PFC Learning Series
tool 4

A Primer on Analyzing Financials of Charities and Nonprofits

Donors, funders, and nonprofit staff seeking to understand an organization's financial position typically start by reviewing the financial statements and reports – this information is the basis of any financial discussion. Beyond understanding the reports, much can be learned from analysis of the information and interpretation of what it is telling you. This analysis can include comparing financial reports to a benchmark such as the budget or the financial report from the previous year to see if the information matches your expectations and needs.

Nonprofit organizations exist for purposes other than earning returns for investors, so traditional measures used to analyze the performance of for-profit entreprises are not well suited for evaluating them. Further, because of varying missions and funding sources, there a few sector-wide norms to guide staff and board members in their analysis.

This primer is a basic tool for donors and funders to help understand and analyze financial statements to determine the financial sustainability of an organization and identify potential red flags.

We promote the growth and development of effective and responsible foundations and organized philanthropy in Canada through provision of membership services, resources and advocacy.
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Philanthropic Foundations Canada would like to thank the following contributors to this primer:
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CONTENT

1 Introduction

Financial statements are your primary source of information about an organization's financial position. Financial information is typically measurable, objective, and comparable over time and it is a useful indicator of overall organizational financial health. Understanding the financial position of a charity or non-profit organization (NPO) is critical when assessing their long-term viability, financial needs, and organizational capacity.

This primer is a basic tool for donors and funders to help understand and analyze financial statements to determine the financial sustainability of an organization and identify potential red flags.

Charities and non-profits work in challenging environments with many facing difficulties in bridging the gap between demand for their services and income levels. Charities are also increasingly in the spotlight for issues relating to expenses or impact. Good financial management is an integral part of the important work they do and contributes to the confidence of funding partners and beneficiaries in the organization.

2 Key Questions

Because nonprofit organizations exist for purposes other than earning returns for investors, traditional measures used to analyze the performance of for-profit entreprises are not well suited for evaluating them. Further, because of varying missions and funding sources, there a few sector-wide norms to guide staff and board members in their analysis.

Understanding financials will help you answer some fundamental questions, such as:

1. Is the charity financially sustainable?
2. Are there good processes for financial management?
3. Are financial resources used efficiently?

Resource Alert

Understanding Reports on Financial Statements (CPA)

Some indicators of financial sustainability can include:

- support from a diverse source of revenues (so they are not reliant on a small number of funders);
- a cash cushion to help weather a storm, and;
- the presence of robust financial reporting systems.

In terms of financial management, processes in place should provide guidance in financial planning, assist in acquiring funds from different sources and enhance organizational efficiency. An organization with solid financial management processes tends to make more informed decisions.

Effective and efficient use of resources helps the organization achieve its objectives and better serve its beneficiaries, be more accountable to donors and funders and increases the respect and confidence of stakeholders.

Not all red flags carry equal weight. While one organization may be struggling with surmountable issues, such as a lack of funds for a specific program, another may possess fundamental flaws such as ineffective programs or problematic governance and management practices.

TIP

Go beyond numbers on a page – Responding to any red flags with flexibility and without judgement and engaging in healthy conversation with leaders is key, and may bring to light opportunities for support.

Governance & Oversight Red Flags

- Accounting and finance functions all lie with one person
- Board is not involved in financial oversight or audit

3 Search for Clues

Start sleuthing in these 3 places[1] for clues on what financials are trying to tell you:

1. The Opinion Letter
2. Statement of Financial Position (sometimes called the "Balance Sheet"); and
3. Statement of Operations (sometimes called the "Income Statement" or the "Income and Expenditure Statement").

Refer to the **KEY TERMINOLOGY** appendix for a definition of key terms used in this primer.

Resource Alert

[Financial Statements Terminology]

Most registered charities make their audited financial statements publicly available. For more information on requesting financial statements from charities, please refer to the Canada Revenue Agency website.

Resource Alert

Research Tips:

Researching a Nonprofit's Financials: Deep-Dive Approach

Researching a Nonprofit's Financials: Moderate Approach

Researching a Nonprofit's Financials: Financial Resources

a. The Opinion Letter

An auditor's opinion letter is full of useful clues – you can find it inside the audited financial statements. An audit represents the highest level of assurance and reliability that can be given by an auditor to an organization. It is recommended that all but the smallest of charities and nonprofits should have an audit each year.

