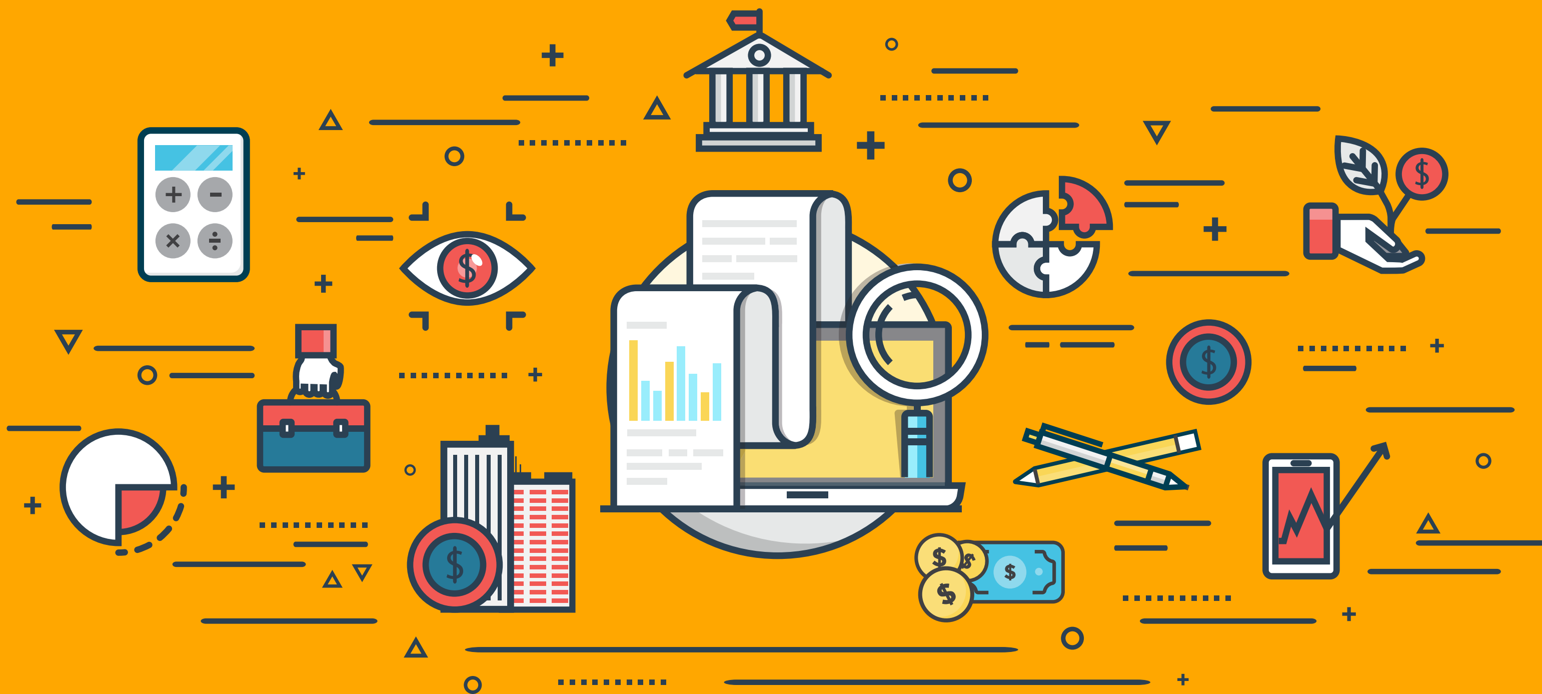
Welcome to Your

KEY FINANCIAL STATEMENTS



A Primer for Nonprofit Board Members

BoardSource®

WELCOME TO YOUR KEY FINANCIAL STATEMENTS: A PRIMER FOR NONPROFIT BOARD MEMBERS

INTRODUCTION

Every nonprofit board member is legally responsible for the financial oversight of the organization he or she serves. You cannot do that without a basic understanding of nonprofit financial statements. This guide is designed to introduce you to the two most important financial documents that you will encounter as a board member — the balance sheet and the income statement — thus helping you meet your fiduciary responsibility.

WHAT ARE FINANCIAL STATEMENTS?

Financial statements are formal written records of your organization's financial activities and position and provide the information you need to identify your organization's financial strengths and weaknesses. Usually, management is responsible for creating the statements, which are typically produced monthly for the month just ended as well as for the year to date. The year-to-date statements provide valuable reference points and allow the board to see how well actual results are following projected assumptions. At year end, the year-to-date figures reflect the accumulation of the previous 12 months of transaction activities applied to the balance sheet and income statement.

