Glossary of Terms

Course 4 - Module 1: Financial Statements

Accounts Payable: The amount owed to vendors and suppliers that have provided goods or services to an organization (for example unpaid invoices that have been recorded).

Accounts Receivable: The amount owned to an organization for services rendered or goods provided on credit.

Assets: What the organization owns

Audit: The procedures performed by an independent certified public accountant (CPA) to be able to give and opinion that an organization's financial statements are fairly stated in all material (significant) respects.

Audit Committee: This committee, or the combined finance and audit committee, selects an independent auditor and serves as a link between the auditor and the board. It ensures that the auditor has full access to financial and related records, reviews the auditor's report and submits it to the board, and arranges for the full board to meet with the auditor.

Audit Opinion Letter: A communication produced by the external auditors after their review of the organization's financial statements for a certain period of time, typically one year, to express their judgment about whether the management-prepared financial statements are "presented fairly" in accordance with generally accepted accounting practices (U.S. GAAP) and accurately reflect the financial status of the nonprofit.

Balance Sheet: Also known as a 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.

Cash Flow: The process of receiving and distributing cash.

Cash Flow Statement: One of the main financial statements of a business or a nonprofit entity. (It is also known as the statement of cash flows.) The cash flow statement reports a company's major sources and uses of cash during the same period of time as the company's income statement. In other words, it lists the major reasons for the change in a company's cash and cash equivalents reported on the balance sheets at the beginning and the end of the accounting period.

Cash from Operating Activities: Focuses on the cash inflows and outflows from a company's main business activities of buying and selling merchandise, providing services, etc.

Cash from Financing Activities: A section of a company's cash flow statement, which shows the net flows of cash that are used to fund the company. Financing activities include transactions involving debt, equity, and dividends.

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

Duty of Care: Fiduciary responsibility, e.g., using your best judgment, actively participating, paying attention, asking pertinent questions.

Expenses: What an organization spends to conduct its activities. Expenses on the income statement are grouped into three categories: Program Services, Management and General, and Fundraising.

Fiduciary Oversight: A fiduciary is a person responsible for the oversight, administration, investment, or distribution of assets belonging to another person or to an organization.

Finance Committee: The finance committee supports the board's responsibility for oversight of the organization's fiscal health. It recommends policies to the full board to safeguard the organization's assets, ensures the completeness and accuracy of its financial records, and oversees proper use of resources.

Financial Statements: Formal written records of the organization's financial activities and position. It provides the information needed to identify the organization's financial strengths and weaknesses.

Fundraising: Expenses incurred in the solicitation of contributions and grants.

Income Statements (Statement of Activities): Reflects your organization's financial activity — revenues and expenses — over time (monthly, quarterly, and annually).

Liabilities: What the organization owes.

Program Services: Expenditures, goods, and services used in activities to fulfill the organization's mission, such as salaries and supplies.

Revenue: 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.

Ratios: Ratios help identify the organization's strengths and weaknesses.

- **Current Ratio:** Ratio measuring an organization's liquidity, or how readily it can pay off all its current liabilities.
- **Days Cash on Hand Ratio:** The ration measuring the number of days of average cash expenses that an organization maintains. It can be expressed either as days cash on hand in short-term situations or in all sources,
- **Quick Ratio:** The ratio measuring an organization's ability to meet short-term obligations from its most liquid, or quick, assets. It compares assets that are quickly and easily convertible into cash (such as cash, cash equivalents, and accounts receivable) to the organization's current liabilities.

Management and General: Expenditures on general oversight and management, such as on recording keeping and budgeting.

Net Assets: The difference between what your organization owns (assets) and what it owes(liabilities). 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.

Non-Operating Income: 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.

Thomas A. McLaughlin, Founder, McLaughlin & Associates

RED FLAGS, YELLOW FLAGS

Are Your Financial Statements Trying to Tell You Something?

Your financial reports come with warning signals. Do you know where to look for them?

Smoke detectors chirp. Automobile dashboards use an array of lights and colors. Computers flash messages in machine language. What do all of these things have in common? They are all methods of telling us when something we are using is about to stop working or go bad.

Wouldn't it be great if nonprofit organizations came equipped with built-in financial warning signals? How nice would it be if the accounting department chirped when cash was running out, or if boxes popped up on the chief executive's computer when the year's revenue is falling dangerously short of projections?

