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Introductory Concepts

The key to the financial success of a nonprofit organization is the use of traditional management tools—forecasts and budgets, well designed and timely financial reporting system, good governance, clearly defined line of business (mission), cash flow planning, fiscal controls, and a lot of goodwill.

Financial planning for nonprofits, like a nonprofit's very purpose for existence, is based on the philosophical aspirations of persons joining together to accomplish mutual goals. The very purpose for existence of a nonprofit is based on hope, sometimes on prayer, and almost always on dreams. Dreams can be unrealistic and can make financial planning a risky venture. The challenge is to stretch and balance precious resources to best accomplish the dream. Together, the two functions—performing the mission and providing the requisite resources—work in tandem to sustain the nonprofit's existence.

Although idealistic aims guide the planning process and dictate a nonprofit's priorities, accomplishment of the goal can be enhanced with astute planning. Readers who are familiar with business management will recognize the planning processes discussed in this book. Similar to the income tax rules concerning tax-exempt nonprofits discussed in Chapter 8, financial planning for nonprofit organizations requires acknowledgment that the special character, language, and tools germane to nonprofits be understood alongside language and concepts applicable to for-profits. When working with a nonprofit organization, it is useful to ask what would make it prosper and flourish like a business. You can ask how an entrepreneur would respond if the same situation arose in his or her successful business. You should wonder whether the stockholders, if the nonprofit had any, would ratify the recommendations being proposed by management?

The financial activity of nonprofit organizations has been the subject of much scrutiny and criticism during this decade. The IRS Form 990 filed annually by charities, complete with details of revenues, expenses, assets, activities, compensation of officials, and many other disclosures can be viewed on the Internet.[1] Charity Navigator was formed in 2001 to grade charities.[2] During 2002 and 2003, the *Boston Globe* presented a series on the results of its investigation of private foundation abuses.[3] As the Enron scandal also unfolded during 2002, Congress approved new standards applicable to publicly traded corporations. This so-called Sarbanes-Oxley legislation was enacted to prevent a repeat of the Enron misrepresentations by improving rules of governance and oversight of financial matters.

The Senate Finance Committee, then headed by Senator Charles Grassley, next turned its attention to the nonprofit sector. After a series of hearings, the committee in July 2004 issued a 19-page report outlining a wide range of new standards to improve public accountability and governance of nonprofits. In response, Independent Sector assembled a Panel on the Nonprofit Sector consisting of 175 executives and experts with extensive knowledge of and experience with public charities and private foundations. Drawn from organizations of all sizes serving diverse missions and geographic locations, they advise the Panel as it develops recommendations on how to ensure that nonprofits remain a vibrant, responsive, and effective part of American society. These participants, all of whom have volunteered for this important work, joined one of eight groups:

- The Panel. Twenty-four nonprofit leaders who reflect the reach and diversity of the country's nonprofit organizations
- The Citizen Advisory Group. Nine leaders of America's business, educational, media, political, and religious institutions
- The Expert Advisory Group. Eight of the foremost scholars and practitioners in nonprofit operations
- The Work Groups. More than 100 nonprofit practitioners are taking part in five groups: Governance and Fiduciary Responsibility; Government Oversight and Self-Regulation; Legal Framework; Small Organizations; and Transparency and Financial Accountability.

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[1] At www.guidestar.org.

[2] See www.charitynavigator.org. In June 2007, their site displayed a rating range of one to four stars for over 5,200 charities based on information in their Form 990.

[3] In one example, $250,000 was paid for the wedding of a foundation trustee. On December 30, 2003, in conclusion to its series on foundation practices, the *Boston Globe* reported that "both the Internal Revenue Service and state attorneys general have inadequate resources to provide effective oversight of private foundations."

- The Advisory Committee on Self-Regulation of the Charitable Sector More than 30 leaders examining how to best strengthen self-regulation, including how build on the work of various organizations and subsectors that have already developed standards, accreditation, and training

The Panel's recommendations to strengthen the transparency, governance, and accountability of charitable organizations were first published in June 2005 followed by a supplement in April 2006. The Panel's work continues in the summer of 2007 as comments on its recommendations are reviewed to compile enhanced standards for financial management and governance. Thanks to the work of the Panel and many others, most of the provisions suggested by Grassley's committee were not enacted in the Pension Protection Act of 2006. As the sector works toward new standards, it recognizes that its ability to improve lives depends on the support of the public, which it will receive only if it earns the public's trust.[4]

The American Bar Association Coordinating Committee on Nonprofit Governance has also issued a report recommending reforms.[5] In addition, the IRS issued its list of *Good Governance Policies for 501(c)(3) Organizations* in February 2007.[6] Readers should be alert for new developments, as the scrutiny of the nonprofit sector will undoubtedly continue. Nonprofits and their boards need to take steps to assure their organization is serving its mission in an efficient and cost-effective fashion following the highest possible ethical standards following standards and using checklists in Chapter 2.

If there is any doubt about the need for good financial management and planning, remember what happened to the United Way of America. Even in what one would think was one of the most well-run organizations in the United States; money was misappropriated by an executive director reportedly for personal gain.[7]

HOW TO USE THIS BOOK

This book provides step-by-step solutions to the dilemmas involved in keeping financial resources and the mission in balance. Financial

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[4] Panel reports, including a draft of the *Principles for Effective Practice,* were released for comments as of June 17, 2007. They are available at www.nonprofitpanel.org/selfreg/Index.

[5] *Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley,* published by ABA in May 2006.

[6] Available at http://www.irs.gov/pub/irs-tege/good_governance_practices.pdf.

[7] The September 27, 1994, Associated Press report of his trial stated, "William Aramony has pleaded innocent to charges that he diverted United Way money to buy such things as a New York City apartment for his girlfriend."

management tools and techniques for nonprofits are explored and reviewed in some detail, with illustrations, examples, checklists, and model forms. As this chapter explains, the concepts and planning methods used by businesses are germane and can be tailored to suit a nonprofit's needs. The financial planning checklist at the end of this chapter is designed as a comprehensive survey of financial planning issues that face a nonprofit.

