3rd Edition

# Financial Management for Nonprofit Organizations

## Policies and Practices

+ Website

John Zietlow
Jo Ann Hankin
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WILEY

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Second edition Copyright © 2007 by John Wiley & Sons, Inc.
Published simultaneously in Canada.



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***Library of Congress Cataloging-in-Publication Data is Available:***

ISBN 9781119382560 (Hardcover)
ISBN 9781119382614 (ePDF)
ISBN 9781119382591 (ePub)

Cover Design: Wiley
Cover Image: © Andrey_Popov/Shutterstock

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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# ABOUT THE AUTHORS

**John T. Zietlow, D.B.A., CTP**, teaches nonprofit financial management as an associate faculty member at Indiana University-Purdue University at Indianapolis (IUPUI) and Indiana University (Bloomington). He was permanently certified through the Treasury Management Association as a certified cash manager (CCM) and is certified through the Association for Financial Professionals as a Certified Treasury Professional (CTP). He has done training and consulting in the areas of cash management, treasury management, and investment management and portfolio performance evaluation. He has co-authored *Cash and Investment Management for Nonprofit Organizations* (2007) and *Short-Term Financial Management* (2017). John is also a professor of finance at Southwest Baptist University, where he teaches nonprofit financial management and strategic consulting practice in the doctoral program in educational leadership, as well as corporate finance, investments, derivatives, personal finance, and managerial economics in the business school. He previously taught at Oral Roberts University, Malone University, Lee University, Mount Vernon Nazarene University, and Indiana State University. While at Indiana State University, he received a multi-year grant from the Lilly Endowment to do research on application of corporate finance to nonprofit organizations. In that field research the primary financial objective of target liquidity which forms a unifying framework for nonprofit financial management was revealed. He holds membership in the Financial Management Association, Association for Research on Nonprofit Organizations and Voluntary Action (ARNOVA; also part of the Social Entrepreneurship/Enterprise Section and the Nonprofit Finance and Financial Management Common Interest Group), Christian Finance Faculty Association, and Christian Business Faculty Association. He may be reached via e-mail at: jzietlow@outlook.com or jzietlow@iupui.edu.

**Jo Ann Hankin** is a nationally recognized consultant in the field of fundraising, and financial/administrative management for nonprofits.

**Alan G. Seidner** was the founder of Seidner & Company of Pasadena, CA, an investment management and consulting firm whose roster included high net worth investors, healthcare organizations, major corporations, nonprofit institutions, and municipalities. In 1998, Seidner & Company ceased operation as its clients were invited to become clients of Fiduciary Trust International of California (FTIC). From 1998 until 2002, Seidner was an independent consultant and a Senior Consultant to FTIC and its parent, Fiduciary Trust International, which later merged with Franklin Resources, parent of Franklin Templeton. From 2005 thru 2007, Seidner was a Senior Vice President at Denver Investment Advisors. Currently he is a Senior Consultant for Client Development with the Pyatt Broadmark Real Estate Lending Funds. He holds Series 7 and Series 63 FINRA registrations.

Seidner was the author of many financial reference works, and was a frequent speaker on investment techniques and strategies. He has served as a speaker on investment techniques and strategies at numerous financial conferences, such as those of The American Institute of Certified Public Accountants and the Graduate Schools of Business of Duke University, Ohio State University, the University of California (Berkeley), the University of North Carolina and the University of Southern California. He has also provided testimony before federal government agencies on the performance of pension fund investments.

**Tim O'Brien, PhD** serves as a practitioner faculty at North Park University, School of Business and Nonprofit Management where he specializes in Nonprofit Financial Management. He also teaches financial accounting, managerial accounting and strategic management for nonprofit organizations. He also teaches at The Spertus Institute. He previously taught at JFK University in Northern California. He also serves as Senior Consultant for Lumity, a nonprofit organization that provides financial consulting services to nonprofits in the Chicago area. He has also served as an international workshop leader, controller, CFO and Director of Finance and Administration in a variety of nonprofit organizations. In addition, he serves as Treasurer for St. Luke's Episcopal Church in Evanston, Il and on the Advisory Board of the Axelson Center at North Park University. Dr. O'Brien holds a BA in Accounting from Queens College, Flushing, NY, an MA in Management from JFK University in Pleasant Hill, CA and a PhD in Interdisciplinary Studies from The Union Institute & University, Cincinnati, OH.

# PREFACE

*Financial Management for Nonprofits* is a book written for use by those presently responsible for or in training for financial management in a nonprofit organization. There are many titles used to identify persons assigned these responsibilities including, but not limited to, the director of finance, chief financial officer, treasurer, controller, chief accountant, director of operations, vice-president of business affairs, business administrator, and financial secretary. Actually, the title of the position is not important; the responsibility is extremely important. Board members are also in view here, especially those serving on the executive committee, finance committee, investment committee, risk management committee, or audit committee.

Our book is written from a managerial decision-making perspective for those in leadership and day-to-day management positions who have oversight responsibility for financial functions or are members of the Board. These leaders and managers may, or may not, be experienced financial managers. Most of the subjects and issues that confront those responsible for financial management and related functions in the small- to medium-sized nonprofit organization are not determined by size, but rather by the mix of assets and strategies employed to accomplish the organization's mission.

Another important focus of this book is to demonstrate that financial management functions are expanding – and when done well, these strategies will make a real difference in the organization's ability to achieve its mission. Effective and responsible financial management contributes toward accomplishing the mission in a number of significant ways, including:

- Financial stewardship and policy setting
- Governance
- Financial reporting and accountability
- Establishing liquidity policy and guiding decisions to maintain that liquidity or rebuild it when depleted
- Strategic planning
- Evaluation of existing and proposed business model
- Evaluation of existing and new programs
- Fundraising evaluation
- Cash planning
- Budgeting and long-range financial planning
- Debt and other liability management
- Operational expertise and strategic internal business consulting
- Empowerment through the sharing of information and harnessing of technology
- Catalyst for cultural change in the organization
- Preservation of investment assets and increase in investment income
- Fraud prevention, detection, and control

Depending on your nonprofit organization's size and scope of activities, the nature and complexity of its financial functions will range from simple to highly sophisticated and complex. In any case, the financial systems used must be designed to provide the information necessary to meet management, fiduciary, and legal requirements. This book is unique among the books available on nonprofit accounting and finance in developing a basis for liquidity targeting as the primary financial objective of the nonprofit – especially noncommercial nonprofit organizations. It then ties other financial decision areas to this liquidity target throughout the book. We include coverage of five major topical categories in order to emphasize the positive contributions of the financial and business functions to the organization and its mission:

- Managing your organization's financial resources
- Establishing and revising financial policies
- Accounting, budgets, and financial reports
- Investing for the short and long term
- Controlling and managing risk, including liquidity risk, cyber risk, interest rate risk, and exchange-rate risk

In this updated and revised third edition, we have added new material on policies, practices, governance, business models, financing vehicles, setting reserve levels, risk management topics, and the revised financial statement format embedded in ASU 2016-14. We have particularly focused on information that is not limited to primarily academic interest, but is state-of-the-art and represents "best practices." We have tapped many new resources to ensure we are including the "best of the best," and we are most grateful for the many researchers, consultants, accounting and auditing firms, risk experts, and other authors whose material has deeply enriched this book. We are also gratified to see that the primary financial objective that was discovered in our grounded field studies, funded by the Lilly Endowment, is now becoming mainstream in the practitioner world. In fact, Mark Jones, an executive at a nonprofit financial institution, renamed our primary financial objective to be an "appropriate liquidity target," a convention we have adopted in this new edition.

Working for a nonprofit organization is an exciting and meaningful opportunity. There are many similarities and differences between nonprofit and for-profit organizations, and it is important to recognize and understand how they are similar as well as dissimilar. By virtue of their mission, nonprofit organizations benefit society by improving the public good.

Close to two million nonprofit organizations of all sizes exist in the United States today, employing many people. Many more nongovernmental organizations exist internationally. Each nonprofit organization has a responsibility to its mission, its constituents, its donors and other funders, its employees, and its volunteers. The proficient financial management of the organization's resources is absolutely critical to enable it to succeed in fulfilling its mission and goals.

As you can see from the material covered in this book, those involved in managing the finances of the organization have a great deal of responsibility. In the process of carrying out these responsibilities, some members of the organization may feel disliked or undervalued by those they serve on a regular basis. Under these circumstances, it is critical for the responsible financial manager to be fair, to understand the interplay between facts and people, and to understand that accountability is not always popular with those being held accountable.

This book is intended to provide current and soon-to-be nonprofit managers, particularly those involved with financial management, with a clear sense of the technical expertise and skills needed to manage this function well for their organization. It will also reinforce the fact that anyone with a financial role is part of a larger group in the nonprofit community who fulfill the same set of major responsibilities and uphold the same ethics and values. The authors hope that the information contained in this book will enable readers to better manage the financial resources of the nonprofit organizations they serve and enhance their overall financial health and viability.

Finally, this book serves as a textbook for certificate programs, undergraduate courses, and graduate courses in nonprofit financial management (particularly in MPA, MBA, MNPM, and MNO programs). Two of us have taught and trained managers and students in nonprofit financial management for roughly 20 years. We believe that the private nonprofit sector is sufficiently dissimilar to business and public sector organizations to merit special focus for students in this fascinating arena. This book has been used at the undergraduate, masters', and doctoral levels. It has also been used as a course manual for nonprofit executive training, in both in-person and online venues. It has helped students gain an appreciation and understanding of educational, healthcare, faith-based, arts, human services, youth services, community development, environmental, and other charitable organizations' financial decision-making. There is a dedicated course support website for students and faculty members at www.wiley.com/go/zietlow. Adopting faculty members are invited to contact John (jzietlow@indiana.edu) or Tim (tobrien@northpark.edu) for guidance on how best to use the book in academic courses or executive training.

# ACKNOWLEDGMENTS

**John Zietlow** acknowledges and is deeply grateful for the contributions of the following individuals whose expertise greatly enhanced specific areas of the book: Gregg Capin, Sue Budak, Dennis Gogarty, Linda Szipo, Thomas McLaughlin, Mary Fischer, Melanie Lockwood Herman, Amy Sample Ward, Lisa Schneider, Dave Meldrum-Green, Dan Busby, Nick Wallace, Bill Hopkins, Steve Dawson, Carolyn King, Wayne Kissinger, Georgette Cipolla, William Michels, John Webb, Darryl Smith, Darryl Deardorff, Jerry Trecek, Bob Reynhout, Dave McFee, Phillip Purcell, Rob Licht, David Holt, and Eric Lane. He especially thanks three individuals at Southwest Baptist University: Bailey Harman, student assistant, Donna Young, librarian, and Chris Keller, MBA Coordinator/COBACS Secretary, for their invaluable clerical and research assistance on this edition.

The genesis of this book was a major field-based research project funded by Lilly Endowment, Inc. This study initiated the insights reported here regarding the practice of financial management of faith-based organizations by providing grant money to Indiana State University. The individuals responsible for evaluating and guiding the grant process were Fred Hofheinz and Jim Hudnut-Beumler. Members of the advisory panel assembled as part of that grant project were so helpful in shaping the research project that underlies some of the significant findings presented in this book. They believed, as we do, that proficient financial management can greatly aid in the accomplishment of charitable missions. A particular thanks goes to the 288 financial managers who took part in the exhaustive survey covering financial management practices employed by their organizations. We also appreciate the research input and critiques provided by Dr. Raj Aggarwal and Dr. Kathleen Eisenhardt.

We are particularly grateful to our editors at John Wiley & Sons, Brian Neill, associate editor, and Pete Gaughan, project editor, who were instrumental in directing the project from inception to publication. We are very appreciative as well to Sharmila Srinivasan, our production editor, for steering this project to completion.

Graduate students at Indiana University–Purdue University at Indianapolis (IUPUI) and Indiana University–Bloomington have enriched and helped shaped this book as they learned from and commented on content in the previous editions of this guide as part of the graduate nonprofit financial management class taught each year since 1999.

Finally, I wish to thank my dear wife, Kathy, for her prayers and for bearing with me in the time-consuming process of putting this guide together. My contribution is dedicated to my parents, Harold and Miriam Zietlow, for their continual encouragement, support, and prayers.

**Jo Ann Hankin** thanks Clariza Mullins, former Treasurer and Investment Officer, Pepperdine University, for her important contribution to Chapter 11 on Cash Management and Banking Relations. Clariza's technical expertise, hands-on experience, and communication style are part of what make this chapter an extremely useful one.

**Alan Seidner** wishes to thank his wife, Carrie, for all her support and help in the completion of this publication.

**Tim O'Brien** wishes to thank the students and faculty at North Park University for their support and guidance. Thanks are also due to John Zietlow for his support and mentorship, and to my wife Karen for her support and editing skills, as well as her patience and loving kindness. I dedicate my part of this work to my dear departed daughter, Vanessa.

# Financial Management *for* Nonprofit Organizations

CHAPTER 1

# UNDERSTANDING NONPROFIT ORGANIZATION FINANCES



Nonprofits include a wide variety of organizations. They are ubiquitous and are part of the fabric of most communities in the United States with a wide array of missions, such as local neighborhood associations, social service agencies, churches, hospitals, and private colleges and universities. These organizations differ from companies in the private sector and government agencies in the public sector in that many of them exist to provide services that cannot or will not be provided solely by the other sectors. Nonprofits also play a unique role in our economy.

Their missions are diverse and offer complexity beyond the scope of this book. While diverse, they have common characteristics such as the fact that they are voluntary and cannot distribute surplus. They also present challenges in terms of financial management and literacy. The intent of this book is to provide insights into the financial management of these organizations, how they differ from the other sectors, and how their finances are governed and managed. It is, in essence, about financial leadership in nonprofit organizations. Proficient financial management enables and enhances mission achievement.

The National Center for Charitable Statistics (NCCS) publishes *Facts about Nonprofits*:

- There are 1.57 million tax-exempt organizations of which over 1.1 million are public charities (2017).
- In 2013, public charities reported $1.73 trillion in total revenue and $1.63 trillion in total expenses.
- In 2013, public charities reported over $3 trillion in total assets.



