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# Management's Analysis of Financial Statements During Tough Economic Times



**Presented by:**

Rachel Day, CPA  
Curtis Blakely & Co., P.C.  
P.O. Box 5486  
Longview, TX 75608  
(903) 758-0734  
rday@ cbandco.com

TSTCI Finance/Marketing/Commercial Conference

# What's the Need

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- Shrinking support mechanisms
- Competition
- Tough economic times
- Strategic thinking and planning for the future

# Tools to Analyze Financial Data

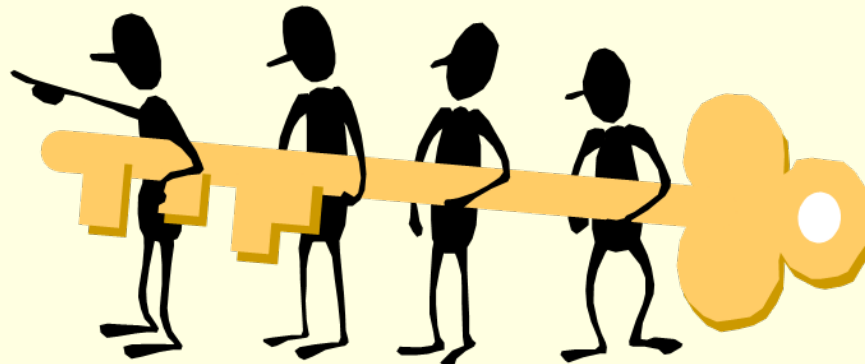
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- Trend Analysis
- Comparison to Benchmarks/Industry Averages
- Analyze Business Units/Segments/Product Lines
- Monitor Ratios
- Forecasting

# Tools to Analyze Financial Data

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The tools to analyze financial data are most useful when used in combination with one another.

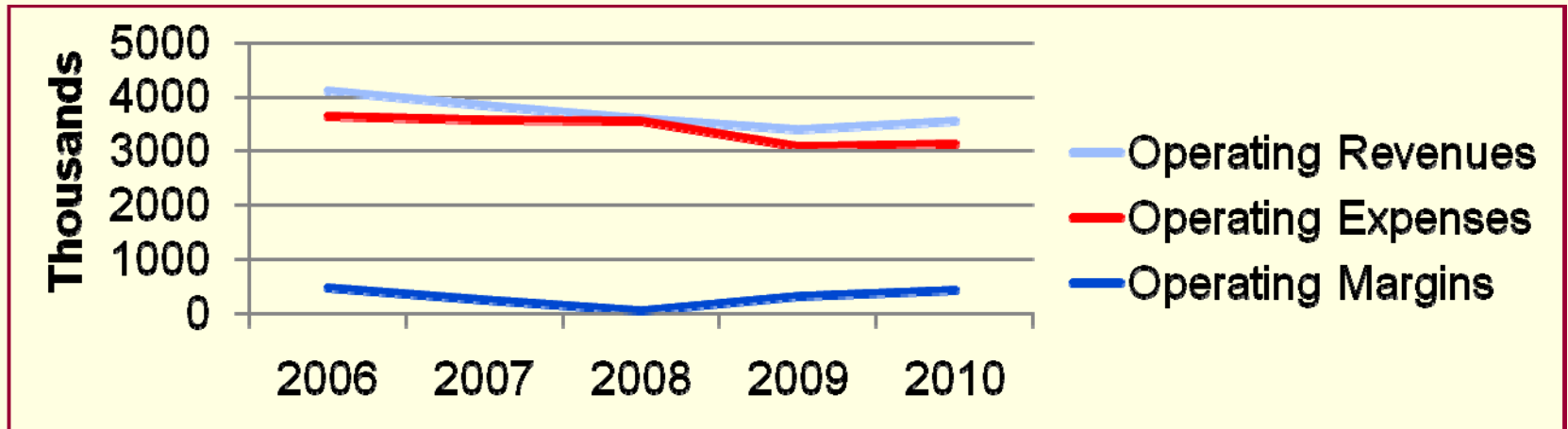


# Trend Analysis

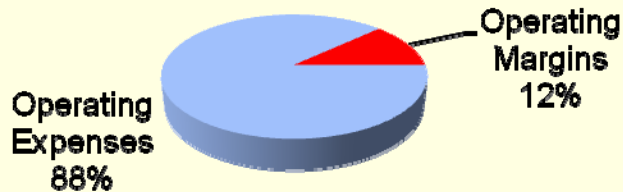
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- Horizontal trend analysis – year to year comparisons
- Vertical trend analysis – common size item
  - Revenues and expenses per access line
  - Revenues and expenses to total revenues
  - Revenues and expenses to total expenses

