



ANNUAL MEETING HANDOUT

Balance Sheets: What Do They Really Tell You?

This working session showed attendees what to look for on the balance sheet, how to do calculations to gauge a museum's health and ways to format statements for more clarity.

Presenters

- » **Patricia Egan**, Principal, Cool Spring Analytics
- » **Nancy Sasser**, Cool Spring Analytics

Annual Meeting & MuseumExpo

As the museum field's premier professional development opportunity, the Alliance's Annual Meeting & MuseumExpo showcases the best thinking from practitioners and visionaries on major issues confronting museums and the communities they serve.

This session handout is from the 2013 Annual Meeting in Baltimore.

Interpreting the Balance Sheet

AAM Conference May 22, 2013, 8:45 am

Patricia Egan & Nancy Sasser

Unrestricted Statement of Activity or Income Statement

Revenue

Operating:

- ▶ Admissions, memberships, other earned
- ▶ Investment income
- ▶ Contributions
- ▶ Net assets released from restriction

Non-operating:

- ▶ Gifts for facilities
- ▶ Gains/losses on investments
- ▶ Net assets released from restriction

Expenses

- ▶ Program
- ▶ Education
- ▶ Marketing
- ▶ Development
- ▶ Facility
- ▶ Administration
- ▶ Depreciation

—

—

—

Change in Unrestricted Net Assets = Surplus or Deficit = Net Income or Loss

- ▶ Operating net income
- ▶ Net gifts for capital campaigns, facilities
- ▶ Net market gains and losses on investments

+

Unrestricted Net Assets beginning of year

—

—

Unrestricted Net Assets end of year

Statement of Position or Balance Sheet

Net Assets (the accumulation of all the years of a museum's surpluses and deficits)

- ▶ Unrestricted
- ▶ Temporarily restricted
- ▶ Permanently restricted

==

Assets (what you own)

- ▶ Bank & investment accounts
- ▶ Money owed to you
- ▶ Building & Equipment

—

Liabilities (what you owe)

- ▶ Payables to vendors
- ▶ Deferred revenue
- ▶ Loans

Net Asset Classes

- ▶ **Unrestricted (UR)** - available to be spent now on operations. Includes accumulated operating surpluses and deficits, property and equipment, and any board-designated funds, such as a cash reserve or endowment.
- ▶ **Temporarily Restricted (TR)** - available either at a future date or for a specific project – not available now to be spent on operations. Includes funds that are restricted by the donor and will be used for an operating activity in the future – for example, a grant for a future exhibition – or a grant for capital purposes, such as purchasing property and equipment. When the restriction is fulfilled, then the net assets are moved (released) to the unrestricted operating statement.
- ▶ **Permanently Restricted (PR)** - funds are never spent, but income generated by investment of the funds may be spent. Most often these are permanent endowment funds.

Four Measures of Financial Health

- ▶ **Working Capital** - consists of unrestricted resources available for operations. Adequate working capital provides financial strength and flexibility to an organization and the ability to meet obligations as they come due. Each organization should determine its own working capital needs. Working capital is the fundamental building block without which organizations cannot grow, take risks, and fulfill their programmatic mission.
- ▶ **Invested Capital** - includes assets usually invested long-term, approximates reserves and endowment, and may be unrestricted, temporarily restricted, or permanently restricted. Income from invested capital is generally available for operations or specific purposes. Each organization should target an appropriate level of invested capital after developing sufficient working capital
- ▶ **Fixed Assets** - includes all land, buildings, equipment, and other fixed assets owned by an organization. The amount that an organization invests in fixed assets will vary, and should be tailored to the needs of the organization and the larger community.
- ▶ **Debt** - includes all short and long-term contractual obligations of an organization such as notes, bonds, and leases payable. Ability to repay debt is key to financial health.

Working Capital

Liquidity + Reserves

**Working Capital = UR current assets – UR current liabilities
+ TR or PR working capital reserves**

or

**Working Capital = UR net assets – Fixed assets (net of
depreciation) - UR investments* + TR or PR working
capital reserves**

Questions to Ask:

- ▶ Is working capital positive or negative?
- ▶ Has working capital grown or declined during the past several years?
- ▶ Is working capital growing in proportion to the growth in operating size (see calculation below)?

