

# Developing, Understanding, & Analyzing Financial Statements

*Kentucky Center for Agriculture & Rural  
Development (KCARD)*



# Financial Statement Basics

---

- Balance Sheet
  - Point in time
- Income Statement
  - Period of time
- Cash Flow Statement
  - All \$'s in and out



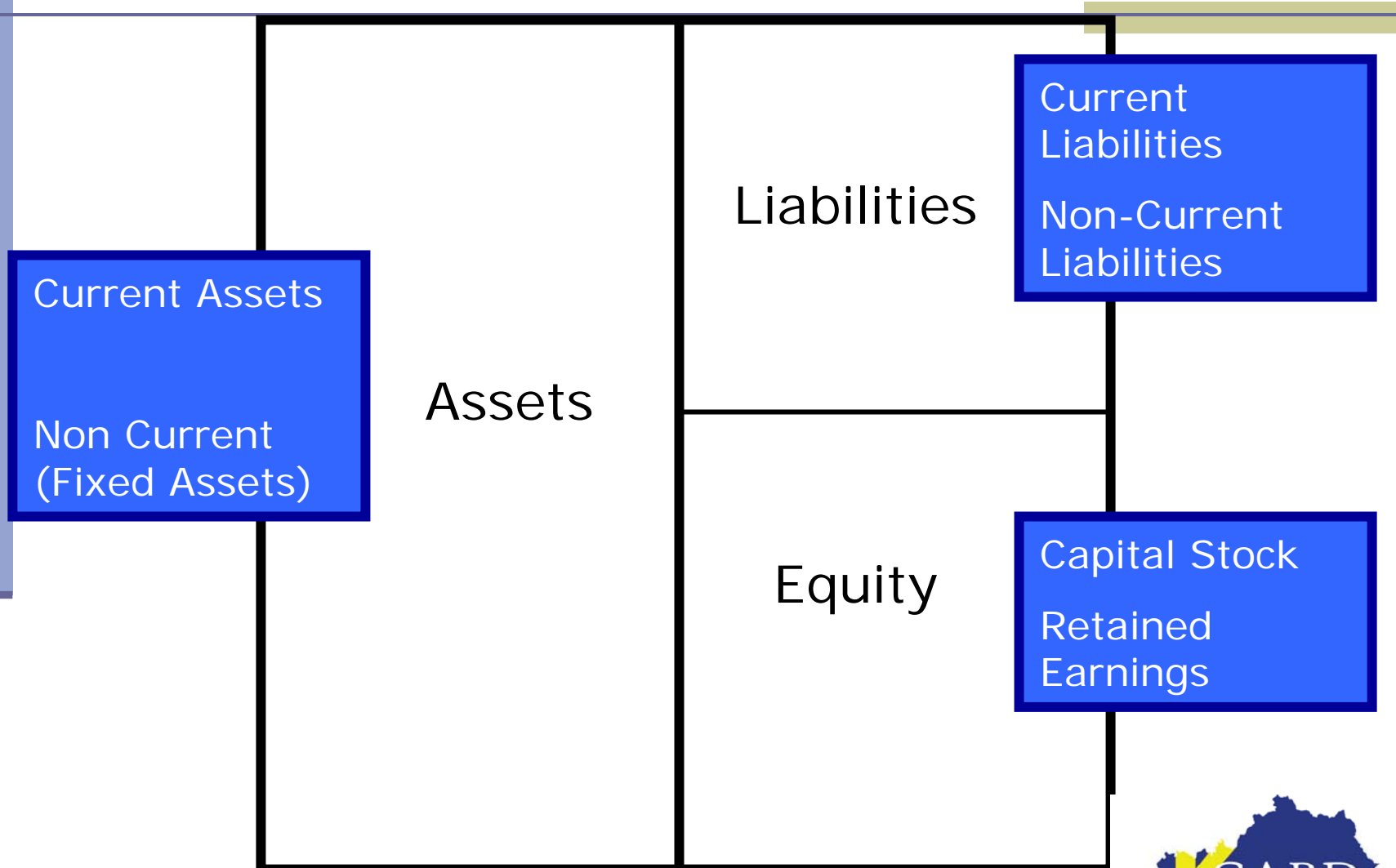
# Balance Sheet

---

- What you own? **Assets**
- What you owe? **Liabilities**
- What's the difference? **Members Equity or Net Worth**
- $\text{Assets} = \text{Liabilities} + \text{Equity}$
- Everything Must Balance



# What a Balance Sheet Looks Like



# Income Statements (P&L, Operating)

---

- Not the same as a cash flow
  - Does not include loans, grants
  - Does not include principal payments, distributions
- Accrual adjustments to cash income
  - Inventories
  - Payables
  - Receivables
  - Prepaid expenses



