

CHAPTER J

FINANCIAL STATEMENTS

FINANCIAL GUIDELINES

and

FINANCIAL AUDITS

UNDERSTANDING YOUR ORGANIZATION'S FINANCIAL STATEMENTS

MONEY: WHO NEEDS IT

Many non-profit organizations rely on limited funds to reach their goals and run their programs. The management of these funds is the responsibility of its members, directors and executive. The good or bad management of an organization's finances will contribute to its success or failure.

CASH VS ACCRUAL ACCOUNTING – WHICH DO YOU USE?

There are two common accounting systems or methods for keeping **track** of an organization's financial situation: **cash** and **accrual**. Cash basis accounting recognizes transactions when the cash changes hands. Many small clubs or organizations with relatively few transactions each month use this system.

Accrual basis accounting recognizes income when it is earned and expenses when they are incurred. Under the accrual method, a bill that must be paid by the organization is included as a liability and money that the organization is owed is listed as an asset on financial statements. Accrual basis accounting gives a more accurate financial picture than cash basis accounting. Below are described financial statements typically used in an accrual system.

TYPES OF FINANCIAL STATEMENTS

The financial situation of an organization is shown to its members through various types of statements. They include:

1. Budget
2. Income Statement
3. Project or Event Report
4. Balance Sheet

All financial statements indicate the type of statement, the organization's name, and the date or time period it covers.

BUDGET

A budget is a written plan that forecasts income (revenue) and expenses (disbursements) for a specified period of time (usually one year). Expressed in dollars, the budget is based

on an organization's goals and ensures realistic planning of programs. Through its use, members can control and co-ordinate finances and programs.

Before approving the budget for your organization, check that the activities planned by your organization are receiving adequate funding and that all expenses are accounted for. A budget indicates predicted revenue, predicted expenses, and a predicted net income or loss (revenue less expenditures).

*Note: If the net income is **bracted** (), the organization anticipates a deficit or loss position for the time period reported. It is in the red!*

What to look for:

1. The budget should be consistent with the organization's goals and plans.
2. Check that revenues and expenses look reasonable, You may want to compare it with previous budgets and income statements.
3. If expenses are greater than revenues, does the organization have surplus funds to cover the loss?
4. Ensure that the Board of Directors approves the budget before the money is spent.

Event or Project Budgets are useful in planning specific projects or programs during the year. A project budget uses the same format as the budget and shows greater detail on a specific project or event.

INCOME STATEMENT

This report, also know as a Statement of Operations or a Statement of Receipts and Disbursements, gives a picture of how much money was earned (revenue) by the organization and how much money was spent (expenses) over a specified period of time.

Note: Revenue and expenses budgeted for the year are compared to the actual revenue and expenses at year end. The variance indicates any difference between the amount budgeted and the amount actually received or spent. The difference may also be shown as a percent difference of the budgeted amount.

The income statement measures the actual progress of the organization. It is usually completed at the end of a fiscal year and is compared with past and future budget

projections, It can also be prepared periodically through the year to check progress and make sure that all plans are on track.

The categories used for revenue and expenses are the same categories used in the organization's budget.

What to look for:

1. Reasons for any significant differences between budget and actual should be explained.
2. Reasons for unbudgeted revenue and expenses should be explained.

PROJECT OR EVENT REPORT

Organizations often prepare a financial statement to report on specific programs or events. Project reporting not only gives an accurate financial record of activities or events but is also helpful when planning future events.

BALANCE SHEET

A balance sheet is a summary of the financial position of an organization at a specific point in time and has three parts.

1. **Assets** - anything of value that the organization owns. Your organization may have one or several of each of two types of assets listed in its balance sheet.
 - i) **Current Assets** are money or items of value which can be readily converted into cash. Examples include securities, inventories, (items for sale and supplies to be used), prepaid expenses, and services.
 - ii) **Fixed Assets** are property or equipment that is expected to last longer than one year.

Fixed assets may be reported by original cost, market value (amount asset could be sold for) or by depreciated value. Depreciation spreads the cost of an asset over its useful life. The annual cost of depreciation (determined by published schedules) will be shown on the income statement. The remaining asset value is carried forward and reported on the balance sheet.

