



Case for Capital Financial Reporting Done Right

By Rebecca Thomas and Rodney Christopher

In *The Case for Change Capital in the Arts*, Nonprofit Finance Fund discusses the broad needs for and uses of capital in the arts. We share how ten performing arts organizations are applying one form of capital — change capital — to realize their artistic and organizational ambitions. We outline core principles and practices that can improve all types of capitalization in the sector but that will require changes in behavior by both nonprofits and funders alike.

One necessary change is to improve the transparency around how organizations manage their capital resources by segregating capital from revenue in financial statements. Conventional nonprofit accounting and reporting allow for the treatment of revenue and capital as the same. The problem is that when capital and revenue are conflated, an organization's reports show an overly optimistic picture of operating health. Organizations that have had capital campaigns for facility projects are familiar with this situation: the capital is often treated as regular revenue, while the expenditures on fixed assets show up on the balance sheet (they are not operating expenses), leading to the communication of an inflated financial performance.

As periodic and extraordinary infusions, capital of all kinds should be managed and accounted for separately.

While NFF is increasingly seeing audits and internal documents that separate capital from revenue, they remain the exception. As a result, users of financial information (whether nonprofit leaders, boards or funders) may be making important decisions based on unintentionally misleading data. In too many cases, organizations are using their incomplete financial reports to justify increased expenses

that true revenue cannot cover. Separating capital flows tells a more accurate story of core operations by pulling away the obscuring effects of capital.

The good news is that nonprofit managers can address this commingling and conflation by making straightforward adjustments for capital in financial reports. When properly discussed with an auditor, this presentation is compliant with Generally Accepted Accounting Principles; management can adopt this treatment for internal reporting regardless of whether it makes the adjustment to audited financials.

When reporting on the raising and expenditure of change capital specifically, this technique provides critical clarity about how an organization is progressing against its plan to adapt in ways that are viable over the long term. The technique allows an organization's leadership and funders to answer the questions:

- Are the capital investments we are making resulting in revenue that progressively covers ongoing costs?
- Do we have enough capital to realize the desired change?
- If not, how much more do we need to raise?

Among the central characteristics of change capital is that its deployment should improve an organization's net revenue (i.e., revenue minus expenses). Therefore, it is important that organizations and investors have access to financial projections and reports that show clearly the proposed and actual progress toward the achievement of net revenue.

This new way of reporting will feel countercultural to some. If broadly accepted by donors and nonprofits as a more transparent way of showing true performance and progress toward a changed state, it can only benefit the entire field.

An investment of capital is typically recorded upon its receipt as temporarily restricted “revenue” on the Statement of Activities (Income Statement) and as temporarily restricted net assets on the Statement of Financial Position (Balance Sheet). Under standard accounting, the capital is released from restriction on the Income Statement, becoming unrestricted revenue, as the funds are used for their intended long-term purpose each year. (This is similar to how any restricted grant would be treated.)

NFF’s proposed reporting technique is distinct from common practice in that the releases of capital from restriction are reported separately from revenue for operations; they are typically presented below the change in unrestricted net assets (i.e., surplus/ deficit) line on the Income Statement.

Figure 1

Figure 1, on the following page, illustrates NFF’s recommended reporting technique in contrast to conventional reporting. The “Conventional Reporting” column, which follows current standards, shows break-even operations that may be interpreted as indicative of adequate financial performance.

However, in this case, a portion of the contributions released from restrictions (\$250K) actually represented a capital investment. When capital is removed from operating revenue, per NFF’s “Recommended Reporting,” it becomes immediately clear that the same organization in the same year actually experienced a \$200K operating deficit (negative change in net assets).

In certain situations, the revelation of an operating deficit may be cause for concern. If the capital had been received for a facility project or other sizeable balance sheet investment, this reporting format would reveal that the organization had been unable to cover its operating expenses with regular revenue.

However, when capital is raised and released against a long-term plan for change, temporary deficits in operations are likely to occur as the organization makes progress toward a new business model that covers its costs. In this

case, the format would show that capital funds were being used appropriately to cover these planned deficits.

The amount of change capital released each year should be at least equal to: 1) any temporary deficits incurred as the organization makes adjustments to its revenue and cost structure and 2) any one-time or extraordinary expenditures or additions to the balance sheet (such as reserve building) that are associated with the change. Typically, the amount of change capital released diminishes each year as deficits narrow and the organization makes progress toward a business model characterized by recurring net revenue (revenue minus costs) and stable operations that support its program goals.

Figure 2

Figure 2, on the following page, illustrates the recommended reporting of financial projections for an organization using \$700,000 in change capital. Notice how the nonprofit expects to have an operating deficit that decreases over the five-year period during which it is deploying capital. By the end of the period, its operations break even.

Benefit of this Reporting Technique

Transparency for all parties is an obvious benefit to the field. However, from a practical management standpoint, reporting capital separately from revenue improves the chances that an organization’s leadership will identify when their original plan is veering off course. As a result, it becomes possible to make course corrections — based on real data about operational health. While no organization is likely to devise the perfect plan and execute it as written, this reporting technique makes it easier to see an organization’s true operating performance as capital is deployed.

