A Board Member's Guide to Financial Statements

Even more than other organizations, non-profits need to be profitable. This enables them to attain their mission.

Education is big business, really big business. The state of California educates six million elementary and secondary students, pays the salaries and wages of thousands of employees, and is involved in the construction and maintenance of more than 8,000 schools.[1] Adventist education, too, is a huge undertaking. Some 5,600 K-12 faculty and administration in the North American Division educate some 63,500 elementary and academy students in 1,031 schools.[2] Both systems have boards that are charged with responsibility for their institutions' financial assets.

Unlike public school boards, however, local Adventist school boards are outfitted with the willing, but not necessarily the able, when it comes to dissecting financial data and using them to make strategic decisions. Fortunately, good boardsmanship does not require financial wizardry. Lay involvement is absolutely essential for the proper functioning of our academic organizations. This article can assist board members in the enormous task of ensuring that schools use their financial resources wisely so as to achieve their mission. It is their responsibility to adequately monitor the financial records of the school. This "implies that board members must be able to understand the accounting procedures and reports presented."[3]

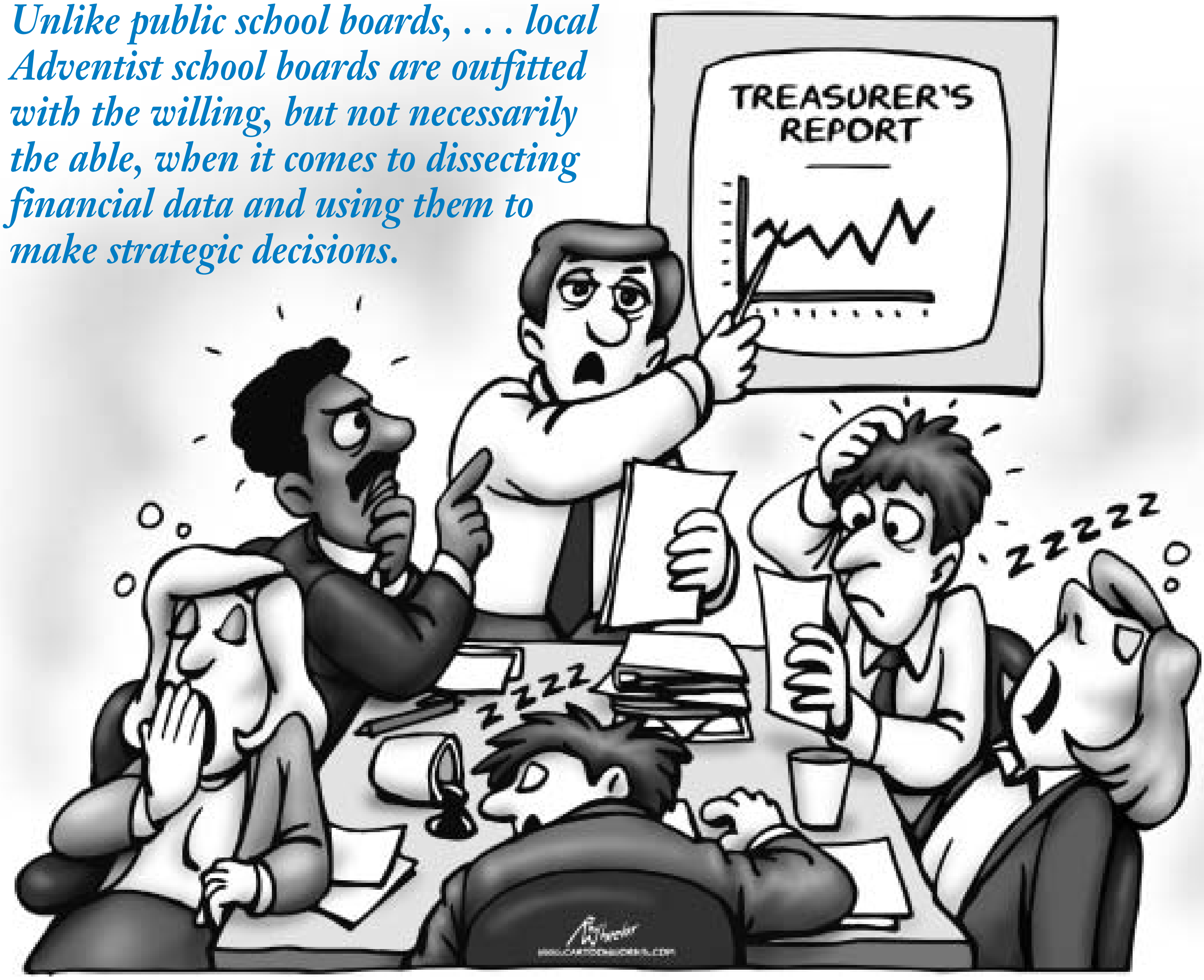
It was late May, the school year was drawing to its close, and I was invited to sit in on the board meeting of one of the largest Adventist schools in the North American Division. As the treasurer concluded his report, he assured the board that the school was poised to meet all of its financial obligations during the upcoming "dry" summer months. Within minutes, a motion was seconded, all in favor said "aye," none opposed, and the motion was carried to accept the financial statements as presented, subject to audit.

