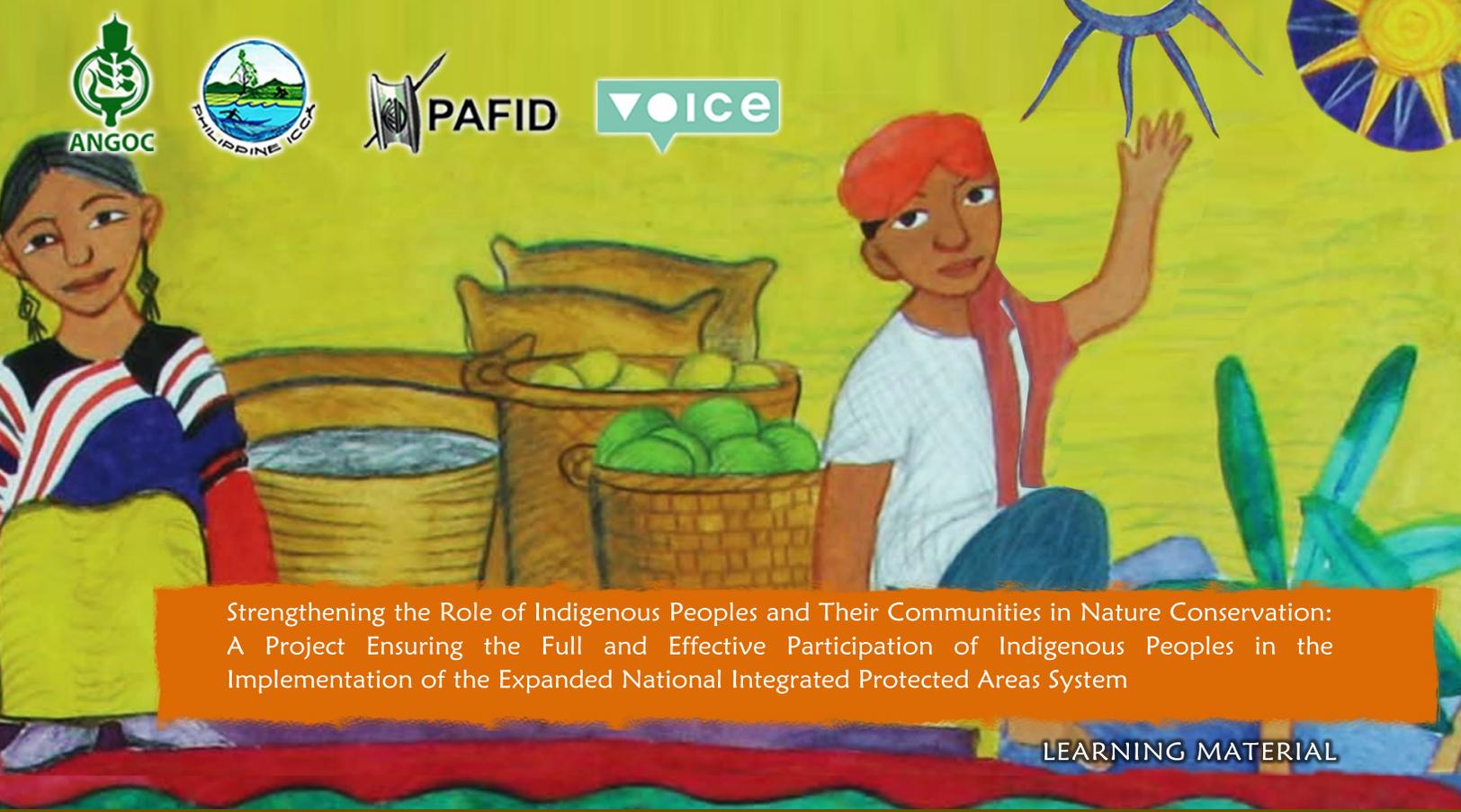




PAFID



Strengthening the Role of Indigenous Peoples and Their Communities in Nature Conservation: A Project Ensuring the Full and Effective Participation of Indigenous Peoples in the Implementation of the Expanded National Integrated Protected Areas System

LEARNING MATERIAL

Understanding Financial Statements of Social Enterprises

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Introduction

Like “ordinary” business enterprises, social enterprises – in particular, those undertaken by NGOs or Peoples Organizations (POs), – are directly involved in producing goods or providing services to a market, while seeking to generate a profit. Apart from these aims, however, they also have explicit social objectives, such as, job creation, training or the provision of local services.

