Assessing an Organization's Financial Health: A Step-by-Step Guide to Decode the Numbers

This document provides guidance on how to review and assess nonprofit financials. The guide is organized into the following sections:

1. **Ratings Reference Guide:** Snapshot guide for understanding the financial health of a nonprofit.
2. **Using Ratios and Indicators to Analyze Financial Health:** Relevancy and calculations of ratios in the rating guide.
3. **Information Sources:** Description of the main information sources for this analysis.
4. **Reviewing Audited (or Unaudited) Financial Statements:** Guidance for reviewing financial statements.
5. **Reviewing the IRS 990 Form:** Guidance for reviewing and navigating IRS 990 Forms.

1. Ratings Reference Guide

The chart below can be used as a reference guide for understanding the financial health of a nonprofit.

- **What this is:** This rating chart is a guideline for understanding strong, good, and weak values of key indicators used to assess the financial health of a nonprofit (e.g. "high" vs "low" cash reserves).
- **What this is not:** This is not a checklist for all the considerations in assessing a nonprofit's financial health nor a required list of thresholds an organization must hit for its overall financial state to be rated as strong, good/average, or weak. For example, an NGO demonstrating >40% UNA balance, >6 months of cash reserves and a diverse funding portfolio that has experienced multiple y/y deficits would not be considered as having "weak" financial health based on the deficits alone. Please see the "Other Considerations" section at the top of Page 2 for additional inputs for assessing overall financial health of an organization.

The overall rating at the organizational level will require contextualization and judgement by the assessor—this assessment should include but not be limited to the guidelines provided below:

Rating	Supporting Data
Strong	✓ A trend of a growing or high unrestricted net asset (UNA) balance, high % of unrestricted net assets (>40% is considered strong), high % of earned revenue (≥20%) and/or cash reserves (ideally ≥6 months, although this is rare; >3 months is sufficient) provide a buffer for covering operational expenses. ✓ A current ratio > 2:1. ✓ Low debt to total assets ratio (well below 50%). ✓ Frequent y/y surpluses; any deficits are outliers and/or due to a timing issue (difference between when grant was booked vs spent). ✓ Diverse funding portfolio (government, private foundations, individual contributions, earned income).
Good/ Average	✓ Stable UNA balance and % (≥25%), 3 months cash reserves. ✓ A current ratio of 2:1>x>1:1. ✓ Low debt to total assets ratio (well below 50%) ✓ Modest surpluses or alternating surplus and deficit y/y; any large deficits are outliers and/or due to a timing issue (difference between when grant was booked vs spent). ✓ Funding is *not* overly consolidated (>40%) with a few key donors.
Weak	✓ A trend of a significantly declining UNA balance and/or negative net assets balance, low (<25%) of unrestricted net assets, and <3 months of cash reserves (<1 month of cash is a red flag). ✓ A current ratio < 1:1 indicates serious risk in meeting short-term obligations. ✓ Debt to total assets ratio ≥ 50% exposes organization to a greater risk of insolvency. ✓ A trend of y/y deficits or significant deficits (≥20% of the organization's expenses) that are not explained by the auditor's notes or timing of when grants were booked vs spent. ✓ Consolidated funding (more than 40% of grant funding over the last 3-5 years comes from 1-2 donors).

Other Considerations

While financial data gives you a sense of the organization's finances, financial health is about more than just the numbers. During your review, be sure to consider these other indicators of financial health:

- Monitoring & Planning: Consistent, accurate, and timely financial reports are prepared and analyzed by qualified individuals. If an auditor has *disclaimed, qualified, or issued an adverse opinion,* the financial statements may be materially misstated and may be unreliable; this is an immediate red flag. Organization prepares budgets in tandem with programmatic/operational needs; management and board monitor financial results compared to the budget and modify programs and activities accordingly.
- Financial Policies: Policies are established for major financial decisions and management (example: policies are in place that establish/plan for an operating reserve to finance cash shortfalls and program growth).
- Board Involvement: Board members understand their roles and responsibilities in financial matters.

