Accounting Best Practices: The Balance Sheet

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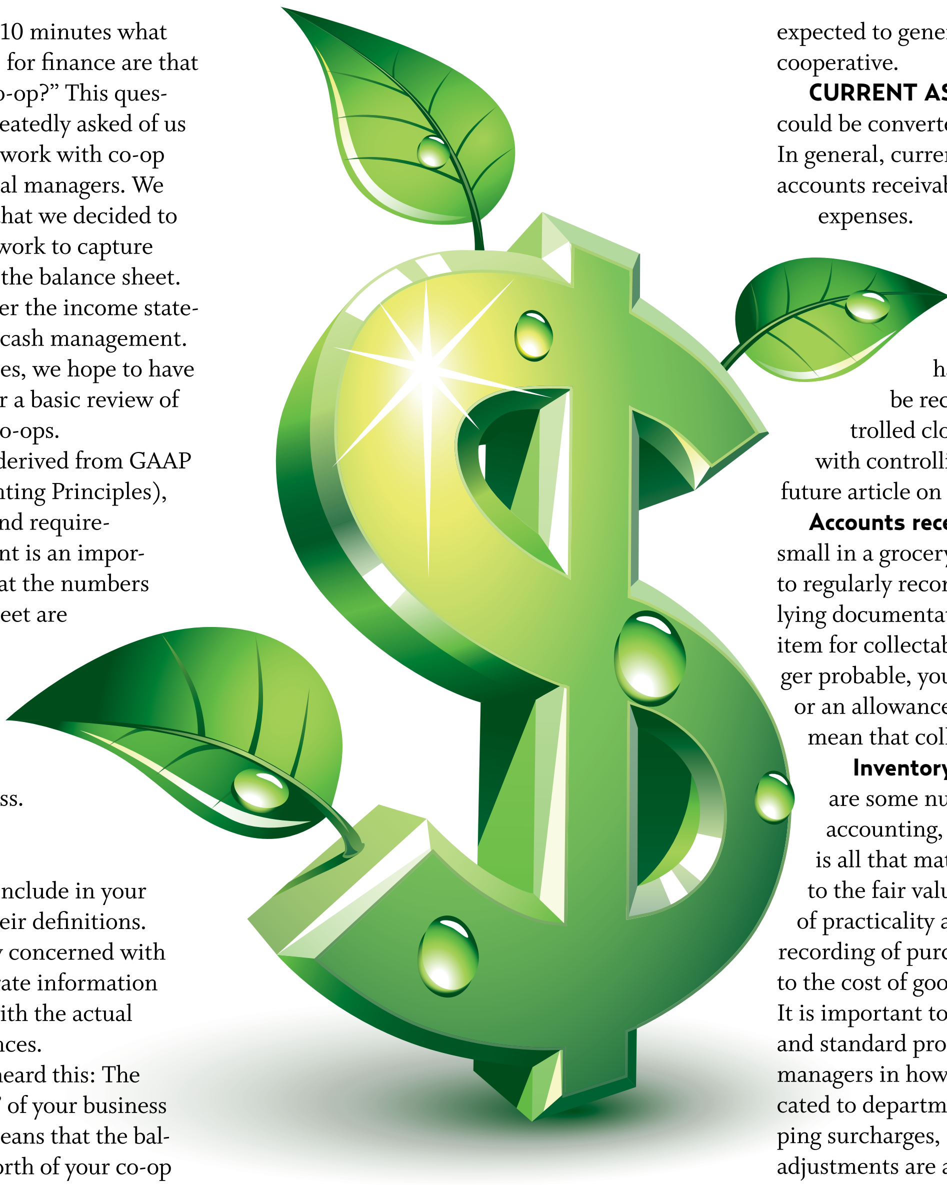
"Can you tell me in 10 minutes what the best practices for finance are that I can use at my co-op?" This question has been repeatedly asked of us in our respective work with co-op finance managers and general managers. We have heard it often enough that we decided to put our heads together and work to capture best practices, starting with the balance sheet. Future installments will cover the income statement, internal controls and cash management. Upon completion of the series, we hope to have generated what is needed for a basic review of financial best practices for co-ops.

