



NONPROFIT FINANCIAL STATEMENT ANALYSIS - WHAT SHOULD I BE LOOKING FOR?

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Many times, I have been asked the following two questions by nonprofit organization board members and senior management:

- What should I be looking for when I review my organization's financial statements, and
- What questions should I be asking of the management team?

► WHAT SHOULD I LOOK FOR IN A NONPROFIT'S FINANCIAL STATEMENTS?

Understanding a nonprofit organization's financial information is not only the key to determining a nonprofit's health but also the building block for making most financial decisions. There is much to be learned from a nonprofit's financial statements other than whether the organization made a profit.

From the financial statements we can learn many things about a nonprofit organization, such as:

- Did the organization have enough cash inflows to cover operations or is it living off its reserves?
- How much of the funds being raised are being spent on programmatic activities?
- How heavily leveraged is the organization?
- How much did it cost the organization to raise money?
- Is there a concentration of funds that come from a specific revenue source that may be putting the organization at risk?
- Does the organization have the ability to meet its obligations?

Since many of us that work for or volunteer for nonprofit organizations in various

capacities do not have the time to review every transaction in exercising our fiduciary responsibilities, it is important that we use other skills to ensure that the financial records are complete, accurate and represent the whole picture of the organization. One of the skills that we might use to meet that responsibility is our analytical skills. Through analysis of the financial results and inquiry of management and staff we can identify unexpected variances and trends that do not meet our expectations. This may bring to light issues that we might want to look into further. The key concept in the previous sentence is *expectation*. How do we develop our expectations and what should our expectations be based upon? This is not an easy question. Our expectations can be based on many things, such as:

- Past experience and performance
- Knowledge of current trends in the organization's charitable sector
- Current budget
- Transaction, event or financial reports delivered in previous board or committee meetings
- Current trends in the economy or the market

Now, some of us may remember back in college a class that we took called *Quantitative and Qualitative Analysis*. This was a class in which you might have been required to do a few case studies in a group setting and you were probably the one that did all the work since no one else showed up for study group. I hope that this is not the case now. Let's refer back to that class for a couple of definitions that are important to understand.

► QUANTITATIVE ANALYSIS

Webster's New World Dictionary defines quantitative analysis as "the branch of chemistry dealing with the accurate measurement of the amounts or percentages of the various components of a compound or mixture."

Now if we all think back to high school chemistry class, we know that chemistry is an exact science. However, contrary to some opinions, accounting is not an exact science since there are certain levels of judgment and estimation involved in accounting.

The word quantitative by itself according to *Webster* means "capable of being measured" and if we think of that definition from a financial and accounting perspective, it would mean separating or breaking up of any whole (the financial statements) into its parts (individual accounts, financial statement line items, groups and class of transactions, accounts and financial line items, etc.), in a way that is capable of being measured in terms of quantity with some degree of precision. In using this definition of the word "measure," it would allow us to determine the nature, timing, function and interrelationship of that which we are analyzing.

Therefore, quantitative analysis for financial and accounting purposes is the measurement of results. The best way to measure results is through formulas, ratios or the expressions of other relationships that can be expressed in mathematical terms. The most common forms of quantitative analysis of financial and accounting data are trends and ratios.

► QUALITATIVE ANALYSIS

Webster defines qualitative analysis as "a branch of chemistry dealing with the determination of the elements or ingredients of which a compound or mixture is composed."

In this definition one does not find a reference to accuracy, exactness or measurement in terms of quantity. For financial and accounting purposes, we must be concerned with analysis that is readily measured in terms of quantity.

Qualitative analysis is difficult to perform since it not subject to an exact measurement. However, there are some ways that qualitative analysis can be useful, if applied correctly.

Nonprofit Financial Statement Analysis

The key to the application of qualitative analysis rests in the ability of the nonprofit organization to select criteria by which the organization will measure performance and efficiency. In order for qualitative analysis to be useful when applied to the financial activity of a nonprofit organization, all parties must concur on the criteria being used. If one party exercises more authority than the others in determining the criteria, there will be questions related to the validity of the analysis.

If the users of the analysis can come to an agreement on the selection and criteria, one transforms qualitative analysis into quantitative analysis. This can be accomplished by the design of standards, benchmarks and key performance indicators for efficiency, effectiveness and performance. This sounds easy but the difficulty is in establishing the criteria, not with the gathering of information or the comparison of the information to the standards, benchmarks and key performance indicators. In establishing these standards, benchmarks, and key performance indicators it is very important to ensure that you remove all bias, distortions, and misinterpretation that could make the results misleading. Misleading results could allow for costly and incorrect decisions to be made.

A perfect example of where there have been problems with qualitative analysis is within the nonprofit watchdog groups. These groups have in one way or another been appointed, directed or have established themselves as the protectors of the public to ensure that the public resources that have been provided to nonprofit organizations are used for their intended purpose. However, all parties have not agreed on what measures truly indicate whether a nonprofit is operating effectively and efficiently.

A key point to understand when calculating ratios for nonprofits is that when using information from the statement of financial position, it is important to be aware of temporarily and permanently restricted net assets and how these types of net assets may affect the ratios. Calculating ratios using only unrestricted net assets may sometimes yield more useful results.

We have included some key financial ratios that are often used to analyze the operations of nonprofit organizations.

Some of the more frequently used financial ratios that can be utilized to perform both a quantitative and qualitative analysis that are specific to nonprofit organizations are as follows:

The Defensive Interval Ratio

$$\frac{\text{Cash, Receivables and Marketable Securities}}{\text{Average Monthly Expense}}$$

This ratio measures the adequacy of the resources of the nonprofit organization to support its mission.

