



# TCG

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THEATRE COMMUNICATIONS GROUP, INC.

## CENTERPIECE

### FOCUS ON:

## THE BALANCE SHEET

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## USING THE BALANCE SHEET TO DIAGNOSE YOUR THEATRE'S FINANCIAL HEALTH

BY PATRICIA EGAN & NANCY SASSER OF COOL SPRING ANALYTICS

Theatres across the country invest both considerable staff time and considerable expense on the annual audit. How useful are the resulting financial statements to you as managers and trustees? Are you able to do more than sigh with relief that the audit is complete, the opinion clean, and the documents ready to go out to the funding community as requested? Or are you able to use your audit as an important management tool?

Every year, TCG asks theatres to complete a fiscal survey based on the audit, and an analysis of the results is published as *Theatre Facts*. This analysis does a terrific job of tracking the trends in theatre operations: earned revenue, contributed revenue and expenses; subscription versus single ticket sales and average prices; numbers of productions and performances, etc.

Analyzing the balance sheet has always been a trickier proposition. Yet, it is the balance sheet that is the key to understanding a theatre's overall financial health. The balance sheet contains the cumulative financial history of an organization and reveals the organization's capital structure—where the theatre has invested its resources.

In this *Centerpiece*, we will identify several key components of the balance sheet that are indicators of financial health, and we will explain how to calculate them. These are not the only financial measures that a theatre should review on a regular basis—you should look at operating figures like earned and contributed revenue trends, subscription and single ticket numbers, etc. Yet, these balance sheet indicators should be added to the tools you use to monitor financial progress, and to identify and plan for future financial investments.

We will also look at this analysis as applied to a sample group of TCG member theatres to see what it says about trends in the theatres' financial health over a four-year period.

Ultimately, the goal of such analysis is not an end in itself—the goal is to support the artistic mission of the theatre. When you, and the other leaders of your theatre, understand the theatre's financial information and trends, you can make better financial decisions that support and enhance your artistic work.

Topical Issues *Centerpiece* Curator: Christopher Shuff, director of management programs, TCG. Copyright © 2003 by Theatre Communications Group, Inc. All articles reproduced by permission of the authors. No portion of this publication may be reproduced in any form, or by any means, including photocopying, without written permission from the publisher or author. Theatre Communications Group, Inc., 520 Eighth Ave., 24th Fl., New York, NY 10018-4156, telephone (212) 609-5900, fax (212) 609-5901, website: [www.tcg.org](http://www.tcg.org). Ben Cameron, executive director; Joan Channick, deputy director; and Rachel Ford, management programs publications associate.

# THE FINANCIAL INDICATORS

## The Basics of the Balance Sheet

The balance sheet (statement of financial position) is the repository of the theatre's financial history—the accumulation of all your surpluses and deficits plus all the capital that your theatre has acquired. There are three sections of the balance sheet:

- ❖ Your **assets**, or what you own (cash, investments, accounts or pledges receivable, prepaid expenses, building and equipment).
- ❖ Your **liabilities**, or what you owe (accounts payable, deferred ticket sales, loans).
- ❖ Your **net assets**, which is the difference between what you owe and what you own.

And within your net assets, there are three major categories<sup>1</sup>:

- ❖ **Unrestricted**—this includes your accumulated operating surpluses and deficits, your property and equipment<sup>2</sup> and any board-designated funds, such as a cash reserve or endowment.
- ❖ **Temporarily restricted**—net assets restricted by the donor for a specific purpose or time period. These can include funds that will be used for operating activity in the future—say a multiyear education grant, 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 your unrestricted operating statement.
- ❖ **Permanently restricted**—net assets restricted by the donor in perpetuity. Most often, these are permanent endowment funds.

The mix of your assets, liabilities and net assets, and the nature of restrictions on each, determine your theatre's capital structure. A healthy capital structure allows the theatre to fulfill its artistic mission and to take artistic risk without significant financial stress. But how can you determine your theatre's capital structure, and how healthy it is?

## What Does the Balance Sheet Say About My Theatre's Financial Health?

There are a few indicators you can track over several years to assess your theatre's capital structure and financial health. The following measures use numbers found on your audit (see "How Do I Calculate the Measures?" on page 3):

<sup>1</sup> Assets and liabilities also carry these restrictions—how much cash is restricted versus unrestricted—but often they are not shown as such on an audited financial statement.

<sup>2</sup> Generally, fixed assets (property and equipment) are unrestricted, though there are exceptions, which are usually noted in an audit.

