UNDERSTANDING FINANCIAL STATEMENTS

In this article, PDQ and XYZ refer to the companies on whose Board of Directors you will be serving. PDQ is a corporation. XYZ is a cooperative.

It is important that the directors of any business, cooperative or otherwise, understand the financial statements of the business. Without a basic understanding of financial statements it will be impossible to make intelligent decisions in many of the situations that arise. Financial statements are not hard to understand after you become acquainted with a few words and thoughts.

The two most important financial statements are the BALANCE SHEET and the OPERATING STATEMENT (sometimes called a PROFIT AND LOSS STATEMENT or INCOME STATEMENT).

THE BALANCE SHEET

The balance sheet is a statement of the financial condition of a company at a particular point in time. It is a picture in words and dollars of the financial strength of the business at a certain date. The balance sheet is divided into two parts, which are usually shown side by side. The totals of the items in the two parts are always in balance. In our examples, first are shown the ASSETS - all of the things owned by the company followed by the LIABILITIES and NET WORTH. Under LIABILITIES are listed all of the debts of the company - the claims of creditors against the assets of the company. NET WORTH is the owners' interest or equity in the company.

For example, let's look at the balance sheet of XYZ (PDQ is similar). Assume that the company had chosen to go out of business on December 31, and that all of the ASSETS when sold brought dollar for dollar the amounts shown under "TOTAL ASSETS." Then:

<table>
<thead>
<tr>
<th>Total Assets</th>
<th>$2,598,968</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount Needed to Pay Creditors</td>
<td>$1,275,500</td>
</tr>
<tr>
<td>(Liabilities)</td>
<td></td>
</tr>
<tr>
<td>Amount Remaining for Owners</td>
<td>$1,323,468</td>
</tr>
<tr>
<td>(Net Worth)</td>
<td></td>
</tr>
</tbody>
</table>

ASSETS: To aid in the analysis of the balance sheet, assets are usually classified into several groupings –

1. CURRENT ASSETS include cash and those assets which in the normal course of business will be turned into cash in the reasonably near future, usually within twelve (12) months from the date of the balance sheet.

   a. CASH is money in the till and on deposit in the bank and undeposited checks.
b. **MARKETABLE SECURITIES** or **TEMPORARY INVESTMENTS**, such as U.S. Government Bonds, have a maturity date of one year or less. These represent short term investments of cash with the intention of reconverting into cash. They should be readily marketable at an approximately definite price.

c. **ACCOUNTS RECEivable** are amounts due the company for merchandise sold but not paid for. Knowing that any business which extends credit is almost sure to encounter some losses, most companies build up a

d. **RESERVE FOR BAD DEBTS**, by charging a reasonable amount to expense each year. The amount of the Reserve for Bad Debts is deducted from total Accounts Receivable in arriving at the net amount shown in the Balance Sheet.

e. **INVENTORIES** are merchandise intended for sale. In order that the balance sheet will represent as true a picture as possible, inventories are usually valued at the lower of actual or current market cost for each item.

f. **NOTES RECEIVABLE** are written promises to pay made by one person to another. Each has a definite maturity date and usually bears a stated rate of interest.

NOTE: **CURRENT ASSETS** are usually listed on the balance sheet according to liquidity, meaning the order in which they normally will be converted into cash.

2. **FIXED ASSETS** include land, buildings, machinery and equipment used in the business and not intended for sale. Since buildings, machinery, and equipment wear out in time, and often become obsolete, a **RESERVE FOR DEPRECIATION** is built up by charging a part of their cost to operations each year over the useful life of each asset. The amount shown in the balance sheet for Fixed Assets is the cost of the assets less the accumulated Reserve for Depreciation.

NOTE: Usually you would NOT find land lumped in with other Fixed Asset items as in our case here. Why?

3. **OTHER ASSETS** include relatively long term investments and other assets which do not fit either the Current Asset (will not normally be converted into cash within twelve months) or Fixed Asset classifications.

