

Key Accounting Terms & Financial Ratios



INTRODCUTION

A key element of any successful business strategy is understanding your democratic corporation's financial position. The key documents that firms use to describe their finances are the **income statement**, the **balance sheet** and the **statement of cash flows**. The income statement describes the firms revenues and expenses for a set period of time, while the balance sheet describes the things a firm owns (its assets and equity) and the things it owes (its liabilities). When firms use accrual accounting, they use the statement of cash flows to understand how money actually moves through a business and whether you're likely to be able to meet your cash needs now and into the future.

When we talk about finances, however, a number of terms are commonly used that unless you spend a lot of your time thinking like an accountant, are likely to be confusing. This glossary defines the most common accounting terms you will likely run into.

Similarly, to analyze the financial statements requires performing various calculations (called financial ratios) to assess how your particular company is performing. It is important to compare your performance to your competitors or your industry average, *and* to your own firm over time. The financial ratios explained in this document are the most commonly used measures of performance and can be used to better understand how your firm stacks up.

GLOSSARY OF KEY ACCOUNTING TERMS

Accounting net income – In this publication, we refer to the net income before taxes (also referred to as Earnings Before Interest) as accounting net income.

Accounts receivables – Money that a customer owes a firm. When a firm has made a sale, but has yet to collect the money, it is considered a receivable.

Accrual Accounting – a method of tracking the performance and position of a firm that recognizes economic events when they occur, rather than when cash actually changes hands. By matching income and expenses to when a transaction occurs, a firm is better able to determine whether it is making a profit selling its product or services. It is the standard accounting practice for all but the smallest companies.

Assets — Things of value which a company owns. Cash, savings accounts, tools, and land are examples of assets. Assets are recorded on the balance sheet and must equal the liabilities plus shareholder equity.

Balance sheet – One of the three key financial statements used in financial accounting. The balance sheet summarizes a firm's assets, liabilities and shareholder equity at a

specific point in time. The balance sheet must always balance, by having the assets equal the liabilities plus shareholder equity.

Board of Directors — Body elected by the shareholder-members to govern the company; make policy decisions; and hire or fire management.

Community Development Financial Institution – a specialized financial institution that lends money or makes equity investments in parts of the economy that are underserved by traditional financial institutions.

Collective account — Unindividuated or unallocated portion of the net book value that is not to be returned to individual members during the lifetime of the corporation.

Collective net income (or loss) — Portion of the net income that includes any nonmember sourced income and will affect the collective account.

Collective allocation — (also called the self-insurance allocation) Collective net income minus the corporate taxes.

Demutualization – The process by which a cooperative changes its legal form to a conventional stock corporation that does not operate on a cooperative basis.

Depreciation – A method of allocating the cost of a tangible asset over its useful life. Depreciation is used to match the cost of an asset to the time that the asset is used to generate income. When a firm purchases an asset, it only recognizes a portion of the cost of that purchase in any given year, in this way larger purchases do not adversely affect income.

Double taxation — Taxation of net income at the corporate level first then again at the personal level with the payment of dividends.

Individual capital account - Internal capital accounts maintained for each member which records the part of the net book value ultimately to be returned to each member. An individual account consists of a membership fee (contributed capital) and written notices of allocation (retained earnings).

Individual net income (or loss) — Percentage of the net income (or loss) which will be allocated to individual members.

Internal capital account cooperative — An employee cooperative whose entire net book value is reflected in internal capital accounts, one for each member, and a collective account.

Labor patronage — Number of hours worked for the company or total labor compensation received from the company by a member or non-member during the fiscal year.

Liabilities – A firm's debts or obligations owed to others by a company. Liabilities include loans, accounts payable, mortgages and deferred revenue. Liabilities are recorded on a firm's balance sheet.

Membership fee — Cost of a membership share as determined by the board of directors.

Membership share — Single class of non-transferable voting stock. Each member owns one and only one membership share. Membership shares are usually common shares and have the highest voting rights within the firm.

Negative patronage allocation — Negative amount allocated to the individual capital accounts of the members in proportion to their labor patronage.

Net income — Amount by which revenues exceed expenses; the bottom line.

Net book value — Difference between the assets and liabilities on the corporate books. In an ICAC, net book value consists of the individual plus the collective accounts and is sometimes referred to as net worth.

Non-member income – The proportion of net income that is derived from the labor of non-members. Non-member income does not receive preferential tax treatment under Subchapter T and is taxed at both the corporate and individual level.

Non-qualified written notice of allocation – A written notice of allocation that fails to meets all of the conditions of the IRS code.

Non-transferable shares – Stocks that cannot be sold or otherwise transferred to an outside party. In a worker co-op, only workers are allowed to own shares and when a member leaves the co-op, the co-op must purchase the share from the member.

Patronage dividend — A dividend or distribution of net income that a co-op makes to its members. As defined by Subchapter T, earnings allocated to members on the basis of labor patronage; can be in the form of cash or written notices of allocation. Patronage dividends may not be declared on non-member or unrelated business income.