Working Capital Ratio = Working capital/Total expenses

Working Capital Ratio

The working capital ratio relates working capital to the size of the organization's operation. An increase in the ratio over time, which indicates growth in financial strength at least in proportion to growth in operating size, is a healthy trend. Each museum should determine the amount of working capital it needs, considering normal operating needs and future financial needs. An organization with a negative ratio has been forced to borrow from temporarily restricted funds or deferred revenue, from the bank, or by stretching what it owes vendors. Organizations with negative ratios are likely to suffer periods of severe cash flow stress or financial crisis.

* A board-designated endowment fund technically could be made available to the company for working capital purposes if the board votes to change the designation on the funds. We're assuming that if a museum has created a board-designated endowment fund, the board and staff would prefer to maintain that fund so it can generate revenue to support operations.

Invested Capital

**Invested Capital (approximates endowment and reserves)
= Total long-term investments**

Questions to Ask:

- ▶ Is invested capital growing or declining?
- ▶ Is invested capital growing in proportion to the growth in operating size (see calculation below)?

Investment Ratio = Total investments/Total expenses

Investment Ratio

Invested capital that provides a significant revenue stream for operations increases the strength and sustainability of an organization. The investment ratio measures the approximate level of invested capital (endowment and reserves). An increase in the ratio over time, which indicates investment growth at least in proportion to growth in operating size, is a healthy trend.

Fixed Assets

$$\text{Fixed Assets} = \text{Total property \& equipment} - \text{Accumulated depreciation}$$

Questions to Ask:

- ▶ Are fixed assets growing or declining?
- ▶ Has the museum projected the increased operating costs of proposed facility additions prior to adding facilities?
- ▶ Is the museum investing in its building and equipment on an ongoing basis to avoid deferred maintenance (see calculation below)?

$$\text{Deferred Maintenance Indicator} = \frac{\text{Accumulated depreciation}}{\text{Depreciation expense}}$$

Deferred Maintenance Indicator

The deferred maintenance indicator is used to assess the relative likelihood of deferred maintenance and need for investment in fixed assets. A declining trend in the ratio is a healthy trend. For those organizations that own facilities or have major leasehold improvements, a deferred maintenance indicator greater than fifteen years may indicate the need to invest in plant. For organizations that own furniture and equipment, but no facility, a deferred maintenance indicator in excess of six years may indicate a need to invest in equipment.

Total Debt

**Debt = Notes/loans payable + Bonds payable +
Lines of credit drawn down + Capital leases payable**

Questions to Ask:

- ▶ Is debt increasing or decreasing?
- ▶ Does the museum have a dedicated source of funds for repayment, for example, pledges to be collected?
- ▶ Has the museum had difficulty making payments on a timely basis?
- ▶ What portion of annual revenue is dedicated to servicing debt, both principal and interest? Is the debt service increasing faster than annual revenues?

Statement of Financial Position - Balance Sheet
June 30, 2009

| | Museum A | Museum Z |
|--|-------------------------|-------------------------|
| Assets | | |
| Cash and cash equivalents | 1,221,000 | 585,000 |
| Accounts receivable and contributions receivable | 950,000 | 450,000 |
| Inventory | 185,000 | 170,000 |
| Prepaid expenses | 150,000 | 200,000 |
| Total current assets | <u>2,506,000</u> | <u>1,405,000</u> |
| Investments | 1,050,000 | 1,800,000 |
| Property and equipment, net | 4,900,000 | 1,200,000 |
| Total assets | <u><u>8,456,000</u></u> | <u><u>4,405,000</u></u> |
| Liabilities and Net Assets | | |
| Liabilities | | |
| Accounts payable and accrued expenses | 425,000 | 250,000 |
| Deferred revenue | 141,000 | 105,000 |
| Notes payable | 450,000 | 100,000 |
| Total current liabilities | <u>1,016,000</u> | <u>455,000</u> |
| Net Assets | | |
| Unrestricted | 2,440,000 | 1,750,000 |
| Temporarily restricted | 2,850,000 | 400,000 |
| Permanently restricted | 2,150,000 | 1,800,000 |
| Total net assets | <u>7,440,000</u> | <u>3,950,000</u> |
| Total liabilities & net assets | <u><u>8,456,000</u></u> | <u><u>4,405,000</u></u> |