By Dave C. Lawrence

Sound familiar? I flipped past the cover sheet provided by the treasurer to simplify the report for board members and zoomed in on the first few lines of the statement (balance sheet). It didn't take long for me to realize that the school had only enough cash in the bank for the next payroll.

What was wrong with this picture? Was the board too trusting? Was the treasurer deceiving them? Did the board even care that the information was wrong? Since I was an invited guest, out of professional courtesy, I delayed making my observations known until after the meeting. I drove home that night pondering many things, including: Why didn't the board ask the right questions?

Unlike public school boards, . . . local Adventist school boards are outfitted with the willing, but not necessarily the able, when it comes to dissecting financial data and using them to make strategic decisions.



What Are the Right Questions to Ask?

So, what are the right questions for a board to ask the treasurer or business manager? It is quite disheartening to realize how easy it is for a school treasurer to deliver half-truths in a blizzard of financial babble! I am equally disheartened by the failure of boards to ask pertinent questions. I have heard it said that figures do not lie, but liars do figure!

My objective here is not to suggest that a treasurer should be second-guessed on every point in a report. It benefits no one for our schools to have a strained relationship between the accounting office and the boardroom. However, if the board is to make informed decisions based on the financial information it receives from the treasurer, it has a fiduciary responsibility to require that the reports be certified and comprehensible. During the time allotted for the treasurer's report at board meetings, the members should ask some basic and practical questions, and get an adequate response from the treasurer.

How Does the Financial Report Relate to the School's Vision?

One of a board's primary responsibilities is to establish and maintain "an organizational structure that supports the vision" of the school, which includes a concern for budget priorities.[4] The board should periodically ask the administration to demonstrate how income and expenditures relate to the vision of the school. For example, the administration might have chosen to focus on professional growth this year. The treasurer should report on the success or failure of that endeavor at intervals throughout the year.

A school cannot expect to grow unless it has a well-conceived mission and focuses intentionally on achieving carefully crafted goals. If the school's overall strategy fails to drive its financial goals, then all the efforts at planning and spending will accomplish very little.

What Do Financial Statements Tell Us?

Financial statements sometimes receive only a cursory inspection by board members, who fear that they will never be able to understand them. Boards do not have the luxury of ignoring the financial statements or "letting the treasurer worry about it." The confusion about statements and the failure to use them effectively can be cured if the board gets some very basic hints about their purpose and content. Following is a listing of the more common types of financial statements and a brief overview of how to use them:

The Statement of Financial Position. This is the non-profit version of the balance sheet. It is a snapshot of the ongoing operation of the school. It can be likened to a picture of an airplane in flight. You cannot tell by looking at the photo whether the plane crashed upon landing! The efficacy of the statement of financial position changes immediately following the "snapshot." It is just one frame of a constantly changing video.

The Statement of Changes in Net Assets. This is the income statement in non-profit parlance. Unlike the balance sheet, the income statement is cumulative. Referring back to the airplane analogy, the income statement tells how far the plane has traveled, how much fuel it has used, etc. In a simplistic way, it compares income and expenses and nets the two to arrive at a "bottom line." But the bottom line is not what is most important. It is more important to understand how the bottom line was calculated than to understand the figure itself.

The Statement of Changes in Financial Position. This is often referred to simply as the cash flow statement. In some respects, this document is a proof statement, as it starts with net income and ends with cash. So, it "reconciles" the income statement to the cash balance. In addition, the cash flow statement summarizes the funds available and how the school has elected to use them. It tracks the source and application of funds.

The Statement of Working Capital and Liquidity. This is not one of the required statements. It is useful, however, in informing board members about the school's ability to meet current and future obligations without their having to make inordinate calculations. (Nobody takes a calculator to a board meeting, anyhow.) The statement represents cash available after all commitments have been fulfilled. This answers the question of whether the school can meet its current obligations as of the statement date.

What are the right questions for a board to ask the treasurer or business manager?

