

01

UNDERSTANDING FINANCIAL STATEMENTS

1.1 FINANCIAL REPORTING

As part of the governance of sport and recreation organisations, financial reports are prepared and used to assist in the management of organisations and provide accountability and information to their members and other stakeholders. If an organisation is a registered charity, from 1 April 2015, there is a statutory requirement to attach financial statements in a new, prescribed format with the annual return to Charities Services*. Failure to comply would likely mean losing charitable status, which means the organisation may be subject to income tax.

* If you are unsure if your organisation is a registered charity, check the charities register at www.charities.govt.nz

Amateur sports clubs are exempt from income tax, unless there is a private benefit to their members. An exemption must be applied for in writing to Inland Revenue as it does not occur automatically. In the past, charitable organisations have had no specific requirements for financial reporting.

Organisations which are not registered charities will likely have, as part of their constitution or ruling document, a requirement to produce financial reports for their members, normally on an annual basis. If the operating expenditure for an organisation is over \$500,000 for the previous two accounting periods, the Charities Act requires, from 1 April 2015, that financial reports for registered charities must be audited or reviewed by a qualified auditor. A qualified auditor must be a member of an accredited body (see Financial Reporting Act sections 35 and 36).

An audit involves detailed testing of financial statements, which may include inspecting, observing, confirming, recalculating, and undertaking inquiry and analytical review, to be able to state that, in the auditor's opinion, the financial statements are free from material misstatement. The cost will vary between organisations so please contact a qualified auditor for a quote.

A review is a more limited approach and focuses on inquiry and analytical review, and concludes that nothing has been discovered that would cause a belief that the financial reports are not free from misstatement.

If a charitable organisation has expenditure of over \$1 million for the last two periods, an audit must be conducted by a qualified auditor.

Organisations that are below the expenditure thresholds or are not registered as a charity may still be required to have an audit or review if the organisation's rules or constitution require one.

1.2 TYPES OF FINANCIAL STATEMENTS

STATEMENT OF FINANCIAL PERFORMANCE

This statement shows if the organisation makes a surplus or deficit from its activities conducted over a 12-month period, called the “accounting period”. It is titled for the year ended as it reports on 12 months of transactions. (If the reporting period is less than 12 months, the title can be changed to “the month(s) ended”.)

The following elements make up the Statement of Financial Performance: Revenue, Expenses and Surplus/Deficit.

Revenue

Can be defined as income earned during the normal activities of the organisation, such as member subscriptions, donations, grants, and fundraising activities. It does not include funds received from money lent to the organisation.

Expenses

Are costs incurred to earn revenue as part of the normal activities of the organisation, such as salaries, electricity, rent, communications and printing. While most expenses are paid out of the bank account, items such as depreciation – which is the allocation of the cost of an asset, such as a computer, over its useful life – are non-cash items.

A Surplus

Will arise if revenue exceeds expenses; otherwise a deficit occurs.

STATEMENT OF FINANCIAL POSITION

The Statement of Financial Position (also referred to as “The Balance Sheet”) allows readers to assess the organisation’s financial standing. Three main areas make up this statement: Assets, Liabilities and Accumulated Funds. It is headed “as at” because it shows what we own and owe at a particular date.

Assets

Are what the organisation owns. Assets are broken down into categories such as current and non-current assets.

Current Assets:

Are cash or expected to be turned into cash within the next accounting period (i.e., a year). Examples are bank, member subscriptions due and inventory.

Non-Current Assets:

Are kept longer than a year, such as land, buildings and vehicles. We normally put these in a schedule at the end of the financial accounts.

Liabilities

Are obligations owed external to the organisation and are split into current and non-current liabilities.

Current Liabilities:

Are due for payment within the next accounting period and include accounts payable. They also include the current portion of long-term loans that are due for repayment in the next accounting period.

Non-Current Liabilities:

Are liabilities containing items such as mortgages and leases which are not due until the next accounting period or beyond.

Working Capital

Is the difference between current assets and current liabilities and is an important part of the Statement of Financial Position. This is because the resources to pay the current liabilities come from the current assets, once these are converted to cash.

Accumulated Funds

Are the difference between the assets and liabilities. Accumulated funds can contain funds contributed by members, accumulated surpluses, and reserves. Reserves are funds that have been set aside for a purpose such as a contingency fund in case of financial emergency, or a maintenance reserve for the organisation’s buildings.

FIT TIPS

Expenditure which creates an asset is called capital expenditure.

Prudent working capital management requires that inventory and accounts receivable are turned into cash as quickly as possible to pay liabilities.

1.3 ACCRUAL AND CASH ACCOUNTING

EXAMPLE: ACCRUAL ACCOUNTING

Accrual accounting includes all transactions incurred within the accounting period, whether they have been paid in cash or not.



A tennis organisation orders a new umpire stand from Acme Engineering.



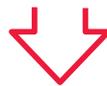
It arrives within the financial year ended 30 June 20X3, but doesn't have to be paid for until 20 July 20X3 – outside the financial year.



Under accrual accounting the umpire stand must be recorded in the accounts. How?



This is done by increasing the assets and the current liabilities as an account payable.



In the same way, if a transaction is paid for within the financial period but doesn't belong there, this must be removed by reducing the expense and creating a current asset called "Prepayments".



