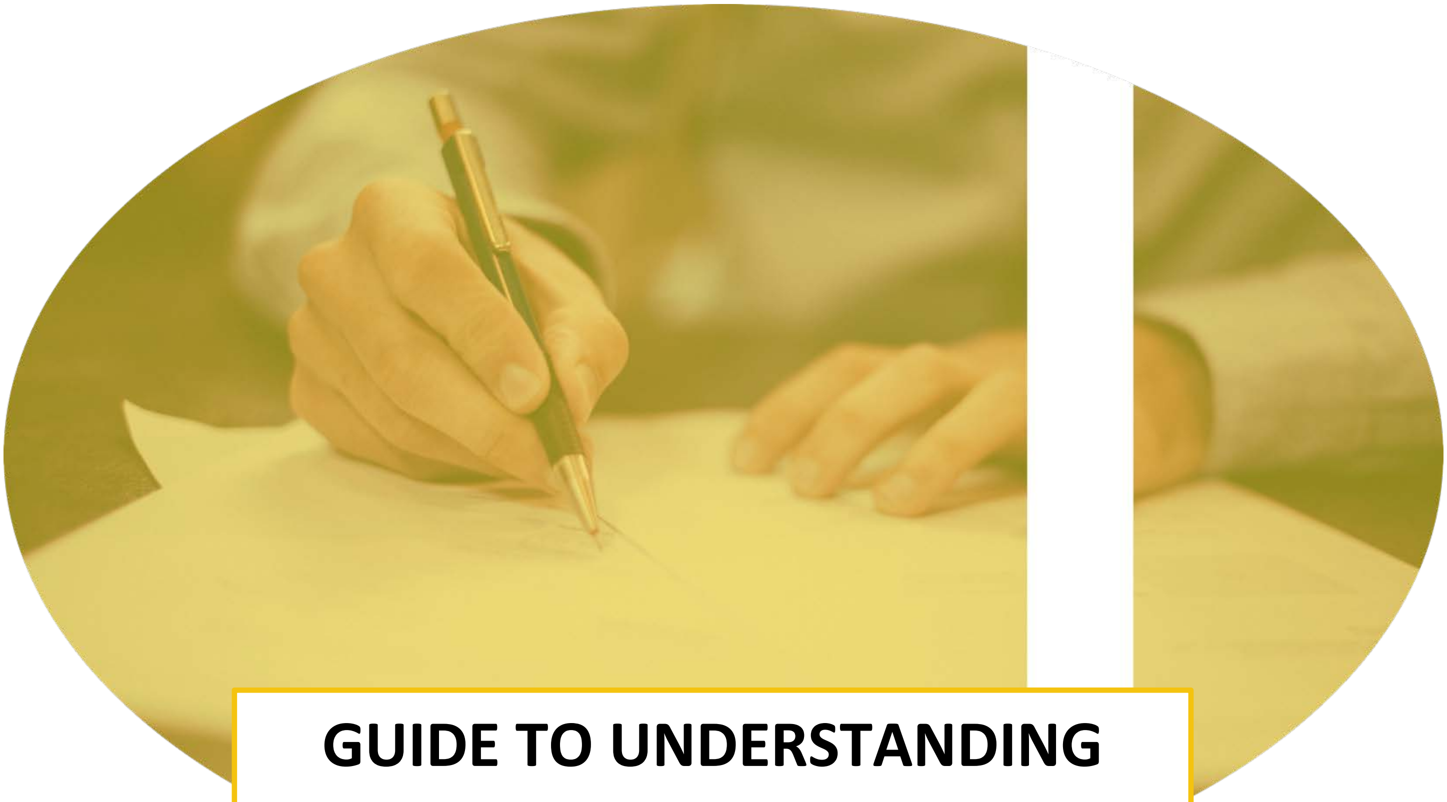


GUIDE TO UNDERSTANDING NONPROFIT FINANCIAL STATEMENTS

ANAFP

Association of Nonprofit Accountants & Finance Professionals

The Association of Nonprofit Accountants and Finance Professionals (ANAFP) is the largest professional association dedicated solely to those working in and/or interested in the field of nonprofit accounting and finance.

