Financial Management in Non-Profit Organizations

Chapter 10

Financial Management

- Financial management focuses on generating financial information that can be used to improve decision-making oriented towards achieving the goals of an organization as well as maintaining a healthy financial situation

Financial Management

- Financial management encompasses the broad areas of:
  - Managerial accounting – relates to the generation of any financial information that managers find useful for the internal management of the organization. It incorporates activities such as developing and implementing budgets as well as various analytic techniques;

Financial Management

- Financial management encompasses the broad areas of:
  - Financial accounting – concerned with providing retrospective financial information to those both internal and external to an organization. It produces regular reports from the accounting system regarding the financial status of the organization at any point in time; and

Financial Management

- Financial management encompasses the broad areas of:
  - Finance – focuses on sources and uses of an organization's financial resources such as cash investments.
- Financial management is not an end in itself, rather a tool. Aside from providing current and historical financial data, financial management is also concerned with the effectiveness and efficiency of an organization.

Responsibility for Financial Managemet

- Ultimately, the Board of Directors is responsible for the prudent management of a nonprofit's funds and assets.
- The Board cannot delegate this responsibility to employees or financial consultants but can rely on the advice and assistance of such people.
- While day-to-day financial management duties are usually undertaken by staff, the Board remains responsible and must maintain proper supervision and control of the work of the employees.

Budgeting

- Budgeting is an important step in the overall planning process.
- The budget is a specific and detailed plan for the fiscal year that defines the resources needed to accomplish its goals and objectives, where the resources will come from, and how they will be used.
- The budget is a plan expressed in monetary terms – it is used as a management tool to motivate, monitor and measure financial performance and to assist in managing operations, revenues and costs.

Budgeting

- Budgets shouldn't be too ridged and be treated as guidelines. There are four elements to ensuring the budget is developed in an "ideal" process.

- First, appropriate involvement of staff is important. The tone is set at the top and should sufficiently engage managers.

- Second, budgeting requires a significant amount of time and energy (may take 3-6 months).

Budgeting

- Third, the process of developing the budget should be engaging, especially for line managers such as program and department heads. At times line managers may be difficult to engage, may need a bottom-up approach.
  - Bottom-up approach starts by having managers provide specific targets or outputs that their programs or departments can accomplish in line with the strategic plan. They then prepare the corresponding budget allocation request to meet these target. Should be combined with direction from the CEO.

Budgeting

- Finally, the budget process should be flexible. It should contain appropriate procedures for approving changes when required so that it enables rather than disables the organization's ability to adapt to changing conditions.
  - Some Organizations have adopted a rolling budget process such that the approved budget is reviewed regularly and revised budget goals are agreed upon during the year within parameters set by the Board.

Budgeting

- Characteristics of a Well-prepared Budget
  - Provides the financial and operational guidance needed to implement policies and directives established by the Board of Directors;
  - Allows management to measure and guide immediate and long-term financial health and operational effectiveness;
  - Guides the acquisition and use of resources;
  - Anticipates operational expenses and identifies income to pay for such expenses;

Budgeting

- Characteristics of a Well-prepared Budget
  - Is a tool for controlling spending and avoiding unplanned deficits;
  - Helps to integrate administrative, staff, and operating activities;
  - Allows monitoring of actual income and expenses;
  - Serves as one of the bases for performance reviews and in some cases, compensation.

Budgeting

- Types of Budgets
  - Capital Budget – shows what capital assets are required for an Organization to operate and the effects of these acquisitions on the operating budget.
    - One of the most significant effects it has on the operating budge is through the inclusion of amortization or depreciation expenses.
    - Some Organizations identify purchases of specific items for the coming year, while others may approve an overall dollar value for capital spending and then evaluate and approve individual items for acquisition throughout the year as the need for those items arise.
    - Decisions regarding the purchase or lease of capital assets involves detailed analysis of the impact and usefulness.

Budgeting

- Types of Budgets
  - Cash Budget – it is a good idea to prepare a cash budget so as to reveal times when there may be a shortage of cash to pay regular operating costs such as salaries and rent.
  - Allows for specific financing arrangements to be made well ahead of any potential cash shortages or so management can speed up the timing of cash receipts and slow down disbursements.
  - Alternatively, Cash Budgets will identify times when excess cash may be on hand and available for investment.

Budgeting

- Types of Budgets
  - Operating Budget – based on a set of detailed assumptions about what the Organization wishes to accomplish in the next fiscal year modified by an analysis of likely external influences on the Organization's income and expenses.
  - Should be based on the accrual method of accounting, which means that the revenues and expenses arising from providing services are both recorded in the same fiscal year even though the cash associated my be received or paid in a different fiscal year. (Follows GAAP)
  - Should not be indifferent to budgeting either a surplus or deficit – accumulated surplus may be spent or a surplus generated may be restricted for capital or program use.

Budgeting

- Roles & Responsibilities in Budgeting
  - Board of Directors – ultimately legally responsible for ensuring budgets meet applicable laws and regulations, are fiscally sound, and will further the Organization's mission.
    - Some Boards restrict their role in budgeting to that of reviewing and approving, while other participate in budget preparation from the beginning.
    - Boards establish general budget policies.
    - Following approval of the budget, Boards receive regular updates on its implementation from the CEO and would approve any significant changes to the budget that become necessary during the fiscal year.

