

# Understanding Financial Statements for Non-Financial Not-for-Profit Directors

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## Agenda

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### Board's Role

- Fiduciary Duties Related to NFP Financial Oversight
- Common Barriers To Full Participation in Financial Oversight
- Roles and Responsibilities of Management, Board and Auditor

### Key Accounting Concepts & Reports

- Financial Reporting Process
- Financial Reporting Concepts
- Accounting for Contributions (i.e., Donations)
- Four Key Financial Statements
- Fund Accounting
- Auditor's Opinion
- Conclusion: Your Role as NFP Director

## Overseeing financial affairs: Every director has a fiduciary duty

“Overseeing the financial affairs of NFPs is a key responsibility of the board, and of every member of the board.”

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## Common barriers to full board participation in financial oversight

1. We have an experienced accountant on our board – why should I have to deal with this?
2. Shouldn't the board be focusing on our organization's mission?
3. Accounting is just too complex for me!
4. Isn't this the job of the auditor or of management?

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## Roles and responsibilities of financial reporting

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|-------------------|--|
| <b>Management</b> | <ul style="list-style-type: none"><li>▪ Prepares financial reports</li><li>▪ Exercises judgment on how certain items are treated</li><li>▪ Develops internal financial controls</li></ul>  |
| <b>Board</b>      | <ul style="list-style-type: none"><li>▪ Oversees management's financial reporting processes</li><li>▪ Satisfies itself as to appropriateness of financial reports</li><li>▪ Oversees appropriateness of financial controls</li></ul> |
| <b>Auditor</b>    | <ul style="list-style-type: none"><li>▪ Provides independent assessment of the financial statements</li><li>▪ Gives a professional opinion on the financial statements</li></ul>   |

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## Board - Auditor relationship

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### Two Key Considerations:

1. **Choice of Auditor**
  - Board selects the auditor
  - Board recommends appointment at the AGM
2. **Auditor Reporting Relationship (Governance Best Practices)**
  - Auditor reports to the board (or board committee)
  - Auditor meets with the board (or board committee) *in camera*, w/o management

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## Internal financial reporting process

1. Staff both create and use financial reports
2. Certain financial reports are submitted to the board and/or board committees
3. A “natural cycle” of financial reporting to the board:
  - Budget for the coming year
  - Audited statements for the previous year
  - Internal in-year financial reports
4. Calendar dates depend on the organization’s fiscal year

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## External financial reporting process

- Stakeholders have an interest in your organization’s financial affairs:
  - Funders
  - Donors
  - Members
  - Canada Revenue Agency (CRA)
  - Others
- Common information requirements are often met through the audited statements and annual report
- Special purpose reports are sometimes required (e.g., funders, donors, CRA)
  - Management prepares
  - Board may oversee

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## Financial reporting concepts – Assets

**Definition:** Things owned by or owed to the NFP

**Current assets:** Cash or items expected to be cash or utilized within 1 year, such as

- Cash in the bank
- Cash equivalents
- Accounts receivable

**Long-term assets:** beyond 1 year, such as

- Capital assets (e.g., buildings, equipment)
- Investments

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## Financial reporting concepts – Liabilities

**Definition:** Amounts owed to others

**Current liabilities:** payable within 1 year, such as:

- Accounts payable
- Bank loan
- Current portion of mortgage payable

**Long-term liabilities:** payable beyond 1 year, such as:

- Mortgage payable (excluding current portion)

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## Financial reporting concepts – Revenues

**Definition:** Amounts associated with increases in economic resources related to its operating activities, such as:

- Grants
- Contributions (donations)
- Fee-for-service – which generates revenue
- Membership fees
- Sale of goods
- Investment Income

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## Financial reporting concepts – Expenditures

**Definition:** Amounts spent related to operating activities, such as:

- Salaries
- Rent
- Office supplies
- Depreciation of capital assets (usually called “amortization of capital assets”)