Before looking at the statements, it is also useful to know the accounting basis used by the treasurer: *cash* versus *accrual*. On a cash basis, income and expenses are recorded only when they are received or paid. The accrual method enters all income and expenses at the time they are incurred. Either system can work, as long as the board members are informed about the method being used, and the treasurer does not conveniently flip-flop from one system to the other. However, the North American Division *Accounting Manual*[5] for academies regards the accrual basis of accounting as more reliable in representing the true financial health of an organization. For the remainder of this article, the accrual basis of accounting will be assumed as the norm.

The next important item is the period being covered by the statement. Most financial statements are dated as of the end of the month. Board members should ask for the date of the statement if it does not appear on the report. If the board attempts to make comparisons to the last fiscal year, conclusions could be skewed if the same number of days are not used to calculate both figures.

Finally, the statements must be read in context, not as isolated snapshots. Context may include the season, unexpected one-time expenses, new management, or a change in the legal environment. There can be external influences on the financial statements that cannot be readily predicted even by a financial soothsayer.

In the next section, I will suggest several questions a board should ask as it examines the treasurer's report. These are not necessarily the *most* important questions, as the financial position of the organization or its vision

may suggest otherwise. Remember, the questions are useless without the correct answers. The board must use the information to influence its decision-making about school finance.

Questions About Cash and Other Assets

It is no accident that *Cash* is the first item on every balance sheet. I once asked seminar attendees to raise their hands if their school had a mission. I then asked them to keep their hands raised if money was not a factor in the accomplishment of that mission. All hands went down. Cash is the common denominator of all business transactions, including educational ones. Cash is king. So, what questions should board members ask about cash and other assets?

- Have all bank statements been reconciled in a timely manner?
- What is the source of all cash

represented? The treasurer should organize the report according to the sources of the cash (e.g., subsidy, tuition, trust fund) and/or intended uses (e.g., reserves, restricted programs, operating expenses, allocated functions).

• How much of the total cash is available to pay current liabilities? Is it sufficient? (This information can also be gleaned from the statement of liquidity and working capital.)

• Is accounts receivable the net for credit balances, or is it a gross figure? Only the gross figure represents the true balance. A receivables aging schedule helps the board understand the effectiveness of the treasurer in collecting monies due the school.

I cannot overemphasize the importance of making sure that receivables get converted to cash in the shortest time possible. No one, including parents, should feel that they have permission to owe money to the school for an extended period of time. It is irresponsible for the school's administration to extend "credit" at the risk of having the school succumb to a cash crisis.

Questions About Liabilities

Liabilities may be either long-term or current. Current liabilities are due and payable within the next 12 months. For purposes of this discussion, I will focus on current liabilities. Generally, there are five major items in the current liabilities section of the balance sheet for most schools: notes payable, accounts payable, trust funds, accrued taxes and expenses, and the current portion of long-term debts. By their very nature, monies owed by the school change daily as new bills arrive and old ones are paid.

Following are very simplistic explanations of each liability item. *Notes payable* are generally loans owed to a bank but could also be money owed to a church or the conference office. *Accounts payable* are the funds due to various vendors for products or services they provided or performed on behalf of the school. *Trust funds* can comprise a significant portion of a school's balance sheet; they are money that the school holds in trust for subsidiary groups such as the home and school association or the senior class. *Accrued expenses* are statements of anticipated expenses: the taxes that come due three days after the statement date, for example. The *current portion of long-term debt* is exactly what the name implies; it is the principal on long-term obligations that will come due in the next 12 months.

In evaluating liabilities, asking the following questions should yield significant information:

• Does the school have enough cash to pay all its current bills?

• Are all outstanding bills represented accurately in accounts payable? What is the average age of each account owed? A schedule of aging can help answer this question.

• Does the school write checks and then wait days before mailing them?

• If there was a "run" on trust accounts today, would it be possible to make all funds available to the different groups?

Here are two quick litmus tests anyone can run using current assets and current liabilities. Take the total of all current assets and reduce that figure by the total of all current liabilities. The result is called *working capital*. A positive number is good news; a negative one is bad news. The current ratio is computed by dividing the current assets by the current liabilities. If the result is less than one, there is a problem; if the result is greater than one, you can breathe easy.

Questions About Income and Expense

The income statement is probably the board's most important financial document because it indicates the school's health for a particular period. If cash is king, as I suggested earlier, then the income statement is the kingdom.

No matter what the statement is called, it is always constructed in the same way: revenue minus expense equals profit. Board members should study this document quickly. In order to understand the income statement, board members need to know the accounting basis on which it was constructed: cash versus accrual. The accrual basis is preferred, for reasons stated earlier. Once the basis is confirmed, relevant questions can be asked:

• How much of the income reported has been converted to cash this month?

