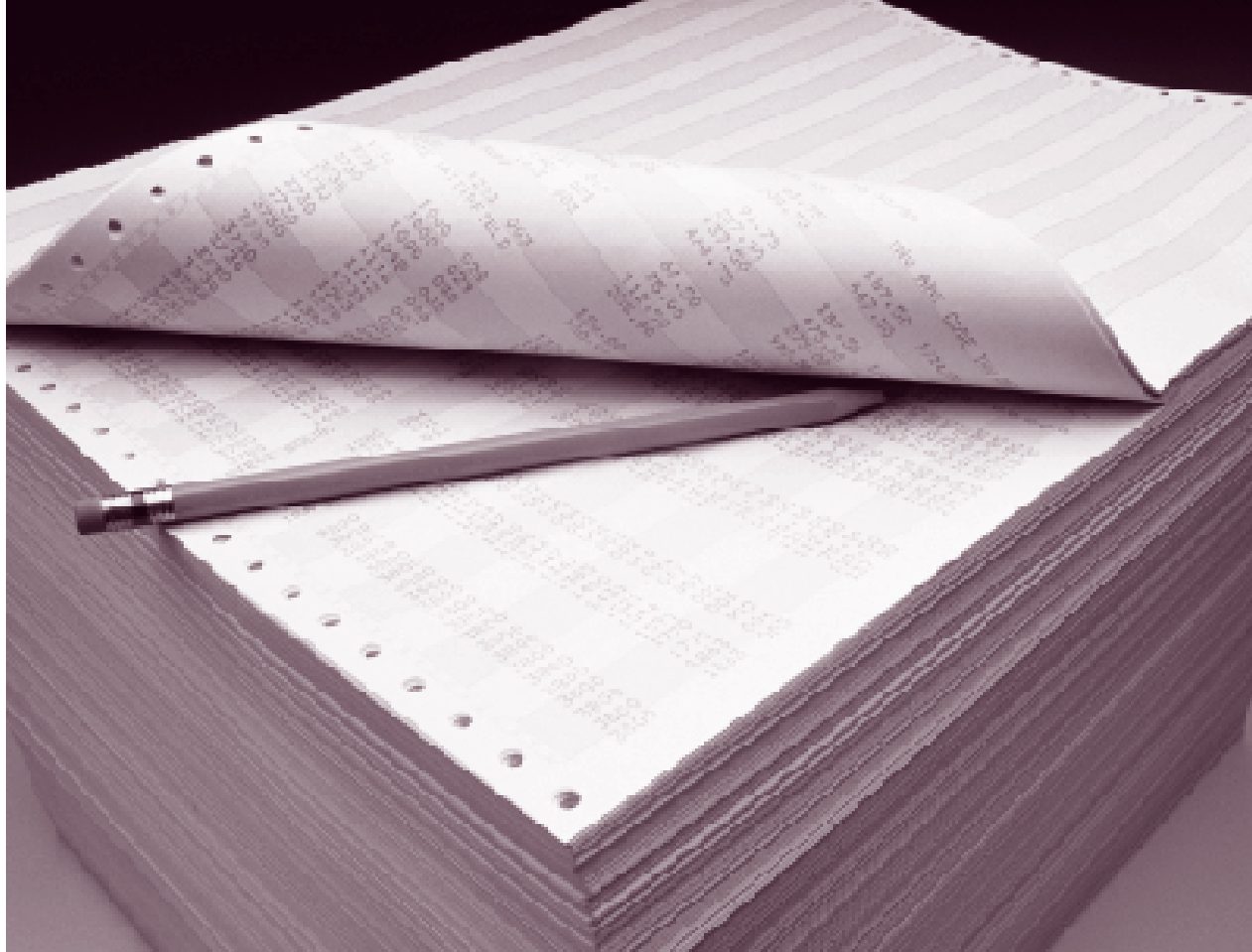


## Assessing Your Organization's Finances



MONEY  
MANAGEMENT

A Guide To Using and Understanding Financial Reports

Launched in 1982 by Jim and Patty Rouse, The Enterprise Foundation is a national, nonprofit housing and community development organization dedicated to bringing lasting improvements to distressed communities.

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# About This Manual

## What is financial assessment?

*Financial assessment is the process of reviewing an organization's financial statements to better understand its fiscal and operational positions and trends. Financial assessment is commonly used by corporate analysts and can be adapted for nonprofit community development organizations' boards of directors, lenders and stakeholders.*

*Assessing Your Organization's Finances* is designed for the staffs and boards of nonprofit organizations; city, county and state agencies; and technical assistants and partners of nonprofit community development organizations. This guide includes information on:

- Financial statements and audits
- Financial analysis
- Key indicators and ratios used in analysis, including measures of an organization's effectiveness, efficiency and control, operational soundness, financial dependency, entrepreneurial orientation, community support and credit worthiness

Not intended as an in-depth text, *Assessing Your Organization's Finances* provides an overview of the different aspects of financial management, written to help nonprofit managers or board members with the details of financial analysis. This manual is one of the books within the *Money Management* series of The Enterprise Foundation's Community Development Library™. The series provides detailed information on:

