

Financial ratio analysis and private club operations

Measurement of financial performance by ratio analysis helps identify organizational strengths and weaknesses by detecting financial anomalies and focusing attention on items of organizational importance. Given that the mission of a nonprofit organization – which most private clubs are – is the reason for its existence, the use of financial resources must be measured in relation to the mission.

While mission and vision statements are often wordy and seemingly convoluted expressions resulting from long meetings and brainstorming sessions, for the purposes of this paper, consider the much simpler verbiage from Note 1 to any club's audited financial statements: "The purpose of the club is to operate the facilities for the benefit of its members." The importance of understanding the link between financial resources and the mission in a nonprofit organization was succinctly articulated by a former CFO of a large nonprofit, when he said, "People who are in financial capacities at nonprofit organizations have to understand that we budget for the mission. We don't change the mission

to suit the budget." Given the factors that differentiate most clubs from for-profit businesses, care must be given to select meaningful ratios that work within the nonprofit arena and measure those items that are critical to the financial well-being of clubs.

When measuring the relationship of financial performance and mission in a private club, four basic questions should be asked:

1. Are financial resources sufficient to support the mission of the club?
2. What financial resources are available to support the mission of the club?
3. How are existing financial resources being used to support the mission of the club?
4. Are financial resources being applied efficiently and effectively to support the mission of the club?

Four generally accepted categories of financial ratios exist. Each is applicable in answering these four questions.

Question	Ratio type
Are financial resources sufficient to support the mission of the club?	Liquidity
What financial resources are available to support the mission of the club?	Solvency
How are existing financial resources being used to support the mission of the club?	Activity
Are financial resources being applied efficiently and effectively to support the mission of the club?	Profitability

What follows is an explanation of how to determine answers to these questions through the application of these four types of financial ratios.

Liquidity ratios

Liquidity ratios measure the ability of clubs to meet their short-term obligations and are consequently concerned with the sufficiency and flexibility of financial resources. Four typical ratios that are used to measure liquidity are the current ratio, quick ratio, receivable turnover (days sales outstanding) and operating cash flow to current liabilities.

Current ratio

The current ratio (current assets / current liabilities) is a measure of working capital. This measurement is critical to any business — and a private club is no exception. Current ratios of higher than 1.0 indicate that the club does not have a deficit in working capital, and therefore, is at risk. A ratio of exactly 1.0 indicates that current assets equal current liabilities, and therefore, enough assets are on-hand to meet known obligations in the next twelve months as they exist at any given balance sheet date. A current ratio of less than 1.0 indicates that current assets are insufficient, in terms of covering current liabilities. Such situations should be addressed and a club in such a position should analyze the reasons for this position to understand how to begin the move to a better standing. Clubs with current portions of long-term debt on the balance sheet, which is secured by a capital assessment stream, might be unduly penalized by this ratio and the accounting for capital assessments. While the current portion of debt would be recorded on the balance sheet, the capital assessment receivable to cover the debt is not typically recorded, and the current ratio would be negatively impacted. This highlights the importance of understanding the components of the ratio and capital and debt structure.

Quick ratio

The quick ratio is an indicator of short-term liquidity and measures the ability to meet short-term obligations with the most liquid assets. The higher the quick ratio is, the better the position of the club.

The quick ratio is calculated as:

$$\text{Quick ratio} = \frac{(\text{Current assets} - \text{Inventories})}{\text{Current liabilities}}$$

This ratio is also known as the “acid-test ratio” or the “quick assets ratio.” The quick ratio is more conservative than the current ratio because it excludes inventory from current assets. Inventory is excluded because some clubs have difficulty turning their inventory into cash — particularly pro-shop inventory. In the event that short-term obligations need to be paid off immediately, there are situations in which the current ratio would overestimate a club's short-term financial strength.

Receivable turnover (days sales outstanding)

Receivable turnover or days sales outstanding (DSO) is a measure of the average number of days that a club takes to collect revenue after a sale has been made. A low DSO reveals that it takes fewer days to collect its accounts receivable. A high DSO number shows that a club is providing its products and services to customers on credit and taking longer to collect money. As the majority of clubs allow 30 days for members to pay their bills, a DSO in excess of that could signal a worrisome trend.

Days sales outstanding is calculated as:

$$\text{DSO} = \frac{\text{Accounts receivable} \times \text{Number of days}}{\text{Total credit sales}}$$

Due to the necessity of cash in operating a club, it is in the best interest of the club — and ultimately its members — to collect outstanding receivables as quickly as possible. By quickly turning sales into cash, a club is able to put the cash to use — ideally to reinvest and fulfill the club mission. The DSO can be used to determine whether a club is effectively collecting money. Given that most clubs prepare annual budgets on a cash basis (not factoring in member payment delays), closely monitoring this ratio can help predict when line of credit facilities or other financing sources for operations are needed.