Planning for a nonprofit's fiscal health and effective operation is an ongoing and continually evolving process. The mission statement is not necessarily revised monthly, but the current financial data should be. Exhibit 1.1 illustrates the overlapping circles of financial management activities. As a first planning step, the organizational structure is evaluated. It should be clear from the rules of governance and procedures who is in charge, as discussed in Chapter 2. All should understand the function of the board, volunteers, and staff, and the roles of the internal and external accountants in the financial affairs.

Next comes planning and evaluation of organizational objectives, as shown on the right-hand side of the circles in Exhibit 1.1. Before spending a penny, the board members and major supporters in concert with staff define the mission and develop specific performance goals. How can funders or members understand the nonprofit's vision without a description of its activities and financial goals? What will provide the volunteers with a source of direction? Dreams and aspirations must be explored, examined, and written down in a mission statement. This "what if" segment of the planning process facilitates evaluation of alternatives. Chapter 3 explores these concepts and provides suggestions for utilizing critical analyses to test the means of accomplishing the mission.

Once the basic philosophical ambitions are understood, financial management translates the mission into financial terms. Aspirations are expressed in numbers as budget planning begins. The end result should be a financial blueprint for achieving mission-oriented goals. Fiscal performance goals are, after all, merely a means to successful program achievements. Chapter 4 explores the process of preparing and monitoring budgets, incorporating staff participation in the process, and fostering staff support for financial goals. Operational as well as capital-addition budgets are discussed.

Although budgeting is designed to allocate the organization's current resources to achieve program goals, effective asset management maximizes the value of those resources. Plans to monitor cash flow to maximize the yield on cash and other investment assets are formulated in Chapter 5. The investment policies and decisions concerning permanent funds are explored. A checklist for managing and monitoring endowment and restricted funds is provided to serve as a tool in protecting these important resources.

Reporting and monitoring financial transactions as they occur is critical. Chapter 6 discusses financial records and the decisions an organization makes in establishing its accounting systems. Useful journals and ledgers are defined and suggestions made regarding design of charts of accounts.

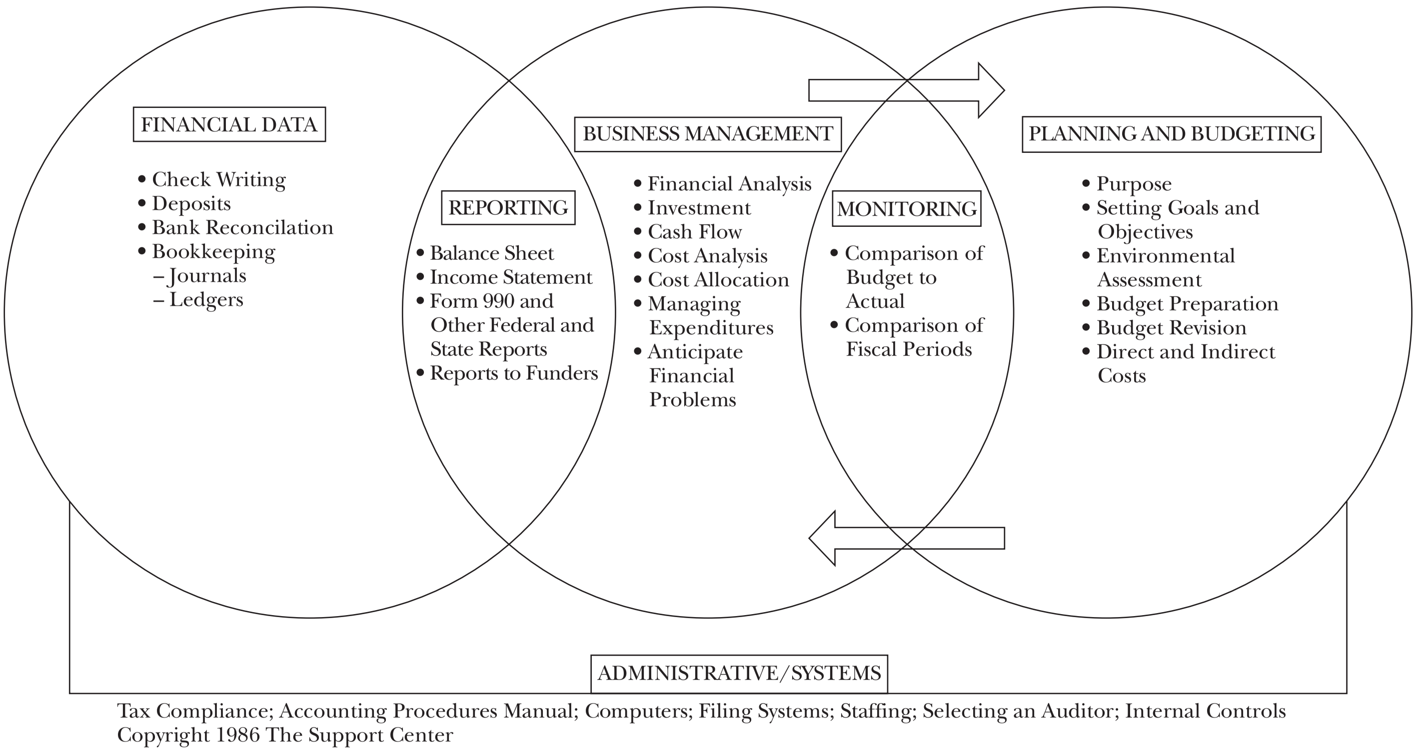

Exhibit 1.1 Financial Management Activities in Nonprofit Organizations

The difference between—and when to use—the accrual method rather than the cash method of accounting is considered. The meaning of FASB and GAAP is explored with an outline of currently applicable pronouncements. A checklist is provided as a guide to computerization and selection of appropriate accounting software. Control and evaluation complete the cycle of financial planning. The task is to monitor, to manage the problems highlighted, and to be aware of how well the reality measures up to the nonprofit's aspirations. The financial planner will want internal controls, such as those described in Chapter 6, installed with the help of the outside accountants to safeguard the nonprofit's resources on a daily basis. The ratio analysis techniques presented in Chapter 7 will be useful in pinpointing any weaknesses and identifying hidden trends. Financial evaluations for purchasing and leasing decisions, employee compliance, and agency agreements implementing strategic alliances are provided. Other financial decisions can be made using the comprehensive checklists and sample forms presented throughout the book.

