Module 4
Fiduciary Responsibilities and Financial Management: Getting the Most for Your Money

Introduction and Overview

Some Basic Accounting Concepts

Assets — "What you own"

Liabilities — "What you owe"

Equity — Known as "Fund balance"

Revenue — "What is earned"

Expense — "What has to be paid to stay in business"

Net Worth — Assets - Liabilities

(Di Lima and Johns, 1996:5:1-2)

> Nonprofit is a tax status, not a business plan.
>
> Anonymous, (National Center for Nonprofit Boards, 1998)

Goals of Financial Reporting

Standard financial reports of nonprofit organizations are not very different from profit companies. The basic elements are the same and are closely tied to cost, revenue and sales volume. Board members must learn to read and interpret financial statements and documents. They do not have to be experts, and they do not have to create financial reports. Accountants do that work for the organization (Di Lima and Johns, 1996:5:17).

Individuals who join the board of a nonprofit organization may think of their responsibilities in terms of how much money he or she should give or which committees he/she will serve on. They may not realize a board member's responsibilities encompass far more. Board members are responsible for the corporate survival, financial viability and program success of an organization. Most important, for purposes of this booklet, they have a fiduciary responsibility (National Center for Nonprofit Boards, 1998).

The concept of fiduciary responsibility — a trust held for the greater community — precedes modern times. Throughout history, from ancient Athens to the American frontier, individuals in the community have been selected to protect the common good — to make and enforce laws, spend public funds or care for the sick. Today's board members, as custodians of something of value to the community, have a similar role (National Center for Nonprofit Boards, 1998).

Board members must understand the issues important to financial integrity and solvency, safeguards and procedures to protect the organization, and signs of financial trouble.

Armed with this knowledge, they will be able to protect and enhance the nonprofit organization's capacity to serve the community (National Center for Nonprofit Boards, 1998).

Important Purposes of Financial Reports

1. To measure financial performance.
2. To monitor changes in financial performance.
3. To target operational changes. (Di Lima and Johns, 1996:5:172)

Board Members Must Monitor Five Areas

1. Spending
2. Profit Performance - Now
3. Profit Performance - Past
4. Profit Performance - Future
5. Cash Availability - Now and Short-Term (Di Lima and Johns, 1996:5:17)

Section I: Financial Issues Board Members Should Address

All nonprofit board members share certain financial concerns that involve the basic health and welfare of the organization. An effective board member should raise the questions listed below at least annually:

Financial Planning

Many nonprofits try to do too much. A sound strategic plan linked with a realistic financial plan will ensure the organization is using its resources effectively. As part of the planning process, the board should work with the staff to identify the organization's mission, develop a strategic plan to fulfill that mission and identify and select programs to achieve strategic goals and objectives.

The planning process should include:

- An evaluation of existing and potential financial resources;
- An examination of internal and external environmental forces affecting the organization and its funding;
- A review of the cost and effectiveness of existing programs; and
- An examination of alternatives and their financial implications.

Once the board has determined programs, time lines and basic costs, those responsible for implementing the programs should be assigned the task of developing the budgets needed to get the job done. Budgets should cover at least one year, and preferably two or more. The benefits of multi-year budgeting easily offset the time required to implement it. Given the great importance of this process, sufficient time and training should be provided to see that the job is done right. Many nonprofits allow three to six months to develop their budget. This process should not be hurried
— too much is at stake.

Questions the Board Should Ask

1. Do we have a current, functional strategic plan? If so, has it been updated in the last three years?
2. Is our financial plan consistent with our strategic plan?
3. When was the last time we reviewed the usefulness of each of our programs?

Sufficient Available Cash

The availability of sufficient cash is critical to any nonprofit operation, for cash is the fuel on which the economic engine runs. Typically, a nonprofit organization will find it satisfactory to hold sufficient cash in a checking account to pay salaries and

expenses for one month. If this is not sufficient cash in the bank, the availability of certificates of deposit or other investments that can readily be converted into cash can allay concerns. Some organizations maintain a line of credit or other borrowing ability to ensure they have enough cash available.

If an organization is short of cash, it should project the amount of cash that should be on hand at the start of each future period, how much will be received or spent during that period, and what will remain at the end of the period. Cash-flow projections are usually done on a monthly basis, although some organizations will project weekly or even daily if they are truly cash poor.

Many organizations use computerized financial spreadsheets to maintain 12 months of cash-flow projections on an ongoing basis. A nonprofit organizations' cash-flow history can help financial managers estimate the current year's cash flow more accurately.

Cash flow projections also enable the organization to plan for the purchase of new equipment and other essentials.

Questions the Board Should Ask

1. Is our cash flow projected to be adequate?
2. Are our cash-flow projections reasonable, objective, and not overly optimistic?

Satisfactory Reserves

Nonprofit organizations should monitor their financial strength to be certain they can continue to perform their important services whatever problems the organization faces or whatever happens to the economy as a whole. One gauge of financial strength is the level of reserves of the organization (National Center for Nonprofit Boards, 1998).

Reserves can be defined in different ways. The simplest definitive assets (or things of value) the organization owns, minus the organization liabilities (or debts). The remain- der is the fund balance, or reserve (National Center for Nonprofit Boards, 1998).

There are problems with this approach. Reserves are useful for such planned events as launching new programs, but they are required when a financial crisis occurs.
Inventory and fixed assets, such as furniture, equipment or buildings, while useful, usually cannot help avert a crisis. Similarly, long-term debts, such as a mortgage on a building, will not necessarily make a current crisis worse, because they are paid off over a long period of time. Also, certain funds held by nonprofits are restricted in how they may be used and will not be available in a crisis unrelated to their restricted purpose (National Center for Nonprofit Boards, 1998).

Reserves might best be defined as those unrestricted assets that are reasonably liquid, minus those liabilities that must be paid off fairly soon. Therefore, a more conservative definition of reserves would be the organization's current assets, minus inventory, less its current liabilities (National Center for Nonprofit Boards, 1998).

Nonprofit organizations can build their reserves only by running at a surplus, whether the surplus is a result of regular operations or special fund-raising efforts. An organization with accumulated reserves will have funds available to invest in equipment and property, apply to program expenses and protect the organization during periods when revenue falls below expenses. Net income builds a surplus, sometimes quickly from such events as a major fund-raising campaign, but usually slowly over time (National Center for Nonprofit Boards, 1998).

The level of reserves that is appropriate varies from organization to organization. Most experts agree that if one year's operating expenses are "in reserve," the organization is in a strong financial position. Most organizations, however, are not able to achieve this level. Each organization should take into account its own circumstances, considering cash flow, capital requirements, etc., and set a reasonable reserve level. Obviously, a foundation will require far greater reserves. On the other hand, a small or newer operating nonprofit might well be lucky to have 10 to 20 percent of a year's expenses in reserve. Practically speaking, 35 to 40 percent of a year's expenses should provide sufficient "breathing room" for nonprofits with reasonably stable sources of income. Whatever target level is selected, the organization should build to this level over five to 10 years by funding reserves as a line item in the budget (National Center for Nonprofit Boards, 1998).

Naturally, organizations that have restrictions on the use of certain funds, such as an endowment fund that allows use of only the income and not the principal, would require more substantial reserves to be able to continue functioning effectively (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Do we have sufficient reserves?
2. Has the board adopted a formal policy for the establishment of reserves?
3. If we have permanent endowments, has the board considered a spending rate policy to ensure the safeguard of the principal?

Relationship Between Revenue and Expenses

If the organization's expenses are rising or falling at the same pace as its revenue, then expenses are said to be "in line." Problems generally arise when expenses are rising more quickly than revenue; if the organization is not already running at a deficit (and consuming its reserves), then at some point in the future, it will be (National Center for Nonprofit Boards, 1998).

Similarly, certain items of expense are directly related to certain sources of income. For instance, it is important to ensure that publication expense is not running far ahead of publication revenue. Keeping an eye on related revenue and expense lines is important (National Center for Nonprofit Boards, 1998).

There are two different and valuable perspectives to keep in mind. The first is a programmatic

perspective: Does this program's income exceed its expense? This analysis can be done at a broad level (total meeting income versus total meeting expense) or at a more specific level (annual meeting income versus its expense). To be able to obtain this type of information, the organization's accounting system must be set up to pro- duce it. Be careful here because many organizations believe they are making a profit in areas where they actually are not (National Center for Nonprofit Boards, 1998).

The other perspective involves what is called "natural" items of income and expense. These items are more difficult to compare because they do not relate to a specific products or programs, but to the organization as a whole. Dues, interest income and professional and maintenance expenses are examples of "natural" classifications of income and expense (National Center for Nonprofit Boards, 1998).

Nevertheless, it is valuable to monitor the larger of these income and expense items in relation to each other. For instance, because salaries are usually one of the largest expenses for nonprofit organizations, special attention must be paid to keep them in line. A useful comparison can be obtained by dividing total salary by total income for both current and historically comparable periods. The idea is the ratio of salary to income should either improve (get lower) between periods or stay in a range appropriate to the organization (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Have we run a gain or a loss?
2. Do we have management reports that identify program and nonprogram revenue and compare them with assigned costs?
3. Are any specific expense areas rising faster than their sources of income?

