

# Interpreting Financial Statements

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Every member of a non-profit board of directors has a fiduciary responsibility for that organization, but all too often, directors are not familiar with accounting terminology and have not been trained in reading and understanding financial statements. This document offers basic information on what these statements are and how they can be used to understand the financial health of a non-profit. Part of the purpose of this document is to develop a common vocabulary so that all board members can effectively assume their responsibilities, instead of deferring to the financial expert on the board. This primer is comprised of four basic sections:

- ⇒ **Terminology and context of financial statements:** This section provides an overview of the keys to understanding terminology and context of financial statements, including the differences between non-profit and for-profit accounting and financial principles, and an explanation of some important concepts and tools that can give meaning to numbers on a statement.
- ⇒ **Types of financial statements:** This section provides a description of the four basic financial reports that boards will normally receive, with some guidance on what things a board member should look for in each of these reports, and some ratios that can help apply meaning to the reports.
- ⇒ **Examples to better understand how to read financial statements:** This section looks at a set of examples, including specific financial statements and key observations, and applications of the “lessons” ideally learned in the earlier sections of this document.
- ⇒ **Concluding thoughts:** This is a collection of thoughts and observations about interpreting financial statements, as well as recommendations.

## Terminology and Context of Financial Statements

This section covers important background information that helps put financial statements of non-profit organizations into context, and explains key concepts prior to looking at any of the actual financial statements. Below you will find seven assertions that provide this background. Board members need to keep these in mind when examining the financial statements from their own non-profit organizations.

1. ***Understand the differences between profit and non-profit organizations.*** While this may be obvious to most board members, it is useful to reiterate that there is a fundamental difference between non-profit and for-profit organizations. A for-profit organization exists for the sole purpose of making money for its owner or shareholders. A non-profit organization exists to fulfill a societal mission, contributing to the community, and hence it is given a special exemption from paying taxes (section 501(c)3 section of the IRS Code). For this reason, non-profits can accept gifts and grants, and the companies, organizations, or individuals making these gifts can use them as tax deductions. Non-profits may also run fundraising events to collect money in a tax-free manner. Unlike for-profit organizations, no one is legally permitted to make money or profit from the success of a non-profit. A non-profit is allowed to make money on a yearly basis and save that money to enhance programs in future years, to build a nest-egg for rainy days, and to pay their employees reasonable wages that are comparable with the local marketplace. Another fact that is often confused is that non-profits pay no taxes whatsoever. This just isn't true, it depends on the state as to whether they pay sales taxes or other fees, and any income generated by a means that is not directly related to its mission is taxable as “unrelated business income tax” (UBIT). (Colorado non-profits do have to collect and pay sales tax.)
2. ***Realize that the financial statements do not tell you anything about how well the non-profit organization is achieving its goals.*** In a for-profit organization, the financial statements are a scorecard of how well they are doing in terms of their primary goal – making money! Financial statements of a non-profit tell you absolutely nothing about how well they are achieving their goals since the goals are about impacting society and serving a specific targeted population. These things must be measured but they are not measured by monetary indicators. The mission statement and programming of a non-profit organization are indicators of its goals and these need to

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## Terminology and Context of Financial Statements (continued)

be operationalized, measured, and reported on to the board and the community on a regular basis. Every board member should push for a meaningful set of indicators of organizational success, but these responsibilities are different from the board member's responsibility to assure the organization's financial health. The ability to read and interpret financial statements is essential to this latter responsibility. Financial statements tell a non-profit how well-positioned they are to meet their goals; whether their programs are operating according to their plans; where financial adjustments need to be made; and they provide indicators of the level of efficiency with which they are operating. In a for-profit organization it is relatively easy to compare how well two oil-producing companies are doing when their financial statements are compared, but this is not true if one is comparing two homeless shelters. They need to evaluate their programmatic success quite distinctly from their financial statements. The financial statements of non-profits provide information about the capacity of these organizations to stay afloat, to continue serving the community, and to indicate how robustly they can operate in a changing economy.

3. **See non-profits as a business.** Outside of some basic differences in taxation and measurements of success for non-profits, it is imperative to recognize that in most (if not all) other respects, these organizations must conduct their business in the same manner as a for-profit business. They need to be able to make payroll. They need to pay their bills in a timely manner. They need to build up a good credit history. They need to build up enough financial reserves to survive difficult economic times. They need to understand how much (if any) money they are making or losing on various programs, so they can accurately predict how much outside support they will need in order to continue operating these programs. They need to understand whether they have a reasonable administrative overhead in operating their organization. While a host of other comparable processes could be enumerated, the bottom line is that even non-profit organizations have a bottom line. This does not in any way say their goals or missions are the same; they are not! But they are businesses that face all of the usual business challenges. Non-profits have noble missions and a need for passion in serving a critical social role. However, unless solid business practices are adhered to and board members are actively reviewing and making decisions based on financial statements, the organization will likely not be around to serve those key missions. These organizations must be run in a business-like fashion; not with the goal of making a profit, but rather with the goal of meeting social, educational, religious, or other causes that are deemed beneficial to the community and to society at large.
4. **Appreciate how more meaning can be gleaned when looking at financial statements in combination.** Each of the four different financial reports that will be discussed here has a unique layout and purpose (as will be discussed next) but it should be recognized ahead of time that interpreting the meaning from these reports can be best accomplished when they are looked at in combination. Some of the key aspects of where and how these reports can be used together will be identified in this narrative. The benefit of doing so should become clearer when specific examples are reviewed.
5. **Recognize that financial statements give a snapshot of the financial status of an organization at a single point in time.** Any financial statement, by definition, provides the summary of some financial measures for a specific time period (end of a month, a quarter, or a year) and does not inherently provide useful information about trends, or other comparative information. The financial reports in an annual audited statement provide data of what happened in the last year, and are historical in nature (not projecting the remainder of the year), but they are critical for reviewing the financial management of an organization. Ideally, financial reports need to be generated monthly to provide critical information to management so that adjustments and strategy changes can be made before a crisis arrives. In addition, it is very desirable to provide to management and the board contextual information so that more meaning can be derived from reports. Providing data on income and expenditures compared with the approved budget can be one of the contexts. However, using this method alone can be misleading, as it inherently assumes that expenditures and revenues will occur in 12 equal increments, rather than following some seasonal trends that are common to most enterprises. So, in addition to

