How to Assess Nonprofit Financial Performance

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IV. UNDERSTANDING FINANCIAL STATEMENTS

A. Overview

This section will describe the structure underlying the financial statements and explain how the statements stated in the Form 990 differ from those in audited financial statements. Sample financial statements are included in this section, while sample 990 Tax returns are presented in Appendix 1.[7] [8]

The accounting system for nonprofits is designed to capture the economic activities of the firm and its financial position. The financial statements are constructed based on the "Accounting Equation" in which:

$$\boxed{\text{Assets} = \text{Liabilities} + \text{Net Assets}}$$

This equation states that the things of value that the nonprofit organization owns (*assets*) are equal to its outstanding debt *(liabilities*) plus the portion of assets funded by the nonprofit's own resources (*net assets*). In a for-profit setting, net assets are labeled *equity* or *net worth*. Until the mid-1990s, nonprofits labeled this account *fund balance*. The accounting equation is the basis of one of the four financial statements called the *Statement of Financial Position, Statement of Financial Condition* or *Balance Sheet.*

However, the accounting equation does not provide information on how or why the assets, liabilities or net assets changed over time. As a result, the financial statements provide a second report called the *Statement of Activity* or *Income Statement.* This statement explains how net

[7] For more detailed explanation of the relation between GAAP, the IRS Form 990 and other nonprofit financial reports see Sumariwalla, R. D. and W. C. Levis. *Unified Financial Reporting System for Not-for-Profit Organizations*. San Francisco: Jossey-Bass, Inc. (2000).
[8] To better understand the GAAP requirements for nonprofit organizations, see the AICPA Audit and Accounting Guide for Not-for-Profit Organizations put out by the American Institute for Certified Public Accountants.

assets changed from one date to another. Essentially, net assets increase when revenues are recorded and decrease when expenses are recorded as follows:

$$\text{Revenues} - \text{Expenses} = \text{Change in Net Assets}$$

In a for-profit context, revenues less expenses is called *net income* or *net profit* and is an indicator of the firm's success. For non-profits, the change in net assets is a *surplus* or *deficit* that is carried forward. Rather than focusing on profit, a nonprofit focuses upon fulfilling its mission. Therefore, the annual surplus or deficit is not necessarily informative about a non-profit's success. One way to assess a nonprofit's performance is to examine how it spends its resources. Hence, many nonprofits prepare a third financial statement called the *Statement of Functional Expenses* that depicts how total expenses are distributed between three functional areas:

$$\text{Total Expenses} = \text{Program Expenses} + \text{Fundraising Expenses} + \text{Administrative Expenses}$$

The distribution between these three areas is a reflection of the nonprofit's mission, values, success and accounting practices.

There are two accounting methods that are commonly used by nonprofit organizations when maintaining their accounting records. The easiest system is the *cash method* of accounting. Under this system, the organization records revenues when cash is received and expenses when cash is paid. While simple, the cash method does not accurately reflect the economic condition of the nonprofit organization. For example, it can receive commitments for donations in advance of cash receipts or incur debts before paying the associated bills. As a result, an alternative method of accounting has been developed called the *accrual method*. CPAs prefer the accrual method since it requires that revenues be recorded when earned and expenses when incurred.

While the 990 tax form can be completed according to the cash method, audited financial statements must be presented on the accrual basis. For simplicity, many nonprofits maintain their records on a cash basis and convert them to an accrual basis at year-end to prepare the annual financial statements. To ensure that financial statements are presented in consistent fashion year to year and are comparable between firms, audited financial statements must be prepared in accordance with *generally accepted accounting principles* (GAAP).[9]

While an accrual-basis Statement of Activity portrays economic changes in the net assets of the firm, stakeholders may also want to understand the nature of cash inflows and outflows. So, an additional financial statement must be presented called the *Statement of Cash Flows.* The statement divides cash movements into three broad categories:

> Change in Cash = Cash from Operations + Cash from Investing + Cash from Financing

Each of the four financial statements and accompanying footnotes will now be discussed in more depth. The financial statements of a fictitious nonprofit, the National Youth Training and Resources Organization (NYTRO), will be used as an illustration.

B. Statement of Financial Condition (Part IV of the Form 990)

The statement provides a snapshot at one point of time of the financial position of the nonprofit. The assets always balance the liabilities and net equity since each asset must be *funded* by resources provided by others or by the organization itself. The Statement of Financial Condition is generally prepared at the end of the fiscal year. Some larger organizations prepare

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[9] An independent body known as the Financial Accounting Standards Board (FASB) sets the accounting standards that are followed by for-profit and not-for-profit organizations. The Governmental Accounting Standards Board (GASB) sets generally accepted accounting principles for state and local governmental units.

this report quarterly or monthly. Figure 3 depicts the comparative statement of financial condition for NYTRO.

