

Critical Elements in Nonprofit Financial Statements

Presented by

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Nonprofit Finance Fund: Where Money Meets Mission



Dedicated to keeping nonprofits in balance and in business.

Serving thousands of nonprofit and funder clients since 1980

- \$185 million in loans; over \$1 billion in capital leveraged for nonprofits
- 500+ Nonprofit Business Analyses; 200+ nonprofit finance workshops
- Formed hundreds of strategic partnerships to advance nonprofit sector

Nationwide network of experts in nonprofit finance

- Lending
- Financial advisory services and workshops
- Assistance in preparing for managed change
- Financial advocacy across the nonprofit sector

"[NFF is]... arguably the most influential voice in the ongoing effort to reshape thinking and practice about nonprofit capitalization."

– *The Nonprofit Times*

Critical Elements of Nonprofit Financial Statements: Webinar Goals



- 1. Review the fundamental concepts and structure of nonprofit financial statements**
- 2. Understand how to analyze this information for your own organization and be able answer the following questions:**
 - What is my "bottom line"?
 - What is my net worth?
 - Why do these matter?
- 3. Improve ability to:**
 - Articulate financial information to your staff, constituents, board, and potential funders
 - Make decisions that strengthen your organization's financial health and support effective program delivery

Money Rules: **For-Profit** Business Quiz



True or False?

Cash is “liquid.”

True

Price is determined by cost, consumer, competition.

True

The consumer buys the product.

True

Growth must eventually generate profits or the business fails.

True

Investment in infrastructure is seen as necessary; overhead is a regular cost of business.

True

Profits drop to the bottom line, are used in the business, and/or get distributed to shareholders.

True

Money Rules: **Nonprofit** Business Quiz



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False

Operating Within a Flawed System



We have seen that the “money rules” are reversed in the nonprofit sector. Therefore, nonprofit managers have a heightened need to:

- Consistently produce financial and program data: reliable and timely reports.
- Seek clarity on how to analyze this data: What should we look for? Who should be involved?
- Use data to create a strong decision-making culture: Leaders need to be willing to make difficult decisions.

Types of Financial Statements



Prepared internally by organization:

- Budgets
- “Internals”
 - Typically revenue and expense actuals compared to budget
 - Less frequently, balance sheet included

Prepared externally by CPA firms:

- Audit
- Review
- Compilation
- IRS Form 990 (sometimes internally prepared)

Required Financial Statements



The Financial Accounting Standards Board (FASB) requires that nonprofit audits provide:

- Statement of Financial Position (Balance Sheet)
- Statement of Activities (Income Statement)
- Statement of Cash Flows
- Statement of Functional Expenses: Required of voluntary health and welfare organizations

Nonprofits typically use one of two accounting methods*.

Cash Accounting

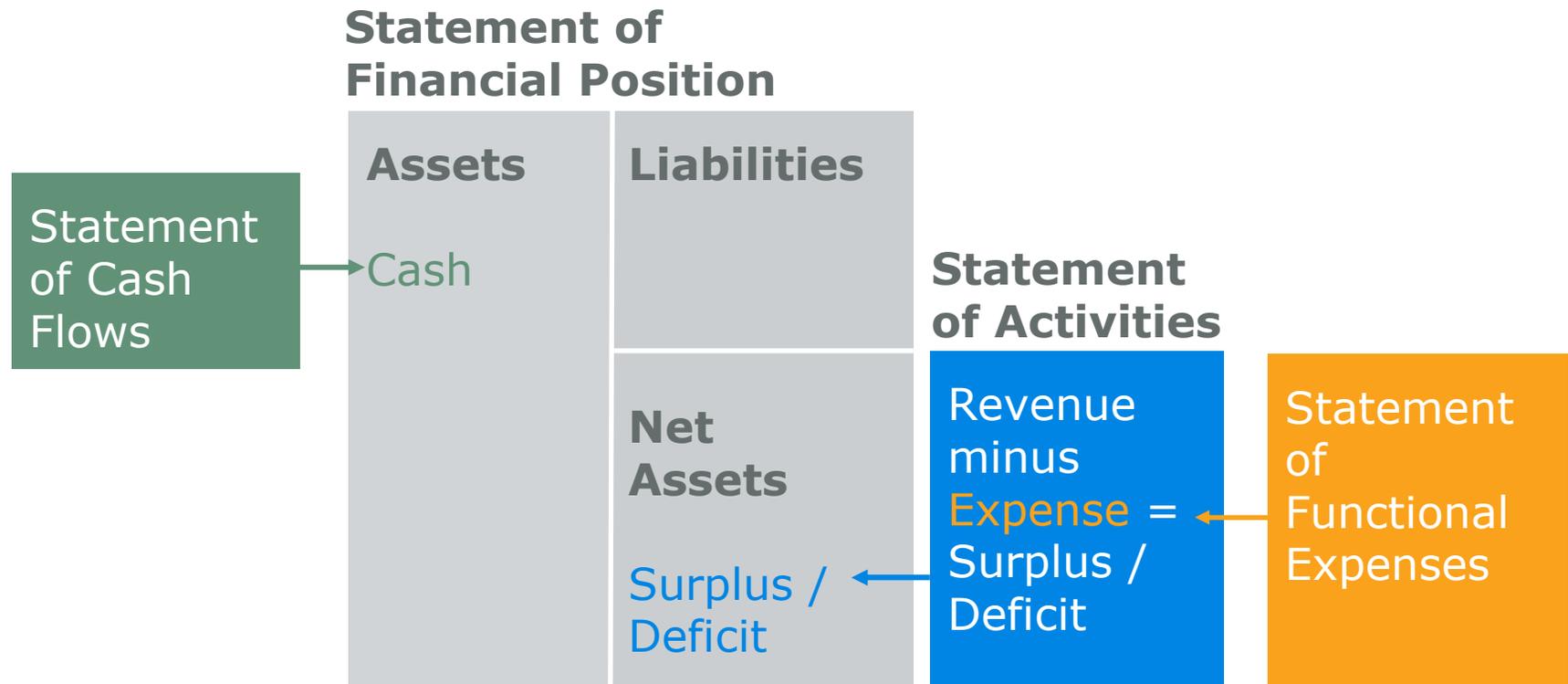
- Similar to balancing your checkbook
- Measures cash in and cash out
- Common for small and / or relatively simple organizations

Accrual Accounting

- A more comprehensive look at your financial situation
- Measures revenue earned and expenses incurred
- Revenue \neq Cash.
- Accrual Includes
 - Accounts Receivables: What others owe you (but not yet!)
 - Accounts Payable: What you owe to others (but not now!)

*Modified cash is a hybrid of Cash & Accrual used by some nonprofits.