Audits offer a key measure of accountability and control with the goal of verifying that the financial statements paint an accurate and fair picture of the organization's financial position and results of operations.

Qualified Opinions

The opinion offered by the auditor can be unqualified or qualified (indicating the existence of scope limitations or discovery of issues during the audit). The latter situation occurs most often due to the auditor's inability to verify cash donations.

Red Flags in the Opinion Letter

- **The use of terms like "except for..." or "it was not possible to..." means the auditor is giving a qualified opinion, which may suggest deeper problems in the organization or warrant further investigation.**
- **Watch out for red flag terms like "we have reviewed" or "we have compiled", which may suggest that there has not yet been an audit. The use of "going concern" means the auditor is worried the organization may be going out of business (because the balance sheet indicates the organization may be unable to pay all creditors).**
- **If the auditor was required to make significant adjustments through journal entries to the original statements prepared by management, this is another red flag.**

1 These three sources of information are inextricably linked, and red flags may well arise on essentially the same topic in any of the 3 places. One may also look to the Cash Flow Statement for information on aggregate cash inflows and outflows.

Timing and Dates

The timing and date of an audit should also be on your radar while assessing financial statements. Normally, audits should be completed within 90 days after the end of the fiscal year. Even if there are good reasons for delays, it means the information in the audited financial statement is outdated by the time you are reviewing it.

Red Flags related to Timing and Dates

- **If the difference between the end of the fiscal year and the date of the opinion letter is more than 120 days, you need to get more information to explain this delay and ask pointed questions about the reasons for the delay.**

8

Financial Position
December 31, 2019

	2019	2018
	$	$
ASSETS		
Current		
Cash	**2,969,673**	3,422,551
Trade, legacies and other receivables (Note 6)	**1,454,030**	1,213,951
Inventories	**28,181**	16,759
Prepaid expenses	**39,974**	67,000
	4,491,858	4,720,261
Long-term		
Land held for resale	**12,000**	12,000
Tangible capital assets (Note 7)	**3,050,971**	2,997,926
Investments	**99,876**	58,222
Restricted investments (Note 8)	**825,445**	723,284
	8,480,150	8,511,693
LIABILITIES		
Current		
Trade payables and other operating liabilities (Note 10)	**770,253**	700,956
Current portions of long-term debt		
Other	**198,000**	42,000
Subject to renewal		767,000
	968,253	1,509,956
Long-term		
Long-term debt (Note 11)	**507,582**	89,096
Deferred contributions related to restricted investments (Note 8)	**825,445**	723,284
Deferred contribution related to tangible capital assets (Note 12)	**26,516**	
Deferred contribution related to land held for resale (Note 13)	**12,000**	12,000
	2,339,796	2,334,336
NET ASSETS		
Unrestricted	**6,140,354**	6,177,357
	8,480,150	8,511,693

The accompanying notes are an integral part of the financial statements.

Sample statement of financial position

2 **Current ratio** is the proportion of the amount of current assets divided by the amount of current liabilities. The **quick ratio** (or the acid test ratio) is the proportion of 1) only the most liquid current assets to 2) the amount of current liabilities. The **quick ratio** assumes that only the following current assets will turn to cash quickly: cash, cash equivalents, short-term marketable securities, and accounts receivable. Hence, the quick ratio does not include inventories, supplies, and prepaid expenses. Source here.

b. Statement of Financial Position (The Balance Sheet)

Sometimes called the "Balance Sheet", the Statement of Financial Position reflects the whole of an organization's assets and liabilities taken at a single point in time, and comes after the opinion letter in an audit.

The Statement is organized by liquidity (closeness to cash or maturity), with Current Assets and Current Liabilities – items that are available (assets) or need to be paid (liabilities) within the coming year, being listed first. The Balance Sheet shows key figures needed to obtain various metrics used to assess the financial situation of an organization.

