

Board Development

Understanding Financial Statements

Are you intimidated by the financial statements presented at your board meetings? Are you looking for basic information about reading financial statements?

If so, the following information is for you!

Not-for-profit organizations need to prepare financial statements for a variety of reasons. These include:

- reporting to funders,
- providing accountability to the community at large,
- assessing how management has discharged its stewardship responsibilities,
- meeting the requirements of the Act under which your board is incorporated (e.g., The Societies Act), and
- evaluating performance.

Financial statements tell the reader about the financial picture of the organization by identifying the revenues and expenditures, the assets, liabilities and net assets of the organization. They also assist in determining whether the organization is on track with its financial and strategic plans. These plans should be identified in the yearly budget. By comparing actual figures with the budgeted figures, an organization can determine how it is doing and whether it needs to re-evaluate and modify its plans.

As a board member, you need to understand the financial statements of your organization so you can make informed decisions.

All board members must understand, and agree with, what they are approving. Take the time to understand what you are reading before you vote to approve financial statements.

In this newsletter, you will find basic information about:

- three key financial statements,
- audited financial statements, and
- a reference guide to accounting terminology.

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Board Development: Understanding Financial Statements

The Statement of Operations is sometimes known as:

- *Statement of Revenues and Expenses*
- *Revenue and Expenditures Statement*
- *Operating Statement*
- *Profit and Loss Statement*
- *Income and Expense Statement.*

Good record keeping is essential to good financial statement preparation and presentation. Books and records must be kept in a secure location so that they can be referred to should the need arise in the future. Books and records may need to be provided to the government or funders to verify reported information.

A. Three Key Financial Statements

They are:

1. Statement of Operations
2. Statement of Financial Position
3. Statement of Changes in Net Assets

1. Statement of Operations

An example of this statement is provided in Table 1 on page 3. This statement always summarizes revenue and expense items. The statement shows where revenue comes from and how much you had left (surplus) or were short (deficit). In the case of a deficit, the negative number should be indicated in parentheses (see the example below). The surplus or deficit is used to increase or decrease the total net assets, a figure that appears on your Statement of Financial Position.

Revenues minus Expenses = Surplus or Deficit or Zero Balance

For example:

Revenue	\$100,000	\$100,000	\$100,000
Expenses	96,000	<u>103,000</u>	<u>100,000</u>
	\$ 4,000	\$ (3,000)	\$ 0
	Surplus	Deficit	Zero Balance

Revenues are money that comes into the organization through grants, donations, interest, fees for service, membership fees, fundraising and other sources of income.

Expenses are amounts paid out by the organization as a cost of operating the organization. Examples of expense items are insurance, salaries, program related costs, fundraising costs, rent and utilities.

Revenue (or expense) items are grouped together and summarized by like categories. This is done to reduce the number of items listed on the statement. It is important that, for comparative purposes, the groupings remain consistent from year to year.

Annually, this statement is prepared indicating all revenue and expense items for the full year of operations. The prior year's figures are presented for comparative purposes (see Table 1).

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Table 1		
XYZ Not-for-Profit Organization		
Statement of Operations		
For the Year Ended March 31, 2004		
	2004	2003
Revenues		
Grants & Donations	\$ 103,135	\$ 85,000
Memberships	300	250
Raffles	<u>150</u>	<u>125</u>
Total Revenue	<u>103,585</u>	<u>85,375</u>
Expenses		
Salaries & Benefits	66,585	55,000
Rent	12,000	10,000
Materials & Services	16,500	8,000
Utilities	<u>3,500</u>	<u>3,000</u>
Total Expenses	<u>98,585</u>	<u>76,000</u>
Excess of Revenues over Expenses	<u>\$ 5,000</u>	<u>\$ 9,375</u>

“The budget is a working document which reflects the joint planning effort of many people.”

Financial Responsibilities of Not-for-Profit Boards

“... The board then ensures that the financial operations of the organization are being appropriately recorded, regularly reported and periodically cross-checked.”

Financial Responsibilities of Not-for-Profit Boards

The Statement of Operations should also be prepared monthly for the board. The board then compares the figures in the statement to the approved budget. The statement indicates what revenue has been received and what expenses have been paid.

Revenue and expense items are shown for the period (e.g. monthly) and for the year-to-date. Year-to-date figures include all revenue and expense items paid from the start of the fiscal period to the end of the current period. For example, a monthly statement for the board would include a column for the current month as well as a separate column showing the totals for revenues and expenses up to this point in time.

A variance report is sometimes prepared showing the difference between budgeted amounts and actual amounts. This provides additional easy-to-read information for the board.