Financial statements do carry all kinds of warning signals — if you know where to look and how to interpret them. We call them red flags and yellow flags. Red flag indicators mean STOP; ask probing questions, and don't move forward until you're satisfied. Yellow flag indicators mean CAUTION; trouble may lie ahead depending on the answers to some well-formulated questions.

There are red flags and yellow flags in just about every type of financial report, but we'll concentrate on the type of financial information most board members see: the audited financial statements. This isn't an exhaustive list of flags, just a handful of the more helpful and interesting ones.

THE OPINION LETTER

An auditor's opinion letter is a rich source of red and yellow flags. It can be found just inside your audited financial statements, and is formatted like a regular letter.

The first sentence of the letter says something other than "We have audited . . . ."

An audit represents the highest level of assurance and reliability that can be given by an auditor to a nonprofit organization. If you see words such as "we have reviewed" or "we have compiled," be forewarned that the information you are about to see has not been subjected to the highest forms of testing and confirmation. In the United States, all but the smallest of nonprofits must have audits each year. Even those not required to have independent audits should strongly consider doing so, since it is the only way an organization can assure outsiders of its own accountability.

A sentence that qualifies the auditors' opinion, usually occurring somewhere in the third or fourth paragraph. The sentence may say something like "except for . . ." or "it was not possible to . . . ."

This yellow flag means the auditor is giving a qualified opinion. It may amount to little more than a technical provision, but it could suggest deeper problems in the organization. In rare instances, it can be a "disclaimer of opinion," meaning the record keeping is so bad that the auditor is unable to give an opinion at all. Read carefully, and beware of the word "except...."

The presence of the words "going concern" toward the end of the letter.
No getting around this one — it's the auditor's equivalent of pulling a fire alarm. It means the auditor is worried that the organization may go out of business within the next 12 months.

The difference between the end of the fiscal year and the date of the letter is more than 90 days.

The difference between the end of the fiscal year and the date of the letter is more than 120 days.
The date at the bottom of the page is officially considered the last day of field work or the last day the auditor spent a significant amount of time on-site. Ordinarily, audits should be wrapped up within 90 days of the end of the fiscal year. The longer the elapsed time, the greater the cause for worry, because it may suggest the nonprofit was unable to get itself organized in time to complete the audit. Ask probing questions about the reasons for the delay. Even if there are good reasons, it means the information in the audited financial statement is stale by the time the board receives it.

THE BALANCE SHEET

After the opinion letter, you'll see the Statement of Financial Position, also called the balance sheet. A flag you may find here:

Asset imbalance
Look for the single largest number under "assets." Depending on the category of asset, you could be seeing evidence of problems. If the amount of cash on hand is large — more than, for example, 10 percent of the total yearly revenue — it may mean the organization's financial managers aren't making efficient use of their excess cash. If the amount of cash is small — 5 percent or less of the total yearly revenue — it could mean the organization is cash-starved.

If "accounts receivable" is the largest category of assets, it means the organization doesn't truly control its most valuable resource. Accounts receivable represent bills that have been sent out but not yet paid. What happens if the people or groups that received those bills never pay them? That would mean the balance sheet needs to be completely restructured, and the financial picture would look grim as a result.

RED FLAGS, YELLOW FLAGS

Are Your Financial Statements Trying to Tell You Something?

THE INCOME STATEMENT

Now move into the body of the financial statements. Look for the second page of numbers, normally titled the Statement of Activities/Income Statement.

Deficits; more expenses than revenue

You'll see parentheses around the number representing the total expenses subtracted from the total revenue. This is not a major cause for alarm, as long as the number appears manageable, but find out why there was a deficit. Is it a fluke, or yet another in a string of bad years? The answers to these questions could reassure you — or prompt you to wave a red flag instead.

THE FOOTNOTES

Finally, look at the footnotes to the financial statements. This is where you will find some juicy details. Here are a few possible flags:

Related party transactions

Not usually forbidden by law (doing so might be a restraint of trade), related party transactions can cause outsiders to question whether the organization is dealing fairly with vendors. Why did the chief executive find it necessary to award her husband that lucrative direct mail contract when there were other companies available?