Social enterprises are also motivated by ethical values, including a commitment to local capacity building, and they are accountable to their members and the wider community for their social environmental and economic impact.

Third, the ownership of social enterprises is broad-based, with governance and ownership structures based on the participation of stakeholder groups, such as producers, users, clients, or local community groups.

And finally, the profits of social enterprises are usually distributed among stakeholders and/or used for the benefit of the immediate community.

As is true for any business, a social enterprise is defined either as manufacturing (single product and multiple products), trading (wholesale and/or retail), service, banking, or farming/agribusiness.

While the above typology is important, it is better way to define an enterprise in terms of its target customers, that is:

- Customer needs (What is being satisfied?)
- Customer groups (Who is being satisfied?)
- The technologies used and functions performed (How are customers’ needs being satisfied?)

The Basic Question

Once the social enterprise has been defined in terms of its customers, further planning and analysis shall focus on the following basic question:

“Can the planned Social Enterprise produce a product(s) at a price that its target customers are willing to buy and can it sell a sufficient number of these products to stay in business?”

Stated another way, can the enterprise: (a) sell its products; (b) what is the number of products it can sell; and, (c) how much it will sell its products.

There are four major areas in enterprise assessment, namely, (i) market; (ii) production and technology; (iii) organization and management; and, (iv) finance. In this discussion, our focus is on financial assessment.

Planning the financial component of a social enterprise is undertaken to determine the following:

Guide Question	Financial Tool
How much initial capital is required at start-up?	Total Project Cost
Where shall this initial capital be sourced?	Sources and Uses of Funds
Is the projected financial performance satisfactory?	<ul style="list-style-type: none"> • Cash Flow Statement • Income Statement • Balance Sheet • Break-Even Analysis • Profitability Ratios (that is, return on investment and payback period)

Addressing the above questions requires the preparation of the above financial tools.

Financial Assumptions: Revenues and Costs

Before the above financial statements and profitability measures can be prepared, however, the financial assumptions of the enterprise regarding revenues and costs must be spelled out.

• Revenues

Revenues are based mainly on the projected selling price(s) of the product(s). Selling prices can be either market-based or cost-based.

Market-based pricing simply means that the enterprise will adopt the prices prevailing in the market for its product(s).

Cost-based pricing means that the selling price of the product will be based on its production cost plus a reasonable margin to cover fixed costs and generate some profit for the enterprise. This can be determined using the following formula:

$$\text{Price} = (\text{Fixed Costs}/50\% \text{ of full capacity}) + \text{Unit Variable Cost}$$

• Costs

The typical enterprise has three types of costs: *Capital and Start-Up Costs*, *Fixed Costs*, and *Variable Costs*.

Capital and Start-Up Costs

- Capital costs include all costs to acquire, build, and install all elements of the production unit, including land, machinery, equipment, and so on.

- Start-up costs are one-time costs associated with getting started in the business, such as legal requirements, engineering studies, feasibility studies, licenses, and the like.

Fixed Costs. Fixed costs are incurred to operate the production unit regardless of the level of production. Fixed costs include management and administrative salaries, rent, depreciation, repair and maintenance, and so on. Fixed costs are normally expressed on a monthly basis.

Variable Costs. Variable costs are those that are related directly to the level of production. Consisting mainly of raw materials and production labor, variable costs can be expressed on a weekly, monthly, and yearly basis and/or on a per-unit basis (Unit Variable Cost, or UVC).

Projected Cash Flow Statement

A projected cash flow statement matches cash inflows (i.e., receipts) against cash outflows (i.e., disbursements) on a periodic basis to determine whether an enterprise has sufficient cash inflows to cover its outflows. Cash flow analysis is particularly important during enterprise start-up since no business achieves 100% production capacity on the day it begins operations.

A Projected Cash Flow Statement is used to determine when an enterprise can generate enough cash to cover all its costs and will no longer have to depend on external funds. Once this is determined, the amount of external funds required for the enterprise and, more importantly, the timing for the infusion of these external funds would also have been determined.