- ❖ **Total Net Assets**—this is what an organization owns after paying off all its liabilities. Total net assets should grow at least as fast as operating expenses each year, indicating that a theatre is building its total capital.
  - ❖ **Working Capital**—the unrestricted resources available for operations. Working capital is the fundamental financial building block of an organization, and it should be a primary focus on the balance sheet. It does not show up as a line item on the balance sheet; yet, it has the largest impact of any of these indicators on a theatre's ability to operate and fulfill its programming mission.
    - ◆ Adequate working capital provides financial strength and flexibility to an organization, the ability to meet obligations as they come due, and the ability to take more risks, knowing you have a cushion to fall back on.
    - ◆ A theatre with negative working capital is likely to suffer periods of cash flow stress or financial crisis and must borrow to meet current needs—for example, borrowing from a bank through a term loan or a line of credit; borrowing from next year's subscription revenues; borrowing from restricted net assets; or "borrowing" from vendors by delaying payments on outstanding bills. Staff spends more time managing cash flow and dealing with unpaid vendors (or looking for new ones who will do business with you!), which means there's less time for the real work of the organization—producing theatre, developing audiences, raising funds and developing a strong board.
    - ◆ We're calculating working capital by subtracting fixed assets and unrestricted investments,<sup>3</sup> from total unrestricted net assets. Please note that unrestricted investments could include board-designated (but not restricted) endowment funds, which are technically available to the organization for working capital purposes. We're assuming that if a theatre has created a board-designated fund, the board and staff would prefer to maintain that fund to generate revenue.
- Working Capital Ratio**—this ratio relates working capital to the size of an 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 theatre should determine its own working capital needs, based on its yearly cycle of cash flow, and any extraordinary expenditures that are anticipated. However, a theatre with three or more months of working capital is generally in a healthy position.

<sup>3</sup> If the audit does not detail unrestricted investments, your business office will have the detail. If your unrestricted investments include any working capital/cash reserve funds, then they should be added back to your total working capital.

## HOW DO I CALCULATE THE MEASURES?

- ❖ **total net assets** = total assets – total liabilities
- ❖ **working capital** = total unrestricted net assets – property and equipment (net of accumulated depreciation) – unrestricted investments
- ❖ **working capital ratio** = working capital ÷ total expenses
- ❖ **invested capital** = total investments
- ❖ **investment ratio** = total investments ÷ total expenses
- ❖ **fixed assets** = (total property + equipment) – accumulated depreciation
- ❖ **deferred maintenance indicator** = accumulated depreciation ÷ annual depreciation expense
- ❖ **debt** = short-term + long-term contractual obligations

- ❖ **Invested Capital**—includes monies usually invested long-term. It approximates reserves and endowment, and it may be unrestricted, temporarily restricted or permanently restricted. Income from investments is available for operations or to support specific purposes. Invested capital that provides a significant revenue stream increases the strength and sustainability of an organization. Each theatre should target an appropriate level of invested capital after developing sufficient working capital.

**Investment Ratio**—this ratio relates investments to the size of an organization’s operation. 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**—includes all land, buildings, equipment and other fixed assets owned by the organization. The amount that a theatre invests in its building and equipment will vary and should be tailored to the needs of the organization and the larger community.

**Deferred Maintenance Indicator**—used to assess the relative likelihood of deferred maintenance and the need for investment in buildings and equipment. This ratio relates total accumulated depreciation to annual depreciation. An organization that invests in fixed assets at a pace that exceeds annual depreciation will show a declining trend in this ratio, which is a healthy trend. For organizations that

own their facilities, a deferred maintenance indicator greater than 15 years may indicate the need to invest in the plant. For organizations that own equipment, but no facility, a deferred maintenance indicator in excess of six years may indicate a need to invest in equipment.

- ❖ **Debt**—includes all short- and long-term contractual obligations of the organization, such as mortgages, lines of credit or other loans. Ability to repay debt is key to financial health. While this is an essential component for organizations to track, TCG does not collect specific debt figures, so we will not look at any debt analysis in this *Centerpiece*.

After you have pulled out working capital, invested capital and fixed assets from your total net assets, you’re left with “other net assets” that are temporarily or permanently restricted and, therefore, unavailable to an organization for working capital. Other net assets will fluctuate annually, and there are no benchmarks for them. The presence of other net assets, however, indicates that a theatre is planning for future needs by securing grants for future programs or raising capital funds.

With all of the above indicators, it’s essential to look at the trends in the numbers over time. While one year can give you a snapshot of where you are now, it cannot tell you whether your financial position is improving or weakening.

