How Do You Read and Understand Nonprofit Financial Statements?

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The answer to the question is a complex one, but each individual statement is equally important especially when used in conjunction with the footnotes. However; before we jump into explaining why each statement is important we must first understand why nonprofit (NFP) organizations are different from their for-profit brethren. NFPs are not owned by shareholders nor do they intend to earn profit to distribute back to shareholders. Instead, NFPs seek to earn revenue to support their program activities which are related to their mission. The mission is the key driver for NFPs, not a return of profit to its shareholders. Financial statements are key components in revealing the financial health of an organization whether NFP or for-profit. An NFP's financial information can get quite complicated, but if you understand the basics, you can glean vital information from the financial statements and related disclosures.

Nonprofits use four main financial reporting statements: statement of financial position (balance sheet), statement of activities (income statement), statement of cash flows and statement of functional expenses. Three of these statements are similar to for-profit company statements, with the exception that the statement of functional expenses is unique to NFPs because it is an analysis of expenses by both nature and function. Understanding the elements of these statements and how they relate to one another can help you understand an NFP's financial position and what resources it has available and how the NFP deploys its resources.

STATEMENT OF FINANCIAL POSITION

The nonprofit balance sheet is also commonly referred to as a statement of financial position or statement of financial condition. This statement is based on the accounting formula, assets equal liabilities plus net assets. This equation is mirrored on a for-profit balance sheet; however, net assets are replaced with owners' equity. The balance sheet offers the best overall perspective on the nonprofit's financial health and stability. In particular, readers evaluate the relationship of assets to liabilities. One of the issues that blur NFPs' financial statements versus for-profit entities' is the ability to determine liquidity (working capital) because of donor restrictions on net assets.

The assets on a statement of financial position are classified as either current or non-current if the NFP has chosen to present a classified statement of financial position. Current assets are the most liquid, meaning they can easily be converted to cash in a relatively short period. Fixed assets are non-current since the assets are expected to be available for a term longer than 12 months form the measurement date (year-end). Similar to assets, liabilities are also classified as current or long-term based on the closeness to maturity. Current liabilities include money owed to creditors in less than a year. Long-term liabilities are due in one year or later. Net assets (equity) is the total amount of residual assets remaining in the NFP.

STATEMENT OF ACTIVITIES

Often referred to as the income statement since the term is more commonly associated with for-profit companies and earnings, the nonprofit statement of activities follows the basic formula: revenues less expenses equals the change in net assets. In a for-profit this is referred to as earnings. The nonprofit statement of activities shows the funds coming into the organization less the costs of operating the organization.

An NFP's revenues, gains, expenses and losses are listed on its statement of activities. Revenue is money earned from an NFP's normal business operations. The expenses on the statement of activities are the costs associated with earning the revenue. When an NFP sells one of its assets, it can experience a capital gain or loss because this activity is not part of its central and ongoing business activity. Revenues less expenses, plus gains less losses, equals the overall change in net assets. The dollar amount of the change in net assets listed on the statement of activities is also found on the cash flow statement under the operating activities section.

STATEMENT OF FUNCTIONAL EXPENSES

The statement of functional expenses is only used by nonprofit organizations based on the importance of monitoring expenditures. In general, this statement breaks down organizational expenses into common categories. This breakdown helps an NFP track how it spends its money. The statement also shows the breakdown of expenses between program services and support services. One of the reasons nonprofits track expenses is to report on the percentage of funds that go toward programs compared to funds spent on administration costs, such as employee salaries and fundraising.

STATEMENT OF CASH FLOWS

The statement of cash flows is similar to the one used by for-profit entities. The statement of cash flows presents operating, investing and financing activities to show the sources and uses of cash.

The cash flow statement can be presented using the direct method (the preferred method) or the indirect method, which is the one that is most commonly used. The direct method shows in the operating activities section the inflows and outflows related to cash flows provided by and used in operating activities. The indirect method starts with the change in net assets, followed by additions to or subtractions related to changes in the statement of financial positon to adjust the change in net assets to a cash basis. The statement of cash flows is divided into four sections. The first section of the cash flow statement is cash provided by or used in operating activities, which shows the cash flows in and out of the NFP in relation to its mission-related operation. The second section, cash flows from investing activities, shows cash the NFP received from or spent on its capital investments. The third section, financing activities, shows the inflows and outflows of cash related to the NFP’s borrowing activities, which is also listed on the statement of financial position. The final and last section is the supplemental information which presents cash paid for income taxes and interest and the non-cash transactions.

FOOTNOTES

The footnotes or disclosures are just as important as the individual statements. The information in the footnotes allows the reader to obtain more information so they can truly understand the numbers in the various statements. The footnotes provide the accounting policies utilized in preparing the financial statements as well as information about the components of the numbers presented in the financial statements. The footnotes are critical to understanding the statements and should be read in detail.