

FINANCIAL RATIO ANALYSIS AND PRIVATE CLUB OPERATIONS

TRACKING THE FINANCIAL HEALTH OF THE CLUB

BY PHILIP NEWMAN

Private clubs are mission driven—serving members is the primary goal. Accordingly, club operations and expenditures are directly tied to the club mission. A former CFO of a nonprofit organization succinctly articulated the link between financial resources and a club’s mission, “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.” By carefully evaluating the club’s financial performance, a club can improve the use of financial resources to further the club’s ultimate goals.

Ratio analysis can help clubs measure their financial performance, identify organizational strengths, and correct operational weaknesses by detecting financial anomalies. Thorough analysis of club financials can help focus attention on those areas most important to the club’s mission.

While ratios are generally intended to help clubs evaluate their financials, there are very few accurate benchmarks that can help a club gauge itself against others in the industry. Balance sheets are predictions of the club’s ability to cope with future financial needs, and clubs aren’t necessarily similar enough in either their future plans or financial practices to compare with one another. Clubs are a reflection of their members, and some clubs have a more financially risk adverse membership. This may lead one particular club to shy away from taking on long term debt obligations for club renovations—perhaps preferring instead to issue monthly capital assessments over the life of a project to pay for improvements. Another club may believe that number of new members the club will attract with renovations will easily offset any debt incurred throughout the renovation process and will chose to take on more long-term debt. The differences in balance sheet ratios between the two example clubs can be extreme. Both meth-

ods of debt management are viable, but an average of the ratios from the two clubs won’t provide a viable benchmark.

WHY CLUBS MONITOR RATIOS

It is critical for each club to monitor its own ratios over time to ensure that they accurately reflect the board’s intended fiscal policy and that changes, positive or negative, are explained. Again, if the balance sheet is a depiction of where the club is headed, shouldn’t it be thoroughly analyzed to make sure it’s headed in the right direction? Ratios help keep a club on the right course.

Since most clubs are nonprofit organizations, clubs should select meaningful ratios that measure items critical to their mission and financial wellbeing.

When measuring the relationship of financial performance and mission in a private club, there are four key questions that clubs should address. Each of these questions corresponds to an applicable category of financial ratios.

QUESTION	RATIO TYPE
Are financial resources sufficient to support the club’s mission?	Liquidity
What financial resources are available to support the club’s mission?	Solvency
How are the existing financial resources being used to support the club’s mission?	Activity
Are financial resources being applied efficiently and effectively to support the club’s mission?	Profitability

LIQUIDITY RATIOS

Liquidity ratios measure the ability to meet short-term obligations and focus on the sufficiency and flexibility of



financial resources. Two of the most important ratios for measuring liquidity are the current ratio and the operating cash flow ratio.

Current Ratio

The current ratio measures working capital. This measurement is critical to any organization.

This is one of the few balance sheet ratios with a clear benchmark: anything greater than 1.0 is considered acceptable. A current ratio less than 1.0 indicates current assets are insufficient to cover current liabilities—a working capital deficit. If a club has a ratio less than 1.0, the club should analyze the underlying reasons to understand how to improve.

To improve its current ratio, the club should take a look at the components of current assets and current liabilities. Determine if the club is incurring liabilities too far in advance of generating revenues, receivables or cash. If the negative current ratio is caused by deferred revenue associated with dues paid in advance, carefully consider whether the club should be concerned about this “soft” liability. It could possibly indicate that the club has spent member dues too soon. Also determine if the club has adequately forecast cash requirements to address this deficit over the remainder of the fiscal year.

Clubs that maintain long-term debt secured by a capital assessment stream on the balance sheet might be unduly penalized in the ratio calculation and the accounting for capital assessments. While the current portion of debt would be recorded on the balance sheet, the monthly capital assessment receivable to cover the debt is not typically recorded to the same extent, so the current ratio would be negatively impacted. This highlights the importance of understanding the components of the ratio and capital and debt structure. The current ratio can be modified to exclude inventory from

current assets. Inventory is excluded because some clubs have difficulty in turning inventory into cash—particularly pro-shop inventory. In the event that short-term obligations need to be paid immediately, the current ratio may overestimate short-term financial strength.

Operating Cash Flow Ratio

The operating cash flow ratio measures how well cash flow generated from operations covers current liabilities.

The operating cash flow ratio can gauge liquidity in the short-term. Cash flow, as opposed to income, is sometimes a better indicator of liquidity, since bills are typically paid with cash. Arguably a more dynamic representation of working capital management than the current ratio, clubs can use this ratio to examine whether they need work harder to collect accounts receivable from members and others or to examine how quickly they are paying vendors. While a vendor may offer a discount or incentive for early payment, it should not be accepted if it adversely affects overall cash flow. Clubs can look at both sides of this ratio and ensure collection policies are enforced and vendor payments are not issued too quickly.