# SAMPLE THEATRE ANALYSIS

Let's look at these indicators for a group of theatres to see what the figures say about their financial health. TCG provided financial data for 19 anonymous theatres that completed the fiscal survey from 1998 through 2002. They are a subset of the 78 Trend Theatres in *Theatre Facts 2002* and reflect the diversity of those theatres with respect to budget size, geographic location and type of theatre. The sample includes the following:

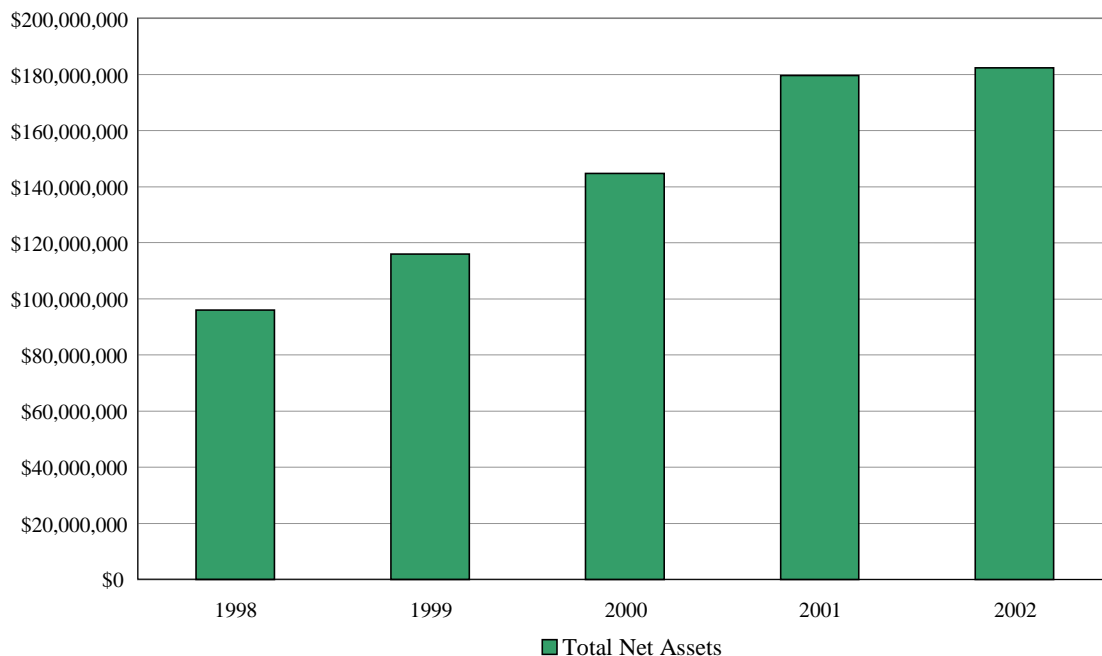
TCG Budget Group	# of Theatres	Budget Size
2	2	\$500,000 - \$999,999
3	5	\$1 million - \$2,999,999
4	4	\$3 million - \$4,999,999
5	6	\$5 million - \$9,999,999
6	2	\$10 million or more

This is a small sample with only a few theatres in each budget group, and our analysis of the theatres by budget group may not be representative of all the theatres in those groups. However, the analysis does illustrate the indicators, and breaking out some of the ratios by budget size gives a sense of how the indicators look for the smaller theatres compared to the larger ones.

## Total Net Assets

Let's begin by setting the context and looking at one number easily taken off a theatre's balance sheet—**total net assets**. As can be seen in the following graph, the theatres added significantly to their total net assets, increasing them 90% over the four-year period, though growth slowed considerably in 2002. This far outpaces the 35% growth in expenses over the period and reflects the success that theatres had in building their net assets through capital campaigns during the strong economy.

