Learning to Read Financial Statements

By Steven Berger

Many nonprofit board members may not know the first thing about a balance sheet. Or an income statement. Or cash flow. Their first reaction upon seeing columns of figures may be to yawn and pass the papers on to someone else.

But for board members, there is no one else. Board members of nonprofit organizations must set and monitor the organization's full array of goals. Like it or not, that includes getting involved in the financial results of the operation. In order for board members to carry out their fiduciary responsibilities effectively, they must be able to read and understand the financial statements that are produced periodically—typically monthly—by management.

So, are board members doomed to boredom and bafflement? Hardly. Financial statements are easy enough to understand—if you know what to look for.

Financial statements summarize an organization's financial position—at a given moment in time as well as over longer periods (monthly, year-to-date, quarterly, annually). They should reflect any variances between the actual operating results and the budgeted goals that were previously approved by the board.

Most organizations have a finance committee that is charged with reviewing financial statements in detail. That is appropriate. The members of the finance committee generally have a deeper understanding of financial statements. They also will perform a more detailed review of the various elements of the statements and report their findings back to the full board.

Still, all board members need to have a basic understanding of the most important elements of a financial statement. They need to know why these elements are important and what actions they should take if these elements are inconsistent with board wishes or out of compliance with generally accepted accounting standards.
These are a few steps you can take to help board members feel more comfortable when reviewing their organization's financial statements:

1. Make sure that all board members receive financial statements at least

seven days before the board meeting, so that they have ample time to review them.

2. At a minimum, see to it that the financial statements include information contained in the actual and budgeted statement of financial position (or balance sheet); statement of activities (or income statement); statement of cash flow. They should also include key volume and operational statistics; key ratios (critical success factors); explanatory notes on those actual financial and statistical elements that vary from the goal.

3. As part of the board orientation process, have new board members spend two hours with the organization's chief financial officer (CFO). They should come away knowing the critical elements of the financial statement, what they mean, and why they are important. Then, the new members should spend an hour or two with the chief executive, who should discuss his or her view of the organization's financial results and goals as they relate to various line items of the financial statements. This last step ensures that the chief executive is conversant with the financial elements of the organization and is completely aware of their implications. (As an alternative, the entire board can be given a half-day educational or training session, conducted by the CFO and the chief executive, on the major financial statement elements.)

4. Have the organization's external auditors attend any board training session and offer their input. They will bring an independent view of the financial statements and can add depth and breadth to the discussions.

Line-By-Line

There are two major financial statements: the statement of financial position (or balance sheet) and the statement of activities (also known as the income statement).

The balance sheet presents the organization's assets, liabilities, and net worth (net assets) at a particular period in time (the reporting date). The income statement presents the financial operating results, income, and expenses over a given period of time.

Every line item on the financial report is important. Board members need to be aware of each line item and, where possible, set goals around these numbers. Without goals, management has no direction for the results of these line items. When goals are placed around balance sheet and income statement items, management gets the guidance it needs for planning. Many organizations fail to set balance sheet goals, but all should.

If board members have any questions, the chief executive and CFO should explain each summary line item. That enables each board member to ask the appropriate questions at board meetings. Without a working knowledge of these line items, it is much harder for board members to perform their governance roles properly. After all, how can the board help set goals without knowing the properties of the line items for which the goals are being set?

Ratios, Trending, Graphing

The most common financial management techniques are ratio analysis, trending, and graphing. Financial ratios are the blending of two or more pieces of financial information to develop additional information that is useful to the reader. Boards can—and should—use ratios to set and monitor goals for management. For example, boards can look at cash on their balance sheets to determine if they are meeting their goals for this asset. Or they can look at a ratio called "days cash on hand," which describes the amount of cash in relation to the amount of total expenses incurred within a defined time period.

The ratio is more enlightening to the board because it places the amount of cash in context to the amount of money that is spent. It also allows the board to set goals around a number. It can ask, "Do we want 20 days, 40 days, or 60 days of cash on hand?"

Trending information allows boards to determine the direction in which the organization is headed. For example, in the graph on page 29, this nonprofit organization has seen its days cash on hand climb from 25 days in 1998 to 40 days in 2002, with a dip in 2000 that can be explained by a temporary operating loss. Graphic representations are easy for most people to understand. They show patterns that are easier to ascertain than a table full of numbers. A good graph should also contain some comparative number to determine if the actual result matches with a board-designated goal, such as a budget or a peer-generated benchmark. Further, goals should be set across time for long-term strategic financial planning.

There are many ways for nonprofit boards to utilize financial statements to move their organizations toward achieving objective results. Boards should require senior management to provide the financial information they need for goal setting and monitoring. If they know what to look for, they'll be less likely to settle for poor data and they'll be better equipped to perform their fiduciary duties.

Steven Berger is president of Healthcare Insights, a software development and training firm. This article is reprinted with permission from the April/May 2003 issue of Board Member, a publication of BoardSource (formerly the National Center for Nonprofit Boards). Text may not be reproduced without written permission from BoardSource. For more information about BoardSource services and publications, including Steven Berger's new guide, Understanding Nonprofit Financial Statements*, call (800) 883-6262 or visit* www.boardsource.org.