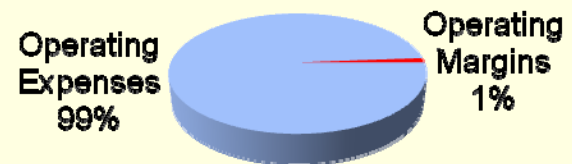
# Trend Analysis



## 2010 Operating Revenues



## 2008 Operating Revenues



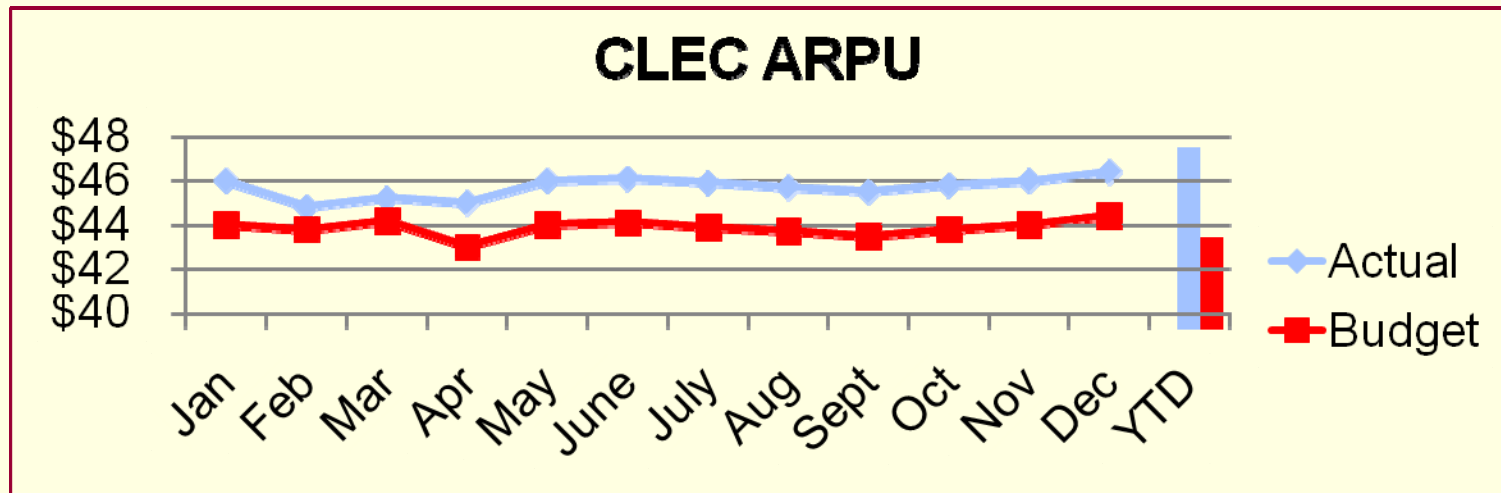
# Trend Analysis

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- Average Revenue per Unit (ARPU)
  - Provides a per unit basis to track revenue sources
  - With trend analysis, measures growth and change of sources
  - Calculation: total revenue / average number of units

