Financial literacy for NFP directors

Role of the board

A key role for a director is to ensure the financial viability of the NFP organisation so that it can achieve its outcomes. Many NFPs may have a treasurer but this does not change the responsibility all directors have to make sure that the organisation makes effective use of its (often limited) resources and also make sure that it continues to remain solvent.

Accordingly, directors are required to read and interpret financial information in order to:

- monitor the financial health or position of the organisation;
- monitor operational performance;
- determine the right asset mix to maintain;
- determine the best way to finance the organisation;
- assess whether the organisation is solvent.

A further point to note is that the more the organisation and the sub-sector in which it operates is known, the easier it becomes to understand the significance of this financial information.

The financial statements

Directors should be familiar with the following three main financial statements:

Income Statement

Often referred to as the profit and loss statement, the income statement is designed to show how much an entity has earned during the period. This will be either monthly or yearly. The statement shows revenue minus expenses, giving profit or loss for the period.

Not-for-profits tend to call this profit 'surplus' and loss 'deficit'.

Formal name = Statement of Profit or Loss and Other Comprehensive Income.

Balance Sheet

This statement presents a 'snapshot' of an organisation's assets, liabilities and equity at a particular point in time, and is designed to show what an entity is worth.

Formal name = Statement of Financial Position.

Cash Flow Statement

This statement is designed to show if an entity is paying its way. It shows the cash flows in and out of the organisation reported under categories of operating, investing and financing activities to give net change in cash for the period.

Formal name = Statement of Cash Flows.

The accounting standards allow the use of alternative titles for the statements, as included above.

Income Statement

Revenues • *Sales of services* • *Sales of product* • *Grants* • *Fundraising* • *Donations* • *Bequests* • *Volunteers* • *Crowdfunding/sourcing* • *Investment returns such as interest received*	Operational revenue from the sale of goods and services, plus other revenue such as interest received. **What to consider:** Assess trends over time and against budget, aiming to increase revenue levels. Need to diversify revenue streams: How heavily reliant is the organisation on grant funding? Can the organisation develop a social enterprise to fund its cause/mission? Are you investing cash (excess to immediate need) to gain a better return? How is the organisation managing/utilising fundraising, bequests, donations, volunteers, crowdsourcing? Is the complexity of grants that cross a number of financial years properly understood?
less Expenses • Direct production expenses • General overheads / admin (Group expenses to best suit your organisational structure and reporting framework)	Shown either by function (such as selling, administration) or by nature (depreciation, staff costs) **What to consider:** Assess trends over time and against budget, aiming to be more cost efficient without impacting service delivery. Have all accrual entries been done? Do you fully acquit all costs incurred when reporting to funding bodies? Can the organisation share resources with other NFPs to reduce costs? What is the best way to attract, retain and manage volunteers? Could the organisation merge with other like-minded NFP's to gain economies of scale and reduce administration and overhead costs?
= Profit/(Loss) or Surplus/(Deficit) for the period	All organisations need to generate profits/surpluses to build equity in the organisation. Only when an appropriate level of reserves has been achieved should the organisation operate with much tighter margins. **What to consider:** Assess trends over time and against budget. What level of equity does the organisation have on the balance sheet? Can the organisation cover a loss?
less Income tax (expense) *= Profit/(Loss) or Surplus/(Deficit) for the period after tax*	Many NFPs are exempt from income tax. If this is the case, there is no need to include these two line items.
+/- Other comprehensive income	Other gains or losses are adjustments to the financial information due to changes in markets. Examples include: asset revaluations due to changes in the real estate market (this is the most common adjustment NFPs might have); adjustments to financial data due to changes in the foreign exchange rate; changes in the fair value of financial assets such as share market investments.
= Total comprehensive income for the year	Total financial result for the period

Interpreting the income statement

The income statement measures the activity of an organisation over a period of time, usually a month or a year. It follows the accrual accounting concept of showing the information in the period when the activity occurred, not when cash has been paid or received (this is what the cash flow statement shows).

The statement measures how the organisation has financially performed in delivering its goods and/or services for the period.

Information is reported against revenue and expenses as follows:

- Revenues:
  - Timing of when earned;
  - Measurement of total value of goods and/or services provided during the period.
- Expenses:
  - Timing of when incurred;
  - Measurement of total cost of using all resources to deliver the goods and/or services during the same period.

To clearly assess how an organisation is performing, it is crucial that the income statement is broken down across the different divisions or diversifications of the business and any non-operating activities, such as interest received. This will allow an assessment of how each division is performing.

Questioning the income statement

Directors need to be monitoring the financial affairs of an organisation and asking questions about anything that seems unusual or of concern.

