Understanding Financial Statements[1]

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Welcome to the world of numbers, arguably the least understood aspect of service as a trustee. In this article we will describe the financial oversight role that a trustee should play. In addition, we will provide the tools you need to understand nonprofit accounting and show how to use these tools to interpret your museum's financial trends. While the laws require that a trustee exercise financial responsibility for the museum, the language of accounting is full of unfamiliar terms, and not-for-profit accounting has some significant differences from for-profit accounting presentation. Board members and managers may need assistance in analyzing the financial strength and operating health of their organizations.

Because the readers of this article may range from those with extensive accounting and financial expertise to those who have never seen financial statements, we have prepared a brief tutorial, "Accounting Basics," which follows. If you understand what constitutes an income statement (statement of activity) and balance sheet (statement of financial position), move ahead to the next section, "Financial Roles and Responsibilities of the Board Member." If these concepts are new to you or difficult to understand, read "Accounting Basics" first and then move on. At the end of the chapter you will find a Glossary of commonly used terms to help you as you read through this article.

Accounting Basics

Income Statement (or Statement of Activity)

A trustee needs to know about and understand two basic financial statements and their uses. The most familiar is the income statement**,** which states what income you receive during the year, what your expenditures are and how your income compares to your expenditures – whether they are in balance or whether you have a surplus or deficit. The income statement is an accounting of where you are at any particular point during the year.

The most familiar use for the income statement is to track progress against the annual budget, which is prepared in the same format as the income statement. The budget is your financial plan for the year. By comparing the income statement to the budget, you can monitor how you are doing as the year progresses. Is income above or below what you expected? What about expenses? Are you staying in balance or are you in danger of running a deficit? Reviewing regular income statements allows you to take action before the end of the year to offset unexpected developments.

The balance sheet is probably the less familiar of the financial statements a trustee needs to understand. Rather than showing how you are doing just this year as the income statement does,

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[1] Adapted from a chapter of the same title in the book, *The Art of Governance – Boards in the Performing Arts* (edited by Nancy Roche and Jaan Whitehead) published by Theatre Communications Group.

the balance sheet shows the accumulated financial results of all the years you have been in business. It shows all the assets you have accumulated over these years and all the liabilities. And it shows how your assets compare with your liabilities, which gives you the best understanding of the long-term financial health of your museum. Although both of the financial statements are closely connected, each shows a different aspect of a museum's financial life.

To help you understand the basics of financial statements, let's start with a personal financial situation as an example. Your family's income statement is the best measure of whether you are living within your means each year. It is made up of your family's revenue and expenses. It is presented as revenue minus expenses equals net income, "net" meaning how much revenue is left after all expenses are paid. Revenue consists of all monies you received from all sources during the year. Your personal revenue might consist of your salary from your employer, revenue from your investments such as stocks and bonds and rental income from a rental property you own. Your personal expenses might include payments on your home and car, insurance, utilities, food, clothing, household expenses and other expenses. Your net income or surplus is the money that remains in your bank account after you deposit the income you earned during the year and pay all your expenses. If you have an overdraft at the end of the year, it means that you had a loss or deficit.

The museum's income statement is quite similar to your personal statement; it just has different categories of revenue and expense. Below are two examples.

Personal Income Statement:	
($ in thousands)	
Revenue:	
Salary at XYZ Corporation	$75
Investment revenue	11
Rental property revenue	5
Total revenue	91
Expenses:	
Housing and utilities	40
Auto expenses	15
Food	20
Clothing	15
Total expenses	90
Net income (loss)	$1

Museum Income Statement:	
($ in thousands)	
Revenue:	
Admissions and membership	$12
Investment revenue	15
Contributions	65
Total revenue	92
Expenses:	
Curatorial, exhibitions, conservation	45
Marketing	13
Fundraising	8
Administration and facility	23
Total expenses	89
Net surplus (deficit)	$3

The income statement is your way of knowing where the museum's income comes from, how it is spent and whether income and expenses are in balance.

Balance Sheet
(or Statement of Financial Position)

The balance sheet is the best measure of the financial health of an organization as it is the accumulation of all its years of fiscal activity. The balance sheet is a snapshot that shows both what you own (assets) and what you owe (liabilities) at a point in time. In your personal finances,

the difference between what you own and what you owe is your net worth. Your net worth increases or decreases each year by the amount of your net income. Examples of what you own are your cash in the bank, your car and your home. Examples of what you owe include your credit card balances and any loans. We have created a sample balance sheet based on the items noted above. The museum's balance sheet is quite similar to your personal statement; it just has different categories of assets and liabilities and uses different terminology. Below are two examples.