These best practices are derived from GAAP (Generally Accepted Accounting Principles), and many involve tax laws and requirements. A qualified accountant is an important resource in ensuring that the numbers you have on your balance sheet are accurate and follow tax and legal requirements. Important note: If you are not certain about a balance sheet number or how to calculate it, please don't guess.



Balance sheet review

This article covers items to include in your balance sheet, along with their definitions. Our review here is primarily concerned with presenting consistent, accurate information for interpretation and not with the actual interpretation of those balances.

Many of you likely have heard this: The balance sheet is a "snapshot" of your business at a moment in time. This means that the balance sheet represents the worth of your co-op expressed in dollars on the date listed. Assets are a compilation of all of the items of value. The dollar amount of liabilities and equity equals the assets amount and tells you which entities own what portion of the assets as of that date.

The order of items included on the balance sheet is standardized. Within each section, line items are generally listed in the order of liquidation: that is, the higher a line is in the assets, liabilities, or equity sections, the sooner it is expected to be turned into cash or, in the case of liabilities, the sooner it requires cash to settle the obligation. What follows here are the items and their definitions listed in the order in which they are usually presented.

One additional note: balance sheet items are generally presented at their fair value, with a few noted exceptions.

Assets

Assets, the first section on the balance sheet, is a list of items of value that are owned or controlled by the cooperative and that are expected to generate future benefit for the cooperative.

CURRENT ASSETS are those items that could be converted to cash within a year. In general, current assets include cash, accounts receivable, inventory, and prepaid expenses.

Cash is the keystone of the balance sheet. It includes all bank or credit union accounts and all cash on hand at your business. It must be reconciled regularly and controlled closely. (The areas associated with controlling cash will be covered in a future article on internal controls.)

Accounts receivable (A/R) are normally small in a grocery store. It is a best practice to regularly reconcile the balances to underlying documentation, and to review each item for collectability. If collection is no longer probable, you should consider a write-off or an allowance for bad debt. This does not mean that collection efforts should stop.

Inventory is valued at cost. There are some nuances in general inventory accounting, but in a grocery store, cost is all that matters. This is an exception to the fair value rule, mostly for the sake of practicality and consistency. The initial recording of purchased inventory items is to the cost of goods or purchases accounts. It is important to adopt consistent practices and standard procedures for department managers in how vendor invoices are allocated to departments, as well as how shipping surcharges, discounts, and other price adjustments are allocated. Cost valuations of inventory must be consistent with how departments evaluate their margins. The only reliable way to know what actual margins are being achieved is to count the inventory. It is a best practice to count perishable departments' inventory every month and quarterly for all other departments. For departments that are not counted every month, an approximation of inventory should be made by using sales and realized margins of those departments.

Prepaid assets are expenses that have been paid prior to the period to which they apply.

The most common is health insurance that is normally paid the month prior to the actual coverage. Examples of prepaid items are insurance, income taxes, rent, and memberships. Lease deposits and down payments on contracts may also be prepaid assets. It is a best practice to set up recurring journal entries to spread the expenses to the correct periods if the asset will be used up over time, as contrasted with being realized due to a specific event such as moving out of a space.

FIXED ASSETS are also valued at cost. Accounting rules may eventually be changed to revalue these to fair value, but the expense and the uncertainty of doing this has delayed any change. Recording fixed assets is highly involved with a new or remodeled store, when costs must be allocated to the project and to the individual items. In a construction project, the costs of financing and carrying the project, including interest, insurance, and utilities, must be allocated to the project and capitalized. The costs to design the project and to construct or install the assets also must be capitalized. These fees include the architect, the attorney for negotiating with the construction contractor or others, and the labor to install the assets. Once the cost of fixed assets to be capitalized has been determined, their economic life, which is the amount of time over which they will be depreciated, must be assigned to them. It is expected that at the end of its economic life the asset must be replaced or that repairs will become a significant cost. It is a best practice to annually review with your accountant the fixed assets depreciation schedule to cull any assets disposed of or sold.