The assets are listed in order of their *liquidity*, i.e. their ability to be converted into cash. The most common assets for nonprofits include:

- Cash and cash equivalents: These are the funds on deposit in the bank or in highly liquid and secure securities, such as US treasury bills. In an audited financial statement cash (or any other asset) that is received with a donor-imposed restriction that limits its long term use must be classified in a separate account from the unrestricted cash.
- Pledges or Grants Receivable: This represents amounts that have been committed to the organization by an outside donor. Rather than the full or *gross* amount that is due, these receivables are carried at *net realizable value*, i.e. the amount that the nonprofit expects to receive.
- Prepaid Expenses: Costs, such as insurance, that are paid in advance of receiving benefits. This asset declines in value (and is recorded as an expense) as the benefit associated with this cost is consumed.
- Investments: This represents the value of stocks and bonds that are held as investments. In audited financial statements, the amount reported is the *fair market value* on the date the financial statements are prepared. On the tax return, this amount may be the *fair market value,* the *historical cost* of the investments purchased or even the lower of the *fair market value* or the *historical cost.*
- Fixed Assets: This account is also called Property, Plant and Equipment. This amount includes the historical cost of land as well as the *net book value* of other long-lived physical assets. The *net book value* is the historical cost of long-lived assets less accumulated

depreciation. The value of fixed assets on the balance sheet does not reflect fair market value or the cost of replacement, since these assets are not generally intended to be sold. Instead the accounting is designed to allocate the cost of a long-lived asset over its useful life. In general, the value of fixed assets is reduced each year by recording a non-cash *depreciation* expense. Often the value of the asset drops according to a straight-line method that reduces the value in equally sized increments over the estimated useful life of the asset.

Note that prior to 1994, the full cost of purchasing a fixed asset was expensed immediately. Hence, many valuable tangible assets were not reflected as an asset in the financial records. When nonprofits implemented the new standard, many chose to not *capitalize* (i.e. record as an asset) the old fixed assets. As a result, many nonprofits have *understated* assets and net assets on their books.

- Collections: Nonprofits may own works of art, historical treasures, or similar items that may not decline in value. Nonprofits must select a policy for recording collection items and consistently apply it to all collections. Some nonprofits chose to retroactively capitalize its collection that had been expensed and depreciate it. Others continued the policy of expensing all acquisitions and contributed collection items immediately. If the collection is capitalized, then depreciation need not be taken of the economic benefit of the asset is not consumed over time.

The most common liabilities include:

- Accounts Payable: Amounts owed to vendors or creditors for goods or services rendered; unpaid bills. Unpaid wages, taxes or grants can be included in this account or reported separately if significantly large.
- Grants Payable: Grant amounts promised to individuals or other organizations.

- Refundable Advances: Also known as deferred revenue. Grants received from donors that have not been recognized as revenue because the conditions of the grant have not been met.
- Due to Third Parties: Certain nonprofit organizations, such as the United Way and federated membership organizations, collect contributions from one group and transfer them to another nonprofit. When these organizations are operating as a transfer agent with no *variance power* to change the recipient, then the associated cash receipts are not recorded as revenues by the transfer agent, rather they are carried as liabilities.
- Long Term Debt: The principal and interest owed to a creditor. These debts can be in the form of bank loans, publicly traded bonds, or privately arranged debt financing.

The net assets are divided into three categories:

- Unrestricted: The portion of net assets that is not restricted by donor-imposed stipulations. This amount is positive when the sum of historical revenues and gains from unrestricted contributions exceeds the amount of unrestricted expenses. The amount is negative when the total historical unrestricted expenses exceeds the unrestricted revenues.
- Temporarily Restricted: The portion of the net assets that are limited by donor-imposed stipulations that either expire with time or can be fulfilled by actions of the organization.
- Permanently Restricted: The portion of the net assets that are limited by donor-imposed stipulations that will not expire with time or be fulfilled by actions of the organization. An endowment is an example of permanently restricted funds.

FIGURE 3

Statement of Financial Condition

National Youth Training and Resources Organization
Comparative Statements of Financial Position
For the Years Ended December 31, 1999 and 2000

	2000	1999
Assets		
Cash	$ 200,000	142,000
Pledges Receivable (net)	120,000	65,000
Investments	755,000	700,000
Prepaid Expenses	15,000	13,000
Fixed Assets (net)	220,000	40,000
Total Assets	$ 1,310,000	$ 960,000
Liabilities and Net Assets		
Liabilities		
Accounts Payable	50,000	60,000
Grants Payable	25,000	
Refundable Advances	20,000	
Long Term Debt	200,000	-
Total Liabilities	$ 295,000	$ 60,000
Net Assets		
Unrestricted	$ 325,000	$ 300,000
Temporarily Restricted	45,000	-
Permanently Restricted	645,000	600,000
Total Net Assets	$ 1,015,000	$ 900,000
Total Liabilities and Net Assets	$ 1,310,000	$ 960,000

C. Statement of Activities (Part I of the Form 990)

The Statement of Activities provides information on the operating activities of a nonprofit between one date and another. The statement provides information on the mix of revenues and expenses. It may also be a useful predictor of future activities. The statement measures activities as resources received and spent. In the case of a nonprofit, it may not fully capture the program service inputs, short-term outputs, or long term outcomes. To emphasize that the statement may not fully reflect an organization’s activities, some nonprofits call this report the Statement of Revenues, Expenses, and Changes in Net

Assets. The statement of activity is divided between the activities that are unrestricted, temporarily restricted, and permanently restricted. It is generally presented in a multicolumnar format (as seen in Figure 4). When revenues are recorded, they are classified into one of the three columns based upon the intent of the donor. Unless otherwise specified, donations, fee for services, even investment income is considered to be unrestricted revenues.