Personal Balance Sheet:	
($ in thousands)	
Assets	
Bank balance	$5
Stocks & bonds	85
Automobile	25
Home, rental property	275
Total assets	$390
Liabilities	
Credit card balances	10
Loans	45
Mortgage	260
Total liabilities	315
Net worth	75
Total liabilities & net worth	$390

Museum Balance Sheet:	
($ in thousands)	
Assets	
Cash	$25
Investments	50
Equipment	15
Facility/museum	280
Total assets	$370
Liabilities	
Accounts payable	30
Memberships received in advance	10
Loan	50
Total liabilities	90
Net assets	280
Total liabilities & net assets	$370

The balance sheet is so named because total assets always equal total liabilities plus net assets; the two sections of the balance sheet always balance each other.

The illustrations above will help you understand the more complex examples used in this chapter. You are now ready to move on to the Financial Roles and Responsibilities of the Board Member.

Financial Roles and Responsibilities of the Board Member

The board of trustees holds the museum in trust for the community. The trust includes responsibility for maintaining or strengthening an organization's financial position. The board is also responsible for maintaining the balance between the desire to invest in the highest quality programs and financial responsibility.

One of the key roles of the board is to help determine the museum's priorities, both on an annual basis and on a long-term basis. Understanding the financial position and financial trends of the museum allows trustees to more fully consider strategic issues they will confront. For example, with the constraint of limited resources, how should a museum spend its funds? Invest in curators? Create new exhibitions? Invest in the facility? Upgrade technology in the public exhibition spaces and in the offices? Hire additional staff? Pay current staff a higher wage? Strengthen working capital to reduce day to day cash flow problems? Raise funds for an endowment? Launch a capital campaign to fund desired priorities? The answers to these questions will determine what is included in the annual budgets and the long-term financial plan of the museum. First we will look at two types of budgets, operating and capital, and then we will review the income statement and balance sheet.

Operating Budget

The board's oversight role as it relates to finances is generally led by a finance committee. The committee works with staff by providing input and feedback on detailed budgets and financial reports that the board later reviews in summary. Each fiscal year, the museum follows a similar financial cycle. Several months prior to the start of each fiscal year, the committee should review the proposed operating budget for the upcoming year to understand the underlying assumptions and ensure that they are realistic and that the budget reflects the operating priorities and long-term goals of the organization. For example, if one of the top priorities of the museum is to improve conservation activities, the committee should verify that the budget accurately reflects all of the costs related to strengthening conservation. The board should approve an operating budget prior to the beginning of a new fiscal year. Generally it should be balanced.

In the annual operating budget, the staff estimates the museum's revenue and expenses as part of the plan for the upcoming year. The operating budget should cover the twelve-month fiscal year of the organization. Each of the line items shown should be supported by a set of detailed budget items and related assumptions. The summary budget should be presented to the board with comparisons to current year budget and year-end projections and to one to two years of actual results from prior years. The history provides context for the proposed budget.

The following are examples of questions that trustees might ask as part of their budget review:

- Is the operating budget balanced? If not, why?
- Does it provide a contingency to handle unforeseen events?
- Does the budget include only current year revenue that is unrestricted and available to be spent on operations?

- What are the riskiest parts of the budget? Is there a fallback position to protect the organization from the risks?
- How do the major budget categories compare to this year's budget and year-end projection?
- What new initiatives are included in the budget?
- Are any existing programs terminated?
- If the budget includes significant increases in earned or contributed revenue, does the staff have a realistic plan for activities to generate the growth and is the development or marketing budget increased to reflect the new activities?
- Does the budget include depreciation as an operating expense? Depreciation is a non-cash expense and each museum must decide how much it can afford to fund.

The operating budget is the plan for the revenues and expenditures of the museum's annual activities.

Capital Budget

The capital budget is a list of all the expected expenditures for the year for building additions and improvements and equipment purchases. As these items are not normally included in the operating budget, the museum must have a source of funding available for capital budget items. Funding sources include special grants to purchase equipment, capital campaigns for facilities and equipment or use of a board designated reserve that could be replenished by funding depreciation. The board should review and approve the capital budget annually.