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*The Statement of Financial Position is sometimes referred to as the **Balance Sheet**.*

The board ensures that financial policies are in place so that they can assist the board in making financial decisions. Typical policies might cover the budget preparation process and approval, signing authority for the organization and petty cash guidelines.

2. Statement of Financial Position

The Statement of Financial Position reflects the balances of the asset, liability, and net asset accounts at a set point in time. It reflects what an organization owns and owes.

	2004	2003
Current Assets		
Cash	\$ 15,000	\$ 13,000
Accounts Receivable	<u>9,000</u>	<u>6,000</u>
Total Assets	<u>\$ 24,000</u>	<u>\$ 19,000</u>
Current Liabilities		
Payroll Payable	\$ 1500	\$ 1250
Accounts Payable	<u>500</u>	<u>750</u>
Total Liabilities	<u>2,000</u>	<u>2,000</u>
Net Assets	<u>22,000</u>	<u>17,000</u>
	<u>\$ 24,000</u>	<u>\$ 19,000</u>

Components of this statement include current assets, depreciable assets, other assets, current liabilities, long-term liabilities and finally, the net assets. Unlike the Statement of Operations which reflects the total revenues and expenses over a finite period of time, the Statement of Financial Position reflects the cumulative value of the assets, liabilities and net assets at a set point in time.

The Statement of Financial Position is always prepared at year-end and may be provided monthly to the board.

An asset is something that is owned by or is owed to the organization.

An example of an asset would be a building that is owned by the organization. Another asset category is cash. Accounts Receivable is a current asset that can reasonably be expected to turn into cash within one year. Capital assets include items such as buildings and vehicles. These assets are depreciated (amortized) over time and the net value is reflected in the statement. Details are provided in the notes to the financial statements.

A liability is something that is owed by the organization such as accounts payable, a bank loan or mortgage on a building. Liabilities are debts that are yet to be paid. Liabilities can either be short term or long term in nature.

A short term liability is also known as a current liability and is paid out within a year or less, whereas a long term liability such as a mortgage is paid out over a number of years.

Net assets are the residual of total assets less total liabilities. Another way of saying this is:

Assets minus Liabilities = Net Assets

Using the numbers from the statement for the year 2004 (see Table 2), we can see that:

$$\text{\$ } 24,000 - \text{\$ } 2,000 = \text{\$ } 22,000$$

The Statement of Operations and the Statement of Financial Position are linked. At the end of each fiscal year, any surplus or deficit is included in the net asset account on the Statement of Financial Position (Table 2).

A surplus will increase the accumulated balance of net assets and a deficit will decrease the accumulated balance of net assets. The net asset account then reflects the accumulated surplus or deficit over a period of time. Any restrictions on the use of the net assets must be identified.

3. Statement of Changes in Net Assets

The Statement of Changes in Net Assets reconciles the balance of the net asset account at the beginning of the year with the balance at the end of the year. Figures for the prior year are shown for comparative purposes.

Table 3		
XYZ Not-for-Profit Organization		
Statement of Changes in Net Assets		
For the year Ended March 31, 2004		
	2004	2003
Balance at the beginning of the year	\$ 17,000	\$ 7,625
Surplus of revenue over expenditures	<u>5,000</u>	<u>9,375</u>
Balance at the end of the year	<u>\$ 22,000</u>	<u>\$ 17,000</u>

This statement identifies any restrictions to this account and starts with the balance at the beginning of the year. In its simplest form, the changes will reflect the surplus or deficit of revenue over expenditures.

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Notes to Financial Statements

Items may appear as notes to financial statements to explain amounts shown in the financial statements or to identify significant accounting policies.

The Statement of Changes in Net Assets is sometimes known as the Statement of Changes in Fund Balances.

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*Another statement that is sometimes prepared is a **Statement of Cash Flows**. It provides information on the sources and uses of cash, and reflects the total changes in cash for the period.*

Most not-for-profit organizations are incorporated under the Societies Act. If your organization is incorporated in a different way, there may be different requirements for audited statements.

B. Audited Financial Statements

An audit of a not-for-profit organization is most often conducted by a professional accountant in accordance with generally accepted auditing principles. This then meets the criteria for ‘audited financial statements’.

The auditor examines financial records and provides an opinion on whether those statements are a fair representation of the financial position of the organization.

An **unqualified opinion** states that the auditor has had access to all the information and that the statements are presented in accordance with generally accepted accounting principles (GAAP). A **qualified opinion** may result if it has not been possible for the auditor to verify all information or when the records and statements are not in accordance with GAAP.

It is common for the auditor to make a statement that it has not been possible to determine if all revenues have been included.

