A BEGINNER’S GUIDE TO UNDERSTANDING NOT-FOR-PROFIT FINANCIAL STATEMENTS

by Matt Vasil, CPA
A Not-For-Profit (NFP) entity is an organization that is generally designed for the benefit of a third party and seeks to carry out their mission without focus on returning profit to an ownership group. These entities are usually exempt from incomes taxes, provided they meet certain guidelines established by the IRS. Colleges, Universities, Foundations and other Charitable Organizations are often designated as Not-For-Profit Entities. These entities produce financial statements that have many unique characteristics that specifically address the needs of the primary users (commonly its donors) and often times are not comparable to those of For-Profit entities.

All financial statements which are reported in accordance with accounting principles generally accepted in the United States of America (also referred to as GAAP) contain 4 key components. The following section provides a brief overview of the 4 components and the nature of the information contained therein.

1. STATEMENT OF FINANCIAL POSITION

The Statement of Financial Position, also known as the Balance Sheet in the for-profit world, provides a snapshot of the assets, liabilities, and net assets of the organization at a point in time. The statement of financial position is designed to provide relevant information about the nature and interrelationship of an organization’s assets and liabilities. The amounts presented are generally aggregations of assets and liabilities that possess similar characteristics. Although the purpose of NFP entities can vary significantly, the key financial indicators on the balance sheet are often the same. Some key areas include:

**Contributions Receivable:** This represents pledges made by outside individuals or corporations to give cash, investments, or other items of value to the organization over a period of time. However, the amount recognized does not necessarily represent donations that are free to use as the organization wishes. That is why a reader of the financial statements must also be aware of the different Net Asset Classifications that are present on the statement of financial position. There are 3 types of restrictions that can be imposed upon a gift by the donor, which are referred to as: unrestricted, temporarily restricted, or permanently restricted. See Net Assets below for a more detailed description of the implications of each type of restriction.

**Investments:** This represents investments held by the organization such as mutual funds, common stock, bonds, and other investment vehicles. It typically excludes short-term cash. Since these balances are recorded at fair value, they can be subject to significant swings from one period to another. There are several technicalities as to where and how investment returns are recognized in a NFP’s financial statements, and, like contributions receivable, they can also be subject to donor restrictions. Some key factors related to investments are the organization’s risk and return objectives. These can normally be found in the Notes to the financial statements (see section 4) and provide the reader a description of how the organization manages its investment portfolio in order to provide returns while balancing market risk.
Net Assets: All NFP entities must distinguish their net assets (equity) into three classifications that are based on the existence or absence of donor imposed restrictions:

- Permanently Restricted
- Temporarily Restricted
- Unrestricted

Permanently restricted net assets result from donors stipulating that the organization must maintain the original corpus of their gift forever. These gifts are then invested by the NFP in order to earn investment returns (income) that can be used to support a variety of purposes. Depending on the stipulations set forth by the donor, the income may be either restricted for a specific purpose (i.e. to give student scholarships at a University), or unrestricted. In the latter case, the board of directors of the organization has full discretion as to when to spend the income. These permanently restricted net assets are most commonly referred to as Endowment funds. These are not to be confused with Board Designated Endowments (which are assets restricted by the board of directors and not an outside donor). Board Designated Endowments are classified as Unrestricted Net assets.

Temporarily restricted net assets are comprised of contributions and unexpended income from permanently restricted net assets which may only be utilized in accordance with the purposes established by the related donors. Temporarily restricted net assets also include contributions restricted due to time. A time restriction simply means that a donor has pledged to contribute to the organization, but has not transferred those assets to the NFP yet. A purpose restriction means that the organization can only spend the funds on the purpose stated in the gift agreement (i.e. a donor states that the funds must be used to support the Library at a University).

Unrestricted net assets represent unrestricted resources over which the Board of Directors retains full control to accomplish any of the NFP’s stated purposes.