WHAT IS THE BALANCE SHEET?

The balance sheet or Statement of Financial Position has traditionally been recognized as the most important of the financial statements due to the comprehensive and illuminating information contained in it. At its simplest, it shows you what your organization owns (assets), what it owes (liabilities), and what remains (net assets) at a specific moment in time.

The balance sheet shows the value of your organization, how much of your debt is current and how much is long-term, and — with the help of ratios — much more (See ratios below).

Some people think of the balance sheet as a scale. Assets and liabilities will not balance until you put net assets on the scale.

Terminology:

Assets are everything an organization owns and are usually listed according to how quickly they can be turned into cash (how "liquid" they are):

- Cash
- Accounts receivable — Money owed to your organization
- Promises to pay — Promised or pledged contributions
- Property, Plant, and Equipment — Fixed assets

Liabilities are everything your organization owes and are usually listed in the order they need to be repaid:

- Accounts payable — Money that your organization knows that it owes vendors and suppliers (unpaid invoices).
- Accrued liabilities — Money that your organization estimates that it owes vendors and suppliers (invoices yet to be received).
- Current portion of long-term liabilities — The portion of long-term debt that your organization must pay in the next 12 months.
- Long-term liabilities — Outstanding debt that has a due date beyond 365 days, such as a mortgage or tax-exempt bond.

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Net Assets are the difference between what your organization owns and what it owes. Net assets can be *unrestricted* as to their use or time of use. Or they may be *restricted* assets, as when a donor puts limits on their use. The restriction can either be *temporary* (if the restriction can be met either with the passage of time or by the purpose being fulfilled) or *permanent* (if the restriction never expires and cannot be removed.) As an example, the principal of many endowments is permanently restricted.

Tip: The *net asset balance* assists you in determining the underlying financial worth of your organization, because it is the value left after the organization's total liabilities are subtracted from its total assets. It is judicious to monitor your organization's net assets over time; a continuously rising trend for this balance sheet line often represents positive operating margins.

WHAT IS THE INCOME STATEMENT?

The balance sheet captures a moment in time. It's like a snapshot. The income statement or Statement of Activities reflects your organization's financial activity — revenues and expenses — over time (monthly, quarterly, and annually). It's like a report card. At most nonprofits, numbers change rapidly as money comes in and bills are paid. This makes it hard to know how much money you've actually earned. The Income Statement answers that question. It tells you if revenue is going up or down and how much profit is left after deducting what it costs to operate your nonprofit. This profit can be used to grow your nonprofit or pay debt. The income statement does not tell you if your organization's financial condition is weak or strong, what you own, what you owe, and what others owe you (see the Balance Sheet).

Which accounting method does your organization use?

The cash method:

- Records revenue when it is received.
- Records expense when it is disbursed.

The accrual method:

- Records revenue when it is earned.
- Records expense when it is incurred.

Because the Income Statement reflects your organization's financial activity over time, it is usually developed monthly, quarterly, and annually. Many nonprofits also create a projected income statement for the next 12 months, based on predictions.

GAAP (Generally Accepted Accounting Practices) requires that the income statement classify revenues and expenditures and be shown as unrestricted, temporarily restricted, or permanently restricted.

Terminology

Revenue is income from providing goods or services to your organization's clients, customers, members, etc. and from other earning activities, such as sales of inventory or earnings on investments. It frequently includes both earned income and income from contributions.

Contributions are assets that have been given to your organization in the form of cash, stock, bonds, art, property, etc.

Expenses are what an organization spends to conduct its activities. Expenses on the income statement are grouped into three categories:

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- Program Services — expenditures, goods, and services used in activities to fulfill the organization's mission, such as salaries and supplies
- Management and General — expenditures on general oversight and management, such as on recording keeping and budgeting
- Fundraising — expenses incurred in the solicitation of contributions and grants

Non-operating income is revenue not related to your nonprofit's programs or mission. The most common item is *realized* investment income — gain or loss from the sale of invested assets, such as common stock or mutual funds, that are owned by the organization.

Net assets are the difference between what your organization owns and what it owes.

Change in net assets is the difference between the revenues earned and expenses incurred over a period of time, otherwise known as profit or loss.

RATIOS

The balance sheet and income statement contain a lot of illuminating information, and while the numbers in themselves are significant, so too are ratios based on the numbers. Ratios help you identify your organization's strengths and weaknesses.