Qualified written notice of allocation – A written notice of allocation that meets all of the conditions of the IRS code. Usually, when the taxable portion of a patronage dividend is paid out in cash, a written notice is considered 'qualified' and the corporation does not have to pay corporate income tax on this portion of its accounting net income.

Retained earnings – The portion of net earnings not paid out as dividends, but retained by the firm to reinvest in its business operations or pay off debt. Retained earnings increase the net book value resulting from the operations of the firm. In an internal

capital account cooperative, the retained earnings is the value in the individual accounts and collective accounts less the value of membership shares.

Return on Assets – A measure of how effectively a business uses its assets to create income in the future. The return on assets is calculated by dividing the net income by the total assets. The ROA is displayed as a percentage, sometimes it is referred to as return on investment. It is different than return on equity which only looks at the equity of a company and is a better indicator for companies that use debt as a business strategy.

Revenues – The money a firm receives from its business activities. It is also referred to as “top line” or “gross income.”

Shareholder equity – The original equity investment in a firm plus any retained earnings. It is calculated by taking a firms total assets and subtracting its total liabilities. In an Internal Capital Account Cooperative, the shareholder equity is the value in the individual and collective accounts, plus any preferred or other outside equity.

Shares of stock – a document that indicates an ownership stake in a firm and entitles the holder to part of the firm’s earnings and assets.

Single taxation — Taxation of corporate net income only at the personal level.

Startup loss account — Optional debit-balance contra equity account which records the startup losses to be allocated to the individual capital accounts over an extended period of time.

Subordinate – A loan or asset that gets paid out after other loans or assets. In the event of bankruptcy or liquidation, debtors are usually paid before holders of equity. Similarly, preferred shareholders are paid out before common shareholders.

Written notices of allocation — Notes that disclose to the recipient the stated dollar amount of the patronage dividend allocated to him or her and retained in the cooperative.

KEY FINANCIAL RATIOS

Financial ratios allow you to cut through the numbers on your income statement and balance sheet and see what the numbers mean using a scale that is easy to understand and compare. The following financial ratios are all easily calculated using the data from your income statement and balance sheet. In a given industry, however, it's likely the case that other 'managerial accounting' ratios will be used, it's important to know these ratios for your industry and how your business compares.

It's equally important to remember that this kind of analysis doesn't provide you with all the answers to key questions, but should hopefully give you the information to ask the right questions.

Leverage Ratios

When your firm borrows money, it is required to make fixed payments of both interest and principal to the lender. If a company's profits increase, the lender is paid the same fixed amount, so any gain from these increases in profits go to the members. The reverse is true if profits fall, the lender is paid the fixed amount, and the members generate less wealth. In this way, debt increases the return for shareholders in good times and reduces them in bad.

The **Long Term Debt Ratio** is used to measure what portion of a firm's total long term capital (both shareholder equity and long term debt) is financed with long term debt. The formula for this ratio is:

$$\text{Long Term Debt} \div (\text{Long Term Debt} + \text{Total Equity})$$

The **Total Debt Ratio** is similar, but includes all the debt a firm has, and therefore also includes the total assets for the firm (both the equity and other assets). The formula for this ratio is:

$$\text{Total Liabilities} \div \text{Total Assets}$$

The higher these ratios are, the greater the financial risk for a company. It's important to remember that the typical debt ratios for a particular industry

can vary widely. You should familiarize yourself with what is expected or standard in your industry.

The **Times Interest Earned Ratio** is a measure of the extent to which earnings cover the interest payments for a particular firm. Lenders generally want the earnings to be a large multiple of the interest payments you're going to make. The formula for this ratio is:

$$\text{Earnings Before Interest & Taxes (EBIT)} \div \text{Interest Payments}$$

The **Cash Coverage Ratio** is similar, but includes the depreciation costs. Depreciation recognizes the expense of an asset, but in reality there is no cash cost in the given period. Therefore to understand the firms ratio of the cash it generates to its interest payments, depreciation is added back in. The formula for this ratio is:

$$(EBIT + \text{Depreciation}) \div \text{Interest Payments}$$

Liquidity Ratios

Liquidity Ratios measure a firm's ability to actually lay its hands on cash to pay back a lender or vendor. They are a measure of a firm's liquid assets compared to their total assets or debt. The idea behind liquid assets is that they can be converted into cash in a relatively short period of time. You may own a piece of expensive equipment, but if you needed to sell that asset, it would likely take a number of months. Marketable securities (such as stock a company owns) or receivables (money a customer owes you) can usually be converted into cash quickly, however.

