Boulder County Arts Alliance

Conversation about Evaluating Not-for-Profit Financial Statements

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BOULDER CHAMBER

Agenda

1. Why Evaluate Financial Statements
2. Context for Analyzing Financial Statements
3. Accrual vs. Cash Accounting
4. Types of Financial Statements
5. Financial Statement Analysis
    - Ratios – Worksheet Examples
    - Other Considerations
    - Indicators of Financial Health and Weakness
6. Summary
7. Questions
8. Additional Resources

Why Evaluate Financial Statements?

- A for-profit exists to make money -> easy to measure from financial statements

- A not-for-profit (NFP) exists to fulfill a societal mission -> more complex

- Both for-profits and NFPs are businesses
  - Serve customers or clients, buy assets, pay rent, make payroll, pay bills….
  - Need cash -> given, borrowed or internally generated (inflows exceed outflows)!
  - Financial Statements are used to assess business: Past, current status, and ability to pursue future activities

Why Evaluate Financial Statements?

- NPF Financial Statements show:
  - How well it is positioned to meet its mission
  - Its capacity to continue to operate over time as business conditions change
  - Resources available to innovate
  - May also show ‘restricted funds’ (unique to NFPs) – $ stipulated by donors/grantors for specific use
- Healthy Financial Statements help NFPs build the case for support
  - Knowledge of weaknesses + specific plans to address them can also help attract support

QUESTIONS/Context for Analyzing Financial Statements

- Type of nonprofit -> Impacts mix of revenues, expenses, assets and liabilities
  - Facility-based
    - Museum (and type: art, history, children's)
    - Performing arts venue
  - Performing arts organization: dance, music, theater
  - Arts school (music, dance, fine art)
  - Membership-based organization

- Size/Scale of business
  - Professionally managed vs volunteer powered or a mixture
  - Accrual vs Cash Accounting (or a mixture)?

- Fiscal year end vs. business cycle

- Are revenues/expenses consistent throughout the year or 'lumpy'?

An Aside: Cash vs. Accrual Accounting

Key difference: timing of when revenues and expenses are recognized

- **Cash accounting** -> Small organizations (and personal finances)
  - Revenue is recognized only when the money is received and expenses only when the money is paid out.

- **Accrual accounting** -> Larger organizations
  - Revenue and expenses are recognized when earned/incurred: even if cash is not received or paid out

  - 'Indicators' of Accrual accounting on Balance Sheet: Accounts Receivable,   Accounts Payable, Deferred Income or Expenses, Depreciation

  - **Capitalized expenses:** assets with a long life (buildings, computers, equipment) are **recorded as an asset on the Balance Sheet** and **depreciated (expensed)** over their useful lives.

- Small organizations may use a mix of Cash and Accrual

Cash vs. Accrual

Example 1 – A choral group performed its holiday concert in late Dec ‘18 and sold $5,000 of tickets through a 3rd party box office. Fiscal year end is 12/31.

- **Cash**: the $5,000 is not recognized as revenue until the box office’s check is **received** in January ‘19.

- **Accrual**: the revenue is recognized in December when it was earned (and becomes an accounts receivable until the check is received.)

Example 2 – An organization pays its utility bills monthly

- **Cash**: the amount owed is not recognized as an expense until the bill is **paid**.

- **Accrual:** the expense is recognized **when the bill is received** (and becomes an account payable until paid/check issued.)

Cash vs. Accrual

Example 3 – Capitalized Expenses: a potter's guild buys a new kiln with an expected 10-year life for $10,000.

- Under the **cash** method, in year 1: cash is reduced by $10,000 and $10,000 is recorded as an expense.

- Under the **accrual** method, in year 1: cash is reduced by $10,000 but only $1,000 is expensed as depreciation. (The remaining $9,000 is recorded as a depreciation expense at a rate of $1,000 per year for the next 9 years).

- In both cases, cash is reduced by $10,000 in year 1 but reported expenses – and, therefore, net income - over the 10 years (and especially in Year 1) will be significantly different.