# Trend Analysis

- Average Revenue per Unit (ARPU)
  - Access Lines
  - Minutes
  - Subscribers



# Trend Analysis

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## ■ Cash Transactions

### ■ Disbursements v. Receipts

- Consider why deficit or excess

### ■ Free Cash Flow

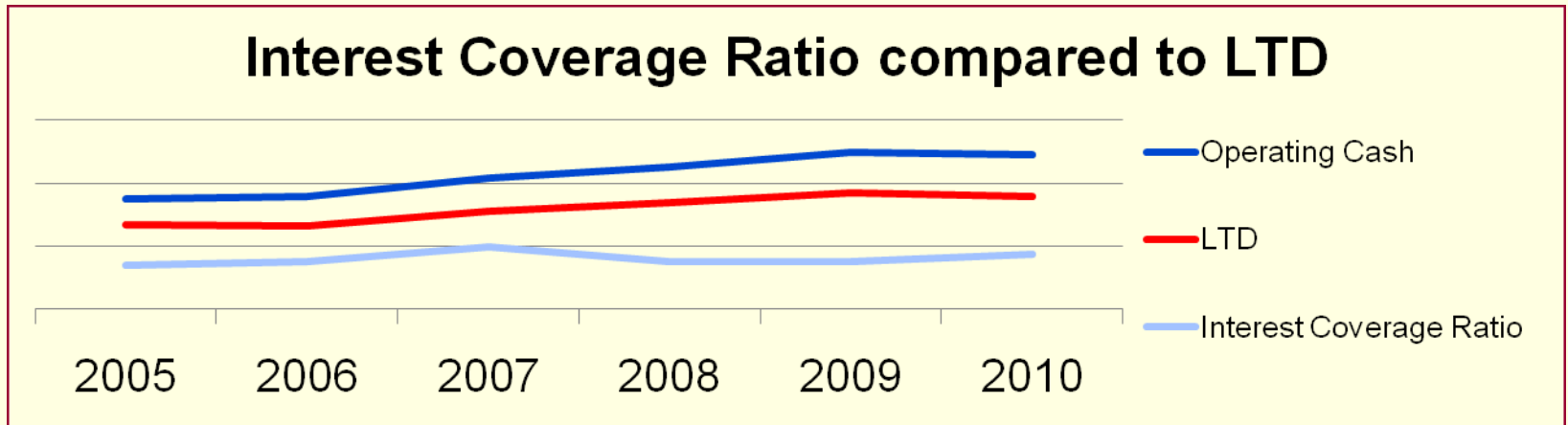
(Operating Cash Flow – Retirement of Debt – CapEx – Taxes = Free Cash Flow)

- Cash available after payment of mandatory obligations
- Measures cash generated by a company
- Consider capital credits to be paid

## ■ Key Ratios

# Trend Analysis

- Debt coverage
  - Times Interest Earned (TIER)
  - Interest Coverage Ratio-Cash Flow
    - Natural drop during economic downturn



# Trend Analysis

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- Churn rate
  - Measures loss of customers, or turnover
  - Calculation: lost customers / total customers for period
    - Customer counts
      - Penetration of services
    - Access line counts
  - To expand, the growth rate must exceed the churn rate

# Trend Analysis

## ■ Penetration of Services

	<u>Current Year</u>			<u>Percent Penetration</u>				
	# Customers	Monthly Rate	Annualized Revenue	CY	PY1	PY2	PY3	PY4
<b>Calling Features</b>								
Call Forward	#	\$	\$	%	%	%	%	%
Call Waiting	#	\$	\$	%	%	%	%	%
Etc.	#	\$	\$	%	%	%	%	%
<b>Class Features</b>								
Caller ID	#	\$	\$	%	%	%	%	%
Voicemail	#	\$	\$	%	%	%	%	%
Dial-Up Internet	#	\$	\$	%	%	%	%	%
Long Distance	#	\$	\$	%	%	%	%	%
DSL	#	\$	\$	%	%	%	%	%
Video	#	\$	\$	%	%	%	%	%
Etc.	#	\$	\$	%	%	%	%	%
<b>Total</b>	#			<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

