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RED FLAGS, YELLOW FLAGS

Are Your Financial Statements Trying to Tell You Something?

Your financial reports come with warning signals. Do you know where to look for them?

Smoke detectors chirp. Automobile dashboards use an array of lights and colors. Computers flash messages in machine language. What do all of these things have in common? They are all methods of telling us when something we are using is about to stop working or go bad.

Wouldn't it be great if nonprofit organizations came equipped with built-in financial warning signals? How nice would it be if the accounting department chirped when cash was running out, or if boxes popped up on the chief executive's computer when the year's revenue is falling dangerously short of projections?

Financial statements do carry all kinds of warning signals — if you know where to look and how to interpret them. We call them red flags and yellow flags. Red flag indicators mean STOP; ask probing questions, and don't move forward until you're satisfied. Yellow flag indicators mean CAUTION; trouble may lie ahead depending on the answers to some well-formulated questions.

There are red flags and yellow flags in just about every type of financial report, but we'll concentrate on the type of financial information most board members see: the audited financial statements. This isn't an exhaustive list of flags, just a handful of the more helpful and interesting ones.

THE OPINION LETTER

An auditor's opinion letter is a rich source of red and yellow flags. It can be found just inside your audited financial statements, and is formatted like a regular letter.

The first sentence of the letter says something other than "We have audited . . . ."

An audit represents the highest level of assurance and reliability that can be given by an auditor to a nonprofit organization. If you see words such as "we have reviewed" or "we have compiled," be forewarned that the information you are about to see has not been subjected to the highest forms of testing and confirmation. In the United States, all but the smallest of nonprofits must have audits each year. Even those not required to have independent audits should strongly consider doing so, since it is the only way an organization can assure outsiders of its own accountability.

A sentence that qualifies the auditors' opinion, usually occurring somewhere in the third or fourth paragraph. The sentence may say something like "except for . . ." or "it was not possible to . . . ."

This yellow flag means the auditor is giving a qualified opinion. It may amount to little more than a technical provision, but it could suggest deeper problems in the organization. In rare instances, it can be a "disclaimer of opinion," meaning the record keeping is so bad that the auditor is unable to give an opinion at all. Read carefully, and beware of the word "except...."

The presence of the words "going concern" toward the end of the letter.
No getting around this one — it's the auditor's equivalent of pulling a fire alarm. It means the auditor is worried that the organization may go out of business within the next 12 months.

The difference between the end of the fiscal year and the date of the letter is more than 90 days.

The difference between the end of the fiscal year and the date of the letter is more than 120 days.
The date at the bottom of the page is officially considered the last day of field work or the last day the auditor spent a significant amount of time on-site. Ordinarily, audits should be wrapped up within 90 days of the end of the fiscal year. The longer the elapsed time, the greater the cause for worry, because it may suggest the nonprofit was unable to get itself organized in time to complete the audit. Ask probing questions about the reasons for the delay. Even if there are good reasons, it means the information in the audited financial statement is stale by the time the board receives it.

THE BALANCE SHEET

After the opinion letter, you'll see the Statement of Financial Position, also called the balance sheet. A flag you may find here:

Asset imbalance
Look for the single largest number under "assets." Depending on the category of asset, you could be seeing evidence of problems. 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.

If "accounts receivable" is the largest category of assets, it means the organization doesn't truly control its most valuable resource. Accounts receivable represent bills that have been sent out but not yet paid. What happens if the people or groups that received those bills never pay them? That would mean the balance sheet needs to be completely restructured, and the financial picture would look grim as a result.

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THE INCOME STATEMENT

Now move into the body of the financial statements. Look for the second page of numbers, normally titled the Statement of Activities/Income Statement.

Deficits; more expenses than revenue

You'll see parentheses around the number representing the total expenses subtracted from the total revenue. This is not a major cause for alarm, as long as the number appears manageable, but find out why there was a deficit. Is it a fluke, or yet another in a string of bad years? The answers to these questions could reassure you — or prompt you to wave a red flag instead.

THE FOOTNOTES

Finally, look at the footnotes to the financial statements. This is where you will find some juicy details. Here are a few possible flags:

Related party transactions

Not usually forbidden by law (doing so might be a restraint of trade), related party transactions can cause outsiders to question whether the organization is dealing fairly with vendors. Why did the chief executive find it necessary to award her husband that lucrative direct mail contract when there were other companies available?

High interest rates charged on short-term borrowing

Banks are pretty good at assessing risks. If they feel it is necessary to charge a high rate on a line of credit (more than about 1.25 percent over the prime rate), maybe you should be worried too.

Lawsuits against the organization

A lawsuit can devastate a nonprofit organization, even if it is unfounded. See if management's response is included in the footnote. A sad reality — the larger and more complicated your organization is, the more likely it is you will routinely have one or more active lawsuits. Check your state's liability laws. You may have more protection than you think.

Financial statements are never likely to chirp, buzz, or change colors. But they don't have to do that to be useful. They contain lots of yellow and red flags. You just have to know how to see them.

Resource: ***Understanding Nonprofit Financial Statements***