- Budgeting
- Cash flow projections
- Financial statements
- Sound financial management
- Federal rules of nonprofit money management
- Accounting software

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# Introduction

Four years ago a large nonprofit housing developer did not submit the financial reports required by its lender. The lender, expecting only that the developer forgot, began to investigate. One month later, after countless hours spent poring over financial statements, the lender knew the story: The nonprofit was losing \$12,600 *each month*. Senior staff of the nonprofit suspected something was wrong, but they did not know how to look into the organization's financials. They thought everything was OK because the organization had more than enough cash to meet the next payroll. The financial reports, which had been carefully prepared using a new version of popular financial software, did not help the staff or the board; either the reports were not saying what had to be said, or no one in the organization knew how to interpret them.

This nonprofit would have closed its doors in six months without further assistance. The cash it had — available from developer fees on a project finished the previous year — was sufficient to carry it for another half year. After that, with six months of continued operating losses, the organization would have folded.

Fortunately, help was available. The lender provided operating funds for the nonprofit to limp into its next deal and next realization of large developer fees. It also helped establish better accounting principles and taught the staff and board how to read financial reports. Now, the nonprofit is thriving.

## A DUAL NATURE

This story is more dramatic than most, but it outlines a common circumstance among nonprofit organizations. Financial statements are always required, and most nonprofits prepare their own, but many nonprofits do not fully understand how to analyze them. If a nonprofit cannot understand its financial statements, its ability to plan, make good decisions, and avoid or work through crises is diminished.

Community development organizations are hybrids. They combine two often conflicting financial realities. First, they are *nonprofit* organizations with mission statements reflecting their high goals and aspirations. Second, they are *developers* entrepreneurial organizations involved in real estate transactions and management. Their financial statements must take account of both these roles.

*Financial statements are always required, and most nonprofits prepare their own, but many nonprofits do not fully understand how to analyze them.*

Sometimes the dual nature of community development organizations mixes like oil and water, and deciphering financial statements is one of those times. The *transactional* nature of the housing business does not fit neatly with the *fund-related* format of nonprofit statements. However, that is what most community development organizations have to deal with, and that is what this manual is about.

## THE BENEFITS YOU WILL GAIN

Learning how to read the financial statements of your nonprofit organization will help you:

- Determine the financial health of your organization.
- Identify *current* problems facing a nonprofit, such as losing money on operations, insufficient cash to meet obligations or not enough working capital for a business cycle. (The financial aspect of these problems may not be apparent until after the financial statements are analyzed.)
- Identify problems that require *immediate attention*, including any possibility that the organization will not have the resources to meet its obligations.
- Identify *potential* problems facing a nonprofit, such as not being able to survive a slowdown in sales or a tardy development fee by examining the financial performance trends and the financial reserves held by the organization.
- Identify the *source* of problems by separating the components of the financial statements to analyze the different programs and projects of the organization.
- Identify possible financial or operational *solutions* to problems, such as increasing cash by decreasing receivables.

# A Financial Statements Primer

This section covers the common terms and classifications comprising financial statements. Board members and staff should understand what these terms mean so they will know what to expect when they pick up an income statement or an audited report.

## STATEMENT OF FINANCIAL POSITION, A.K.A. BALANCE SHEET

The statement of financial position, commonly called the balance sheet, reports the financial position of an organization at one moment in time, providing a snapshot of your company's financial health. The information contained in the balance sheet shows your organization's ability to meet present and future obligations with its current resources.

### Standard Format of a Balance Sheet

The balance sheet contains the first three of the five major account types:

- Assets
- Liabilities
- Net assets

Assets comprise one part of the balance sheet, and liabilities and net assets comprise the other. The assets section shows what you own or what resources you have available; the liability and net assets section shows what you owe plus the net balance of those resources.

### The Basic Accounting Equation

Assets – Liabilities = Net Assets

*or*

Assets = Liabilities + Net Assets

Your balance sheet reflects the financial status of your organization at a specific point in time. A subsequent balance sheet prepared the next day could show a very different picture. For example, you could receive a major grant or sustain an uninsured casualty loss, either of which would drastically change the financial statement. It is more common, however, for changes to occur gradually over the course of a longer trend. They are reflections of what is happening with revenues and expenses, as shown on the organization's income statement.

## BALANCE SHEET EXAMPLE

The following is a sample balance sheet. Descriptions of account classifications, and measures you can use to successfully analyze the financial statements, are provided later in this book. (Note: Forever Homes is a fictitious example of a community development corporation.)

