Section 4: Getting the Most Out of Your Financial Statements

Financial statements are critical to a CAA as they report its operating results and financial condition. While a CAA's management is responsible for preparing the statements, a CAA's board of directors is responsible for reviewing and discussing them at each board meeting. **CSBG Organizational Standard 8.7** requires a CAA's governing board to receive financial reports at each regular meeting that include the following: (1) an organization-wide report on revenue and expenditures that compares budget to actual, categorized by program; and (2) a balance sheet/statement of financial position. **CSBG Organizational Standard 8.9** also requires a CAA's governing board to annually approve an organization-wide budget.

This Toolkit will help both CAA boards and management comply with these requirements and derive the maximum benefit from the CAA's financial statements by addressing the following:

- **Part I: How to Use Financial Statements —The Process**
  Part I focuses on what the board and management should do with the financial statements. The detailed process presented here is the ideal. Each board must decide what steps in the process are important for its organization, what is best left to management, and what is best left to its finance committee. The bottom line: most boards should be doing more financial review than they are inclined to do.

- **Part II: What's in the Financials**
  Part II focuses on the information included in the financial statements. It examines each of the five component parts of a set of basic financial statements.

Part I: How to Use Financial Statements—The Process

What Is GAAP and Who Is FASB?

Over time, a body of rules and conventions has developed for financial statement presentation. These rules are referred to as Generally Accepted Accounting Principles (GAAP). In the United States, the Financial Accounting Standards Board (FASB) has taken on primary responsibility for formulating GAAP and now offers a free comprehensive online tool (available at *http://asc.fasb.org/*) that allows nonprofits to determine the GAAP accounting and reporting requirements in any situation. CAAs may find the AICPA's Audit and Accounting Guide for Not-for-Profit Entities even more helpful.

The discussion in this Toolkit does not focus on the intricacies of GAAP, but it reflects that body of guidance. No law requires financial statements to be prepared in accordance with GAAP. However, if an organization that does not follow GAAP seeks an outside audit of its financial statements, the auditor's opinion letter most often will include a qualification that the statements do not conform to GAAP. If the CAA has an Single Audit (formerly referred to as an OMB Circular A-133 audit) which is required if the CAA expends at least $750,000 in federal funds in its fiscal year, the auditor is required to determine and note in the auditor's report whether the financial statements comply with GAAP.

Given that some funding sources may not accept an audit report with a non-GAAP qualification, **CAPLAW advises CAAs to adopt GAAP-financial policies and present GAAP compliant financial statements.**

Requirements for Federal Grantees

Organizations that receive federal grants or subgrants must comply with federal rules concerning financial systems intended to safeguard the use of those funds and ensure the funds are used for their intended purposes. The key requirements are contained in 2 C.F.R. Part 200, the Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Grants (the Uniform Guidance), which require that the financial management system of each non-federal entity provide, among other things:

1. Accurate, current, and complete disclosure of the financial results of each Federal award or program in accordance with the reporting requirements set forth in §200.327;

2. Records that identify adequately the source and application of funds for federally-funded activities. Grantee records must contain information pertaining to federal awards, authorizations, obligations, unobligated balances, assets, expenditures, income and interest;

3. Effective control over, and accountability for, all fund, property, and other assets, including controls to safeguard all assets and assure that they are used solely for authorized purposes; and

4. A comparison of expenditures with budget amounts for each Federal award.

Subpart E of the Uniform Guidance sets forth **Cost Principles** that define the different types of costs (e.g., direct and indirect) that may be charged to a federal award, explain generally how costs may be recovered from a federal award, and identify specific costs which may be recovered from federal awards. **Appendix IV to the Uniform Guidance** guides the determination of **indirect cost rates** for nonprofit grantees, which are used to recover costs that are not readily identifiable with a specific federal award. For recipients of grants funded by the U.S. Department of Health and Human Services (HHS), the Uniform Guidance is codified at **45 C.F.R. Part 75** and includes a few variations specific to HHS funded programs.

Tip

CHECK YOUR AWARD DOCUMENTS

Check your notice of award (if a federal grant or cooperative agreement) or grant agreement terms and conditions (for a state grant or contract) to confirm which federal rules govern your grants. In some cases, states may incorporate other rules relating to program eligibility, allowable costs, and financial systems and statements as well. Check all references to state statutes and administrative rules to be sure you are aware of the requirements you must meet to comply with each agreement.

Common Myths About Nonprofit Financial Statements

Myth 1: "Only a CPA Can Read Financial Statements"

Financial statements can be intimidating to those who are unfamiliar with them—all those numbers and columns. Nonetheless, with minimal effort, anyone can gain insights into a CAA's finances by reviewing its financial statements. The rules governing how information is presented in a CAA's financial statements are designed to make that information understandable to a lay audience.

Even board members who regularly review financial statements produced by businesses find nonprofit statements somewhat perplexing. There are at least two reasons for this. First, the CAA often prepares interim financial statements for review at its regularly scheduled board meetings in non-standard formats or without notes. The lack of explanation and conformity with established norms in the corporate world is troubling to many who otherwise are comfortable with financial statements. Second, as will be discussed, nonprofit financial statements divide net assets and income into two distinct categories designed to reflect the degree to which the net assets and income are subject to legal restrictions. This additional information does not appear in financial statements for business entities. Fortunately, any confusion can be addressed through education.

Myth 2: "Financial Statements are Only of Interest to Management, Not the Board"

Understanding the financial condition of the organization and guiding the use of resources are core legal responsibilities for boards. Financial statements are an important board tool for assessing management's performance and stewardship of the organization and its resources.

CASE SCENARIO #1:

INCORPORATING A THOROUGH DISCUSSION OF ORGANIZATION FINANCES INTO THE MEETING

Blue CAA (BCA) has a board meeting scheduled for next Wednesday night. The packet for the board meeting went out last week, which contained the Statement of Financial Position (or Balance Sheet) included as Exhibit 1 on the following page. The meeting agenda accompanying the packet includes reports from the heads of the Head Start and weatherization programs, a discussion of whether BCA should hire an assistant vice president for human resources, a report from the head of HR on a new employee evaluation form, and routine matters. At the time the agenda was drawn up, BCA's executive director was unsure whether BCA's CFO, Howard Castle, would be able to attend the meeting because Castle's son has a Little League game the night of the meeting. Nobody was all that concerned whether Castle would attend because the discussion of finances usually takes no more than five minutes. Most board members believe that the Gloria Watson, BCA's executive director, can report the amount of cash on hand just as well as the CFO, particularly because nobody worries about financial issues so long as there is enough cash to cover 3 months of expenses.

At the board meeting, the reports on Head Start led to a very lengthy discussion of changes in the menu and the difficulty some children were experiencing in getting used to eating so many vegetables. This led to a variety of comments about the possibility of cultural bias in concerns about childhood obesity. In the last five minutes of the meeting, the chair asked Gloria to report on the finances. She pointed out that the cash balance had slipped slightly below the desired 3 months of operating expense level but noted that she understood that a payment had arrived the day after the financial statements were prepared. A board member asked why the accounts payable and salaries payable line items were so much higher than the previous month but the chair noted that it was time to adjourn and commented that he was confident that BCA always paid its bills on time.

LESSON: BCA's board is being remiss when it comes to financial issues. The board should thoroughly discuss BCA's finances at each board meeting. To facilitate that discussion, the packet sent to board members should include a complete set of financial statements, including the balance sheet, together with a schedule or summary reporting on how expense and income items deviated from budget and basic analysis of the adequacy of the cash position and BCA's progress towards its goals for operating reserves. In a perfect world, BCA's board would have a finance committee, and that committee would include key financial metrics and a summary of BCA's finances in the board packet. At the meeting, the board should be discussing the results of operations and key asset and liability balances. It should be assessing the adequacy of BCA's financial resources and whether those resources will permit BCA to pay its bills and liabilities in an orderly and timely fashion.

Too often, boards want these discussions to be quick. This is a mistake. No organization can survive on reports about program accomplishments and ideas for new programs alone. At the end of the day, everything comes back to financing programs and new ideas. In fact, as part of their reports to the board, the heads of the Head Start and weatherization programs should be asked to discuss the adequacy of program finances and budgetary expectations in addition to offering examples of program accomplishments.

Myth 3: "The CAA's Outside Auditors Prepare the CAA's Financial Statements and Monitor its Finances"

The professional standards governing auditors couldn't be clearer: management is responsible for the preparation and the content of the CAA's financial statements. If management is unable to prepare financial statements without significant assistance from the outside auditors, both the board and management are most likely making decisions based on inadequate information.

Exhibit 1: Statement of Financial Position (Balance Sheet)

BCA
Statement of Financial Position
September 30, 2019
with comparative totals as of June 30, 2019

	9-30-19	6-30-19
Assets		
Cash	$160,000	$200,000
Receivables	501,100	281,100
Prepaid expenses	200,000	100,000
Land, buildings, equipment (net of accum deprec)	1,500,000	1,510,000
Total assets	**2,361,100**	**2,091,100**
Liabilities and Net Assets		
Liabilities		
Accounts payable	190,000	170,000
Line of credit payable	250,000	150,000
Unemployment Comp Reserve	80,000	50,000
Total liabilities	**520,000**	**370,000**
Net Assets without Donor Restrictions		
Available for operations	-8,900	11,100
Invested in fixed assets	1,500,000	1,510,000
Board designated reserves	100,000	100,000
Subtotal - Unrestricted net assets	**1,591,100**	**1,621,100**
Net assets with donor restrictions	**250,000**	**100,000**
Total Net Assets	**1,841,100**	**1,721,100**
Total Liabilities & Net Assets	**$2,361,100**	**$2,091,100**

Myth 4: "Only the Financially Savvy Board Members Need to Pay Attention to the CAA's Finances"

This is the biggest and most dangerous myth of them all. Too often, the non-financially oriented members of a board delegate the discussion of the organization's finances to the financially literate members of the board. Many board members think this review is best relegated to a finance committee so that valuable board time isn't wasted. This approach treats finance as separate and distinct from mission. Nothing could be further from the truth. Some managers share this myopia. These individuals are mission people, who erroneously believe finance and accounting are a nuisance, best left to the technicians.

CAAs operate as nonprofits, but CAAs are nevertheless businesses. Like other business corporations, CAAs employ people, pay utility bills, rent property, and borrow money from banks. A CAA will face bankruptcy if revenue doesn't exceed expenses or cash flow does not permit the CAA to timely pay its bills. A CAA that ceases to exist has no mission.

The term "nonprofit" can be confusing, leading some board members to believe that a "nonprofit" cannot make a "profit" and must strive to have revenues equal expenses exactly. This is a very dangerous misunderstanding. A nonprofit can generate a profit (referred to in the nonprofit world as a "surplus" – which occurs when revenues exceed expenses), but it can't distribute that profit to board members or anyone else as a "dividend". There is nothing wrong with earning a surplus. Any surplus the nonprofit generates becomes part of its net assets, providing reserves to sustain the organization through hard times, resources to take risks on new programs, and a way to manage cash flow problems that result from governmental funders delaying payments on cost reimbursement contracts. Building net assets and adequate cash reserves can be very challenging for CAAs because so many governmental funding agreements include "use it or lose it" requirements. CAA boards must understand the need to build adequate net assets and cash reserves and the challenges posed by governmental funding requirements, and work together to develop strategies that will ensure their CAA's continuing financial health.

Myth 5: "Mission is Greater Than Any Financial Concern"

Mission needs finances and can easily be constrained by them if they are not fully understood. Those who refuse to acknowledge the link between mission and finances are setting themselves up to be "rolled" on issues of policy by those who are comfortable with finances. Rather than debate a decision on the merits, the financially literate sometimes focus on financial aspects of the debate, causing those who believe there is only one way to look at numbers to concede policy calls.

CASE SCENARIO #2:

FINANCES AFFECT MISSION

Assume that BCA is considering a new program to combat gang activity in a neighborhood. Some on the board oppose the proposed approach. Rather than arguing the merits, they may look to the numbers. The opponents may ask an accountant to prepare a financial forecast that assumes a two percent growth in a base grant for the program, and expenses that grow at ten percent per year. Under those assumptions, the program is not financially viable. Those assumptions, however, are open to question. The city has expressed great interest in this program and shown a willingness to fund it to the max. Moreover, the forecast does not take into account that adding this program would allow BCA to spread its overhead costs over a larger base, reducing the burden each other program must bear and freeing some unrestricted funds that are currently used to subsidize programs with inadequate grant funding to cover their share of overhead costs. Unless the program's proponents are willing to challenge a dubious financial assumption, they may yield to the claim that the program will produce a large and unacceptable deficit. But to mount that challenge, the program's proponents must be willing to examine the numbers and underlying assumptions, including the impact on the overall budget, recognizing that the financial facts and figures can be viewed through different prisms.

LESSON: No board member should ever blindly accept financial projections without understanding the assumptions that lie behind it. There are different ways to interpret numbers, and budget proposals always are based on assumptions. Unless a board member understands the assumptions that have been used to create the numbers, they will cede the policy battle to those who are willing to wage the battle based on the numbers.

Board Review of Financial Statements

Every regular board meeting should include a review of the CAA's financial statements, whether year-end audited statements or interim statements. Typically, the interim statements are less formal than the audited ones, but if the CAA's accounting system is a good one, these statements should be relatively accurate. To give board members the information they need for effective oversight and direction setting, the interim financial statements must include a Statement of Financial Position (Balance Sheet) and an organization-wide Statement of Activities (Income Statement) with comparisons to budget. The interim statements should include program-by-program revenue and expense reports and compare actual results achieved to specific program budgets. Most CAAs will expect their management to do the most detailed comparisons of program-by-program and grant-by-grant revenues and expenses to budget, and bring unexpected results to the attention of the finance committee and/or full board.

