Nonprofit Financials: What Your Board Needs to Know

Association *TRENDS*

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About CliftonLarsonAllen

CliftonLarsonAllen (CLA) provides training, consulting, audit, tax and outsourced accounting services to more than 2,000 associations and their related foundations, political action committees, and for-profit entities. We serve more than 6,000 nonprofits nationwide from our 90+ offices.

CLA has consulted with hundreds of nonprofits and foundations throughout the country in strategic and business planning, program development and evaluation, leadership transition, board development, financial and organizational assessments, financial systems analysis and design, etc.

Your Presenter

Nat Bartholomew has over 25 years of public accounting experience and has served clients within the nonprofit community his entire professional career. Nat is CLA's National Leader for Associations and Membership Organizations.

Nat's clients include: American Nurses Association, Association for Financial Professionals, Dental Trade Alliance, Marine Corps Association, Military Officers Association of America, National Association of Secondary School Principals, National Business Officers Association, National Private Truck Council, Sheet Metal & Air Conditioning Contractors of North America and a host of similar trade and professional associations.

Learning Objectives

By the end of the session, you will know:

- The roles and responsibilities of governance and management
- How to read and interpret nonprofit financial statements
- How accounting standards affect nonprofit financial reporting
- How to know if a nonprofit is gaining or losing ground
- How to spot signs of financial health, as well as red flags

ACCOUNTABILITY AND BOARD FIDUCIARY RESPONSIBILITY

Defining Accountability

Nonprofit board members are required to:

- Operate with a clarity of purpose
- Maintain legal knowledge
- Maintain ethical behavior that extends beyond the requirements of the law
- Conduct regular self-evaluation of mission, programs, and operating policies
- Maintain responsibility for fiscal oversight

Governance Responsibilities

- Establishing mission and philosophy
- Planning
- Selection and supervision of top management
- Ensuring adequate resources and managing them effectively
- Setting policies to effectively guide operations and programs
- Reviewing financial and programmatic performance as compared to objectives

Governance Responsibilities (cont'd)

- Organization of the board to work effectively
- Recruitment and orientation of new members
- Advocacy for the organization in the community
- Ensuring legal and ethical integrity

What Does the Law Require?

- Duty of Care
  - Diligence and attentiveness to board responsibilities. Act as “an ordinarily prudent person” would “in a like position and under similar circumstances.”
- Duty of Loyalty
  - Faithful pursuit of the interests of the organization rather than personal interests or the interest of another person or organization.
- Duty of Obedience
  - Act with fidelity, within the bounds of law generally, to the organization’s mission.

Duty of Care

- Attend meetings and actively participate in the work of the board
- Scrutinize the work of committees having authorization of the board
- Participate in board actions. If you are there, you are responsible
- Know the books and records
- Protect the organization's assets consistent with donor restrictions and legal requirements

Duty of Care (cont'd)

- Assist the organization in obtaining adequate resources
- Honor your duty to investigate and report potential theft or mismanagement

Duty of Care (cont'd)

- Ensure financial accountability:
  - Oversee the organization's chief executive
  - Check that resources are used prudently
  - Implement procedures to ensure accurate records
  - Ensure segregation of duties
  - Maintain internal controls
- Document decision-making in board minutes

Duty of Loyalty

- Avoid conflicts of interest or the appearance of such conflict. If questions arise, the burden of proof that no conflict exists lies with the director
- Establish a written policy on avoiding conflicts of interests
- Do not lend money to a director or the director’s family unless the board deems it will benefit the corporation

Duty of Loyalty (cont'd)

- Do not divert a corporate business opportunity for your own personal gain
- Adhere to the rules of the Internal Revenue Code regarding self-dealing

Duty of Obedience

- Ensure the organization remains obedient to its central purpose
  - Be familiar with state and federal statutes and laws related to the organization
  - Comply with deadlines for all local, state, and federal filings
  - Be familiar with the organization's governing documents and follow the provisions of those documents
  - Where appropriate, obtain opinions of legal counsel or accountants

Fiduciary Responsibility

Financial oversight is a core responsibility of the board

That means that ALL board members:

- Have equal and shared fiduciary responsibility for the organization
- Understand the content and significance of financial statements and audit