Because nonprofits vary in size, structure, income reliability, and other financial aspects, your board, in conversation with management and your auditors, should establish a set of financial ratio standards or benchmarks that are most appropriate for your organization.

Here are five key ratios that you should understand and be able to articulate.

Current Ratio

Source: Balance sheet

The current ratio measures your organization's ability to meet its current financial obligations.

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The higher the ratio, the better off your organization is. A healthy ratio for most organizations is in the 2.0 to 4.0 range. That level indicates that the organization is financially solvent, having double to quadruple the financial means to meet its current financial obligations. A 1:1 ratio means there is no working capital.

Quick Ratio

Source: Balance sheet

The quick ratio measures your organization's ability to meet its short-term financial obligations with assets that can quickly be turned to cash.

$$\frac{\text{Cash} + \text{Cash Equivalents} + \text{Accounts Receivable} + \text{Unconditional Promises to Pay}}{\text{Current Liabilities}}$$

Like the current ratio, a range between 2.0 and 4.0 is considered healthy.

Days Cash on Hand

Source: Balance sheet and income statement

This may be the most important of all ratios for board members. It measures the number of days of average cash expenses that the organization maintains.

$$\text{Cash} + \text{Short-Term Investments} \div (\text{Total Expenses} - \text{Non-Cash Expenditures}) \div 365 = \text{Days Cash on Hand from Short-Term Sources}$$

$$\text{Cash} + \text{Short-Term Investments} + \text{All Long-Term Investments} \div (\text{Total Expenses} - \text{Non-Cash Expenditures}) \div 365 = \text{Days Cash on Hand from All Sources}$$

Like the current ratio, a higher value is always preferred. The board may want to exclude restricted cash from this equation so as not to overstate the organization's ability to meet its basic operating needs.

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Debt-to-Equity Ratio
Source: Balance sheet
The debt-to-equity ratio tells you the proportion of debt versus assets being used to support your organization. It tells you how deeply your organization is in debt and what percentage of your assets are tied up in liabilities.

$$\frac{\text{Total Liabilities}}{\text{Total Net Assets}}$$

A lower debt-to-equity ratio implies a more financially stable organization. Nonprofits with higher debt-to-equity ratios may be taking too much financial risk as debt must be repaid and the organization may not be able to make the payments.

Operating Margin Percentage
Source: Income Statement
Operating margin percentage is a useful ratio because it measures the organization's bottom line (before non-operating revenues) compared to its total revenues. The ratio allows you to quickly and rather accurately determine the extent of your organization's profitability on its core operations.

$$\frac{\text{Excess of Support \& Revenues Over Expenses}}{\text{Total Support \& Revenues}}$$

Higher values are preferable.

SAMPLE BALANCE SHEET AND INCOME STATEMENT

A key challenge to understanding financial statements is recognizing the wide diversity of nonprofit organizations and the multiplicity of audiences and clientele they serve. Because of this diversity, nonprofit financial statements differ in format and appearance from one organization to the next. The following examples represent a fictional nonprofit; they are meant to be an amalgamation of several types of nonprofits operating throughout the U.S. While these fictional statements may not be precisely like the statements used by your nonprofit, all the common and essential elements are shown to enable you to relate to your organization.

See Next Page

SAMPLE BALANCE SHEET

Financial Statements Explained

ABC CHARITIES, INC.

Statements of Financial Position (Balance Sheet)
At December 31, 2015 and 2014 (in thousands)

Assets (WHAT THE ORGANIZATION OWNS)	**December 2015**	**December 2014**
Current Assets		
Cash	1,200	2,000
Investments — Short Term	6,500	5,400
Total Cash and Cash Equivalents	7,700	7,400
Gross Accounts Receivable	12,000	12,800
Less: Allowance for Doubtful Accounts	(2,800)	(2,600)
Net Patient Receivables	9,200	10,200
Unconditional Promises To Pay	5,000	5,000
Inventory	500	400
Prepaid Expenses	400	300
Other Current Assets	900	700
Total Current Assets	**22,800**	**23,300**
Long-Term Investments — Unrestricted	62,300	55,000
Trusteed Investments	10,000	12,200
Deferred Financing Costs	1,300	1,400
Other Noncurrent Assets	73,600	68,600
Property, Plant & Equipment		
Land and Land Improvements	2,000	2,000
Buildings	20,000	18,000
Leasehold Improvements	700	700
Equipment and Fixtures	10,500	9,000
Construction in Progress	1,500	1,000
Total PP&E	34,700	30,700
Less: Accumulated Depreciation	(18,000)	(15,000)
Net PP&E (book value)	16,700	15,700
Total Assets	**113,100**	**107,600**
Liabilities (WHAT THE ORGANIZATION OWES)	**December 2015**	**December 2014**
Current Liabilities		
Accounts Payable	6,000	4,500
Current Retirement on L/T Debt	1,500	1,400
Total Current Liabilites	**7,500**	**5,900**
Long-Term Debt	64,800	66,200
Other Long-Term Liabilites	2,000	2,100
Total Long-Term Liabilites	**66,800**	**68,300**
Total Liabilities	74,300	74,200
Net Assets (DIFFERENCE BETWEEN WHAT IS OWNED AND OWED)	**December 2015**	**December 2014**
Unrestricted	32,600	27,900
Temporarily Restricted	4,200	4,200
Permanently Restricted	2,000	1,300
Total Net Assets	**38,800**	**33,400**
Total Liabilities & Net Assets	**113,100**	**107,600**