CAPLAW recommends a six-step approach to the review process:

Step 1: Review by the CFO and Executive Director

The Executive Director's review of the financial statements provides an essential control to ensure that the statements are complete and accurate, and that all of the financial information the ED is aware of has been communicated to the CFO or Fiscal Director and is reflected clearly in the reports. The CFO or Fiscal Director's review should focus on identifying any underlying financial problems that should be pointed out to the Executive Director and the finance committee.

Many Executive Directors and CFOs also expect Program Managers to review financial reports of income and expenses in comparison to budgets for their programs. This review provides an important additional opportunity to spot errors or omissions in the preparation of the statements.

Step 2: Preliminary Review by the Finance Committee

The CAA board should have a standing finance committee. The committee should review the financial statements in advance of the board meeting, prepare an analysis of the statements to send to all board members before the meeting, and designate the committee chair or another committee member report on the statements at the board meeting. If the CAA board does not have a finance committee, the Treasurer should be designated to review the statements in advance of the meeting and lead the discussion. The Treasurer should work closely with the CFO or Fiscal Director to be sure they have a clear understanding of the statements and of any issues that should be pointed out to the board. The CFO or Fiscal Director should be present at the board meeting and be prepared to answer questions that board members raise.

Step 3: Review by Every Board Member

Ideally, every board member should receive a packet of financial information at least one week in advance of the scheduled board meeting. The packet should include a complete set of financial statements, and if possible, an analysis of the statements from the board's finance committee or the CAA's CFO or Treasurer. Each board member—no matter how financially illiterate—should review the financial statements before the meeting.

Step 4: Regular Discussion of the Financial Statements

The meeting agenda should set aside sufficient time to permit a thorough discussion of the financial statements. The discussion should include a review of:

- The **Statement of Financial Position** (or the Balance Sheet) (Exhibit 1), including discussion of:
    - Liquidity—the CAA's cash position in relation to its obligations—to ensure that the CAA will be able to meet its obligations as they become due;
    - Net assets without donor restrictions available for operations; and
    - Net assets with donor restrictions.
- The **Organization-wide Statement of Activities** (or Statement of Revenues and Expenses) (Exhibits 2A and 2B), including discussion of:
    - Program-by-program analysis of revenue and expenses; and
    - Variances from budget—comparing what actually happened with the annual plan.
- The **Statement of Cash Flows** (Exhibit 3), including discussion of:
    - Why the CAA's cash has increased or decreased over the period reported on the financial statements;
    - The impact on cash that results from comparing the sources and uses of cash in three categories – operating activities, investing activities, and financing activities; and
    - Why the accrual basis information about revenues, expenses, and net income reported on the Statement of Activities is related to the actual increase or decrease in cash for the period.
- The **Statement of Functional Revenues and Expenses** (Exhibit 5), including discussion of:
    - The revenues and expenses associated with each program, with management, and with fundraising;

- The extent to which each program, and the management and fund raising functions generated sufficient income to cover its costs; and
- The extent to which each program generated sufficient income to cover its fair share of the management and overhead costs of the CAA.

- The CAA's **overall financial health**, including:
  - Key financial metrics;
  - Stability of the CAA's grants and other revenue sources;
  - Progress toward goals for net assets without donor restrictions;
  - Progress toward achieving target days of cash on hand; and
  - Any other matters involving finances warranting discussion.

Step 5: Once-a-Year Discussions

At least once a year, the board should discuss the following matters in detail (though the board need not address all of these topics at the same meeting):

- The auditor's annual report and management letter (note: the auditor should meet with the full board or the finance committee to present the report, answer board members' questions, and alert the board to any problems encountered during the audit and any issues the auditor has identified in regard to the organization's financial health);
- The CAA's annual organization-wide budget;
- The CAA's system of internal controls;
- The CAA's overall financial health, including its liquidity and unrestricted net assets; and
- The CAA's long-term financial plans and needs.

Step 6: Questions and Answers

Time should be set aside during each discussion of the CAA's finances for a robust Q & A session. Questions should be encouraged.

CASE SCENARIO #3:

A COMPLETE SET OF STATEMENTS

BCA's CFO, Howard Castle, decided that providing the board with a complete set of financial statements is a mistake. In Castle's view, the board should review a detailed schedule showing each program, the revenue associated with the program, and the related expenses. He does not provide a balance sheet presenting assets, liabilities, and net assets, and also does not provide a comprehensive organization-wide statement of activities that presents income and expenses from all activities and the resulting changes in net assets. Castle believes CAAs are unique because of their reliance on multiple revenue streams that must be used for specified purposes. In his view, entity-level financial statements make no sense because grant revenue from one program (e.g., weatherization) cannot be used to finance another program (e.g. Head Start).

Castle is providing the board with useful information, but he is ignoring the value of entity-level financial statements. BCA has a revolving line of credit to finance its working capital. In administering the loan, the bank looks to the entity as a whole, which means the board needs to also look at the entity as a whole to make sure that there is sufficient liquidity to satisfy BCA's bank. Similarly, BCA's trade creditors (e.g., the electric utility, suppliers, communications company) also focus on BCA as an entity rather than on particular streams of revenue. The board should be looking at BCA through the eyes of those creditors. Moreover, not all assets are restricted to a particular program. Most organizations have unrestricted cash, receivables, and fixed assets (equipment and buildings). The board should be monitoring these on an ongoing basis. Finally, if the board wants to expand into new areas, it needs to understand the resources available for expansion.

The accounting profession shifted two decades ago from the approach advocated by Castle to one that favors entity-level financial statements for nonprofits. This in part reflects the desire to make financial information more accessible to board members who are familiar with standard business financial statements. Although Castle may have legitimate reasons for disagreeing with the current approach to nonprofit financial reporting, he should keep one fact squarely in mind: providing the board with a complete set of financial statements does not preclude him from supplementing the financial statements with schedules that show operations on a program-by-program basis. In fact, that is to be encouraged. One effective option is to use a columnar approach to the income statement, including both the totals for each category across the organization, and a breakdown across the columns by grant or program. An example of this approach is found in the Statement of Functional Revenues and Expenses in Exhibit 5.

LESSON: A board member who does not receive a complete set of financial statements, including the balance sheet, should demand them. Examples of these statements, including a balance sheet, a statement of activities (income statement) and a cash flow statement, can be found in the appendices to this section. Those who think board members won't understand them or will be hopelessly confused are doing everyone a disservice, including themselves.

Examining Budget Variances

CAAs and their boards should routinely review variances between actual and budgeted revenues and expenses. This review involves comparing key income and expense accounts and resulting net income against budgeted amounts.

Budget variances can provide an early warning, protecting the CAA from unexpected outflows of financial resources and shortfalls in expected revenues. Both management's and the board's responses will be far more meaningful if the problems are identified during the year rather than when the board examines the audited financial statements several months after the end of the fiscal year, when the resulting problems may be insurmountable rather than correctable. In addition to protecting the CAA's fiscal integrity, a careful examination of variances from budget can provide programmatic and operational insights. Assume, for example, that labor expense is running twenty percent above budget. Management should identify the underlying problem and its plan to resolve it. For example, the CEO might report:

- One program has incurred substantial overtime due to increased demand and management plans to add several positions which will result in overall labor savings through reduced overtime.
- Income from the energy program is based on the volume of services provided and is below projections because staff have been unable to process the anticipated volume of paperwork. Management plans to retrain staff to streamline processing.
- Management has identified an opportunity to reduce labor costs by increasing the number of families assigned to Head Start family case managers.
- Several employees were discovered to be submitting time sheets with fictitious hours. Those employees have been fired and all employees are being re-trained on this issue.
- The demand for mortgage counseling services is much higher than anyone anticipated. Several proposals have been written to explore additional funding.
- The CAA is looking at holding group sessions on early fatherhood rather than relying so heavily on one-on-one counseling.

In sum, budget variances and the entire discussion of finances provides an opportunity for a systematic examination of programs.

In all CAAs, management should be reviewing the details of variances from budget systematically. The board has some latitude in how it approaches the review of variances. It may want management to provide a detailed schedule, or it might ask management to prepare a short discussion of the causes of major variances and strategies management intends to use to deal with them. If in reviewing the details of variances from budget, the board opts for a robust and complete schedule, the report should display the variances for the current period (month or quarter) and the year-to-date. It should show both the dollar variance and percentage that the actual revenue or expense line item comprises the budget for that line item.

Some boards might agree to examine all variances above a certain percentage, but the better approach is to target the examination of variances that are both material and meaningful. Materiality will often turn on the particular income or expense category. As an example, assume the budget shows that $10,000 of charitable contributions will be received each month. In the past, all contributions have come from a fundraising event held in August. As a consequence, there is not much point in focusing on a $10,000 variance from the budgeted January amount, but if there is a large cumulative variance in September, the board should determine why the August event failed to produce the expected revenue. The board may also request that staff break the annual budget into monthly segments that reflect the seasonal nature of key revenue and expense items. In this approach, comparison of actual year-to-date income to the year-to-date budget for the fundraising event would have made it clear that the event was not planned to occur in the earlier months and avoided needless anxiety.

Tip

DEMAND SPECIFIC SOLUTIONS TO BUDGET VARIANCES

Management should prepare complete explanations of all material budget variances and management recommendations for addressing them for presentation to the board at its regular meetings. At the next board meeting, management should report to the board on the actions it has taken to address the unfavorable variances discussed at the prior meeting.

Actually addressing a problem is more difficult than simply adjusting numbers on paper. Management should identify the root cause behind each material variance and tell the board the steps it will undertake to resolve the underlying problem and deal with the consequences of revenue shortfalls and/or cost overruns. Simply adjusting the budget numbers, reducing the budgeted income item or increasing the budgeted expense item is rarely a solution.

The CAA's management and the board's finance committee should also be reviewing budget variances for each program. The organization-wide budget may be meeting expectations, but individual programs may be "busting" their budgets. Problems with one program may be camouflaged when they are aggregated with the other programs. The finance committee should highlight any material program variances during its presentation to the board. The best practice is for management to provide the board with a program-by-program analysis of variances.

If a CAA uses or "borrows" grant funds received for one program, such as Head Start, to pay for expenses, including payroll, for another program, the transaction often violates the first program's terms and conditions, and may cause serious problems, including cost disallowances and potential program termination. If one grant program's budget is overspent, or funds are not being received in a timely fashion, the board should ask management how the costs are being paid to ensure that inappropriate funding sources are not being used. Unrestricted funds or working capital loans are the most likely appropriate source of funds, as the CAA must avoid using funds that are restricted to other programs.

CASE SCENARIO #4:

EXAMINING BUDGET VARIANCES

BCA maintains its books and records using the calendar year. At its October meeting, BCA's board is reviewing a schedule of budget variances for the period ending September 30, 2019, which is included in the Appendix (Exhibit 2B). This schedule was assembled by BCA's management and was reviewed by BCA's finance committee before the board meeting. Caesar Cruz, the head of BCA's finance committee, is leading the discussion.

Before Cruz can get one word out, board member Marsha Harris asks why personnel expenses are so much higher than budgeted. Personnel costs for the first 3 months of the fiscal year have consumed 36% of the annual budget amount even though only 25% of the year (3 months) is reported in these statements. Cruz assures Harris that the finance committee asked the same question, particularly because personnel expenses are BCA's largest cost category. Gloria Watson, BCA's executive director, jumps into the conversation. She notes that BCA has been receiving an unusual number of requests for services in one of the programs and has had to pay overtime and even bring in a temporary employee to keep up with the volume of people needing help.

Watson turns the discussion back to Cruz, who then notes that income from government grants and contracts is also running ahead of the budget, with 29% of the annual budget amount already billed out at the end for the first 3 months.

Cruz says that BCA is billing the state for the unexpected volume of services that Watson just described, and consequently the amount billed is greater than what was planned. The finance committee is concerned that unless the state increases the overall contract amount, BCA will run out of money for this service before the end of the fiscal year and will have to stop providing it. Loretta Champion, a new board member, objects to any suggestion that people be turned away. Cruz tells her that BCA will have no choice, it just won't have the money needed to keep the program going. He notes that management is already concerned that BCA's cash position is getting worse and has actually had to extend the line of credit to borrow more cash to cover its payroll and bills on time.

LESSONS: Watson and Cruz probably weren't looking forward to this discussion. But imagine if there had been no budget, review of variances, or discussion of finances. The board would have first learned of the problems facing BCA a year later, when the audited annual financial statements were distributed. By then, it might be too late to address problems that had a year to fester.

Take particular note of how the variances were reviewed. Management first reviewed them. It then discussed the variances with the board's finance committee. That is as it should be. The examination of budget variances is often viewed as a task for the board. It is, but management is also charged with reviewing variances. Management should be constantly analyzing the financial data produced by the accounting system. After all, management is charged with running the agency. The board is performing an oversight function, making sure that management is asking the right questions and operating within the constraints imposed by the organization's financial resources. If there is a problem, management should identify and resolve it.

Management can approach the presentation of budget variances to the board in one of several ways. It can provide the board a complete schedule, a schedule showing just the material variations, or a written summary. Less information may be more in this case; presenting just the material variations lessens the chance that the board may get distracted by unimportant issues. In any event, the board should devote meeting time to discussing the variances that are material and problematic.