# Accounting Methods – Cash vs. Accrual

---

## ■ Cash

- Revenue and expenses are counted in the year they are actually received or paid
  - Most commonly done in farming
  - Can be manipulated for tax purposes

## ■ Accrual

- Value of revenues and expenses are counted in the year they were produced, regardless of when they were paid
  - More accurate picture of profit/loss



# Income Statement

Sales

Minus Cost of Goods Sold

**= Gross Profit**

Minus Expenses

**= Net Income**



# Income Statement Options

---

- Alternative Formats
  - Year-to-date
  - Actual vs. Budget
  - Actual vs. Year Ago
- Year-to-date is a must, monthly is inadequate
- Maintain consistency throughout reports



# What is COGS?

---

- Cost of Goods Sold
- Should be those direct costs of the products that you are selling
- Raw Materials/Products, Plant Labor, Plant Electricity, Bags & Boxes, Freight, etc.



# Cash Flow Statement

---

- Only (and all) cash transactions are included
- $\text{Cash Inflow} - \text{Cash Outflow} = \text{Net Cash Flow}$
- $\text{Opening balance} + \text{Cash Inflow} - \text{Cash Outflow} = \text{Closing Balance}$
- What items are listed on the income statement but not the cash flow?
- Vice versa?



# Evaluating Financial Statement

---

- Financial Health
- Performance Measures
- Integrity of the Statements



# Balance Sheet Analysis

---

## ■ Liquidity Measures

- The ability to pay your bills when they come due
- Current ratio = Current Assets/Current Liabilities
  - Target: > 2.0
- Working Capital = Current Assets – Current Liabilities
- Working Capital as % of Sales = (Current Assets - Current Liabilities) / Total Sales



# Balance Sheet Analysis

---

## ■ Solvency

- Ability to pay all debts
- Debt to Asset ratio = Total Liabilities / Total Assets
  - Warning: > 50%
- Debt to Equity ratio = Total Liabilities / Total Equity
  - Measures the leverage of the business

# Income Statement Analysis

---

## ■ Profitability Measures

- $ROA = \text{Net Income} / \text{Assets}$
- $ROE = \text{Net Income} / \text{Equity}$
- $\text{Gross Margin} = (\text{Total Sales} - \text{COGS}) / \text{Total Sales}$
- $\text{Profit Margin} = \text{Net Profit before tax} / \text{Total Sales}$



# Income Statement Analysis

---

- Operational Efficiency Measures
  - Expense to Sales = Operating Expenses / Total Sales
  - Labor to Sales = Total Payroll Expenses / Total Sales
  - Assets to Sales = Total Assets / Total Sales
  - Labor to Gross Income = Total Payroll Expenses / Gross Income
  - Inventory Turnover = Cost of Sales / Inventory



# Integrity Validation

- Key Questions
  - Have your bank statements been reconciled?
  - Who created the reports? Responsible for records?
  - Are the business records separate from the farm records?
  - Have these statements been audited?
  - For projections: Key assumptions? Basis for assumptions? Industry standards? Quotes? Letters of intent?
- Comparative Process
  - Benchmarks
    - Align (compare) to industry standards
    - Significant differences....WHY, WHY, WHY?
  - Key Performance Indicators (KPI)
    - Determine baseline of performance
    - Use of a metrics/measurement analysis process



# Benchmarks

---

- **Definition:** *A standard or point of reference in measuring or judging the future and/or current value or success of your company in order to determine your future business needs and plans.*
- **From a Financial Perspective**
  - Financial Ratios
  - Balance Sheet
  - Income-Expense Statements
- **Business Description Category**
  - Corporations (> 35 total employees)
  - S- Corporations (< 35 total employees)
  - Sole Proprietors (Single Owner)
- **Information Resources**



# Key Performance Indicators (KPI)

*You can't manage what you do not measure!*

- Financial and non-financial metrics used to define and measure progress toward organizational goals
- Assess present state of the business & prescribe a course of action.
- Used to "value" difficult to measure activities such as:
  - the benefits of leadership effectiveness (expense and
  - cost control;
  - business engagement;
  - customer service and satisfaction.
- Typically tied to an organization's strategy.
- Examples of KPI's:
  - Cash Flow - Operating profit % (Net Income (pre-tax) - Return on sales % ("Bottom Line" -> Net Income/Sales) - Gross margin % (Total Profit / Revenue) - Product margin % (Product Cost / Selling Price) - Service margin % (Technical W2's / Selling Price) - Return on assets % (Net Income / Total Assets) - DSO (Days Sales Outstanding)