# Trend Analysis

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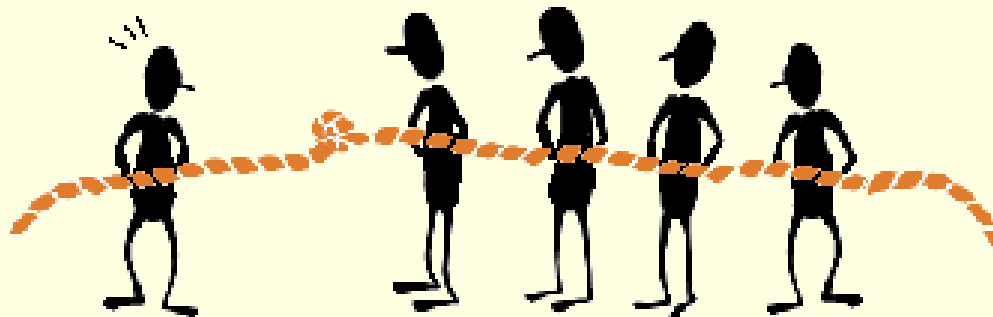
- Other significant drivers
  - Payroll and benefit costs per hour
  - Payroll and benefit costs per \$ revenue
  - Cellular partnership distributions
  - Support revenues to total revenues
  - Revenue Generating Units (RGUs)
    - Sources or units of revenue creation
    - With trend analysis, measures change in number of units to generate revenue
    - Versus ARPU which measures revenue generated by the units

# Benchmark Comparisons

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Don't simply compare your organization to another.

**UNDERSTAND** why your organization performs better or worse than the other.



# Benchmark Comparisons

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Why your organization performs differently from others...

- Consider causes such as:
  - Density
  - Population
  - Demographics
  - Terrain
  - Weather

# Benchmark Comparisons

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- Provided from several sources
  - Audit firm
  - Consulting firm
- Take a look at industry reports
  - Texas PUC Scope of Competition Report  
<http://www.puc.state.tx.us/telecomm/reports>
  - NECA Industry News, FEC Report, Trends Report  
<http://www.neca.org>

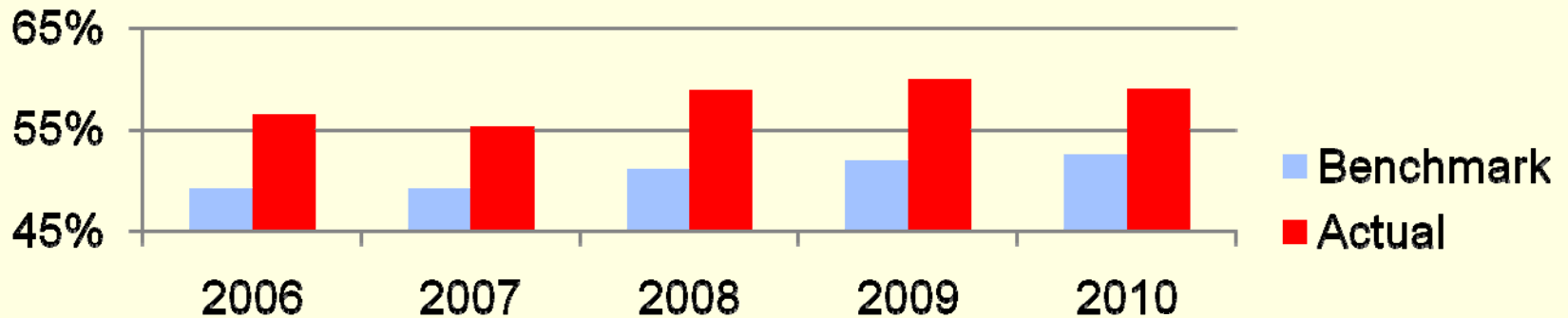
# Benchmark Comparisons

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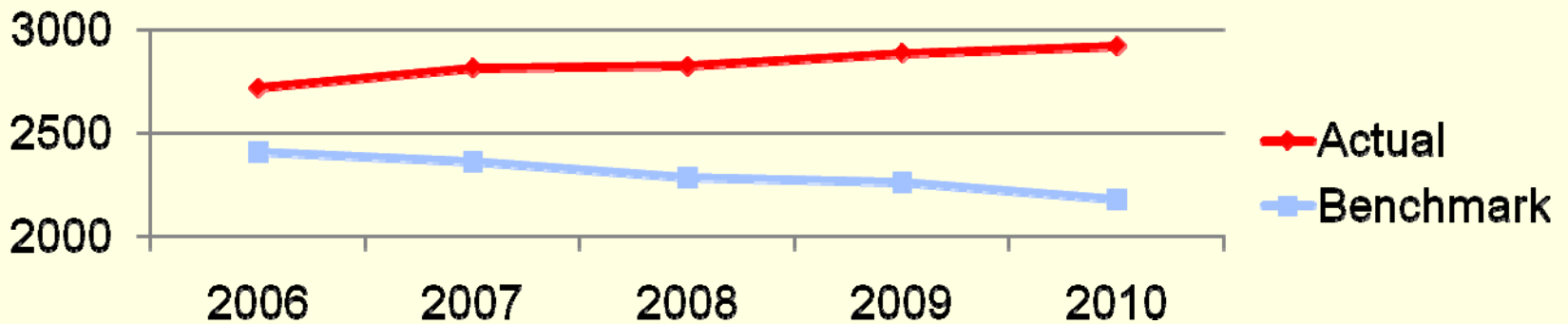
- Fiber deployment
- DSL percentage of revenues
- Churn: access lines or DSL lines
- Revenue growth or decline
- Average remaining life of plant

