

Demystifying Financial Statements: Assessing the Nonprofit Business Model

Presented by

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Overview: Nonprofit Finance Fund® (NFF)



NFF, a nonprofit 501(c)(3), has served thousands of nonprofits and funders since 1980. Our impact:

- Over \$250 million in loans, \$30 million in re-grants and \$1.4 billion in leveraged capital
- Over 1000 customized financial consultations
- Hundreds of partnerships and publications advancing financial awareness and friendlier funding practices for all nonprofits

Serving the nation from several local offices

- Northeast: Boston and New York City
- Mid-Atlantic: Philadelphia, Newark and Washington, D.C.
- Midwest: Detroit
- West Coast: San Francisco and Los Angeles

NFF:
“...arguably the most influential voice in the ongoing effort to reshape thinking and practice about nonprofit capitalization.”

-The Nonprofit Times

NFF: How Do We Help the Sector?

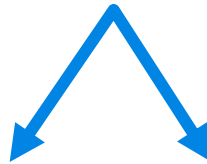


Financing	Financial Consulting
Loans and Lines of Credit New Markets Tax Credits Program-Related Investment Services	Situation Analysis & NBAs Program Profitability Modeling Scenario Planning Financial Reporting Assistance Strategic Collaboration Planning Clinics and Workshops
Long-Term Facility Management	Thought Leadership & Partnership
Systems Replacement Plans Building For the Future Facilities Planning Workshop	Nonprofit advocacy Studies of the nonprofit economy NFF Capital Partners

The Nonprofit Enterprise Triangle

Mission and Program

What you do, and how you do it.



Capacity

The people, space, and processes that allow you to do what you do.

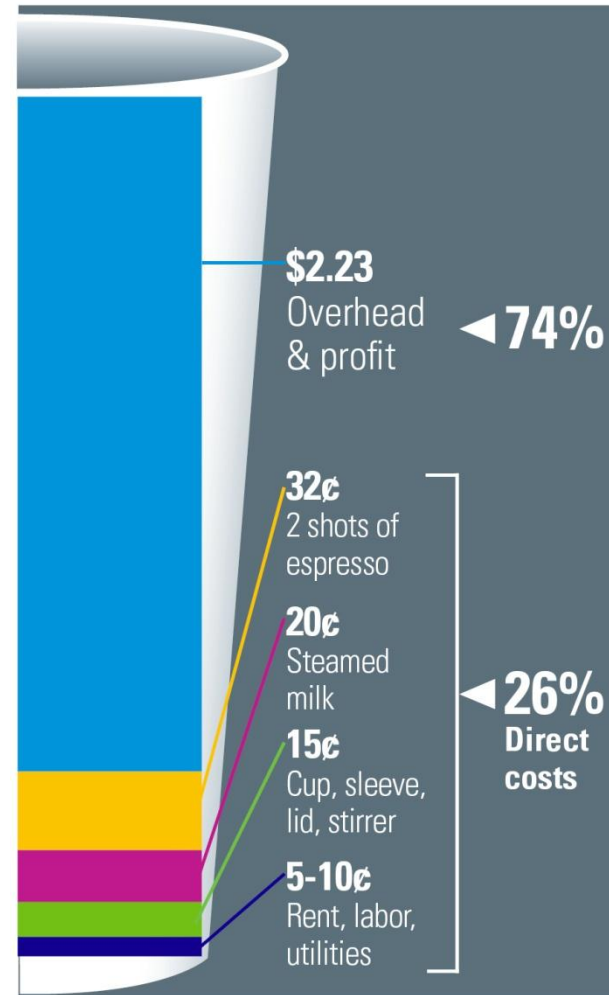
Capital

What resources and assets you have to work with.

“Rules” of FOR-PROFIT Finance

In the **for-profit** world,

- ▶ **Customer** buys the product
- ▶ Price includes the **full cost** of doing business.
- ▶ Overhead and profits are seen as **necessary and regular** part of the business



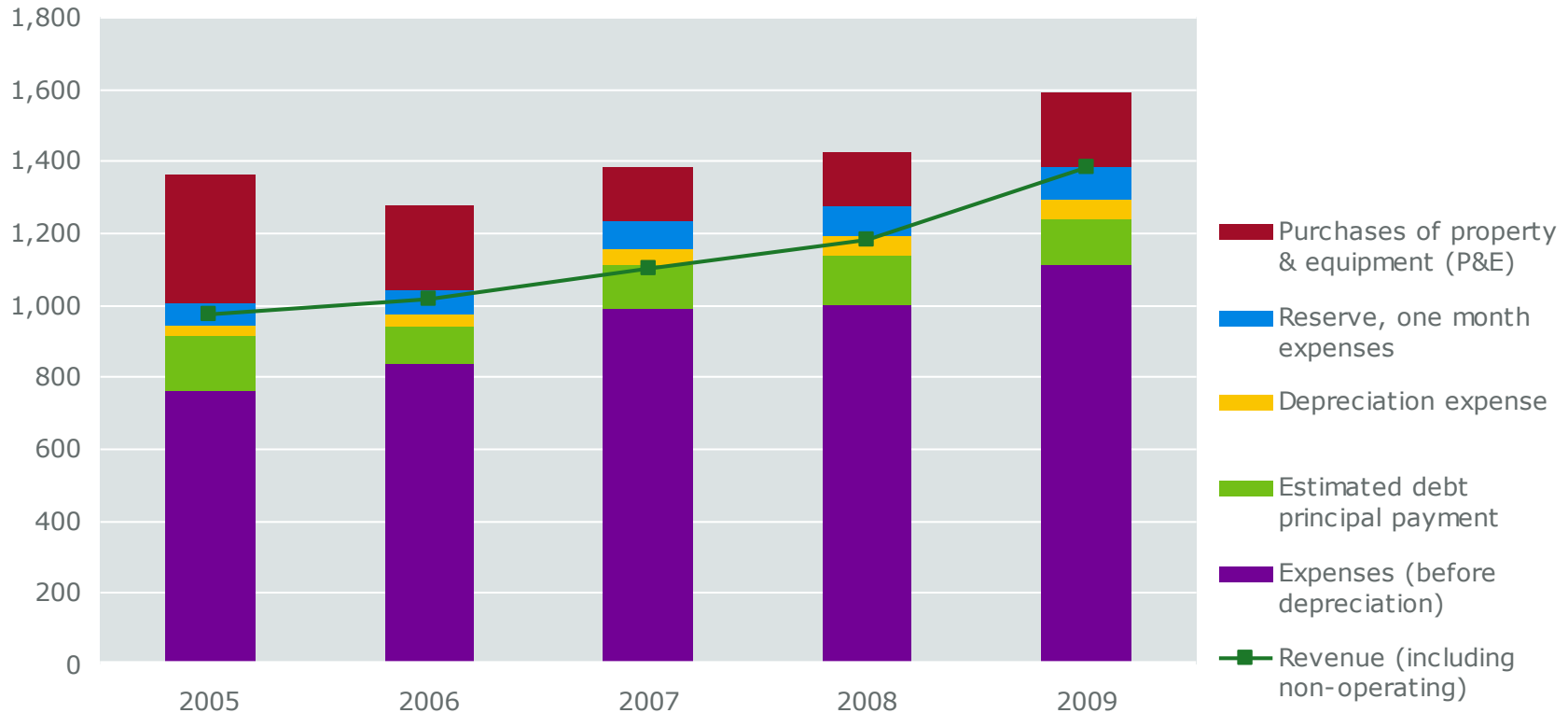
Source: Matt Milletto, Vice President of the American Barista & Coffee School

But in the **nonprofit** world,

- ▶ Client often does not pay for the product
- ▶ Nonprofits rely on third parties (donors and funders) to pay for the cost of products and services
- ▶ Donors and funders want most of their contribution to go directly to the people served
- ▶ Overhead and profits are often seen as **unnecessary and unrelated** to achieving the mission

Determining the Right Amount of Surplus to Meet Ongoing Needs

Total Cost of All Business Activity (\$ in thousands)



Today's Objectives

- This session will demystify nonprofit financial statements and provide a practical framework for assessing the health and sustainability of a nonprofit's underlying business model.