For example, if a subscription held by the organisation is paid in advance for the following year, subscription expenses are reduced and prepayments are increased.



Member subscriptions that are owing at the end of the year are recorded by increasing subscription income and creating a current asset called "Accounts Receivable".



If however, members pay subscriptions before they are due, the subscription income is reduced and a current liability account is created called "income received in advance".

EXAMPLE: CASH ACCOUNTING

Cash accounting is the simplest form of accounting and records only transactions during the accounting period which go in and out of the bank account(s). This simple example illustrates this:



A badminton organisation has received income of \$12,000 in cash and is owed \$3,000 in subs from its members at its financial year end.



It has paid cash expenses of \$9,000 and owes \$1,500 for invoices received but not yet paid for.

The difference between both methods is \$1,500 caused by the members' subs of \$3,000 not yet received, less the \$1,500 in expenses owing.

As shown in this example, there can be a difference between accrual profit and cash surplus. This can explain why we can make a healthy accrual profit, and yet not have as much cash in the bank as we expected.

	REVENUE	LESS EXPENSES	SURPLUS
Cash Accounting	\$12,000	\$9,000	\$3,000
Accrual Accounting	\$15,000 (\$12,000 + \$3,000)	\$10,500 (\$9,000 + \$1,500)	\$4,500

1.4 CASE STUDY

HAMPDEN TENNIS CLUB

Hampden Tennis Club is a fictitious New Zealand tennis club.

It is a registered charity and reports under Tier 3 of Public Benefit Entity Simple Format Reporting – Accrual (Not-for-profit).

As a prospective committee member, you have been given a preview of the financial reports section of their Performance Report, and some background information.

The club membership and subscriptions as at 30 June 20X3 are as follows (exclusive of GST):

90 adults@	\$347.82
14 midweek@	\$217.39
17 couples@	\$521.74
178 juniors@	\$310.44

During the last financial year, the club lost six adult, four midweek, and two couple memberships, but gained 15 junior members. You have been told the strong junior membership will continue, placing a strain on court use at times. Two adult members did not pay their subscriptions and their subs were written off.

Two years ago, the club undertook a strategic review.

As part of the review, the management committee was concerned about the steady decrease in adult members that had been occurring, although there had been strong growth in the juniors. It was decided to diversify the income as subscriptions were becoming unsustainable to support the club.



As the cash flow had appeared to allow it, a secretary/manager was employed at a cost of \$60,000 per annum from 1 July 20X1.

MANAGERS'S MAIN FOCUS AND IDEAS

Generate income for the club, such as applying for grants for operational expenses.

- Project manage the new pavilion project, which has been in the planning stage for over five years. The pavilion will contain changing rooms and shower facilities, which at present do not exist.
- Ask club members to sell wine as a fundraiser. The management committee decided to create a more social atmosphere to the club and try to raise more club funds in the process.
- A small bar area was created in the club house 18 months ago, complete with four bar tables.
- Encouraged by the initial success of the use of the bar, a part-time bar staff member was employed from 1 July 20X2 at a cost of \$15,000 per annum.
- Previously club members had volunteered for bar service, with the manager holding the liquor licence.

OTHER INCOME

Two years ago, a tennis coach was employed to run lessons for members and non-members. This has proved very popular, mainly due to the coach – a retired professional tennis player, now in his late 60s.

There have been some grumblings at the club about lessons taking place with ball machines and balls everywhere during the midweek.

There are eight courts in the complex, and Hampden Tennis Club was one of the first to adopt synthetic tennis courts and provide night-time lighting. The courts are now starting to show their age.

A growing source of revenue is hireage of the courts by non-members. Bookings are made online and paid by credit card, and a code is issued to unlock the security gate.

REQUIRED:

Based on the information given, and from the financial reports (below), make a list of your first impressions of the club.

HAMPDEN TENNIS CLUB

Below are the Statement of Financial Performance and Statement of Financial Position for the Hampden Tennis Club year ending 30 June 20X3. These will be used as the basis for examples in the following chapters.

Statement of Financial Performance for the year ended 30 June 20X3

	NOTES	\$ 20X3	\$ 20X2
REVENUE			
Grants, donations, fundraising and similar revenue	1	2,261	17,125
Fees, subscriptions and other revenue from members	2	66,435	68,474
Revenue from providing goods or services	3	125,896	83,251
Interest, dividends and other investment revenue	-	-	-
Total Revenue		194,592	167,950
EXPENSES			
Expenses related to public fundraising	4	2,087	-
Volunteer and employee related costs	5	75,000	60,000
Costs related to providing goods or services	6	51,865	28,253
Other expenses	7	100,411	96,475
Total Expenses		229,363	184,728
Surplus/(Deficit) for the period		(34,771)	(16,778)