Intangible assets may also be recorded in certain circumstances. Financing costs, including attorney and commitment fees, should be capitalized and amortized over the life of the loan. Costs of a new store or expansion—such as training costs, advertising, and other pre-opening costs—may not be capitalized, since they are one-time costs that do not have a significant value for future years.

Investments and deposits in other cooperatives are generally recorded at cost since that is the amount at which they may be redeemed. These amounts will include initial ownership investments, retained patronage, and deposits. If the amount is unclear from the records, the co-op you are an owner of should give you a summary of what they have recorded as your investment.

It is important to analyze any **patronage dividends** received since they may represent several different things. The patronage dividend for a qualified dividend normally has cash and noncash components. The noncash component is what will be recorded as an asset. ▶

The patronage dividend for a nonqualified dividend will not have a cash component but should be recorded as an asset.

Another important point here is that the nonqualified patronage dividend will be income for book purposes but not for tax purposes. When a payment is on a prior year qualified patronage dividend, the payment will not be current income but will instead reduce the retained patronage asset. For a payment on a prior year nonqualified patronage dividend, the book treatment is to reduce the asset and not show income. But for tax purposes, the amount is income in the year received.

One last important point on patronage dividends is that they are recorded on the day you receive them, unrelated to the year the paying cooperative earned the profit or when they declared the dividend.

Liabilities and Owners' Equity

In general, liabilities tell you what is owed to outside parties. Owners' equity is the portion of liabilities that has been paid and is therefore owned and controlled by the co-op's membership. Expressed differently: Assets are a probable claim on something of value, liabilities are a probable obligation remaining on those assets, and equity is the difference between the two.

Liabilities that should be recorded are more likely to be missing from your accounting system than unrecorded assets. Lost vendor invoices or unrecorded accruals are common examples of what should be captured in what is owed but often is missed. Whenever you close a period, you should ask yourself if there are any additional liabilities that have been incurred that have not yet been recorded. You should always investigate to make sure that you have recorded *all* payables through the date listed on your balance sheet.

Assets are a probable claim on something of value, liabilities are a probable obligation remaining on those assets, and equity is the difference between the two.

CURRENT LIABILITIES are those items that are due to be paid within a year of the balance sheet date. In general, current assets include accounts payable, accrued liabilities and the current portion of debt.

Accounts payable include day-to-day expenses, where an invoice is received for goods or services. Delays in approving, processing, or pricing invoices may cause some late recording or payment issues. It is a best practice to pay only approved invoices and hold store departments to time schedules for processing.

Accrued liabilities are generally amounts that are determined by the cooperative based on applicable laws or timing of transactions. It is a best practice to record these accruals, which include paid time off (PTO), payroll, payroll taxes, sales taxes, real estate taxes, and gift certificates.

Accrued PTO should be recorded for the amount of the obligation to pay staff when they separate from service. It is a best practice that carryover be limited to a set number of hours, both to encourage people to take time off and to limit the liability.

Accrued payroll should be recorded for the portion of a payroll that falls in the period prior to when it is paid. This is generally done by taking the number of days in the prior period divided by all days in the payroll times the gross pay. Further refinement can be made but this is the most common method. Accrued payroll taxes are amounts owed from past pay periods that have not been paid. Additional liabilities arising from payroll include withholdings such as employee share of health insurance and pension plan contributions, as well as any employer pension plan matching. These accruals can

My Food Cooperative Balance Sheet

June 30, 2012

ASSETS	
CURRENT ASSETS	
Cash	$500,000
Accounts receivable	20,000
Inventory	300,000
Prepaid expenses	40,000
Total current assets	860,000
FIXED ASSETS	
Land	200,00
Building	2,300,000
Equipment	3,000,000
Total fixed assets	5,500,000
Less accumulated depreciation	1,500,000
Net fixed assets	4,000,000
OTHER ASSETS	
Intangible assets—net	10,000
Investments and deposits in other cooperatives	130,000
Total assets	$5,000,000

LIABILITIES AND OWNERS' EQUITY	
CURRENT LIABILITIES	
Accounts payable	$500,000
Accrued liabilities	300,000
Current portion of long-term debt	200,000
Total current liabilities	1,000,000
LONG-TERM LIABILITIES	
Long-term debt less current portion	2,100,000
Total liabilities	3,100,000
OWNERS' EQUITY	
Owner shares	700,000
Preferred shares	200,000
Retained patronage	400,000
Retained earnings	600,000
Total owners' equity	1,900,000
Total liabilities and owners' equity	$5,000,000

generally be calculated in a preset fashion and should make generating them almost automatic.