2. Using Ratios and Indicators to Analyze Financial Health

The financial health of an organization is often assessed using the following common ratios:

Ratio	Why it's relevant	Calculation	Rating
Cash reserves (months of cash)	The cash reserve ratio offers a sense of fiscal flexibility to meet operating expenses. It demonstrates how many months the organization could meet operating expenses if revenues were totally shut off. So, if an organization stopped receiving all sources of revenue tomorrow, how many months would it be before it has to close its doors because it can't pay its bills? In general, higher numbers are better since it means an organization has the flexibility to withstand short-term disruptions or blips while still being able to meet payroll. It is considered good business practice to keep at least 3 months (ideally 6) of cash reserves.	Total Cash (Total Expenses/12)	Strong: More than 3 months of cash reserves; 6 months of cash is ideal but uncommon. Good/Average: 3 months of cash. Weak: Less than 1 month of cash reserves.
Current ratio	The current ratio measures the coverage of near-term obligations with cash, near-term pledges receivable, accounts receivable, etc. Ratio of x > 1 means Current Assets can cover Current Liabilities, indicating short-term financial stability. Ratio of x < 1 means Current Liabilities are greater than Current Assets, indicating a short-term liquidity issue. To put it another way: If the current ratio is 1.8, that would mean for every $1 the organization owes, it has $1.80 to pay it. What we want to see is that this ratio is AT LEAST 1. Wouldn't you be worried if in the short-term you had more bills owed in the next few months than you had money to pay it?	Current Assets Current Liabilities	Strong: Ratio of x>2:1 Average: Ratio of 2:1>x>1:1. Weak: Ratio of x<1:1.
Debt to Total Assets ratio	This financial leverage ratio is used to measure a nonprofit's ability to handle its obligations, including its ability to meet financial requirements for outstanding loans.	Long-Term Debt Total Assets	High ratio (≥50%) indicates reliance on debt financing and exposes organization to greater risk of insolvency.

Unrestricted Net Assets:

In addition to these common ratios, it is important to understand an organization's unrestricted assets as they are arguably the single best indicator of an organization's financial position. If this number is NEGATIVE, it's a red flag. This means the organization has essentially borrowed from restricted funds to cover expenses.

There are a few ways to analyze the level of unrestricted net assets, including:

Indicators	Why it's relevant	Calculation	Rating
Change in Unrestricted Net Asset Balance	Looking at the annual change in unrestricted net assets gives a much better picture of the resources available for a nonprofit to cover its operating activities than looking at overall surplus/deficit.	(Unrestricted Net Assets in year 2) - (Unrestricted Net Assets in year 1)	Strong: A trend of a growing or high UNA balance; high % of unrestricted net assets. Good/Average: Stable UNA balance and %. Weak: A trend of a significantly declining UNA balance and/or negative net assets balance; very low % of unrestricted net assets.
% of Unrestricted Net Assets	The % of unrestricted net assets may tell a more valuable story than the absolute figures, as it helps us understand how much of the organization's net worth is unrestricted. For example, a very low % of unrestricted net assets (such as through an over-reliance on government grants) shows that the organization may not have a buffer to cover operating expenses.	$\frac{\text{Unrestricted Net Assets}}{\text{Net Assets}}$	
Months of unrestricted liquid net assets (ULNA)	One common indicator to assess liquidity is the months of ULNA* available; this liquidity measurement provides similar insight to the months of cash on hand. *A positive unrestricted net assets balance may not necessarily be liquid, and therefore may not be readily available for use. To find the unrestricted *liquid* net assets (or ULNA), you must subtract non-liquid net assets (plant, property and equipment, or PPE, *less any liabilities*) from unrestricted net assets. *Note*: This is a tricky measure to calculate, as only the share of the PPE that is owned by the organization should subtracted out of UNA. In other words, ULNA=UNA – PPE – liabilities on PPE. Also, there may be other non-liquid net assets (in addition to PPE) to consider, such as certain investments that are not readily convertible to cash.	$\frac{\text{Unrestricted Liquid Net Assets}}{\text{(Total Expenses/12)}}$	Strong: At least 3 months of liquid net assets (ideally 6) provide a buffer for covering operational expenses. Good/Average: 3 months of ULNA. Weak: <1 months of ULNA is a red flag.

Do you love ratios? *Check out more financial ratios you can use, as presented by Propel Nonprofits (formerly the Nonprofit Assistance Fund)!*

3. Information Sources

- ✓ **Audited Financials (preferred):** Financial statements that have been audited by an independent auditor provide credibility to the statements. These statements offer insight into the financial history and operations of the organization through financial notes and disclosures. Audited balance sheets should also separate net assets into unrestricted and restricted categories. *See pages 4-5 for more details.*
- ✓ **Unaudited Financials:** Some small or young organizations may not have audited financials for all years, and instead provide unaudited financial statements. *See pages 4-5 for more details.*
- ✓ **IRS Form 990:** Most tax-exempt organizations, nonexempt charitable trusts, and section 527 political organizations registered in the United States are required to file an IRS Form 990 each year. The form gives the IRS an overview of the organization's activities, governance and detailed financial information. *See pages 6-7 for more details.*

4. Reviewing Audited (or Unaudited) Financial Statements

Ideally, use audited financial statements when assessing the financial health of an organization. If audited financial statements are not available, the organization should not be penalized for having unaudited financials.