Total Net Assets - 19 Theatres

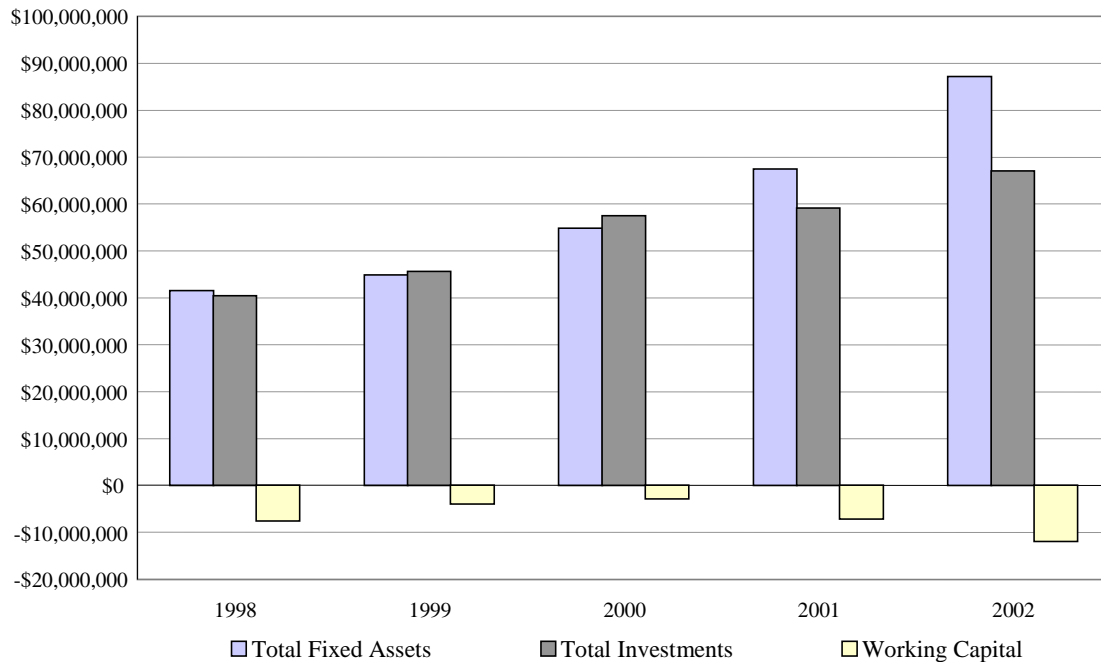


## Components of Net Assets

And where did that growth occur? Let's look at the three key components of the total net assets:

Net Assets	1998	1999	2000	2001	2002	4-yr chg 98-02
Working Capital	(\$7,505,000)	(\$3,815,000)	(\$2,786,000)	(\$7,103,000)	(\$8,095,000)	(8%)
Total Investments	\$40,467,000	\$45,568,000	\$57,538,000	\$59,142,000	\$67,022,000	66%
Total Fixed Assets	\$41,544,000	\$44,939,000	\$54,815,000	\$67,486,000	\$87,127,000	110%

**Total Net Asset Components - 19 Theatres**



**Working capital** for the theatres was negative all five years. While it improved through 2000, declines in 2001 and 2002 took it down below the 1998 level, for an overall decrease of 8%. Fourteen of the nineteen theatres had negative working capital in 2002, and seven were negative all five years. As noted earlier, an organization with negative working capital must borrow funds from somewhere to meet current obligations.

Theatres whose negative working capital is the result of operating deficits may have taken out loans or opened lines of credit as part of their cash management. They will be diverting operating resources to meet the loan obligations, unless they have capital campaigns planned to help them retire the debt and cover the loan's interest payments.

We know that some of these theatres have loans to finance building expenditures while capital campaign funds are being raised. The capital campaigns may be budgeted to pay both principal and interest on those loans, so the loans would not be a burden for the theatres' operating budgets, provided those campaigns meet their goals and pledges are collected on schedule.

**Investments** grew 66%, and continued to increase in 2002, demonstrating that theatres continued to add to their endowment funds at a rate that outpaced stock market declines. While

sixteen of the theatres have investments, 90% of the investments are held by only six theatres—most theatres have not been able to develop significant investment funds.

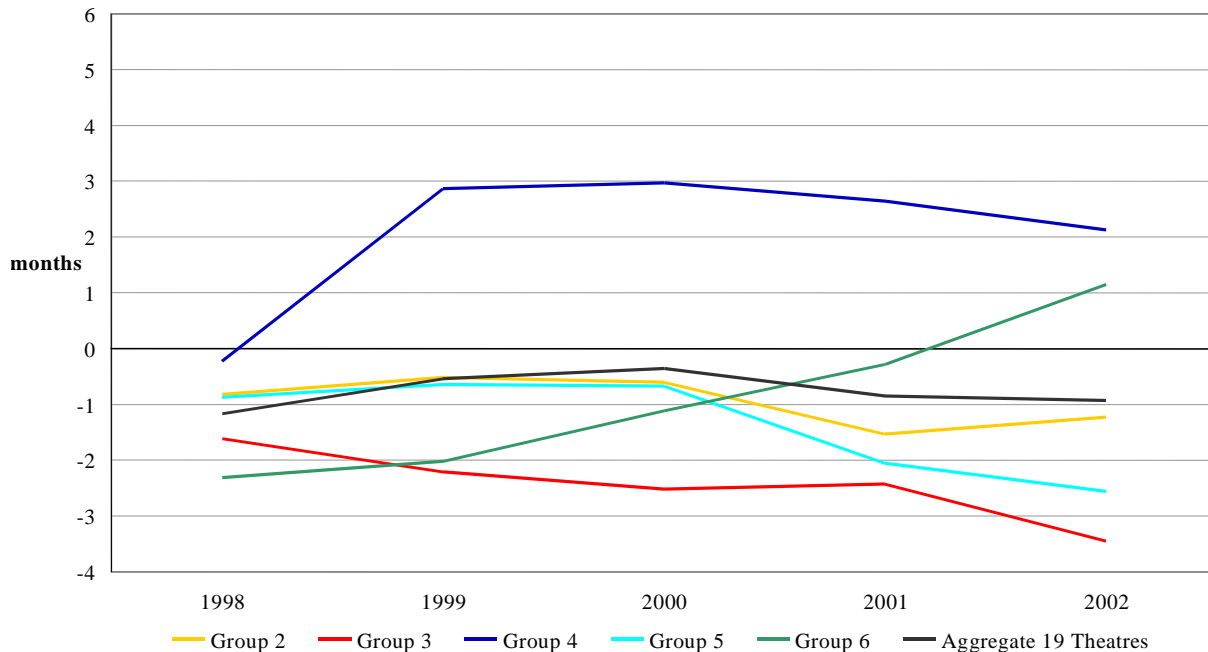
The largest increase in net assets was for **fixed assets**, which increased 110%. Theatres were building new buildings, renovating old buildings and replacing and buying new equipment.

