Financial Review Basics for Grantmakers

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Professional Services to Not-for-Profit Organizations

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When reviewing an organization for a grant, grantmakers typically request the following documents from a potential grantee:

Organizational Budget
Project or Program Budget
Financial Statements, audited or unaudited
IRS Form 990

This primer will provide a basic explanation of the information contained in each of these documents and offer some hints for gleaning the important facts quickly and easily. You do not have to be an accountant or financial expert to gain a better understanding of a nonprofit organization's operations from the financial documents.

Organizational Budget

This document is a projection of the organization's expected revenues and expenses for the current or coming year. It will be clearly divided into "Revenues" and "Expenses" and at the minimum, should include the following:

Revenues:

Every organization should have a minimum of two sources of income: contributions and interest. Why? Because all organizations should be utilizing some kind of interest bearing account for the contributions they collect. Most organizations also have other sources of income, including but not limited to: Program Revenue, Special Events Revenue, Government Contracts and the mysterious "Miscellaneous Income." Miscellaneous income is generally a combination of small income sources that on their own would not amount to a material source of income.

Expenses:

Organizations often vary in how they present their expenses in their budget. Some groups elect to present expenses by function, such as salaries, rent, supplies, etc. Others present their budget by the broad categories of "Program", "Administrative" and "Fundraising" with varying degree of detail under each category, either by function or program.

As a grantmaker, you may wish to request that grantees format their budget in a particular way to provide you with the information you most need to know.

Program or Project Budget

This document is similar to the Organizational Budget, except that it serves to isolate those revenues and expenses pertaining to the particular program or project.

When Reviewing a Budget, Ask Yourself …

1. Is the budget balanced?

Simply, this means, "Does the organization plan to earn at least enough revenue to cover all of its expense?" Ideally, the organization will plan to earn more than it spends, returning the surplus at the end of the year to the organization's reserve. Advanced organizations even budget for a specific surplus, including "Addition to Reserves" as a line item expense.

2. Does the budget look complete?

Are all reasonable sources of income identified? Are all reasonable expenses identified? For example, a school without a designated salary expense would raise a red flag. Conversely, you want to be aware of any padding or extraneous expenses. For example, a literacy program with international travel expenses may also raise concerns.

3. Does the budget seem reasonable or realistic?

The best tool for answering this question is common sense. But consulting the other financial documents you have received or previous years' performance can add a lot. When reviewing a budget, it would be helpful to have the prior year's audited financial statement or at least a copy of the organization's IRS 990, which if not provided by the organization, can be obtained from guidestar.org.

Look to see if the budgeted revenues, both as a whole and separately are comparable to those earned in previous years. For example, an organization that earned only $30,000 in grants in each of the two previous years (as found in the financial statements) should not expect to earn $130,000 in the coming year without a solid explanation for how they hope to achieve such an increase in support.

Conversely, if an organization that annually earns $60,000 in government contracts budgets to earn only $10,000 in the coming year, they may have lost a major contract or seen funding in their area drastically cut under a new administration.

Also look to see if expenses are comparable to previous years. If they are either significantly higher or lower, seek an explanation. Costs will increase if programs are being expanded and will decrease if programs have been eliminated or downsized.

Financial Statements

Financial statements are a compilation of financial “snap shots” that tell you different things about the organization’s past financial performance. Whether audited or not, complete financial statements should include the following financial tables:

Statement of Financial Position (also known as Balance Sheet)
Statement of Activities (also known as Income Statement of Revenue and Expenses)
Statement of Cash Flows

And may also include:

Statement of Functional Expenses

Even a quick review of these documents can tell you a lot about an organization.

Statement of Financial Position

This table is a picture of the organization’s financial health at the close of the fiscal year or other specified time period. It is sometimes helpful to think of this document in terms of “If this organization closed its doors tomorrow, what would we have?”

The statement is always broken into two sections: **Assets and Liabilities & Net Assets.**

Assets are any resource, object, or right of measurable financial value and include liquid assets (cash and cash owed to the organization and negotiable instruments, such as securities, quickly turned into cash) and non-liquid assets (buildings, supplies, etc. with value, but are more difficult to turn into cash). If the organization were to close tomorrow, its assets would be what it would have at its disposal to settle debts.