Meeting the Budget

This question goes to the heart of the difference between for-profit and nonprofit organizations. A for-profit's financial success is measured by how much profit it earns — the more the better. The same cannot be said for a nonprofit organization.

Although a nonprofit does need to build and maintain its reserves, too great a sur- plus may imply that it could have provided more services or products for the good of the community, or that it needed to raise less revenue. Neither conclusion is good for the image of the organization (National Center for Nonprofit Boards, 1998).

Nonprofit organizations measure success not only by the good they do for the com- munity, but also by how well they managed to meet, or "make," their budgets.
Fulfilling the mission is the bottom line; balancing the budget makes it possible. Board members should be aware that making either more or less than the amount budgeted results from a variety of circumstances. For example, if the organization makes more than was budgeted, it is possible that it spent too little on programs or that it padded the budget with extra expenses just to be on the safe side. It can also mean, of course, that the organization was more successful than anticipated in enlisting grants or other revenue (National Center for Nonprofit Boards, 1998).

Similarly, making less than was budgeted can occur for a variety of reasons. The organization might have taken on unanticipated tasks or allowed expenses to go out of line. Both income and expenses budgeted need to be compared with actual income and expenses for the full story to be told (National Center for Nonprofit Boards, 1998).

If a nonprofit organization does not have a budget, it is difficult to determine whether it is being managed effectively, although some would conclude the lack of a budget alone is a clear indication of poor management. Simply breaking even — running at a very small gain or loss — is not enough. Expected performance (i.e., a budget) should also be projected, both to create a goal for volunteers and employees and to create a measuring device for success and failure (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Are we regularly comparing our financial activity with what we have budgeted?
2. What procedures, do we use to make sure the differences between what was budgeted and what actually happened are being appropriately addressed?

Propriety of Expenditures

Many nonprofit organizations exist at the whim and will of the public they serve. If they behave in a fashion that seems wasteful or inappropriate, the public can turn against them: Sources of funding dry up and the organization can be hurt or put out of business.

What exacerbates this situation is that nonprofits operate in a fishbowl. Their activities are open to the scrutiny of volunteers, members and the public. The federal government, through the Internal Revenue Service (IRS), requires the nonprofit make its annual reporting document (Form 990) available for inspection or duplication to anyone who requests it. Thus, it is critical that a nonprofit not only appear to be acting appropriately, but that it actually is acting appropriately (National Center for Nonprofit Boards, 1998).

The appearance of propriety extends not only to fulfilling the organization's exempt purpose, but also to how efficiently it is perceived to be achieving its ends. Each organization must look to others in its field to determine that its operating and fund raising costs are reasonable in comparison. Although there are no true nationwide or industrywide standards, each entity can be compared to its peers (National Center for Nonprofit Boards, 1998).

Other areas of special concern invariably include compensation and benefits to senior staff, especially the chief executive and to officers and board members. (See "Avoiding Conflicts of Interest," page 10.) Due to substantial attention by the press, Congress and the IRS, there are stringent new rules in place for excessive compensation

or unreported benefits. Nonprofits must be especially careful to operate within these rules if they wish to avoid penalties and appear to be acting appropriately (National Center for Nonprofit Boards, 1998).

Benefits to officers or board members may not come as cash compensation; but may instead be hidden in such items as an above-market rental agreement by the nonprofit for property owned by the board member. This and similar types of arrangements can result in loss of the organization's exempt status and must be avoided at all costs. The damage resulting from even the appearance of such a relationship can be quite substantial (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Does the board provide oversight to safeguard against waste and fraud?
2. Does the board provide oversight of contractual agreements to ensure the organization's exempt status will not be questioned or impaired?
3. Does the board provide for internal controls over expenditures to ensure their propriety?
4. Are we acting in accordance with the IRS rules on executive compensation?
5. Are we fulfilling our tax-exempt purpose as granted by the IRS?

Insuring Against Risks

Even with the greatest vigilance on the part of the board and staff, problems may arise that threaten the financial health of the organization. Board members should make sure the organization is managing risks, either by insurance or by other means, to ensure its continued existence. The organization's assets should be insured, and everyone involved with cash and securities should be bonded. If being open for business is critical to the organization, business interruption insurance can provide income lost if the organization is forced to close for a time (National Center for Nonprofit Boards, 1998).

The National Center for Nonprofit Boards has produced several publications dealing with risk management that are available as a packet entitled The Board Member's Guide to Legal, Liability, and Insurance Issues. In addition to reviewing such texts, the board could reasonably ask for an update of the insurance the organization is carrying. If the organization has an independent auditor, the auditor could be asked for a formal or informal opinion on whether the insurance carried appears satisfactory (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Is everyone who handles cash, checks or investments bonded?
2. Do we carry appropriate insurance to ensure the organization can continue to function under adverse circumstances?

Meeting Guidelines Set by Funding Organizations

Organizations that receive funding from the federal government, foundations, individual donors or other entities must usually follow specific rules and guidelines or face suspension or retraction of funding. The board is ultimately responsible for ensuring this income is managed properly.

Recipients of private grants or contributions: Frequently, donors provide funding for a restricted purpose, such as research in a specific area, a particular project or a specific prize. These restricted funds must be spent for their designated purpose.
Nothing is more certain to damage a nonprofit organization's ability to attract funds than for it to be found using restricted funds for no restricted purposes (National Center for Nonprofit Boards, 1998).

An organization that receives restricted gifts must account for the funds carefully so it can prove these funds were used for the purpose intended. Nonprofit organizations have developed a system called fund accounting to address the need for accountability to donors and funding organizations and to ensure that gifts are spent for their designated purpose. Each fund is a complete set of accounts and constitutes a separate accounting entity, allowing the organization to report accurately to the board and to funding organizations on the status of restricted funds (National Center for Nonprofit Boards, 1998).

Recipients of federal funding: Strict rules apply to recipients of federal funds. Any organization expending $300,000 in federal funds is required to conduct a special audit of its handling of those funds. This is called an A-133 audit because it was communicated to the public in the Office of Management and Budget's (OMB's) Circular A-133. The requirements for A-133 audits vary, based on the number and amount of federal awards received (National Center for Nonprofit Boards, 1998).

OMB A-133 requires that outside auditors review and report on whether the funds provided were spent for the precise purpose intended and in a fashion appropriate to all federal guidelines. It also requires the outside auditor report on the effectiveness of the system of internal controls in ensuring compliance with federal rules and grant terms. Every nonprofit receiving federal funding is now subject to this increased scrutiny. Organizations that have not correctly complied tend to appear in newspaper headlines locally or nationally, depending on the gravity of their errors (National Center for Nonprofit Boards, 1998).

Public exposure is not the only unpleasant result of failure in this regard. The federal government has many penalties it can bring to bear, the harshest being a suspension of funding or a demand for the return of grants (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Has the board established internal controls to ensure that restricted funding received is appropriately spent and accurately accounted for?
2. Are we providing timely reports as requested by funding organizations?

Avoiding Conflicts of Interest

In our increasingly competitive environment, opportunities for conflicts of interest are growing. Nonprofit board members must remain vigilant in their efforts to avoid such conflicts. Even an appearance can cause significant damage.

Some of the clearest and most serious conflicts of interest occur when a staff member or volunteer receives an inappropriate financial gain from the organization. This type of conflict, mentioned earlier in the section on propriety of expenditures, is known as private inurement. This refers to the concept of "coming into use" or "to take and have an effect." It is tied to conflict of interest because of personal benefit gained. One example is a board member renting space that he owns to the organization at more than fair market value. The IRS looks for private inurement when it audits nonprofits. If such a conflict of interest is found, the individual receiving the excessive financial benefit must return it and pay penalties. Board members can also be assessed penalties if they knowingly approved the transaction or contract (National Center for Nonprofit Boards, 1998).

A subtler conflict of interest appearing frequently in nonprofits occurs when a board member is involved at a significant level in another competing or potentially competing organization, either for-profit or nonprofit. It is clear breach of fiduciary responsibility for a board member to intentionally, or even accidentally, convey confidential information to such an organization. If a situation presents the possibility this might occur, the board member should resign one of the board positions (National Center for Nonprofit Boards, 1998).

If confidential information or valuable services are provided to a for-profit competitor, the breach of fiduciary responsibility may be ever greater, since the nonprofit will be financially disadvantaged as a result. For example, a board member or officer might discuss plans for a conference to be given by a nonprofit with a for-profit organization that is a likely competitor. Given the risks involved, it is best for a nonprofit to refrain from commercial transactions with organizations that employ members of the nonprofit's board as staff or directors (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Do we have a policy prohibiting conflicts of interest?
2. Do any of our board members have potential or actual conflicts of interest?
3. Have we reviewed compensation packages and fee-for-service arrangements to ensure compliance with the IRS's excessive payments sanctions, which could impose severe penalties against individuals?

Section II: Systems that Protect Nonprofit Organizations

Certain systems should be in place to protect every nonprofit organization. Management is responsible for making sure the organization implements and maintains these systems, but the board should assess itself to see that management is following board policies (National Center for Nonprofit Boards, 1998).