	NOTES	\$ 20X3	\$ 20X2
NOTES TO THE STATEMENT OF FINANCIAL PERFORMANCE			
Grants, donations, fundraising and similar revenue	1		
Wine sales fundraiser		2,261	-
Grants (unrestricted as to purpose)		-	17,125
		2,261	17,125
Fees, subscriptions and other revenue from members	2		
Member subscriptions		66,435	68,474
		66,435	68,474
Revenue from providing goods or services	3		
Bar takings		36,522	23,551
Tennis lessons		67,800	38,100
Court bookings (non-members)		21,574	20,700
		125,896	82,351
Expenses related to public fundraiser	4		
Wine fundraiser		2,087	-
		2,087	-
Volunteer and employee related costs	5		
Wages and salaries		75,000	60,000
		75,000	60,000
Costs related to providing goods and services	6		
Bar purchases		29,565	24,553
Tennis professional (lessons)		20,000	10,000
Opening bar inventory		6,300	-
Less closing inventory		4,000	6,300
		51,865	28,253
Other expenses	7		
Audit		2,500	2,500
Bad debt		696	-
Bank fees		300	300
Cleaning		6,000	5,500
Depreciation		30,765	32,769
General expenses		3,561	6,779
Insurance		2,200	2,100
Interest		3,600	4,000
Electricity		24,600	22,650
Printing		1,200	800
Rates		2,300	2,150
Repairs and maintenance (tennis courts)		18,804	10,127
Repairs and maintenance (building)		2,485	5,600
Telephone/Internet		1,400	1,200
		100,411	96,475

HAMPDEN TENNIS CLUB

Statement of Financial Position as at 30 June 20X3

	NOTES	\$ 20X3	\$ 20X2
ASSETS			
Current Assets			
Bank accounts and cash		21,432	11,100
Accounts receivable	7	9,100	5,800
Accrued income		-	450
Inventory		4,000	6,300
Prepayments		1,100	1,000
Total Current Assets		35,632	24,650
Non-Current Assets			
Property, plant and equipment	8	394,452	420,000
Total Non-Current Assets		394,452	420,000
Total Assets		430,084	444,650
LIABILITIES			
Current Liabilities			
Accounts payable		4,000	6,000
Accrued expenses		3,550	3,800
GST payable		6,155	3,700
Unused grant with conditions	9	30,000	-
Borrowings	10	10,000	10,000
Total Current Liabilities		53,705	23,500
Non-Current Liabilities			
Borrowings	11	80,000	90,000
Total Non-Current Liabilities		80,000	90,000
Total Liabilities		133,705	113,500
NET ASSETS		296,379	331,150
ACCUMULATED FUNDS			
Retained earnings		320,650	337,428
Surplus/(Deficit)		(34,771)	(16,778)
Pavilion Reserve Fund	12	10,500	10,500
		296,379	331,150

NOTES	\$ 20X3	\$ 20X2		
NOTES TO THE STATEMENT OF FINANCIAL POSITION				
7. Accounts receivable				
Subscriptions owing (GST inclusive)	9,100	5,800		
Total	9,100	5,800		
8. Property, plant and equipment				
	Opening carrying amount	Additions	Depreciation impairment	Closing carrying amount
Club house	110,000		3,300	106,700
Land	140,000			140,000
Synthetic courts and lighting	151,000		21,895	129,105
Plant and equipment	19,000	5,217	5,570	18,647
	420,000	5,217	30,765	394,452
9. Unused grant with conditions				
Pavilion fund-project not yet started			30,000	-
Total			30,000	-
10. Borrowings				
Current Loans				
Hampden City Council 4% interest on reduced balance			10,000	10,000
Non-current Loans				
Hampden City Council 4% interest on reduced balance			80,000	90,000
Total Borrowings			90,000	100,000
II. Pavilion Reserve Fund				
Fund for new pavilion building			10,500	10,500
Total			10,500	10,500

HAMPDEN TENNIS CLUB

Statement of Cash Flows as at 30 June 20X3

	NOTES	\$ 20X3	\$ 20X2
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash was received from:			
Donations, fundraising and other similar receipts		32,261	-
Fees, subscriptions, receipts from members		62,869	65,284
Receipts from providing goods and services		126,346	88,259
Interest, dividends and other investment receipts		-	-
Net GST		1,764	3,789
Total		223,240	157,332
Cash was applied to:			
Payments to suppliers and employees		(197,691)	(122,632)
Net cash flows from operating activities		25,549	34,700
CASH FLOWS FROM INVESTING AND FINANCING ACTIVITIES			
Cash was applied to:			
Acquisition of property, plant and equipment		(5,217)	-
Loan repayments		(10,000)	(10,000)
Net cash flows from investing and financing activities		(15,217)	(10,000)
Net Increase/(Decrease) in Cash		10,332	24,700
Opening Cash		11,100	(13,600)
Closing Cash		21,432	11,100
This is represented by: Bank		21,432	11,100

1.5 ANALYSIS OF FINANCIAL STATEMENTS

HAMPDEN TENNIS CLUB

Financial statements can be analysed using ratios and percentages as tools to help determine the financial health of an organisation.

The ratios may, however, in their own right not be an indicator of how truly an organisation is performing and are subject to some limitations, such as:

Historical data being used. The past may not be indicative of the future.

Changes in the way information is presented. For example expenses may be grouped differently, making comparisons difficult.

Economic environment. If the economy is poor, this will make getting grants or attracting members to your club difficult, and may not necessarily be reflective of the club.

Changing patterns and tastes. These can have an impact on financial results, for example if leisure time is scarce with busy lifestyles.

Interpreting results can be difficult. For instance, an organisation might have sold off a strategic piece of land to temporarily create more cash, improving the ratios.

