immune to adjustments regardless of whether the current-value, replacement-value or purchasing-power approach is used.

Accounts receivable, so long as they are truly "current," are so close to being converted into cash that any adjustments for inflationary changes would probably be immaterial. However, more and more sophisticated lenders will be asking for detailed and aged lists of accounts receivable to help them decide whether this account should be accepted at face value — other than making customary allowances for bad debt losses.

Long-term notes receivable, on the other hand, will have to be discounted for the loss in purchasing power.

Marketable securities have traditionally been stated at acquisition cost, possibly with a footnote disclosure of current market value. Naturally, the purchase price may be completely unrealistic — depending on when the securities were acquired. Needless to say, if they were purchased before the last recession their restatement can cause a lot of grief, while if they were acquired at the "bottom" of the market, there will be pleasant effects on the income statement. Investments in unconsolidated subsidiaries, as well as purchases of 5% or 10% of the stock of totally unrelated companies will be considered to be a proportionate share of the equity of the other company, rather than the amount of the reporting company's original investment. Since presumably the other company is also on a "current-value" basis, the investment would thus be stated at a realistic value.

Inventories are probably first-rate candidates for adjustments, since they are stated at totally misleading figures. The first in, first out method probably comes closer to a realistic figure, but the traditionally conservative pricing at the *lower* of cost or market works to defeat the concept of current values. The last in, first out method, which has been adopted for tax saving considerations by many companies, is so far removed from replacement values that the adjustment will probably be quite sizable. Whatever method is used by the business, to translate the balance sheet into current values will require stating inventories at the amount it would cost today (the balance sheet date) to replace the items.

Plant and equipment are invariably stated at original acquisition cost less accumulated depreciation. Adjusting these figures to current values presents a whole

new set of problems. It would be unrealistic and wrong under the concept current or replacement values to simply substitute the current cost of replacing machinery, equipment, and buildings for the historical cost. The emphasis should be on productive capacity, substituting the type of equipment currently available that would produce the same output. Some very surprising results could happen when manufacturing equipment is (for purposes of restating balance sheet values) replaced by more modern and technologically advanced machines that could match the production of the currently used, possibly outmoded, machinery. Naturally, accumulated depreciation as well as current changes for depreciation expense must be adjusted along with the plant and equipment account, and useful lives must be reviewed with an eye towards future technological advances rather than the physical usefulness of the asset.

Land and income-producing real estate fall into the same troublesome category as plant and equipment. Land and natural resources are unique, since they cannot be reproduced or increased. Most lenders will look at land from the standpoint of realizable value, provided there is a reasonable expectation that the land will be sold. Raw land may be valued at its ultimate realizable value less the cost of developing it for its intended purpose. Natural resources lend themselves to valuation on the basis of expected return and future cash flow. Rental properties are subject to established appraisal procedures, and most lenders will automatically substitute their own valuation estimate for whatever appears on the financial statements. Accountants have, with proper disclosure, substituted appraised values for historical costs in this area for a while. The dilemma has been the disposition of the appraisal surplus and its amortization.

The "Fuzzy" Intangibles

Undoubtedly the most controversial area is that of intangibles which occupy a permanent place on the balance sheet. Goodwill, or the excess of the total purchase price given for a going business over the values assigned to specific assets, is not eligible for amortization under the tax laws. Therefore, most small businesses keep this capitalized investment on the balance sheet forever — long after the actual value of any goodwill has passed. Despite the fact that it is not a tax-deductible expense, the value of goodwill should be written off over a realistic period of time and charged to the cost of doing business. No matter how well established the acquired business was, unless the acquiring business can earn the confidence and continued patronage of the customers of the predecessor, they will not remain customers and there will be no beneficial effect of goodwill. To a lesser degree this would apply even to a "captive" market (where the acquired company had an exclusive process, product or license) since nothing seems to be irreplaceable any more in today's world of rapid technological advances.

The Debt Structure

Moving over onto the liability side of the balance sheet, current accounts payable and accrued expenses will be viewed much like current accounts receivable — they require the use of cash within such a short period of time that any reevaluation appears unnecessary and an exercise in futility.

