Charity Intelligence

Clarity for charities

Financial Due Diligence using Financial Statements

For

Philanthropy Ireland

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Content

1. Introduction

The purpose of this document is about helping grant makers to understand financial statements.

The reason we want do financial due diligence and look at a charity's financial health is less to judge the charity than to understand the risks of making a donation, grant or social investment. It also helps to identify what management should focus on.

In the current financial climate, many good charities are struggling to remain on a solid financial footing. In some cases, supporting the charity might give it the necessary breathing space to recover its finances. However, a clear understanding of the risks surrounding its finances is essential to any decision on whether or not to fund. Some funders embrace risk, and would willingly take on a high-risk challenge; others are more risk-averse and prefer low-risk options.

2. Purpose of Financial Statements

The aim of accounts and reports is to provide a clear picture of a charity's activities and financial position. The trustees' annual report is also an opportunity to describe their work to the public and to funding bodies. Although these requirements may seem rather onerous to a small charity, they do require them to define their aims and activities clearly and to manage their finances well, both of which help to ensure that their organisation is more effective.

But overall, they do help you decide the past, present and future of a charity.

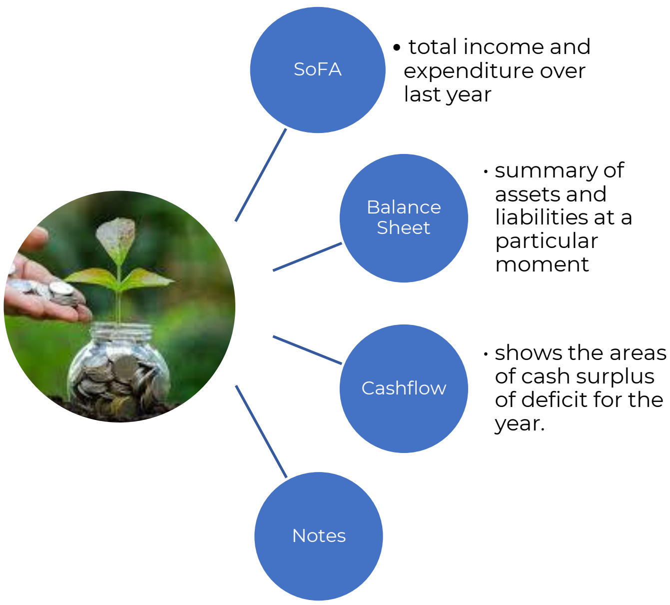
3. Explanation of Financial Statements

3.1 Charity (Statement of Recommended Practices) SORP

The Charities SORP is a Statement of Recommended Practice which sets out how charities should prepare their annual accounts and report on their finances. The SORP is an interpretation of the underlying financial reporting standards and generally accepted accounting practice.

While SORP as it is not yet mandatory in Ireland some charities have adopted still many charities follow Irish law and therefore use FRS 102 - The Financial Reporting Standard applicable in the UK and Republic of Ireland accounting standards.

3.2 Components of Financial Statements



3.3 Comparing SORP and FR 102

SORP	FR 102	Notes
SoFA	Income and Expenditure account	SoFA is more detailed but the most striking difference is the analysis of funds.
Statement of Financial Position	Balance Sheet	
Cash flow	Cash flow	

3.4 Statement of Financial Activities (SoFA)

The key things to report are the funds in, the funds out and the funds carried forward to spend in future periods

The SoFA brings together all the resources available to the charity and shows how these have been used to fulfil the charity's objectives. Incoming resources will include new endowments received by the charity, donated assets and donated services.

The SoFA should analyse the key activities carried out. Activity lines should show the split between unrestricted and restricted income (and endowment funds, if relevant).

