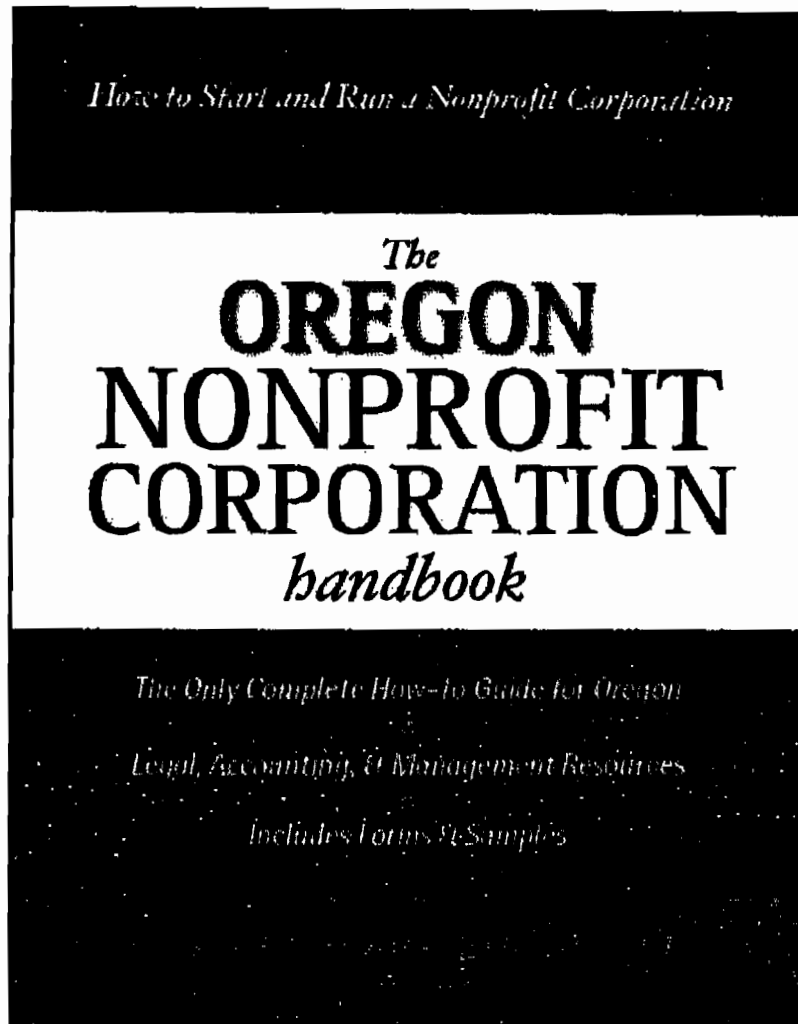


The following is an excerpt from



Chapter 25: Evaluating Your Organization's Financial Health

pages: 571-591

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25 EVALUATING YOUR ORGANIZATION'S FINANCIAL HEALTH

Your Board and management have responsibilities for being sure your organization is managing its resources effectively to achieve your mission. You'll want to use the financial reports we discussed in Chapter 23 to evaluate the extent to which your plans, as expressed in your annual budget, are working. Beyond comparing the actual revenue you've generated and expenses you've incurred to your budget plan, you'll want to continuously evaluate your organization's overall financial health.

Many Boards and some Executive Directors are initially confused about the steps they should take to monitor their organization's financial health and financial management.

This chapter provides guidance on making good use of financial reports, and suggests specific questions Boards and Executive Directors should discuss when reviewing financial information. It also provides a step-by-step guide for Executive Directors and program managers to monitor the financial consequences of their work.

This chapter will also help you determine whether your organization needs to obtain an independent audit to be certain that your financial statements are giving you a fair picture of your financial position. And it will help you prepare for audits and reviews by funding sources and regulatory agencies.

THIS CHAPTER COVERS

- **How to Ask the Right Questions About Your Financial Statements**
- **The Manager's Role in Monitoring Financial Performance**
- **Should Your Nonprofit Have an Independent Audit or Review?**
- **Understanding and Preparing for Audits**
- **Will Your Organization Need an A-133 Federal Funds Audit?**

HOW TO ASK THE RIGHT QUESTIONS ABOUT YOUR FINANCIAL STATEMENTS

Here are the eight basic questions you'll want to ask as you review your nonprofit's financial statements:

How Financially Strong is This Organization?