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## Financial reporting concepts – Net revenues

$$\text{Net Revenues} = \text{Total Revenues} - \text{Total Expenditures}$$

- If positive, called *Excess of Revenues over Expenditures* (an “operating surplus”)
- If negative, called *Deficiency of Revenues over Expenditures* (an “operating deficit”)

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## Contributions – A special type of revenue

Accounting term for donations is **contributions**

**Definition:** Contributions are non-reciprocal transfers

- The contributor does not receive anything in exchange for the contribution
- Unique to NFPs
- Can be a significant percentage of an NFP's revenues
- Government funding is considered to be a contribution

### Three types of contributions

1. **Restricted Contribution** – Externally imposed conditions as specified by the donor
2. **Endowment Contribution** – A restricted contribution with the stipulation that the resources be maintained permanently
3. **Unrestricted Contribution**
  - No externally imposed conditions
  - Organization is free to use the funds as it sees fit

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## Contributions – Accounting methodologies

NFPs are required to distinguish between contributions and other revenues

- Must report on contributions in financial statements
- Must report on each type separately

**Two methods of accounting for contributions, which affects when revenue is recognized:**

1. Deferral Method
2. Restricted Fund Method

**Choice of method:**

- Can choose either method if NFP receives externally restricted contributions
- Must choose the Deferral Method if NFP does not receive externally restricted contributions

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## Contributions – Deferral method of accounting

**General principle for Deferral Method:**

- Contributions are taken into revenues when related expenditures are incurred, not when the contributions are received

**Accounting Requirements under Deferral Method:**

- Tracking of both contributions recorded and when related expenditures made
- Distinguishing contributions for capital and contributions for operations
- Tracking amortization of contributed capital assets separately
- Accounting for three types of contributions (restricted, endowment, unrestricted)

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## Contributions – Restricted fund method of accounting

### General principle for Restricted Fund Method

- A contribution is taken into revenues of a restricted fund when the contribution is recorded, not when the expenditure is made

### Accounting Requirements for Restricted Fund Method

- Requires at least one externally restricted fund - Contributions included as revenues in the current period
- Non-restricted contributions are accounted for in a “general fund” or “operating fund” - general fund uses the Deferral Method
- Restricted contributions that do not correspond to any restricted fund are accounted for in the general fund
- Endowment contributions require an “endowment fund” (separate restricted fund)

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## Key NFP financial statements

1. **Statement of Operations (Pg.10)**
  - Sometimes called an “Income Statement”
  - Summary of transactions over a defined period of time
2. **Statement of Financial Position (Pg. 12)**
  - Sometimes called a “Balance Sheet”
  - Financial status at a point in time
3. **Statement of Changes in Net Assets (Pg. 21)**
  - Identifies categories of net assets
  - Changes in each category over a period of time, to determine final balances at a point in time
4. **Statement of Cash Flows (Pg. 24)**
  - Focuses on cash
  - How cash is generated; how cash is used

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## Statement of operations (p. 11 of Guide)

### NOT-FOR-PROFIT ORGANIZATION STATEMENT OF OPERATIONS For the Current Year Ended December 31

	Current Year \$000	Previous Year \$000	
<b>Revenues</b>			
Total Revenues	10,642	9,914	Increase in revenues = 7%
<b>Expenditures</b>			
Total Expenditures	10,602	9,844	Increase in expenditures = 8%
<b>Excess of Revenues Over Expenditures</b>	40	70	Reduction in operating surplus = \$30,000 Operating surplus in both years is well below 1% of total revenues

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## Statement of financial positions (p. 13 of Guide)

- Net Assets = Total Assets – Total Liabilities
  - Rearranged: Total Assets = Total Liabilities + Net Assets

### NOT-FOR-PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION As at December 31 of Current Year

	Current Year \$000	Previous Year \$000	
<b>Assets</b>			
Current Assets	2,537	2,420	
Investments & Capital Assets	1,628	1,650	
	4,165	4,070	Total assets increased by 2%
<b>Liabilities and Net Assets</b>			
Current Liabilities	347	295	
Mortgage & Other	890	940	
Deferred Contributions	118	85	Deferred contributions increased by 40%
Net Assets	2,810	2,750	
	4,165	4,070	Net assets increased by 2%