Budgeting

- Roles & Responsibilities in Budgeting
  - CEO – to facilitate and oversee the preparation and approval of the budget as well as implementation once approved. This includes:
    - Arranging and staffing early strategic planning sessions with the Board;
    - Preparing options and recommendations to guide budget development;
    - Ensure the budget is accurate and adheres to Board policies and that budget scheduling is met;
    - Reviewing draft budgets and making resource allocation decisions; and
    - Present the recommended budget to the Board.

Budgeting

- Roles & Responsibilities in Budgeting
  - CFO–plays a major and sustained role, often having day-to-day responsibility for coordinating budget development, implementation and monitoring. This includes:
    - Creating the budget development calendar and ensuring deadlines are met;
    - Communicating budgeting policies and procedures to managers and line staff;
    - Establishing the format for budget drafts;
    - Developing revenue and expense forecasts based on reviews of economic and competitive trends;
    - Collaborating in setting expense and revenue targets in line with strategic plan and programs;

Budgeting

- Roles & Responsibilities in Budgeting
  - CFO–plays a major and sustained role, often having day-to-day responsibility for coordinating budget development, implementation and monitoring. This includes:
    - Evaluating draft budgets from program or unit managers for accuracy, reasonableness, applicable guidelines, and anticipated resources;
    - Discussing draft budgets with the CEO and other managers as needed;
    - Writing up recommendations for reducing, increasing, or reallocating requested resources;
    - Preparing the budget document once the CEOs budget decisions are made and helping present to the Board; and
    - Once approved, overseeing its implementation and monitoring.

Budgeting

- Roles & Responsibilities in Budgeting
  - Program, Unit, Activity or Department Managers – may be best equipped to provide information on current program needs, revenues, costs, and the effects of reducing or expanding individual programs.
    - Their involvement is essential and they are also held accountable for the allocated resources by regularly reviewing financial reports prepared by the CFO and developing corrective action plans when problems arise.

Budgeting

- Roles & Responsibilities in Budgeting
  - Steps in the Budget Preparation Process
    - A set of assumptions and guidelines is prepared that create the context within which mangers will develop detailed budget for their areas. They will be provided policies, goals, and performance expectations stemming from the policies and strategy established by the Board.

Budgeting

- Roles & Responsibilities in Budgeting
  - Budget Review and Adoption
    - Once budgets for the responsibility areas are complete, they are aggregated.
    - It is common that the total of all spending requests exceeds projected revenues – thus begins a process of negotiation to first eliminate any inefficiency in the budget, then to either find more revenue or reduce expenses.
    - It is important to identity “hard” and “soft” revenues and expenses. Hard – fixed or confirmed. Soft– variable or unconfirmed.

Budgeting

- Roles & Responsibilities in Budgeting
  - Budget Implementation – an effective budget presentation in written form communicates to managers the amount that can be spent and what it can be spent on.
  - Evaluation – a comparison of variances from budgeted to actual results should be done on a periodic basis, typically monthly or quarterly.

Budgeting

- Other Budget-setting Methods
  - **Zero-based budgeting** focuses on a thorough re-evaluation of every facet of an organization's operation to determine whether it should be continued: thus it assumes that the organization is starting from zero.
    - This method is very time consuming;
    - Can feel threatening to managers and staff; and
    - Best applied at times of financial crisis.

Budgeting

- Other Budget-setting Methods
  - **Rolling Budgets** is a relatively new approach and rather than creating an annual budget that remains static for the year, a budget is prepared and reviewed regularly (month or quarterly).
    - Unlike traditional budgets which may yield occasional variances, this process the budget is systematically are calculated at each review period;
    - More time consuming;
    - Requires constant and effective communications;
    - Best applied to dynamic environments where costs and revenues can vacillate extensively over short periods of time.