Red Flags in the Balance Sheet

- **If the amount of cash on hand is large — more than, for example, 10 percent of the total yearly revenue — it may mean the organization's financial managers aren't making efficient use of their excess cash.**
- **If the amount of cash is small — 5 percent or less of the total yearly revenue — it could mean the organization is cash-starved.**
- **Components of cash and cash equivalents are at risk of losing value.**
- **Accounts receivable are unlikely to be collected, and no provisions have been taken for uncollectable amounts.**
- **Invested assets held by the organization are at high risk of depreciation.**
- **Significant changes (both increases and decreases) in figures between years.**
- **No operating reserve (internally restricted funds) – ideally enough to cover 3–6 months of expenses or reserve funds are in excess of one year's operating budget.**
- **Current ratio[2] of less than 1 may suggest that the organization does not have enough capital on hand to meet its short-term obligations.**
- **If organization has inventory, quick ratio of less than 1 may suggest that the organization does not have enough liquid assets to meet its short-term obligations**

Resource Alert

Non-Profit Financial Statement Analysis Guides:

- Analyzing Financial Information Using Ratios
- Financial Statement Analysis for Non-Profits
- Nonprofit Financial Stability KPI Recommendations
- How to Assess Nonprofit Financial Performance (US)
- Guide to Accounting Standards for Not-for-Profit Organizations

c. Statement of Operations (The Income Statement)

The Statement of Operations reflects the revenues and expenditures of an organization over a period of time, showing the net balance between the two: the *excess* (or *deficiency*) of revenues over expenditures for the period. Generally, charities and non-profits are expected to spend any revenues on program delivery. However, small operating surpluses kept as a precautionary measure are not unreasonable.

Various categories are used to organize revenues and expenditures. Revenues are categorized according to source of funds, including grants, contributions, fundraising events, social entreprise sales, etc., while expenditures are grouped by object (e.g. payroll, rents, supplies), by function (e.g. program delivery, fundraising, administration) or by program (e.g. children's programs, adult programs), usually listed from largest dollar value to smallest.

Red Flags in the Statements of Operations

- The organization has a growing deficit from year to year
- Budgeted income and expenses are not based on solid assumptions
- There are large discrepancies between the budget and actual statement
- Revenue sources change drastically from year to year
- Fundraising expenditures constitute significant percentage of funds raised compared to other charitable organizations.
- Organization is heavily dependent on a single source of revenue, such as government grants or donations (reflecting state of economy).
- Revenues are highly restricted – funding does not sustain the organization's overhead (core funding).

d. The Footnotes

Footnotes prepared by the auditor can help the reader to interpret the balance sheet and income statement. They offer additional information to explain accounting methodologies, irregularities, and inconsistencies.

Red Flags in the Footnotes

- Related party transactions – can cause outsiders to question whether the organization is dealing fairly with vendors
- High interest rates charged on short-term borrowing
- Lawsuits against the organization

5

Operations
Year ended December 31, 2019

	2019	2018
	$	$
Revenues		
Contributions		
Donations and other contributions (Note 4)	**2,252,446**	1,323,156
Fundraising campaigns (Note 4)	**1,673,236**	2,098,340
Legacies	**959,269**	1,753,665
Revenue from operations	**3,103,252**	2,850,993
Unrestricted net investment income	**75,166**	34,045
	8,063,369	8,060,199
Expenses		
Salaries and employee benefits	**4,897,876**	4,245,695
Operating expenses	**1,677,656**	1,291,397
Publications, promotion and special event expenses	**186,602**	217,089
Fundraising campaign costs and legacy fees	**906,373**	958,261
Professional fees	**170,728**	117,503
Interest and bank charges	**95,397**	104,109
Interest on long-term debt	**42,027**	71,295
Amortization of tangible capital assets	**118,227**	103,411
Amortization of the transaction costs related to long-term debt	**5,486**	5,486
	8,100,372	7,114,246
Excess (deficiency) of revenues over expenses	**(37,003)**	945,953

The accompanying notes are an integral part of the financial statements.

Sample statement of operations

4 Next Steps

What can your organization do to improve its financial practices?

Board members and staff may not necessarily have the financial literacy skills required to fully understand financial statements. Creating a culture of inquiry, skills building, and inclusion is beneficial for the Board members, staff and the organization.

Tips:

- Assemble a skilled team to put in place financial management processes and practices
- Keep reports at highest summary level to focus on strategic matters (rather than less strategic matters such as operational costs)
- Use dashboards (visual representations) as they are easy to comprehend
- Provide access to training
- Use the resources in the **Tools and Resources** section to learn more

A final word – numbers on a page are a key part of analyzing financials, but for a full understanding of a charity's finances, discussion with its leaders is crucial.