The value of the office equipment can be depreciated while land is not depreciated since it is not consumed over time and seldom declines in value. Notes relating to the valuation

of fixed assets are usually included in the balance sheet or are attached as an appendix.

2. **Liabilities** - debts or amounts owed by the organization. This includes money owed to suppliers for services and amounts owed to employees for wages or salaries.

i) **Current liabilities** are obligations due and payable within one year (including any loan **principle** payments).

ii) **Long term liabilities** are obligations such as loans or a mortgage to be paid off in more than one year.

3. **Equity, Net Worth or Capital**

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

Reviewing the association's equity is important because it shows the accumulated worth of an organization.

Relationship between the Income Statement and the Balance Sheet

The net income (or loss) from the Income Statement is brought forward to the Balance Sheet. To obtain the year end equity position, net income is added or net loss is subtracted from the equity position at the beginning of the year.

Note: A balance sheet must always be in balance!

What to Look For:

1. What items are included under accounts receivable? When are these accounts to be received? Are they overdue? Is there any possibility of not receiving the money that is overdue?

2. What items are included under accounts payable? When are they due? Is there enough cash to cover them?

3. Compare the current balance sheet with previous years; statements. Identify any trends that might be an indication of changes to the financial health of the organization. (Changes in equity.)

4. You may want to discuss whether or not the organization is fully insured for the replacement value of assets.

5. If there are any investments, are they earning a reasonable rate of return?

YOUR ORGANIZATION'S FINANCIAL HEALTH

Financial Ratios

Financial ratios can be use to evaluate the financial stability of an organization. Information from the balance sheet is essential to calculate financial rations. Table 1 shows two types of ratios and how they are calculated.

Table 1

<u>Ratios</u>	<u>Calculation</u>	<u>Example</u>
<i>Liquidity:</i>		
Current Ratio	= $\frac{\text{Current Assets}}{\text{Current Liabilities}}$	= $\frac{\$800}{\$2,350} = .34$
<i>Debt Financing:</i>		
Percent Debt to Assets	= $\frac{\text{Total Liabilities}}{\text{Total Assets}} \times 100$	= $\frac{\$2,350}{\$15,800} \times 100 = 15\%$

Liquidity refers to the ability of the organization to meet cash obligations as they come due in the short term (less than 12 months) and is usually measured by the current ratio.

A current ratio of .34 indicates there are 34 cents worth of current assets to back up each dollar of current liabilities. A current ratio of less than 1 means that there are insufficient current assets to cover short term debt. This could cause cash flow problems. An

organization that has its current ratio greater than one would be able to pay its immediate bills from current assets.

Debt financing refers to the ability of an organization to cover debts. The lower the ratio, the less risk of financial difficulties for the organization and less risk to creditors.

In this example the Percent debt to assets ratio shows that only 15% of assets are encumbered by debt. This is a strong financial position. An organization with a debt to assets ratio of over 100% would be in a very weak position.

CONCLUSION

Members learn about the financial health of their organization by reading the financial statements. It is your responsibility as a director or member to understand the financial statements of your organization. You will then be able to determine the financial status of your organization and make sound financial decisions to ensure that it remains healthy.

FINANCIAL GUIDELINES

Internal Controls for Non-Profit Organizations

The public has an expectation that non-profit organizations keep careful track over funds left in their custody. It is important for the reputation of the organization, that a good system of accounting controls be adopted and followed at all times. Procedures on how accounting routines are to be handled should be well documented.

Banking

Operating Account

1. The bank account to handle ongoing operating expenses should require dual signatures for all disbursements.
2. The operating account must be reconciled monthly with a formal bank reconciliation. All old outstanding items should be investigated. The person reviewing the account should initial the bank reconciliation as evidence of the review.

Other Bank Accounts

1. Other bank accounts can be used by the organization for special purposes. Each account should be handled in a similar fashion as the operation account.
2. In a number of cases, organizations providing funding may require that the funds be segregated from normal operating funds and that the funds only be disbursed for specific purposes. In this case, the accounting system used must keep track of the receipts and disbursements so that a complete accounting of the funds can be provided to the organization supplying the funds.

