

HOW TO READ FINANCIAL STATEMENTS—A PRIMER FOR CDCs

I. WHAT FINANCIAL STATEMENTS TELL YOU

In his online publication entitled, *How to Read Financial Statements*, Steven Berger stresses the importance for Board of Directors of nonprofit organizations to read and understand financial statements in order for them to set financial goals and meet their fiduciary responsibilities to the organization.

Members of the Finance Committee, in particular, and Board members in general, are encouraged to develop a basic understanding of the important elements of financial statements and to recognize when these elements are not consistent with the financial goals and objectives of the organization or out of compliance with general accepted accounting standards. Mr. Berger notes that financial statements summarize an organization's financial position at a given moment in time as well as for longer periods—monthly, quarterly, year-to-date, or annually—and should reflect any variances between the actual operating results and the budgeted goals that were previously agreed upon by the Board of Directors.¹

Financial statements of your CDC contain all of the information managers need to support the current and future decisions you make on the operations of the organization. They are periodic reports that summarize the financial affairs of your CDC (See Sample Cash Availability Analysis).

II. MODIFYING YOUR CHART OF ACCOUNTS

This Primer assumes that your organization is using a computerized accounting system and also assumes that your organization is a new, non-profit CDC with an Accounting or Finance Manager. You have already interviewed the personnel at the bank close to your office and established that its location, business hours, and automated banking systems are very convenient to your operations. You agree that the monthly and other fees are reasonable, you have identified the bank representative who will be the liaison for your CDC, and you are assured that all of your questions for your business needs will be appropriately answered. Your checks are ordered, you have all of your banking and financial office supplies and your Operating Account is in place.

Your Finance Manager has already set up the accounting files, procedures and systems that will allow you to find accurate information, in an efficient manner, to answer questions from the Treasurer of the Board of Directors. Now you and the Finance Manager are ready to review the modifications to the Chart of Accounts for your non-profit CDC and these modifications include accounts to monitor funds, grants, pledges, and contributions or sponsorships.

Your Chart of Accounts is the road map to your General Ledger. It is from your Chart of Accounts that financial information is reflected on the General Ledger—considered by some as the heart of the

¹ *Learning to Read Financial Statements*, Steven Berger, the Grantsmanship Center, online publication. See <http://www.tgci.com/magazine/03summer/read1.asp>.

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accounting system². These accounts are examined and adjusted before being transferred to the financial statements that will tell you the financial health of your CDC and provide the basis on which future operational decisions will be made.

III. ACCOUNTS PAYABLE AND RECEIVABLE

In the non-profit community, executives know the “waiting/can’t wait games”—waiting on the reimbursable funds from that federal or local government grant to be deposited in the operating account or waiting on payment for services already rendered while daily discussions are managed with the landlord, phone company, office products supplier, and other vendors who cannot wait to be paid.

The Accounts Payable records all of the outstanding invoices received or financial liabilities due within the next thirty days as well as your aged payables—those bills that are long overdue to your vendors. This record is generated from a number of specific ledger accounts included in your Chart of Accounts and informs the organization on its outstanding financial commitments.

This report, generated monthly, points you in the direction of your bottom line and the financial data from this report will also let you know whether or not your bank balance or cash on hand is as healthy as you would like to believe that it is.

The Accounts Receivable records the value of services rendered or business income generated or anticipated—the funds due and owing to your CDC—and also is generated from several specific ledger accounts included in your Chart of Accounts. In membership organizations that generate unrestricted income through its members and/or other products, the accounts receivable will reflect the value of invoices mailed to its members as well as any outstanding payments on products/services sold.

IV. INCOME AND EXPENSE ACCOUNTS AND CASH FLOW STATEMENTS

All of the income received by your CDC is “debited” to your Operating Account and your expenses are “credited” to the same account. The Finance Manager would have completed ledger accounts for your vendors as well as for those sources that fund your operations. With the use of automated accounting systems, Financial Managers are now relieved of having to create a manually-organized ledger account for each vendor and funding source since the system usually prompts this action when a new vendor is introduced into the system.

Vendor ledgers will usually include specific information about each vendor including terms of payment, any discounts available for early payments, contact information, and other pertinent data.