Operating cash flow ratio

The operating cash flow (OCF) ratio measures how well cash flow generated from a club's operations cover current liabilities.

$$\text{OCF} = \frac{\text{Cash flow from operations}}{\text{Current liabilities}}$$

The operating cash flow ratio can gauge liquidity in the short-term. Using cash flow, as opposed to income, is sometimes a better indication of liquidity simply because cash is how bills are normally paid.

Target setting

While there are a few studies of these ratios for the club industry, the most powerful use of them is to monitor individual performance. Understanding how these statistics trend over time is vitally important to predicting problems and issues that might not be obvious in monthly or quarterly financial statements.

Solvency ratios

Solvency ratios reveal whether a company can meet its long-term obligations. While debt was once a taboo subject in club boardrooms, today it has become much more acceptable for a club to carry some level. That debt has been accompanied by increased scrutiny of club financial statements through the use of debt covenants by lending institutions. Unfortunately, many of these institutions fail to understand thoroughly the economics of private clubs, which has led to covenants designed for commercial clubs being applied to the financial statements of clubs, which are, in most cases, entirely different enterprises.

Consider the following solvency ratios and how they might be applied to club financial statements on a monthly, quarterly or annual basis. Since no two clubs are alike, trending these ratios historically for an specific club is their most valuable purpose.

Debt ratio

The debt ratio compares total debt to total assets and can be used to gain a general idea as to the amount of leverage being used by a club. A low percentage means that the club is less dependent on leverage (i.e. money borrowed from and/or owed to others). The lower the percentage, the less leverage a club is using and the stronger its equity position. In general, the higher the ratio, the more risk that club is considered to have taken on.

$$\text{Debt Ratio} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

The easy-to-calculate debt ratio is helpful to potential members looking for a quick glance at a club's leverage.

However, note that this ratio is not a pure measure of debt (or indebtedness), as it includes operational liabilities, such as accounts payable and taxes payable. Clubs use these operational liabilities as going concerns to fund the day-to-day operations and are not really "debts" in the leverage sense of this ratio.

Debt to equity ratio

The debt-equity ratio is another leverage method by which a comparison is made of a club's total liabilities to its total members' equity. This is a measurement of how much suppliers, lenders, creditors and obligors have committed to the club versus what the members have committed.

The debt-equity ratio provides another vantage point on a club's leverage position, in this case, comparing total liabilities to members' equity, as opposed to total assets in the debt ratio. Similar to the debt ratio, a lower the percentage means that a club is using less leverage and has a stronger equity position.

$$\text{Debt-Equity Ratio} = \frac{\text{Total liabilities}}{\text{Shareholders' equity}}$$

As the debt-equity ratio appears frequently in investment literature, prospective members might be likely to apply it when assessing the financial strength of a club to join. However, like the debt ratio, this ratio is not a pure measurement of debt because it includes operational liabilities in total liabilities.

The debt-equity ratio provides a more dramatic perspective on a club's leverage position than the debt ratio percentage.

Capitalization ratio

The capitalization ratio measures the debt component of a club's capital structure, or capitalization (i.e. the sum of long-term debt liabilities and members' equity) to support a club's operations and growth.

Long-term debt is divided by the sum of long-term debt and members' equity. This ratio is considered to be one of the more meaningful of the debt ratios as it delivers key insight into a club's use of leverage.

There is no right amount of debt. Leverage varies according to capital projects that have been undertaken or deferred, and the stage of the club's development. Nevertheless, low debt and high equity levels in the capitalization ratio indicate "investment" quality.

$$\text{Capitalization Ratio} = \frac{\text{Long-term debt}}{(\text{Long-term debt} + \text{Shareholders' equity})}$$

A club's capitalization (not to be confused with its market capitalization) is the term used to describe the makeup of permanent or long-term capital, which consists of both long-term debt and members' equity. A low level of debt and a healthy proportion of equity in capital structure is often viewed as an indication of financial fitness.

Prudent use of leverage (debt) increases the financial resources available to a club for growth and expansion. It assumes that the club can generate more on borrowed funds than it pays in interest expense and fees on these funds. However successful this formula may seem, it does require a club to maintain a solid record of complying with its various borrowing commitments. As mentioned previously, the capitalization ratio is one of the more meaningful debt ratios because it focuses on the relationship of debt liabilities as a component of total capital base (i.e. the capital injected by members and lenders).

