IDEAS

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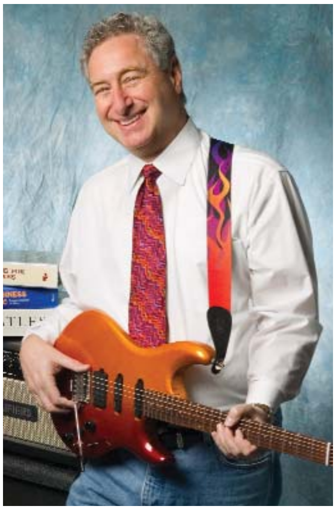
ASK ALAN | BY ALAN FRIEDMAN

WANT CREDIT? FIRST, A FINANCIAL STATEMENT

As I discussed in last month's issue of *Music Inc.*, a supplier's willingness to extend credit to its music store customers has become a hot topic. Obtaining supplier credit has always been a lively point of discussion between retailers and suppliers alike, but it became somewhat of a sore subject at the tail end of 2006. The recent pull back of supplier credit seems directly related to the demise of some notable music product retailers last year and the bad debts left in the wake of their self-destruction.

Always one to indulge controversial entertainment and "stir the pot," so to speak, I moderated a panel discussion of credit professionals at the 2007 winter NAMM show. I dubbed the program "The Loan Rangers of Music Retailing." Cute title, huh?

The panel consisted of Larry Dunn, CFO of Kaman Music; Karren Salter, general manager of customer financial services for Yamaha Corp. of America; Jim Satterberg, vice president



Friedman and industry credit managers weigh in on the importance of financial statements

of GE Capital; and Greg Grieme, president of BGE Financial. In other words, it featured the financial voices of a major supplier, distributor, inventory flooring financier and rental instrument lender.

The "Loan Rangers" program began with my opening remarks about the importance of timely and accurate financial statements. To drive home my point, I asked both the Loan Ranger panelists and the 100 or so people in the audience at NAMM's Idea Center to take a look at some sample financial statements (a balance sheet and income statement) of two different hypothetical music stores.

One store showed a couple-hundred-thousand-dollar net profit, and the other store was barely breaking even. I then asked the audience and panelists a simple question: "Which store was financially doing better?"

Of course, it wasn't the store showing the large profit. That store was recording its band rental income incorrectly, which was, in turn, over-inflating its bottom-line income by several hundreds of thousands of dollars. The other store, which was barely showing any net profit, was actually doing quite well. Its low profitability was caused by an excessive depreciation expense (a non-cash expense). While this accounting methodology is technically correct, the excessive depreciation was understating the true profitability of the store.

This exercise aimed to illustrate the importance of both generating accurate financial statements and understanding how to read and interpret them — an important task routinely performed by the Loan Rangers panelists. And so began the Loan Rangers' interactive conversation.

The following is an edited transcript.

Me: I think we can both agree [2006] wasn't a stellar year for many music retailers, as evidenced by the recent demise of Brook Mays Music and Woodwind & Brasswind, to name just two. Additionally, many music product suppliers suffered significant financial losses from these and other business failures of their music retailing customers.

In light of the bad debts suffered by suppliers like Yamaha, I would think our audience would first like to know how credit decisions are made and granted to music store customers.

Dunn: Our company starts with a basic credit application, which I think is a common requirement for all companies in this industry. When we send it out, we expect that application to come back to us filled out with all the credit information we require.

From that, we will check all of the information, including bank and trade references; that's where we start. As a general rule, the bigger the amount of credit the retailer is looking for, the more information we're looking for.

Alan mentioned the importance of financial statements. It would be ideal if we could all get audited financial statements, but that's pretty rare in our industry. So what we do look for is an association with a CPA firm or quality accounting firm. That association adds a lot of credibility to the retailer's financial statement.

As you just pointed out, Alan, those financial statements can just as easily be done right, or they can be done wrong. The way the debits and credits appear on those financial statements could be the difference between granting a $10,000 credit line and requiring the customer be sold on a c.o.d. basis. That's fundamentally how we go about extending credit.

The higher the credit requested, the more financial information we look for.

Salter: Financial statements are very important to us. However, we view credit as a sales tool to distribute our product. One of the functions of our company is to increase our market share and distribution, and through the use of credit, we're able to do that. As a manufacturer's distributor, we look for customers who really know how to merchandise our products, excel in service and have a good financial foundation.

In addition to receiving financial statements, we're frequently able to extend larger lines of credit because we require additional collateral coverage, and we frequently have ongoing conversations to monitor the trends of our retailing customers' businesses.

'I can't ever remember a loan request granted to one of our closely-held business clients where the bank didn't require a personal guarantee.'

Me: I'd like to discuss the topic of personal guarantees. I often get asked by our clients if I think they're being singled out because their bank and/or vendor is requiring a personal guarantee on a loan or credit line. Frankly, in all of the 25 years I've been practicing public accounting, I can't ever remember a loan request granted to one of our closely-held business clients where the bank didn't require a personal guarantee of that loan by the owner of the business.

Since every business owner has the ability to distribute out all loan proceeds to themselves personally the day after a loan is funded, banks want to make sure they can seek repayment from either the business itself or its owners.

More importantly, the willingness of a business owner to personally guarantee a bank or vendor debt demonstrates to the bank and/or vendor the owner's commitment to fully repay that debt. Karren, is there anything you'd like to add to this point?

Salter: Music store owners have an investment in their business — it's your equity position. But as a creditor, we extend lines of credit to our retailing customers, and that represents our investment in their business. Accordingly, additional collateral of some form is a reasonable and routine request.

Satterberg: I'd like to add that since GE Capital is third-party lender that extends much of the same kind of credit, it would be unusual — in fact, it would be very rare — that we wouldn't ask for a personal financial statement and a personal guarantee to back up that credit.

It's very important that the music retailer's commitment is on the dotted line since, as Karren said, we are effectively an investor in the music retailer's business.

All these financial statements we've been speaking of are very important to us in helping to predict the future. A lot of the time, these financial statements will cause us to ask a lot questions. But the asking of these questions is really in the music retailer's best interest. These inquiries and the answers we receive are indicative of the partnership we've formed with our music store customers. These financial statements and the communications that go along with them are invaluable to us.

Me: I'd like to add a comment to Jim's remark about requiring personal financial statements. If you happen to be a company that's reporting very little profit but there happens to be a large amount of owner's compensation being paid, your bank and suppliers will sometimes not be able to fairly judge how well you are doing by looking at your company's bottom line. Accordingly, it is often to the business owner's advantage to provide his or her banks and suppliers with both "business" and "personal" financial statements for the following reason.

Your company may not be showing a lot of net income or retained earnings in the business due to a high owner's salary, which may, in turn, cause your banks or suppliers to limit the amount of credit you're extended. If, on the other hand, you provide them with a personal financial statement that shows you are amassing a fair amount of wealth — like cash and real estate, or a rapid reduction of personal debt — your bank and suppliers may reverse themselves by extending you additional credit because they realize there is wealth that just happens to be on your personal balance sheet instead of in the business.

The next issue of *Music Inc.* will continue the dialogue with all of the Loan Ranger panelists, featuring their insights into the varying issues, obstacles, and solutions to obtaining and managing the bank and supplier credit vital to all music product retailers. Stay tuned … **MI**

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