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BEHIND the NUMBERS

Nonprofit Performance Measurement:
 The Use and Misuse of Ratio Analysis
By Eric Fraint, President
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Funders, donors, executive directors, board members, and other senior organization staff members all have an interest in knowing how well the nonprofit organizations they work with are performing. A powerful tool for measuring financial performance is ratio analysis. Ratio analysis, when used correctly, provides insight to an organization's performance over time and as compared to other similar organizations. However, ratios can be misused and misunderstood. As the old saying goes, a little knowledge can be a dangerous thing. Applying ratios in a mechanical fashion without an understanding of the underlying numbers and their meanings can lead to erroneous conclusions about the performance of an organization. This article will discuss the proper use and some common misapplications of four commonly used ratios to help you avoid the pitfalls of ratio misuse when analyzing the performance of a nonprofit organization.

Current Ratio

The current ratio, perhaps the best known of all ratios, is a simple yet powerful measure of an organization's short-term liquidity, i.e., how well an organization can meet its short-term debt obligations. The ratio is computed by dividing total current assets by total current liabilities. A current ratio greater than one is desirable. It shows that the organization has more current assets than current liabilities, indicating that the organization should be able to satisfactorily meet its current obligations.

In a for-profit environment the current ratio is a simple calculation with a fairly clear meaning. However, in a nonprofit environment one needs to consider the current portion of temporarily restricted net assets. Why is this important? Temporarily restricted net assets on a nonprofit's Balance Sheet have the characteristics of a liability. To illustrate, consider this example: assume your organization has current assets of \$100,000 and current liabilities of \$100,000. Your current ratio is 1 (\$100,000/\$100,000). Assume that a funder then gives you a temporarily restricted \$50,000 grant. Your current assets now increase to \$150,000 (since the grant was received in cash or a pledge). With nonprofit accounting rules your current liabilities are unchanged since the grant was recorded as temporarily restricted revenue. If one mechanically computes the current ratio you would divide \$150,000 of current assets by \$100,000 current liabilities to arrive at 1.5, a 50% improvement over the previous ratio of 1! But are you really better off in meeting your short term needs? While you have \$50,000 of additional assets, the funds are restricted to a future period or purpose. If for some reason the restrictions were never met the funds presumably would have to be returned. These funds, therefore, are very similar in character to a liability. The solution to this problem, then, is to add the current portion of the temporarily restricted net assets, in this example \$50,000, to your liabilities. You now divide \$150,000 by \$150,000 to see that in fact your current ratio is unchanged.

Debt to Equity Ratio

A common long-term measure of liquidity is the debt-to-equity ratio. For a nonprofit organization, this is computed by dividing long-term debt by total net assets. A better calculation would exclude permanently restricted net assets since those assets would not be available to pay down the debt. High debt-to-equity ratios may indicate an organization with long-term liquidity problems.

Here again one must be careful to avoid the mechanical application of this seemingly simple ratio. Consider this example: an organization's audit report shows \$1.8 million dollars of long-term debt and only \$600,000 of net assets. A mechanical application of the debt-to-equity ratio would produce a ratio of 3—a troubling result. Such an organization, absent other mitigating factors, would appear to be over-leveraged. Assume further, though, in this example that the organization's audit report reveals in its footnotes that almost all of the long-term debt is in the form of forgivable loans. This type of loan is common with social service agencies that may get support in the form of loans that are forgivable at some future point in time. Clearly, in this example, the forgivable loans, since they never have to be repaid, are not true long-term debt obligations and, as such, should be excluded from the calculation of this ratio. The long-term viability of this organization suddenly improves dramatically with this important information gleaned from the audit report footnotes.

Financial Flexibility Ratios

Financial flexibility refers to the flexibility of an organization's capital structure. Organizations with Balance Sheets heavy with fixed assets, buildings for example, are considered to be less flexible financially than an organization with assets invested in marketable securities, as buildings cannot be sold as quickly as securities and therefore cannot be converted to cash easily. One ratio to measure this would be to take fixed assets, net of depreciation, and divide by total assets. The closer the ratio to one, the less financially flexible is the organization.

A problem with this financial flexibility ratio is that it does not take into account that an organization heavily invested with fixed assets in the form of real estate can probably quickly turn its equity into cash by borrowing money from a bank using the asset as collateral. Furthermore, if the real estate was purchased many years ago, the market value of these assets may be significantly higher than the carrying value on the organization's Balance Sheet, further enhancing the organization's borrowing capacity.

Profitability Ratios

Measuring profitability in a for-profit environment is usually simple enough—divide net income by sales—with the higher the ratio the better. However, in a nonprofit environment things are, once again, not so simple. First, while a nonprofit does need to break even, or show a surplus to cover its costs, too much positive net income, or increase in net assets, may be a bad thing. It may indicate that the organization is not spending enough money on its programs. Secondly, nonprofits have at least three types of changes in net assets: one each for unrestricted, temporarily restricted, and permanently restricted net assets. Which ones should a profitability analysis be based on? Due to nonprofit accounting rules relating to revenue recognition of multi-year grants, looking at the total net change in assets rather than a subset of the three types may be misleading.

Consider this example: assume an organization's audit report shows a loss for the year of \$75,000 on total revenue of \$750,000. This organization has a negative profitability ratio of 10%.

Assume, however, that the \$75,000 loss is a combination of a positive

change of \$25,000 in unrestricted net assets and a negative \$100,000 change in temporarily restricted net assets. The positive increase of \$25,000 of unrestricted net assets is a more meaningful indication of the results for the year. The change in the temporarily restricted category is likely the result of a multi-year grant received in a previous year with the \$100,000 loss resulting from restrictions expiring this year.

In conclusion, ratio analysis can provide many useful insights into an organization's performance. But organizations must use these ratios wisely to derive their full benefit.

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