Reading Nonprofit Financial Statements:
How to Be a Financial Detective

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March 16, 2010
Grant Managers Network, Baltimore, MD
Overview of Financial Statements

Most Frequently Used Financial Reports

• Budget
• Income Statement
• Balance Sheet
• Audit
• IRS Form 990
• Cash Flow Reports
• Financial Reports Must be:
  ▪ Accurate and consistent
  ▪ Available soon enough to be of use in planning
  ▪ Understood in context of the organization’s situation and needs
  ▪ Understood in relationship to the program activities
Financial Reports
The Audit

- What is an audit?
- Three levels of financial report
- Compilation
  - Uses information from the nonprofit with no review from CPA
- Review
  - CPA reviews to see if it “makes sense”
- Audit
  - Receives in-depth review, balancing, and testing
  - Highest level of review by CPA
Financial Reports

The Audit (continued)

- Audit Reports
  - Opinion letter
  - Financial Reports
  - Notes to the Financial Reports
  - Management Letter

- When is an audit required by law?
  - Varies by state

- When audit is requested by funder
  - Other types of audits
  - Single audit for government grants
Audit Opinion Letter

The Board of Directors
Nonprofit Organization’s Name

We have audited the accompanying statements of financial position of Nonprofit Organization as of June 30, 2009 and 2008 and the related statements of activities, functional expenses and cash flows for the years then ended. These financial statements are the responsibility of Nonprofit Organization, Inc.’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Organization’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Organization as of June 30, 2009 and 2008 and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Signature or initials of auditor
Date (When statements were accepted by management)
Nonprofit Financial Term: Statement of Activities

• What the Income Statement tells us:
  - Amounts of Income and Expenses for certain period
  - Resulting Surplus (profit) or Deficit (loss)

• Income Categories
  - Support
    • Voluntary contributions
  - Revenue
    • Earned income

• Contribution Categories
  • Unrestricted
  • Temporarily Restricted
  • Permanently Restricted
Contribution Categories

Unrestricted, Temporarily Restricted, Permanently Restricted

• Categories are required by GAAP as a way to assure accountability to donors

• Record contributions based on any donor restrictions

• Classification affects Income Statement and Balance Sheet
• **Unrestricted Net Assets**
  - Free from external restrictions
  - Available for general use

• **Temporarily Restricted**
  - Specific donor-imposed restrictions that will expire over specified period of time or by performing defined activities.
  - When restriction is satisfied, funds can be transferred into unrestricted net assets with an accounting entry and classified as “Net Assets Released from Restrictions” in Support section of the Income Statement.
  - When and how much to release is at the discretion of the organization
• Permanently Restricted Net Assets
  - Contributions for which donor has designated a purpose or time restriction that will never expire.

Example: Scholarship fund that uses interest or investment income for scholarships but can never reduce the principal

- Most nonprofits do not have Permanently Restricted Net Assets
In-Kind Contribution

- Donation of good or services
- Reflects public support of organization
- Can be used for matching funds and challenge grants
- Historical information about true costs of activities
- Required by accounting rules, if material in amount
- Also recorded as expenses for goods or service
GAAP rules for recording in-kind contributions:

- **Contributed Goods**
  - Record all material in-kind contributions
  - Value of donated equipment/supplies recorded at amount organization would have paid for similar items

- **Contributed Services**
  - Only services that meet very specific criteria are recorded according to GAAP rule
  - One of the following conditions must be met:
    - Services create or enhance non-financial assets (such as a building)
    - Services must meet all three of the following:
      1. Require specialized skills
      2. Are provided by someone with those skills, and
      3. Would have to be purchased if they were not donated
Using the Income Statement

- **Unrestricted surplus or deficit**
  - If there are more expenses than income, the cash has to come from somewhere. This means:
    - There are accumulated Unrestricted Net Assets from prior years or
    - They will have future liabilities
  - Surplus or deficit in Temporarily Restricted funds is more an indication of timing that operational results.
    - Surplus funds need to be released in future periods
    - Deficit funds indicates previous grants have been released