# Benchmark Comparisons

## Support to Revenue Ratio



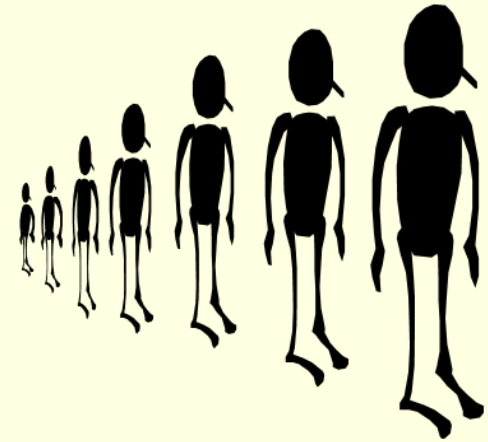
## Number Access Lines



# Business Units

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- Examine contributions to margin by product line
- Subtotal by unit looking at:
  - Direct and indirect expenses
    - Selling general and administrative
  - Fixed and variable expenses
    - Depreciation
- Consider effects of bundled services



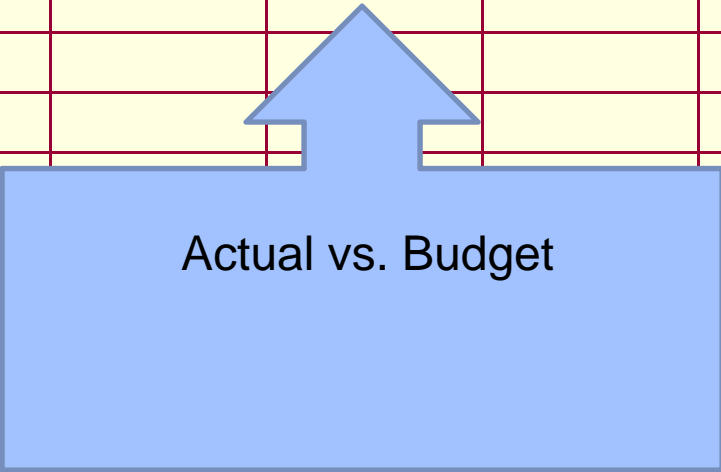
# Business Units

Description	Current YTD Actual	% of Revenue	Prior YTD Actual	% of Revenue	Fav/(Unfav) Variance
Total Revenue					
Direct Costs					
Contribution Margin					
Indirect Costs					
Gross Margin					
Selling, General, Administrative					
Depreciation, Amortization					
Operating Income (Loss)					
Other Income (Expense)					
Income (Loss) Before Taxes					
Income Tax Expense					
Total Net Income					

Current Year vs. Prior Year

# Business Units

Description	Current Year Actual	% of Revenue	Current Year Budget	% of Revenue	Fav/(Unfav) Variance
Total Revenue					
Direct Costs					
Contribution Margin					
Indirect Costs					
Gross Margin					
Selling, General, Administrative					
Depreciation, Amortization					
Operating Income (Loss)					
Other Income (Expense)					
Income (Loss) Before Taxes					
Income Tax Expense					
Total Net Income					



