Chapter 1

Increased Complexity and Mounting Challenges: Time to Prepare

Not-for-profit entities (NFPs) should be riding high, according to a recent Giving USA Philanthropy,[1] charitable giving reaching an all-time high in of $390 billion. This included the millions of dollars, donated to Planned Parenthood, Meals on Wheels, the ACLU and others, which were received just days after potential federal budget cuts were announced. Although these gifts could be considered one time reactions to current events, contributions are still up from prior year levels. The bull market is strong, inflation is low, hovering right around the 2 percent mark, and interest rates are still very low.

However, this good news does not tell the whole story for most NFPs. The Blackbaud Institute's Charitable Giving Report[2] (Blackbaud Report) provides additional insights into the risks that many NFPs will encounter if they have not adapted to the mounting challenges brought about by generational changes, donor preferences and requirements for transparency and communication. The Charitable Giving Report showed that generations X and Y are approximately 57 percent of the U.S. population but make up only 26 percent of the donor population and contribute around 20 percent of the dollars. Generations X and Y also tend to give to fewer nonprofits than the Baby Boomers or Silent Generation did. The younger cohorts ask more questions and expect to know how the funds will be used. They are also interested in statistics related to service efforts and accomplishments.

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[1] Giving USA Philanthropy Report. Accessed on September 18, 2017 at https://givingusa.org/see-the-numbers-giving-usa-2017-infographic/

[2] Blackbaud Institute for Philanthropic Impact, 2016 Charitable Giving Report. Accessed on September 18, 2017 at https://institute.blackbaud.com/asset/2016-charitable-giving-report/

Communication is another important factor in donor satisfaction. When an organization takes steps to improve its service level and initiate programs, it is important to communicate the changes to donors so that they can better understand the need when an organization asks for funding.

Example

A large nonprofit animal welfare organization performed a needs assessment and instituted new programs and services to be responsive to the needs of the community. At the time the changes were instituted, management knew that they would need to raise additional capital. Management hired a consultant to help them prepare for the capital campaign. His job was to assess the reputation of the organization in the market and make a recommendation on the size of the campaign based on donor and grantor feedback. Management and the board were very surprised when the consultant indicated that it was unlikely the organization would be able to raise even 25 percent of their target. When asked what the issue was, the consultant told management that their donor and grantor base believed the organization was a well-run organization but that funders were unaware of the operational additions and improvements that had been made. The consultant advised the board to create a mechanism to improve donor communication and postpone the campaign.

Generational differences are not the only issue when it comes to delivering services and raising money. The Nonprofit Times[3] reported the following statistics that were shared by the executive vice president of A Changing World, at its recent industry conference.

- Diversity is found in both urban and rural areas. Populations in small town have changed by more than 40 percent for people of Hispanic descent and people of two or more races
- In the early 70s, only about 45 percent of women attended college versus 75 percent today. This has altered employment, professions and wealth.
- In recent years over 35 percent of married women have higher income than their husbands
- Approximately 8 percent of people under 50 years old inherited their wealth. Most people today earn their wealth. In 2012, $1.1 billion in new major gifts came from billionaires under the age of 40.

The Blackbaud Report showed that 89 percent of gifts from $1,000 to $4,999 were made online. But only 11 percent of gifts over that amount were made online. Mobile giving continues to increase. These statistics have implication for fundraising in the future and it is likely that additional infrastructure investment will be needed to adapt to changing times.

In addition, NFPs that receive a significant part of their revenue from government grants and contracts are under an ever-increasing number of regulatory requirements as well as threats of federal budget cuts. And to top it off, nonprofits will be required to implement new accounting and disclosure standard that will significantly impact financial statement presentation beginning with calendar year end organizations in 2018. It's no wonder that high performing boards are devoting more time and other resources to strategic planning and risk assessment. It's clearly time to prepare.

