

Financial statements *and* economic loss

This is the first part in a series of two articles providing practical guidelines for analysing financial statements when assessing economic loss.

INTRODUCTION

The assessment of the loss of earning capacity of self employed plaintiffs or those who conduct a business through a partnership or company can present a real challenge to plaintiff lawyers. The starting point of the assessment is an analysis of the financial statements of the plaintiff's business with a view to determining firstly whether the plaintiff has suffered a loss, and secondly the quantum of that loss. Analysis of the financial statements will enable assessment of whether the past performance of the business can be used as a gauge for the future performance and to what extent. The challenge is in isolating the effect of the plaintiff's injury on the business from the myriad of factors that can impact on the bottom line of any business.

Although focused on the assessment of loss of earning capacity in

personal injury matters, the guidelines have wider application to claims for economic loss generally.

UNDERSTAND THE INDUSTRY AND THE PLAINTIFF

In order to usefully analyse financial statements it is necessary to have a sound understanding of the industry in which the plaintiff operates, the positioning of the plaintiff's business within the industry, the interaction of clients, people, products and capital which results in the gross income derived and the plaintiff's individual ability and experience in the business and industry. The plaintiff is a good starting point for this information, but may not be the best person to provide an objective assessment of the likely success of the business, had the injury or other event not occurred. The plaintiff may also not have a real comprehension of the full effect of the event on the business.

Industry and government statistics can be a useful tool in identifying the effect of external changes within the industry that may impact on the plaintiff's business and also provide a means of 'benchmarking' the performance of

the plaintiff's business. Such statistics will need to be used with caution, however, for, as is the nature of statistics, they may not accurately reflect what a particular business would have done. A detailed understanding of the position of the plaintiff's business in the relevant market is necessary to determine what use can be made of industry statistics in a particular case.

UNDERSTAND THE BUSINESS STRUCTURE

The plaintiff may derive income through various entities. It is critical to understand the relationship between the plaintiff and the entity (or entities). If one or more entities are involved, then assessment of the plaintiff's loss on the basis of personal income tax returns alone may result in a significant understating of the plaintiff's loss.

The various business entities that may be encountered are:

- Partnerships/joint ventures
- Companies
- Trust estates (discretionary and unit)
- Superannuation funds
- A combination of the above.

Mariano Rossetto is Director of Furzer Crestani Services. **PHONE** 02 9635 3044
EMAIL mrossetto@fcspl.com.au

For example, a plaintiff may carry on business as a company, although all of the income of the company results from the plaintiff's personal exertion. In this scenario, the net of the company profit (adjusted for any wage or director's fees paid to the plaintiff so as to avoid 'double dipping') reflects the plaintiff's earning capacity, not the amount received as a wage and/or director's fees and disclosed in the plaintiff's personal tax return.

Understanding the business entity is also critical in determining what documentation is required in order to assess the plaintiff's loss.

OBTAIN THE NECESSARY INFORMATION

The documentation and other information required will depend on the nature of the plaintiff's claim and the business structures utilised to derive the income, but will usually include the following:

1. The business financial statements for at least four financial years prior to the date of the event to the date of the assessment. These should include detailed profit and loss statements and balance sheets which provide a line-by-line description of all income, expenses, assets and liabilities. Note that the income tax returns for a business only provide a summary of key financial information in accordance with Australian Taxation Office guidelines. This summary is usually insufficient to enable a proper analysis of the plaintiff's claim.
2. The plaintiff's personal income tax returns and notice of income tax assessments for at least four financial years prior to the date of the event to the date of the assessment. Depending upon the business entity, income tax returns of the plaintiff's spouse, children, business partner and so forth may also be required.
3. Statistics, which may be industry or government derived, for the industry in which the plaintiff carries on business.

4. An understanding of the roles and duties of the plaintiff and employees in the business and how these roles have changes since the event.
5. Wage records for all employees to enable the determination of substitute or additional labour.
6. Depending on the type of claim, the following records may also be required:
 - gross income records, such as invoice books
 - bank deposit/receipt books
 - bank statements
 - cash/cheque payment books/records/cheque butts
 - general ledger records
 - lease agreements
 - minute books
 - management accounts
 - diaries, appointment books
 - debtors ledger
 - creditors ledger
 - stocktake records
 - contracts of sale of business
 - partnership agreements
 - minutes of meetings
 - valuations.

ANALYSING THE PROFIT AND LOSS STATEMENTS

The following information provides an analysis of key individual components of the profit and loss statement.