Because not all nonprofits qualify for tax-exempt status, Chapter 8 explores the criteria for, and the means of obtaining, special tax treatment. Confusion arises because the activities of nonprofits and for-profits are often the same or very similar. Financial planners need to understand the breadth of activity permissible to an exempt organization. Issues pertaining to the use of unrelated business income to support exempt purposes are also discussed. A glossary of tax and financial terms unique to nonprofits precedes the index at the end of the book.

ATTRIBUTES OF NONPROFITS

The world of nonprofits includes a broad range of institutions: charities, business leagues, political parties, schools, country clubs, cities, cemeteries, employee benefit societies, social clubs, united-giving campaigns, and a wide variety of other pursuits. For financial planning purposes, it is useful to distinguish between organizations that direct their efforts outwardly, or externally, and those organizations whose work is focused internally, or toward benefiting their members. Nonprofit organizations share the common attribute of being organized for the advancement of a group of persons, rather than particular individual owners or businesses. Sometimes it is useful for the organization to think of its beneficiaries as clients for planning purposes. Applying this concept, nonprofits can be divided into different groups as follows:

- *Type 1.* Nonprofits that operate to serve the public good by providing health care, education, culture, and social welfare service to the public (hospitals, schools, libraries, and homeless shelters, for example)

- *Type 2.* Organizations that serve both the public and their members (churches, public interest groups, and civic leagues)
- *Type 3.* Nonprofit membership organizations that are member oriented or that focus their activities on fulfillment of member services (social clubs, business leagues, and labor unions)

A nonprofit can utilize the same tools as commercial businesses that perform essentially similar services or sell goods. Likewise, the nonprofit can and should patronize its constituents or customers who fall into basically two groups:

1. *Patrons or investors.* Those who provide resources or money to the nonprofit
2. *Constituents or customers.* Those to whom services and goods are provided.

Type 1 and 2 organizations as described above have both investors and customers. Type 3 organizations primarily have customers. All three types must focus on keeping their investors and customers happy.

Investors want a return on their money. The return that investors in Type 1 and 2 nonprofits receive is mostly intangible and the investment is inspired by compassion for the mission. Their benefit comes through their conscience and knowing they help someone else. Volunteers who invest time must feel important and useful and be shown that their contribution of time is valued and appreciated. Hiring a volunteer coordinator can be an important choice in attracting and maintaining this vital source of financial support.

Type 2 and 3 nonprofit customers choose whether to participate in the nonprofit's programs and use the services or goods proffered. These nonprofits must make every effort to attract customers and give them top priority. The old adage, "Make new friends but keep the old," is a suitable refrain for a membership campaign. Whether one is silver or the other is gold, new and renewing members are an invaluable resource to a wide variety of nonprofits. A nonprofit's attitude toward them can significantly impact its success. Although it is not easy to measure this intangible in the annual budget, it can be invaluable.

For those customers receiving the nonprofit's free or low-cost services, there is an invisible interaction with the investors or contributors. How the nonprofit is perceived or evaluated by its customers can impact the attitude of its investors. The financial planners should ask if the organization treats those to whom it provides services with the highest respect. How does the general public, particularly the nonprofit's contributors, view the value of its services to the community in aiding the sick, poor, uneducated, or other persons in need?

In deciding what to call its investors, some organizations cause confusion by choosing the term *member.* As explained in Chapter 8, a membership organization is one whose members elect the governing board. To avoid this misconception, contributors should be called members only if they actually have this voting right. The name *member* is also tainted by several tax limitations on the income tax deduction of membership dues.

CAN NONPROFITS *PROFIT*?

The pursuit of profit in the normal sense is not the primary motivation of nonprofits, but there are no specific constraints or sanctions prohibiting the accumulation of funds in excess of liabilities, or capital, as long as the mission, or exempt purpose, is served. For many, the term *nonprofit* implies a prohibition against the receipt of revenues in excess of expenditures. Such a view suggests that a nonprofit cannot have a profit and is expected, instead, to lose money. Whatever the result is called, a nonprofit can generate revenues in excess of its expenses and accumulate a reasonable amount of working capital or fund balances. It can save money to build a building, to expand operations, or for any other valid reason serving its underlying exempt purposes. It can borrow venture capital to establish a new project. Basically, a nonprofit can operate without a profit motive and still produce what many think of as a profit.

Meaning of *Profit*

For nonprofit organizations, profit can mean many things, including bringing good; making progress; or being gainful, useful, advantageous, or productive.[8] These terms connote benefit to others and acknowledge the selfless purposes and activities of the organization. Profit for a nonprofit does not always come just from the bottom line. Instead, profit may be measured in terms of the number of books published, increases in attendance or test scores, or enhancement of the profession's public image. Although not necessarily measurable in financial terms, discovering a cure for a disease is the yield, return, or reward for a research organization's efforts.

When a hospital buys a magnetic resonance imaging (MRI) machine to offer better health care, it may reasonably expect the machine to pay for itself plus provide a steady stream of excess revenue, or profit. The hospital may use such profits to improve its diagnostic capabilities or use them to purchase a building, to expand other departments, or for any other valid reason serving its underlying nonprofit purposes. The distinguishing factor

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[8] *Webster's Deluxe Unabridged Dictionary,* 2nd ed., New York: Simon & Schuster, 1982, p. 1437.

is the motivation for undertaking the activity that might generate the profit. Did the hospital buy the machine simply to make a profit or instead to better improve the health of its patients?

An accurate perspective on the term *nonprofit* focuses on the lack of self-interest in the financial results of the operations. The directors or trustees serve as stewards of the funds to assure they are devoted to meeting the socially desirable goals. The income, or profit, is not distributable to its members, directors, or officers. Just like a for-profit business, the nonprofit can pay salaries and employee benefits to its workers (including its directors), as long as the pay is reasonable in relation to services performed. There are two things it cannot do: (1) distribute the net profit as a return on capital to the people who fund and control the organization, or (2) accumulate profit or capital resources in excess of that needed to accomplish the mission.