Liabilities represent any claim on the organization’s assets by an outsider and include accounts payable, accrued expenses and outstanding loans. If the organization were to close tomorrow and did not incur another expense, liabilities are the payments the organization would still be obliged to make.

Net Assets are the difference between total assets (what is owned) and total liabilities (what is owed) and should match the excess or deficit identified at the close of the year on the Statement of Activities.

Assets - Liabilities = Net Assets

When Reviewing A Statement of Financial Position, Ask Yourself …

1. Can the organization cover its current liabilities?

Generally, you want to know if the organization can cover its current liabilities (the obligations due within a year) with its cash and accounts receivable. This calculation is known as a Quick Ratio.

To obtain a Quick Ratio, you would take the cash and accounts receivable and divide it by current liabilities. For most nonprofits, you would want to see a ratio of 1 or more. A ratio of less than one may mean that the organization is facing or may face cash flow issues.

2. How much does the organization rely on borrowed money?

You would determine this by calculating the organization's Debt to Net Asset Ratio. This calculation is obtained by dividing loans and notes payable by net assets.

For some organizations, a debt management allows them to leverage their available assets to provide the greatest amount of services in a given year. For others, an over reliance on borrowed money main indicate that the organization is having a hard time meeting its obligations. A high debt to net assets ratio should be followed up with questions in order to determine whether or not it is an appropriate strategy for the organization.

3. How does this year compare to last year?

In most audited financial statements, you will see the previous years figures restated to the right of the current year for comparison. You would want to note any significant deviation between years. As a whole, a significant increase in liabilities and a decrease in assets may be a red flag.

Deviations in the make up of assets may also be a signal. For example, an increase in cash and a decrease in hard assets like buildings or supplies may indicate that the organization is selling off its hard assets to meet its obligations. While there may be other sound management reasons for selling off hard assets, further explanation from the organization is warranted (and may be found in the notes to the statement, which will be discuss ed later)

Statement of Activities

This is a record of the organization's financial activities of the year. Like a budget, the Statement of Activities always includes Revenues and Expenses. Unlike a budget, accounting rules specify a specific presentation of the financial information included in a Statement of Activities.

<u>Revenues</u>

Revenues for nonprofits are broken down into 3 categories: *Unrestricted, Temporarily Restricted and Permanently Restricted.* These categories may be presented in columns across the page or sequentially down the page, after the expenses for each category.

> *Unrestricted* revenues are those funds the organization earns or receives for which no donor-imposed stipulation has been made.
>
> *Temporary restricted* revenues include those contributions for which a donor has specified a particular use or time period. Temporary restricted contributions are released from restriction when the stipulation is met. For example, if an organization receives a grant for a particular program, the restriction is met when the organization incurs expenses for that program.
>
> Time restrictions may also be placed on donations, and such donations would be released with the passage of time. For example, a grant may be given specifically in support of an organization's 2004 operations. This restriction would be met as the organization incurs expenses in 2004.
>
> *Permanently restricted* funds are those contributions made to an organizations endowment. These funds may not be used for any other purpose and are never released from restriction, generally speaking.
>
> A note on "quasi-endowments" and/or "Board Designated Funds": these unrestricted funds are revenues set aside by the organization, often at the direction of the board, to create a reserve. Such funds are not permanently restricted and may be released for use at a later date according to the organization's spending policy or board discretion.

All Statement of Activities should include at least two sources of income, contributions and interest, and generally include many more.

Frequently, you will see a revenue line for "Net Assets Released from Restriction", which represents money contributed for a particular purpose or program either in the current year or in prior years and released from restriction according to the practices outlined above.

<u>Expenses</u>

Expenses are presented by major classification including *Program Services* (which may be further broken down by major program), *Management & General, and Fundraising*.

Program expenses include those expenses related to the actual pursuit of the organizations mission and include, among other things: rent, salaries, utilities, and supplies.

Management & General expenses are those expenses related to the administrative management of the organization. Management and general expenses are a requirement of doing business and include, among other things, the salaries for the financial staff and human resource staff, the cost of an audit, and board materials.