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

- Charitable contributions from individuals, corporations, foundations, and bequests in 2014 were $358.4 billion (an increase of 7.1 percent over 2013).[1]

In a report issued by The Moody's Foundation in 2012, financial literacy in nonprofit managers is increasing, but there is still much room for improvement.

> As organizations deal with the fluctuations in their sources of funding, having an understanding of the need for financial flexibility has taken on increased significance, and financially literate managers can help their organizations craft sound strategies and objectives that will keep their organizations not only afloat, but thriving during temporary economic declines (Moody's 2012, 38).[2]

The number of registered charitable organizations has exploded from roughly 300,000 in 1970 to 1,599,471 in 2016. There are many more small organizations and churches that are not registered. One-half of the nonprofit sector's revenue goes to the largest 15 percent of these organizations, some of which are large hospitals and universities. Faced with growing missions and shrinking resources, many organizations have relied more on for-profit activities, such as issuing credit cards with their logos and selling their mailing lists to advertising firms in order to augment their revenues. Most of these same organizations have overlooked the potential of better financial management to enhance revenues from better investment management and faster cash collections or reduce costs from better negotiations with banks and other vendors and process reengineering.

## 1.1 THE IMPACT OF THE GREAT RECESSION

The Urban Institute and NCCS published a research paper in 2014 on how the "Great Recession" (2008–2012) impacted the nonprofit sector. The study examined the closure rates of nonprofit agencies for two time frames. The baseline timeframe was from 2004 to 2008 and the recession time frame from 2008 to 2012. They looked at closure rates across several subsectors: arts and culture; education; environment; health; human services; international affairs; public and societal benefit; and others. Some conclusions of this study:

- In all subsectors, organizational closure was more prevalent during the recession period than during the baseline period.
- In both time periods and across all subsectors, smaller organizations (revenues of between $50,000 and $99,999) were most vulnerable to closure.
- The largest increase in closure rates was in international organizations, while human services experienced the least increase.
- In addition to higher closure rates, the recession is also associated with loss of revenue among smaller nonprofits. Eight percent of all organizations with $50,000 to $99,999 in revenue in 2004 had revenue fall below $50,000 in 2008. That share jumped to 11 percent for the 2008 12-month period.[3]
- While this study did not directly state that organizations without sufficient liquidity did not do well, it could be considered a safe assumptions that in an era when revenues and liquidity were constrained, many did not survive.

In 2012, Baruch College (CUNY) conducted research in six cities to determine how the economic challenges of the great recession affected nonprofit organization. Researchers found that corporate donations, government grants, and investment income decreased while individual contributions and demand for services increased. Organizations needed to reduce their service delivery and cut expenses in order to survive.[4]

In a challenging environment, proficient financial management is a must. The framework of this book is intended to be of immediate value to nonprofit financial professionals and board members. This handbook caters to the chief financial officer, budget director, or treasurer with little or no formal training, business-only training, or too little time (perhaps due to a multitude of responsibilities) or support staff to do the job the way he or she knows it can be done. Our other target audiences are the chief executive officer (or executive director) and board members. This handbook specifically includes material for small and resource-constrained organizations, as well as large ones. Material is presented in an easy-to-use format, including forms or checklists where helpful. The discussion goes beyond the buzzwords to provide reasonable steps toward more proficient treasury management. We incorporate a number of concepts:

- Primary financial objective
- Donor accountability and stewardship
- Learning organization, reengineering, and benchmarking
- Balanced scorecard
- Program selection and cost-benefit evaluation
- Social entrepreneurship
- Strategic alliances and collaborations
- Accounting and financial reporting basics
- Financial statements and ratio analysis
- Budgeting techniques, including cash budgeting
- Financial forecasting and planning in the long term
- Liquidity measurement and analysis
- Fundraising evaluation
- Fraud prevention and detection
- Advanced cash flow management
- Investment and other financial policies
- E-business, cyber risk, and fraud detection and prevention
- Financial aspects of human resource management
- Cross-sector initiatives
- Sustainability practices

## 1.2 DEFINITION OF NONPROFIT ORGANIZATIONS

In the broadest terms, *nonprofit* is a designation given by the IRS to describe organizations that are allowed to make a profit but that are prohibited from distributing their profits or earnings to those in control of the organizations. If these organizations apply for and receive tax-exempt status from the IRS, they are not required to pay federal income taxes or state business income taxes except in specific cases, which are discussed later in this book. This classification makes them distinctly different from for-profit corporations, which distribute profits to their owners or shareholders and must pay corporate income taxes on their earnings. As a Section 501(c)(3) organization, the entity does not have to pay federal unemployment taxes. Furthermore, tax-exempt organizations *may* also be exempt from paying property tax, sales tax, and use tax – not all states exempt nonprofits from all of these taxes and challenges are mounting in some locales to take back these exemptions to meet governmental budget shortfalls.

In addition, contributions to some nonprofit organizations are tax deductible for donors. After receiving federal tax exemption, refer to the National Association of State Charity Officials website (www.nasconet.org) to see whether your organization is required to register with a state to solicit for contributions or be exempt from state taxes in that state. Further details regarding nonprofit organizations can be found in Sections 501 through 521 of the IRS code (www.irs.gov).

The approximately 1.9 million nonprofit organizations in the United States include about 1.6 million tax-exempt organizations registered with the IRS as 501(c) organizations as well as the 312,000 churches that are not registered with the IRS. It is worth noting that over 275,000 charities lost their tax-exempt status in 2011 because of their failure to comply with new IRS regulations that required nonprofits with less than $25,000 in annual gross income to file a new form (Independent Sector, 2016).[5] The number of nonprofit organizations in the United States must be estimated because many churches and very small nonprofits are not included in the IRS statistics. Churches, integrated auxiliaries of churches, and associations or conventions of churches, as well as any organization normally having gross receipts each year that are $5,000 or less may be considered tax exempt under Section 501(c)(3) even without filing the IRS Form 1023. Some of these may file this form to obtain recognition from exemption from federal income tax anyway, simply to receive a determination letter from the IRS that both recognizes their 501(c)(3) status and indicates whether contributions to them are tax deductible for federal income tax purposes.[6]

The Independent Sector report that in 2013, nonprofit organizations provided 5.3 percent of the United States' Gross Domestic Product[7] is further underscored by these estimates compiled by the Independent Sector and the Urban Institute.

- Over 10 percent of all paid employees in the United States are employed in the nonprofit sector. Between 2000 and 2010, employment in the nonprofit sector grew an estimated 18 percent, a rate faster than the US economy (Independent Sector, 2016)
- Total public charity revenues in 2013 were estimated to be $1.73 million, with 48 percent coming from private dues and services, 24 percent flowing from government grants and contracts, 13 percent arising from private contributions, and the remaining 15 percent from other sources, such as investments, interest, and dividends
- Healthcare and education garnered about 59 percent of total nonprofit sector revenues in 2013.
- Private contributions go largely to religious organizations: In 2014, 32 percent of private contributions were received by congregations and other religious entities, according to the Indiana University Center on Philanthropy's Giving USA report. Education ranked a distant second, gathering 15 percent.[8]

**(a) 501(C)(3) CORPORATIONS.** Most organizations are qualified for tax-exempt status under Section 501(c)(3) of the IRS code. These organizations are usually termed "charitable" nonprofits. Included here are religious, educational, scientific, literary, social welfare, private foundations, and other charities. Their 501(c)(3) status gives them tax-exempt status *and* enables donors to give tax-deductible donations to them. Other 501(c) organizations are tax-exempt, but donors may not deduct donations to these organizations from their federal income taxes.

The management implications of tax-exempt status are fourfold:

1. Organizations are responsible for putting the mission first. Programs and activities must support that mission, which is to be of benefit to society and serves as the foundation for the organization's founding and ongoing existence. This stipulation implies that income-earning activities may be taxed if not closely linked to the organization's primary programs and services.
2. The organization does not issue stock and may not pay out excess revenues (those over and above expenses) to employees, board members, clients, or donors. This stipulation *does not* imply that the organization may not make a "profit," surplus, or net revenue, however. It does imply that the capital structure of the nonprofit is limited to debt financing, which many nonprofits limit or shun entirely, and the change in net assets, which may be obtained only by taking in revenues over and above period expenses. In the for-profit world, those accumulated profits are labeled "retained earnings." One advantage for nonprofit financial managers is that they need not concern themselves with issues of when and how much in cash dividends and share repurchases to initiate.
3. Nonprofits are not owned by their permanent capital providers, unlike the shareholder-owned for-profit organization. This stipulation implies that outside parties such as donors may not exercise direct control over the organization's affairs, particularly its financial policies.
4. Without shareholders as the stewardship focus of the nonprofit, the primary financial objective is not maximizing profits or shareholder wealth. This stipulation implies that the organization must determine and implement in its operations a different primary financial objective. We believe that objective to be achieving and maintaining a target level of liquidity.

We shall see the significance for managers and board members of items 2 and 4 later in this chapter and then more fully in Chapter 2.

The 501(c)(3) category includes about 76 percent of all tax-exempt organizations registered with the IRS in 2015. Exhibit 1.1 profiles the various categories of tax-exempt

| **501(c)(3)** | **Religious, educational, charitable, and similar** |
|---|---|
| 501(c)(4) | Civic leagues, social welfare organizations, and local associations of employees |
| 501(c)(5) | Labor, agriculture, and horticultural organizations |
| 501(c)(6) | Business leagues, chambers of commerce, and real estate boards |
| 501(c)(7) | Social and recreational clubs |
| 501(c)(8) | Fraternal beneficiary societies and associations |
| 501(c)(9) | Voluntary employee beneficiary associations |
| 501(c)(10) | Domestic fraternal beneficiary societies |
| 501(c)(12) | Benevolent life insurance companies |
| 501(c)(13) | Cemetery companies |
| 501(c)(14) | State chartered credit unions |
| 501(c)(15) | Mutual insurance companies |
| 501(c)(17) | Supplemental unemployment benefit trusts |
| 501(c)(19) | War veteran's organizations |
| 501(c)(25) | Holding companies for pensions and other entities |
| Other 501(c) subsections | |

*Source:* US Internal Revenue Service.

**EXHIBIT 1.1** TAX-EXEMPT CATEGORIES–IRS

| Type of Organization, IRS Code Section | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|
| **Tax-exempt organizations and other entities, total** | **1,616,053** | **1,599,013** | **1,723,315** | **1,702,267** | **1,751,993** |
| Sections 501(c) by subsection | 1,484,818 | 1,442,197 | 1,568,454 | 1,548,948 | 1,599,471 |
| (1) Corporations organized by act of Congress | 449 | 615 | 708 | 638 | 643 |
| (2) Title holding corporations | 4,933 | 4,730 | 4,752 | 4,499 | 4,501 |
| (3) Religious, charitable, and similar* | 1,081,891 | 1,052,495 | 1,117,941 | 1,184,547 | 1,237,094 |
| (4) Social Welfare organizations | 93,142 | 91,056 | 148,585 | 84,155 | 83,392 |
| (5) Labor and agriculture | 50,046 | 48,545 | 48,711 | 46,576 | 46,591 |
| (6) Business leagues | 69,198 | 66,985 | 68,208 | 63,919 | 63,866 |
| (7) Social and recreation clubs | 56,880 | 54,962 | 56,139 | 47,956 | 48,482 |
| (8) Fraternal beneficiary societies | 50,763 | 48,578 | 47,773 | 46,264 | 44,610 |
| (9) Voluntary employees' beneficiary associations | 7,240 | 6,884 | 6,909 | 6,559 | 6,446 |
| (10) Domestic fraternal beneficiary societies | 16,432 | 16,049 | 16,998 | 16,226 | 16,469 |
| (12) Benevolent life insurance associations | 5,575 | 5,486 | 5,601 | 5,304 | 5,320 |
| (13) Cemetery companies | 9,636 | 9,482 | 9,858 | 8,977 | 9,125 |
| (14) State chartered credit unions | 2,797 | 2,711 | 2,326 | 1,887 | 1,812 |
| (15) Mutual insurance companies | 999 | 905 | 871 | 723 | 698 |
| (17) Supplemental unemployment benefit trusts | 130 | 112 | 110 | 103 | 98 |
| (19) War veterans' organizations | 33,737 | 31,674 | 32,039 | 29,749 | 29,493 |
| (25) Holding companies for pensions and other entities | 865 | 813 | 815 | 790 | 756 |
| Other 501(c) subsections | 105 | 115 | 110 | 76 | 75 |

*Includes private foundations. There are organizations in Section 501(c)(3) that do not need to apply for recognition of tax-exempt status. Included in this group are churches, other interchurch, integrated auxiliary, and conventions or associations of churches. Furthermore, with the exception of private foundations, if organizations have normal gross receipts in each taxable year of $5,000 or less they do not need to apply for recognition. Finally, some organizations are covered by a group exemption letter given to their parent affiliate. If a Section 501(c)(3) organization did not apply for recognition of tax-exempt status, it is not included in this number.

*Source:* Tax Exempt and Government Entities, Exempt Organizations (IRS). Table 25 of IRS Data Books 2013–2016.

**Exhibit 1.2** Breakdown of Tax-Exempt Organizations in the United States

organizations in the United States and Exhibit 1.2 provides a numerical breakdown of 501(c)(3) and other categories of 501(c) organizations. Faith-based organizations are the largest single category within the 501(c)(3) world, and they will receive correspondingly greater attention in this volume. We also highlight managerial applications for healthcare and education in most chapters due to the disproportionate size of many of these entities. Many of these are also faith-based organizations as they are affiliated with religious organizations.

**(b) BYLAWS AND ARTICLES OF INCORPORATION.** The articles of incorporation (or charter) and bylaws are the initial documents that spell out the rules, regulations, and procedures for nonprofit corporations and form the basis for subsequent policy setting.

Nonprofit charitable organizations are exempt under Section 501(c)(3) of the Internal Revenue Code. Other tax-exempt organizations covered in this section include those exempt under Sections 501(c)(4) through 501(c)(25). Descriptions of these organizations are in Exhibit 1.1. The number of organizations for each type is shown in Exhibit 1.2. Note the increase in the total number of tax-exempt organizations, despite the fact that the IRS has worked to weed out closed or merged organizations from its data file.