Financial data from your income and expense accounts are organized in the monthly Accounts Payable and Accounts Receivable or Monthly Income Statements. The expenses are pulled from all of your outstanding payables; your purchases and cash expenses and the total of all vendor ledgers should be

² *Alpha Teach Yourself Accounting in 24 Hours*, Carol Costa and C. Wesley Addison, CPA (Pearson Education, Inc), 2001.

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consistent with the balance in the Accounts Payable. Funds received from funders, contributions, sales of products or services, and memberships are posted to your Accounts Receivable and also will be reflected in your Cash Flow Statement.

According to the U.S. Securities and Exchange Commission, these data are used to generate your monthly Income Statements, which show how much money a company made and spent over a period of time. The Cash Flow Statement tells the story of monies exchanged between your CDC and entities outside of your organization over a period of time.³ The financial information from these statements will inform your Balance Sheet and your Profit and Loss Statement.

V. STRAIGHT-LINE & OTHER DEPRECIATION

The equipment you purchase as well as the furniture and furnishings to be used in the operations of your business have a “useful life”. The term of that useful life—number of years for depreciation—is usually assigned by the Internal Revenue Service (IRS) and varies from equipment to equipment and type of furniture and furnishings. For example, vehicles are usually assigned a useful life of five (5) years and equipment within a range of 3-5 years.

According to Linda Pinson, author of *Keeping the Books: Basic Recordkeeping and Accounting for the Successful Small Business*, “If you buy business property that has an expected life in excess of one year that is not intended for resale, it is considered depreciable property. The cost (generally in excess of \$100) must be spread over more than one year and the depreciation deductions claimed over the useful life or recovery period of the property.”⁴

Over the years, as the federal government sought to encourage business investments, some equipment were afforded accelerated depreciation or “to speed up” their deductions over a shorter period of time. While this is more important for for-profit companies, since depreciation is treated as an expense that lowers a company’s tax obligation, in the non-profit industry, depreciation also plays a role on your Chart of Accounts and accumulated depreciation is always reflected on your Balance Sheet and Profit and Loss Statement.

The Chart of Accounts should include several asset-depreciation accounts and the Depreciation Schedule includes each category of assets, but these should reflect only straight-line depreciation—monthly depreciation of assets or monthly expense.

VI. READING FINANCIAL STATEMENTS—TEN TIPS TO REMEMBER

Financial statements can be daunting to non-financial managers who were not trained in principles of accounting or did not have opportunities to stay engaged in the financial operations of a nonprofit organization on a consistent basis. The following ten tips are offered to encourage your interest:

³ *Beginners’ Guide to Financial Statements*, online publication by The U. S. Securities and Exchange Commission, See <http://www.sec.gov/investor/pubs/beginstmtguide.htm>.

⁴ *Keeping the Books: Basic Recordkeeping and Accounting for the Successful Small Business*, Sixth Edition, Dearborn Trade Publishing, 2004.

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1. Chart of Accounts are flexible and efficient allowing new accounts to be added to answer your financial monitoring questions and meet your reporting needs.
2. Your Accounts Payable and Accounts Receivable reports are significant financial documents that frame your day-to-day operational decisions and other short- or long-term, decision-making strategies.
3. Income or Revenue Statements show how much funds were received by the CDC from all of your sources of income—Funders, sales of services or publications, bank interest, membership and other miscellaneous income streams—over a period of time.
4. The Cash Flow Statement tells the story of monies exchanged between your CDC and entities outside of your organization over a period of time. It includes income and expenses.
5. The Balance Sheet tells a story of your CDC and its operations and is the picture that is closely examined by the bank if you should ever need a loan.
6. The Board of Directors has fiduciary responsibility for the CDC and must be able to read and understand financial statements.
7. Include your Auditor in significant Board meetings and use them for training the Board of Directors.
8. Since computerized systems fail and system crashes are known entities your Accounts Receivable, Accounts Payable, General Journal Entries, and Financial Statements should be printed on a monthly basis.
9. Keep your records and statements simple so that they can be read, understood and interpreted.
10. Learning takes time, be patient with yourself.

