Understanding the Balance Sheet

An online CBL200 series course, Mastering the fundamentals
Provided as part of the CBLD program

www.cdsfood.coop/cbld

Webinar: September 10, 2008

Recorded for later use by registered participants

Related files are available

https://cdsfood.centraldesktop.com/understandingthebalancesheet/av

Presented by Mark Goehring

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As directors, what financial indicators will help us understand the organization's financial condition?

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Common Indicators of Financial Condition

Growth (top line)

Profitability ,net income (bottom line)

Solvency – debt to equity

Solvency is the relationship of long term debt to owners' equity. It is a measure of the proportion of long term capital being provided by the creditors (debt) versus the owners (equity). It indicates who is financing the permanent assets of the company.*

Liquidity – current ratio, quick ratio, working capital

Liquidity is a measure of the business' ability to pay its bills on time. It is the relationship between current assets and current liabilities. Liquidity is a sensitive barometer of month to month operations.*

* From University of Wisconsin Center for Cooperatives, http://www.uwcc.wisc.edu/info/FINREV.html

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Understanding Financial Statements

Balance Sheet

Describes how much the coop is worth, the owners' position in the business
What the coop has and where it came from
A picture of where a business is at a point in time

Income Statement

Also known as profit and loss statement or statement of operations
Tells the story of what happened during a period of time
Shows if the coop made or lost money and how much

Sources and Uses/Cash Flow

Tells how cash is generated and used
Describes cash implications of financing activities, investing activities and operating activities

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Now in its sixth edition, this book is great if you're interested in seeing the interconnectedness of the three types of financial statements.

EXHIBIT 3.1—CONNECTIONS BETWEEN INCOME STATEMENT AND BALANCE SHEET
Dollar Amounts in Thousands

INCOME STATEMENT FOR YEAR	
Sales Revenue	$52,000
Cost of Goods Sold Expense	33,800
Gross Margin	$18,200
Operating Expenses	12,480
Depreciation Expense	785
Amortization Expense	325
Operating Earnings	$ 4,610
Interest Expense	545
Earnings before Income Tax	$ 4,065
Income Tax Expense	1,423
Net Income	$ 2,642

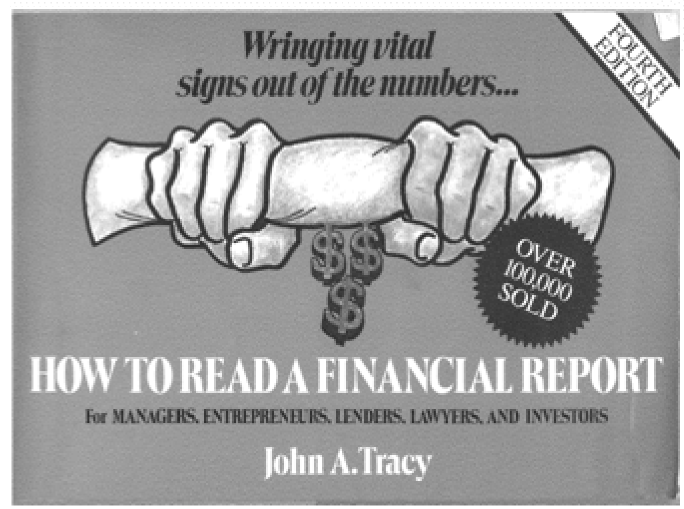
BALANCE SHEET AT END OF YEAR		
Assets		
Cash	$ 3,265	
Accounts Receivable	5,000	
Inventory	8,450	
Prepaid Expenses	960	
Total Current Assets		$17,675
Property, Plant, and Equipment	$16,500	
Accumulated Depreciation	(4,250)	12,250
Goodwill	$ 7,850	
Accumulated Amortization	(2,275)	5,575
Total Assets		$35,500
Liabilities and Stockholders' Equity		
Accounts Payable—Inventory	$ 2,600	
Accounts Payable—Operating Expenses	720	$ 3,320
Accrued Operating Expenses	$ 1,440	
Accrued Interest Expense	75	1,515
Income Tax Payable		165
Short-Term Notes Payable		3,125
Total Current Liabilities		$ 8,125
Long-Term Notes Payable		4,250
Capital Stock	$ 8,125	
Retained Earnings	15,000	
Total Owners' Equity		23,125
Total Liabilities and Stockholders' Equity		$35,500

EXHIBIT 3.2—CONNECTIONS BETWEEN BALANCE SHEET CHANGES AND CASH FLOWS FROM PROFIT-MAKING ACTIVITIES FOR YEAR
Dollar Amounts in Thousands

BALANCE SHEET at	End of Year	Start of Year	Change
Cash	$ 3,265	$ 3,735	$ (470)
Accounts Receivable	5,000	4,680	320
Inventory	8,450	7,515	935
Prepaid Expenses	960	685	275
Property, Plant, and Equipment	16,500	13,450	3,050
Accumulated Depreciation	(4,250)	(3,465)	(785)
Goodwill	7,850	6,950	900
Accumulated Amortization	(2,275)	(1,950)	(325)
Total Assets	$35,500	$31,600	
Accounts Payable—Inventory	$ 2,600	$ 2,300	$ 300
Accounts Payable—Operating Expenses	720	375	345
Accrued Operating Expenses	1,440	985	455
Accrued Interest Expense	75	50	25
Income Tax Payable	165	82	83
Short-Term Notes Payable	3,125	3,000	125
Long-Term Notes Payable	4,250	3,750	500
Capital Stock	8,125	7,950	175
Retained Earnings	15,000	13,108	1,892
Total Liabilities and Stockholders' Equity	$35,500	$31,600	

PROFIT-MAKING ACTIVITIES FOR YEAR	Income Statement	Cash Flows
Sales	$ 52,000	
Deduct $320 Increase		$51,680
Cost of Products	(33,800)	
Add $935 Increase		
Deduct $300 Increase		(34,435)
Operating Expenses	(12,480)	
Add $275 Increase		
Deduct $345 Increase		
Deduct $455 Increase		(11,955)
Depreciation Expense	(785)	0
Amortization Expense	(325)	0
Interest on Debt	(545)	
Deduct $25 Increase		(520)
Income Tax	(1,423)	
Deduct $83 Increase		(1,340)
Bottom-Line Profit, or Net Income	$ 2,642	
Cash Increase from Profit-Making Activities		$ 3,430

22 *Profit isn't everything*



OK.