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## Terminology and Context of Financial Statements (continued)

comparing to budget on a year-to-date basis, one might also want to present these numbers in comparison to the same time period in the last fiscal year. In both of these cases, showing percentage and dollar variances from the base (either budget or last year's values) will provide additional insight. Finally, the presentation of financials can also provide internal cost accounting, showing the revenues and expenses associated with specific programs, thus helping the board understand more about internal specifics.

6. **Understand the differences between handling the organization's accounts on a cash versus an accrual method of accounting.** While this isn't directly related to how one reads a financial statement, this understanding does give an additional contextual factor for a board member. Some smaller non-profits use a cash method of accounting, which essentially works like a family checkbook. When revenue comes in, it is deposited and when a bill comes in, it is paid. The key is just to make sure you don't start writing bad checks that have insufficient funds. It is the easiest to use, but a cash method may provide a very incomplete picture. Sometimes you have knowledge that there are outstanding debts the organization owes, but they are not reflected because the bill hasn't arrived yet. Similarly, you may know that you have a grant of thousands of dollars scheduled to come in, but it hasn't yet been booked.

On the other hand, an accrual method of accounting takes into consideration a much longer time horizon and it provides a more accurate picture of how the organization is doing. Accrual basis accounting recognizes income when it is earned and expenses when they are incurred. Under the accrual method, a bill that must be paid by the organization is included as a liability and money that the organization is owed is listed as an asset on financial statements. If you have an obligation coming in, you enter it as an IOU, even if you have no bill, and similarly when you receive a new pledge from a donor, but have received no money, you still book it as revenue. This method looks more realistically at grants, and the management of the organization. Usually more mature or sophisticated non-profits use an accrual method, although this isn't always the case. However, a board member should know what accounting method the organization uses for better understanding of financial statements. Before leaving this section, it should be mentioned that occasionally an organization may use a modified cash basis—which is essentially a hybrid of these two—but this is relatively rare.

7. **Use ratio analyses to provide more meaning to financial statements.** One way that additional information can be discerned from financial statements is to use ratios of various values on these sheets. This is a common technique taught in business schools at colleges and universities. In this document, a number of key ratios will be highlighted to help board members understand how robust and solid their organizations are. Using such ratios allows for comparison against some standards as well as other organizations, irrespective of size of the organization, since it shows the mathematical relationship between important variables. Usually, boards are not presented these ratios as part of the financial presentation, but they can shed considerable light on the health of the organization. One must be careful to look at both the value of the ratio and the trend of some of these ratios over time.
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## Types of Financial Statements

This section aims to explain and highlight the elements of four different financial statements that required for submission on the annual filing of Form 990, the equivalent of an annual tax form for a for-profit organization. These four include:

1. **Balance sheet** (Statement of Financial Condition)
2. **Income statement** (Statement of Activity)
3. **Statement of cash flows**
4. **Statement of functional expenses**

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## Types of Financial Statements (continued)

There may be other financial reports that management may present to the board, or may integrate with these four primary statements, such as a budget or cash flow projection, but the four primary statements will be focused on here.

### 1. Balance sheet

A balance sheet (also referred to as a statement of financial condition or statement of financial position) tells the reader the total assets of an organization, the total liabilities (or debts/obligations) of the organization on a specific date (looking at a single point in time), and lets the reader know how much is essentially “left over” and available to the organization. This statement is called a balance sheet, namely because the numbers must balance, as will be shown. Refer to Exhibit 1 (page 7) to see a balance sheet or statement of financial condition to see how this is usually laid out, and in the next section on examples, Exhibit 1 will be what is used to clarify some of the important lessons on interpreting these financial statements. In a for-profit organization, the layout is precisely the same, but they will discuss “equity” and “profits,” whereas in a non-profit the terms “net assets” or “net revenue” are used. The concepts and principles are identical, but the difference in terminology suggests that non-profits don’t make profits; however, net revenue funds perform in exactly the same manner. A statement of financial condition certainly is typically produced on a monthly basis and is always presented as part of an annual report or in the audited statements.