LIABILITIES: These are usually located on the right-hand side of the balance sheet. In analyzing a balance sheet, it is helpful to know when assets will be converted into cash, as we have stated above. It is also helpful to know when liabilities or debts must be paid. For this reason, Liabilities in the balance sheet are grouped into –

1. **CURRENT LIABILITIES**, which usually include all debts that fall due within one year, such as:
   
a. **ACCOUNTS PAYABLE** include amounts payable for merchandise, supplies and services.
b. **ACCRUED EXPENSES** include salaries, wages, interest, taxes and other expenses which have accumulated and are owed but have not been paid.

c. **NOTES PAYABLE** are short term loans and also the portion of long term loans due within one year.

d. **DIVIDENDS (PATRONAGE REFUNDS) PAYABLE**, etc., are the amount of dividends which the board of directors of the company has voted to pay in cash or merchandise within one year from the balance sheet date.

e. **BONDS PAYABLE** are promissory notes which may be secured or unsecured. If the bonds are unsecured, they are known as debentures. They may be either current or long term liabilities depending on the maturity dates.

2. **LONG TERM (OR DEFERRED) LIABILITIES** are notes and other debts payable over a period of several years. (See 1 c. under CURRENT LIABILITIES.)

**NET WORTH:** This is the difference between what the company owns (Assets) and what it owes (Liabilities). It is the owners’ interest or equity in the assets of the company. It includes common stock, preferred stock, and retained earnings. In a cooperative, these retained earnings might be in the form of allocated reserves. (undistributed patronage refunds) or unallocated reserves.

**THE OPERATING STATEMENT**

As noted earlier, this statement is sometimes called the Profit and Loss Statement or the Income Statement. It shows how well the company did or how successful its operations were for a specific period of time. This statement is easy to understand, but a few brief observations may be helpful:

1. In the operating statement of a cooperative, **SALES** are sometimes referred to as **PATRONS’ PURCHASES**.

2. **COST OF GOODS SOLD** is the cost to the company of the merchandise sold to its customers or patrons. It is the total of the inventory at the beginning of the period plus purchases during the period less the inventory at the end of the period.

3. **DEPRECIATION** is that portion of the cost of buildings, machinery and equipment charged to operations for the specific period of time covered by the operating statement. (See comments on Fixed Assets.)

**ANALYZING THE STATEMENTS**

A careful study of the balance sheet of a company at a given date and of the operating statement for a period of time yields much valuable information. A better picture of the financial health of a company is obtained by comparing the current balance sheet to earlier balance sheets and by comparing the operating statement to previous operating statements for similar periods of time.

In analyzing the BALANCE SHEET, two of the first things to look for are:
1. **ACCOUNTS RECEIVABLE.** The amount of accounts receivable will usually increase during the peak of business activity and will decline during the slack period each year. At the low point, the total of accounts receivable should be less than a month's sales usually. A higher figure may indicate inadequate collection procedures or too lenient a credit policy or both.

2. **INVENTORIES.** The ratio of sales to inventory is called Inventory Turnover. A company with a high rate of turnover will need less money to operate with than a company with a slow turnover. An inventory turnover ratio of 6 to 1 is usually satisfactory for a company in the retail general farm supply business. In other businesses, different inventory turnover ratios would make sense.

Two other things or groups of things can be applied to the analysis of the balance sheet.

1. **WORKING CAPITAL.** This is the difference between total current assets and total current liabilities. The amount of Working Capital is an indicator of the ability of a company to meet its obligations promptly and take advantage of available discounts.