FIGURE 4

Statement of Activities

National Youth Training and Resources Organization
Statement of Activities
For the Year Ended December 31, 2000

Changes in Unrestricted Net Assets:	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**	**Total**
Revenues and Gains:				
Public Contributions (net)	$ 800,000	$ 165,000	$ 45,000	$ 1,010,000
Program Service Revenue	46,000			46,000
Investment Income	42,000	5,000		47,000
Net Assets Released from Restrictions	125,000	(125,000)		0
Total Revenues, Gains, Other Support	$ 1,013,000	$ 45,000	$ 45,000	$ 1,103,000
Expenses and Losses:				
Program Services	$ 676,000			$ 676,000
General Administration	197,000			197,000
Fund-Raising	115,000			115,000
Total Expenses and Losses	$ 988,000			$ 988,000
Increase in Net Assets	$ 25,000	$ 45,000	$ 45,000	$115,000
Net Assets at Beginning of Year	300,000	0	600,000	900,000
Net Assets at End of Year	$325,000	$45,000	$645,000	$1,015,000

The most common revenues for nonprofits are:

- <u>Contributions</u> are an unconditional transfer of cash or other assets to a nonprofit or a settlement or cancellation of a liability in a voluntary nonreciprocal transfer. This includes unconditional promises to pay cash or other assets in the future. To be recognized as revenues, there must be some documentation to verify that the promise was made and received.

If a donor imposes a *restriction* on the contribution than the use of the contributed assets is limited; however, the donor can not demand repayment. These contributions are recorded as either temporarily or permanently restricted revenues depending on the donor's restrictions. When the restriction expires, the amount of the contribution is removed from the temporarily restricted section of the statement of activity and placed in the unrestricted column. In the case of NYTRO in Figure 4, $125,000 of previously restricted revenues were removed from the temporarily restricted column and recorded in the unrestricted section.

If however the donor imposes a *condition,* then the proposed contribution may be rescinded. If the asset is received in advance of the condition being fulfilled, then the asset transfer is recorded as a liability (refundable advance) rather than a revenue. When the *conditions* are met, then this liability is eliminated, and revenues are recorded.

Contributions are recorded at their fair market value at the time of the gift. If the contribution is a series of future cash payments, then the discounted present value of the payments is recorded in revenues immediately as if there were an implied interest rate associated with the donation. With the passage of time, the interest component of the contribution is recognized as a contribution. If uncertainty is associated with the future payments, the nonprofit can reduce the value of a contribution by the anticipated defaults.

Some contributions are not provided in cash, rather they are in the form of *in-kind* goods and services. Organizations often seek to include these non-cash contributions to provide a more complete picture of the organization's funding sources and activities. When recorded in the financial statements, they are recorded as equal and offsetting revenues and expenses. Recognition of most contributed goods and services can not be included in statement of activities on the Form 990, but can be disclosed in a later section. Under GAAP, most contributed goods can be recorded as an offsetting contribution and expense when the unconditional transfer occurs. Contributions of collection items are not required to be recognized as revenues under certain conditions. Contributed services can be recognized if they require specialized (i.e. professional) skills and create or enhance a non-financial asset.

- Program Service Revenues are exchanges between a nonprofit and a another party, in which the nonprofit provides a service in exchange for a transfer of a cash or another asset. Increasingly nonprofits are relying on fees from governmental agencies or from clients to pay for services.
- Membership Dues: Some organizations have members that pay an annual fee to receive some basic services.
- Special Events Revenue: Revenues raised by special fundraising events are recorded separately from contributions. Under GAAP, the gross revenues from the events are recorded as revenues and the associated costs are shown as fundraising expenses. In the Form 990, the associated costs are recorded as a reduction in revenues rather than fundraising expenses.
- Investment Income: This reflects the income earned off the investment portfolio. It includes dividends on stock as well as interest on bonds. Under the cash basis, this would be when the dividends and interest are received. Realized gains/losses on investment securities may be included in this account or under as its own line item. Under GAAP accounting,

investment income will also include changes in the market value of the investments, i.e. changes in the unrealized gains and losses in investment securities.

In the Statement of Activities, the expenses are divided into three functional categories:

- o Program Expenses are the costs associated with the delivery of goods and services to beneficiaries, customers or members that fulfill the organizational mission.
- o Fundraising Expenses include publicizing and conducting fundraising campaigns, maintaining donor mailing lists, conducting special fund-raising events, preparing and distributing fund-raising manuals, and other activities involved in soliciting contributions or memberships.
- o Administrative Expenses include general and managerial costs such as oversight, business management, record-keeping, budgeting, financing and related administrative activities.

D. Statement of Functional Expenses (Part II of the Form 990)

The Statement of Functional Expenses is a statement that is unique to nonprofit organizations. It provides information on the distribution of costs between three functional categories and by natural categories, such as salaries, occupancy costs, and depreciation. If an organization has several major programs, it can separate program expenses into several categories as seen in Figure 5. For most organizations this statement is optional. Voluntary health and welfare organization, however, are required to issue this statement.

Many costs are actually joint costs that are incurred to deliver both program and support services. When joint costs arise, the management must allocate the costs to the appropriate functional categories.