Profit Prohibitions

There are few, if any, reasons—legal, ethical, or otherwise—why nonprofits should not accumulate excess funds, or capital, as long as such funds are devoted to the mission. Consider two authoritative interpretations of the term *nonprofit*. The State of Texas says a "nonprofit corporation means a corporation no part of the income of which is distributable to its members, directors, or officers." Similarly, the State of New York provides a two-prong test for determining whether a corporation is qualified to be treated as a nonprofit entity:

1. New York nonprofits must be formed for a nonpecuniary purpose *and*
2. No part of their assets, income, or profit is distributable to, or may inure to the benefit of, its members, directors, or officers with certain exceptions otherwise permitted.

The word *pecuniary* simply means "that which relates to money."[9] Clearly, a nonprofit must receive, hold, and use money to operate. The nonprofit's purpose or reason for having money must not be solely to generate more money. Money can be its means, but not its end. Without specifically saying so, the New York law requires that the nonprofit focus on accomplishing its mission, and that mission must be something other than receiving, spending, and accumulating money.

Note that the second test anticipates the nonprofit may produce a profit; the test simply prohibits insider benefit. The American Institute of Certified Public Accountants' Audit Guide for Not-for-Profits states that the term *not-for-profit* is not intended to imply that a voluntary health and welfare organization cannot obtain revenues in excess of expenses in any

[9] Ibid., p. 1420.

particular period; rather, it implies that the organization is not operated for the financial benefit of any *specific individual or group of individuals.*[10]

A nonprofit organization receiving excess revenues, or profit, for the year must decide what level of balances it should reasonably accumulate. Must the money be expended during the coming year? Can the money instead be set aside or saved for a rainy day? A number of different factors influence the answers. For federal tax purposes, the question is whether the organization's nonprofit purposes are served by saving the money rather than spending it on programs. The tax code contains no numerical constraint on the amount of fund balances a tax-exempt organization can maintain. The only specific spending mandate applies to private foundations and requires that 5 percent of the average fair market value of the investment assets be distributed annually for charitable purposes.

Another factor in the decision is the attitude of the organization's funders. A successful nonprofit with money in the bank may meet some resistance to its requests for donations. It may have to justify its need for funding as compared to a nonprofit whose programs may be curtailed unless it receives the funding. The BBB/Wise Giving Alliance standards say an organization should have unrestricted assets available for the following fiscal year of not more than three times the current year's expenses or the next year's budget, whichever is higher.[11] Note temporarily or permanently restricted funds may not be treated as "available for this purpose." See Chapter 5 (Restricted Gifts; Endowments) for consideration of such funding and Chapter 6(FASB, GAAP, and Nonprofits) for accounting definitions.

Why Seek a Profit?

The belief that a nonprofit organization must lack profit motive can limit its success and ultimately its existence. True enough, an organization's top priority is not to produce profits—it dedicates itself to carrying out a mission to benefit others. Yet profit can enhance the ability to perform its mission just as the year-end profit distributed as dividends to shareholders influences a for-profit common-stock market price.

Consider what happens when a nonprofit never generates revenues in excess of expenses. Such an organization cannot finance the expansion of its activities, accumulate a decent level of working capital, retire debt, or meet countless other financial capital needs; its existence might be tenuous, to say the least. Certainly, a newly established nonprofit should plan to

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[10] *Industry Audit Guide: Audits of Voluntary Health and Welfare Organizations Including Statement of Position 87-2,* 2nd ed., New York: American Institute of Certified Public Accountants, 1988.

[11] According to the 10th standard of the 20 listed in their Standards for Charity Accountability; see www.give.org/standards/newcbbbstds.asp.

generate revenues in excess of expenditures—profit—in its first few years to accumulate sufficient working capital.

DIFFERENCE BETWEEN NONPROFITS AND FOR-PROFITS

A nonprofit organization is distinguishable from a for-profit business in many respects. One distinguishing factor between them is the motivation for undertaking an activity that generates revenue. The fact that a nonprofit charges for the services it performs is not evidence of profit motive. A hospital may pay all of its costs with patient charges. Whether such a hospital is a nonprofit depends on why it was created and how it operates. Is its purpose to promote the general public's health or solely to earn a profit? In other words, does it exist to support an ideal or particular individuals?

A nonprofit decides to adopt a project because of its value to society or its members rather than its potential to generate monetary profits, although one worthy project may be chosen over another based on revenue expectations. Accordingly, the challenges in achieving financial success may be considerably more daunting for nonprofits than for for-profits.

Capitalization: Philanthropists versus Investors

A nonprofit's need for capital, or unrestricted and available-to-spend, funds, to commence and to continue operation is similar to a for-profit's: Capital provides the financial underpinning to bridge gaps in the flow of funds and to ensure that financial obligations can be paid in a timely fashion. Consider, for example, a social club's capital requirements. The typical club has a physical site for its members to congregate and socialize. Whether the club buys and maintains its own building or leases facilities, the club needs capital to do so. Before agreeing to provide the property to the club, the landlady/lord or building seller will require evidence of the club's financial viability, or capital available to finance acquisition and upkeep. The capital may come from the membership assessments or from existing club funds accumulated from profitable club operations in the past. It may also use borrowed capital to buy and operate the property.

The economic rewards customary in business—dividends, interest, and capital appreciation—are not available to those who invest in nonprofits. The standards used by a nonprofit supporter to measure returns on their money are very different from a for-profit investor's. The tools for measuring success, however, are similar. Financial indicators that evidence goals accomplished can be used as a measure. The prosperity of a nonprofit can be evaluated by counting the number of children clothed and fed during the year, by comparing the per-patient costs this year with last, or by studying the number of new professionals qualified due to a business league's training efforts.

Philanthropists who donate capital funds to a nonprofit to obtain buildings or to establish endowments certainly expect the organization to "profit" or benefit from the gift in a sense. In donating capital, the donors are investing in the mission. They recognize and intend their capital to be an unselfish gift directed outward in service of a public purpose. In effect, nonprofits operate on a one-way street. Much of the money they receive is just such one-way money—donations made out of pure generosity, for which nothing is provided or expected in return. Privately owned businesses, in contrast, operate on a two-way street. For-profit organizations generally receive funds from investors who expect something in return.