Forever Homes CDC balance sheet — detailed as of Dec. 31, 2000

		Balance Dec. 31
<b>ASSETS</b>	<b>CURRENT ASSETS</b>	
	Cash — Checking	\$ 4,015
	Cash — HOME Funds	34,000
	Cash — Savings	0
	Cash — Petty Cash	250
	Accounts Receivable	1,000
	Prepaid Expenses	450
	<b>Total Current Assets</b>	<b>39,715</b>
	<b>INVESTMENTS</b>	
	Land/Buildings	30,000
	Construction in Progress	15,000
	Salable Property	56,000
	Long-Term Investments	0
	<b>Total Investments</b>	<b>101,000</b>
	<b>FIXED ASSETS</b>	
	Office Furniture & Equipment	30,000
	Accum. Depr. — Furn. & Equip.	(13,500)
<b>Total Fixed Assets</b>	<b>16,500</b>	
<b>OTHER ASSETS</b>		
Notes Receivable	5,000	
<b>Total Other Assets</b>	<b>5,000</b>	
	<b>TOTAL ASSETS</b>	<b>\$ 162,215</b>
<b>LIABILITIES</b>	<b>CURRENT LIABILITIES</b>	
	Accounts Payable	\$ 3,200
	Payroll Liabilities	6,800
	Accrued Expenses	0
	Purchaser's Deposits	0
	<b>Total Current Liabilities</b>	<b>10,000</b>
	<b>LONG-TERM LIABILITIES</b>	
	Lease Payable	3,000
	Notes Payable	0
	HOME Funds Payable	135,000
	<b>Total Long-Term Liabilities</b>	<b>138,000</b>
	<b>TOTAL LIABILITIES</b>	<b>148,000</b>
	<b>NET ASSETS</b>	<b>14,215</b>
	<b>TOTAL LIABILITIES &amp; NET ASSETS</b>	<b>\$ 162,215</b>

## STATEMENT OF ACTIVITY, A.K.A. INCOME STATEMENT

The statement of activity, more commonly known as the income statement, measures the results of an organization's activities by reporting its revenues and expenses for a month, quarter or year, and the difference between the two. You have a profit if there is a surplus or a loss if a deficit is reported. The income statement may also be referred to as the statement of revenue and expenses or as the profit and loss statement.

### Standard Format of Income Statements

The income statement contains the last two of the five major types of accounts:

- Revenues
- Expenses

Revenues *less* expenses *equals* net income.

Revenues represent resources flowing into the organization for a specific period; expenses represent those resources flowing out. The resulting difference is the net income — profit or loss. In the nonprofit world, it may be more appropriate to refer to net income as surplus or deficit. It is also referred to as the change in net assets.

Although the standard format of an income statement is simple, the information it conveys can be as detailed as you want, with revenues and expenses grouped and subtotaled into sub types, or classifications. Whereas the balance sheet shows the financial position — or strength — of the organization for the report date, the income statement shows the financial performance — or how the organization is using its resources.

## INCOME STATEMENT EXAMPLE

The following is a sample income statement. Descriptions of account classifications, and measures you can use to successfully analyze the financial statements, are provided later in this book.

**Forever Homes CDC income statement —**  
detailed (not consolidated) as of Dec. 31, 2000

		<b>Current Period</b>	
<b>REVENUES</b>	Grants (unrestricted)	\$ 60,000	
	Grants (restricted)	220,000	
	Contributions	25,000	
	Fund-Raising Event	5,000	
	Program Fees	0	
	Training Fees	21,000	
	Consulting	20,000	
	Sale of Property	0	
	Interest Income	<u>75</u>	
		<b>Total Revenues</b>	<b><u>351,075</u></b>
	Cost of Property Sold	0	
<b>EXPENSES</b>	<b>PERSONNEL EXPENSES</b>		
	Salaries	203,000	
	Benefits	<u>45,500</u>	
		<b>Total Personnel Expenses</b>	<b>248,500</b>
	<b>DIRECT PROGRAM COSTS</b>		
	Program Supplies	0	
	Equipment Rental	2,000	
	Staff Training	2,000	
	Marketing/Advertising	2,000	
	Printing & Reproduction	2,400	
	Publications & Memberships	1,500	
	Travel	<u>4,500</u>	
		<b>Total Direct Program Costs</b>	<b>14,400</b>
	<b>INDIRECT AND NONPROGRAM COSTS</b>		
	Fund-Raising & Event Costs	2,000	
	Rent	18,500	
	Utilities	2,100	
	Telephone	3,900	
	Insurance	5,000	
	Office Supplies	5,000	
	Postage & Delivery	3,500	
	Repairs & Maintenance	0	
	Legal Fees	4,000	
Accounting & Auditing Fees	4,000		
Miscellaneous	0		
Interest	960		
Depreciation	<u>13,500</u>		
	<b>Total Indirect and Nonprogram Costs</b>	<b><u>62,460</u></b>	
	<b>Total Expenses</b>	<b><u>325,360</u></b>	
	<b>NET INCOME</b>	<b><u>\$ 25,715</u></b>	

# Know What You Are Looking At

An income statement may not necessarily report all incoming resources and outgoing uses. For example, proceeds of a bank loan coming into the organization and the payments going out may not be reflected. You need to make a deliberate decision to include income, such as development fees, either before it is received but after it is earned or only once it is received.