Income is split between:

- Donations and legacies (including grants which are not performance-related)
- Income from charitable activities: income earned from the supply of goods or services under contractual arrangements, and from performance-related grants
- Income from other trading activities: income earned from both trading activities and from fundraising events
- Investment income

Expenditure is shown by activity and will likely include:

- Costs of raising funds (e.g., fundraising and non-charitable trading activities)
- Charitable activities, split into key activities

  Each activity expense will include direct costs and a proportion of the overheads/indirect costs. The notes to the accounts (see below) in the annual report must provide an analysis where relevant, for example, explaining the proportion of support costs allocated to a significant activity

Note:

1. While all charities are encouraged to analyse their expenditure by activity in their annual accounts, only those above the statutory audit threshold (£1 million gross income) are required to do so. Charities under the threshold can analyse their income and expenditure using a different method.
2. Note that governance costs, such as audit, legal and trustee costs, are reported separately from charitable activities.

3.5 Balance Sheet

A balance sheet shows the position of your charity at a given date. As a snapshot of what the charity owns and owes at that point in time, it gives the reader a picture of the organisation's financial security and whether it has enough reserves to support itself in unforeseen circumstances.

It includes:

- Assets: everything the organisation *OWE* such as:
    - Current assets – cash and cash equivalents, such as gift cards or certificates, accounts receivable and grants receivable
    - Fixed assets – depreciable furnishings or equipment

- Liabilities: everything the organisation *OWES* such as accounts payable, grants due to other organisations, or debts

:

    - Current liabilities – payments that have to be paid in a year
    - Deferred Contributions- maybe current or long term
    - Long term liabilities- amounts that will be paid off in more than one year

- Charity funds, reserves or net assets, split between total unrestricted (including designated), endowment and restricted funds. Your net assets are those remaining after liabilities have been subtracted (or: assets minus liabilities = your net assets or charity funds)

- Net Assets = total assets minus total liabilities

The bottom half of the balance sheet will be analysed to show the amounts held in each of the endowment, restricted, designated and general funds.

3.6 Cash Flow

The statement of cash flows provides a picture of the cash coming in and going out in a given period, it shows how a charity uses its money throughout the year, and deals only with cash movements, therefore ignoring items such as debtors or creditors.

Cash flow management is an important aspect of financial stability, and a statement should ideally be produced regularly to see timings of cash requirements and to assess capacity to meet these. For example, a charity may receive regular grants for an activity, but if an instalment is paid late, this can affect ability to meet project expenses or other ongoing costs such as salaries, rent or utilities.

The statement of cash flows typically includes up to three sections, depending on your sources of cash. For most non-profits, this means net cash from:

- Operating activities, such as unrestricted funds raised from fundraising or income from operations that generate fees
- Investing activities, such as expenses or earnings from the purchase or sale of equipment or other long-term investments
- Financing activities, such as earnings from issuing or redeeming bonds

But in Ireland the statement itself is not different, but there are different requirements for which charities must prepare one. The Charities SORP requires all "larger" charities with income over €500,000 to prepare a statement of cash flows, regardless of whether they could take the exemption under section 1A of FRS102.

Summary comparison

	SOFA	**Balance Sheet**	**Cash Flow**
Time	Period of time	A point in time	Period of time
Purpose	Profitability	Financial Position	Cash movements
Measures	Income, expenses, profitability	Assets, liabilities, funds	Increases and decreases in cash
Starting point	Revenue	Cash balance	Net income
End point	Net income	Retained earnings	Cash balance

4. What information in Financial Statements can Grant makers use?

Fundamentally the main question is “Is the charity financially sound?”

Taking each component of the financial statements you can look at:

1. What it is telling you and ask yourselves is this the normal for the charity circumstances

2. Financial ratio analysis

   Financial ratio analysis is one of the tools you can use to improve your financial decision making. But you need to decide which ones are relevant to your organisation. It’s all about proportionality.