Budgeting

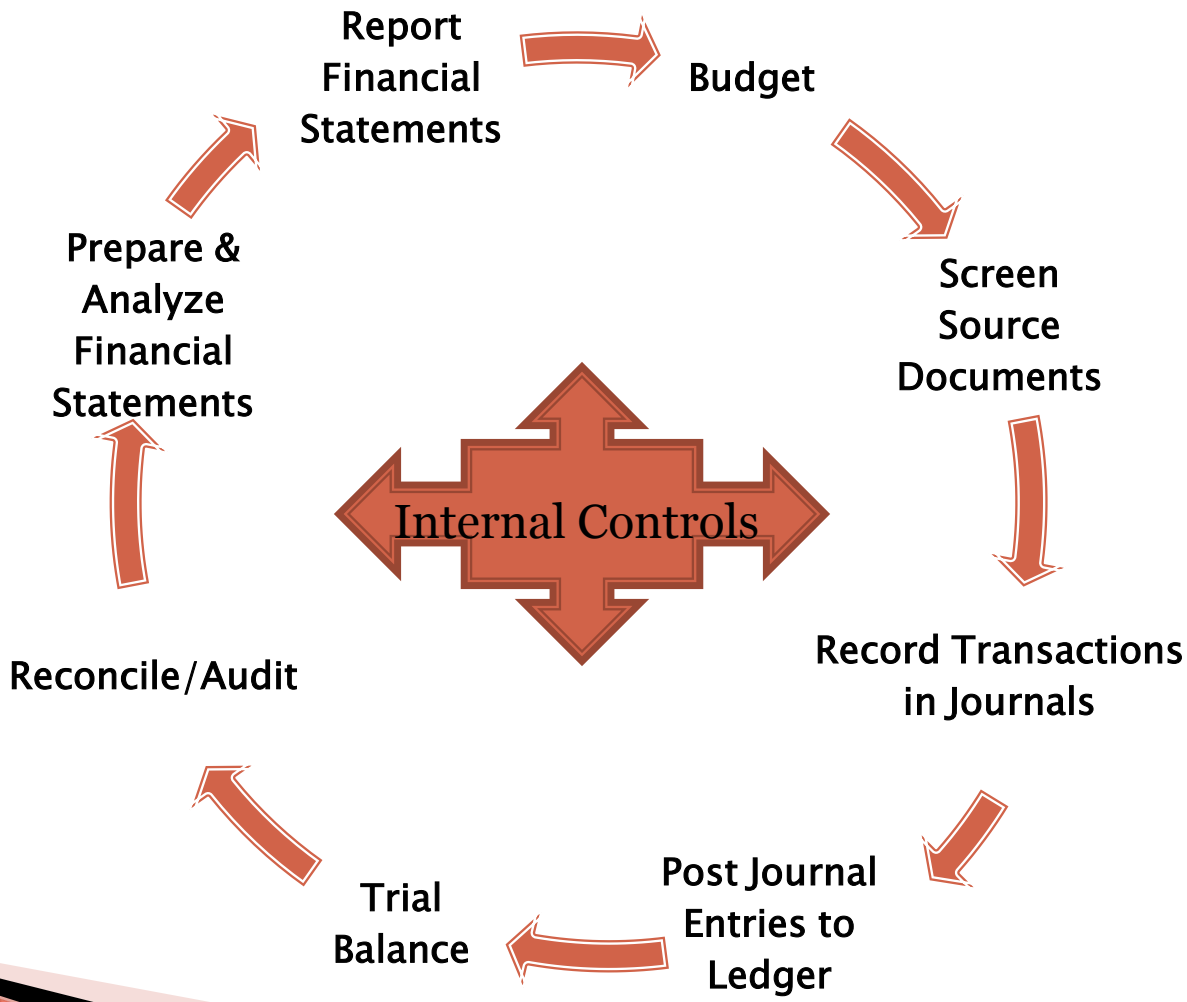
- Other Budget-setting Methods
  - **Activity -based Budgets** focuses on developing budgets for clusters of activities, rather than the traditional method of line item costs.
    - Allows the organization to know how much it is spending on what, thus informing resource allocation decisions;
    - Forces managers to consider what resources are actually needed for programs and functions since it is based on activities;
    - Helps with negotiating with funders who only want to fund direct costs and are unwilling to fund indirect costs necessary to run a program or activity; and
    - There is no universal standard for calculating indirect costs associated to activities.

Internal Control

- Internal control is developed to allow an organization to achieve plans, protect resources, motivate employees, evaluate performance, alter management to variations from the plan, and take corrective action.

- It can be defined as a process, effected by an organization's Board of Directors, Management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in three categories:
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations.

Non-Profit Accounting Cycle



Internal Control

- The Committee of Sponsoring Organizations (COSO) publication *Internal Control–Integrated Framework* consists of five components that form an integrated systems that can react to changing conditions:

  1. Control Environment – refers to statements about the integrity, ethical values and competence of the organization's people including management's philosophy and operating style; and the attention and direction provided by the Board of Directors. It is the foundation for all other components of internal control.

Internal Control

- The Committee of Sponsoring Organizations (COSO) publication *Internal Control–Integrated Framework* consists of five components that form an integrated systems that can react to changing conditions:

  2. Risk Assessment – the identification and analysis of risks, both inside and outside the organization that threaten the ability of the organization to achieve its objectives. This assessment forms the basis for developing a plan for minimizing the most serious of the risks identified.

Internal Control

- The Committee of Sponsoring Organizations (COSO) publication *Internal Control–Integrated Framework* consists of five components that form an integrated systems that can react to changing conditions:

  3. Control Activities – policies and procedures that help ensure that management directives are carried out; occurs as all levels of the organization; included policies on what needs approval, verification or reconciliation; and what reviews should be made of operating performance, security of assets, and segregations of duties.

Internal Control

- The Committee of Sponsoring Organizations (COSO) publication *Internal Control–Integrated Framework* consists of five components that form an integrated systems that can react to changing conditions:

4. Information and Communication – Information systems are key to an effective system of internal control. Internal information, as well as information about external events, activities, and conditions must be communicated in useful ways to enable management to make informed decisions.

Internal Control

- The Committee of Sponsoring Organizations (COSO) publication *Internal Control–Integrated Framework* consists of five components that form an integrated systems that can react to changing conditions:

5. Evaluating – the internal control system must be regularly monitored and evaluated by management and the Board of Directors to ensure that it sis working as planned. The failure to carry out and act on this kind of evaluation is in large part responsible for many scandals that have plagued nonprofits in recent years.