The Four Financial Statements

- Income Statement (Profit & Loss or Statement of Financial Activity)
- Balance Sheet (Statement of Financial Position)
- Statement of Functional Expenses*
- Statement of Cash Flows

* Unique to NFPs (other statements are also used by for-profits); accrual accounting rules for contributed income and pledges are also unique

The Income Statement (or Profit & Loss or Statement of Financial Activity)

- Revenues and Expenses **for a set period of time** such as the most recent year
  - Revenues: Contributed, Earned, Other
  - Expenses*: Programs, Administration, Fundraising

- Revenues minus Expenses = Change in Net Assets (Net Income or Loss)

- Change in Net Assets is reflected on the Balance Sheet

- Over time, to build cash reserves, NFP must generate more Revenues than Expenses

*NFPs face pressure from donors/grantors to keep administrative and fundraising expenses low

The Balance Sheet (Statement of of Financial Position)

- Snap Shot –> at a point in time (typically fiscal year end)

  - What the NFP **Owns** (Assets)
  - What the NFP **Owes** (Liabilities)
  - What the NFP **Has** net of Liabilities (Net Assets = “Equity” in a for-profit)

Assets – Liabilities = Net Assets

or

Assets = Liabilities + Net Assets -> Balance

- Net Assets = sum of all the annual surpluses and deficits accumulated over an organization’s entire history

- Change in Net Assets (Income Statement) will be reflected on the Balance Sheet

Balance Sheet (or Statement of Financial Position)

- Assets: usually listed from top to bottom by rank of liquidity (ease of converting to cash)
  - Cash
  - Savings
  - Accounts Receivable – Short Term (< 1 year)
    - SUBTOTAL Current Assets
  - Inventory
  - Long Term Receivables (could be pledges)
  - Equipment
  - Property
    - SUBTOTAL Long Term Assets
    - TOTAL ASSETS

- Liabilities: also ranked with nearest-term obligations at the top
  - Accounts Payable
  - Deferred Income
  - Payroll Payable
  - Line of Credit
    - SUBTOTAL Short Term Liabilities (<1 year)
  - Mortgage Debt or Other Long Term Liabilities
    - TOTAL LIABILITIES

- Net Assets (also called equity, retained earnings, fund balance)
- Liabilities + Net Assets (= Total Assets)

LEXINGTON ARTS ACADEMY
STATEMENT OF FINANCIAL POSITION
JULY 31, 2012
(WITH COMPARATIVE TOTAL FOR 2011)

	2012	2011
ASSETS		
Cash and cash equivalents	$ 93,033	$ 141,591
Contributions receivable	585	1,300
Prepaid expenses	27,742	19,216
Total current assets	**123,372**	**164,118**
Net property and equipment	85,536	65,534
Total assets	**$ 206,896**	**$ 229,652**
LIABILITIES AND NET ASSETS		
Liabilities		
Accounts payable	$ 5,096	$ 5,961
Payroll liabilities	11,381	6,905
Prepaid tuition	55,353	45,120
Line of Credit	8,314	11,296
Total current liabilities	**80,144**	**69,282**
Long term liabilities	-	-
Total liabilities	**80,144**	**69,282**
Net assets		
Unrestricted	126,752	160,370
Restricted	-	-
Total net assets	**126,752**	**160,370**
Total liabilities and net assets	**$ 206,896**	**$ 229,652**

A healthy balance sheet shows sufficient LIQUIDITY to:

- Pay the bills
- Weather a rainy day
- Repair, replace, improve fixed assets
- Innovate and experiment
- Adapt for the future
- Retire debt (as scheduled)