Questions trustees might ask include:

- Is capital or non-operating revenue (for example grants for equipment purchases) and expenditure budgeted and tracked separately as part of the capital budget?
- Is the capital budget balanced with revenue sources identified?
- Does the staff maintain a multi-year schedule of capital purchase needs so the museum can plan for future capital outlays?

Monitoring Finances–Income Statement (or Statement of Activity)

Once the operating budget has been approved and the museum's fiscal year begins, the board oversees the operating results, that is, what the museum is actually earning and spending. The actual results should be regularly compared to the budget, and differences should be explained. It is inevitable that actual revenues and expenses will vary from the budgeted amounts. It is difficult to accurately predict the public's response to an exhibition and what the exact admissions will be. Despite the best expense budgeting, unforeseen circumstances can crop up in all areas of the operation, particularly during exhibitions. Budgeting a contingency can provide a cushion for such situations. Ultimately, it is essential that the staff monitor revenue and

expenses and reforecast actual year-end results regularly for the board's review. If the projection shows a deficit, the board and staff should engage in a discussion of ways to close the gap.

The fundamental difference between for-profit and not-for-profit accounting is that not-for-profit organizations have three types of net assets that come to them through their charitable contributions. When donors contribute gifts to a not-for-profit organization, they can designate whether they are temporarily restricted and must be held until a designated time or used for a specific purpose or whether they are permanently restricted and can never be used for current operations (such as an endowment fund). If there is no designation then the gift is considered unrestricted and can be used for current operations. The museum cannot restrict a contribution; only the donor can. Some examples of temporarily restricted contributions are gifts for specific programs or exhibitions, gifts for operations for future years and capital campaign gifts for facilities that are not yet purchased or built. When the restriction is fulfilled, then the net assets are released to the unrestricted operating statement. However, prior to restrictions being lifted, temporarily restricted donations should be segregated and not used to pay for operations. Permanently restricted contributions such as gifts to an endowment are restricted by the donor in perpetuity.

The income statement that follows is one example of the type of year-to-date financial information that should be provided to board members monthly. It includes an unrestricted operating section that includes only the portion of contributed income that can be used for current operations. This is followed by a section that details non-operating and restricted funds that should be reported and monitored by the board separate from operating activity. Trustees may want to see other relevant columns of information such as year-to-date budget, percentages of total, variance percentages, etc.

Sample Year-to-Date Income Statement

($ in thousands)

	Prior Year-to-Date Actual	Current Year-to-Date Actual	Prior Year Total Actual	Current Year Annual Budget	Current Year-End Projected	Budget to Projected Variance
Unrestricted Operating						
Revenue						
Earned						
Admissions	$299	$67	$498	$244	$267	$23
Membership	414	153	690	569	610	41
Museum store	567	216	945	722	654	(68)
Other earned	116	43	350	400	427	27
Total earned revenue	1,395	478	2,483	1,935	1,958	23
Investment/interest	495	561	1,500	1,699	1,699	0
Contributed						
Individual	619	690	1,375	1,425	1,380	(45)
Corporate	116	88	350	340	353	13
Foundation	220	173	440	450	433	(17)
Government	1,205	1,247	3,650	3,795	3,780	(15)
Special events/ gala	306	335	306	310	335	25
In-kind	12	15	35	40	45	5
Contributed subtotal	2,476	2,549	6,156	6,360	6,326	(34)
TR net assets released for operations	1,191	624	2,165	1,850	1,891	41
Contributed total	3,667	3,173	8,321	8,210	8,217	7
Total revenue	5,557	4,211	12,304	11,844	11,874	30
Expenses						
Program						
Curatorial, exhibitions, conservation	2,460	1,241	4,100	3,725	3,761	(36)
Education programs	363	263	740	765	797	(32)
Program subtotal	2,823	1,504	4,840	4,490	4,558	(68)
Marketing	480	181	800	725	723	2
Development	347	790	1,050	1,115	1,129	(14)
Museum store	459	163	765	480	493	(13)
Administration and facilities	1,504	1,631	4,850	4,900	4,942	(42)
Total expenses	5,612	4,269	12,305	11,710	11,845	(135)
Income (loss) from operations	**(54)**	**(58)**	**(1)**	**134**	**29**	**(105)**
Unrestricted Nonoperating						
TR net assets released for nonoperating	0	0	10	0	5	5
Investment revenue in excess of draw	1	(1)	3	0	0	0
Capital gifts	0	0	0	0	50	50
Deaccessions	0	0	15	0	7	7
Accessions	0	0	30	0	10	10
Change in unrestricted net assets	(53)	(59)	(3)	134	81	(53)
Temporarily Restricted (TR)						
Contributions	985	701	2,222	1,968	1,923	(45)
Net assets released from restriction	(1,191)	(624)	(2,175)	(1,850)	(1,896)	(46)
Change in TR net assets	(206)	77	47	118	27	(91)
Permanently Restricted (PR)						
Contributions	26	10	5	0	10	10
Change in PR net assets	26	10	5	0	10	10
Total change in net assets	($233)	$28	$49	$252	$118	($134)