2. ** RATIOS.**
   
a. **CURRENT RATIO** is the ratio of total current assets to total current liabilities. This ratio helps show whether the level of working capital is high enough. If a company has good control over Accounts Receivable and a good Inventory Turnover ratio, a Current Ratio of 2 to 1 ($2.00 of Current Assets to $1.00 of Current Liabilities) will usually be adequate.
   
b. **DEBT TO NET WORTH RATIO** is total liabilities divided by net worth. It shows the dollars the creditors have put up in relation to the dollars the owners have put up. In a typical retail farm supply company such as perhaps XYZ or PDQ, a debt to the net worth ratio of 1 to 1 or higher would be risky and would tell directors and managers that the company's chances of securing additional borrowed funds were slight. In fact, if the ratio is too high, pressure from creditors may restrict the activities of the company.
   
c. **RATIO OF NET WORTH TO FIXED AND OTHER ASSETS** is computed as follows:

   \[
   \frac{\text{Net Worth}}{\text{Fixed Assets & Other Assets}}
   \]

   Here a ratio of 1 to 1 would mean that creditors were supplying all of the operating funds used by the company. A ratio of 1.5 to 1 would be desirable.

3. **RETURN ON INVESTMENT.** Any company, whether it is a cooperative or an ordinary corporation, must realize a return above costs from its operations if it is to survive. This is the definition of profitability. A cooperative differs from an ordinary corporation in the way these funds, savings, or profits are distributed. Probably the easiest and best single measure of profitability is the **RETURN ON INVESTMENT**. This measure, usually expressed as a percentage, is figured as follows:

   \[
   \frac{\text{Net Profit After Taxes} \quad \text{or Net Savings for the Co-op}}{\text{Net Worth}}
   \]

   This return on investment should be at least as high as the same amount of funds could earn if invested elsewhere under a similar risk. To look at it another way, a company should
generate at least enough funds through operations to provide a fair return to the owners and to make principal payments on long term debt.

SOURCE AND APPLICATION OF FUNDS STATEMENT

The source and application of funds statement is a summary of the net changes in the amount of working capital resulting from net transactions during a specific period of time. Its primary purpose is to show the causes of the change in working capital for the given period.

EXAMPLE A:
Funds Provided:
Operations $15,000
Funds Applied:
Payment of Dividends $5,000
Increase in working capital $10,000

EXAMPLE B:
Funds Provided:
Operations $8,000
Issuance of five-year notes $25,000
$33,000
Funds Applied:
Purchase of Land 18,000
Payment of dividends 5,000
23,000
Increase in working capital $10,000

EXAMPLE C:
Funds Provided:
Operations $2,000
Issuance of five-year notes 20,000 $22,000
Funds Applied:
Payment of dividends 12,000
Increase in working capital $10,000

If all three of the foregoing examples were presented for analysis, we would recognize that Example A would probably create a favorable impression because the total increase in working capital was made possible through income derived from operations.
Example B would be less desirable because of the smaller amount of working capital increase provided through operations.

Example C would reflect an undesirable trend because, in essence, this organization found it necessary to borrow money in order to meet its dividend payments. The primary question raised in Example C is, how will this organization be able to repay the $20,000 borrowed on five-year notes?

The following are examples of both sources and uses of funds:

1. **MAJOR SOURCES OF FUNDS**:
   a. Current operations (net income plus conversion of noncurrent assets into working capital via the depreciation, depletion, and amortization processes - i.e., the net income as shown by the income statement plus depreciation, depletion, and amortization represents the amount of working capital provided by current operations.)
   b. Sale of capital stock and contribution of current assets by owners.
   c. Sale of long-term obligations (bonds, long-term promissory notes).
   d. Sale of noncurrent assets fixed assets, long-term investments, and intangible assets.
   e. Profit on sale of temporary investments of cash or other current assets, or on settlement of current liabilities.

2. **MAJOR APPLICATIONS OR USES OF FUNDS**:
   a. To pay cash dividends.
   b. To retire long-term liabilities and capital stock.
   c. To replace or purchase additional fixed assets, intangible assets, long-term investments, or other noncurrent assets.
   d. To cover loss from operations.