understand what portion of spending goes directly to program services in contrast to support services.

quick ratio. Cash, marketable securities, plus receivables divided by current liabilities. This *liquidity ratio* is a more stringent test of the ability to meet current obligations as they come due than the widely used *current ratio*. Sometimes called the acid test.

ratio analysis. Comparison of one number with another in order to gain insight from the relationship between the numbers.

receivables turnover. Revenues and support divided by accounts receivable; see also *average collection period.*

return on assets (ROA). Increase in net assets divided by total assets; *profitability ratio* that measures the rate of return the organization earns on its total assets.

return on equity. *Profitability ratio* that assesses the amount of profit earned on each dollar of equity.

return on net assets (RONA). Increase in net assets divided by net assets; profitability ratio that measures the relative increase in net assets.

review of financial statements. Auditor review for form and accuracy; in a review, the auditor does not perform the extensive testing of records and detailed review that are part of an audit.

solvency. Ability to meet current and future obligations.

times-interest-earned ratio. Income before interest expense divided by interest expense; this *coverage ratio* assesses the ability of the organization to make its required annual interest payments.

total asset turnover. Total unrestricted revenues and support divided by total assets; this *asset turnover ratio* assesses the number of dollars of revenue and support generated for each dollar invested in assets. The more revenue and support per dollar of assets, the more efficiently the organization is using its investment in assets, other things being equal.

total margin ratio. *Profitability ratio* that compares the excess of revenues over expenses with total revenues to determine the overall profits earned, including all sources of revenues and expenses, per dollar of revenues.

Questions for Discussion

14-1. The primary purpose of an audit is to discover fraud. True or false? Explain.

14-2. Who takes primary responsibility for audited financial statements issued to the public?

14-3. What is covered in the three paragraphs of the typical audit opinion letter?

14-4. In general, what are healthy signs in the cash flow statement?

14-5. Why are financial statements accompanied by notes?

14-6. What are the major classes of ratio analysis? What can we learn from each class?

14-7. What are the major elements of financial statement analysis?

14-8. What types of comparisons should be made with ratios?

14-9. What are some potential problems with ratios?

Problems

14-10. Exhibits 14-8 and 14-9 present the statements of financial position and statements of activities for the Disabled American Veterans (DAV) Charitable Service Trust. For both 2007 and 2006, calculate:

a. common size ratios for the statements of financial position and statements of activities,
b. the current ratio,
c. days of cash on hand,
d. the debt ratio,
e. the debt to equity ratio,
f. the total margin ratio, and
g. the program services ratio.

14-11. Refer to the 2007 annual report of the American Civil Liberties Union (ACLU) in answering the following questions. The ACLU financial statements are located in the Student Resources Folder of this book's Web site at www.pearsonhighered.com/finkler.[8]

1. Do the financial statements reflect the activities of the ACLU local affiliates? How do you know?

[8] This problem and its solution were written by Drew Franklin. Used with permission.

Exhibit 14-8

Disabled American Veterans (DAV)
Charitable Service Trust
Statements of Financial Position
As of December 31, 2007 and 2006

Assets	**2007**	**2006**
Cash and Cash Equivalents	$ 1,909,606	$ 1,044,193
Interest and Dividends Receivable	61,244	52,582
Campaigns' Pledges Receivable—Net of allowance for assessment fees and uncollectible pledges of $449,162 in 2007 and $464,486 in 2006	373,788	358,632
Prepaid Expenses and Other	16,244	25,367
Investments	10,944,924	9,653,039
Total	$ 13,305,806	$ 11,133,813
Liabilities and Net Assets		
Liabilities:		
Accounts payable—DAV	$ 201,721	$ 171,550
Accounts payable—other	910	1,017
Annuity payment liability	3,857,262	3,679,148
Total liabilities	4,059,893	3,851,715
Unrestricted Net Assets	9,245,913	7,282,098
Total	$ 13,305,806	$ 11,133,813

Source: http://www.dav.org/cst/documents/cst_annual_report.pdf

2. Did the ACLU receive any endowment type donations during 2007? How do you know?
3. How much did temporarily restricted net assets change during the year ended March 31, 2007? How much of the temporarily restricted net assets became unrestricted in that year?
4. Under the approach used by the ACLU, which of the following would be considered to be cash equivalents?
   a. Checking account
   b. Savings account
   c. Three-month treasury bill
   d. Six-month treasury bill
   e. One-year treasury bill
5. How might you assess the ACLU's short-term liquidity? Is the trend improving or deteriorating? What do you think of the trend?
6. The ACLU had a decrease in net assets for the year ending March 31, 2007. Calculate the total margin for 2007 and 2006. Is the trend improving or deteriorating? Are there any elements in the calculation that might lead you to believe that one year is worse than the other? Explain.
7. Describe how you might measure *Return on Net Assets* to assess the ACLU's profitability. What does this measure reflect in terms of the organization's financial position?
8. Describe the organization's use of financial leverage and its implications on financial position.
9. If you were a fund-raising manager for the organization, and your compensation was somewhat tied to dollars raised, would you rather be focused on new membership or current members?
10. The ACLU reports its program services expenses separately from supporting services expenses. Do generally accepted accounting principles require the organization to make this distinction? Why or why not? Why and for whom might this distinction be informative?
11. Suppose you have a friend who is considering making a donation to the ACLU. She wants to know how much of her money would go directly to the organization's major activities as opposed to paying for administrative expenses. Which ratio would you advise her to use? Calculate the values for 2006 and 2007. Did the

