DOLLARS & SENSE

*By Brandie O'Dell*

# Financial Statement Measurements

In any business, it is important to understand the business finances. Financial records are used to track the performance of the operation. There are generally three objectives of maintaining these records. These objectives are profitability, reduction of risk and liquidity. Profitability is defined as the ability of the operation to cover all costs over time and accumulate wealth. Business owners seek to reduce risk to avoid losses of wealth over time. Liquidity is the ability to avoid negative cash flow by paying all financial obligations as they are due.

To perform such financial analysis, a company must have data. This data can be in the form of financial statements, tax records or any other internal recordkeeping. There are many computerized recordkeeping programs on the market today to assist in tracking income and expenses.

There are two main accounting systems, cash and accrual. Cash basis is the most widely used as it is the method acceptable by the IRS. Cash basis of accounting tracks income and expenses as they are received and paid. Accrual basis of accounting is the method accepted by generally accounted accounting principles within the United States of America and is used in most financial statements. This method tracks income and expenses as they are earned and realized. Once you have your data, it can be organized into financial statements. The statements include the balance sheet, income statement and cash flow statement. These statements are used to calculate the profitability, liquidity, solvency and financial efficiency of your operation.

In order to build equity and grow a business, it must be profitable. The easiest way to track profitability of a business is to calculate its net income. This is calculated by subtracting all business expenses from all business income. Another profitability ratio is gross profit. This is calculated by subtracting cost of goods sold from income. In a farming operation, cost of goods sold with include the cost of products for resale or the direct costs associated with the manufacture of a product such as feed, labor, and herd replacement costs. Since this method does take into consideration general and administrative expenses, this would be used to analyze the direct costs associated with your sales.

Liquidity measures the company's ability to repay current liabilities using current funds in the short run. A ratio to measure liquidity is the current ratio. To calculate, current assets would be divided by current liabilities. A goal would be 1.5 to 2. A current ratio of 2 would mean the company has the ability to repay all of its current obligations twice in the short run using only the current assets. Another ratio to measure liquidity is working capital. This is calculated as subtracting current liabilities from assets. A high working capital amount would be an indication that the operation has the ability to meet its current obligations as well as the ability to invest in the business or reduce long term liabilities.

Solvency measures the company's ability to repay debt obligations following the sale of all assets at a point in time. A ratio used to measure solvency is the debt to asset ratio. This is calculated by dividing total liabilities by total assets. A goal is 40% or lower. A ratio of 40% would indicate that the company's total assets exceed the total liabilities resulting in equity in the business totaling 60% of total assets. Another ratio is the equity to asset ratio which is calculated by dividing total equity by total assets. A goal is 60% or higher.

Financial efficiency measures the intensity a business uses its assets to generate gross revenues. It also measures the effectiveness of production, pricing, financing and marketing. A ratio used to measure this is the asset turnover ratio. In this ratio, gross revenues are divided by total assets. A goal is 35% or higher. The asset turnover ratio measures capital efficiency or profit based on volume of output relative to capital.

Understanding financial measurements is important in any business operation. Profitability, liquidity, solvency and financial efficiency are only a few of the options. A few other measurements for a dairy operation could include net income on a cwt basis, pounds of milk per cow, net income per cow, and benchmarks. Accountants and banking relationship managers can assist with any financial measurements desired. ✱

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