Financial Statements are Connected



The Two Bottom Lines

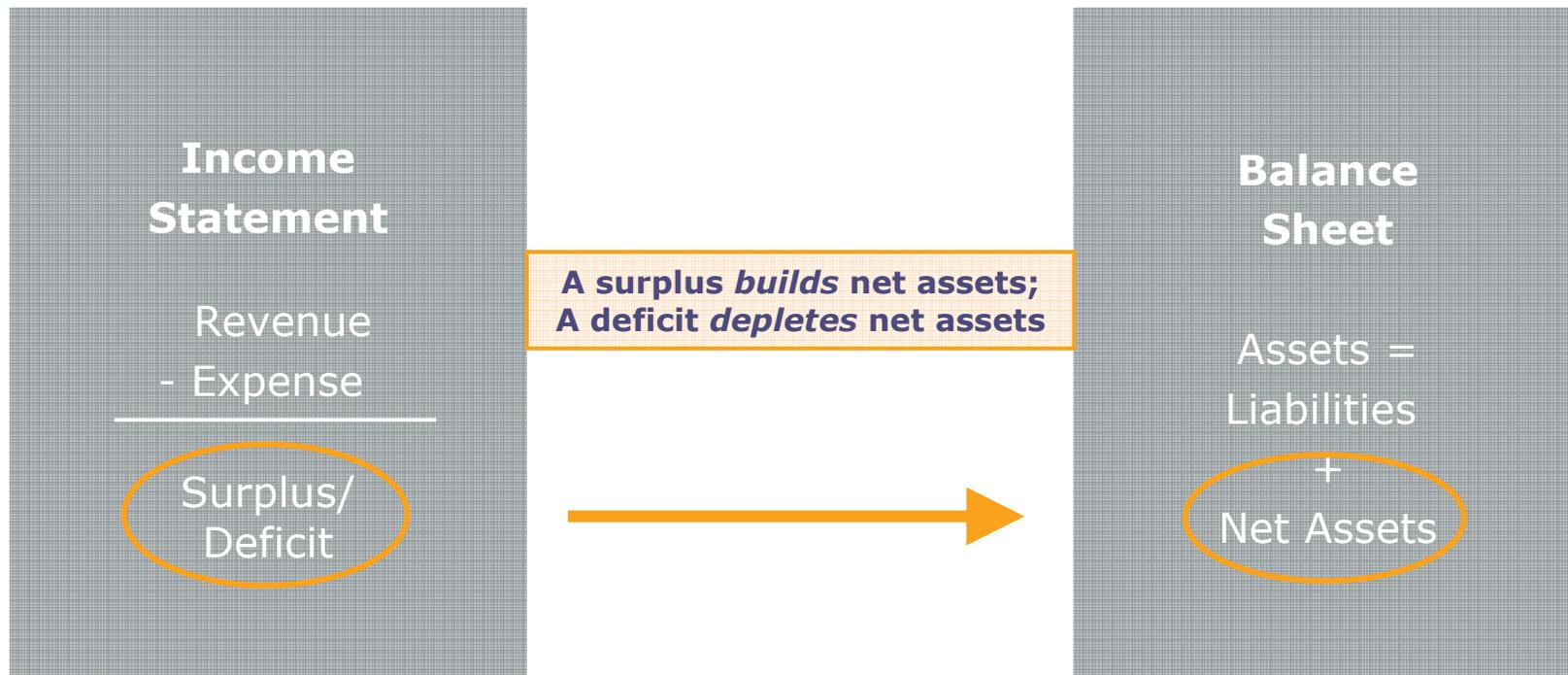


Income Statement: Surplus/Deficit

- Income Statement reflects the annual results of a grantee's core business

Balance Sheet: Net Assets

- Balance Sheet provides a picture of overall financial health



What Can We Learn? The Income Statement Can Help Reveal:



Revenue Dynamics

- Where does the organization's money come from?
- Is it reasonably diversified or at risk?
- Do revenue streams appear reliable / consistent?

Cost Dynamics

- What does the organization spend on operating activities?
- Are expenses adjusted in line with revenue changes?
- Note: Statement of Activities will not present expenditures on capital items or debt principal repayments.

Profitability and Savings

- Does the organization cover its costs?
- Are surpluses sufficient to meet balance sheet obligations?
- Is the agency saving? If so, is it enough?

Sample Statement of Activities



ABC Center Statement of Activities

Years ended June 30, 2005 (\$ in thousands)

	Operating Activity			Total
	Unrestricted	Temp. Restricted	Pem. Restricted	
Operating Revenue				
Earned				
Investment Income	7	-	-	7
Performance Fees	280	-	-	280
Ticket Sales	160	-	-	160
Rental Income	10	-	-	10
Earned Operating Revenue	457	-	-	457
Contributed				
Individual	248	-	-	248
Foundations & Corporations	162	58	-	220
Government	47	-	-	47
Special Events, net	44	-	-	44
Net Assets Released from Restrictions	749	-749	-	-
Contributed Operating Revenue	1,250	-691	-	559
Total Revenue	1,707	-691	-	1,016
Operating Expenses				
Personnel	550	-	-	550
Professional Fees	39	-	-	39
Occupancy	90	-	-	90
Interest	-	-	-	-
Support	583	-	-	583
Total Expenses	1,262	-	-	1,262
Change in Net Assets	445	-691	-	-246

Restricted Revenue FAQs



What are they?	Restrictions enable donors to specify exactly how their funds are to be spent.
Who implements them?	Only donors (Foundations, government agencies, individuals, etc.) can implement restrictions.
Difference between restriction and designation?	Only donors can restrict funds; a board of directors can designate funds.
What types of restrictions are there?	<p>Temporarily restricted: Funds restricted for a certain period of time or programmatic purpose.</p> <p>Permanently restricted: Typically an endowment.</p>
How do we 'unrestrict'?	Meet donor-imposed criteria (end of fiscal year, program enrollment levels met, etc.)
What are the implications?	Knowing the restriction level of your resources is critical for decision-making!

Revenue Goes Into Three “Buckets”



Unrestricted Revenue

Earned Contributed



Temporarily Restricted Revenue

Purpose Timing

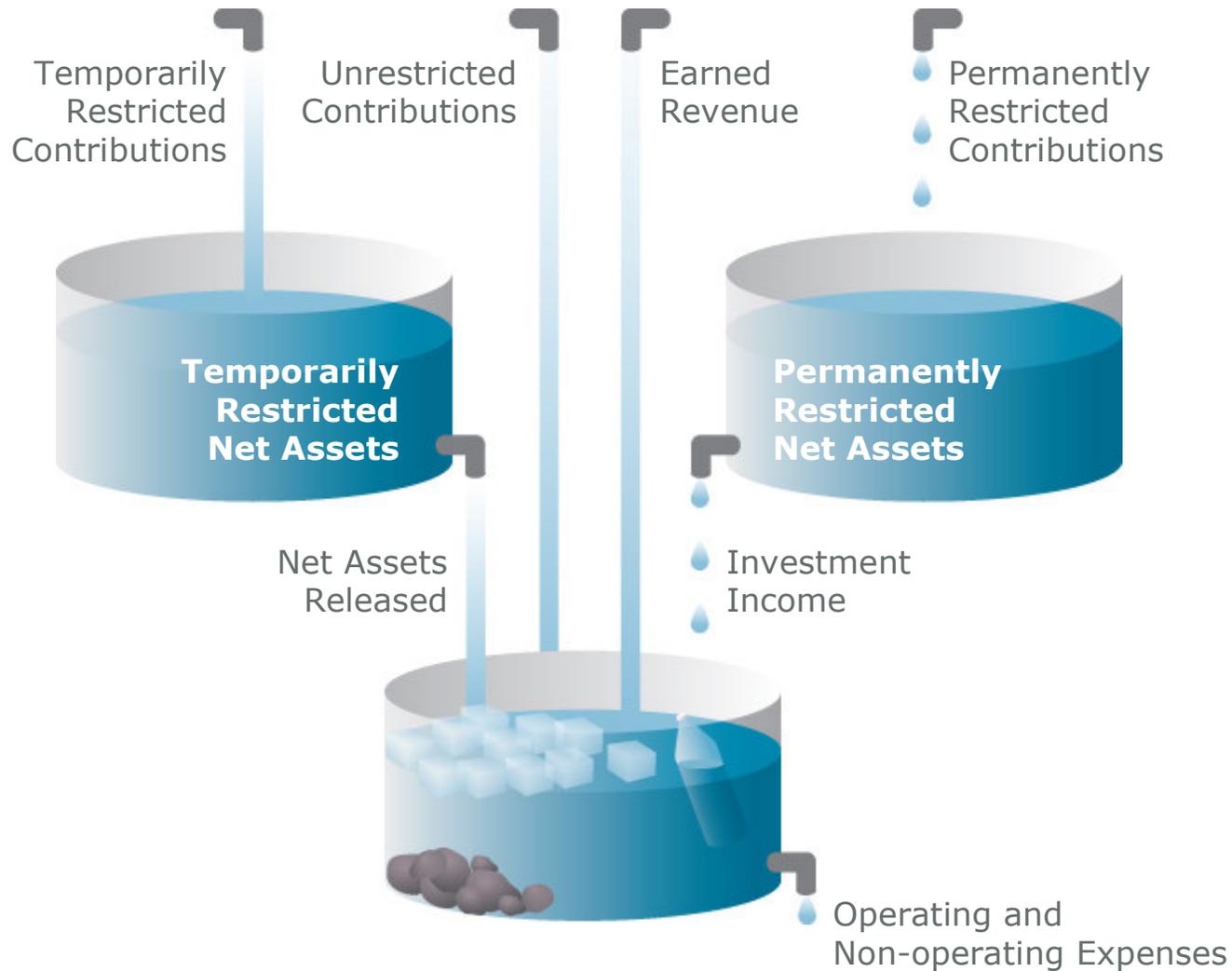


Permanently Restricted Revenue

Endowment



Relationship of Revenue Restrictions to Operations



ABC Center Statement of Activities



ABC Center Statement of Activities

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Determining True Operating Surplus/Deficit



ABC Center Statement of Activities (Revised)

Years ended June 30, 2005 (\$ in thousands)

	Operating Activity			Total
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Special Events, net	44	-	-	44
Net Assets Released from Restrictions	152	-152	-	-
Contributed Operating Revenue	653	-94	-	559
Total Revenue	1,110	-94	-	1,016
Operating Expenses				
Personnel	550	-	-	550
Professional Fees	39	-	-	39
Occupancy	90	-	-	90
Interest	-	-	-	-
Support	490	-	-	490
Total Expenses	1,169	-	-	1,169
Surplus/Deficit Before Depreciation	-59	-	-	-59
Depreciation Expense	93	-	-	93
Surplus/Deficit After Depreciation	-152	-	-	-152
	Non-Operating Activities			
Non-Operating Revenue:				
- Capital Campaign	597	-597	-	-
Change in Net Assets	445	-691	-	-246