   Financial ratios are useful if they are:

- Calculated using reliable, accurate financial reports (such as an annual audit or final report)
- Calculated consistently from period to period
- Used in comparison to benchmarks or goals
- Viewed both at a single point in time and as a trend over time
- Interpreted in the context of both internal and external factors

An excel worksheet is available for all these ratios and calculations are in appendix

4. Red flags

4.1 SoFA -What is the SoFA telling you:

4.1.1 Is income covering expenditure?

4.1.1.1. Yes

- A surplus its normal a sign of a healthy charity
- Continuous surplus could indicate its isn't carrying out its purpose
- A one off could mean an unexpected donation for example

4.1.1.2 No

- one off deficit could mean an unplanned reduction in income
- deficits running over a number of years leading to dwindling reserves might suggest poor cost control
- it could be a strategy to reduce reserves if reserves are too high so not to leave money idle

WHAT TO DO

Look over previous accounts to find a trend or look forward using management accounts and budgets. Look for steadiness, predictability, and awareness of the risks to various income streams

4.1.2 Where does the money come?

There is no ideal combination of income but consider:

4.1.2.1 How is the charity's income made up?

- A broad mix- the broader the mix is, the less reliant the charity is on any one source of funding
- Only one type of income is a risk

4.1.2.2 How reliable is each different stream of income?

4.1.2.3 What are the trends in the income streams?

4.1.2.4 How important is statutory funding (found generally under 'income from charitable services')? How might policy changes affect this, eg, government cuts?

4.1.2.5 How much is 'generated' (eg, by the fundraising department in the form of grants, donations and events, or from investment in an endowment)?

4.1.2.6 How important are legacies?

4.1.2.7 How much of the organisation's funding is restricted versus unrestricted?

4.1.2.8 What contribution do gifts in kind make?

4.1.2.9 Does the charity have a profitable income stream? What does it do (eg, runs a shop chain)? Could a profitable income stream be grown through social investment?

4.1.3 Where does the money go?

Being able to compare figures with those from previous years, helps analysts to understand what is happening at a charity, and where its priorities lie. Staff numbers, detailed in the notes to the accounts, should also be split between activities, enabling us to see where resources are allocated, and how those changes from year to year.

4.2 Key Measurements of a SoFA

Ratio	**What they tell us**
Reliance Ratio	Reliance on a type of income. Awareness of the risk of a major reduction in income if this type is reduced or stopped. May be helpful for more than one type of income, including special events
Earned income ratio	Earned income as a percentage of total income. Organizations with earned income have more autonomy and flexibility
Self-sufficiency ratio	The proportion of operating expenses that are covered by earned income
Personnel costs ratio	Since staff cost is usually the largest part of the budget, any changes in the percentage of budget Total expenses used for staff is notable.
Benefit cost ratio	Benefit costs are driven by many external factors and can increase at a different pace than other costs.
Admin cost ratio	Low administration costs do not signal that a charity is good: they signal the opposite. Charities that trim these functions to the bone—often for the sake of a fundraising story—might struggle to run their operations smoothly, analyse their data, or plan for the future.

Fundraising efficiency	The average £ amount of contributions raised from each £ spent on fundraising. Cost of fundraising is dependent on the type of contributions solicited (large grants vs. small individual donors, for example). Target based on comparisons and analysis.
Cost per "unit" of Service or program efficiency	If the charity uses program-based recordkeeping and has an identifiable "unit" of service, this ratio is very helpful in evaluating financial efficiency and identifying any changes over time
Net Asset Growth	If the organisation is growing ie a surplus

4.3 Red flags on a SoFA

- The organization has a growing deficit from year to year
- Budgeted income and expenses are not based on solid assumptions
- There are large discrepancies between the budget and actual statement
- Revenue sources change drastically from year to year
- Fundraising expenditures constitute significant percentage of funds raised compared to other charitable organizations.
- Organization is heavily dependent on a single source of revenue, such as government grants or donations (reflecting state of economy).
- Revenues are highly restricted – funding does not sustain the organization's overhead (core funding).

4.4 Balance Sheet- what is it telling you?

4.4.1 Reserves- Is there enough for a rainy day?

4.4.1.1 Unrestricted net assets help to smooth the inevitable ups and downs in revenue and stabilize expenses, therefore maintaining programs and effectiveness. The amount of unrestricted net assets compared to total expenses provides the initial financial health rating for each grantee. The change in unrestricted net assets over three years shows how the grantee is managing its reserves over time.