ANAFP serves its members and advances its mission by promoting nonprofit fund accounting and finance as a specialized profession; providing educational resources to those working in the profession; coordinating the research, debate, and processes that improve the profession; working to preserve the quality of the profession and serving as an advocate for standardized nonprofit accounting and finance practices; collecting and disseminating data and information about the profession; and defining tools and resources that enhance the performance of those working in the profession.

More information about the Association of Nonprofit Accountants and Finance Professionals can be found on the association's website at www.anafp.org.

Table of Contents

Overview

Everyone working in nonprofit accounting and finance should have a strong grasp of reading and understanding nonprofit financial statements. In addition, nonprofit Board of Directors should also familiarize themselves with the unique way in which nonprofits present their financials. Although most individuals have a general understanding of accounting and the accounting principles, it's interesting to note that most of what is learned in schools, especially in accounting courses, is generally geared towards for-profit companies, and, as you will see, the way in which nonprofits present their financial statements is a bit unique.

In nonprofit accounting, there are four required financial statements that organizations must produce, and we will touch on each of these in this guide. The four required financial statements are: Statement of Financial Position, Statement of Activities, Statement of Cash Flows, and Statement of Functional Expenses.

Readers may also access ANAFP's "Step-by-Step Guide to Creating Nonprofit Financial Statements" by visiting ANAFP's website at www.anafp.org.

Statement of Financial Position

The Statement of Financial Position is similar to the for-profit world's Balance Sheet in that it lists, at one given point in time, the values of all the assets held by the organization and the values of all the debts owed. However, the Statement of Financial Position also reports the organization's net assets. Similar to equity, the net assets section denotes the "value" of the nonprofit. As nonprofits do not have "owners", there is no equity or ownership in the business, thus no "equity" section exists on the financial statements. So, in the nonprofit world, instead of the accounting equation "assets = liabilities + equity" that most people are used to seeing, the equation is "assets = liabilities + net assets".

Assets =

Liabilities + Net Assets

The net assets section of the Statement of Financial Position is further divided into two designations as denoted in Exhibit 1. There is the "with donor restrictions" designation and the "without donor restrictions" designation. These two classifications are used to segregate any funds that the nonprofit may have access to as of the date of the statement into whether or not any of the funds are required to be spent in a certain manner – thus the donor has imposed restrictions on how their donations/funds can be spent. For example, if an individual donates money to a nonprofit organization and limits how the organization can use the funds, that money is considered restricted solely for that purpose, thus it has donor restrictions. Depending on the nature of the donor-imposed restriction, these funds may be classified internally by the organization into "permanently restricted" (such as endowments that cannot be spent at any time) or "temporarily restricted" (such as funds that are to be eventually spent on a specific project/activity). On the other hand, if an individual donates money to an organization but never specifies on what or how the organization can use the funds, these funds are considered to be "unrestricted" and will appear on the financial statement as "without donor restrictions".

Occasionally funds are restricted internally (i.e., management or the Board of Directors may decide to restrict some of the without donor restricted funds). Although these internally-restricted funds are still classified on the Statement of Financial Position as "without donor restrictions", the internal restriction is noted in the statement or in the accompanying notes (such as in the example in Exhibit 1 whereby the Board of Directors restricted $1M of the organization's unrestricted funding for a given purpose – with that purposed detailed in the notes section).

In the end, readers of the financial statement will be able to look at the organization's net assets on Statement of Financial Position and will see how much net assets the organization has and how much of that can be spent at the nonprofit's discretion (without donor restrictions) and how much of the net assets are "tied-up" and must be spent on a specific project/activity.