• Does total income also include income that has been reported for accounting purposes only?

• Do total expenses also include "paper expenses" such as depreciation and accrued expenses?

• Are there any one-time expenses? (Cost of converting storage space into a computer lab, for instance.) Are there any extraordinary expenses? (Costs incurred due to a loss in a legal proceeding, for example.)

In assessing the net income figure, it is important to recognize that net income will almost never equal cash. For example, the treasurer records tuition income at the beginning of a month, but it might take 45 or more days to collect on that billing. Likewise, an expense might be recorded before the payment is sent to a vendor. So, like the other statements, the income statement must not be reviewed in isolation.

The Statement of Cash Flows

Prior to 1988, the accounting community did not report cash flow as it does today. In 1994, a statement of cash flows was generally required by all non-profit organizations, including schools. The benefits of this statement are profound enough to warrant a welcome party from all who review school financial statements. The statement of cash flows monitors transactions that change the amount of cash available to the school. Not all business transactions change cash or working capital. When students' accounts are billed at the beginning of each month, for example, that transaction does not affect the cash balance. If, however, payments were received for those billings before the closing date of the financial statements, there would be an adjustment to cash.

Now for questions relating to the statement of cash flows:

- How is the total outflow of cash broken down between operating expenses, trust funds, and other liabilities?
- How much of the school's available cash is being used to service debts?

It has been my experience that many school treasurers deliberately downplay the importance of the statement of cash flows. And many boards do not seem to mind. However, this statement is arguably the most important component of the financial statements, and boards should request one if the treasurer has not provided this information. The primary purpose of the statement of cash flows is to represent the changes in cash balance from period to period, which is valuable information for board members.

A Word on Budgets

Financial statements have relevance only within the context of the budget. It follows, then, that the budget must be given utmost priority. In Luke 14:28, the Lord asks, "'Suppose one of you wants to build a tower. Will he not first sit down and estimate the cost to see if he has enough money to complete it?'" (NIV).[6] The budget is the road map for achieving the financial goals of the school, and as such, must be consulted on a regular basis.

The income statement is probably the board's most important financial document because it indicates the school's health for a particular period.

Be sure that the budget implies an agenda for profitability. Even more than other organizations, non-profits need to be profitable. This enables them to attain their mission. The "non-profit" title merely describes the tax status and is not a description of the school's cash flow. The budget must ensure a profitable operation, which requires effective control throughout the year. A school needs a well-conceived fiscal strategy and a supporting budget to thrive, yet many schools ignore the budget due to expediency or what they incorrectly label "faith." The Lord supports responsible planning, and a well-constructed budget gives evidence of planning.

The budget has to be more reliable than the weather forecast. This suggests that there should be many updates along the way. Therefore, the original budget must allow for flexibility and tests at levels above and below budget norms. This aids the decision-making process when the financial picture varies widely from what was budgeted. The board might determine, for example, that a 10 percent drop in enrollment would require a reduction in staff. If the reduction occurs, then the decision was already made.

A vital but often ignored tool is the cash budget. The outflow and inflow of cash never occur simultaneously. The cash budget is a very carefully determined estimate of the monthly or weekly schedule of cash inflow and outflow for the year. It allows the treasurer to invest excess cash when it is not needed and make sure it is available when needed.

In Conclusion

Board members are responsible for the financial operation of the school. Despite being non-profit institutions, Adventist schools should operate profitably. An organization that merely accumulates excess cash in order to boast about its inflated value is not a profitable operation. The motive for operating profitably should be to attain the school's mission. Profit allows the school its best chance of attaining and expanding its goals. Profits may also be used to replace or repair a worn-out plant and equipment, to create student scholarships, fund operating reserves, invest in service and outreach projects, and invest in the professional development of faculty, staff, and administration.

Dave C. Lawrence, M.B.A., *is Vice-Principal for Finance at La Sierra Adventist Academy in Riverside, California.*

REFERENCES

1. *Understanding School Finance: California's Complex K–12 System* (February 2000). Available from the World Wide Web: (http://www.edsource.org.

2. North American Division Office of Education, December 31, 2003.

3. Warren E. Minder, "Budgets and Boards," *Journal of Adventist Education* 62:2 (December 1999/January 2000), pp. 29-32.

4. Ed Boyatt, "Boardmanship 101," *Journal of Adventist Education* 62:2 (December 1999/January 2000), p. 5.

5. North American Division *Accounting Manual* (1997), p. 201.04.

6. Quoted from the *Holy Bible, New International Version*, copyright © 1973, 1978, International Bible Society. Used by permission of Zondervan Bible Publishers.