What Nonaccountants Should Know About Nonprofit Financial Statements
http://www.duganlopatka.com/resources/articles/published-articles/39-not-for-profit-articles/265-financial-statements-article

Without some assistance, nonaccountants may find it difficult to fully understand financial statements. But your nonprofit organization may benefit if you and other key personnel learn the fundamentals of financial statements. Here's a primer to help you interpret the numbers.

Every nonprofit organization's financial statements produced for external use should include four parts:

1. A balance sheet (sometimes called a statement of financial position),
2. An activities statement (sometimes called support, revenue, expenses and changes in net assets),
3. A cash flow statement, and
4. Explanatory footnotes.

Voluntary health and welfare organizations should also include a statement of functional expenses.

The Balance Sheet
The balance sheet is a snapshot of your financial situation at a moment in time, such as at your year end. The balance sheet shows:

• What you own,
• What you owe — in the form of loans and accounts due to others and some-times grant or contract money that you have received but not yet fully earned, and
• Your equity or net assets.

The balance sheet lists assets and liabilities in order of liquidity. That is, how quickly they can be turned into cash or will require cash.

<u>Net assets</u> consist of the difference between what you own and what you owe, and are broken down into donor-restricted amounts. Donor restrictions can be either temporary or permanent.

The Activities Statement
The activities statement shows support, revenue and expenses for a set period, such as the most recent year. It reports all income you received during the year and identifies amounts temporarily or permanently restricted by donors. It also reports income by function as well as your major programs and supporting services, including an important reconciliation of net assets.

The reconciliation shows specifically how last year's net assets plus this year's surplus or deficit produce this year's net assets. You can design the activities statement to report your regular operating activities separately from nonoperating activities, such as investment results.

And comparing the monthly activities statement with your budget can be useful in explaining changes from your original expectations.

The Cash Flow Statement
The cash flow statement reconciles the surplus or deficit to the change in cash balance. For instance, depreciation is an expense in your activities statement but does not require cash. Unpaid revenue you earned and have not yet collected is included in income — but does not increase cash.

The cash flow statement groups cash flows into these types of activities:

• Normal operating activities,
• Investment activities, such as purchase or sale of investments or fixed assets, and
• Financing activities, including loans and repayments.

Explanatory Footnotes
Footnotes are valuable for understanding how the financial statements were prepared. They explain whether the organization follows the cash or accrual basis of accounting. When you use the accrual

basis, you record revenue when earned and expenses when incurred, not when they are paid. Footnotes provide additional information about:

- Equipment depreciation,
- Loan terms,
- Lease commitments,
- Other potential liabilities, and
- Volunteer services and other contributions.

Reviewing Financial Statements

What should you look for when you review a financial statement? Start with the surplus or deficit.

Nonprofit organizations can have either in any year, but repeated deficits or results that differ greatly from budgets are cause for concern.

Other important topics to consider in your financial review include:

Donor restrictions. The financial statements should use net asset classes to reflect donor restrictions, including both temporary restrictions that will be removed by events or the passage of time and permanent restrictions, such as donor-established permanent endowment funds.

Board designations. Only donors can impose restrictions. The board may choose to use unrestricted assets for a specific purpose. Unlike donor restrictions, board designations can be changed at the governing board's discretion.

Donor conditions. Donor-imposed conditions on contributions are outside your control. For example, matching requirements mean that contributions are not recorded. But if donors have not imposed conditions, donor-pledged contributions should be recognized in the financial statements even if you won't receive them until a future year.

Timeliness. The date financial information is available depends on your nonprofit's complexity and need for outside information, such as invoices from suppliers and reports from investment managers. But in general, information the organization prepares should be available within four to 12 weeks after the balance-sheet date.

Investments. Look at your investment return. Have you adopted a sound and prudent investment policy, taking into account how long the money can be tied up?

For example, have you placed funds that can be invested for only a few weeks or months in money-market accounts, and invested endowment or retirement-plan funds in a diversified portfolio of stocks and bonds? Ask board members or outsiders with financial expertise to help develop your investment policy. Most important, make sure your organization follows the policy.