Some questions to ask may include:

- Has the information for both revenue and expenses been shown when the activity occurred?
- Have any other accrual accounting policies been followed? If yes, what are they clearly understood?
- Have all expenses been correctly included? For example:
  - Has depreciation been included?
  - Do any accounts receivables bad debts need to be written-off?
  - Have employee on-costs (unused annual leave and long service leave) been included?
- Are there any donated goods or services (including volunteers) that need to be included?
- Are there any unusual expenses?
- Is there a reliable budget and is the actual information being tracked against the budget?
  - Are significant variances explained when they exist between the actual and budget information?
  - Do these explanations seem reasonable and/or does something need to be done?

Balance Sheet

Format	Description	What to consider
Assets	An asset is a resource the entity controls and uses to generate its goods and/or services. Simply put, assets are what the entity owns.	How easily do the assets cover the liabilities? This is a coverage margin and identifies the risk to the organisation of becoming insolvent.
Current assets *Cash, Receivables* *Grants received in advance,* *Inventory, Prepayments*	Those assets expected to be converted to cash, used, consumed or sold within 12 months from the date of the balance sheet	How liquid are the assets? In other words, how easily can they be converted to cash? Have any asset values been impaired?
Non-current assets *Investments,* *Property plant & equipment;* *Intangibles*	Those assets which are not classified as current assets. In other words, it is expected the entity will continue to have the asset for longer than 12 months from the balance sheet date.	Does the organisation have the right asset mix? Are funds locked into assets owned that would be better sold to free up cash and leased back?
Total assets	(current assets + non-current assets)	(There is no right or wrong answer to this question; it completely depends on what is best for the organisation.)
Liabilities	Liabilities are existing obligations of the organisation. They may require cash to be paid or a service to be fulfilled. Simply put, liabilities are what the entity owes.	Are all debts recorded on the balance sheet? Is the timing of when debts need to be paid or fulfilled understood?
Current liabilities *Payables, Borrowings,* *Provisions*	Obligations of the entity expected to be settled or paid within 12 months from the date of the balance sheet.	Are the accrual adjustments that have been made understood? For example, provisions for employee entitlements. When does the organisation start to accrue long service leave? Is it appropriate?
Non-current liabilities *Borrowings,* *Provisions*	Obligations of the entity not expected or due to be settled until after 12 months from the date of the balance sheet.	This is a very important issue, especially if the organisation acquits grants to funding bodies, as all costs to deliver a program must be acquitted in the year it is incurred.
Total assets	(current liabilities + non-current liabilities)	
Net Assets	(total assets – total liabilities)	
Equity *Contributed equity, Reserves,* *Retained profits*	Equity represents what asset value would be left over for the members of the organisation if all the liabilities were paid out. It also represents the organisation's safety margin; that is, the extent to which the total assets cover the total liabilities.	Is the level of equity growing or shrinking? It will grow with profits and shrink with losses. Does the organisation have a policy about the level of equity it must maintain? For example, enough equity to cover: 6 or 12 months of operating costs; Full liquidation costs.
Total Equity	(total equity equals net assets)	

Interpreting the balance sheet

The balance sheet is an aggregated listing of all the assets/resources owned or controlled by the organisation and all the liabilities/obligations it owes to others at a specific point in time. It represents the state of the company's financial position or health and accumulates its information from one reporting period to the next; that is, if the organisation ends a period with cash of $10,000 then it also starts the next period with $10,000.

As the statement is a snapshot in time, it is necessary to compare the results over a number of periods to get a sense of a trend of what is happening

Questioning the assets

- Existence
  - Do the assets actually exist?
  - Do you need to conduct a stock take to ensure inventory exists?
  - How do you check that the plant and equipment matches what is recorded on the depreciation schedule?
  - A mislaid asset must be removed from the balance sheet.
- Control/ownership
  - If there is some dispute about control or ownership of a significant asset, should it be included in the balance sheet?
  - Ownership needs to be considered carefully in NFPs where, for example, government capital grants may not deliver full ownership of an asset used to deliver a program/project. Does the asset revert to the government at the end of the program/project?
  - An NFP organisation may have the use of land donated to it by the relevant state or territory government. By law, the organisation is unable to sell the land and it reverts back to the government if the NFP ever folds.
- Value
  - What value is recorded on the balance sheet?
  - Has the asset value been impaired?
  - What is its market value if the organisation wanted to sell it?
  - Assets are not allowed to remain on the balance sheet overvalued. Alternatively, have the assets been revalued upwards? Was an independent valuation conducted?