Gross income

Gross income may also be described as 'sales', 'gross fees', 'gross commissions', or some other description, dependent upon the nature of the business. The description 'gross sales' is typically used if the income is from sale of goods. 'Gross fees' is used when the income is derived from the provision of

services. A business may also have more than one activity, and therefore require more than one income description.

The basis of disclosing income is generally either:

1. Cash or receipts basis – where income is disclosed when it is received.
2. Accruals basis – where income is disclosed when the income accrues, which is usually when an invoice is raised.

It is important to understand the basis upon which income is disclosed, as the income figures in the profit and loss statements may not reflect the actual trading results of the entity. This is particularly so if the cash or receipts basis is used, as it may be some time after the relevant event before the loss becomes apparent in the financial statements. A failure to appreciate this may result in an understating of the plaintiff's loss. Likewise, use of the cash basis may give the appearance that the gross income of the business fluctuates widely, making it difficult to identify a trend.

The nature of the business is obviously relevant to the composition of the gross income figure and therefore the extent to which a decrease in this figure actually represents a loss to the plaintiff.

By way of example, for a carpenter or furniture maker, gross income will include components such as labour and materials. Each job will vary as to the proportion of labour and materials. A higher gross income need not mean that there has been more work performed, but may simply reflect an increase in the cost of materials (see attachment A).

This example demonstrates that where there are costs of sales, gross profit is as important, or at times more relevant, than gross income. The key is the interaction of material costs, labour and the profit margin on these elements.

Other factors impacting on gross income are:

- Seasonality
- Economic trends
- Industry changes
- Competition
- Labour availability.

ATTACHMENT A SUMMARY OF TRADING ACCOUNT

	1/7/92 to 30/6/93	1/7/93 to 30/6/94	1/7/94 to 30/6/95	1/7/95 to 30/6/96	1/7/96 to 30/6/97	1/7/97 to 30/6/98
Gross Sales	375,000	400,000	395,000	437,800	1,212,000	430,000
Less: Cost of Sales						
- Opening Stock	15,600	11,700	7,660	3,315	14,041	18,889
- Purchases	191,100	197,960	212,905	225,248	974,448	218,075
- Less: Closing Stock	11,700	7,660	3,315	14,041	18,889	14,439
Total Cost of Sales	195,000	202,000	217,250	214,522	969,600	222,525
Gross Profit	180,000	198,000	177,750	223,278	242,400	207,475
Gross Profit Margin	48.00%	49.50%	45.00%	51.00%	20.00%	48.25%

Relevant industry statistics can be of great assistance in determining the potential impact of such factors.

Cost of sales

These are the direct costs involved in the sale of a good. Other costs of the business are known as operating costs. Elements normally included in cost of sales (COS) are:

- Opening stock
- Purchases
- Direct labour (employees/subcontractors)
- Direct manufacturing costs
- Closing stock.

The accuracy of COS will often depend upon the accounting systems and procedures of the business. Often, in small business, the cost of preparing an accurate COS is oppressive and of little assistance in the day to day operations. However, when assessing economic loss, an inaccurate COS will ultimately impact on the assessment of a reasonable level of gross profit for projections. It may therefore be necessary to have an accurate COS calculated from the business records for the purposes of assessing economic loss.

One area in financial statements where COS is often inaccurate is opening and closing stock. Closing

stock, in particular, is an easy area for adjustment of profit (in particular taxable income), and if understated has the effect of decreasing profit dollar for dollar.

If no corresponding adjustment is made the following year, the profit will increase by the amount of the previous year's understatement and the amount will be recovered (although frequently if an adjustment is made, it will be carried forward for some years). When assessing economic loss, even if the understatement is recovered in the following year, it may affect the assessment of the plaintiff's loss, particularly if the understatement occurs in the years before, during or after the event.

Gross profit

Gross profit (GP) is simply the difference between gross sales and COS.

Note that where gross sales have been derived from the sale of materials and labour, GP will usually represent the profit made on both labour and materials. The profit generated from each of these components is likely to vary and may in fact be zero. For example, a carpenter may not charge any profit margin on the materials purchased and therefore GP should represent the labour income charged to the client.

For example, if the figures in the table were used to represent the operations of a carpenter, and it was assumed the carpenter charged no profit on materials, then the GP represents the labour income. If the carpenter charged \$80 per hour, then for the year ended 30 June 1997, the hours charged to clients were 3,030 ($\$242,400 \div \80 per hour). If the carpenter worked 50 weeks in the year, this would equate to 60.6 chargeable hours per week ($3,030 \text{ hrs} \div 50$ weeks).