The trustees are responsible for preparing, periodically reviewing, and amending these documents to keep pace with the mission and support structure of the organization.

The articles of incorporation are prepared and submitted when the organization first applies for state corporate status, and they are maintained in the state office responsible for corporate records (i.e., secretary of state's office).

The board of trustees (or board of directors) is also responsible for drafting the bylaws, which serve as the organization's operating rules. Bylaws are more detailed than the charter and include information such as the number and tenure of trustees, how and when meetings are to be called, when reports are to be presented, how board vacancies are to be filled, and other details needed to ensure the consistent and efficient operation of the organization.

The trustees are legally responsible for periodically reviewing the nonprofit organization's bylaws and articles of incorporation to ensure that they accurately reflect what is happening in the organization. It is also the trustees' responsibility to ensure that those provisions of the governing documents are followed.

Once these two documents are in place, the trustees should develop policy manuals covering their own service, personnel, finances, equipment, and other areas. These policies should address issues related to the operational and financial means of implementing the organizational mission, such as conflict of interest, human resource management, cash controls, cash management, investment guidelines, debt and liability guidelines, risk management (including financial statement compilation/review/audit and cyber risk), property, and facility use.

## 1.3 CHARACTERISTICS OF NONPROFIT ORGANIZATIONS

A nonprofit organization has most or all of these characteristics:

- Public service mission
- Organizational structure of a not-for-profit or charitable corporation
- Governance structures that preclude self-interest and personal financial gain
- Exemption from paying federal taxes
- Special legal status stipulating that gifts made to the organization are tax-deductible

We shall introduce the mission and the organizational structure in this chapter. We detail these items as well as governance structures and tax and legal provisions in subsequent chapters.

**(a) ORGANIZATIONAL MISSION.** One essential difference between a nonprofit and for-profit corporation centers on its mission. The ultimate mission of for-profit organizations is to generate wealth for the owners/shareholders, ranging from an individual, as sole proprietor, to corporate ownership through the purchase of shares.

A nonprofit organization does not include the concept of ownership and, therefore, has a completely different thrust. Its mission is to serve a broad public purpose, which is clearly incompatible with ownership and personal gain. This prohibition of "private inurement" does not prevent nonprofit organizations from paying salaries to their employees, including the chief executive officer or chief financial officer. The board members typically donate their time as a public service and receive no compensation, with the exception of a few private foundations which compensate directors a nominal amount for necessary services the directors perform for the organizations.

These requirements also *do not* prevent nonprofit organizations from making money. Nonprofit organizations can and do make money in the same way as for-profit organizations. The difference is that the surpluses earned must be directed to the public purpose for which the nonprofit organization was established, held in reserve, or turned over to another organization with a public purpose. Thus, a key element of all nonprofit organizations is the use of earnings from the endeavor to promote the organizational goals, not to enrich the owners or stockholders.

The customers of nonprofit organizations are as diverse as their missions. Constituencies may include not only people, but also historic buildings, forests, endangered animals, and sports teams, individually or collectively. In addition, the people who have given their time, money, and other types of assets to further the cause are as much customers of the nonprofit as the actual recipients of the service being provided. They ask the most difficult questions of the nonprofit, have the greatest knowledge of the asset base, and are able to measure it against the activity performed on behalf of the organization. The organization acts as a steward both for its clients and its donors.

A for-profit organization has a clear mission (to make a profit) and a clear decision-making path for achieving it. However, the public service nature of a nonprofit poses a major challenge in terms of identifying and articulating its mission and developing criteria for measuring its success. The mission statement must not only define what the organization is and does; it must also state these concepts in a way that enables its achievements to be measured and evaluated. As we shall see a bit later in this chapter, many nonprofits are unclear even as to the primary financial objective(s) that they are or should be pursuing.

After developing its mission statement, a nonprofit organization faces two additional major challenges: identifying its client population and sources of funding, and within funders, identifying its donor constituency and level of involvement. After clearly identifying the group it intends to serve, a nonprofit must design an organizational structure that reinforces its commitment to the target group. It must then establish an image in the community, provide direction to potential funding sources, and either attract or repel the people to be served by the nonprofit organization.

**(b) ORGANIZATIONAL STRUCTURE.** The structure of an organization defines the roles and responsibilities of those charged with pursuing its mission – the board of directors/trustees, committees, staff, officers, outside contractors, and volunteers. A nonprofit organization must be structured to meet its goals. Water reclamation projects will require a structure involving engineers and construction experts, while feeding the homeless requires a completely different set of skills and financial resources to meet that goal. Although both operate as nonprofits, one may need to retain a huge amount of capital-intensive equipment, while the other may require only a portable cooking facility.

The type of nonprofit determines the organizational structure and complexity of its membership. Medical research, conducted in conjunction with commercial medical development, requires a strict accounting for the input of each member or contributor and an equally strict accounting for any profit or gain realized from the joint venture. The organizational structure for financial management, including treasury and controller duties, will be addressed in greater detail in Chapter 4. We shall document how control and reporting duties, springing from chief financial officer (CFO) education and training as well as time and staffing concerns, have unfortunately taken precedence over treasury duties.

## 1.4 UNDERSTANDING THE LANGUAGE OF THE NONPROFIT ORGANIZATION

Some of the terms most commonly used by nonprofits with working definitions follow:

*Articles of incorporation* Legal document used to create a nonprofit organization; sometimes termed a "charter."

*Board of directors* Two or more individuals who serve as the governing body of an organization.

*Board of trustees* Governing board of the nonprofit corporation (trust or charity); see *board of directors.*

*Bylaws* Set of rules that govern a nonprofit organization's internal affairs.

*Chair of board* Person selected by board to be its leader.

*Chief financial officer/controller* Staff member most responsible for financial analysis and decision-making; in smaller organizations without finance staff this role may be jointly assumed by the CEO and the bookkeeper or board treasurer.

*Conflict of interest* State of affairs that looks suspicious and raises questions of appearances.

*Deferred giving* A charitable gift made before one's death.

*Endowment* An accumulation of contributions that is held for investment; earnings, if any, can be distributed to programs.

*Fiduciary* One who is legally bound to oversee the affairs of another using the same standards as one would employ to look after his or her own assets.

*501(c)(3)* Section of the IRS Internal Revenue Code that defines charities as a special type of tax-exempt, nonprofit corporation; other than testing for public safety organizations, all 501(c)(3) organizations are eligible to receive tax-deductible donations.

*Fund* Separate accounting records for a part of the organization, such as permanent endowment, board-designated investment amounts, or restricted for a specific purpose by donors. Grant tracking falls under this.

*Fund accounting* Technical accounting term that refers to a system of accounting for funds by project, so that assets and liabilities are grouped by the purpose for which they will be used; use of fund accounting is inconsistent with newer accounting standards' emphasis on showing the financial position of the organization as a whole, but many organizations continue to use fund accounting for internal bookkeeping and stewardship purposes.

*Nonprofit* Corporation that is not allowed to distribute profits or surpluses to its board or those in control of the organization.

*Officer of corporation* Legal representative of the board of nonprofit corporation: president, vice president, secretary.

*Permanent fund* A fund in which the principal is never spent.

*Philanthropy* Goodwill; active effort to promote human welfare.

*Restricted fund* A fund that has been contributed to a nonprofit organization for a specific, designated purpose and cannot be used for general operations.

*Secretary* Officer of nonprofit board responsible for preparing board agendas, minutes, and other documentation of business of the nonprofit board.

*Stewardship* Holding something in trust for another.
*Tax-exempt* Not subject to income taxes.
*Treasurer* Traditionally, the chief financial officer of nonprofit organization; now used in more restricted sense as board member having the primary responsibility for the board's oversight of financial policy and financial issues such as budget approval.
*Unrestricted fund* A fund contributed to a nonprofit organization whose use is determined by the board of directors.
*Volunteer* One who does meaningful, but unpaid, work for the nonprofit organization.

## 1.5 FINANCIAL POLICIES

We cannot emphasize this strongly enough: The most important aspects of proficient financial management in the nonprofit sector are the primary financial objective and the financial policies the organization uses. Second in importance are the tools and practices used, but these are primarily means of implementing the objective and policies. Throughout this book, we emphasize how the various financial management areas link up to the primary financial objective, and we provide guidance on appropriate financial policies in those areas. While we view this as critically important, many clients and students report that their organization does not have financial policies or that if there are policies, they are not aware of them. We postulate that sustainable financial practices in nonprofit organizations rely on this foundational concept.

Policy is the rule of law for an organization in a particular decision area. Examples include an organization's investment policy or internal cash control policy. Policies should be viewed as a set of guidelines (laws, rules) or principles for how day-to-day business should be performed. Some policies are determined internally; others are prescribed for the organization by outside organizations and are necessary in order to accept funds from those organizations or to work within applicable laws and regulations. Even if policies are not written down, all organizations have some financial policies that comprise the guiding principles regarding how they do certain things. Were it not for policies, a method or plan would have to be established each time someone needed to do something. Think of procedures as the specific steps that will be followed in order to implement a particular policy.

To help us distinguish between policy and procedure, let's consider two general definitions for policy and procedure, one authoritative and the other practical:

| | **Authoritative** | **Practical** |
|---|---|---|
| Policy | A definite course of action adopted as expedient or from another managerial consideration | A set of guidelines or principles defining an organization's philosophy about how business should be conducted |
| Procedure | The act or manner of proceeding in any action or process; conduct | Steps and/or actions to be taken to comply with a specific policy |

Throughout this book, we illustrate financial policies and some financial procedures. In addition, for those wishing to further investigate policies and procedures, Chapter 5 provides guidance on how to go about setting policies in many areas, for organizations that have never before formalized their policies and for those organizations that wish to revisit their policies periodically to modify and update them. Chapter 15 builds on that discussion and introduces additional ways to review policies. In today's donor, grantor, and regulatory environments, it is extremely important to be able to document and communicate policy.

## 1.6 FINANCIAL PRACTICES

A special focus in this book that sets it apart from other books in the field is the our presentation of the "state of the art" regarding practices in nonprofit financial management. We develop this profile in three ways:

1. We provide survey evidence from studies we have done as well as others on the degree to which organizations use tools and techniques in carrying out the finance function. Critical evaluation is offered on current practices.
2. We profile business-sector practices that nonprofit sectors may adapt for their charitable missions and for earned income ventures.
3. We present brief case studies or single-organization illustrations of "best practice" implementation, including anecdotal observations we have made and illustrations gathered from consulting firms and financial service providers.

Practices covered include the following:

- Primary financial objectives
- Organizing the finance function
- Accountability structure
- Use of technology in treasury
- Conforming to external watchdog standards
- Cash and liquidity management
- Banking selection and relationship management
- Budgeting
- Cash forecasting
- Financial ratio analysis
- Reporting
- Long-range financial planning
- Capital project evaluation
- Investment policies and management, short-term and long-term
- Relative use of different forms of debt
- Bank borrowing and how banks view nonprofit organizations
- Tax-exempt bond issuance
- How bond raters view nonprofit organizations
- Earned income ventures/social entrepreneurship
- Evaluating mergers and acquisitions
- Risk management
- Foreign exchange and interest rate risk exposure

- Board duties and how they are viewed
- Internal controls
- Financial accountability

In the companion book, *Cash & Investment Management for Nonprofit Organizations* (published in 2007), we provide more in-depth guidance on:

- How and why cash management and investments provide financial strength for the nonprofit
- Cash and liquidity management
- Appropriate size for cash and operating reserves
- Using reserves to self-fund new program and program expansion capital expenditures and maintenance
- Short-term investment policies and practices
- Long-term investment policies and practices
- Endowment
- Pensions

All of these decision areas steer the organization toward accomplishment of its primary financial objective.

## 1.7 PRIMARY FINANCIAL OBJECTIVE

Board members and financial executives who come to nonprofit organizations from the business sector are often confused and frustrated by the different environment. Consider the two polar extremes in Exhibit 1.3. At one extreme are organizations that are able to gain all of their revenue from product or service sales. These "commercial" organizations look much like businesses and are sometimes labeled "businesses in disguise." But most nonprofits are religious organizations or charities, which find themselves at or near the opposite pole, with their revenues coming from grants and gifts. These are termed "donative" or donation-dependent nonprofits. They provide "public goods" free of charge or at subsidized rates to their clients. Before directly addressing the most appropriate financial objective for a nonprofit, let us discuss why this is important.

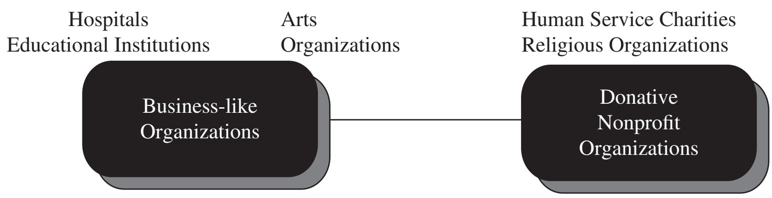


**EXHIBIT 1.3** SPECTRUM OF NONPROFIT ORGANIZATIONS

### (a) DIFFERENCES BETWEEN BUSINESSES AND DONATIVE NONPROFITS.

***(i) Businesses Have a Numerical, Specific Objective: Maximize Stock Price.*** This specific objective typically translates into maximizing long-run risk-adjusted profits. Intermediate targets that foster increased profits and stock price are also pursued. These targets include increasing market share (a company's percentage of total industry sales), increasing quality, increasing share of mind (identified by company's target audience), and increasing short-run revenues or reducing short-run costs (or both). Nonprofits that are business-like in nature, such as hospitals and private schools or colleges, can adopt many of these same intermediate targets. However, donative nonprofits generally do not see their revenues automatically increase when they provide more services. This fact is significant for three reasons.

1. The donative organization is forced to do additional fundraising just to cover the added costs of providing more of the same or new services, instead of simply collecting higher revenues from additional sales, as a business would.
2. The nonprofit that does not understand this linkage will find itself in an ever-worsening financial shortfall each period that transpires without new donations.
3. A large percentage of nonprofit funding (grants and contributions) is restricted for time or purpose. In addition, nonprofits often receive multiyear grants, and GAAP accounting standards require that the total amount be recorded when the grant agreement is received. This requirement creates a situation where nonprofit accounting practices differ significantly from businesses (often creating a lot of confusion in the boardroom).