Interest coverage ratio

The interest coverage ratio is used to determine how easily a club can pay interest expenses on outstanding debt. Some version of this ratio is usually embedded into the covenants of a mortgage or other similar debt. The ratio is calculated by dividing earnings before interest and taxes (EBIT) by the interest expenses for the same period. The lower the ratio, the more the club is burdened by debt expense. When an interest coverage ratio is 1.5 or lower, the ability to meet interest expenses may be questionable.

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest expense}}$$

The ability to stay current with interest payment obligations is a critical ongoing concern. While the non-payment of debt principal is a seriously negative condition, a club with financial/operational difficulties can stay alive, as long as it is able to service its interest expenses.

In a more positive sense, prudent borrowing makes sense for most clubs. The operative word here is "prudent." Interest expenses affect profitability, so the cost-benefit analysis dictates that borrowing money to fund assets has to have a positive effect. An ample interest coverage ratio would be an indicator of this circumstance, as well as a substantial additional debt capacity. This ratio can be tricky for banks to apply to clubs, as EBIT would include depreciation for commercial companies. Clubs often consider capital assessments, joining fees or similar capital charges as the "revenue" items that would cover depreciation. For this reason, clubs need to ensure an understanding of how banks intend to calculate the various ratios that may be included with their debt agreements.

Cash flow to debt ratio

This coverage ratio compares operating cash flow to total debt, which, for purposes of this ratio, is defined as the sum of short-term borrowings (i.e. the current portion of long-term debt and long-term debt). This ratio provides an indication of a club's ability to cover total debt with its yearly cash flow from operations. The higher the percentage ratio is, the better the club's ability to carry its total debt.

$$\text{Cash Flow to Debt Ratio} = \frac{\text{Operating cash flow}}{\text{Total debt}}$$

Some variation of this ratio is often part of a club's debt covenant requirements. Defining operating cash flow from the lender's perspective is again critical to ensuring a club can enter into debt with a clear understanding of the commitment and benchmarks to which it is agreeing. Failure to achieve some of these ratios can trigger dire financial consequences, including allowing the lender to call the debt.

Activity ratios

Activity ratios focus on the allocation of scarce resources. In considering its mission, a club identifies those activities that are critical to members as a whole and those activities that are, in essence, support activities. All clubs must determine how resources are used or distributed between various activities.

Different activity ratios can be applied to a club's financial statement on a monthly, quarterly or annual basis. Since clubs can have widely differing activities, care should be taken to measure the activities that matter to the members — as outlined in a strategic plan.

Turnover ratios

Turnover ratios measure the number of times inventory is replaced during a given time period. The turnover ratio is calculated as cost of goods sold divided by average inventory during the time period. A high turnover ratio indicates that the club is producing and selling its goods quickly. Turnover ratios should be calculated for all significant inventories sold (e.g. food and beverage, golf and other merchandise). Naturally, turnover ratios for perishable items, such as food, should be significantly higher than those of non-perishables. A decrease in turnover ratios should beget questions regarding the menu or merchandise offerings as members appear disinterested (assuming prices have not changed).

$$\text{Inventory Turnover} = \frac{\text{Cost of sales}}{\text{Average inventory during the time period}}$$

Turnover ratios are most powerful when viewed alongside other operating data. For example, consider if food revenue decreases but food turnover increases, assuming no increase in cost of food or decrease in menu prices, why inventory might turn faster. This could be an indication that inventory is leaving through the back door. Factoring ratios, such as turnover into the budgeting process, can assist in forecasting cash flow requirements.

Payroll ratios

Given that payroll is the single largest controllable expense at any club, it stands to reason that it is the area that most clubs would scrutinize from as many perspectives as possible. While clubs have long been advised to monitor payroll as a percentage of operating revenues, many have focused on a couple of variations of this theme. The theory behind monitoring payroll as percentage of revenues is expressed by a simple question. If revenues are not as high as anticipated or budgeted, how quickly were or can changes be made to reduce related labor costs?

Two of the most popular ratios are:

$$\text{Overtime Burden} = \frac{\text{Overtime costs}}{\text{Total hourly labor}}$$

$$\text{Hourly Labor Burden} = \frac{\text{Hourly labor}}{\text{Operating revenue}}$$

One club reports that by monitoring overtime burden, it reduced overtime to less than 1 percent of hourly labor, which was down from 4 percent a few years prior. This equated to significant savings and the discovery that overtime was being used as a vehicle to pay employees above approved hourly wages. The club now monitors the statistic on a weekly basis and shares the data with all managers to reinforce accountability.

Many clubs monitor the hourly labor burden rate on a daily, weekly and monthly basis for significant departments, in an effort to ensure they are staffed as efficiently as possible. A fine line exists between delivering efficiency and sacrificing member service, but the most successful clubs are those that monitor how that line moves on a daily basis.

