READING THE FINANCIAL STATEMENTS – A BASIC GUIDE

PURPOSE

To provide an introduction for Directors who are less experienced financially.

Here are a few tips on how to make sense of the financial statements – the **Profit & Loss Statement** and the **Balance Sheet**.

PROFIT & LOSS STATEMENT

This tells you, as the name suggests, whether the organisation has made a **Net Profit** (sometimes called a surplus) or **Loss**, which is usually in brackets and also can be called a deficit.

HINTS AND TIPS

> Does the Statement show the **Income** and **Expenses** for the month and for the year-to-date? If it doesn't, ask if you can have those two columns next time.

> Can you get a Statement for the year-to-date, comparing the actual figures for this year with the figures for the year-to-date budget? If you can't, ask if you can have those figures for the next meeting.

> If those Reports cannot be produced, suggest you get a new accounting/bookkeeping system, and suggest that maybe budgets would be useful.

> Do not worry too much about month-to-month results (although consistent profits are always nice) – it's the year-to-date figure you need to focus on, particularly as the year draws to an end. At the beginning of the year, in particular, the profits will tend to be higher because the year's program will not have kicked in yet. In fact, if in a particular month there is a loss, don't freak out ('we're roooned!!!'), because losses will happen; sometimes you'll expect them, sometimes you won't. Consistent losses though, are a Bad Sign.

> Does the organisation produce a **Job Profit & Loss Statement** for each separate grant/project/program? (You've never heard of Job reports? They are mini Profit and Loss Statements and give you a report on a particular grant, or for a particular project, to tell you how much income you've received, and how much you have spent.)

> If it does, have a look at them, even if it's only for those projects for which you have a particular interest – if the Job has a **Net Profit** (the last line for each Job), then ask the question: is this project complete and acquitted? A grant is acquitted if you've sent off a financial and activity report to the funding agency and they have ticked everything off and declared that you have spent the money in accordance with the terms of the funding agreement and they consider the project now completed. If it is, then the profit is now yours, unless the terms of the funding agreement require that any unexpended, or un-spent, funds have to be returned On the other hand, if the project is not completed then the profit or surplus is actually unexpended grant funds. That is, these are funds you have been given to undertake a project or activity that has not yet been completed, and that 'profit' represents the amount of funds you have left with which to complete the project or activity. Unexpended grant funds will be included in the **Balance Sheet** as a **Current Liability**. If that's the case, then you can reduce the organisation's year-to-date profit by that amount because that money's not really yours until you've spent it on that project. You might also ask the question 'Are the unexpended funds sufficient to complete the project?'

> On the other hand, if the **Job Profit** & **Loss Statement** shows a (**Loss**), the question arises 'Is there any unexpended grant funding (which should be shown in the **Liabilities** section of the **Balance Sheet**) for this particular project that can be shifted to income for this Job?' If the answer is no, that means that that project/program has run at a loss. If

the answer is yes, then maybe some of the unexpended grant funds need to be taken up as income, at least until that little unexpended grant fund pot is empty.

> If you have a **Job Profit** & **Loss Statement** or a **Profit** & **Loss Statement** (for the whole organisation) which has actual and budget, look out for big differences (don't get hung up on little ones) between the two because they indicate that whatever was expected to happen, didn't. Perhaps some payments were made earlier than expected, but you need to know, where there is a difference, whether that difference will diminish as the year progresses – because (as noted in the fifth bullet point) the closer you get to the end of the year, the less time there is to make adjustments.

> Look at the **Expenses**. Is there an expense called, say, 'Office Equipment', or 'Computers'? Does the 'Repairs and Maintenance' figure look out of whack? These indicate that maybe there are items that have been put into **Expenses** when they should be in the **Balance Sheet** and recorded as **Non-current Assets**.

> Is the organisation provided with goods or services at a substantially reduced rate, or for nothing at all? If this is the case then you need to get an estimate of the value of this 'in-kind' support to record in the accounts as income, being either a donation (if it's from a private individual) or as sponsorship (from a business). This is then offset by the same dollar value as an 'expense', being whatever it is that you've got for nothing or for minimal cost. Since the income equals the expense it makes no difference to the **Net Profit** or (**Loss**) recorded but it (a) lowers the percentage of your gross income that is received from government, and (b) might help you in terms of the GST-free supply of goods and services under the 75% Rule. If there is no obvious entry for in-kind, ask whether there should be.