## Let’s Look at the Three Ratios:

### ❖ Working Capital Ratio

We looked at the aggregate working capital ratio for all the theatres, and also looked at the ratio by budget group to see how the different size theatres were faring.

**Working Capital Ratio - 19 Theatres**



The working capital ratio for all the theatres improved considerably through 2000, but then declined the next two years, and was just under negative one month in 2002.

The Group 4 theatres were the strongest and had three months of working capital in 2000 before declining in 2001 and 2002.

The Group 6 theatres were the only ones to show steady improvement and went from negative to positive in 2002.

The other groups were negative all five years. Group 3 theatres were the only ones with a declining working capital ratio during the strong economy of the late 1990s, and they dropped further in 2002.

Interestingly, the Group 5 theatres, which made a large investment in their fixed assets—a 185% increase—and have a strong investment ratio (see below), have the weakest working capital ratio of the three larger budget groups.

Since working capital is a basic financial building block, and it has a large impact on how a theatre operates, we talked to two theatres with negative working capital—their stories follow on the next two pages.

# A Tale of Two Theatres

Two managing directors described how their theatres—Theatres A and B, respectively—developed negative working capital. In one case, they didn't recognize the magnitude because they were simultaneously adding to investments and buildings. In the other, a strategic investment of cash reserves to fuel revenue growth could not be sustained and a theatre that had been stable enough to invest its reserves is now fully drawn on a bank line of credit they have not been able to repay.

## Theatre A

"The first thing I do every morning is turn on the computer at home and check the balance in our bank account," said the managing director of "Theatre A," which has a \$2.5-million budget with negative working capital.

The manager described how the theatre had conducted a capital campaign to purchase and renovate a building, establish an endowment fund and pay off debt. The campaign reached its overall goal, but with more gifts restricted to the endowment fund than originally planned, the debt was not paid off, and the theatre took out a mortgage to pay off the building costs.

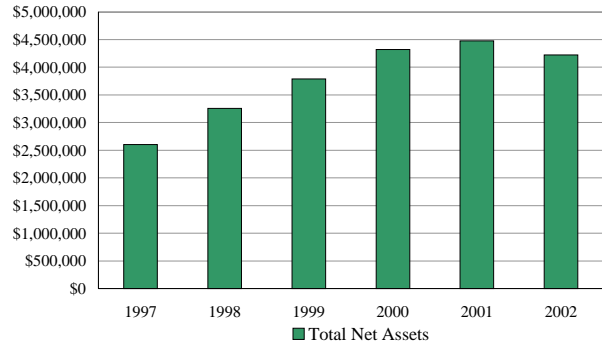
At the same time, the board made a commitment to invest in program quality and expansion to make the theatre more competitive in its community. But annual contributed revenue didn't meet expectations, and the theatre ran operating deficits the last three seasons. By FY2002, the theatre had \$1.5 million in negative working capital, financed partly by a \$250,000 line of credit and a \$500,000, seven-year mortgage. The theatre pays both principal and interest payments out of the annual operating budget. The managing director described how he juggles the remainder of the negative working capital:

"It really requires us to plan cash flow—when we can do an expensive show, and when we need to do a show that we know will sell well. We moved up the subscription renewal deadline just because we need the cash earlier. We used to pay vendors in 30 days, now we have difficulty paying in 90 days. I have trouble getting the board to understand the severity of the situation—we've cried wolf so many times."

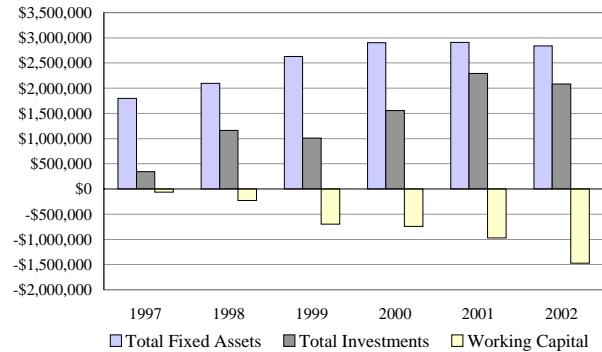
The theatre did not realize the magnitude of their negative working capital, as it was masked by the growth in fixed assets and investments. Now they plan to determine a working capital target as one component of a capital campaign to eliminate debt, add to the endowment, fund theatre renovations and purchase another building.