Many other activity ratios can be applied to clubs. Cover count and average check analysis are commonplace, but when used in conjunction with ratios such as inventory turnover, they can shed even more light on what has happened at the club, and indeed, what may happen going forward.

Profitability ratios

Profitability ratios are used to assess the ability to generate earnings as compared to expenses or other relevant costs during a specific period of time. For most profitability ratios, clubs will want to have a higher value compared to a previous period or industry benchmark. As one might expect, applying traditional ratios for profitability, which emanate from the for-profit world, can be challenging. Some of the nuances of club economics and the source and use of funds in clubs can create a challenge in applying profitability ratios.

A number of questions arise:

- Should depreciation be included in the calculation of net income?
- Should initiation or other joining fees as revenue items be included when calculating these ratios?
- What role should dues play in these calculations as there are no directly attributable costs to that revenue line, or are all costs directly attributable to that revenue line?

The key to applying any statistic is to calculate it uniformly across time periods to ensure that appropriate targets are set and results are measured and interpreted consistently.

Three profitability ratios stand out as the most commonly used:

$$\text{Profit Margin} = \frac{\text{Net income}}{\text{Total revenues}}$$

$$\text{Return on Assets} = \frac{\text{Net income}}{\text{Average total assets}}$$

$$\text{Operating Efficiency Ratio} = \frac{\text{Income before fixed expenses}}{\text{Total revenues}}$$

While each ratio is relatively simple to understand, an agreement must be reached as to which items will be included in their components. Consider whether net income and total revenues should include initiation or entrance fees, as well as whether capital assessments should include depreciation. Club economic theory dictates that none of these items should be included in calculations of profitability, as they are of a "capital nature." Indeed, prior to the issuance of Statement of Financial Accounting Standards No. 117 in 1995, many clubs reported such items directly to the balance sheet — a clear indication that the industry felt it had no place in profitability calculations. Meanwhile, a recent club survey included these items as revenue and expense items — an indication that one must read the fine print before benchmarking clubs.

Financial institutions continue to struggle with the same dilemma when writing debt covenants for clubs. Too often, covenant calculations in loan documents fail to appreciate the source and use of funds for most clubs.

Talking about profit ratios in the club world often leads to one specific area – food and beverage. Possibly due to lack of familiarity with such concepts as food gross profit or beverage cost of sales, this seems to be the only area of club operations to feature talk of a “loss” (i.e. “How much does our club dining operation lose?”). Note that club management is never asked how much is lost by the golf department or as a result of the swimming pool. This might result from the fact the food and beverage department is typically the only department to produce an income statement – thereby arriving at a departmental loss. Yet if similar statements were produced for all club departments, a much clearer picture of how much dues are actually used across the club would emerge. Expressed another way, dues would be shown to cover the losses in all the departments. Furthermore, capital expenditures can provide another hurdle in the quest to determine the profitability of every club department. Consider which area of the club would look least profitable and require more support from the dues dollar if clubs were to allocate depreciation to each department based on the assets used by that department.

While the point of an exercise such as this is not to question the long-term sustainability of any given club department, it can be used as an ongoing metric to determine if financial resources are applied efficiently and effectively to support the mission of the club. If budgetary expectations can be established for the level of profitability of each department in terms of required levels of dues support, clubs can measure and track trends for each department. If the golf department is expected to incur a loss every year of approximately 40 percent of dues, then a profitability ratio has, in fact, been established upon which the club can measure and report. Therefore, if the departmental loss is only 35 percent of dues, the club has beaten its profit forecast by five percentage points. Conversely, if the loss is 45 percent of dues revenue, it will have consumed more dues dollars than anticipated – thereby adversely affecting another department. Consolidating these profit ratios for every department offers the overall ratio for the club.

Remember the mission

Having now reviewed all four ratio types, pay heed to a favorite quotation from Goethe, who said, “The first sign we don't know what we are doing is an obsession with numbers.” Clubs must take care in their application of metrics. Revisit for a moment the four questions that began this series:

1. Are financial resources sufficient to support the mission of the club?
2. What financial resources are available to support the mission of the club?
3. How are existing financial resources being used to support the mission of the club?
4. Are financial resources being applied efficiently and effectively to support the mission of the club?

The common element to all four questions is the “mission of the club.” A failure to understand or appreciate the mission of the club results in the risk of changing that mission to suit the budget, rather than budgeting to suit the mission.

Questions on how to apply these analytical tools to specific clubs are welcome. Contact us at +1 800 966 0428 or visit us online at www.rsmus.com/privateclubs.

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