The most difficult internal problems to identify are those due to accretion, or gradual accumulation, rather than through gross mismanagement or malfeasance. As an organization grows, seemingly insignificant erroneous activities or behaviors tend to develop incrementally. When these activities first arise, they are too small to be important. The impact of these errors can grow with the organization, however, resulting in a major problem when the matter finally comes to light (National Center for Nonprofit Boards, 1998).

The job of a diligent board member is to make sure that management not only reviews established accounting procedures, but also to ensure the board regularly takes a fresh look at ongoing routines. All of these systems taken together provide protection, allowing the safe and efficient operation of the organization (National Center for Nonprofit Boards, 1998).

Internal Controls

Internal controls are those processes and procedures that protect the assets of an organization and promote its efficient operation. For internal controls to succeed, they must address both concerns simultaneously. For example, a process to pay bills that is efficient but occasionally pays invoices that should not be paid sacrifices too much in protection of assets, cash in this case, to achieve an otherwise valuable efficiency. A good balance is at the heart of a good system of internal controls (National Center for Nonprofit Boards, 1998).

Protection of assets is fundamental to the wellbeing of a nonprofit organization. The board, with the help of its staff, must create internal controls that will protect those assets most subject to waste or theft.

The key to good internal controls is segregation of duties. This concept requires the organization to separate incompatible elements of certain transactions. For instance, whoever is approving invoices to be paid should not be preparing the checks to pay the invoices, and whoever is preparing the checks should not be signing or mailing the checks. Separating these functions makes it much more unlikely that an organization will pay an inappropriate invoice (National Center for Nonprofit Boards, 1998).

Similarly, the person who receives cash should not be the person who records that receipt in accounts. By controlling both sides of that activity, an individual could misappropriate the cash and cover up that fact in the financial records (National Center for Nonprofit Boards, 1998).

Board members of nonprofit organizations should insist on effective internal controls. Good controls can be achieved by a procedure as simple as requiring two signatures on a check, or

can be as complicated as requiring at least five different staff members to be involved in preparing a disbursement (National Center for Nonprofit Boards, 1998).

Board members should ask if there is an up-to-date accounting manual detailing correct procedures. If the board has any doubt about the internal controls, it should address questions to the organization's auditors. If the auditors are not reasonably satisfied with the state of the controls, then the board should consider an internal control study. Such a study involves a thorough review of the controls and results in a written report delineating any shortcomings (National Center for Nonprofit Boards, 1998).

Good controls require the segregating of duties, and that requires at least two or three and preferably more staff members. It is much more difficult to achieve or maintain good internal controls in small organizations. Board members of these organizations must, therefore, work hard to gain as much protection as possible for their assets (National Center for Nonprofit Boards, 1998).

Techniques and services are available to help small organizations. Cash receipts can be best protected by establishing a policy that all receipts must be sent, not to the organization, but to the organization's bank for deposit. This "lock box" process, while it can be somewhat costly, provides excellent control over receipts (National Center for Nonprofit Boards, 1998).

Small organizations can gain enhanced control over disbursements in a number of ways. A member, officer or volunteer can provide the second signature on a check. If a second signature would unduly delay disbursement, then a copy of each check, whether valid or void, could be sent to a designated officer along with the canceled invoice that caused the check to be created. This after-the-fact review is far better than no review at all (National Center for Nonprofit Boards, 1998).

Nonprofits of every size work hard to develop whatever assets they have. Good internal controls will ensure that these hard-won assets are not lost or consumed inefficiently.

Questions that Boards Should Ask

1. Do we have the appropriate checks and balances necessary to prevent errors, fraud and abuse?
2. Are we alert to the possibility of fraud, since there has been an increase in recent years among nonprofits?

Accounting Policies and Procedures

Every nonprofit should have written policies and procedures governing how it does business. The reason for written procedures is clear: Written procedures are easier to follow, especially over time. Two specific documents are most important to have in place:

Accounting manual: This document contains the guidelines for maintaining good

internal controls. Each step in the fiscal process should be analyzed, and the best, most appropriate procedure for handling that step should be described in writing (National Center for Nonprofit Boards, 1998). The resulting document can indicate which staff members are responsible for which steps in the process, and even who is to substitute in case of absence. An accounting manual prepared or reviewed by professionals and kept up-to-date, is an essential tool for a nonprofit organization (National Center for Nonprofit Boards, 1998).

Investment policies: The most critical asset of most nonprofit organizations — after their board, leadership and staff — is cash. Organizations should have procedures for safeguarding cash, for ensuring its liquidity and for keeping it productively employed at all times. These procedures combine to form the cash management element of the organization's investment policy. A good investment policy will:

- Delineate a specific philosophy of investment management and establish parameters for investment risk and return;
- Assist the designated investment manager and protect his or her position by setting up practical guidelines and clear performance objectives; and
- Establish a process for reviewing investment objectives and strategies and reviewing the manager's performance (National Center for Nonprofit Boards, 1998).

Some policies, especially those for organizations with smaller reserves, actually indicate which specific investments are allowed. For example, a conservative investment policy might allow "only FDIC-insured bank accounts with balances under the $100,000 limit and short-term U.S. Treasuries." Policies for organizations with larger reserves might exclude certain high-risk investments or state what proportion of the reserves must be in stocks (equities) rather than in bonds (debt instruments) (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Have we adequately documented our policies and procedures with respect to all of our financial activity?
2. Do we have an investment policy? If so, are we following it?

External Audits

The key role of the external auditor is to attest to the accuracy of the organization's financial statements, although it may also embrace consultation on internal controls, investment policies or related subjects. The principal purpose of an external audit is to keep the board and other key constituent groups apprised of the organization's financial position. Secondary purposes include meeting government regulations and qualifying for loans or grants (National Center for Nonprofit Boards, 1998).

To effectively perform this function, auditors must be absolutely independent of

management and must, by the rules of the profession, avoid financial inducements and resist pressure of any kind from management to alter their opinion. When auditors have failed to maintain their independence, lawsuits have followed (National Center for Nonprofit Boards, 1998).

A good audit firm will work with management, while maintaining an independent, critical eye. The firm should provide, in addition to an opinion on the financial statements, a written report (the “management letter” or “letter of reportable conditions”) highlighting any major weaknesses in internal controls and other significant operational deficiencies (National Center for Nonprofit Boards, 1998).

A truly professional audit firm will maintain its perspective and independence year after year. If the board is satisfied with the audit firm’s competence, independence and perspective, the board need not replace it. The audit firm’s in-depth understanding of the nonprofit’s operation, gained during years of auditing the organization, can be exceedingly valuable, but this insight is only valuable so long as it is accompanied by an appropriately high level of ethics and responsibility (National Center for Nonprofit Boards, 1998).

If an organization is too small to afford the expense of an annual external audit, alternative solutions are available. Some small nonprofits have an audit performed every two years. This provides the assurance that only an audit can provide, while cutting cost almost in half.

Another alternative, which provides considerably less assurance, is a “review” pro- vided by an external auditing firm. A review is much less thorough than an audit, but it does ensure the financial statements have been prepared on an acceptable basis and that this year’s numbers make sense given the prior year’s performance. While this service has been available for a number of years and tends to cost half the price of an audit, its inability to provide substantial assurance has made it less popular with nonprofit boards (National Center for Nonprofit Boards, 1998).

An organization with financially astute volunteers may ask those volunteers to undertake a “members’ audit.” Two or more members visit the organization and test its fiscal activities and records. For example, they might test the appropriateness of some of the checks written, looking at each invoice that required payment and how the payment was entered into books of account (National Center for Nonprofit Boards, 1998).

Additional member audit procedures might include an investigation of how receipts are being processed, whether key assets actually exist, or whether the payroll records are in good order (National Center for Nonprofit Boards, 1998).

The key to success in a member’s audit is that no area of activity be sacrosanct. It is essential the members undertaking this effort be free to look where they please and be creative in their investigations. Some organizations using member audits have an external auditor accompany the volunteers to aid or guide their efforts (National Center for Nonprofit Boards, 1998).

Section III: Major Financial Roles in Nonprofits

The entire board of a nonprofit is legally responsible for the organization's financial success. In routine operations and governance, however, many boards delegate certain financial duties to designated individuals or committees. Nonprofits may vary in size and organizational structure, but they share certain basic financial management responsibilities. These responsibilities include protecting the assets of the organization; collecting income; paying debts once they are properly documented; recording receipts, disbursements, and necessary adjustments; and providing accurate, timely reports. Most professionals would agree that financial reports produced within 10 days of the end of the month are considered timely (National Center for Nonprofit Boards, 1998).

Financial responsibility is generally distributed among the following board and staff functions.

Board Committees

Some boards assign one committee (usually called the finance committee) to oversee financial operations. This committee's role could include regular, in-depth review of the organization's financial activity; oversight of the budgeting process; and operation or review of other activities such as fund-raising, employment practices, the audit, and investment performance (National Center for Nonprofit Boards, 1998).

In larger organizations with more volunteers, additional committees might be responsible for specific areas. These committees could include an audit committee, a budget committee, and a personnel committee.

An audit committee can be useful for a member of reasons. Its primary function is to accept and review reports provided by external auditors and to select the firm that will provide the next year's audit. The audit committee can also serve as a neutral third party to review conflicts between the auditors and management. If such conflicts arise, it is critical that the auditors have an opportunity to express their concerns in a private session with a duly designated audit committee (National Center for Nonprofit Boards, 1998).