Another major threat to NFPs is the fact many have notoriously weak internal controls especially in the technology area. But cyber threats are not the only data breaches that nonprofits face. Some breaches are caused by error but analysis of data show that NFPs,

[3] www.thenonprofittimes.com/management-tips/diversity-changing-fundraising-methods/

with their donor information, are of interest to hackers. Additionally, NFPs are typically easier targets than large retailers and financial institutions.[4] Breach events can lead to loss of reputation and financial stability due to loss of donor confidence and the cost of settlements.

The knowledge and focus of NFP boards has generally in the program aspects of the organization. Board members have tended to trust management in the areas of finance, technology and legal matters. The difficult part is that when board members are interested and ask questions, auditors and other outsiders may believe that they are functioning well as an oversight body. This may provide a false sense of security especially if the members don't have the ability to critically challenge what is presented.

Boards can also fall into judgment traps and biases. Governance is enhanced when board members increase their skepticism and challenge the information presented by management before the decision-making process gets so far down the road that it is almost a foregone conclusion. This includes explicitly considering alternative perspectives and engaging management and listening to diverse points of view on the issue at hand.[5] Board members may defer to others who they believe have more expertise or because they do not want to appear controversial.

Example

During 2015, a small NFP, primarily funded with federal dollars had what, for it, amounted to a massive fraud. The organization's mission is to assist troubled juveniles in navigating the court system. Like many small organizations, it had limited funds to pay for administrative personnel. The accounting department consisted of one bookkeeper who was primarily responsible for cash receipts, cash disbursements, and payroll. She approved invoices, recorded them, reconciled the bank account and prepared checks for signature. The CFO scanned the support for expenditures and signed the checks. The bookkeeper also performed the analytical procedures, which included a comparison of budget to actual and current period expenditures to prior period expenditures. The analysis was included in the monthly board packet along with a list of checks written during the month in sequence. The check listing was provided so that the board could scan the names of the vendors and see that all checks were accounted for. Several of the board members were very engaged and asked questions during the monthly meetings. One day an attorney was attending the monthly board meeting. As he listened to the financial presentation made by the CFO he scanned the analytical procedures. Then he asked a question, "What's in this line item?" The bookkeeper explained that it was the court costs, court reporting fees, and counseling fees paid in connection with the organization's main program and that the expenses were right on budget. He made this observation. "That may be true but you should go out for bid because these costs are way too high." The board voted to go out for bid on the major items. During that process, they discovered that the bookkeeper had set up a fictitious vendor and embezzled $1.8 million over seven years.

The board was left scratching their heads and wondering what happened. They were engaged, they asked questions and the bookkeeper had been with the organization for 15 years. The preceding story was based on a case of fraud that gained national attention in 2015. The sad thing about it is that although the bookkeeper was prosecuted, the organization was unable to recover most of the money because it had been spent to finance her son's business.

(continued)

[4] Cyber Security for Not-for-Profits, PB Mares, accessed on September 17, 2017. https://trust.guidestar.org/2015/05/11/cyber-security-for-not-for-profits/

[5] Enhancing Board Oversight: Avoiding Judgment Traps and Biases. Committee of Sponsoring Organizations. Accessed on September 17, 2017 https://www.coso.org/documents/coso-enhancingboardoversight_r8_web-ready%20%282%29.pdf.

> Unfortunately, most NFP boards are not well trained in analyzing financial information. And most are not knowledgeable about fraud indicators or internal control. Lack of segregation of duties is a higher risk in small to midsize nonprofits that is difficult to overcome. Therefore, a board of directors, as the oversight body needs to understand what can go wrong if the organization chooses to accept the risk that lack of segregation of duties brings and identify oversight procedures to help to mitigate the risk. Boards of directors need to be more sophisticated and knowledgeable of fraud and other risk areas in the current environment.