Such decisions get to the core of financial reporting — selecting accrual or cash flow basis of accounting. Accrual systems measure expenses when they occur and income when it is earned; cash systems measure expenses when they are paid and income when it is received. Accrual-based financial reporting systems provide better information on expenses than cash-based systems as they reveal incurred liabilities and committed income hidden by a cash system. Accrual accounting is the only method that is considered to conform to generally accepted accounting principles.

## ACCOUNT CLASSIFICATIONS

There are five major account types:

- Assets
- Liabilities
- Net assets (equity)
- Revenues
- Expenses

While they will provide an adequate financial picture, they can be further divided into classifications to give a more accurate financial picture. What follows is a common way of grouping these account types into useful categories that relate to the activities of the organization, and definitions of these categories.

## Assets

**Current Assets** — Cash, accounts receivable, prepaid expenses and other assets that can be readily converted to cash or consumed within one year of the organization's accounting cycle.

**Investments** — Typically stocks, bonds and other securities.

**Fixed Assets** — Land and durable property and equipment held and used in normal operations and depreciated over future periods.

**Other Assets** — Accounts in this catch-all section vary among industries and organizations. Typically, this category contains any assets that do not fit into other categories, particularly non-current assets such as long-term notes receivable (loans to others). It also includes non-depreciable fixed assets such as buildings purchased for renovation and resale (housing inventory).

## Liabilities

**Current Liabilities** — Obligations that are expected to be satisfied with current assets or within one year, such as accounts payable, wages and other payroll liabilities; also called short-term notes.

**Long-Term Liabilities** — Obligations, such as bonds, pensions and long-term notes (or loans), that are not expected to be satisfied within the current period (one year) but paid in future periods.

## Net Assets

**Assets – Liabilities = Net Assets**, or, said another way: What you own *less* what you owe *equals* your net worth. Equivalent to a for-profit organization's equity, the net assets account represents the cumulative effect of all of the organization's transactions throughout its life.

## **Revenues**

Most nonprofit organizations classify revenues as either restricted or unrestricted. Restricted revenue refers to income or resources that come from a special source and must be used for a specific purpose or program. Unrestricted revenue refers to income that can be used at the nonprofit's discretion for any activity (for programs or administration). You can define classifications within classifications. For example, you may want a classification for revenue accounts related to federal contracts or to property operations.

## **Expenses**

How expenses are grouped varies greatly between industries and companies and may also be determined by how management wants to see the information reported. Many nonprofits classify their expenses as program and non-program, often called general and administrative, or G&A. Program expenses are those that are directly attributable to a specific program. Nonprogram expenses refer to those costs that may not be directly attributed to a program but are incurred in the operation of the organization (fund raising). Other classifications, such as direct and indirect expenses, may exist as well.

# Audit Reports

Financial statements that have been examined by a disinterested third party are called audited reports. Audited financials, especially those without auditor exceptions, provide stakeholders with greater confidence than unaudited financials because the reports reflect the nonprofit's actual financial position. It goes without saying that the accuracy of the analysis depends on the accuracy and completeness of the information given to the auditor.

An audit report includes the following components:

- Opinion letter
- Balance sheet or statement of financial position
- Income and expense, operations statement or statement of activity
- Statement of cash flows
- Statement of retained earnings or statement of changes in fund balance
- Notes to financial statements

**Opinion Letter** — Four types of opinions may be presented in the opinion letter:

- 1. Unqualified Opinion** — This states that the financial position of the organization at the time of the audit is presented fairly. This is the opinion you want to have presented in the financial statements because it means:
  - Accounting principles selected by the owner have general acceptance.
  - Accounting principles used are appropriate for the owner.
  - Disclosures, such as financial statement notes, are adequate to allow the user to use, understand and interpret the financial statements.

- Data presented in the financial statements are classified and summarized in a reasonable manner.
- Underlying events and transactions, within a range of acceptable limits, are reflected in the financial statements.
- The financial statements have not been materially affected by changes in accounting principles.

The following variations may be found within an unqualified opinion that should be questioned:

- *Uncertainty*— An unqualified opinion may be issued, and the auditor will modify the standard report by adding an explanatory paragraph.
- *Uncertainty related to going concern\**— Arises when the auditor concludes there is substantial doubt about an entity's ability to continue to exist.
- *Uncertainty unrelated to going concern\**— Arises when an auditor cannot collect sufficient competent evidence to support management's accounting estimates (there may be pending litigation or a question regarding management's ability to recover a cost for a particular project or investment).
- *Lack of consistency*— Inconsistent treatment of an item from one year to the next may distort a user's ability to compare the two years by a stated amount. An example would be a change in liability accrual policies. When there is a material lack of comparability caused by a change in accounting principles, an explanatory paragraph follows the opinion paragraph, which remains unqualified.

*\*Caution: A going concern issue is very serious and should be investigated immediately since the auditor is saying the business may not survive.*

**2. Qualified Opinion** — This is issued when one of the following circumstances has a material impact on the financial statements:

- *Scope limitation*— Sufficient evidence cannot be collected because of circumstances or restrictions imposed by the client (poor or unavailable records for part or all of the year).
- *Departure from generally accepted accounting principles*— This occurs when there is a disagreement between the auditor and management about the treatment or amount of an item. An auditor cannot dictate the treatment of an item; therefore, if management disagrees, the auditor can only comment about it in the report.