4.4.1.2 Look at the reserves statement – is it sufficient to run the organisation efficiently for a period of time. Depends on size of charity.

4.4.2. How strong is the balance sheet?

4.4.2.1 Assets

- Fixed assets – could be used a security
- Investments - sometimes frowned upon – but useful for security, diverse income streams but could be a gift that cannot be cashed in
- Cash – large balance could be just timing

4.4.2.2 Liabilities

Expect to see long term liabilities as current recognition of a loan financing as a source of capital

4.5 Key Measurement of a Balance Sheet

Ratio	What they tell us
Current Ratio	An indication of the organization's ability to pay obligations in a timely way (within 12 months). A useful indicator of cash flow in the near future
Quick Ratio	Measures if liquid assets will cover current liabilities
Daily Cash on Hand	Measures liquidity and estimates how many days of organizational expenses could be covered with current cash balances
Debt Ratio	How much the organization is relying on funding from others, such as loans, payables, and obligated Indication of how much of a cushion there is.

Days of Liquid Net Assets	Measures if there are enough liquid resources to cover typical operating expenses
Debtors -Accounts receivable ageing	As receivables get older and more delinquent, it indicates potential collection or billing problems and cash flow issues
Creditors - Accounts payable ageing	An indication that the organization has cash flow problems and potentially severe financial problems.

4.6 Red flags on a balance sheet

- If the amount of cash on hand is large — more than, for example, 10 percent of the total yearly revenue — it may mean the organization's financial managers aren't making efficient use of their excess cash.
- If the amount of cash is small — 5 percent or less of the total yearly revenue — it could mean the organization is cash-starved.
- Components of cash and cash equivalents are at risk of losing value.
- Accounts receivable are unlikely to be collected, and no provisions have been taken for uncollectable amounts.
- Invested assets held by the organization are at high risk of depreciation.
- Significant changes (both increases and decreases) in figures between years.
- No operating reserve (internally restricted funds) – ideally enough to cover 3–6 months of expenses or reserve funds are in excess of one year's operating budget.
- Current ratio of less than 1 may suggest that the organization does not have enough capital on hand to meet its short-term obligations.
- If organization has inventory, quick ratio of less than 1 may suggest that the organization does not have enough liquid assets to meet its short-term obligations.

4.7 What is the cash flow telling you?

- **Ability to produce future net cash inflows**
- **Ability to meet obligations**
- **Need for external financing**

The cash flow statement how's that cash flow from operating activities rose year on year -largely a result of an increase in creditors—which is not uncommon for a growing organisation. This is principally the advance income from schools and grant funders—i.e., grants paid but where expenditure has not yet occurred. (But is that prudent)

However, annual cash flow statements are of less interest than monthly cash flows included in charities' management accounts. This is where access to management accounts is most crucial. It is interesting, of course, to see the charity's forward budgeted income and expenditure, and how that impacts on its current balance sheet—but, in difficult times, management accounts are the only way to tell how a charity fares month to month. The SOFA shows income and spending for the past year; the budget forecasts both for the current year; and the balance sheet records the charity's net worth. The management accounts show the reality of the current situation, for instance, how the charity is progressing against the budget; where the differences are and why; what cash is coming in month by month, and what the monthly obligations are—payroll, rent, and bills. They are the only place we can really see, for example, that even though a charity is due a grant in the current financial year, this might not arrive in time to meet shorter-term obligations.

In the absence of management accounts, you can look to trends in the creditor and debtor position on the balance sheet – beware of timings e.g., could be consequence of amount of business before end of year not yet invoiced.

The frequency of charities having to actively manage short-term cash flows is increasing: as mentioned earlier, a charity analysis client of ours, although promised decent grants from well-known grant-makers, simply lacked cash short-term and was closed by its trustees. The trend towards payment by results contracts places further strain on charities that often cannot afford to deliver a service and be paid in arrears. Charities that have pulled out of the Work Programme cite cash flow predictability as a major issue. Whilst NPC does agree that charities should measure their impact and make a difference in their work, financially, they are often less able than the prime contractor to bear the financial risk and manage differences in timing.