As discussed in chapter 7, the methods by which fraud is perpetrated come in many forms. The Association of Certified Fraud examiners estimates that the cost of embezzlement, mismanagement, and fraud is approximately 5 percent of revenue each year. The cost in dollars is high but in the NFP sector where donors, government funding sources and regulators entrust an organization with public money, fraud and mismanagement can create fear and cynicism. Is it any surprise that benefactors, foundations, federal and state governments, and other stakeholders want more emphasis on transparency and accountability? They rightfully ask "Why were the indicators of trouble overlooked? How did nonprofits' leaders and directors let this happen on their watch?"

Clearly, some players are corrupt or inept. In other cases, lapses in accountability come from an overemphasis on the NFP's mission at the expense of attention to its organizational processes and structures. When this imbalance occurs, agencies fail to

- create and uphold internal controls,
- evaluate risks to the business,
- identify where theft could occur,
- understand and comply with laws and regulations and contract and grant provisions, and
- identify financial warning signs that would encourage organizational changes to streamline resource allocation.

Why does the imbalance occur? Why do paid and volunteer leaders fail to attend to these important aspects of management? Although in hindsight it may appear that many leaders and board members are fiscally irresponsible and negligent in their fiduciary duties, the more likely explanations are that leaders and board members

- are unaware of the laws and regulation they need to follow.
- are unable to analyze the organization's financial statements.
- operate the organizations with very few resources and with pressure to use them on programs instead of administration.
- are committed to the mission of the nonprofit and the constituents served, perhaps at the exclusion of other priorities and responsibilities.
- trust the motives and activities of their fellow board and staff and view checks and balances as a formality, or even a sign of distrust.
- are preoccupied by the daily administrative demands and unable to take the time or space to examine systems.

To anyone who has ever served as a volunteer board member or led an NFP, these are no doubt familiar reasons for lack of oversight. But, in the eyes of the IRS, funding sources, donors, and the general public, there are no good reasons for such lapses, and there is no margin for error. Because the resources of a nonprofit belong to the community, NFPs are accountable for what they do with them. And when grantors, whether federal, state, or foundation, are involved, compliance is a condition of funding. Beyond these understandable, if dangerous, rationales for poor compliance, there is the issue of those who know the rules but choose not to follow them.

In 2015, Wheeling Jesuit University was ordered to pay the federal government $2.3 million as a settlement to resolve allegations that the University misspent federal funds. The time period under question spanned approximately six years. The allegations stemmed from an audit by the National Aeronautics and Space Administration (NASA) in 2012. The court records show that investigators believed that the vice president of sponsored programs, a former federal official, purposely misspent federal money.

According to the fraud investigation that followed, the funds were spent to increase the level of the vice president's salary as well as on cellphones, computers, technical support and salaries for other staff who were not involved in working with the grants, including a secretary in the vice president's private law office. The settlement money was to be repaid over five years from operating funds and could not be paid with donations or federal money.[6] According to later reports the payback caused severe financial distress to the University as well as loss of funding.

In September 2017, the Justice Department reported that Columbia University agreed to a settlement amounting to $9.5 million to resolve allegations that it improperly charged the National Institutes of Health (NIH) for facilities and administrative costs on more than 400 federal grants. The court documents showed that the University overstated the maintenance and operations expense of the facility used to carry out the research. Universities can charge a higher indirect cost rate for research conducted on campus to offset maintenance and operations expenses but the research was conducted in buildings owned by the state of New York. If the University had used the appropriate indirect cost rate it would have had a substantially lower reimbursement. The University claimed that it was an inadvertent error. However, management is responsible for knowing and following Federal Regulations when they enter into grant agreements. A special agent in the Office of the Inspector General's Department of Health and Human Service stated, "It is disturbing that Columbia University, a prestigious institution, would improperly seek excessive cost reimbursements from NIH. Money gained by such behavior deprives other research programs of funds that could yield life-altering new treatments."[7]

As these cases illustrate, a tarnished reputation and adverse financial ramifications in nonprofits can come from both *malfeasance* (the intention to defraud or harm) and from *nonfeasance* (failing to carry out expected responsibilities). In either scenario, though, the buck stops at the top. These situations call into question the role of NFP leaders and their boards. A main function of paid and volunteer leadership in nonprofits is to set the tone from the top and communicate the organization's commitment to integrity, ethical values, financial transparency, and accountability, as well as compliance with laws, regulations, and provisions of contracts and grants. Knowledge and capacity are important but insufficient ingredients in organizational compliance. Administrators and board members must also have the courage to act responsibly.