Preparation of a realistic Projected Cash Flow Statement requires answers to the following three questions:

- What preparatory activities must be completed before the social enterprise can actually begin production?
- What is the length of time required to put together all the different elements so that the enterprise can actually begin production?
- Once an enterprise begins actual operations, how long will it take before it achieves its planned 100% production capacity?

Following are sample preparatory activities that must be completed before an enterprise can actually begin production:

- finalizing agreements to acquire a lot where physical facilities will be constructed (including the resolution of any right-of-way issues);
- actual construction of the production facility;
- testing of machinery and equipment;
- securing the necessary business permits and licenses;
- training of workers and staff;
- Finalizing marketing agreements with identified customers;
- production test runs; and,
- pilot marketing activities.



Following is a sample projected cash flow of a rice marketing project.

Table 1. Sample Projected Cash Flow Statement Integrated Rice Marketing Project of the Rural Women's Marketing Cooperative, Inc. (12 Months, Monthly Basis)

MONTH	1	2	3	4	5	6	7	8	9	10	11	12	TOTAL
Cash Inflows													
• Cash Sales	0	0	10	10	10	20	20	30	30	30	30	30	220
• Collect-Credit Sales	0	0	0	10	20	20	30	30	30	30	30	30	240
• Other Inflows	0	0	0	10	10	0	10	0	10	0	10	0	40
Subtotal -	0	0	10	30	40	40	60	60	70	60	70	60	500
Less: Cash Outflows													
• Capital Costs	40	20	0	0	0	0	0	0	0	0	0	0	60
• Start-Up Costs	10	10	0	0	0	0	0	0	0	0	0	0	20
• Fixed Costs	0	0	10	10	10	10	10	10	10	10	10	10	100
• Variable Costs	0	0	20	30	40	40	40	40	40	40	40	40	370
Subtotal -	50	30	30	40	50	50	50	50	50	50	50	50	550
Net Inflows/-Outflows	(50)	(30)	(20)	(10)	(10)	(10)	10	10	20	10	20	10	(50)
Add: External Funds	50	30	20	10	10	10	0	0	0	0	0	0	130
Net Cash Flow	0	0	0	0	0	0	10	10	20	10	20	10	80
Add: Cash Bal., Begin	0	0	0	0	0	0	0	10	20	40	50	70	
Cash Balance End	0	0	0	0	0	0	10	20	40	50	70	80	

Following is a description of the main components of the Projected Cash Flow Statement.

Cash Inflows. Care should be taken to ensure that goods produced are not equated with goods sold. The schedule of production is an internal decision made by the management of an enterprise, while actual sales is based on external market forces and subject to seasonal fluctuations.

Not all sales are done on a cash basis; oftentimes, goods are sold on credit. The cash received from the collections of sales on credit should be listed during the period when these are actually received, not during the period when the sales transaction was made.

Cash Outflows. Only transactions involving the disbursement of cash should be listed. Depreciation, a non-cash cost, should not be listed in the cash flow. Loan amortization payments (both principal and interest), on the other hand, are listed in the Cash Flow as they involve the disbursement of cash. (Conversely, only the payment of interest income, not the payment of principal, is included in the Profit and Loss Statement.)

Costs are listed in the periods when cash is actually disbursed to pay for them. Capital and Start-up costs are listed during the pre-operating period when the different elements of the enterprise are still being assembled prior to the start of production. Fixed and variable costs (also known as operating costs) are incurred (and listed) when the enterprise has actually begun production.

Net Inflows (Outflows). This is the difference between Cash Inflows and Cash Outflows.

External Funds. During periods when cash outflows exceed the combined total of the cash inflows and the beginning cash balance, external funds must be infused into the enterprise to cover the cash shortfall. External Funds may be drawn either from the proponent NGO, the beneficiaries of the project, sympathetic individuals and groups, the donor, or any combination of the four parties. The amount of external funds to be infused into the enterprise should be exactly equal to the cash deficit to avoid possible over-funding.

Net Cash Flow. This is the sum of the net inflows (outflows) and external funds. During periods when external funds are infused into the enterprise, this sum should be equal to zero, again to avoid over-funding of the enterprise.

Cash Balance, Beginning. This is the amount of cash available to the enterprise at the beginning of a particular period. At enterprise start-up, this should be equal to zero.

Cash Balance, Ending. This is the amount of cash left available for the enterprise at the end of a particular period. It becomes the beginning cash balance for the next period.