Long-term debt, on the other hand, is a hotly debated item. There is true leverage in a mortgage that has 40 or 50 years to run. If inflationary trends continue even at a modest pace, the last payment due in the year 2016 or 2026 may be peanuts in the cash flow statements of those years. Accountants are not ready to do anything about long-term debt, but lenders tend to ignore it except for taking annual payments into account for their evaluation of the repayment ability of the applicant. A possibility for adjusting long-term debt to current values is to discount a debt at current interest rates and show the gain or loss as if the company were to retire the debt now. However, barring very unusual circumstances, few businesses would be inclined to accelerate the repayment of a long-term debt obligation, and thus the adjustment appears futile. Nevertheless, in due time businesses, regulatory agencies and the accounting profession will have to come to grips with this problem if reform is to apply to the total balance sheet rather than just the asset side.

The use of reserves, particularly valuation reserves and deferred tax items, on the balance sheet is not wide-spread in small businesses and it may suffice to say that most reserves will probably disappear altogether under the concept of current value restatements.

The Effect on Income

That leaves the question of the disposition of these adjustments necessary to bring the balance sheet in line with economic reality. Since reserves are a taboo, all adjustments will have to be shown on the income statement — for better or worse.

What is a true measure of income — or for that matter, management performance? Disregarding for the moment the concept of replacement values, it is the best possible match of operating income with the related costs attributable to the same period. But does a FIFO inventory priced at the lower of cost or market really reflect the cost of doing business? The LIFO method produces a much more realistic cost picture, since the purchases and manufacturing expenditures reflected in cost of sales are at the most recent prices. But LIFO leaves the balance sheet with unrealistically low values that require an adjustment to replacement costs. Clearly that adjustment is a period cost which could greatly distort the cost of sales for the current year, unless the opening inventory is restated under the same criteria — an adjustment below the bottom line. Depreciation is another significant cost figure and if plant, equipment, land, natural resources and rental properties are restated on the balance sheet depreciation charges must reflect these adjustments.

There may be quite a few "below-the-bottom-line" adjustments, and there should be a distinction between current-period gains and losses resulting from restatements of balance sheet accounts and "holding" gains and losses, where the effect on the income statement is not yet realized through sale or other disposition.

An Invitation to Defraud?

The pressures that are bringing about these changes in accounting concepts and procedures come from financial analysts, investment advisors and big banks. They have long contended that they are the ultimate and only true users of financial information and that they have never been given the information they really needed to make decisions on investment recommendations and the granting of credit. They have long substituted their judgment for the historical cost figures that appeared in the financial statements.

Now management and their accountants are asked to furnish data which are largely based on assumptions. Accountants will be facing a very difficult role. The public has always been entitled to rely on the opinion expressed by CPA firms that the financial position of the company is fairly presented. Audit procedures and generally accepted accounting principles are designed to protect the public against management fraud — preventing management from "window-dressing" its financial statements. And in a number of law suits the public has left no question about the fact that it means to take the

matter of reliance at face value. It remains to be seen whether the current trend towards substituted values will prove to be a haven for those who aim to make their companies look a few shades better than what the situation really is. It appears that the responsibility for the "fair presentation" of financial data will have to be shared by those who contribute input to the revamped composition of the balance sheet. It is one thing to restate inventories at current market values if all items are purchased but quite another thing when the stock is composed mostly of manufactured goods and an entirely new ballgame when it comes to substituting a completely new set of manufacturing equipment and plant for the existing facilities if such a substitution is to be measured by productive capacity rather than merely recalculating the plant investment on the basis of replacement costs.

With the new emphasis on the balance sheet, with adjustments in the income statement going both ways, and with all effects of restatements finding their final resting place in stockholders' equity, the temptation to manipulate may be greater than ever and much harder to control.

Bankers are in a much better position than financial analysts because they are closer and can ask specific questions and require detailed analyses that go beyond the financial position at a fixed date. They can find out about transactions consummated just before the balance sheet date for the sole and specific purpose of improving the company's current ratio. They make it their business to find out how fast inventories turn over and what and WHO makes up the list of current receivables. Repayment ability is still the overriding consideration for the extension of credit, even if the revamped balance sheet shows a greatly improved debt-equity ration.

What It Means to the Small Business

Businesses, as well as the accounting profession, will be forced into making some rather radical changes to accommodate the true users of the financial statements — creditors, potential lenders and investment advisors. For the owner or manager of a small business, these changes may be much less dramatic and probably some time in coming. But it will be good to realize that the banker downtown is looking at the balance sheet with a much different eye — through a pair of glasses that make automatic adjustments to current values.

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