To be sure, improved reporting is not a substitute for data-based decision making. But, clearer communication of financial performance can equip managers, board members and funders with the information they need to inform actions that improve an organization’s chances of long-term vibrancy.

Figure 1: Conventional vs. Recommended Reporting

\$ in thousands, represents only unrestricted funds	Conventional Reporting	Recommended Reporting
Operating Revenue		
Earned		
Tickets	500	500
Contracts	300	300
Commissions	65	65
Total Earned Revenue	865	865
Contributed		
Individuals	45	45
Government	40	40
Foundations	150	150
Net Assets Released	400	150
Total Contributed Revenue	635	385
Total Operating Revenue	1,500	1,250
Operating Expenses		
Salaries & Benefits	1,050	1,050
Consultants	225	175
Occupancy	75	75
Support	150	150
Total Operating Expenses	1,500	1,450
Change in Net Assets (Surplus/Deficit)	0	(200)
Non-Operating Expenditures		(50)
Capital Received		700
Capital Released		250
Total Change in Net Assets Operating & Non-Operating	0	0

Legend

- Net Assets Released conflates capital (\$250K shown below) and revenue (\$150K) in "Conventional Reporting," overstating health of regular operations.
- Operating Revenue should include regular revenue and any new recurring revenue that will be generated as capital is invested to support the cost structure.
- Operating Expenses include costs that are a part of regular operations and new expenses that have/will become part of ongoing operations as capital is used. Conventional reporting often commingles Operating and Non-Operating Expenses.
- Change in Net Assets is overstated when Capital Released is considered ordinary revenue. Our Recommended Reporting shows true operating performance.
- Non-Operating Expenditures represent one-time or episodic costs that are not associated with regular operations but are covered by Capital Released. When capital is used to make balance sheet investments (such as a reserve or facility project), organizations may indicate these items below the Total Change in Net Assets line. Balance sheet investments would not show up on the income statement of audited financials.
- Capital Released is separated from Net Assets Released to provide an accurate picture of Operating Revenue. It is sufficient to cover the Deficit and Non-Operating Expenditures. Capital Received* is also separated from Contributed Revenue.
- Total Change in Net Assets, the difference between Operating and Non-Operating Revenue and Expenses, is the same.

*Capital Received may be temporarily restricted.

Figure 2: Financial Projections, Recommended Technique

\$ in thousands, represents only unrestricted funds	2011	2012	2013	2014	2015
Total Earned Revenue	865	880	890	900	950
Total Contributed Revenue	385	400	430	450	500
Total Operating Revenue	1,250	1,280	1,320	1,350	1,450
Total Operating Expenses	1,450	1,475	1,450	1,450	1,450
Change in Net Assets (Surplus/Deficit)	(200)	(195)	(130)	(100)	(0)
Non-Operating Expenditures	(50)	(25)	0	0	0
Capital Received	700	0	0	0	0
Capital Released	250	220	130	100	0
Total Change in Net Assets Operating & Non-Operating	0	0	0	0	0
Cumulative Use of Capital	250	470	600	700	700

Among the things NFF has learned in our work with nonprofit organizations is that this recommended change in reporting is uncomfortable for many. Organizations may show operating deficits in the early years of implementing a change strategy. In this environment, where deficits may be interpreted as indicative of poor management or worse, questionable viability, few want to show deficits even if those deficits are covered by capital.

The distinction between capital and revenue is the norm among for-profit businesses. The reporting approach described here is intended to adapt this practice to the very distinct needs of nonprofits. Thus, while the result may seem rather unfamiliar to nonprofit managers and funders, it may well resonate with staff and board members who bring their commercial perspectives along.

NFF recommends that nonprofits receiving capital for any purpose make a commitment to use this reporting technique first in their internal management reports. (Changes to basic bookkeeping and accounting may not be required. The technique asks nonprofits to implement some modest adjustments to the data that is generated by their accounting software before sharing it as a report.)

After a quarter or two, when management has gained comfort with interpreting and articulating how the organization is deploying capital to invest in the long-term health of its programs and operations, these reports should be shared with the board. Some early discomfort may be alleviated by showing both methods side by side, to make abundantly clear how capital flows are veiling operations. When donors and funders are providing substantial amounts

of capital — especially change capital — nonprofits should be prepared to share their internal reports in this new format with those investors.

To the donors and funders who do and will provide capital to nonprofits, NFF recommends that they exhibit patience as organizations learn to absorb this level of transparency. Wherever possible, such investors should encourage nonprofits to make adjustments to their plans and the timing of their expenditures of capital, rather than punish them when things inevitably do not go according to plan.

A field-wide shift toward distinguishing capital from revenue will take some time and involve a learning curve for many organizations. By allowing managers to see and react more quickly to their ongoing economics, this transparency ultimately supports stronger decision making. More informed decision making will go a long way toward ensuring the long-term success of nonprofit organizations everywhere.

Organizations require both capital and revenue to survive and thrive. Funders have a responsibility to articulate to nonprofits whether they will be builders of healthy organizations, necessary annual supporters, or both. Nonprofits have a responsibility to articulate the size and scope of their need for each kind of money. Separating capital from revenue in internal planning and reporting at a minimum — and desirably, in audited financial statements over the longer term — is a first and significant step toward more open communication and hopefully, more appropriate funding and financing for the field.