Are you ready for the balance sheet lesson?

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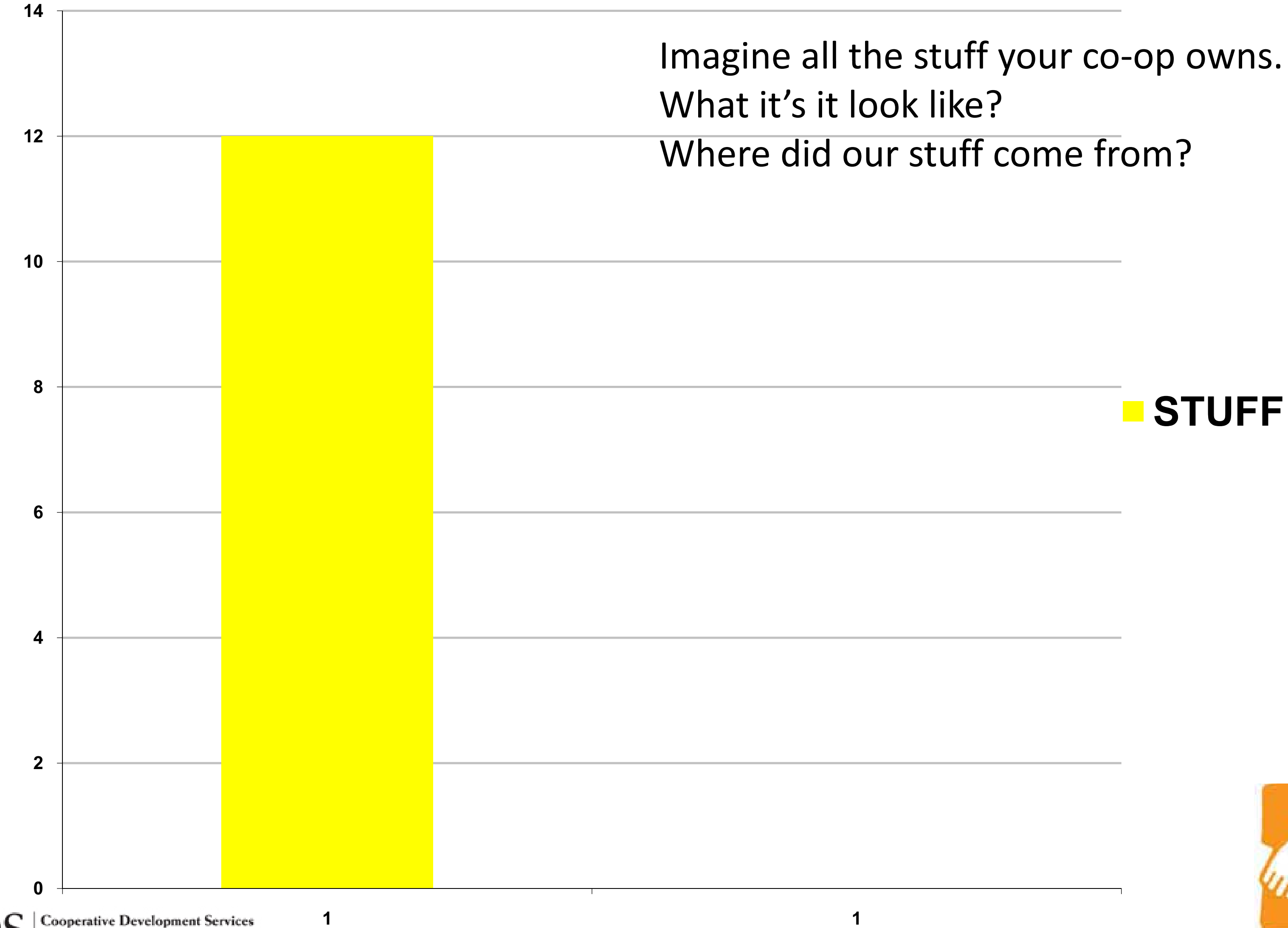
Imagine all the stuff your co-op owns.
What it's it look like?
Where did our stuff come from?



