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Frequently Asked Questions

Question

How do we interpret our financial statements?

Answer

Readers of financial statements can learn a great deal about the health of a nonprofit organization by examining the numerical information presented. In particular, financial information helps readers:

- **Measure the organization's efficiency, using factors such as:**
  - Units of service produced compared to costs
  - Fundraising income compared to amounts spent on fundraising
  - Net income in a fee-producing program compared to the fees received

- **Evaluate the adequacy of financial resources, often through:**
  - Liquidity ratios, such as the current ratio
  - Comparison of total liabilities or total assets with net assets (formerly called fund balance)
  - Cash flow projections

- **Seek significant financial trends by:**
  - Vertical analysis (looking at a simple line item as a percentage of total revenue or expense)
  - Horizontal analysis (comparing prior periods with the current period)

For different organizations, different numbers will have different meanings. For example, imagine an organization that shows an operating deficit for the year of $20,000. Is that a red flag? In a small organization with few reserves, such a deficit may indeed indicate serious over-spending of failure to generate revenue. In a large organization, $20,000 may represent less than one percent of revenue and may not be significant. Yet another organization may be purposefully spending down cash reserves on an important program and this "deficit" may represent that decision. For still another organization, a loss of $20,000 may not be a concern by itself, but because it represents the third consecutive year of deficits, does cause concern.

Ratios, too, have different meanings in different situations. For example, a new organization may find it spent 90 percent of its dollars on fundraising. In an established organization, such a ratio would certainly be a red flag. But on closer look, this new organization's services are delivered by volunteers, and the only paid staff they have is a fundraiser.

Just as a fast food chain and an airline are in different businesses with different financial indicators, a specific ratio will mean something different in different types of nonprofits. There are different red flags for arts organizations than there are for human service organizations, and different red flags for organizations that rely on donations than for organizations that rely on individual fee payments.

In several cases, ratio analysis is used to evaluate the organization's financial health. Ratios are a tool for comparing numbers representing different aspects of an organization's financial status. The value of the tool is in identifying which numbers to compare, and determining what the comparison might indicate. Although accountants have determined certain standard ranges for these ratios within some nonprofit industries (arts, libraries, human service agencies, etc.), it is most important to identify the trends in your own organization and analyze changes over time. Therefore, instead of giving specific ranges in the following examples, this article indicates the likely significance of a "high" or "low" relationship between the numbers compared in the ratio.

Financial Indicators from the Statement of Activities (Income Statement)

Surplus or deficit

If income is greater than expenses within a given period, say a year, the organization has generated a surplus. If expenses are greater than revenue, the organization experiences a deficit for the period. There is no rule that says organizations should have surpluses, deficits, or break even. Typically nonprofits budget to break even. However, organization may deliberately decide to spend down their cash reserves (expandable net assets) for a specific purpose such as starting a new program. Doing so results in an operating deficit, but one which is planned. Similarly, if a nonprofit has determined that it needs a cash reserve for specific future purposes (cash flow, investing in a new program guarding against future declines in funding, etc.), the Statement of Activity should reflect an operating surplus. An "unplanned" surplus, deficit, or even a break even position should be analyzed to determine its causes and to plan for the implications.

Budget to Actual for Revenue and Expense

Perhaps the most commonly used financial indicator is a comparison of budgeted revenue to actual revenue, and budgeted expense to actual expense. These comparisons are made on both a monthly and a year-to-date basis. Significant variations from budget should be investigated to see whether new projections should be make based on actual experience, and/or whether managerial intervention is appropriate.

Functional Expense Ratios

When completing Federal Form 900, nonprofits must report expenses functionally, broken down into the categories of Program , Management and General Activities, and Fundraising. Donors and agencies who evaluate nonprofit performance, often look to see that most of your organization's funds are being used for programmatic purposes. However, different sources recommend differing practices and policies for allocating expenses among the functional expense categories. As a result, it is important to develop consistent guidelines within your own organization to determine which of your expenses go to program support, and which to management and general activities or fundraising.