Unrestricted Revenue & Expenses
FY 2009

| | Museum A | Museum Z |
|--|----------------------|------------------------|
| Earned Revenue | 1,620,000 | 1,475,000 |
| Investment Revenue | 10,000 | (75,000) |
| Contributed Revenue | 4,880,000 | 4,550,000 |
| Total Revenue | <u>6,510,000</u> | <u>5,950,000</u> |
| Total Expenses | <u>6,450,000</u> | <u>6,000,000</u> |
| Net Income (Change in Unrestricted Net Assets) | <u><u>60,000</u></u> | <u><u>(50,000)</u></u> |

Calculation of Ratios

| | Museum A | Museum Z |
|---|--------------------|------------------|
| Working Capital | | |
| Unrestricted net assets | 2,440,000 | 1,750,000 |
| Less property and equipment (net) | 4,900,000 | 1,200,000 |
| Less unrestricted investments | 0 | 0 |
| Plus TR or PR working capital reserves | 0 | 0 |
| Working capital | (2,460,000) | 550,000 |
| Working Capital Ratio | | |
| Working capital | (2,460,000) | 550,000 |
| Divided by total expenses | 6,450,000 | 6,000,000 |
| Working capital ratio | -38% | 9% |
| WCR in months | (5) | 1 |
| Investments | | |
| | 1,050,000 | 1,800,000 |
| Investment Ratio | | |
| Total investments | 1,050,000 | 1,800,000 |
| Divided by total expenses | 6,450,000 | 6,000,000 |
| Investment ratio | 16% | 30% |
| Fixed Assets | | |
| | 4,900,000 | 1,200,000 |
| Deferred Maintenance Indicator | | |
| Accumulated depreciation | 3,300,000 | 450,000 |
| Divided by depreciation expense | 275,000 | 115,000 |
| Deferred maintenance indicator (yrs) | 12.0 | 3.9 |
| Debt | | |
| Notes, mortgages payable | 450,000 | 100,000 |
| Bonds payable | 0 | 0 |
| Lines of credit | 0 | 0 |
| Capital leases payable | 0 | 0 |
| Total Debt | 450,000 | 100,000 |

Museum A

Disaggregated Statement of Position

June 30, 2009

| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total |
|--|--------------------|------------------------|------------------------|-----------|
| Assets | | | | |
| Cash and cash equivalents | (1,779,000) | 2,800,000 | 200,000 | 1,221,000 |
| Accounts receivable & contributions receivable | - | 50,000 | 900,000 | 950,000 |
| Inventory | 185,000 | | | 185,000 |
| Prepaid expenses | 150,000 | - | - | 150,000 |
| Total current assets | (1,444,000) | 2,850,000 | 1,100,000 | 2,506,000 |
| Investments | - | - | 1,050,000 | 1,050,000 |
| Property and equipment, net | 4,900,000 | - | - | 4,900,000 |
| Total assets | 3,456,000 | 2,850,000 | 2,150,000 | 8,456,000 |
| Liabilities and Net Assets | | | | |
| Liabilities | | | | |
| Accounts payable and accrued expenses | 425,000 | - | - | 425,000 |
| Deferred revenue | 141,000 | - | - | 141,000 |
| Notes payable | 450,000 | - | - | 450,000 |
| Total current liabilities | 1,016,000 | - | - | 1,016,000 |
| Net Assets | | | | |
| Unrestricted | 2,440,000 | - | - | 2,440,000 |
| Temporarily restricted | - | 2,850,000 | - | 2,850,000 |
| Permanently restricted | - | - | 2,150,000 | 2,150,000 |
| Total net assets | 2,440,000 | 2,850,000 | 2,150,000 | 7,440,000 |
| Total liabilities & net assets | 3,456,000 | 2,850,000 | 2,150,000 | 8,456,000 |
| Working capital (other formula) | | | | |
| UR current assets | (1,444,000) | | | |
| minus current liabilities | 1,016,000 | | | |
| Working capital | (2,460,000) | | | |