FIGURE 5

Statement of Functional Expenses

National Youth Training and Resources Organization
Statement of Functional Expenses
For the Year Ended December 31, 2000

	Program Services		Supporting Services		
	Educational/ Scholarships	Recreational Programs	General Administration	Fund-Raising	Total Expenses
Salaries	$ 65,000	$ 88,000	$ 82,000	$ 15,000	$ 250,000
Employee Benefits	15,000	22,000	20,000	3,000	60,000
Payroll Taxes	7,000	11,000	10,000	1,500	29,500
Total Personnel Costs	$ 87,000	$ 121,000	$ 112,000	$ 19,500	$ 339,500
Professional Fees	-	-	-	45,500	45,500
Supplies	45,000	10,000	8,000	8,000	71,000
Telephone	10,000	15,000	7,000	7,000	39,000
Postage	10,000	5,000	5,000	3,000	23,000
Occupancy Costs	20,000	20,000	15,000	3,000	58,000
Equipment Rental and Maintenance	5,000	5,000	20,000	-	30,000
Printing and Publications	20,000	45,000	$ 2,000	26,000	93,000
Travel	40,000	40,000	$ 1,000	3,000	84,000
Conferences and Meetings	20,000	15,000	7,500	-	42,500
Scholarships	143,000	-	-	-	143,000
Interest	-	-	14,500	-	14,500
Total before Depreciation	$ 400,000	$ 276,000	$ 192,000	$ 115,000	$ 983,000
Depreciation	-	-	5,000	-	5,000
Total Expenses	400,000	276,000	197,000	115,000	$ 988,000

D. Statement of Cash Flows (not included in the Form 990)

The final financial statement provides information on the cash inflows and outflows of the organization between one date and another. The cash flows are separated into three different business activities as shown in Figure 6:

- Cash from Operating Activities: This section depicts the cash inflows and outflows arising for the organization's primary business of raising unrestricted and temporarily restricted funding and providing program services.

This section can be depicted in one of two formats. Both methods result in the same net cash from operating activities amount. In the main body of the cash flow statement in Figure 6 is the *direct method* that essentially restates the unrestricted and temporarily restricted portions of the income statement as if it were on the cash basis. The reconciliation at the bottom of the figure is an example of the *indirect method*. The indirect method starts with the change in net assets from the Statement of Activity and converts it from the accrual to cash basis using various adjustments. Given the design of accounting records, most nonprofits use the indirect format to depict their cash from operations.

- <u>Cash from Investing Activities:</u> This section depicts the cash inflows and outflows associated with the purchase and sale of long-lived assets and investments.

- <u>Cash from Financing Activities:</u> This section depicts the cash inflows and outflows associated with receipts and repayments of funds provided by creditors and by donors whose permanently restricted contributions are recognized in the statement of activity.

When the three sections are totaled the statement of cash flows explains how the cash at the beginning of the reporting period was converted to the balance at the end of the period.

FIGURE 6

Statement of Cash Flows

National Youth Training and Resources Organization
Statement of Cash Flows
For the Year Ended December 31, 2000

Cash Flows from Operating Activities:	
Cash Received from Unrestricted and	
Temporarily Restricted Contributors	$ 930,000
Cash Received from Service Recipients	46,000
Grants Paid	(118,000)
Cash paid to Employees and Suppliers	(837,500)
Interest Paid	(14,500)
Interest and Dividends Received	37,000
Net Cash from Operating Activities	$ 43,000
Cash Flows from Investing Activities:	
Purchase of Investments	$ (45,000)
Fixed Asset Purchases	(185,000)
Net Cash Used for Investing Activities	$ (230,000)
Cash Flows from Financing Activities:	
Addition to Endowment	$ 45,000
Issuance of Long Term Debt	200,000
Net Cash from Financing Activities	$ 245,000
Net Increase in Cash	$ 58,000
Beginning Cash Balance	142,000
Ending Cash Balance	$ 200,000

Reconciliation of change in net assets
to net cash provided by operating activities

Change in Net Assets	$ 115,000
Adjustments	
Depreciation Expense	5,000
Restricted Contributions to Endowment	(45,000)
Increase in Pledges Receivable	(55,000)
Increase in Refundable Advances	20,000
Increase in Grants Payable	25,000
Decrease in Accounts Payable	(10,000)
Increase in Prepaid Expenses	(2,000)
Unrealized Gains in Long-Term Investments	(10,000)
Net Cash Provided by Operations	$ 43,000

E. Footnotes

The footnotes are an important but often overlooked component of the audited financial statements. These notes describe the accounting principles used by the management of the nonprofit in preparing the financial statement. If joint costs are allocated, generally the footnotes will describe how these allocation decisions are made. The notes include a description of the entity being audited, which can include a depiction of the mission and key programs. If a nonprofit receives or has restricted funding, then the footnotes provide detailed information on the amounts, time and nature of stipulations imposed. Nonprofits can disclose the use of contributed services that are not recorded as revenues. If a nonprofit has expensed its collection, then it must describe its collection and accounting and stewardship policies for collections. It must also describe items that are removed from the collection for any reason and disclose the fair market value of those items.

E. The Role of an External Auditor

Depending on a nonprofit's size and funding sources, it may be required to have an annual financial audit. An audit is a systematic examination of the financial records of the organization. A *financial audit* undertaken by a certified public accountant (CPA) following a set of prescribed auditing procedures. The auditor's work may include examining the internal controls and a systematic analysis of the substantial transactions. The auditor is asked to provide an *audit opinion* on whether the financial statements are presented fairly in all material respects the financial position of the organization and in conformity with generally accepted accounting principles. If the auditors believe that the statements meet these expectations, then they issue an *unqualified* opinion as in Figure 7. If the financial statements do not meet these criteria, they can issue a *qualified* opinion, and the auditor's letter would indicate the reason for the qualification.