In looking at a financial statement, let’s first focus on the elements on the left column and not focus on the values until later. Assets are always listed at the top of these sheets and include all things of value to the organization. Assets include:

**Cash**  
**Checking account balances**  
**Savings accounts**  
**Short-term investments**  
**Long-term investments**  
**Accounts receivable**  
**Inventory**  
**Equipment (less depreciated value)**  
**Vehicles**  
**Property (including real estate)**

There may be other assets that a particular organization wishes to highlight or include, depending on the business they are in, and not all organizations will have (or report out) each of these categories of assets. Note that in the example provided in Appendix 1, they only report on a few of these—as they either don’t have them, or they have decided to collapse some of these categories—and the level of detail is strictly the prerogative of a given organization. In the section on Assets at the top of the statement of financial condition, one often sees the assets clustered into three different categories, which becomes important in one of the ratios that will be discussed shortly. The three categories are:

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## Types of Financial Statements (continued)

1. **Current assets:** These refer to liquid assets, like cash and short-term investments, checking and savings accounts, etc.
2. **Property and equipment:** As the terms suggest, this category includes owned property (even if mortgaged), equipment (including the amount which has been depreciated), and all other fixed assets.
3. **Other assets:** These can include long-term investments or other assets not included in the first two categories.

Turning our attention to the first ratio to be discussed, these three categories of assets become very important. Any non-profit organization needs to be concerned about whether they have enough money to pay anticipated debts, payroll, etc. In other words, they have to have enough liquid assets to meet their obligations as they come due in the short term (less than 12 months). One way of determining this is to calculate a **current ratio**. This ratio is calculated by taking the current assets (net liquid assets) and dividing that number by the total projected liabilities. For example, a current ratio of .94 indicates that there are 94 cents worth of current assets to back up each dollar of current liabilities. A current ratio of less than 1 means that there are insufficient current assets to cover short-term debt. This could cause potentially severe cash flow problems. An organization that has its current ratio greater than one would be able to pay its immediate bills from current assets. A good rule of thumb is that a current ratio greater than 1.5, or even higher, if possible, is desired.

$$\text{Current ratio} = \frac{\text{Net liquid assets}}{\text{Projected liabilities}}$$

While the organization may have more assets overall, since property or equipment cannot be made liquid easily, these resources can't be counted upon in order to pay bills, and this same logic applies to long-term debt. While a current ratio is not often provided in traditional business reporting, it is important for board members to know what this ratio is and how to use it, to keep vigilant in not exposing the organization to unnecessary risk.

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A second ratio that is worth understanding when looking at a statement of financial condition is a **debt ratio**. When a board is faced with a decision about whether or not to take out a loan to cover some business expansion, they are faced with a question: can the organization handle this debt? One way to help answer that question is to calculate a debt ratio. Debt ratio is calculated by taking any long-term debt and dividing it by the total assets of the organization. The lower the ratio, the less risk of financial difficulties for the organization and less risk to creditors, and the higher it is, the less able the organization will be to cover its debts. One needs to be very cautious in allowing this ratio to rise above a value .50.

$$\text{Debt ratio} = \frac{\text{Debt liabilities}}{\text{Total assets}}$$

## Types of Financial Statements (continued)

### Exhibit 1

#### Social Agency A

#### Statement of Financial Condition

	<u>ASSETS</u>	Dec 31, 2011
<b><u>Current assets</u></b>		
UBS checking		\$3,540
Wells Fargo checking		90,141
UBS account		50,547
Cash		\$149
Inventory		\$1,376
Total current assets		145,753
<b><u>Property and equipment</u></b>		
Digital cameras		2,131
Van		19,296
Copy machine		1,259
Trailer		3,697
Equipment		7,631
Accumulated depreciation		(26,885)
Total property and equipment		7,129
<b>TOTAL ASSETS</b>		<b>\$152,882</b>
<b>LIABILITIES</b>		
Payroll liabilities		629
<b>TOTAL LIABILITIES</b>		<b>\$629</b>
<b>NET ASSETS</b>		
Unrestricted net assets		133,920
Restricted net assets		18,962
<b>TOTAL LIABILITIES &amp; NET ASSETS</b>		<b>\$152,882</b>



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## Types of Financial Statements (continued)

When a board member looks at a statement of financial condition, some of the things they should look for, and questions they should ask, include the following:

- ⇒ What items are included under accounts receivable? When are these accounts to be received? Are they overdue? Is there any possibility of not receiving the money that is overdue?
- ⇒ What items are included under accounts payable? When are they due? Is there enough cash to cover them?
- ⇒ Compare the current balance sheet with previous years' statements. Identify any trends that might be an indication of changes to the financial health of the organization. Is there any change in the amount of net assets?
- ⇒ You may want to discuss whether or not the organization is fully insured for the replacement value of assets.
- ⇒ If there are any investments, are they earning a reasonable rate of return?
- ⇒ Are there too many assets in cash available, and does this suggest that investment of some resources may be in order?

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### 2. Income statement

The second, and perhaps the most useful and important financial statement is the income statement (commonly referred to as a statement of activities). See Exhibit 2 (page 8). This financial report is also sometimes known as a P & L (profit and loss) statement. Since non-profits don't have profits, technically P & L is the wrong title. This statement shows the revenues and expenses for a given period of time, clarifying whether restricted or unrestricted funds are being used (with restricted funds reflecting grants or other funds designated for specific programming projects). This sheet identifies different types of revenue and, at a minimum, shows the amount spent on programming, administration and fundraising. These sheets may also be laid out to show the relative income and expense associated with different program activities or cost centers to assist management in decision making.

This statement can be presented in a number of manners, comparing the report at a point in time compared with the budget, compared with the same time period last year, and variances in either dollars, percentages, or both. As stated earlier, this comparable data adds important meaning and if not provided, you may want to ask for such a presentation or calculate these yourself. Income statements without comparisons are next to useless.