Exhibit 1

STATEMENT OF FINANCIAL POSITION
As of December 31, 2021

ASSETS	
Current Assets	
Cash and cash equivalents	152,846
Investments	7,223,286
Accounts receivable	23,875
Contributions and grants receivable	1,875,326
Prepaid expenses	9,255
Non-Current Assets	
Equipment, net	125,832
TOTAL ASSETS	**9,410,420**

LIABILITIES AND NET ASSETS		
LIABILITIES		
Accounts payable		158,246
Accrued expenses		57,218
Payroll withholding		63,432
	Total liabilities	278,896
NET ASSETS		
Net assets with donor restrictions		2,191,553
Net assets without donor restrictions (operating)		5,939,971
Net assets without donor restrictions (board designated)		1,000,000
	Total net assets	9,131,524
	TOTAL LIABILITIES AND NET ASSETS	**9,410,420**

It is important to note when reviewing financial statements that some smaller nonprofit organizations, especially those not using a fund accounting system, may produce financial statements with the term “fund balance” instead of “net assets”. Likewise, nonprofits using accounting software that is designed primarily for the for-profit industry, may produce financial statements with the term “equity” instead of “net assets”. In the end, the nonprofit’s accountant should edit this term when producing the required Statement of Financial Position so that the terminology adheres to the nonprofit accounting standards.

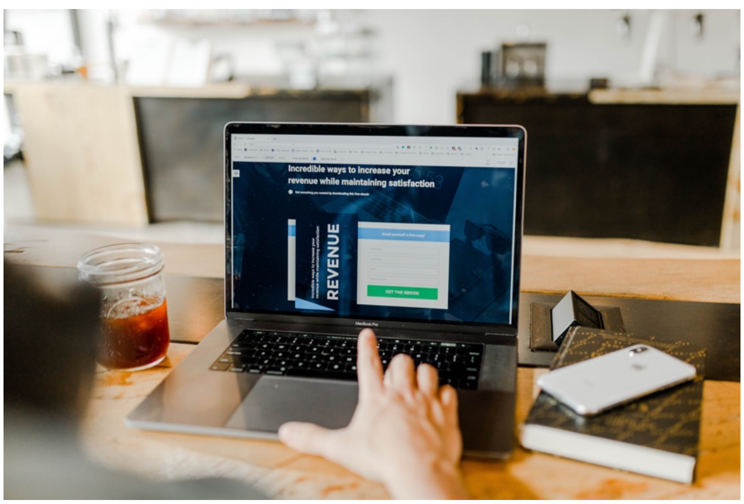
In 2016, the U.S. Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-14 which made some terminology changes to nonprofit financial statements. However, often times the old terminology is still in popular use today so it’s important to know these terms as well. Under this ASU, the term “net assets without donor restrictions” replaced the terms “unrestricted net assets” which was previously used on nonprofit financial statements. Likewise, the term “net assets with donor restrictions” was mandated to replace the terms “temporarily restricted net assets” and “permanently restricted net assets”. The ASU also required any Board of Director designations, such as funds that are internally restricted by the Board, to be fully disclosed on the financial statements – including listing the purpose of the restriction and the amount. Organizations also have to disclose the type, purpose, and amounts for all donor restrictions. Endowments, which are included in “Net Assets with Donor Restrictions”, as well as any

underwater endowments, need to be disclosed in the notes by listing the current fair value of the endowment less the original value of the donation, as well as the organization's policy regarding appropriating funds from underwater endowments.

In addition to segregating net assets based on donor restrictions, the Financial Accounting Standards Board (per Statement of Financial Accounting Standards No. 117) requests organizations to further report -- either in the net assets section of the Statement of Financial Position or within the financial statement notes -- any assets that are donated to the organization with "stipulations that they be used for a specified purpose, be preserved, and not be sold" (i.e., land or works of art) or assets donated with "stipulations that they be invested to provide a permanent source of income" (i.e., endowments). Thus, the notes section helps provide readers, in narrative format, any additional information that cannot be relayed by looking at the statement itself.

Statement of Activities

The Statement of Activities is the next financial statement produced and is in lieu of the Income Statement (sometimes called the Profit and Loss Statement) that is used by for-profit companies. This statement reports the change in net assets with donor restrictions and without donor restrictions. As shown in Exhibit 2, this is accomplished by listing each net asset fund in a separate column.



In the first section of the Statement of Activities, the revenues generated during the reporting period are listed first – and separated into whether the revenues have any donor-imposed restrictions. ANAFP's "Step-by-Step Guide to Creating Nonprofit Financial Statements" explains how best to accomplish this distinction in various accounting systems so that staff accountants can easily generate this statement.