Today's Goals:

- Review the **basics** of nonprofit financial statements: what is the basic architecture of financial statements, how do the statements connect, and why does it matter?
- Discuss **5 key indicators** to watch out for – including, how well does an organization operate on a year-to-year basis? How much risk can an organization absorb in this environment?
- Highlight tips for using financial data to prompt **further questions and due diligence** (i.e. what further questions does the financial data raise?)

Mandatory

IRS Form 990

Public document

Shows financial activity, assets and liabilities, and governance details of the nonprofit

Mandatory For Many

Audits

Audits required for budgets over a certain size.

Third party presentation of financial activities and resources.

Reviews or compilations optional for smaller orgs.

Necessary for All

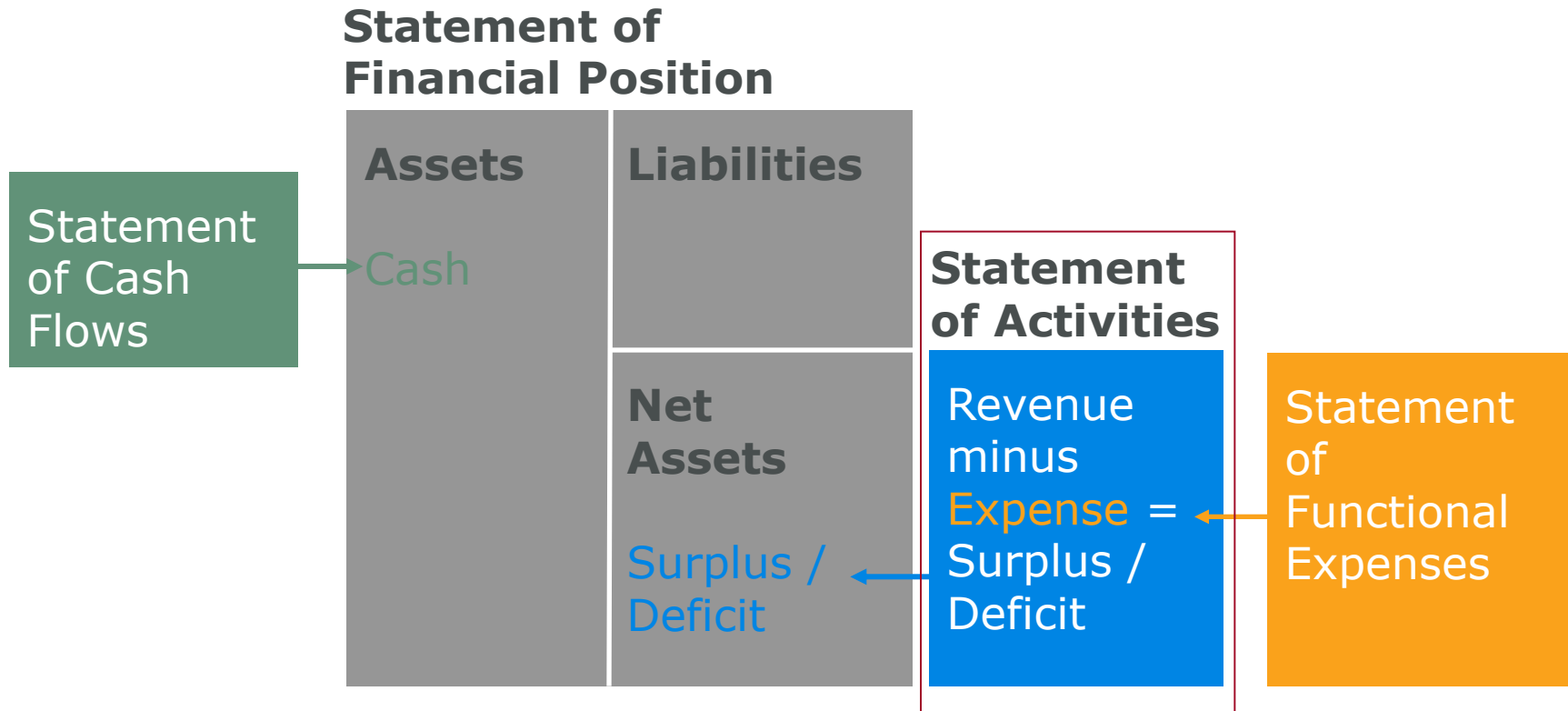
Internal Financial Statements

Budgets

- Organizational
- Programmatic
- Budget vs. Actual

Monthly cash flow projections

Financial Statements are Connected



Understanding Your Grantee's Income Statement

INCOME STATEMENT

REVENUE

Earned

Program fees

Government earned

Contributed

Private Sources

Government Grants

EXPENSES

Personnel

Professional fees

Occupancy

Program Costs

Admin Costs

Other

Surplus/Deficit

← **Revenue Dynamics:** Where did the organization's money come from? Were revenue streams reliable or at risk? Was seasonality a factor?

← **Expense Dynamics:** How did the organization spend its money? Were expenses predictable? Was management responsive to operating changes and prepared to make difficult decisions?

← **Profitability & Savings:** Were costs covered? Was the organization able to generate savings? Address longer-term balance sheet needs?

Sample Statement of Activities



ABC Center Statement of Activities

Years ended June 30, 2010 (\$ in thousands)

	Operating Activity			Total
	Unrestricted	Temp. Restricted	Perm. Restricted	
Revenues, Gains and Other Support				
Support				
Foundations	113	58	-	171
Government	57	-	-	57
Corporations	49	-	-	49
Individuals	248	-	-	248
Total Support	467	58	-	525
Investment Income	7	-	-	7
Program Fees, Tuition, other	484	-	-	484
Net Assets Released from Restriction	749	(749)	-	-
Total Revenue, Gains and Other Support	1,707	(691)	-	1,016
Operating Expenses				
Program Services	1,004	-	-	1,004
Supporting Services				
Administrative	209	-	-	209
Development	49	-	-	49
Total Supporting Services	258	-	-	258
Total Expenses	1,262	-	-	1,262
Change in Net Assets	445	(691)	-	(246)

Revenue Goes Into Three “Buckets”