On a limited basis, a tax-exempt organization is allowed to compete directly with nonexempt businesses. Revenues from unrelated business activities comprise a major source of funding for some nonprofits. The Internal Revenue Code places such a nonprofit on the same footing as competing businesses by imposing a regular income tax on profits they generate from a business. If the unrelated business activity becomes too substantial, the organization can lose its exemption.[12] Chapter 8 considers the question of when a business is "unrelated" and described the level of business activity allowed.

Revenues: Constituents versus Customers

Recipients of a nonprofit's goods, services, or monetary grants in aid are distinct from, but similar to, a for-profit's customers. A prosperous nonprofit most likely treats its program-service constituents—the poor, the sick, the culture seekers, the students—as a business would its customers. It values their patronage and caters to their needs. Whether the nonprofit charges for the goods and services provided or furnishes them on a reduced or no-fee basis, the methods used by a for-profit in purveying similar goods can be observed.

Traditionally, some nonprofits charge for the goods and services they provide to their program service recipients; hospitals and universities are good examples. Churches certainly encourage their congregants to tithe. Many nonprofits provide free services that are financed by a complex variety of donations, grants, and other income sources. Some operate with volunteer labor and sell or distribute donated goods. One important distinction is the fact that it may be impossible for some organizations to charge for the services provided. The public depends on immediate and free response from its firefighters or policemen and women, for instance. Having library doors open in the evening for students to do research is expected.

When a nonprofit does charge, the charge may not necessarily cover costs of the service; for-profits only sell things for less than cost if forced

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[12] See the author's book entitled *Tax Planning and Compliance for Tax-Exempt Organizations*, 4th ed., Chapter 21 (Hoboken, NJ: John Wiley & Sons, 2004), for a discussion of the unrelated business income tax.

to do so by market apathy. Obviously, it is more difficult for nonprofits to raise prices, partly because of the public's expectations and partly because of the economic need of the organization's constituents. Ironically, the tight budget situation created by cuts in government funding typically comes during depressed economic periods or when new tax rules reduce or remove the tax benefit of contributions, thus discouraging philanthropy. Suffice it to say that a nonprofit is significantly different from a for-profit in many ways, even though its operations and financial decisions may often appear to be similar.

FOR-PROFIT TOOLS

Although businesses do not often show movies for free or feed the poor, they do operate schools, hospitals, theaters, galleries, publishing companies, and conduct other activities that are also carried on by nonprofit organizations. The nonprofit's reason for conducting the activity and the ultimate benefit from the capital are definitely different. Nonetheless, the financial issues look much the same; both types of organization can use similar financial tools. Just as discussed above under the generating-profit issue, there is no reason why a nonprofit cannot use a for-profit model to manage its financial affairs. A nonprofit that operates in a businesslike fashion may be more likely to succeed. Some of the tools that might be useful include:

- *Business plan.* To achieve idealistic goals, nonprofits can develop a long-range plan that looks like what is called a business plan, complete with market surveys, cost projections, and strategic goals. Like a for-profit, a nonprofit can:
  - Accumulate reasonable reserves by earning more than it spends
  - Be clear about who makes decisions
  - Follow sound financial practices for both planning and reporting
- *Critical analysis of decisions.* A nonprofit considers how a for-profit would make a similar financial decision. In considering a question, the nonprofit might ask:
  - What would make this nonprofit prosper and flourish?
  - How would an entrepreneur respond if the same situation arose in his or her business?
  - Last, but not least, if the nonprofit had stockholders, would they ratify the recommendations being proposed?
- *Traditional management tools.* The management tools for achieving organizational objectives are the same whether the objectives are

business oriented or mission oriented. Like for-profits, a nonprofit's management tools include:

- Forecasts, budgets, and ratio analysis
- Well-designed and timely financial reports
- Defined lines of communication and responsibility
- Cash-flow monitoring system
- Efficient organizational structure with fiscal controls
- Identification of the target served (i.e., the customers or constituents)
- Clearly defined line of business (mission)

PURSUIT OF FINANCIAL SUCCESS: SOME OBSERVATIONS

However different the nonprofit is from a business, the methodology for measuring and achieving success is conceptually the same. Before launching into the technicalities of financial planning for nonprofits, readers may wish to consider the following observations regarding the pursuit of financial success.

Be Realistic about Expectations

Nonprofit organizations are created to accomplish a mission—often based on dreams of curing a societal need. Rational, even scientifically determined, projections can be wrong. The polls may say people are worried about feeding children, but they may not respond with contributions needed to do so. The compassion felt toward those with a disease may wane. Fundraising is often successful because of the energy and influence of board members. The nonprofit organization, however, is seldom their top priority; having a great fundraising chair one year does not assure the success of next year's campaign. It is often impossible to find the perfect board chair. A matrix for setting goals with a view to the reality of available resources can be found in Chapter 3.

A healthy dose of realism is also appropriate when the nonprofit's funds are invested. Critical evaluation of the risks inherent in purchasing stocks, bonds, mutual funds, hedge funds, real estate partnership interests, and the like is important. The prudent investor rule and other issues to consider in making such purchasers are presented in Chapter 5.

Make Use of Intangible Resources

A nonprofit's goodwill can be a highly valuable and useful resource. Opportunities abound today for a nonprofit, for example, to allow a credit-card company to use its logo for an "affinity card." Scientific discoveries or symphony performances can be licensed for public distribution. Tangible resources, such as museum spaces, gardens, football stadiums, auditoriums, and similar facilities may also have value outside their use by the organization. The resourceful nonprofit rents or otherwise creates revenues from these otherwise idle assets. Care and careful planning is required. Chapter 5 (Getting Resources) discusses the tax aspects of earning revenue from intangible resources.

Forming strategic alliances to leverage the nonprofit's know-how can also be valuable. Cooperative research projects, educational conferences, and publications, for example, can spread administrative costs and maximize potential for return for all the partners working together on the projects. The business league that recognizes its need for a skilled financial manager it cannot afford to hire might try to find one or more similar leagues with whom to share such a person.