Fundraising expenses are those expenses directly related to bringing funds into the organization and include, among other things, the salaries of the Development staff, the cost of direct mailings, and special events.

When Reviewing A Statement of Financial Position, Ask Yourself …

1. How reliant is this organization on contributions?

Ideally, organizations will have a diversity of revenue sources, including contributed funds, program revenue and/or government contracts (which may also be called program revenue by some organizations). To determine how reliant an organization is on contributions, you would divide the contributed income by total income.

As contributions are one of the least reliable sources of income, an over reliance on contributed support may pose problems in a down economy. That said, many organizations remain nearly 100% contribution supported, although other revenue schemes are becoming increasingly common among innovative nonprofits.

2.How reliant is this organization on *MY* contribution?

To determine the significance of your requested contribution, divide the grant request by the total revenue the organization received. (You may also calculate this figure using the projected total revenue included in the budget.)

In order to maintain an organization's independence, a common rule of thumb dictates that one funder should not supply more than 10% of an organization's total revenue. However, different donors and foundations have different philosophies about what percentage of an organization's revenue they are willing to supply, and differing levels of support may be more appropriate for different foundations and/or the organizations they support.

For example, with a new or younger organization, a foundation may feel comfortable providing a significant portion of the organization's revenue as it gets started and grows it reputation. Similarly, a foundation may feel more comfortable being a primary sponsor of a new, innovative or particularly needed program. And some corporate funders prefer to be the "sole sponsor" of highly visible programs.

On the flip side, however, a foundation may feel uncomfortable providing the majority of resources for an organization or program if it cannot make a long-term commitment to providing a similar level of support each year or to assisting the organization to find other resources. Similarly, if an organization or program seems to be losing major supporters and is looking to your foundation to help make up the difference, it may be useful to inquire as to why other foundations are reducing their support.

3. How much of the organization's revenue for the year remains temporarily restricted?

By dividing temporarily restricted net assets by total net assets and multiplying by 100, you will get the percentage of funds that remain temporarily restricted at year end. In most cases, however, you can simply "eye ball" the figures to tell if there are significant temporarily restricted funds.

Unless saving for a future program or specific purchase, an organization should not have large amounts of temporarily restricted funds at the close of a year. If they do, it may indicate that they are not appropriately allocating their expenses for specific programs or grants or that they are having difficulty with a specific program.

For example, a particular organization may have been successful in raising funds to provide after school art and music classes to minority children in their community. However, because of scheduling conflicts, under advertisement or surplus supply of such program in their community, they are not attracting enough students to begin classes. As such, much of the money raised for this specific program cannot be "released from restriction".

Additionally, some organizations may be successful in raising temporarily restricted (program or project specific) funds or permanently restricted, but unable to cover their administrative and general expenses due to a lack of unrestricted revenue.

4. How does this organization spend its money?

This is the fundamental question one seeks to answer when reviewing financial statements. And there are many ways to come up with an answer. The trick is to decide what is important to you or your foundation.

One way is to look at the organizations *expense ratios*. Commonly used by charity watchdogs and rating agencies, nonprofit managers often dispute these ratios and their use remains controversial to some. However, when used along with other factors, these common ratios can serve to raise red flags and provide guidance for further fact gathering. The most common expense ratios look at the major categories of expenses. The most common among these ratios is the Program Expense Ratio.

Program expense ratio is calculated by dividing an organization's program expenses by total expenses. At a minimum, most watchdogs require that at least 60% of total expenses be comprised of expenses directly related to the provision of goods and services related to an organization's mission. Most organizations exceed this minimum standard.

You may also wish to look at what portion of the organization's program expenses are attributable to a particular program to determine how important the program you are asked to fund is to the organization's overall operations.

5. How efficient is the organization's fundraising strategy?

Another expense ratio you may wish to look at is the *fundraising ratio.* This is calculated by taking the amount an organization spent on fundraising and dividing it by its total contributions (or those revenues directly generated from fundraising activities). The resulting number is a rough estimation of how much of each dollar raised was spent to bring that dollar in the door. Most watchdogs say that for any given year, an organization's fundraising ratio should be no higher than 35%—or an organization should not spend an average of more than 35 cents of each dollar raised on fundraising.