Despite these limitations, ratios and percentages can be very useful in understanding financial reports.



ANALYSIS OF FINANCIAL REPORTS – HAMPDEN TENNIS CLUB

Below is a list of common ratios that have been adapted for analysis of non-profit financial reports. We will use some of these in analysing the financial performance of Hampden Tennis Club.

A) Statement of Financial Performance

* Credit sales are issued to the customer via accounts receivable; therefore cash sales are not included in the formula

RATIO	FORMULA			EXPLANATION
Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales}}$	X	$\frac{100}{1}$	The percentage of gross profit per sales dollar from selling goods
Revenue mix	$\frac{\text{Income by category}}{\text{Total income}}$	X	$\frac{100}{1}$	Shows mix of income an organisation has by percentage
Mark-up	$\frac{\text{Gross profit}}{\text{Cost of sales}}$	X	$\frac{100}{1}$	Margin in relation to the cost of sales
Expense control	$\frac{\text{Expenses}}{\text{Revenue}}$	X	$\frac{100}{1}$	Individual expenses or categories of expenses can be compared as a percentage of sales. Trends are important
Fundraising efficiency	$\frac{\text{Fundraising expenses}}{\text{Fundraising revenue}}$	X	$\frac{100}{1}$	Measures fundraising expenses as a percentage of funds received
Programme efficiency	$\frac{\text{Programme expenses}}{\text{Total expenses}}$	X	$\frac{100}{1}$	Shows the amount of expenses spent on organisational programmes as opposed to total expenses
Return on revenue	$\frac{\text{Net surplus}}{\text{Revenue}}$	X	$\frac{100}{1}$	Surplus generated from each revenue dollar
Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$	X		Efficiency of inventory management
Days of sales in inventory	$\frac{\text{Ending inventory}}{\text{Cost of goods sold}}$	X	$\frac{100}{1}$	An alternative method of calculating inventory sales
Average collection period	$\frac{\text{Average accts rec}}{\text{Credit sales*}}$	X	$\frac{365}{1}$	Average days taken in collecting accounts receivable
Return on accumulated funds	$\frac{\text{Net surplus}}{\text{Avge accum funds}}$	X	$\frac{100}{1}$	Shows the percentage return on accumulated funds of the organisation
Interest cover	$\frac{\text{Net surplus before int}}{\text{Interest expense}}$			Shows ability to meet interest expense from the net surplus

B) Statement of Financial Position

RATIO	FORMULA			EXPLANATION
Debt/equity	$\frac{\text{Total liabilities}}{\text{Accumulated funds}}$	X	$\frac{100}{I}$	Funding provided by creditors versus accumulated funds
Equity ratio	$\frac{\text{Accumulated funds}}{\text{Total assets}}$	X	$\frac{100}{I}$	Shows percentage of assets funded by the club
Liabilities/ assets	$\frac{\text{Total liabilities}}{\text{Total assets}}$	X	$\frac{100}{I}$	Percentage of assets to liabilities
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$:I	Measures ability to meet short-term debt (solvency)
Liquidity, quick or acid test ratio	$\frac{\text{Cash + accts rec}}{\text{Current liabilities} - \text{bank overdraft}}$:I	Immediate liquidity: ability to meet immediate debts from near-cash assets
Days of cash on hand	$\frac{\text{Cash \& cash equiv}}{\text{Total operating exp}}$		365	The number of days that cash is available for cash expenses
Operating reserve ratio	$\frac{\text{Operating reserves}^*}{\text{Total operating exp}^\wedge}$:I	*Operating reserves equals total unrestricted net assets minus fixed assets (net of debt) \wedge Total operating expenses equals total annual expenses less depreciation

1.6 RECONCILIATION OF ACCRUAL AND OPERATING CASH SURPLUS

The net deficit in the Statement of Financial Performance for 20X3 was a loss of (\$34,771) through calculating revenue and expenses under the accrual system. Net cash flow from operating activities in the cash flow statement, however, showed a surplus of \$25,549.

How can we explain the difference?

We need a reconciliation that starts with the accrual loss of (\$34,771) and then add back the non-cash item of depreciation and the increases and decreases in the working capital areas – which are sources of, and depletions of, cash. We should arrive at our net cash flow from operating activities of \$25,549.

NET DEFICIT FROM STATEMENT OF FINANCIAL PERFORMANCE	(34,771)
Add back depreciation	30,765
Less decrease in accrued revenue	450
Add increase in accounts receivable	(3,300)
Less decrease in inventory	2,300
Add increase in prepayments	(100)
Add decrease in accounts payable	(2,000)
Add decrease in accrued expenses	(250)
Less increase in GST	2,455
Less increase in unused grant with conditions	30,000
Net cash flow from operating activities	25,549

Cash flow statements are useful to see the differences between the accrual surplus or deficit and the net cash flow operating activities increase or decrease. Although there has been an accrual loss, there has been a cash increase from operating activities.

The two main causes of these differences are the non-cash expense of depreciation and the unused grant which is not yet counted as revenue.