For these reasons, financial management is more challenging for the donative nonprofit. Soon we shall point to a more appropriate primary financial objective.

***(ii) Businesses Can Price Their Services and Then Use Revenues to Gauge Their Marketing Success.*** "Business-like" nonprofit entities, such as hospitals and educational organizations, can and do gauge marketing success from revenues for some of their programs and services, insofar as they do not violate their exempt status and societal role. Donatives and dues-based nonprofits may also apply this standard to certain of their earned income ventures. Revenues do not clearly reflect the quality and quantity of all services provided, however.

***(iii) Businesses Typically Know Who Their Customers and Owners Are.*** Knowing who customers and owners are may be difficult for nonprofit organizations, particularly donative ones. Are the donors the customers, the owners, both, or neither? Or is the organization tied permanently to the activities specified in the charter and/or articles of incorporation, in a sense owned by its founders or society? Determining this is important because in order to assess trade-offs correctly when making major programmatic decisions, especially when finances are tight, managers must make the assessment based on the proper criteria. Some organizations have gone overboard with this, defunding, mothballing, or radically changing key programs due to declining financial support, even though those programs were central to their missions.

***(iv) The Typical Pattern of Cash Flows Often Differs, Particularly for the Donative Nonprofit.*** In donative nonprofits, the fiscal year often begins with a stockpile of financial resources that must cover the shortfall of donations experienced prior to the major inflow around Thanksgiving and Christmas. The stockpile may include one or more of: cash on hand, short-term securities, bank loans, soon-due pledges receivable, or salable merchandise. The service effort is typically constant or almost so during the year, and the payroll and supplies expenditures continue on a fairly steady basis. Donations tend to cluster around Easter and the period from Thanksgiving to Christmas. The organization lives off its stockpile, to a large degree, until the heavy inflows materialize, at which time it replenishes its stockpile. When face-to-face fundraising is done, and wills and bequests are received periodically as a matter of course – as with Father Flanagan's Boys Town – the organization may use an income stream generated by endowments to partly offset the dry periods. The restricted nature of many of the large gifts, wills, and bequests may preclude interest or principal from being used for operational needs. Consequently, many nonprofits may experience a short-term need for funds during their operating cycles. The need for funds may have resulted from a downward trend in donations, a predictable seasonality in the receipt and disbursement of cash, or an unexpected event affecting costs, such as a strike. The worst case may occur when demand suddenly accelerates: When a business experiences higher sales, the sales revenues typically offset the higher costs, but a nonprofit has no assurance that donations will increase quickly when more services are provided. During the height of the Great Recession (2008–2009), many nonprofits were faced with the perfect storm of financial management. Their donations went down, the value of their investments decreased, and the need for services rose.[9]

Taken together, these operating characteristics of organizations that depend on donations for a significant percentage of their annual revenues drive their financial focus to a different objective. We now turn to some survey evidence to find out what that objective is.

**(b) SURVEY EVIDENCE ON THE PRIMARY FINANCIAL OBJECTIVE.** In our early 1990s Lilly Endowment–sponsored study of 288 chief financial officers of faith-based organizations, "financial break-even" (revenue equals expenses) was the dominant financial objective (111 respondents), followed by "maximize net revenue" (59 respondents).[10] As secondary objective, respondents indicated a concern for cost minimization (34 respondents), avoiding financial risk (25 respondents), and maximizing net donations (20 respondents). One observation we make here is that financial risk avoidance is justifiably gaining attention from nonprofit organizations. *Yet we believe that break-even and cost minimization are inadequate as primary financial objectives.* It would be much better to focus on net revenue, financial risk, net donations, or cash flow – all of which represent more focused attention to the positive contribution the finance function can make to mission achievement. Maximizing cash flow or net revenue, or attempting to break even, will force attention on cost control. Accordingly, cash flow or net revenue may retain the best of each of the other two related objectives while adding to them. This in no way negates the importance of program outreach and quality attainment, but indicates ways in which resources will be allocated to carry out the mission. Yet, we argue that the primary financial objective is to set and strive to achieve a targeted liquidity level. (See Exhibit 1A.1 for more on this study and its results.)

Subsequent to that study, the Lilly survey instrument was revised to include more objectives from which to choose as the organization's primary financial objective. A fax-back survey was administered in 2002 to member organizations of a group of faith-based international outreach organizations, now part of a larger group called Missio Nexus.

The results are fascinating. Respondents were asked first to select their organization's primary financial objective. The results are shown here:

| Percentage of Respondents | Primary Financial Objective |
|---|---|
| 35.7% | Break even financially |
| 21.4% | Maintain a targeted level of cash reserves and financial flexibility |
| 14.3% | Maximize cash flow |
| 7.1% | Minimize costs |
| 7.1% | Maximize net revenue |
| 7.1% | Maximize net donations |
| 7.1% | Make a small surplus |
| 0.0% | Avoid financial risk |

The key point to note is that ten years after the original survey 35.7 percent (21.4% + 14.3%) of a similar group of nonprofit organizations were focusing much more on cash flow and cash position – or "liquidity management" (just as many as were following the "received wisdom" that has been recommended by various sources to nonprofits: of not making a profit but covering costs).

More recent evidence we have comes from a 2011 survey of 514 mid-sized nonprofits conducted by Indiana University and conference surveys from a Rice University development-finance annual symposium. The Indiana University survey finds that "striving to meet an appropriate liquidity target over time – that is, "maintaining a targeted level of cash reserves and financial flexibility" (37.6 percent) and "assuring an annual surplus so the mission can be achieved in down years" (26.6 percent) – are the top two primary financial objectives for organizations. An additional 23.7 percent reported that breaking even financially was a primary financial objective for organizations."[11]

Three preconference surveys administered to attendees of the Rice Development & Finance Symposium in 2014–2016 found that between 33 percent and 45 percent of the respondents selected "achieving and maintaining a targeted level of cash reserves and back-up liquidity" as their organization's primary financial objective.[12] Clearly, targeting liquidity and achieving financial flexibility while doing so constitute the financial objective that is primary in the minds of nonprofit financial managers. Simply "balancing the budget" no longer suffices, as surpluses are necessary to build and sustain the cash flow needed for a thriving organization.

**Cash flow** refers to the difference between cash inflows and cash outflows in a given period. **Cash position** is the amount of cash and near-cash investments held by the organization. **Liquidity management** includes forecasting, and managing cash flow and the cash position, and ideally should include setting and managing toward a preferred cash position, or liquidity target. A **liquidity target** includes the elements of the cash position, along with unused short-term borrowing capacity. Your organization may have a pre-approved line of credit with a bank, some of which has not been borrowed or "taken down" at present.

Also important to note here is that the majority of respondents in each of the surveys chose an objective *other than financial break-even* as best describing their organization's primary financial objective. Apparently an increasing number of CFOs have concluded that striving for financial break-even cannot suffice as a nonprofit's primary financial objective. We elaborate on liquidity targeting in the next sections.

**(c) FINANCIAL OBJECTIVE FOR PURELY FINANCIAL DECISIONS.** Richard Wacht, an academic who has written on nonprofits, proposes that a nonprofit's financial objective be limited to "purely financial decisions" and is best stated as "cost minimization, subject to the absolute constraint of maintaining organizational liquidity and solvency over time."[13] He arrives at this objective by assuming that the financial objective must be largely divorced from the programmatic, mission-related objectives. While we see this as true up to a point, we believe that the program and financial objectives are more closely and holistically linked in most organizations' decision-making and in most major spending and service-level decisions.

**(d) RECOMMENDED PRIMARY FINANCIAL OBJECTIVE: APPROPRIATE LIQUIDITY TARGET.** Our view, based on field evidence we have gathered, survey evidence, and the environmental and management constraints nonprofits face, is that the primary financial objective of organizations is to ***strive to meet an "appropriate liquidity target" over time***. Managing cash flow, the cash position, and back-up sources of cash are the keys to accomplishing this. Implementation of this objective requires marshaling (a) enough cash, (b) at the right time, and (c) not overpaying to have that cash available, while (d) protecting that cash from impairment, and then (e) spending that cash in support of the mission while adhering to donor stipulations. We develop the basis for this conclusion in Appendix 1A and in Chapter 2.

When this primary objective is described to clients and our college-level financial management students, the response is often that this seems obvious when stated. It seems to make sense to them because of its intuition but is not generally thought of as being normative.

For those uncomfortable with a single objective, consider the financial objectives articulated by William Hopkins, former treasurer of ChildFund:[14]

- Cost effectiveness
- Financial accountability
- Maximization and protection of cash flows
- Maintaining liquidity that ensures the future of the organization

Were we to implement these objectives in our organizations, we would order them in terms of importance:

- Maintaining liquidity that ensures the future of the organization
- Maximization and protection of cash flows
- Cost effectiveness
- Financial accountability

No doubt some readers will express surprise that we placed financial accountability last. An important first step toward financial health and sustainability is maintaining the necessary amount of liquidity. At a minimum, this entails setting up an **operating reserve.**[15] Formally, an operating reserve is:

…an unrestricted fund balance set aside to stability a nonprofit's finances by providing a "rainy day savings account" for unexpected cash flow shortages, expenses or losses. These might be caused by delayed income payments, unexpected building repairs, or economic conditions.

While championing accountability, we prioritize liquidity for two pragmatic reasons:

1. Managers tend to focus on one or at most two primary objectives, and we believe the first two in our ordering of Hopkins's list are the most important objectives.
2. Environmental factors and the accounting training of the CFO of many organizations ensure that much attention will be paid to financial accountability.[16]

We have seen a small number of organizations that are not as careful in being accountable as we would hope.

## 1.8 CONCLUSION

The nonprofit environment is a challenging one for financial managers. Multiple stakeholders, confusion about what financial objective to pursue, limited staff, funding, and technology resources, and inattention to cash and treasury management are all factors contributing to the difficulty of the nonprofit financial management.

We have presented the main structural components, the key policy areas, and the primary financial objective in this chapter. We profiled the survey evidence regarding the objective that the chief financial officers of charities say that they pursue, and found that cash position and cash flow management are becoming more prominent. We then recommended as a primary financial objective striving to meet an "appropriate liquidity target" over time. This entails running surpluses in some years, possibly deficits in a few years. We develop the idea of liquidity management, including monitoring the cash position and managing cash flow, in greater detail in Appendix 1A and in Chapter 2.

In the remainder of this book, we provide guidance on how this cash position and cash flow management focus translates into financial policy and practices. In our next chapter we turn to a fuller investigation of why these concerns should be at the top of a nonprofit organization's financial concern list.

## Notes

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# APPENDIX 1A

# THE LILLY STUDY FINDINGS

## THE LILLY STUDY

We have seen much hyperbole about the true state of financial management in nonprofit organizations. This is especially the case regarding perceptions of social services charities, religious, and art organizations – really all nonprofits outside the health and education sectors. A large group of these donative organizations, which depend on gifts for 60 to 100 percent of their annual operating revenues, was the focus of a two-phase study completed in the early 1990s. This study was funded by the Lilly Endowment, Inc. as part of a project entitled "Organizational Goals and Financial Management in Donative Nonprofit Organizations" conducted by John Zietlow.

More than 1,000 religious or religiously based organizations in four categories were selected for study: denominational headquarters, denominational foreign missions (where the headquarters was separate), independent foreign mission agencies, and localized rescue missions. The latter are often called homeless shelters, but their work goes beyond sheltering.

Treasury management topics were studied in detail in Phase 1 of the project. Questions were asked on a 12-page mail survey about organizational and financial goals and all "short-term financial management" (STFM) or treasury management areas: cash management, cash forecasting, inventory management, accounts receivable and accounts payable management, bank selection and relations, fundraising evaluation, short-term investing, short-term borrowing, risk management, and organizational attributes. Logical organizational characteristics were studied to better understand why certain organizations functioned more effectively or efficiently than others: size, age of the organization, role and interest of the board of directors, and formal training and experience of the chief financial officer.

Completed surveys were received from 288 (29 percent) of the surveyed organizations, a good response rate for a survey that is lengthy and difficult to complete. Based on the survey responses, and with the help of an expert advisory panel, each organization's survey responses were scored based on the financial management sophistication portrayed in the answers provided. For each of the four categories listed, the "best in class" organization was visited in person, as was an "average-rated" organization. How and why CFOs followed specific approaches and used various financial management techniques was the focus of in-depth interviews along with additional decision making and board evaluation questionnaires. Interviews were conducted with the CFO, CEO, and the outside (nonemployee) board member most familiar with that organization's financial management.

The typical organization was small, having an annual revenue of only $800,000, on average. One-half of the CFOs had related business experience, typically eight years or more.

The "best of the best," those organizations having the highest overall STFM score in their respective categories, were:

Independent Foreign Mission: Campus Crusade for Christ (Orlando, FL – John Webb, Director of Finance)
Denominational Mission: (1) Church of God Missionary Board (Anderson, IN – Darryl Smith, CFO); and (2) Southern Baptist Board of Missions (Richmond, VA – Carl Johnson, CFO)
Rescue Mission: Peoria Rescue Ministries (Peoria, IL – Reverend Jerry Trecek, CEO and CFO)
Denominational Headquarters: Church of the Brethren (Elgin, IL – Darryl Deardorff, CFO)

The findings provided in the next section are mostly linked to survey results, although our understanding of these findings was enriched by what was learned in the onsite visits. We now turn to what the survey results revealed.

**KEEP THE MISSION FIRST!** The first principle that the survey results revealed cannot be emphasized strongly enough: Mission first! Nonprofit organizations do not answer to stockholder owners but instead must adhere to the charter and mission of the organization. Finance sustains mission. Regrettably, some organizations permit a proposed new program to take precedence over existing programs, simply because corporate or foundation or government grant money is easier to get for the proposed program (which often is not closely linked to the charter or mission of the organization).