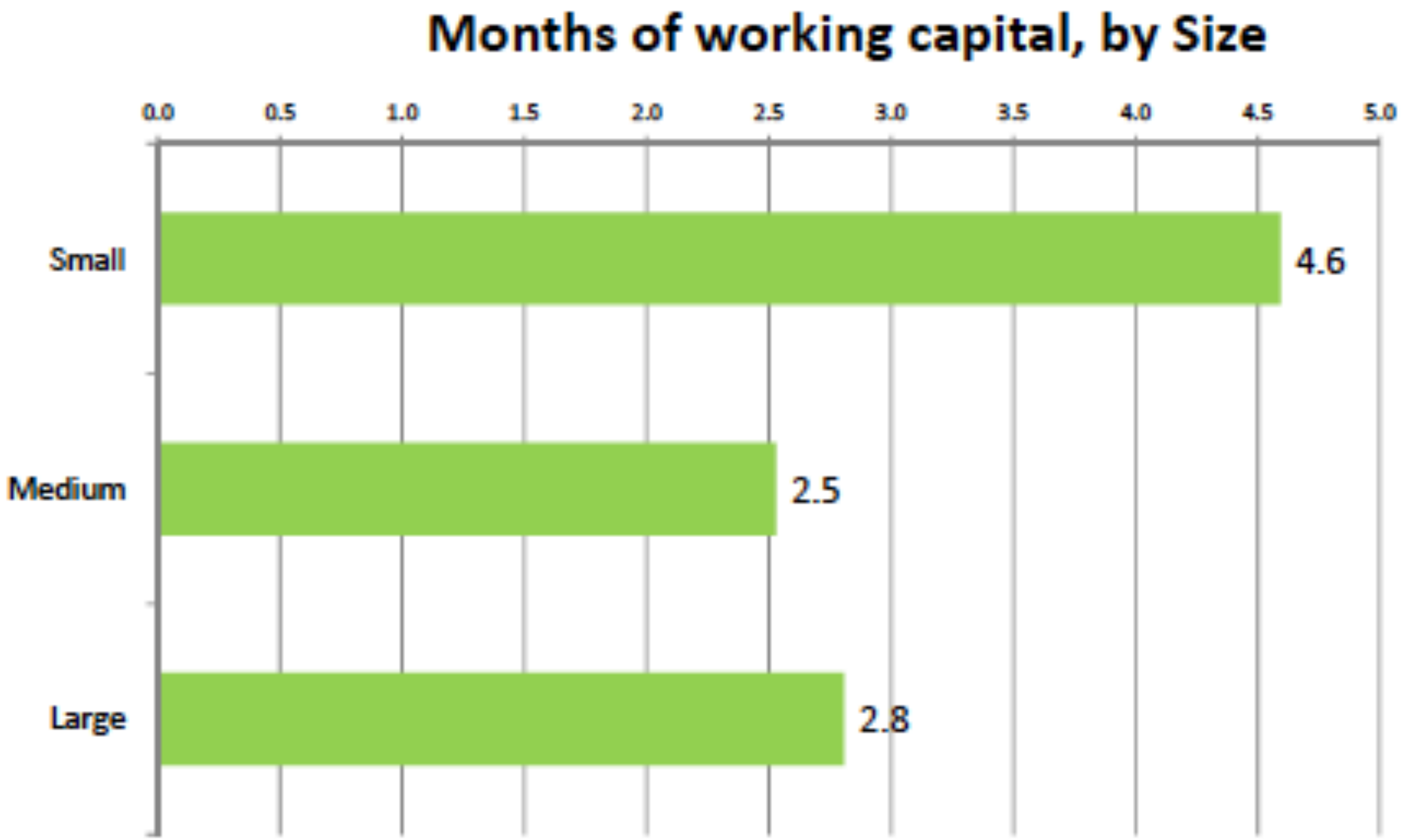
Both the Balance Sheet and Income Statement are needed to assess financial health of an organization