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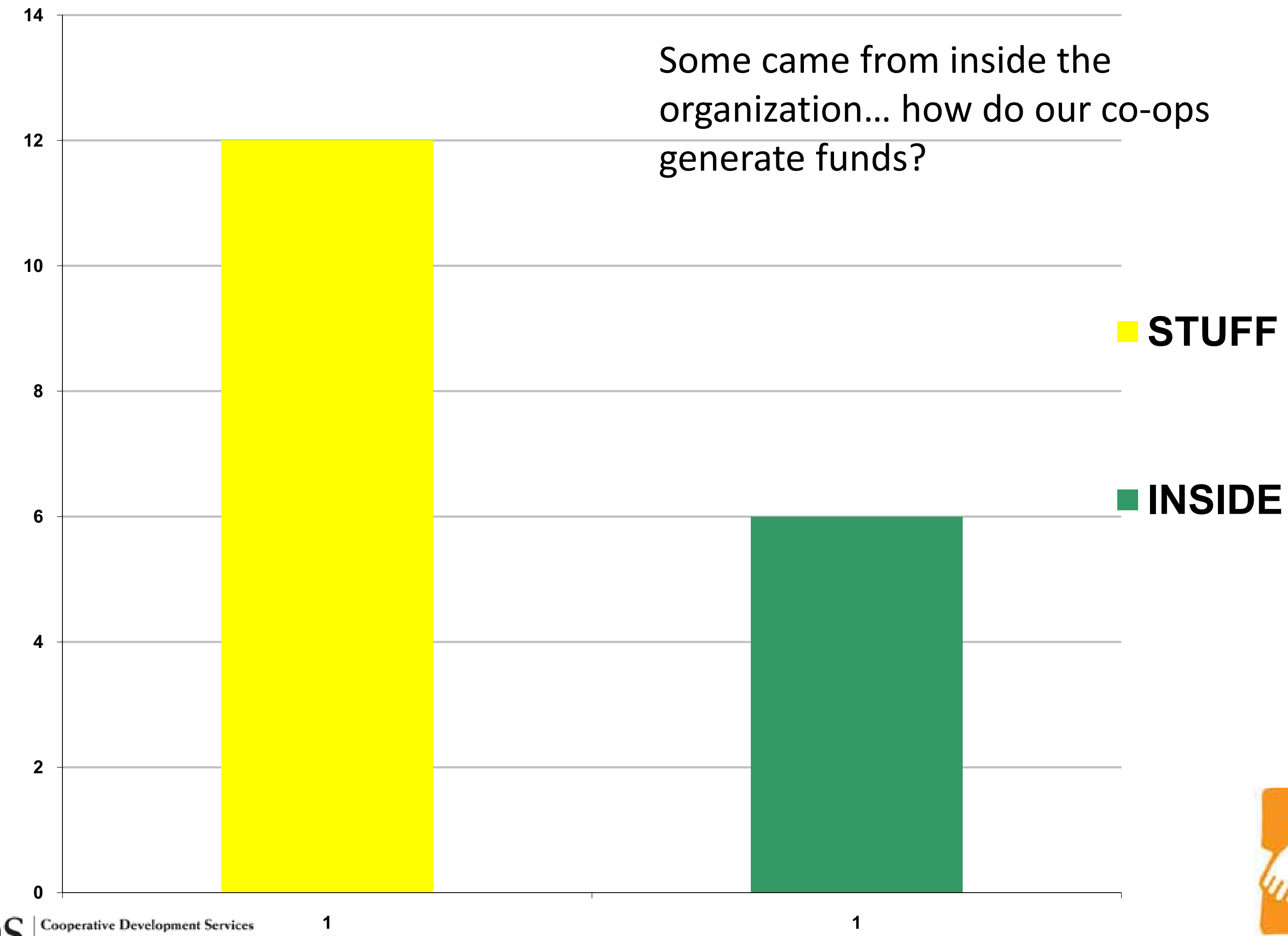
14
12
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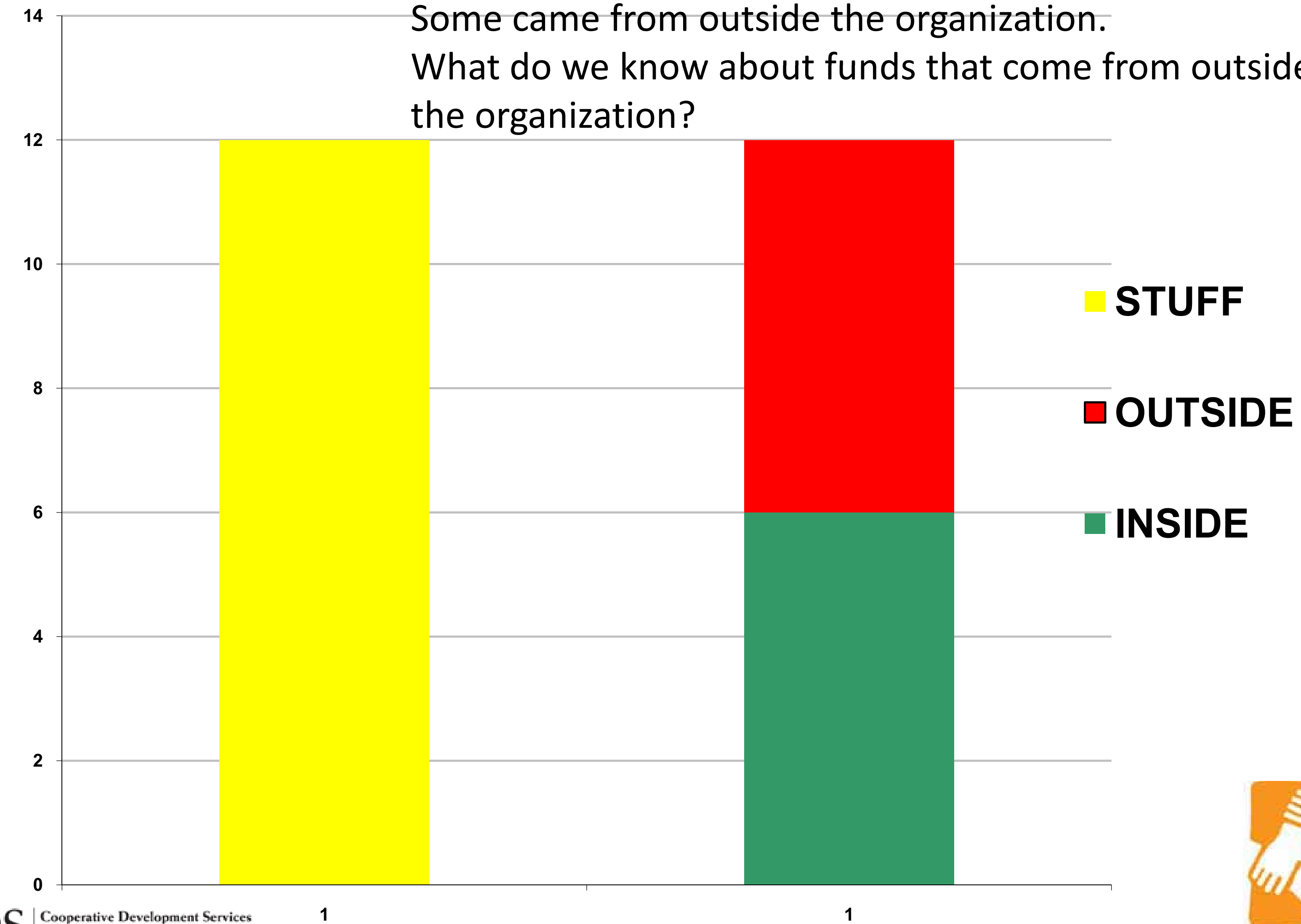
1
Some came from inside the organization… how do our co-ops generate funds?
STUFF
INSIDE