If reviewing audited financials, please be sure to read the following:

(a) Auditor's Opinion: Has the auditor issued an "unqualified" opinion on each audit (find this on the first page)?

   a. An unqualified opinion states that the financial statements have been prepared in accordance with relevant accounting standards. If an auditor has *disclaimed, qualified or issued an adverse opinion,* the financial statements may be materially misstated and may be unreliable; this is an immediate red flag.

(b) Auditor's Notes: The auditor's notes are a core reason why audited financials are preferred – they provide invaluable context on the figures presented in the Balance Sheet and Income Statements.

Reviewing the Balance Sheet and Income Statement:

The Balance Sheet and Income Statement are the two key financial statements to review:

- Balance Sheets are snapshots in time (comparison: your bank account on any given day).
- Income Statements are the results over time (comparison: your yearly salary - all expenses for the year).

<u>Relationship</u>: The Surplus/Deficit on the Income Statement represents the Change in Net Assets on the Balance Sheet.

(a) Balance Sheet (aka Statement of Financial Position): A snapshot of the organization's assets (including unrestricted net assets), debts and other liabilities at a fiscal year end.

Key Term	What it Means
Assets	Everything the organization has or owns. Typically listed from most liquid (*current assets*, namely cash) to least liquid (*long-term assets*, such as property or equipment).
Current Assets	Any assets that you can turn into cash *in the next 12 months* (ex: cash and cash equivalents, current portion of grant receivables, inventory, prepaid expenses).
Liabilities	Everything the organization owes to others; includes short-term and long-term liabilities.
Current Liabilities	Any liabilities you must pay *in the next 12 months*. This may include accounts payable, payroll, deferred revenue and short-term loans.
Net Assets	What the organization has or owns, free and clear of any liabilities ("net worth"). If you have a positive number, it means your assets are greater than your liabilities. *Equation: (Assets – Liabilities) = Net Assets*
Unrestricted Net Assets	Unrestricted net assets are assets that an organization has available to it immediately, without needing to first meet any donor restrictions.
Change in Net Assets	Sometimes called an "increase/decrease in net assets," this is the same number you will see on the Income Statement for surplus or deficit.

Key considerations when reviewing the Balance Sheet:

- What the NGO owns: What assets does the organization have, how liquid are they, and are they restricted?
- What the NGO owes: What liabilities does the organization have and when are they due?
- Net worth: Do assets exceed liabilities? Have they accumulated surpluses over time?

Key indicators that stem from the Balance Sheet: Cash on hand, current ratio, debt to net worth ratio, change in unrestricted net assets.

Confused? *Check out this [free 15-minute training video] and/or this [Balance Sheet cheat-sheet] prepared by Propel Nonprofits (formerly the Nonprofit Assistance Fund)!*

(b) Income Statement (aka Profit and Loss Statement, or P&L): A summary of the organization's financial activity (revenue and expenses) of over a period of time, generally one year.

Key Term	What it Means
Contributions	Contributed revenue from individuals, foundations, corporations and government.
Earned Revenue*	Earned revenue from contracts, fee-for-service, ticket sales, memberships.
Other Income	Other types of income may include in-kind donations and interest income; confirm other income sources with the organization.
Net Assets Released	When donor restrictions are met, NGOs can "release" previously restricted funds to cover expenses.
Expenses	Typically broken out by program services, management and general, and fundraising.
Change in Net Assets	Surplus or deficit – sometimes called an "increase/decrease in net assets."

**** Notes on earned revenue:***

- Government contracts: Some organizations classify government work differently. For example, a government contract is often considered "earned revenue" while a government grant is considered a "contribution." If the organization you are reviewing receives substantial support from the government, be sure to ask whether this support is in the form of a grant or contract and whether these sources are treated differently on the income statement.
- Revenue models: Organizations that have a consistent earned revenue stream are better poised to whether changes in grant funding that can occur year-to-year. However, it is important to remember that earned income does not work in many non-profit business models. Therefore, although useful to have, lack of earned income does not necessarily imply risk for the organization.
- In-kind: Auditing standards allow for monetary valuation of donated services (e.g. legal services, product donations), but organizations are required to increase expenses by the same amount, so there is no net effect on the operating surplus/deficit. If in-kind contributions make up a significant share of revenue, it is important to note this, as this is not "true" unrestricted revenue that the organization can use to pay for its operations.