Functional expenses. Expenses should be reported by the function they accomplish. Each major program can be a function. Together these are referred to as program expenses. Operating costs should be classified as management and general. Costs to bring in contributions and donations should be classified as fundraising costs.

Some organizations also have membership-development costs. Supporting services include management and general, fundraising and membership development.

Aging of amounts owed to the organization. The age of receivables due the organization is important. The older these become, the less likely they'll be collected. Watch the trends here. Be sure a collection policy is in place and that it is followed.

Ratios. Important ratios that will help you understand financial statements include:

• *Current ratio.* Obtain this ratio by dividing current assets by current liabilities. This ratio shows the nonprofit's ability to pay its current bills and should generally be not less than 1 to 1.

• *Program services percentage*. Dividing program services by total expenses shows what portion of your expenditures you use to provide direct service. Dividing program services by total support and revenue gives insight into how much of your total budget you spend on program services. Generally, a percentage of 70% to 85% or more is good, but this depends on the nature of your organization. Organizations must spend at least 75% of their total revenue each year on program services to be a part of the combined federal United Way campaign.

• *Ratio of fundraising costs to fund-raising revenue*. This ratio gives insight into the cost of raising money for a specific event and also for your entire fundraising activity. Although this ratio varies widely, fundraising costs exceeding 50% of the revenue raised may cause questions about your primary purpose. When calculating fundraising costs, do not classify direct expenses, such as meal costs for a fundraising dinner, as fundraising costs.

<u>Tax-filing requirements</u>. Be sure that annual filings are complete and familiarize yourself with the content of these public documents that anyone may peruse. Some important federal filings include:

- Form 990 or 990EZ and 990 Schedule A for all organizations eligible to receive contributions,
- Form 990T for organizations that conduct unrelated business activities, and
- Form 5500 for organizations with employer-funded qualified retirement plans or employee benefits plans.

<u>Computer security</u>. Determine what computer-security measures the organization uses, including backups and off-site storage of backups, password and surge protection, and up-to-date antivirus software.

Independent Accountants

Independent accountants reporting on an organization's financial statements supply an accompanying letter stating which of the four types of report they prepared:

1. An audit report, which represents the most thorough level of verification and typically includes confirmation of accounts with outsiders and verification of calculations,
2. A compliance audit, which is also fairly extensive and focuses on verifying com-pliance with requirements of specific funding grants or contracts,
3. A review, which is less intensive and typically involves analysis of normal relationships — such as comparisons of loan interest with amounts owed, payroll taxes with payroll, and account balances or activity with those of previous years and with budgets, or
4. A compilation, which involves the least oversight and is limited to putting information received into proper financial statement format without further investigation or analysis.

But regardless of the type of service provided, the independent accountant will look further if anything appears to be wrong.

Understanding Is Key

These explanations of balance sheets, activities statements, cash flow statements and explanatory footnotes should help demystify the language of accountancy. With demystification should come understanding, allowing you to interpret the numbers like a pro. The importance of understanding financial statements can hardly be overemphasized.

Other resources:
The SEC's Beginners' Guide to Financial Statements
http://www.sec.gov/investor/pubs/begfinstmtguide.htm

Preparing and Understanding Financial Statements
From Free Church Accounting
http://www.freechurchaccounting.com/understanding_financial_statements.html

The required principal financial statements are the statement of activity; the statement of financial position; and the statement of cash flows. The order in which the statements are normally prepared and the nature of the data presented in each statement are as follows:

Statement of Activity **(Statement of Revenue and Expense)**—a summary of your organization's support and revenue, expenses, and changes in net assets for a specific period of time, such as a month or year.

The statement of activity, also known as the statement of revenue and expenses, reflects a church's or nonprofits support and revenue, expenses, and changes in net assets (fund balances) for a certain period of time such as month, quarter, or year.

It shows the church's or nonprofit's source of income and how they used their resources. The form of the statement will depend on the type and size of an organization and the accounting method used. However, the statement must show the changes in restricted, temporary restricted, permanently restricted and total net assets.

When preparing a statement of activity using the pure fund accounting method, you will show each of your funds individually in columns.

When preparing this statement using the Statement of Financial Accounting Standards (SFAS) Numbers 116 and 117, you will use the restricted, unrestricted, and permanently restricted headings in your columns.