# Business Units

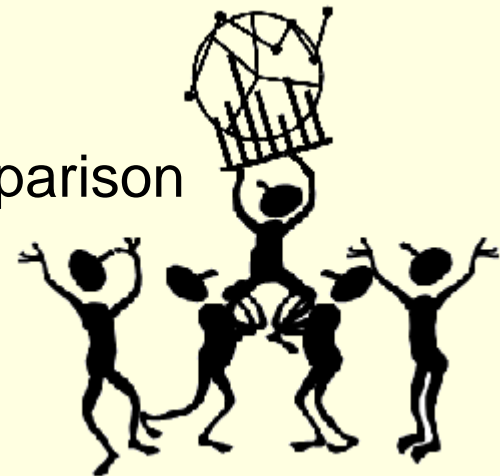
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- More specific units will be more beneficial
  
- Business units to consider:
  - ILEC
  - CLEC
  - Internet
  - Cable TV
  - Security
  - Fiber Transport
  - Long Distance
  - Other Non-Regulated

# Monitor Ratios

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- What results are desired?
  - Trend analysis
  - Industry comparisons
    - PUC recommended levels
  - Comparison to other business segments
- Limitations of ratios
  - Hard to get “apples to apples” comparison
  - Distortion based on timing



# Monitor Ratios – Key Ratios (1)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
<b>Liquidity Ratios</b>	<b>Solvency and ability to meet short-term obligations; ability to take on new short-term obligations</b>		
Current Ratio	Ability to pay short-term debts	Current Assets / Current Liabilities	2:1-4:1
Quick Ratio (Acid Test)	Ability to pay short-term debts with most readily available liquid assets (inventory is difficult to turn into cash)	(Cash + Marketable Securities + Accounts Receivable) / Current Liabilities	1:1 or greater
A/R Turnover	How quickly firm collects its accounts receivable	Sales / Average Accounts Receivable	Industry (higher the better)
Inventory Turnover	Number of days worth of inventory on hand	Cost of Goods Sold / Average Inventories	Industry

# Monitor Ratios – Key Ratios (2)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Working Capital Ratio	Assets tied up in working capital, or amount of assets required to run operations	$(\text{Current Assets} - \text{Current Liabilities}) / \text{Total Assets}$	Industry
Operating Cash Flow to Current Liabilities	Current cash availability to current obligations	$\text{Cash Flow from Operations} / \text{Average Current Liabilities}$	Industry (higher the better)
<b>Activity Ratios</b>	<b>Measure success of a business unit</b>		
Average Revenue per Unit (ARPU)	Revenue sources and growth	$\text{Total Revenue} / \text{Average Number of Units}$	Industry
Operating Revenue per Employee		$\text{Operating Revenues} / \text{Number Full-Time Employees}$	Industry
Operating Revenues per Access Line		$\text{Operating Revenues} / \text{Access Lines}$	Industry

# Monitor Ratios – Key Ratios (3)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Operating Income before Interest, Taxes, Depreciation, and Amortization (OIBTDA) per Connection	Operating income per connection (excludes non-operating income)	OIBTDA / Connections	Industry
Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA) per Connection	Net income per connection	EBITDA / Connections	Industry
Access Lines per Route Mile		Access Lines / Route Mile	Industry
Plant in Service per Access Line		Gross Plant in Service / Access Lines	Industry

# Monitor Ratios – Key Ratios (4)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Net Investment per Access Line	PUC EM ratio monitoring investments in operations per access line	((TPUC + Plant in Service + Working Capital + Self Insurance Reserve Amounts) – (Accum. Depr. + Deferred Income Taxes + Contributions in Aid of Construction + Customer Deposits + Deferred Credits + Contingency Reserves + Other Sources of Cost-Free Capital)) / Access Lines	Industry
General Funds to Plant in Service	PUC EM ratio monitoring funds available compared to plant in service	(Cash + CDs + MES + TBills, etc) / (Gross Plant in Service before Accum. Depr.)	20%
Operating Expenses per Access Line		Operating Expenses / Access Lines	Industry

# Monitor Ratios – Key Ratios (5)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Operating Expenses per Employee		Operating Expenses / Number Full-Time Employees	Industry
Net Operating Income per Access Line		Net Operating Income / Access Lines	Industry
Average Number of Employees per 1,000 Access Lines		Number Full-Time Employees / Access Lines x 1,000	Industry
End Billing per Access Line		Total End User Billing / Access Lines	Industry
Cellular Income to Margin Ratio		Cellular Partnership Income After Tax / Net Margin	Industry
Return on Assets Before Partnership Income		(Net Income - Partnership Income) / Total Assets	Industry