## Fiscal Snapshot of Theatre A

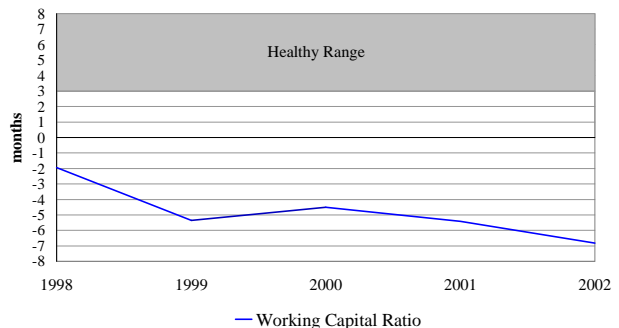
Total Net Assets



Net Asset Components



Working Capital Ratio



## Theatre B

“I didn’t realize how the accumulated deficit would bite me in the back. I think about it every morning from about 3 to 5 AM.” So said the managing director of “Theatre B”—a theatre that only four years ago was in a strong financial position. The theatre had a cash reserve fund that included both restricted funds and board-designated funds from operating surpluses, contributing to a working capital ratio of 27% and an investment ratio of 31%—healthy for a theatre with a budget of \$1.2 million.

In 2000, however, the theatre approved using the board-designated reserve funds over a three-year period to upgrade equipment and support expanded marketing and development efforts, as part of a strategic plan to increase audiences and build the contributor base. This was followed by the hiring of a new artistic director, and a commitment to greater investment in the artistic product.

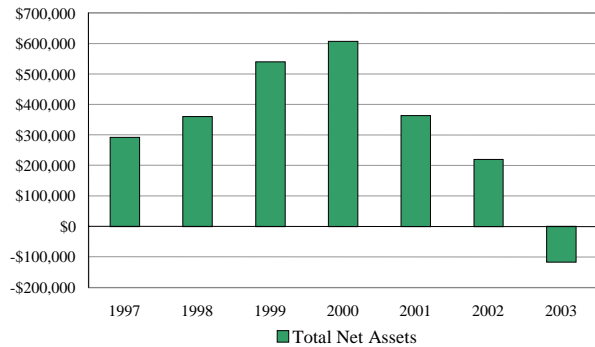
The last three seasons, expenses were higher than anticipated, fundraising did not meet goals, and the theatre ran deficits. The working capital dropped from the high of 27% in 2000 to negative 21% in 2003. The manager says they didn’t feel the deficits at first: “Cash flow got tight at times, but we accelerated contributions and pushed out payables. We could no longer invest subscription revenue in certificates of deposit, because the money was gone by July 1.” The board took out a line of credit and was able to pay it back the first two years, but has not been able to pay it down fully in the last year. They have not used the restricted cash reserve fund, which is collateral for the line of credit, viewing it as the last resort.

“We went from a culture of being fiscally conservative to stretching ourselves,” said the managing director. “The accumulated deficit is an albatross around my neck—leveraging the line of credit and using subscription revenue to pay for the past season’s expenses. If I had hindsight, we would have been much more conservative about the growth.”

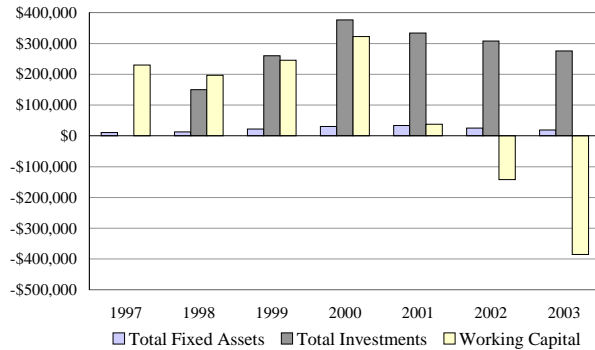
The board recently created a financial stability task force to develop a plan to re-establish their working capital and reserves.