Some functional expense ratios are:

Take Program Expense and divided by Total Expense
If high, most of the expenses are related to program. Relatively little is spent on management or on fundraising.

Take Fundraising Expense and divided by Total Expense
If high, a large percentage of expenses are spent on fundraising efforts. Prospective donors may draw the conclusion that too high a portion of their contribution will be spent on fundraising, rather than on program services.

Financial Indicators from the Statement of Position (Balance Sheet)

Short term liabilities coverage ratio (quick ratio)

Will there be enough cash to pay bills in the immediate or near future? Add together all assets that can be used to pay bills over a specific period of time, such as one month or three months and compare this with the bills that must be paid within that same period of time.

Take Cash + Unrestricted Investment + Accounts Receivable and divided by Current Accounts Payable + Current Accruals
If high, there may be too much in cash, some could be earning more if invested. If low, you may be in danger of a cash flow crisis, not enough cash to pay pressing bills.

Current Ratio

Will cash flow be adequate to pay bills over the next year?

Take the Current Assets and divide by Current Liabilities

If high, Same as above. Caution: Even if current ratio is adequately calculated for the year, there may be periods within the year where there is an inadequate cash to pay bills.

Deffered Revenue or Net Temporarily Restricted Assets

Deferred revenue traditionally refers to cash which has been received for some restricted condition which has not yet been met. Under the new Statement of Financial Accounting Standards No.116 issued by the Financial Accounting Standards Board (FASB), most of these funds will be held not as deferred revenue, but as an addition to temporarily restricted net assets.

To determine the ratio, take the Deferred Revenue and divide by the Cash + Savings - or - take the Temporarily Restricted Net Assets and divide them by the Cash + Savings.

If deferred revenue or temporarily restricted net assets exceeds cash and savings, you may be spending restricted cash for purposes other than those which the funder intended, or using monies designated for future purposes (such as magazine subscription fulfillment) to meet current expenses.

Financial Indicators Using Information from More Than One Financial Statement

Fund Balance Ratio or Unrestricted Net Assets Ratio

The fund balance ratio, now called the unrestricted net assets ratio, measures the amount of unrestricted, spendable equity to the organization's annual operating expense.

To determine the ratio, take Expendable Unrestricted Net Assets and divide them by Annual Expenses.

If low, the organization has little unrestricted, spendable equity available to meet temporary cash shortages, an emergency, or deficit situation in the future. This may be the case even in organizations with significant unrestricted net assets, if the major portion of equity is tied up in fixed assets.

Days Receivables

The days receivables ratio measures the average number of days it takes to collect on a sale or service performed for a fee. This ratio is useful to organizations which earn significant portions of their revenue from fees charged to clients or from product sales.

To determine this ratio take the Accounts Payable times 365 days and divide by purchases.

If high, payments taking longer than 30 or 60 days are inconsiderate and may result in friction with community vendors. In addition, the organization may be incurring additional costs as a result of late or deferred payments (e.g., late fees, interest expense, etc.). A very long days payables ratio or a sudden increase in days payable may indicate an inability to pay bills.

Failure to Produce Financial Information

In order to assess the financial health of your organization, timely and reliable financial information must be available. Lack of adequate financial information may indicate that not enough time is available from staff or outside contractors to perform the accounting function, that staff needs more training in financial statement perpetration, or that financial systems need to be improved.

Final Comments

Ultimately, the most important performance measure of a nonprofit is not to be found in financial statements at all. To determine "success," a nonprofit must measure progress against its goals. For example, perhaps an organization has set as a goal providing 200 terminally ill patients with hospice care over twelve months. Determining how many patients were served and at what cost is not difficult. But these calculations show how efficient the has been - not how effective the group has been at providing compassionate, professional care for these patients. It is important to remember that financial indicators are powerful tools for nonprofit managers, when used in pursuit of meaningful goals.