The principal concern of the budget committee is to review and discuss the budget with management before it is presented to the full board. The initial review by the committee tends to be more in-depth and thus relieves the board of the necessity of spending an undue amount of time analyzing specific items in the budget. Once the committee has satisfied itself at a more detailed level, the board as a whole can review the estimated income and apportionment of expenditures to determine that they are in line with the programmatic and strategic goals of the organization (National Center for Nonprofit Boards, 1998).

Many nonprofits function without a personnel committee, instead leaving the work to an executive committee or the board as a whole. When a personnel committee is established, it is usually charged with the responsibility for negotiating the contract

with the chief executive, and perhaps with other senior staff as well. Other duties can involve working with the human relations staff to see that compensation, benefits, and employment-related issues are handled appropriately throughout the organization.

Financial committees of a board must exercise the same care as the full board itself to refrain from micromanaging the organization. Simply put, the board hires management to manage; the board's role is to oversee. Board attempts to actually man- age the organization waste staff time and result in substantial inefficiencies. Even where embezzlement or mismanagement has required the board to take a stronger role in management, the board should work hard to put good staff managers in place quickly and remove itself from day-to-day affairs as soon as safety will allow (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Do we have an annual external audit?
2. If we do not have an annual audit, what are we doing instead?
3. What are the key characteristics of a good audit firm?

Treasurer

The key volunteer financial management role in nonprofit organizations is that of the treasurer. In larger organizations, the staff assists the treasurer, but in smaller organizations the treasurer may well have hands-on responsibilities. In all nonprofits, the treasurer is responsible for overseeing financial operations to make certain that things are done in an appropriate fashion.

In most nonprofits, the treasurer is charged with the custody of the corporate funds and securities, keeping full and accurate account of all receipts and disbursements, and the books and financial records of the organization. The treasurer is also charged with depositing money and other valuables to the credit of the corporation in depositories approved by the board. It is the treasurer's responsibility to see that disbursements voted by the board are made and that appropriate vouchers are received (National Center for Nonprofit Boards, 1998).

In most organizations, the treasurer reports on the financial activity, often by making presentations to the board. Because the treasurer generally prepares, or has management prepare, reports for his or her use at board meetings, board reports are generally provided on a quarterly, semiannual, or annual basis (National Center for Nonprofit Boards, 1998).

The treasurer often has budget preparation duties as well. This can begin with the preparation of a preliminary statement of receipts and disbursements for the board's comment. This statement then serves as the basis for the upcoming year's budget.
Budget preparation in larger organizations is generally a staff responsibility, though the treasurer often is involved well before the board reviews the document (National Center for Nonprofit Boards, 1998).

Frequently, treasurers are required to be bonded by their nonprofit to ensure "faithful performance" and restoration of all books and records, vouchers, money, and other properties to the organization. Bonding is especially necessary in small organizations, where the treasurer's responsibilities are hands-on (National Center for Nonprofit Boards, 1998).

In larger organizations, staff will assist the treasurer. Staff involvement may be extensive, significantly reducing the actual handling of funds or processing of financial activity by the treasurer. However, whether such assistance is substantial or non- existent, the treasurer remains responsible for oversight of the organization's financial activity.

Chief Executive

When an organization has a chief executive, he or she has many of the treasurer's duties. The chief executive is responsible to the board for daily administration, including staffing and operations. The executive's principal role is implementing and coordinating programs, but he or she also has basic responsibility for the financial records of the organization (National Center for Nonprofit Boards, 1998).

In all nonprofits, the chief executive has some level of contractual capability for a wide variety of financial activities, such as making investments, entering into leases, and negotiating contracts. Frequently, there will be a cap on the level of activity that the chief executive can enter into without officer or board approval. Approval may come as a motion by the board, a sign-off by an officer, or an additional signature on a check (National Center for Nonprofit Boards, 1998).

Practically speaking, the chief executive is often responsible for presenting the budget to the treasurer or to the board as a whole. The chief executive will work with his or her staff to provide possible anticipated figures for receipts and disbursements that are as accurate as possible. In this way, the organization can best execute the programs that will fulfill its mission (National Center for Nonprofit Boards, 1998).

What Constitutes Excessive Pay for Chief Executives?

In recent years, excessive executive compensation has become an issue for many nonprofit organizations. Those who believe that the nonprofit sector has become too professional and "corporate" cite excessive compensation as an example of how many organizations are losing sight of their mission and their distinctiveness as non- profit organizations.

Because revelations of inordinately high compensation can erode donor confidence and cause increased public skepticism, board members should pay close attention to compensation decisions.

The compensation of the five highest paid officers or managers of the organization is included on the IRS Form 990; an informational tax form that most nonprofit organizations must file each year. The Form 990 is a public document that must be made available by mail or at the

organization's office when requested by members of the public including journalists. For this reason, compensation can't be considered a private matter, and all board members should be aware of its implications (BoardSource, 2002).

The compensation of nonprofit executives usually lags far behind the compensation of leaders in business and government. The real challenge many boards face is not how to reign in excessive compensation but rather how to find the resources to pay appropriate salaries.

- To evaluate the appropriateness of executive compensation, consider:
- The size and complexity of the nonprofit.
- The mission area, geographic location, and financial condition of the organization.
- The qualifications required for the job.
- Compensation at comparable organizations.

A new wrinkle has been added to the challenge of determining appropriate compensation. In 1996 Congress passed legislation that enables the IRS to impose excise taxes and other penalties on nonprofit executives who are over compensated. When deter- mining appropriateness, the IRS evaluates whether an independent board decided the compensation, if appropriate comparable compensation data was obtained, and if the basis for determining compensation was documented (BoardSource, 2002).

This new power will allow the IRS to penalize individuals receiving more compensation than their positions warrant, rather than resorting to revoke the tax exempt status of the organizations (BoardSource, 2002).

Bookkeeper, Controller, Director of Finance

Which individuals assist the chief executive in managing financial activity depends on the size of the organization. The smallest organizations might simply have a part- time bookkeeper to handle the financial record keeping. Somewhat larger organizations might have a full-time bookkeeper or controller. In any case, the bookkeeper or controller is responsible for entering the financial activity, especially receipts and disbursements, into the books and records. It is his or her job to produce timely and accurate financial statements, monthly or perhaps quarterly (National Center for Nonprofit Boards, 1998).

The bookkeeper or controller is also responsible for monitoring the cash and investment accounts, making sure that the amounts reported by the banks or investment companies reconcile precisely with the records of the organization. This staff member also usually prepares the payroll, though generation of checks and payroll tax returns are often outsourced (National Center for Nonprofit Boards, 1998).

In large organizations, the director of finance generally has several staff members reporting to him or her. For instance, a controller would be responsible for managing the financial records and tracking financial activity. The controller usually has a staff of clerks who handle accounts payable, accounts receivable, and the like. If the director of finance is also responsible for administration, he or she may supervise management information

systems, human resources, and facilities management staff (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. What financial committees do we have? What are their responsibilities?
2. Does the committee that meets with the auditor have a private session each year with the auditor?
3. Do we have the proper staff for our financial activities?

Section IV: Understanding the Financial Condition

Board members must understand the financial condition of their organization in order to serve and protect it. Financial insight is essential to making wise decisions on the vast majority of board matters.

Numerous documents are available to those who are not fully versed in reading and understanding financial reports. For example, the National Center for Nonprofit Boards has published a booklet entitled Understanding Nonprofit Financial Statements: A Primer for Board Members, which explains the basic language of finance, how to read a financial statement, and how to work with the numbers to gain insight into the organization's financial condition (National Center for Nonprofit Boards, 1998).

Unfortunately, even those skilled at reading financial statements may have difficulty understanding information offered by nonprofit organizations. Accounting for these entities is somewhat different from that for profit-making ventures, and confusion can result. If a board member is not satisfied with his or her understanding of the financial statements and explanations provided, the member should insist that the organization provide better information (National Center for Nonprofit Boards, 1998).

Better information can take a variety of forms. For example, because no one can absorb all the details in a financial report, communicating less (but more meaningful) information is sometimes better than simply providing detailed information with no explanation. The staff might write a narrative describing the highlights of the reporting period to accompany the highlights of the reporting period to accompany the financial report. Charts and graphs can point out the most important trends or relationships. Finally, because board members must have the details as well, reports should be standardized so that the board can quickly access the details and compare items with those in previous reports (National Center for Nonprofit Boards, 1998).

Each board member is responsible for gaining a sufficient level of comfort and understanding of the numbers. If any issue, large or small, is not clear, the board should seek clarification. A diligent board member will ask as many questions as are needed to lay to rest any doubt or uncertainty.

Documents the Board Should Receive

There is no single standard for all nonprofits regarding which financial statements the board should receive. The area of greatest diversity is found in the internally pre- pared financial statements.

Internally Prepared Financial Statements

Most nonprofit organizations prepare financial reports on a monthly basis. This information is certainly needed for management, but may not be necessary for the board to review. Many boards find quarterly internal financial statements to be sufficient.