Assessing Liquidity

Liquidity determines the CAA's ability to pay its staff, bills, and other financial obligations on time. The CAA simply must have cash available when it is needed to meet immediate obligations. A CAA's balance sheet may include far more assets than liabilities, but that does not necessarily mean that the CAA can meet its obligations as they become due. As an example, the income statement may show grant revenue earned and the balance sheet may have a corresponding line item for grant revenue receivable, but neither of those numbers represents cash that can be used to pay employees, the health insurance provider, or the power company. At the end of the day, CAAs must look to its cash position and cash flow rather than accounting net income to understand whether the organization has sufficient liquidity. With the assistance of management, the board should take the following steps to assess whether or not the CAA has sufficient liquidity:

Step 1: Ask the Fundamental Question

The board should begin by identifying all liabilities that are due within the next 12 months. It should then ask what assets the CAA will use to pay those liabilities. The board should first look at the cash balance. It should then turn to marketable securities (if the CAA has any investments) and accounts receivable. Marketable securities can be quickly converted to cash, though being forced to sell securities quickly to meet current obligations can result in the CAA taking losses on its investments. This should be avoided by careful cash planning. While accounts receivable usually become cash within a relatively short period of time, if the collection of accounts receivable begins to slow down, the CAA must investigate to determine the cause, which may include disputes over the CAA's right to receive the amount it believes it is owed. The CAA must also note any restrictions on the use of cash and other assets imposed by funders.

Step 2: Review the Statement of Cash Flows

The board should review the statement of cash flows to gain a better understanding of where cash is coming from and where it is going. The statement of cash flows is discussed in Part II (see Exhibit 3).

Step 3: Review a Projection of Cash Flows

The statement of cash flows focuses on what has happened to cash in the past. To understand whether cash will be adequate in the future, management should develop and update a cash flow projection. The cash flow projection should identify the amount of cash the CAA will have at the beginning of the next month and then predict the amount of cash which will be received and used each month for the next 12 months, and the cash balance that will result at the end of each month. As each month is completed, management should extend the cash flow projection for an additional month so that the projection always includes 12 months. Management should consider sharing summarized projections with the finance committee and with the full board if significant cash flow problems are identified. A detailed discussion is best left to the finance committee, but when there are significant shortfalls in projected cash flow, the board should have sufficient information to discuss the shortfall. When the projections show an increased number of larger ending cash balances than was projected, the board should take the opportunity to discuss how the excess should be invested (or at least set a guiding policy for approaching surpluses).

Step 4: Review Aging Schedule

Management should prepare, and the board should receive, an aging schedule for receivables, showing the amounts due within 30, 60, 90, and 120 days, or other appropriate timeframes. The schedule should also identify receivables that are unlikely to be collectible.

Step 5: Review Key Metrics

Management should prepare and the board should review key liquidity metrics, including the days of cash on hand (distinguishing between restricted and unrestricted cash) and the ratio of net assets available for operations to the annual operating expenses. The finance committee should work with the CEO and CFO to identify the metrics that the board will find most significant. Further discussion of these and other metrics is found in the section "Reviewing Ratios", which covers key metrics that track the availability of cash when it is needed, building unrestricted reserves, and other indicators of financial health for CAAs.

Step 6: Review Lines of Credit and Other Loans

The board should periodically review major loan agreements including lines of credit. Although the types of loans will differ from CAA to CAA, typical ones include mortgages and revolving lines of credit which require "resting" (paying any outstanding balances off fully and not drawing down any additional cash) for specified periods. The focus should be on compliance with covenants and restrictions and on the CAA's ability to retire the loans. Management should be working with both the internal staff and when necessary, outside counsel, to monitor compliance with loan covenants. In addition, the board, or at least the finance committee, should consider reviewing advances and repayments in the line of credit on a monthly basis. This would be presented along with the receivables report so that board members may compare cash flows, receivables and use of the line of credit.

CASE SCENARIO #5:

CURRENT ASSETS WENT UP SO WHY WORRY?

BCA's financial statements are attached in the Appendix to this section. This Scenario focuses on Exhibit 1, the Statement of Financial Position (or Balance Sheet).

BCAs cash balance has dropped by $40,000 during the first quarter of its fiscal year ($160,000 at the end of September, from $200,000 at the end of June). However, BCA's assets have jumped by $270,000 over the same quarter, representing a 13 percent increase. Board member Susan Gallagher has little knowledge or interest in finances. When Hank Simpson, a member of BCA's finance committee, and the city's treasurer, goes beyond the five minutes allotted to his finance report, Gallagher is quick to point out that Simpson's time is up, and it is now time to proceed with more important matters. She points out that they haven't hired anyone new and that assets are up by almost $300,000 dollars. "So why do we need to discuss this boring stuff?"

Simpson looks at Gallagher slightly irritated, and points out that BCA's liabilities have jumped from $370,000 to $520,000, or 41 percent. Maureen Whipple, another board member, backs Simpson up, pointing to the $100,000 increase in the line of credit. Whipple says, "I am mighty concerned that our line of credit is now over the limit we agreed to, and even with that, our cash balance has dropped. This is really worrying when we're so unsure about our funding for next year."

LESSON: Simpson and Whipple are absolutely right to look beyond cash balances and other current assets. The asset side of the balance sheet represents only half of the story. Organizations like BCA are constantly incurring current liabilities and then using proceeds from accounts receivables to pay those liabilities. If the relationship between current assets and current liabilities keeps deteriorating, BCA may be unable to pay employees, the phone company, the utility company, or its other creditors.

BCA has a revolving line of credit with its bank. Typically, lines of credit require that the borrower "rest" the line of credit for one full month each year. This means the organization must pay off the entire balance of the line of credit and not draw on it for the "resting" month. Looking at BCA's Balance Sheet, it looks like BCA will only be able to rest the line of credit if it can make some real progress collecting its receivables.

The CEO has explained that almost all of the $501,100 in receivables reported at the end of September are from two state contracts. The state has not made payment on BCA's requests for reimbursement for 2 months. Whatever the reason for the growth in receivables, the board's task is to understand what is happening and what actions need to be taken. Hopefully, management has investigated why the state is paying so slowly. It's possible that the state may be reviewing BCA's requests for reimbursement more closely, with the expectation of denying a significant portion of the requested reimbursement. Alternatively, there may be no problem with BCA's billings, and the source of the delay is within the state's own systems. Hopefully, the CEO has already taken the initiative to find out what is happening and developed strategies to deal with any further delays.

TWO IMPORTANT TAKEAWAYS: First, boards shouldn't focus exclusively on cash and other asset balances. They must look at the relationship between assets and liabilities, and the status on net assets without donor restrictions that are available for operations. Comparison to balances from the prior period is particularly helpful for spotting disturbing trends.

Second, there is always a story behind the numbers. Sometimes there isn't a problem, but sometimes there is. A board must be willing to ask questions so that it understands the story and can act, if necessary. Because the members of management are normally full-time employees rather than volunteers, they should be even more proactive. The board, however, should never assume that management will fix the problem or has everything under control. One of the board's oversight functions is to keep management engaged and focused.

Reviewing Ratios

Financial statements are often intimidating. More importantly, they do not include analysis, but rather, are just a summary of the financial facts. The statements, for example, may tell management and the board that the CAA had $140,000 in cash on hand as of the balance sheet date, but the statements do not state whether that amount is sufficient. It is up to the management and the board to ascertain what the facts mean and to draw conclusions. Financial analysts use a number of metrics, referred to as financial ratios, to help them get a grip on the data. CAA boards and management should do the same.

Step 1: Identify Key Ratios

There are literally hundreds, if not thousands, of financial ratios that can be created from financial statement information. The board should work with management to identify several meaningful financial ratios that the board can use to monitor the CAA's financial performance and position. This is a case where less may be more, particularly if the board is relatively unsophisticated when it comes to financial matters. In some cases, the board may want to delegate this review to the finance committee, with the committee instructed to report significant concerns to the full board when appropriate.

1. **Defensive Interval Ratio.** One of the best indicators of liquidity is the defensive interval ratio, which compares liquid assets to expenses.

$$\frac{\textbf{Cash + Marketable Securities + Receivables Average}}{\textbf{Monthly Expenses}}$$

The resulting number represents the theoretical number of months that the organization could cover its average expenses by utilizing what are viewed as highly liquid assets.

2. **Liquidity Ratio.** The liquidity ratio is another metric for measuring whether a CAA will be able to pay its bills on time.

$$\frac{\textbf{Cash + Marketable Securities + Receivables + Inventories}}{\textbf{Liabilities}}$$

Obviously, a number greater than one is better than a number less than one, but that certainly doesn't guarantee that the CAA will be able to convert its assets to cash on a timely basis. If, for example, people who owe the CAA money are unable to pay it, having a large value for receivables on the balance sheet is meaningless. As another example, businesses convert their inventories to cash through sales. Nonprofits, however, may be giving away rather than selling their inventories as part of their mission. If that is the case, the numerator should exclude inventories. As that should suggest, the formulation of any metric should take the CAA's particular circumstances and practices into account.[1]

3. **Days of Cash Indicator.** This is an even simpler and more direct ratio. To estimate the amount of cash needed for one day of operation, divide the annual expense budget by 365 days. To determine the days of cash on hand at the end of the month, divide the month-end cash balance by the estimated cash required for one day of operation.

Comparing the number of days of cash on hand from month to month provides an easily computed and understood indicator of whether the organization's cash position is improving or deteriorating.

4. **Accounts Payable Indicator.** The accounts payable indicator may provide an early warning sign that the CAA is unable to satisfy its debts as they become due. Compute this indicator by dividing the Accounts Payable at the end of the month by the average monthly expenses (computed by dividing the annual budget by 12).

Both the board and management should begin asking for explanations if the resulting number is increasing. For example, if the CAA has typically had Accounts Payable equal to 1.5 months of expenses and begins to see that ratio increase to 2 or 2.5 months of expenses, the CEO and Board will want to understand why the CAA is delaying paying its obligations.

Another way to assess whether the CAA is falling behind in paying its bills would be for management to prepare an accounts payable aging schedule showing what portion of the total accounts payable have been outstanding for 30, 60, and 90 or more days.

Careful analysis is needed to use either of these ratios since it is possible that CAA's creditors have agreed to these delayed payments. Slowing down the flow of cash leaving the CAA is part of a reasonable strategy to cope with a temporary cash flow problem.

5. **Expenses to Net Assets.** Comparing total annual expenses (from the annual budget) to net assets is often useful for assessing the CAA's ability to withstand adverse financial circumstances. CAAs with significant fixed assets (land, buildings, and equipment) should exclude the portion of the net assets comprised of investment in fixed assets from the net assets in this ratio.

6. **Net Income Indicator.** CAAs aren't interested in turning a profit when "profit" is thought of as money available to pay investors. However, a surplus can be used to build organizational capacity. One way to measure the extent of surplus is referred to as the savings indicator. This indicator shows the % of total expenses that the net income comprises by dividing the net income (revenues minus expenses) by total expenses.

Most CAAs have fairly limited opportunities to grow their net income because most governmental funding agreements are structured in "use it or lose it" terms. In such agreements, the CAA is not entitled to receive or keep any revenue that exceeds the amount of allowable expenses permitted by the agreement. This reality makes it difficult for CAAs to build their net assets. CAAs that are committed to improving their sustainability will need to figure out strategies to obtain funding that allows them to have revenues exceed expenses.

7. **Total Debt to Total Assets.** Organizations have long compared their debt to some base. One way to do this is to compare total debt to total assets. Not surprisingly, there is not one right percentage for the total debt to total assets ratio. In fact, there is a great deal of variation in this number among different industries. Utilities, for example, incur a lot of debt relative to their assets because they have very predictable streams of revenue. On the other hand, tech companies are notorious for incurring little debt relative to their assets. The reason is quite simple: tech companies have very unpredictable revenue streams,

and even when a tech company has a runaway best selling product, that product may soon be obsolete. Similar variations should be expected in the nonprofit sector. Certainly, CAAs finance their operations differently than hospitals, universities, or museums do.

Even if there were a target number, there is another problem with this metric. The CAA could hit the target but find itself in financial trouble if the terms of a loan require an immediate payment, but there is insufficient cash on hand to make the payment.

Once again, all financial ratios are useful only if they are first customized to fit the organization's particular facts and circumstances, and then used to identify trends and spark questions.

Step 2. Make the Proper Comparisons

So far, we have examined a number of financial metrics or ratios and identified a number of problems with them. Does that mean CAAs should ignore these ratios? Absolutely not. When used correctly, ratio analysis is very effective, but to do that, management and the board must not use ratio analysis as a mechanical benchmark, which brings us to Step 2. Ratio analysis is best undertaken on a comparative basis.

- **Internal Trends.** A CAA's management and board should monitor any given ratio over time. If for example, a CAA's days of cash on hand indicator has hovered at 45 days for the last five years, management and the board should be asking lots of questions if the indicator suddenly drops to 20 days. In other words, the focus should be on why a number has changed, not on hitting a particular number. While it is often helpful to set a target for indicators like days of cash on hand, the targets should be re-evaluated periodically to be sure they are still relevant. For example, a CAA that had previously been funded almost entirely through federal awards which permitted drawing down cash from the Federal Treasury and then shifted its funding mix to include major agreements that provide cash on a cost reimbursement basis, will need to increase its target for days of cash on hand to reflect the need to meet cash demands while waiting for reimbursements.

- **Other Organizations.** Management should also consider comparing the CAA's ratios to other similarly situated CAAs, and then sharing the results with the board. There are two critical steps in this process. First, management must identify appropriate organizations for inclusion in the comparison. Second, management must obtain the financial data. Management might begin assembling a list of comparable organizations by reviewing the directory of the CAA state association. To a certain extent, this suggestion is aspirational. Many organizations simply will be unable to obtain the necessary information to produce a meaningful list of comparative entities. Even if some of the information is available through Form 990s or other publicly available sources, the analysis may only be meaningful if the mix and source of funding is similar for all the organizations included in the comparison.