4.8 Key ratios of Cash flow

Ratio	What they tell us
Operating cash flow	A ratio less than 1 indicates short-term cash flow problems; a ratio greater than 1 indicates good financial health, as it indicates cash flow more than sufficient to meet short-term financial obligations.

Questions to consider:

Operating Activities: Is the company generating cash from its primary business activities?

The operating activities section provides you with an indication of how much cash the company is generating from its primary business operations—usually the sale of products and services. If the subtotal in this section is too low or negative, it means that the company is not generating enough cash through its main business activities—definitely a red flag! A cash flow deficit from operating activities will have to be compensated using financing or investing activities, or by using cash reserves from prior periods.

Investing Activities: How is the company using its excess cash? Is it selling assets to compensate for a cash flow deficit from its operating activities?

This section shows the cash generated from investing activities. Investing activities include all activities in which the company has expended cash with the expectation of generating an additional income or profit for the company. It includes activities such as lending money, collecting on loans, acquiring and selling marketable securities, and acquiring and selling land, buildings, or equipment. If the subtotal in this section is negative, it means that the company used cash to purchase investments; if it is positive it means that the company sold investments to provide an inflow of cash. If the company is selling its assets, it could be an indication of a cash flow problem.

Financing Activities: How is the company financing its operations?

This section shows the cash generated from financing activities. Financing activities include transactions related to obtaining internal or external sources of funds. In this section, you will find the cash inflows from the proceeds of stock and debt issues, and the cash outflows from the repurchase of stock, the repayment of loans, and dividend payments, among others. If the subtotal of this section is positive, it usually indicates that the company raised cash through the issuance of debt or stock; if it is negative, it may mean that the company used its cash to pay off its debt, repurchase stock, or pay dividends.

4.9 Red flags on a cash flow

- Negative Net Cash Flow from Operating Activities – Money is coming out greater than money coming in.
- Large cash can signify not charity not using resources to provide to beneficiaries.
- A large, positive net cash flow from financing activities can mean a charity is accumulating a lot of debt or is using debt to grow.
- Net cash flow from investing activities can sometimes be negative if a company is investing in long-term assets.
- increases in Accounts Payable show up in the Cash Flow Statement as a “source” of cash.
- Significant increases in Accounts Receivable will show up as a “use” of cash and can mean collectability problems are on the horizon

6. Conclusion

Past, Present and Future

Every grant funder will have a different objective, deal with different sizes of charities and provide different sizes of grants and also have different ideas and different risks.

1. **Don't waste time**
2. **Ask relevant questions**
    1. Will they go bust?
    2. Are they sustainable
    3. Do they have the resources/capability with a well aligned budget
3. **Accept risk**
4. **Act with urgency**
5. **Be open**
6. **Enable flexibility**
7. **Communicate with purpose**
8. **Be proportionate- It's** a balancing act of art and science, due diligence is all about proportionality

7. Glossary of Terms

Term	Definition/Meaning
Assets	Assets are the money, goods and property which an organisation possesses, including any legal rights it may have to receive money, goods, services and property from others.
Balance Sheet	Assets are the money, goods and property which an organisation possesses, including any legal rights it may have to receive money, goods, services and property from others.
Capital Budget	This is the plan for large-scale expenditure on building or equipment, together with the plan for funding such purchases.
Capitalisation	When property or equipment is purchased and treated as an asset on the balance sheet, it is said to be capitalised. This means that the cost is not treated as an operating cost and is not charged to the expense accounts
Charitable activities	When property or equipment is purchased and treated as an asset on the balance sheet, it is said to be capitalised. This means that the cost is not treated as an operating cost and is not charged to the expense accounts
Cost of generating funds	The costs of activities undertaken for a fundraising purpose
Creditors	The amounts owed by an organisation to others – included in liabilities
Debtors	The amounts owed to the organisation for goods or services supplied. 'Aged debtors' is a breakdown of the total owed to the organisation month by month
Depreciation	An allowance for wear and tear made on long-lasting property and equipment. An amount charged annually as an expense to spread the cost of fixed assets over their useful economic life
Designated funds	Designated funds are unrestricted funds which have been earmarked for a particular purpose by the trustees
Endowment	An endowment is a special type of restricted fund which must be retained intact and not spent
Expendable endowment	This is a type of endowment fund where trustees have the discretion to eventually convert the fund into expendable income