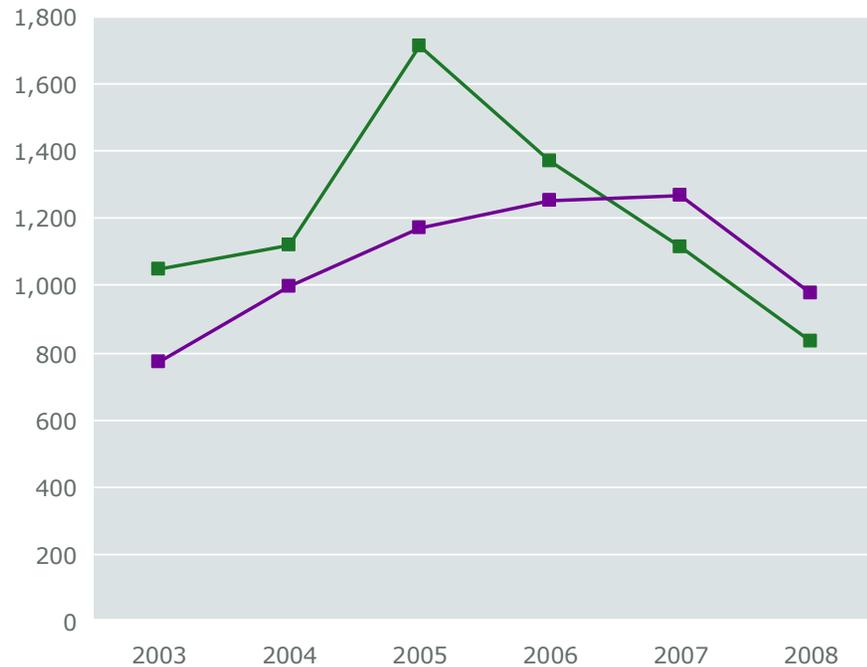
Non-operating revenue segregated and placed "below the operating line"

Non-Operating Dollars Hide True Operating Performance



Unrestricted Revenue & Expenses (including non-operating)

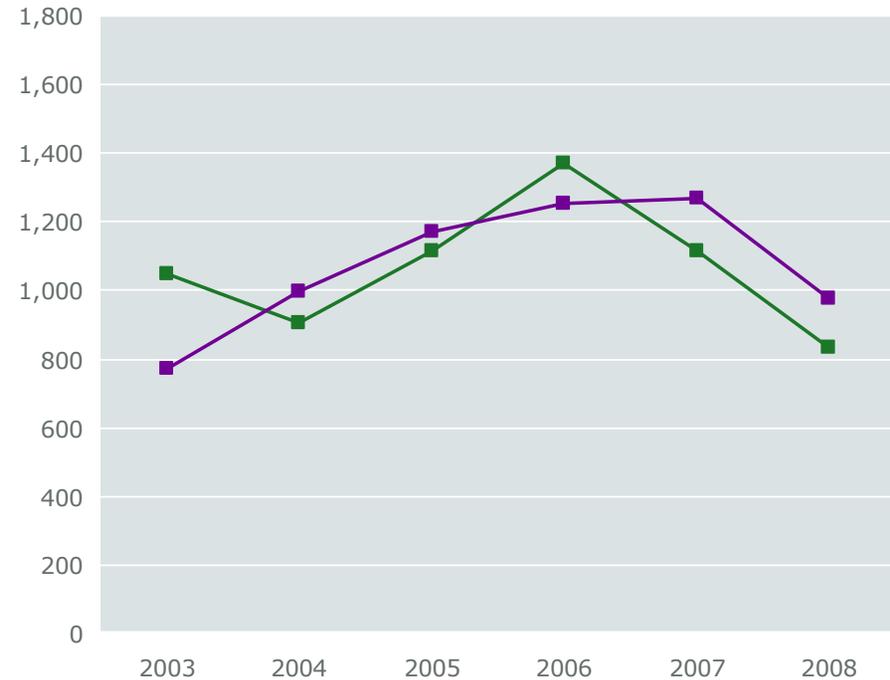
(\$ in thousands)



- Revenue
- Expenses (before depreciation)

Operating Revenue & Expenses

(\$ in thousands)



With capital campaign revenue "below the line," this organization is not breaking even!

Determining True Operating Surplus/Deficit



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Determine true operating Surplus / Deficit

BEFORE AND AFTER DEPRECIATION

Appreciating Depreciation



Every fixed asset purchased will depreciate over its useful life

- Accountants use pre-determined useful life data for various types of fixed assets.
- By definition, fixed assets are “capitalized” (i.e., appear on the balance sheet and are depreciated on the income statement as a non-cash expense)

Reflects concept that fixed assets lose value over time

Arguably an approximation of how much surplus cash needs to be set aside (or raised through a campaign) for replacements

Operating Performance and Surplus Size: Understanding 'Full Costs'



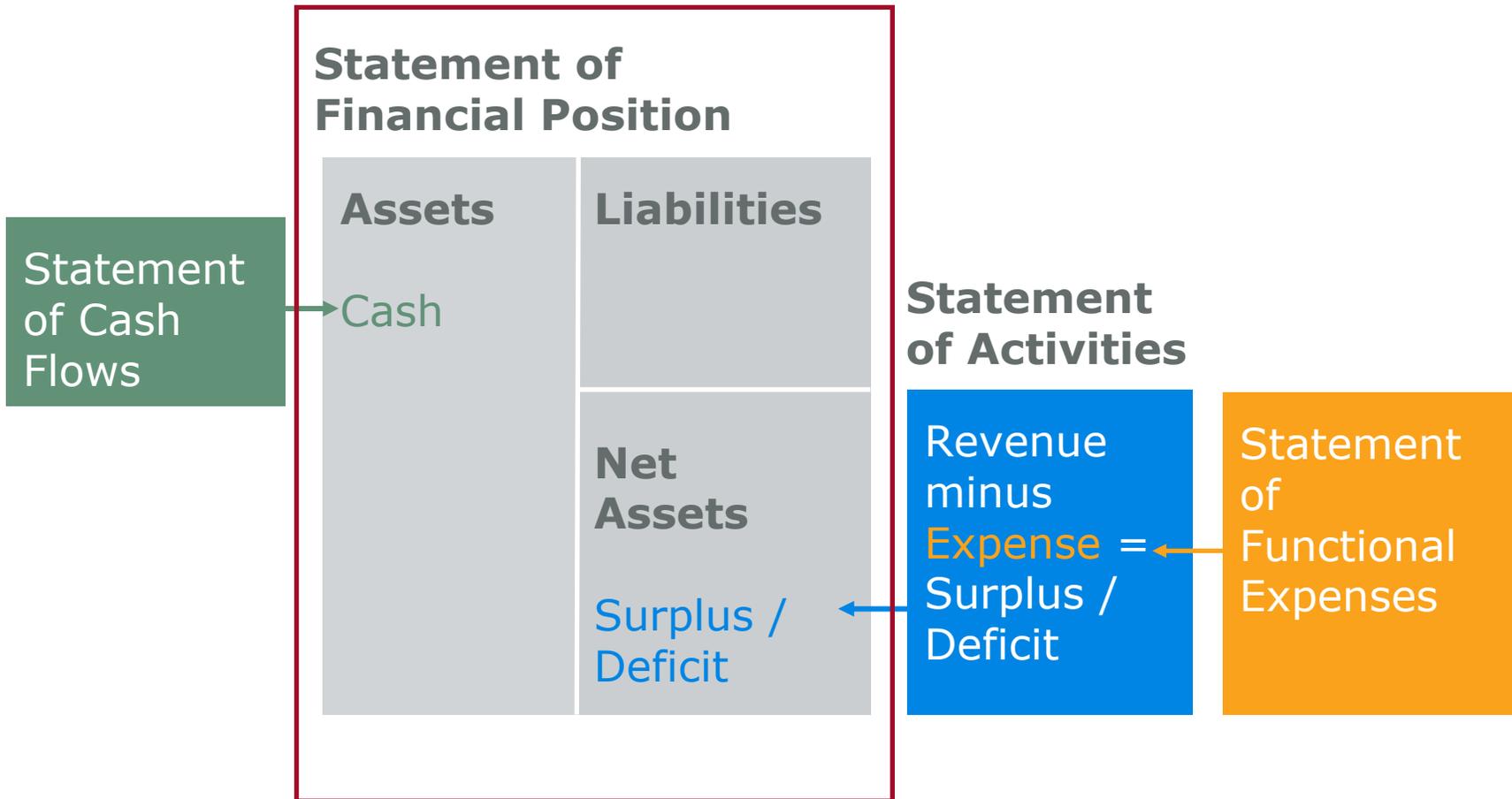
It's easy to forget that organizations must absorb the 'full cost' of delivering programs

- Restrictions implicitly...and often times explicitly...forbid organizations from using funds to pay for indirect costs
- Leaders and management have become desensitized and trained to 'accept what they can get'

Full costs include:

- Total operating expenses
- Depreciation expense
- Debt payments
- New capital investments
- Savings for the future

Financial Statements are Connected



What does it tell us?