BALANCE SHEET

While the **Profit** & **Loss Statement** is a measure of the organisation's performance during the period, the **Balance Sheet** tells you how financially sound it is. It comes in two parts: **Assets** and **Liabilities**, and **Equity**. The assets and liabilities are broken down into **Current Assets** and **Current Liabilities**, and which change in value during the course of the year – with items such as bank balances, how much people owe you (**Receivables**), stock or inventory for sale, in **Assets**; and how much you owe others (**Payables**), loans payable in the next twelve months, amounts set aside for staff annual leave and unexpended grants in the **Liabilities**. Then you have **Non-current Assets** and **Non-current Liabilities**, which do not change routinely on a day-to-day basis, and include things such as office equipment, production equipment, motor vehicles (**Non-current Assets**) and provisions for long service leave and loan repayments past twelve months (**Non-current Liabilities**). The difference between the value of all assets and all liabilities is the **Net Assets**, which has to be the same as the second part of the **Balance Sheet**, which is called **Equity**. (And no. I don't know why it's called that, because if your liabilities are more than your assets, I'd hardly call that fair!)

HINTS AND TIPS

> The first thing you want to look at, as with the **Profit** & **Loss Statement**, is the bottom line. Do **Total Assets** exceed **Total Liabilities**, and by how much. (If they don't, the organisation is in strife.) While you're examining that little bit of information – the line that says **Net Assets** (right down the bottom) – just check that the **Current Year Earnings** figure is the same as the **Net Profit** (**Loss**) for the period (year-to-date) in the **Profit** & **Loss Statement**. This will confirm that you are comparing apples with apples, or, more correctly, an apple with another apple that hasn't had a bite taken out of it. If the figures are different, it could indicate that the two reports were prepared on different days, so which figure is correct?

> The **Net Assets** (which equals **Equity**) represents the sum of all the profits and losses the organisation has made or incurred since the day it was incorporated. At the end of the year, that year's profit or loss is added to, or subtracted from, the **Retained Earnings** at the beginning of the year, and becomes the opening balance of **Retained Earnings** for the new financial year.

> An organisation may have a very healthy level of net assets but that doesn't necessarily mean it's financially sound. That's because a sound organisation needs a healthy level of what is called **Working Capital** to operate on a day-to-day basis. **Working Capital** is the amount of money you would be pretty sure of having if you decided to shut up shop. So you'd have the money that's in the bank, plus some money from **Receivables** (for invoices sent out, but which haven't been paid yet), but discounting or not counting the value of computers, furniture and what are referred to as **Non-**

current Assets. In other words, what can be turned into cash, and quickly? To calculate **Working Capital**, subtract the value of **Non-current Assets** – that is, the written-down value (or original cost, less accumulated depreciation) from the **Net Assets**. That tells you basically what your cash reserves are. Funding agencies suggest that net assets should be 20% of your annual budget but I think a much safer and useful benchmark is for your **Working Capital** to be 20% of budget. Put simply, if you collected all of your **Receivables** (what people owe you), sold all your stock, cashed in all the term deposits, and used that cash to pay all the bills, how much would be left over in a fire sale situation where you got bugger all for the computers and furniture – which is likely.

> Now, having satisfied yourself that you are in a comfortable position, you should look for reassurance that the recorded balances of all items in the **Balance Sheet** are reliable, and these are questions generally for the Treasurer, but that's not to say any Committee member or Director can't ask the questions either.

ASSETS

> Bank accounts: have the bank accounts been reconciled? Are there any long overdue cheques that haven't been cashed (less likely these days with Internet banking), or any outstanding deposits?

> Is there an **Undeposited Funds** balance? Is it significant (over, say, $1000)? This might indicate that receipts are not being banked as promptly as they should be.

> Is the bank account in overdraft (this would show up as a bank account balance in brackets)? Why?

> Are there substantial amounts sitting in the cheque account? Could funds be placed in interest bearing deposits?