Questioning the liabilities

- Value
  - Is the value at which liabilities are being reflected satisfactory? For example, when should long-service leave start to be accrued and is the resultant liability high enough?
  - Are all accounts payables recorded?
  - Are these debts being paid on time or are they overdue?
- Discount
  - If the liability is likely to be payable some years in the future, can the liability be brought to account at its discounted present value?
- Contingent
  - Does the organisation have any contingent liabilities? They do not appear on the balance sheet but are included as a note to the financial statements. The organisation will need to plan how they will cover the liability if it eventuates. A filed law suit is a contingent liability from when the law suit is filed until there is an outcome.

Cash Flow Statement

Cash flows from operating activities Receipts from customers Payments to suppliers and employees Interest received/paid Income taxes paid (if required) *Net cash from operating activities*	Records the cash inflows and outflows generated by the operations of the business. What to consider: • Assess trends over time and against budget. • The net cash flows from operating activities is considered the most important cash flow to monitor and should be a positive number for established businesses. A positive number shows that the operation of the business is generating cash that is surplus to operating requirements. • Indicators of lack of sufficient generation of operating cash flow that may lead to solvency issues are: - net operating cash flows are negative; - cash receipts from customers are less than cash payments to suppliers and employees; - Net operating cash flow is not sufficient to cover the purchases of property, plant and equipment. • The figures on the cash flow statement will not be the same as those on the P&L or income statement due to accrual adjustments, timing differences and GST being included in the cash flow statement figures.
Cash flows from investing activities Proceeds from sale of PPE Payments for PPE Proceeds from sale of investments Payments for investments *Net cash from investing activities*	Records the cash inflows and outflows generated by the investing activities, which includes the buying and selling of the entity's property, plant and equipment and its investments. What to consider: • Assess trends over time and against budget. • Is the organisation investing in its property plant and equipment? This will show as a negative number. Often if an organisation is cash strapped it will slow down in replacing its asset base. It is useful to assess the trend over a number of years. • Also assess if the organisation is putting cash into investments (a negative number) or if it is selling its investments (a positive number).
Cash flows from financing activities Proceeds from borrowings Repayment of borrowings *Net cash from financing activities*	This section is often not required for NFPs and is simply left off the statement. • The section records the cash inflows and outflows generated from the financing activities of the business, which includes the buying and selling of its own equity (shares) and the movements in the entity's borrowings (taking out more borrowings or making repayments). • As NFPs are not share based businesses, the buying and selling of its own equity (shares) is irrelevant. • Also, NFPs often don't have borrowings. If an organisation has borrowings, the net result of inflows and outflows will show if borrowings have been increased across the year (positive number) or reduced (negative number).
Net increase/decrease in cash	*Net operating cash flow + net investing cash flow + net financing cash flow*
Cash at the beginning of year	
Cash balance at end of year	Net increase/decrease in cash + cash at the beginning of year

Interpreting the cash flow statement

The cash flow statement identifies how the organisation's cash has been generated through the year and how the cash has been used. Reported in the three categories of operating, investing and financing, it provides a better breakdown of the cash and an easy way to assess what area of the business generates or uses the cash.

The cash at the end of the financial period shown in the cash flow statement usually includes:

- Cash on hand, at bank, and in transit. This is the amount that will appear in the balance sheet; and
- 'Cash equivalents' or 'very liquid financial instruments', such as short-term money market facilities.

The cash amount in the cash flow statement can be different to the cash reported on the balance sheet. If the figure is different, it is important to understand what the cash flow statement has been reconciled to, for example it could be reconciled to cash less an overdraft facility.

The cash flow statement is an extremely effective way of monitoring the historical flow of cash through the organisation's bank accounts. The cash flow forecast is used for future cash flow. If the organisation is not generating sustainable operating cash flow, it is likely, sooner or later, to fail, regardless of how much profit (on an accrual basis) it is generating because it is effectively 'burning' cash.

Whether or not the organisation has net current assets (that is, total current assets greater than total current liabilities), if debts cannot be met as and when they fall due, there is a risk that it will be declared insolvent. Sustainable operating cash flow is the best protection against not being able to meet debts as and when they fall due.

Cash short falls need to be managed.

Questioning the cash flow statement

- Has the cash flow statement been reconciled to 'cash and cash equivalents'? That is, have all cash flows been identified and included in the statement?
- Is the net cash from operating activities generating a surplus?
- Is the organisation self-generating?
- Is the net cash from operating activities greater than net profit after tax reported on the income statement?
- If net operating cash flow is negative, how has the business sourced cash? That is, selling assets or increasing borrowings?

About us

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