Sales tax collected from shoppers should be recorded as a liability and not recorded on the income statement as part of sales. The complexity and illogic of sales tax systems is well recognized. It is a best practice to periodically review sales-taxable items since this can reduce the taxes and penalties owed when the inevitable state sales tax audit occurs. And don't forget use tax. If the cooperative uses products off the shelf or orders supplies shipped from other states, it may owe use tax. A system should be developed to capture those amounts.

Real estate and personal property taxes differ by state and sometimes by county in the timing of the tax in relation to the period covered. Sometimes payments are considered to be for the prior year and sometimes for the current year. The tax bill should outline the period covered by the tax paid. It is a best practice to accrue an estimate for taxes due at the balance sheet date.

Gift certificates are a liability until used. Abandoned property laws may apply to unused gift certificates, but most states require that they be honored indefinitely. Eventually, it may be clear that some certificates will not be used. If they are no longer a probable claim, you will need to review state law for any guidance.

LONG-TERM LIABILITIES include lines of credit, notes, and mortgages, which are initially recorded at the amount of cash received. Accrued interest must be recorded as of the balance sheet date for the interest owed since the last time it was paid. This is easy for lines of credits and mortgages with an amortization schedule and monthly payments. Often interest for a few weeks will not be recorded since it is small and recurring. But with owner loans where interest is paid annually or less frequently, this interest accrual is critical to presenting an accurate balance sheet. When presenting formal financial statements, it is a best practice to segregate the current portion of debt. This is the amount of principal that will be paid in the next year after the balance sheet date.

The **OWNER'S EQUITY** section is generally the most static, with less to regularly adjust than the rest of the balance sheet. **Owner shares** are typically presented first. This is the amount paid in by owners to purchase their ownership rights. The amount is normally recorded as only what has been paid and not the full owner share amount. If the full owner share amount is recorded, it should be offset by a subscription receivable amount within the equity section giving the same end result. It is a best practice to have a database of owner shares with names and investment amounts and reconcile it against the books. It is also a best practice to have a consistent policy for how withdrawing owners are treated. In order to be considered equity and not a liability, the board does, in fact, need to reserve the right not to refund owner investments. While this is true, declining to refund owner shares is uncommon and only done if the refund is a financial burden for the cooperative.

It is a best practice to read your **preferred share** agreement to determine how to record the dividends. Normally, dividends on preferred shares should only be recorded as a liability when the board has declared them as payable. Dividends on equity are not considered to be expenses for the income statement; they are recorded as a reduction of retained earnings.

Retained patronage dividends are the noncash portion of patronage dividends the cooperative has paid to owners. As with owner shares, a database of names and amounts should match the books. Refunds of retained patronage dividends are normally only done by declaration of the board that the retained amounts from a certain year are payable. At that time, the amount should be reclassified from equity to a liability account. Retained patronage dividends of withdrawing owners are generally not paid out. By not regularly paying this out, the co-op may avoid any questions about abandoned property until the board declares the amount payable.

Retained earnings are the place where the income statement interacts directly with the balance sheet. Income and losses increase and decrease retained earnings. Retained earnings should not have any other activity except dividends and prior-period entries. It is a best practice to avoid prior period entries, corrections of past-year errors. When prior period entries are recorded, they need to be highlighted since they do need to be separately stated for tax purposes and in formal financial statements.

This quick review of definitions and best practices for the balance sheet is the first of a series, in which we'll review the income statement, cash management, and internal controls for best practices. ■