Training Series for Nonprofit Professionals

Understanding Non-Profit Financial Statements: key reports, what they tell you, and why it matters

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One of the biggest challenges facing non-profits today is the lack of a solid understanding of financial statements by key leaders in the organization. This is a critical shortcoming for many non-profit board members as most often, they have a fiduciary responsibility to the organization they serve. Fiduciary responsibility means you are accountable to the organization and act as trustees of the organization's assets. It is the board's primary role to ensure the entity is well-managed and financially sound.

This session will give you a basic understanding of various financial reports, what each tells you, and what the numbers ultimately are telling you about your organization. But first, let's address a very common and basic misconception. The term "non-profit" DOES NOT mean that your organization is prohibited from generating a surplus. In the commercial sector, that surplus (revenue minus expenses) is called a profit.

In this case, the term non-profit is used to describe an organization that has been granted tax exempt status by the Internal Revenue Service (IRS). This exemption status is granted under one of the sections in 501(c) of the tax code – i.e. (3) for charities and foundations, (6) for trade associations.
All this means is that the operating surplus is not subject to federal taxes by the IRS, provided it meets a few conditions. Note: Your organization may be subject to what is known as an "Unrelated Business Income Tax" or UBIT, but that is another topic.

So let's look at some of the most common financial statements for non-profit organizations including:

- Balance sheet
- Profit and Loss Statement
- Budget/Forecast
- Tax Returns
- Audits / Reviews

Balance Sheet – The balance sheet is a snapshot of your financial health on any given day of the year. The balance sheet will typically say "As of (the date)" meaning that on that day, that is the financial picture of your organization. A balance sheet is similar to your personal financial statement, listing all your organization's assets, everything you owe, and your net worth (sometimes referred to as "net assets"). The net worth is simply the total assets minus the total liabilities.

Assets and liabilities are also broken down into short-term or "current" (available or payable within 12 months) or long-term or "fixed" (greater than 12 months). For example, current assets may include your checking and savings account balance, any account receivables (people who owe you money), or any prepaid expenses you may have (such as a deposit on a facility for an upcoming meeting). Long-term assets include any land or property you own, furniture and fixtures, or other assets not readily convertible to cash.

The balance sheet can tell you a lot about your organization's health, aside from how much money is in the checking account. For example, your company's "Current Ratio" is calculated by dividing your current assets by your current liabilities. If this calculation is less than 1.0, that is an indication that the organization is having trouble meeting its current obligations. Suppose you have $20,000 in your checking account and no other current assets, and you have $12,000 in accounts payable (current liabilities) and no other current liabilities, your current ratio is $20,000/$12,000 = 1.66, or expressed another way, you have enough current assets to pay your current liabilities 1.66 times.

In more complex organizations, a similar calculation known as the Quick Ratio can be determined by including only those current assets that are quickly converted to cash at a value close to their book value. An organization with a large amount of inventory in current assets may exclude this amount in calculating its Quick Ratio, as the inventory might have to be liquidated below book value in the event of a financial emergency.

Another key ratio determined from the balance sheet is your organization's debt to equity ratio, which tells you how much of your company's assets are financed by debt. A debt to equity ratio of 1:1 means that your organization has exactly half of its assets financed by debt and half are owned. A higher debt to equity ratio can impact your borrowing ability or show that the organization may have trouble meeting its obligations.

Profit and Loss – Sometimes called a statement of activities, this report shows the financial impact of your operations over a certain period of time, unlike the balance sheet, which is for one specific day. A P&L statement will typically state "for the period ended (date)." Make sure you know what the period is – is it the most recent month, quarter, or year? Is it last year?

There is so much the P&L report can tell you about your organization, but at the most basic level, it shows if you are bringing in more revenue than your expenses. If you are, you will show a net surplus. If you are not, you will show a new loss for the period. Net losses are obviously not sustainable over a long period of time.

Most board members are tempted to flip to the last page of the P&L and see if there is a net surplus or loss and react accordingly. I do it too! But don't assume that a net surplus for the period is necessarily a sign of good health. You have to dig a little deeper. Look at the sources of revenue – are they likely to be recurring or one-time bumps to revenue? Typical non-profit sources of revenue include: member dues, fees for services, grants, donations, event revenue, or sometimes sponsorships. Caution, if you have a large percent of revenue from sponsorships, you may be subject to UBIT mentioned above.

What percent of your revenue generated is used to deliver on your programs and services in your mission compared to the percent used for general overhead of the organization? You'll likely need to know that if you are seeking grants.

Another good tool for you to use is to compare your P&L for a specific time period to the prior time period (typically the year before). For example, comparing your P&L for the first three months of the year to the first three months of the prior year will give you an indication of the sustainability of revenue sources. It will at least draw contracts and obvious differences will jump off the page, prompting you to ask the question – what happened here?

Budget/forecast – Your organization should have a financial or budget committee that prepares and reports on your actual operations compared to the board approved budget. There is a lot of information in that last sentence: You need a treasurer, you should have a committee prepare the reports not just one person, the committee should submit a budget for the board to approve IN ADVANCE of the upcoming year, not during the operating year, and the board should approve that budget. As a board member you should expect (and demand) a financial report to be included at each board meeting. And you should feel comfortable asking questions if something seems out of line or you just don't understand it. It's your responsibility! But remember, a budget is just someone's estimate of what the revenue and expenses will look like for the upcoming year. Any large deviation from the approved budget should be questioned.

Tax Returns – as a non-profit entity, you are required to file an annual tax return, regardless of the size of your organization. If your organizations revenue is under $50,000 you can file the online 990-N Electronic Notice (e-postcard). Important: Organizations that qualify for this form but fail to file a return for three consecutive years will automatically lose their tax-exempt status. If this happens, there is a lengthy process, as well as an $800 fee, to get the status reinstated.

Depending on the type of non-profit you operate, the tax return may vary. When in doubt, get a Certified Public Accountant (CPA) to prepare your returns! They may be willing to donate the services as an in-kind donation.

Audits or Reviews – Not all non-profits need to have an independent audit conducted. If your organization receives federal or state grant funds, you may be required to have an audit conducted. Also, if your organization has more than $1 million in revenue, it is a good idea to have an audit. Audits

can be expensive and time consuming. But they also provide you with a financial "clean slate" each year, providing a great deal of protection and peace of mind for board members and staff. Typical audit findings in small staff non-profits center around a lack of segregation of duties (i.e., one person is handling too many of the financial tasks creating the potential risk for financial malfeasance). Talk with your auditor about your circumstances and ask how they would set up the process to minimize this risk.

A review is often done in place of an audit, sometimes on a rotating basis. Reviews are less costly and less involved, but come with some disclaimers from the reviewer. Typically, the reviewer is not attesting to the accuracy of the financials and has conducted fewer "tests" and checks on the financial processes. Nonetheless, in a smaller organization a review may give the board peace of mind knowing that an outside party looked at the numbers.

There are many other financial reports and processes that non-profits may be involved with. But a basic understanding of these reports will give you the tools you need to be able to ask the right questions.

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