Unrestricted Revenue

Earned Contributed



Temporarily Restricted Revenue

Purpose Timing

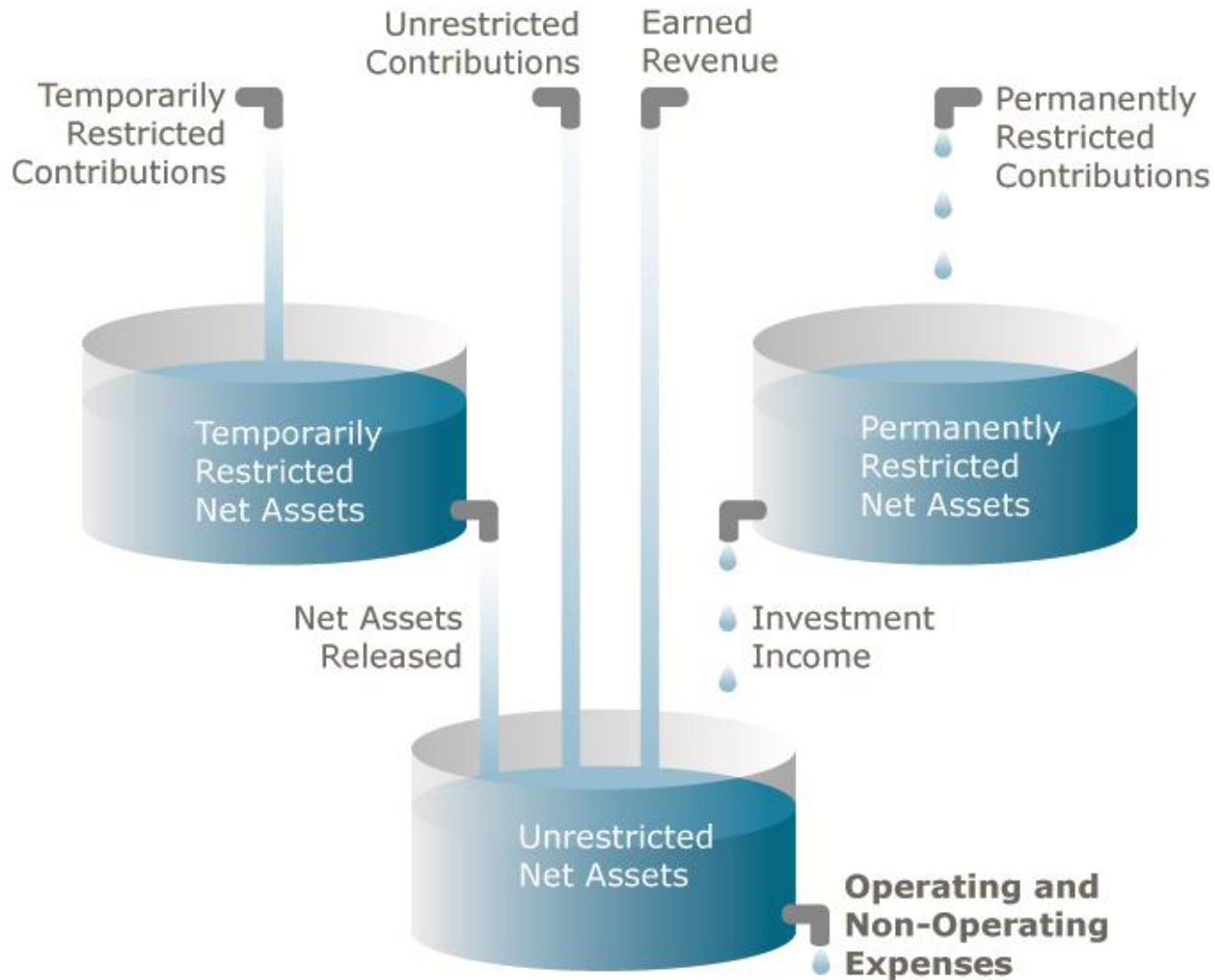


Permanently Restricted Revenue

Endowment



Revenue Also Flows Among Buckets



ABC Center Statement of Activities



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ABC Center Statement of Activities



ABC Center Statement of Activities (Revised)

Years ended June 30, 2010 (\$ in thousands)

	Operating Activity			Total
	Unrestricted	Temp. Restricted	Perm. Restricted	
Operating Revenue				
Earned				
Investment Income	7	-	-	7
Program Fees & Tuition	410	-	-	410
Rental Income	30	-	-	30
Government Earned	10	-	-	10
Earned Operating Revenue	457	-	-	457
Contributed				
Individual	248	-	-	248
Foundations & Corporations	162	58	-	220
Government	47	-	-	47
Special Events, net	44	-	-	44
Net Assets Released from Restrictions	152	(152)	-	-
Contributed Operating Revenue	653	(94)	-	559
Total Revenue	1,110	(94)	-	1,016
Operating Expenses				
Personnel	550	-	-	550
Professional Fees	39	-	-	39
Occupancy	90	-	-	90
Support	490	-	-	490
Total Expenses	1,169	-	-	1,169
Surplus/Deficit Before Depreciation	(59)	-	-	(59)
Depreciation Expense	93	-	-	93
Surplus/Deficit After Depreciation	(152)	-	-	(152)
	Non-Operating Activities			
Unrestricted Non-Op Revenue (e.g. capital campaign receipts/releases)	597	(597)	-	-
Net gain (loss) on sale of assets	-	-	-	-
Change in Net Assets	445	(691)	-	(246)

Breakdown of Revenue:
Earned vs. Contributed

Temp. restricted revenue has
met donor-imposed
restrictions

Natural classification
of expenses

Determine true **Operating**
Surplus / Deficit

Non-operating revenue segregated
and placed "below the
operating line"

Non-Operating Dollars Hide True Operating Performance

Unrestricted Revenue & Expenses (including non-operating)

(\$ in thousands)



- Revenue, including non-operating
- Expenses (before depreciation)

Operating Revenue & Expenses

(\$ in thousands)



With revenue for capital projects "below the line," this organization is not breaking even!

Determining True Operating Surplus/Deficit

ABC Center Statement of Activities (Revised)

Years ended June 30, 2010 (\$ in thousands)

	Operating Activity			Total
	Unrestricted	Temp. Restricted	Perm. Restricted	
Operating Revenue				
Earned				
Investment Income	7	-	-	7
Program Fees & Tickets	410	-	-	410
Rental Income	30	-	-	30
Government Earned	10	-	-	10
Earned Operating Revenue	457	-	-	457
Contributed				
Individual	248	-	-	248
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Determine true operating Surplus / Deficit

BEFORE AND AFTER DEPRECIATION

Every fixed asset you purchase will depreciate over its useful life

- Accountants use pre-determined useful life data for various types of fixed assets.
- By definition, fixed assets are “capitalized” (i.e., not listed as an expense on the income statement but appear on the balance sheet and are depreciated on the income statement as a non-cash expense)

Reflects concept that fixed assets lose value over time

Arguably an approximation of how much cash needs to be set aside for replacements

Your Turn: Understanding Operating Performance



It's your turn. How would you interpret the Statement of Activities for this organization?

- Based on this statement, how do you think the organization is doing?
- Are they generating surpluses?
- What do the changes between 2009 and 2010 tell us?
- Does anything unusual stand out?
- What don't we know? What additional questions about operations do you have for this organization?

Your Turn: Understanding Operating Performance

SUNRISE CHILDCARE						
Statement of Activities FY2010						
Operating Activity	2009			2010		
	Un-restricted	Temp Restricted	2009 Total	Un-restricted	Temp Restricted	2010 Total
(in thousands)						
Revenue, Gains and Support						
<i>Earned</i>						
Program Fees	33	-	33	34	-	34
Investment income	2	-	2	2	-	2
Other	3	-	3	5	-	5
<i>Contributed</i>						
Individuals	62	-	62	65	-	65
Grants	116	107	222	125	150	275
In-kind Contributions	33	-	33	6	-	6
Released from Restriction	135	(135)	-	74	(74)	-
Total Revenue, Gains and Support	383	(28)	354	310	76	387
Operating Expenses						
Personnel	224	-	224	189	-	189
Professional Fees	44	-	44	86	-	86
Occupancy	11	-	11	12	-	12
Program & Admin Costs	98	-	98	84	-	84
Interest	2	-	2	1	-	1
Total Operating Expenses	378	-	378	371	-	371
Change in net assets	4	(28)	(24)	(61)	76	15