In organizations with satisfactory reserves, a finance committee might analyze the

monthly or quarterly reports, while the board reviews only the annual internally pre- pared statements and the external audit. Boards with no finance committee should consider reviewing the organization's financial statements at least quarterly (National Center for Nonprofit Boards, 1998).

Audited Financial Statements

Much more consistency among boards exists on the matter of reviewing externally prepared financial statements; the board should always review year-end audited financial statements (National Center for Nonprofit Boards, 1998).

These year-end statements should include:

- A statement of financial position: Previously called a balance sheet, this statement shows the assets and liabilities of the organization at a given point in time, in this case at year-end. Whenever possible, this statement (and the statement of activities described below) should include comparative figures from the previous year, as long as there has been no change in year-end or the chart of accounts.
- A statement of activities: Previously called a statement of revenue and expense, this statement shows revenue and expenses for a specified period of time, in this case, one year, and whether there was a net gain or loss.
- A statement of changes in net assets: Previously called a statement of change in fund balance, this statement is occasionally combined with the statement of activities. It reflects the beginning net assets plus the current period's net gain or loss, and may include other adjustments to reach the ending net assets.
- A statement of cash flows: This statement is prepared in a format that focuses on where cash came from and how it was used. This statement should not be confused with the cash-flow statement discussed earlier, which is a tool for managing cash (National Center for Nonprofit Boards, 1998).

In addition to the statements listed above, every group of audited financial statements must be accompanied by certain required footnotes that help the reader understand the organization's financial situation; board members should read these footnotes carefully. The notes highlight significant accounting policies, major acquisitions or changes in operations, pension requirements, lawsuits, and other significant information, and pro- vide details on significant matters (National Center for Nonprofit Boards, 1998).

On occasion, an organization will want more detailed information than is required in the basic audited report. In these situations, the auditors will attach to the notes a separate opinion, followed by additional statements or supplemental schedule. This opinion will indicate the level of assurance the auditors are providing on these statements. Readers should be aware that the level of assurance might not be the same as for the basic audited statements (National Center for Nonprofit Boards, 1998).

There is sometimes confusion about what is being purchased when an audit is per- formed. An audit is the process by which certified public accountants are able to form an opinion as to whether the organization's financial statements fairly reflect its financial position,

the changes in its net assets, and its cash flow. It is a lengthy and thorough study of the organization's financial records and procedures that looks not only at the numbers themselves, but also at whether appropriate accounting principles were used, and, if so, whether they were consistently applied (National Center for Nonprofit Boards, 1998).

An audit does not guarantee that the financial statements are perfectly accurate, because it is concerned only with material or significant amounts. Nor does it ensure the competence, wisdom, or honesty of management.

Various opinions may result from an audit. Most organizations receive a "clean" (or unqualified) opinion, but some do not. Listed below are the different types of opinions and why they might be received.

- An unqualified (clean) opinion, the highest level of assurance the auditor can provide, is used when the auditor is satisfied with the financial statements. The three paragraphs of a typical clean opinion are provided in Appendix A. This type of opinion sometimes includes a fourth paragraph drawing the reader's attention to a particular matter. This fourth paragraph follows the opinion para- graph of a clean opinion. It does not reduce the level of assurance the auditor is expressing; it simply refers to the full disclosure of the matter in question in the footnotes at the end of the financial statements. Examples include opinions based in part on the work of another auditor, or emphasis on a matter such as the unknown outcome of a lawsuit.
- A qualified opinion is provided when the auditor expresses reservations on a specific issue. Qualified opinions frequently result when the organization is following accounting principles that are generally accepted, according to the American Institute of Certified Public Accountants. A qualified opinion should encourage board members to ask questions directly to the auditors.
- An adverse opinion is a negative opinion and is used when the financial statements are misleading and management will not correct them. These are exceedingly rare and should alert the board that strong corrective action is required.
- A disclaimed opinion indicates that the auditor is unable to form an opinion. It may arise because of a lack of independence or because of a scope limitation, meaning that the auditor has been unable to gather information to form an opinion (e.g., he or she cannot rely on the beginning inventory count because no audit was conducted at the end of the previous year). This type of opinion can also result when the organization's internal controls are unsatisfactory. When a board receives a disclaimed opinion, it should promptly investigate the cause of the disclaimer (National Center for Nonprofit Boards, 1998).

In addition to providing an opinion on the financial statements, auditors are generally required to provide a Management Letter, sometimes called a Letter of Reportable Conditions. This letter should always be distributed to the board because it provides the auditor's observations on any significant deficiencies discovered in the internal control structure of the organization. In addition, this letter may mention other matters that the

auditor believes are of sufficient import to require the attention of management. If no reportable conditions are discovered, no written communication is required (National Center for Nonprofit Boards, 1998).

Other Important Financial Reports

In addition to the audited financial statements and the management letter, other financial reports may be required of a nonprofit organization by the federal government or by state governments, grantors, donors, or affiliated organizations. The most important of these is the IRS Form 990, which provides information, to the federal government about how the organization raised its revenue and for what purpose and in what fashion it incurred its expenses. In addition, the Form 990 requires that a beginning and ending statement of financial position be provided. For charitable, educational, or scientific organizations, additional information must be provided on Schedule A (National Center for Nonprofit Boards, 1998).

Board members should consider reviewing, or having a committee review, the Form 990 before it is filed, because this document communicates to the IRS how the organization is fulfilling its tax-exempt purpose. In addition, the IRS requires non- profit organizations to make the Form 990 available for inspection or duplication to anyone requesting access to it. Thus, accurate and effective communication is essential (National Center for Nonprofit Boards, 1998).

Board members should consider reviewing the reports that result from the OMBA- 133 audit, which is required for organizations expending $300,000 in federal funds. In a series of five separate reports, the auditor is required to attest to the fact that there is "reasonable assurance that the organization or institution is managing federal awards in compliance with applicable laws and regulations," and that the organization is safeguarding the federal funds (National Center for Nonprofit Boards, 1998).

These five reports are sent directly to the Single Audit Clearinghouse. If an organization fails to meet government standards, then the grant-making agency may cut off or demand refunds of awards. Thus, attention to these reports is strongly recommended.

Whether or not the board members review other required year-end reports is largely a matter of their significance to the organization. Whenever a report involves the potential of substantially increased or reduced funding, board review is advisable.
Reviewing insignificant reports draws time and attention away from other matters, however, board members should focus their attention where it will do the most good (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Is our financial staff providing us with accurate and timely financial statements that allow us to understand the financial state of the organization? If not, how could the statements be improved?
2. Does our annual audit have a clean opinion? If not, why not and what is being done about it?
3. Do we regularly review the Form 990? Does it accurately represent or organization?
4. Are we filing on a timely basis all the reporting documents we are supposed to be filing?

Signs of Financial Distress

Certain occurrences portend trouble. Board members should be alert to the following signs of organizational distress (National Center for Nonprofit Boards, 1998).

Critical income sources declining: Every nonprofit organization relies on certain major sources of income. A membership organization may rely on dues, meeting income; education, or publications as is its key sources; a charitable organization's revenue may come entirely from contributions. These critical sources should be tracked carefully. Any significant decline in these key sources is a sure sign of trouble.

Certain expenditures increasing: Certain expenses should be watched more closely than others in nonprofit organizations. The most important of these are salary and benefits, because these represent a major portion of the organization's expenditures. Nonprofit organizations use benefits as an incentive somewhat more frequently than do for profits, and tracking these expenses, as a percentage of total expenses can be very illuminating.

One expense that tends to indicate problems is the miscellaneous expense account. If this item increases, hidden costs or less-than-adequate bookkeeping may be the cause. In either case, an inquiry is warranted. Another expense to watch is consult- ants' fees. If this expense goes up noticeably, it may reflect activity that could be better brought in house. In addition, a rise in consulting costs can signal an undisclosed major issue (National Center for Nonprofit Boards, 1998).

Private inurement: Any board member who is benefiting financially from the non- profit organization may pose a substantial threat to the organization's survival. When the IRS audits a nonprofit organization, it invariably attempts to ferret out incidents of private inurement. If it finds any appreciable amount, it can revoke the entity's tax-exempt status. The only individuals who should be gaining financially from a nonprofit organization are those who are employed by the organization, and that benefit should be only in the form of reasonable salary and benefits. All others who receive benefits should do so as a result of the organization's fulfillment of its exempt purpose (National Center for Nonprofit Boards, 1998).

Unplanned auditor turnover: Board members should be curious about an unplanned auditor change, which often signals a substantial disagreement between management and the auditing firm. The board, either directly or through its finance or audit committee, should investigate any unplanned auditor turnover. Any investigation should include a dialogue with the auditors during which management is not present (National Center for Nonprofit Boards, 1998).

Board micromanagement: One of the most serious problems a nonprofit can face is too much detailed operational management by the board. A board that is involved in many small-dollar decisions is creating enormous inefficiencies. Good board members will monitor the board's involvement in management and suggest appropriate corrections.

Questions the Board Should Ask

1. Are our key sources of income rising or falling? If they are falling, what are we doing about it?
2. Are our key expenses, especially salary and benefits, under control?
3. Have we had unplanned auditor turnover?
4. Are we micromanaging?

