

# Understanding Nonprofit Financial Statements

The previous article in this series introduced you to [nonprofit financial reports](#). We continue on this topic by diving a little deeper into the specific reports, how to understand them, and how to share them with your stakeholders - donors, board members, and community members alike. Understanding nonprofit financial statements is essential for assessing the organization's health, sustainability, and effectiveness in fulfilling its mission.

## Key Financial Statements

**Note:** Most nonprofit organizations operate using the accrual basis of accounting, which recognizes revenue when they are earned and expenses when they are incurred. This contrasts with the cash basis of accounting, which recognizes revenues and expenses when the cash is received or disbursed. The accrual basis is consistent with generally accepted accounting principles (GAAP) in that it enables the organization to relate revenues with the expenses required to generate those revenues. Most government funders require organizations to report their activities using the accrual basis. All of the statements listed below, with the exception of the Cash Flow Forecast, use the accrual basis.

- *Statement of Financial Position* (Balance Sheet): This statement provides a snapshot of the organization's assets, liabilities, and net assets at a specific point in time. Assets include cash, investments, and property, while liabilities encompass debts and obligations. Net assets are categorized into unrestricted and restricted, reflecting the organization's funding sources and usage restrictions.
- *Statement of Activities* (Income Statement): This statement outlines revenues and expenses over a specific period, illustrating how funds are generated and spent. Revenue sources may include donations, grants, and program service fees, while expenses cover program costs, administrative expenses, and fundraising efforts. The difference between total revenues and expenses shows the organization's surplus or deficit (Change in Net Assets) for that period.
- *Statement of Cash Flows*: This statement details cash inflows and outflows from operating, investing, and financing activities. It helps stakeholders understand how the organization generates and uses cash, which is crucial for maintaining liquidity and operational viability.
- *Budget Variance*: This statement compares actual revenues and expenses to budgeted revenues and expenses. Any difference between actual and budgeted amounts should prompt analysis and decisions on how to take advantage of opportunities or to address challenges.
- *Cash Flow Forecast*: This statement shows projected cash inflows and outflows and the resulting change in available cash. Because the other statements listed above are based on accrual accounting, the Cash Flow Forecast is a critical tool for understanding the actual cash outlook.

## Key Metrics to Consider

- *Revenue Diversity*: A diverse revenue stream reduces dependency on a single source, enhancing financial stability. Look for a mix of donations, grants, and earned income. However, revenue diversity in and of itself is not a guarantee or indicator of sustainability. Many large, successful organizations rely on very few types of funding so that they can focus their efforts on attracting and retaining the interest of certain key contributors (e.g. governments, foundations, or high net worth individuals).
- *Liquidity Ratios*: These assess the organization's ability to meet short-term obligations. A commonly used measure is the current ratio, calculated by dividing current assets by current liabilities.
- *Liquid Unrestricted Net Assets (LUNA)*: This term refers to the amount of cash, investments, and receivables that the organization has available to spend without restrictions. It is calculated by subtracting fixed assets (and the debt associated with those fixed assets) from unrestricted net assets. LUNA is typically expressed in the number of months of typical operating expenses it will cover. For example, an organization with \$1 million in net assets and \$40 thousand in fixed assets less fixed asset debt and \$400 thousand in monthly operating expenses has a LUNA of  $((\$1,000,000 - \$40,000) / \$400,000) = 2.4$  months.

## Best Practices for Stakeholders

- *Regular Review*: Stakeholders should routinely review financial statements to stay informed about the organization's financial health and make informed decisions.
  - Management (executives and department/program managers) should review the financial statements at least monthly in order to be able to take timely action if needed.
  - The Board of Directors, either as a whole or its Finance Committee, should review the financial statements at least quarterly, if not monthly.
- *Engage with Management*: Discuss any questions or concerns with the nonprofit's management. Understanding the context behind the numbers can provide valuable insights.
  - The CFO or Director of Finance should review and discuss the financial statements with program directors and the organization's leadership team to answer any questions, highlight critical issues, and recommend actions.
  - The CFO and Chief Executive Officer or Executive Director should review and discuss the financial statements with the Board Treasurer, Finance Committee, or Board Chair in advance of presenting the information to the full Board of Directors, to ensure that management understands the potential questions and concerns that the Board may have about the financial results.
- *Benchmarking*: Compare financial performance with similar organizations to gauge effectiveness and identify areas for improvement. To this end, we recommend

developing strong relationships with peer organizations and utilizing services such as [GuideStar](#) in order to obtain financial information for comparison purposes.

- *Simplify financial information for laypeople*: Stakeholders who are not fluent in finance may have difficulty understanding standard financial statements. Some strategies to increase accessibility and comprehension are:
  - *Dashboards*: Like the dashboard of an automobile, financial dashboards distill key performance indicators (KPIs) into easy to understand metrics that compare the organization's performance to its budget, its performance in prior periods, and/or the performance of other organizations. The dashboard can be enhanced with color coding, such as green (indicating good performance), yellow (indicating a metric to watch and discuss), and red (indicating unsatisfactory performance or an urgent concern).
  - *Graphics*: The use of visual exhibits can leverage the concept of “a picture is worth a thousand words.”
    - *Line and Bar graphs*: These graphics are useful in depicting trends and comparative metrics (e.g. revenues over time, revenues compared to expenses).
    - *Pie Charts*: These graphics are useful in depicting percentages of a whole (e.g. sources of revenue, categories of expenses).

## Conclusion

Understanding nonprofit financial statements is vital for ensuring accountability, transparency, and strategic decision-making. By familiarizing themselves with these documents, stakeholders can better assess an organization's performance and impact, ultimately fostering greater trust and support within the community.

## About this Series

Subsequent articles in this series will cover other topics related to nonprofit financial management. Here is a list of, with links to, previous articles:

1. [Introduction](#)
2. [Internal Controls](#)
3. [Segregation of Duties](#)
4. [Finance Roles and Responsibilities](#)
5. [Accounting Systems, Software, and Platforms](#)
6. [Reporting](#)

## About the Author

For over 30 years, Robert Pascual has been a leader in nonprofit financial management as a CFO, consultant, conference speaker and educator. He holds an MBA from the Haas School of Business at the University of California and is the founder and principal of [Robert Pascual, MBA](#)

[LLC](#). He has worked with small, mid-size, and large nonprofit organizations spanning the fields of education, workforce development, housing, health, philanthropy, social services, media, fiscal sponsorship, nature, and the environment. Each of these organizations has faced both unique and common challenges, some of which are probably similar to ones that you wrestle with.