EXHIBIT 14-9

Disabled American Veterans (DAV)
Charitable Service Trust
Statements of Activities
For the Years Ended December 31, 2007 and 2006

	Unrestricted	
	2007	**2006**
Support and Revenue:		
Contributions—net of assessment fees and provision for uncollectible pledges of $428,587 in 2007 and $433,252 in 2006	$ 4,771,172	$ 2,654,400
Contributions of charitable gift annuities	241,245	178,626
Bequests	2,178,924	32,436,803
Investment income—net	766,580	384,670
Total support and revenue	7,957,921	35,654,499
Expenses:		
Program services	6,053,675	34,754,236
Management and general	85,933	75,499
Fundraising	179,277	168,316
Total expenses	6,318,885	34,998,051
Change in Net Assests before Change in Unrealized Appreciaion of Investments	1,639,036	656,448
Change in Unrealized Appreciaion of Investments	324,779	428,159
Change in Net Assets	1,963,815	1,084,607
Net Assests—Beginning of year	7,282,098	6,197,491
Net Assests—End of year	$ 9,245,913	$ 7,282,098

Source: http://www.dav.org/cst/documents/cst_annual_report.pdf

ratio improve or worsen between 2006 and 2007? Explain.

14-12. Refer to the 2002 annual report of the Make-A-Wish Foundation (Wish), in answering the following questions.[9] The complete report is located in the Student Resources Folder of this book's Web site at www.pearsonhighered.com/finkler.

1. Did the accounting firm of KPMG audit all of the Make-A-Wish Foundation chapters? How do you know?
2. Would you say that the financial statements are free of error, since they have been audited by a CPA?
3. What was the range of the cost of wishes granted in 2002? How do you know?
4. Under the approach used by Wish, which of the following would be considered to be cash equivalents?
   a. Checking account
   b. Savings account
   c. Three-month treasury bill
   d. Six-month treasury bill
   e. One-year treasury bill
5. Is there any difference in the way that Wish treats the donation of land, buildings and equipment from the way it treats the contributions of cash that are restricted for the purchase of land, buildings, and equipment? If so, how, and how do you know? If not, why not?

[9] This is adapted from a final exam prepared by Dwight Dension, Steven Finkler, Robert Purtell, and Edward Roche. Reprinted with permission.

6. Wish records supplies using the FIFO method. Assuming that there has been an average rate of inflation of 2.5 percent in recent years, if Wish used LIFO would they have reported a higher or lower increase in net assets than they did using FIFO?
7. In their notes, Wish indicates that it performs eight functions, listed below. Which of these eight qualify as program services, as opposed to support services?
   a. Wish granting
   b. Chapter support
   c. Program-related support
   d. Committee and board support
   e. Training and development
   f. Public information
   g. Fund-raising
   h. Management and general
8. Wish had a decrease in net assets for the year ending August 31, 2002. Would you say that a sizeable portion of that decrease resulted from stock market losses on Wish's investment portfolio? Explain.
9. Did the amount of land Wish owned increase or decrease during the year ending August 31, 2002? How do you know?
10. How much did permanently restricted net assets change during the year ending August 31, 2002? How much of the temporarily restricted net assets as of August 31, 2002 are restricted for the specific purpose of wish fulfillment?
11. Does Wish include any provision (i.e., liability) for lawsuits in its financial statements? How do you know?
12. What is the Program Services Expense Ratio for Wish for the year ending August 31, 2002?
13. What were fund-raising costs, as a percent of total revenue and other support, for the years ending August 31, 2002 and 2001?
14. a. What percent did Program Service Expenses grow from 2001 to 2002?
    b. What percent did Support Service Expenses grow from 2001 to 2002?
    c. Which is growing at a faster rate, Program Service Expenses or Support Service Expenses?
15. Did Wish meet any donor restrictions during the year ending August 31, 2002, allowing restricted contributions to become unrestricted? If so, how much?
16. What is the unrestricted total margin for the year ending August 31, 2002?
17. From the combined statement of cash flows we see that the change in contributions receivable required a negative adjustment of $710,659 for the year ending August 31, 2002. How would you interpret this adjustment? Explain.
18. Cash used for investing activities was over $9 million. Should we be concerned with this cash decrease? Why or why not?
19. Looking at Wish's assets on the combined statements of financial position, would you consider investments to be short-term or long-term? Why?
20. Assuming that the obligation to international affiliates is short-term, and deferred rent is long-term, what is the current ratio for 2002?
21. What is the ratio of total debt to equity for 2002?
22. Based on your calculation of total margin, current ratio, and debt to equity, in Questions 16, 20, and 21, and your overall review of the financial statements and notes of Wish, how would you categorize their financial position? Circle just one answer.
    a. Weak
    b. Neutral
    c. Strong
23. What is your overall assessment of the finances of Wish?

Case Study Problem

14-13. For the Major Medical Center financial statements on the following pages, complete the following:
   a. Read the auditor's opinion letter. Are any flags raised?
   b. Review the financial statements. Search for unusual items. What things catch your eye on the balance sheet, operating statement, and cash flow statement?
   c. Review the notes. Do any of them raise cause for concern?
   d. Calculate the following ratios: common size, current, quick, days of cash on hand, receivables turnover, average collection period, fixed asset turnover, total asset turnover, debt, debt to equity, times-interest-earned, operating margin, total margin, ROA, and RONA.
   e. What do you think of Major Medical Center's financial status?