Financial Accountability for Nonprofit Organizations

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Importance of Financial Information

- Always a gap between aspirations and resources
- Competition among programs for more resources
- Fundraising is crucial, but so is controlling expenditures
- Budgets are plans for how to use money, where, and when. They are internal documents.
- Accounting involves keeping track of income and expenditures
- Basic financial reports go to donors and other outside supporters.

1. Budgets

- Preparing budgets forces resolution of competing priorities
- They set up limits, internal controls, and accountability
- Usually prepared on an annual basis
- Involve forecasts of revenues and expenditures
- Include personnel costs, facilities, supplies, equipment, other items (see Figure 15.1)
- Must consider uneven revenue flows; save resources for expenses in lean times
- Some income may be restricted in use
- Engagement of staff builds credibility, allegiance

Budgets, continued

- Often based on incremental changes to previous year’s budget
- Zero-based budgeting: starting with goals and allocating resources independent of previous year
- Monthly financial reports allow managers to track income and expenses, suggesting items needing attention
- Break-even or small surplus sought for end of year
- Surpluses returned for improvements in programs and services

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Financial Reports for Outsiders

- Provide objective information about our finances to donors, contributors, others
- Indicate financial strength of organization, efficiency, compliance
- Usually prepared and distributed annually
- Types of financial reports
  - Balance sheet or statement of financial position
  - Statement of activity
  - Statement of functional expenses
  - Statement of changes in financial position
  - IRS form 990

2. Balance Sheet

- Shows the value of all the organization’s
  - resources it has: assets
  - the debts it owes: liabilities
  - the net resources it has: fund balances
- Assets minus liabilities equal fund balances
- Income and expenses tracked every day, summed up periodically
- Must comply with regulations of the national Financial Standards Accounting Board

Assets

- Assets include everything the organization owns and could provide economic benefits for it
- Usually grouped into (see Figure 15.3)
  - Current assets: cash, short-term investments, accounts receivable, grants receivable, equipment and supplies, pre-paid expenses
  - Fixed (long-term) assets:
    - Tangible: things such as land, buildings, long-term investments, endowment funds
    - Intangible: things such as patents, copyrights

Assets, continued

- Tangible assets decline in market value, so must be depreciated annually
  - Straight line depreciation: equal amounts deducted from value each year of expected useful life of item
  - Accelerated depreciation: since most benefit from item comes early, larger amounts deducted in earliest years
- Intangible assets decline in value too, process called amortization

Current vs. Fixed Assets

- Current assets are things that could be turned into cash quickly
- Fixed assets include things necessary to carry out business; not turned into cash quickly
- High proportion of current to fixed assets allows flexibility in financial decisions
- High proportion of fixed assets indicate long-term stability of organization
- Importance of maintaining balance: enough current to cover coming expenses; enough fixed to ensure stability over longer term

Liabilities

- All claims against the organization’s resources, debts, obligations, loans
- Current liabilities, such as accounts payable, awards promised, acquisition contracts
- Long term liabilities, such as mortgages, notes payable
- Should minimize costs of borrowing (interest) and guard against the risks of highly fluctuating cash needs (insufficient reserves lead to taking out loans)

Fund Balances

- Does not refer to balances in your checking account. Those are assets remaining for use.
- Refer to net resources of organization, subtracting liabilities from assets.
- Change when more income arrives (increase in assets) and when debts incurred (increase in liabilities)

Fund Balances

- Some sponsors stipulate the uses to which gifts may be used.
- Typical types of funds
  - Current funds, unrestricted
  - Current funds, restricted
  - Land, buildings, equipment fund
  - Endowment fund
- Goal of maximizing unrestricted gifts to allow great flexibility in financial decisions

3. Statement of Activity

- Indicates the volume and kinds of activities carried out by organization
- Includes the revenues generated and the types of expenses (see Figure 15.4)
- Often includes categories of revenue and categories of expenses for each program
- Difference between total revenue and total expenses indicates surplus or deficit for year
- Surplus will show up in increased fund balances, while deficit will diminish them.