Handling of Cash

1. Depending on how the organization handles the payment of rewards, normal accounting controls may not be possible due to the nature of the payment (e.g. A receipt for the payment is not provided). The board should have well documented procedures on how the payment of rewards is to be handled. The handling of cash should be kept to a minimum. For example, a board member (or third party) handling the payment of a reward should be issued a cheque from the bank

account payable to the person handling the reward payment. Rewards not claimed by the informer should be held in a special bank account for a period of 1 year and if still not claimed, the funds should be returned to the operation account.

2. When the organization is engaged in fund raising activities that involve the handling of cash, two people should be in custody of that cash until it is deposited in the bank account.

Donations and Restricted Contributions

1. A separate bank account could also be required if a significant contribution has placed restrictions on how the funds are to be used. If the funds provided is significant, then separate reporting of the receipts and disbursements maybe required as part of the year end financial statements. The organization should contact its chartered accountant to determine the appropriate format for the year end financial statements whenever a new "restricted contribution" is anticipated. This will prevent problems from occurring when the year end statements are prepared.
2. If donations are collected and receipted as an official donation for tax purposes, a separate general ledger account must be maintained. A reconciliation should be prepared each calendar year to reconcile the funds recorded as donations and official tax receipts issued. Numeric continuity of the receipt numbers must be maintained at all times. Voided receipts must be kept on file.

Record Keeping of Disbursements

1. An invoice from a supplier must support each disbursement made by the organization.
2. The cheque number and date of the cheque and the general ledger accounts being charged must be recorded on the supplier invoice.
3. The signing officer must be presented with the supporting documentation along with the cheque at the time the cheque is signed. The signing officers must initial the supplier invoice as evidence of their review.
4. The supplier invoices should then be filed either by the month or by supplier. A new set of files should be created for each fiscal year.

5. Payments to the board or staff person for expenses incurred require special handling. A special form should be designed to handle the task of collecting the required information and approvals. A receipt should support each expenditure. If mileage is being reimbursed, a listing of the date, distance travelled and purpose of the trip should be noted. The person requesting the reimbursement should sign the special form and supporting documentation. A cheque can then be prepared and handled in the same fashion as by any other supplier.

Monthly Financial Reporting

The Board of Directors should receive and approve an accounting of receipts and disbursements at each meeting. A comparison between the actual operating results and the operating budget should be made. Any significant deviation from the operating budget should be explained to the Board. The Board of Directors should approve the annual operating budget each year. The annual budget may require updating during the year if the changes to the organization's objectives are warranted.

FINANCIAL AUDIT REQUIREMENTS

Financial Reports Used by Public Accountants in the Province of Ontario

1. Notice to Reader

This report is attached to financial statements where the accountant has done very little or no work to ensure the accuracy of the numbers. He/she has simply assembled the clients numbers in the form of a balance sheet and an income statement. Because of the amount of time taken this is the least expensive financial statement.

2. Review Engagement Report

This report is attached to financial statements where the accountant has reviewed, analyzed and discussed the numbers with the client to provide some level of assurance that the financial statements are not misleading. This report requires more of the accountant's time to prepare; therefore will cost more.

3. Audit Report

This report is used by the accountant when he/she has completed an audit of the clients records. This requires, among other generally accepted auditing procedures, third party confirmation of balance sheet amounts, and sample testing of transactions in the clients records. An analysis of cut-off procedures at the fiscal year end is also required for accounts payable, accounts receivable, and cash transactions. This report will cost the most, because it involves the greatest amount of time on the part of the accountant.

OACS recommendation for local Crime Stopper Programs

Technically, registered charitable not-for-profit organizations are required to have an annual audited financial statement prepared and filed with the regulatory authorities of the Federal and Provincial Governments.

Therefore the CCSA cannot recommend anything less than a full audit be prepared each year. In practice, however, many organizations file annual financial statements with a "Review Engagement Report" or a "Notice to Reader" attached and it is very rare for a Government to refuse a financial statement for this reason.

Ed Lemont. 2 January 2001