Fiduciary Responsibility

- Ensure the protection and appropriate use of the organization's assets
- Establish program revenue and expense objectives which are consistent with the mission of the organization
- Insist on income-based spending
- Thoroughly discuss and adopt an annual budget that reflects the financial objectives and strategies of the organization <u>before</u> the beginning of its fiscal year

Fiduciary Responsibility (cont'd)

- Review financial statements regularly and compare them to budget. Ensure that you account for significant variances and require timely course adjustments as needed
- Ensure that strong and appropriate internal financial controls, processes, and practices are in place
- Establish appropriate financial policies to guide organization operations
- Where possible, establish an operating reserve to finance cash shortfalls and program growth

Fiduciary Responsibility (cont'd)

- Assess annual audit implications and approve action plans to strengthen performance
- Establish and monitor a system to ensure that the organization is in compliance with all relevant financial laws and regulations
- Approve non-routine contractual obligations as defined by approved board expenditure authorization policies
- Establish adequate risk management mechanisms

Treasurer Responsibilities

- Provide the eyes and ears of the board in the finance area
- Report to the board the financial condition of the organization on a regular basis
- Monitor internal controls, financial planning
- Ensure that timely, accurate financial information is presented to the board in a clear and concise manner

Finance Committee Responsibilities

- Provide monthly review of financial statements
- Oversee financial operations:
  - Budgeting
  - Policy development
  - General financial planning – current and long-term
- Be alert to signs of financial problems
- Risk assessment
- Investment oversight (often delegated to an investment committee)
- Audit oversight (often delegated to an audit committee)

Audit Responsibilities

- Select audit firm and define service expectations
- Discuss scope and timing of work with auditor
- Respond to audit findings and recommendations
- Present annual financial statements
- Review conflicts between auditors and management

These items are often codified in writing in an Audit Committee Charter

Executive Responsibilities

- Carry out board policy and directives
- Administer internal controls
- Monitor financial goals and objectives
- Process financial information
- Prepare budgets and financial information
- Provide accurate, timely and meaningful information
- Keep the board appropriately informed
- Maintain key relationships (sponsor, community, etc.)

MANAGEMENT VS. GOVERNANCE

Governing Functions

- Strategic Direction – setting a direction for the organization that reflects its constituents needs
- Resource Development – developing financial resources that support program activities
- Financial Accountability – managing financial resources that ensure honesty and cost-effectiveness
- Leadership Development – developing the human resources that lead the organization today and in the future

Management Functions

- Program Planning and Implementation – taking the strategic directions to the next level of detail and putting it into action
- Administration – ensuring the effective management of the details behind the program

Understanding Board and Staff Roles

Answering two important questions…

- How to determine distinct roles for board and staff so that each has a clear job description
- How to engage board and staff in a complementary manner to provide organizational leadership

Determining Different Roles

- Governance is the ultimate responsibility of the board, while the responsibility of the staff is management.
- Rather than seeing the nonprofit board's job as a function of *management, it is first and fundamentally* a responsibility for *ownership.*
- Board should ask, in regards to programs and initiatives, "Why are we doing this, rather than, how can we do it?"

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FIVE NONPROFIT FINANCIAL BASICS

Financial Basic #1

There are two types of nonprofit income.

- Support
- Revenue

Financial Basic #2

Financial information is based on periods of time.

- Past………………………….Financial Statements
- Future……………………….Budget
- Present Reality………….Cash Flow Projections

Financial Basic #3

Numbers are meant to be compared.

- Current year actual vs. current year budget

  vs. last year actual

  vs. five year trend

Financial Basic #4

Anticipation is the key to financial stability.

- Management needs TIME to adjust if revenues are not coming in according to plan.

Financial Basic #5

Financial health is essential for the effective delivery of nonprofit services.

NONPROFIT FINANCIAL STATEMENTS

Know What You Are Looking At

Organizations produce various types of financial reports, which provide different types of information to readers, and are used for varying purposes.

- Internal Financial Statements
- Financial Statement Compilation
- Financial Statement Review
- Audited Financial Statements
- Single audit and yellow book reporting
- Form 990
- Budget

Cash vs. Accrual Basis Accounting

- Cash Basis Accounting records income when **cash is received** and expenses when they are actually **paid**.
- Accrual Basis Accounting records income when it is **earned** and expenses when they are **incurred**.