Step 3. Monitor Trends

In addition to monitoring financial ratios, management and the board should monitor trends in the balances of specific asset, liabilities, net asset, revenue, and expenses accounts over time.

Step 4. Allocate the Work

Management should be using ratio analysis to keep the CAA on solid financial footing. For that reason, the board, including the finance committee, should look to management to prepare the ratios and the analysis. That, however, does not mean the board must be passive, taking what management gives it. The finance committee should discuss the ratios or other indicators that would be helpful to its understanding of the CAA's financial health and progress toward financial goals with management, Both the board and management should understand that this is an area in which "less is more", and that the goal is not to create a larger and larger list of indicators, but rather to select those that provide the most meaningful information to support effective board oversight.

Increasing a CAA Board's Financial Literacy

CAA boards are responsible for ensuring the financial health and effective financial management of the organization. To fulfill these responsibilities, all board members must understand the CAA's financial information. Each CAA should commit to developing the board's understanding of its financial health and of the information provided through its financial reports.

Many CAAs find it helpful to ask their independent auditor, another auditor, or the CFO to provide board members with in-house instruction on the organization's financial health and financial information. One approach that can be particularly illuminating is to use the CAA's own financial statements as the basis for the in-house training. People are often most receptive to new information when they see how it relates to a problem or task that they must address.

Sending board members and financial staff to training conferences and workshops such as those offered by CAPLAW, the Community Action Partnership and the National Association of State Community Services Programs is another way to increase financial knowledge and encourage learning from peers. In addition, CAA board members and financial staff should access online resources, including PowerPoint presentations and pre-recorded webinars and audio conferences offered by these national partners.

Many higher education institutions, nonprofit capacity building organizations, and state and national nonprofit associations also offer courses, webinars, and live workshops in financial analysis targeted to nonprofit board members. Other options include hiring a board development consultant or asking a local university with an accounting, business, or nonprofit management program if a member of its faculty might work with your organization to develop a customized training.

Increasing the financial literacy of board members is consistent with the CAA's mission. While some may view using CAA funds to train board members in financial analysis as a wasteful diversion of funds from mission, consider that the overall purpose of a CAA is to strengthen low-income communities, including board members who reside in and represent the community. Once someone knows how to analyze financial statements and budgets, they can use those skills to assist other nonprofits operating in the community and in their regular occupation.

Part II: What's in the Financials

Financial statements are the traditional tool used to analyze an organization's finances as they offer a systematic way to communicate financial information.

CAA boards must review the annual financial statements prepared by management at the end of the fiscal year, as well as review the financial statements as they are presented in the independent auditor's report. CSBG Organizational Standard 8.7 requires a CAA's governing board to receive financial reports at each regular meeting that include the following: (1) an organization-wide report on revenue and expenditures that compares budget to actual, categorized by program; and (2) a balance sheet/statement of financial position. Further, CSBG Organizational Standard 8.9 requires the governing board to annually approve an organization-wide budget. As discussed in Part I of Section 4 of this Toolkit, financial statements shared with the board should usually be GAAP-compliant.

It's also extremely important that management prepare interim financial statements each month as a tool to monitor the CAA's financial health. These would preferably be prepared and reviewed by the finance committee on a monthly basis. The full board should review the interim financial statements at its regular meetings throughout the year. These statements might not contain the final adjustments for items like the allowances for depreciation that must be included in the audited financial statements, and often don't include formal Notes to the Financial Statements like those presented in the audited financial statements, but they can and should accurately reflect assets, liabilities, net assets, revenues, and expenses with meaningful comparisons to both prior periods and the annual budget.

Tip

INVEST IN A GOOD ACCOUNTING SYSTEM

As should be apparent, the board will be relying on unaudited interim financial statements throughout the year as it makes decisions. The board cannot rely on an outside auditor to detect mistakes in these statements. Given that reality, the board should value an accounting system that produces accurate interim financial statements. If the statements are incomplete or filled with errors, management and the board may be relying on faulty financial data as they make decisions. For this reason, both management and the board should invest resources in an accounting system that assures accurate financial data and reports.

Investment in competent fiscal management staff is equally important. CAA accounting is complex and designing understandable financial reports is extremely challenging. Boards will receive the greatest return on their investment in effective financial management by investing in both highly qualified fiscal managers and regularly updated software that facilitates meeting the CAA's complex tracking and reporting needs.

CASE SCENARIO #6:

THE IMPORTANCE OF STRONG ACCOUNTING SYSTEMS AND INTERNAL CONTROLS

BCA and fellow CAA YCA are two Community Action Agencies that are identical in all respects except one. BCA and YCA both have the same number of employees, and similar programs, revenues, and expenses. BCA, however, has a stellar accounting system, while YCA's system is deficient in a number of respects. As a result, YCA's monthly financial statements often are incomplete and contain errors. Both BCA and YCA undergo a year-end independent audit. At the end of that process, both BCA and YCA issue financial statements in the same format and in both cases, the independent auditor issues unqualified audit opinions. Before that could happen, the auditors asked YCA to make 54 adjustments to its financial statements. The auditors only asked BCA to make two minor adjustments to its financial statements.

LESSON: An organization's financial accounting system and internal controls make a difference. Throughout the year, BCA's board is making decisions based on accurate financial information. That is not true in the case of YCA's board. It is driving at night with its headlights at half power.

The Basic Set of Financial Statements

Financial statements for CAAs are usually comprised of the following four basic statements, plus footnotes:

- **The Statement of Financial Position** (Exhibit 1), more commonly known as the Balance Sheet, reports a CAA's financial condition as of a given date. It includes assets, liabilities, net assets—what the CAA owns, what it owes to creditors, and its net worth.

- **The Income Statement** (Exhibits 2A and 2B), often titled the Statement of Activities and referred to as the Profit and Loss Statement, reports the CAA's income and expenses and net income for a specified period of time. The Income Statement is sometimes confused with the CAAs annual budget, but they are two very distinct documents.

  The confusion between the budget and the Income Statement often arises from the fact that the CAA's internal financial statements typically present the Income Statement report of actual revenues and expenses that have been recorded for a given month or for the year to date in comparison to the budget. The actual revenues and expenses represents what has actually happened, while the budget presents the plan the board approved for revenues and expenses.

  The Income Statement reports what has happened in the past, while the budget is a plan or projection of future events. While the Income Statement for the entire fiscal year must be included in the audited financial statements, every CAA also needs statements which report income and expenses for the current month and the fiscal year to date. The income statement explains what happened during the specified period. The net income reported on the income statement explains why the CAA's net assets (presented on the Balance Sheet) either increased or decreased during the period being reported. When the CAA reports a positive net income on the Income Statement, the net assets on the Balance Sheet will increase by the amount of the net income. When the CAA reports on net loss on the Income Statement, the net assets on the Balance Sheet will decrease by the amount of the loss.

- **The Statement of Cash Flows** (Exhibit 3) makes it clear how the CAA has obtained and used cash. The rules that govern financial accounting place heavy emphasis on measuring economic income on the Income Statement on the accrual basis rather than cash inflows and outflows. The experts agree that this focus is the appropriate one. Nevertheless, management and the board must go beyond the Income Statement to understand what activities or actions provided and used cash during the year, and what the resulting increase or decrease in cash has been. The Statement of Cash Flows often reassures readers who are frustrated by accrual accounting that the CAA really does know how it has obtained and used cash and can explain why the net income reported on the Income Statement does not equal the increase or decrease in cash over the period being reported.

- **The Statement of Functional Expenses** (Exhibit 4) divides the CAA's expenses into at least three categories: program services, fundraising, and management and general expenses. This format has always been required by the IRS on Form 990. Recent changes in nonprofit accounting rules have resulted in the Statement of Functional Expenses becoming a required statement for all nonprofit organizations. The Statement of Functional Expenses uses a matrix format that displays a list of types of expenses in rows and then uses columns to show the purposes for which expenses were incurred. The reader of the Statement of Functional Expenses can see both the total amount of Personnel Expenses and the portions of that total amount that were expended for Programs, Management, and Fundraising.

  Most CAAs will find the Statement of Functional Expenses much more useful if they break the overall category of "Programs" down into separate columns for each of its major programs, such as early childhood education, emergency services, energy assistance, etc.

- **The Statement of Functional Revenues and Expenses** (Exhibit 5). For interim financial reporting, it is even more useful to present a Statement of Functional Revenues and Expenses, although this format is not required in the GAAP-compliant statements that will be presented in the audited financial statements. The Statement of Functional Revenues and Expenses parallels the CAA's budget and provides readers with an opportunity to understand the relationship between revenues available for specific programs and the expenses which are incurred in those programs.

- **The Footnotes to the Financial Statements** (Exhibit 6). Formal financial statements contain footnotes (actually endnotes) that provide background information about the CAA and detail about how various accounting conventions were applied in assembling the statements. These are considered an integral part of the financial statements. When asked to review financial statements, most financial professionals will start with the footnotes. While all CAAs will prepare footnotes to their annual financial statements, many will not prepare complete footnotes to monthly interim financial statements.

Accrual Accounting Method

Most CAAs use the accrual basis of accounting. For some board members, financial statements prepared using the accrual basis are initially confusing. This is actually one of the main reasons that CAAs need to provide training in reading financial statements for every board member. It is probably easiest to understand accrual accounting by thinking about it in contrast to the other common basis (or method) for accounting, the cash basis. Most of us are very familiar with cash basis accounting because it is how we manage our personal accounts. We record income when we receive it and we record expenses when we authorize payments to come out of our accounts by writing checks or paying our bills electronically. In the cash basis of accounting, income is recorded when the CAA actually receives payments and deposits them into its bank accounts and an expense is recorded when checks are written, or electronic payments authorized. For an organization using the cash basis of accounting, the income statement will look just like the checkbook, reporting all the cash coming in and going out.

But the financial reality of a CAA is more complicated than this oversimplified picture. Why? Like most businesses, CAAs have some sources of income that require submitting a billing or request for reimbursement and waiting for the funder to send payment. Similarly, many CAAs pay employees for the work they did in one month on the first day of the following month and have a variety of other bills that are paid in the month after the goods or services are received.

In the accrual basis of accounting, these realities are described as receivables and payables and are reported on the balance sheet as assets (for the receivables) and liabilities (for the payables). The CAA has a legal right to receive what is owed and a legal obligation to pay what it owes to employees and others. To understand the financial condition of the CAA, the board must be made aware of the whole picture, including the receivables and the liabilities. The accrual basis of accounting presents the impact of receivables and payables clearly. The cash basis of accounting does not include recording and reporting these important items.

What many find most confusing in accrual basis financial statements is that the recording of these amounts that the CAA is owed or owes to others impacts the income statement as well as the balance sheet. This is because recording the fact that the CAA has incurred expenses to fulfill the requirements of a grant and is now owed reimbursement from the funder increases the grant income as well as increases the amount reported as grants receivable. Similarly, recording the fact that the CAA owes a consultant $1,000 for a training provided to staff during the month increases both the professional services expenses for the month and the liability account for vendors payable.

Consequently, the revenues, expenses and net income reported on the accrual basis of accounting will be different from that reported using the simpler cash basis. The accrual basis net income presents a more accurate picture of the true economic outcome of the CAA's activities. Accrual basis accounting is extremely important for understanding the financial health of the CAA. But boards must take care when reviewing accrual basis statements to also pay attention to the CAA's actual cash position. Despite having a legal right to receive the amounts shown as receivable from funders, the CAA will confront serious problems if it does not have sufficient cash available to pay its bills on time.

Cash vs. Accounting Income

Financial accounting and the resulting statements can be confusing to many people because they rely on a series of conventions that attempt to measure something approximating economic income rather than the CAA's net cash intake.

The following are just a few examples where those developing the principles underlying financial statements choose to use the accrual basis of accounting to focus on economic income and wealth rather than cash inflows and outflows.

- **Borrowed Money**. When a CAA borrows money, it clearly has more cash on hand. On first impression, the loan proceeds might be viewed as revenue. However, the CAA also has an obligation to repay the loan. As a consequence, the borrowed funds are not treated as additional revenue and the repayment of the loan is not treated as an expense. Instead, the borrowed funds are recorded as a liability and repayment of the principal balance of the loan is recorded as reduction in the liability, not as an expense. However, interest on the loan is recorded as an expense.

- **Deferred Revenue**. Assume a CAA receives fees for services, and it asks people to pay in advance for next year's services. Looking at the cash inflow, many people would reasonably conclude that the CAA has income when it receives the cash. However, under the accounting rules, the CAA must recognize the income next year, when it actually delivers the services, rather than this year. The accounting rules assume that there will be expenses next year associated with delivering those services as the services are provided. By deferring recognition of the income until next year, the CAA better matches the income with the expenses of generating it.

- **Depreciation**. When a CAA purchases a new car or a building, it is not permitted to record the entire purchase price as an expense in the year that it acquires the car or building. Permitting the CAA to fully expense the car at the time it acquires the car would provide a measure of cash flow. However, the new car or building will provide benefit over multiple periods. The accounting rules require a portion of the purchase price to be charged or expensed in those periods in which the car or building provides benefit, thereby better matching the expenditure with the periods benefited. The annual expense representing the benefit provided in each period is referred to as depreciation.

- **Vacation Pay Liabilities**. Many CAAs agree to pay employees for unused vacation when they leave employment (and some states require it), but don't set aside funds ahead of time. If the focus were on cash, the CAA would reduce its income by the amount it paid to departing employees when paid. There are two problems with that approach. By failing to treat a portion of the future payments as an expense in the year the employee provides services to the CAA, the CAA would fail to match the revenue it receives with the expense of generating that revenue. Equally, if not more important, the CAA would not be recognizing a future obligation (liability) that could be very large. If the board doesn't adequately keep track of that promise, the CAA may discover that it lacks the resources to meet its obligations when they become due in twenty years.