If a qualified opinion is given, the auditor should include an explanation in the report that states the reasons for the qualified opinion, including the effects or potential effects of the qualification on the financial statements. The opinion paragraph will say that statements are fairly presented “except for...” or “with the exception of...” the explanations noted.

**3. Adverse Opinion** — This is an opinion in which the auditor states that the financial statements do not fairly present the financial position of the entity at the date of the audit. This means that the financial statements taken as a whole cannot be relied upon.

**4. Disclaimer of Opinion** — This is issued when the auditor is unable to provide an opinion because sufficient evidence could not be collected, or there is substantial doubt about an organization’s continued existence.

While qualified, the adverse or disclaimed opinions generally indicate serious problems. A deviation from a clean opinion applies only to the items described in that opinion.

Anything other than an unqualified opinion indicates potential problems and should be thoroughly questioned immediately.

Review any notes to statements carefully. The notes — generally available only with audited financials — can provide explanations and information not available elsewhere.

# Clearing Up Financial Analysis

Assessing an organization's financial statements is a new challenge for many boards. Here are some guidelines to help you set up and interpret a financial analysis:

- **Use comparable statements** — Financial statements can be presented in a variety of time frames (monthly, quarterly or annually), accounting methods (accrual, cash or a mixture of the two), audited or unaudited and, if audited, with a variety of opinion letters. *Only* use equivalent statements when making comparisons over time.

Use these comparisons to help you think through organizational operations, status, projections, and growth or reduction scenarios. Financial analysis provides a different way of viewing current, past or projected operations and organizational status. It's an X-ray of your nonprofit. Financial results *always* reflect operations and status. The results are useful only if they help you better understand the organization.

- **Look for trends** — Operations and status change as an organization takes on new programs or progresses through a learning curve in operating an existing program. Look for trends by comparing results across *at least* two, and preferably three, years (a process that analysts call spreading the financials). This comparison gives deeper insight into an organization's future.
- **Look for red flags** — There are indicators that measure the financial or organizational strength that is critical for the long-term success of most nonprofits. Poor results on those indicators, such as lack of sufficient cash (or assets easily converted into cash) to meet immediate obligations, are red flags that may require quick action. These indicators are described in the section on Analyzing Financial Statements.
- **Set benchmarks for future analysis** — Each of the ratio indicators used in organizational financial analysis has a desirable range. Use the range indicated in the Analyzing Financial Statements section as a starting point for creating organization-specific benchmarks.

## CAVEATS

As in any industry, the financial statements of nonprofit community development organizations may contain nuances that need to be understood before the statements can be interpreted correctly. These nuances include:

- **Earnings before non-cash charges (EBNCC)** — Nonprofits that own real estate mark large line items for depreciation, as an expense and as an accumulated charge against the real asset. Similarly, nonprofits that operate loan funds record reserves for bad debts as an expense and as an accumulated charge against the real asset. These *non-cash* charges distort the analysis of the nonprofit's financial statements because, often, the more successful the nonprofit, the more negative its fund balance. *Always* net out depreciation and reserves for bad debts when using expense, asset and fund balance information.
- **Pass-through funds for capital outlays** — Pass-through funds are grants, typically from a government agency to a nonprofit, for investments in housing and other developments owned by another corporation (this is done to satisfy federal program regulations). The funds are accounted for as income, although they do not reflect income or cash that is usable for operating the nonprofit because of the commitment.

An example is when funds from the HOME Investment Partnership Program or a Community Development Block Grant are awarded to a nonprofit for investment within a housing project owned by the nonprofit itself or by a single-asset corporation or partnership affiliated with the nonprofit. When the funds are lent to either of these affiliates, the nonprofit may account for the amount as a note receivable, even though it does not expect to receive payment on the note in a timely manner. Carefully examine your financial statements, including auditor's notes, to uncover these pass-through amounts.

- **Restricted funds** — Restricted funds are those provided to a nonprofit exclusively for the operation of specific programs or for developing specific projects. Within the financial statements, these funds should be recorded in the restricted category. Fund accounting rules require that restricted accounts be segregated from unrestricted accounts. Note, however, that Financial Accounting Standards Board (FASB) Standard 117 requires that income, assets and net assets be categorized as permanently restricted, temporarily restricted or unrestricted, while, as a general rule, all expenses are unrestricted.
- **Interfund transfers** — Nonprofits may show transfers of funds between restricted and unrestricted accounts. If these interfund transfers are only on paper, they may confuse the analysis of ratios and indicators. Review the statements carefully when interfund transfers are identified.
- **Ownership of housing projects** — In analyzing the finances of a nonprofit, the ownership of its housing projects can be confusing. If housing is owned by the nonprofit or by a single-asset corporation controlled by the parent, it should be accounted for as part of the organization's overall finances.

