Reviewing Financial Information of Private Sector Partners

Private Sector Engagement Toolkit - Tip Sheet #8:

Reviewing the financial information of potential private sector partners is a crucial step in evaluating the value and risk of engaging with them. If they are intended to be a "lead firm," a business capable of influencing other firms and other players due to their position in a supply chain, they are more likely to have good financial records that will support this review. If they are a micro, small or medium enterprise (MSME), their financial record-keeping may be incomplete or lacking.

A review of financial information helps understand a few key aspects of a firm:

- It helps us understand their overall financial stability.
- It helps us evaluate the financial controls they have in place.
- It helps us assess their willingness to be open and transparent with us.

One critical issue is that some firms may be hesitant to share detailed financial records with us as they may fear having confidential information revealed publically. Depending on the circumstances, we may need to limit our review to summary financial information supported by their business references (i.e. suppliers, banks, customers, etc.). We should also consider a mutual non-disclosure agreement to assure them their proprietary information will remain private. Regardless, we should try and gain an understanding of the financial condition of a private partner including their revenue, expenses, income, assets, liabilities and debt, each of which are described below.

There are two key financial statements that support this review; the Balance Sheet and the Income Statement.

Balance Sheet: The balance sheet presents a company's financial position at the end of a specified date. For example, the amounts reported on a balance sheet dated December 31, 2010, reflect that instant when all of the transactions through December 31 have been recorded. The balance sheet provides a picture of what a firm owns and what it owes to other parties at that specific time and has three main sections:

- Assets are anything that the firm owns that has value. Companies calculate the monetary value of everything they own and put it under the asset side of the balance sheet. Assets include *current assets* such as cash and money owed to the company; *fixed assets* including physical items such as buildings, land, machinery, furniture, etc.; or *other assets* (items that do not fit in the above categories). An important category of current assets are accounts receivable, which explains any amounts owed to the firm from customers, borrowers, etc.
- Liabilities include anything that costs money, including any obligations to pay something at a future date. These include bank loans, mortgages, bills for materials purchased that are unpaid, rent that is owed, etc. Liabilities include *current liabilities* such as accounts payable, taxes, staff salaries or anything due in the next year; and *long-term liabilities* including loans, mortgages and property leases. All debts that a firm has are included as liabilities.
- Shareholder equity is the difference between assets and liability. It tells you what is left for the owners (or stockholders) after all the debt has been paid.

Balance Sheet
December 31, 20X3

Assets				**Liabilities**		
Current assets				**Current liabilities**		
Cash		$100,000		Accounts payable	$ 80,000	
Short-term investments		50,000		Salaries payable	10,000	
Accounts receivable		75,000		Interest payable	15,000	
Inventories		200,000		Taxes payable	5,000	
Prepaid insurance		25,000	$450,000	Current portion of note	40,000	$150,000
Long-term investments				**Long-term liabilities**		
Stock investments		$ 40,000		Notes payable	$110,000	
Cash value of insurance		10,000	50,000	Bank Loan	35,000	
				Mortgage obligation	75,000	
Property, plant & equip.				Deferred income taxes	80,000	300,000
Land		$ 25,000		Total liabilities		$450,000
Buildings and equipment	$150,000					
Less: Accum. depreciation	(50,000)	100,000	125,000			
Intangible assets						
Goodwill			275,000	**Stockholders' equity**		
				Capital stock	$300,000	
Other assets				Retained earnings	160,000	
Receivable from employee			10,000	Total stockholders' equity		460,000
Total assets			$910,000	Total liabilities and equity		$910,000

A balance sheet provides key information:

- It helps demonstrate whether a firm can pay its current debts. By comparing the current liabilities to current assets, we can determine whether the firm has resources to meet short-term financial needs.
- It helps understand the firm's overall financial strength. By looking at fixed assets we can see the value of the physical items the company owns. These assets might be considered as collateral against any future borrowing.
- It helps highlight the value that the owners of the business currently have after all creditors and debts have been paid.

A balance sheet does not tell you how the firm made money. This is reported from the income statement (below). It also does not tell you the current value of the business. This is because the fixed assets represent investments made at one time to enable the firm to generate revenue and do not necessarily represent their value to the business in the future.

Income Statement: The income statement reports the firm's earnings over a specific period of time and is a good measure of the firms' profitability. Income statements can be quite simple with a few line items or quite detailed, depending upon the complexity of the business and the detail of the accounting system the firm is using. Regardless, an income statement typically includes data on the firms' revenue, expenses and profits.

- Revenue reflects the sales the firm has made. These may or may not have been paid in that time period.
- Expenses are payments the firm has made or the consumption of assets. There are often two big categories of expenses. *Cost of goods sold* represents the direct input costs of the materials or services sold by the firm and *operating expenses* represents the ongoing costs of running the business.
- Income is what is left after expenses are deducted from revenue. The Income Statement may include different levels of income, including gross income (income after costs of goods sold are deducted from revenue), operating income (income after standard expenses are deducted) and net income (income after all extraordinary income and expenses are calculated)

Income Statement	
For the Years Ending [Dec 31, 2008 and Dec 31, 2007]	
Revenue	
Sales revenue	110,000
Service revenue	70,000
Interest revenue	
Other revenue	
Total Revenues	**180,000**
Expenses	
Advertising	1,000
Commissions	1,000
Cost of goods sold	65,000
Furniture and equipment	500
Insurance	100
Interest expense	4,200
Maintenance and repairs	75
Office supplies	50
Payroll taxes	100
Rent	1,000
Salaries and wages	55,000
Travel	500
Utilities	200
Other	17,460
Total Expenses	**146,185**
Net Income before taxes	33,815
Income tax expense	14,936
Income from Continuing Operations	**18,879**
Income from discontinued operations	500
Net Income	**19,379**

An income statement provides key information:

- It describes the sources of the firms' income. (i.e. goods sold, fees, subscriptions, service calls, interest, etc.)
- It describes the types and amounts of expenses the firm incurred, and may reveal the reasonableness of those expenses.
- It gives a picture of the profitability of the firm over a given time period. The Net Income line is the profit of the firm over the time period of the income statement.

The income statement does not reflect overall profit because revenue in one period may be a result from expenses or investments made in previous periods (i.e. advertising may pay off over a long period of time). It also may not reflect how much cash the firm has or earned (i.e. sales may not be paid for in a given time period). Finally, an income statement does not predict the future due uncertainty and changing business conditions.

CONTACT

Mercy Corps Global Headquarters
45 S.W. Ankeny Street
Portland, OR 97204
503.896.5000
800.292.3355

Ted Volchok
Senior Advisor, Economic and Market Development
tvolchok@mercycorps.org

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