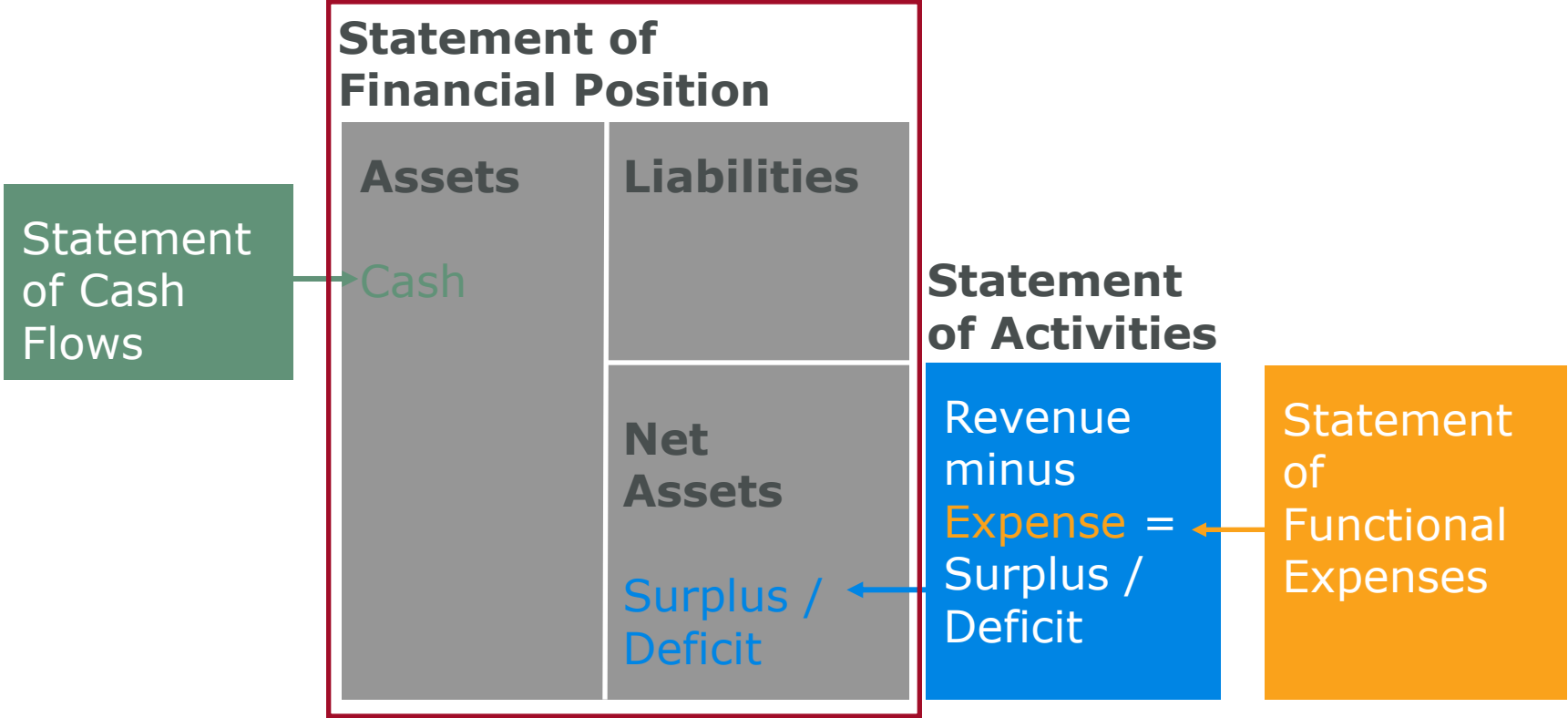
Profitability: A Guideline for Operating Results

Financial Indicator	Healthy	Moderately Healthy	Requires Immediate Attention
<p><u>Unrestricted Surplus/Deficit</u> (as % of expenses)</p>	<p>Surpluses <i>consistently</i> cover full costs, contributing to healthy balance sheet and savings (3%+)</p>	<p>Breakeven results or periodic surpluses insufficient to cover full costs (-3% to +3%)</p>	<p>Consistent and/or growing deficits (-3%+)</p>

BREAK



Nonprofit Audited Financial Statements



How to Read the Balance Sheet: Assessing Financial Health

BALANCE SHEET

ASSETS

Does the organization have access to appropriate resources?

- **Cash** - How much? How "liquid?"
- **Receivables** - Are they slow to collect? Are they at risk?
- **Investments** - How much? Are they restricted?
- **Property & Equipment** – How do you deal with maintenance issues?

LIABILITIES

Does the organization owe more than it owns?

- **Payables, Debt** - How is cash flow managed? Are you using debt appropriately?

NET ASSETS

- **Unrestricted Net Assets** – Do you own more than you owe? How much is liquid?
- **Temporarily Restricted Net Assets** – Do they support core programs?
- **Reserves** – Does the organization have them? Are they suitable to their needs?

An organization's **adaptive capacity is directly tied to its balance sheet**

If the organization has...

- No unrestricted cash or receivables
- A fully drawn line of credit
- Little or no reserves available to management
- Significant wear-and-tear of fixed assets

...It has very little ability to respond or adapt in challenging times

- Borrowing to replace lost income is rarely appropriate

Knowing where the organization stands will inform the urgency and types of action leadership should take

NFF encourages organizations to develop a savings plan for their future

- Maintaining appropriate levels of cash on hand and in board-designated reserves can enable an organization to mitigate risk, pursue new opportunities and improve the long-term health of its capital structure

Establishing strategic uses of reserves may require:

- Assess the organization's long-term capital needs
- Based on this assessment, select appropriate reserve designations and targets
- Designate current reserves accordingly and/or fundraise for additional funds

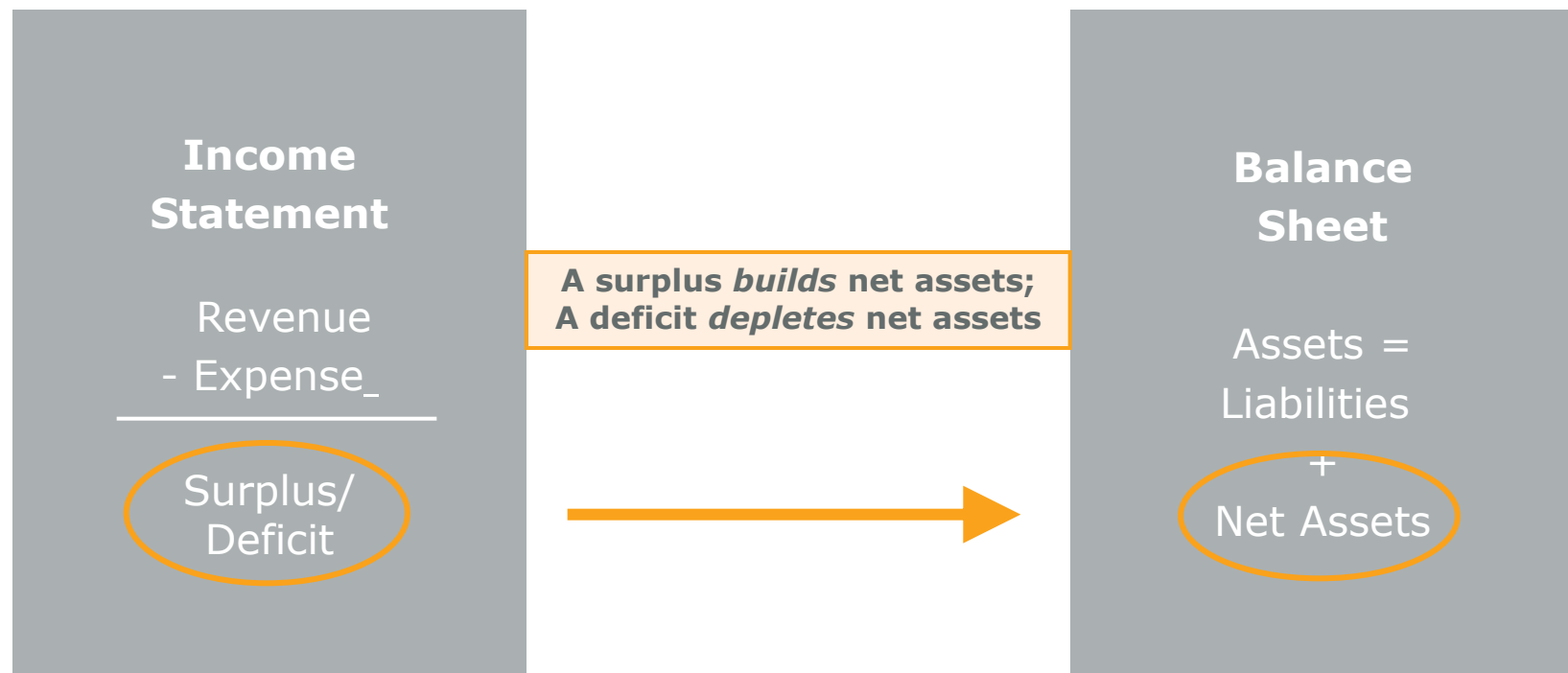
The Two Bottom Lines

Income Statement: Surplus/Deficit

- Income Statement reflects the annual results of a nonprofit's business

Balance Sheet: Net Assets

- Balance Sheet provides a picture of overall financial health



Financial Position Tells The Organization's Story

Evolution of Financial Position

Statement of Financial Position

FYE 06/30/09 (\$ in thousands)

