Appendix 2
p. 11, *The Missing Links* by Caroline Mondon (Industrial Press, 2016)
www.themissinglinks.info

H. Rami Balance Sheet and Income Statement with Financial Analysis

Each year a company, whether created as an SARL (limited liability) or SA (incorporated), must present its annual financial statements, consisting of a *balance sheet*, an *income statement*, and *notes*. In addition to account details, the notes to the financial statements provide information on the company's commitments.

Balance Sheet

The balance sheet presents a photograph of the company's financial situation at the closing of the period. It consists of two tables providing figures for the last period as well as those of the preceding period. The *table of assets* describes the use of the company's resources (what has been done with the capital provided), while the *table of liabilities and shareholders' equity* includes capital, provisions, and debt.

Simplified Balance Sheet

Assets	**Liabilities and Shareholders' Equity**
Fixed Assets Tangible – buildings – equipment (E) Intangible and financial	*Liabilities* Loans and overdrafts Shareholders' advances (B) Accounts payable Taxes and social charges Deferred revenue
Current assets Inventory Other current assets Accounts receivable Cash	*Shareholders' equity* Share capital (A) Reserves (D) Net income (C)
Prepaid assets	*Provisions*
TOTAL ASSETS	**TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY**

A. Funds provided by shareholders.
B. Funds, other than share capital, to ensure the financial stability and cash needs necessary for operations.
C. Net income may be positive or negative.
D. Results not distributed to shareholders.
E. Acquisition cost less accumulated depreciation.

Income statement

The income statement presents the total of *revenues* and *expenses* for the period. The difference between the two is net income (positive) or net loss (negative).

Simplified Income Statement

Revenues (A) Sales Other income
Operating expenses (B) Salaries and social charges Purchases Depreciation expenses and provisions Overheads, taxes
Operating income (C) = (A) – (B)
Financial expenses (D)
Net income before income tax and exceptional income and expenses **(E) = (C) – (D)**
Exceptional income and expenses (F)
Employee profit sharing and income taxes (G)
NET INCOME (H) = (E) + (F) – (G)

A. Amounts invoiced during the period (and not cash received by the company). In general, customers pay after two to four months: what is billed in November will not be paid until March. Consequently, it is important to follow particularly closely the level of customer balances and "doubtful accounts." A useful policy is to determine a maximum level of "customer credit" beyond which no further orders may be accepted

B. Operating expenses ("Cost of sales" in the U.S.) are applied by commercial and industrial managers. They include all costs incurred to run the company and develop, manufacture, sell, and distribute the products. Operating expenses are useful in judging the proper control of the supply chain.

C. Useful in judging the performance of the operating teams.

D. Includes loan interest expense and other banking interest costs (discounting and overdraft).

Example: Financial Analysis of the H. Rami Company

H. Rami is incorporated as an SARL. To finance its activities, the company resorts to share capital and shareholders' advances as well as to external financial entities. A balance must be found between the resources from shareholders and those from external creditors. The situation presented to shareholders at the Annual General Meeting following the last period is as follows:

Balance Sheet of H. Rami SARL (in Euros)

Assets		**Liabilities and Shareholders' Equity**	
Fixed Assets Building and equipment	 70 281	*Liabilities* Loans Shareholders' advances Accounts payable Income taxes and social charges	544 026 57 624 95 098 110 495
Total fixed assets	**70 281**	***Total liabilities***	**807 243**
Current assets Raw material inventory Work in process Finished goods inventory Accounts receivable Cash	 129 802 169 886 60 781 498 066 86 223	*Shareholders' equity* Share capital Reserves (A) Net income (B)	170 000 18 451 19 345
Total current assets	**944 758**	***Total shareholders' equity***	**207 796**
TOTAL ASSETS	**1 015 039**	**TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY**	**1 015 039**

A. Results not distributed to shareholders.

B. Shareholders will decide at the Annual General Meeting not to distribute results.

Income Statement of H. Rami SARL (in Euros)

Revenue Sales	 2 120 487
Operating expenses Salary costs Purchases and subcontracting Depreciation expense Overheads	2 017 804 956 391 919 471 36 023 105 919
Operating income	**102 683**
Financial expenses	75 161
Net income before taxes	**27 522**
Income taxes	8 177
NET INCOME	**19 345**

Financial Analysis: Notes on Income Statement and Balance Sheet for H. Rami

Net Income:

Net income is only €19 345, or 0.9% of sales.

H. Rami is characterized by labor-intensive activity, as salary costs (salaries and social charges) represent 47% of operating expenses.

Net income represents 0.96% of operating expenses and 2.02% of salary costs. Increasing salary costs by more than 2% would be enough to change H. Rami's net income to a net loss position.

In addition, after calculating employee profit sharing and income taxes and taking into account the proportion of net income which shareholders decide to maintain in reserves to reinforce the financial situation of the company, this result does not allow shareholders to declare dividends.

Finally, operating income, at some 5% of sales, is inadequate in this industry where it is generally considered that the ratio should exceed 15%.

If operating income were to attain this level, H. Rami could reimburse its debts much faster.

Debt:

The level of debt (more than €800 000 or 38% of sales) is very high for a small company, whose fixed assets (building and equipment valued at €70 281) are not significant and do not provide a serious guarantee for banks.

The very significant level of inventory (the total of raw materials, work in process, and finished goods amounts to more than €360 000) does not either provide an adequate guarantee, as it is essentially made up of specific raw materials (various kinds of wood) and work in process, which will perhaps not be billed in either the near or distant future.

The amount of financial expenses is linked to the level of debt. At €75 161, financial expenses represent more than 3.5% of sales. Banks, and particularly the Bank of France, pay special attention to this ratio. H. Rami's ratio greatly exceeds the generally accepted level for industrial activity. Such a significant level of financial expenses will prevent the company from obtaining any type of bank financing (short-term or medium-term loans).

Self-Financing Capacity:

Self-financing capacity is equal to net income plus depreciation expense; for H. Rami this equals more than €55 000. It may be compared to the amount of loan capital reimbursed during the period, some €200 000 (about 25% of debt amounting to €800 000).

The difference of €150 000 cannot be covered by cash balances, which only amount to €86 000. If the level of accounts receivable and inventory does not fall, shareholders will have to provide additional funds to avoid receivership.

Working Capital Requirements:

Working capital requirements represent the amount of resources required by the company to finance inventory, work in process, and accounts receivable, considering the amount of credit given by suppliers (with usual payment terms of 60 days), the tax department (e.g., business tax, VAT), and social organizations (social costs being paid at the end of the period covered).

For H. Rami working capital requirements are as follows (in euros):

944 748 – (95 098 + 110 495) = 739 155, or more than 4 months of sales.

This significant amount arises partly from accounts receivable (€498 066, or 2.8 months of sales) and partially from inventory (€360 469 €, or 2 months of sales).

Inventory Turnover Ratio

Inventory turnover ratio is an indication of how the company's inventories are used. The higher the ratio, the faster the turnover of inventory and the shorter the transit delay of factory orders.

It is equal to: $\frac{\text{Operating Expenses (see Income Statement)}}{\text{Inventory (see Assets)}}$

For H. Rami, it is: $\frac{2\ 017\ 804}{360\ 469} = 5.6$

There are only 5.6 inventory rotations in the year, which means that the inventory coverage represents more than two months of production for H. Rami.