## MANAGEMENT AND FINANCIAL OBJECTIVES

***Management Objectives*** Maximizing the quality and quantity of service was selected by most respondents as the primary management objective, followed by maximize quality. Mission-minded organizations are service-minded, as one would expect.

***Financial Objectives*** Break-even (total revenues equal to total expenses) was the dominant choice selected as descriptive of the organization (111 of the 288 respondents), followed by maximize net revenue (59 respondents). As a secondary objective, respondents indicated a concern for cost minimization (34 respondents), avoiding financial risk (25 respondents), and maximizing net donations (20 respondents).

We note that, on the positive side, financial risk avoidance is justifiably gaining attention by religious nonprofit organizations. However, break-even and cost minimization are inadequate as primary financial objectives, in our view. It would be much better to focus on net revenue, financial risk, and net donations – all of which represent more focused attention to the positive contribution the finance function can make to mission achievement. Even the latter objectives are secondary in our opinion. In chapter 1 we proposed and in Chapter 2 we defend an objective that supersedes these objectives—that of achieving an appropriate liquidity target. One must recognize the overlap between the break-even and cost minimization and maximizing net revenue objectives, as shown in Exhibit 1A.1. Maximizing net revenue or attempting to break even will force attention on cost control. Accordingly, net revenue may retain the best of the other two objectives while adding to them. This in no way negates the importance of program outreach and quality attainment, but it indicates ways in which resources will be allocated to carry out the mission. We also note that

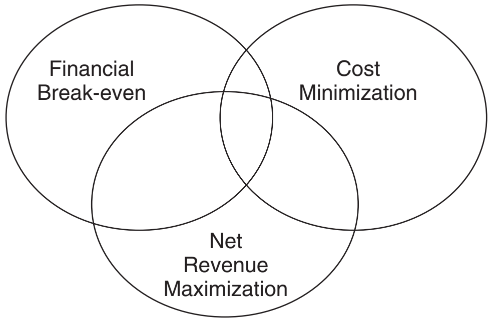



**Exhibit 1A.1** Overlap of Several Popular Financial Objectives

some organizations budget for a "contingency" or add a "savings account (or operating reserve) contribution" in their expense listing, implying that "break-even" objective is in fact a "small surplus" objective. Using a very conservative revenue and support forecast along with a realistic expense forecast has the same result as adding a contingency or reserve set-aside.

We consider "net revenue" as a second-best primary financial objective for most non-profits. We imagine the following conversation between two chief financial officers (CFOs), CFO #1 who believes net revenue is the best objective and CFO #2 who believes a liquidity target is the best objective:

Topic of Discussion: "What is the best primary financial objective – to maximize funding? If no, what should be the primary financial objective?

CFO #1: "No. Net revenue should be the primary financial objective."
CFO #2: "No, setting and reaching a target amount of liquidity should be the primary financial objective."
CFO #2 then cross-examines CFO #1.
CFO #2: "Then you want to maximize net revenue?"
CFO #1: "No."
CFO #2: "So, do you want to strive for a target amount of net revenue?"
CFO #1: "Maybe, yes."
CFO #2: "What would you set your target based on?"
CFO #1: "A funding target, maybe."
CFO #2: "Could an organization still fail financially, or fail to meet its other financial goals when doing this?"
CFO #1: "Yes, I guess so."
CFO #2: "Why?"
CFO #1: "Well, I guess it might have inadequate cash or other forms of liquidity, and either go out of business or not be able to make investments in growth or new programs."
CFO #2: "OK, could we derive a target net revenue and have that serve as a means to the end of reaching a liquidity objective?"
CFO #1: "Yes, I suppose we might."
CFO #2: "How?"

CFO #1: "By having a liquidity target and then backing into the required net revenue to bring in that year to reach or maintain that target amount."

CFO #2: "And what would that required net revenue be based on?"

CFO #1: "Financial projections for the organization. I would project operational and capital (property, plant, equipment) needs, which combined would be my funding need. From that I would then know what my financial cash flow would need to be for that period. We would then determine how much outside financing through loans or bonds we might go after, and the gap that remains would have to be funded through internal funding in the form of net revenues."

CFO #2: "Exactly! I believe we are making an assumption here about the mission, mission funding, and reaching the primary financial objective."

CFO #1: "I am not sure I understand; could you explain?"

CFO #2: There must be a direct tie between the mission (and its programs), the funding of that mission through revenues and support, and meeting the primary financial objective. We have to ensure consistency between this year's programmatic outreach, funding mix and amount, and reaching the target liquidity amount.

An example will help us see how these items tie together. Our organization has a debt policy that is "maxxed out" at this point in regards to outstanding borrowings. It does not anticipate any investment gains or losses during the year, and all revenues and support will be received in cash during the year. It has a target liquidity (Appropriate Liquidity Target) of $475,000 for the year just ended. The organization's ALT, or target liquidity, has been set at $500,000 for next year. Let's say that in the coming year the planned mission level and its programs will require the following expenses and expenditures:

| | |
|---|---|
| **Expenses:** | |
| Program Expenses | $750,000 |
| Management Expenses | $125,000 |
| Fundraising Expenses | $45,000 |
| Depreciation Expense (not allocated to above categories yet) | $30,000 |
| Total Expenses | $950,000 |
| **Other Expenditures:** | |
| Working Capital (Inventories, Receivables, Short-Term Growth Capital) | $50,000 |
| Addition to Storage Space | $100,000 |
| Repayment of Previous Borrowings | $20,000 |
| Total – Other Expenditures | $170,000 |

The most accurate and realistic forecast of revenues and support for the upcoming year is:

| | |
|---|---|
| **Revenues & Support:** | |
| Revenues | $875,000 |
| Support | $125,000 |
| Total – Revenues & Support | $1,000,000 |

Note that this organization plans to "run a surplus," or positive net revenue, of $50,000 ($1,000,000 − $950,000). Recall that the organization's ALT, or target liquidity, has been set at $500,000 for next year. Note that this is $25,000 higher than this past year's target liquidity of $475,000, due perhaps to organizational growth.

Is the projected net revenue, based on the mission's plan and related expenses and expenditures, sufficient to maintain the organization's target liquidity of $500,000? If not, what action(s) might we recommend?

First, let's adjust the expenses for the fact that depreciation is a noncash expense. It is a bookkeeping entry (see chapter 6), and does not represent a cash outflow. Cash expenses then equal $920,000 (= $950,000 – $30,000).

Second, we add other expenditures to the adjusted expense amount to get funding need.

$$\begin{aligned}\text{Total Funding Need} &= \text{Adjusted Expenses} + \text{Other Expenditures}\\ &= \$920{,}000 + \$170{,}000\\ &= \$1{,}090{,}000\end{aligned}$$

Third, we find the difference between Total Revenues & Support and Total Funding Need:

$$\begin{aligned}\text{Excess (Shortfall) in Funding} &= \text{Total Revenues \& Support} - \text{Total Funding Need}\\ &= \$1{,}000{,}000 - \$1{,}090{,}000\\ &= (\$90{,}000),\ \text{or a } \$90{,}000 \text{ Shortfall}\end{aligned}$$

Finally, we check to see if our projected Excess (Shortfall) in Funding will suffice given the existing target liquidity level of $475,000 and the required target liquidity level of $500,000:

$$\begin{aligned}\text{Required Target Liquidity} &= \text{Existing Target Liquidity} + \text{Excess (Shortfall) in Funding?}\\ \$500{,}000 &= \$475{,}000 + (\$90{,}000)?\\ \$500{,}000 &> \$385{,}000\end{aligned}$$

Or, in words:

$$\text{Required Target Liquidity} > \text{Existing Target Liquidity} + \text{Excess (Shortfall) in Funding}$$

Now, how might we address this $115,000 projected deficiency? The temptation is to task the development office with bringing in an additional $115,000. The problem here is that that would take more resources to invest, and many nonprofits are unwilling or unable (do not have the extra funds) to make that investment. Additionally, we are uncertain regarding the ability of more development effort to bring in an additional $115,000 when it is presently expected to raise $170,000. Another option is to establish or increase the size of a credit line with a financial institution. We turn down this option because borrowing is not a means of bringing in reliable, yearly revenues and support to fund ongoing annual expenses. The painful option, but most likely one in the short-run, is to reduce our planned expenses and other expenditures to be able to meet our primary financial objective of $500,000 (and, we might add, that may only need to be $475,000 with a lower level of expenses and expenditures). After studying the make-up of the planned expenses and expenditures, management and the board finance committee jointly determine that (1) $475,000 will suffice as a revised target liquidity with a somewhat smaller programmatic expenditure next year, leaving us with a $90,000 gap (= $115,000 previous gap − $25,000 reduction in liquidity target) and (2) outflows may be pared by reducing program expenses by $70,000, management expenses by $10,000, and working capital expenditures by $10,000. Our financial plan now generates enough of a net surplus to deliver a slightly smaller-than-planned level of programmatic services and achieve the primary financial objective of maintaining a target liquidity level of $475,000. We now insert our modified numbers to recheck whether our projected Excess (Shortfall) in Funding will suffice given the revised required target liquidity level of $475,000:

$$\begin{aligned}\text{Excess (Shortfall) in Funding} &= \text{Total Revenues \& Support} - \text{Total Funding Need}\\ &= \$1{,}000{,}000 - \$1{,}000{,}000\\ &= \$0\\ &\text{No excess or shortfall.}\end{aligned}$$

$$\begin{aligned}\text{Required Target Liquidity} &= \text{Existing Target Liquidity} + \text{Excess (Shortfall) in Funding?}\\ \$475{,}000 &= \$475{,}000 + \$0?\\ \$475{,}000 &= \$475{,}000.\end{aligned}$$

Let's circle back to see what this implies about net revenue (or surplus, as it is commonly called). Were you able to detect the planned net revenue to bring this about? The $80,000 reduction in planned expenses implies the net revenue for the year will now be $130,000 (=$1,000,000 - $870,000). Had the organization not made these calculations and been accepting of running a slight surplus of $50,000, by the end of the upcoming year it would have seen its liquidity drop by $115,000 from $475,000 to $360,000. It is easy to see how and why so many nonprofits experience cash shortages as they plan only small surpluses, or worse, break-even operating results.

***Achievement of Financial Objective: How Well Are You Doing, Regardless of Objectives Pursued?*** Self-ratings on the achievement of the stated financial objective were: excellent (14 percent of respondents), very good (43 percent), good (30 percent), fair (10 percent), and poor (4 percent). This self-rating was one of the best predictors of the organization's overall Short-Term Financial Management (STFM) Score. The overall score was determined based on a careful evaluation of each question in terms of its ability to indicate proficient financial management. An expert advisory panel, assembled under guidance of the Lilly Endowment, assisted in this process. Our rationale for doing this scoring is that primitive financial management process and techniques are unlikely to achieve effectiveness in an organization's financial management outcomes. Individual questions within the survey were differentially rated, based on appropriateness for the size and type of organizations studied. We were impressed by the fact that most respondents had a fairly accurate idea of how effective their financial management process was, and the tabulated results indicate that sophistication (what the questionnaire was really measuring) had a strong correlation with perceived effectiveness (as measured by the respondent's self-assessment).

***Is the Indicated Financial Objective Really Operational?*** This finding is fascinating. A hypothetical decision was posed to the respondent to find out whether the financial objective was actually being pursued or was merely a stated objective. A new or expanded program recommended by the CEO or board clearly conflicts with the financial objective: What would most likely be done? In 46 organizations (17 percent), the program would be fully implemented anyway; in 68 organizations (24 percent), it would be scaled down somewhat, but the financial objective would still be set aside; and in 166 organizations

(59 percent), the objective would be met by scaling down the program adequately or not implementing it at all. In other words, the finance function imposes essentially no discipline on 46 of the organizations that responded, and in an additional 68 organizations, that discipline is weak. Possibly this is due to ignorance among the officers regarding either the proper role of finance or the importance of sound financial management. The good news is, that in roughly three in five organizations, the financial objective held sway over programmatic expansion that would be financially jeopardizing.

Some nonprofit executives would object to our conclusion that forging ahead with a new program despite the fact that it causes the organization to fall short of meeting its primary financial objective implies poor management "because we are called to do this and faith must be exercised." For organizations with a religious orientation, this response may be legitimate. Finance staff would carefully monitor such program initiatives to ensure that additional funds are ultimately raised to vindicate that faith. Where sufficient funds do not materialize during program implementation, this fact should be made apparent to the CEO and board in order to (1) ensure that the organization does not unduly expand those programs (draining resources from other important program areas) or add new ones until cost coverage is attained, and (2) inform decision makers of the types of situations about which to be more cautious in the future. As Ron Mattocks, author of *The Zone of Insolvency*, likes to say, "faith and prudence are not mutually exclusive."

## ON-SITE INTERVIEWS, QUESTIONNAIRES, AND ARCHIVAL STUDIES

The second phase in the Lilly study involved field studies of eight selected organizations. In-depth interviews, study of archived documents such as board meeting minutes and financial reports, and a statistical study of cash flows were executed for each of the eight organizations. A pattern of financial decision making appeared from these studies, particularly for those organizations that were scored highly on the financial management proficiency rating that we applied to the survey results. Bear in mind that the organizations studied are noncommercial, donative nonprofits. These results and the conclusions we garner from them are still applicable to commercial nonprofits such as hospitals or colleges, but healthcare and educational foundations as well as private foundations may see the liquidity target as a secondary objective.

## THE APPROPRIATE LIQUIDITY TARGET MODEL

We call the model the "Appropriate Liquidity Target" model of financial decision making. Exhibit 1A.2 provides a graphical presentation of the hierarchy of factors influencing decision making in this model. Notice that the central concentric circle depicts the primacy of the organization's mission – its charitable purpose.

Note the financial objective nearest to the center – "liquidity target." It appears that organizations strive to maintain, within some range they are comfortable with, a certain amount of liquidity – an Appropriate Liquidity Target (ALT). This target may also be called an "Approximate Liquidity Target," in that it is managed intertemporally. This is just a fancy way of saying that the organization's liquidity may dip below or shoot above the targeted range in any given year, but the organization will attempt to return its level of liquidity to the prescribed range in the following year(s). What might be an acceptable amount of liquidity for one organization could well be too high or low for another, very similar organization.