Both methods are correct.

Statement of Financial Position **(Balance Sheet)**—a list of the assets, liabilities, and net assets as of a specific date, usually at the close of the last day of a month or a year.

A statement of financial position shows assets, liabilities, and net assets as of the end of a period such as a month, quarter, or year.

Because it shows how the two sides of the accounting equation (Assets –Liabilities = Net Assets) *balance* in your organization, it is often referred to as a balance sheet.

Statement of Cash Flows —a summary of the cash receipts and cash payments for a specific period of time, such as a month or a year.

The statement of cash flows provides information about the cash receipts and distributions of a church or nonprofit. It also shows the extent to which the resources of an organization were obtained from, or used in operating, investing, or financing activities.

The statement of cash flows can be prepared with two different methods:

- Direct method: begins by listing all sources of cash from operations during the period and subtracts all operating outflows of cash to arrive at the net cash flow.
- Indirect method: starts with the change in net assets from your statement of activity and adjusts backwards to reconcile the change in net assets to the net cash flows.

From Fiscal Responsibility and Oversight: Empower Your Board to Lead
By Melanie Lockwood Herman
http://www.nonprofitrisk.org/library/articles/board121108.shtml

Board members exercise overall responsibility for the fiscal affairs of the nonprofits they serve. To discharge this responsibility board members must:

- Have a keen interest in the fiscal affairs of the nonprofit, including its overall, current financial position, the reliability of the reports the board receives, and the effectiveness of the nonprofit's management of incoming and outgoing funds.
- Require regular, timely and complete financial reports from internal finance staff or contract staff and expect the board to hold staff accountable for meeting the standards of timely reporting (for example, providing financial statements no later than three weeks after the close of the prior accounting period).
- Ask critical questions about the financial reports the board receives, including budgets, periodic financial statements, the annual Form 990 and annual, sometimes audited, financial statements.

Keep in mind that a board that fails on *any* of the above issues is incapable of meeting its legal *duty of care*. A CEO who fails to empower the board to discharge its duty of care is arguably derelict as a leader.

In many cases the board roster will include several people who are comfortable reviewing nonprofit financial statements. These individuals may volunteer to serve on the finance committee. Other board members may defer to these individuals and refrain from getting involved in the nonprofit's fiscal affairs. While a talented finance committee is a valuable asset, the remaining board members cannot abdicate their responsibility for providing thoughtful fiscal oversight. Any evidence that one or more board members *do not understand the financial presentations* should be addressed with prompt training and assistance.

Board Finance Orientation: A Suggested Agenda
Scheduling a briefing on the nonprofit's finances and the broader topic of understanding nonprofit financial statements is an important step in empowering the board to provide effective oversight of financial matters. Consider the following suggested elements of a 90-minute orientation; customize the topics, resource materials and timeframe to suit the culture and circumstances of your nonprofit.

Part 1 — **Understanding Nonprofit Financial Statements** (30 minutes)
Consider starting off with an introduction to nonprofit financial statements. Be aware that the degree of familiarity and comfort with this topic is likely to vary. The goal is to get the entire board in sync with the manner in which financial information will be transmitted to the board, and enable individual board members to feel comfortable asking questions about the nonprofit's results. To make this segment more productive, consider providing a list of questions that board members should ask to evaluate the nonprofit's fiscal health or obtaining copies of a resource document on nonprofit financial statements.

Part 2 — **Overview of [Name of Nonprofit]'s Finances and Budget** (30 minutes)
During this segment the session leader should present a brief overview and analysis of the nonprofit's Statement of Financial Position, Statement of Activities, and Statement of Cash Flows for the most recently available accounting period. Copies of these documents should be provided as part of the orientation materials.

Part 3 — **Additional Finance Resources** (30 minutes)
During this segment of the briefing the presenter should call the board's attention to the resources below, all of which provide a picture of the nonprofit's fiscal health and financial management strategies. Suggested background materials to support this presentation include:

- Audited financial statements for the year just ended,
- Narrative highlights of the past fiscal year,
- Consolidated schedules of audited statements—five years,
- Approved operating budget for the current year,
- Financial policies and procedures, and
- Investment policies and procedures.