Glossary

Items	Explanations
Accrual Basis	Used whenever you have Accounts Receivables and Account Payables.
Chart of Accounts	Determines how the accounts will be shown in the General Ledger – the heart of the accounting system (Cash is always listed as the first on this list). The Chart of Accounts becomes the General Ledger. These accounts are examined and adjusted before being transferred to the financial statements.
Accounts Payable	A record of payments owed to vendors by your CDC and should be generated on a monthly basis. This is the first account to be listed in Liabilities section of Balance Sheet.
Accounting Period	The period of time covered by the income and other financial statements that are included in the reports.
Accounts Receivable	A record of amounts owed to your CDC
Accrued Expenses	Expenses incurred by your CDC but not paid (e.g., payments to consultants, taxes, interest on accounts).
Accrued Income	Income earned by your CDC but not yet received (e.g., payments for services rendered on behalf of funder, sales of publications, membership dues).
Other Income	Income that is earned from sources other than sales of products and services. For example, interest income earned from bank account.

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Items	Explanations
Assets	Everything owned by the CDC or owed to the CDC that has cash value.
Financial Statements accounts	Balance Sheet (reflects the net worth of the company) and Profit and Loss Statement .
Balance Sheet	Provides information on what the CDC owns and owes at a fixed period in time—the financial position of the CDC’s Assets, Liabilities and Equity Accounts .
Budget	A set of financial goals for your CDC that contains projected income and expenses over a set period of time—usually one year. The performance of the CDC is measured against these income and expense objectives. The budget is agreed upon, or voted on, by your Board of Directors.
Profit/Loss Statement	Contains Income, Cost of Sales (difference = Gross Profit) and Expenses—tracks overall success or failure of the daily business operations.
Organizational costs	Costs for setting up a business—cash expenses usually incurred for intangible things (e.g., licenses)—remember that these costs are <i>amortized</i> over time.
Liabilities	Debts incurred by the CDC: Bank loans, personal loans, credit card purchases, taxes payable to federal or state governments.
Long-term liabilities	Principal amounts on installment loans on which payments are made for an extended period of time.
Equity	Values of business or property after claims or expenses are deducted.
Retained Earnings	Net profit or loss of the CDC—first account reviewed when viewing Balance Sheet—if business has been in existence for more than 1 year, the Balance Sheet section will have retained earnings (prior years) and net profit (current year).
Capital Account	Amount of the initial investment put into the business to get it started and found in “equity” section of Balance Sheet.
Capital Expenditures	A record of expenses for the purchases of items such as property and equipment that has a useful life of more than one year (fixed assets).
Asset Accounts	Carry debit balances.
Liability accounts	Carry credit balances.
Accumulated depreciation	Written off as an expense—the same is done for Accumulated Amortization .
GENERAL LEDGER	
General Ledger Must always be kept in balance	Basic structure of the accounting system where accounts can be examined and adjusted. At the end of the month, balances are transferred to the Balance Sheet and Profit and Loss Statement.
Debit Accounts	All expenses are considered to be Debit Accounts. Every debit that is posted will have a credit posted to offset it.
Debit—you increase	A positive number—every account in the General Ledger has either a debit or credit balance. NOTE: when all of these are added, they should = “0” since they are meant to offset each other.
Credit—you decrease	A negative number.

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Items	Explanations
General Journal Entries	Entries posted directly to the General Ledger.
DEPRECIATION	
Fixed Assets	Items purchased for use by your CDC that are depreciated over a fixed period of time determined by the expected useful life (determined by IRS) of the equipment. For example, desks, chairs, computers, printers, copying machines.
Depreciation Accounts	An account that is set up to record the decrease in the month-to-month and year-to-year value of equipment.
Depreciation (straight-line)	An expense and a deduction for tax purposes; <i>can be accelerated</i> as allowed by federal government.
Accumulated depreciation expense	Preferable that it be written off at the end of the year as a means of reducing tax liability. If written off monthly, could reduce the net profit.
Prepaid Expense	Is an asset (e.g., insurance)— Account is established in the Asset portion of Charts of Accounts.
Income Accounts in General Ledger	Income Accounts carry “a minus in front of the number” (e.g., -\$3,000) when they are reflected in the General Ledger as reminder that Income Accounts in the General Ledger usually carry “credit balances”. The minus signs are removed when this number is carried over to the Profit & Loss Statement.
CASH RECEIPTS AND CASH DISBURSEMENT JOURNALS	
Cash Receipts Journal	All revenue is recorded in the Cash Receipts Journal—the section the accounting system that processes all incoming cash and distributes it to various accounts in the General Ledger
Year-to-Date Report	A total of all of the months to that point in the calendar year—information to the current month as shown on the Profit and Loss Statement
Cash Disbursement Journal	Tracks outgoing payments or revenue. These data are also posted to the General Ledger Account.
Accrual Accounts	Should be checked monthly—be sure to check the following: Accounts Payable; Payroll Taxes Payable. If bills due for the previous month are paid on time, this account should have a zero balance.
Checks issued	All checks issued by your CDC should be posted to the General Ledger at the end of the month.
Petty Cash Records	A record of small business purchases made with cash instead of with a business check. Receipts for all cash purchases should be saved.
Deposit in Transit	Bank deposit posted in the accounting system, but did not reach the bank in time to be included on the monthly statement.
Trial Balance	A report that lists all of the accounts in the General Ledger and their year-to-date balances. It is usually generated for the accountant’s review of year-to-date financial data before it is transferred to the Balance Sheet and the Profit and Loss statements.