2. STATEMENT OF ACTIVITIES

The Statement of Activities, known as the Income Statement in the for-profit world, provides a summary of the income and expenditures of the organization including income received from donors, fundraising events, federal grants, and other sources, as well as the expenses incurred in performing the organization’s activities. The income not only comes from many sources, but is also classified into the net asset categories previously explained. On the expense side, there are also classification categories. Typically, expenses are classified by their functional classification as opposed to their natural classification. Functional classification segregates expenses into the following basic categories:

Program Services are activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for, and the major output of, the organization and often relate to several major programs. For example, a university may have programs for student instruction and research, among others. Similarly, a health and welfare...
organization may have programs for health or family services, research, disaster relief, and public education, among others.

**General and Administration** activities include oversight, business management, general recordkeeping, budgeting, financing, and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities.

**Fundraising** activities include publicizing and conducting fund-raising campaigns; maintaining donor mailing lists; conducting special fund-raising events; preparing and distributing fund-raising manuals, instructions, and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies, and others.

These categories differ from that of a for-profit entity, who typically report expenses by their natural classification (e.g. rent, salaries, utilities, etc.) In a NFP organization, naturally classified expenses can exist in any of the 3 basic functional categories, depending on how the entity operates. For example, the salaries and benefits paid to the President of a NFP may be allocated among the 3 categories based on the percentage of time the President devotes to each aspect of the organization (soliciting donations, running programs, and managing employees). The statement of activities concludes with an overview of the ‘profitability’ for the period, which is called the change in net assets.

### 3. STATEMENT OF CASH FLOWS

The Statement of Cash Flows can be presented using two different methods, however we will focus on the most commonly used method, which begins with the ‘change in net assets’ shown on the statement of activities. The objective of the cash flow statement is to reconcile the change in net assets per the statement of activities to the actual cash received or spent by the organization during the year. This is required because there are many non-cash transactions that are included in the overall change in net assets figure as a result of applying accounting principles generally accepted in the United States. For example, depreciation taken on buildings and equipment is not an actual cash expense and therefore must be added back to the change in net assets to arrive at the change in cash for the year. Additional adjustments for accrued assets and liabilities (payments or receipts that were incurred but not paid/received) are necessary to convert back to the cash basis.

The second objective of the cash flow statement is to segregate the cash activities of the organization into three categories:

- Operational Activities
- Investing Activities
- Financing Activities

Cash flows from operations measure the cash inflows and outflows caused by core operations of the organization (e.g. program services offered). Typical items classified as operational cash flows are changes in accounts receivable, accounts payable, and contributions receivable, and gains/losses on investment.
accounts. This category often gives a good indication of how effectively management is running the organization and its key services.

Cash flows from investing activities generally refer to the acquisition or disposal of equipment, investments or other assets throughout the year. These activities financially support the organization, but are not a part of their core activities.

Cash flows from financing activities generally reflect the financing activity of the NFP and include receipts of assets that, by donor restriction, must be used for long-term purposes and debt activity.

4. FOOTNOTE DISCLOSURES

All financial statements require information beyond that provided in the statements of financial position, activities, and cash flows in order to adequately communicate the financial activity and condition of the organization. This information is provided in the footnote disclosures, which explain further details of the amounts recorded in the basic financial statements. The footnotes also include the following key disclosures:

**Significant Accounting Policies:**
This section describes the significant policies followed by the NFP in accounting for its activity in accordance with generally accepted accounting principles (GAAP). This footnote should list each significant category for which a selection was made. One example is depreciation expense, where an organization has various alternatives; some organizations record a higher percentage of depreciation when the asset is first purchased and less as it gets older, whereas others choose to depreciate an asset equally over time.

**Significant estimates:** This footnote describes the methods used by the NFP to determine the amounts recorded in the financial statements that are based on estimates. One of the most notable estimates in NFP financial statements is the reduction of contributions receivable for estimated uncollectible amounts (aka the allowance for doubtful pledges). Since this is a highly subjective estimate based on future events, it is necessary for the footnotes to describe how the estimate was computed.

**Additional information and details:**
These disclosures can vary widely, but basically include all other information that the NFP has determined is necessary for a reader to materially understand the financial status of the organization. They include matters ranging from contractual commitments made to concentrations of revenues to benefit plan information.
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