Internal Control

- Broad Elements of an Internal Control System
  - **Clear audit trail –** should be in place in order to trace any transaction in the accounting system back to its source.
  - **Reliable personnel** – capable, trustworthy and appropriately supervised.
  - **Segregation of Duties** – benefits is that one person may catch a problem missed by another, unless there is collusion.

Internal Control

- Broad Elements of an Internal Control System
  - **Proper Authorization** – all spending must be supported by proper authorization and authorization limits and procedures should be established
  - **Proper procedures** – to reduce errors ICS is heavily dependent on standard operating procedures in the form of a policy/procedures manual, which should be kept updated.
  - **Physical safeguards** – Cash should be kept in the bank, blank cheques should be locked up, computer backups should be kept in a separate location and inventory should be locked up with appropriate access controls.

Internal Control

- What an Internal Control System Cannot Do
  - The design of the ICS is a function of the resources available – cost must be = to benefit.
  - Even the best ICS can only provide reasonable assurance to management and the Board about the organization's progress.
  - Breakdowns can occur in the ICS due to simple error, faulty judgment, collusion, breaches, fraud – BUT MOST LIKELY LACK OF CAPACITY.

Internal Control

- Responsibility for Internal Control Systems
  - Board of Directors – primary role is oversight of the ICS – often carried out by an Audit Committee.
  - CEO – has the ultimate responsibility – sets the "tone at the top" – and delegate day-to-day tasks to senior mangers.
  - CFO or Senior Financial Manager – provides critical technical leadership in the development, implementation, and maintenance of the ICS.
  - All other Staff – should understand why ICS is necessary; how they work; and their responsibility for supporting them.

Internal Control

- The Role of Board Committees
  - Finance Committee
    - A Finance Committee is comprised of the Volunteer Board Treasurer and finance staff.
    - Responsible for monitoring performance against budget, providing advise on investment policies, making investment decisions on behalf of the organization, and reviewing or deciding insurance coverage plans, pension plans, unusual fundraising matters, or expense reimbursements.

Internal Control

- The Role of Board Committees
  - Audit Committee
  - Composition of this committee usually includes three or more Directors who are independent and financially literate.
  - In a small organization this may be the work of the Finance Committee.
    - An Audit Committee has two main responsibilities:
      - first to assist the Board of Directors in assuring itself that appropriate account policies and internal controls are established and followed and that financial statements and reports are issued on time an in accordance with regulatory obligations; and
      - Second, to encourage and facilitate communication among the Board, management, and external auditors.

Internal Control

- The Role of Board Committees
  - Audit Committee
  - The committee should meet at least twice a year, before and after the audit and then on an as need basis.
  - Basic functions of the Audit Committee are:
    - Audit planning and preparation;
    - Oversight of information and control systems;
    - Review of annual financial statements;
    - Review of audit results;
    - Appointment of Auditors; and
    - May include review of compliance with funders' regulations; ensuring required documentation is sent to CRA, review of fundraising methods; and adherence to ethical codes.

Internal Control – Auditing

- **Compliance Auditing** is an internal audit function used by many non-profit agencies to detect error or fraud – i.e. internal controls.

- **Independent Audit** is an external body, usually and independent public accountant who reviews and gives opinion of the fairness of the financial statements and financial controls of the agency.

- **Operational Audit** determines whether the agency is managing or utilizing its resource in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices.

Independent Audits

- ***Independent (Recipient Initiated) Audit***
  - This means an Independent Auditor contracted by the Recipient to conduct an audit of the Recipient's financial processes, controls, accounts and records.
- ***Ministerial Audit***
  - This means an audit of the Recipient's accounts, records and supporting documentation conducted by the Minister in accordance with the terms and conditions of the contribution agreement.
- ***Independent Auditor***
  - This means an auditor who is independent from the Recipient and is a member of an accounting body that is recognized by the Province/Territory in which the Recipient has its administrative offices.

Independent Audits

- Generally an independent audit serves two purposes:
  - It provides an assurance to the reader of the financial statements, that these reports, including the Statement of Financial Position (Balance Sheet), and Statements of Revenue and Expense, are a fair reflection of the current financial position of the organization, and a fair representation of the revenues and expenditures stemming from the operations of the organization for the period covered.
  - The audit also is a management tool. The management letter prepared by the independent auditor highlights weaknesses in accounting and governing financial management processes and assists management (the Recipient) in developing an action plan to correct any weaknesses.

Independent Audits – Recipient Initiated

- In this type of audit, the Recipient will contract an independent auditor to perform the audit. Generally the auditor will examine the financial processes that the Recipient has in place to manage its financial operations.
  - The auditor will also examine the controls that the Recipient has in place to ensure that they accurately capture financial transactions and to safeguard financial assets.
  - The auditor will examine the accounts to determine whether transactions have been properly recorded.

Independent Audits – Recipient Initiated

- The auditor will examine the records to determine whether there is appropriate documentation to support financial transactions, such as payments and receipts of funds.

- Upon completion, the auditor will prepare a report that will express an opinion as to the audit findings. Generally, when the auditor has cited weaknesses in either the financial management operation processes, management controls, the accounts or supporting documentation, the Recipient should develop an action plan to implement the corrective measures.

Independent Audits – Ministerial Audit

- While the reasons for the audit are the same, the main difference here is that the audit is conducted not only to determine whether the financial statements of the Recipient represent a fair reflection of the Recipient's financial position and its operations, but also to provide assurance that the activities and financial statements are a result of carrying out the activities within the terms and conditions of the Contribution Agreement.