- What you 'own' vs. what you 'owe' and the net result
- The balance sheet reflects everything that has happened to your organization up and until that point
- The cumulative impact of the circumstances that surround you and the decisions that you make
- It indicates your ability to manage risk or pursue new opportunities

1. Economic environment risk

- Funding shifts and cutbacks
- Audiences reduced ability to pay

2. Field-wide risk

- Demographic shifts
- Changes in audience engagement/participation
- Technology advances and expectations

3. Artistic risk

- Artistic success may not translate into profits
- Commercial success may require artistic compromise

Financial Position Tells a Story



Statement of Financial Position

FYE 06/30/05 (\$ in thousands)

Assets		Liabilities	
Cash	191	Payables	57
Receivables	55	Debt	114
Prepaid Expenses	41		
Other	-		
P&E (Net)	760		
Long-Term Receivables	-		
Total Assets	\$1,047	Total Liabilities	\$171
		Net Assets	
		Unrestricted	771
		Temporarily Restricted	105
		Permanently Restricted	0
		Total Net Assets	\$876
Total Assets	\$1,047	Total Liabilities & Net Assets	\$1,047

The Balance Sheet: Revealing Strength & Ability to Absorb Risk



Several “tools” on your balance sheet are key to assessing financial health and ability to absorb risk

- **Cash:** How much? Is it restricted?
- **Receivables:** Are they slow to collect? Non-existent?
- **Property & Equipment:** Is the organization investing in its fixed assets?
- **Debt:** Does the organization owe more than it owns?
- **Line of Credit:** How is cash flow managed?
- **Net Assets:** Are they restricted? Do temporarily restricted net assets best support core programs? Are unrestricted net assets liquid?
- **Reserves:** Do they exist? What are board policies concerning the use of reserves? Are reserves suitable to the agency’s needs?

Is the distribution of assets appropriate, given the core business?

The Statements are Connected

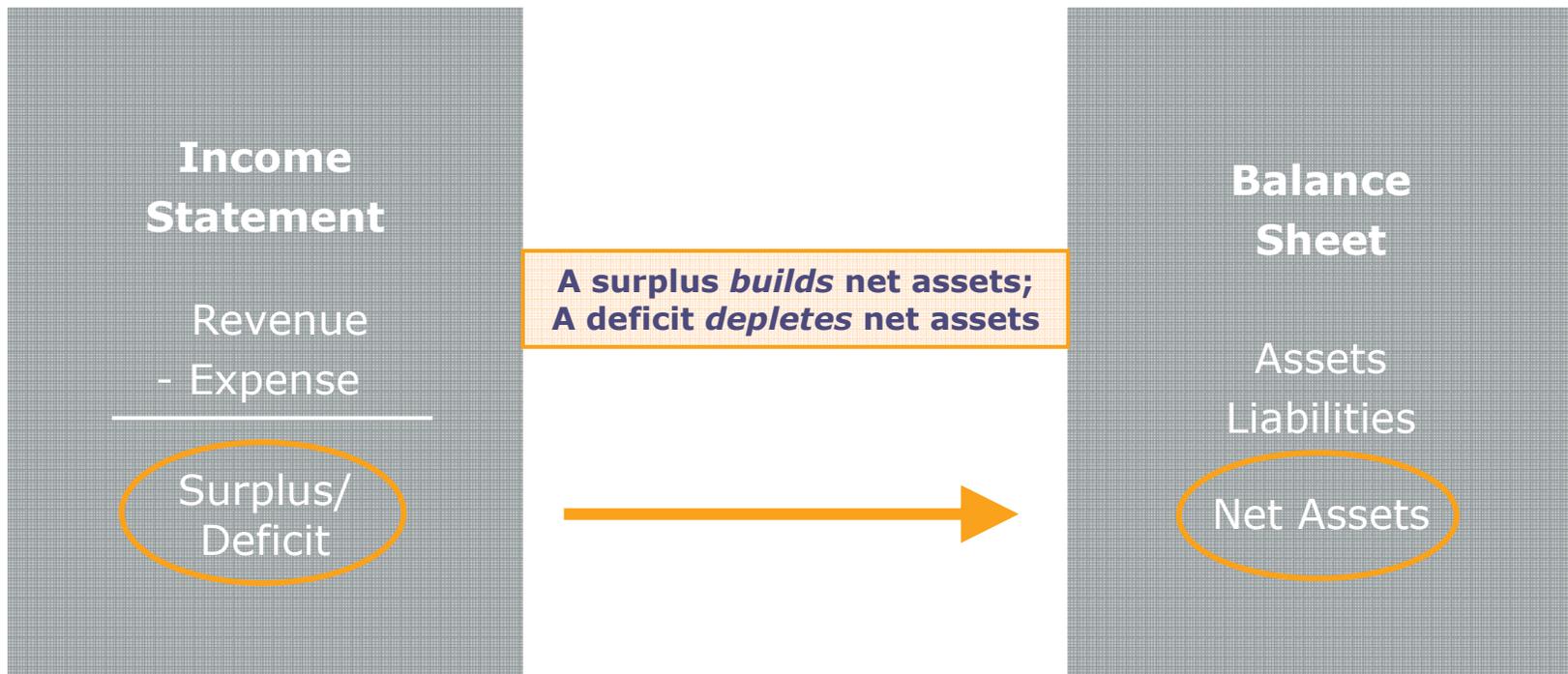


Income Statement: Surplus/Deficit

- Reflects the annual results of a grantee's core business

Balance Sheet: Net Assets

- Provides a picture of overall financial health



Financial Position Tells a Story



Evolution of your Financial Position

Statement of Financial Position

FYE 06/30/04 (\$ in thousands)

Assets		Liabilities	
Cash	296	Payables	131
Receivables	612	Debt	0
Prepaid Exp.	22		
Other	29		
P&E (Net)	256		
Long-term receivables	39	Total Liabilities	131
		Net Assets	
		Total Unres.	325
		Temp. Rest	797
		Perm. Rest	0
		Total Net Assets	1,122
Total Assets	\$1,253	Total Liab./Net Assets	\$1,253

From 7/1/04 to 6/30/05

You engage in operations:

Revenue

Earned
Contributed

Expenses

Personnel
Professional
Occupancy
Interest
Support

Deficit -\$246

Statement of Financial Position

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Change in net assets -\$246

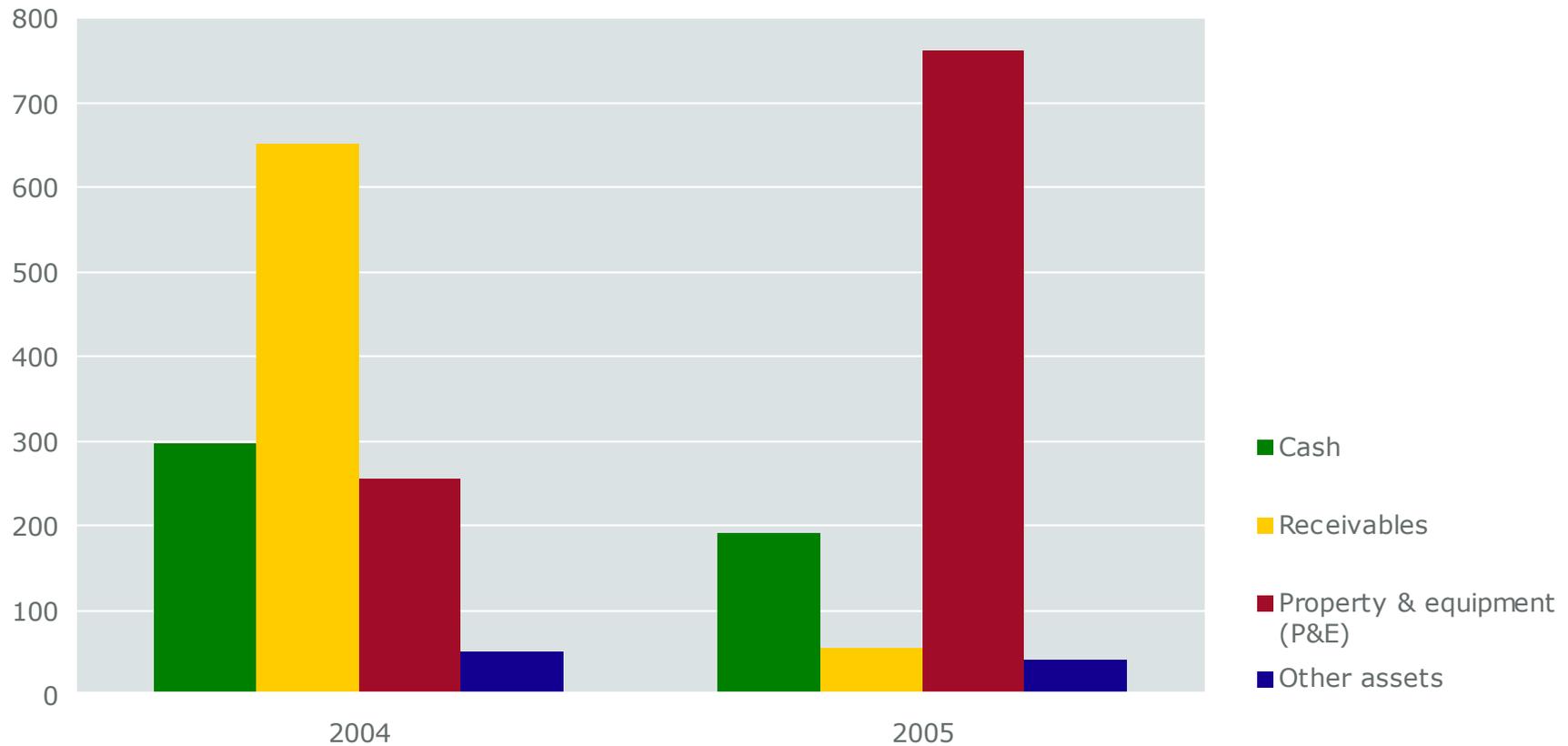
Take Away: Surpluses and deficits change net assets.

A Decision Affected the Balance Sheet



Total Assets

(\$ in thousands)

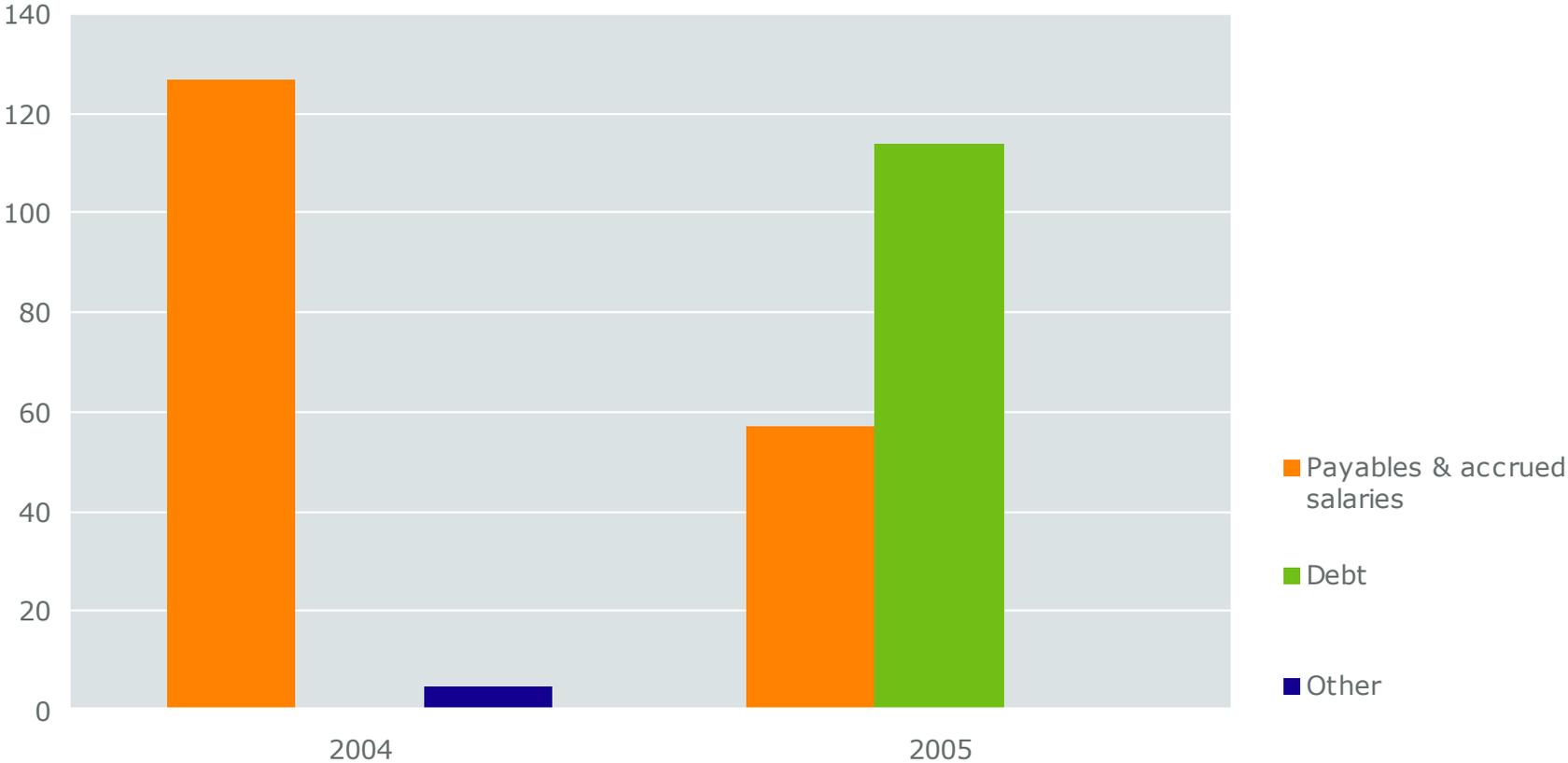


How Were the Fixed Assets Financed?



Total Liabilities

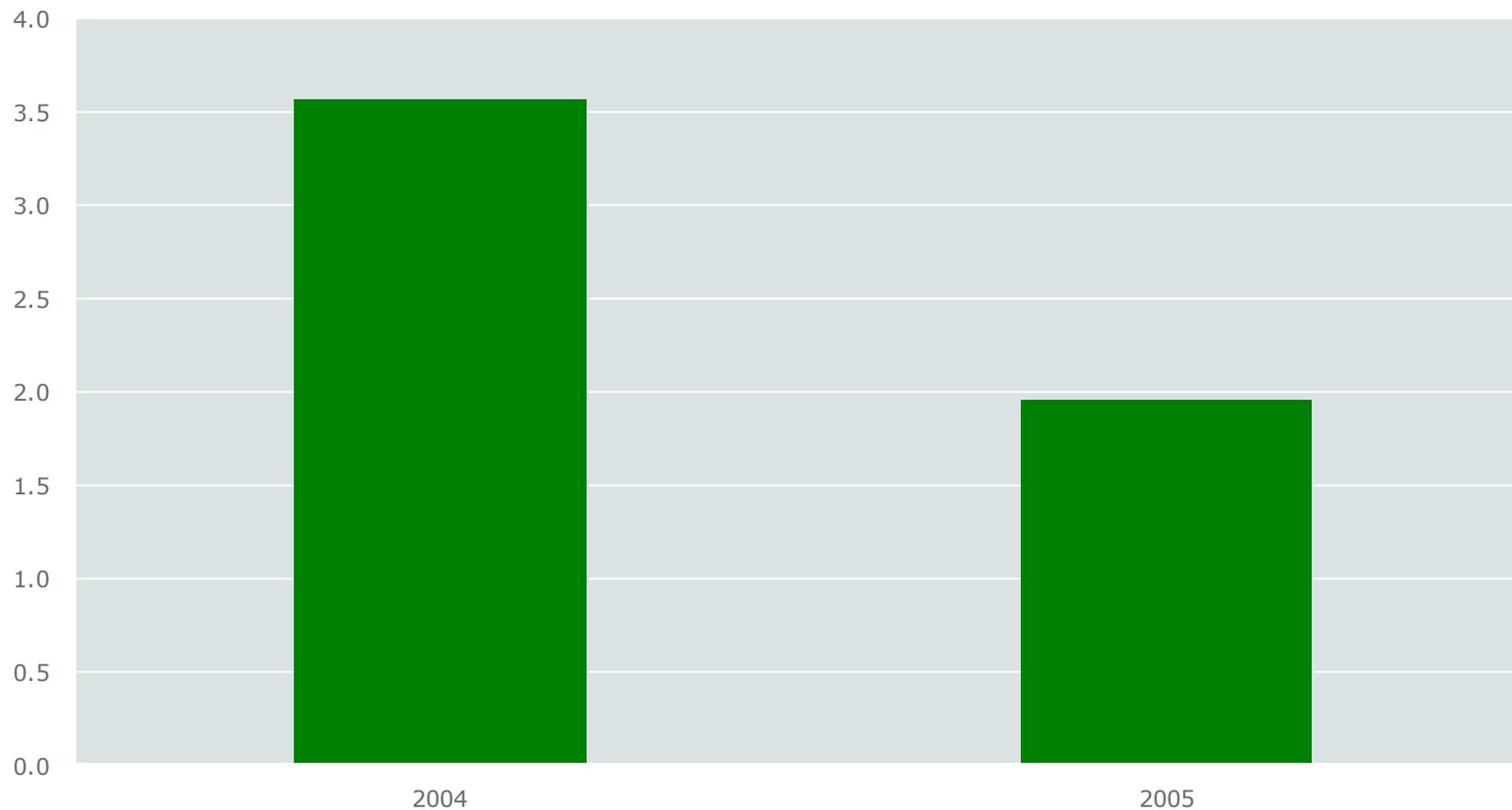
(\$ in thousands)



