Analyzing Financial Statements of Nonprofits

While review of a non-profit's financial statements is probably not the easiest part of the due diligence process, their understanding plays a key role in determining the stability of an organization. A donor should invest time in this area to get another glimpse into a non-profit that may not be apparent from a site visit or in discussions with a faith-based leader.

TYPES OF FINANCIAL STATEMENTS

Financial statements give information based on different time periods. To understand an organization's financial past, a donor should review the Income Statement, or in non-profit terms, the Statement of Activities. This financial statement tells the reader if the organization's revenues were adequate to cover expenditures over a designated time period. Simply put, the amounts that came in need to cover the amounts that were disbursed. To understand a non-profit's financials at one point in time, a donor should review the Balance Sheet, or Statement of Financial Position. This statement shows the assets, liabilities and net assets of an organization. Assets consist of items that are owned while liabilities are amounts that are owed. Net assets are merely the difference between the total assets and the total liabilities. Finally, to understand an organization's financial future, review of budgets or cash flow projections can provide the necessary information to determine how solid a non-profit's financial future is.

THE AUDIT OPINION

A good starting point in reviewing financial statements is an organization's audit opinion. Statements that have been audited have gone through a process in which an independent third party who is a financial expert verifies that the amounts shown on the financial statements are accurate and fair. A donor should begin by examining the auditor's opinion to see that it is unqualified. The unqualified opinion includes a standard sentence that the financial statements present fairly, in all material aspects, the financial position of the organization. If an unqualified opinion is rendered, a donor has reasonable assurance that the numbers can be relied upon. If there is any reference to an exception or to the organization's status as a going concern, a donor has found a serious red flag.

Other items of concern that may be included in an auditor's opinion include any outstanding litigations, inadequate internal controls, or uncertainties pertaining to IRS or state audits. In addition, if the auditor is unable to render an opinion, some serious questions need to be addressed to the organization's leadership before any contribution is made. Many smaller or religious organizations are not required to have an audit performed, and the absence of an audit in these situations is not necessarily a red flag. In these situations, the donor will want to be assured that the person preparing the statements has financial training or qualifications necessary to prepare reliable statements. Additionally, references to the notes to financial statements, which are found at the end of audited statements, are a good way to clarify other notable financial information.

THE STATEMENT OF ACTIVITIES

After examining the opinion, the first statement to review is the Statement of Activities. At least two and preferably three years of financial data should be analyzed. Comparative data can show trends and patterns that one year of data will not provide. Begin with the overall results of the time periods presented, which are usually in one-year segments. Review the bottom line of the Statement of Activities to see if the change in net assets is positive or negative. A positive change in net assets means that revenue exceeded expenses. Alternatively, a negative change in net assets means that expenses were greater than revenue. A negative change existing for the past two years can be a sign of financial trouble. This requires some explanation from the non-profit's leadership.

Next, focus on the top portion of the statement where support and revenue are present. Non-profit revenue is either derived from contributions or earned revenue. How much of the non-profit's income is support vs. earned income? Generally, the more income that can be earned, the more self-sufficient a non-profit is, and the better off it is financially. Unfortunately, earned revenue is more likely to be the exception rather than the norm, particularly in a faith-based non-profit.

In the area of support, how much is government support and how much is private or foundation support? Some experts feel a healthy faith-based group derives at least 80% of its revenue from individuals and the remainder from government and foundations. While some faith-based organizations do accept government funding for their programs, there are some drawbacks to government grants that need to be pointed out. Often, the high cost of administering a government grant makes the grant much less valuable than at first glance. In addition, a faith-based group may not be able to separate its programs into secular and faith filled pieces and therefore would not qualify for government funding.

Another potential item of concern is significant funding from a single source. If 20% or more of revenue is from one source, a serious concern should exist in the donor's mind. The loss of that one funding source could put the organization in critical financial straits. Once again, it is appropriate to ask questions of the non-profit leaders.