High interest rates charged on short-term borrowing

Banks are pretty good at assessing risks. If they feel it is necessary to charge a high rate on a line of credit (more than about 1.25 percent over the prime rate), maybe you should be worried too.

Lawsuits against the organization

A lawsuit can devastate a nonprofit organization, even if it is unfounded. See if management's response is included in the footnote. A sad reality — the larger and more complicated your organization is, the more likely it is you will routinely have one or more active lawsuits. Check your state's liability laws. You may have more protection than you think.

Financial statements are never likely to chirp, buzz, or change colors. But they don't have to do that to be useful. They contain lots of yellow and red flags. You just have to know how to see them.

Resource: ***Understanding Nonprofit Financial Statements***

SAMPLE BALANCE SHEET

Financial Statements Explained

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

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

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**
Net Assets Without Donor Restictions	32,600	27,900
Net Assets With Donor Restictions	6,200	5,500
Total Net Assets	**38,800**	**33,400**
Total Liabilities & Net Assets	**113,100**	**107,600**

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

Donor restrictions on hov and vhen the assets can be used

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
$ 21,900

$\frac{\$21,900}{\$7,500} = 2.9$

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

ABC CHARITIES, INC.
Statement of Activites (Income Statement)
For the Year Ending December 31, 20XX (in thousands)

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

Donor has placed restrictions on the use of assets. when those criteria are met they are considered "Released from Restriction"

when restricted Assets are used for their intended purpose and are "released" from restriction they are represented as a reduction in restricted assets and an increase in unrestricted assets.

	Without Donor Restrictions	With Donor Restrictions	Total
INCOME			
Individual Contributions	8,285		8,285
Grants	-	60,000	60,000
Net Assets Released from Restrictions	20,000	(20,000)	-
User Fees	5,250		5,250
Contract Income	3,900		3,900
Total Support & Revenue	37,435	40,000	77,435
EXPENSE			
Personnel	24,000		24,000
Program Related Materials	6,985		6,985
Rent & Utilities	4,750		4,750
Marketing	1,375		1,375
Total Expenses	37,110	-	37,110
Change in Net Assets (Surplus/Def)	$ 325	$ 40,000	$ 40,325

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

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

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

$$\frac{\$40,325}{\$77,435} = 52\%$$

Change in Total Net Assets as a result of operations *

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

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.

Current Assets

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.

Cash + Cash Equivalents

+

Accounts Receivable

+

Unconditional Promises to Pay

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.

Cash + Short-Term Investments

÷

(Total Expenses − Non-Cash Expenditures)

÷ 365

= Days Cash on Hand from Short-Term Sources

Cash + Short-Term Investments + All Long-Term Investments

÷

(Total Expenses − Non-Cash Expenditures)

÷ 365

= 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.

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

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 examples presented in this packet are for 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.

Cash Flow Statement Company XYZ FY Ended 31 Dec 2017 All Figures in USD		
Cash Flow From Operations		
Net Earnings		2,000,000
Additions to Cash		
Depreciations		10,000
Decrease in Accounts Receivable		15,000
Increase in Accounts Payable		15,000
Increase in Taxes Payable		2,000
Subtractions From Cash		
Increase in Inventory		(30,000)
Net Cash From Operations		2,012,000
Cash Flow From Investing		
Equipment		(500,000)
Cash Flow From Financing		
Notes Payable		10,000
Cash Flow for FY Ended 31 Dec 2017		1,522,000

NFP-ABC
STATEMENT OF FINANCIAL POSITION
December 31, 2018

ASSETS

Current assets:	
Cash	$ 110,500
Restricted cash	300,000
Grants receivable	450,000
Accounts receivable	15,500
Employee advances	50,000
Prepaid expenses	25,000
Total current assets	951,000
Property and equipment, net	1,200,000
Total assets	$ 2,151,000

LIABILITIES AND NET ASSETS

Current liabilities:	
Accounts payable	$ 250,000
Current maturities of notes payable	750,500
Security deposits	50,000
Total current liabilities	1,050,500
Line-of-credit	50,000
Notes payable, net of current maturities	785,500
Total liabilities	1,886,000
Net assets:	
Unrestricted	15,000
Temporarily restricted	250,000
Total net assets	265,000
Total liabilities and net assets	$ 2,151,000