There are three ratios that are germane to statements of activity: a revenue to-date ratio, a payroll ratio, and an unrestricted net assets ratio. **A revenue to-date ratio** gives the reader a clearer picture as to whether the organization is doing better than last year, which one would hope to be the case. This ratio is calculated by taking the revenue for a given time period, and dividing it by the revenue for the same period last year. Ideally this number should be 1.0 or greater. If it is lower, ask why! Has there been a decline in the economy, or is there some other obvious cause? Examine the causes of this downturn and make sure that management has plans for fixing this.

$$\text{Revenue to-date ratio} = \frac{\text{Revenue to-date for a given period}}{\text{Revenue to-date for same period last year}}$$

The **unrestricted net assets ratio** looks at current assets as a percentage of the budgeted annual expenses. This gives a measure of whether or not you have adequate resources, not just to meet payroll, but also to handle current obligations and to shut down the organization in an orderly fashion, or to handle crisis situations without any fundamental interruptions in service.



## Types of Financial Statements (continued)

**Exhibit 2**  
Statement of Financial Activities  
Social Agency A

	Jan - Dec	Budget	\$ Over Budget	% of Budget
<b>Income</b>				
Other income	\$300			
Prog. fee income	\$111,961	\$125,000	\$-13,039	89%
Custom programs	27,814	17,000	10,813	164%
Grant income	106,225	122,500	-16,275	87%
Individual donor	71,014	80,200	-9,185	88%
Individual donor - restricted	15,224			
Corporate donors	32,285	35,000	-2,714	92%
Special event	49,380	37,000	12,380	133%
In-Kind donations	0	700	-700	0%
Interest income	4,325	4,000	325	108%
Merchandise sales	116			
<b>Total income</b>	<b>418,644</b>	<b>421,400</b>	<b>-2,756</b>	<b>99%</b>
<b>Expense</b>				
Payroll expenses	289,182	296,934	-7,752	97%
Rent	31,415	33,000	-1,585	95%
Telephone	4,506	4,520	-14	100%
Office supplies	2,474	2,800	-326	88%
Transportation	13,624	12,350	1,274	110%
Prog. food	11,587	9,500	2,087	122%
Prog. equipment & supplies	4608	2,600	2,008	177%
Prog. facility rent	15,961	12,500	3,461	128%
Printing/publications	11,967	12,200	-233	98%
Marketing	9,033	7,850	1,183	115%
Furniture & office equipment	403.			
Memberships and fees	1,737			
Insurance	8,327	7,700	627	108%
Postage	3,738	5,500	-1,762	68%
IT	3,713	1,750	1,963	212%
Event fundraising	0	490	-490	0%
Travel	1,004			
Meals & entertainment	241	200	41	121%
Copier	0	350	-350	0%
Conferences, education/training	1,187	1,050	137	113%
Depreciation	6,425			
Bank charges	430	400	30	107%
Consultation	1,232	1,600	-368	77%
Credit card processing	5,177	4,700	477	110%
Audit	3,789			
<b>Total expense</b>	<b>\$431,770</b>	<b>\$417,994</b>	<b>\$13,776</b>	<b>103%</b>
<b>Net ordinary income</b>	<b>\$-13,126</b>	<b>\$3,406</b>	<b>\$-16,532</b>	<b>-385%</b>

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## Types of Financial Statements (continued)

When a board member looks at a statement of activities, some of the things they should look for, and questions they might ask, include the following:

- ⇒ The first thing to look for on a statement of activities is whether the income is greater than the expenses? If not... why not?
- ⇒ Look to see if the organization has a plan or goal for increasing reserves.
- ⇒ Has there been a balance between providing more services vs. building reserves?
- ⇒ Have reserves been drawn upon during this period and is there a planned and approved, or other situational reason for doing so (such as using reserves for a capital project)? Have investment values gone down because of a bad market? Is an operations loss due to less demand for services, or does the organization have a bad pricing model?
- ⇒ Look at the budget compared with actual amounts spent, and look at these both from a monthly and a year-to-date (YTD) basis.
- ⇒ If possible, look at a comparison to the equivalent time during the previous year.
- ⇒ Look at the percentage and the dollar difference from the budget, being careful to make sure that both the dollar value and the percentage value indicate a meaningful variance.
- ⇒ Determine if there are any significant revenues or expenses that weren't budgeted. What is the reason for this? Is the answer reasonable?

### 3. Statement of cash flow

The third financial statement that will be discussed is the Statement of Cash Flow, which provides a retrospective look at the changes in assets due to operations, investments, depreciation, and cash. The statement of cash flow merely shows the change in types of resources on the balance sheet from the past year to the current year. This form is required for the tax Form 990 which must be submitted, but because the statement looks backward at the changes during the previous year, it is really of limited value in managing or changing patterns for the future. Trying to develop prospective cash flow models is very important for any organization, but especially for small non-profit organizations, as the number one reason that small organizations fail is a cash flow challenge. For smaller, more fragile non-profits, a prospective set of cash flow projection tools are essential. However, the statement of cash flow is important and even critical to provide in the establishment of credit, as it is an indicator of resilience and credit worthiness. The 990 tax form requires three changes to be reported:

1. Cash from operations
2. Cash from investments
3. Cash from financing

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## Types of Financial Statements (continued)

One will always see operational cash and investments results in the typical non-profit statements, but cash from financing will seldom be seen in non-profit organizations. Before proceeding, it may be worth pointing out that since cash flow is so highly related to the success of smaller, non-profit organizations, some considerations ought to be given to the nature of the organization's fiscal year. If the big fundraising event of an organization occurs annually in late November, it is probably inappropriate to have a calendar-based fiscal year. This is because if the fund-raiser is not successful, there is little opportunity to fix the situation before the end of December, and this will reflect badly on the organization. Instead, the organization might want to start its fiscal year on October 1, allowing the management to know what they have to spend for the remainder of the fiscal year.

