What are financial statements?

Financial statements are produced from the organisation's accounting records. They are a summary of all the transactions for a specified period of time and show the financial position of an organisation. In particular, the financial statements tell us:

- where the organisation's money came from
- how the money was used up
- the outcome for the period, ie a surplus or deficit
- what the organisation is worth (on paper).

Financial statements can cover any period of time – for example, a month, a quarter or one year. The annual financial statements are used as the basis for the annual accounts and external audit.

It is common for the annual financial statements to include the previous year's figures for the purpose of comparison - so you can see what has changed from one year to the next. Is it getting better - or worse?

The simplest of all financial statements is the Receipts & Payments report. This is a summary of the cashbook and includes details of cash balances at the start and end of the reporting period. The other two main reports relevant to NGOs are:

• The Income & Expenditure report • The Balance Sheet.

Together these contain a lot of useful information.

The income and expenditure report

In the not-for-profit sector, the equivalent of the profit and loss account is the Income & Expenditure report (or account). It is either produced from a *trial balance* (as described above) where the accruals-based system of accounting is used; or it is based on a receipts and payments account with adjustments for 'loose ends'.

It records as a summary:

- all categories of income and expenditure which belong to that year
- all income not yet received but belonging to that financial year
- all payments not yet paid but belonging to that financial year.

Income items usually appear first in a list down the page, followed by the summary of expenditure items. The difference between total income and total expenditure, often called the *outcome*, appears on the bottom line and is expressed either as:

- 'excess of income over expenditure' where there is a surplus; or
- 'excess of expenditure over income' where there is a deficit.

This excess figure is then included on the Balance Sheet under the heading of accumulated funds. There should be an accompanying Balance Sheet for the same date that the Income & Expenditure report is prepared at.

Statement of Income & Expenditure for the year ended 31 December Year 8

			Year 7
INCOME:	UC	UC	UC
Donor Income:			
-DFID	48,000		45,000
-SMILE Trust	48,000	96,000	45,000
Other Income:			
-Donations & Fundraising	6,750		6,600
-Training Fees	14,640		12,250
-Sales	11,765		6,768
-Bank Interest	832	33,987	698
TOTAL INCOME:		129,987	116,316
EXPENDITURE:			
Personnel Costs		52,580	48,780
Training Expenses		20,588	18,743
Vehicle Running Expenses		15,686	12,670
Depreciation		12,455	13,633
Administration:			
-Audit/Accountancy	587		500
-Bank Charges	455		387
-Board Meetings	2,057		1,480
-Postage & Stationery	4,838		6,776
-Publicity	396		325
-Rent & Utilities	9,994		6,524
-Repairs & Renewals	539		324
-Telephones & Fax	9,341	28,207	6,803
TOTAL EXPENDITURE:		129,516	116,945
EXCESS OF INCOME /(EXPENDITURE) FOR THE YEAR:		471	(629)

UC = Unit of Currency`

The Balance Sheet

The purpose of a Balance Sheet is to assess the financial position – or ‘net worth’ – of an organisation at a given date. If the organisation ceased operating at that date and all of its assets were converted into cash, and all of its debts were paid off, then what was left over would be what the organisation was ‘worth’.

The Balance Sheet is a list of all the assets and liabilities on one particular date and provides a ‘snapshot’ of the financial position of an organisation.

Components of a Balance Sheet

The Balance Sheet is in two parts. One part records all balances on assets accounts, the other records all balances on liabilities accounts plus the Income & Expenditure account balance.

The Balance Sheet will either be presented with the assets listed on the left and the liabilities presented on the right of the page, or more commonly nowadays, listed down the page with assets presented first then liabilities deducted from them.

Assets

Assets are classified into two parts:

- *Fixed assets* – tangible long-term assets such as buildings, equipment and vehicles, having a value lasting more than one year. Fixed assets are shown on the Balance Sheet after an allowance for wear and tear – or *depreciation* – has been made (see an explanation of what depreciation is later in this chapter).