Some came from outside the organization.
What do we know about funds that come from outside the organization?



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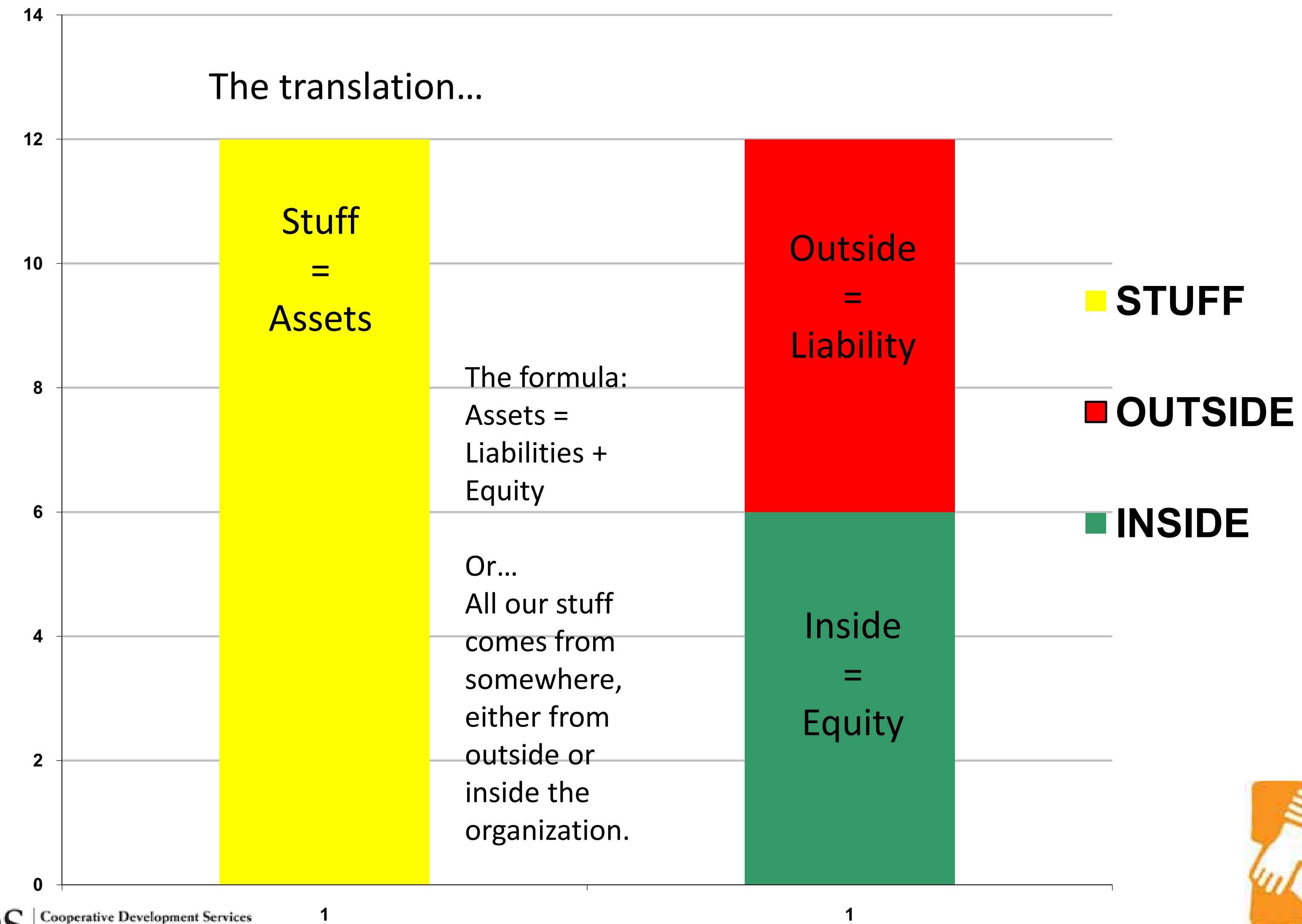