## Fiscal Snapshot of Theatre B

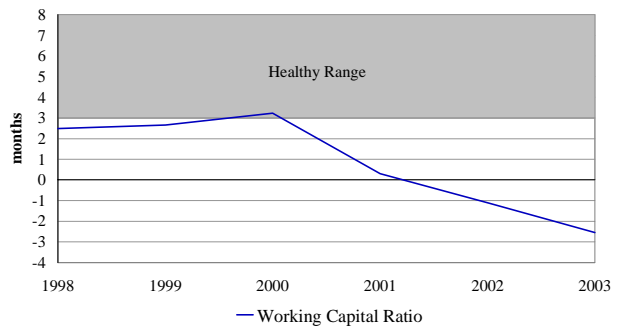
Total Net Assets



Net Asset Components

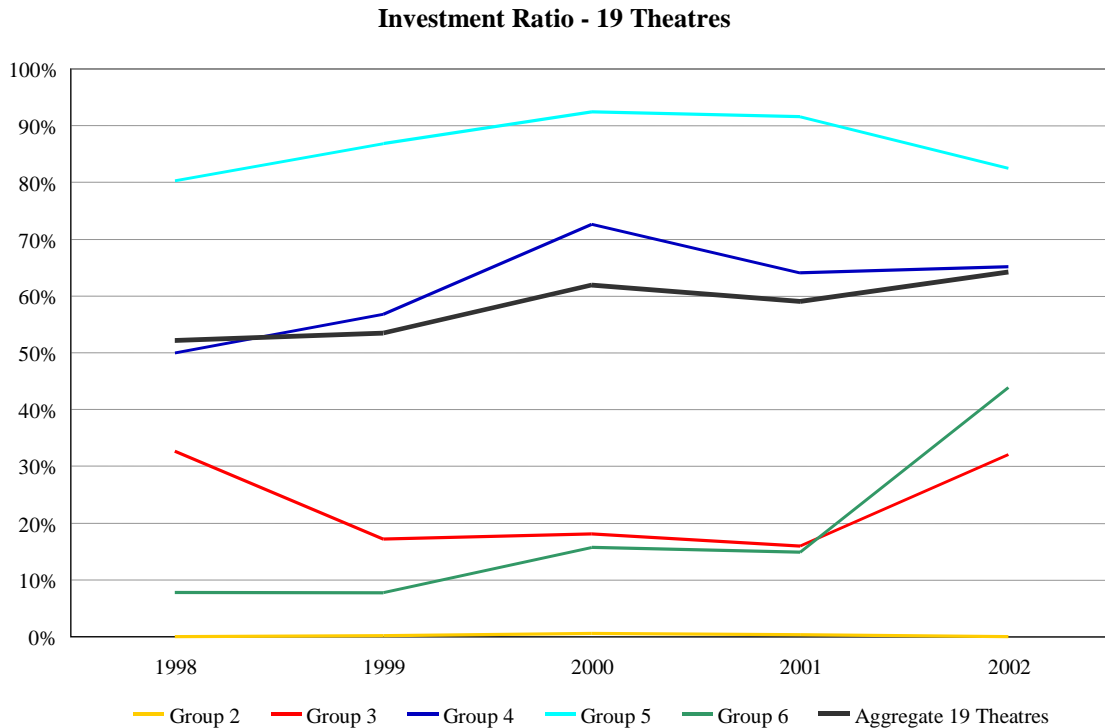


Working Capital Ratio



## ❖ Investment Ratio

We'll look at the investment ratio by budget group as well, to see how the growth in investments related to the theatres' operating budgets.



For the aggregate 19 theatres, the investment ratio increased over the period, including from 2001 to 2002, showing that, despite a weakened market, the theatres were adding to their investments at a rate that exceeded the growth in operating budgets.

The Group 4 and 5 theatres had the strongest ratios, not surprisingly, as the larger theatres tend to have a greater ability to raise endowment funds. The Group 6 theatres were below average, but the small sample may simply reflect an unusual selection of those theatres. Group 6 showed the greatest growth, however, with a big jump in 2002, suggesting that these theatres may have capital campaigns underway for endowment funds.