Statement of Activity, cont.

- Revenues categorized by source, such as contributions, grants
- Expenses categorized by programs
- Both show type of restrictions
- Show how revenues and expenses led to changes in fund balances over the year
- Surpluses indicate organization’s effectiveness in financing its current and long-term operations
- Deficits indicate need for management attention to increase revenue and decrease expenses

Cash vs. Accrual accounting

- Cash approach tracks income and expenditures when they occur: short-term view. Checks arrive, bills are paid.
- Accrual tracks anticipated income and promised expenditures: longer-term view. Contracts are signed, pledges made but payments or gifts happen later
- Cash transactions may lag behind actual incurrence of future expense and miss liabilities coming in the future

4. Statement of Functional Expenses

- Provides even greater detail on expenses for each program and services supporting all: management & general, fundraising
- Each expense item is categorized by program where it occurred and by kind of expense (see Figure 15.5)
- Enables tracking expenses across programs

5. Statement of Changes in Financial Position

- Focuses on cash
  - Where it came from
  - How it was used to increase assets or reduce liabilities
  - Amount of cash on hand at end of previous year compared with cash on hand at end of this year
- Organization shown in Figure 15.6 used cash to increase its investments, grants, pledges, pre-paid expenses, equipment, and to decrease its debts.

6. Analysis of Financial Statements

- Statements indicate strength or weakness of organization
- Examining them is useful for donors, prospective employees, others
- Five analyses
  - 1. Working capital and current ratio
  - 2. Debt-equity ratio
  - 3. Fund mix
  - 4. Growth ratio
  - 5. Program emphasis

Working Capital

- This is a short-term liquidity indicator.
- Is this organization able to pay its expenses on time?
- High when current assets are high in relation to current liabilities
- Extremely high ratio suggests idle assets for possible use in program expansion or investments
- Current assets divided by current liabilities.
- Ratio of around 2 to 1 considered favorable.
- Figure 15.3: $19,870 divided by 5,045 = 3.94

Debt-equity ratio

- This is an indicator of long-term risk.
- Can this organization avoid bankruptcy?
- Risks high when total liabilities exceed total assets.
- Total liabilities divided by sum of liabilities plus total fund balances
- Larger figures indicate higher risk.
- Figure 15.1: $5,205 divided by sum of 5,205 and 40,165 = .11

Fund Mix

- How much flexibility is there in financial decisions?
- Goal of maximizing the proportion of unrestricted funds to total assets.
- Larger percentages indicates high flexibility.
- Figure 15.1: $30,255 divided by 45,370 = .67 or 67% of assets are unrestricted

Growth ratio

- How much is this organization growing in worth?
- Useful in comparing an organization over several years and in comparing two or more organizations
- Indicated by the percent annual change in fund balances: FB now minus FB previous year, divided by FB previous year.
- Figure 15.3: $40,165 minus 36,654, then remainder is divided by 36,654 = .09 or 9% growth rate this year.

Program emphasis

- To what extent is this organization focusing on providing services vs. sustaining itself?
- Indicated by percent of revenue used for management & general plus fundraising expenses
- No more than 25% recommended.
- Divide sum of M & G plus F by total revenue
- Figure 15.4: $2,630 plus 3,383, divided by 34,480 = .17 or 17% of the organization’s revenue is being used for self-sustaining purposes, while 83% goes for programs.

Using IRS form 990 for data

- Total revenue given on line 12
- Management & general and fundraising expenses given on lines 14 and 15
- Fund balances given on line 21
- Current assets: total of figures in lines 45 to 53.
- Total assets given on line 59
- Current liabilities: total of figures in lines 60 to 63
- Total liabilities given in line 66
- Unrestricted and restricted funds given in lines 67 – 69
- Fund balances given in line 73

Assignment

- Get most recent financial reports from your organization. If not available there, go to www.guidestar.com and locate most recent IRS form 990 report.
- Calculate all five ratios
- For each, discuss the implications