

Time to Talk Finances: How to dissect finances at your nonprofit

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- Who am I, and what am I doing here?
 - I'm David Orlinoff, an independent financial consultant doing business under the name Concord Financial Organization. It's not a coincidence that the initials are CFO.
 - We'll cover some of the concepts and practices that underlie good understanding and management of the finances of a nonprofit. I hope that at the end of the session you'll have learned some answers and that you'll also be better positioned to ask insightful questions at your own nonprofit.
 - Please interrupt with questions as they arise. I'll defer answering if I think your question is too specific or if the answer needs to be too detailed.

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- This seminar could be called “Finance without Fear.”
 - A lot of people are scared off by numbers.
 - Finance is about people and relationships as much as it is about numbers.
 - We’ll talk about both.

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- Let's start with some history and vocabulary
 - The accounting system we use today is called “double-entry bookkeeping” and was invented by Italian merchants in the 15th Century to keep track of who owned what shares in the profits of merchant vessels.
 - They created the “Fundamental Accounting Equation”: $\text{Assets} = \text{Liabilities} + \text{Owners' Equity}$.

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- Assets: what a business owns.
- Liabilities: what the business owes to other entities or persons; i.e., the claims against the assets.
- Owners' equity: the residual after subtracting liabilities from assets.

- Note that this is for businesses, not nonprofits.

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- In a nonprofit, the fundamental accounting equation is: $\text{Assets} = \text{Liabilities} + \text{Net Assets}$.
 - Assets: what the nonprofit owns (same as a business).
 - Liabilities: what the nonprofit owes to other entities or persons; i.e., the claims against the assets (same as a business).
 - Net Assets: the residual after subtracting liabilities from assets (same concept as for a business, different terminology).

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- Why is the fundamental accounting equation different for a nonprofit? Why is the residual called “net assets” rather than “owners’ equity”?
 - Because nonprofits don’t have owners.
 - ✓ Nonprofits are corporations organized under state law but don’t issue stock and don’t have shareholders.
 - ✓ In a for-profit company, profits belong to the owners (shareholders if it’s a corporation); in a nonprofit, profits are reinvested in the mission.

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- The fundamental accounting equation forms the basis of the Statement of Financial Position, commonly known as a Balance Sheet.
 - A Balance Sheet or Statement of Financial Position shows a picture of the organization's reported account balances as of a point in time, usually the end of the fiscal year.
 - The fiscal year should normally be based on the organization's natural business year.

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- Another important equation:
 - In a for-profit business: Revenue – Expenses = Net Income.
 - In a nonprofit: Revenue – Expenses = Change in Net Assets.
 - ✓ Revenue: what the business or nonprofit brings in from its various revenue streams.
 - ✓ Expenses: what the business or nonprofit spends to carry out its operations (specifically in a nonprofit: to carry out its mission and to fund the costs that support its ability to do so).

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- In a nonprofit, the equation “Revenue – Expenses = Change in Net Assets” forms the basis for the Statement of Activities or Income Statement.
 - The Statement of Activities reports on the results of operations over a period of time, usually the fiscal year.
 - In a nonprofit, Change in Net Assets represents the increase or decrease in the residual between assets and liabilities during the period reported (usually the fiscal year). Positive change = profit; negative change = loss.
 - Profit is NOT a dirty word in the nonprofit world!

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- In a nonprofit, we usually expand the term “Revenue” to “Revenue and Support.”
 - Nonprofits generally have three main categories of income: earned, contributed, and investment income.
 - ✓ Earned income includes fee for service, tuition, etc., and is usually called revenue.
 - ✓ Contributed income includes donations, grants, bequests, etc., and is usually called support.
 - ✓ Investment income includes interest, dividends, and gains/losses, and is usually considered as part of revenue.
 - Think about the three types of revenue and support as slices on a pie graph. What are the relative sizes of the slices in your nonprofit?

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- The financial statements we're going to use as samples are prepared on the "accrual basis" of accounting, which differs from the more intuitive "cash basis" with respect to the timing of certain transactions.
 - In the cash basis, we recognize transactions in our books when cash changes hands. This is similar to the way individuals maintain their personal finances.
 - In the accrual basis, we recognize transactions based at the time of actual economic substance, regardless of when cash changes hands.

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- Examples of accrual transactions:
 - ✓ Revenue or cost is recognized when cash is exchanged...
 - Ticket sales at the box office
 - Salaries expense
 - ✓ Revenue or cost is recognized before cash is exchanged...
 - A donor submits a pledge
 - Office supplies purchased on credit
 - ✓ Revenue or cost recognized after cash is exchanged...
 - Ticket sales for the upcoming season are recognized as revenue as the shows are presented
 - Insurance policy for the coming 12 months is paid for up front

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- Now let's look at some sample financial statements. We're going to use as an example a performing arts company with a total budget just under \$300,000.
 - In this context, we use the word "budget" to mean revenue – an easy-to-use approximation of the scale of a nonprofit.