Many nonprofit housing projects are owned by partnerships structured to use Low-Income Housing Tax Credit benefits. However, the nonprofit general partner may own as little as 1 percent or even 0.1 percent. In other cases, the nonprofit may own a portion of a for-profit that, in turn, owns a percentage of the partnership that owns the real estate. Therefore, it is important to look beyond the percentage of ownership and read the documents controlling the activity of the partnership itself.

You need to determine the level of control that the nonprofit has over the operation of the partnership. When you analyze the fiscal impact of the property on the nonprofit, use the correct percentage of income, expenses and cash flow. Pay attention to the contingent liabilities the nonprofit has incurred in the form of warranties to the other partners and to agreements that outline the terms under which the nonprofit may receive deferred development fees or an incentive management fee.

- **FASB 116** — Along with FASB 117, FASB 116 is a rule that changed how nonprofits record and report contributions. The organization must record an entire amount pledged as a receivable and as revenue at the time of the commitment, even though the payout may occur over a period of time. If the payout occurs over a period of years, the pledge must be discounted for inflation during that period.

# Analyzing Financial Statements — What Does It All Mean?

Following are different ratios and other measures of the financial health of community development organizations. Some of the measures (such as *control, operational soundness, and quick response*) are standard ratios used to analyze financial statements of nonprofit and for-profit corporations alike. Other measures (such as *effectiveness, financial dependence, and entrepreneurial orientation*) were created for community development organizations and may need more information than is available in financial statements. Each measure will tell you something important about an organization; using all of them will give a more complete picture.

Following are 10 measures you can use to successfully analyze a nonprofit's financial condition. Each has indicators that define how the measure is computed, as well as a desirable range for good organizational health. A discussion paragraph on each measure will help you understand how to apply the results.

## EFFECTIVENESS

*The extent to which the community development organization is addressing its mission and meeting its short- and long-term goals*

### Indicators:

- Number of housing units produced and sold or leased over a given period
- Number of commercial square feet produced and sold or leased over a given period
- Number of units under management at the end of a given period
- Number of clients served by a program

### Desirable Range:

- At least 90 percent of the goals set

### Discussion:

The effectiveness of operations is measured by comparing actual results with organizational goals. To do this, measurable goals must be set (typically for a year) and a tracking system must be in place so the organization can determine progress. Obviously, goals are not often in financial statements and must be secured from management. Deviations outside the desirable range come from setting goals too high for operations. If this is the case, the organization should examine its operating resources, systems and procedures to determine if operations can be improved to reach the goals, or if operations are as efficient as possible and goals need to be reduced.

## EFFICIENCY

*The extent to which the organization is cost conscious, produces economies of scale, places units at sustainable costs and stabilizes its production function*

### Indicators:

- Cost per unit of housing: total expense divided by total units produced
- Cost per square foot of commercial space: total expense divided by total square footage of commercial space produced
- Percentage of expenses directly attributable to production, projects and program services: total program expense divided by total expenses
- The amount of overhead compared with production: nonprogram expense divided by production

### Desirable Pattern:

- A trend of lowering costs

### Discussion:

Community development organizations show a wide variation in their efficiency results, as different organizations work in differing contexts. Each nonprofit can create its own benchmarks to measure whether the organization is improving its efficiency over time. It is also possible to benchmark your organization's productivity against that of organizations creating a similar product in the same general market.

## CONTROL

*The extent to which the organization has short-term managerial control over its revenue stream*

### Indicators:

- Receivable ratio: accounts receivable divided by total current assets
- Unrestricted fund ratio: total unrestricted revenue divided by total revenue

### Desirable Range:

- Receivable ratio: less than 25 percent
- Unrestricted fund ratio: greater than 25 percent

### Discussion:

Accounts receivables are promises to pay that have not yet turned into cash. The higher the ratio of accounts receivable to current assets, the less flexibility a nonprofit has to use its current assets for organizational purposes. The amount and ratio of receivables held by an organization will depend on the type of businesses operated. As with other ratios, nonprofits can create their own benchmarks and measure their progress over time. As we mentioned in the caveats, be wary of receivables from related parties, such as subsidiaries in real estate partnerships. If they are not likely to be fully collectible, they can skew any analysis.

A large and *growing* receivable ratio may be a **red flag**.

Unrestricted funds can be used for any legitimate purpose by the organization, whereas restricted funds can be used only for defined purposes. A higher percentage of unrestricted funds gives an organization more flexibility in its use of revenues.

## OPERATIONAL SOUNDNESS

*The extent to which the organization operates at or above break-even*

### Indicator:

- Deficit ratio: (total revenues minus total expenses) divided by total expenses

### Desired Range:

- Greater than zero percent

### Discussion:

Even nonprofit organizations need to have revenues to pay all expenses; otherwise, expenses (and probably operations) have to be curtailed. Most nonprofits try to break even, and in doing so often wind up experiencing a net loss. Organizations that make a profit have the luxury of expanding operations or building reserve funds for the unexpected occurrences that always occur.

Depreciation and pass-through funds, which were items mentioned in the caveats, can have an enormous effect on the bottom line. Before making this computation, scrutinize your statements for depreciation and pass-through adjustments.