The accrual accounting conventions applied to a CAA's operations don't create expenses and income, but rather shift income and expenses among accounting periods to better measure annual economic income. If the normal accounting period were 25 years, net cash flow would more closely approximate accrual-based accounting income. What creates the difference is the fact that accounting statements are prepared on an annual basis—a relatively short period of time.

The Balance Sheet (Exhibit 1)

The Balance Sheet—or Statement of Financial Position—provides a snapshot of a CAA's assets and liabilities at any given point in time, typically at the end of each month. Unlike the balance sheet for a for-profit business, the balance sheet for a CAA will draw distinctions between net assets that are subject to legal restrictions and unrestricted net assets. This classification scheme will be discussed later in the section under the heading "One Other Issue of Note - Restrictions."

There is a fundamental problem with any balance sheet. By the time the board reviews it, the balance sheet is out of date. For example, a year-end balance sheet may report the CAA's assets and liabilities as of June 30th. Assets and liabilities will have changed by the time the board reviews that balance sheet in September or October when the outside auditors sign off on the statements. This is another reason why both management and the board need timely, accurate interim financial statements and must focus on trends rather than specific account balances at a single point in time.

As a general rule, the financial statements reflect historical cost rather than fair market value. For example, assume a CAA purchased a parcel of real estate for its headquarters for $500,000 twenty years ago. Real estate values have increased dramatically over the 10 years the CAA has owned the property. The market now values the parcel at $5 million. Nevertheless, the CAA must continue to carry the land on its books at $500,000, the price it paid for the original purchase.

Those new to accounting will find this focus on historical cost confusing, asking why the increase in value is not reflected in the CAA's balance sheet and income statement. The reason is simple: there is another principle at work, which is equally as important. Historic value is objective, but current value is not, which is why the accounting rules do not permit the use of market value accounting except under certain circumstances: while fixed assets (land, buildings, and equipment) are reported at their historic cost, marketable securities (e.g., stocks and bonds) must be reflected on the balance sheet at their current market value, and declines in inventory value (but not increases in value) must be reflected in the carrying value of the inventory. In recent years, accounting principles have begun to reject their traditional focus on historic value. But GAAP in the United States continues to require use of historic cost for land and buildings. Anyone who wants to understand when the balance sheet is valuing a category of assets at other than historical value should review the footnotes.

Beyond the issues involved in recording the value of certain assets at cost, a CAA's financial statements omit several important assets, including the value of the CAA's workforce, know-how, and reputation. These assets may not be readily convertible to cash, but they are nevertheless important. Management and the board should never overlook these intangibles.

The balance sheet is divided into three sections. The first section lists assets, the second lists liabilities, and the third lists net assets, which have resulted from accumulated surpluses. The total of the net assets is equal to the difference between the total assets and the total liabilities. The report is referred to as a "balance sheet" because the total of the assets must be equal to (balance with) the combined total of the liabilities and net assets.

Assets

By tradition, assets are listed in the order or ease with which they can be converted to cash. This means that cash, marketable securities, accounts receivable, and inventories are listed first. Sometimes these are referred to as current assets. If your CAA holds certain funds in trusts, such as for self-funded employee health insurance plans, vacation pay, or unemployment insurance reimbursement, these may be listed separately in the asset category. Then equipment, land and buildings, and intellectual property are listed.

Liabilities

The liabilities section of the balance sheet is ordered by date by which payment is due. Some balance sheets will present the liabilities in two categories – current for those that will come due within the next 12 months – and long-term for those that will not be due for more than one year from the balance sheet date. Obviously, the board should be concerned about the current liabilities because they will require cash payment within the next 12 months. Although the day of reckoning for the long-term liabilities is farther in the distance, long-term liabilities frequently represent larger obligations, so the board must focus on accumulating the cash necessary to retire this debt.

The liabilities section also includes capitalized leases, representing the CAA's obligation to make a series of payments that will eventually result in its purchase of specific assets, which are often copiers or vehicles. Recent changes in GAAP requirements have resulted in more leases being capitalized as opposed to being treated as the equivalent of a monthly payment. Organizations reporting capitalized leases in the liability section will also report the cost of the asset being leased in the asset section, reflecting the fact that despite being referred to as "leased", the asset is essentially owned by the nonprofit.

Contingent Liabilities

The accounting rules require that contingent liabilities be reflected in the financial statements when the liability can be valued and when it is relatively certain that the organization will become liable for the cost. For example, when a CAA is sued, it must determine whether the potential judgment against it must be reflected as a liability on the balance sheet or disclosed in the footnotes. While a lawsuit is pending, potential liabilities are typically reflected in the footnotes, but not on the balance sheet, because it is usually not yet possible to know whether the CAA will be required to pay a judgement.

Net Assets

In the case of a business corporation, the difference between assets and liabilities is referred to as equity, and includes both the shareholders' investment in the company and the accumulated profits, which may either be retained in the company or may be made available for distribution to shareholders. In the nonprofit context, the equivalent of the equity section of a for-profit balance sheet is referred to as **net assets**. Net assets function as the nonprofit organization's equity, representing the resources it has to fall back on in hard times and also resources that the board may choose to make available to undertake new activities or take reasonable risks to build the nonprofit's capacity. Within the net assets section, nonprofits must distinguish **net assets without donor restrictions** from **net assets with donor restrictions**. Within net assets without donor restrictions, many nonprofits also report subsections for **board designated net assets** and for **net assets invested in fixed assets** (property, plant and equipment). You'll find more discussion of the distinctions within the Net Assets section sections (see "Two Categories of Net Assets" below).

In nonprofit organizations, net assets increase when revenues exceed expenses and decrease when expenses exceed revenues. The total net assets at the end of the year is equal to net assets at the beginning of the year, plus the net income for the year, which is referred to as the increase in net assets. As previously noted, the income statement connects last year's balance sheet with this year's balance sheet through the change in net assets being equal to the net income for the year.

The Income Statement or Statement of Activities (Exhibits 2A and 2B)

Of the four statements that make up a complete set of financial statements, the income statement is probably the most straightforward. The first part of the income statement includes revenues. This may include grant revenue, contributions, income from the sales of goods and services, and investment income. The second part of the statement lists categories of expenses. Some organizations choose to classify expenses as program, fundraising, and general administration rather than or in addition to providing line items for more familiar notions of expense, such as salaries, rent, utilities, and supplies. The final section of the income statement reports the difference between the total revenues and the total expenses, which is expressed as the net increase or net decrease in net assets. It is this net increase or net decrease in net assets that connects the income statement to the balance sheet by explaining how the net assets increased or decreased over the period being reported. Some income statements actually display the change in net assets, showing that the net assets at the beginning of the period, plus the net income for the period, equals the net assets at the end of the period.

Some of the items on the income statement that tend to confuse non-accountants include:

Volunteer Labor

Many board members will be surprised to learn that the value of volunteer labor is reflected as income in the income statement if the volunteer services are provided by an individual with specialized expertise such as a lawyer or CPA, or a skill that requires licensure such as a plumber or electrician. A corresponding expense, "in-kind labor expense" is recorded as well, resulting in no increase in net income. If volunteer labor results in the creation of an asset (such as volunteers building a home for Habitat for Humanity), the value of the in-kind contribution is determined by the increase in value of the asset as a result of the volunteer labor. The CAA must also record this increase in value of the assets on the balance sheet. This admittedly unusual rule forces both management and the board to focus on the value of volunteers.

Fiscal Agent vs. Fiscal Sponsor vs. Subrecipient vs. Provider of Services

There are complex accounting rules that distinguish between fiscal agent, fiscal sponsorship, and subrecipient relationships. Normally, when a CAA provides services under a grant, it includes the grant revenue in its income statement. However, on occasion, the CAA may simply be acting as a fiscal agent for a government agency. This is different from acting as a fiscal sponsor or utilizing subrecipients to carry out certain projects.

Fiscal Agent

A fiscal agent relationship refers to an arrangement between a CAA and another charitable organization, where the CAA serves as the legal agent for that organization. Unlike a fiscal sponsorship relationship, the CAA (the agent) acts on behalf of the other organization (the principal), which has the right and legal duty to control and direct the CAA's activities. In the case of a CAA serving in a true fiscal agent role, neither grant revenue nor offsetting expenses are included in the CAA's income statement. Instead the funds received are recorded on the balance sheet as a liability, which is reduced as the funds are disbursed for the purposes specified by the other organization. This is the right result, but management and the board should not simply ignore this activity. The activity should be a part of the CAA's mission, meaning that the board and management should be monitoring it and assessing performance. These arrangements generally should be described in the footnotes when material. The board should be certain that both it and management understand each funding relationship clearly, including understanding the extent of the responsibility that the CAA holds for proper management of any funds that are transferred to the other entity to carry out specific projects.

Fiscal Sponsor

A fiscal sponsorship relationship differs from a fiscal agent relationship. A CAA that serves in a fiscal sponsor role accepts funding on behalf of another project, often a new charitable effort that has not yet obtained its own 501(c)(3) tax-exempt status. Under IRS rules governing fiscal sponsors, the CAA (the sponsor) must have complete control and discretion over the funds spent by the sponsored project and ensure that uses of the funds further the CAA's own tax-exempt purposes. This results in the income being recorded as the sponsor's income and the expenses associated with the income being recorded as the sponsor's expenses.

The CAA will need to enter into a written agreement with the new group spelling out the responsibilities of both the CAA as sponsor and the new group as the sponsored project. The funder will award the funds to the CAA for the purposes of the sponsored project. The CAA will oversee the finances and operation of the project to ensure it meets the funder's requirements and is consistent with the CAA's mission and IRS requirements for tax-exempt charitable organizations. The CAA will need to have an accounting system structure that facilitates providing regular financial reports to the sponsored group so that they can review how the funding is being used. Fiscal sponsorship requires careful oversight and clear written agreements. Boards of CAAs interested in serving as a fiscal sponsor should get professional assistance to structure the sponsorship agreement clearly and then ensure that management is monitoring the performance of the sponsored group.

Service Provider: Pass-Through Entities and Subrecipients

CAAs will need to become familiar with the requirements of the Uniform Guidance, 2 C.F.R. Part 200, for subrecipients of federal funds. Management must take the lead in ensuring that the CAA meets its responsibilities when it is a subrecipient. CAAs become subrecipients when federal funds are passed through a state agency or other grantee to the CAA which, as a subrecipient, carries out a portion of the federal award. From an accounting standpoint, funds received through a pass-through entity as a subrecipient will be recorded as income in the CAA's records, and the expenses associated with the agreement will be recorded as the CAA's expenses. CAPLAW offers a variety of resources addressing a CAA's responsibilities as a subrecipient of federal funds.

Many CAAs also enter into agreements with other nonprofit organizations in which the CAA serves as the pass-through entity and the other organizations are subrecipients of the CAA. Such agreements are not fiscal sponsorships or fiscal agent relationships. The funding the CAA receives to "pass-through" to the other entities is recorded as income on the CAA's income statement and the amounts passed through to sub-recipients are recorded as expenses. Typically the amounts passed through to subrecipients are recorded in an expense category captioned "subrecipient expenses", rather than included in the typical line item categories of the CAA.

Depreciation

Depreciation is an expense. It represents a portion of the cost of a capital asset (e.g. a building, a truck, or a piece of equipment) that is allocated to each year in which the equipment provides benefit. The accounting rules prescribe depreciation timeframes for different asset categories. Depreciation is an attempt to match income with the costs of generating that income. The financial statement reader should keep one critical point in mind: the annual allowance for depreciation bears absolutely no relationship to the economic decline in the value of any given asset. The balance sheet may show a large balance for any particular asset, but the CAA may need to replace that asset next year. While depreciation is an expense, and is frequently an allowable expense for governmental funding, it does not consume cash. The outflow of cash occurs at the time the purchase is made, but the expense of depreciation is recorded for each year the asset is in service.

Restricted Contributions

One additional challenge to understanding the CAA's income statement may arise from accounting requirements that require distinguishing contributions that have been restricted by the donor or grantor from those the CAA receives without donor restrictions. Accounting requirements and options for presenting the information about restricted contributions clearly will be discussed in detail later in this section.

The Statement of Cash Flows (Exhibit 3)

This is the most complex of the four basic CAA financial statements. The uninitiated may initially be put off by the seemingly indecipherable lines. Even seasoned accountants have trouble fully comprehending this statement, but it does contain valuable information that is accessible to even the financial neophyte. It's probably helpful to look first at the lines at the bottom of the statement that report the net increase or decrease in cash and then show the opening cash balance and the ending cash balance that has resulted from the increase or decrease in cash.

The rest of the Statement of Cash Flows presents information about what caused cash to increase or decrease, breaking the information into three categories of cash flows – those from operating activities, those from investing activities, and those from financing activities. The combination of these three sections yields the net increase or decrease in cash reported at the bottom of the statement.

Keeping the following two points in mind makes the Statement of Cash Flows something that is both useful and understandable:

- The Statement of Cash Flows is based on the fact that cash is either used in or provided by the following activities: operations, investment, and financing activities. For this purpose, investment is broader than stocks, bonds, and options. It involves the purchase or sale of any asset that is capital in nature. That means investment assets exclude cash, accounts receivable, and inventories. So the Statement of Cash Flows presents the changes in cash balance in three sections:

  - *Cash provided from or (used by) operations*
  - *Cash provided from or (used by) investment activities*
  - *Cash provided from or (used by) financing activities*

  The cash provided from or (used by) all three sections is totaled together to equal the total change in cash.

