ASSOCIATION OF SMALL FOUNDATIONS
for foundations with few or no staff

Resource packet for

Navigating Nonprofit Financials

Characteristics of Financially Healthy Nonprofits

1. Board of directors and management hold themselves responsible for long-term stability in terms of both programs and financial performance.
2. All board members understand their roles and responsibilities in financial matters.
3. A realistic and well-considered budget is prepared and approved by the board.
4. Budgets are prepared in tandem with planning for programs and operating needs.
5. Management and board are committed to manage with the goal of an operating surplus each year.
6. Consistent, accurate, and timely financial reports are prepared and analyzed by qualified individuals.
7. Management and the board monitor financial results as compared to the budget and modify programs and activities in response to variances.
8. Management realistically plans and monitors cash flow so as to be able to meet obligations.
9. Financial policies are in place that establish, or have specific plans to establish, an operating reserve to finance cash shortfalls and program growth.
10. Policies are established for major financial decisions and adequate and appropriate internal controls.
11. Management is committed to compliance with all legal and funder reporting.
12. The board and management regularly review short-term and long-term plans and develop goals and strategies for the future.

Source: Minnesota Nonprofits Assistance Fund, 2004

Audit

Three levels of financial reports prepared by a CPA:

- Audit—receives in-depth review, balancing, and testing to assure that the information is current; the highest level of financial review
- Review—receives more review than a compilation and usually enough to determine if the financials make sense
- Compilation—uses information from the nonprofit with no review

Audit reports consist of:

- Opinion letter, issuing a qualified or unqualified opinion
    - An **unqualified opinion** is given without reservations when the auditor believes the nonprofit followed all accounting rules appropriately and that the financial reports are an accurate representation of the company's financial condition
    - A **qualified opinion** is given with reservations when the information provided was limited in scope and/or the nonprofit has not maintained standard (GAAP) accounting principles
- Financial reports
- Notes to the financial reports
- Management letter highlighting any internal controls issues, even minor ones

Statement of Financial Position (Balance Sheet)

The statement of financial position is a snapshot in time, compared to the statement of activities that shows revenue and expenses over a period of time. It presents an organization's financial assets and liabilities as of a specific date.

Assets are what the organization owns:

- **Current assets—**the sum of all assets that could be converted to cash in less than one year (e.g., cash and cash equivalents, accounts receivable, inventory, and marketable securities) **(lines 1-8)**

- **Long-term assets—**the sum of all assets that are not current assets (e.g., buildings, property, equipment, and long-term CDs) **(lines 10-11)**

Liabilities are what the organization owes:

- **Current liabilities—**the sum of all money owed by a organization and due within one year **(lines 14-19)**

- **Long-term liabilities—**the sum of all money owed by an organization and not due within one year **(line 21)**

Net assets are what the organization has accumulated:

Total Assets – Total Liabilities = Total Net Assets
Line 13 – Line 22 = Line 25

Look for the following key items:

- **Unrestricted net assets—**the organization's cushion for possible deficits or for changing programs, expanding, and so on **(line 23)**

- **Temporarily restricted net assets—**inform the user of an obligation to fulfill a responsibility at a future point in time. The funds will need to be available at the appropriate time. **(line 24)**

- **Amounts of cash and current assets—**Cash in the bank pays the bills. It is best if the organization has enough cash to pay at least one month's bills. Current assets will turn into cash in the near future.

- **Amount of debt—**How much debt is there, and what is it used for? Loans are a valuable tool to manage cash flow, build the organization, and finance buildings and equipment.

- **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**, like an endowment, you may want to determine how those finds are invested or held

- **Significant changes in assets and liabilities** from the previous year should fit with changes in the way the organization works. If not, they may be early indicators of problems.

Statement of Activities (Income Statement)

Income and expenses for a certain period of time and the resulting profit or loss **(line 13)**, compared to the statement of financial position that provides a snapshot in time.

Income categories

- **Support—**voluntary contributions including grants and donations from foundations, government, and individuals
- **Revenue—**income earned from delivery of goods or services

Contribution categories—GAAP accounting rules require three categories to ensure accountability to donors. Contributions are recorded based on *donor* restrictions, and the classifications affect both the balance sheet and income statement.

- **Unrestricted net assets—**assets that are free from any external restrictions and are available for general use by the nonprofit

- **Temporarily restricted net assets—**assets (e.g., program grants) with specific donor-imposed restrictions that will expire over a defined period of time or by performing defined activities

  Once the restriction is met, temporarily restricted funds are transferred into the unrestricted category with an accounting entry "Net Assets Released from Restrictions." Deciding how much to release and when is the responsibility of the nonprofit.

- **Permanently restricted net assets—**contributions (e.g., scholarship funds) for which the donor has designated a purpose or time restriction that will never expire. Very few nonprofits have permanently restricted net assets.

Look for the following key items:

- **Surplus or deficit in unrestricted funds—**If there are more expenses than income, the cash has to come from somewhere. There may be accumulated unrestricted net assets from previous years (remember, the income statement is only for a certain period of time), or the organization will have liabilities to pay in the future.

- **Surplus or deficit in temporarily restricted funds—**reflects timing more than operational results. Surplus funds need to be released in future periods; deficit indicate that previously received grants have been released for use.

- **Temporarily restricted funds—**grants received for future periods should not be included in a current income statement

- **Sources of income—**The more types of income and sources the better, because the organization has less risk of a sudden change. Some organizations have fewer options than others.