SOLVENCY RATIOS

Solvency ratios address an ability to meet long-term obligations. While debt was once a taboo subject at clubs, it has become more acceptable to carry some. With debt comes increased scrutiny of financial statements through debt covenants from lending institutions. Unfortunately, many institutions fail to understand the economics of private clubs, which has led to covenants designed for commercial businesses being applied to clubs, which are often drastically different kinds of institutions.

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 ratios for a specific club historically provide valuable information. If a club has worked through a strategic planning process, a business plan can help drive strategic plan success, a key component of which is the financial element, usually a budget or forecasted financial statement. Properly structured financial forecasts can help a club accurately predict its balance sheet and other statements, such as the operating statement or cash flow forecast. Ratios can also be forecast using these statements and used as an ongoing tool throughout the year to ensure that deviations from the financial plan can be corrected so that the overall business and strategic plans can be achieved.

Debt to Equity Ratio

The debt-equity ratio compares total liabilities to total members’ equity. This is a measurement of how much suppliers, lenders, creditors and obligors have committed to the club versus how much members have committed.

The debt-equity ratio provides a good vantage point on leverage—in this case, comparing total liabilities to members’ equity as opposed to total assets in the debt ratio. A lower percentage means that a club is using less leverage and has a stronger equity position. Some banks use a version of this ratio (total liabilities divided by total net worth) in loan documents and routinely require the ratio to be 1.0 or less.

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

ONE CLUB REPORTS THAT BY MONITORING OVERTIME BURDEN, IT REDUCED OVERTIME TO LESS THAN ONE PERCENT OF HOURLY LABOR (DOWN FROM FOUR PERCENT A FEW YEARS PRIOR). THIS EQUATED TO SIGNIFICANT SAVINGS

The debt-equity ratio provides a dramatic perspective of leverage for a club and is one of the most important ratios to track over time. If the ratio begins to deteriorate, club leaders should be able to understand why. Did the club incur debt that was used to sustain operations that should have been reinvested into club facilities? Is the club's equity depleted due to continued large operating losses or a lack of new member joining fees? If the club is a refundable equity club, can it compute what its debt to equity ratio would be if the club did not have to refund equity to exiting members? Would that be a catalyst for discussing lowering the refundable percentage to preserve the long-term future of the club? Clearly the debt-equity ratio can illustrate a number of business conditions of which a club should be aware.

Capitalization Ratio

The capitalization ratio measures the debt component of capital structure, or capitalization (i.e., sum of long-term debt liabilities and members' equity), to support a club's operations and growth. This ratio is considered to be one of the more meaningful debt ratios, as it delivers insight into use of leverage.

There is no right amount of debt. Leverage varies according to capital projects 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.

A club's capitalization (not to be confused with market capitalization) is 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 are often viewed as an indication of financial fitness.

Prudent use of leverage (debt) increases the financial resources available to use

for growth. It assumes that the club can generate more on borrowed funds than it pays in interest and fees. However successful this formula may seem, it requires a club to maintain a record of complying with 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).

Creditors would prefer this ratio to be lower because it might indicate a reduced risk on their part. To improve their ratios clubs should carefully evaluate if they can retire debt using accumulated cash reserves that arguably are earning less in interest than they are paying in debt. If the reserves are not available, is there an appetite for approaching the membership with a proposal for member capital infusions to retire the debt? Not an easy sell in today's economy, but, in this age of running a club like a business, this is a finance option that should at least be on the club's boardroom table. If current members can be convinced that their long-term membership costs are better controlled with more members—members who will likely join their club if a better capital structure is in place—then perhaps the appetite may be stronger than club leadership may have thought.

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 and those that support activities. Clubs must determine how resources are distributed between these 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 those that matter to the members—as outlined in a strategic plan. For example, is the club carefully monitoring ratios in food and beverage (other than cost of sales), golf course maintenance, pro shops or guest room departments? Activity ratios can be designed and monitored for virtually all departments and often provide a better snapshot of what is going on than a lengthy financial statement. Turnover and payroll ratios typically act as the most useful activity ratios.

Turnover Ratios

Turnover ratios measure the number of times inventory is replaced in a given period. They are calculated as the cost of goods sold divided by average inventory during a time period. A high turnover ratio indicates producing/selling 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 should be significantly higher than those of non-perishables. A decrease in turnover ratios might beget questions regarding menu or merchandise offerings, as members may appear disinterested (assuming stable prices).