The Debt Affected Liquidity



Months of Expenses Covered by Cash



Months of Liquidity

- Represents the number of months an organization could operate with current cash and near cash
- To calculate, divide short-term liquidity at some point in time by average monthly operating expenses

What is the right amount for a nonprofit?

- Organizations may need more or less liquidity, depending on their stage of development, cash flow cycles, capital needs, etc.
- Heavily government-funded nonprofits sometimes have to make do with as little as one month (or less)
- NFF encourages most organizations to aim for three months through a combination of cash (and near cash) on hand and access to cash through a line of credit

Months of Liquidity: Rule of Thumb



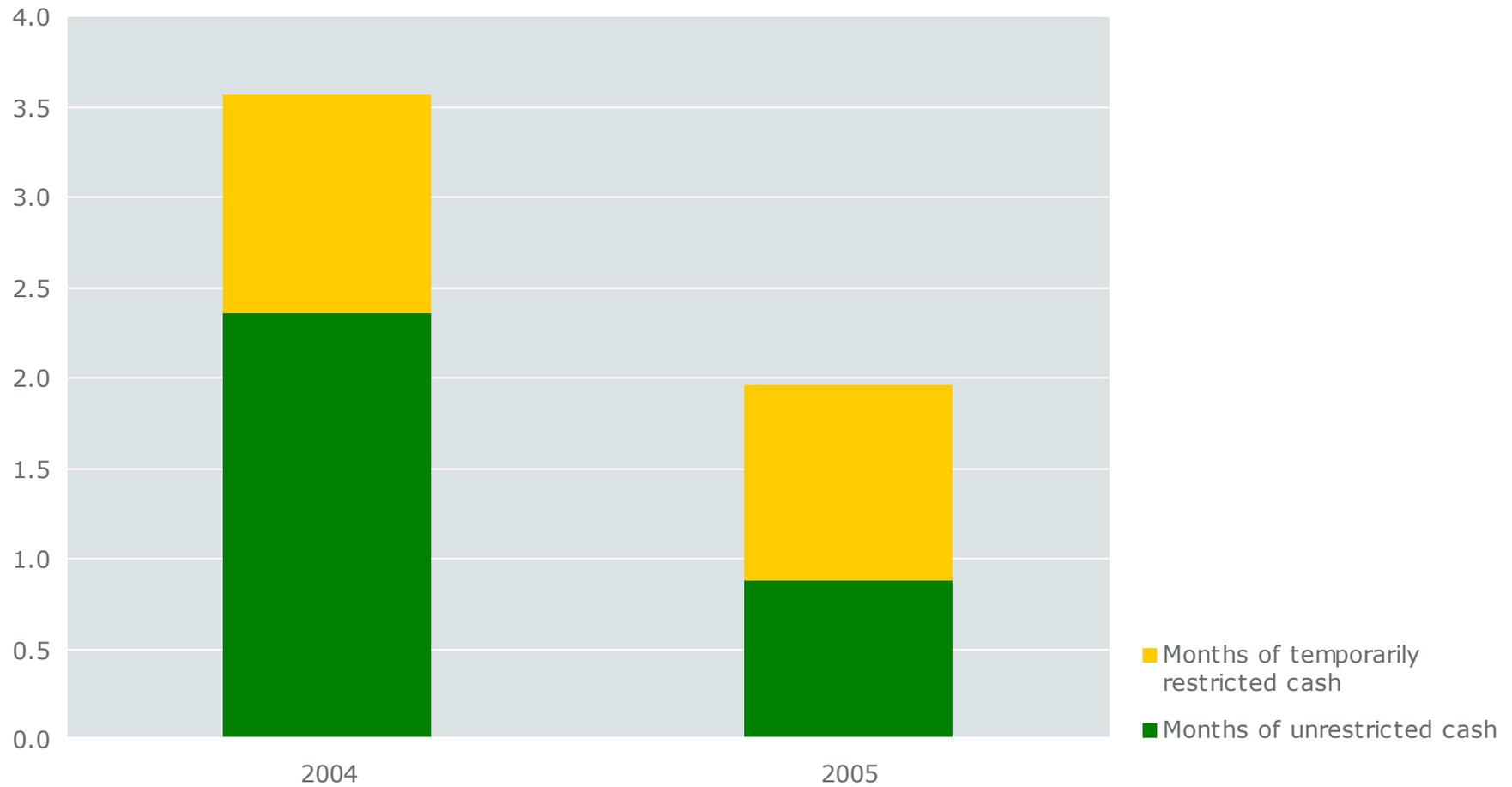
Right amount for an organization?

Months of Expenses Covered by Liquidity	Operating Situation
0	Crisis – Scrambling for cash, delaying payment to vendors, overdrawing checking account.
Less than 3 month	Cash is tight – Relying on line of credit, delaying payment to vendors.
3-6 months	Room to breathe – Can do some long-term thinking. Little room for “rainy days.”
6+ months	Handles risk – Able to withstand increasingly acute shocks such as large facility repairs, funding cuts and possibly recessions.

Understanding Nature of Cash



Months of Expenses Covered by Cash



Types of Liquidity Measures



- **Cash:** existing cash balance
- **Liquid net assets:** the *liquid* portion of unrestricted net assets (not in a board reserve or fixed assets)

Where Are Net Assets?