Assets		Liabilities	
Cash	296	Payables	131
Receivables	612	Debt	0
Prepaid Exp	22		
Other	29		
P&E (Net)	256		
Long-term receivables	39		
		Total Liabilities	131
		Net Assets	
		Unrestrict	325
		Temp Restr	797
		Perm Restr	0
Total Assets	\$1,253	Total Net Assets	1,122
		Total Liab/Net Assets	\$1,253

**From
7/1/09 to
6/30/10
You engage in
activities and
operations**

**Statement of
Activities and
Statement of
Cash Flows**

Statement of Financial Position

FYE 06/30/10 (\$ in thousands)

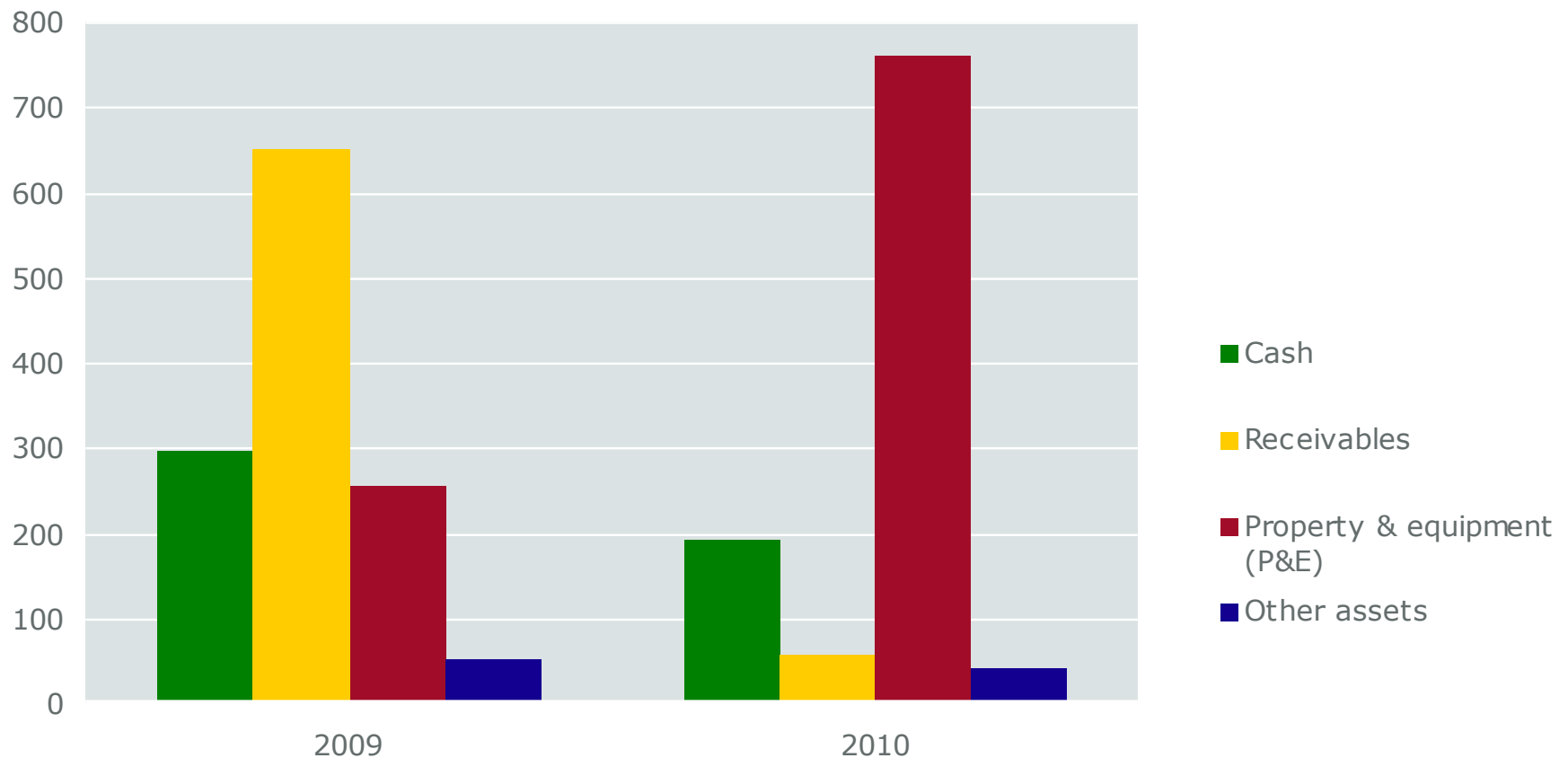
Assets		Liabilities	
Cash	191	Payables	57
Receivables	55	Debt	114
Prepaid Exp	41		
Other	-		
P&E (Net)	760		
Long-Term receivables	-		
		Total Liabilities	171
		Net Assets	
		Unrestrict	771
		Temp Restr	105
		Perm Restr	0
Total Assets	\$1,047	Total Net Assets	876
		Total Liab/Net Assets	\$1,047