### Exhibit 3

#### Statement of Cash Flows

#### Social Agency A

#### Cash flow from operating activities:

Changes in net assets	\$20,009
Depreciation expenses	6,352
Decrease in inventory	(468)
Decrease in payroll liabilities	(139)

**Net cash from operating activities** **\$25,754**

#### Cash flow from investment activities:

Purchase of fixed assets	(1,553)
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Net cash from investment activities (1,553)

**Net Increase in cash and cash equivalents** **\$24, 201**

***Cash and cash equivalents, beginning of year*** **\$129,912**

***Cash and cash equivalents, end of the year*** **\$154,113**

Additionally, when an organization runs into a cash flow problem, there are a number of strategies that it may want to employ to survive these tough times; such as drawing on an ongoing line of credit; using reserves; getting a loan from a bank; obtaining a loan or special gift from board members or benefactors; delaying payment on bills that are due; refinancing property that is owned; or trying special efforts to collect outstanding accounts receivable. Not all of these options will be available to a given organization, but since cash flow is such a challenge, a board should have a good understanding of what options are available to it.

#### 4. Statement of functional expenses

The final document to explain is the statement of functional expenses, which also is required in the Form 990. This statement provides information on how the non-profit organization is spending its money and tells funders and potential donors how much of every dollar goes to the programming that is devoted toward the organization's mission. This statement requires expenditures to be allocated into the following three categories:

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## Types of Financial Statements (continued)

1. Management and administration
2. Programming
3. Fundraising

### Exhibit 4

#### Statement of Functional Expenses

##### Social Agency A

Programming	\$305,291	70.7%
Administration	79,360	18.4%
Fundraising	<u>47,120</u>	10.9%
<b>Total expenditures</b>	<b>\$431,771</b>	

## Examples to better understand how to read financial statements

The percentages of these three elements are then calculated, showing the amount of each dollar going to each of these three expense areas. So if only 10% goes to programming, and the rest is admin or fundraising, then there isn't much leverage going on and a donor's pledge isn't really going to the mission, but rather to these other overhead expenses. At the same time, a donor must recognize that organizations must be managed, and funds need to be raised, so understanding some norms against which a board member can compare is useful. The percentage of administrative costs in comparable organizations normally runs between 15% and 20%. In larger organizations, (\$2 million or more) these administrative costs may be lower. For fundraising, the norm is probably between 15 and 20 cents on the dollar of funds raised, but less during a capital campaign. This statement is usually only produced for the annual audit, but if the numbers are good (low administrative costs and high leverage on philanthropy) the organization may want to highlight these figures in external communication and fundraising communications, as such values reflect a well-managed organization, and a good investment of a donor's dollars.

The next section of this document looks at some actual examples of financial statements, and tries to take the reader through these, showing what they tell you, or fail to tell you. Each bullet reflects an observation that can be discerned from these statements, highlighting some key points. By going into this detail, it will hopefully show the reader where and how to look at these financial statements. Let's look at the examples that have been presented thus far in this document describing what these statements are, and this time look at what they actually tell us. In looking at Exhibit 1 (page 6), here are some observations about the **statement of financial condition**.

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## Examples to better understand how to read financial statements (continued)

- ⇒ First, note that it is balanced, with total assets equaling \$152,882 and the total liabilities and net assets equaling that same value.
- ⇒ Next, let's look at the current ratio. To do that, take the current assets of \$145,753, and divide it by the liabilities of \$629. This gives a value slightly above 231! Wow... it ideally should be greater than 1.5, but 231??? Something is probably wrong here... you never see a value that high! The fact that liabilities are less than a thousand dollars should raise eyebrows. They don't owe any rent for next month? They don't have any vacation owed to employees? They don't have any obligations for the next payroll? The answer to all of this is that this organization must be using a cash method of accounting (which it is), which can be very misleading, because it fails to anticipate anything. The current ratio would probably be more than fine if they showed their liabilities in an accrual method, but this should raise concerns about the financial information you are getting.
- ⇒ The sheet shows no debt, so a debt ratio calculation is irrelevant.
- ⇒ This sheet shows no accounts receivable; because the work of this group is almost entirely in the summer—and these are audited statements conducted at the end of the calendar year—this makes sense. You have to look for what is not in these statements, not just what is in them.
- ⇒ The sheet includes accumulated depreciation. (Depreciation reflects the wear-and-tear of an asset, which reduces its value.) Ask whether this is just used to balance the spreadsheet, or is the organization actually setting aside this amount of money in order to be able to replace the capital equipment in an orderly manner? Most small non-profit organizations do not actually fund depreciation, because they believe they can't afford to do so. However, when the van ultimately must be replaced, will they have the money to buy another? These are questions that a board member should consider when looking at a statement such as this.
- ⇒ Finally, one should note that this organization has almost \$134,000 of unrestricted net assets, and this fact will be returned to as we look at the statement of activities for this organization.

Now let's look at Exhibit 2 (pages 8) and what the **statement of financial activities** tells us.

