The Basics of Reading Association Financial Statements

Knowing the basics of reading the numbers on a financial statement is essential to understanding the financial health of an association. Many people admit that accounting is not their area of expertise and therefore leave it to others (or the auditors) to explain what they are seeing on the financial statements. With a few simple lessons, you can learn what financial statements really tell you and how to use them to understand the true financial health of your association.

Definitions of the Most Commonly Used Financial Statement Terms

Income Statement

An income statement can also be referred to as a Profit and Loss Statement, or a Statement of Operations for not-for-profit organizations. It shows the revenue and expenses incurred by an association over a period of time.

Balance Sheet

The Balance Sheet, or a Statement of Financial Position, shows the amount of assets (what is owned), liabilities (what is owed) and capital, or the net assets for not-for-profit organizations (what is left over) of an association at one point in time.

Items on the balance sheet are usually broken down into short term and long-term categories, with the long-term period usually being a year or more. On the balance sheet the assets always equal to the liabilities plus the equity (or net assets in the case of a not-for-profit).

Statement of Cash Flows

The statement of cash flows is a financial statement that shows how changes in balance sheet accounts and income affect cash, and breaks the analysis down to operating, investing and financing activities.

Knowing What's Behind the Numbers

Financial statements reflect real world events but aren't always the whole story.

Things like market forces, the economy, and technology are not reflected in the financial statements so it is important to understand that they are just one piece of the puzzle when it comes to decision making.

The numbers are easier to understand if you have a solid understanding of what the association does and what it's goals are. Financial statements can also be influenced by management estimates and judgement. Audits or review engagements are helpful to determine if the estimates being made are appropriate.

Easy Ratios

Working Capital Ratio (also known as the Current Ratio) – the liquidity of an association is a strong indicator of it's health. Liquidity refers to how easily an association can turn assets into cash to pay any of it's obligations. The working capital ratio is calculated by dividing current assets by current liabilities. The higher the working capital ratio the better, however ideally at least 1.0, but preferably greater.

Quick Ratio – similar to the working capital ratio, the quick ratio calculates the short-term liquidity of an association. It is calculated by first removing inventory from current assets and then dividing by current liabilities. The reason is that inventory often takes some time to sell. Again, the higher the ratio the more liquid the association. You wouldn't want to see a quick ratio of less than 1.0.

Operating Margin – this ratio is calculated by subtracting expenses from revenues and dividing that sum by the revenues. This is an important forecasting ratio because it illustrates the associations ability to produce a surplus, which can be drawn on if needed in the future. Generally, an operating margin of 25% or higher is considered favorable.

Operating Reserve – the operating reserve addresses whether an associations resources are sufficient to support its goals. It compares net assets to total expenses. Not-for-profit organizations should aim to have an operating reserve ratio of 100% of its revenues, or enough to cover a least 12- months of their annual revenues.

Questions to Consider

When a board member or executive looks at the financial statements, some of the things they should consider are:

- What items are included in accounts receivable and accounts payable? When are they to be received/paid? Are they overdue? Is it possible they may never be collected?
- Compare the balance sheet with the previous year's statement for the same time period. Look for any trends that may indicate a change to the health of the association.
- Is there enough or too much cash available and should some of it be invested?
- Are revenues higher than expenses and if not, why not?
- If not, does your association have a plan to increase revenue?
- Have investments increased or decreased and what is the reason? Has the market gone down?
- Are the actual amounts in line with the budget?
- What amounts are owed to the government? Directors are personally liable for unpaid taxes so it's important to understand how they are being handled.

The Audit

It is important to understand the role the auditor plays regarding the financial statements. It is a common misconception that if an audit has been done that every single item has been checked. To read more about the role of an audit, review engagement, or notice to reader, review our previous article on the subject strauss.ca/difference-audit-review-engagement/

The Board's Responsibilities

The directors of an association have the responsibility to oversee the finances.

As a director (or executive), you do not need to be a financial expert; however, you do need to understand how financial information is presented. It is a reasonable expectation, to do regular reviews of the information prepared for that purpose by engaging in questioning and participating in discussions. In the end, it is the Board of Directors who are accountable for the financial affairs of your association—if you do not understand something presented in a set of financial statements, then it is your responsibly to ask questions and ensure that your question and the answer are included in the minutes of the meeting. strauss.ca/what-are-the-financial-responsibilities-of-an-association-board/

SAMPLE STATEMENT OF FINANCIAL POSITION

Accounts receivable includes amounts from membership dues, event and sponsorship revenue for example. All are expected to be collected

Includes prepaid management fees (billed one month in advance) prepaid insurance and expenses for items such as events or inventories.

Assets

	20XX	20XX
CURRENT ASSETS		
Cash	$150,000	100000
Investments	300,000	300,000
Accounts receivable	4,500	5,000
Prepaid expenses and inventories	60,000	60,000
	$514,500	$465,000

Liabilities and Net Assets

CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$20,000	$50,000
Government remittances payable	25,000	6,000
Deferred revenue	100,000	100,000
	145,000	156,000
NET ASSETS		
Unrestricted	369,500	309,000
	369,500	309,000
	$514,500	$465,000

This is normal accounts payable and amounts saved to pay yearly audit expenses.

Amounts owed to the government for GST returns.

Revenue collected for the following year's membership dues.

No restrictions on when the assets can be used. This number helps assess the underlying value of the association.

CURRENT RATIO

Current assets
(514,500)
÷
Current liabilities
(145,000)
= 3.5

QUICK RATIO

Cash
(150,000)
+
Investments
(300,000)
+
Accounts Receivable
(300,000)
=
454,500
÷
Current liabilities
(145,000)
= 3.1

SAMPLE
STATEMENT OF OPERATIONS AND CHANGES IN NET ASSETS

Revenue collected from additional sources such as events, sponsorship and advertising.

Revenue:	20XX	20XX
Membership fees	$ 200,000	$ 200,000
Conference revenue	500,000	500,000
Corporate sponsorship program	30,000	50,000
Professional development course fees	30,000	20,000
Investment income	2,000	500
Other	20,000	20,000
Advertising	5,000	5,000
Foreign currency exchange gain (loss)	1,000	1,000
	$ 788,000	$ 796,500

Expenses:		
Management fees	$ 200,000	$ 150,000
Conference expenses	250,000	250,000
Promotion and marketing	100,000	100,000
Regulation	50,000	50,000
Board, executive and committee meetings	20,000	20,000
Office and general	40,000	50,000
Government relations	10,000	10,000
Professional development courses	10,000	10,000
Professional fees	20,000	20,000
Awards and bursaries	10,000	10,000
Commissions	10,000	10,000
Insurance	1,000	1,000
Telephone	1,000	1,000
Leadership development	5000	5,000
Research	500	500
	$ 727,500	$ 687,500
Excess of revenue over expenses	60,500	109,000
Net assets, beginning of year	309,000	200,000
NET ASSETS, END OF YEAR	$ 369,500	$ 309,000

Management fees as contracted.