

STEVEN BERGER, CPA



THIRD EDITION

**UNDERSTANDING
NONPROFIT**

FINANCIAL STATEMENTS

BoardSource®

Library of Congress Cataloging-in-Publication Data

Berger, Steven H.

Understanding nonprofit financial statements / by Steven Berger. —
3rd ed.

p. cm.

Includes bibliographical references.

ISBN 1-58686-104-2 (pbk.)

1. Nonprofit organizations—Finance.
2. Nonprofit organizations—Accounting.
3. Financial statements. I. Title.

HG4027.65.B47 2008

658.15'12--dc21

2008001683

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First printing, February 2008

ISBN 1-58686-104-2

Published by BoardSource

1828 L Street, NW, Suite 900

Washington, DC 20036

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- a biennial conference that brings together approximately 800 board leaders for two days of learning and sharing

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Preface

Every board member of a nonprofit organization — whether or not a member of the board's finance committee — is charged by law with minimum responsibilities of financial oversight for that organization. This book is designed to provide board members with the ability to understand the basic financial documents that they will encounter as board members — and to know what types of documents and information to request from the nonprofit's managers. Without these documents and without a full understanding of them, no board member will be able to meet his or her fiduciary responsibilities.

Introduction

Every nonprofit organization exists to provide value and benefits. If it did not, the organization would not attract a clientele, customers, or donors to sustain it. The benefits, which are rendered to the organization's clientele, are called the *value proposition*. Some of the more common ways to measure value are through customer satisfaction, employee satisfaction, operational excellence, community benefits, or financial results.

In each case, the value must be defined and measured. But raw performance data are not enough to provide meaning. There must be some relative comparison so that numbers can be understood in a context that renders them meaningful. These comparisons generally take the form of ratios that are derived from raw data. For example, some of the more important financial ratios that help define value include operating margin percentage, number of days cash on hand, or debt service quotient.

This book concentrates on one major and widely recognized method of measuring value: financial statements and their implications for outcomes. It is organized to maximize a nonprofit board member's understanding of the most important financial elements within his or her organization. At the outset, the book reviews the function of the board in its goal-setting role, which includes financial outcomes. This sets the stage for examining the differences between simple accounting and the board's function in analyzing accounting numbers to portray financial outcomes.

Understanding the major elements of the financial statements is the heart of the book, and attention is given to the key ways in which those elements represent the real financial outcomes of the operations performed by the organization's senior management and staff over the relevant time period.

The remainder of the book highlights similarities and differences of interim versus audited financial statements, some very specific ways to use available financial information to fulfill the board's fiduciary responsibilities, and, finally, how to utilize financial information to measure organizational performance.

What should become evident is the relationship between long-term (five- to 10-year) financial plans and short-term (one year) budgets established by the board, and how these are translated into actual operating results portrayed in the interim (monthly or quarterly) financial statements. It should also become clear how interim results relate to the final results reported in the audited financial statements and why any major differences must be taken seriously.

By the conclusion of the book, board members should have a greater ability to appraise and evaluate such things as statements of financial position and statements of cash flow and activities, and to better understand and communicate with the organization's chief executive about the financial outcomes of the organization. This book will also assist the board in working with chief executives to set organizational goals, which the executives are responsible for meeting, and for evaluating the financial aspects of the chief executive's performance.

Included with this book is a CD-ROM that contains sample financial documents and a Microsoft® PowerPoint® presentation on financial practices that can be used at board meetings to improve financial skills. A description of the contents of the CD-ROM is found in Appendix 2.