- In-depth analysis would require information over multiple years

Key Measures of Liquidity/Financial Health

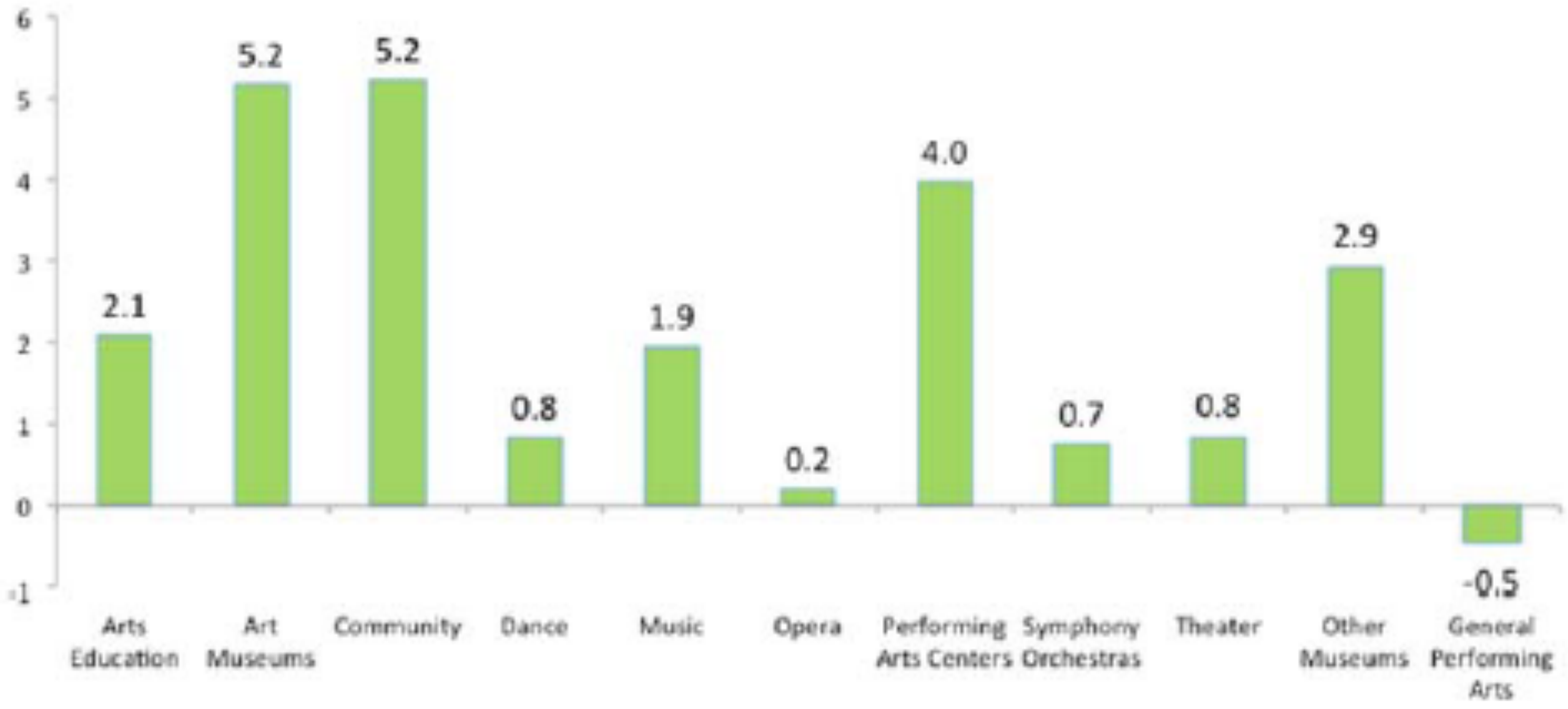
- **Days Cash on Hand** (usually measured in months): estimates how many days or months of organizational expenses could be covered with current cash balances
  - *Cash divided by (total cash expenses divided by 12)*
- **Working Capital**: measures ability to pay current liabilities with short term assets
  - *Current Assets (cash, cash equivalents, accounts receivable) minus Current Liabilities*
  - Negative working capital is a ‘red flag’
- **Months of Working Capital on Hand**:
  - *Working Capital divided by (total cash expenses divided by 12)*

SIZE MATTERS



Data representing more than 55,000 cultural groups from the Cultural Data Project, National Center of Charitable Statistics and Theater Communications Group.