Anything easily convertible into cash

an allowance for receivables that may not be collected

Contributions that have been promised to the organization without any conditions that have to be met

Assets that were donated or purchased with the hope that they will generate income

The portion of long-term debt that your organization must pay within 12 months

Outstanding debt that has a due date beyond 365 days

No donor restrictions on how and when the asset can be used

Tip: This number assists you in determining the underlying value of the organization. A continuously rising trend represents positive operating margins.

Donor restrictions that can be met over time

Donor restrictions that will never expire

Quick ratio:

Cash + Cash Equivalent ($7,700)
+
Accounts Receivable ($9,200)
+
Unconditional Promises to Pay ($5,000)
÷
Current Liabilities ($7,500)

$7,700
$9,200
+ $5,000
$21,700

$$\frac{\$21,700}{\$7,500} = 2.9$$

Current ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\frac{\$22,800}{\$7,500} = 3.0$$

Debt-to-Equity Ratio:

$$\frac{\text{Total liabilities}}{\text{Total unrestricted net assets}}$$

$$\frac{\$74,300}{\$32,600} = 2.3$$

SAMPLE INCOME STATEMENT

Statement of Activites Explained

No restrictions on how and/or when the net assets are used

Donor has placed restrictions on the use of the net assets that can be met over time or by purpose fulfilled

Donor has required gift to be held in perpetuity (not used); generates income that must be used according to donor's intent

Commonly includes expenses directly related to program delivery, such as salaries, supplies, purchased services

Expenditures related to oversight and administrative activities, such as record keeping and finances

Total cost of fundraising efforts

Revenue/expenses not related to mission, such as income from investments

Changes in the fair market value of investments that the organization could sell

ABC CHARITIES, INC.

Statement of Activites (Income Statement)
For the Years Ending December 31, 2015 & 2014 (in thousands)

	UNRESTRICTED	TEMPORARILY RESTRICTED	PERMANENTLY RESTRICTED	TOTAL 2015	TOTAL 2014	PERCENTAGE CHANGE
Public Support & Revenues						
Net Service Revenues	43,600	10,000	--	53,600	50,000	7.2%
Contributions	9,000	--	700	9,700	9,000	7.8%
Grants	3,400	--	--	3,400	3,200	6.3%
Total Support and Revenue	56,000	10,000	700	66,700	62,200	7.2%
Expenses						
Program Services	40,600	7,000	--	47,600	45,800	3.9%
Management and General	10,190	3,000	--	13,190	12,000	9.9%
Fundraising	710	--	--	710	700	1.4%
Total Expenses	51,500	10,000	--	61,500	58,500	5.1%
Excess of Support & Revenue over Expenses	4,500	--	700	5,200	3,700	40.5%
Non-Operating Income (Expenses)						
Gain/(Loss) on investments	1,200	--	--	1,200	1,000	20.0%
Total Non-Operating Income	1,200	--	--	1,200	1,000	20.0%
Excess of Support & Total Revenue over Expenses (Total margin)	5,700	--	700	6,400	4,700	36.2%
Net Assets, Beginning of Year	59,500	4,200	1,300	65,000	62,300	4.3%
Change in net unrealized gains & losses on investments	(1,000)	--	--	(1,000)	(2,000)	-50.0%
Net Assets, End of Year	64,200	4,200	2,000	70,400	65,000	8.3%

Operating Margin Percentage: Allows you to quickly determine the organization's profitability on its core operations; the higher the value the better.

$$\frac{\text{Excess of Support + Revenue over Expenses}}{\text{Total Support \& Revenue}}$$

$$\frac{\$5,200}{\$66,700} = 7.8\%$$

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