When most of us think of courage, we think of people who risk life and limb to save others or who put their well-being at risk for a greater good—the firefighter or the whistleblower, for example. But there are other, potent forms of courage required for assuring organizational integrity, and you'll learn about them throughout this book. Could the destruction wrought by Bernie Madoff have been avoided or contained if more people had been willing to confront his conflicts of interest, question his investment

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[6] https://www.insidehighered.com/quicktakes/2017/09/28/virginia-tech-professor-arrested-charged-fraud

[7] https://www.washingtonpost.com/news/grade-point/wp/2016/07/14/columbia-university-to-pay-9-5-million-to-settle-fraud-charges/?utm_term=.b633e8b9ce67

methods, or resist the pull of unsustainable returns? Could people of courage have bolstered and supported those who *did* speak out about Madoff's methods? We'll never know. We can't rewrite the past, but we can provide the tools to avert future catastrophes.

To be effective as a nonprofit these days, it takes more than a passion for the mission. It takes the knowledge, skills, and courage to

- identify factors in the environment that affect the organization,
- read and analyze financial information,
- understand the laws, regulations, and provisions of contracts and grant agreements so the organization will be in compliance, and
- assess the risk to the organization.

After evaluating the circumstances facing the organization in light of those factors, the leaders and the board need to have the courage to make the right decisions and the skills to act on that courage.

Call to Action

Nonprofit leaders and their boards certainly have cause to be overwhelmed with the tasks before them. Regulation is increasing, ways of conducting programming and fundraising are not as effective as they once were and external threats such as cybersecurity are growing.

Success in this environment demands the willingness to continue to analyze donor and constituent behavior, to learn, to innovate, to focus on transparency, accountability and better ways of telling the organization's story. Boards will need to do a better job of assessing risk, implementing stronger internal controls and strategy execution. The remaining chapters of this book are designed to provide nonprofits and their boards with the practical knowledge and guidance, as well as with the electronic tools and templates, they need to make sense of the regulations, to implement strong internal controls, and to cultivate the courage to act on that knowledge.

In today's uncertain and ever-changing environment, a nonprofit organization needs strong leaders and a strong board to successfully fulfill its mission. We like to think of it as

$$\text{Mission} = \text{Compliance} \times \text{Courage}$$

or

$$M = C^2$$

Conclusion

There is no doubt nonprofits are operating in a world where many of their usual ways of operating no longer work, regulation is increasing and the threats are coming from external sources, such as hackers, that they have never had to deal with before. Those charged with governance as well as executive management will need to spend more time evaluating risk and creating a solid strategy for moving forward. Even with the focus on governance over the last 10 years, board members are still frequently selected based on their interest in and knowledge about the organization's mission. Boards tend to focus less on internal governance issues, believing that mission is more important than governance. In this complex and challenging environment, the focus on governance by regulators and funding sources is unmistakable. Organization leaders and board members must realize that organizational process and structure, far from detracting from the mission, are irreplaceable ingredients in effectively accomplishing its program goals. In the new environment, neglecting these structural issues is no longer an option. Along with increased oversight, as discussed in this chapter, penalties for noncompliance have increased. Further, board members have accepted a legal *duty* for proper management of the organization's affairs, and good intention is not an excuse for lapses. Succeeding chapters will equip NFP executive management and board members with the knowledge and skills to better discharge their responsibilities in the nonprofit environment in the years to come.