In the same revenue section, any donor-restricted funds that are spent during the reporting period will be listed, in total, in one line-item on the statement called "net assets released from restrictions". Accountants typically state that those revenues were "released" from their donor-imposed restrictions once the expenses were incurred or a period of time lapsed. Thus, the amount of donor-restricted funds spent or released due to time restrictions will be listed as a negative number under the "with donor restrictions" column because these funds lost their "restrictions", and the same amount will appear as a positive number under the "without donor restrictions" column. The total of these two numbers, of course, will be zero. The purpose of this "movement" of funds from the "with donor restrictions" column to the "without donor restrictions" column is because all expenses, including those expenses incurred with donor-restricted funds, will appear solely in the "without donor restrictions" column as all expenses are considered unrestricted – it's just the revenues (funds) that are restricted.

Expenses, which are by nature considered "unrestricted" even if they were spent with restricted funds, will appear solely in the unrestricted column. All expenses will be listed based on their functional area, and these amounts will tie to the amounts listed on the Statement of Functional Expense. In addition, the ending net asset balances on the Statement of Activities will also tie to the amounts listed in the net assets section of the Statement of Financial Position.

Exhibit 2

STATEMENT OF ACTIVITIES
For the Twelve Months Ending December 31, 2021

	Without Donor Restrictions	With Donor Restrictions	Total
REVENUES			
Individual donations	32,475	42,458	74,933
US government contracts	345,758	0	345,758
Foundation grants	0	6,216,832	6,216,832
Interest income	360	0	360
Investment return (net)	2,854	0	2,854
Net assets released from restrictions	6,745,285	(6,745,285)	0
Total Revenues	7,126,732	(485,995)	6,640,737
EXPENSES			
Direct program services	6,001,397	0	6,001,397
General & administrative	933,847	0	933,847
Fundraising	2,754	0	2,754
Total Expenses	6,937,998	0	6,937,998
Change in net assets	188,734	(485,995)	(297,261)
Net assets at beginning of year	6,751,237	2,677,548	9,428,785
NET ASSETS AT END OF PERIOD	**$6,939,971**	**$2,191,553**	**$9,131,524**

As opposed to the for-profit world's Income Statement which shows a profit or loss for the reporting period, the Statement of Activities instead shows a positive or negative change in each net asset fund. In Exhibit 2, you see that the revenues collected during the reporting period that had donor-imposed stipulations were less than the expenses incurred using donor-restricted funding. Thus, there is a drop in the ending balance of the net assets with donor restrictions. Individuals used to reading for-profit financial statements may misconstrue this as a "loss"; however, non-profits are not in the business of making a profit (or a loss), thus this is not necessarily the case. Instead, the financial statement is showing that the organization expended some of the net assets that were obtained in a prior financial period(s). This is not necessarily a loss but a utilizing of funds for their intended purpose -- thus meeting the donor-imposed restrictions.

Per FASB's Accounting Standards Update (ASU) 2016-14, nonprofits should report net investment returns on the Statement of Activities. Thus, external costs for investments plus all direct internal costs associated with the strategic and tactical activities involved in generating investment return (such as salaries, benefits, travel costs, and other costs associated with staff who are responsible for the development and execution of the organization's investment strategy) will be netted against the actual investment income listed in the revenue section of the Statement of Activities. These investment expenses will therefore not show up under "expenses" but in "revenues". As shown in Exhibit 2, the investment revenues less any investment fees are shown in the line item "investment return (net)".

For readers of a nonprofit's financial statements that are trying to assess the organization's financial stability, it is best to analyze the nonprofit's historical financial statements to ascertain if the organization has been consistently utilizing its net assets and not replenishing them with additional funding as this could possibly indicate long-term instability.

As noted earlier, net assets denote the value of the organization. However, since restricted net assets cannot easily be used by the organization (i.e., without satisfying the donor-imposed restrictions), it is quite common in the non-profit world to consider the organization's "net assets without donor restrictions" to be the actual value of the organization. Thus, if the organization had to close its doors, those unspent funds with donor restrictions would have to be returned to the donors since the organization did not earn them and only the funds without donor restrictions would remain as the value of the organization.