A Decision Affected the Balance Sheet

Total Assets

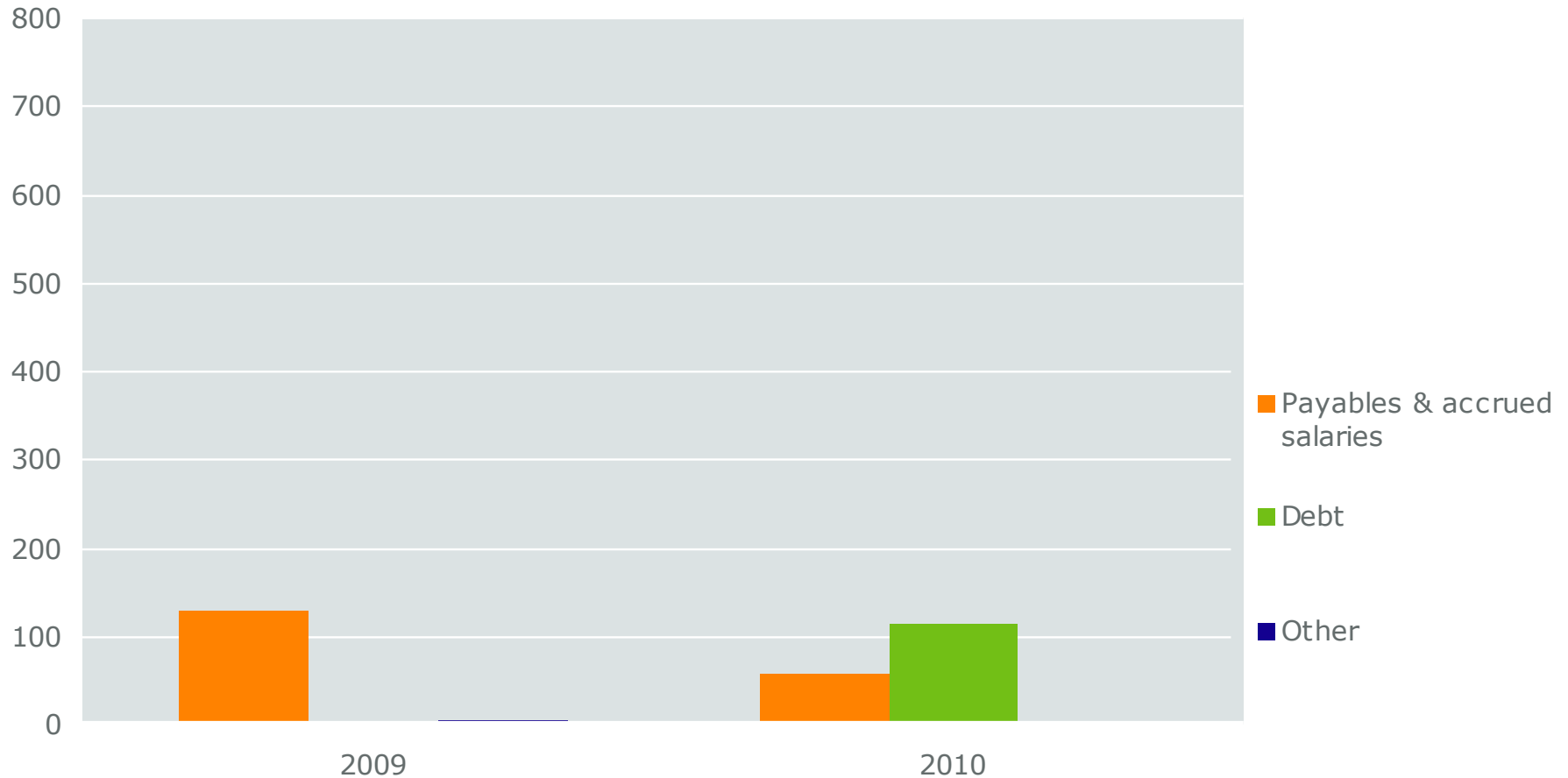
(\$ in thousands)



How Were the Fixed Assets Financed?

Total Liabilities

(\$ in thousands)



Your Turn: Determine the Strength of the Balance Sheet

It's your turn again. How would you interpret the Balance Sheet for this organization?

- Based on this data, how do you think the organization is doing?
- What changed? What might these changes suggest?
- What does the total net assets tell us?
- Does anything unusual stand out?
- What questions would you have for this organization?

Your Turn: Determine the Strength of the Balance Sheet

SUNRISE CHILDCARE Statement of Financial Position

Assets	2009	2010
Cash	34	63
Investments	10	9
Grants receivable, current	250	205
Grants receivable, long-term	81	80
Other assets	12	16
Property & equipment (net)	25	20
Total Assets	412	393

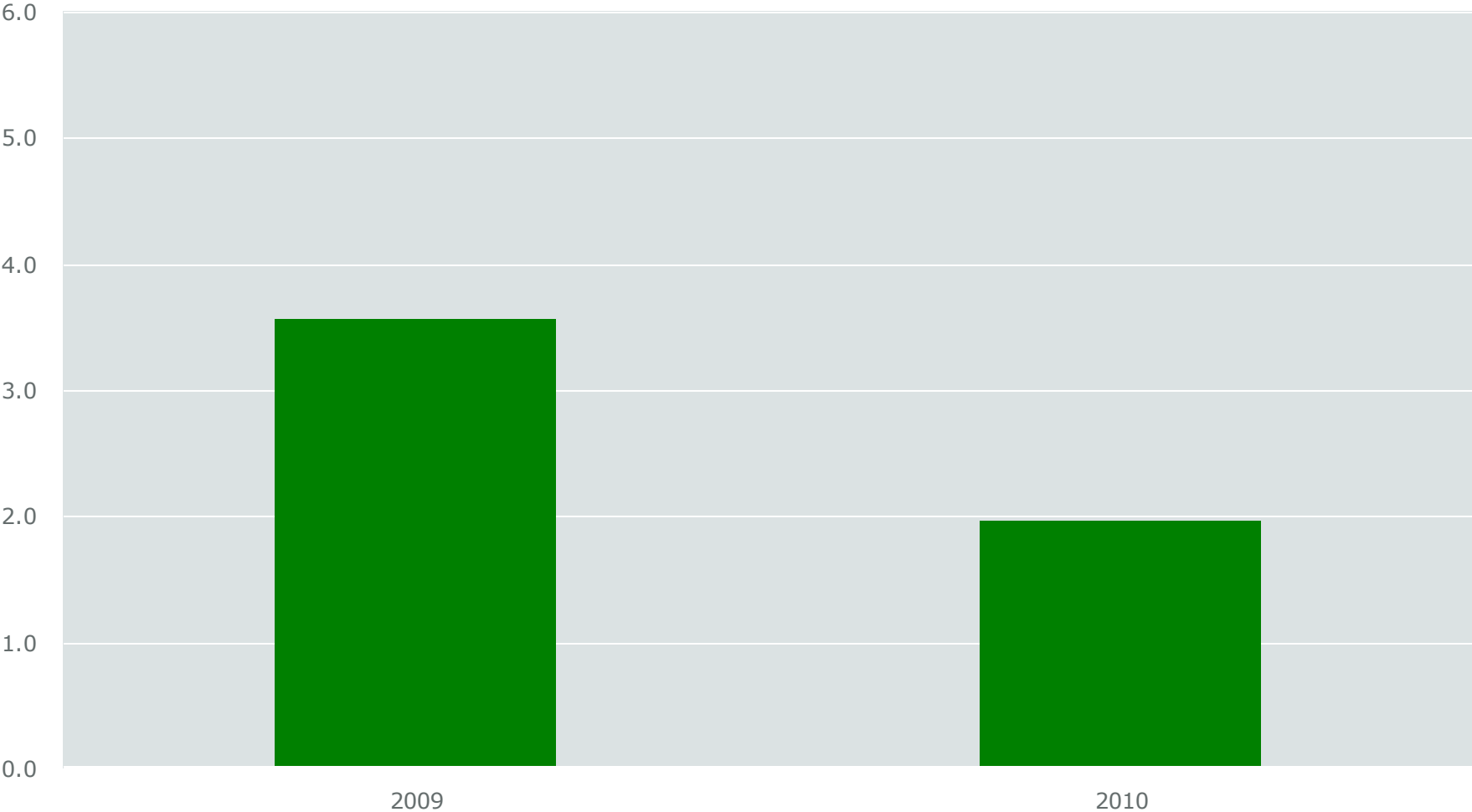
Liabilities	2009	2010
Accts payable/accrued exp.	58	53
Accrued salaries	29	30
Line of credit payable	30	-
Total Liabilities	117	83

Net Assets		
Unrestricted net assets	71	10
Temporarily restricted net assets	224	300
Total Net Assets	295	310
Total Liabilities & Net Assets	412	393

Liquidity Was Affected



Months of Expenses Covered by Cash



Months of Liquidity

- Represents the number of months an organization could operate with current cash and near cash
- To calculate, divide short-term liquidity at some point in time by average monthly operating expenses

What is the right amount for nonprofits?

- NFF encourages most organizations to aim for three months through a combination of cash (and near cash) on hand and access to cash through a line of credit
 - Heavily government-funded nonprofits sometimes have to make do with as little as one month (or less)
 - Organizations may need more or less liquidity depending on stage of development, cash flow cycles, capital needs, etc.

	Cash	Working Capital	Liquid Net Assets
What it measures	Existing cash balance	The difference between current assets and current liabilities	The <i>liquid</i> portion of unrestricted net assets

Organizations may need more or less liquidity depending on their state of development, cash flow cycles, capital needs, etc.