Section V: Dealing with the Outside Financial World

Most board members are uncomfortable when they have to make major decisions for their nonprofits on long-term financial issues. Such challenges as selecting the right bank or insurance provider, the appropriate places to invest or the right types of insurance can be a problem for those not experienced in financial matters.

Choosing a Bank

When making this critical decision, it is important to choose a sound and stable financial institution as well as one that is experienced with nonprofits and is comfortable serving them. To bankers, especially lenders, nonprofits are substantially different from for-profit organizations. Finding a bank that understands how non- profits operate is key (National Center for Nonprofit Boards, 1998).

To find such an institution, the board should consult other nonprofits in the community to find out which banks they use. Try to select a bank with a branch near the organization's offices. Many nonprofits make daily deposits, and other transactions also may require a trip to the bank.

Not all banks provide similar services, so the board should identify the organization's needs and choose a bank that can meet them. Common services, such as taking deposits and paying on checks, are available from every bank. Many nonprofits want advice on handling investments, and this type of service frequently is available from banks today. Other features to consider include lock box services and direct deposit of payroll into employees' accounts (National Center for Nonprofit Boards, 1998).

Although most banks have lending programs, some are not interested in lending to nonprofits, especially those without assets to pledge as security. This unwillingness to lend can be a problem, since nonprofits frequently have cyclical income. Cash flow may increase around the time of an annual fund-raising event, at the end of the year when taxpayers make last-minute tax-deductible contributions, or during membership renewal season. For many nonprofits, the availability of a line of credit to even out cash flow fluctuations can be critical (National Center for Nonprofit Boards, 1998).

When selecting a bank, send a request for proposals (RFP) to two or three financial institutions. The RFP should describe the services the organization needs, the aver- age balances in its various accounts, the average number of checks written per month and the average receipts per month. A copy of the most recent year-end financial statement should also be included. Give each bank at least three to four weeks to submit a proposal (National Center for Nonprofit Boards, 1998).

Be as specific as possible in your request as to the information you need and the for- mat in which you require it. Banks each have their own format in which they pro- pose to provide services. Since none of these is quite the same, the information required becomes exceedingly difficult to compare. Some nonprofits provide a computer template, or a written form, which they ask the bank to fill out and return along with their standard response format. This provides the board with at least a chance of being able to compare

apples with apples, rather than apples with oranges (National Center for Nonprofit Boards, 1998).

Nevertheless, the real challenge generally begins at the point at which proposals are received. The first order of business is to make sure the key services the organization requires are available. The next task is to evaluate the cost of those services.

Banks generally offer two alternatives: paying a fee for each transaction, or maintaining a minimum balance in a noninterest-bearing account, thus covering transaction costs. It is important to compare the cumulative transaction charges the organization is likely to incur with the minimum balance alternative. Frequently, the fore- gone interest on the minimum balance will be greater than the transaction costs. This is a way for the bank to protect itself and make extra money. Generally, if transaction costs are less than the foregone interest on the minimum balance, the bank will not charge a fee. However, should the transaction costs exceed the foregone interest, the bank will almost invariably charge for the additional transactions (National Center for Nonprofit Boards, 1998).

Establishing a good banking relationship is an extremely important step in a non- profit's financial life, especially if the organization needs refinancing of a long-term debt or a line of credit that it may borrow against from time to time. Thus, negotiate with the current bank over key services required before switching to another financial institution (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Are we satisfied with the services our bank currently provides?
2. When was the last time we checked to see if our banking costs are appropriate?

Obtaining Insurance

The board also should seek insurance providers who are familiar with nonprofit organizations. The insurance requirements of nonprofits are similar to those of other types of organizations, but there are some significant differences. Insurance needs vary based on the size, wealth and types of activities of the nonprofit. A good insurance agent or broker with substantial nonprofit experience should be able to provide details about the alternatives. Other nonprofits can recommend knowledgeable agents or brokers.

All organizations large enough to have an office should have basic insurance cover- age such as that provided in the standard office liability package. Such coverage includes property insurance, which protects against loss due to damage or destruction of real property, furnishings and equipment. The policy should cover property belonging to others that may be on the organization's premises, as well as the non- profit's property when in transit. A good property insurance policy will cover dam- aged or lost property for its replacement value rather than its original cost or some other figure. A standard office

liability package also includes protection against claims for bodily injury or property damage resulting from the nonprofit's activities. Generally, this coverage applies to activity conducted on the organization's property (National Center for Nonprofit Boards, 1998).

In addition to the basic office liability package, nonprofits should consider the following:

- Bonding for employees and volunteers who handle cash or securities. A fidelity bond is relatively inexpensive to purchase and is essential for smaller organizations where appropriate segregation of duties may not be possible.
- Coverage for art or other unique items on the organization's premises. These items generally require a "floater" on the basic property insurance policy.
- Coverage for papers and records, both electronic media and hard copy.
- Convention cancellation and interruption insurance to protect against loss of income from special events or major conferences. There are well-documented incidences of earthquakes or violent storms preventing events from taking place. Without insurance, the nonprofits would have been badly hurt financially.
- Auto insurance, if the organization has vehicles. They must be insured for all drivers.
- Directors and officers (D&O) liability insurance, which protects the organization's volunteers from suits brought by dissatisfied members of their community or people outside the organization who feel the volunteers have behaved inappropriately. D&O insurance should cover legal fees and successful claims against the organization. Nonprofit organizations frequently win these cases, but the legal costs can be high (National Center for Nonprofit Boards, 1998).

To keep premiums low, the organization should consider maintaining a higher deductible. A competitive Request for Proposals (RFP) is another good way of finding the best value in insurance costs (National Center for Nonprofit Boards, 1998).

When purchasing insurance, it is absolutely critical the policies are read carefully to confirm the coverage being obtained. If no board or staff member has the expertise to understand the details of each policy, then additional assistance, either paid or volunteer, should be sought. The organization's insurance policies should be reviewed in depth at least every two years (National Center for Nonprofit Boards, 1998).

Questions the Board Should Ask

1. Have we thoroughly reviewed our operation to make sure we are appropriately insured?
2. Do we have directors and officers liability insurance?

Making Investments

A nonprofit's foremost concern in the investment area is to make sure there is sufficient cash available to operate. The initial available funds should be maintained in a Federal Deposit Insurance Corporation (FDIC)- insured bank account, usually a checking account (National Center for Nonprofit Boards, 1998).

When funds begin to accumulate, other interest-bearing bank accounts are generally the first "investment" made. Such accounts should be monitored to make sure they remain within the $100,000 range of the FDIC coverage. Given a further increase in investable funds, the next move is often to short-term U.S. Treasury bills, which are the most secure investment available. They lack some liquidity, but they provide a better yield than bank accounts (National Center for Nonprofit Boards, 1998).

With an additional accumulation of assets, the board should consider broadening the investment alternatives. The first step is to identify the operating cash the organization needs and separate it from funds for short-term or long-term investment.
Immediate operating funds should be kept in readily accessible bank accounts (National Center for Nonprofit Boards, 1998).

Short-term investments should be made with an eye toward high liquidity, since they may be needed at any time. It is important to preserve capital while seeking the best return possible, commensurate with the need for liquidity. Short-term investment vehicles include U.S. Treasury and other U.S. government agency obligations, certificates of deposit (but not in excess of the FDIC limit), money market accounts (especially those backed by the U.S. Treasury), and more exotic items such as repurchase agreements (with U.S. government obligations as collateral). All these investments are secure and reasonably liquid (National Center for Nonprofit Boards, 1998).

For long-term investments of funds, the investment goal should include growth equal to or preferably in excess of inflation. In these types of investments, fluctuations over the short-term are to be expected. Long-term investment planning frequently focuses on allocating assets among stocks, bonds and some cash. The exact mix should be expressed in an investment policy developed and approved by the board of directors, usually with the assistance of outside investment advisors (National Center for Nonprofit Boards, 1998).

There are a variety of investments to consider for a long-term portfolio. Equity investments may include both small-capitalization and large-capitalization stocks. Large-cap stocks are from corporations like General Electric, IBM and Microsoft. A small-cap stock has greater risk but greater potential for reward. Some nonprofits also include international stocks in their portfolios. On the fixed-income side, most nonprofits purchase high-quality U.S. corporate bonds. Some may add riskier, higher-yielding bonds and perhaps international bonds (National Center for Nonprofit Boards, 1998).

Diversification is a key strategy when building a long-term portfolio. The spread of investments among stocks, bonds and cash protects the organization from substantial diminution of its capital over an extended period. Generally, nonprofits avoid speculative

investments such as commodities, derivatives or on margin (National Center for Nonprofit Boards, 1998).

It is essential that no staff member or volunteer be solely responsible for selecting investments. The board as a whole should follow the investment policy it has accept- ed. It is critical that outside advisors should select specific investments if they are riskier than certificates of deposit or Treasury bills.

Questions the Board Should Ask

1. When was the last time our investment policy was reviewed?
2. Are we making sure that no board or staff member is individually responsible for selecting investments?
3. Are we satisfied with the performance of our investments given the level of risk appropriate for these funds?