The auditors can also issue an unqualified opinion modified by explanatory language. For example, if they feel the statements are fairly stated but outside parties should be warned about a financial problem, they occasionally include wording indicating concern about an organization's ability to continue as a *going concern.*

FIGURE 7

Unqualified Audit Opinion

Independent Auditor's Report

We have audited the accompanying statement of financial position of the National Youth Training and Resources Organization as of December 31, 2000 and the related statements of activities, functional expenses and cash flows for the year then ended. These financial statements are the responsibility of the management of the National Youth Training and Resources Organization. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes the assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the National Youth Training and Resources Organization as of December 31, 2000 and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

(Signature)

(Date)

As an alternative to a full financial audit, a nonprofit can hire an outside auditor to either *compile* or *review* the financial statements. A compilation means that the auditor has looked at the financial statements without verifying any of the balances or assuring that the statements adhere to GAAP. With a review, an accountant has conducted an examination of the accounting records and provides an assurance that he is not aware of any material modifications needed to make the statements conform with GAAP. A review entails substantially more work for an auditor than a compilation, but it provides a negative, or weaker assurance, than an audit. These services may improve the reliability or relevance of the financial statements; however, the auditors have not thoroughly examined the financial records and are not providing an opinion on the accuracy of the financial statements. In either case, the auditors issue a letter that can be sent to outsiders. These letters will use the words *compilation* or *review* instead of audit.

Generally, if a nonprofit organization receives $300,000 in federal awards either directly or indirectly, it is subject to a special *A-133 audit*. The Office of Management and Budget (OMB) Circular #133 prescribes the audit requirements which include a traditional financial audit as well as an audit to examine an organization's internal control structure in more detail, to verify that the federal funds were handled and spent in compliance with the grant, and to assess whether the organization is in compliance with various federal laws. These audits must be conducted by CPAs that have undertaken additional training.

In addition to the audit opinion, most auditors also provide the nonprofit organization with information regarding their *audit findings*. These findings are shortcomings in the financial system, such as poor internal controls, weak accounting practices, or insufficient safeguarding of assets. The auditor often requests that these shortcomings be corrected before the next audit is conducted. To help assess the quality of financial management, board members and substantial stakeholders can request information regarding the audit findings.

A final audit issue to consider is the quality of the auditor. Auditors vary considerably in their overall knowledge of accounting and auditing as well as their specific experience in not-forprofits. Unfortunately, some auditors do not perform a quality audit of a not-for-profit. This may because they are inexperienced, are doing the work *pro bono*, or believe it is unlikely that there will be adverse consequences from doing a substandard job. Before relying on the auditor's opinion, it is important to determine whether the auditor completed a high-quality audit.

F. Supplemental Disclosures in an Annual Report

Some nonprofits prepare a special annual report that is distributed to donors or other interested parties. A recent study (Christensen and Mohr 2001) indicates that museums frequently prepare such reports. They found that the reports varied in length from 2 to 220 pages. Most but not all contained financial statements. The financial information comprised 10% of the report, in contrast to corporate annual reports that were 48% financial information. The museum reports often contain information on attendance, the donors and their giving levels, a description of the organization and its mission, and a discussion of the past year's activities including major acquisitions and tallies of volunteer hours. A similar study of environmental organizations (Khumawala, Gordon, and Kraut 2001) finds that financial information composes about 10% of the annual report; supplemental disclosures include program descriptions, the success of various lobbying efforts as well as lists of board members, donors and staff.

G. Supplemental Disclosures in the Form 990

The Form 990 is designed primarily as an informational tax return. Hence, the form is designed to help the IRS determine if a nonprofit is in compliance with various federal laws and is permitted to maintain its tax-exemption. Figure 8 outlines the supplemental disclosures included in the Form 990.

FIGURE 8

Differences in Reporting Requirements Between the Form 990 and Audited Financial Statements

Present in the Form 990 but not required for audited financial statements

- Information on officers, directors and compensation (was Schedule A, now Part V)
- Description of mission and program services (optional in audited financials) (Part III)
- Partial reconciliation between Form 990 and audited financial statements (Part IV-A and Part IV-B)
- Responses to yes/no questions regarding compliance with various legal requirements (Part VI)
- Analysis of income-producing activities (used to determine if firm is fulfilling operational tests required to maintain exempt status) (Parts VII and VIII)
- Ownership information on taxable subsidiaries (Part IX)
- Information regarding transfers associated with personal benefit contracts (Part X)

Present in audited financial statements but missing from the Form 990:

- Information on whether the statements are audited and received a qualified or unqualified opinion
- Accounting principles used to prepare the statements
- Description of the entity being audited
- Cash flow statement
- Amounts, timing and conditions associated with restricted funds

Practices in the Form 990 that are not consistent with Generally Accepted Accounting Principles (GAAP):

- The accounting method for many accounts are not disclosed in the 990
- Use of an indeterminate basis for allocating joint costs to program activities rather than to administrative or fundraising activities in Form 990
- Unrealized gains and losses on investments are reported in the Form 990 but are reflected in value of the investments and the equity in the audited financial statements
- Recognition of most contributed goods and services can not be included in the Form 990, while certain non-cash contributions can be included in the audited financials
- Limited or no information is disclosed about revenues and expenditures associated with restricted funds are provided in the 990
- Indirect costs of selling merchandise (such as selling, general and administrative costs) can be included in cost of goods sold
- The 990 requires that nonprofits carry revenues from sales of merchandise, special events, and rental activities net of expenses as a gain/loss included in revenue rather than having the separate components shown in revenues and expenses. GAAP accounting allows netting of only for incidental or peripheral activities.