Projected Income Statement

An income (or profit-and-loss) statement shows the financial results of a business over a given period of time. The Projected Income Statement summarizes the expected financial performance of a business and is often a major factor in determining whether or not to undertake the business.

Following is a sample Projected Income Statement.

Table 2. Sample Project Income Statement
Ondoy's Mini-Restaurant and Fast Food Enterprise for the 6-month period ending 31 December 2009

	M1	M2	M3	M4	M5	M6	Total
Gross Revenues							
• Sales	200	300	300	300	300	300	1,700
• Other Income	0	100	0	100	0	100	300
Subtotal	200	400	300	400	300	400	2,000
Less: Variable Costs	100	200	200	200	200	200	1,100
Gross Margin	100	200	100	200	100	200	900
Less: Fixed Costs	100	100	100	100	100	100	600
Net Income	0	100	0	100	0	100	300

When prepared periodically during the actual operations of an enterprise, Income Statements can be used to evaluate financial performance in a variety of ways, such as:

- Have profits increased over time?
- Have sales increased over time?
- Have costs of production been reduced?
- How does this business compare with other business?
- How does this business compare with other industry averages?
- How does this product compare with one in a completely different line of production?

Projected Balance Sheet

The balance sheet is the statement of the financial position of a business that lists the assets, liabilities, and owner's equity at a particular point in time. In other words, the balance sheet illustrates the business's net worth.

The balance sheet – along with the income and cash flow statements, enables potential investors to gain insight into the enterprise and its operations. The balance sheet states the financial position of the enterprise at the end of the reporting period, while the income statement and statement of cash flows cover the entire reporting period.

Four important takeaways provided by the balance sheet include:

1. **Liquidity** – Comparing a company's current assets to its current liabilities provides a picture of liquidity. Financial liquidity refers to how easily an asset can be converted into cash without affecting its market price. Stock and bonds assets are very liquid since they can be converted to cash within days. However, large assets, such as property, plant, and equipment, are not as easily converted to cash. A company is considered liquid if its current assets are greater than current liabilities, thus enabling it to cover its short-term obligations. Two common measures of liquidity are the **Current Ratio** and the **Quick Ratio**. The current ratio, which compares current assets to current liabilities, is calculated by dividing current assets by current liabilities. It measures a company's ability to pay off short-term debts. On the other hand, the quick ratio measures a company's ability to meet its short-term obligations with its most liquid assets. The quick ratio is calculated by dividing liquid current assets (i.e., cash, marketable securities, and receivables) by total current liabilities.
2. **Leverage** – Leverage involves the use of borrowed capital as a funding source when investing to expand the firm's asset base. When a company is "highly leveraged," this means that it has more debt than equity. How a company is financed indicates how much leverage it has, which indicates how much financial risk the company is taking. Comparing **debt to equity** is a common way of assessing leverage on the balance sheet.
3. **Efficiency** – Using the income statement with the balance sheet makes it possible to assess how efficiently a company uses its assets. For example, the **Asset Turnover Ratio**, which divides revenues by fixed assets, indicates how efficiently the company turns assets into revenue. Generally, a higher ratio implies that the company is efficient in generating

sales or revenues. A lower ratio suggests that the company is not using the assets efficiently and may have internal problems.

4. **Rate of Return** – Figures in the balance sheet can also be used to evaluate how well a company generates returns (i.e., profits from investment). Two measures are the **Return on Equity (ROE)** and the **Return on Assets (ROA)**. ROA indicates how effectively an organization is taking earnings advantage of its base of assets, while ROE shows how effectively an organization is taking advantage of its base of equity, or capital. ROE is the result of net income divided by equity, while ROA is calculated net by dividing net income with average assets.

To calculate, assume the following figures for a hypothetical company:

- Assets = 100;
- Net Income = 20; and,
- Shareholders Equity = 30

On the basis of the above figures, the ROE for this hypothetical company would be 67% (20/30), while the ROA would be 20% (20/100). Higher ratios (whether ROE or ROA) indicate higher efficiencies and greater effectiveness by a company on the use of its assets and invested equity.

Structure of the Balance Sheet. The balance sheet is divided into two sides (or sections). The left side of the balance sheet lists all of the assets of an enterprise. On the right side, the balance sheet outlines liabilities and shareholders' equity.

