Audits and Financial Statements Simplified

Nonprofit organizations are not required to pay income taxes on income generated from services relating to their exempt purpose. However, they are required to file an annual form with the Internal Revenue Service called a Form 990. Form 990 presents the financial statements of the organization and other related information and must be filed four and a half months after the nonprofit organization's year-end. This form is for informational purposes only and is made available to the general public during normal business hours or mailed to any individual who covers the cost of mailing and copying.

Nonprofit organizations designated as a 501(c)(3) organization by the Internal Revenue Service are also required to file a Form PC with the Massachusetts Attorney General's Division of Public Charities. Form PC requires the nonprofit organization to provide various information on the organization and it's fundraising activities. In addition, the Form 990 must be attached to the Form PC. According to the Massachusetts Attorney General's Division of Public Charities, nonprofit organizations with revenues of equal to or more than $250,000, must also conduct an annual independent audit by an outside certified public accountant (CPA). Those with revenues between $100,000 and $249,000 may conduct a review of their financial statements performed by a certified public accountant in lieu of an independent audit. Any nonprofit with revenues of $99,999 or less is not required to conduct an independent audit or review of their financial statements. The cost of an audit varies depending on the size of the organization. Audit fees are usually significantly more than a review of the financial statements. An Audit requires examination of supporting documentation for various transactions during the year, including confirmation and inspection if deemed necessary. A review consists primarily of analytical analysis and inquiries by the outside certified public accountant regarding the financial statements and the operations of the nonprofit organization.

*From this point on, for discussion purposes the term auditor will be used interchangeably with the firm conducting an account review, as will the terms audit and review.

What a nonprofit audit does

Audited financial statements should be presented to the organization's management and Board of Directors in draft form for their review and acceptance. Staff should be working with the auditor to determine the most effective way to accurately present the financial information. The audited financial statements should not shock the board or management of an organization, as they should be accurately reporting the finances on a monthly basis. Boards should expect to get a

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balance sheet and profit and loss statement (also called income statement) at every meeting or more often if it is determined to be necessary.

Each audit will begin with a letter from the firm who is conducting the audit giving their opinion on the organizations financial statements. This is the only part of the audit that the organization does not have control over. The rest of the audit is made up of financial information that the organization gives to the auditor. Therefore, during the year it is important to keep accurate records and have a system in place that has expenses assigned to specific programs, general operating expenses or fundraising.

Statement of Financial Position or Balance Sheet

The first page of the audit is called the Statement of Financial Position. This statement is also known as a balance sheet. This is a snapshot of the organizations finances as of a certain date. In an audit it will be the fiscal year end, usually December 31 or June 30. At a board meeting it will usually be the end of the most recently completed month. This statement captures the cumulative effects of earlier financial decisions. It shows the amount of all assets the organization owns, the liabilities (or debt) outstanding or owed and the net assets (or retained earnings in the for profit world) owned by the organization. Assets equal liabilities and net assets therefore the term "balance" sheet.

Types of assets

There are two major types of assets:

Current assets usually consist of cash or assets that can be quickly converted into cash.

Among the categories under current assets you may see on the Statement of Financial Position will be:

Cash & Cash Equivalents-which is the cash the organization has in the bank or invested in an account that can be easily converted to cash such as a money market account.
Accounts receivable-which is money owed to the organization that has not yet been paid.
Inventories-which are significant expenses that have been made on things that are still on hand at the organization such as products ready for sale.
Prepaid Expenses-Expenses like insurance and rent that have been paid during the current period (month) for expenses that will be incurred in the next period.

Fixed assets include permanent assets of the organization like computers and other office equipment, office furniture, cost of improvements to office space such as renovations and any other significant things an organization may own. (Buildings and Land are also included in this category if the organization owns any).

Depreciation: When an asset has a useful life of usually more than one year and costs enough to be considered a fixed asset, usually more than $500 (this figure is to be determined by the organization and their auditor) for a nonprofit organization it will be depreciated. What this means is that if you buy a computer for $2,000 that the organization is going to use for five years instead of considering the entire $2,000 an expense during the year you buy it, it is classified a fixed asset and for five years $400 per year is counted as a depreciation expense. So that the cost of the computer can be spread out over the time it will be used.