1.7 ANALYSIS OF STATEMENT OF FINANCIAL PERFORMANCE

FINANCIAL PERFORMANCE

Revenue – Vertical analysis

The vertical analysis shows the percentage of a line item, such as member subscriptions, against total revenue. It is calculated as follows:

$$\frac{\text{Revenue item}}{\text{Total revenue}} \times \frac{100}{1}$$

Example for wine sales fundraiser

$$\frac{2,261}{194,592} \times \frac{100}{1} = 1\%$$

REVENUE ITEM	\$ 20X3	% OF REVENUE	\$ 20X2	% OF REVENUE
Wine sales fundraiser	2,261	1%*	-	0%
Grants	-	0%	17,125	10%
Member subscriptions	66,435	34%	68,474	41%
Bar takings	36,522	19%	23,551	14%
Tennis lessons	67,800	35%	38,100	23%
Court bookings	21,574	11%	20,700	12%
Total Revenue	194,592	100%	167,950	100%

Horizontal analysis

The horizontal analysis shows the percentage increase or decrease of a revenue item between a base year and one or more years. It is calculated as follows:

$$\frac{\text{Dollar change} = \text{amount of item in comparison year (20X3)} - \text{amount in base year (20X2)}}{\text{Amount of item in base year}} \times \frac{100}{1}$$

Example for member subscriptions:

$$\frac{66,435 - 68,474}{68,474} \times \frac{100}{1} = -3\%$$

The vertical analysis shows membership revenue declining from 41% to 34% as a total of revenue, but down only 3% between the years, as shown by the horizontal analysis.

Tennis lessons have increased dramatically as a percentage of total revenue from 23% in 20X2 to 35% in 20X3 from the vertical analysis. The horizontal analysis shows a 78% increase between 20X2 and 20X3. Bar takings have also increased dramatically, but this is due to a full trading year in 20X3.

REVENUE ITEM	\$ 20X3	\$ 20X2	% 20X2/20X3
Wine sales fundraiser	2,261	-	-
Grants	-	17,125	-
Member subscriptions	66,435	68,474	-3%
Bar takings	36,522	23,551	55%
Tennis lessons	67,800	38,100	78%
Court bookings	21,574	20,700	4%
Total Revenue	194,592	167,950	

Grants, donations and fundraising

A major focus of the new manager was to raise revenue to diversify from its subscription base. An initiative was to purchase wine from a local winery and ask members to sell this. However not all members were on board with the fundraising. As at 30 June 20X3 all the wine had been sold or discarded as it was past its use by date.

Fundraising efficiency	$\frac{\text{Fundraising expenses}}{\text{Fundraising revenue}}$	X	$\frac{100}{1}$	
20X3	$\frac{2,087}{2,261}$	X	$\frac{100}{1}$	92.3% of revenue is taken up with expenses

Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales}}$	X	$\frac{100}{1}$	
20X3	$\frac{174^*}{2,261}$	X	$\frac{100}{1}$	7.7% – this means 7.7 cents gross profit per \$1 of sales

*Gross profit calculation: Wine sales \$2,261 less cost of wine \$2,087 = \$174

The profit was probably not worth the effort, and questions should be raised about the selling price per bottle, and the lack of buy-in from members which means it is probably not a good idea to run future similar fundraisers.

During the year a grant of \$30,000 was received to assist with the building of the new pavilion. This grant cannot be included as revenue until it is used for the purpose it was given, which has not yet begun. No other grant money was received during the year, despite this being a focus of the new manager.

From the vertical analysis, we have seen that the revenue is split amongst five areas, with subscriptions from members contributing 34% of the revenue. Although the reliance on subscription revenue has decreased from 20X2 diversifying its income to meet the costs of running the club is still an ongoing challenge. The membership has also been falling, and also two bad debts occurred during the year – which apparently has never occurred before (assume a beginning debtors' figure for 20X2 of \$2,700).

Average collection period subscriptions	$\frac{\text{Average accts rec}}{\text{Credit sales}}$	X	$\frac{365}{1}$	
20X3	$\frac{9,100 + 5,800}{2} / 66,435$	X	$\frac{365}{1}$	41 days
20X2	$\frac{(5,800 + 2,700)}{2} / 68,474$	X	$\frac{365}{1}$	23 days

As can be seen, the average time to collect subscriptions in 20X2 was 23 days, which increased to 41 days in 20X3 – a worrying trend, especially as there are falling club member numbers in the higher subscription category. The influx of juniors is bringing in more revenue but is the cause of complaints from the adult members because of their large usage of court time.

REVENUE FROM PROVIDING GOODS OR SERVICES:

Bar Takings

The mark-up and gross profit percentages have considerably weakened from 20X2 to 20X3. This requires investigation into why this has occurred.

The question also might be asked, after a modest profit in 20X2, why the club decided to spend \$15,000 in wages in 20X3 on a part-time bar person.

The inventory turnover has improved – that is, the club is selling more, but both mark-up and gross profit percentages offset the higher volume of sales.

It should also be pointed out that other expenses, such as electricity, have not been allocated to the bar, which would make the situation even more unprofitable.