Let's assume that you are a board member of a museum that sent you the statement above accompanied by a set of comments explaining both year-to-date and projected variances. What would you look for to monitor how the museum is doing this year? Let's start with a few general questions.

- Comparing the first two columns, are there any areas where the museum is doing much better or worse than the prior year? If so, why?
- Reviewing the variance column, what has caused any major differences between budget line items and projections of year-end?
- Is a deficit projected for unrestricted operations?
- If revenue shortfalls or expense overruns are projected for year-end, are steps being taken today to make up for the variances?
- How does the year-end projection compare to the year-to-date actual? Given planned activities and the number of months remaining in the fiscal year, is the projection reasonable?

On an annual basis, you can look at operating ratios to track the financial trends over several years. If you are interested in sources of revenue and general types of expenses as they change over time, you should review:

- Revenue reliance ratios that look at how much of the museum's total expenses are covered variously by earned, contributed and investment revenue
- The program and administrative ratios that measure how much of the museum's budget is spent on programs and administration

If you are interested in whether it is getting more or less expensive to raise or earn a dollar, you should review:

- The development efficiency ratio that measures what portion of each dollar of a contribution is spent to attract the gift
- The marketing efficiency ratio that measures what portion of each dollar of admissions is spent to generate the sale

Sample operating ratios and their calculation are shown in Appendix 1.

The museum's patron database contains a wealth of data on attendance, membership, and donors that staff should be analyzing to inform revenue-generating activities. The trustees and staff should identify a small number of indicators from this data and from the museum's operations to track in addition to financial trends. Examples include:

- Number of exhibitions and educational programs
- Attendance
- Number of members and renewal rate
- Average admissions ($)
- Average store sales per admission
- Number of donors and average gift
- Total employment by department

Monitoring Finances–Balance Sheet (or Statement of Financial Position)

The balance sheet or statement of financial position provides the best assessment of the financial health of an organization as it reflects the museum's financial history, i.e., the accumulation of all surpluses and deficits plus all the capital the museum has acquired. It provides information on the financial strength and well-being of the organization that cannot be learned from looking at the museum's annual income statement. It reflects the museum's position at one point in time, the day the balance sheet is prepared. In addition to operating reports, the board should receive monthly balance sheets and have the opportunity to question changes in assets and liabilities. The balance sheet may be single column or include a comparative column if desired.

As you can see on the sample balance sheet that follows, there are three sections: your assets or what you own; your liabilities or what you owe; and your net assets or the difference between what you owe and what you own. The for-profit equivalent to net assets is owners' equity.

As previously noted, the fundamental difference between for-profit and not-for-profit accounting is the existence of three net asset classes in not-for-profit accounting: unrestricted, temporarily restricted and permanently restricted.

- Unrestricted assets, liabilities and net assets include your accumulated operating surpluses and deficits, your property and equipment and any board-designated funds such as a cash reserve or endowment.
- Temporarily restricted assets and net assets are restricted by the donor for a specific purpose or time period.
- Permanently restricted assets and net assets are restricted by the donor in perpetuity. Most often, these are permanent endowment funds.

The single-column balance sheet frequently does not distinguish unrestricted assets and liabilities from those that are temporarily or permanently restricted, so it is difficult to tell which assets are available to support operations.