Contracts with Outside Advisors

The selection of capable outside advisors or consultants is vital to the success of many activities a nonprofit may enter into. As when choosing a bank or insurance broker, an excellent place to start looking for a particular type of advisor is other nonprofits. Good, current references are also essential so the board can consult other organizations that have worked with the prospective advisor in the same capacity. It is also a good idea, and an inexpensive safety check, to contact the Better Business Bureau or local consumer affairs office when dealing with someone who is new to the organization to determine whether the individual or company is known for having problems (National Center for Nonprofit Boards, 1998).

The organization's formal agreement with the advisor identifies the elements of the relationship. At a minimum, the agreement should include statements or descriptions of the following:

- The services to be provided;
- A designated nonprofit contact;
- A time line, including milestones to measure progress;
- Costs;
- The payment procedure and schedule, including progress billing;
- The form of the final work product;
- The stipulation that final payment is predicated on the organization's satisfaction with the work performed;
- Penalties for failure to perform;
- The ability to extend the agreement if mutually desired; and,
- The termination notice period and penalties, if any. (National Center for Nonprofit Boards, 1998).

The agreement must state specifically that the advisor is an independent contractor, not an employee of the organization, and as such has full responsibility for his or her income taxes, Social Security taxes, and insurance. Draft agreements may be avail- able from the organization's attorneys. Before any agreement is finalized, have it reviewed by an attorney to ensure that the organization is well protected (National Center for Nonprofit Boards, 1998).

Question the Board Should Ask

1. Do we have appropriate contracts in place with all of our current outside advisors?
2. What procedures do we have in place to make sure that all future outside advisors will sign an appropriate contract before they begin to work for us?

Section VI: The Budget Process: Planning and Implementation Fundamentals of a First Rate Budget

Budgets are more than a bunch of numbers on a page. A well-crafted budget tells its reader your organization's story in dollar terms. It describes where your money comes from and where it will be spent. It shows those programs and projects that are your organization's core, as well as services that are more tangential to your mission. In short, a budget is a series of educated guesses about the money your organization will bring in and spend in the coming year (Soto, 2002:1).

The budget process is complex. It involves a lot of people, many assumptions, accurate data and, most importantly, a total understanding of the organization. While the number of factors that go into the budget process sometimes appears endless, I have distilled what I believe are the 10 "essentials" to creating a good budget. Get these 10 essentials right and you've given yourself the very real chance of having a budget that can help guide your organization (Soto, 2002:1-2).

1. Review the Mission

Before setting numbers to paper, the budget process involves plenty of discussion on the current state of the organization and its larger context. Did the prior year's budget come close to the actual financial numbers? What are the national and local economies doing? Has the need for your organization grown or diminished in the community it serves? Has the level of programs or projects grown in such a manner as to outstrip the available resources? Has "mission-creep" developed — that is, has the organization gone far beyond its core mission? (While there is nothing inherently wrong with mission-creep, expanding an organization's mission should happen because of conscious choices, not because of panicked pursuit of funds). These kinds of questions will help focus budget-related decision-making and assumptions down the road (Soto, 2002:1-2.

The answers to these questions are in the mission statement. An organization's mission statement lays out exactly why the organization exists and whom or what it will serve. The statement goes a long way to helping develop a coherent budget that follows the mission-set guidelines (Soto, 2002:1-2).

The mission statement should be referred to constantly throughout the budget process, if only to provide the much needed reality check of whether you should be doing this as opposed to that (Soto, 2002:1-2).

The mission statement should be referred to constantly throughout the budget process.

2. Establish Budget Assumptions

Spelling out budget assumptions provides an organization with guidelines for working with the numbers. It also provides a foundation from which every member of the "budget team" can work, avoiding surprises and disagreements about fundamentals later in the budget process, when it would be harder to change. Typical assumptions that are developed during the initial budget planning phase include such things as percent- age of across-the-board staff raises, increased program or membership fees, increased or decreased staffing levels, facilities expansion or contraction (Soto, 2002:3).

An example of a revenue assumption would be an increase in the amount of money raised from individuals due to plans for an additional appeals mailing in the upcoming year. You can base realistic (that is, not too optimistic) revenue projections on the history of previous appeals' results. Concurrently, in this example, fund-raising expenses for the extra appeals campaign would also increase. This increase must be factored into that expense line item's budget cost (Soto, 2002:3).

3. Have Adequate Revenue, Cost Information from the Prior Year

Remember past is prologue. The budget numbers are not created in a vacuum. The numbers you set down as hoped-for predictions are based, in large measure, on the numbers that have happened already. This obvious point is made only to highlight the great need for accurate and detailed financial information. The adage "garbage in, garbage out" is especially true here. Management cannot make educated guesses (remember that is all any budget really is) without good numbers from the past (Soto, 2002:3).

If your organization has an inadequate accounting system (if during the year you have trouble accessing good, accurate interim financial reports that provide the level of detail needed to make good management decisions) then formulating a sound budget will be nearly impossible. It is vital that your general ledger system be maintained properly during the year so you can use its information in trying to predict the future (Soto, 2002:3).

It is vital that your general ledger system be maintained properly during the year.

4. Review and Update Overhead Cost per Program

Properly allocating overhead costs is critical to understanding and measuring the costs of providing services. Often based on time sheets or square footage, overhead cost allocations are used by organizations to "spread out" the costs of those items that are shared between the nonprofit's three major functional expense areas of pro- gram services, administration and fundraising (Soto, 2002:3-4).

For example, property and liability insurance is necessary for the operation of an entire

organization. However, it is a cost that could be spread by percentage to each program or project within the major functional expense area. The same is true for such costs as rent, telephone office supplies and administrative support personnel. It is important that the organization spread out these types of costs so as to understand the nature and extent of a program or project's total costs (Soto, 2002:3-4).

5. Tie Budget Line Items to the Chart of Accounts

A common mistake in the budget process is not tying budget line items to those line items on an organization's chart of accounts. If the two are not aligned, the usability of interim budget-to-actual variance reports is diminished. This negates the most important reason for the budget — its existence as the point of reference for actual revenue and expenses experienced throughout the year.

Your budget is the canary in the coalmine. When financial numbers are starting to get of whack, the budget is there to tell you so.

However, it can only do so if you can compare the budgeted numbers to the actual financial activity on a line-by-line basis (Soto, 2002:4).

The best way to tie your budget to the chart of accounts is to use the chart of accounts listing as your guide from the beginning of the budget process. For example, if the organization tracks salary expense by three different account line items called "salaries-administration," "salaries-fund-raising" and "salaries-program services," be sure to budget for each line individually. Do not simply put in your budget a single line item projected cost called "salaries." You must consider each account item as a separate cost. That way, when you see interim financial reports during the year, you will see a direct link between actual line-item costs and your projections. For more information, visit the California Nonprofit Association (CAN) website to view an example of a chart of accounts. The site is at http://www.CAnonprofits.org. Click on "OCOA" to see the sample (Soto, 2002:4-5).

6. Focus First on Income, then on Personnel Costs

Whenever I observe an organization going through the budget process, most of the discussion seems to revolve around expenses. This tendency probably happened because expenses are the one area an organization can get its arms around. Costs are, for the most part, easily predictable (Soto, 2002:5).

The same is not true about income. The hardest thing for any nonprofit to predict is how much money it will raise during the year, especially if it is an organization that depends heavily upon large foundation grants. Work long and hard to establish realistic support and revenue budget numbers. Use most of your time and energy on this and less time and energy on your costs. It is also useful to the budget process if you know and remember the hierarchy of fund-raising efforts:

- The most stable, efficient and responsive of all funding are smaller, individual donations.
- Much less stable and efficient is funding from foundations and government agencies.
- Least stable and most costly of all is revenue earned from special events. (Soto, 2002:5).

When you do look at expenses, spend the bulk of your time on personnel-related costs. Why focus on personnel costs? Well, take a look at your own payroll-related costs — I'll wager that they make up between 65 and 75 percent of your overall costs. How do I know this? Most nonprofit work is notoriously labor-intensive. It is work for and by people (Soto, 2002:5).

Also, make sure you pay enough to attract and retain good people. Constantly hiring and losing and hiring again can be an unexpected drain on your income. Monitor your fringe benefits costs regularly to make sure you are doing your best to reward your staff. "For love of the work" typically will only go so far when an employee has received minimal cost of living raises for the last few years. Be sure to factor all the benefits costs into your equations. Additionally, include fringe benefits costs into your equations and into most, if not all, grant proposals. Most grantors realize the importance of benefits to the overall program costs. Take care of your personnel cost and you will have solved most of our expense-related concerns. Just as with your work on the support and revenues side, know and understand all the costs related to employing someone (Soto, 2002:5).

7. Seasonality

In order for a budget to be truly useful, it must predict the future by the economic seasons of the organization as well as by the program or project. In other words, your annual budget must try to reflect the activity as it might really occur, broken out by the 12 months of the fiscal year and within the appropriate program or project heading (Soto, 2002:5).

Do not take your numbers and simply divide by 12.

This is especially true of your support and revenues. Do not take your numbers and simply divide by 12 — that would be cheating! Take the time and effort to figure out when you expect the money to come in and get spent. Know your grantors' funding cycles, when you expect to see the results of your solicitation drives, when you begin to sell tickets to your major fund-raising dinners. Capture the ebb and flow of your support and revenue. This method will tell you when to make major new purchases or when you may need to make short-term cutbacks. As discussed above, if you are an organization that receives the bulk of your support from individual small donors, you will probably have a more even flow of support than those nonprofits that depend more heavily upon major grants and

government contracts. Factor all this information into your calendar budget (Soto, 2002:5-6).