A **review engagement** is not an audit. It is less expensive and less detailed. It does not provide the same level of assurance as an audit by a professional accountant and does not satisfy the requirement for an “audited financial statement.”

Some small organizations appoint two people, without signing authority, to audit the accounts of the society by reviewing a sample of transactions to determine whether policies have been followed and to review the accuracy of the transactions.

What is necessary? It depends on the requirements of the funders, government requirements, policies established or bylaws of the organization. Some not-for-profit organizations require that a yearly audit be conducted by a professional accountant.

Note: The Societies Act of Alberta states that an incorporated society must present, at its annual general meeting, a financial statement of income, disbursements, assets and liabilities, signed by the society’s auditor (Section 25 of the Societies Act). In addition, a society will make an annual return to the Registrar that includes the audited financial statement presented at the last annual general meeting of the society (Section 26 of the Societies Act). The audited financial statements that must accompany the annual return need not be audited by a professional accountant unless a) the bylaws of the society so require, or b) a fee is being charged to perform the audit. (Alberta Regulation 122/2000, Societies Act 1(4)).

A reminder....

Board members may be personally liable if they do not fulfill their responsibilities and this includes reading and understanding financial statements and financial policies.

The board is responsible for the overall operations of the organization. Board members need to know how to read and interpret financial statements. They also need to know and understand all financial policies established by the organization.

Board members need to ensure that funds are spent in accordance with the board objectives. They share equally in carrying out the mandate of an organization by:

- attending and participating in board and committee meetings,
- approving the budget and financial policies,
- reviewing and approving financial statements, and
- ensuring that funds are used for the purpose intended.

Financial responsibilities do not have to be overwhelming if you:

- understand that the board has the ultimate responsibility for governance,
- understand the legislative requirements,
- have good financial policies in place,
- know the roles and responsibilities within the organization,
- seek professional help when needed,
- have board members who take their financial responsibilities seriously,
- have an approved budget in place and monitor it, and
- take the time to read and understand the financial statements!

You can do it!

Something to think about...

“The bylaws of your organization must state who keeps the financial records for the society. You **must** keep the financial records and books properly. Failure to do this causes major problems for societies. Poorly kept or improper books create suspicion, even if there has been no fraud or stolen funds. Nothing destroys a society more than the idea that it does not have control of its finances.”

Financial Responsibilities of Not-for-Profit Boards Workbook

Board Development: Understanding Financial Statements

The board is responsible for approving all financial policies, although it may delegate some duties to a Finance Committee or Treasurer.

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Board Development: Understanding Financial Statements

Additional reference material available from the Board Development Program:

*Financial Responsibilities of
Not-for-Profit Boards
Workbook*

*Financial Responsibilities of
Not-for-Profit Boards
Newsletter*

*Developing Policy
Newsletter*

*Roles and Responsibilities of
Not-for-Profit Boards
Newsletter*

**These materials are
available online at
www.albertabdp.ca**

C. Reference Guide to Accounting Terminology

Asset - something that is owned by or is owed to the organization.

Amortize - to deduct the cost of assets over a period of time

Audit – review and examination of financial books, records and internal controls to determine the reliability of the information.

Budget – the organization’s financial plan, usually prepared annually to forecast revenue and expense items. Throughout the year, the board reviews whether the organization is on track with actual figures compared to budgeted figures. The budget is a tool to monitor financial activities throughout the year.

Expenses – amounts paid out by the organization as a cost of running the organization.

Fiscal Period – the period for which the organization’s statements and budget have been prepared.

GAAP (Generally Accepted Accounting Principles) – the broad and specific standards, procedures, and applications that are adopted by the accounting professions as guidelines for measuring, recording and reporting the financial transactions and activities of an organization.

Governance – the way a board exercises its authority, control and direction over the organization.

Internal controls – plans, procedures and records adopted to enhance the safeguarding of assets and the reliability of financial information. An example of an internal control is an adequate segregation of duties, i.e. the same person who approves an expense is not the same person who signs the cheque.

Liability - what the organization owes to someone else.

Net Assets – the difference between what is owned and what is owed.

Policy – a statement outlining a guideline for future action. Policies express the will of the board.

Professional Accountant – trained and certified professionals who are authorized to conduct financial reviews and audits. Within Alberta there are three types of professional accountants who may do this: Certified General Accountants (CGA), Chartered Accountants (CA) and Certified Management Accountants (CMA).

Revenue - money that comes into an organization for services provided or goods sold. This can be from grants, donations, interest, fees for service, membership fees, fundraising and other sources of income.

Review Engagement – an examination of books and records where the scope of the review is not as comprehensive as an audit and no audit opinion is expressed.