- ⇒ One should note, that this layout of financial activities is typical of what a board member might receive in their normal monthly (or quarterly) meetings, showing the actual expenditures compared with the budget, and then shows variances in both dollars and percentages. One might want to refer to Exhibit 6, which would be more typical of what one sees in the audited statements. There is much more information and context in Exhibit 2, and a board member should try and evaluate these details carefully and look for trends or patterns.
- ⇒ The first thing to look at is the total expenses and total revenue, and see what the difference is. We see that they have lost \$13,126 for the year, looking at the column header for "January through December." This could either be a monthly or quarterly report given to the board at a regular meeting, or the yearlong summary that is part of the audit report, but in any case, the organization lost money for the year. We already have looked at the statement of financial condition, and know they have the money to cover this loss.
- ⇒ The next thing to look at is the sources of revenue and how the actuals compare with the budget.
- ⇒ The first area of concern is that their program fee income is less than budgeted, and one should ask why this is... do they need to increase marketing, adjust prices, or both? While not a huge problem, it is more than 10% off budget, and since it is the source of revenue that was most at variance with the budget, some investigation here seems to be in order.

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## Examples to better understand how to read financial statements (continued)

- ⇒ The individual donor giving is below budget; however, when taken in combination with the fact that there is an unbudgeted individual donor gift that is restricted, there doesn't seem to be any concern.
- ⇒ The special event was quite successful, which alleviated the overall reduction in revenue; even with this success, however, they still were about \$3,000 below plan.
- ⇒ There is nothing that causes enormous concern in looking at the income section of this statement, but there are some things that need to be monitored, and the conscientious board member will note these variances and watch the trend of those in the upcoming months and quarters.
- ⇒ On the expense side, we see that the organization spent nearly \$14,000 more than budgeted, and since revenues were down slightly, this should be understood.
- ⇒ One thing that should be understood is that the vast majority of expenses in any non-profit organization are in personnel or payroll expenses. In this case, in the budget, the expenses of \$296,934 of planned payroll expenses account for 71% of the planned budget of \$417,994. This is pretty normal, but the board member should know that staffing costs are this dominant in the budgets of this kind of organization.
- ⇒ In terms of specific expenditures, look down both the percentage variance and the dollar variance columns to see where any problems might lie. Be careful of the percentage column, as these values can fluctuate widely. For example, look at percentage variances for program food, program equipment and supplies, and program facility rentals. You see percentage variances from the budget of 122% 178% and 128%, respectively. On the surface one might think that the one that has actual expenses being 177% greater than budgeted would be the biggest problem. In fact, it has the lowest dollar variance from budget of any of the three. This should make it clear that one needs to look at both the dollar variances and the percentage variance in order to spot problems, and judge their magnitude.
- ⇒ If one looks for what single line item caused the budget to be most out of kilter, it is the audit; as it was not budgeted, it caused nearly \$3,800 of the expense problem that is shown on this statement. Why wasn't this budgeted, and should it be in the future?
- ⇒ If one looks at the other line items that contribute to the deficit during the year presented, they seem to be the three program expenses mentioned earlier, accounting for \$2,087, \$2,008, and \$3,461 respectively, and a total of \$7,556, of excess expense for the programs run by this organization. This could be interesting, as it was these programs that failed to meet their income goals mentioned earlier. If one considers that program fees were more than \$13,000 short of plan, and the expenses are more than \$7,500 more than budget, there may be a problem in pricing of these programs. Or perhaps there is some other factor, such as not having a critical mass to hold these programs. The financial statement alone cannot answer these questions, but they can raise such questions. Management should explore and explain the circumstances, and propose changes if appropriate.
- ⇒ One ratio that is appropriate to consider at this time is the ratio of unrestricted net assets. The statement of financial activities tells us that annual expenditures were \$431,770 (remember to use actuals, not budgeted figures), so we can calculate this ratio. One goes to the statement of financial position (page 6) and sees that the current assets are \$145,773. One divides this value by the expenditures of \$431,770 and finds that this ratio is 33.8%, which is considerably higher than the norm of 25% for non--profits, but still short of the goal of 50% or slightly more. However, it is in a nice comfortable range, so there is no need to calculate the other ratios, as there is plenty of liquidity to handle any short-term problems.
- ⇒ Finally, note that depreciation wasn't budgeted either, but the accounting rules require that it be included in these financial statements. As mentioned earlier, it is quite common not to fund depreciation in smaller non-profit organizations. The board should periodically review whether they can or should fund depreciation.

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## Examples to better understand how to read financial statements (continued)

Let us now look at the *statement of cash flows* and see what it can tell us, so reference Exhibit 3 on page 10.

⇒ The statement of cash flows was the audited statement for this organization for the year preceding the aforementioned statement of activities.. So the statement presented shows that the net assets of the organization increased by \$24,201 in the preceding year, and this was due almost exclusively due to operations. Now, realize that if the numbers in the statement of financial activities that we just reviewed are found to be accurate in the audit, then the loss of \$13,127 will be shown on the next audited statement of cash flows. The number of \$154,113 for the end of last year will be decreased by the \$13,127 (and adjusted by any changes in investments) to be the starting number in the cash flow analysis for the coming year.

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The *statement of functional expenses* is the last statement to be looked at for this organization, and that report is found in Exhibit 4 on page 11.