It is amazing how much more helpful the budget is when you look at it with 12 months of variable predicted activity spread across monthly columns, especially when looking at the support and revenue members. Except for special events and various solicitation campaign-related expenses and major program start-up or shut- down costs, most expenses need to be regular throughout the year. Putting the budget into this format will make your budget-to-actual variance reports more useful and relevant to your decision-making needs (Soto, 2002:5-6)

8. Communicate Variance Reports

Just as the budget is not created in a vacuum, it should not reside only in the hands of the board and management. The proper use of the budget demands that it be communicated on a regular basis to as many staff as possible. It is not enough to ask for input from program and supporting services personnel while the budget is being created and then not include them in the interim reporting during your fiscal year. They need to know where they stand relative to what was predicted for them (Soto, 2002:6).

Of course, instituting this practice means your organization must have an accounting system that allows the general ledger to track allocated costs by program or project. Program staffers need to see these numbers and discuss the variances with management. This process makes the overall efforts of the organization that much more meaningful for everyone and will go a long way toward preventing political maneuvering and suspicion between resource-strapped programs and projects (Soto, 2002:6).

Just as the budget is not created in a vacuum, it should not reside only in the hands of the board and management.

9. Minimize Budget Modifications

It is recommended that an organization make all budget modifications at the same time — mid-year — unless a major event occurs that requires sudden, unexpected expansion or contraction. Roughly five to six months into the new fiscal year, the organization should hold a mini-summit on the status of the budget as written com- pared to the actual results of the year. Any new information regarding funding or costs should be discussed. Changes to the budget should be infrequent. The importance of the variances cannot be stressed enough when comparing the budget to the actual financial numbers. These variances provide valuable information about board and management's understanding and knowledge of the organization. Erasing these variances wipes out this information (Soto, 2002:6).

Do not make changes to the budget on the fly just to avoid having to explain the differences at a board or committee meeting. The variances mean something. Being ahead of or behind the actual numbers is meaningful. It is up to the management to figure the sources and significance of the differences (Soto, 2002:6).

10. Treat the Budget Process Seriously

Finally, do not just talk a good game about the budget process — take it seriously. Set a time frame for its development and stick to it. When presenting it to the board, stress its importance. Then, once it is board-approved, sell it to the staff. They helped create it, so assure them that they will be included throughout the year in update meetings where wide variances will be discussed and minimal differences applauded (Soto, 2002:6).

A good budget can be a source of quiet confidence, allowing management to play out "what-if" scenarios, gauging different economic and operational factors. It can be used to instill trust between the board and management, and between management and employees. Most of all, a good budget can allow an organization to get the most out of its resources, in today's volatile economic world, that is no mean feat (Soto, 2002:6).

Conclusion

A functioning nonprofit organization provides services or products of such great importance that the community dedicates time and money to help it achieve its purpose. Board members are custodians not only of the organization's assets and liabilities, but also of the accumulated efforts of those who preceded them in founding and expanding the entity they now serve. Board members hold in trust the economic engine that is the nonprofit's ability to continue to serve the community. Protecting and enhancing this capacity are the true financial responsibility of board members of nonprofit organizations.

APPENDIX A

Example of an Auditor's Opinion in Letter Form

An unqualified or "clean" auditor's opinion as recommended by The American Institute of Certified Public Accountants:

Independent Auditor's Report
Board of Directors
XYZ Nonprofit Organization, Inc.
City, State

We have audited the accompanying statement of financial position of the XYZ Nonprofit Organization, Inc., (the Organization), as of December 31, 2001 and 2000, and the related statements of activities, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the XYZ Nonprofit Organization, Inc., as of December 31, 1998 and 1997, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Auditing Firm Name
City, State
April 21, 2002

(Source: National Center for Nonprofit Boards, 1998)

APPENDIX B

Tax and Information Filing Calendar for Nonprofit Organizations

Table 1: Federal Filings

Filing	Form	Due Date*
Initial Formation		
• Application for Employer Identification Number?	SS4	ASAP after formation
• Application for Recognition of Exemption 501(c)(3)	1023	15 months after formation
• Other than 501(c)(3)	1024	15 months after formation
Payroll Forms and Returns		
• Unemployment Tax	940/940EZ**	1//31
• Social Security and Withholding Tax	941	4/30, 7/31, 10/31, 1/31
Information Returns		
• Wages and Tax Statements	W-3/W-2	1/31
• Miscellaneous Income Statements	1099MISC	1/31
• Interest Income Statements	1099INT	1/31
• Other Income	1099 Series	1/31
• 1099 Transmittal	1096	1/31
Exempt Organization Returns	990/990EZ	5/15
• Group Exemption Update	(List)	9/30 for upcoming year
Exempt Organization Business Tax	990-T	5/15
• Estimated Payments		3/15,6/15, 9/15, 12/15
Political Action Committee		
• FEC Initial Registration		
• FED Filings (Election Year)	4X	4//15, 7/15, 10/15, 1/31
• Interest Income	1120POL	ASAP after formation3/15

Employee Benefit Plans

- Pension 401(k)

Under 100 participants	5500C/R	7/31
100 or more participants	5500	7/31

- Health, Group Life Disability, or Dependent Care

Under 100 participants	5500/CR	7/31
100 or more participants	5500	7/31

- Group Legal Services or Educational Assistance

Under 100 participants	5500/CR	7/31
100 or more participants	5500	7/31
• Cafeteria Plans Disability, or Dependent Care		
Under 100 participants	5500/CR	7/31
100 or more participants	5500	7/31

*Based on tax and plan years ending December 31**501(c)(3) organizations may be exempt.

(Source: National Center for Nonprofit Boards, 1998)

APPENDIX C

Tax and Information Filing Calendar for Nonprofit Organizations

Table 2: State Filings

Filing	Due Date*
Initial Formation	
• Combined Registration Application	ASAP after formation
• Application for Exemption	ASAP after formation
• Charitable Solicitation Registration***	ASAP after formation
Payroll Forms and Returns	
• Unemployment Tax**	4/30, 7/31, 10/31, 1/31
• Payment of Taxes Withheld	20th of month (varies by state)
• Annual Reconciliation and Report of Withholding	1/31
Personal Property Tax*	varies by locale
Sales and Use Tax*	varies by locale
Report of Unclaimed Property	11/1
Annual Corporate Report	4/15 (varies by state)
Copy of Federal Form 990	5/15 (not required by all states)
Corporate Income Tax Return	1/31
• If Organization Receives Unrelated Business Income	3/15 (varies by state)
• Estimated Payments	3/15, 6/15, 9/15, 12/15

Charitable Solicitation Annual Report*	5/15
Political Action Committee	
• State Election Reports (Election Year)	4/15, 7/15, 10/15, 1/31
• Corporate Income Tax (on Interest Income)	3/15 (varies by state)

*Based on tax and plan years ending December 3

**501(c)(3) organizations may be exempt

***501(c)(3) only

****501(c)(3) may apply for exemption

(Source: National Center for Nonprofit Boards, 1998)

APPENDIX D

Financial Management Assessment Hints

Financial Management
Ask the right questions. Get price information. Read how other organizations have funded ambitious technology plans. This section will provide you some of the tools to accomplish financial goals (BoardSource, 2002).

Ask the Right Fund Management Questions
You will be able to plan more efficiently if you have all the answers. Asking the right questions will guide you through the process. This section will provide you with many useful questions to consider in budgeting for technology implementation (BoardSource, 2002).

Define Your Needs
The first step in any search effort is defining your organization's needs. If you do not know what you want, you will not find it and you will waste financial and human capital.

Key Questions to Ask Your Organization
- What are we trying to accomplish?
- What information do we need to achieve that goal?
- How much time and money do we have?

Understand the Vocabulary
The next step is to generate a list of key words and phrases to use as search terms. Take time to understand the vocabulary. Use references such as dictionaries, encyclopedias, textbooks, and handbooks to help if you are not completely familiar with the research area.

Determine Appropriate Sources for your Purchase
Find out where you can make the type of purchase. Remember different vendors use different orders of operation (BoardSource, 2002).

Cost Compare Options
Look at the costing from the different vendors. Do not just look at the bottom line. Know what each offer entails (BoardSource, 2002).

To assess district technology costs, keep in mind the following elements of your technology plan:

- Infrastructure
- Hardware
- Upkeep and Upgrades
- Software
- Professional Development

Determining Technology Costs

Technology is not cheap, but with research and full knowledge of the things you need you can cut costs. Determine your costs before investing in new technology. This section will show you what to include when determining your technology costs.

As you begin developing your funding approach, use the following questions to steer your process:

- How much money is available for technology implementation?
- How big a part of the budget should it be?
- How much is needed for equipment, restructuring, software, continuing charges, i.e. program updates or phone line charges?
- Will additional funding be needed?
- Are any monies available from grants, state aid programs, business partner- ships?
- Will it be necessary to pass community bond issue or levy?
- It is wise to conduct a market analysis when planning for expenses involving new technology (BoardSource, 2002).

References

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