Start with the Balance Sheet or *Statement of Financial Position*. This statement presents the assets, liabilities and net assets of the organization on a specific month-end date. It may present a comparison of assets, liabilities and net assets at two different dates, for example, the end of the last year, and the end of the most recently completed month.

Look first at the *net assets* line. Net assets represent the net worth of the organization at the date specified on the statement. It's helpful to think of net worth as what would be left if the organization gathered in everything it owns of value (cash, investments, land, buildings, etc.) and collected all that is owed to it (receivables), and then paid off everything it owes to others (wages, payroll taxes, payables, mortgages, etc). The *net assets* are roughly equivalent to *Owner's Equity* in business financial statements.

If the *net assets* amount is shown in <brackets>, the organization has a negative net worth, owing more than it owns. If it's not shown in brackets, the organization has a positive net worth – at least on paper. Like businesses, nonprofits report the land, building, and equipment at the amount they cost when purchased, less accumulated depreciation. This "book value" can be far from market value, that is, what the land, building or equipment could be sold for today. If the market value is much higher than the book value, the net assets will understate your organization's actual net worth. If the market value is much lower than the book value, the net assets will overstate your actual net worth.

Looking at the *net assets* is a first step. To really evaluate your organization's financial strength, you'll have to ask a few more questions.

Can the Organization Meet Its Obligations on Time?

Simply having a positive net worth doesn't guarantee that the organization can pay its employees, its payroll taxes, and its vendors on time. That depends upon its cash position or liquidity. Look again at the Balance Sheet (*Statement of Financial Position*). Create a subtotal of all the cash accounts and any receivables or investments which can be readily turned into cash. Next, look at the

liabilities. Create a subtotal for wages, taxes, and other accounts payable shown as current liabilities. Then compare your cash and cash equivalents subtotal to your current liabilities subtotal.

Does the organization have more cash or items which can readily be turned into cash than current liabilities, or at least as much? If so, it will probably be able to meet its obligations on time. If not, it will have difficulty paying everything on time. If it has significantly more cash than is required to meet current liabilities, it is in a good position to take on additional obligations through expansion or taking reasonable risks. Or, it may be time to invest some excess cash in longer term investments.

If the Balance Sheet (Statement of Financial Position) provides information about two points in time – the end of the current month and the end of the previous month or previous fiscal year – you can evaluate whether the cash position (i.e. cash available to meet obligations or invest) is improving or worsening. Compare the cash balances, the accounts receivable, and the accounts payable. If the accounts receivable are increasing, find out why. Does the increase simply reflect a higher volume of service and higher amounts being billed, or does the increase reflect difficulty collecting what is owed to the organization? If the accounts payable are increasing, ask for an "aging," i.e. a list which shows which of the amounts have been owed for 30, 60, 90, or more days. Then determine why payments have not been made and what will be the consequence of further delays.

Are There Limitations on What the Organization Can Do With Its Resources?

While having a positive net worth is clearly better than having a negative net worth, simply noting that the net assets line on the balance sheet is positive doesn't tell the whole story. Ask a few more questions.

Is part of the net assets balance actually a true or quasi-endowment fund? A true endowment is an endowment built by donor contributions which were specifically directed to the endowment. A quasi-endowment is one which has been created by Board action, deciding to treat certain funds as endowment, but not bound by any donor direction. Both types of endowments restrict the use of the principal and provide direction for the use of earnings generated by the principal, either directing them to general operations or to some restricted use.

In general, the principal of endowments is not available to support operation of the organization. So as you think about the organization's immediate financial strength, don't think of the endowment as available for immediate

needs. However, the endowment does contribute to overall financial strength by representing a future source of certain revenue through the income generated by investing the endowment.

Next, look for the portion of net assets which represents investment in fixed assets. Some organizations will show this as a separate line in the net assets section called *property, plant and equipment*, or *capital net assets*. Others will include it in the total net assets and you will have to do some analysis to figure it out.

To determine the portion of the organization's net assets which represents investment in fixed assets, find all the asset accounts which include land, buildings, equipment, leasehold improvements, etc. Next, find all the liability accounts which are related to these fixed assets - typically, mortgages payable used to finance the purchase of property and buildings, or notes payable associated with major equipment purchases. To compute the portion of total net assets invested in fixed assets, subtract the liabilities you identified from the assets you identified.

If your financial statements are being prepared fully in accordance with formal accounting standards, you will see net assets broken down into three groupings: unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets.