- The Statement of Cash Flows begins with the accrual basis net income or loss (net increase in net assets). This is net income shown on the Income Statement. Since the net income has been computed using the accrual method of accounting, it is not the same as the net increase in cash. The lines below the net income (loss) list the adjustments that would have to be made to the accrual basis net income to make it equal the net increase (decrease) in cash.

  For example, the accrual basis net income is based on recording fee income based on the fees charged, not the fees collected. The accrual method has recorded the amount of fees still owed to the CAA as a receivable. To make the accrual basis net income match the increase/decrease in cash for the period, the CAA would have to reduce the accrual basis net income by the amount that the receivables increased from the prior year. This type of analysis is done to adjust the accrual basis net income for any increases or decreases in receivables or payables.

Part II of the Appendix to Section IV includes an example (Exhibit 3) that provides board members with a step-by-step approach to analyzing the Statement of Cash Flows.

The Statement of Functional Expenses (Exhibit 4)

As previously noted, the Statement of Functional Expenses is relatively straightforward. It provides additional details about a CAA's expenses by displaying which portion of each line item expense was incurred for the purpose of management, fundraising, or program services.

Location

In formal financial statements like those you will see in your CAA's audit, the Statement of Functional Expenses is most commonly presented directly after the Statement of Cash Flows. Some organizations choose to incorporate information about the total expenses for program, management and fundraising as one-line amounts on the Statement of Activities and present the more detailed matrix style information typical of the Statement of Functional Expenses as part of the footnotes.

The Detail

Some organizations choose to break down program expenses further by individual programs. For example, a CAA with Head Start, weatherization, counseling, and housing programs would show the program expenses for each of these programs, providing management and the board with a far better understanding of what resources each of these programs consumes.

Allocations

Some line item expenses will need to be distributed among multiple functional categories through allocation formulas, which can introduce some discretion into the process. CAAs must establish clear, consistent methods for allocating costs among functions in a cost allocation plan. CAAs with direct federal funding relationships, such as Head Start, may use their cost allocation plan to negotiate a federal indirect cost rate. CAAs without direct federal funding relationships may be required to submit their written cost allocation plan to their state or other funders for approval. In either case, the board should have a basic understanding of the cost allocation methods the CAA is using. The allocations in the Statement of Functional Expenses should be based on these plans or rates.

What About Income?

What is missing from the Statement of Functional Expenses is the income side of the equation. Although "profits" are not a driving force for a CAA—at least in the Fortune 500 sense of the word—management and the board should be assessing whether each program covers its expenses. This is particularly important in the case of CAAs—most of which are highly reliant on grant revenue—because grant agreements may not permit the CAA to use grant revenue to cross-subsidize other programs.

While the formal Statement of Functional Expenses included in the CAA's audited financial statements will not typically include information on revenues, CAAs are free to present both income and expenses in the functional matrix format in their internal financial statements. There is a sample Statement of Functional Revenues and Expenses in the Appendix to this section (Exhibit 5). Both the board and management should be looking at the income side of the equation on a program-by-program basis. This format makes it clear which programs have generated enough income to fully cover the expenses of each program including management and fundraising costs. Board members should understand that when the total income provided by funder grants does not cover the full cost of the expenses of a program, the CAA will have to raise unrestricted funds to cover the gap.

Grant Funding Periods

Management and the board should also be monitoring both revenues and expenses on a grant-by-grant basis so that they know the amount of each grant and its expiration date. Such a schedule will help management and the board assess the extent to which individual grants can be counted on for future revenue.

The Footnotes to the Financial Statements (Exhibit 6)

As noted, the footnotes to the financial statements contain important information that should be reviewed by all financial statement users. Many of the footnotes are mandatory for the presentation of GAAP-compliant formal financial statements. Many CAAs prepare detailed GAAP-compliant footnotes only at year-end and use a more informal bullet point narrative to highlight issues in monthly financial statements. CAAs using this more informal approach for monthly statements should be sure that every board member has a copy of the most recent audited statements that includes the complete footnotes.

GAAP accounting rules specifically dictate that certain information be disclosed in footnotes for GAAP-compliant statements. The rules often go so far as to prescribe the format for numerical disclosures. The footnotes will generally include the following information, but the level of detail differs significantly from organization to organization:

- **The Organization.** A brief discussion of the organization's legal form, purposes, and tax-exempt status.
- **Consolidation.** If the financial statements include other entities (such as subsidiaries—i.e., organizations that the CAA controls through membership, board of director appointments, or ownership arrangements), a listing of entities that have been included in the financial statements and principles used to produce the consolidated financial statements.

  Frequently, audited financial statements presented on a consolidated basis will also include schedules that present the Balance Sheet, Statement of Activities, Statement of Cash Flows, and Statement of Functional Expenses for the primary CAA before other entities have been consolidated with the CAA. The statements may also include a "consolidating" statement that shows how all the various legal entities have been fit together to produce the consolidated financial statements.

  This note will also describe whether the CAA has subsidiaries or related entities and how they are treated in the financial statements.
- **Accounting Methods, including:**
  - Use of estimates
  - Depreciation methods
- **Treatment of Net Assets**
  - Net assets without donor restrictions
  - Net assets with donor restrictions
  - Board designated net assets (a part of net assets with donor restrictions)
- **Cash and Cash Equivalents**
- **Accounts Receivable**
- **Contributions and Pledges Receivable**
- **Investments**
- **Reserves for Specific Purposes**

- **Property and Equipment**
- **Depreciation**
- **Revenue Recognition**
- **Distinction between Exchange Transactions and Gifts and Grants**
- **Donated Assets, Materials, and Services**
- **Change in Accounting Principle**
- **Reclassifications**
- **Available Resources and Liquidity**
- **Investments and Fair Value Measurement**
- **Notes Payable and Long-Term Debt**
- **Lease Commitments**
- **Contingencies**
- **Retirement Plans**
- **Financial Instruments with Concentrations of Credit Risk**

Sample wording for some of the Notes to Financial Statements that are common in CAA audited financial statements can be found in the Appendix to this section (Exhibit 6).

Tip

UNDERSTANDING CONSOLIDATED FINANCIAL STATEMENTS

Most boards will need specific training to understand consolidated financial statements. The training should emphasize the legal relationships between the entities with emphasis on any risks that the CAA confronts as a result of the operations of its related entities.

CASE SCENARIO #7:

THE FOOTNOTES CONTAIN VITAL INFORMATION

Albert Matson is a new member of the BCA's board. Being a banker, Matson asked for a copy of BCA's year-end audited financial statements at the time he joined the board. When he looked at the balance sheet, he was puzzled by the $50,000 reserve for unemployment compensation. After reading footnote 8 to the financial statements he has a better understanding of the liability represented by that number. He recognizes that by self-insuring to cover unemployment insurance benefits, BCA may be reducing the annual payments it would otherwise have to make to the state unemployment compensation insurance fund. Matson, however, is worried that if BCA is forced to lay off employees, its obligation to pay benefits could exceed the reserve. At the board meeting, Matson asks whether BCA has explored obtaining secondary insurance to protect itself.

LESSON: The footnotes to the financial statements are an integral part of those statements. Matson did what all experienced bankers and others who regularly work with financial statements do: he read the footnotes to the financial statements to gain a better understanding of the assumptions and conventions underlying the numbers. In this instance, Matson recognized that BCA might be exposing itself to greater risk than the board realized. He also saw a possible way to reduce that risk while retaining some of the savings from self-insuring BCA's obligation to fund unemployment compensation. Matson should have also noticed the pending litigation revealed by the footnotes. Management should be regularly updating the board on that litigation.

One Other Issue of Note — Restrictions

GAAP accounting rules require that nonprofit organizations distinguish whether or not gifts received carry donor-imposed restrictions which may be either temporary or permanent. As the word implies, the restrictions on permanently restricted gifts will never expire. In contrast, donors making temporarily restricted gifts or grants intend that the nonprofit will use the gift for specified purposes or in specified time periods.

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The impact of receiving donor-restricted gifts is reflected on both the balance sheet and the income statement. When a restricted gift is received, it increases the net assets with donor restrictions. When the restrictions are fulfilled, the net assets with donor restrictions are reduced. When a permanently restricted gift is received, the net assets with donor restrictions are increased. Since the restriction is permanent, this portion of the net assets with donor restrictions cannot be reduced by the fulfillment of restrictions. Accounting rules permit the nonprofit to present the net assets with donor restrictions in distinct segments, differentiating those that are permanently restricted from those that the donors intend to be used (previously described as temporarily restricted assets).

Two Categories of Net Assets

The balance sheet should divide net assets into two primary categories: (1) Unrestricted - Net Assets without Donor Restrictions; and (2) Net Assets with Donor Restrictions. Your presentation may include sub-segments of each of the two categories, but must clearly present a total of Net Assets without Donor Restrictions and Net Assets with Donor Restrictions as well as the combined total of all Net Assets.

- **Net Assets without Donor Restrictions.**

  The name says it all. Previously described as unrestricted net assets, these are net assets that are not subject to restrictions imposed by grant makers or donors. The CAA board can use them as it sees fit.

  Gifts and grants received without donor restrictions are considered unrestricted. All revenues from fees for services or product sales are classified as unrestricted under GAAP rules (although federal funds financial management requirements in the Uniform Guidance, 2 C.F.R. Part 200, may actually impose some limitations on the use of fees that are deemed “program income”).

  Your CAA may decide to present your Net Assets without Donor Restrictions in segments to increase readers’ understanding of your financial condition. Typical segments in the Net Assets without Donor Restrictions include Net Assets Available for Operations, Board Designated Net Assets, and Net Assets Invested in Fixed Assets. GAAP rules require that all the segments be added together to present Total Net Assets without Donor Restrictions.

- **Net Assets with Donor Restrictions.**

  These net assets are subject to the restrictions that donors require be placed on their gifts or grants some of which may be permanent. By accepting gifts or grants with donor restrictions, your CAA has agreed to use the funds only for the purposes specified by the donor or in some cases, only in the time period specified by the donor. The portion of Net Assets with Donor Restrictions that are not permanently restricted gifts/grants are those that have not yet been “released” by meeting the donor’s restrictions.

  For many CAAs, the restricted net assets will include funds received under a foundation grant that have not yet been expended for allowable costs specified by the grantor. Until the expenses are incurred to fulfill the restricted purpose, the net assets will be classified as restricted. When the expenses to fulfill the restricted purpose are incurred, the financial statements will reflect the fulfillment of the restrictions as a “release from restricted net assets” which will reduce or, if all restrictions are fulfilled, eliminate the balance in the temporarily restricted net assets account. For a discussion of many government grants, see below “How Restricted is Restricted: Cost Reimbursement Grants”.

  Some donors require that their gift be treated as permanently restricted, meaning that the gift itself may not be used but instead should be invested to generate income for future years. Gifts with permanent donor restrictions are often characterized as endowment gifts. In addition to requiring that their gift be restricted permanently and treated as an endowment, the donor may also specify the uses which can be made of the earnings from investment of their gift – typically specifying either that the income be available for general operations or for a specific purpose or program. While in general, the organization may not spend endowment or other permanently restricted gifts, there are very specific legal requirements that a CAA’s board must be aware of to manage endowment gifts properly.

  Your CAA may choose to present your Net Assets with Donor Restrictions in segments to communicate the nature of the restrictions involved. For example, you might present Net Assets with Donor Restrictions for Homeless Services or Net Assets with Donor Restrictions for Nutrition Services. GAAP rules require that all segments of the Net Assets with Donor Restrictions, both temporary and permanent, be added together to present the Total Net Assets with Donor Restrictions.

Tip

HOW RESTRICTED IS RESTRICTED: COST REIMBURSEMENT GRANTS

GAAP accounting rules for the treatment of funds received through government grants and awards are complex and go beyond the scope of this Toolkit. Although most CAAs receive a substantial portion of their total income from governmental sources, many of the funding agreements are structured on a cost reimbursement basis, in which the CAA must first incur allowable expenses and then request reimbursement. The nature of these reimbursement agreements generally results in these governmental funds being classified in the "unrestricted" category for GAAP purposes, despite the reality that many restrictions are included as part of the governmental agreement.

The technical nature of the GAAP rules for classifying income as unrestricted or donor restricted requires that CAAs have highly competent fiscal managers with expertise in nonprofit accounting. Most board members rely on the auditor's opinion for assurance that their organization is correctly recording restricted grants. It is not necessary for board members to become expert nonprofit accountants. Instead, it is important that the board understands the nature of the grants the CAA receives and the presence or absence of restrictions on the net assets. The presence of restrictions on the net assets, represents a commitment or obligation to use resources in donor-specified ways. The absence of restrictions, represented in unrestricted net assets, represents the resources that the board can direct toward purposes which it believes are in the best interest of the CAA.

LESSON: It is important to understand the distinctions among the various types of income to ensure your financial statements are accurate and in compliance with GAAP.

Presentation

Balance Sheet (Exhibit 1)

There are two common ways that CAAs present information about restrictions on the balance sheet.

Method 1. Many CAAs provide a summary at the end of the balance sheet that analyzes the net asset balance in terms of the two major categories—unrestricted (Net Assets without Donor Restrictions) and restricted (Net Assets with Donor Restrictions).

Method 2. Some CAAs present the entire balance sheet, including assets, liabilities, and net assets, in columns titled Net Assets without Donor Restrictions and Net Assets with Donor Restrictions, and include a third column titled Total to combine the two columns. The appropriate portion of each asset, liability or net asset is placed in the corresponding column, and the two columns are then summed to show the total net asset balance.