- In a Ministerial Audit, the auditor(s) will examine whether the Recipient has carried out its operations in accordance with the contribution agreement. This type of audit focuses only on the financial activity and management processes as they relate to the programs listed under the agreement.

- The auditor also evaluates the efficiency and effectiveness of program management, assesses the quality of financial control measures and mechanisms in place to manage risk effectively, and assures compliance with Ministry's policies and rules and regulations related to the provision of the Contribution or Service Purchase Agreement.

Independent Audits

- **Unqualified Opinion** – An auditor will provide an unqualified opinion, when, based on the examination it has been determined that the financial reports fairly represent the financial position and activity of the organization in accordance with Generally Accepted Accounting.

- **Qualified Opinion** – *This is a statement written upon the front page of an audit done by a professional auditor. A qualified opinion suggests that the information provided was limited in scope and/or the entity being audited has not maintained GAAP standards.*

- An auditor will provide a qualified opinion, when, based on the examination it has been determined, that the financial reports, subject to exceptions noted, are a fair reflection of financial position and results of operations. In certain cases, the exceptions can be material enough to warrant the restatement of the financial reports to address the effect the deficiency has played upon the financial position, financial activity, or both.

Independent Audits

- **Denial of Opinion (Adverse Audit Opinion)** – *This is a professional opinion made by an auditor indicating that an organization's financial statements are misrepresented, misstated, and do not accurately reflect its financial performance and health.*

- An auditor will in some cases, deny an opinion, if, based on the review, it was not possible to determine with any confidence the fairness of the organization's financial reports. Events such as the organization failing to maintain adequate accounts, and significant lack of records to support transactions would be cause for a denial of opinion.

Operational Auditing

- **Performance control** is concerned with the processes that we define as task control: the rules, procedures, forms and other devices that govern the performance of specific tasks to assure that they are carried our effectively and efficiently within responsibility centres or the organization as a whole.

- By demonstrating where changes in policies and procedures are desirable, operation auditing can help and organization improve both its effectiveness and efficiency.

- Project controls uses somewhat different techniques as considerations include cost, quality and time requirements and the essentials of the system for controlling projects are work packages, budges, cost and output reporting and plan revisions.

Operational Audit

What different skill set would a financial auditor need in comparison to an operational auditor?

- **Process Flow Analysis** – is an effective technique which can map levels of decision making for a particular activity, thereby assisting managers to focus on potential problem areas or gaps in the service delivery by the organization's employees.

- Once process analysis has laid out all tasks, decision points and documents generated in conjunctions with a particular activity, managers can then determine if all possible tasks have been considered, and where if at all, tasks should be monitored.

Operational Audit

- The Province of Manitoba, when there is a Service Purchase Agreement or Contribution Agreement with an Agency, typically requires that an Agency have financial controls, governance, policy and procedure controls in place according to the Provincial Standard.

- The Province and the Federal Government will usually require the Agency conduct independent:
  - annual financial audits
  - annual policy review
  - bi-annual policy adherence reviews
  - 5 year external agency evaluations
  - Forensic audit or Ministerial Audit

Provincial/Federal Reviews

- **Annual financial audits** – independent external audits of financial statements and controls.
- **Annual policy review** – Representative from the Government meets with the Agency to compare Agency policy to Provincial/Federal Standards.
- **Bi-annual policy adherence review** – Representative from the Government meets with the Agency to discuss how the Agency monitors and ensures that Board, Management and Staff adhere to the Agency's Policies.
- **External agency evaluations** – An Agency will be required to tender an external consultant to conduct a internal/external quantity and quality evaluation for the Agency.
- **Forensic audits or Ministerial Audit** – An agency will have CRA or a Representative of the Minister's office to conduct a "forensic investigation" in to all controls and measures of the Agency.

Financial Reporting

- The financial reporting process may be thought of as the concluding phase of the cycle that begins with planning then moves to implementation and controlling.
- Reporting helps managers, the Board and outsiders understand the current financial status of the organization.
- Reporting internally and externally will have different detail on the financial statements and schedules.

Financial Reporting

- All financial reports are prepared using generally accepted accounting principles or GAAP so that they are readily understandable by their users and somewhat comparable from organization to organization.

- Some expert opinions conclude that for Canadian organizations, converting to IFRS, while costly in the short-term due to initial planning and conversion costs, will ultimately be more cost-effective than following Canadian GAAP by precluding the need for expensive reconciliations when dealing with foreign markets and by encouraging entities to streamline processes to exact cost efficiencies.

- In fact, based on experiences overseas, the longer term benefits tend to quickly outpace the initial costs of IFRS conversion. It's also become apparent that while IFRS implementation will be mandatory for publicly accountable enterprises in Canada by January 1, 2011, many private and nonprofit organizations could also benefit from the value IFRS contributes to operations.