# Monitor Ratios – Key Ratios (6)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Support to Revenue		Total Support Revenue / Total Revenue	Industry
Support per Access Line		Total Support Revenue / Access Lines	Industry
Capital Credits per Access Line		Capital Credits Paid / Access Lines	Industry
<b>Cash Flow Ratios</b>	<b>To assess earnings quality</b>		
Overall Cash Flow Ratio	Whether business is generating enough cash from its business to sustain itself, grow, and return capital to its owners	Cash inflow from Operations / (Cash outflow from Investing + Cash outflow from Financing)	>1

# Monitor Ratios – Key Ratios (7)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Cash Flow to Earnings	In addition to Overall Cash Flow Ratio to measure quality of cash flow generation (does cash flow increase accompany earnings increase)	Operating Cash Flow / Net Earnings	Industry (consistency)
<b>Leverage/Coverage Ratios</b>	<b>Funds supplied from external financing v. owner equity</b>		
Debt Service Coverage Ratio	Ratio monitoring cash flow coverage of total long-term debt obligations	(Net Income + Interest Exp + Depr + Amort) / Total Principal + Interest Payments	4:1-5:1

# Monitor Ratios – Key Ratios (8)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Interest Coverage Ratio- Cash Flow	Ability to generate cash to cover debt charges	Operating Cash Flow / (Average Current Liabilities + Long-Term Debt)	Higher the better
Equity Capitalization	Ratio monitoring equity coverage of operations, or total capitalization the members or stockholders own	Total Equity / (Total Equity + Total Long-Term Debt + Total Short-Term Debt)	>=40%, preferably 50%
Pre-Tax Times Interest Earned (TIER) (Interest Coverage Ratio-Earnings)	Monitors ability to cover interest charges	(Net Income + Interest Expense + FIT) / Interest Expense	2.5-3.0
Debt to Cash Flow Ratio	Long-term debt covered by cash generation	Long-Term Debt / Operating Cash Flow	5:1
Equity Percentage	Percentage of earnings retained	Equity / Total Assets	Industry

# Monitor Ratios – Key Ratios (9)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Debt to Equity	Percentage of the assets provided by owners	Long-Term Debt / Equity	Industry (lower the better)
Debt to Assets	Percentage of the assets provided by debt obligations	Total Debt / Total Assets	Industry (lower the better)
<b>Profitability Ratios</b>	<b>Rates of profit for the company</b>		
Net Profit Margin	Profit generated per \$ sales	Net Income / Sales	Industry (higher the better)
Return on Investment (ROI)	Profit generated per \$ investment	Net Income / Total Tangible Assets	Industry
Return on Assets (ROA)	Profit generated per \$ assets	Net Income / Average Total Assets	Industry

# Monitor Ratios – Key Ratios (10)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Return on Equity (ROE)	Ratio monitoring profit generated per \$ equity	Net Income / Equity	11-13%
Return on Rate Base (Invested Capital)	Ratio monitoring the return on invested capital	Net Income / ((TPUC + Plant in Service + Plant Held for Future Use + Telephone Plant Acquisition + Materials and Supplies + Prepayments + Other Invested Capital Additions) – (Accum. Depr. and Amort. + Deferred Federal Income Taxes + Contributions in Aid of Construction + Customer Deposits + Other Invested Capital Deductions))	Industry

# Monitor Ratios – Key Ratios (11)

<u>Ratio</u>	<u>Measures</u>	<u>Calculation</u>	<u>Results Desired</u>
Labor to Expense	Labor as a percentage of total expenses	Labor / Total Operating Expense	Industry
Working Capital to Revenue	How well the company is using its working capital to generate sales, or ability to manage cash to generate sales	(Current Assets - Current Liabilities) / Total Revenues	Industry

# Forecasting

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- Use to determine what performance drivers are relevant
- Know what drives changes
- Consider methods to measure impact of changing factors
- Set goals or performance standards
- Know where your biggest dollars come from