V. FINANCIAL PERFORMANCE MEASURES

Based on the focus groups and informal interviews, we identified questions commonly asked by the stakeholders to assess the performance of a nonprofit:

FIGURE 9
Questions Asked to Assess Financial Performance

1. Mission
   - o What is your organizational mission?
   - o Is the mission consistent with the stakeholder's values?
   - o How does that translate into goals and objectives?
   - o What is the business model/strategy?
   - o What are present obstacles to fulfilling the mission?
2. Service Delivery
   - o What is the demand for these services?
   - o What type, volume and quality of services are delivered?
   - o Are these services compatible with mission?
   - o Are they meeting goals and objectives (are $ spent on right stewardship things)?
   - o What are present obstacles in service delivery?
3. Organizational Management
   - o What is the experience and expertise of management?
   - o What is the quality of internal support systems?
   - o What is the administrative efficiency?
   - o What is the appropriateness of compensation?
4. Organizational Funding
   - o What cash funds are available?
   - o What non-cash contributions (goods, services volunteers) are used and available?
   - o How financial supportive are board and community?
   - o How financial supportive are commercial activities?
   - o Is there continuity of support and diversity of income streams?
   - o How compatible is the funding with the mission?
   - o How efficiency is fundraising and development?
   - o What are present obstacles in funding and support?
5. Financial Health
   - o What is the cash flow position?
   - o How financially stable is the organization?
   - o Does it have accumulated wealth to sustain it if funding is reduced?
6. Financial Management
   - o What is the quality of internal control system?
   - o How prudent is the cash and investment management?
   - o Are non-financial assets prudently managed?

For many stakeholders, the most critical questions relate to an organization's mission, its appropriateness, and its success in fulfilling it. These first two issues cannot be readily answered using financial or quantitative measures.[10] This section will examine how the third issue of program accomplishment may be answerable, in part, through eight sets of financial measures. We will do this by describing various financial analysis techniques and how they apply in the nonprofit setting. These techniques have been drawn from a variety of sources including Tuckman and Chang 1991, Gross, Warshauer, Larkin 1991, Hodgkinson and Weitzman 1996, Stevenson, Pollak, and Lampkin 1997, Forrester 1998, Maddox 1999, and Froelich, Knoepfle, Pollak 2000.

A. Peer Benchmarking

In many cases, it is difficult to look at the financial statements alone and gain insight into the operation of the firm and its current and long-term prospects. Benchmarking a firm against a peer can lend perspective to the analysis. Several attributes should be considered when searching for an appropriate benchmark. Often computing an average of three to four organizations will create a benchmark that is not overly volatile. The peers should be roughly comparable in mission, industry classification, and size. When benchmarking compensation or changes in program services, it is often helpful to use nonprofit organizations in the same geographic area or sensitive to the same fluctuations in funding. The nonprofit itself may be able to suggest some suitable peers. Alternatively, one can search the IRS tax filings for similar organizations. The recent filings are industry coded using the National Taxonomy of Exempt Entities (NTEE). This

[10] A publication that addresses these issues is *The Five Most Important Questions You will Ever Ask about Your Nonprofit Organization* by Peter F. Drucker.

classification system is being replaced by the North American Industry Classification System (NAICS), which also covers for-profit organizations.[11]

B. Common-Sizing Financial Statements

To become familiar with an organization's emphasis, it is helpful to determine how its resources are distributed. This can be accomplished through *common sizing,* i.e. converting to percentages, several financial statements. The Statement of Financial Condition is generally divided by total assets, the Statement of Activities is divided by total revenues, and the Statement of Functional Expenses is divided by total expenses. The following insights can be developed:

- Asset Concentrations: Analysis of the asset mix can help identify the resources available to deliver future services. Missing from this analysis is the value of a nonprofit's staff or any internally developed expertise. Many older nonprofits have not capitalized their fixed assets or may be holding valuable collections that are not reflected at their fair market value on the financial statements. Hence, an analyst may want to develop a list of unidentified assets.
- Revenue Concentrations: By looking at the mix of revenues, one can assess a non-profit's reliance on different forms of revenue, see if this reliance has shifted over time, or if it has a substantially different profile from some if its industry peers. If a nonprofit is following GAAP and receives large multi-year grants then the contributions will be high in years that grants are awarded and relatively small in the subsequent years. A common practice when analyzing these firms is to average revenues over three years.
- Expense Concentrations: This analysis can reveal the nature of the *production function* needed to run organization. For example, how important are personnel costs relative to total costs; does the organization provide indirect services through giving grants to others or

[11] For more information on these classification systems, go to: http://nccs.urban.org/ntee-cc/index.htm

does it provide the services directly. The expense concentrations also indicate whether resources are consumed by delivering program services or support services (fundraising and administrative). One particular measure that many stakeholders use is the program efficiency ratio which is $\frac{\text{Program Expenses}}{\text{Total Expenses}}$. This measure indicates what percentage of the resources consumed are used to provide program services. As seen in Appendix 3, several watchdog organizations rely on this as a key measure of success. The *Chronicle of Philanthropy* publishes comparative ratios for large nonprofits each year. Many nonprofits emphasize their efficiency in marketing materials, by stating things like for every dollar you give x% is spent on program.