Financial reporting standard	This is a statement of required accounting practice for all company accounts and all accounts which purport to give a true and fair view. It is obligatory for all published accounts to comply with Financial Reporting Standards. They are issued by a committee of accounting bodies and cover a range of accounting topics, with updated versions issued regularly
Financial statements	The accounts of an organisation including the notes to the accounts and any other statements which are required to be include
Fixed assets	These are assets which continue to be of value to the organisation year after year and which the trustees hold on a long-term basis and therefore do not intend to dispose of in the short term
General funds	These are unrestricted funds which have not been earmarked and may be used generally to further the charity's stated objects.
Impairment	This is the term used to describe a fall in value of an asset. An impairment review may be required for certain tangible fixed assets. This is usually when some major event has occurred which causes you to think that the previous values ascribed to the asset are no longer valid.
Incoming resources	All resources available to a charity, including incoming capital (endowment), restricted income, gifts in kind and intangible income
Liabilities	Liabilities are the amounts owed by an organisation at the balance sheet date. The cost will have already have been incurred, but the bill not paid.
Net book value	The net book value is calculated for tangible fixed assets by taking the original cost or valuation amount and deducting the accumulated depreciation. The net book value is the amount at which tangible fixed assets are stated in the balance sheet
Permanent endowment	This is a type of endowment fund where the trustees must retain the fund intact as capital and use the funds to generate income or hold the assets (depending on the terms of the trust). The trustees have no discretion to convert the endowment into expendable income.
Restricted fund	This is a fund subject to specific trusts within the objects of the charity (e.g. by a letter from the donor at the time of the gift, or by the terms of a public appeal). It may be a capital fund, which cannot be spent but must be retained for the benefit of the charity, or it may be an income fund, which must be spent on the specified purpose within a reasonable time.

Statement of financial activities	Financial statement introduced especially for charities in the SORP. Summarises all incoming resources and application of resources. Replaces the income and expenditure account as a primary financial statement, it goes further by bringing together all the transactions of a charity
Statement of recommended practice	Guidance on the appropriate treatment of items in the accounts of specialised bodies. Its title as a statement of 'recommended' practice does not mean it is optional; adoption is required to show a true and fair view.
Stock	The value of goods on hand at the balance sheet date will be included in stock under current assets.
Support costs	These are part of the direct charitable expenditure and may be the management of projects from a central office. They may include a fair proportion of central office running costs.
Tangible fixed assets	Long-term assets that have some substance, such as buildings and equipment
Unrestricted funds	These are funds held for the general purposes of the charity, to be spent within the stated objects.

8 Ratios

Typical charity financial ratios:

Ratio	Indicates	Answers which question	Formula	Rule of thumb	Red flag
Current Ratio	Liquidity	will current resources cover current liabilities?	Current Assets /Current Liabilities	> 2	< 1
Days of Liquid Net Assets	Liquidity	are there enough liquid resources to cover typical operating expenses?	Unrestricted Net Assets / 365	> 180 days	< 90 days
Quick Ratio	Liquidity	Will the most liquid assets cover current liabilities?	(Cash + investments + debitors)/Current Liabilities	> 1	<25
Days of Cash on Hand	Liquidity	Is there enough cash to cover typical operating expenses	(Cash + Marketable Securities) (Total Expenses - Bad Debt Expense - Depreciation Expense)/365	> 90 days	< 30 days
Operating Margin or LUNA	Surplus	Do typical operating revenues cover typical operating expenses?	(Current Year Unrestricted Net Assets + Previous Year Unrestricted Net Assets) /Unrestricted Revenue and Other Support	> +5%	decreasing
Net Asset Growth	Surplus	Is surplus improving?	(Current Year Total Net Assets - Previous Year Total Net Assets) =Previous Year Total Net Assets	> +5%	decreasing
Reliance	Solvency	How much does this organization depend a single type of income	Single largest type of income/ Total Income	> 10%	> 75%
Government Revenue Ratio (also called Reliance on Government Ratio)	Solvency	How much does this organization depend on government money	Government Revenues /Total Revenue	<25%	> 75%
Earned Income	Solvency	Does the organisation have automy?	Earned Income/Total expenses		
Debt to Assets	Solvency	What percentage of assets were financed with debt?	Total liabilities/ Total unrestricted net assets	< 1	> 2
Fundraising Efficiency	Effectiveness	What does it cost this	Total Contributions/ Fundraising Expenses	> 2	< 1