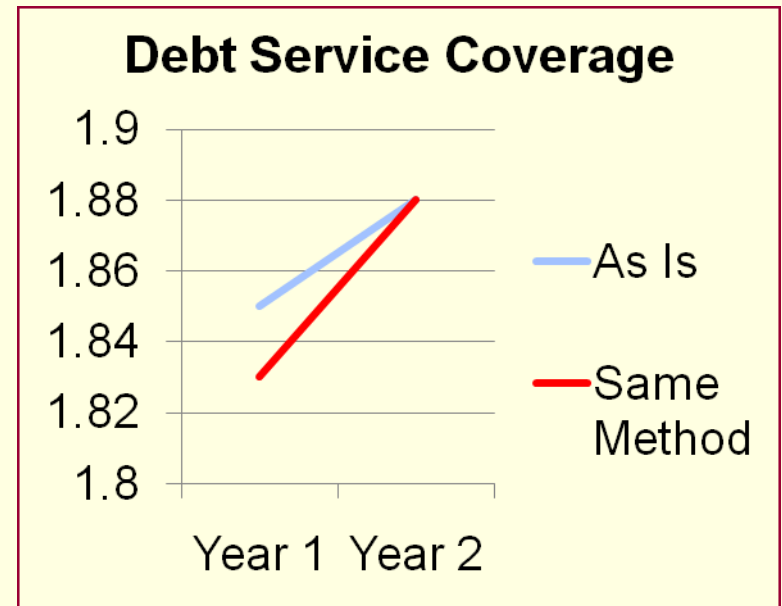
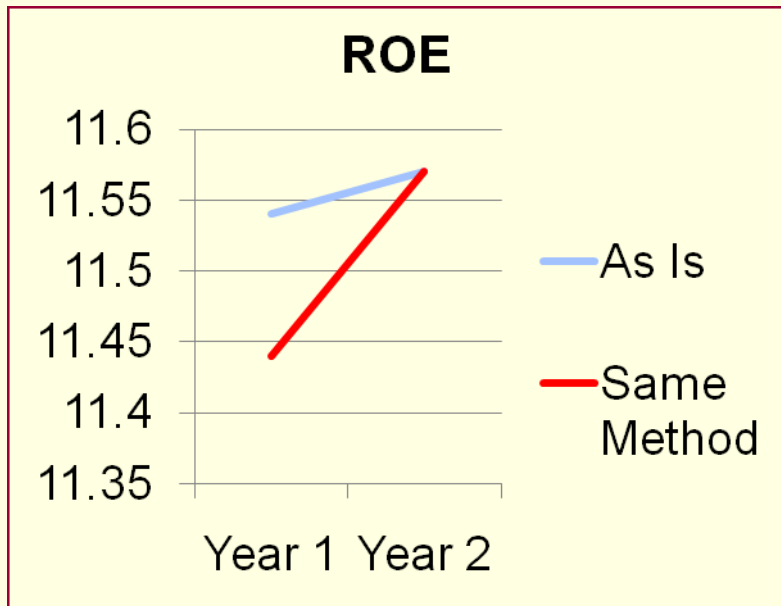
# Forecasting

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- Consider changing factors
  - Known access line increases or decreases
  - Changing accounting rules
    - Operating vs. Capital leases
  - Revenue or expense changes
    - Rate changes
    - Tax effects
    - Fully depreciated assets

# Forecasting

- Effect of change in method to account for leases
  - 5-yr lease of \$130,000 equipment
  - Same net income, adjusted for change in interest, depreciation
  - Year 1 before change in method, year 2 after



# Forecasting

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- Know what your drivers are:
  - Support mechanisms dependent on expenses and investment decisions
  - Cost saving measures may not flow to bottom line completely or at all

# Other Evaluations

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- Capital expenditure activity
  - Interim orders to date
  - BOD approved or budgeted
  - Remaining orders anticipated v. budgeted
- Loan/Grant fund usage
  - Consider time constraints of program
- Status capital credit rotation v. cash flow
- Financial results v. budget

# Winner of “It’s Not My Job” Contest

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# Questions?

## **Management's Analysis of Financial Statements During Tough Economic Times**

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