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Items	Explanations
Balance Sheet	The account balances in the Assets section of the Balance Sheet are debits . The account balances in the Liability and Equity sections are credits . The Balance Sheet shows the solvency of the operations of the CDC and the financial information contained in this report is used to make future management decisions.
Leasehold Improvements	Costs incurred in modifying the rented space to operate your CDC.
Balances on Balance Sheet	Not closed, but carried over to the next year.
Net Profit	The difference between debits and credits—it is carried over to the next year as Retained Earnings

**CASH AVAILABILITY ANALYSIS
xxx-COMMUNITY DEVELOPMENT CORPORATION**

Account	Vendor	\$ Amount	Balance
Bank Account: xxxx (8/31/05)		10,000.00	
Bank Account: xxxx (8/31/05)		45,000.00	
Total Community Union account balance			\$ 55,000.00
Total Community Bank Account		2,500.00	
			2,500.00
			\$ 57,500.00
Deposit In Transit			
	1	2,150.00	
	2	1,000.00	
	3	1,500.00	
			4,650.00
			\$ 62,150.00
Total Outstanding Checks:			
	10022	6/29/2005	Nepark
	10025	7/31/2005	C.Jackson
			5,000.00
			1,000.00
			6,000.00
			\$ 56,150.00
Adjusted Cash Book Balance 8/31/05			
Anticipated Receipts			
		5,000.00	
		5,000.00	
		10,000.00	
			20,000.00
Total Cash Available through 9/27/05			<u>\$ 76,150.00</u>

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Recommended Readings:

1. *Alpha Teach Yourself Accounting in 24 Hours, Edition Two*, Carol Costa and C. Wesley Addison, CPA (Pearson Education, Inc), 2006.
2. *Keeping the Books: Basic Recordkeeping and Accounting for the Success Small Business, Sixth Edition*, Linda Pinson (Dearborn Trade Publishing), 2004
3. *Accounting the Easy Way, Edition 4*, Peter J. Eisen, Barrons Educational Series Inc., 2003.
4. *Accountants' Handbook, Edition 10*, Paul Rosenfield, John Wiley & Sons Inc., 2003.
5. *Alpha Teach Yourself Accounting in 24 Hours*, Carol Costa and C. Wesley Addison, CPA (Pearson Education, Inc), 2001.
6. *Accounting and Finance for Your Small Business*, E. James Burton and Steven M. Bragg, John Wiley & Sons, Inc., 2001.
7. *Accounting Business Review Books, Edition 4*, Peter J. Eisen, Barrons Educational Series Inc., 2000.
8. *Beginners' Guide to Financial Statements*, online publication by The U. S. Securities and Exchange Commission, See <http://www.sec.gov/investor/pubs/begfinstmtguide.htm>
9. *Learning to Read Financial Statements*, Steven Berger, the Grantsmanship Center, online publication. See <http://www.tgci.com/magazine/03summer/read1.asp>.
10. *Financial Statements: A Step-by-Step Guide to Understanding and Creating Financial Reports*, Thomas Ittleson, Book-mart Press, 1998.

Disclaimer: NCCED had provided this information as a general service to community development corporations (CDCs) and community based organizations (CBOs). The information contained in this Primer does not reflect accounting advice for the general financial operations of any nonprofit organization. Financial advice on reading and interpreting financial data should be obtained from a professional tax consultant or your Auditor.