Key considerations when reviewing the Income Statement:

- Revenue: How is revenue trending? What is the organization's key revenue source(s)? Is revenue diversified? Does the organization receive mostly restricted or unrestricted revenue?
- Expenses: How is the organization spending its revenue (allocation across different programs compared to operational costs, like staffing and fundraising)? What are biggest expense drivers? Which programs represent the largest percentage of expenses over time and why?
- Change in Net Assets: Is the organization spending within its means? Does the organization experience y/y surpluses or deficits? How significant are the surpluses/deficits (% of total expenses)?

- *Note:* It is more important to look at the trend over time rather than the current year's surplus/deficit only. Also, an organization can have a "planned deficit" (for example, an organization may temporarily increase spending on fundraising or strategic planning to better position themselves for future years). However, it is worrisome if an organization has had consecutive years of significant operational deficits, which can erode the unrestricted net assets (or the equity) of the organization.

Key indicators that stem from the Income Statement: Year-over-year deficits and surplus (and therefore trends in revenue and expenses), funding makeup (e.g. contributions vs. earned revenue), allocation of spending (e.g. programmatic vs. fundraising expenses).

5. Reviewing the IRS 990 Form

While the IRS 990 form does not include the rich context available in an auditors' notes, the content can be used to provide similar insight on the organization's **(a) financial health** as you would be able to find through the Balance Sheet and Income Statement. The IRS 990 form also provides additional context on **(b) organizational capacity** that you will not always find in an auditor's note, such as specific governance and disclosure policies, compensation of key staff, and level of public support.

The charts below highlight where this distinct information can be found in the IRS 900 Form. This information has been adopted and consolidated from content made available by Propel Nonprofits (previously the Nonprofit Assistance Fund), which is a fantastic open source resource for nonprofit financial analysis, among other topics.

(a) Financial Health Analysis

Topic	Data	Source on IRS Form 990
Surplus or Deficit	Unrestricted Net Assets, End of Year	Part X, column (B), line 27
	Unrestricted Net Assets, Beginning of Year	Part X, column (A), line 27
Use of Expenses	Total Expense	Part IX, column (A), line 25
	Total Program Expense	Part IX, column (B), line 25
	Total Management & General Expense	Part IX, column (C), line 25
	Total Fundraising Expense	Part IX, column (D), line 25
Liquidity of Reserves	Fixed Assets, End of Year	Part X, column (B), line 10c
	Mortgages, End of Year	Part X, column (B), line 23
Cash on Hand	Cash - non-interest bearing	Part X, column (B), line 1
	Savings and temporary cash investments	Part X, column (B), line 2

Hate Math? *Make it easy on yourself by "filling in the blank" – use this 990 Decoder Worksheet provided by Propel Nonprofits to get the numbers you need!*

(b) Organizational Capacity

Topic	Data	Source on IRS Form 990
Program Services	Mission statement	Part III, Question 1
	Changes in program services (yes/no)	Part III, Question 3 (if yes, go to Schedule O)
	Program service accomplishments of the three largest (in terms of expenses) programs	Part III, Question 4

Topic	Data	Source on IRS Form 990
Governance, Management & Disclosure	Number of voting board members (Q 1a) and number of independent voting board members (Q 1b)	Part VI, Section A, Question 1
	Did the organization recently become aware of a significant diversion of assets?	Part VI, Section A, Question 5
	Meeting documentation for the board and committees	Part VI, Section A, Question 8
	Conflict of interest policy and compliance	Part VI, Section B, Question 12
	List of states where the organization is required to file a Form 990	Part VI, Section C, Question 17
	If/how the organization makes key documents available for public review	Part VI, Section C, Question 18
Compen-sation	Process for determining compensation (engagement of independent reviewers, use of comparability data, etc.)	Part VI, Section B: Question 15
	Highest compensated employees and any compensation provided to board members	Part VII, Section A
	Is the organization paying for items such as first-class travel, discretionary spending accounts, personal services (e.g. maid, chef) etc.?	Schedule J, Part I, Question 1a
	Sources used to substantiate the compensation of the CEO/ED (committee, independent consultant, board approval, etc.)	Schedule J, Part I: Question 3
Financial Statements & Reporting	Accounting method used to prepare the Form 990 (cash, accrual, or other)	Part XII, Question 1
	Extent to which the organization's financial statements were compiled, reviewed and audited by an independent accountant or committee	Part XII, Question 2
Public Support	Public support (% of revenue)	Schedule A, Part II, Question 14
Fundraising Activities	Indication of activities used to raise funds (mail solicitations, government grants, etc.)	Schedule G, Part I, Question 1
	Use and compensation of professional fundraiser consultants	Schedule G, Part I, Question 2
	Financial return on the year's special fundraising events	Schedule G, Part I