Unfortunately, this statement is often inaccurate. Many large contributions are provided on a temporarily restricted basis with stipulations that the funds be spent often exclusively on program services. The small, individual donations are then used to cover administrative and fundraising costs.

Since the program efficiency ratio is a prominent ratio, it may be subject to financial misreporting. Nonprofits purchase goods and services that may provide benefits to program as well as fundraising and administration. Through an allocation process, joint costs such as salaries, employee benefits, and rent are distributed between the three functional areas. Historically, nonprofits have been accused of allocating too many costs of direct mail marketing campaigns to program expenses. GAAP now limits this joint cost allocation decision. With about one-third of all nonprofits reporting zero fundraising expenses on their 990 Form, it is suspected that some nonprofits still intentionally allocate a disproportionate amount to program expenses. Finally, assessing program efficiency using the Form 990 produces artificially favorable efficiency ratios. Since the Form 990 allows the organization to record various administrative and fundraising costs as reductions in revenues rather than expenses, these support service expenses are understated relative to program expenses.

C. Trend Analysis

Another technique to analyze an organization is to conduct a trend analysis. For this approach, at least three years of financial information is required. The annual growth rates in important accounts such as program expenses, support services, total revenues, cash and compensation are computed. Generally, stakeholders look for positive and sustained growth in these categories with program expenses growing as fast or faster than support services or compensation. If this is not occurring, it may be that the organization had previously underinvested in compensation or support functions, or it may be an indicator that management is inefficient or is being excessively compensated or accepting perquisites, such as an expense account. If revenue growth consistently exceeds program service growth, it may be an indication that the organization is strengthening its long-term financial health or that it is not sufficiently expanding its programs.

D. Comparisons in Relation to the Budget

Another method of assessing an organization's performance is to compare its reported financial information to its budget. Most nonprofits undertake an annual budgeting process that entails developing budget projections for the following year, obtaining the approval of the board for incurring the anticipated expenses, carrying out its operations, and then reporting to the board on its performance for the year. The annual budget is not a formally disclosed document, but board members and selected donors can receive copies.

E. Profitability Measures

In a for-profit setting, it is critical to know if the firm is operating profitably. For non-profits, the excess of revenues over expenses is not necessarily an indicator of good performance. In small non-profits, many budget their operations to ensure that they provide the maximum program services. One measure of that is whether revenues are fully consumed as expenses in the period received, i.e. the organization never reports a profit or a loss.

As a firm becomes larger, it is more difficult to operate with expenses fully offsetting revenues. Larger nonprofits seek to regularly report a modest excess of unrestricted revenues over expenses, creating some slack in the organization that can be used to support services of there are delays in receiving funding or an unexpected drop in revenues.

Larger organizations often have investments and some moneymaking activities. The objective is to generate a profit that can be used to finance the program services. For these activities, it is common to compare the profit to the size of the activity. For example:

- Return on Investments is defined as $\dfrac{\text{Investment Income}}{\text{Average Investments}}$
- Gross Margin is defined as $\dfrac{\text{Sales of Merchandise - Cost of Goods Sold}}{\text{Sales of Merchandise}}$
- Margin on Rental Activities is defined as $\dfrac{\text{Rental Revenue - Rental Expenses}}{\text{Rental Revenue}}$

F. Liquidity Ratios

A concern for many nonprofits is their ability to pay their obligations on time (*liquidity).* Today, in for-profit companies, liquidity is assessed by looking at *free cash flows.* This is often measured by: Cash from Operating Activities + Cash from (Nondiscretionary) Investments. Since the Form 990 does not require a cash flow statement, it often not possible to compute free cash flows. Instead, analysts compute more traditional liquidity measures as follows:

- <u>Current Ratio</u> is defined as $\frac{\text{Current Assets}}{\text{Current Liabilities}}$, where current assets are the assets that will be converted into cash in the next 12 months, and current liabilities are the debts that become due in the next 12 months. It is measure of a nonprofit's ability to pay its obligations on time. Nonprofit balance sheets often do not classify assets and liabilities as current or long-term. An estimate of current assets includes cash, receivables, inventories, and prepaid expenses. An estimate for current liabilities is total liabilities minus bonds, mortgages and bank debt maturing in over one year.

- <u>Net Working Capital</u> is defined as Current Assets- Current Liabilities. This is an alternative method of assessing a nonprofit's ability to pay its short-term obligations.

- <u>Days Cash On Hand</u> is defined as $\frac{\text{Cash and Cash Equivalents}}{\text{Monthly Expenses}}$. Assuming that the organization stops receiving revenues, this measures gives a sense of how many months a nonprofit can continue to pay bills. It has been suggested that having at least, three, if not six months of cash on hand is desirable.

- $\frac{\text{Accounts Payable}}{\text{Monthly Expenses}}$. This measure indicates how many months of expenses are still owed to creditors.

G. Measures of Financial Distress or Vulnerability

While liquidity measures help assess a nonprofit's ability to continue in operations in the short term, they not as helpful in predicting long term viability, i.e. *solvency.* The basic definition of solvency is whether net assets are positive. However, nonprofits can be viable with negative net assets. This because many important assets of the firm are not recorded in the financial system at all or are severely understated. An alternative measure is leverage, which is often defined as $\frac{\text{Total Liabilities}}{\text{Total Assets}}$. The measure indicates how much of a nonprofit's assets are funded by other people's money. Debt financing is important to allow nonprofit's to grow and to help asset intensive organizations support and expand their facilities. However, an overly high reliance on debt financing can put a nonprofit at risk. If creditors become concerned, they may demand debt repayment or be reluctant make new loans. If the nonprofit fails to make debt or interest payments in a timely fashion, the creditors can force the termination or liquidation of the organization.