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- We'll look at its Statement of Activities and its Statement of Financial Position; i.e., its Income Statement and Balance Sheet.
 - These are prepared in accordance with Generally Accepted Accounting Principles (GAAP) and formatted as though they had been audited.
 - A full set of audited statements would also include a Statement of Cash Flows (and possibly a Statement of Functional Expenses) as well as several footnotes.

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- Now that we've reviewed a sample set of basic financial statements, what can we do with the information on them?
 - We can use them to understand how our nonprofit looks to outsiders (potential lenders or donors).
 - We can use them to understand our business better.
 - We can use them to compare our actual results to our budget.

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- How do outsiders look at our financial statements?
 - If we want to borrow money, what do our statements say to potential lenders?
 - ✓ Are we well capitalized?
 - ✓ Do we have the capacity to pay loans back?
 - ✓ Do we have assets that could be pledged as collateral?
 - If we want to ask for significant gifts or grants, what do our statements say to potential donors?
 - ✓ Is our financial house in order (i.e., do we spend and steward our money wisely)?
 - ✓ Do we already have enough money, or are we so strapped that they'd be risking putting money into a "black hole"?

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- What can we learn internally from our statements?
 - Let's look at the big numbers. They give us the first clue about what's important.
 - Let's think about comparative data. Financial statements are more informative when they compare across years than when they stand alone.
 - Let's think about strategy. Does our revenue and support pie graph, for instance, look the way we think it should? What actions might we want to start planning to make it look better?

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- Let's talk about budgets – what are they and how do they get created in the first place?
 - There are three basic types of budget: operating, cash, and capital.
 - ✓ The operating budget is what we looked at in the budget vs. actual exhibit.
 - ✓ We don't have time to move beyond this budget today.
 - Regardless of the type of budget, the most important component in preparing one is the assumptions. It's crucial that this responsibility be shared appropriately between board and committee members and key staff.

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- Uses for the operating budget:
 - As a planning tool – the process of developing assumptions brings together all the relevant history, forecasts, and strategies.
 - As a measurement tool – the comparison of actual results to the budget creates a foundation for evaluation and for course corrections as needed.
 - As a control tool – variances may indicate that some process is not well managed or has been subject to fraud or manipulation.
 - As a statement of values – the budget forces a focus on what the organization thinks is worth paying for and communicates that to stakeholders.

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- The final three topics:
 - Controls
 - Compliance
 - CASH

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- Controls:
 - It's everyone's responsibility to institute and enforce proper controls, especially over cash.
 - ✓ Segregation of duties – if your nonprofit isn't big enough to divide responsibilities among a number of staff, find appropriate roles for board members.
 - ✓ No one person should ever have control over money coming in, money going out, and money being accounted for.
 - ✓ Think about fidelity insurance (bonding) that protects your nonprofit in the event of theft by an employee or other trusted person.

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- Compliance:
 - Make sure all your filings are timely.
 - Make sure your 990 is accurate.
 - Consult with a lawyer and/or CPA to make sure you're keeping up with all new requirements.

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- CASH:
 - Keeping track of your cash is vital whether your books are on the cash basis or the accrual basis.
 - It's not enough to know how much you have now. You have to know if you're at any risk of running out of cash so that you can take preventive action.
 - A daily or weekly cash report is very helpful.
 - A cash flow forecast can be the most useful planning tool available to you.

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- Elements of an effective cash forecasting process:
 - Understand your expenditures pattern.
 - Understand your receipts pattern.
 - Understand your capacity for borrowing on your line of credit, if you have one and may need to access it.

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- Expenditure considerations:
 - ✓ Do you pay your employees weekly, bi-weekly, semi-monthly, monthly, or a combination?
 - ✓ Do you pay your bills regularly (e.g., every other week)?
 - ✓ Are there outgoing payments whose timing you don't control (e.g., interest withdrawn by your bank or rent paid by automatic transfer)?
 - ✓ Are there seasonal elements in your expenditures (e.g., special events, specific PR or printing expenses, etc.)?
 - ✓ Are there expenditures you can defer with little risk?

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- Receipt considerations:
 - ✓ Do you have recurring sources of revenue such as government grants or contracts?
 - ✓ Do you have relatively smooth fundraising income?
 - ✓ Do you have pledges or accounts receivable that you can count on collecting?
 - ✓ Are there seasonal elements in your receipts (e.g., special events, special fundraising campaigns, etc.)?

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- Borrowing considerations (if applicable):
 - ✓ What is the maximum availability under your line of credit?
 - ✓ Do you usually carry a balance?
 - ✓ Are you required to pay down the balance in full for some period during a year?

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- The absolute best and worst ways to manage your cash:
 - The best: collect any overdue pledges and accounts receivable.
 - The worst: hold off on paying payroll taxes.
 - ✓ Whatever the opposite of a “get out of jail free” card is, this is it!

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- Bonus information you won't hear at most seminars like this: the absolute best and worst kinds of contributions you can receive.