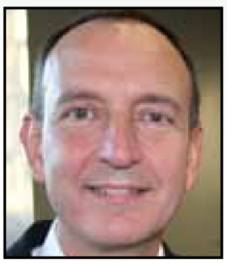
Demystifying Financial Statements

by Lisa Hoffmeyer



by Jim Walker

To provide a more comprehensive look at selected topics of interest to our membership, the Coalition introduced Preconference Short Courses; three-hour mini workshops held Sunday afternoon before the Statewide Affordable Housing Conference.

Demystifying Financial Statements Preconference Short Course was presented by Jim Walker, Community Development Loan Officer with the Florida Community Loan Fund and Dave Baker, Development Advisor with PNC Bank.

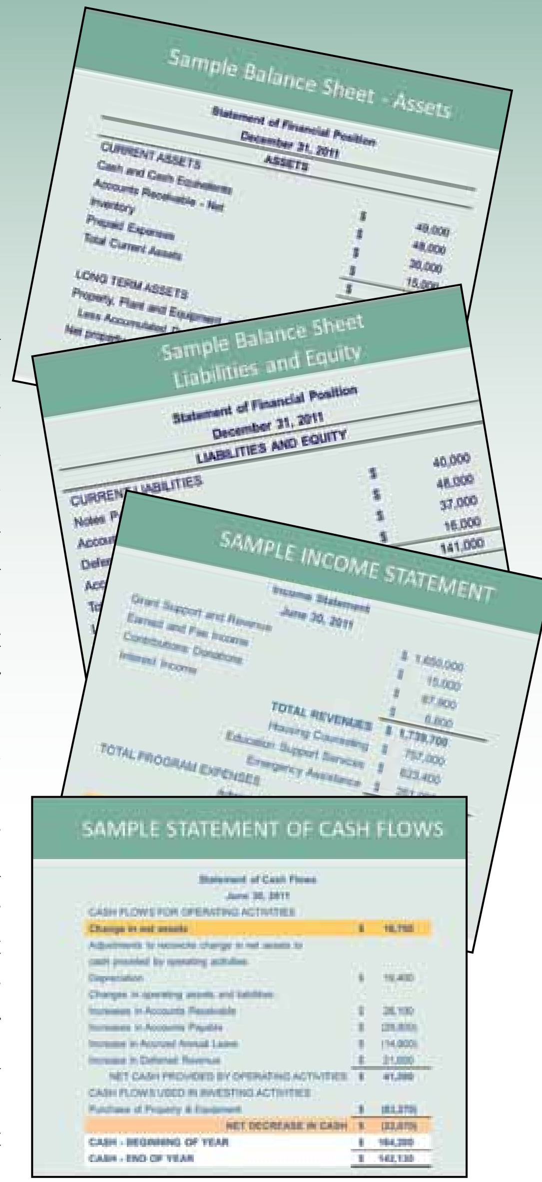
Financial statements are a report of an organizations' financial position either at a specific point in time or its operations over a period of time. The four basic statements are:

- Balance Sheet or Statement of Financial Position
- Income Statement or Statement of Activities
- Statement of Cash Flows
- Statement of Functional Expense

Understanding how to read these statements is a skill required of nonprofit executive directors, nonprofit board members, lenders and other funders. Knowing when to generate these statements, what information they contain and knowing how to interpret the data are an essential part of running a healthy nonprofit business.

Balance Sheet: Assets = Liabilities and Equity (net assets)

The Balance Sheet is a snapshot of a company's financial position at a given point in time. While typically reviewed annually as a part of the compilation of the year's financial statements or a part of an audit, more frequent (monthly or quarterly) review is recommended. The Balance Sheet is a valuable management and governance tool for nonprofits and consists of two parts that must balance.



Assets are the things a business owns that has value. This means assets can be sold or used to provide services or fund projects. Assets include cash, cash equivalents (investments that can easily be converted to cash), short-term investments, accounts receivable, inventory, property and equipment.

Liabilities are the amounts of money that an organization owes others. Liabilities can include money borrowed from a bank (note payable), money owed to suppliers for materials (accounts payable), wages owed to employees, and any other financial obligations to provide goods or services in the future.

Equity (Net Assets), sometimes called capital or net worth, is the difference between Assets and Liabilities.