Turnover ratios are most powerful when viewed alongside other operating data. For example, consider why inventory might turn faster if food revenue decreases, but food turnover increases, assuming no increase in cost or decrease in prices. This could indicate 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 largest controllable expense at clubs, it stands to reason that it would receive the most

scrutiny. 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 a percentage of revenues is expressed by a simple question:

If revenues are not as high as anticipated or budgeted, how quickly can changes be made to reduce labor costs?

Two of the most popular ratios are overtime burden and hourly labor burden. One club reports that by monitoring overtime burden, it reduced overtime to less than one percent of hourly labor (down from four percent a few years prior). This equated to significant savings and the discovery that overtime was used as a vehicle to pay employees above approved hourly wages. The club now monitors this on a weekly basis and shares the data with managers to reinforce accountability.

Many clubs monitor an hourly labor burden on a daily, weekly and monthly basis for significant departments to ensure efficient staffing. A fine line exists between delivering efficiency and sacrificing service, but successful clubs monitor how that line moves on a daily basis.

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 shed more light on the club's situation and how it may change in the future.

PROFITABILITY RATIOS

Profitability ratios are used to assess ability to generate earnings as compared to expenses or other relevant costs during a specific period. For most profitability ratios, clubs want to have a higher value compared to a previous period or industry benchmark. As one might expect, applying traditional ratios for »»

FINANCIAL RATIO FORMULAS FOR STAYING TRUE TO THE CLUB'S MISSION

RATIO	MEASURES	FORMULA
Current	Liquidity	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$
Operating Cash Flow	Liquidity	$\frac{\text{Cash Flow from Operations}}{\text{Current Liabilities}}$
Debt to Equity	Solvency	$\frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$
Interest Coverage	Solvency	$\frac{\text{EBIT}}{\text{Interest Expense}}$
Cash Flow to Debt	Solvency	$\frac{\text{Operating Cash Flow}}{\text{Total Debt}}$
Inventory Turnover	Activity	$\frac{\text{Cost of Sales}}{\text{Average Inventory for Period}}$
Overtime Burden	Activity	$\frac{\text{Overtime Costs}}{\text{Total Hourly Labor}}$
Hourly Labor Burden	Activity	$\frac{\text{Hourly Labor}}{\text{Operating Revenue}}$
Profit Margin	Profitability	$\frac{\text{Net Income}}{\text{Total Revenues}}$
Return on Assets	Profitability	$\frac{\text{Net Income}}{\text{Average Total Assets}}$
Operating Efficiency	Profitability	$\frac{\text{Income Before Fixed Costs}}{\text{Total Revenues}}$



UNDERSTANDING HOW THESE STATISTICS TREND OVER TIME IS VITAL TO PREDICTING FISCAL ISSUES THAT MIGHT NOT BE OBVIOUS IN MONTHLY/QUARTERLY FINANCIAL STATEMENTS.

profitability, which emanate from the for-profit world, can be challenging. Some of the nuances of club economics and source and use of funds can create a challenge in applying them.

A number of questions arise:

- Should depreciation be included in the calculation of net income?
- Should initiation or other joining fees be included as revenue items 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 appropriate targets are set and results are measured and interpreted consistently.

Three profitability ratios stand out as most common: profit margin, return on assets and operating efficiency.

While they are relatively simple, the club should reach an agreement regarding what is included in their components. Consider whether net income and total revenues should include initiation or entrance fees and whether capital assessments should include depreciation. Club economics dictate that none of these items 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—an indication that the industry felt it had no place in profitability calculations. However, some include these items as revenues and expenses—an indication that one must read the fine print before benchmarking.

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.

A focus on profit ratios often leads to discussion of food and beverage profit and loss. Possibly due to lack of familiarity with such concepts as food gross profit or beverage cost of sales, this is often the only area to feature talk of a “loss” (i.e., “How much does our club dining operation lose?”). Note that management is never asked how much is lost by the golf department or swimming pool. This might result from the food and beverage department typically being the only department to produce an income statement—thereby arriving at a departmental loss. Yet, if similar statements were produced for all departments, a much clearer picture of how dues are used across the club would emerge. Expressed another way, dues cover the losses in all departments.

Furthermore, capital expenditures can provide another hurdle in determining profitability for every department. Consider which area would look least profitable and require more support from dues if clubs were to allocate depreciation to each department based on assets used by each.

While such an exercise is not to question long-term sustainability of any department, it can be used to determine if financial resources are applied effectively to support the mission. If budgetary expectations are established for the level of profitability of each department in terms of required support from dues, clubs can 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 is 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 percent. Conversely, if the loss

is 45 percent of dues, 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

While there are a few studies of these ratios for the club industry, they are powerful tools to help clubs monitor individual club performance. Understanding how these statistics trend over time is vital to predicting fiscal issues that might not be obvious in monthly/quarterly financial statements. Having 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 original questions relative to the mission of the club:

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

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

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