Three Categories of Income and Assets

1. **UNRESTRICTED**—Assets which are free of all donor-imposed restrictions and are therefore available for use by the organization subject only to those broad limits that relate to the nature of the organization, its by-laws, or its contractual agreements. All assets with non-donor-imposed limits, such as board designation for a specific purpose, are considered unrestricted.

Three Categories of Income and Assets

2. **TEMPORARILY RESTRICTED**—Contributed assets received with donor-imposed limitations that may be removed by actions of the organization or that expire with the passage of time.

Three Categories of Income and Assets

3. **PERMANENTLY RESTRICTED**—Contributed assets received with donor-imposed limitations that may never be removed by time or the actions of the organization.

More on "Unrestricted" Assets

The accounting standards' usage of the word unrestricted is not the same as the donor's typical usage of the word unrestricted.

- To a donor, an unrestricted grant is a general operating grant that may be used in any area of the nonprofit.
- In the accounting standards definition, unrestricted grants include general operating grants AND funds that have been used by specific activities within the nonprofit, according to donor intent. What is NOT included is funds the nonprofit has received but not yet used (spent) for the purpose the donor specified.
- The accounting standards use temporarily restricted net assets as a holding tank for funds that have not yet been used according to a specific time or action / purpose restriction.

Types of Expenses

DIRECT EXPENSES are easy to attribute to the activity that incurs them, and are therefore “assigned” or “allocated” to that activity. Some examples of direct assigned expenses follow:

- Supplies ordered and used by Program A.
- Postage paid for a Program A mailing.
- Travel costs for Program A.

Types of Expenses (cont.)

Some direct expenses are easy to attribute to activity, but they are not charged in a discrete way to the activity. They are often "allocated" to programs by an appropriate formula.

- Rent for the space occupied by Program A when it shares premises with Programs B and C. Often the total rent is allocated based on share of square footage occupied.
- Compensation and benefits for staff assigned to Program A. Staff often work on multiple programs and therefore their time, and thus their compensation and benefits must be allocated to the various programs they work on each pay period.

Types of Expenses (cont.)

INDIRECT EXPENSES are difficult to attribute to individual activities because they benefit the entire organization. These are sometimes referred to as overhead expenses. These are often totaled and allocated back to programs using one agreed-upon formula.

- Portion of accounting, tax and/or audit fees
- Portion of the executive director's salary
- Portion of the board of directors' expenses

The Anatomy of an Audit

Audited financial statements consist of the following elements:

- Independent Auditors' Report
- Statement of Financial Position (Balance Sheet)
- Statement of Activities (Income Statement)
- Schedule of Functional Expenses (optional)
- Statement of Cash Flows
- Notes to the Financial Statements
- Supplementary Information (optional)

The Statement of Financial Position

Shows the organization’s financial position at a particular point in time.

ASSETS: Economic resources the organization owns or has been promised.

LIABILITIES: Financial obligations; what the organization owes to others.

NET ASSETS: The difference between total assets and total liabilities.

–The “Classified SFP”

Assets = Liabilities + Net Assets

- This is the equation that gives the "balance sheet" its title.
- NET ASSETS represent the accumulation of surpluses or deficits the organization has achieved since it began operating.
  - If, through the years, surpluses have exceeded deficits, net assets will be a positive amount.
  - If the opposite has occurred, the organization will show negative net assets and could be in financial trouble.

The Statement of Activities

Shows all of the organization's financial activities from the beginning to the end of the fiscal year.

- Sources and amounts of income
- How income was spent
- How much income was left (surplus) at the end of the year, or by how much income was overspent (deficit) at the end of the year

FINANCIAL STATEMENT ANALYSIS FUNDAMENTALS

Financial Statement Analysis

Financial analysis enhances the story told in the financial statements. It produces some insights that allow the reader to form judgments…and questions.

Financial analysis must always be done with an eye on the organization's overall context.

- Sector, core "business"
- Age or lifecycle stage
- Size

Financial Statement Analysis (cont.)

Financial analysis uses quantitative tools.

- Changes and trends
- Comparisons with similar organizations
- Ratios

CHARACTERISTICS OF NONPROFIT FINANCIAL HEALTH

Characteristics of Financial Health

Financially healthy nonprofits….

1. Have sufficient financial resources to ensure stable programming.
2. Have a ready source of internal cash, or access to cash, available in times of shortfalls.
3. Are committed to income-based spending.
4. Retain, at the end of each year, positive cash and net assets.