Additional Components of Audited Financial Statements

Statement of Functional Expenses

This statement, which is required for all health and welfare organizations, but only recommended for other nonprofits, is a more detailed presentation of the expense information contained in the Statement of Activities.

The Statement of Functional Expense presents expenses by major function, such as salaries, rent, utilities, travel, etc. for each major category of expense (Program, Management & General, and Fundraising.) For organizations with more than one major program, functional expenses are also broken down by specific program.

This statement provides further clarification of expenses and it is useful to note the distribution of important expenses like salary and rent across program and major expense category.

Auditor's Opinion

This is the first page of any audited financial statement and tells you what the auditors did and what they found.

The first sentence generally states that the firm "has audited the accompanying statements." If this letter states that the firm merely "reviewed" or "prepared a compilation" —a full audit of the statements was not conducted and the auditors are limited in what they can say or attest to about the organization's financial condition.

If there were any major irregularities found in the process of conducting an audit, this letter will call attention to them. If there were none, as is the most common occurrence, the letter will contain language similar to the following:

"In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC organization as of (close of fiscal year) in conformity with generally accepted accounting principals."

Notes

Notes are an essential part of every financial statement and contained additional information and clarifications to the numbers presented. You should skim the notes, keeping in mind the following.

General Disclosures

In most cases, the first note is an explanation of the organization's tax status and purpose. The second will be a summary of accounting practices and outline the both the GAAP presentation requirements and the specific practices of the particular organization.

Assets

Some organizations add more detail to the numbers presented at a high level in the proceeding statements. For example, specific property and equipment may be listed in the notes as opposed to the statement of financial position. You can learn a lot about various properties owned and/or managed by reviewing the notes.

Related Party Transactions

Related party transactions are also detailed in the notes and may be of interest. Related parties are any party that can exercise major control or significant influence over the organization. Common related party transactions revealed in the notes include: payments to or from an affiliated organization, services or goods purchased from a board member, renting space from a related entity or board member or the donation of same.

Realized and Unrealized Gain on Investments

The details of an organization's investment performance are often included in the notes. This is an important note to review when reported gains are particularly high. In many cases, the greatest gain is "unrealized" or "paper gains" on securities held but not sold. The amount included in the balance sheet represents the value of the securities if they would have been sold at the close of the fiscal year. But they weren't and that value has therefore not truly been captured and may actually be significantly lower should the organization move to sell those securities at a future point.

The IRS Form 990

The Form 990 is simply the tax return for an organization exempt from paying most taxes, or more commonly, a not-for-profit corporation. The 990 is also the most publicly available document a not-for-profit produces.

In many ways, the 990 is a financial statement in another format and much of the information and guidance provided on reviewing a financial statement can be applied to the information included on the 990. Although certain revenues and expenses are reported differently on the 990 than they would be in an audited financial statement, the basic principles of analysis apply.

Page 1, Part I: **This is the equivalent of the Statement of Activities**
Page 2, Part II: **This is the equivalent of the Statement of Functional Expenses**
Page 3, Part IV: **This is the equivalent of the Statement of Financial Position**

But the 990 also provides useful information generally not including on in financial statements, including:

Page 4, Part V: **List of Officers, Directors, Trustees and Key Employees, including hours and compensation**

From this section you can both identify the trustees and monitor the compensation of the key employees. A word of caution, however, in order to judge whether or not the compensation paid to an employee is unduly large, you should consult salary charts and other 990s for similarly sized organizations in similar fields. Often people outside the nonprofit sector have a misperception that salaries in the sector are or should be low - or at least lower than those in the for-profit sector. While this is very often the case, it is not always so. In particular, CEOs, Directors of Development and CFOs may be competitively compensated.

Schedule A, Part I: **Compensation of the 5 Highest Paid Employees other than Officers, including titles and hours**

See above notes on compensation.

Schedule A, Part II: **Compensation of the 5 Highest Paid Independent Contractors for Professional Services**

From this section you can monitor what service providers are being utilized by an organization. It is not uncommon to see outside fundraisers listed here.

Schedule A, Part IV: **Support Schedule**

From this section you can monitor an organizations revenue history over the prior 4 years. It is useful to take note of any significant deviations or down ward patterns.