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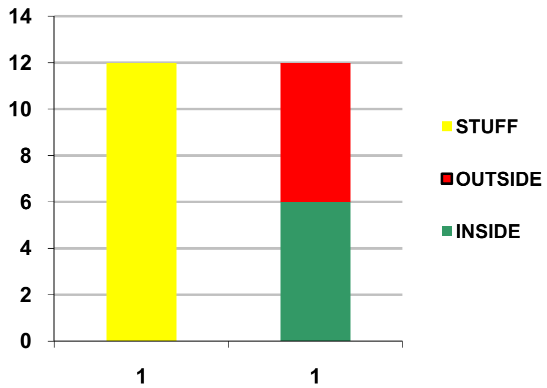
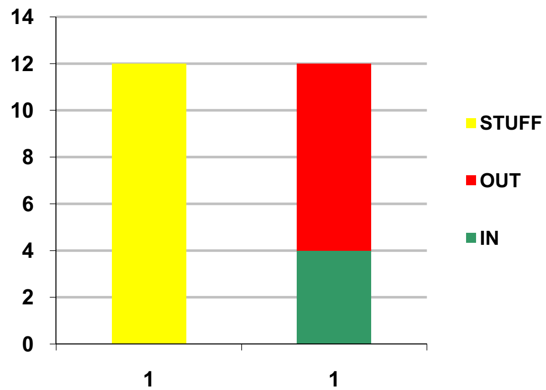
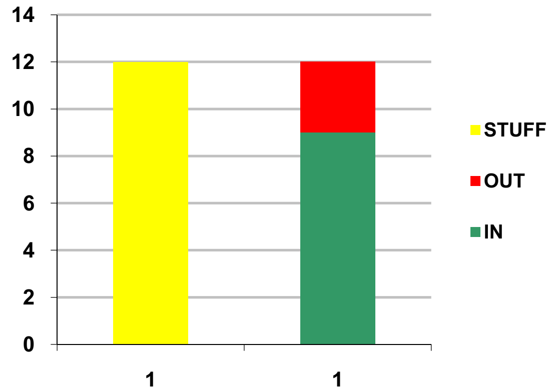
Seeing the relationship: “outside to inside” or “debt to equity”



Median debt to equity relationship of 102 co-ops in the 2005 Operational Survey, published July 2006.



Upper quartile debt to equity relationship of 102 co-ops in the 2005 Operational Survey, published July 2006.



Lower quartile debt to equity relationship of 102 co-ops in the 2005 Operational Survey, published July 2006.

How would these relationships be expressed?

Solvency – debt to equity

Solvency is the relationship of long term debt to owners' equity. It is a measure of the proportion of long term capital being provided by the creditors (debt) versus the owners (equity). It indicates who is financing the permanent assets of the company.

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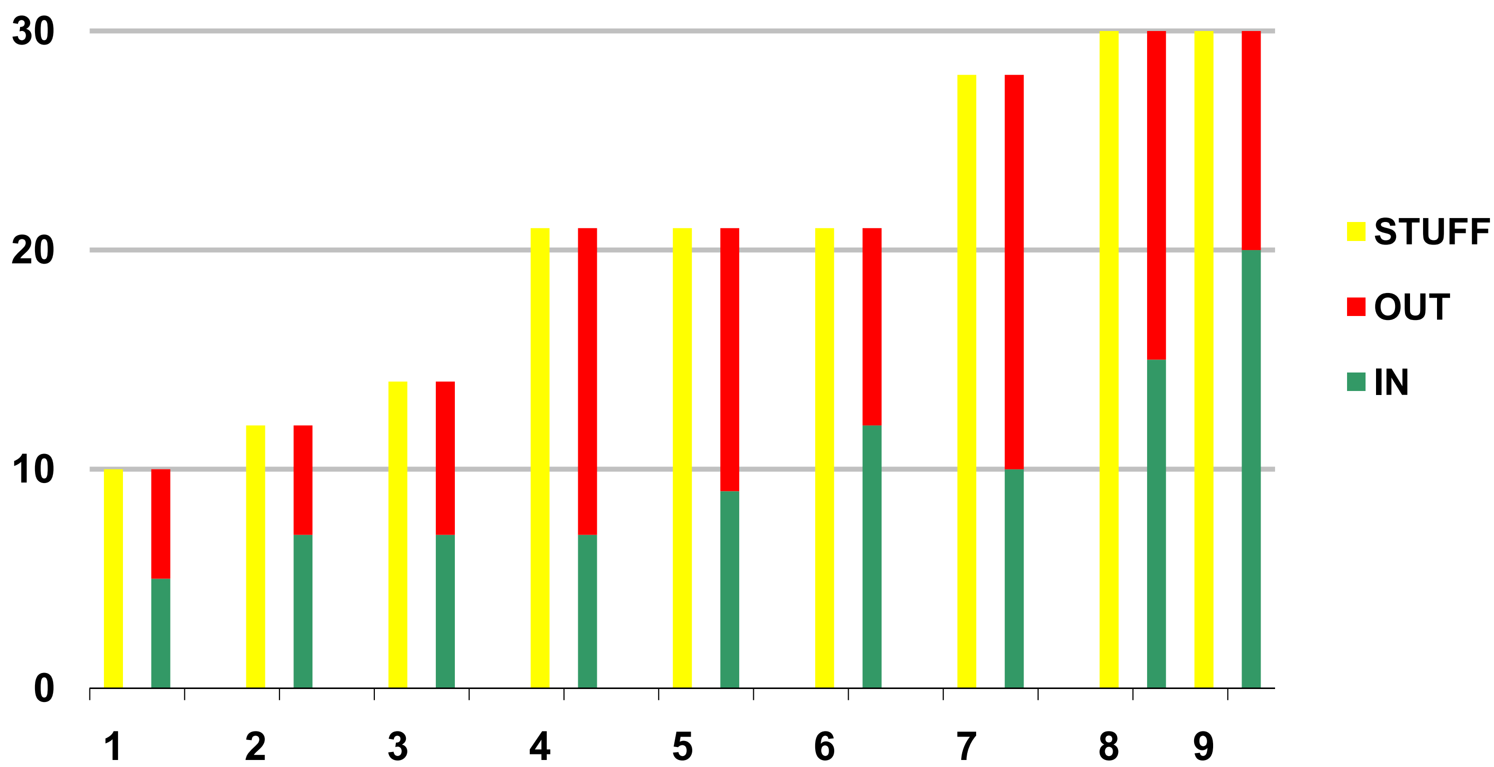

Comparison 1 shows a co-op that has 3 times more stuff (assets) 9 years after the first snapshot. First there is a steady rise, followed by two significant jumps, maybe expansions. Those new assets were financed primarily by debt (out). After the spurts, there is a decline in equity (in) – maybe due to post-expansion losses.