Jim Walker, Community Development Loan Officer, Florida Community Loan Fund, talks about the tools for managing money.

Equity can be unrestricted (for example, a grant received by a donor that the nonprofit is free to use for any legitimate purpose), temporarily restricted (a project funded by a grant that will be "forgiven" after a period of time as long as the terms of the grant are met) or permanently restricted (a grant used to fund a property that must be permanently maintained as affordable housing).

Reviewing Balance Sheets can reveal:

- Cash Trends - is the organization's cash increasing or decreasing?
- Working Capital Ratio (current assets minus current liabilities) measures how much in liquid assets an organization has available to build and fund their current business. An increase in this ratio over time could signal that the organization may be able to invest more money in mission-based activities or it could mean they plan to build reserves for an unexpected expense or decrease in funding.
- How well are accounts receivable being managed? Are efforts being made to collect on invoices outstanding more than 90 days?
- Are loans being made to related entities or other parties? Is the nonprofit acting like a bank?
- How is inventory being managed? Are unsold but completed houses on the books for more than six months?
- Leverage = Debt/Equity. A high D/E ratio may be an indication an organization is taking on too much debt.
- Current Ratio – This is mainly used to give an idea of an organization's ability to pay back its short-term liabilities (debt and accounts payable) with its short-term assets (cash, inventory, receivables). The higher the current ratio, the more capable the organization is of paying its obligations. A ratio under 1 suggests that the nonprofit may be unable to pay off its obligations if they came due at that point.

Income Statement (Profit and Loss)

Revenue – Expenses = Change in Net Assets

The Income Statement or Profit and Loss shows the financial performance over a period of time (monthly, quarterly, annually). This statement connects the balance sheet from one period of time to the next.

Dave Baker, Development Advisor with PNC Bank, responds to specific issues raised during this Short Course.

Statement of Cash Flows

This summarizes the changes in an organization's cash position and what caused those changes. Even if an organization reports an increase in net assets on the income statement (their revenue exceeded their expenses), the amount of cash on the balance sheet may be lower than its beginning cash. This is because net income is not just kept in the bank, but can be used for financing accounts receivable (payments the organization made to vendors that have not yet been reimbursed by a funder), investing in assets (buying a new building for affordable housing) or decreasing accounts payable aging (paying vendors in 30 days, rather than 90 days).

Statement of Functional Expenses

This statement provides important detail about a nonprofit's operations. It categorizes the organizations expenses into three general categories:

- Program Expenses - Cost of goods and services directly related to each major program;
- Administrative Expenses - Costs of managing the organization (recordkeeping, budgeting, management payroll, generating financial reports, administrative activities); and
- Fundraising Expenses - Costs of fundraising campaigns and events.

Ratios of these three expense categories are used to measure efficiency and how effectively a nonprofit uses its resources.

For example, an organization that spent 85% on Programs, 8% on Administration and 7% on Fundraising will generally be looked at more favorably by a funder or donor than one who spent only 50% on programs, but 25% on Administration and 25% on Fundraising.

Donors and lenders do understand that successful nonprofits require a sound infrastructure to operate and a claim of zero fundraising and/or administrative fees is unrealistic. As a rule of thumb, most funders expect that no more than 25% will be spent on Administration and Fundraising expenses combined.

Participants talk with Dave Baker and Jim Walker about various expense categories.

Financial Statements often contain notes that offer additional information and clarification. Notes provide a context in which the statements are interpreted and disclose further detail on items that may not be readily apparent when reviewing only the numbers.

A clear understanding of how to interpret financial statements is crucial to a nonprofit's management, key staff and board so they can jointly exercise fiscal responsibility. It is the executive director's/CEO's duty to ensure that the board consists of members who can knowledgeably evaluate the reports. It is the board's responsibility to require regular, timely and complete financial reports from the executive director/CEO and be able to ask critical questions about the reports they receive. Armed with current financial statements and with the ability to properly interpret them, the board, staff and management can efficiently and effectively guide their nonprofit to success and sustainability. HNN

THANK YOU PARTNERS

The Florida Coalition gratefully appreciates all our Partners for Better Housing. We also give a special recognition to **Bank of America Charitable Foundation, Inc.** for its support.

PLATINUM SPONSORS