Method 1

Balance Sheet
December 31, 20X2 and 20X1

	12/31/20X2	12/31/20X1
Assets		
Current Assets:		
Cash	$3,500	$5,000
Accounts receivable	$5,000	$6,000
Prepaid expenses	$500	$500
Total Current Assets	$9,000	$11,500
Liabilities and Net Assets		
Liabilities:		
Accounts payable	$2,000	$1,500
Accrued expenses	$5,000	$5,500
Total Current Liabilities	$7,000	$7,000
Net Assets:		
Unrestricted net assets		
Available for operations	$200	$1,200
Board designated reserves	$800	$800
Total Unrestricted Net Assets	$1,000	$2,000
Temporarily Restricted Net Assets	$1,000	$2,500

Method 2

Balance Sheet
December 31, 20X2 and 20X1

	20X2 Unrestricted	20X2 Temporarily Restricted	20X2 Total	20X1 Unrestricted	20X1 Temporarily Restricted	20X1 Total
Assets						
Current Assets:						
Cash	$1,000	$2,500	$3,500	$1,500	$3,500	$5,000
Accounts receivable	$5,000	$0	$5,000	$6,000	$0	$6,000
Prepaid expenses	$500	$0	$500	$500	$0	$500
Total Current Assets	$6,500	$2,500	$9,000	$8,000	$3,500	$11,500
Liabilities and Net Assets						
Liabilities:						
Accounts payable	$1,000	$1,000	$2,000	$1,000	$500	$1,500
Accrued expenses	$4,500	$500	$5,000	$5,000	$500	$5,500
Total Current Liabilities	$5,500	$1,500	$7,000	$6,000	$1,000	$7,000
Net Assets:						
Unrestricted net assets						
Available for operations	$200		$200	$1,200		$1,200
Board designated reserves	$800		$800	$800		$800
Total Unrestricted Net Assets	$1,000		$1,000	$2,000		$2,000
Temporarily Restricted Net Assets		$1,000	$1,000		$2,500	$2,500
Total Net Assets	$1,000	$1,000	$2,000	$2,000	$2,500	$4,500
Total Liabilities and Net Assets	$6,500	$2,500	$9,000	$8,000	$3,500	$11,500

In the example above, the nonprofit had $3,500 in cash, $2,500 of which was donor restricted, and the remaining amount was subject to no restrictions, and none of the nonprofit's other assets were restricted. The balance sheet would show $2,500 under the restricted column and $1,000 under the unrestricted column. The two columns would then be summed, and the result would be displayed in the third column as the overall cash balance. This method is more complex than the Method 1, and generally requires use of higher-end fund accounting software, but it shows the limitations on each category of assets, which provides great insight into the CAA's liquidity. A CAA, for example, may have a large cash balance, but if all of it is restricted, the board should not look to the cash to satisfy needs outside of the permitted uses.

The Income Statement and Restrictions (Exhibits 2A and 2B)

The Income Statement (Statement of Activities) distinguishes contributions with donor restrictions from contributions received without donor restrictions. It also reflects the organization's fulfillment of donor restrictions. There are two common methods to display the receipt of restricted gifts and the fulfillment of restrictions on gifts previously received. One method uses multiple columns, one for unrestricted gifts and grants and one for gifts and grants with donor restrictions, The other method is referred to as "stacked" and presents all of the unrestricted activity in the top section, then presents the restricted activity, in a section below the unrestricted activity. Samples of both formats are included in the Appendix to this section (Exhibits 2A and 2B). Both formats are designed to help readers of the statements understand whether gifts received have been restricted and whether restrictions have been fulfilled or must be fulfilled in future periods.

Not as Complex as It Sounds

Many board members will initially be intimidated by the terminology and the multiple columns. However, the overall concept is actually quite simple to understand once it becomes clear that the numbers simply mirror the restrictions in gifts and grants received by the CAA. A little effort on the part of board members will produce significant insight to the limitations on the use of certain assets.

Concluding Thoughts

Financial management is the responsibility of management and the board, not the auditors. In fact, to meet requirements that the auditor is independent of the organization, auditors may not engage in management functions. Beyond the issue of independence, auditors conduct their audit once a year, following the close of the CAA's fiscal year. Even if the auditors were monitoring the adequacy of the CAA's financial resources, it would only be once a year, which is insufficient. Monitoring any organization's finances is an ongoing process, which must be undertaken at each board meeting and continuously by management.

Equally, or possibly even more important to recognize, the primary function of the auditors is NOT to assess the CAA's financial condition, but rather, to assess whether the financial statements present that condition fairly, whatever that condition might be. While the auditor must evaluate whether the statements about liquidity that management has provided in the footnotes are reasonable in relation to the information available to the auditor, the CAA, including both the management and the board, is responsible for determining whether the organization has adequate cash to meet its obligations. The auditor's opinion letter will state that the auditors considered the reliability of the financial statements based on the assumption that the organization would continue to operate. In situations in which the ability of the CAA to continue operations is seriously in question, the auditors will note that the assumption that the entity will continue to operate may not be appropriate.

A CAA's financial statements contain important information. Many board members who are unfamiliar or uncomfortable with financial matters will decide to ignore the statements. This is a mistake. Here are some basic principles to keep in mind.

- Anyone can read financial statements. It may initially take a little bit of effort, but not all that much.
- Board members have a legal duty to monitor finances, which means reading the financial statements.
- Finance and mission are integrally linked. The financial statements provide an opportunity to discuss the CAA's mission in an organized and meaningful way.
- The financial statements measure financial performance and condition. They do not, however, measure whether a CAA is achieving its mission. The board should spend considerable time discussing whether the CAA's programs are effective and how to best measure effectiveness.

Endnotes:

1. 2 C.F.R. Part 200.
2. See Accounting Standards Codification (ASC) 958 605 20.

CAPLAW
Community Action Program Legal Services, Inc.

APPENDIX TO SECTION 4

Getting the Most Out of Your Financial Statements

PREFACE

Part I – BCA Sample Financial Statements, provides example financial statements cited in Section 4 of the Toolkit. The sample statements are based on the financial statement layout of an existing CAA, but the numbers have been changed, the statement layouts have been simplified, and some account detail has been aggregated, thereby reducing the number of accounts. We have included an annotated list of some of the accounts most commonly found in CAA financial statements which do not appear in these samples.

Part II – A Closer Look at BCA Financials, focuses on what the numbers on the sample statements in Part I might mean. The questions raised and answers provided are meant to illustrate some of the issues and information that a board can discover through a systematic examination of the financial statements. But those discussions are speculative. Only a discussion with BCA's management can reveal the story behind the numbers. That is why financial oversight requires discussion rather than just distribution of the financial statements.

Part I - BCA Sample Financial Statements

Exhibit #1: Statement of Financial Position (Balance Sheet)

BCA
Statement of Financial Position
September 30, 2019
with comparative totals as of June 30, 2019

	9-30-19	6-30-19
Assets		
Cash	$160,000	$200,000
Receivables	501,100	281,100
Prepaid expenses	200,000	100,000
Land, buildings, equipment (net of accum deprec)	1,500,000	1,510,000
Total assets	**2,361,100**	**2,091,100**
Liabilities and Net Assets		
Liabilities		
Accounts payable	190,000	170,000
Line of credit payable	250,000	150,000
Unemployment Comp Reserve	80,000	50,000
Total liabilities	**520,000**	**370,000**
Net Assets without Donor Restrictions		
Available for operations	-8,900	11,100
Invested in fixed assets	1,500,000	1,510,000
Board designated reserves	100,000	100,000
Subtotal - Unrestricted net assets	**1,591,100**	**1,621,100**
Net assets with donor restrictions	**250,000**	**100,000**
Total Net Assets	**1,841,100**	**1,721,100**
Total Liabilities & Net Assets	**$2,361,100**	**$2,091,100**

Exhibit #2: Statement of Activities (Income Statement)

a. Exhibit 2A: Columnar Format
b. Exhibit 2B: Stacked Format

BCA
Statement of Activities (Columnar Format)
7/1/19 through 9/30/19

	Without Donor Restrictions	With Donor Restrictions	Total
SUPPORT AND REVENUE			
Foundation and corporate grants	$ 45,000	$ 250,000	$ 295,000
Governmental grants & contracts	240,000	-	240,000
Contributions from individuals	15,000	-	15,000
Events (net of expenses)	5,000	-	5,000
Investment income	1,300	-	1,300
Total support and revenue	306,300	250,000	556,300
Net assets released from restrictions	100,000	(100,000)	-
Total support and revenue	406,300	150,000	556,300
EXPENSES			
Personnel	329,000	-	329,000
Professional Services	35,000	-	35,000
Occupancy	22,300	-	22,300
Other expenses	50,000	-	50,000
Total expenses	436,300		436,300
INCREASE IN NET ASSETS	**(30,000)**	**150,000**	**120,000**
NET ASSETS, Beginning of Year	1,621,100	100,000	1,721,100
NET ASSETS, End of 1st Qtr.	$ 1,591,100	$ 250,000	$ 1,841,100

BCA
Statement of Activities (Stacked Format)
7/1/19 through 9/30/19

	7/1/19 - 9/30/19	Annual Budget	% Budget Realized	Projected Year End
Support & Revenues w/o Donor Restrictions				
Foundation and corporate grants	$ 45,000	$ 30,000	1.50	50,000
Governmental grants & contracts	240,000	830,000	0.29	830,000
Contributions from individuals	15,000	60,000	0.25	50,000
Events net of expenses	5,000	50,000	0.10	50,000
Investment income	1,300	5,000	0.26	3,000
	306,300	975,000	0.31	983,000
Net assets released from restrictions	100,000	225,000	0.44	225,000
Total Unrestricted Support and Revenue	**406,300**	**1,200,000**	**0.34**	**1,208,000**
Expenses w/o Donor Restrictions				
Personnel	329,000	920,000	0.36	950,000
Prof Services	35,000	40,000	0.88	40,000
Occupancy	22,300	45,000	0.50	50,000
Other expenses	50,000	170,000	0.29	165,000
Total Expenses w/o Donor Restrictions	**436,300**	**1,175,000**	**0.37**	**1,205,000**
		-		
Increase in Net Assets w/o Restrictions	**(30,000)**	**25,000**	**-1.20**	**3,000**
Support with Donor Restrictions				
New TR Grants Received	250,000	360,000	0.69	325,000
Released from Temp Restrict	(100,000)	(225,000)	0.44	(225,000)
Increase in Net Assets w/ Restrictions	**150,000**	**135,000**	**1.11**	**100,000**
Increase in Total Net Assets	**120,000**	**160,000**	**0.75**	**103,000**
Net Assets, Beginning of Year	**1,721,100**			
Net Assets, End of 1st Qtr.	**1,841,100**			

Exhibit #3: Statement of Cash Flows

BCA
STATEMENT OF CASH FLOWS
Quarter ended September 30, 2019

	9-30-19
CASH FLOWS FROM OPERATING ACTIVITIES:	
Increase in net assets	$ 120,000
Adjustments to reconcile increase in net assets	
to net cash provided by operating activities:	
Depreciation	10,000
(Increase) decrease in:	
Accounts receivable	(220,000)
(Increase) decrease in:	
Prepaid expenses	(100,000)
Increase (decrease) in:	
Accounts payable	20,000
Unemploy reserve	30,000
Net cash provided by operating activities	(140,000)
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchase of equipment	-
Net cash used in investing activities	-
CASH FLOWS FROM FINANCING ACTIVITIES	
Increase in Line of Credit	100,000
Net cash from financing activities	100,000
NET INCREASE (DECREASE) IN CASH AND EQUIVALENTS	(40,000)
CASH AND EQUIVALENTS, BEGINNING OF QUARTER	200,000
CASH AND EQUIVALENTS, END OF QUARTER	$ 160,000

Exhibit #4: Statement of Functional Expenses

BCA
Statement of Functional Expenses
July 1, 2019 through September 30, 2019

	7/1/11 thru 9/30/11	Management	Fundraising	Program X	Program Y	Program Z
Personnel	329,000	60,000	20,000	79,000	80,000	90,000
Professional Services	35,000	15,000			10,000	10,000
Occupancy	22,300	2,030	2,000	11,500	2,325	4,445
Other expenses	50,000	3,730	7,130	6,140	13,000	20,000
Total Expenses	**436,300**	**80,760**	**29,130**	**96,640**	**105,325**	**124,445**

Exhibit #5: Statement of Functional Revenues and Expenses

BCA
Statement of Unrestricted Revenues and Expenses by Function
July 1, 2019 through September 30, 2019

	7/1/19 through 9/30/19	Administrative	Fundraising	Program X	Program Y	Program Z
Unrestricted Support and Revenues						
Foundation grants	45,000			5,000		
Government contracts	240,000			35,000	85,000	120,000
Individual gifts	15,000		15,000			
Events net of expenses	5,000		5,000			
Investment Income	1,300		1,300			
Released from Temp Restrictions	100,000		40,000	28,000	40,000	32,000
Total unrestricted support and revenue	**406,300**	**0**	**61,300**	**68,000**	**125,000**	**152,000**
Direct Expenses						
Personnel	329,000	60,000	20,000	79,000	80,000	90,000
Professional Services	35,000	15,000			10,000	10,000
Other Expenses	50,000	3,730	7,030	6,240	13,000	20,000
Subtotal direct expenses	**414,000**	**78,730**	**27,030**	**85,240**	**103,000**	**120,000**
Allocated Expenses						
Occupancy	22,300	2,030	2,000	11,500	2,325	4,445
Direct and allocated expenses	**436,300**	**80,760**	**29,030**	**96,740**	**105,325**	**124,445**
Allocation of administrative expenses	**0**	**(80,760)**	**6,594**	**21,974**	**23,924**	**28,267**
Expenses after allocation of administrative expenses	**436,300**	**0**	**35,624**	**118,714**	**129,249**	**152,712**
Excess (deficit) of support & revenue over total expenses	**($30,000)**	**0**	**$25,676**	**($50,714)**	**($4,249)**	**($712)**

Exhibit #6: A Few Sample Notes to the Financial Statements

A Few Sample Notes to the Financial Statements

Organization:

DESCRIPTION OF ORGANIZATION
Community House, Inc. (the Organization) is a private, nonprofit, social service agency serving Sample area, Adams, and Washington counties. Founded in 1905, its mission is to provide services and resources to develop, support and foster self-reliance, economic independence and dignity in people of all ages. The Organization receives approximately 46% of its annual support from one governmental agency (44% from two governmental agencies in 2018). Additional support is primarily from donations and program fees.