Characteristics of Financial Health

Financially healthy nonprofits….

5. Have accumulated surpluses which are greater than the current year's deficit if there has been a deficit for the year.

6. Have established, or have specific plans to establish, an operating <u>reserve</u> to finance cash shortfalls and program growth.

7. Have boards and management that hold themselves responsible for the financial stability of the organization.

FINDING THE CHARACTERISTICS OF FINANCIAL HEALTH IN YOUR FINANCIAL STATEMENTS

Financial Indicators

1. Financially healthy nonprofits have sufficient financial resources to ensure stable programming.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Net Asset Position	Total assets minus total liabilities	A positive number represents accumulated surpluses / solid financial performance	Statement of financial position (balance sheet)

Financial Indicators

1. Financially healthy nonprofits have sufficient financial resources to ensure stable programming.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Permanent Capital	Funds that have been restricted by a donor. The restriction usually prohibits use of the "corpus"	Organization has a supporter who believes in it enough to make a permanent investment.	Statement of financial position (balance sheet)
Semi-permanent Capital	Funds that have been restricted or designated by the board	Leadership recognizes the need for working capital	Statement of financial position (balance sheet)

Financial Indicators

2. Financially healthy nonprofits have a ready source of internal cash available in times of shortfalls.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Working Capital	Current assets minus current liabilities	How much of the assets are liquid and available for day to day needs	Statement of financial position (balance sheet)
Current Ratio	Current assets divided by current liabilities	Proportion of liquid assets to the claims on those assets (should be > 1)	Statement of financial position (balance sheet)

Financial Indicators

2. Financially healthy nonprofits have a ready source of internal cash available in times of shortfalls.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Quick Ratio	Cash + accounts receivable ÷ current liabilities	More conservative than current ratio for showing liquidity	Statement of financial position (balance sheet)
Cash on Hand to Current Liabilities Ratio	Cash divided by current liabilities	Measures liquidity strictly on the basis of cash on hand	Statement of financial position (balance sheet)

Financial Indicators

3. Financially healthy nonprofits are committed to income-based spending.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Unrestricted Surplus / (Deficit)	Income less expenses = surplus (deficit if negative)	Positive number means the organization lived within its means for the time period shown.	Statement of activities

Financial Indicators

4. Financially healthy nonprofits retain, at the end of each year, positive cash net assets.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Positive Cash Net Assets	Cash + receivables – temporarily restricted net assets > zero	Positive number means the organization has enough liquid assets to cover what has already been received in temporarily restricted funds, with some left for operational needs.	Statement of financial position (balance sheet)

Financial Indicators

5. If there has been a deficit for the year, financially healthy organizations have accumulated surpluses which are greater than the current year's deficit.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Net Asset Position	Total net assets at end of year	Positive number means there are enough net assets at the beginning of the year to "fund" the current year deficit, if there is one.	Statement of financial position (balance sheet)

Financial Indicators

6. Financially healthy organizations have established, or have plans to establish, an operating reserve to finance cash shortfalls and program growth.

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Presence / Absence of a Reserve	Assets include a cash reserve or similar fund, and net assets shows the same fund	The organization's leaders have acted upon a perceived need to dedicate resources to financial stability	Statement of financial position (balance sheet)

Financial Indicators

Other helpful indicators

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Debt / Net Assets Ratio	Loans + notes payable divided by net assets	Indicates how much debt the organization carries in proportion to its net worth. The higher the %, the more the organization relies on borrowed money for its ongoing operations.	Statement of financial position (balance sheet)

Financial Indicators

Other helpful indicators (cont.)

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Contributions to Total Revenue Ratio	Contributed income divided by total revenue	Measures the proportion of revenue that comes from grants, donations, other charitable contributions. A diverse mix is ideal.	Statement of activities

Financial Indicators

Other helpful indicators (cont.)

INDICATOR	DEFINITION	WHAT IT TELLS ME	WHERE I FIND IT
Program to Total Expenses Ratio	Program expenses divided by total operating expenses	Measures the proportion of expenses used to support programming vs. how much is spent for general management and fundraising.	Statement of activities

The Importance of Trends

	2006	2007	2008	2009	2010
Support & Revenue					
Expenses					
Change in Net Assets					
Net Assets Beginning-of-Year					
Net Assets End-of-Year					

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