		organization to produce contributions?			
Cost per unit of service (or program efficiency)	Effectiveness	What percentage of typical expenses are in “core" programs and how efficient they are in fulfilling its mission.	Program Expenses/ Total Expenses (or total units provided)	< 75%	<65%
Self Sufficiency	Solvency	What proportion of operating expenses that are covered by earned income?	Total earned income/total expenses	>10%	<10
Staff cost	Efficiency	Are staff costs increasing?	Total staff costs/total expenses		
General, Admins & fundraising	Efficiency	What proportion of expenses are spent on administration & fundraising?	Gen+admin+fundrasing costs/ total expenses		

9. Cheat Sheets

9.1 SOFA

See attached worksheet

9.2 Balance Sheet

See attached worksheet

9.3 Cashflow

See attached worksheet

10. Examples

10.1 Example 1: Mandatory Financial Due Diligence depending on size

	Grants below £100k and Low Risk	**Grants below £100k and Low Risk**	**Grants awards over £5m**
Who	Checks to be conducted by the grant or policy team with support from finance.	Due diligence conducted by internal finance professionals	Due diligence to be compliant with internal guidelines and to be conducted by finance professionals with support from external experts if required.
Requirements	• Individual legal entity checks (Companies House and regulator). These shall include a check on whether the entity is trading. • Financial viability checks	Further requirements in addition to the previous column: • Financial: cash flow and reserves- consider the impact of the recipient taking on outcome-based grant. Check for evidence of financial distress or over-reliance on grant funding.	Further requirements in addition to the previous two columns: • A mandatory site visit and detailed analysis of financial accounts. • Quarterly reviews of performance.

10.2 Example 2 of Assessment Criteria

Assessment Criteria	Excellent	Good	Satisfactory	Below expectations
1. Financial security	Healthy and diverse financial base, getting stronger	Is well funded and stable, with fairly diverse income	Financially stable, but would benefit from additional funding or greater income diversity	Financial concerns
2. Quality of financial management	Uses voluntary or unrestricted income appropriately	Makes good use of voluntary income	Sometimes uses voluntary income to supplement statutory contracts	Uncertain about how voluntary donations used/poorly used
3.Efficiency and unit costs	Strong financial management demonstrated .Boosts efficiency through detailed cost analysis/ efficiency targets Has excellent cost data	Internal cost controls and benchmarking processes Has better than average cost data	Sound financial management, e.g., internal cost controls but no efficiency improvement targets Has average comparative cost data	Weak financial management e.g. few cost controls Unfavourable cost data
4.Risk analysis	Financial Risks- it is important to look at internal factors, related to existing resources, and external influences, related to how the organisation is able to respond to events out of its control			

10.3 Example 3

Document	**Red flag**	**y/n**	**notes**
Auditor report	Going concern		
	Qualified position		
Balance Sheet	Does it balance?		
	Current ratio		
	Does it have a cushion?		
	Are net assets negative?		
SoFA	Is it dependent on one source of income?		
	No detail on income		
	Are expenses appropriate?		
	Is the deficit growing?		
Budget v actual	Major variance		