- **Temporarily Restricted Funding**
  - Grants received for future periods should not be included in a current income statement
Using the Income Statement
(Continued)

• Reliance on Sources of Income
  - The more types of income and sources the better
    • Less risk due to sudden changes in funding

• Comparison to Budget
  - Budget is most effective tool for monitoring financial progress
  - Budget should be developed with good assumptions and agreement on goals

• Income and Expense
  - Types of income and expenses should fit with how the organization works and how similar organizations operate
  - Significant changes from previous years should fit with changes in organizations operations
  - Organization should have general understanding of how to evaluate costs of their program activities
Balance Sheet

Nonprofit Financial Term: Statement of Financial Position

• Balance Sheet Formats
• What the balance sheet tells us
  - Financial assets and obligations as of a specific date
• Assets
  - What the organization owns
• Liabilities
  - What the organization owes
• Net Assets
  - Equivalent to Net Worth or Equity
  - What the organization has accumulated to retain
Using the Statement of Financial Position

• Balance in Unrestricted Net Assets
  - Unrestricted Net Assets is the organization’s “cushion: for possible deficits or the need to use financial resources for changing programs, moving or expanding.

• Balance in Temporarily Restricted Net Assets
  - Informs the user of an obligation to fulfill in future periods
    • Funds would need to be available at appropriate time

• Amounts of Cash and Current Assets

• Relationship of Current Assets and Current Liabilities
  - This is the “current ratio”
  - Organization should have at least $1 in current assets for every $1 in current liabilities
  - Higher ratio means more assets than liabilities and they can pay their bills
  - If possible, use unrestricted current assets to calculate ratio by factoring out Temporarily Restricted cash and receivables
• Amount of Debt
  - How much debt is there?
  - What is debt being used for?
    • Loans are valuable tool for nonprofits to manage cash flow, build the organization, and finance buildings and equipment

• Types of Assets and Liabilities
  - The types of assets and liabilities should fit with the way the organization works and how other similar organizations operate.
  - If the organization has Permanently Restricted Net Assets, such as an endowment, determine how they are invested or held.

• Changes in Assets and Liabilities
  - Significant changes from prior years should fit with changes in the way the organization operates.
Other Parts of the Audit Report

• Statement of Cash Flows
  - Summary of total sources and uses of cash
  - Not equivalent to a cash flow management report

• Supplementary Schedules
  - Included at the request of the organization to expand the information
  - Financial information on supplementary schedules is usually not audited

• Notes to the Financial Statements
  - Information about the organization’s structure and legal status
  - Details about significant financial statement items
  - Leases and other future obligations
  - Temporarily restricted funds
  - Accounting policies
  - Potential liabilities or risks
  - Subsequent events
  - Notes may be requested by the organization
Reviewing Unaudited Financial Statements

• Accounting Standards
  - Financial Accounting Standards Board (FASB)
  - Government Accounting Standards Board (GASB)
  - Generally Accepted Accounting Principals (GAAP)
  - Cash accounting and Accrual accounting
    • Timing difference – when to record income and expense
  - Quality of financial report and accounting
Financial Reports for Small Organizations

(Continued)

Reporting to the IRS

• Annual 990 Report

• Why is the 990 form required?
  - Content of the 990:
    • Income by category
    • Expenses, categorized by functional expense category
    • Balance sheet
    • Description of program accomplishments
    • Certain salary information (public information)
    • List of certain donors (not public information)
    • Board List
  - Publicly available for review
  - Other required reporting:
    • Attorney General
    • Secretary of State
• **What the Budget tells us**
  - Financial aspect of plans to carry out the mission and programs, based on projected events and activities.