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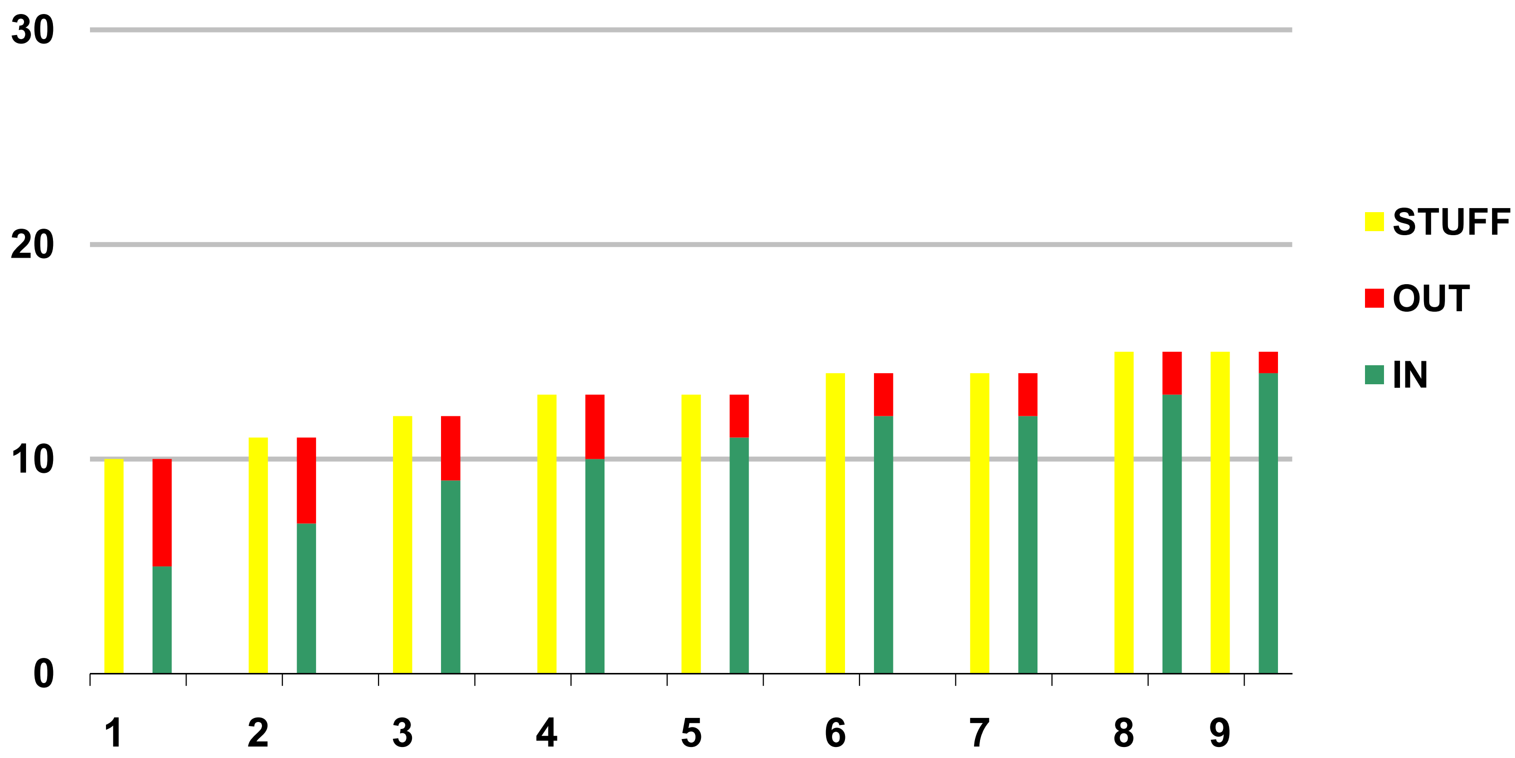

Comparison 2 shows a co-op with comparatively little growth in assets. The existing debt is being paid off. This co-op might be getting poised to take advantage of an opportunity. It may be failing to leverage its members' assets, or perhaps the co-op is looking forward to possibilities that will serve members and others better.