As shown on the next page in the sample balance sheet, assets may include: bank account balances; money owed to you or accounts and pledges receivable; prepaid expenses or expenses paid in advance; investments; and buildings and equipment. A few of the assets are worthy of highlighting:

- Contributions receivable are pledges and grants that have been promised but not paid. A trustee should review this number to make sure that the museum is recording pledges and collecting them on a timely basis.
- Prepaid expenses are expenditures that have been made for future exhibitions or other future activity. Trustees should be aware of the magnitude of prepaid expenses, especially if cash flow is tight.
- Investments can be unrestricted, temporarily restricted or permanently restricted. Endowments, reserves and excess cash are sources of investments. Endowment investments provide a revenue stream that increases the strength and sustainability of an organization. Each museum should target an appropriate level of endowment after developing sufficient resources for operations or working capital.

- Property and equipment is all the land, buildings, equipment and other fixed assets owned by the museum. It is usually shown net of accumulated depreciation. The amount that a museum invests in its building and equipment will vary, and should be tailored to the needs of the organization and the larger community. However, every museum should maintain the fixed assets that it owns, providing for regular upgrade and replacement. Generally, the museum's collections are not shown on the balance sheet.

Sample Balance Sheet
($ in thousands)

	Fiscal Year-End
Assets	
Cash and cash equivalents - unrestricted	$1,590
Cash - restricted	$6,985
Accounts receivable	192
Contributions receivable	9,165
Prepaid expenses	89
Inventory	276
Investments	41,245
Property & equipment, net	8,250
Other assets	55
Total assets	$67,847
Liabilities and Net Assets	
Liabilities	
Accounts payable and accrued expenses	$437
Memberships received in advance	62
Line of credit	0
Notes payable	150
Other liabilities	100
Total liabilities	749
Net assets	
Unrestricted	
Operating	12,537
Board designated endowment	15,911
Unrestricted total	28,448
Temporarily restricted	13,150
Permanently restricted	25,500
Total net assets	67,098
Total liabilities and net assets	$67,847

Assets

Trustees should understand the nature of the museum's assets. Questions about assets might include:

- How much of the cash is restricted – for example, grants for future years? This sample balance sheet makes that clear by reporting unrestricted cash separately from restricted.
- Are restricted funds held until they are utilized for the intended purpose?
- How old are the accounts receivable?
- Has the museum had difficulty collecting any accounts or contributions receivable?
- Are contributions receivable balances regularly reconciled to development reports?
- What is the inventory and how old is it?
- What types of investments does the museum have?
- Are endowment investments growing in proportion to growth in operating size?
- Is investment in property and equipment growing or declining?
- Is the museum investing in its property and equipment on an ongoing basis to avoid deferred maintenance?
- Has the museum projected the increased operating costs of proposed facility additions prior to adding facilities?

Liabilities

Liabilities may include: accounts payable; unpaid payroll taxes; next year's memberships; and loans. Several of the liabilities are worthy of more attention:

- Memberships received in advance represent memberships for future years.
- Notes payable, lines of credit, mortgages and capital leases are contractual obligations of the museum. Together, they represent the total debt incurred by the museum. The ability to repay debt is key to financial health.

Sample questions trustees may want to ask about liabilities include:

- Have all payroll taxes been paid on a timely basis?
- What is the age of the accounts payable? Are vendors paid on a timely basis?
- Is debt increasing or decreasing?
- Does the museum have a dedicated source of funds for debt repayment, for example, capital campaign pledges that will pay off a building mortgage?
- Has the museum had difficulty making debt payments on a timely basis?
- Is the line of credit used for the purpose stated, and is it repaid according to the terms of the loan?

Net Assets

Sample questions focusing on net assets include:

- Are all grants for specific projects and future years shown as temporarily restricted?
- Are board designated funds shown as unrestricted? Are the assets intact and ready to be used for the designated purpose?
- Are permanently restricted net assets intact? Is the income being used according to the wishes of the donor?
- Do total net assets grow at least as fast as operating expenses each year?

Working Capital

One key element of the balance sheet does not appear as a single balance sheet line item – working capital. Working capital consists of the unrestricted resources available for operations. It is a fundamental financial building block of an organization and should be a primary focus for trustees. Working capital may be determined by using the traditional calculation of total unrestricted current assets less unrestricted current liabilities. Note that this formula looks only at unrestricted current assets and liabilities. If the balance sheet does not separate unrestricted from restricted assets, then doing the calculation with total current assets will overstate working capital, as it will include restricted assets that are not available, by definition, to meet current liabilities.

If your balance sheet doesn't include sufficient detail to do the above calculation (i.e, does not separate unrestricted from restricted assets or current from long-term assets and liabilities), you may approximate working capital with the calculation: total unrestricted net assets less property and equipment (net of accumulated depreciation) less unrestricted investments.