Merging two or more organizations can yield operational efficiencies and enhance the long-term financial viability of the nonprofits joining forces. A photographic exhibition space, sculpture garden, and a children's art center might fare better together rather than in competition with each other. A host of factors might indicate suitable candidates—nature of services provided, economic size, staff skills and longevity, board composition and organizational structure, and so on. Affiliations are discussed in Chapter 7 (Affiliations and Agency Agreements).

Nonprofit Mentality Is Often "Penny Wise and Pound Foolish"

The financial success of some organizations stems from their ability to recruit cadres of volunteers and pounds of donated goods. They tap a wealth of support and goodwill and run on the belief that intangible assets can sustain them. Such resources must, however, be supported by a management structure capable of relieving overworked volunteers and underpaid staff members. Too many nonprofits suffer from classic burnout inefficiencies: lost grants from missed application deadlines, penalties and interest for failures to file returns or deposit payroll taxes, poor program performance, and high employee turnover. Some of a certified public accountant (CPA) firm's most troublesome clients (and often those with the highest fees) will be those organizations who sought volunteer help from somebody's friend who, unfortunately, had little or no experience with nonprofits. In most cases, a nonprofit operates much more efficiently with well-paid staff empowered to hire reputable experts as necessary.

Financial Accounting for Nonprofits Is Different

A nonprofit should engage independent accountants who are both familiar with and experienced in providing accounting services to nonprofits. Expect the CPAs to be responsive to the organization's particular needs, to evaluate fiscal record-keeping systems, and to make suggestions. Ask the CPAs to help to design readable financial reports that can be understood by board members and supporters who are nonaccountants. Expect accountants to translate the meaning of the numbers and the footnotes. Always ask if they have prepared a management letter to report weaknesses in the organization's fiscal management systems, and if so, follow up on the implementation of the suggestions included. Be sure the financials are presented using fund accounting, the preferred system for nonprofits to distinguish restricted and permanent funds from unrestricted moneys as discussed in Chapter 6.

Volunteer service organizations formed to provide assistance to nonprofit organizations exist in many cities throughout the United States. An organization in need of an accountant, lawyer, or other financial advisor experienced in nonprofits should identify such local volunteer groups. The CPA society, the bar association, and the united giving campaign organization typically have such public service programs. Such groups are a good resource for referrals to professionals who work with nonprofits, for educational materials, and information regarding resources available to nonprofits in the area. Some of them provide pro bono or sliding-scale financial management services. Many sponsor educational classes and maintain a library of useful information.

Producing an Audit Trail Benefits the Organization in Many Ways

Being able to connect the source document (for instance, invoice for a hospital stay) with the accounting reports provides the detail required for good budgeting and also facilitates information retrieval (when the patient calls six months later for a copy of the receipt). Fiscal assets are safeguarded by such connections. It only takes a moment to indicate that an invoice has been paid with a particular check number on a particular day. Such a simple step prevents overpayments and provides the answer to many questions.

Well-meaning volunteer bookkeepers and treasurers may not be capable of or have the time to maintain proper records. Although hiring a part-time accounting clerk recommended by auditors may strain the budget at first, overall operational improvement may recoup the cost. Knowing who does what is particularly important for an organization with few or no staff members performing all the accounting tasks. It is critical to develop methods of checks and balances by establishing a good system of internal control. The person who opens the mail and records the financial transactions should never, for example, be permitted to sign the checks. See Chapter 6 (Internal Controls) for a discussion and checklist.

Enhancing Computer Capabilities May Not Cure Financial Ills

Late, incomplete, or incorrect financial reports are not necessarily due to technological deficiencies. If the lack of good financial information is due to poor organizational structure, low personnel skill levels, or volunteer distraction, the problem will not be solved with new technology. Although some checkbook programs, such as QuickBooks, do not contain audit safeguards a CPA might prefer, they may provide a good alternative for the modest nonprofit that lacks a staff person trained in bookkeeping and accounting.

However, the nonprofit should not skimp on the technology acquisition budget. A lot of valuable human resources are wasted on inadequate or ill-suited software. A donor database system is an invaluable fundraising tool that can also enhance volunteer efforts. Better yet (and correspondingly more costly) is an integrated financial reporting system that allows the donor data to be simultaneously entered in the accounting records and the donor database. See Chapter 6 (Computerized Accounting). The acquisition budget should include money to train personnel to effectively use the system. Also keep in mind that computer software designers continually make improvements that obsolete existing systems. The technology budget should always include the purchase of regular upgrades to the software programs. Using the Internet to communicate with the nonprofit's constituents and the public can quickly recoup the cost of designing and maintaining a web site.

Respect the Organizational Structure or Change It

People managing a nonprofit should read and understand the organization's charter and bylaws and then see that the rules are followed. Find out if the board of directors or trustees hold regular meetings documented with reasonably detailed minutes of its decisions. Are new board members and officers chosen annually in accordance with the bylaws? Is proper notice of meetings communicated to responsible parties in a timely manner? Does a board executive committee hold regular meetings with the organization's managers? Does the finance committee meet regularly to review periodic financial reports that reflect comparisons to the approved budget? These issues are discussed in Chapter 2 (The Role of the Board). Determine whether the organization has a special relationship with another nonprofit; specific rules govern the activities of nonprofits established to support another organization.

Know Who's in Charge

Separation of duties is a cardinal rule for fiscal responsibility. Know who's in charge and who's responsible for what. Financial management is more successful when the right mix of people work with a full knowledge of their job and the interrelationships between those jobs. The hierarchy established depends on the form of organization. Most commonly, a nonprofit is managed by its board of directors, which is either chosen by its membership or the existing board members themselves as a self-perpetuating body. The board sets policy; the staff carries out the programs and manages the organization according to the policies. The board must be sufficiently involved so that the staff does not function as the board. Board governance policies, expressed in written procedures, make it possible for all to know their role and work in concert. The written procedures can also facilitate certain tasks that are difficult, for example, firing an ineffectual but well-loved executive director. Always ask if the board sets policy rather than making daily operating decisions? See Chapter 2.