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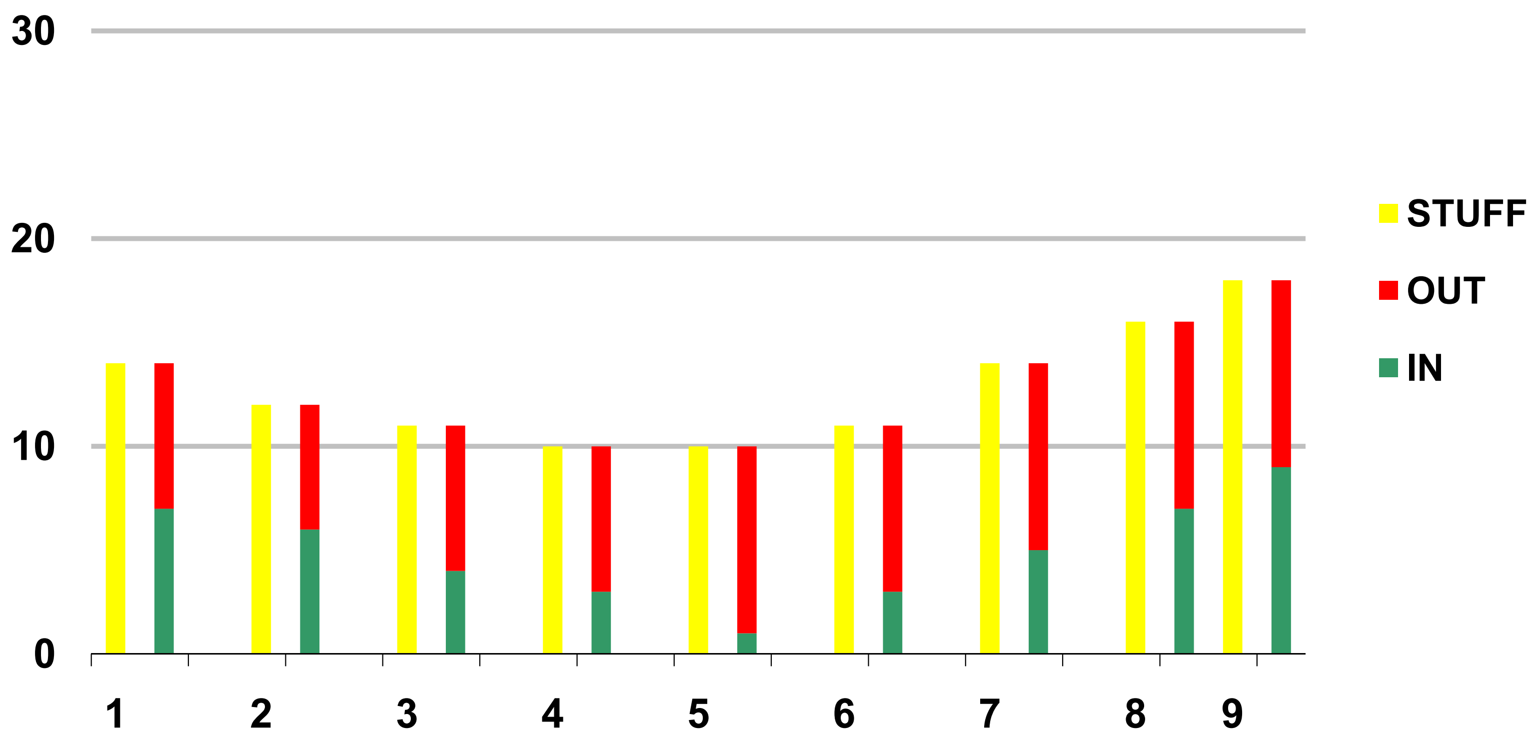

Comparison 3 shows a downward trend in assets followed by an upward trend. Liabilities have remained relatively stable; what has changed is equity. Perhaps this co-op wasn't profitable for many years, and lost most of its equity (green). But it has been turned around and now looks strong.

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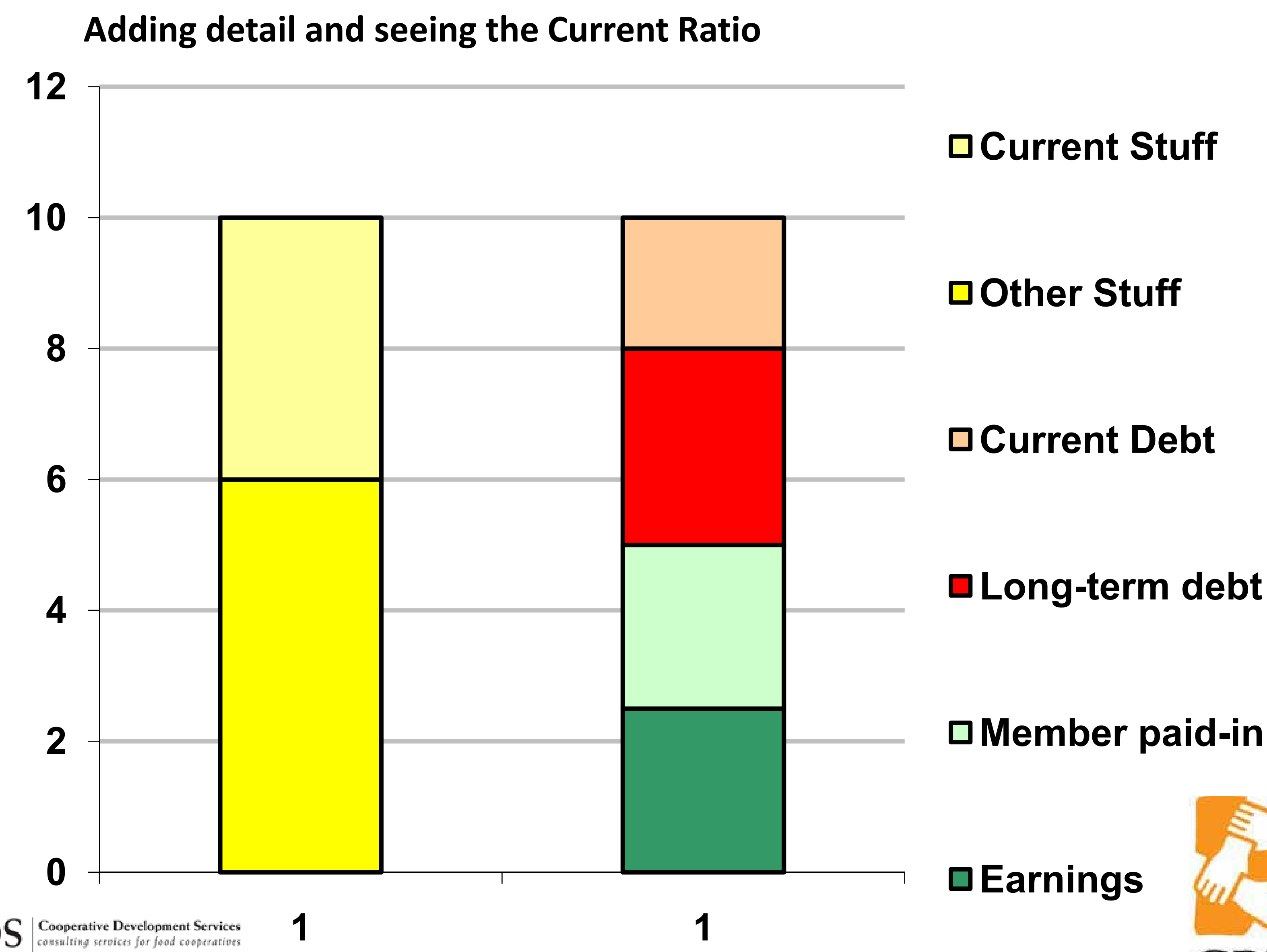