Statement of Cash Flows

The next financial statement that nonprofit organizations must produce is the Statement of Cash Flows. For the most part, this statement is produced following the same procedures used by for-profit companies. This statement shows the inflow and outflow of cash within the organization. As shown in Exhibit 3, the Statement of Cash Flows starts with the change in net assets – which is the same amount listed on the Statement of Activities. The changes in the balance sheet accounts are then added to this amount to derive at the total increase or decrease in cash. When this total amount is added to the cash balance at the beginning of the reporting period, you will end up with the current cash balance, which will match the amount listed on the Statement of Financial Position.

Exhibit 3

STATEMENT OF CASH FLOWS
For the Twelve Months Ending December 31, 2021

CASH FLOWS FROM OPERATING ACTIVITIES	
Change in net assets	(297,261)
Adjustments to reconcile change in net assets to net cash provided (used) by operating activities:	
Depreciation	3,145
Decrease (increase) in operating assets:	
Contributions and grants receivable	722,456
Accounts receivable	10,824
Prepaid expenses	2,487
Increase (decrease) in operating liabilities:	
Accounts payable and accrued expenses	(142,543)
Net cash provided (used) by operating activities	299,108
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchases of investments	(879,244)
Purchases of equipment	(8,215)
Net cash provided (used) by investing activities	(887,459)
Net increase (decrease) in cash and cash equivalents	(588,351)
Cash and cash equivalents at beginning of year	741,197
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**152,846**

Non-profits are allowed to use either the direct or indirect method of reporting cash flows. Organizations can use the method that is most beneficial to them for reporting purposes.

Readers of the Statement of Cash Flows will primarily be looking to see if there was an inflow or outflow of cash during the reporting period. But for assessing liquidity, readers should review the notes of the financial statements. Per FASB's Accounting Standards Update (ASU) 2016-14,

nonprofits must provide a qualitative description of how the organization manages its resources in order to meet liquidity needs and manage liquidity risk, as well as a quantitative description of the financial assets available for general expenditures within one year of the balance sheet date. FASB defines a financial asset as being 1) cash, 2) evidence of ownership interest in an entity, or 3) a contractual agreement with another entity that clearly shows the organization's intent to receive cash or an exchange of a financial instrument. Nonprofits are not allowed to include in this calculation of financial assets an untapped line of credit. The goal of this liquidity disclose is for readers to see how much funds the organization has available at the date of the balance sheet to meet cash needs for one year.

Statement of Functional Expenses

The Statement of Functional Expenses details the expenses incurred during the reporting period and categorizes them by functional area: program services, general and administrative, and fundraising.

Nonprofits have the option to present this information as a standalone statement (as shown in Exhibit 4), on the face of the Statement of Activities, or in the notes; however, most organizations elect to follow the first option.

Best practice, although not required, is to break-out the program service costs by the organization's various programs and list the expense categories from highest to lowest as shown in Exhibit 4. Program services are considered "direct costs" as they are the mission-related activities performed by the organization, while general and administrative and fundraising costs are considered support services or "indirect costs". Should the nonprofit allocate any costs among program and support functions, this allocation methodology should be disclosed in the notes. For example, if rent is allocated to programs based on level of effort, this specific methodology should be disclosed so readers understand how rent is attributed to each program and support function.

In most cases, the expense categorizes will consolidate several of the chart of accounts into overarching categorizes that explain the general nature of the expense. For example, if the nonprofit has separate accounts in the accounting system for airfare, lodging, and meals, the total of these costs may appear on the Statement of Functional Expenses simply as "Travel". As described previously, investment expenses should not be included in the Statement of Functional Expenses but instead be included in the Statement of Activities as net investment returns.

In the end, the total expenses reported on the Statement of Functional Expenses will equal the same amounts reported on the Statement of Activities by functional area.