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## Statement of financial positions (p. 13 of Guide)

- $Working\ Capital = Current\ Assets - Current\ Liabilities$
- $Working\ Capital\ Ratio = Current\ Assets / Current\ Liabilities$

### NOT-FOR-PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION As at December 31 of Current Year

	Current Year	Previous Year
<b>Assets</b>	<b>\$000</b>	<b>\$000</b>
Current Assets	2,537	2,420
Investments & Capital Assets	1,628	1,650
	<u>4,165</u>	<u>4,070</u>
<b>Liabilities and Net Assets</b>		
Current Liabilities	347	295
Mortgage & Other	890	940
Deferred Contributions	118	85
Net Assets	<u>2,810</u>	<u>2,750</u>
	<u>4,165</u>	<u>4,070</u>

Working capital increase  
= \$65,000

Working capital ratio decreased from  
8.2 to 7.3

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## Statement of changes in net assets (p. 23 of Guide)

**Net Assets are disaggregated into categories, reflecting the categories in the Statement of Financial Position:**

- Invested in Capital Assets (optional disclosure)
- Endowments (restricted by donors to maintain the capital permanently)
- Internally Restricted (restrictions imposed by the board)
- Unrestricted (no restrictions at all)

**Statement shows the changes over a period of time (e.g., fiscal year) via a “matrix” presentation:**

- Columns are the net asset categories
- Rows are the changes from opening balance to closing balance

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## Statement of cash flows (p. 26 of Guide)

**Identifies cash provided by, or used in, three areas over the year:**

- Operations
- Investing activities
- Financing activities

**Some accounting entries in previous statements do not involve cash, such as:**

- Amortization of capital assets is an expenditure, but no cash outlay
- Accounts receivable is an asset reflecting revenues, but no cash received
- Amortization of deferred contribution increases current revenues, but cash received in a previous period

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## Fund accounting (p. 28 of Guide)

- An optional method of tracking restricted contributions and internally restricted net assets
- Each fund has its own revenues and expenditures, assets and liabilities, and net asset balance (called "fund balance")
- NFP formally establishes funds segregated by purpose, such as
  - Capital Assets
  - Endowments
  - Operations
- Funds are typically presented as columns in the financial statements
  - Statement of Operations and Fund Balances
  - Statement of Financial Position
  - Statement of Cash Flows
- Under fund accounting, the NFP can choose the method of accounting for contributions:
  - Deferral Method
  - Restricted Fund Method
- If your NFP is using fund accounting, consult the Guide

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## Year-End Audited Financial Statements – Auditor’s Opinion (p. 35 of Guide)

1. **Auditor reviews what management prepares:**
  - Gathers “audit evidence”
  - Assesses internal controls and procedures
  - Reviews accounting policies
2. **Key question auditor will answer:**
  - *Do the financial statements paint a picture that is a fair presentation of the organization’s financial position and results of operations?*
3. **Report contains three elements:**
  - Audited financial statements
  - Accompanying notes
  - Auditor’s opinion
4. **Two versions of the auditor’s opinion:**
  - Unqualified
  - Qualified

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## Conclusion – Your role as a director

“You do not have to be a financial expert,  
but you do need to question and probe  
management and the auditor until you are  
satisfied your issues have been addressed.”

satisfied your issues have been addressed.”

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## Resources

- *A Guide to Financial Statements of Not-For-Profit Organizations (NFPs): Questions for directors to ask*  
[cpacanada.ca/financialliteracypublications](http://cpacanada.ca/financialliteracypublications)



A Guide to Financial  
Statements of Not-For-Profit  
Organizations  
QUESTIONS FOR DIRECTORS TO ASK



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# Q & A

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