Adequate working capital provides financial strength and flexibility to an organization, the ability to meet obligations as they come due, and the ability to take more risks, knowing there is a cushion to fall back on. An organization with negative working capital is likely to suffer periods of cash flow stress or financial crisis and must borrow to meet current needs – for example, borrowing from a bank through a term loan or a line of credit; borrowing from next year's revenues; borrowing from restricted net assets; or "borrowing" from vendors by delaying payments on outstanding bills.

Questions about working capital might include:

- Is working capital positive or negative?
- Does the museum have periods of cash flow stress?
- If cash flow is tight, does the organization prepare detailed cash flow projections that show expected receipts and disbursements?
- Has working capital grown or declined during the past several years?
- Is working capital growing in proportion to the growth in operating size?

The mix of your assets, liabilities and net assets and the nature of restrictions on each determine your museum's capital structure. A healthy capital structure allows the museum to fulfill its artistic mission and take artistic risk without significant financial stress. But how can you determine your museum's capital structure and how healthy it is?

Balance Sheet Measures and Ratios

Balance sheet measures and ratios may be used to track the overall health of the museum. We suggest that board members track five measures annually for several years using the audit as the source of data to calculate:

- Total net assets
- Working capital
- Invested capital
- Fixed assets
- Debt

Key ratios include the following:

- Working capital ratio – relates working capital to operating expenses to determine the number of months of working capital available.
- Endowment ratio – relates endowment investments to operating expenses to compare the growth rate of endowment to the growth rate of expenses.
- Deferred maintenance indicator – also known as the "age of plant", looks at the average age of an organization's fixed assets.
- Debt ratio – relates total debt to unrestricted net assets to provide a rough measure of financial risk

The calculation of these measures and related ratios is explained in Appendix 2. You should look at these indicators, along with the operating measures, for your museum over a three to five year time span to identify trends. You are probably aware of what some of these indicators show – for example, that you have times during the year when cash flow is tight or you have outdated equipment that needs replacement. But tracking the measures can put this information on a quantitative rather than an anecdotal level. It allows for a dispassionate analysis that makes it possible to articulate trends and financial needs.

Other Financial Responsibilities

In addition to understanding and monitoring financial statements, trustees have other financial responsibilities. The board oversees the selection of auditors and the audit process and should review and comment on the draft audit, management letter and tax return. Trustees should annually approve the selection of an audit firm to prepare an audit report that consists of the auditor's opinion, a balance sheet, income statement, statement of cash flow and footnotes. The auditor, after examining the museum's internal financial records, may issue a clean opinion (no

significant objections to the statements) or a qualified opinion (the auditor disagrees with one or more aspects of the financial statements). If the auditor questions the viability of the museum, there will be a "going concern" paragraph in the opinion. The finance (or audit) committee should review and approve the audit engagement letter and discuss any issues of concern with the auditors. When the audit is complete, the committee should meet again with the auditors to review the draft documents and understand any difficulties encountered during the process. In performing an audit it is key that the auditors complete their work with an objective state of mind, free from any influence or relationship that could impact interpretation or statement of the numbers. This independence should result in accurate financial statements upon which the museum's stakeholders can rely. The museum's tax return, or form 990, is available to the public via the Internet. The board should ensure that the return tells the museum's financial story in a desired format.

If your museum has an endowment, working capital reserves or other board-designated reserves, the board should establish policies on their investment and use. The board should ensure that any endowment maintains its value for the future while providing current income to support operations. In addition, the board should establish an endowment investment policy that balances risk and return, establish a spending rule that does not deplete the endowment, select investment managers to manage the investments, if needed, and regularly monitor investment management performance.

Finally, the board should act as a resource to management in evaluating the financial impact of operating and capital investment decisions.

Board Education and Training

Your orientation of new board members should include training on financial literacy. In addition, you may want to suggest that the treasurer and business manager do an annual educational presentation of the museum's finances to the board. Finally, there are numerous external opportunities and sources for both trustees and staff to receive financial training.

Conclusion

You now have a basic understanding of your financial oversight role as a museum trustee. In addition you have some tools to understand and analyze your museum's financial reports. If you have difficulty understanding the financial statements, the most important thing you can do is to ask questions, questions and more questions. If you are confused by the presentation or explanation of information, you probably are not alone.