Exhibit 4

STATEMENT OF FUNCTIONAL EXPENSES
For the Twelve Months Ending December 31, 2021

	Program Services				
	Early Education	**Higher Education**	**General & Administrative**	**Fundraising**	**Total Expenses**
Wages	2,473,772	1,549,654	572,328	2,065	4,597,819
Fringe benefits	808,944	588,869	127,660	689	1,526,162
Consultants	144,096	43,158	38,869	-	226,123
Rent	38,262	37,220	89,873	-	165,355
Office Supplies	45,314	20,118	48,212	-	113,644
Postage and Shipping	71,668	7,684	25,132	-	104,484
Legal Fees	50,061	32,487	4,582	-	87,130
Accounting Fees	14,352	43,487	5,782	-	63,621
Telephone and Internet	10,654	4,188	6,542	-	21,384
Insurance	6,439	215	5,354	-	12,008
Bank Fees	2,685	2,187	5,487	-	10,359
Printing	3,331	1,187	2,154	-	6,672
Dues and Membership	597	768	1,872	-	3,237
TOTAL	**$3,670,175**	**$2,331,222**	**$933,847**	**$2,754**	**$6,937,998**

Readers of the financial statements will primarily look to the Statement of Functional Expenses to ascertain how the nonprofit spends its funds. For example, what percentage of spending is on general and administrative costs as opposed to being spent directly on the programs. In addition, how much does the organization spend on salaries and rent as a percentage of total spending. Readers should keep in mind that spending on general and administrative costs, and other costs such as salaries and rent, does not necessarily equate to inefficiencies or waste within the organization. These are simply the cost of doing business and will be incurred by any business entity. In addition, readers should take into account that many nonprofits allocate overhead costs to direct program spending to both help showcase higher program spending in relation to general and administrative spending and to ensure programs account for their share of the operating costs.

Thus, it's important for readers to review the notes section for additional clarity when reviewing the financial statements.

Notes to Financial Statements

As mentioned throughout this guide, the notes section of the financial statements provides readers with additional insight by presenting calculations and explanations that cannot be easily relayed in the financial statements themselves. Some of the information readers can obtain from the notes section may include a summary of the organization's activities; key accounting policies and changes that are helpful when comparing the current year statement to prior year statements; investment information; fair value measurements; important contracts, leases, and agreements that are in place for which the organization is liable; fixed asset information; credit risks; and other areas that the nonprofit and their accountants feel would be helpful for readers.

In addition, there are several required disclosures that must be made in the notes section of the financial statements, if applicable. Some of these disclosures, listed throughout this guide, include the following:

- Any Board of Director designations, such as funds that are "restricted" by the Board, including the purpose of the restriction and the amount.
- All donor restrictions listing the donor, type of restriction, purpose of funds, and amounts.
- Assets that are donated to the organization with "stipulations that they be used for a specified purpose, be preserved, and not be sold".
- Assets donated with "stipulations that they be invested to provide a permanent source of income".
- Underwater endowments listing the current fair value of the endowment less the original value of the donation, as well as the organization's policy regarding appropriating funds from these underwater endowments.
- The allocation methodology used by the organization should it allocate any costs among program and support functions.

- A liquidity calculation providing quantitative information on how much the organization has available at the date of the balance sheet to meet cash needs for one year as well as a qualitative description on how the organization manages its resources in order to meet liquidity needs and manage liquidity risk.

Conclusion

The Statement of Financial Position, Statement of Activities, Statement of Cash Flows, and Statement of Functional Expenses represent the four primary financial statements that nonprofit organizations prepare. However, although not required, some organizations may include additional statements that provide even more insight into an organization's finances. Familiarizing oneself with how these financial statements are developed will undoubtedly help users better understand a nonprofit organization's financial position. And, from this standpoint, users can more easily begin to interpret the statements through such techniques as common-sizing and performing ratio analyses to get a better understanding of how the organization is performing financially – a key skillset for anyone working in or doing business with a nonprofit.

Individuals are encouraged to read ANAFP's "Step-by-Step Guide to Creating Nonprofit Financial Statements" to gain an even better and in-depth understanding of how nonprofit financial statements are derived. This guide is available on ANAFP's website at www.anafp.org.

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