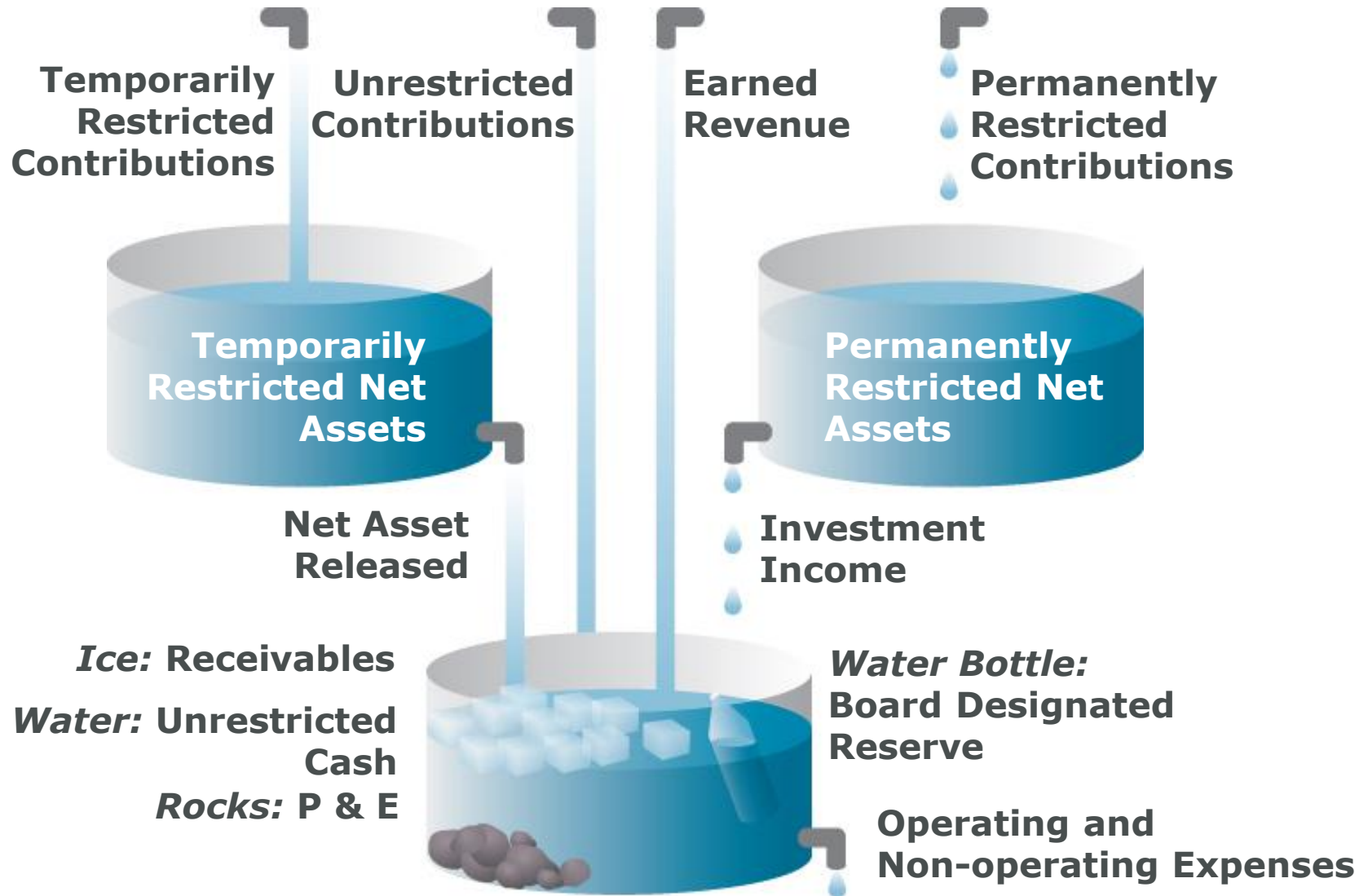
Where Are Liquid Net Assets?

ABC Center Statement of Financial Position

(\$ in thousands)

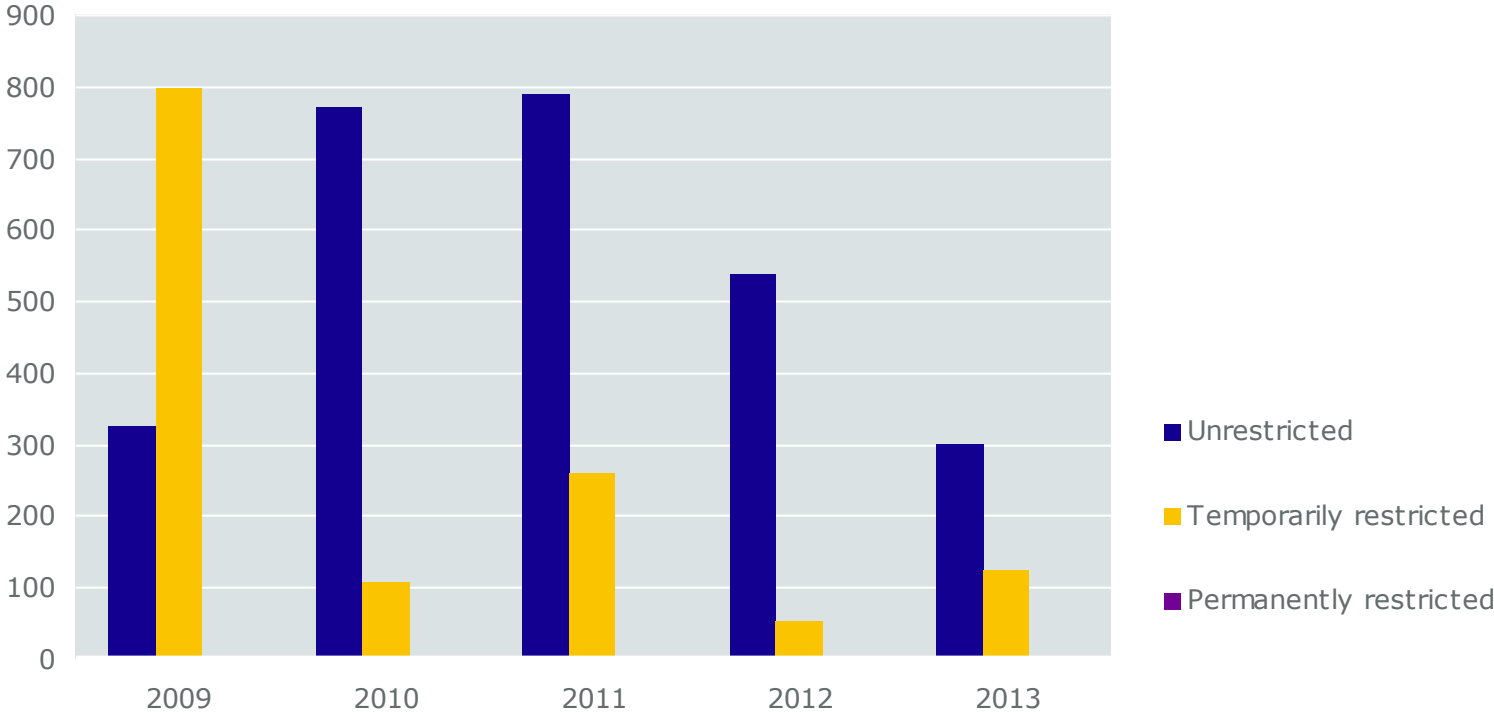
	06/30/09	06/30/10		06/30/09	06/30/10
Assets			Liabilities		
Current			Current		
Cash and Equivalents	296	191	Accounts Payable	127	57
Grants & Pledges Receivable	612	55	Other Current Liabilities	5	-
Prepaid Expenses	22	41	Total Current Liabilities	131	57
Other Current Assets	29	-	Long-Term		
Total Current Assets	959	287	Long-Term Debt	-	114
Long-Term			Total Long-Term Liabilities	-	114
Long-Term Investments	-	-	Total Liabilities	131	171
Grants & Pledges	39	-	Net Assets		
Net Fixed Assets (P&E)	256	760	Unrestricted		
Total Long-Term Assets	295	760	Undesignated	70	125
Total Assets	1,253	1,047	Unrestr. - Board Designated	-	-
			Unrestr. - P&E	256	646
			Total Unrestr. Net Assets	325	771
			Temp. Restricted Net Assets	797	105
			Perm. Restricted Net Assets	-	-
			Total Net Assets	1,122	876
			Total Liab. & Net Assets	1,253	1,047