Economic Conditions Must Be Anticipated

Economic conditions influence the nonprofit's revenue and expenditure flows and must be considered during the planning process. An inflationary or deflationary period may have a significant impact. A real-estate price collapse has in the past and may again cause hardships for nonprofits and the demise of those that were not properly prepared for the resulting economic changes. The political climate sometimes demands balanced federal and state budgets and can cause significant changes in the way nonprofits are financed.

Long-Range Planning Is Indispensable

Plotting the future of the organization according to agreed goals and objectives and converting them into definitive steps over a period of three, four, five, or more years greatly improves chances for success. Each program a nonprofit initiates requires energy and financial resources that are more economically recouped when the program functions successfully over a period of years. In other words, a decision to expend funds to launch, or continue, programs should be made in view of their impact over a period of time. Thought of in business terms, the nonprofit invests its resources in each program it sponsors. One of the objectives of long-range planning is to evaluate the return on such investments over a number of years. Similarly, an important part of the planning process plots annual revenues and expenditures. Such budgets approved by the board prior to the beginning of each fiscal year and regularly monitored throughout the year can contribute immeasurably to a nonprofit's financial stability as discussed in Chapters 3 and 4.

Know Why the Nonprofit Organization Has Tax-Exempt Status

Ask to review Form 1023 or 1024, the original application seeking recognition of tax-exemption, to find out why the IRS decided the nonprofit qualified for tax-exempt status. Look at a few years of operational history, such as the annual reports or Forms 990, to see if the purposes of the organization have changed or evolved. Identify the exempt constituency—those persons the organization was formed to serve. Check information about the organization on the Internet at Guidestar.org or on the nonprofit's own web site. Ask whether exempt constituents are in fact being served or if, instead, the private interests of specific individuals are benefited to the detriment of the intended beneficiaries. Find out who's in charge of whatever reports are required by local, state, and federal authorities regulating the nonprofit and be assured they are timely filed. See Chapter 8.

COMPREHENSIVE FINANCIAL PLANNING CHECKLIST

As a prelude to the book, the following checklist (Exhibit 1.2) presents a series of issues with specific questions to be asked in evaluating the financial well-being of a nonprofit organization. Chapters of the book in which the issues are explained in detail are noted. Some issues that are beyond the book's scope, such as insurance and investment manager performance, deserve attention with other references.

Exhibit 1.2 Financial Planning Checklist for Nonprofit Organizations

This checklist poses questions a nonprofit's chief financial officer in concert with the board treasurer or finance committee might review each year. Most answers should be yes*, but some questions deserve a* no *answer or specific information. The objective is to comprehensively survey financial-planning issues that face a nonprofit organization at least annually.*

A. Organizational Issues (Chapter 2)

1. Is the organizational mission clearly defined? ☐
   a. Is the mission statement printed? ☐
   b. When was it updated? ☐
   c. What does IRS Form 1023 or 1024 say purposes are? ☐
2. Does the nonprofit organization have a functioning board with members that exercise their fiduciary responsibilities? ☐
   a. Are board meetings regularly scheduled and well attended? ☐
   b. Does the executive committee supervise interim decisions? ☐
   c. Do minutes of directors' meetings reflect efforts to be responsive to exempt constituents by considering the best interests of the community (members or general public) served? ☐
   d. Are decisions made with the view that funds belong to public or members? ☐
3. Should a finance and/or audit committee of the board be established? ☐

Exhibit 1.2 Financial Planning Checklist for Nonprofit Organizations *(continued)*

4. Do board and organizational policies ensure management and control of the organization's resources?	☐
a. Are prudent-investor rules followed?	p. 2
b. Are personal financial interests monitored?	p. 2
c. Is there short- and long-term financial and program budgeting?	p. 3
d. Are approved plans evaluated systematically?	p. 4/5
e. Is satisfaction of funding requirements monitored?	p. 5
f. Is proper risk management assured?	p. 5/6
g. Must information be disclosed to the public?	p. 6
5. Are government reporting requirements satisfied?	p. 6

B. Monitoring Self-Dealing (Chapter 2)

1. Are there written policies governing financial transactions between the organization and its insiders (and families)?	☐
2. Should each board member sign a formal conflict-of-interest statement?	☐
3. Were there any financial transactions with insiders this year?	☐
a. Are compensation levels reasonable	☐
b. How do salaries compare to similar organizations?	☐
c. Was anything brought from or sold to an insider?	☐
d. If so, was fair market paid?	☐
e. Was the value determined by independent parties?	☐
4. If such a transaction occurred, did private inurement (benefit) result?	☐
5. Does the organization sell products or goods produced by volunteers or members?	☐
6. Did the nonprofit accept gifts that require other organizational funds to manage or conserve (a bailout)?	☐

C. Short- and Long-Term Budgeting (Chapter 4)

1. Is the budgeting process timed properly?	☐
a. Do officers of the board change prior to budget approval?	☐

- b. When is the annual meeting? ☐
- c. Is budget approved after major funding requests are filed? ☐

2. What type of budget is appropriate for this organization? ☐
   - a. Would zero-based budgeting allow critical evaluation of priorities to allow cutback in spending? ☐
   - b. Would a functional expense or line-item budget allow for review of program goals? ☐
   - c. Are budgets required for fundraising events? ☐
3. Are the proper steps taken in the budget preparation process? ☐
   - a. Are goals and objectives for a three- to five-year period developed first (long-range plan)? ☐
   - b. Are long-range goals quantified—raising an endowment, financing new facilities, or increasing staff? ☐
   - c. Are the prior year's results evaluated? ☐
     - i. Were objectives achieved? ☐
     - ii. If not, were they unreasonable? ☐
     - iii. What caused variances? ☐
     - iv. Were changes indicated by the ratio analyses (Chapter 7)? ☐
   - d. Have objectives for the coming year been established? ☐
   - e. Are new projects sufficiently documented? ☐
   - f. Are estimates of revenues and cost of programs realistic? ☐
   - g. Is the budget proposed by staff for approval by board (with intervening steps as the nature of organization dictates)? ☐
4. Are ancillary budgets prepared to implement the overall budget? ☐
   - a. Cash flow projections (Chapter 5)? ☐
   - b. Investment objective ☐
   - c. Membership renewal tracking? ☐
   - d. Capital expenditure timing? ☐
   - e. Restricted fund budgets? ☐
5. Is a follow-up system for monitoring the budget in place? ☐
   - a. Are financial reports timely, with actual expenses and income compared to those budgeted? ☐