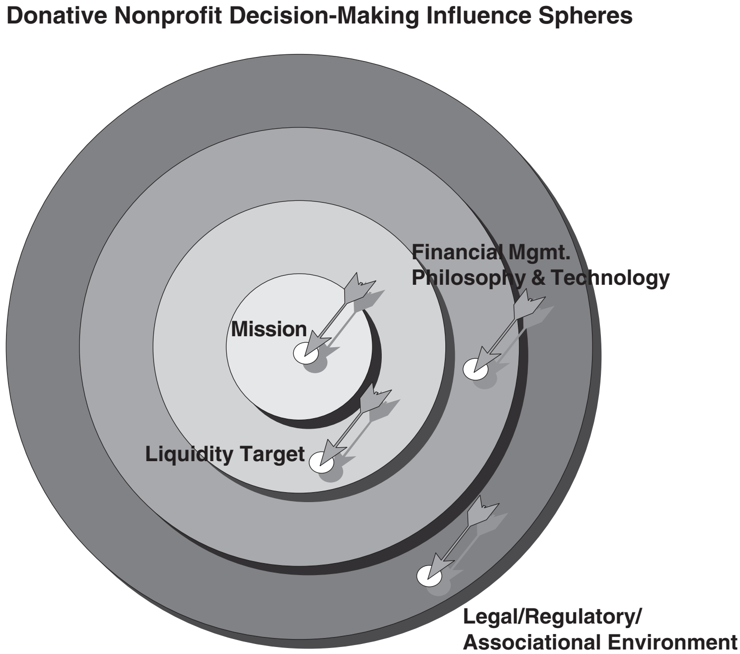



**Exhibit 1A.2** Overlap of Several Popular Financial Objectives

Why is this important for us as financial decision-makers or board members? The ALT model suggests that (1) the liquidity target range is actually the chief financial objective of the donative nonprofit organization, and (2) mission-related program initiatives may actually be managed in such a way to assist the organization in meeting its target. That items 1 and 2 hold may be masked by two factors: (1) it does not necessarily happen each year, but over time, and (2) the level of mission-related program initiative may be managed more with new program development and expansion/reduction of existing programs than with a given year's "output" level of program services. This fact seems to imply that the cart (financial resources) is driving the horse (mission-related program delivery). However, it may simply be that the managers of these organizations are well aware of the inability to tap external equity and the limited ability to utilize long-term debt (and, in many cases, a disinclination to use short-term debt) and are thus assigning more importance to liquidity and its linkage to survival. Without financial health, and with a threat to survival, the organization's ability to deliver its mission today and into the future is jeopardized. Funders are becoming aware of the tie between an organization's cash flow and its capacity to deliver on its mission: "Understanding the cash flow of the organizations you are granting to will tell you a lot about the degree of capacity they have to deliver on the results they are promising."[1]

The Appropriate Liquidity Target model can be expanded to show behavioral aspects of managerial decision making. The joint effect of three categories of variables drives the programmatic and resource allocation decisions as the donative nonprofit organization strives to reach its ALT. We can see the environmental, mission, and financial management categories in Exhibit 1A.3.

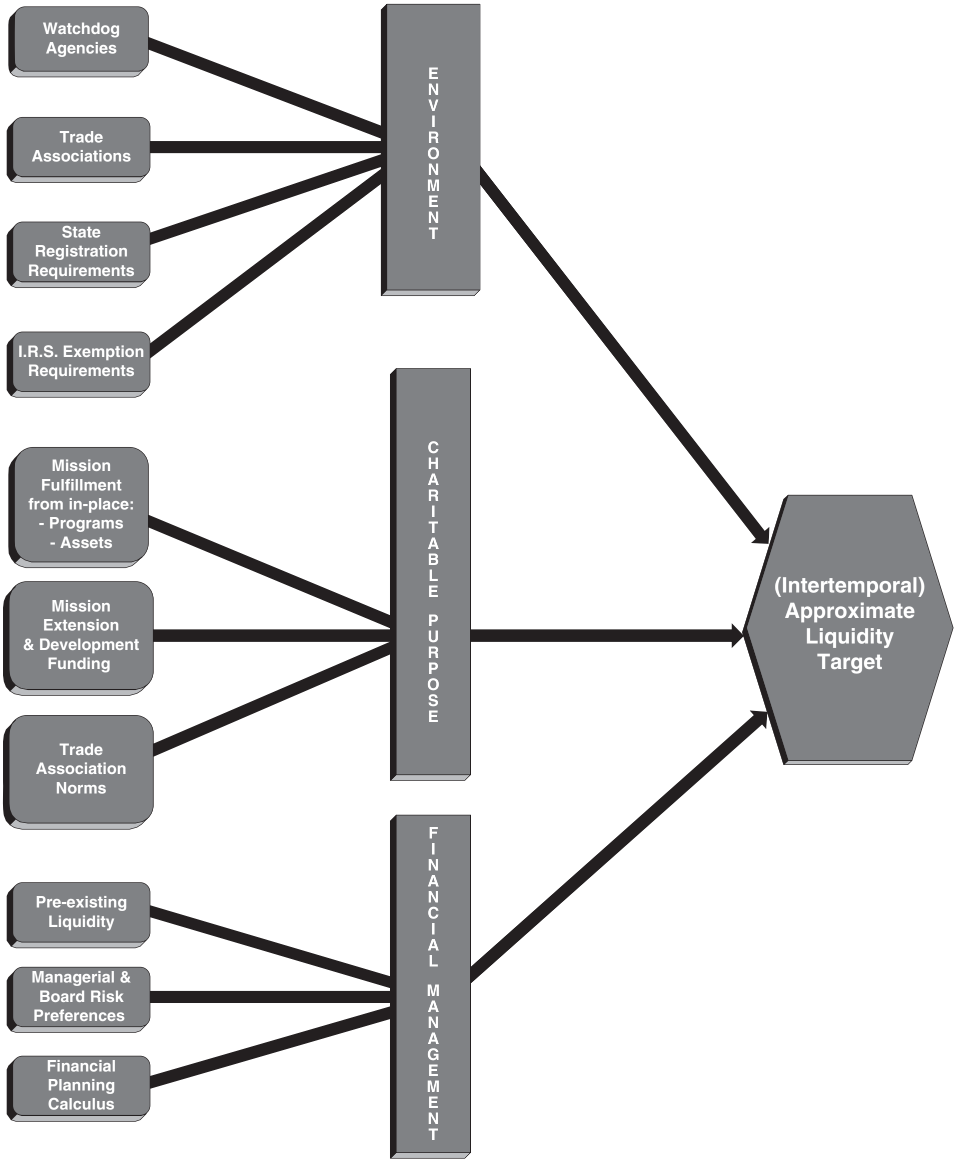



**Exhibit 1A.3** Intertemporal Appropriate Liquidity Target Model

Although not shown in the exhibit, the model allows for feedback effects from the realized liquidity position in any given year to the mission delivery (for assets and programs in place), mission expansion or growth path, and preexisting liquidity for following periods.

The box labeled "financial planning calculus" needs further explanation. This "calculus" involves the philosophy as well as technology employed for cash budgets, operational budgets, and pro forma financial statements. So it encompasses both short-run and long-run financial planning methodologies, including (for faith-based organizations) the decision maker's view of the relevance of faith in developing the coming years' output levels. For example, your organization might use incremental budgeting, in which next year's figures are simply small adjustments made to this year's budget or in light of this year's actual revenues, support, and expenses. We shall have more to say about this in Chapters 8 and 9.

Throughout the remainder of this book, we provide practical and policy guidelines regarding how to set the liquidity target and how to forecast and manage cash flows to best ensure the maintenance of that target and the continued financial vitality of the organization. Our next step is a deep dive on nonprofit liquidity in chapter 2.

## Note

1. Miles Wilson, director of The Grantmaking School, part of the Dorothy A. Johnson Center for Philanthropy and Nonprofit Leadership at Grand Valley State University, as quoted by Nancy Burd, "On the Money: The Key Financial Challenges Facing Nonprofits Today—and How Grantmakers Can Help," Grantmakers for Effective Organizations, 2009, pg. 11. Available at: www.geofunders.org.

CHAPTER 2

# LIQUIDITY MANAGEMENT



## 2.1 INTRODUCTION

We need to set the financial context for nonprofit financial management and for the special importance of liquidity management in the nonprofit sector. In this chapter we make the case for liquidity – ability to pay bills, meet emergency shortfalls, fund growth, and maintain flexibility – as critical to your organization's financial health and financial sustainability. We lay out the reasons behind our continuous emphasis on liquidity by profiling the legal, environmental, and institutional constraints on nonprofit financial managers. We then move into a critical analysis of the financial ratings available from charity watchdog agencies, which we find overly constraining with regard to liquidity management. You may wish to review the distinction between narrow liquidity and broad liquidity in Chapter 1 before proceeding, as there is a basic understanding of this distinction that we assume in our development of the theory and practice of setting liquidity policy.

Nonprofits that do not have enough accessible financial resources may divert their attention from mission accomplishment to coping with financial pressures.[1] We often hear of donation-dependent nonprofits thrust into a cash crunch or cash crisis due to the loss



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

of a key donor or part of their donor base. However, contract-based nonprofits are at least as vulnerable if not more so: Managers may underestimate the costs of carrying out the contract; unexpected increases in cost elements such as rent, energy, benefits, or insurance may occur; or several years of inflation may turn what was once an adequate contract revenue amount into an insufficient sum. Consider this observation from Stephen Rathgeb Smith:

> In short, the cash flow problem is not an idiosyncratic occurrence or primarily due to mismanagement; instead it is built into the very structure of the contracting regime. Cash flow problems are to be expected. Nonprofit managers are in the position of coping with chronic cash flow concerns. Managers respond with a variety of strategies. They may delay their payments to their vendors, ask their bankers for easier terms on their loans, request that staff take unpaid leave or vacation time, temporarily lay off employees or freeze hiring, even in cases of staff of staff members leaving. In particularly serious cases, agency executives may forego some of their salary or decide to suspend payment of the agency's payroll taxes.[2]

The latter tactic would end the agency in legal problems, if detected. In an update to his work on government contracting, Rathgeb Smith suggests that due to additional competition for organizations with government contracts, as well as the fact that many of these contracts do not fully fund the work that needs to be done in order to meet increasing performance-based funding, further pressure is placed on cash flow and liquidity.[3] Smith suggests that nonprofits try to deal with the chronic cash flow concerns by one or more of the following funding strategies:

- Obtain a line or credit or win an increased line from their bank
- Gather donations from individuals or grants from corporate foundations
- Tap into the principal of their endowments

Most nonprofits find that these three funding strategies fail them however.[4] Only nonprofits with collateral – something like inventories or receivables from sales or fees that can be sold to recoup dollars not repaid – or a longstanding reputation are viewed favorably by bank lending officers. Significantly increasing private gifts is difficult at best, and many foundations prefer to fund capital expenditures or projects, not operating expenses. Relatively few agencies can tap the local United Way funding stream, and that only after a lengthy application and review process. Mid-sized and small nonprofits rarely have endowments, and even if they do, only a small percentage of that endowment can be used for operations in a given year (and borrowing directly from an endowment or using endowment as collateral is fraught with complexity: when creating the endowment, you will want to get donors to agree to allow for the use of principal in an emergency; to tap the established endowment fund you will need to ask the donor to change the terms of the endowment retroactively, necessitating petitioning a court and perhaps getting the approval of a state's attorney general's office if the donor is deceased).[5] For all of these reasons, new monies are difficult to come by; knowing this, government administrators may prefer to contract only with large nonprofits.

We see cash flow problems as endemic to the nonprofit sector, particularly for organizations outside the healthcare or educational fields. From a managerial perspective, we believe that liquidity management is one of the most important yet least studied areas in the management of nonprofits. Liquidity is the key component to financial sustainability. *Liquidity* in our view may be broadly defined as being able to meet present and future draws on cash without impairing the mission or programs of the organization, incurring significant expense, or diminishing the financial health of the organization. This broad view of liquidity includes financial flexibility[6] (able to withstand cash flow declines and able to take advantage of near-term opportunities such as price declines or the ability of the organization to augment its future cash flows).[7] A more popular, but deficient view, is to look at the *solvency* of the organization – the extent to which its assets exceed its liabilities. We view liquidity broadly, encompassing both the definitions of liquidity here as well as solvency. *Our concern? Many managers and board members, as well as charity watchdog agencies, have either ignored liquidity management or have limited their analysis of nonprofit finances to solvency.* We demonstrate the weakness of the solvency view in this chapter and offer guidance on how your organization can set its desired liquidity level. By so doing, it has gone a long way toward ensuring its financial sustainability.

**(a) IMPORTANCE OF LIQUIDITY.** Liquidity policy and practice has been largely overlooked in nonprofit management periodicals and textbooks. Notable exceptions are discussed later in this chapter – those by Wacht and Ramirez. Also, Grønbjerg notes that growing donative human service organizations require access to liquid reserves to cope with cash flow problems.[8] Recently, three practitioner's guides to making cash flow projections, an important facet of liquidity management, have become available.[9] In most instances when cash or marketable securities are discussed, the problem of inadequate liquidity is briefly mentioned but the possibility or desirability of excess liquidity is not addressed. The coverage gap is surprising for two reasons. First, nonprofit managers, employees, and board members commonly lament the perennial cash crunch or ongoing cash crisis faced by their organizations (see Hall).[10] Second, this area of financial management is one that shares very much in common with business. The views of Aaron Phillips, former director of research of the Association for Financial Professionals, are worth quoting at length:

> The one unifying consideration all organizations share, whether publicly held, privately held, government, or not-for-profit, is the concern over liquidity management. It is a safe assumption that a for-profit entity will not remain in business long if it either lacks liquidity or does not effectively manage its liquidity. Empirical research has documented that corporate financial liquidity measures are important for assessing and/or pricing credit, determining bond ratings, forecasting bankruptcy, etc. Similarly, a not-for-profit organization cannot continue to meet its mission objectives, or at the very least risks jeopardizing its relationship with its stakeholders, if it lacks prudent liquidity management. In short, liquidity management is a major concern for every organization.[11]

Agency theory motivates us to better understand organizational liquidity. The argument is that managers (agents) build excess liquidity, or slack, because they are overly concerned about risk. In businesses, managerial risk aversion exceeds stockholder risk aversion, because stockholders are well diversified. The same argument *may* extend to donative nonprofits. To the extent that there are multiple organizations engaging in similar services (and with the same or very similar values and philosophies), the probability of organization failure and dissolution is of less concern to donors than to the organization's managers. Donors may simply reallocate donations to surviving organizations when one of the existing organizations fails. Recognize that this does not negate the fact that adequate liquidity, being the core component of financial health, is vitally important.