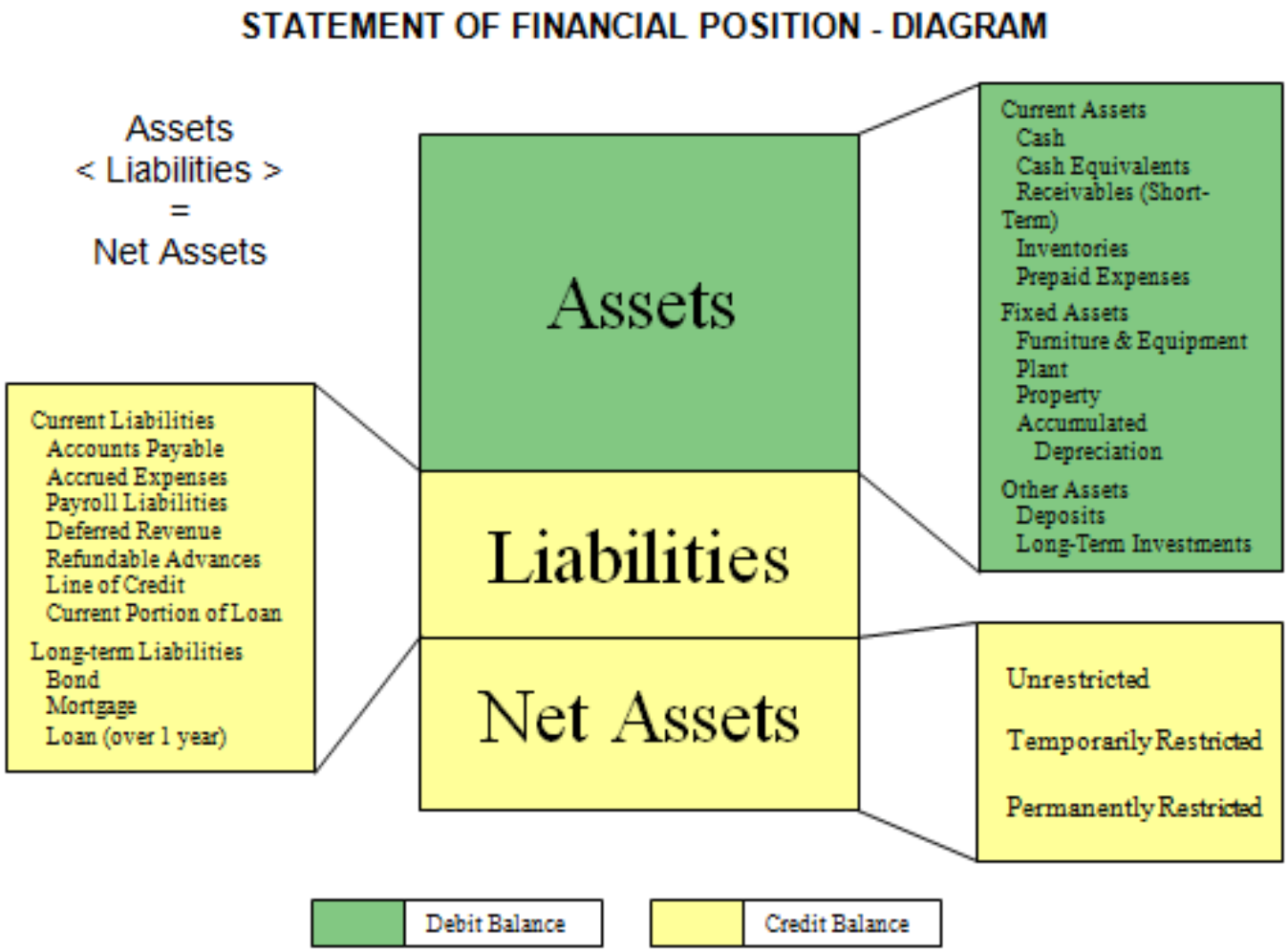
Financial Reporting

- Financial Statements – four main types
  - Statement of Financial Position or Balance Sheet
    - ASSETS=LIABILITIES + EQUITY (or net assets)
      - Assets are what the organization owns or what is owed to them.
      - Liabilities are what the organization owes to someone else.
      - Equity is what is left over from the assets once all the liabilities have been paid.

Financial Reporting

- Assets would include cash, investments, accounts receivable, prepaid amounts, and capital assets.
- Liabilities include accounts payable, payroll payable, loans payable and deferred grant revenue.
- Equity includes unrestricted net assets and restricted assets (scholarship fund, particular program or endowment)

Financial Reporting



Financial Reporting

- Financial Statements – four main types
  - Statement of Operations or Statement of Revenues and Expenditures or Income Statement
    - Shows what the organization received as revenue and what was spent over a particular period of time.
    - The difference between what was received and what was spent is either a surplus or deficit.
    - The only disclosure requirement for revenue is that contributions should be disclosed by major source.
    - There are no disclosure requirements for expenditures, but typically are reported by function (program, fundraising) or by object (rent, salaries) or type of expense.

Financial Reporting

- Financial Statements – four main types
  - Statement of Operations or Statement of Revenues and Expenditures or Income Statement
    - Beginning in 2009, nonprofit organizations that classify their expenses by function must adhere to new disclosure principles regarding their allocated expenses.
    - For example, if fundraising or general support expenses are allocated to functions other than fundraising or general support (administrative expenses), the policy for and nature of these expenses as well as the basis on which the allocations have been made and the amount must be explained.