A deficit ratio below zero may be a **red flag** for an organization, and almost always will be a red flag if the deficit ratio stays below zero across two or three years.

## FINANCIAL DEPENDENCY

*The extent to which the organization is financially dependent on single sources of revenue*

### Indicators:

- Government ratio: revenue from government divided by total revenue
- Foundation, corporation, trust ratio: revenue from foundations, corporations and trusts divided by total revenue

### Desired Range:

- Government ratio: less than 40 percent
- Foundation ratio: less than 40 percent

### Discussion:

Raising revenue from diverse sources, including net income from operations, protects an organization against shifts in any one funding stream. For example, your revenue stream will be adversely affected if the organizations that made a sizeable grant to you change their priorities or impose time limits of support. Similarly, if your city or state government changes leadership or priorities with elections, your operations may be adversely affected.

## QUICK RESPONSE

*The extent to which the organization has the financial capacity to respond quickly to opportunity and threat*

### Indicators:

- Current assets ratio: current assets divided by total assets
- Cash assets ratio: cash assets divided by total assets
- Current assets-to-liabilities ratio: current assets divided by current liabilities
- Working capital ratio: (current assets minus current liabilities) divided by (fund balance plus total liabilities)

### Desired Range:

- Current assets ratio: greater than 50 percent
- Cash assets ratio: greater than 25 percent
- Current assets-to-liabilities ratio: greater than 2
- Working capital ratio: greater than 25 percent

### Discussion:

Organizations heavily invested in real estate, as are many housing and commercial real estate developers and owners, are likely to have very low current assets and cash assets ratios. These organizations — property rich and cash poor — may need to have a strategy for realizing cash during periods of cash shortages, through refinancing, sales or other means.

The current assets-to-liabilities ratio tells an organization whether it is likely to have the cash it will need to retire short-term liabilities in a timely fashion. Any ratio close to 1:1 can be dangerous; any ratio below 1:1 is a technical definition of bankruptcy and is often a clear reflection of the organization's inability to meet its obligations. Declining trends of this ratio, especially when the ratio is below 2:1 and falling, are **red flags**.

The proper working capital ratio depends largely on the length of the organization's business cycles. Many nonprofits operate programs for public agencies and are reimbursed monthly for expenses incurred. If the public agencies pay promptly, these organizations may need as little as four to eight weeks of ordinary operating expenses for working capital.

Nonprofits that develop residential housing, commercial real estate or community facilities have a development cycle that can be as long as two to three years. If they are paid only after the development is finished, these organizations will need enough working capital to sustain them through that development period.

## ENTREPRENEURIAL ORIENTATION

*The extent to which the organization relies on development fees, service fees, rental income or business-related income*

### Indicator:

- Fee ratio: revenue from fees divided by total revenue

### Desired Range:

- Greater than 20 percent

### Discussion:

Increasingly, nonprofits are looking toward accruing fee income, both to increase total income and to hedge against becoming overly dependent on foundations or public agencies. Do not forget, however, that fee income will always have the *expense* associated with providing the products or services that bring in the fee income. As fee income increases, the net result may deteriorate an organization's bottom line.

## COMMUNITY SUPPORT

*The extent to which the organization receives financial support from individuals and local institutions such as churches, small business, fraternities, sororities, etc.*

### Indicator:

- Local fund-raising ratio: revenue from special events and local fund raising divided by total revenue

### Desired Range:

- Greater than 5 percent

### Discussion:

Monies for nonprofit organizations are available from all areas of the country, even the poorest, as long as the individuals and institutions within those areas choose to support the organizations. Local fund raising is a tangible measure of how well the community supports an organization. It gives an opportunity for neighbors to be involved with an organization and gives a clear measure of support from donors. Additional information about the character of fund raising may be needed from management to determine this ratio.

## CREDIT WORTHINESS

*The extent to which the organization can cover short- and long-term debt*

### Indicators:

- Long-term debt ratio: long-term debt divided by total assets
- Short-term debt ratio: (accounts payable plus short-term portion of long-term debt) divided by cash assets

### Desired Range:

- Long-term debt ratio: less than 75 percent
- Short-term debt ratio: less than 50 percent

### Discussion:

Long-term debt is an obligation that is due more than one year in the future. Short-term debt is an obligation due within a year and is a current liability. Long-term debt, such as mortgage obligations, may have a short-term portion — that part of the debt that is due within one year — and that portion will be listed as a current liability in audited financial statements.

Both long- and short-term debt for organizations that develop and own property may be less rigorous than they appear on the balance sheets. Debt that is owed to public agencies may be forgivable, in whole or in part, so long as the organization lives up to the covenants defined within the loan documents.

An example would be renting some percentage of housing units for the life of the mortgage to households that have incomes within a target range. The debt will be listed on the organization's books, but a closer reading of the notes to audited financial statements should show the exceptions.

## ORGANIZATIONAL SECURITY

*The extent to which the organization has short- and long-term reserves*

### Indicators:

- Short-term ratio: (cash assets plus deferred revenue\*) divided by annual operating expenses
- Long-term ratio: endowment divided by annual operating expenses
- Combined security ratio: short-term ratio plus long-term ratio

\* Deferred revenue refers to income that is committed and recognized as a receivable, but not yet in-hand.