Liquidity Funds Indicator

$$\frac{\text{Net Assets – Restricted Endowments – Fixed Assets – Prepaid Expenses}}{\text{Average Monthly Expenses}}$$

This indicator measures how many months the organization has before it will consume its liquid assets, assuming that no additional revenue flows into the nonprofit organization.

Accounts Payable Aging Indicator

$$\frac{\text{Accounts Payable}}{\text{Average Monthly Expenses}}$$

This indicator tells us how many times during the course of a year the nonprofit organization is able to turnover its accounts payable.

Fundraising Efficiency

$$\frac{\text{Total Contributions (Except Government Grants)}}{\text{Fundraising Expense}}$$

This ratio measures the relative cost to produce voluntary contributions from the general public.

Net Operating Ratio

$$\frac{\text{Total Revenue – Total Expenses}}{\text{Total Revenue}}$$

This ratio provides the nonprofit organization with a measurement of efficiency. It can be particularly useful to nonprofits that sell products or provide services for a fee, such as colleges and universities, camps, conference centers and healthcare facilities.

Management Expense Ratio

$$\frac{\text{General and Administrative Expenses}}{\text{Total Expenses}}$$

This ratio measures efficiency of the nonprofit organization in using the general support raised from the unrestricted contributions in relation to the overall activities of the organization.

Charity Expense Ratio

$$\frac{\text{Unrestricted Contributions}}{\text{Total Expenses}}$$

This ratio measures the use of funds raised from the general public to total overall activities of the nonprofit organization.

Cash Flow Return

$$\frac{\text{Operating Cash Flows}}{\text{Total Assets}}$$

This ratio measures the efficiency with which the nonprofit has used all the assets at its disposal to generate cash flows.

Liquidity Ratio

$$\frac{\text{Cash, Receivables, Inventories and Marketable Securities}}{\text{Total Liabilities}}$$

This ratio indicates the financial strength of the nonprofit organization.

Nonprofit Financial Statement Analysis

Net Temporarily Restricted Asset Ratio

$$\frac{\text{Temporarily Restricted Net Assets} + \text{Deferred Revenue}}{\text{Cash and Cash Equivalents}}$$

This ratio indicates if the nonprofit organization is borrowing from the future or from net assets intended for future periods.

Debt Ratio

$$\frac{\text{Average Total Debt}}{\text{Average Total Unrestricted Net Assets}}$$

The for-profit world calls this the debt-to-asset ratio. It is useful for nonprofit organizations that carry debt.

Unrestricted Net Asset Ratio

$$\frac{\text{Unrestricted Net Assets}}{\text{Total Annual Expenses}}$$

This ratio measures the amount of unrestricted, spendable net assets, in relation to the nonprofit organization's annual operating expense.

Fundraising Expense Ratio

$$\frac{\text{Fundraising Expenses}}{\text{Total Expenses}}$$

This ratio measures efficiency in fundraising activities to the total activities of the nonprofit organization.

Program Service Expense Ratio

$$\frac{\text{Program Service Expenses}}{\text{Total Expenses}}$$

This ratio measures efficiency in the funds spent on the nonprofit organization's mission and the total expenses. This is a very key ratio in the eyes of donors.

Grants-to-Expense Ratio

$$\frac{\text{Grant Revenue}}{\text{Total Expenses}}$$

This ratio measures the use of grant funds raised from governments, foundations and others to total overall activities of the nonprofit organization.

Cash Flow Liquidity

$$\frac{\text{Cash} + \text{Marketable Securities} + \text{Operating Cash Flows}}{\text{Total Current Liabilities}}$$

This ratio measures the ability of the nonprofit organization to cover its current liabilities.

- Do we have a whistleblower protection policy? Has this policy been communicated to the staff?
- Are we satisfied that our auditor is independent?
- Does our auditor understand that (s)he has unrestricted access to the board/audit committee?
- Has our auditor made recommendations for improvements in controls that were not required to be communicated to the board of directors?
- Has our auditor received a clean peer review report?

Nonprofit Tax Topics

- Are there any possible failures to comply with rules related to receipt of gifts (acknowledgement, quid pro quo, etc.)
- Have we complied with the public disclosure requirements of Form 990 on request?
- Is there anything about our organization or its operations that we would be embarrassed to read about in the local newspaper or discussed on the evening news?
- Have we filed all required government reports (Form 990, state forms, etc.) on a timely basis?
- Have we made all payroll tax deposits required on a timely basis? (If this is not done, officers and board members can be held personally liable.)

Internal Controls, Accounting and Financial Topics

- Is there a healthy attitude about internal controls, originating at the very top of the organization?
- Does senior management have the ability to influence or override internal controls?
- Do we have written procedure manuals for important financial and operational areas?
- How soon after the end of an accounting period is a budget-to-actual comparison made and significant variances (or lack thereof, where expected) investigated?

▶ WHAT QUESTIONS SHOULD I ASK?

Being part of the board of directors or audit committee of a nonprofit organization comes with a significant amount of fiduciary responsibility. We have discussed what one should look for in analyzing the financial statements themselves. However, this must be accompanied by asking questions of management as well. You need to understand if there is anything going on within the nonprofit organization that you should know about. In addition, there are certain questions that should be asked of the accounting and finance team of the organization to enable you to satisfy your fiduciary responsibility to the organization.

Listed below are some questions that you might want to consider asking of any nonprofit organization. This list is not meant to be all inclusive and we hope that

these questions may actually lead you to identify more questions. The one thing to remember is that you should be asking questions and receiving satisfactory answers in order to fulfill your fiduciary role.

Governance and Oversight Topics

- Do we have a formal conflict of interest policy?
- What transactions have we had with related parties (other than the executive director's compensation)?
- Were all related party transactions approved by the board – with full knowledge of the relationship, and without input from the related party?
- Has the executive director's total compensation been approved by the board?
- Do we have a record retention policy?

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