Remember that the portion of the net assets invested in fixed assets won't be immediately available to support operations. The organization would have to sell its fixed assets, or borrow against them, in order to obtain cash for operations use. As you look at the organization's investment in fixed assets, think about how essential these assets are to the organization's ability to conduct its operation. Does owning them reduce operating costs or does it tend to increase operating costs by requiring constant maintenance expenses?

Finally, look for restrictions relating to operations which may have been placed on portions of the net assets. If your financial statements are being prepared fully in accordance with formal GAAP accounting standards, you will see net assets broken down into three groupings: *unrestricted net assets*, *temporarily restricted net assets*, and *permanently restricted net assets*.

The term "restricted" refers to a restriction placed on the use of assets by an outside party supplying the funds. For example, a donor may say "use my contribution only for the toys in the children's program" or a government contract may require "use these funds solely to meet the costs of the mental health services approved in the contract budget."

The term "temporarily restricted" is used to refer to restrictions which will be met through the passage of time, the use of funds for the specified purpose, or some other action. The term "permanently restricted" refers to assets which will have restrictions on their use forever, i.e., a permanently restricted endowment.

Less formally presented financial statements may not separate net assets into unrestricted, temporarily restricted, or permanently restricted groupings. If yours have no breakdown, you'll need to ask whether any of the funds the organization receives are restricted by the donor. If so, you will want to get help to modify your statements so these restrictions are presented clearly.

Your evaluation of overall financial strength should include recognition that restricted funds may be used only for their restricted purposes, and are not available for other purposes. Thus, restricted net assets represent resources that have already been received and are available to carry out restricted purposes in the future, but are not available for general, unrestricted purposes.

How Can I Tell If the Organization Is Complying with Restrictions on the Use of Funds?

In some organizations, a substantial part of the resources received carry restrictions attached by donors or grant funders. The restrictions may be either fairly general (use this money only for the children's program) or very specific (use this money only to buy art supplies for the children's program). The Statement of Support, Revenue, and Expenses (Statement of Activities) should let you see that restrictions have been established by the donor/funder, and that the spending of these funds has been in accord with the restrictions.

There are two common ways that nonprofits show the existence of restricted funds in their financial statements. If your nonprofit uses the standard GAAP reporting format, you'll see a distinction made between unrestricted and temporarily restricted gifts and grants on the statement reporting revenues and expenses. The gifts or grants that your organization received with donor restrictions will be presented in a column titled "temporarily restricted" (or "permanently restricted" if the gifts were to an endowment). In this approach, you'll also see a line at the bottom of the income section which reports on amounts "released" from temporarily restrictions and added to unrestricted income. This line indicates that you have complied with the donors' restrictions and used their funds according to their wishes.

Some nonprofits choose not to use the GAAP format. You can read more about this choice in Chapter 23. If your nonprofit is not using the GAAP format, you should still be able to see evidence that you are tracking donor restrictions

by looking at the Balance Sheet. There you will see a line item labeled "deferred revenue- grants received in advance" in the Liabilities section. This line item reports on funds which the nonprofit has received with restrictions which it has not yet used for the restricted purposes. When the nonprofit does use the funds for the purposes directed by the donor/grantor, the "deferred revenue" line item in the Liabilities section will be reduced and the grant income line item on the Statement of Activities (income statement) will be increased by the same amount. This entry reflects the fact that the nonprofit has earned the right to use the restricted funds by incurring costs which meet the donor's restrictions.

Understanding how nonprofits report on receiving and using restricted funds can be challenging, in part because different nonprofits use different methods. If you are not clear how you can see the receipt and use of restricted funds on your nonprofit's financial statements, it will be worthwhile asking an accountant to explain your current system and help you think through whether a different method would work better for your organization.

Is the Organization "Breaking Even"?

To answer this question you'll have to see the Statement of Activities (Statement of Support, Revenue, and Expenses). This statement reports on revenues and expenses over a period of time – a month, a quarter, or a year. Expect to see both revenues and expenses broken down into separate categories describing the type of revenue (grants, contributions, fees, interest, etc.) and the types of expenses (salaries, taxes, rent, supplies, etc.).

There are two important ways to look at this information. First, look at the bottom line – the *net income* which may also be called the *excess (deficit) of revenues over expenses* or the *increase (decrease) in net assets*. If revenues exceed expenses, the net income will be positive. If expenses exceed revenues, the net income will be negative and shown in brackets. This positive or negative net income for the period you are looking at is really the explanation of whether the net worth (net assets) of the organization is growing or shrinking. A positive net income will result in an increase in the net assets (net worth). A negative net income will result in a decrease in the net assets (net worth).