At the end of the listing of fixed assets on the audit there will be a subtraction of accumulated depreciation. This is all of the depreciation combined from the current year as well as previous years for everything the organization owns. But the concept remains simple-if you acquired all of your fixed assets last year for $50,000 and are depreciating them over 5 years, accumulated depreciation would equal $10,000 the first year and total fixed assets would equal $40,000 the first year.

* In some ways this is an oversimplification as there are different methods and lengths of time for depreciation and organizations may acquire new fixed assets each year, but the concept is basically the same. If you have an item that you will be using for more than 5 years the time frame would increase and there are also methods where you do not depreciate the asset equally each year. If you have questions about your specific depreciation your auditor should take the time to explain them to you.

Types of Liabilities

Current Liabilities are amounts the organization owes, but have not been paid as of the date of the statement.

Accounts Payable *are bills the organization has received, but not yet paid.*
Other Payables *include interest expenses that have been incurred and will come due during the year.*
Accrued Expenses *are expenses that have been incurred by the organization, but the organization has not paid yet. An example of this is work by employees that has been performed, but not yet paid.*

Other types of liabilities are short and long term loans or mortgages that are owed by the organization.

Net Assets
Net assets are not part of liabilities. They are listed as a separate category after liabilities. Net assets consist of the accumulation of profit and losses of the organization since its inception. Net assets are the same as retained earnings in a for profit organization.

Income Statement or Profit and Loss Statement or Statement of Activity

This statement shows the revenues, expenses and profit (or loss) a nonprofit has over the course of a given time period. In audits, this period will be the fiscal year usually July 1 to June 30 or January 1 to December 31. For board meetings this should be from the beginning of the fiscal year through the end of the last full month that was completed before the board meeting. Organizations should be monitoring their burn rate (average amount spent each month) to make sure that it is reasonable with regard to the amount that is being received and with the board approved budget. If there are discrepancies the board needs to address them before they become a major problem.

The revenues and expenses will be divided into general categories and also divided by whether the money has restrictions on how it is spent. The categories are usually:

Public Support
Contributions cash given by individuals
Grants money granted from private foundations or other agencies
Donated services and assets is the fair value of anything given to the organization from specialized skill volunteer hours to office equipment.

Program Revenue *Fees received by a nonprofit organization for usually providing a product or service. The fees can be received from the public or an agency contracting the organization to perform the service.*

Program Service Contracts and Grants

Government and other funding source contracts for services provided.

Other Revenues

Interest-earned income on organization money

Reclassifications-which is money given to the organization for a specific program and spent for that purpose during the next year. The amounts are reclassified from restricted to operations when the amounts are spent for the purpose intended.

Expenses

Expenses are divided into three categories:

Program Expenses or Program Services expenses incurred directly as a result of running programs

Administration- operating expenses that are not directly related to program expenses.

Fundraising expenses generated in activities to raise money.

Change in Net Assets is the amount the organization made or lost during the year. Income minus expenses.

Net assets at the beginning of year are the accumulated profit or loss generated by the organization from its inception to the beginning of the year.

Net assets end of year is beginning of year plus the change in net assets

Statement of Functional Expenses

This sheet covers the same period of time as the income statement. It presents expenses by categories similar to the chart of accounts the organization uses (salaries, rent, benefits, office supplies, etc.). Expenses have functional classifications of Program Services, Management and General and Fundraising. Organizations with multiple programs sometimes choose to include a schedule of program services that spread the expenses over the different programs, showing the expenses of each program.

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Statement of Cash Flows

The statement of cash flows covers the same time period as the income statement and shows what is actually happening to the cash of the organization during the time period covered. Cash transactions are classified by the type of activity: operating, investing and financing. Inflows and outflows of cash during the year are classified into the appropriate category. It also lists the amount of cash at the beginning of the year. The net change in cash is added to the cash at the beginning of the year to reconcile to the cash balance at the end of the year.