### Desired Range:

- Short-term ratio: three months' reserve
- Long-term ratio: nine months' reserve
- Combined security ratio: 12 months' reserve

### Discussion:

Reserves permit an organization to weather financial downturns. Reserves also enable an organization to invest in its future through staff training, financial investments or other ways that trade an up-front cash outflow for an expected future gain. Creating reserves requires an organization to be profitable, and too few nonprofits have the excess revenues necessary to tuck away cash for a rainy day.

## Notes

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## THE ENTERPRISE FOUNDATION

The Foundation's mission is to see that all low-income people in the United States have access to fit and affordable housing and an opportunity to move out of poverty and into the mainstream of American life. To achieve that mission, we strive to:

- Build a national community revitalization movement.
- Demonstrate what is possible in low-income communities.
- Communicate and advocate what works in community development.

As the nation's leader in community development, Enterprise cultivates, collects and disseminates expertise and resources to help communities across America successfully improve the quality of life for low-income people.

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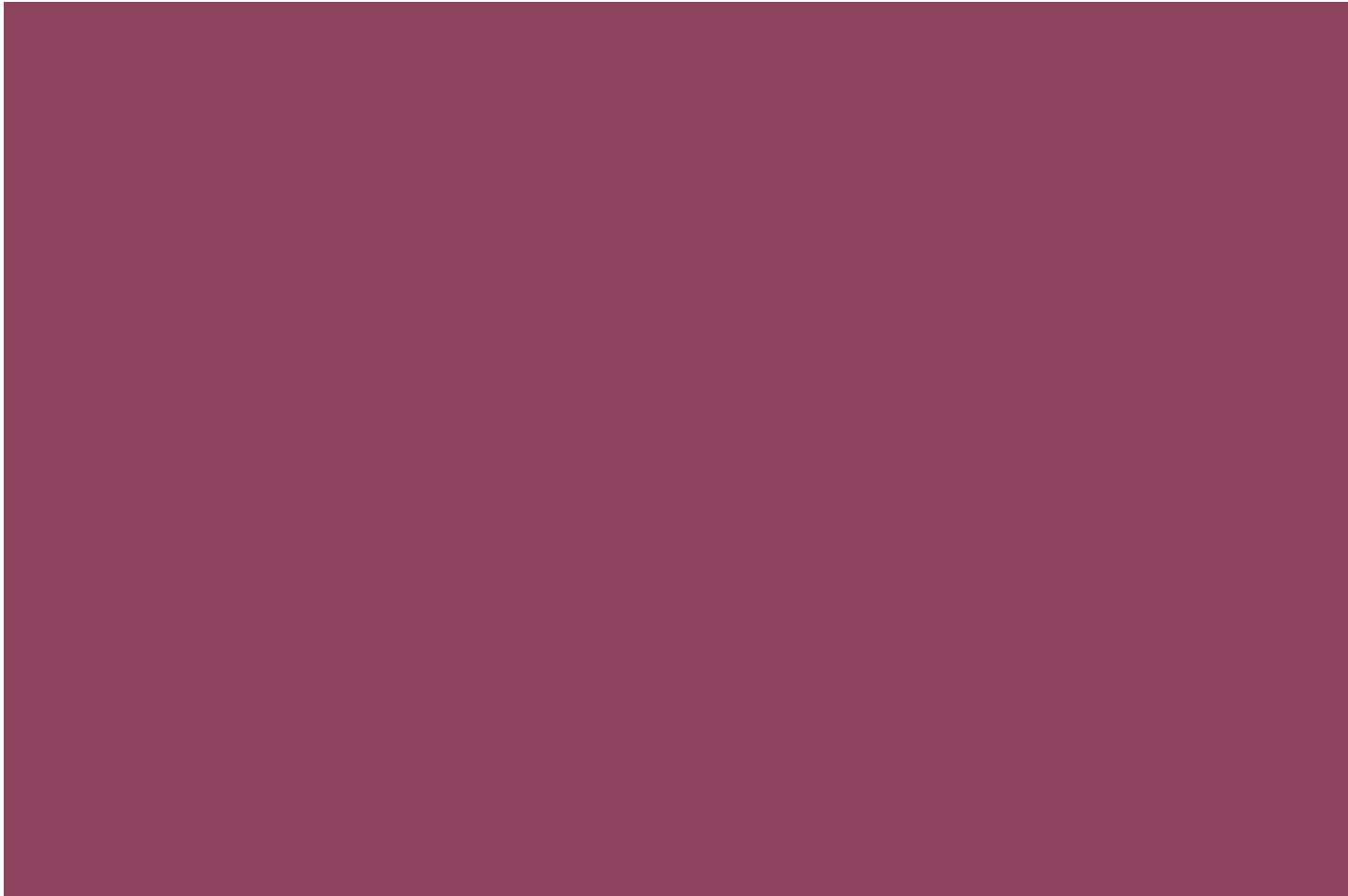
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