Understanding Nonprofit Financial Statements

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The leaders of nonprofit organizations are dedicated to creating positive change in their communities and the wider world through a variety of awareness, volunteer and fundraising activities. Nonprofit leaders generally have strong communication skills and work well with others. However, these leaders may find it difficult to understand the complex financial statements that assess the fiscal wellbeing of their organizations.

Understanding nonprofit financial statements is essential to the overall growth and success of any nonprofit organization. Leaders must be able to read, analyze and interpret data in order to best plan for an organization's future. The following tips and pointers can help even the most financially inexperienced nonprofit leader understand the basics of a financial statement. Individuals who have previously worked in the for-profit sector should pay particular attention to the ways in which nonprofit statements differ from those of for-profit companies.

Five Common Components of Nonprofit Financial Statements

Most nonprofit financial statements include four to five different sections. These *statements within the statement* are used to break down and explain the organization's finances. Nonprofit organizations are often required to provide these statements to donors and to the federal government. It is best to work with a financial advisor or accountant to prepare statements that will be used for tax purposes or released to the public.

The following five components are usually included in nonprofit financial statements. In some situations, an organization may not need to include a statement of functional expenses. A statement of functional expenses is generally included when an organization's employees handle multiple duties or handle duties outside the scope of their job descriptions.

Statement of Financial Position

Generally referred to as a balance sheet in the world of for-profit corporations, this statement provides information about the overall financial wellbeing of a nonprofit organization. This statement lists an organization's assets and liabilities. These items are generally listed in some sort of chronological order. Liabilities may be listed by the dates that they need to be paid. Assets may be listed so that changes can be tracked on a monthly, quarterly and yearly basis.

Statement of Activities

Much like a for-profit corporation, a nonprofit organization must list its revenues and expenses. Nonprofit revenues come from items such as donations, membership dues and gains on investments. Assets are usually listed as a part of overall revenue; the difference between net assets and assets is discussed later in this paper.

Nonprofits generally incur expenses through offering services and programs to the public. The cost of offering such services and programs are counted as expenses. Operation expenses, such as salaries and office supplies, are also included in this statement. The expenses of running a nonprofit are often known as*supporting services expenses*.

The Cash Flow Statement

The cash flow statement is used to track either a surplus or deficit in the cash assets held by a nonprofit organization. Anything that increases or decreases the cash balance of a nonprofit's bank account must be included in this statement. The most common items included on the cash flow statement are normal operating gains and losses, investment gains and losses, and finance items such as loans and loan repayments.

Statement of Functional Expenses

A statement of functional expenses breaks down salary payments according to the duties completed by an employee. Imagine that an administrative assistant spends 70 percent of her time on administrative duties and 30 percent of her time on fundraising duties. On the statement of functional expenses, 70 percent of her pay would be recorded as an operating expense while 30 percent of her pay would be recorded as a fundraising expense.

Footnotes for Financial Statements

The footnotes included by a nonprofit's leadership and management should detail how outside forces affected items listed throughout the financial statement. The footnotes might also include information about plans to address shortcomings in the future. The footnotes are one of the most important aspects of a nonprofit's financial statement because they offer insight into the actual operations of the nonprofit beyond the simple record of numerical values found in other sections of the statement.

Understanding Assets & the Statement of Financial Position

In order to understand the statement of financial position, it is necessary to understand the nature of assets. Remember that assets are anything a nonprofit has or owns that can be described in monetary value. This includes bank accounts, investments and equipment. When analyzing financial statements, it is common to see both *assets* and *net assets* listed. Understanding the difference between the two is crucial to understanding nonprofit financial statements.

Assets refer to the total of an organization's monetary and investment assets, which are listed under the statement of financial position and the cash flow statement. An organization's overall assets generally reflect how much money the organization has *before* considering its liabilities.

An organization's **net assets** are calculated by subtracting liabilities, or what the organization owes, from total assets. Net assets reflect the amount of money left over after all expenses have been subtracted from assets.

Understanding Revenues and Expenses

Due to their unique nature, nonprofit organizations must be careful when recording revenues. It is important that revenues be broken down to clearly reflect their sources. When recording revenues, nonprofits generally list them in one of three different asset categories. They must be recorded under one of these categories at the time of donation.

Unrestricted net assets are those which a donor gives freely to an organization without stipulation. An organization may use the donations to meet any expenses or run any programs that it sees fit.

Temporarily restricted net assets are those assets that a donor gives with conditions. For example, a donor might require that the money he or she gives to an organization be used to buy school supplies for children in the organization's after school program. *Permanently restricted net assets* are those that a donor stipulates must never be used in their entirety. Such assets generally form part of what is called an organization's *endowment*. Organizations use the interest earned on their endowments to pay for expenses but do not use money from the endowment itself.

Reviewing a Nonprofit Financial Statement

Once you have familiarized yourself with the various sections of a nonprofit financial statement, you are ready to begin analyzing and reviewing the statement. Use the following steps as a guide when reviewing such a statement. Remember that it is important to look both at the little details and the overall picture. If you have questions, jot them down as you go and be sure to check with the organization's financial advisor to be sure you understand different aspects of the statement.

Review the statement of financial position. Look over this statement to get a good idea of the overall financial wellbeing of the organization. Pay special attention to any areas that seem particularly promising or troubling. Pay attention to how the organization's assets and liabilities compare. Are there significantly more liabilities than assets? Keep such discrepancies in mind when analyzing the cash flow statement and the statement of activities.

Analyze the statement of activities. After you have gained an overall picture of an organization's fiscal status, carefully review the statement of activities. Pay attention to how much money the organization is spending on providing services and programs to the public. You may want to jot down this information so that you can compare it to the organization's overhead or operational expenses.

Review the cash flow statement and statement of functional expenses, if included. Carefully read the cash flow statement and analyze how the organization is spending its money. If the organization is spending more money than it is taking in, pay careful attention to how the money is being used. Is it used for operational expenses or to provide programs? In general, donors are more willing to give to nonprofit organizations that are able to control their operations spending.

Read and analyze the footnotes. Carefully read over the footnotes on the financial statement to understand how current market factors and economic conditions may have affected the nonprofit in a given year. Armed with this information, you can weigh whether or not the organization responded wisely to the challenges with which it was presented.

Applying Your Understanding of Nonprofit Financial Statements to Everyday Operations

After reading your nonprofit's financial statement, look for areas in which your organization can improve. Identify areas in which your organization has excelled and be sure to share these items with your staff and donors. Remember that it is important that you always look for ways to increase your organizational spending on services and programs while decreasing operational costs.

If you run a nonprofit organization or are beginning a career in the nonprofit world, learning how to read a financial statement is absolutely essential. If you can read a financial statement, you can better respond to the challenges that face your organization. Be sure to carefully review your nonprofit organization's financial statement as soon as it is released.