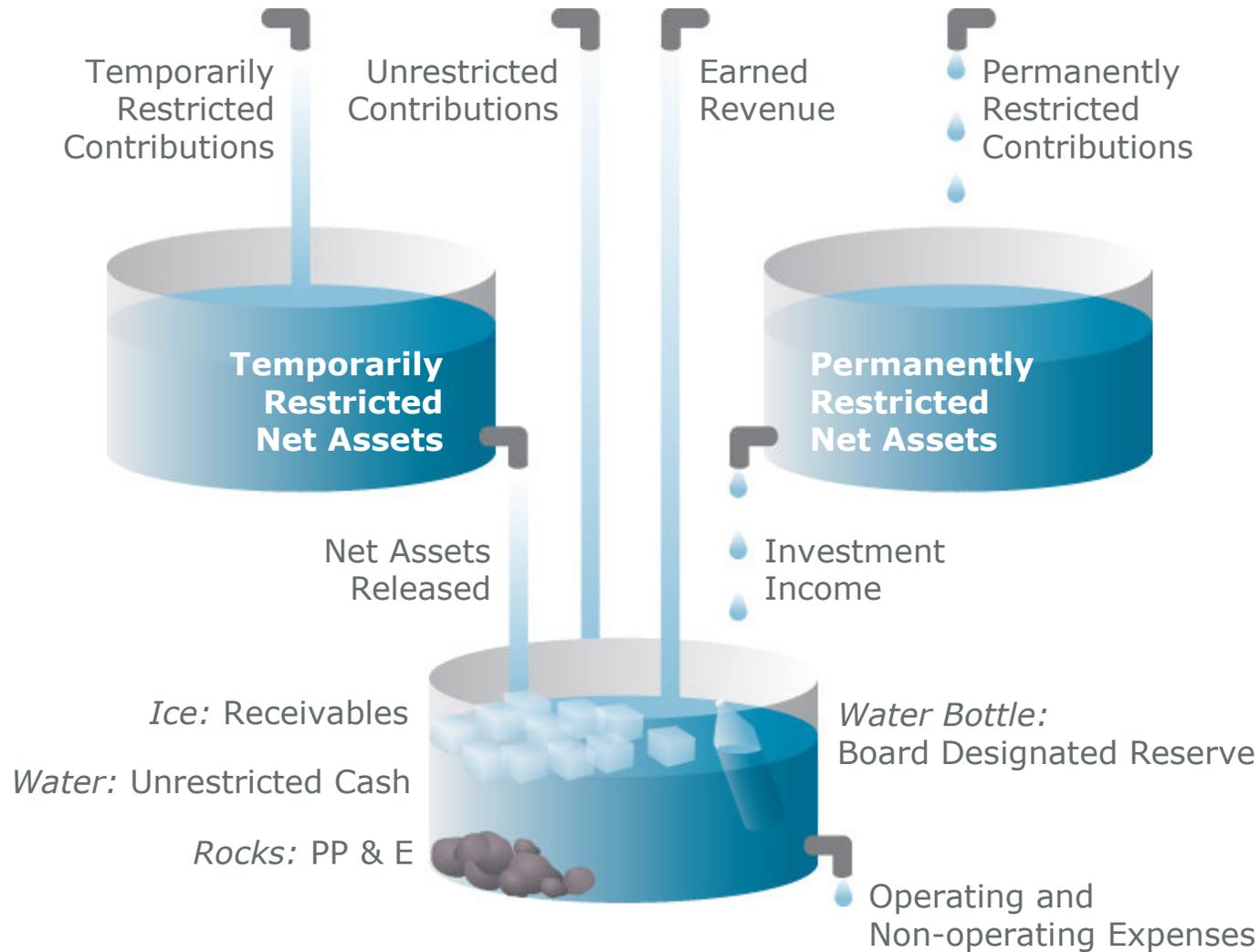


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Examine Net Asset Composition

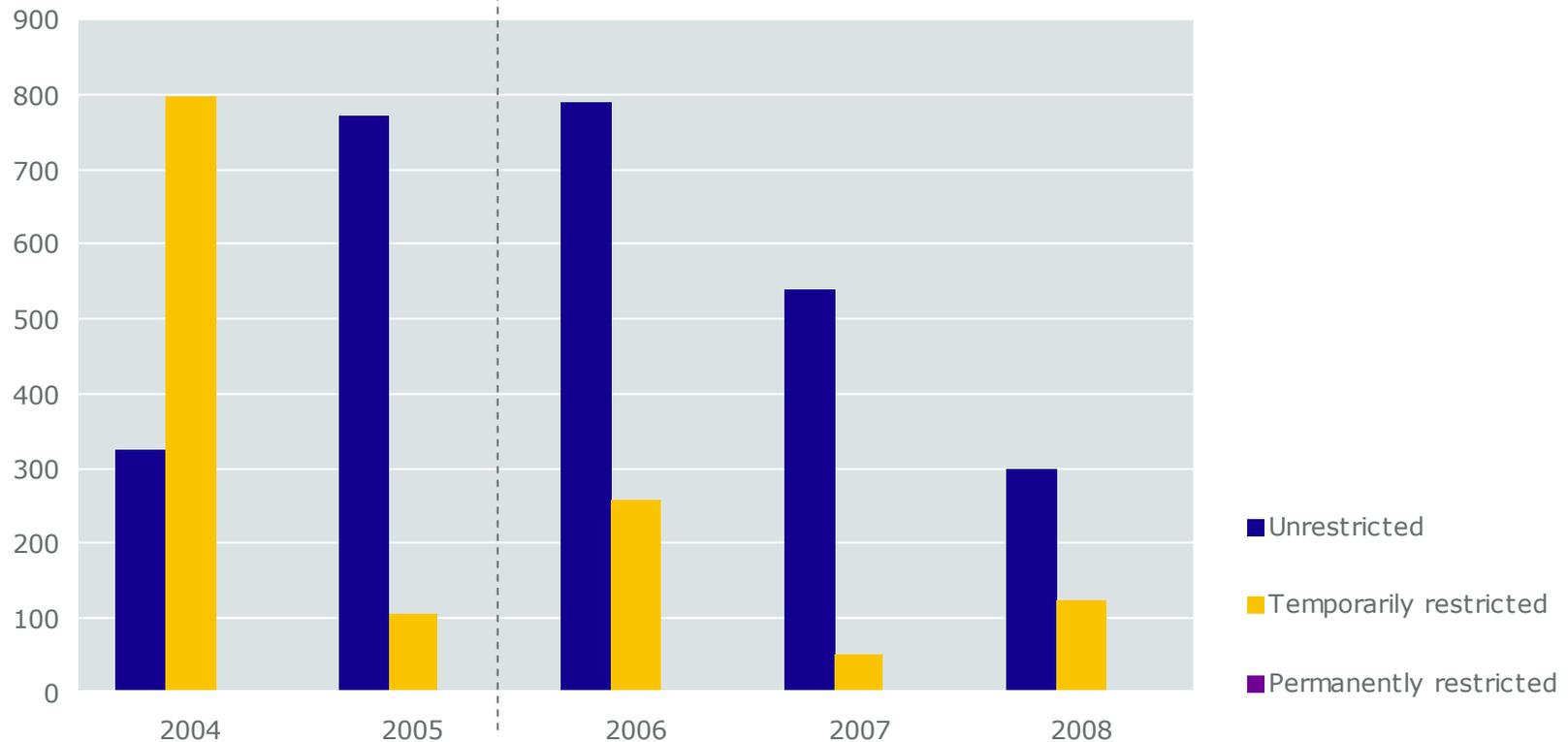


Net Assets Sometimes Hide Risk



Total Net Assets

(\$ in thousands)



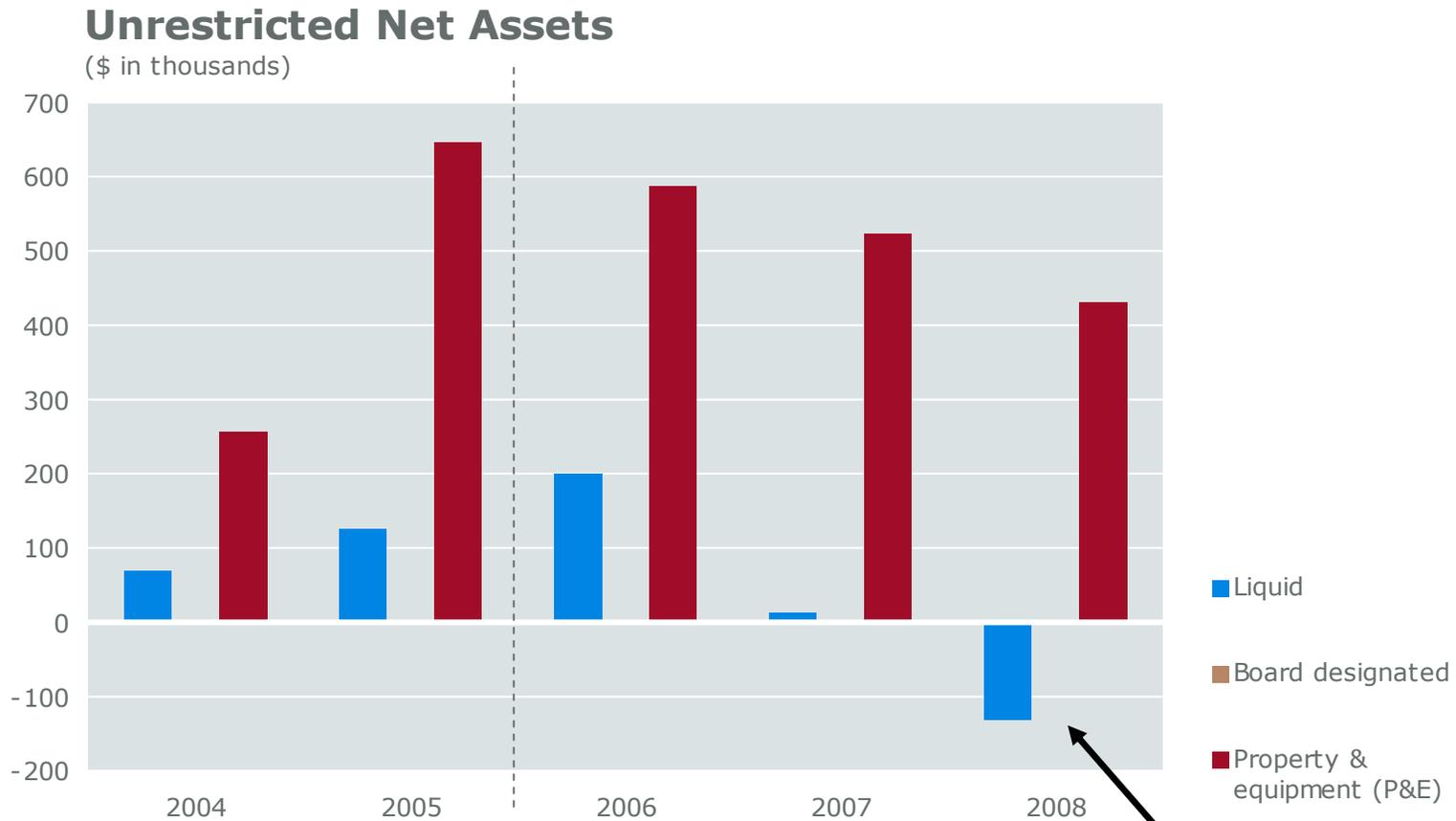
Net assets represent the difference between total assets and total liabilities, effectively net worth. Net assets are categorized as unrestricted, temporarily restricted, or permanently restricted.