Resource Alert

- A Guide to Financial Statements of Not-For-Profit Organizations: Questions for Directors to Ask
- Nonprofit Financial Health Analysis Worksheet & Dashboard
- Models and Components of a Great Nonprofit Dashboard

Learning Tools:

- Colour Accounting (easier to understand accounting course)
- Financial Responsibilities of Not-for-Profit Boards (Muttart Foundation)

5 Tools and Resources

The tools and resources in this section aim to provide charities and funders with more information and access to tools and resources to learn more about understanding and analyzing charity and non-profit financials.

A. DEFINITIONS, GUIDES AND TOOLS

PFC Webinar on Analyzing Financials, October 28, 2020
with Michael Bernucci, Mongiat-Bernucci Chartered Accountants

Definitions and Financial Statement Samples

Financial Statements Terminology

Understanding Reports on Financial Statements (CPA)

Non-Profit Financial Statement Analysis Guides

Financial Statement Analysis for Non-Profits (download)

A Guide to Financial Statements of Not-For-Profit Organizations: Questions for Directors to Ask

Nonprofit Financial Stability KPI Recommendations (download)

How to Assess Nonprofit Financial Performance

Guide to Accounting Standards for Not-for-Profit Organizations

Dashboards for Financial Analysis

Nonprofit Financial Health Analysis Worksheet & Dashboard (download)

Models and Components of a Great Nonprofit Dashboard

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Researching a Nonprofit's Financials: Financial Resources

Websites for more information

BoardSource

Charity Village

Bridgespan

B. KEY TERMINOLOGY

Assets: resources owned by an organization (including accounts receivable)

Contributions: a type of revenue to NPOs; accounting term for donations

- **Restricted contributions**: contribution subject to externally imposed restrictions as outlined by donor
- **Endowment contributions**: restricted contribution specifying that resources contributed be maintained permanently
- **Unrestricted contributions**: NPO is free to use funds in any manner it chooses (neither restricted nor endowment)

Current Assets: all the **assets** of a company that are expected to be sold or used as a result of standard business operations over the next year. **Current assets** include cash, cash equivalents, accounts receivable, stock inventory, marketable securities, pre-paid liabilities, and other liquid **assets**.

Current Liabilities: short-term financial obligations that are due within one year or within a normal operating cycle

Current Ratio: ratio that measures a company's ability to pay short-term obligations
[CURRENT RATIO = CURRENT ASSETS/CURRENT LIABILITIES]

Expenditures (expenses): the amounts spent by the NPO in its operating activities. Examples are salaries, rent and office supplies. Also included in expenditures is "depreciation" of capital assets (usually called "amortization of capital assets")

Liabilities: debts or financial obligations owed by an organization (accounts payable)

Long-Term Assets: Assets that are not intended to be turned into cash or be consumed within one year of the balance sheet date. Long-term assets include long-term investments, property, plant, equipment, intangible assets, etc.

Long-Term Liabilities: obligations to make payments in the future, beyond one year. Examples are loans outstanding and mortgage balances. However, mortgage or loan obligations that are to be paid within the coming year are shown as a current liability.

Net Assets: difference between what is owned by the organization and what is owed by it; amount that is available for the organization to use in the future to continue to operate and achieve its goals [NET = ASSETS – LIABILITIES]

Net Revenues: the difference between total revenues and total expenditures.
[NET REVENUES = TOTAL REVENUES – TOTAL EXPENDITURES]

Quick Ratio: measures a company's ability to meet its short-term obligations with its most liquid assets
[QUICK RATIO = (CURRENT ASSETS – INVENTORY)/CURRENT LIABILITIES]

Revenues: the amounts recorded by the organization associated with increases in economic resources related to its operating activities. Examples are grants from governments (or foundations) and contributions (donations).

Time Frame

- **Point in time**: as of a particular reporting date
- **Cumulative sums over time**: value of an activity during a fixed period of time

Working Capital: amount of cash and other assets a business has available after all its current liabilities are accounted for
[WORKING CAPITAL = CURRENT ASSETS – CURRENT LIABILITIES]

Working Capital Ratio: how many dollars of current assets are on hand for each dollar of current liabilities; A ratio value greater than 1 signals the capacity in the short run to pay all current liabilities from current asset sources.
[WC RATIO = CURRENT ASSETS/CURRENT LIABILITIES]

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Established in 1999, Philanthropic Foundations Canada (PFC) is a national member association of grantmaking foundations, charitable organizations and corporate giving programs. PFC seeks to promote the growth and development of effective and responsible foundations and organized philanthropy in Canada through the provision of membership services, resources, and advocacy.

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