		\$ 20X3		\$ 20X2
Bar sales		36,522		23,551
Less:				
Cost of sales				
Opening inventory	6,300		-	
Add purchases	29,565		24,553	
Less closing inventory	4,000	31,865	6,300	18,253
Gross profit		4,657		5,298
Less wages		15,000		0
Net/(loss) profit		(10,343)		5,298

Gross profit mark-up	$\frac{\text{Gross profit}}{\text{Cost of sales}}$	X	$\frac{100}{1}$	
20X3	$\frac{4,657}{31,865}$	X	$\frac{100}{1}$	= 14.7%

20X2	$\frac{5,298}{18,253}$	X	$\frac{100}{1}$	= 29.0%
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Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales}}$	X	$\frac{100}{1}$	
20X3	$\frac{4,657}{36,522}$	X	$\frac{100}{1}$	= 12.8%

20X2	$\frac{5,298}{23,551}$	X	$\frac{100}{1}$	= 22.5%
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Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Average inventory}}$		
20X3	$\frac{31,865}{(6,300 + 4,000)/2}$		= 6.2 times
20X1	$\frac{18,253}{(6,300 + 0)/2}$		= 5.8 times

Tennis Lessons

These began in 20X2 when the club received an approach from retired tennis professional Lewis Christian. They have proved to be very popular, especially amongst the high schools, which are sending students for lessons. The lessons are held in groups of 10, at a cost of \$30 + gst per person.

In 20X2, 127 hours of lessons were held for \$38,100 in sales, the cost of which was \$10,000 paid to Lewis. This yielded a profit of \$28,100.

There are no significant additional costs as Lewis is able to use old club tennis balls, and while they are not new, they are acceptable to use.

Realising how much profit the club was making from him, Lewis demanded an increase in his fee to the club for the next season.

During 20X3 the 226 hours of lessons were fully booked out and made a profit of \$47,800. Some members have heard rumblings from Lewis that the hourly fee of \$88.50 he received is still not enough.

The sales for 20X3 are calculated as 226 hours of lessons with 10 people paying \$30 each – therefore 226 x 10 people x \$30 = \$67,800 less the \$20,000 dollars paid to the professional.

Gross profit margin	$\frac{\text{Gross profit}}{\text{Sales}}$	X	$\frac{100}{1}$	
20X3	$\frac{47,800}{67,800}$	X	$\frac{100}{1}$	= 71%
20X2	$\frac{28,100}{38,100}$	X	$\frac{100}{1}$	= 74%

The profits, with no other significant expenses, are good at 74 cents per every dollar in 20X2 even though they decreased slightly to 71 cents in 20X3..

There is a risk to this income, however, as the professional is rumoured to be unhappy with his fees, and his coaching abilities make him an attractive drawcard for another club.

Court Bookings

Non-members

Non-members can book courts online and receive a code to unlock the club gate. The manager keeps an eye on the bookings during the week days to ensure their stay is no longer than booked.

Bookings from 5pm to 9pm on week nights are not policed, apart from any club members who may question non-members on courts.

The cost to book a court is \$46 + gst per hour.

Some of the more social members of the club who don't enter the competitions believe this is too cheap, and if four people play the cost is only \$11.50 + gst each. They are thinking of resigning and just paying the casual rates.

In 20X2, 450 hours were booked, and in 20X3, 469 hours. This averages out to around 25 hours per week over the season's 18 weeks. Most of the play occurs during the week days and on Sundays, with not too much distraction to the normal membership.

The income of \$20,700 in 20X2 and \$21,574 in 20X3 has no direct expenses, except the wear and tear on the synthetic courts.

Expenses

Vertical analysis

The vertical analysis for expenses is expressed as a percentage of total expenses.

EXPENSE ITEM	\$ 20X3	% OF EXPENSES	\$ 20X2	% OF EXPENSES
Audit	2,500	1%	2,500	2%
Bad debt	696	0%	-	0%
Bank fees	300	0%	300	0%
Cleaning	6,000	3%	5,500	4%
Depreciation	30,765	18%	32,769	21%
General expenses	3,561	2%	6,779	4%
Insurance	2,200	1%	2,100	1%
Interest	3,600	2%	4,000	3%
Electricity	24,600	14%	22,650	15%
Printing	1,200	1%	800	1%
Rates	2,300	1%	2,150	1%
Repairs & maintenance (courts)	18,804	11%	10,127	7%
Repairs & maintenance (building)	2,485	1%	5,600	4%
Telephone/Internet	1,400	1%	1,200	1%
Wages & Salaries	75,000	43%	60,000	39%
Total expenses	175,411		153,975	

Horizontal analysis

The horizontal analysis shows the percentage increase in expenses from 20X3 (base year) to 20X2.

EXPENSE ITEM	\$ 20X3	\$ 20X2	% CHANGE
Audit	2,500	2,500	-
Bad debt	696	-	-
Bank fees	300	300	-
Cleaning	6,000	5,500	9%
Depreciation	30,765	32,769	-6%
General expenses	3,561	6,779	-47%
Insurance	2,200	2,100	5%
Interest	3,600	4,000	-10%
Electricity	24,600	22,650	9%
Printing	1,200	800	50%
Rates	2,300	2,150	7%
Repairs & maintenance (courts)	18,804	10,127	86%
Repairs & maintenance (building)	2,485	5,600	-56%
Telephone/Internet	1,400	1,200	17%
Wages & salary	75,000	60,000	25%
Total expenses	175,411	156,475	

Repairs and maintenance of courts is a concern and shows an 86% increase from 20X2 to 20X3 in the horizontal analysis.

Wages and salary has increased due to the employment of a part-time bar staff member.