Net Working Capital to Total Assets Ratio. The difference between a company's current assets and its current liabilities is referred to as its Net Working Capital. The current assets are assets that can reasonably be expected to be turned into cash within a year, while the current liabilities is the portion of debt that is due within one year. The net working capital is a rough measure of a firm's potential reservoir of cash. The formula for Net Working Capital is:

$$\text{Current Assets} - \text{Current Liabilities} = \text{Net Working Capital}$$

Comparing a firm's net working capital to its total assets tells you the extent to which your assets are tied into working capital. If this ratio is low, it usually indicates the firm has some cash flow problems. If the ratio is high, it might indicate that too much liquid assets are being kept in the company and not being deployed to grow the company. The formula for this ratio is:

$$\text{Net Working Capital} \div \text{Total Assets}$$

The **Current Ratio** is another formula used to measure a firm's capacity to pay its short term obligations. The formula for this ratio is:

$$\text{Current Assets} \div \text{Current Liabilities}$$

The **Quick Ratio** measures the same thing, but instead of looking at assets that can be likely be turned into cash within a year, it only includes assets that can be turned into cash within a very short period (such as 90 days). The formula for this ratio is:

$$(\text{Cash} + \text{Marketable Securities} + \text{Receivables}) \div \text{Current Liabilities}$$

The **Interval Measure** determines how many days a firm could operate if operations ceased or sales came to a standstill. To calculate this ratio, you also need to know the average daily costs of your operation, this is simply the total operating costs for the firm divided by 365. This is a very conservative measure, but can help you understand how your firm would fare if there was a major crisis that interrupted your business. The formula for this ratio is:

$$(\text{Cash} + \text{Marketable Securities} + \text{Receivables}) \div \frac{\text{Average Daily Expenditures}}{\text{from Operations}}$$

Efficiency Ratios

Efficiency ratios measure how effectively a company is using its assets to create wealth for the members. Simply put, if the company has funds available it should be using those funds for a real purpose, either to grow the business or to pay out to the members (either today or in the future) in the form of patronage dividends. This isn't to say that having assets like cash which don't really do anything to grow the company's revenues is a bad idea. Some assets act like insurance for potential downturns in the market or to deal with fluctuations in your revenue cycle. Generally speaking, however, business owners either want a company to turn earnings into assets that will result in increased revenues in the future, or to take that money out of the company.

The **Asset Turnover Ratio** or the sales to assets ratio, measures how many dollars of revenue each dollar of assets creates. A company with an asset turnover ratio of 1.5 generates \$1.50 in revenue for each dollar of assets. The higher this ratio, the more efficient a firm's assets are being used. This ratio will vary between industries. To calculate this ratio, you need to calculate the average total assets, which is simply the average of the total assets at the beginning and end of the year. The formula for this ratio is:

$$\text{Sale} \div \text{Average Total Assets}$$

The **Average Collection Period** measure how fast your customers pay their bills. This figure is critical. The longer your collection period, the more cash you are going to have to 'float' to cover the cost of delivering the service or product your customer bought. This can significantly change the borrowing needs of a firm. A collection period of 90 days or more is likely an indication of a serious problem. The formula for this ratio is:

$$\text{Average Receivables} \div \text{Average Daily Sales}$$

The average receivables is simply the accounts receivables at the beginning and end of the year (or 4 quarters), while the average daily sales is the total sales divided by the number of days in a period (365 for a year).

The **Inventory Turnover Ratio** measures that rate at which a company is turning over its inventory. In other words, how many times a year does your inventory move in and out of the business? For a firm that sells products, a high turnover ratio is usually good, it means that you're not putting money into a producing things that sit on a shelf for a long period of time. The formula for this ratio is:

$$\text{Cost of Goods Sold} \div \text{Average Inventory}$$

The cost of goods sold is simply how much it costs to produce the product that you sell, almost always, it includes the labor costs associated with producing the product. It does not include the financing costs, however. The average inventory is the average of the firm's inventory at the beginning and end of the year.

Day's Sales in Inventory. Sometimes managers also measure the inventory in relation to how many days it would take to sell that inventory. In other words, this tells you that your firm has sufficient inventories to maintain sales for a set number of days. If it takes you 30 days to produce your product and you only have 15 days' worth of inventory on hand, you've likely got a problem. The formula for this ratio is:

$$\text{Average Inventory} \div (\text{Cost of Goods Sold} \div 365)$$

Profitability Ratios

The **Gross Profit Margin** tells you what percentage of your sales is taken up by the cost of producing your product or delivering your service. It is a useful measure because it allows you to measure profitability without considering the cost of financing or other overhead costs. As a startup, your net margin (see below) might be lower than your competitors, but if your gross margin is comparable, it's likely the case that you're not operating inefficiently. The formula for this ratio is:

$$(Sales - Cost of Goods Sold) \div Sales$$

The **Net Profit Margin** tells you what percentage of your sales the company keeps after paying all of its expenses. A high profit margin is usually a good thing, but with high margins, you often find higher prices, which naturally leads to lower sales. The formula for this ratio is:

$$\text{Net Income} \div \text{Sales}$$

The **Return on Assets** measures how effectively a business uses its assets to create income in the future. By taking profits and turning them into productive assets (such as new machinery or technology, or increasing productive staff), a firm can expect to generate increased revenues. The return on assets or return on equity plays a significant part in determining how a cooperative should split its net income between collective and individual accounts. The formula for the ratio is:

$$\text{Net Income} \div \text{Average Total Assets}$$

The **Return on Equity** is a similar measure, although it's important to calculate both when analyzing your company's performance. A high ROE might indicate that a firm is being very efficient at turning assets into income, but if a firm carries a lot of debt, the ROE might be high, while the ROA might be low, indicating there is a potential problem. The formula is:

$$\text{Net Income} \div \text{Average Shareholder Equity}$$