- *Current assets* – the more *liquid* assets such as cash in the bank, payments made in advance and stocks. These, in theory at least, can be converted into cash within 12 months.

The term *liquidity* is used to describe how easy or otherwise assets can be turned into cash. So, money held in a bank account is considered to be very liquid, while money tied up in a vehicle is clearly not liquid at all.

Liabilities

Liabilities are also divided into short and long-term liabilities:

- *Current or short-term liabilities* – including outstanding payments, and short-term borrowings – ie those having to be paid within 12 months.

- *Long-term liabilities* – such as loans that need to be paid after 12 months. However, for NGOs such borrowings are not common.

Working capital

These are the funds that the organisation has available as a cushion or safety net for running the organisation's operations in the short term. Also known as *net current assets*, they are calculated by deducting immediate debts (current liabilities) from short-term funds (current assets).

Accumulated funds

Accumulated funds represent the true worth of the organisation – in the form of capital and/or cash reserves which have been built up from surpluses in previous years. Accumulated funds are classified as liabilities. In an NGO the funds are held in trust for the organisation in pursuance of its objectives. If the NGO should close down, any funds remaining after all the debts were paid off would have to either be returned to the original donors (practically quite difficult to do) or passed to another NGO with similar objectives.

Component:	**Description:**
FIXED ASSETS:	*Less liquid assets, those having a significant value lasting more than*

	one year, eg cars, office equipment, property.
CURRENT ASSETS:	*The more liquid assets – can usually be converted into cash within one year.*
Cash	Money held in the bank and as cash.
Debtors	Money owed to the organisation, such as loans and unpaid invoices.
Prepayments	Value of items paid for in advance such as insurance premiums or office rent.
Grants Due	Grants owed to the organisation for projects already started in the reporting period.
Stocks	The value of raw materials or supplies such as publications or T-shirts for sale.
CURRENT LIABILITIES:	*Those paid within one year of the year-end.*
Creditors & accruals	Money owed by the organisation at the year-end such as bank overdrafts and unpaid bills.
Grants in advance	Grants received for a particular purpose but not yet spent, so carried forward to the next financial year.
OTHER LIABILITIES:	*Longer term commitments and reserves.*
Accumulated funds	The total of all accumulated surpluses and deficits achieved

	since the organisation started. The funds are held as cash and/or equipment and can be restricted or unrestricted.
General funds	These are the part of the accumulated funds that are unrestricted and available for general use - the organisation's 'safety net' money. Also called General purposes fund.
Designated funds	Part of the General funds, money set aside for specific purposes, eg replacing equipment.
Long-term loans	Any loans to others that have to be repaid in more than 12 months' time, eg a mortgage on a building or a capital loan from a donor.

Balance Sheet as at 31 December Year 8

	Note	Year 8 UC	Year 8 UC	Year 7 UC
Fixed Assets				
Tangible Assets	1		112,091	122,696
Current Assets				
Cash at bank and in hand		8,095		2,880
Grants Receivable		10,000		5,000
Debtors	2	2,459		1,000
		20,554		8,880
Current Liabilities payable within 12 months				
Creditors and accruals	3	3,262		2,664
Net Current Assets			17,292	6,216
Net Assets			**129,383**	**128,912**
Represented by:				
FUNDS	4			
General Purposes Fund			13,292	6,216
Designated Fund – Equipment Replacement			4,000	-
Designated Fund – Fixed Assets			112,091	122,696
Total Funds			**129,383**	**128,912**

[UC = Unit of Currency]

Interpreting financial statements

The aim when reviewing an NGO's financial reports is to assess the health of the organisation and to check that funds are being used as intended – ie to achieve organisation objectives. Numbers taken on their own don't tell us very much. We need something to measure them against – such as comparing them to similar organisations, standard measures or targets, or previous years' accounts.

When we interpret the Balance Sheet and Income & Expenditure statement we use two types of financial analysis:

• *Trend analysis* which asks: how are we doing compared with the last period?

• *Ratio analysis* which provides a means of interpreting and comparing financial results.