An asset is a resource with economic value that a company owns or controls with the expectation that it will provide a future benefit. Assets are reported on a company's balance sheet and are bought or created to increase a firm's value or benefit the firm's operations. An asset is expected to generate cash flow, reduce expenses, or improve sales, regardless of whether it is manufacturing equipment or a patent. Assets can be broadly categorized into short-term (or current) assets, fixed assets, financial investments, and intangible assets.

A liability is the obligation of a company, usually a sum of money, which has not yet been completed or paid for. Liabilities are settled over time through the transfer of economic benefits including money, goods, or services.

Liabilities include loans, accounts payable, mortgages, deferred revenues, earned and unearned premiums, and accrued expenses.

On both sides, the mainline items are generally classified by liquidity. Assets and liabilities are also separated into two categories: **current** (expected to be concluded in 12 months or less) and **long-term** (12 months or greater).

Following is a sample balance sheet.

Table 3. Sample Balance Sheet
**Ondoy's Mini-Restaurant and Fast Food Enterprise
As at 31 December 2009**

Assets		Liabilities and Equity	
Current Assets		Current Liabilities	
Cash	400	Accounts Payable	300
Accounts Receivable	200	Notes Payable	400
Inventory	500	Subtotal -	700
Subtotal -	1,100		
		Long-Term Liabilities	
		Bonds Payable	300
		Long-term Debt	400
Long-Term Assets		Subtotal -	700
Plant, Property, Equipment	600	Total Liabilities -	1,400
Intangibles	300		
Subtotal -	900	Shareholders' Equity	
		Share Capital	400
		Retained Earnings	200
		Total Equity -	600
Total Assets -	2,000	Total Liabilities & Equity -	2,000

The total amount of assets on the balance sheet should always equal the total of all liabilities and equity accounts (Assets = Liabilities + Equity). This is known as the **accounting equation**. Otherwise, a balance sheet is considered to be *unbalanced*, and should not be issued until the underlying accounting error that is causing the imbalance has been located and corrected.

Similar to all financial statements, balance sheets will have minor differences between organizations and industries. However, there are several line items that are almost always included in common balance sheets.

Following are the commonly-found line items in a balance sheet. These are classified under Current Assets, Long-term Assets, Current Liabilities, Long-term Liabilities, and Equity.

- **Current Assets**

Cash and Equivalents. The most liquid of all assets, cash, appears on the first line of the balance sheet. Cash Equivalents are also lumped under this line item and include assets that have short-term maturities less than three months or assets that the company can liquidate on short notice, such as **marketable securities**. Companies will generally disclose what equivalents it includes in the footnotes to the balance sheet.

Accounts Receivable. This account includes the balance of all sales revenue still on credit, net of any allowances for doubtful accounts (which generates a bad debt expense). As companies recover accounts receivables, this account decreases and cash increases by the same amount.

Inventory. This item includes amounts for raw materials, work-in-progress goods, and finished goods. The company uses this account when it reports sales of goods, generally under **cost of goods sold** in the **income statement**.

- **Long-term Assets**

Plant, Property, and Equipment. Property, Plant, and Equipment (also known as PP&E) capture the company's tangible fixed assets. This line item is noted net of depreciation. Some companies will class out their PP&E by the different types of assets, such as Land, Building, and various types of Equipment. All PP&E is depreciable, except for Land.

Intangible Assets. This line item includes all of the company's intangible fixed assets, which may or may not be identifiable. Identifiable intangible assets include patents, licenses and secret formulas. Unidentifiable intangible assets include brand and goodwill.

- **Current Liabilities**

Accounts Payable. Accounts Payables (AP) is the amount a company owes suppliers for items or services purchased on credit.

Current Debt/Notes Payable. These include non-AP obligations that are due within one year's time or within one operating cycle for the company, whichever is longer. Notes payable may also have a long-term version, which includes notes with a maturity of more than one year.

Current Portion of Long-Term Debt. This account may or may not be lumped together with the above Current Debt account. While they may seem similar, the current portion of long-term debt is specifically the portion due within the current year. For example, if a company takes on a bank loan to be paid off in 5-years, this account will include the portion of that loan due in the next year.

- **Long-term Liabilities**

Bonds Payable. This account includes the amortized amount of any bonds the company has issued.