Financial Reporting

- Revenues-(Operating+ Programming +General Expenses)+unrestricted surplus/deficit from beginning of fiscal year
- **Revenue** is the value of what is received by the organization, usually through fundraising, donation, service purchase agreements, funding agreements, foundation grants, self-generated funds and others.
- **Operating Expenses** are usually considered salaries, benefits, advertising, meeting expenses, staff travel costs, etc.
- **Programming Expenses** are usually considered expenses incurred through direct service to people utilizing services; for example transportation, childcare, snacks, program materials, etc.
- **General Expenses** usually include insurance, office supplies, administration staff salaries, utilities, lease/rent, amortization, etc.
- Surplus/Deficit from the Income Statement is recorded in the equity section of the Balance sheet. Surplus can be considered restricted or unrestricted.

Financial Reporting

- Financial Statements – four main types
  - Statement of Changes in Net Assets or Fund Balances
    - This statement is sometimes combined with the statement of revenue and expenses and provides details regarding the changes between the opening and closing fund balances, including any transfers of resources between funds.
    - In general this statement will reveal the extent to which an organization's operations have added to or depleted its net assets.

Financial Reporting

- Financial Statements – four main types
  - Statement of Cash Flows or Statement of Changes in Financial Position
    - Is a record of all funds coming into the organization and all funds flowing out during a particular period of time.
    - Financial information is presented on a “cash” basis versus that of the Statement of Operation which is presented on an “accrual” basis.
    - This statement shows the organization’s ability to raise cash from various sources and how cash is used to support programs and services.

Financial Reporting

- The most commonly used format for the cash flow statement is broken down into three sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities.
- There are two methods for preparing the cash flow statement – the direct method and the indirect method. Both methods yield the same result, but different procedures are used to arrive at the cash flows.
- Under the direct method, you are basically analyzing your cash and bank accounts to identify cash flows during the period.
- Prepare a worksheet for each major line item, and eliminate the effects of accrual basis accounting in order to arrive at the net cash effect for that particular line item for the period.

Financial Reporting

- In preparing the cash flows from operating activities section under the indirect method, you start with net income per the income statement, reverse out entries to income and expense accounts that do not involve a cash movement, and show the change in net working capital.

- Entries that affect net income but do not represent cash flows could include income you have earned but not yet received, amortization of prepaid expenses, accrued expenses, and depreciation or amortization.

- Under this method you are basically analyzing your income and expense accounts, and working capital.

Financial Reporting

- The unique aspects of accounting and financial reporting for nonprofit organizations centre upon accounting for revenues from contributions; capital assets and collections held; and income from controlled and related entities.
- One of the key aspects is that contributors to the Organization can impose restrictions on how the resources they contribute can be used. This is the genesis of fund accounting
- Restrictions on contributions can only be imposed by a contributor from outside the Organization.
- A restriction may be implicit in the fundraising appeal by the Organization or contributors may have imposed restrictions of their own making.

Financial Reporting

- A Board of Directors may impose internal restrictions on contributions but these are generally referred to as appropriation.
- Fund Accounting is the breaking up of an Organization's financial statements on the basis of the purposes of various funds.
- Elements of a fund can include assets, liabilities, net assets, revenues and expenses.
- A key decision for a nonprofit is determining its accounting policy for contribution revenue.

Financial Reporting

- This policy not only determines the format of the financial statements but also determines the bottom line. Two methods are permitted – the deferral method and the restricted fund method.

- The deferral method, restricted contributions that cannot be expended in the year in which they are received must be deferred and account for as revenue in the year in which the related expenses are incurred.

- The balance of deferred contributions represents the accumulation of restricted resources subject to restrictions that have yet to be complied with.

Financial Reporting

- The restricted fund method, contributions are accounted for as revenue in the year received regardless of whether the related expenses were incurred.
- The balance of the restricted funds represents the accumulation of resources subject to restrictions that have yet to be complied with.
- Illustration of both methods can be found on page 406.

Financial Reporting

- Another unique aspect occurs when an organization receives a contribution of materials and/or services.
- Fair market value must be estimated using market or appraisal values and the goods or services must be used in the normal course of the Organization's operation.
- Except where donations of capital assets, accounting for donated materials and services does not affect an Organization's bottom line, since their value is counted as a contribution and an expense (i.e. services). This can be tracked through the donation receipts.
- CRA does not allow receipts to be issued for services and thus any tracking system must be for internal or pubic relations purposes only.

Financial Reporting

- Organization usually account for contributions on a cash basis.

- However, pledges can be recognized as contributed revenue if:
  1. The amount to be received can be reasonable estimated; and
  2. The ultimate collection is reasonably assured.

- Bequest revenue most often does not meet these criteria since will must be probated and are subject to legal challenges.

Analyzing Financial Statements

- Types of Financial Statement Analysis:
  - Comparative Financial Statements – Multiple year
    - Budget
    - Revenue & Expense Statement
    - Balance Sheet
  - Surplus/Deficit Analysis and spending plans
  - Expense or Cost Ratios

The Analytical Process

- Three general categories of analysis activities are necessary:
  - Assessment of the organization's strategy
  - Analysis of the significant accounting issues, and
  - Analysis of the significant financial management issues

The Analytical Process

- Strategic Assessment – understanding the organization's overall strategy, for example:
  - The relevant competitive and regulatory forces
  - The nature of the organization's clients or customers, and
  - Possible changes in client needs in the future

The Analytical Process

- Accounting Issues – assessing the accounting issues the organization faces:
  - Read the notes to the financial statements
  - Look for the large numbers on the financial statements
  - Are any of the assets influenced by a distinction between book value and market value?
  - To what extent is the surplus figure valid?
  - What is the nature of the organization's liabilities?