> If there are **Receivables**, ask if the **Receivables Reconciliation** (this is a MYOB report) has a zero out-of-balance amount – this means that the sum of all your **Receivables** (individual debtors) is the same as the amount recorded in the **Assets** section of the **Balance Sheet**. Enquire as to whether there are any individual debtors who are dragging the chain, what percent they are of total debtors (the **Receivables** amount), and what's being done to get payment. If there are some really delinquent debtors, does a provision need to be made for **Doubtful Debts** that might have to be written off?

> Does the organisation carry stock (items for resale)? Is the stock figure correct? Merchandise such as t-shirts will probably be written off as an expense when paid for, but if you are a publisher, or you buy and sell artwork, then that should be valued, at cost.

> Have loans been made to employees? This may give rise to a Fringe Benefits Tax liability.

LIABILITIES

> I noted above the need to check the **Receivables Reconciliation**. Do the same with the **Payables**, sometimes also referred to as **Trade Creditors**. Do the individual creditors add up to the same as the recorded liability? Are there any who haven't been paid for more than 90 days? If so, why? Check the taxation liabilities, for GST and PAYG tax. Perhaps look at the report for three months ago, six months ago – are the balances comparable? If the balances are increasing it may indicate that your BAS (Business Activity Statement) lodgements are behind.

> Make sure that employee superannuation contributions are up to date. These should be paid monthly.

> Annual leave entitlements may be accrued on a weekly or fortnightly basis in the accounts (but usually they aren't). Is the recorded liability correct? Are there any employees who are now entitled to Long Service Leave?

> Unexpended Grants or Grants in Advance should be looked at in conjunction with the Grant Income recorded in the **Profit** & **Loss Statement**. Does the unexpended balance truly represent the balance of funds not yet spent? In my view, operational funding should be brought into the **Profit** & **Loss Statement** on a monthly basis – that is, when you bank the money it goes into the **Balance Sheet** as a liability. That's because if you shut up shop the next day, or didn't spend the money in accordance with the provisions of the funding agreement, then that money might have to be returned to the funding agency. Then as the year progresses, activities happen and money is spent, you bring it out of Unexpended Grants because now it's your income and you're entitled to it. For operational funding, that would happen on a month-to-month basis. For project funding, it will be in accordance with how much has been spent as

recorded in the **Job Profit** & **Loss Statement**. This underscores the importance of making sure that Job reporting is meticulous. I have seen cases of unspent grant funds returned, only to later discover that there were costs incurred on that project but which were not allocated to that Job. I have seen some weird and wonderful uses of the Job reporting facility in MYOB and cannot stress enough the importance of using Jobs for discrete grant or project reporting, and all costs and income that are not related to a particular grant or project should be allocated to a Job that picks up only **Core costs** and **Core income** – that is, general activities. Most project- and activity-related grants (as distinct from general operational funding) will be based on a budget, and that budget will form part of the funding agreement, which is effectively (if in not so many words) saying 'We will give you this amount of money and you have to spend it on these items, and not on anything else unless we give you the okay to do so.' You must not, then, include in that Job any costs which were not in the budget because the funding agency isn't going to accept the presence of those costs and your Job Profit & Loss Statement is going to show that you have spent more than you really have because you are including costs not approved and not relevant.

Initially this may all seem rather complicated and confusing but once you've got your head around how the organisation's activities translate into numbers, you'll feel very pleased with yourself.

Casual readers of financial statements usually seem to have a mental block about the relationship between the **Profit** & **Loss Statement** and the **Balance Sheet**, which is perfectly understandable. I know when I first started my accounting studies (having taken those High School subjects that would get me into Engineering), I had real problems with double entry bookkeeping and related concepts and barely (I reckon) scraped a Pass, but once I'd got my head around it everything fell into place.

As I said, the **Profit** & **Loss Statement** is a measure of your financial progress on a month-to-month, week-by-week, even hour-by-hour basis; while the **Balance Sheet** is a freeze-frame at the end of that particular period whose progress has been recorded. A corollary: you have a water tank with a tap at the bottom. Water goes in at the top (income) and is drawn out by the tap (expenses) and the amount of water at any time represents your net assets.