Exhibit 1.2 Financial Planning Checklist for Nonprofit Organizations *(continued)*

- b. Are variances analyzed to determine why projects were wrong? ☐
- c. Is the budget revised for recurring changes during the year? ☐

D. Evaluating Performance with Ratio Analyses (Chapter 7)

1. Is the current ratio or working capital level (cash and other liquid assets compared to debts due in one year) at least 2:1? ☐

   (Note that too low a ratio means short-term liquidity problems; too high sacrifices income for safety.) ☐
2. Is the acid test or quick ratio at least 11: (Cash today compared to debts due in one month)? ☐
3. Do contributors or members satisfy pledges on time? ☐
4. Compare this year's sources of funding to the past five years (has funding base changed?). ☐
5. Measure activity costs to overall expenses (how much of revenue devoted to exempt purposes?). ☐
6. Analyze profitability or lack of it for all income-producing activities. ☐

E. Satisfying Donor Restrictions (Chapter 5)

1. Are all restricted funds accounted for separately?
   - a. Endowments ☐
   - b. Plant and equipment ☐
   - c. Restricted donations or grants ☐
2. Does the cost of managing and reporting on a restricted fund outweigh its benefit? ☐
3. Can costs associated with restricted projects be identified? ☐
4. Are matching-fund grant records available to measure compliance? ☐
5. Is endowment income sacrificed for capital appreciation? ☐
6. What is the extent of, and reason for, interfund borrowing? ☐

F. Prudent Investor Rules (Chapter 5)

1. Is maximum amount of interest earned on short-term cash funds? ☐
   - a. Is cash flow planning utilized for liquid funds? ☐

- b. Are bills paid on a scheduled basis? ☐
- c. Are services invoiced timely allowing efficient collections? ☐
- d. Is there a membership renewal system? ☐
- e. Are non-interest-bearing accounts kept to a minimum? ☐
- f. Can tracing of restricted funds be accomplished through the accounting system rather than separate bank accounts? ☐
- g. Are higher long-term interest rates obtained on funds committed for use in over six months or a year? ☐
- h. Is short-term borrowing available if needed? ☐

2. Are investment policies prudent? ☐
   - a. Is priority given to preservation of the endowment or to production of current income? ☐
   - b. Are provisions made for replacement of the physical plant or facilities or adequate working capital for new projects? ☐
   - c. Should property be leased or purchased? Mortgaged or not? ☐
3. Is an outside investment manager utilized? ☐
   - a. Are investment yields measured using a "true" cost basis? ☐
   - b. Should the organization use two different managers? ☐
   - c. Are investments sufficiently diversified? ☐
   - d. Should stocks be sold? Collections deaccessioned? ☐
4. Is the organization prepared for economic change?
   - a. For disinflation or inflation? For business cycles? ☐
   - b. How will new tax legislation affect the organization? ☐
   - c. What are the funding source consequences of such changes? ☐

G. Hazards for Risk Management

1. What measures are needed to protect assets from risk of loss? ☐
   - a. Does the nonprofit organization have insurance or does it self-insure? ☐
   - b. Are deductible levels commensurate with working capital? ☐
   - c. Are properties maintained in good condition? ☐
   - d. Is adequate data available to identify lost items? ☐
   - e. Is property labeled and identified with organization's name? ☐

Exhibit 1.2 Financial Planning Checklist for Nonprofit Organizations *(continued)*

- f. Are personnel required to be trained before using equipment? ☐
- g. What is the condition of physical facilities in which they work? ☐

2. What types of insurance are appropriate for the organization?
   - a. Basic fire, theft, vandalism, and extended coverage? ☐
   - b. Liability? ☐
   - c. Workers' compensation? ☐
   - d. Volunteer/employee auto usage? ☐
   - e. Officers and directors' errors and omissions? ☐
   - f. Fidelity bond for employees/volunteers? ☐

H. Public Disclosure of Financial Condition (Chapter 6)

1. Are annual financials issued by independent accountant(s)? ☐
   - a. Is positive assurance provided by an audit appropriate? ☐
   - b. Would negative assurance provided by review suffice? ☐
   - c. Is a compilation report sufficient? ☐
   - d. Is an audit required by funding agencies or foundation? ☐
   - e. Is a "single-audit" required under OMB A-133? ☐
   - f. Do revenue sources, level of internal accounting skills, or lack of internal control indicate a need for an audit? ☐
2. Have recommendations in the auditor's management letter been implemented? ☐
3. Are accounting/business staff and systems adequate? ☐
   - a. Are monthly financial reports, including budget comparisons, available in a timely manner? ☐
   - b. Are they provided to the board? ☐
   - c. Would hiring a trained bookkeeper/accountant reduce outside accounting fees and/or allow timely reports? ☐
   - d. Should records be computerized? ☐
4. Is a system of internal control in place? (Chapter 6) ☐
   - a. Does the bookkeeper or custodian of funds sign checks? ☐
   - b. What contracts are approved by a board member? ☐

c. Is proper documentation required for expenditures? ☐

d. Are personnel policies in writing? ☐

e. Must expenditures in excess of the budget be approved? ☐

f. Are asset records adequate (serial numbers, etc.)? ☐

5. Are archival records evidencing exempt activities kept (theater performance program, student grades, patient records) (Chapter 8)? ☐

6. Is a governmental reporting compliance calendar maintained? ☐

a. Are Forms 990, 990PF, or 990-T filed timely? ☐

b. Are payroll taxes withheld, deposited timely reported? ☐

c. Must Forms 5500 be filed for benefit plans? ☐

7. Is Form 990 made available to public upon request? ☐

8. Are fundraising or lobbying limit tax disclosures made? ☐

9. Must the nonprofit register as a charitable solicitor or file other repors in states in which it conducts activities? ☐