Examine Net Asset Composition



Uncovering Liquidity: Net Assets

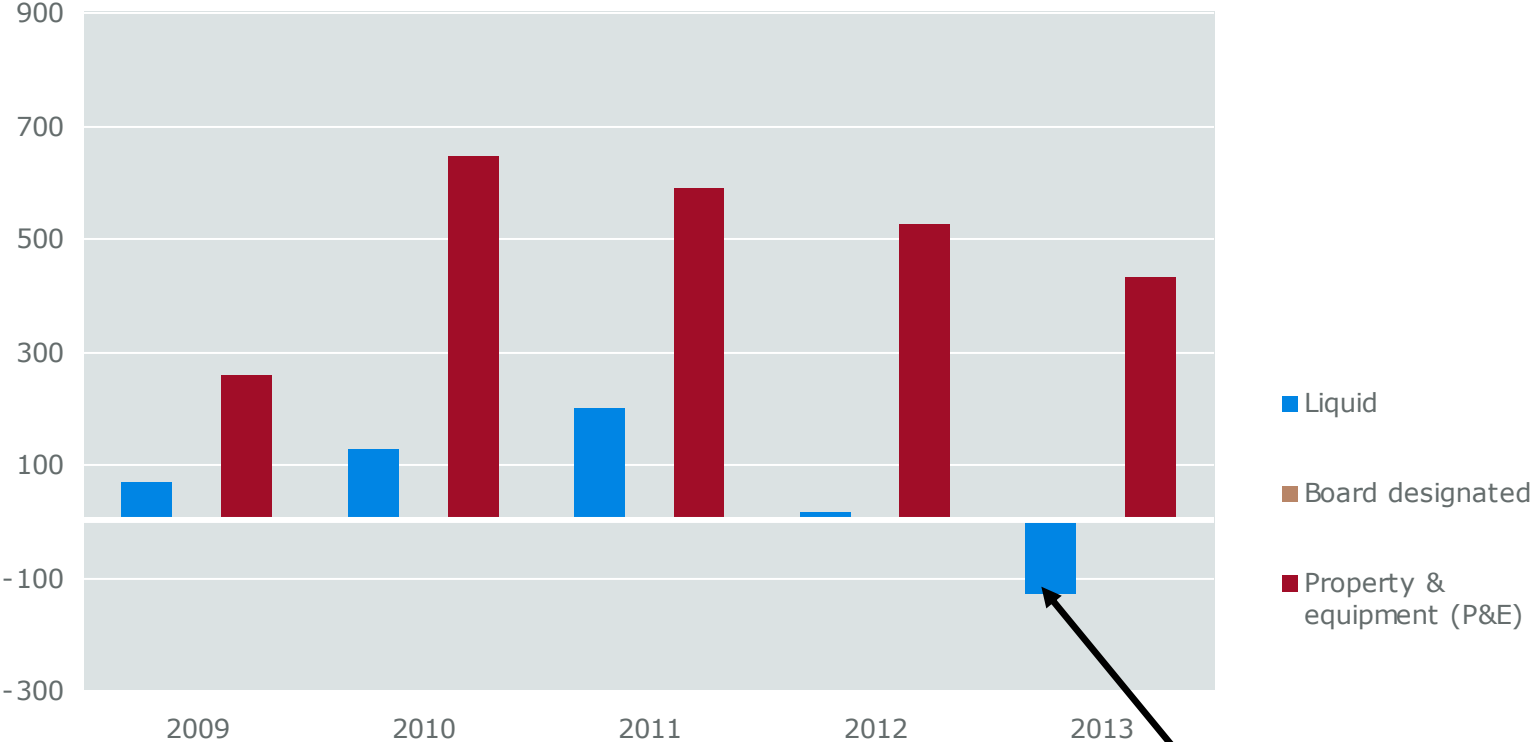
Total Net Assets (\$ in thousands)



Uncovering Liquidity: Liquid Net Assets

Unrestricted Net Assets

(\$ in thousands)



**Owing more than you own
on an unrestricted basis**

Calculating Own Liquid Net Assets

	2010
Unrestr. P&E Net Assets Calculation	
P&E (net of accumulated depreciation)	\$760
– P&E-related Debt	(\$114)
= Unrestricted P&E Net Assets	\$646
Liquid Net Assets Calculation	
Unrestricted Net Assets	\$771
– Unrestricted Board Designated	–
– Unrestricted P&E Net Assets	(\$646)
= Liquid Net Assets	\$125

Months of Liquidity: A Guideline

Months of Expenses Covered by Liquidity	Operating Situation
0	Crisis – Scrambling for cash, delaying payment to vendors, overdrawing checking account.
Less than 3 months	Cash is tight – Relying on line of credit, delaying payment to vendors.
3-6 months	Room to breathe – Can do some long-term thinking. Little room for “rainy days.”
6+ months	Handles more risk – Able to withstand increasingly acute shocks such as large facility repairs, funding cuts and possibly recessions.

Your Turn: Calculating Liquidity

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Total Liabilities & Net Assets	412	393

Operating Activity	2009	2010
Revenue, Gains and Support	383	310
Operating Expenses	378	371
Monthly Operating Expenses	32	31

_____ **Months of Cash**

_____ **Months of
Liquid Net Assets**

Review: Where to Find Past Financial Trends

Income Statement

- **Profitability & Savings:** Were costs covered? Were surpluses sufficient to pay for debt principal payments and facility or equipment purchases? Were you generating adequate savings?
- **Revenue Dynamics:** Where did the organization's money come from? Were revenue streams reliable or at risk?
- **Expense Dynamics:** How did the organization spend its money? Were expenses predictable? How well did the organization manage what was fixed vs. variable? Was management responsive to operating changes and prepared to make difficult decisions?

Balance Sheet

- **Health of Balance Sheet:** Are the size, nature and distribution of assets, net assets and liabilities appropriate to support the organization's business and programs over the long term?
- **Liquidity:** Is there enough cash available to cover current obligations? How quickly can the organization convert receivables to cash? How liquid are the net assets? Is some cash restricted or spoken for?

Income Statement

- **Operating deficits** that appear ongoing, especially if deficits are large in relation to the operating budget
- **Revenue swings** that are significant from year to year (i.e., changes in amounts from major funding sources)

Balance Sheet

- **Significant liabilities** in relation to assets which are not temporary/seasonal in nature (e.g., debt, payables)
- **Steadily declining or negative unrestricted net assets**
- **Low or declining liquidity**, as measured by months of cash or unrestricted liquid net assets
- **Sold investments or real estate** to generate cash
- **Line of credit** consistently maxed out during the year

A Financial Health Checklist

- ✓ *Unrestricted operating results are consistently positive (surpluses!)*
- ✓ Full costs are regularly covered by reliable revenue
- ✓ Reinvestment in fixed assets to offset depreciation
- ✓ Evidence of ability to manage debt
- ✓ Liquidity is sufficient to withstand risk and pursue new opportunities

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