Unrestricted net assets have no external restriction as to use or purpose.

Temporarily restricted net assets have a donor-imposed time or purpose restriction that, once satisfied, are released.

Permanently restricted net assets e.g., traditional endowments, refer typically to funds with donor-imposed stipulations that the principal not be spent; some or all of the earnings are available for specific or general operations.

Unrestricted Net Assets Are Not Necessarily “Liquid”

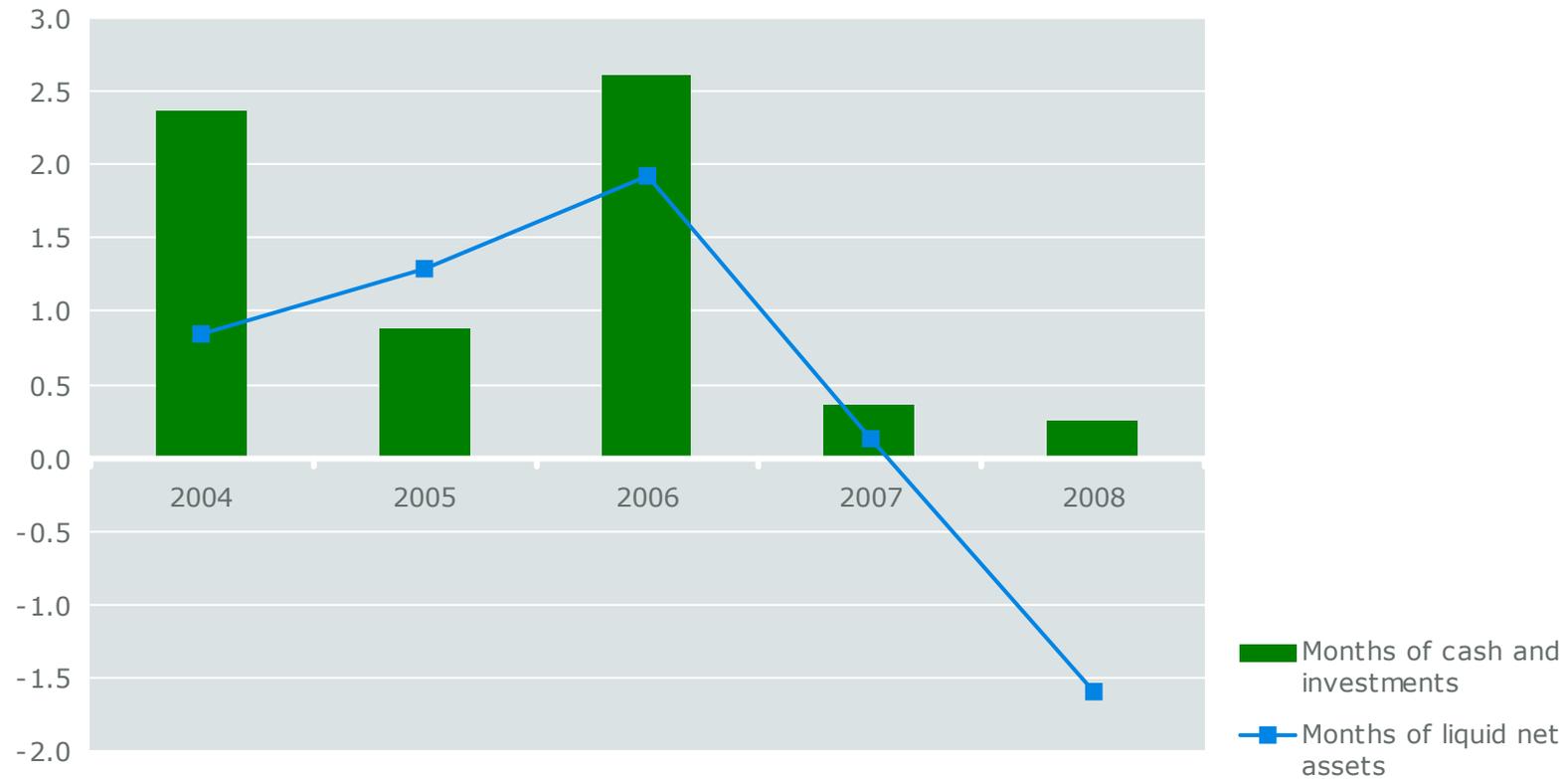


**Owing more
than you own**

Cash is Not Always Liquid



Months of Cash vs. Liquid Net Assets



Understand your Balance Sheet



If your balance sheet has...

- No cash or receivables
- A fully drawn line of credit
- Little or no reserves available to management
- Fixed assets with significant wear-and-tear

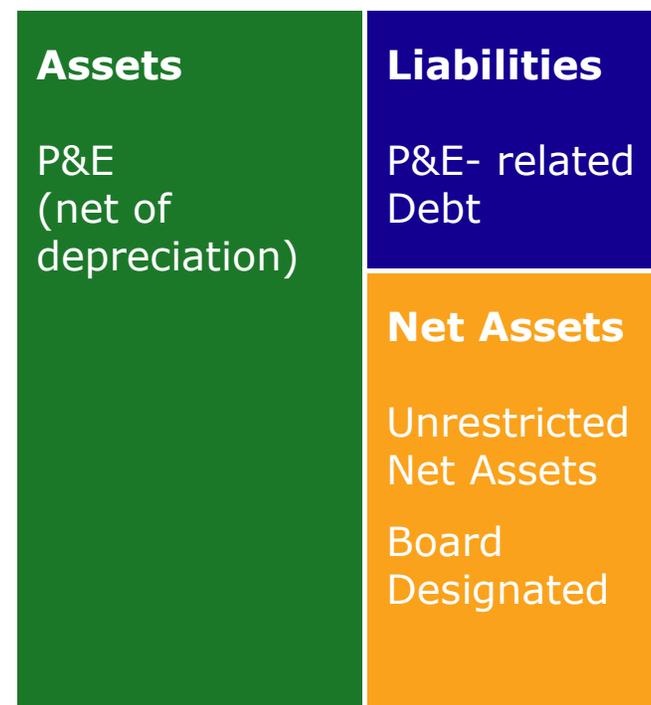
...then there are no dollars immediately available to draw on in challenging times

- Borrowing to replace lost income is rarely appropriate

Calculate Your Own Liquid Net Assets



	2005
Unrestr. P&E Net Assets Calculation	
P&E (net of accumulated depreciation)	760
- P&E-related Debt	-114
= Unrestricted P&E Net Assets	\$646
Liquid Net Assets Calculation	
Unrestricted Net Assets	\$771
- Unrestricted Board Designated	-
- Unrestricted P&E Net Assets	-646
= Liquid Net Assets	\$125



Calculate Your Own Liquid Net Assets



	Year	Year
Total Net Assets	_____	_____
less Temporarily Restricted	_____	_____
less Permanently Restricted	_____	_____
= Total Unrestricted Net Assets	_____	_____
less Board Designated (Unrestricted)	_____	_____
less Net P&E* (Unrestricted)	_____	_____
= Liquid Net Assets	_____	_____
divided by average monthly expenses	_____	_____
= Months of Liquid Net Assets	_____	_____

* Net P&E = Gross PE minus accumulated depreciation minus facility-related debt

Financial Statements Summary



Reliable, accurate and timely financial data is a first step to “owning” your numbers and telling your story.

Even with good data, it is important to know what to look for (e.g. indicators that reveal the degree or risk an enterprise can tolerate, given its future plans and goals).

Key stakeholders need to have a common understanding of your financial story. Remember: it is the health of your enterprise that supports or jeopardizes the success of your programs.

Ask questions often!

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Thank you



Thank you for your participation and to the generous support of MetLife Foundation.

Evaluation

<http://www.zoomerang.com/Survey/?p=WEB229XS88NRRQ>

Please join our upcoming conference call
Wednesday, December 16th, 2009 at 1:00 PM Eastern

<https://www1.gotomeeting.com/register/121858720>

To learn more about NFF,
visit us at nonprofitfinancefund.org

For questions about this webinar and NFF services available to Dance/USA, Theatre Communications Group (TCG), and the League of American Orchestras, please contact:

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