- ⇒ This statement shows very simply that about 71% of the organization's funding goes to programming, about 18% is administrative, and about 11% is fundraising. All of these values fall within the expected norms, and don't raise any concerns.
- ⇒ One can look at this data and do some specific analysis of the fundraising efforts. We can see from this report that the organization spends \$47,120 on fundraising. If we look at the statement of financial activities on page 9, we can look at the various sources of income from which they received income. Although the fundraising didn't impact income from program fees, custom programs, interest income, sales, or the "other" category, it can be seen as responsible for all of the other sources of donors and fundraising events. If one sums the fundraising revenue shown in the statement of activities, one arrives at a number of \$241,843. If one takes this the amount of \$47,120 spent on fundraising, and divides it by the funds raised, one gets a value of about 19 cents of cost for every dollar raised, which is in the accepted range.
- ⇒ When looking at a statement of functional expenses, it is often interesting to understand how they arrived at these figures, because they are a function of cost accounting decisions having to do with how time is allocated. The ED of a non-profit organization is the main administrator and manager of the organization, but also probably does some fundraising, and also is involved in some program activities. How one decides to allocate the percentages of his or her salary and benefits can gerrymander these values. The point here is that this is an art form and not a rigorous accounting methodology and so it is worth understanding what is behind the numbers that are presented.

**Important Note:**

The next section of this report goes step-by-step through the financial statements of another non-profit organization (as has been done in the last several pages), to provide more illustrations on how to read financial statements. For those gluttons for punishment, read on! For those who have had enough, skip to some concluding comments on pages 17 and 19 of this document.



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## Examples to better understand how to read financial statements (continued)

Let us now look at another organization and another set of financial statements. If one looks at Exhibit 5 (below), one finds the **statement of financial position** for another non-profit organization.

- ⇒ One sees that the sheet is balanced with a total of \$591,188 for both total assets, and the total of liabilities and net assets.
- ⇒ One sees that there is vacation accrual, accounts payable, and other accrued liabilities in this statement, showing clearly that they are using an accrual method and that they have some believable numbers here, unlike the previous example, which was examined.
- ⇒ The current ratio would be derived by dividing current assets of \$459,324 by liabilities of \$24,130, yielding a very impressive (and believable) value of 19.0.
- ⇒ One can see by the amount of reserves this organization has that they are in a very impressive financial condition. This will be amplified as we look at some of the other financial statements.

**Exhibit 5**  
Social Agency B  
Statement of Financial Condition

<b>ASSETS</b>	
<b><u>Current assets</u></b>	
Cash	\$459,324
Prepaid rent	123,954
Total current assets	583,278
<b><u>Property and equipment</u></b>	
Equipment	8,339
Accumulated depreciation	(429)
Total property and equipment	7,910
<b>TOTAL ASSETS</b>	<b>\$591,188</b>
<b>LIABILITIES</b>	
Accrued and other liabilities	5,826
Vacation accrual	4,876
Accounts payable	13,428
<b>TOTAL LIABILITIES</b>	<b>\$24,130</b>
<b>NET ASSETS</b>	
Unrestricted net assets	567,058
<b>TOTAL LIABILITIES &amp; NET ASSETS</b>	<b>\$591,188</b>

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## Examples to better understand how to read financial statements (continued)

Looking at the next financial statement, Exhibit 6 (below), we see that they have combined the statement of activities with the statement of cash flows.

- ⇒ This is the form that they submitted for their audit, and illustrates the differences between a monthly statement of activities and the far more compressed version shown in audited statements. There is much less information about revenue sources and expenditures, and no budget comparisons are made.
- ⇒ They had a very positive year and made over \$98,000 over the previous 12 months.
- ⇒ If one calculates a net assets ratio, one takes the current assets from Exhibit 5 of \$583,278 and divides it by annual expenses of \$487,105 and gets a value of 119.7. This is an incredible number and unusually high. Earlier, it was mentioned that high reserves might be of concern to funders and especially foundations, and under normal circumstances, seeing a ratio this high may indeed give them some concern. However, this organization is ramping up to conduct a capital campaign, and they are receiving funds given in anticipation of the announcement of the campaign. If explained to funders, this would likely erase any concerns.
- ⇒ One can also see that their presentation provides the data necessary for a statement of functional expenses, although they have decided to create a separate document for that purpose.

### Exhibit 6

#### Statement of Activities and Cash Flows

#### Social Agency B

##### Revenues and other support:

Contributions	\$536,392
Grants	37,257
Interest, dividends, and unrealized gains	11,645

**Total revenue** **\$585,294**

##### Expenses:

Program services	382,948
Support services	
Management and administrative	39,747
Fundraising	64,410

**Total expenses** **\$487,105**

**Change in net assets** **\$98,189**

***Cash and cash equivalents, beginning of year*** ***\$468,869***

***Cash and cash equivalents, end of the year*** ***\$567,058***

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## Examples to better understand how to read financial statements (continued)

The ***statement of functional expenses*** for this organization is shown in Exhibit 7, below and on page 18.

- ⇒ This very detailed examination of fundraising and administrative expenses provides a lot of detail, but the bottom line is that the percentages are well within the norms, and may even be worth highlighting, since nearly 80% of all funds go toward their mission programming.
- ⇒ The administrative costs percentage at 8.2% is extremely low, and can either tell the community how efficient they are, or tell the board that they may be investing too little in administration.
- ⇒ In terms of fundraising expenses, one sees that they raised \$536,392 in contributions and \$37,257 in grants, as shown on the previous financial statement, for a total of \$573,649. If one takes the fundraising expenditures of \$64,410 and divides that by the amount raised, one gets a value of 11 cents of expense for every dollar raised, which is extremely good.