In analysing the vertical and horizontal expenses, attention should be paid to the percentage increases, although some items might display a large percentage increase, but a relatively small dollar amount.

Similarly, some items like bad debts, show no change however this is just because there is no base amount to compare it with. This should also be investigated depending on the item and dollar value.

We need to determine why there are significant changes, and whether— such as in the case of repairs and maintenance for the tennis courts - this trend is going to continue.

1.8 ANALYSIS OF STATEMENT OF FINANCIAL POSITION

WORKING CAPITAL

Working capital is the difference between the current assets and current liabilities.

In 20X2 there is \$24,650 of current assets less \$23,500 of current liabilities. This means there is an excess of current assets of \$1,150 (\$24,650 – \$23,500).

For the 20X3 year, current liabilities exceed current assets by \$18,073.

Further analysis of the working capital for 20X3 presents a problem.

The operating bank account as at 30 June 20X3 contains \$21,432, which is less than the grant of \$30,000. No separate bank account has been set up to tag these funds, which means the funds have been combined with the operating bank account. The grant received has been used to pay operating expenses and other costs, which is a serious financial position to be in.

We can further analyse working capital as follows:

Current Ratio

This ratio assesses our ability to pay our current liabilities from our current assets.

Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$:1	Ideal ratio is 2:1 (\$2 of current assets to \$1 of current liabilities)
20X3	$\frac{35,632}{53,705}$	= 0.66:1	This means there is 66 cents of current assets for every \$1 of current liability
20X2	$\frac{24,650}{23,500}$	= 1.05:1	This means there is 1.05 dollars of current assets for every \$1 of current liability

Quick Asset Ratio

Inventory is removed from this calculation as, in a situation where cash is needed in a hurry, selling inventory would likely lead to reduced selling prices, which might damage the organisation even further.

Quick asset ratio	$\frac{\text{Cash + accts rec} - \text{inventory}}{\text{Current liabilities}}$:1	The ratio assesses the entity's ability to pay its current liabilities with inventory removed. Ideal ratio is 1:1 (\$1 of current assets to \$1 of current liabilities)
20X3	$\frac{31,632}{53,705}$	= 0.59:1	This means there is 59 cents of current assets for every current liability dollar
20X2	$\frac{18,350}{23,500}$	= 0.78:1	This means there is 78 cents of current assets for every current liability dollar

Debt to Equity

This shows the funding provided by creditors versus accumulated funds. An organisation should, as a general rule, own more of itself than its creditors do.

Debt to equity ratio	$\frac{\text{Total liabilities}}{\text{Accumulated funds}}$:	1	Ideal is to have more equity than debt
20X3	$\frac{133,705}{296,379}$	=	0.45:1	This means there is 45 cents of liabilities to an accumulated funds dollar
20X2	$\frac{113,500}{331,150}$	=	0.34:1	This means there is 34 cents of liabilities to an accumulated funds dollar

While the ratio is less than 50 cents of total liabilities to accumulated funds, the trend is unfavourable and movsupwards from 0.34 to 0.45.

Liabilities to Assets

This measures the percentage of assets funded by liabilities.

Liabilities to assets	$\frac{\text{Total liabilities}}{\text{Total assets}}$	X	$\frac{100}{1}$		Ideal ratio is <50%
20X3	$\frac{133,705}{430,084}$	X	$\frac{100}{1}$	= 31.1%	This means assets are 31.1% funded by liabilities
20X2	$\frac{113,500}{444,650}$	X	$\frac{100}{1}$	= 25.5%	This means assets are 25.5% funded by liabilities

While the organisation's assets are funded with less than 50% liabilities, a concern is the increase from 20X2 to 20X3.

Equity Ratio

This is the inverse of the total liabilities to total assets percentage and shows the percentage of assets funded by the club.

Equity ratio	$\frac{\text{Accumulated funds}}{\text{Total assets}}$	X	$\frac{100}{1}$		Ideal ratio is >50% equity or ownership of assets
20X3	$\frac{296,379}{430,084}$	X	$\frac{100}{1}$	= 68.9%	This means the organisation owns 68.9% of its assets
20X2	$\frac{331,150}{444,650}$	X	$\frac{100}{1}$	= 74.5%	This means the organisation owns 74.5% of its assets

Although the ratio is above 50%, from 20X2 to 20X3 the percentage has worsened, with the club now owning 5.6% less of its assets.

Unrestricted Net Assets Ratio

Due to the uncertain nature of non-profit organisations (unanticipated decrease in revenues or increases in expenses), reserves are sometimes held to cushion the impact. Hampden Tennis Club has no reserves set aside in a bank account for this purpose. It does have a Pavilion Reserve Fund of \$10,500 for the building – but these funds are not held in a separate bank account.

If an organisation is creating a reserve out of its own funds, best practice is to ring-fence them by opening a separate bank account. That way the money does not get mixed up with the normal operating bank account.

During 20X3 Hampden Tennis Club received a grant of \$30,000 towards the new pavilion. This is restricted to being used for pavilion funds only. This remains a liability until it is spent on its restricted purpose, at which point it transfers from being a liability to income. However, similar to the club's own pavilion fund, the \$30,000 has been included in the normal bank account and, as noted above under working capital, this is undesirable to say the least.

The unrestricted net assets ratio measures the amount of net assets not subject to restrictions as a percentage of operating expenses.