**(b) ARE NONPROFITS OVERLY RISK-AVERSE?** The difficulty in assessing whether nonprofit managers are too risk-averse comes when trying to jointly assess (1) the probability of organizational failure relative to the amount of liquidity held, and (2) the relative risk aversion of donors versus boards and managers of donative organizations. Without saying as much, charity watchdog organizations have made this joint assessment. These public watchdog organizations, in their desire to provide tangible, quantitative benchmarks of the effectiveness and efficiency of nonprofits, have adopted the solvency view of liquidity in their evaluative guidelines. Of the three major organizations – BBB Wise Giving Alliance, the American Institute of Philanthropy (CharityWatch), and Charity Navigator – two have explicitly adopted a prescribed *maximum* level of reserves (unrestricted net assets) that organizations may hold. Charity Navigator recently changed its rating system, but the revisions do not reflect any change in how it rates liquidity.[12] A fourth information provider, GuideStar, also makes three financial measures—months of expenses held in cash, months of expenses held in cash and short-term investments, and months of expenses held in estimated unrestricted liquid net assets—available to interested parties, while withholding judgment on "how much is too much." The Financial SCAN Report provided by GuideStar, in conjunction with the Nonprofit Finance Fund, is very insightful and provides numerous tables and graphs that the manager as well as the funder will find invaluable.[13]

When a watchdog agency prescribes a maximum, what it is saying is that beyond this level, the organization is holding excess resources that should instead be used for current program or service provision. The reason we must tackle and understand these prescriptions is that they have financial policy implications that have not been identified. These policy guidelines may be appropriate for commercial nonprofits but will severely limit the management style of smaller, contract-based, or donative religious organizations. Watchdog agencies rightly hold nonprofits to standards that avoid excess reserves, but say nothing about the chronic issues related to inadequate liquidity. They in effect establish a ceiling but not a floor on this chronic problem. These standards may reduce the number of nonprofits which hoard cash but not from nonprofits that are constantly struggling to stay afloat in the face of great uncertainty. Management efficiency is diminished due to constant concerns about liquidity. It is necessary to understand what the policy implications of these agency standards are. The implications fall into two major categories: (1) capital structure – many organizations prefer to self-fund future acquisitions, capital projects, and major program expansions, which implies a large buildup in cash reserves; and (2) liquidity management. Not only do many nonprofits avoid or minimize short-term borrowing (two-thirds of religious nonprofits avoid short-term borrowing – see Section 2.5 – but short-term borrowing is the primary source of backup liquidity for businesses, according to Kallberg and Parkinson)[14] – but they may hold their assets in a very illiquid form, such as pledges receivable. For example, often, the "wealth" of many nonprofits, particularly of religious institutions, is in their buildings and fixtures. The work of churches takes place largely in these facilities and the cost of maintaining these structures places an additional drain on liquidity.

Next, we need to know whether these standards rest on a sound financial management foundation. One might use one of three approaches to document and test the liquidity management approaches used by donative religious nonprofits and the degree of impact of the watchdog agency liquidity prescriptions.

1. A survey approach to data collection may be used. Survey evidence collected from 288 donative religious organizations provides information on the espoused liquidity management objectives, how liquidity is measured, and the policy toward and utilization of debt financing.

**2.** A nonprofit financial database may be used to study the incidence of "problem organizations," defined as those having more than the prescribed amount of reserves. The best study of actual nonprofit liquidity management practices to date is conducted by Andres Ramirez (2011). Ramirez harnessed the methodology used by the finest corporate finance research and applied it to nonprofits. He studied cash as well as cash as a percent of yearly expenses. His primary findings of interest include:

- Nonprofits in his sample held the equivalent of three months of annual expenses in cash and another nine months of expenses in savings (short-term investments).
- Ramirez's study documents that nonprofits also hold cash for the same reasons as businesses. Businesses hold cash for logical managerial reasons, or in some cases for reasons related to the governance of the organization: (1) transaction motive (it is the least-expensive way to finance daily operations), (2) precautionary motive (as a buffer against unpredictable declines in revenue and support), (3) speculative motive (to take advantage of future investment opportunities, which may also be unanticipated), and (4) governance-related reasons (the board and management superintend liquidity correctly and for good reasons or hold too little or too much liquidity to gain personally or stand in the way of donors' and other funders' best interests from being carried out). Smaller nonprofits, those with riskier (less predictable) revenues and support, and those with higher surpluses (surpluses divided by expenses; these surpluses, presumably, accumulate these in the form of cash over time), tend to hold more cash, similar to practices in the business sector.
- When drilling down into organizations that appear to hold "excess cash," Ramirez discovered that they will then invest more in land, buildings, and equipment than similar organizations holding less cash. This use of cash to fund asset growth underscores the need to prefund growth by building up liquidity. We call these amounts "strategic reserves."
- When organizations have higher level of liquid investments (public securities, including stocks and bonds), those that are easily and quickly sold for their fair market value, they tend to hold less cash, which suggests that managers are aware of and manage substitutes for cash wisely.
- Organizations spending relatively more on program expenses tend to hold higher levels of cash. Our interpretation of this is twofold: (1) that these organizations might be using the extra cash as an insurance policy or buffer against revenue declines, and/or (2) they might recognize there are relatively fewer non-program amounts that they have discretion over to spend down in the event of unexpected revenue declines or expense spikes (consistent with the Tuckman and Chang interpretation of the administrative cost ratio).
- More diversified revenue and support streams are positively associated with higher cash holdings. Ramirez questions whether this might be due to a reduced importance for donations and grants (so, less outside monitoring, perhaps leading organizations to hold too much cash) or to the greater required resources and counterintuitively greater volatility of overall nonprofit revenues and support. Our thought here is that managers and boards may couple both revenue diversification and higher liquidity to hedge against uncertainty in future revenues and support as well as expenses.

- Boards with more members hold more cash, whereas officer compensation is negatively correlated with cash (more cash held is associated with lower compensation).
- When there is funding coming from donor-advised funds and from board member loans, this is associated with lower levels of cash.
- Donors do not penalize organizations that hold high levels of cash. They evidently do not see governance/agency problems that might result in too-high liquidity levels. Quoting Ramirez: "Because of the uniqueness of nonprofit organizations, high cash reserves could be seen as prudent management—a precautionary cushion, agility for transactional purposes, and flexibility for speculative purposes—instead of an indication of agency problems." He concludes his study: "It appears that cash holdings in the nonprofit sector, like their for-profit counterparts, can be largely explained by precautionary and speculative measures … The evidence presented in this study is consistent with a harmless view of cash. Nonprofits with higher excess cash are those who grow assets more. Cash is very valuable for organization, and donors seem to agree."[15] So do we.

We have every reason to believe these results are credible and replicable, but would like to see the study redone using audited financial statements rather than the 2000–2006 Statistics of Income (SOI) Form 990 data that was used in this study.

**3.** One could use simulation modeling or scenario analysis to show how the maximum liquidity limits the financial management options for small donative nonprofits that:

**a.** Do not use debt financing

**b.** Do not typically generate positive operating cash flows (first category on statement of cash flows)

**c.** Are unable to launch capital campaigns

**d.** Have no endowments

To the best of our knowledge, no one has yet employed the third approach to study liquidity or to help set the desired liquidity level for an actual organization.

Before we go any further with our liquidity analysis, we must explain what we mean by donative organizations, give helpful counsel from corporate finance experts, and survey some early landmark studies of liquidity management in healthcare and educational organizations. We illustrate practice and inform policy by providing evidence regarding the financial management practices of a group of donation-dependent nonprofits. We then broaden the focus to commercial organizations, such as private schools and colleges and healthcare organizations. We show how the popular watchdog agency standards may be misguided and detrimental to your organization's financial health and conclude by providing a checklist of factors that will assist you in setting your liquidity policy.

## 2.2 NONCOMMERCIAL NONPROFIT ORGANIZATIONS

Nonprofit organizations often rely on sources other than product or service sales for much of their revenue and support. For public charities reporting to the IRS, about 48 percent of total revenue comes from service fees and goods sales revenue (not including government contracts).[16] This figure is largely affected by hospitals and colleges and universities. Many nonprofits rely heavily on donors (20 percent of total revenue overall, 44 percent for arts, culture, and humanities organizations),[17] or granting agencies for much of their operating revenue. Some types of nonprofit organizations, including religious organizations, gather over 90 percent of their revenues from donations. Some call these *donative organizations* because of their primary income source, while others view these as organizations having a *high collectiveness index*, where "collectiveness" refers to gifts and grants as a percentage of total resources.

**(a) GUIDANCE FROM FINANCE THEORY.** While corporate finance theory is well developed for businesses, it is still in the earliest stage of development for nonprofits. In fact, the only broad-range financial theory of nonprofit organizations was developed over 30 years ago by Richard Wacht. Wacht prescribes for all nonprofit entities the financial goal of "cost minimization, subject to the absolute constraint of maintaining organizational liquidity and solvency over time."[18]

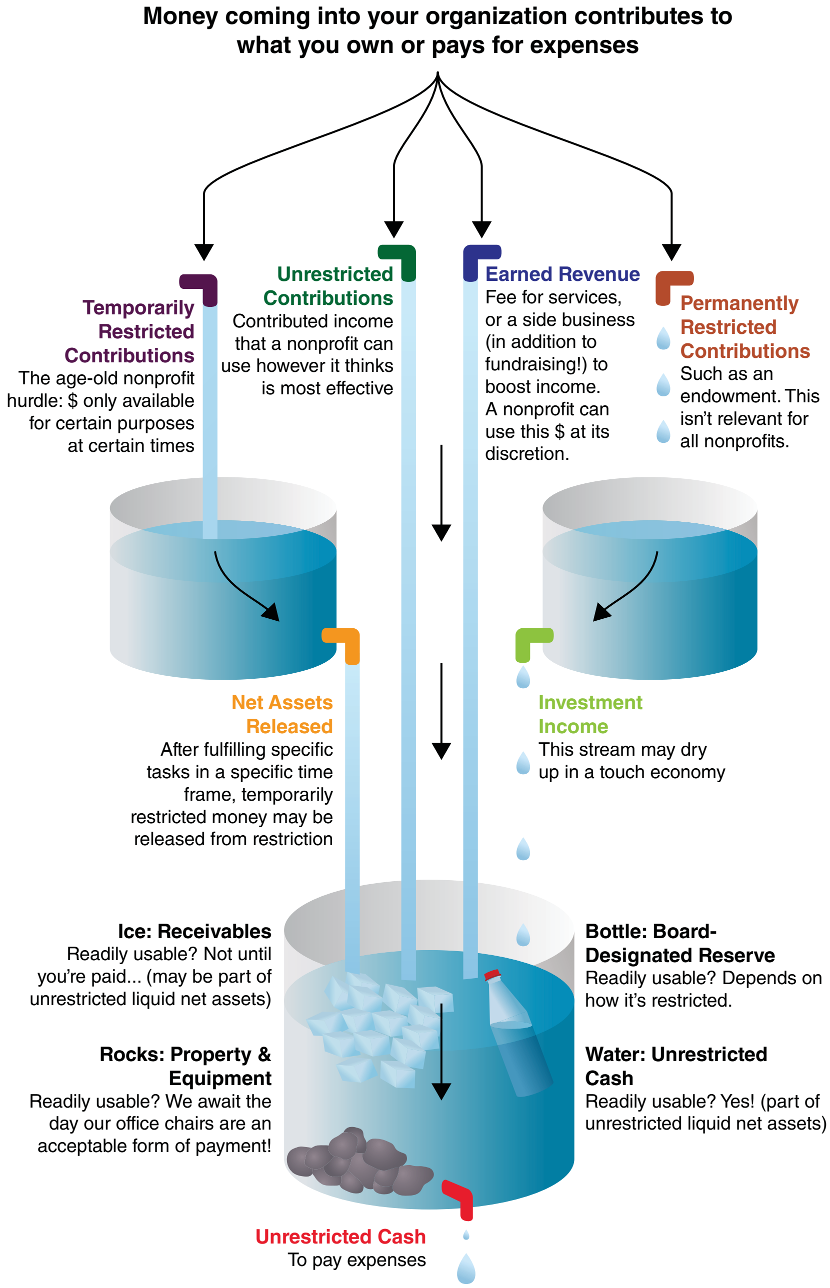
Wacht advocates a cash flow balancing approach to nonprofit financial management. He states at one point that "the financial manager must ensure that actual cash inflows and outflows are balanced and operations are proceeding according to plans." [19]

**(b) EVALUATION OF FINANCE THEORY.** We commend Wacht as the true pioneer in the field of nonprofit financial management theory development. He recognized the importance of liquidity along with cost control. Furthermore, he is the only one to ever devise a full-blown model of how mission and finance may work together in a nonprofit organization.

Wacht is somewhat vague on the specific implementation of the financial goal. He does note that new project implementation or existing program expansion can prevent the organization from meeting its financial goals of liquidity and solvency, and may plunge the organization into a financial crisis. Implied in his framework is the ability of an organization to develop and correctly utilize a fairly detailed financial model. Without such a model, there would be no way for the financial manager to back or reject proposed capital projects or program expansion initiatives. In our view, liquidity management should be more proactive than reactive, and organizations should start liquidity planning right from the start-up of the organization. All nonprofits should incorporate the riskiness of their cash flows into their assessment of "How much liquidity is enough?" Recently, Grant Thornton, which has a strong practice in nonprofit accounting and auditing, postulated an approach to developing "risk reserves." This approach is sound for several reasons. First, it engages managers from across the organization in evaluating strategic risks and then applies financial modeling to arrive at projections that are probabilistic. This method provides a data-driven metric that is foundational, logical, and a good way to set policy. It also increases financial literacy through engagement and education for managers who usually function strictly on the operating budget level.[20]

Wacht overlooks the cash position and short-term securities components of an organization's liquid reserve by arguing that financial uncertainties must be dealt with by having "sufficient flexibility built into the budgets and financing arrangements to avoid jeopardizing the solvency of the organization."[21] Put simply, only by managing down the cost structure (and increasing the amount of operating cash flow) or taking out a loan can the organization deal with a possible revenue shortfall or expense spike. Again, we believe that proactive liquidity management may forestall these more drastic measures if an appropriate target liquidity is set and maintained.