Financial analysis should be considered in light of an individual museum's mission, current environment and strategy. Ultimately, financial analysis and reporting is not an end in itself but a means to inform decision making that supports the artistic mission of the museum. When you and the other leaders of your museum understand the museum's financial information and trends, you can make better financial decisions that support and enhance your artistic work and build an appropriate capital structure that best sustains the artistic goals and programs of the museum.

Appendix 1

Operating Ratios

The American Association of Museums (AAM) and the Association of Art Museum Directors (AAMD) each conduct an annual fiscal survey of museums. It is useful to compare the figures calculated below to those of museums of similar budget size in the surveys.

The first three measures look at how much of the museum's total expenses are covered variously by earned, contributed and investment revenue. Understanding trends in a museum's reliance on types of revenue may clarify changes in the operations and marketplace. Trends should be reviewed to determine whether they are consistent with the organization's strategic goals and future plans. The measures are calculated as follows:

Earned Revenue Ratio = Total unrestricted earned revenue ÷ Total expenses

Contributed Revenue Ratio = Total unrestricted contributed revenue (including net assets released from restriction) ÷ Total expenses

Investment Revenue Ratio = Investment revenue ÷ Total expenses

The program and administrative ratios measure how much of the museum's budget is spent on programs and administration:

Program Ratio = Program expenses ÷ Total expenses

Administrative Ratio = Administrative expenses ÷ Total expenses

The development efficiency ratio measures what portion of each dollar of contributions is spent to generate all contributed revenue:

Development Efficiency Ratio = Development expenses ÷ Total contributions

The marketing efficiency ratio measures what portion of each dollar of admissions is spent to generate the sale:

Marketing Efficiency Ratio = Marketing expenses ÷ Total admissions

Appendix 2

Balance Sheet Measures and Ratios

Balance sheet measures may be calculated using numbers found on the audited balance sheet, income statement, statement of cash flows and footnotes. The measures are calculated as follows.

Total Net Assets = Total assets – Total liabilities

Working Capital = Total unrestricted net assets – Property and Equipment (net of accumulated depreciation)[2] – Unrestricted investments[3]

The most prevalent format for the balance sheet does not delineate between current and long-term assets, nor does it segregate unrestricted assets and liabilities from temporarily and permanently restricted assets and liabilities, which makes a traditional calculation of working capital difficult. However, if your balance sheet includes this detail, it may be preferable to calculate working capital using the traditional ratio below:

Working Capital = Total unrestricted current assets – Unrestricted current liabilities

Endowment investments = Total investments that provide a revenue stream

Fixed Assets = Total property & equipment – Accumulated depreciation

Debt = Short-term + long-term contractual obligations

The measures may be analyzed further by calculating the ratios that follow and tracking the trends over several years.

Net Asset Ratio = Total net assets ÷ Total expenses

This ratio relates net assets to the size of an organization's operation. An increase in the ratio over time, which indicates net asset growth at least in proportion to growth in operating size, is a healthy trend.

Working Capital Ratio = Working capital ÷ Total expenses

This ratio relates working capital to the size of an organization's operation. An increase in the ratio over time, which indicates growth in financial strength at least in proportion to growth in operating size, is a healthy trend. Each museum should determine its own working capital needs, based on its yearly cycle of cash flow, and any extraordinary expenditures that are anticipated.

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[2] Property and equipment is generally unrestricted, though in some situations it may be restricted. For example, construction-in-progress that is funded by a capital campaign may be temporarily restricted until the construction is complete and the contributions are released. If fixed assets are restricted, do not subtract them from the working capital calculation.

[3] Unrestricted investments may not be broken out separately on an audit, but internal business office records should identify this figure.

Endowment Ratio = Endowment investments ÷ Total expenses

This ratio relates investments to the size of an organization's operation. An increase in the ratio over time, which indicates investment growth at least in proportion to growth in operating size, is a healthy trend.

Deferred Maintenance Indicator = Accumulated depreciation ÷ Annual depreciation expense

This ratio is used to assess the relative likelihood of deferred maintenance and the need for investment in buildings and equipment. This ratio relates total accumulated depreciation to annual depreciation (these numbers are found in the audit footnotes and statement of cash flows). An organization that invests in fixed assets at a pace that exceeds annual depreciation will show a declining trend in this ratio, which is a healthy trend. For organizations that own their facilities, a deferred maintenance indicator greater than fifteen years may indicate the need to invest in plant. For organizations that own equipment but no facility, a deferred maintenance indicator in excess of six years may indicate a need to invest in equipment.