LIQUIDITY VARIES WIDELY BY ARTISTIC DISCIPLINE



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NATIONAL CENTER FOR ARTS RESEARCH, 2014

Personal Financial Statements Worksheets - Scenario 1

BALANCE SHEET:					
ASSETS			LIABILITIES & NET ASSETS		
Checking/Savings	$	10,000	Credit Card Debt/Line of Credit	$	4,000
Current Assets	**$**	**10,000**	**Total Current Liabilities**	**$**	**4,000**
Furniture, Artwork	$	1,000			
			Long Term Liabilities	$	-
Long Term Assets	**$**	**1,000**	**Total Liabilities**	**$**	**4,000**
			Net Assets (Assets - Liabilities)	$	7,000
Total Assets	**$**	**11,000**	**Total Liabilities & Net Assets**	**$**	**11,000**
INCOME STATEMENT					
Annual Income	**$**	**46,000**			
Annual Expenses					
Rent	$	24,000			
Food, etc.	$	20,000			
Total Annual Expenses	**$**	**44,000**			
Net Income	**$**	**2,000**			

Personal Financial Statements - Scenario 2 (Car Loan) `

BALANCE SHEET:				
ASSETS			LIABILITIES & NET ASSETS	
Checking/Savings	$	10,000	Credit Card Debt/Line of Credit	$ 4,000
			Car Loan - Due within 1 year	$ 7,000
Current Assets	**$**	**10,000**	**Total Current Liabilities**	**$ 11,000**
Furniture, Artwork…	$	1,000		
Automobile	$	24,000	Car Loan (Due years 2-3)	$ 10,000
Long Term Assets	**$**	**25,000**	**Long Term Liabilities**	**$ 10,000**
			Total Liabilities	**$ 21,000**
			Net Assets (Assets - Liabilities)	$ 14,000
Total Assets	**$**	**35,000**	**Total Liabilities & Net Assets**	**$ 35,000**

INCOME STATEMENT		
Annual Income	**$**	**56,000**
Annual Expenses		
Rent	$	24,000
Food, Gas, Insurance, etc.	$	24,000
Total Annual Expenses	**$**	**48,000**
Net Income	**$**	**8,000**

Financial Ratios	**Scenario 1**	**Scenario 2**
Monthly Expenses (Annual Expenses/12)	**$ 3,667**	**$ 4,000**
Working Capital (Current Assets - Current Liabilities)	**$ 6,000**	**$ (1,000)**
Cash Months on Hand (Cash/Monthly Expenses)	**$ 2.7**	**$ 2.5**
Working Capital Months on Hand (Working Capital/Monthly Expenses)	**$ 1.6**	**$ (0.3)**

Performing Arts Organization

Profit and Loss (Cash Basis)

	Jan - Dec '16	%
Income		
Contributed Income		
Grants (SCFD and Other)	30,000	
Corporate	500	
Individual	35,000	
Total Contributed Income	65,500	59%
Earned Income		
Classes	20,000	
Ticket Sales	25,000	
Performance fee	500	
Total Earned Income	45,500	41%
Misc. Income	155	
Total Income	111,155	
Expense		
Total Expenses		
Programming Expenses		
Total Personnel	56,000	
Total Non-Personnel/Production	30,000	
Total Programming Expenses	86,000	83%
Total Administrative Expenses	15,000	14%
Total Fundraising	2,500	2%
Total Expense	103,500	
Net Income	7,655	

Balance Sheet Standard

Cash Basis

	Sep 6, '17
ASSETS	
Current Assets	
Checking/Savings	
Checking	35,000
Total Checking/Savings	35,000
Total Current Assets	35,000
Fixed Assets	
Equipment	15,607
Accumulated Depreciation	-10,501
Total Fixed Assets	5,106
TOTAL ASSETS	40,106
LIABILITIES & EQUITY	
Equity	
Opening Bal Equity	1,000
Retained Earnings	31,451
Net Income	7,655
Total Equity	40,106
TOTAL LIABILITIES & EQUITY	40,106

Months Cash on Hand:
Total Cash on BS/ (Cash Expenses on P&L/12)

(Months Cash on Hand: 35,000/ (103,500/12) = 4.1 months

Note: in this case, months of cash on hand = months of working capital on hand

Other Considerations

- Revenue diversification vs. concentration: How well can the organization weather the loss of a few funders/students/patrons?