Another important way to look at revenue and expense information is in comparison to the organization's budget for the time period. Hopefully, the organization has a complete annual budget which shows all the planned sources of income and all the planned types of expenses. You can compare the actual revenues and expenses reported on the Statement of Activity to the planned revenues and expenses presented in the budget. Your questions will be, "Are things going as we had planned? Are we generating the income we thought we would? Are we controlling costs within the limits set in the budget?"

You will also want to look at your revenues and expenses in comparison to prior years. This can be particularly helpful when you have some revenues or expenses which do not occur evenly throughout the year. For example, if you have major fund raising activities every year in December, simply comparing your fund raising income and expense to your annual budget in October won't really tell you whether you're on track. It will be more helpful to compare your current year to past years, and especially helpful to think about what percentage of fund raising income was generated by October in previous years compared to the percentage of your annual budget for fund raising income which has been generated by October this year.

This approach of comparing the current year revenues and expenses to past years allows you to look at trends. Over the past three years, has the percentage of your total income coming from individual donors or program fees increased or decreased? Has the percentage of fund raising income consumed by fund raising expenses increased or decreased? Hopefully you have already thought through what your goals are in these areas as you worked on preparing your annual budget. If you have set a goal of increasing the percentage of your total income which comes from individual donors, you can evaluate whether you are achieving that goal by looking at trend information.

Is the Organization Using Its Resources Wisely?

This is perhaps the most important question of all. To answer it, you must know what the mission of the organization is, and the financial statements must give you enough information to be able to tell the purpose of the expenses as well as their descriptive character. For example, looking at a report which shows that the organization spent x dollars in salaries for the year, tells us the character of the expenses (i.e. salaries) but doesn't tell us the purpose (i.e. were the salaries spent for programs for children, seniors, or for administrators?).

We can get some information about the purpose of expenses through a functional presentation on the Statement of Activities or through a separate Statement of Functional Expenses. (See Appendix 20.) The functional presentation will distinguish expenses for program, administrative, and fundraising purposes, and if the organization has several different programs, distinguish the costs associated with each.

With functional expense data you can consider whether the organization seems to be spending its resources in accord with its mission and in a way which reflects its priorities. You may want to ask whether the organization can also convert this functional expense information into a cost per unit of service (this requires defining units of service and tracking them). The unit of service cost will allow you to compare the cost to provide a service at your organization

with the cost at another similar organization. Of course, such a comparison requires that both organizations have reliable data and have defined things similarly.

You may want to ask to have some supplemental information included on your financial reports to help you keep tabs on key indicators of both program and financial performance. For example, you may ask to see the number of clients served each month in comparison to your capacity, i.e. an average attendance of 200 in a child care facility licensed for 250 could be a sign that the organization needs to enroll children more rapidly or may have customer satisfaction problems. Average client census of nine in a residential care facility with sixteen slots would indicate potentially serious problems. This type of service utilization information is very important for organizations depending on payments per service provided.

Are the Books In Balance?

While most readers of financial statements will have to rely on someone with greater accounting knowledge to evaluate the quality of the accounting in the organization, there is one simple test you can do to alert yourself to very obvious problems with the accounting.

To do the test, you must have the financial statements for two consecutive periods, i.e. for January and February. Take the total *net assets* from the first of the two periods, and add the *net income* (change in net assets) for the second period to it. The answer should be the same number as is shown for the total *net assets* of the second of the two periods. If it's not, seek help from someone knowledgeable about accounting. This could be an indication that the books are not in balance.

How Do We Know the Financial Statements Are "Right"?

An audit completed by an independent CPA will give you the greatest assurance that the information presented on the financial statements presents the organization's financial position and activity fairly and should be relied upon. However, audits are generally done only once a year, and in small organizations, the cost of an audit may simply be too great to consider.

However, there are a number of simple procedures and cross checks which the accountant or executive director can perform each month to test the reliability of the statements. Be sure the organization has written fiscal policies and procedures and that they include the basic tests of accuracy. You could also ask a Director with a business background to review the financial records in detail at least once a year. You may also want to ask the treasurer to complete the

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following checklist of simple tests in the following section to verify the financial statements and include the checklist with the financial report.