Other flags on the Statement of Activities include excessive fund-raising, administrative, or payroll expenses, which could indicate wastefulness or a poorly run organization. On the other hand, it could merely indicate that the non-profit leaders have not properly split out administrative costs and allocated appropriate amounts to programs, resulting in program related costs understated and administrative costs overstated. This is another reason to emphasize the importance of statement preparation by a financially trained person. Also, be aware that administrative costs of a large national or international organization tend to be higher than those of a small grass roots organization. Large amounts in the miscellaneous expense category are a reason to ask questions. Finally, trends that indicate declining revenues, increasing operating losses, or elimination of programs can indicate financial uncertainty.

THE STATEMENT OF FINANCIAL POSITION

The next statement to review is the Statement of Financial Position. Start again with an overall picture. Are the non-profit's assets greater than its liabilities? If so, the net assets will be positive, a good start in confirming financial stability. Too many years of negative net assets will lead to an organization's demise. Compare cash, which is an asset, with current liabilities to see if the organization has the ability to pay its bills out of the cash it has on hand. If current liabilities exceed cash on hand, this could signal an unstable financial situation that could indicate cash flow problems. Look at total assets on hand. Even if a non-profit has substantial assets, if the assets are made up entirely of inventory, buildings, or receivables, cash flow problems could become severe. None of those assets can pay the bills if cash is tight.

Next, examine the amount of accumulated depreciation on the fixed assets. If the accumulated depreciation on buildings and equipment is approaching the total value of the assets, it could mean that assets are old and will need replacement in the near future. Does the organization have a plan and the funds available to replace those worn out assets? Look at endowment and reserves over several years. If they are eroding over time, it is important to determine whether or not endowment is being used to fund operations, which is strictly prohibited.

Of course, the opposite situation could also be a reason to decline funding. If an organization has more than two years of operating expenses on hand in cash and investments, the question of financial need should be raised. The non-profit should be given a chance to explain large increases in endowments or investments that may be earmarked for significant projects in the future. If not, perhaps a donor's funds would be better utilized in a less well-off organization.

The liabilities section of the Statement of Financial Position also needs to be reviewed. One line item that needs particular scrutiny is payroll tax liability, which is found under the current liabilities section of a financial statement. A large balance could indicate the non-profit is using payroll taxes withheld from employees to pay for operations. The IRS will show little mercy before it seizes any and all assets to satisfy a tax levy, and it makes little difference if the funds seized are grant payments recently made by an unsuspecting donor. If payroll tax liability is not listed, on the other hand, inquire as to the balance. It is rare that an organization has no payroll tax liabilities, so if a non-profit says that none exist, be wary.

Continuing in the liabilities section, look for a line item entitled deferred revenue or refundable advance. This refers to funds received that relate to work or a contract that has not yet been completed. If the non-profit went out of business today, it would have to return those funds, and if a corresponding amount of cash is not on hand to cover those advances, the company is not making ends meet, which is another flag.

THE BUDGET

The third statement to review, this time to gauge future financial health is the budget. A budget should exist for the nonprofit as a whole and for any projects for which an organization is seeking support. If the budget is for a project, the biggest question is whether or not the community will receive a benefit at least equal to the amount of the

donor's investment. Compare the total cost of the project to the amount being asked of the donor. A donor should not be expected to support an entire project.
If possible, compare the total cost of the project to similar projects of other organizations. The budget should include a solid plan for revenues and not just focus on the expense side of the equation. Expenses should be reasonable when compared to sustainable income. Ideally, the income should include a mix of individual and foundation funding and both earned and contributed revenue, although as was pointed out above, faith-based organizations usually have little earned revenue.

With the added information gleaned from review of the financial statements, the financial health of a non-profit should be easier to gauge, resulting in a more complete picture of the non-profit in question. A little thoughtful digging should give a donor reasonable assurance that the funds contributed will not be going into a "black hole," but rather will be making a lasting contribution to the community.