Long-Term Debt. This includes the total amount of long-term debt (excluding the current portion, if that account is present under current liabilities). This account is derived from the *debt schedule*, which outlines all of the company's outstanding debt, the interest expense, and the principal repayment for every period.

- **Shareholders' Equity**

Share Capital. This is the value of funds that shareholders have invested in the company. When a company is first formed, shareholders will typically put in cash. For example, an investor starts a company and seeds it with Php10 Million. Cash (an asset) rises by Php10 Million, and Share Capital (an equity account) rises by Php10 Million, thus maintaining the balance of the balance sheet.

Retained Earnings. This is the total amount of net income the company decides to keep. Every period, a company may pay out dividends from its net income. Any amount remaining (or exceeding) is added to (deducted from) retained earnings.

Break-Even Analysis

There are two components to break-even analysis, namely, break-even selling price (BESP) and break-even sales volume (BESV).

Break-even selling price (BESP) is the price that the enterprise needs to charge for its product in order to cover all fixed and variable costs.

The break-even selling price is calculated using the following formula:

$$\frac{\text{Total Fixed Costs} + \text{Total Variable Costs}}{\text{No. of units to be produced}}$$

On the other hand, the break-even sales volume is the number of units of the product that the enterprise must sell in order to cover all fixed and variable costs.

Before break-even sales volume can be determined, the gross margin (GM) per unit must first be computed. The gross margin is the difference between the selling price of one unit of the product and the variable cost per unit.

The variable cost per unit (VCU) can be determined by dividing the Total Variable Costs by the number of units to be produced when the enterprise is operating at full capacity.

The break-even sales volume is calculated using the following formula:

$$\frac{\text{Total Fixed Costs (TFC)}}{\text{Gross Margin (GM)}}$$

Assume the following:

- total fixed costs per 20-day work-month is PhP100;
- the selling price of one unit of the product is PhP2.00;
- the VCU amounts to PhP1.00; and,
- the GM is equal to PhP1.00.

The figures are applied to the above formula as follows: $TFC (100)/GM (2-1)$.

On the basis of the above assumptions, the break-even sales volume is equal to 100 units of the product to be sold in one work-month.

The break-even point is one good indication of the risk at which the enterprise is operating. If the target number of products to be sold is close to the break-even sales volume, the business is operating at a high level of risk.

On the other hand, if the target number of products to be sold are substantially above the break-even point (and the enterprise is confident about its market assumptions), then the business is probably operating at low risk. □

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The Asian NGO Coalition for Agrarian Reform and Rural Development (ANGOC) a regional association of national and regional networks of civil society organizations (CSOs) in Asia actively engaged in promoting food sovereignty, land rights and agrarian reform, sustainable agriculture, participatory governance, and rural development. ANGOC member networks and partners work in 10 Asian countries together with some 3,000 CSOs and community-based organizations (CBOs). ANGOC actively engages in joint field programs and policy discussions with national governments, intergovernmental organizations (IGOs), and international financial institutions (IFIs).

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The formation of Bukluran Para sa Pangangalaga ng Kalikasan ng Pilipinas (BUKLURAN, Inc.) or the Philippine Indigenous Peoples Community Conserved Territories and Areas Consortium (Philippine ICCA Consortium) is a nationwide network of community membership-based indigenous people’s organizations (IPOs) of all ethnographic types. It is premised on bringing together indigenous peoples who assert and utilize traditional governance to protect community-conserved areas. Common to its members is the shared view that indigenous peoples’ survival depends on the protection of valuable knowledge systems and the ancestral lands on which we thrive and persist. Our community-conserved areas can become the ultimate driving force in the conservation of biodiversity when our rights to our land and resources are respected and recognized.

Our main purpose is to carry out and realize the full recognition and respect for the rights, governance and self-management of our ancestral lands.

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Philippine Association for Intercultural Development, Inc. (PAFID) is a social development organization which has been assisting Philippine indigenous communities to secure or recover traditional lands and waters since 1967. It forms institutional partnerships with indigenous communities to secure legal ownership over ancestral domains and to shape government policy over indigenous peoples’ issues. PAFID works exclusively with the indigenous peoples’ sector, specifically upon written or signed requests for assistance from indigenous communities or their representatives. PAFID envisions indigenous communities as responsible stewards of their resources.

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