Trend analysis

Trend analysis takes at least two sets of figures compiled using the same accounting techniques and showing information for two consecutive periods, usually year on year. By comparing the figures, it may be possible to detect trends and use this information to forecast future trends or set targets.

Trend analysis is more meaningful if also combined with financial ratio analysis.

Financial ratio analysis

Financial ratio analysis is used widely in business to assess the profitability and efficiency of companies. Ratio analysis in the not-for-profit sector is less common, but is nonetheless very useful if adapted for the sector.

Ratios allow comparison of reports expressed in different currencies and between organisations of different scale by converting them into a like measure. Donor agencies often use this technique when assessing performance, especially to compare relative costs – such as central administration – between similar organisations or projects.

The importance of ratios is in the clues they may provide to what is going on, not as absolute measures of good or bad performance. Ratio analysis helps Board members and managers answer three important questions:

- *Financial sustainability* – will our organisation have the money it needs to continue serving people tomorrow as well as today?
- *Efficiency* – does our organisation serve as many people as possible with its resources for the lowest possible cost?
- *Effectiveness* – is our organisation doing a responsible job of managing its money?

Analysing the Income and Expenditure statement

You can use ratios on the Income & Expenditure report by converting each line item into a percentage of total income (that means to divide each item by total income and multiply by 100). This gives a guide as to the relative importance of different areas on the statement.

For example, the relative costs of administration versus direct project costs. This is useful for drawing attention to the important areas and away from insignificant issues.
This calculation will also give an indication of the level of *donor dependency* – by dividing the total of donor grants by total income and multiply by 100. If your financing strategy is leading you towards less dependence on external aid, the dependency ratio will help to set and monitor your target level.

A further level of analysis can be obtained by comparing the ratios for the current and previous years' figures to detect trends.

Analysing the Balance Sheet

Again, try dividing everything by the total income figure shown on the accompanying Income & Expenditure statement to give an indication of the relative importance of items on the Balance Sheet.

- The S*urvival Ratio* can be calculated by dividing general reserves, sometimes called 'free reserves' (that's the part of the Accumulated Funds which are unrestricted, not held as capital and for general use) by total income (from the accompanying Income & Expenditure statement). If you then multiply the resulting figure by 365 this will give an indication, in days, of how long the organisation could survive in the coming year if income dried up and levels of activity remain the same. Of course, this is a highly hypothetical scenario as in practice the organisation would contract operations if its income was drastically reduced.

- The *Acid Test* or *Quick Ratio* asks the question: *Can we pay off our debts now?* It divides Current Assets less the less 'liquid' assets such as stocks and prepayments (in other words, short term debtors and cash balances only) by Current Liabilities (short-term creditors and overdrafts). The resulting ratio should ideally be in the range of 1:1. A ratio of 1:1 suggests an organisation has sufficient cash to pay its immediate debts.

- The *Current Ratio* asks the question: *Can we pay off our debts within 12 months?* It divides total Current Assets by total Current Liabilities to find a further test of an organisation's (longer term) liquidity. A result of 2:1 is considered satisfactory. Again, convert the figures for both years shown on the Balance Sheet to detect significant trends.

Ratio:	Formula:
1. Donor Dependency: Expressed as %	TOTAL DONOR INCOME X 100 TOTAL INCOME
2. Income Utilisation: Expressed as %	EXPENDITURE ITEM X 100 TOTAL INCOME
3. Survival Ratio: Expressed in weeks or days	GENERAL RESERVES* X 52 or X 365 TOTAL INCOME * these are un-restricted funds for general purposes under Accumulated Funds. Alternatively use Net Current Assets.
4. Acid Test or Liquidity Ratio: Expressed as a ratio n:n*	CURRENT ASSETS – PREPAYMENTS CURRENT LIABILITIES *Answer should be in the range of 0.8 to 1.2:1. A result of 1 to 1 means there are sufficient funds to cover immediate debts.
5. Current Ratio: Expressed as a ratio n:n*	CURRENT ASSETS.... CURRENT LIABILITIES *A result of 2:1 is considered satisfactory – enough to pay off the debts within 12 months.