The importance of having in place a comprehensive financial reporting & forecasting tool

Many non-profit organizations, like their fellow for-profit companies, have compliance covenants that have to be met at periodic intervals, often at year end. For example, if a non-profit organization has a bank loan or a public bond, the governing documents (the loan agreement or the bond issuance documents) will almost certainly contain a series of compliance covenants. Those covenants will typically cover such things as –

- The requirement to file quarterly financials (P&L's and Balance Sheet) within 45 days of the end of each quarter.
- The requirement to notify the lender, or the bond administrator, of any material adverse event that may have occurred during the past quarter.
- The requirement that the organization obtain audited financials prepared in accordance with GAAP at the end of each year and that these be forwarded to the lender or bond administrator within a specific number of days after the financial year end eg. 120 days after year end.
- The requirement to meet certain financial ratios at the end of each financial year. These ratios typically include –
    - The Debt Service ratio. This ratio, often the most difficult to comply with, measures the ability of the organization to service the debt on its Balance Sheet. The formula to calculate the Debt Service ratio is Net Income before Depreciation, Amortization and Interest (numerator) ÷ Interest Expense + principal payments (denominator). The minimum ratio specified in the covenant will often be 1.2 to 1.35.
    - The Current ratio. This ratio is Current Assets ÷ Current Liabilities, and a typical ratio minimum mandated in the applicable covenant might be 1.5.
    - Days Cash on Hand. The formula to calculate this is Cash & Cash Equivalents + Investments on hand at the end of the year (e.g. money market or brokerage funds) (numerator) ÷ Total Expenses for the previous year before Depreciation and Amortization (denominator) X 365.
    - Net Worth. This is simply the total of Net Assets for the non-profit, on the Balance Sheet at year end. The covenant might specify that the organization has to maintain a certain minimum Net Worth.

These are the some of the typical financial covenants that both non-profit and for-profit organizations have to comply with, the most onerous being the year end covenants. In addition to these, often non-profits have quite a bit of other compliance. For example, grantors often impose conditions that must be reported on and complied with. Accordingly, non-profit organizations typically have a range of compliance that they have to perform annually and sometimes quarterly as well. All of this compliance has implications for the type of Accounting software used by the non-profit. But that is the topic for a subsequent article.

The purpose of this article is to discuss why a non-profit organization might want to have a comprehensive monthly financial reporting and forecasting package in place. It is important that every well run organization, be it non-profit or for-profit, have in their arsenal a comprehensive financial reporting and forecasting tool. To persuade the reader of the truth of this proposition, we're going to walk through a couple of real-world scenarios, situations that occur every day in organizations across the country.

Let's assume we are a non-profit organization, and that we have a $500,000 loan from a local bank. The loan document has all of the covenants mentioned above. Our non-profit operates on a June 30 year end. Our loan covenants require a minimum Debt Service ratio of 1.3 at year end, a current ratio of 1.4 at year end, a minimum Net Worth (ie. Net Assets in non-profit parlance) of $2.5M, and a minimum of 150 days for the Days Cash on Hand covenant.

We're going to explore two scenarios. In one scenario our non-profit has a good monthly financial reporting and forecasting package in place. In the other scenario it doesn't.

At December 30, halfway through our financial year, we become aware that our largest grantor is cutting the amount of the grant of $1M that he normally provides to us each year, by 50% i.e. we're getting $500,000 for the year instead of $1M. We've already received the $500,000 in our first half; thus, no additional $500,000 will be forthcoming in the second half of our year.

In our non-profit with the monthly financial reporting and forecasting package in place, we will immediately put this piece of bad news into our reporting and forecasting model. Accordingly, our total year Revenue forecast will be $500,000 less than we'd budgeted at the beginning of this financial year. We run our forecasting model with the revised total year Revenue number, and find that at the end of our financial year (6/30) we are likely to not be able to meet our 1.3 Debt Service covenant, because of this $500,000 shortfall in expected total year Revenues. When we realize this, at December 30, we write to our loan officer and explain to him that we expect that we'll be in default of our Debt Service covenant at 6/30, in 6 months' time, because of an unanticipated Revenue shortfall. Put another way, our financial reporting and forecasting package allows us to anticipate a likely default 6 months before it will actually occur. The advance notice we've given our lender is not only appreciated; it affords him time to notify his superiors of this likelihood, and respond to us in a considered fashion, well in advance of this default actually occurring. It also communicates to our loan officer the message that we're anticipating what our situation will be well into the future. Our loan officer thanks us for notifying him in advance, and tells us he has organized a waiver of this covenant, should we end up not making the 1.3 covenant minimum.

Now let's look at the same set of circumstances, except that our non-profit does <u>not</u> have in place a financial reporting & forecasting package. The lack of this package means that we don't know whether the Revenue shortfall that we learned about in December is likely to cause us to default on our Debt Service covenant at the end of our financial year. So we don't write to our loan officer. We proceed through the rest of our financial year and at the end of it we discover that we didn't make our Debt Service ratio. We are in default. At this point we have to write to our loan officer and request a waiver of this default. Our loan officer has limited time to react, and the default has already occurred. He might decide to accelerate the loan because of the default, rather than providing us with a waiver. Even if he does provide us with a waiver, our auditors are likely to insist that our default be disclosed in our year end published financials. This in turn may adversely impact our grants in the subsequent year because grantors will read our financials and discover this default. None of the consequences that flow from this are likely to be good.

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A significant advantage of having in place our financial reporting & forecasting package, is that we know at December 30, well in advance of our financial year end, that we're likely to be $500,000 short. and what the most likely effect of this is going to be on our total year numbers. And we still have 6 months before our year end, to react to and potentially alter our total year numbers. We may be able to replace this $500,000 with a similar amount from another source. Or we may decide that because of this Revenue shortfall, we are going to have to cut some costs, in order to minimize the impact of this Revenue shortfall on our total year earnings. In fact, because we have in place our forecasting model, we can simulate exactly what impact various changes, like cost cuts, and Revenue shortfalls, will have on our total year earnings numbers.

A comprehensive financial reporting & forecasting package enables us to take a proactive stance; to anticipate the effect various real-world events will have on our total year earnings, and, among other things, our compliance covenants. And it provides us with this information at a point where we can take action to positively change our trajectory.

Are you convinced of the benefits of having in place a comprehensive financial reporting & forecasting package?

The next article in this series will build on this one, discussing the key components comprising a financial reporting & forecasting package, and how to design and implement this tool in your organization.

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