Unrestricted net assets ratio	Unrestricted net assets		X	$\frac{100}{I}$	Ideal is >100%
	Total operating expenses				
20X3	$\frac{265,379^*}{229,363}$	X		$\frac{100}{I} = 116\%$	*Net assets less pavilion fund less restricted grant (\$296,379 - \$10,500 - \$30,000 = \$265,379)
20X2	$\frac{320,650^*}{184,728}$	X		$\frac{100}{I} = 174\%$	*Net assets less pavilion fund (\$331,150 - \$10,500 = \$320,650)

The unrestricted net assets to operating expenses in 20X2 is good at 174% of expenses, i.e., the net assets of the organisation cover well over a year's worth of expenses. However, in 20X3 this worsens to 116%.

Days of Cash on Hand

This measures the number of days of cash that an organisation has to pay its current obligations.

Days of cash on hand	Cash & cash equiv* Total operating exp – depn	X 365	Ideal ratio is at least 90 days
20X3	$\frac{21,432}{229,363 - 30,765}$	X 365	= 39 days
20X2	$\frac{11,100}{184,728 - 32,769}$	X 365	= 27 days

*Cash and cash equivalents include term deposits (if any)

While this ratio looks healthy and increases from 20X2 to 20X3 – the bank account figure contains restricted cash – i.e., \$10,500 for the pavilion reserve in both 20X2 and 20X3 – and in 20X3 there is a \$30,000 restricted grant that has been deposited.

If we remove the restricted reserve (\$10,500) and cash grant item (\$30,000), the days of cash on hand looks like this:

20X3	$\frac{21,432 - 10,500 - 30,000}{229,363 - 30,765}$	X 365	= -35 days
20X2	$\frac{11,100 - 10,500}{184,728 - 32,769}$	X 365	= 1 day

The days of cash on hand now moves from 1 day to negative -35 days, which of course is a very serious situation and means it is unable to pay its obligations.

1.9

EXERCISE 1

FINANCIAL ACCOUNTS ANALYSIS

The Tuki Tuki Greens Golf Club Inc. is a non-profit golf club, which has had ups and downs financially in recent years.

The club has 194 members in 20X3 – up from 190 in 20X2. Due to the very low membership numbers, which are capped at 200, club members occasionally contribute financially to the club. They are quite happy to do that, as no bookings are required to play the course because of the low membership numbers for a golf course of this quality.

From the start, the club has leased the golf course from a nearby farming family trust, but owns all of the improvements such as the club house and maintenance equipment sheds.

To save cash handling and bank fees, club members must use their club membership cards to purchase items from the bar, which means all sales are on credit and are entered through the club's computer system. At the end of the month members are emailed a statement and expected to settle in full within 20 days.

A committee member of the golf club's management team has approached you for help to analyse the accounts as he is concerned about the club's financial position, especially as he may get some tricky questions at the annual general meeting coming up.

Additional information

- The club levied members an extra \$110,000 during the year to pay for fairway irrigation and replacement fixed assets.
- The level of both Inventory and Accounts Receivable remained stable throughout 20X2, so the closing balance figures at year end can be used as an average.
- The loan, which was taken out on 1 October 20X2, is an interest-only loan, and repayable in five years' time. Interest is payable at 8% per annum.
- The interest rate payable on the mortgage is 10% per year and the mortgage was increased on 1 October 20X2.
- The club is very unhappy with the financial position for 20X3, given the successful efforts to increase bar sales and to raise the capital from members.

TUKI TUKI GREENS GOLF CLUB INCORPORATED

Statement of Financial Performance for the year ended 30 September 20X3

	\$		\$	
	20X3		20X2	
Member subscriptions (all credit)		291,000		285,000
Sales (all credit)	230,000		160,000	
Less cost of sales	126,500		95,000	
Gross Profit		103,500		65,000
Rent Received		10,000		10,000
Total Revenue		404,500		360,000
Less operating expenses				
Course maintenance	286,700		264,000	
Administration	80,000		70,000	
Financial	16,800	383,500	6,000	340,000
Surplus		21,000		20,000



TUKI TUKI GREENS GOLF CLUB INCORPORATED

Statement of Financial Performance for the year ended 30 September 20X3

	\$ 20X3	\$ 20X2
Accumulated Funds		
Capital from members	71,000	50,000
Reserves	110,000	
Surplus	20,000	20,000
Total	201,000	70,000
Current Assets		
Cash	2,000	-
Prepaid expenses	8,000	-
Accounts receivable (subscriptions)	61,000	25,000
Accounts receivable (bar sales)	50,000	15,000
Inventory (bar stock)	80,000	30,000
Total	201,000	70,000
Non-Current Assets		
Buildings	110,000	116,000
Course improvements	126,000	34,000
Machinery	64,000	50,000
Total Non-Current Assets	300,000	200,000
Total Assets	501,000	270,000
Current Liabilities		
Bank overdraft	35,000	80,000
Accounts payable	63,000	45,000
GST payable	22,000	15,000
Total Current Liabilities	120,000	140,000
Non-Current Liabilities		
Loan	60,000	
Mortgage	120,000	60,000
Total	180,000	60,000
Total Liabilities	300,000	200,000
Net Assets	200,000	70,000