Community House focuses its work primarily in Southwest, North, and Northeast Sample County while providing additional services as needed throughout Adams County and western Washington County. Major service areas include:

- Early Childhood Programs: working to support child development from birth through age six to ensure that young children are prepared to be successful in school. Programs include Head Start, Early Head Start; Preschool Promise, Peninsula Children's Learning Center and an innovative multicultural Parenting Program;
- Youth and Family Programs: helping school-age children succeed through youth development and academic support programs before and after-school care programs at four schools in North, Northeast, and Southwest Sample;
- Anti-poverty Family Support Services: including operation of Southwest Sample's largest food pantry, and provision of housing and supportive services for homeless families at the 19th Avenue Apartments program; and
- Senior programs keeping elders active, health and socially connected through an array of activities at the Community House Senior Center and Senior Transportation Program.

Liquidity:

AVAILABLE RESOURCES AND LIQUIDITY
The Organization regularly monitors liquidity required to meet its operating needs and other contractual commitments, while also striving to maximize the investment of its available funds. For purposes of analyzing resources available to meet general expenditures over a 12-month period, the Organization considers all expenditures related to its primary operations to be general expenditures. It excludes financial assets with donor or other restrictions limiting their use.

Leases:

LEASE COMMITMENTS
The Organization leases program and administrative facilities under operating leases with varying expiration dates from June 2020 through June 2023. Total monthly lease payments for use of facilities approximated $12,800 in 2019 and 2018. The Organization

also leases space in the Multnomah Center under a lease that is renewed annually. The Organization also leases copiers and a printer under operating leases.

Rent expense under all agreements approximated $193,200 and $225,100 for the years ended June 30, 2019 and 2018, respectively.

The Organization's future minimum annual lease commitments under noncancelable leases are as follows:

Year ending June 30, 2020	$ 143,800
2021	129,300
2022	130,900
2023	134,200
Total	$ 538,200

Pensions and Retirement Plans:

RETIREMENT PLAN

The Organization has a 403(b) plan available to all non-leased employees who normally work 20 hours or more per week. The Organization may make matching contributions for all qualified employees who make salary deferrals into the plan. The amount of the match, if any, is determined on an annual basis. In January 2018, the match was discontinued. The Organization's contributions to the plan for 2018 totaled approximately $21,800.

Exhibit #7: Road Map to Financial Statements

Road Map to Financial Statements

One of the most common sources of confusion for boards reading financial reports is that different organizations use different terms to describe the same type of report. The table below provides a quick list of the multiple names that are frequently given to each of the 5 financial statements that are included in the Appendix to Section 4.

Nonprofit Financial Statement	"Also Known As"	What's in This Statement?
Statement of Financial Position (Exhibit 1)	● Balance Sheet	● Assets ● Liabilities ● Net Assets
Statement of Activities (Exhibits 2A and 2B)	● Income Statement ● Profit & Loss Statement ● Statement of Support, Revenues, and Expenses	● Revenues ● Expenses ● Net Income
Statement of Cash Flows (Exhibit 3)	n/a	Cash flows from: ● Operating activities ● Investing activities ● Financing activities ● Net change in cash
Statement of Functional Expenses (Exhibit 4)	n/a	Matrix of expenses displayed by line item and by functional categories – management, fundraising, and programs
Statement of Functional Revenues and Expenses (Exhibit 5)	Program report	Matrix of both revenues and expenses displayed by line item and functional categories – management, fundraising, and programs

Part II - A Closer Look at BCA Financials

Example 1: How to Assess Liquidity

Even a brief look at **Exhibit 1 - Statement of Financial Position** would make BCA's weakening cash position obvious and raise questions about its ability to meet its obligations on time. If BCA were following best practices, its management would have alerted the board's finance committee to the changed circumstances and developed a proposal for dealing with the growing cash flow problems if necessary. The board member or other person charged with leading the discussion on finances should have anticipated the obvious question about the increase in the line of credit and the possible use of restricted cash for unrestricted purposes and been prepared to discuss it regardless of whether somebody asked about it.

One useful way to assess liquidity is to compare the cash balance ($160,000) to the current liabilities ($520,000), and then ask: "How are we going to make up the shortfall ($150,000)?"

The board should begin by reviewing the significant increase in receivables. For many CAAs, a large portion of this number represents amounts that the CAA is entitled to be reimbursed under government grants. Both management and the board should examine a schedule aging the reimbursements (e.g., amounts due and expected to be received in 30, 60, 90, and 120 days). Management should indicate whether circumstances exist that might turn routine reimbursements into ones that are denied. Management should also provide the board with aging schedules for any other receivables. In all likelihood, the funds collected as these receivables are paid by various governmental sources the organization has invoiced will be the primary source for repaying the current liabilities.

BCA's Balance Sheet shows a significant increase in the line of credit during the first quarter of the fiscal year. The Treasurer reports that the current balance of $250,000 is actually above the $200,000 line of credit limit that the board previously authorized. The board should discuss whether it wishes to continue the increase in the line of credit limit and ask management to present its plan for paying off the line of credit during the "rest" period, the month that the bank requires the line of credit to carry a zero balance.

Example 2: What about Looking at Land, Building, and Equipment?

The facts are the same as Scenario 5 in Section 4 of the Toolkit, which focuses on **Exhibit 1 - Statement of Financial Position**, but Gallagher now asks about how the land, building, and equipment affect liquidity.

By and large, as a starting point, board members need to remember that the balances reported for fixed assets (land, building, and equipment) reflect historical cost of these items (reduced by accumulated depreciation, which builds up as depreciation expense is recorded each year). This means that the amounts shown on the balance sheet for the fixed assets may bear no relationship to current value. On a practical level, BCA could sell its building or mortgage its land to raise cash to meet its current liabilities, but each of those actions is a major and involved one. Although selling its headquarters is one way to pay employee salaries, organizations don't routinely sell operating assets to pay recurring operating expenses. This does not mean that a discussion of long-term borrowing or asset sales is off limits, but that discussion is best undertaken as part of longer-term planning efforts. It probably should start as a discussion between the finance committee and management until there are firm proposals.

Example 3: Is There Another Way to Measure Liquidity?

The facts are the same as Scenario 5 in Section 4 of the Toolkit, which focuses on **Exhibit 1 - Statement of Financial Position**. Gallagher is still skeptical about devoting more meeting time to the financial statements, but she did notice that BCA lost $366,781 last year and that **Exhibits 2A and 2B - Statement of Activities**, reports that BCA has a unrestricted net loss of ($30,000) during the first quarter of the fiscal year, Gallagher says, "I know I may be a financial neophyte, but we can't keep losing money like this forever.

In the long run, Gallagher is absolutely correct. BCA's problems are actually greater than the $(30,000) unrestricted loss that the Statement of Activities would suggest. BCA's cash position is deteriorating, as evidenced by the need to increase the limit on the line of credit and increases in both accounts payable and amounts owed to the unemployment compensation reserve. To understand what is happening to BCA's cash position, Gallagher will need to review the Statement of Cash Flows, which focuses on the nitty-gritty of cash in and out rather than accrual-based accounting net income.

For many readers, the Statement of Cash Flows is complex and a seemingly indecipherable document when first examined. The average board member can easily cut through the complexity by understanding that the purpose of the statement is to explain what happened to cash during the quarter. The change in the cash balance during the quarter is reported on the third line from the bottom, captioned "Net Increase (Decrease) in Cash and Equivalents". **Exhibit 3 - Statement of Cash Flows** reports a decrease in cash ($40,000) over the first quarter of the fiscal year.

The explanation for this drop in cash is provided in three segments reporting on cash flows from operating activities, investing activities, and financing activities. In this case, operating activities resulted in a reduction in cash of ($140,000). This reduction in cash was offset by borrowing cash through drawing down an additional $100,000 from the line of credit. In this example, BCA didn't report any investing activities which would typically include the purchase or sale of equipment or other fixed assets.

Board members who are frustrated by accrual accounting, which records income when it is earned and expenses when they are incurred regardless of when cash is received or disbursed, may find the cash flows from operating activities helpful. It begins with accrual basis net income (increase in net assets) and then shows why this number is different from the actual decrease in cash. In this case, part of the explanation is that depreciation does not consume cash. A bigger factor is that while BCA recorded $535,000 in both unrestricted and restricted grants (both foundation and government) during the quarter, it has also recorded an increase in grants receivable of $220,000. This reflects that the grant income recorded using the accrual basis of accounting is not the same thing as the cash actually collected and deposited into BCA's bank account.

The Operating Activities section of the Statement of Cash Flows also explains that BCA increased both its accounts payable and its liability for contributions to its unemployment reserve. Again, accrual accounting required recording expenses as they are incurred, but BCA lacked the cash to pay some of its obligations and consequently saw its liabilities increase. The Statement of Cash Flows contains lots of other information, but this discussion illustrates how the board should use the statement. Management and the finance committee should be reviewing the other entries in greater detail.

Beyond reviewing the Statement of Cash Flows to understand what has happened to BCA's cash position, the finance committee and management should be reviewing an updated Cash Flow Projection, which is a very different financial management tool. The Cash Flow Projection should predict what cash will come in and flow out in each of the next 12 months in order to understand whether BCA will have the cash it needs when it needs to meet its obligations. Given BCA's poor cash position, the board should expect management to provide a plan to improve cash and the finance committee should monitor whether the plan is actually working.

Example 4: Is There Anything Else the Board Can Use to Make the Process Easier?

The facts are the same as Scenario 5 in Section 4 of the Toolkit, which focuses on **Exhibit 1 - Statement of Financial Position**. Whipple has grown tired with the BCA board's reluctance to meaningfully discuss BCA's finances. She urges board members to take a hard look at BCA's net assets. While the total net assets grew from $1,721,100 at the end of June to $1,841,100 at the end of September, she is concerned that the increase of $150,000 in net assets with donor restrictions is masking the decline in net assets without donor restrictions, which decreased by $30,000. That ($30,000) reflects the reality that BCA's unrestricted income fell $30,000 short of its expenses.

Whipple points out that $250,000 of the grants BCA recorded during the first quarter were donor restricted. BCA was able to use only $100,000 of its donor restricted funds during the first quarter, resulting in the net assets with donor restrictions increasing by $150,000. While this is good news to the extent it represents funders being willing to provide funding for future activities, the unrestricted net loss has resulted in reducing BCAs unrestricted net assets. In fact, BCA's unrestricted net assets available for operations became negative ($8,900). What this really means is that the $100,000 in net assets that the board had designated for a future capital campaign is being consumed by its operating losses.

Another concern that Whipple hopes to hear management address lies in the fact that while BCA's net assets with donor restrictions total $250,000 at the end of September, its cash balance is only $160,000. This raises concerns that BCA may be using restricted cash to meet its unrestricted obligations.

Example 5: Budget Variances Can Show More than Just Shortfalls

The facts are the same as Scenario 4 in Section 4 of the Toolkit, which focuses on **Exhibit 2B - Statement of Activities (Stacked Format)**. As the discussion of the personnel expenses exceeding the budget is coming to an end, Max Weingard, another board member, pipes up, "What is going on with the Professional Services? We're only a quarter of the way through the year and we've spent 88% of the budget." Weingard is absolutely right to raise this point. Cruz offers the following explanation: BCA's independent audit, which is one of its largest Professional Service expenses, was concluded in September, so the expense was recorded when the bill was received. The budget for Professional Services also included funds for consultation on how to improve staff morale, which was scheduled for the first quarter of the year when BCA had anticipated that staff would be under less stress than later in the fall. Unfortunately, August and September turned out to be two of BCA's busiest months ever, but the contract with the consultant required going ahead with the staff morale sessions.

LESSON: Weingard makes an excellent point. Anyone reviewing any financial schedule must understand the assumptions and conventions used in assembling and presenting the data. This is one reason the board should be reviewing financial data at each board meeting. It takes time and familiarity with the reporting system to understand the data produced by the system. That requires regular discussions.

Example 6: Projections Really Help

Exhibit 2B presents the Statement of Activities in the "stacked" format, which places unrestricted activity at the top of the report and restricted activity at the bottom. The numbers and results from activities are just the same as those on Exhibit 2A, which presents the Statement of Activities in the "columnar" format. One advantage of the "stacked" format is that it leaves room for comparison with the budget, and computation of the % of budget realized, and also adds a fourth column for Projected Year End. The Projected Year End information is extremely helpful to board members. It provides management's most recent estimate of how the year will end up. Most CEOs and CFOs inform the board continuously as conditions change both in terms of expenses and also in terms of the availability of income. But it is very difficult for board members to put all those pieces together to understand whether management believes that the combination of all those changes will produce a positive or negative result.

Exhibit 2A presents management's projection that the year will end with a net increase in unrestricted net assets of $3,000. That's not as good as BCA planned for in the budget, which projected the net increase unrestricted net assets (unrestricted net income) to be $25,000, but it's certainly a more positive picture than the first quarter results showing a net unrestricted loss of ($30,000). Of course, management must be prepared to discuss the basis for its projection in detail with the finance committee.