Exhibit 1
Not-for-Profit Financial Ratios

Ratio	Formula	Averages by Size of Not-for-Profit	
Liquidity Ratios			
Days cash on hand: Measures the number of days of expenses that can be covered from existing cash and cash equivalents. Generally, higher values indicate a stronger liquidity position, although there is both a benefit and an opportunity cost to holding cash reserves.	(Cash + cash equivalents) ÷ [(Total expenses – depreciation expense)/365 days]	**Total assets**	**Average value**
		$100,000 to $500,000	123 days
		$500,000 to $1,000,000	146
		$1,000,000 to $10,000,000	99
		$10,000,000 to $50,000,000	76
		>$50,000,000	57
Months of spending: A less extreme measure of liquidity than days cash on hand since it assumes receivables can be collected to sustain operations. Generally, higher values indicate a stronger liquidity position.	(Current assets – current liabilities + temporarily restricted net assets) ÷ [(Total expenses – depreciation expense)/12 months]	**Total assets**	**Average value**
		$100,000 to $500,000	4.22 months
		$500,000 to $1,000,000	5.24
		$1,000,000 to $10,000,000	3.84
		$10,000,000 to $50,000,000	3.35
		>$50,000,000	2.42
Operating Ratios			
Savings indicator: Measures the net revenues that are retained by the organization as a percentage of expenses. Generally, not-for-profit organizations must maintain some surplus to replace existing facilities and extinguish debt. This ratio should be evaluated in the context of the anticipated needs of the organization.	(Revenues – expenses) ÷ Total expenses	**Total assets**	**Average value**
		$100,000 to $500,000	4.5%
		$500,000 to $1,000,000	6.0%
		$1,000,000 to $10,000,000	4.3%
		$10,000,000 to $50,000,000	4.5%
		> $50,000,000	9.6%
Contributions and grants: Measures the extent to which revenues are received from donors and grantors. Since this ratio measures the organization's dependence on voluntary support, high values indicate less diverse revenue sources and greater susceptibility to economic downturns.	Contributions & grants revenue ÷ Total revenue	**Total assets**	**Average value**
		$100,000 to $500,000	59%
		$500,000 to $1,000,000	56%
		$1,000,000 to $10,000,000	47%
		$10,000,000 to $50,000,000	34%
		>$50,000,000	15%
Fundraising efficiency: Indicates the amount of contributions raised for each dollar of fundraising cost. Higher values indicate greater fundraising efficiency.	Total contributions (other than government grants) ÷ Fundraising expenses	**Total assets**	**Average value**
		$100,000 to $500,000	$16.94
		$500,000 to $1,000,000	$16.47
		$1,000,000 to $10,000,000	$11.45
		$10,000,000 to $50,000,000	$11.93
		>$50,000,000	$12.86
Spending Ratios			
Program service expense: Measures expenses incurred on mission-related programs as a percentage of total expenses. Donors generally view higher values as desirable since this represents resources that are being directed to mission-related programs.	Program services expenses ÷ Total expenses	**Total assets**	**Average value**
		$100,000 to $500,000	85.3%
		$500,000 to $1,000,000	86.1%
		$1,000,000 to $10,000,000	85.2%
		$10,000,000 to $50,000,000	86.2%
		>$50,000,000	86.8%
Management expense: Measures management and general costs as a percentage of total expenses. Donors generally view higher values as undesirable since this represents resources that are not being directed to mission-related programs.	Management and general expenses ÷ Total expenses	**Total assets**	**Average value**
		$100,000 to $500,000	12.3%
		$500,000 to $1,000,000	11.7%
		$1,000,000 to $10,000,000	12.6%
		$10,000,000 to $50,000,000	12.3%
		>$50,000,000	12.4%
Fundraising expense: Measures fundraising costs as a percentage of total expenses. Donors generally view higher values as undesirable because these represent resources that are not being directed to mission-related programs.	Fundraising expenses ÷ Total expenses	**Total assets**	**Average value**
		$100,000 to $500,000	2.5%
		$500,000 to $1,000,000	2.2%
		$1,000,000 to $10,000,000	2.2%
		$10,000,000 to $50,000,000	1.6%
		>$50,000,000	0.8%