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Sample Balance Sheet

[From 2005 Operational Survey, representing 102 co-ops with 128 outlets.]*

Assets			
Current Assets	40%		
Other Assets	60%		
Total Assets			100%
Liabilities			
Current Liabilities	20%		
Long term Liabilities	30%		
Total Liabilities		50%	
Equity			
Member paid-in	25%		
Earnings	25%		
Total Equity		50%	
Total Liabilities and Equity			100%

Totals rounded*

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Steps to Fiduciary Responsibility

1. Have expectations

Policies to Safeguard Financial Condition
Policies to Guide Fiscal Planning
Policies to Ensure Asset Protection

2. Assign responsibility

3. Check

Monitor Compliance with Policies

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Policy Type: Executive Limitations
Policy Title: B – Global Executive Constraint
Last Revised:

*The General Manager shall not cause or allow any practice, activity, decision, or organizational circumstance that is unlawful, **imprudent**, or in violation of commonly accepted business and professional ethics and practices, or in violation of the Cooperative Principles.*

Note: this policy and the three policies that follow are taken from the CBLD team's most recent sample policy set. Contact your CBLD consultant to receive the whole set.

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Policy Type: Executive Limitations

Policy Title: **B1 – Financial Condition and Activities**

Last revised:

With respect to the actual, ongoing financial conditions and activities, the General Manager shall not cause or allow the development of fiscal jeopardy or material deviation of actual expenditures from board priorities established in Ends policies.

The GM will not:

•Allow sales to decline or be stagnant.

•Allow operations to generate an inadequate net income.

•Allow liquidity, or the ability to meet cash needs in a timely and efficient fashion, to be insufficient.

•Allow solvency, or the relationship of debt to member/owners' equity, to be insufficient.

•Incur debt other than trade payables or other reasonable and customary liabilities incurred in the ordinary course of doing business.

•Acquire, encumber or dispose of real estate. *(Note: a board could replace this with Asset Protection policy B3.6 – "…Fail to exercise due diligence in contracts and real estate acquisitions.")*

•Allow tax payments or other government-ordered payments or filings to be overdue or inaccurately filed.

•Allow late payment of contracts, payroll, loans or other financial obligations.

•Use restricted funds for any purpose other than that required by the restriction.

•Allow financial record keeping systems to be inadequate or out of conformity with GAAP.

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Policy Type: Executive Limitations
Policy Title: **B2 – Business Planning and Financial Budgeting**
Last revised:

The General Manager shall not cause or allow business planning and budgeting, for any fiscal year or the remaining part of any fiscal year to deviate materially from the board's Ends priorities, risk financial jeopardy, or fail to be derived from a multiyear plan.

The GM will not cause or allow plans that:
- Risk incurring those situations or conditions described as unacceptable in the board policy "Financial Condition and Activities."
- Omit credible projection of revenues and expenses, owner investment and return, separation of capital and operational items, cash flow, and disclosure of planning assumptions.
- Plan expenditures in any fiscal year that would result in default under any of the cooperative's financing agreements or cause the insolvency of the cooperative.
- Have not been tested for feasibility.
- Provide less for board prerogatives during the year than is set forth in the Governance Investment Policy.

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POLICY TYPE: EXECUTIVE LIMITATIONS

POLICY TITLE: **B3 – ASSET PROTECTION**

LAST REVISED:

The General Manager shall not allow assets to be unprotected, unreasonably risked, or inadequately maintained.

The GM will not allow:

•Equipment and facilities to be inadequately insured, or otherwise unable to be replaced if damaged or destroyed, including coverage for any losses incurred due to business interruption.

•Unnecessary exposure to liability or lack of insurance protection from claims of liability.

•Inadequate security of premises and property.

•Data, intellectual property, or files to be unprotected from loss, theft or significant damage.

  •Improper usage of members' and customers' personal information.

•Uncontrolled purchasing or purchasing subject to conflicts of interest.

•Lack of due diligence in contracts and real estate acquisitions. *(NOTE: This policy is an alternative to Financial Conditions policy B1.6. A board would not need or want both.)*

•Damage to the co-op's public image.

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Remember, when doing the “checking” part, judge based on reasonableness…

See the CBLD recorded webinar on Roles and Responsibilities of Directors for more on reasonable and prudent evaluation of information presented by management.

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CBLD 2008 online workshops (recordings and resource packets available)

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CBL 200 series: Mastering the fundamentals

The Cost of Governing: Building a Board Budget
Wed, March 12

Accountability: Acting on GM monitoring reports
Wed, April 2

Legal Roles and responsibilities, including fiduciary responsibility
Wed, May 14,

Recruiting and orienting new directors
Tues, July 22

Dealing with complaints from staff and members
Wed, Oct 22

Understanding the balance sheet, including fiduciary responsibility
Wed, Sept 10

CBL 300 series: Thinking and acting strategically

GM Compensation
Wed, April 9

Member Economic Participation
Wed, April 16

The Board's Role in Expansions
Wed, May 7

Including members in the Ends dialogue
Wed, July 9

Understanding member needs and motivations
Tues, October 14

Trends and life cycles of cooperatives
Wed, October 29

CBL101s (in-person, all day)
9 offered in 2008
Coming up…
Sept 20, Twin Cities
Oct 11, Sacramento

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