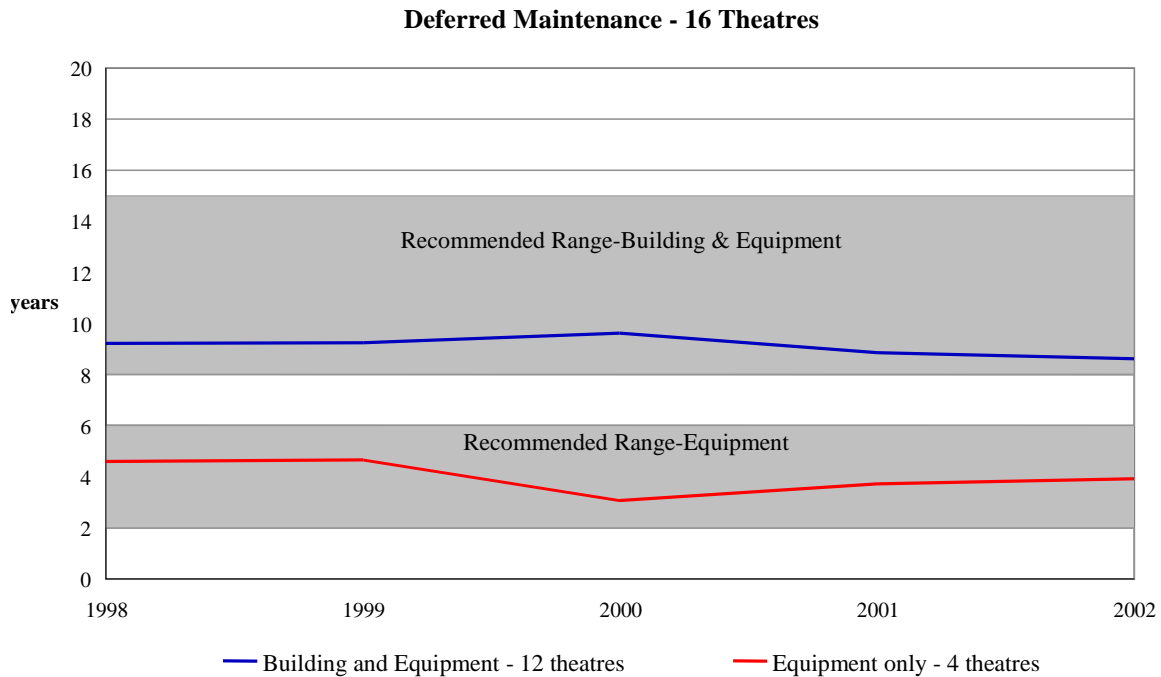
### HOW REPRESENTATIVE IS THIS SAMPLE OF TCG THEATRES?

This sample group of 19 theatres was slightly financially stronger than the 78 Trend Theatres reported in *Theatre Facts 2002*:

- ❖ The growth in total net assets of 90% for this sample group is greater than the 78% growth posted by the 78 Trend Theatres.
- ❖ The Change in Unrestricted Net Assets (CUNA) or Net Income as a percentage of operating expenses for the sample group was greater than for the 78 Trend Theatres in every year except 1998.
- ❖ The working capital ratio for the sample group declined 8%, while the 78 Trend Theatres' ratio declined 12% over the period.

## ❖ Deferred Maintenance Indicator

There is more variation in this indicator by the theatres' fixed asset structure than by budget group, so we divided the theatres into those that own buildings (or have significant leasehold improvements) and those that own only equipment, because the recommended ranges vary for the two groups.



Given the major investment that the theatres made in property and equipment, it is not surprising that the trend for both these groups was flat to declining, which is a positive trend. There were individual theatres in the sample, however, whose deferred maintenance indicators increased over the period, reflecting the fact that they made minimal re-investments in their fixed assets.

## WHAT CAN YOU CONCLUDE FROM THIS ANALYSIS?

During the strong economy of the late 1990s, theatres added significantly to their buildings, equipment and investments. But the theatres' working capital was negative throughout the period: In total dollars it declined between 1998 and 2002, and as a percentage of operating expenses, it improved only minimally.

Going into fiscal 2003, with the weaker economy, the theatres have more fixed assets with greater carrying costs—higher overhead and more annual reinvestment to maintain the

facilities. But with negative working capital, they have no cushion to fall back on—the weakest theatres may have difficulty sustaining themselves.

### How Can You Use This Analysis?

Look at these indicators, along with other operating measures, for your theatre over a three- to five-year time span to identify trends. You are probably aware of what some of these indicators show—for example, that equipment in the

scene shop needs to be replaced or that you have times during the year when cash flow is tight. But understanding how to calculate and track those measures can put this information on a quantitative rather than an anecdotal level. It allows for a dispassionate analysis that makes it possible to articulate trends and financial needs to board members and funders.

Working capital is arguably the most important element of a capital structure, yet organizations tend to focus on concrete targets like building renovations or endowment funds when contemplating capital campaigns. Yet, any manager who has struggled to make payroll regularly knows that a strong working capital position would strengthen their ability to raise funds both for artistic programming and for other capital

needs. Building working capital through the operating budget is a difficult proposition, particularly during tight economic times. But adding a working capital component to capital campaigns can be a means to strengthen short-term capital needs, while adding to long-term capital investments and fixed assets.

Like any financial analysis, these indicators should be considered in light of an individual theatre's mission, current environment, and strategy. Ultimately, the goal of such information and analysis is to further the artistic work of the organization—building an appropriate capital structure that best supports the artistic goals and programs of the theatre.

—Cool Spring Analytics provides consulting services to nonprofit organizations in three primary areas; financial analysis; assessments, strategic planning and workout plans; and financial management and reporting. Pat and Nancy can be contacted at [pegan@toadmail.com](mailto:pegan@toadmail.com) and [nrsasser@comcast.net](mailto:nrsasser@comcast.net) respectively.

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