The Analytical Process

- Financial Management Issues – analysts consider ratios
  - Profitability
  - Liquidity
  - Assets Management
  - Long-term Solvency
  - Expense %

Ratios

- **Profitability Ratio** attempts to measure the ability of an organization to generate sufficient funds from its operations to both sustain itself .

$$\text{Profit margin} = \frac{\text{Surplus}}{\text{Revenue}}$$

- This ratio effectively measures how much of each dollar in revenue received by an organization ultimately becomes surplus.

Ratios

- **Liquidity Ratio** measure the extent to which an organization has an ability to convert its non-cash assets in to cash.

$$\text{Current ration} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

- A figure of 2.0 is generally used as an appropriate industry level. That is, current assets should be roughly twice as large as current liabilities.

Ratios

- **Assets Management Ratio** helps us to assess how effectively an organization is using its assets.

$$\text{Asset turnover} = \frac{\text{Revenue}}{\text{Total assets}}$$

- This ratio allows us to determine how many dollars of revenue the organization has earned for each dollar it has invested in assets. May be higher if an organization has an asset base that is used up several times during the year or may be lower if an organization has a high proportion of fixed assets.

Ratios

- **Long-term Solvency Ratios** provide an indication of the way an organization has financed its assets over the long-term.

- Two issues here, the first is the balance between debt and equity financing

$$\text{Debt/Equity} = \frac{\text{Total Liabilities}}{\text{Equity}}$$

- The higher this ratio, the greater the organization's "leverage" that is, the greater the extent to which it has utilized external funds (debt) to supplement its internal funds (equity).

Ratios

- The second is the ability of the organization to meet its debt obligations.

$$\text{Leverage} = \frac{\text{Total assets}}{\text{Equity}}$$

- Effectively, this ratio is the same as the debt/equity ratio plus one. This is true by virtue of the fundamental accounting identity: A=L+E.

Ratios

- Ratio of Program Expenses to Total Expenses

% of Program Expenditures of total Expenditures

$$= \frac{\text{Program Expenses}}{\text{Total Expenses}}$$

- Results in a percentage that indicates how much of every dollar spent is spent on programs.

Ratios

- Ratio of Administration Expenses to Total Expenses

% of Administration Expenditures of total Expenditures

$$= \frac{\text{Administration Expenses}}{\text{Total Expenses}}$$

- Results in a percentage that indicates how much of every dollar spent is spent on Administration.

Ratios

- Ratio of Fundraising Expenses to Total Expenses

% of Fundraising Expenditures of total Expenditures

$$= \frac{\text{Fundraising Expenses}}{\text{Total Expenses}}$$

- Results in a percentage that indicates how much of every dollar spent is spent on Fundraising.

Ratios

- Ratio of Contribution Revenues to Fundraising Expenses

% of Fundraising Expenditures of total Expenditures

$$= \frac{\text{Fundraising Expenses}}{\text{Total Contributed or Donated Revenue}}$$

- Results in a percentage that indicates how much it costs to raise a dollar.

The Role of Surplus

- Surplus in an organization's budget often sounds like good business, however, funders have different policy on surpluses. For example the funding agreement with Province of Manitoba does not take back surplus and does not top up deficits.

- However, the surplus has to be spent in the area which it incurred and in order for and agency to utilize the surplus for other needs, they board will have to write the funder explaining the reason for the surplus , the financial controls in place to correct for future surplus and the request being made.

The Role of Surplus

- Self-generated surplus is considered proceeds earned by the organization through donations, fundraising, or community economic development projects. The Board of Directors may or may not restrict the surplus for various purposes.

- The Board may restrict surplus in anticipation of future capital needs or to support anticipated growth of the agency.

- The restricted surplus is reflected on the balance sheet.

Surplus and Growth

The key idea is that an organization must finance the cash outflows that take place between the acquisition of assets or the prevision of service and the subsequent collection of accounts receivable. If managers of growing organization use debt to finance these increases in services the organizations indebtedness will continue to expand until such time as growth slows or stops.

Surplus and Growth

- While a variety of finance or strategic options other than debt exists for a rapidly growing organization, the five that the greatest impact are:
  - Slowing growth
  - Shortening the collection period for accounts receivable
  - Shortening the service provision period
  - Extending period for paying accounts payable, or
  - Generating equity via either surplus or additional contributions.

Presenting Financial Statements

In order for the Board of Directors to fulfill their responsibilities, board members must be able to rely on financial information that is:

- **Accurate**—Information must be reliable and accurate. Resolve any question about the quality of recordkeeping or accounting first.
- **Timely**—Information should available to the board within 2 or 3 months at the latest.
- **In Context—**Information should be presented in relationship to the history, goals and programs of the organization.
- **Appropriate**—No *one-size-fits-all financial report exists.* Reports must be designed to communicate information specific to the organization's current circumstances in a format that matches the knowledge level and role of board members.