## Concluding Thoughts

Hopefully this document has prepared you to be better able to make sense of the financial statements that are presented to an average board member. There are just a few additional things that might be worth some discussion before concluding.

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### ***Understand the audit report***

Somewhere about three or four months after the close of a fiscal year, the board ought to be expecting an audit report and management letter from the auditor the organization has hired to accomplish these tasks. It is usually a somewhat intimidating report, and yet one cannot let this be the focus. Every board member needs to go through it carefully and understand what is in the document.

One thing that may initially confuse a reader is that the cover letter usually starts out by explaining that this is an “unqualified report.” One may wonder why the organization paid this money to get something or somebody that is unqualified. This unfortunate terminology often presents confusion, but in actuality, it means that they have no “reservation” in stating what they report, and that there are no “qualifications” in their conclusions, that they are just what they state.

Many audit reports have footnotes that explain certain entries. It is important to read these (although they often put them in ridiculously small fonts!) as they usually include important information, and tell the story far more completely. Don't overlook the footnotes... that's where the good stuff is often hidden!

Board members also should pay special attention to the management letter, and if it isn't provided by management, they should ask for it. This is the document that the auditors prepare telling management (and the board) what changes in controls or procedures are needed to protect the organization. Quite often in a very small organization, auditors will mention the need for segregation of duties, so that one person isn't in charge of everything financial, and that there are some checks and balances and procedures in place to prevent embezzlement, etc. Since small organizations probably can't afford a separate person, they may want to have reviews before checks can be sent out. Finally, it should be mentioned that many small non-profit organizations do not get a formal audit because of the expense involved. Increasingly, however, funding agencies will not make grants to organizations without audited statements. You should try to make the audit a priority to get funding.

## Examples to better understand how to read financial statements (continued)

### Exhibit 7

#### Statement of Functional Expenses

#### Social Agency B

	Program	Mgt. & Admin,	Fundraising	Total
<b>Personnel expenses:</b>				
Salaries and wages	\$185,626	\$20,625	\$0	<u>\$206,251</u>
Benefits and taxes	38,698	4,300		42,997
<b>Other expenses:</b>				
Fundraising	-	-	64,410	64,410
Dir. program expense	61,993	-	-	61,993
Office Rent	18,268	961	-	19,229
Consultants	11,065	-	-	11,065
Project X funding	10,944	-	-	10,944
Accounting	-	7,747	-	7,747
Parking and mileage	5,108	1,703	-	6,811
Technology expenses	6,713	-	-	6,713
Supplies	15,625	-	-	15,625
Telephone, FAX, Internet	2,820	940	-	3,760
Transportation	3,091	343	-	3,434
Repairs and maintenance	3,086	-	-	3,086
Facility supplies	3,014	-	-	3,014
Insurance	1,904	635	-	2,539
Office supplies	2,480	-	-	2,480
Dues and subscriptions	2,000	-	-	2,000
Equipment	1,919	-	-	1,919
Director's emergency account	3,393	-	-	3,828
Fees	1,484	-	-	1,484
Staff development	1,394	-	-	1,394
Security	1,240	-	-	1,240
Postage	-	1,123	-	1,123
Miscellaneous	1,462	22	-	1,884
Professional fees	630	431	-	1,061
Board expenses	-	517	-	517
Online fees	475	-	-	475
<b>Total Expenses</b>	<b>\$382,948</b>	<b>\$39,745</b>	<b>\$64,410</b>	<b>\$487,105</b>
	<b><u>78.6%</u></b>	<b><u>8.2%</u></b>	<b><u>13.2%</u></b>	

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## Concluding Thoughts (continued)

### ***Understand the use of volunteers in financial statements***

Volunteers are critical to the operation of most non-profit organizations, which couldn't operate without the services of these people who give their time in support of the mission. It is technically acceptable to include "volunteer time" as an asset in the financial statements in certain circumstances. However, if you see this element in financial statements, be very careful. It artificially raises the perceived financial strengths of the organization, and can be very misleading. Such volunteer time assets must be in the "other assets" category, and one should be careful not to include it in any ratios, as this "asset" is never spendable. Volunteer time can indirectly affect financial statements in another way. In some smaller non-profit organizations, the leadership is entirely a volunteer effort, thus the statement of functional activities will be distorted greatly, as that means 100% of all donations go to programming. As soon as such organizations mature, and they hire an executive director, these ratios will shift enormously. In general, volunteers are critical, but they don't belong in financial statements.

### ***Look at ratios if possible, and let them help drive your questions***

As has already been emphasized, ratio analysis can help tease out a lot of additional information from financial statements. Use these tools to help form your questions as you seek to better understand what is going on financially in your organization.

### ***Evaluate your management team***

A board member has a fiduciary responsibility for the organization, and part of that responsibility is evaluating, hiring, and firing the CEO of the organization. A board member should feel free to ask questions and to determine whether or not the ED has a handle on the numbers, the business processes, and the financial cycles of the organization. Equally important, but distinct from the financial, does the ED have a handle on the mission and metrics that indicate the extent to which the organization is meeting these goals? The ED does not need to be a financial expert *per se*, but does he or she understand the basics, and draw upon others appropriately to understand and clarify financial issues? You need to trust your gut and your impressions, and not hesitate to ask questions, even if you are not confident in your financial acumen. There will likely be others on the board who have additional expertise, and you have a responsibility to ask—and get answers. It is part of your "duty of care" that is one of every board member's basic responsibilities.

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