There is one circumstance where transactions (payments and receipts in the nature of income and expenses) could go into either the **Profit** & **Loss Statement** or the **Balance Sheet**. That is if your organisation acts as an auspicing body for others, usually individual artists or unincorporated associations or groups. So, you could record the receipt of the grant as if it were your income and the accompanying expenses likewise. The advantage of doing it that way is that you can create a Job in MYOB and produce a **Job Profit** & **Loss Statement** which (a) tells you quickly how much has been spent and how much is left to spend, (b) gives you a concise statement which you can give to the auspicee, and (c) gives you a statement which you can use to acquit the grant. The other way is to record the receipt, in the first instance, as an unexpended grant but then, as you pay out on behalf the auspicee you just debit the payments to the unexpended grant liability (which is a credit item) in the **Balance Sheet** until the unexpended grant balance is zero. Now this is probably the more correct treatment of the funds, because it's not really your money, just money you hold for someone else, but doing it that way doesn't allow you to produce a **Job Profit** & **Loss Statement**. That's why most organisations just record the income and expenses on their own account.

To summarise, then: review the **Profit** & **Loss Statement**. Have you made a profit? Is it huge? Maybe some of that income hasn't really been earned yet and needs to be bumped back into unexpended grants. Are there expenses that have been incurred but haven't yet been paid or included in **Payables**? Do the accounts show a huge loss, in which case maybe there is income sitting in unexpended grants which has been earned and needs to be taken up as income. Have you finished projects that haven't been paid for, or invoiced? Does anything look weird? Then turn to the **Balance Sheet** and check that the Current Year Earnings is the same amount as the bottom line on the **Profit** & **Loss Statement** and, if that statement has shown a loss, what effect has that had on the **Net Assets**?

As the meetings go by, you will find that it all starts to make sense, and that it all has a certain elegance to it (well, maybe not!), satisfying that your assets minus your liabilities has to be equal to your equity, and that, on the other side of that coin, the difference between two balance sheets has to be the profit or loss that has been earned during the intervening period.

After a while you'll also feel more comfortable asking questions, and not just about items which don't quite look right to you. You'll start to look at the statements as a provider of information generally, and question how well they fulfil that function. Bookkeepers, like a drunk pedestrian, can wander all over the place, impossible to predict. You'll have those who will create a new expense code every time they enter an item for the first time, so rather than simply recording 'Travelling Expenses', you'll have 'Meals', 'Accommodation', 'Overseas Airfares', 'Local Airfares', 'Bus Fares', 'Taxis, 'Per Diems', 'Excess Baggage', 'Airport Parking'... you get the picture. You'll finish up with a ten page **Profit** & **Loss Statement** if you don't rein them in. On the other hand, I've seen an income line 'Grants' which actually covers over twenty different funding streams: with those, you do need to know all the details. In other words, the statements need to give you (not your bookkeeper) the information you need to see how things are travelling.

Brian Tucker CPA

Thanks to Fiona Carter and the Committee of Tracks Dance in Darwin for reviewing the initial draft and coming up with excellent suggestions to make it clearer to the non-financial reader. Thank you also to my daughter Fiona for casting her editorial and non-financial eye over the rough drafts and helping to shape this piece into the final version.

REFERENCES

> Fishel, D, The Book of the Board, Federation Press, Sydney, NSW (2003; 3rd edn. 2014)

ABOUT POSITIVE SOLUTIONS

Positive Solutions offers a range of services to non-profit boards throughout Australia. Board development workshops and detailed board reviews can be tailored to the needs of each organisation. To find out more about how Positive Solutions can help you, contact: info@positive-solutions.com.au or call 07 3891 3872.

THE BOOK OF THE BOARD

The Book of the Board is Australia's standard reference book for board and committee members of non-profit organisations. Authored by Positive Solutions Director, David Fishel, and currently in its third edition, The Book of the Board provides clear guidance on the role of the non-profit board, formal and legal responsibilities, and the ways in which the board can maximise its effectiveness for the organisation.

> RRP $59.95
> Positive Solutions Price $55 Inc. GST