Whether or not the carpenter actually charged \$80 per hour or worked 60.6 chargeable hours over 50 weeks will be a matter of evidence and other documentation. Calculations such as these can be used to test the validity of claims, or in some cases provide an alternative means of calculating the plaintiff's loss.

Operating expenses

Operating expenses are costs that cannot be directly related to a sale of a good or are not directly incurred as part of providing a specific service.

Operating expenses are either variable, fixed or a combination of both.

For the most part, variable expenses vary in line with gross income or gross profit. Examples are

fuel costs, printing and stationery, salary and wages, telephone and so forth. However, certain variable expenses may vary in line with other factors. For example, staff amenities or training vary in relation to the number of staff, rather than the dollar value of wages or gross income.

Fixed expenses are fixed in amount, regardless of the level of gross income or profit. Examples are filing fees, lease payments, rent, some elements of power costs and depreciation.

Certain operating expenses may combine an element of both fixed and variable. For example, motor vehicle expenses include the fixed costs of registration and insurance, however items such as fuel and repairs and maintenance are variable and dependant upon the number of kilometres driven.

The operating expenses below require more detailed comment.

Depreciation

Depreciation should be representative of the decrease in the value of an asset. The depreciation is a non-cash item, but does represent cash in reality on the basis that the asset has reduced in value.

Depreciation is an accounting entry. The value of the depreciation as per the profit and loss statement can be different to the amount claimed for tax purposes. However, for most small businesses the accounting depreciation is equal to the tax depreciation.

The value of the depreciation claimed as an expense each year is generally determined by a rate of depreciation for each asset. The rate of depreciation over the life of the asset may be too great or too little. Accordingly, upon disposal of the asset, there may be an adjustment, being a 'loss' or 'profit' on disposal of the asset. The loss represents an amount indicative of insufficient depreciation charges over the life of the asset. A profit indicates that depreciation was excessive over the life of the asset.

If a loss or profit on disposal occurs, an adjustment to depreciation should be considered when reviewing

past financial statements.

Leasing

The issue of consideration with leasing is similar to that of depreciation. That is, what should be allowed as an annual expense over the longer term? The answer will be dependent upon the asset and the intention of the business leasing the asset.

For example, if a motor vehicle is leased over a three-year period, and at the end of the three years it was intended to obtain another new vehicle and continue to lease new vehicles every three years, then the future operating costs should include the future leasing costs. The actual value of future leasing costs will be dependent upon interest rates and the cost of the replacement vehicle.

However, assume equipment was purchased by way of lease over a five-year period, and at the end of the five years the equipment was retained over the next 15 years. The leasing cost expressed in the profit and loss statements over five years would not necessarily be representative of the operating cost for the 20-year life of the asset.

Motor vehicle

This is one expense where plaintiffs like to 'have their cake and eat it too'. The reason for this is that often the cost of a private motor vehicle is claimed as being 100% for business use. So for income tax purposes, the overall taxable income is reduced. However, when it comes to making a claim for economic loss, a plaintiff may claim that it is not all for business use. Difficulties arise if the plaintiff wants it both ways.

If any claim is to be made as in the circumstances above, then the plaintiff should be made aware of the consequences in respect of their claim, that is, creditability and/or tax office investigations.

Salary and wages

A plaintiff's claim often comprises the cost of replacement or additional labour costs. An increase in the overall

wage figure following the injury or event may not be an accurate measure of this component of the plaintiff's claim, particularly if the increase in the wages figure occurs in conjunction with an increase in gross income. Analysis of wage records would be required to determine whether the increased wages figure was a response to any increase in business, resulting in the increased gross income, or due to the replacement or supplementing of the plaintiff's labour, or a combination of both.

Remuneration of Proprietors


Remuneration may be in the form of:

- Salary and wages
- Directors fees
- Bonus
- Commission
- Management fees
- Superannuation contributions
- Motor vehicle
- Fringe benefits
- Consulting fees
- Trust distributions
- Dividends
- Profits.

The above items are commonly used terms, however there may be different methods of payment. Plaintiffs are often confused as to their real remuneration. For example, many plaintiffs consider 'drawings' as their wages.

When calculating a net profit or net income that would have been derived by the plaintiff but for the event, it is necessary to 'add back' the remuneration to the plaintiff that has been claimed as an expense in the profit and loss statement. This is also important when assessing the plaintiff's income post event, so as to ensure the correct past and future loss is correctly quantified.

Net profit

Net profit is simply gross income less all expenses. Any projection of the net profit of a business should be calculated following proper consideration and analysis of the components in the profit and loss statement. 

Part two of this article will appear in the April 2004 edition of Plaintiff.