Several academic studies have examined the measures that are mostly likely to predict financial distress or vulnerability in the form of a substantial decline in program services or in net assets (Tuckman and Chang 1991, Greenlee and Trussel 2000, Trussel and Greenlee 2001). These studies indicate that when the following ratios differ substantially and adversely from their industry peers, these firms are more likely to experience financial distress:

- Profit Margin defined as $\frac{\text{Total Revenues - Total Expenses}}{\text{Total Revenues}}$
- Revenue Concentration Index defined as the sum of squares of each revenue source divided by total revenues.
- Administrative Cost Ratio defined as $\frac{\text{Administrative Expenses}}{\text{Total Expenses}}$
- Equity Balances defined as $\frac{\text{Total Equity}}{\text{Total Revenues}}$
- Size defined as the natural log of total assets.

H. Activity and Efficiency Measures

The primary efficiency measure used to assess nonprofits is the program efficiency ratio described in the subsection on common sizing. While frequently used, the program efficiency does not reflect well the activity of the firm. When reported accurately the program efficiency ratio depicts the input costs of the services provided. Most stakeholders are interested in the direct deliverables (outputs) or the long term benefits outcomes. Given the present financial disclosures, it is not possible to determine the number of clients served, the man-hours of services provided, or the any measurable benefits received.

Recent concern over the inability to assess this critical element of performance has led to books aimed to improve their organizations and manage more efficiently (Antos and Brimson 1994; Dropkin and LaTouche 1998; Drucker 1992; Eadies and Schrader 1997; Firstenberg 1996; Pynes and Schrader 1997; Wolf 1990). Many attempt to bring business concepts such as reengineering, quality management, and benchmarking to bear on the nonprofit sector, usually with the intent of raising the level of organizational and program performance. Hence, the reader should recognize that an important limitation of current financial statements is their relative inability to assess whether an organization is efficiently accomplishing its mission.

A more fruitful activity may be to assess fundraising efficiency using a measure such as $\frac{\text{Fundraising Expenses}}{\text{Contributions} + \text{Special Event Revenue}}$. The measure assesses the cost of generating a dollar of contributions. An analysis by the National Center for Charitable Statistics that revealed that on one-third of recent 990 tax forms reported zero fundraising expenses. One suspicion is that nonprofits are allocating fundraising expenses to program or administrative costs, allowing them to reduce this ratio to zero. In addition, a number of nonprofits may be recording revenues from direct mail and telemarketing campaigns as the receipts less the associated fundraising expenses.

Alternatively, a fundraising ratio of zero may indicate that the agency is accepting contributions from federated fundraising agencies, such as the United Way, or headquarters/umbrella organizations, and these agencies are recording the fundraising expenses. Rather than an indicator of fundraising efficiency, a fundraising ratio of zero may indicate that the financial statements do not materially reflect the financial condition of the organization.

I. Compensation Issues

A final area to consider is compensation. Three issues regularly emerge in the nonprofit setting: Are top executives excessively compensated? Are other employees adequately compensated? Are employees effectively compensated? The first question can be examined by looking at Form 990 and the required Schedule A that includes the salary, benefits and expense account disclosures for the five highest paid employees of the organization. These amounts can be compared to compensation reported by comparable institutions on their Form 990s. Nonprofits, however, can understate an individual's compensation by creating multiple reporting entities. For example, hospitals often pay doctors through both their operating nonprofit and an associated foundation. Each tax return only reports a portion a doctor's total compensation. The latter two questions are more difficult to determine. The total compensation and benefits are reported in the statement of functional expenses, however, headcount is not provided. As regards the effectiveness of the compensation, many nonprofits do not pay incentive compensation, since such payments may be interpreted as violating the *nondistribution constraint* that prohibits nonprofits from distributing their excess earnings to third parties. The latter two questions can best be answered by asking management for supplemental information.

VI. CONCLUSIONS

This report has discussed the state of nonprofit financial reporting and provided advice on how to analyze a nonprofit's financial performance using currently available information. In this section, we present some expected enhancements in financial reporting and outline a plan for making additional improvements.

A. Anticipated Improvements

Stakeholders interested in a single nonprofit tax filing are presently able to go the Guidestar website and download a scanned version of the document. The National Center for Charitable Statistics is completing a "digitized" version of these filings. The digitized information is expected to be available in late 2001 and will allow users to analyze almost all of the Form 990 datafields for almost all recent filers of the Form 990 and 990EZ.

Recently, the National Association of State Charity Officials (NASCO) has worked together to develop a unified registration statement. In the eleven participating states, a nonprofit will be able to complete a single annual filing that will be accepted in a number of states. The NCCS is working with NASCO and others to develop software that will allow nonprofits to file the unified registration statement electronically. Potentially, this software may accommodate more complex financial reporting, such as audited financial statements.

A third project underway at NCCS will produce information that will classify not only the nonprofit by its industry code but also classify its programs. This project relies heavily on the information reported in Part III of the Form 990. Currently, this section is often left empty or is not accurately completed by the nonprofit filing the return.

B. A Plan for An Improved Performance Assessment