Debt Ratio = Total debt ÷ Unrestricted net assets

The debt ratio provides a rough measure of financial risk – the higher the level of debt to net assets the higher the potential level of financial risk. This measure should be viewed in the context of working capital levels, dedicated sources for repayment of the debt, and total temporarily and permanently restricted net assets.

Glossary

Assets are all the resources owned by the museum such as cash, accounts receivable, investments, prepaid expenses, inventory and fixed assets.

Audit report consists of the auditor's opinion, a balance sheet, income statement, statement of cash flow and footnotes. The auditor, after examining the museum's internal financial records, may issue a clean opinion (no significant objections to the statements) or a qualified opinion (the auditor disagrees with one or more aspects of the financial statements). If the auditor questions the viability of the museum, there will be a "going concern" paragraph in the opinion.

Balance sheet (or statement of financial position) is one of the three primary financial statements. It summarizes assets, liabilities and net assets at a given point in time. It provides information on the financial strength and well being of the organization. It is usually prepared on a monthly basis.

Capital budget is a budget of all capital expenditures or purchases of long-lived assets for a given year and the resources that will be used to purchase them.

Cash flow projection contains details of all expected cash inflows and outflows for a given future period. (Not to be confused with the "statement of cash flows" in the audited financial statement).

Debt includes all short and long-term borrowings, including capital leases, of the organization.

Depreciation is the method used to spread the cost of fixed assets over the estimated life of the asset rather than assuming the entire cost of the asset in the year it is purchased. Each year the asset is in use bears a portion of the cost. Assets such as software may be depreciated over a short life (three to five years) and assets such as buildings are depreciated over a longer life (perhaps forty years). Accumulated depreciation is the sum of all depreciation expense since the assets were purchased.

Endowment is an established fund that is invested to produce present and future income for a museum. Endowment may be unrestricted, temporarily restricted or permanently restricted.

Expense includes the total monies expended by the museum during a given period. All expenses are unrestricted.

Fixed assets include all land, buildings, equipment and other fixed assets that are owned. Also called property and equipment or plant, fixed assets have long lives and are generally used by the museum for several years or more. See depreciation above.

Income statement (or statement of activity) is one of the three primary financial statements. It reports revenue and expenses and the related surplus or deficit for a given period.

Investments include monies usually invested long-term. It approximates reserves and endowment. Revenue from investments is available for operations or to support specific purposes.

Investment policy is a written policy that specifies how a museum may invest funds long-term. The policy usually includes ranges for the portion of the portfolio that is invested in equities, fixed income and cash. It also includes a spending rule ("see spending rule below").

Liabilities include all the obligations incurred by the museum that are unpaid.

Management letter is a document issued by the auditors at the same time as the audit that details any weaknesses in the financial systems and internal controls of the museum.

Net assets are what an organization owns after paying off all that it owes.

Operating budget is an estimate of revenues and expenses for activities that are recurring from year to year. Operating budgets do not include revenues and expenses related to capital campaigns and additions to fixed assets.

Operating ratios provide information on the trends in sources and uses of annual financial resources.

Permanently restricted assets and net assets are restricted by the donor in perpetuity. Most often, these are permanent endowment funds.

Revenue includes all sources of income earned from programs and investments and contributed by public and private sources. Contributions can be unrestricted, temporarily restricted or permanently restricted. Most earned revenue is unrestricted, but revenue from restricted investments may be restricted.

Spending rule is a formula that determines what portion of the endowment market value may be spent each year.

Statement of activity (see income statement)

Statement of cash flows, one of the three primary audited financial statements, summarizes the sources and uses of the organization's cash during the period of the income statement. It contains valuable information not available elsewhere in the audit such as investment activity, purchase of fixed assets and issuance and repayment of long-term debt.

Statement of financial position (see balance sheet)

Temporarily restricted assets, liabilities and net assets are restricted by the donor for a specific purpose or time period. These can include funds that will be used for operating activity in the future. When the restriction is fulfilled, then the net assets are released to the unrestricted operating statement.

Unrestricted assets, liabilities and net assets include your accumulated operating surpluses and deficits, your property and equipment and any board-designated funds, such as a cash reserve or endowment.

Working capital consists of the unrestricted resources available for operations.