- **Types of income and expense—**should fit with the way the organization works and how other similar organizations operate

- **Trends in income and expense—**significant changes from the previous year should fit with changes in the way the organization works

Using Ratios to Understand Nonprofit Financial Statements

Before using financial ratios, please keep in mind:

- You don't have to use ratios in your review of an organization's financial statements. Use them only if you find them to be helpful.
- Know what the ratio means before you calculate it.
- Ratios are only one piece of the puzzle. An unfavorable ratio should lead to a question—there may be a logical explanation.
- As you become more comfortable with assessing financial statements, you may begin to calculate ratios instinctively.

Note: If possible (though not always available), use unrestricted net assets rather than total net assets to calculate ratios. Because unrestricted net assets represent the uncommitted funds available to pay debt, they may tell a very different story.

Current Assets ÷ Current Liabilities = Current Ratio

Does the organization have enough assets to meet its current liabilities? Alternatively, does it have enough assets on hand to pay its debts over the next 12 months?

> **What you're looking for:** A ratio ≥ 1
>
> **Calculation (using balance sheet):**
> (Line 9) ÷ (Line 20) =
> $2,192,922 ÷ $1,594,363 = 1.36
>
> The organization has 1.36 times more liquid assets than debt obligations
> over the next 12 months.

Cash ÷ Current Liabilities = Quick Ratio

Does the organization have enough cash to meet current liabilities?

What you're looking for: A ratio ≥ 1

Calculation (using balance sheet):
(Line 1) ÷ (Line 20) =
\$25,755 ÷ \$1,594,363 = .016

The organization does not have adequate cash to meet its debt obligations over the next 12 months. Its receivables will be key in meeting these obligations.

Cash at Fiscal Year End ÷ Estimated Monthly Expenses = Cash on Hand

Does the organization have adequate reserves? Alternatively, if no more revenue came in, for how long would the organization be able to meet its basic financial obligations?

What you're looking for: 3-month operating reserve (few nonprofits achieve this)

Calculation:

Total expenses/12 (line 12 income statement /12) = estimated monthly expenses
\$9,483,868/12 = \$790,322

Cash and cash equivalents (line 1 balance sheet) ÷ estimated monthly expenses =
\$25,755 ÷ \$790,322 = .033 months

This organization has far from adequate cash on hand to cover average operating expenses.

Total Liabilities ÷ Total Net Assets = Debt to Net Assets

Measures borrowed funds against owned funds

What you're looking for: A ratio < 1

Calculation (using balance sheet):

Total liabilities (line 22) ÷ total net assets (line 25) =
\$4,020,659 ÷ \$3,179,743 = 1.26

This organization owes 1.26 times as much as it owns.

ABC Youth Center
Statements of Financial Position (Balance Sheet)
As of June 30, 2010 and 2009

		2010	2009
	ASSETS		
	Current Assets		
1	Cash & Equivalent	$25,755	$602,929
2	Accounts Receivable	$323,092	$208,986
3	Receivable / Other	$175,000	$175,000
4	Pledges & Grants Receivable, Current Portion	$1,562,409	$1,027,750
5	Inventories for Sale of Use	$0	$0
6	Investment/Securities, Current Portion	$0	$49,967
7	Investment/Other	$0	$0
8	Other	$106,666	$49,851
9	**Total Current Assets**	**$2,192,922**	**$2,114,483**
10	Pledges & Grants Receivable, Net of Current Portion	$1,278,334	$1,256,138
11	Investment/Securities, Net of Current Portion	$0	$12,492
12	Fixed Assets	$3,729,146	$3,438,823
13	**Total Assets**	**$7,200,402**	**$6,821,936**
	LIABILITIES AND NET ASSETS		
	Current Liabilites		
14	Accounts Payable	$1,166,995	$588,703
15	Grants Payable	$0	$0
16	Deferred Revenue	$0	$0
17	Loans and Notes, Current Portion	$330,859	$285,901
18	Tax-Exempt Bond Liabilities	$0	$0
19	Other	$96,509	$162,814
20	**Total Current Liabilities**	**$1,594,363**	**$1,037,418**
21	Loans and Notes, Net of Current Portion	$2,426,296	$2,096,608
22	**Total Liabilities**	**$4,020,659**	**$3,134,026**
	Net Assets		
23	Unrestricted	$1,453,794	$1,295,899
24	Temporarily Restricted	$1,725,949	$2,392,011
25	**Total Net Assets**	**$3,179,743**	**$3,687,910**
26	**Total Liabilities and Net Assets**	**$7,200,402**	**$6,821,936**

ABC Youth Center
Statements of Activities (Income Statement)
For the Years Ended June 30, 2010 and 2009

		2010	2009
	REVENUE		
1	Contributions	$5,876,576	$2,326,576
2	Government Grants	$2,903,427	$6,229,217
3	Program Services	$88,860	$0
4	Investments	$103,476	$81,807
5	Special Events	$0	$0
6	Sales	$0	$0
7	Other	$3,362	$124,707
8	**Total Revenue**	**$8,975,701**	**$8,762,307**
	EXPENSES		
9	Program Services	$7,683,884	$7,281,758
10	Administration	$1,339,846	$1,184,624
11	Other	$460,138	$235,589
12	**Total Expenses**	**$9,483,868**	**$8,701,971**
13	**Net Gain/Loss**	**($508,167)**	**$60,336**