- Mix of earned vs. contributed income: Some mix is healthy and generally encouraged by funders

  - Organizations are increasingly under pressure to increase earned income AND keep ticket prices low (which reduces earned income) to make programming more accessible.

  - Pay attention to deferred or unearned income (eg. pre-paid tuition, theater subscriptions) vs. cash balances: Cash has been received but the organization has not **earned** the funds.

- Fixed vs. variable cost structure: varies by type of organization, but ability to throttle spending generally means lower risk.

  - Organizations with high fixed costs (large paid staff, high rent/utilities/future debt repayments) generally should have larger cash reserves/working capital

Other Considerations:

- Seasonality of revenues/cash flows: Is there sufficient cash on hand to weather the lean (typically summer) months?

- Deficits (chronic or unplanned): a deficit, in and of itself, is not a red flag but should trigger additional inquiry.

  - Deficits may reflect timing differences rather than financial instability. For example, organizations may build cash reserves in prior periods in anticipation of future spending needs. This is healthy!

- Debt: chronic vs. short-term for working capital (line of credit)
  - What are the repayment terms of the debt? Does the organization typically generate enough cash each year to easily repay the debt?

WHAT TO WATCH FOR
IS THERE A BALANCE SHEET PROBLEM?

METRIC	RED FLAG	POSITIVE INDICATOR
Liquidity	• Inappropriate cash and liquid net assets on hand • Current liabilities > current assets	• Growing months of expense coverage • Presence of dedicated reserves
Health of Balance Sheet	• Line of credit consistently drawn • Unpaid debts • Growing wear and tear of fixed assets	• Attention to obligations • Reinvestment in fixed assets

rta rebecca thomas + associates

See "Measurements of Liquidity" above

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2012 Income Statement Summary		
Revenues		
Grants and Contributions	$ 186,646	24%
Tuition, Ticket Sales & Fees	575,418	73%
Other	24,948	3%
Total Revenue	$ 787,012	
Expenses		
Program Services	721,057	88%
Management & General	59,764	7%
Fundraising	39,809	5%
Total Expenses	820,630	
Change in Net Assets	(33,618)	
Net Assets, beginning of year	160,370	
Net Assets, end of year	$ 126,752	

Key Measures	
Monthly Expenses	68,386
Working Capital	43,228
Cash Months on Hand	1.36
Working Capital Months on Hand	0.63

Summary

- Financial Statements tell a story: past, present and possible future

- Adequate liquidity is essential to an organization’s financial health

    - Both the Balance Sheet (*ideally* for last two years) and Income Statement (for the prior year) are needed to assess financial health

    - Focus on mix of revenues and expenses, changes in cash, current assets, current liabilities and crunch the numbers

- Knowing a nonprofit’s financial strength and weaknesses can help drive planning, build the case for support, and balance:

    - Mission – What the NFP does and Why
    - Capital – What the NFP Has and How it’s distributed
    - Capacity – NFP’s ability to meet its mission

Questions?

Additional Resources:

Interpreting Nonprofit Financial Statements: This 2012 'white paper' from Social Venture Partners Boulder County was written as a primer for nonprofit board members and others wanting a better understanding of nonprofit financials.   It is a fairly easy read and good resource. (see: svpbouldercounty.org)

Principles and Practices for Nonprofit Excellence in Colorado: Colorado Nonprofit Association's Principles and Practices document, 4th edition. This is well respected in Colorado's nonprofit sector and provides guidance in key areas of operations including governance, financial management, fundraising, etc. in a digestible format.   Registration is required to download the document but its free and easy to do. (see: https://www.coloradononprofits.org/resources/principles-practices)

Nonprofit Finance Fund (nff.org): Wealth of resources on the website. Its Financial Self Assessment for Arts Organizations (https://nff.org/fundamental/financial-self-assessment-worksheet-arts-organizations), has a great worksheet.

Additional questions?   Feel free to reach out to me through the Boulder Chamber at Deborah.malden@boulderchamber.com or 303.870.5263 cell.