• **Plans and Goals**
  - Programmatic should be decided before the financial resources can be budgeted
  - Budgets are just numbers on a page unless there is a plan to support the numbers

• **Based on Assumptions**
  - Understanding the assumptions of the budget is as important as the numbers.
  - Significant amounts need to be supported by a realistic plan

• **Types of Budgets**
  - Overall organizational budget
  - Program or project budget
  - Grant budget
  - Capital budget
  - Long-term budget
Program-Based Financial Reports

- Assigning Income to Programs
  - Designated grants and contributions
  - Specific contracts and earned income
  - Unrestricted contributions may or may not be allocated among programs

- Direct Expenses
  - Expenses that are needed to carry out a program
  - Might be exclusively for the program
  - Might be shared with other program areas
  - Calculation of allocation should relate to the program activity in a supportable way

- Indirect Expenses
  - Benefit all areas and can't be specifically assigned
  - Also know as Overhead expenses
  - Can be allocated to each program using reasonable methods
  - Some funders define or restrict allocations
Allocation Methods

• Allocating Expenses
  - Divide between several departments based on a justifiable formula

• Why Allocate Expenses?
  - Get accurate information on costs of programs
  - Receive reimbursement or other funding for the true cost of program activities
  - Monitor and manage programs

• Create Calculation That Can Be Supported With Data
  - Calculation method should remain the same
  - Allocation may change as amounts and activities change
Commonly Used Methods For Allocation

- Direct assignment of expenses
  - Used when the type of expense has a relationship to a program that can be identified and measured

- Percentage of expense budget
  - Percentage of overall expense budget is a simple method to use for allocating costs

- Staff time usage
  - Rests on theory that since staff usually makes up the largest percentage of budget, other expenses often have some relationship to staff size
  - Using time allocation requires reliable method for tracking use of staff time
Red Flags
Revenue
(Refer to statement of activities/ income statement, current year budget, and cash flow projections)

- Decrease in annual revenue
- Revenue Trends: Up and Down?
- Little or No Funding Diversity
- Increase in accounts receivable balances
  (aging receivables 120 days or more)
- Loss of significant funding source
Expenses
(Refer to statement of activities/ income statement, current year budget, and cash flow projections)

• Primary Costs of the Organization do not relate to program/mission
• Salaries seem out of line in comparison to similar organization
• Program, admin and/or fundraising costs seem too high or too low relative to annual budget
• Increase in accounts payables balances and/or organization behind in paying key expenses such as taxes or rent.
Assets
(Refer to statement of financial position/balance sheet)

- Decrease in Net Assets from previous year(s)
- No Net Assets
- Higher percentage of restricted assets v. unrestricted assets
Cash and Cash Reserves
(Refer to statement of financial position/balance sheet)

• Operating deficits for longer than a year, trend of dipping into reserves to pay routine expenses.
• Regular cash flow problems
• Organization has little or no unrestricted cash reserves
  (Minimum of 1 month of operating expenses is suggested, 3 months is preferred, 6-12 months best)
• Organization has little or no reserve and does (or does not) have a line(s) of credit.
Other

- Financial reporting outdated and/or financial information does not make sense
- Unusual items (loans to/from ED; large amounts of short term debt)
- Late Audits (more than 6 months after close of fiscal year) and/or problems listed in audit notes
- Indicates of altered financial statements (copies provided rather than originals) and/or missing documentation related to account balances
- High dependence on one or two funders (Including government contracts)
- Significant delays in providing standard financial information (audits, current budget, balances sheets, cash flow projection)
- Resignation of key employees/high turnover/ board disengagement/low staff morale
- Unfamiliar vendors
- Reports of unhappy vendors, client/customers complaints, donor dissatisfaction.
Some Questions to Consider Asking:

• Is the organization financially solid right now? If not, do they have a plan to get there?

• Are there any troubling trends in either the revenue or expenses side? Can they explain those trends and provide a plan for reversing them?

• What are the organization's primary (top 5) funding sources? Are these sources well diversified?

• If the project requires additional funds, do they have a realistic plan to raise those funds?

• Is the organization well managed? Do they have the necessary resources to perform the program that is being proposed (both from a programmatic as well as financial perspective)?