**(c) COMPLEXITY OF NONPROFIT CASH FLOWS.** The Nonprofit Finance Fund created a "bucket diagram" that illustrates the liquidity issue in nonprofit organizations (Exhibit 2.1).




*Source:* The Nonprofit Finance Fund. **USED BY PERMISSION.**

**Exhibit 2.1** Why Net Assets Will Not Pay the Bills

According to The Nonprofit Finance Fund, this graphic represents how total net assets do not reflect ready cash available to cover expenses.

A major difference between a for-profit enterprise and a nonprofit organization is the fact that nonprofits have restrictions placed on their funding. Not all cash is available for use to fund the organization's operations. This places a serious constraint on the finance manager who must take this into account when forecasting cash flows.[22] All other things equal, managers much prefer to have funding come from the middle "inlet pipes" of unrestricted contributions and earned income. Managers who take a false sense of security in a large dollar amount of net assets are bewildered when they cannot pay bills or expand operations due to icy and rocky conditions (money tied up in receivables and property and equipment). We advocate use of this diagram in a session that you might schedule as part of a board retreat or with your management team to give a visual understanding of the financial dimensions of your nonprofit.

## 2.3 EVIDENCE ON LIQUIDITY MANAGEMENT IN THE NONPROFIT SECTOR

Three groups surveyed nonprofit liquidity-related management practices in nonprofit organizations previously. The surveys focus on healthcare, education, and faith-based donative organizations. These surveys, though dated, are the best gauges we have of actual policies and practices.

**(a) LIQUIDITY MANAGEMENT IN THE HEALTHCARE SECTOR.** The first survey, by Hahn and Aggarwal, focuses on healthcare organizations. It dealt primarily with the receivables management of hospitals.[23] That survey detected areas of possible improvement in receivables monitoring and collections that would increase organizational liquidity. Some of the key findings are:

- Working capital management (primarily current assets and current liabilities) is primarily handled by the controller (24 percent) or finance or fiscal director (18 percent).
- Most responding managers spend between 5 and 10 percent of their time on working capital management, with about one-quarter of the managers spending 11 to 15 percent of their time on such topics – a surprising response compared to similar business manager survey results, which show much larger percentages.
- Only 36 percent had a cash planning horizon under one year, with 45 percent using a year or more as their horizon.
- Cash budgets are revised yearly by 14 percent, semiannually by 7 percent, quarterly by 20 percent, monthly by 36 percent, biweekly by 2 percent, weekly by 13 percent, and daily by 3 percent of the respondents.
- Checks are processed by 93 percent of the respondents in a day or less.
- About 77 percent of the hospitals regularly invested surplus cash in the money market, meaning almost one-quarter do not.
- While 24 percent of respondents stated that they could achieve an average days of receivables of 30 to 45 days, only 7 percent of the firms actually achieve that collection experience.

- Average days of receivables is listed as the primary measure of receivables monitoring.
- Fully 96 percent of the hospitals took advantage of trade credit and cash discounts offered.
- Inventory management was the weakest part of working capital management.

**(b) LIQUIDITY MANAGEMENT IN COLLEGES AND UNIVERSITIES.** Another survey, conducted by the National Association of College & University Business Officers (NACUBO) and summarized in Marsee, investigated cash and investment management in colleges and universities.[24] The information that follows is representative of that study's findings.

Of the 453 survey responses, 208 colleges and universities (46 percent) indicated that their depository institution was the primary financial institution used when making investments such as certificates of deposit or repurchase agreements.

The responses also indicated that the typical cash manager:

- Handles both the cash management and investment decisions (70 percent), usually as the chief financial administrator
- Is operating under the guidelines of an institutional investment policy (65 percent)
- Feels relatively free of local politics when making investment decisions (82 percent)
- Works primarily with in-state banks (83 percent)

Neither the Hahn/Aggarwal nor the NACUBO study addressed the role of or the objective for liquidity management.

**(c) LIQUIDITY MANAGEMENT IN FAITH-BASED DONATIVE ORGANIZATIONS.** We believe the greatest insight regarding the uniqueness of nonprofit organizations should come from the subgroup(s) that is (are) most purely nonprofit. In this section we briefly recap the methods used in our Lilly research study (see Appendix 1A for background and more detail on that study). Donative nonprofits – those relying on donors for much or all of their operating revenues – were selected for study on this basis. Four types of faith-based organizations served as the sampled group of nonprofit organizations: (a) denominational headquarters; (b) denominational foreign mission headquarters (where operated separately); (c) independent mission agencies; and (d) domestic rescue missions.

The study, funded by the Lilly Endowment, was conducted in two phases in the early 1990s. Survey evidence we collected from 288 donative religious organizations provides visibility into the espoused liquidity management objectives, how liquidity is measured, and the policy toward and utilization of debt financing. The topics covered include those mentioned earlier along with other short-term financial management topics, such as inventory management and bank relations. Field studies also were conducted at eight selected organizations. Two organizations were selected from each of the four subtypes, with ensuing individual on-site visits for approximately two and a half days. During the field studies, archival data were collected (budgets, variance reports, board minutes, financial policies, audited financial statements, and forecasts) and in-depth personal interviews were conducted. The interviews were with the chief financial officer (CFO), chief executive officer (CEO), and usually also with the board member most involved with financial decisions. Bear in mind that the "key informant" responses are from the vantage point of individuals holding these three roles, with the most extensive questioning done with the CFO.

***(i) Study Findings.*** This section presents several of the main findings regarding liquidity management. Many of the findings are provided later in the section on the importance of liquidity management, in that they bear on the factors determining the vitality of liquidity.

Organizations manage by planning (including policy setting), executing, and controlling. The finance function focuses mostly on the planning and controlling activities. We profile the survey responses in planning first, then executing (one measure), and controlling. Then we turn to our field study findings, including a basic model of the apparent operational financial objective.

***(ii) Short-Term Policies and Planning.*** Only one in four organizations (24.3 percent) has an explicit overall policy for the liquidity management (worded in the questionnaire as "the management of its current assets and liabilities – working capital"). Most of those organizations that do have such a policy (56 percent) indicate that it is risk-avoiding ("current asset and liability levels selected to keep risk to a minimum"), with the second most common response (28 percent) being situational ("current asset and liability levels selected depending on the financial position of the agency"). Interestingly, only 10 percent of those organizations having a policy consider that policy to be risk-accepting ("current asset and liability levels selected to increase interest income, while accepting the possibility that short-term borrowing may be needed"). Sixty percent of the organizations have an investment policy, which all organizations should have. Field studies revealed that almost none of the policies separately addressed short-term investments.

Surveyed organizations scored better on operating budget practices than on cash forecasting practices. Eighty-nine percent of the organizations have (and presumably use) an operating budget, leaving 11 percent with a handicapped short-term planning system. Forty-four percent of the surveyed organizations develop a cash forecast – an exercise that is absolutely vital for liquidity management. Based on a survey by Campbell, Johnson, and Savoie, Fortune 1000 treasurers consider short-term cash flow projections to be one of the most valuable tools for liquidity management.[25] Beginning to project cash inflows, cash outflows, and the resulting cash position, is the first place to start in improving short-term financial management for over one-half of our surveyed organizations.

Organizations with more solvency typically have a greater degree of their assets in the form of short-term, or current assets. Current assets are those that are either already in the form of cash or will be converted to cash within a year. A mere 13 percent of responding organizations have a target current assets-to-total assets (CA/TA) ratio value. This ratio, recommended for practitioner use by Herzlinger and Nitterhouse and others,[26] is a solvency measure that gets at *relative liquidity* (closeness to cash) of the organization's asset investment. In his 1989 ratio compilation study, Chris Robinson found a wide range of actual values for this "asset ratio" for faith-based organizations: Churches had a median ratio value of 0.06, while foreign mission agencies invested about one-half of their assets in current assets.[27] (The latter do so because they serve as "conduits," as profiled in our framework, presented later.)

Using a slightly different ratio, from data compiled in 2006 by Dan Busby and his staff at the Evangelical Council for Financial Accountability (ECFA), we find that the cash-to-revenue ratio for the 1,200 faith-based organizations then holding membership in ECFA is 0.21.[28] This implies that a typical organization could survive for about 2.5 months, on average, if revenues were interrupted ($2.5 = 0.21 \times 12$ months). Assuming revenues (or total revenues and support) equals expenses for this group overall, this demonstrates that these organizations hold less in cash reserves than the commonly advocated target of 3–6 months of expenses. Bear in mind that the latter guideline is strictly for operating reserves, and does not include additional amounts that should be held for prefunding capital assets or new programs.

***(iii) Executing Liquidity Management.*** One measure of liquidity management execution is provided by a question regarding whether the organizations practice daily active cash management. Daily active cash management involves setting the day-ending cash position early in the day (before noon), then making funds movement and short-term investing and borrowing decisions in light of that cash position. About one-half of the organizations state that they do this, which would be considered quite good given their size ($800,000 median annual revenue).

***(iv) Controlling.*** Organizations do well at calculating monthly budget variances (actual amount versus budget), with four in five organizations doing so, and another 8 percent making quarterly comparisons. Unfortunately, only two in five organizations compute and analyze financial ratios, and half of those organizations do so on a monthly basis. The asset ratio is monitored by almost one-half of the organizations, although as mentioned earlier, most of these do not manage it toward a specific target value. Possibly the best news is that 78 percent of the organizations say that they use information technology to monitor and/or forecast their cash positions.

***(v) Primary Financial Objective: Lessons from the Field Studies.*** The second phase in the Lilly study involved field studies of eight selected organizations. In-depth interviews, study of archived documents such as board meeting minutes and financial reports, and statistical study of cash flows were executed for each of the eight organizations. A pattern of financial decision making appeared from these studies. From the perceived pattern, a new model of organizational financial decision making was developed. The model, which we call the "Appropriate Liquidity Target" model of financial decision making, describes how nonprofits make financial decisions. (See Appendix 1A for more on this model.)

Interestingly, charity watchdog agencies now include some facets of liquidity in their ratings of nonprofits. Before we see what the charity watchdog agencies prescribe for your organization's solvency and liquidity, we need to establish just how critical liquidity management is for nonprofits. The next section is one of the most important in this book, because it provides the arguments for our central financial objective of managing the organization's target cash position and cash flows.

## 2.4 FACETS OF LIQUIDITY MANAGEMENT

Liquidity management in the business sector is defined as "the allocation of liquid resources *over time* to meet resource needs for payment of obligations due and for various investments that management undertakes to maximize shareholder wealth."[29] Changing the last phrase to read "to attain its mission" recasts the definition for nonprofit organizations. Gallinger and Healey allege that the failure of managers to provide adequate liquid resources to both meet near-term bills and finance growth initiatives has been the cause of as many business failures as have economic recessions. They indicate that the most fundamental objective of liquidity management is to ensure corporate solvency (pay bills as they become due) or ensure corporate survival. The key issues in liquidity management are to minimize "insolvency risk" by (1) determining how much to invest in each component of current assets and allocate funding needs to each component of current liabilities, and (2) managing these investments and allocations effectively and efficiently.

**(a) LAYERS OF LIQUIDITY.** We can view liquidity management in a way useful to managers by establishing "tiers of liquidity."[30] Here the organization's liquidity is viewed in tiers of decreasing liquidity, with six major layers of liquidity (see Exhibit 2.2).

For our discussion of nonprofit liquidity management, it is helpful to distinguish among solvency, liquidity, and financial flexibility. We shall combine all three in the idea of "broad liquidity," or "liquidity, broadly defined." Managers following best practices actively manage all facets of broad liquidity.

**(b) SOLVENCY.** An organization is *solvent* when its assets exceed its liabilities. The larger the degree to which assets exceed liabilities, the more solvent the organization is. In the nonprofit context, this difference is labeled "positive net assets" (see Chapter 6 for definitions of these items). When evaluating solvency, we usually go one step further and compute *net working capital*, which equals current assets minus current liabilities. A related measure, the *current ratio*, compares current assets to current liabilities by dividing current assets by current liabilities. This data is available on the organization's balance sheet, which we also detail in Chapter 6.

**(c) LIQUIDITY.** Further, an organization is *liquid* when it can pay its bills on time without undue cost. Clearly an organization is *illiquid* if it is consistently unable to take cash

| Liquidity Tier | Comments |
|---|---|
| Tier 1: Cash flow, cash balances, and the short-term investment portfolio | Most liquid. Watch out for restricted cash and for previously designated unrestricted cash. Watch out for restricted short-term investments (may serve as collateral for a loan). |
| Tier 2: Short-term credit | This, more so than cash balances and ST investments, provides the majority of the liquidity reserve for businesses. To a degree, a line of credit from a financial institution can substitute for cash balances or short-term investments in Tier 1. May come from a board member or members. In extreme difficulties, some nonprofits have been permitted to borrow using an endowment fund as collateral. |
| Tier 3: Management of cash flows | Examples are to encourage donors (especially on pledges) or foundation grantors to give unrestricted funds for operations or to build a reserve or to accelerate their giving, as well as for the organization to delay payments, offer services at lower prices, offer easier credit terms, or alter inventory positions. |
| Tier 4: Renegotiation of debt contracts | Some lenders (such as board members) are more flexible than others. |
| Tier 5: Asset sales | The organization is beginning to liquidate valuable assets simply to provide cash to stay afloat. As things get to an extreme financial exigency scenario, (1) living endowment donors may release spending restrictions, and/or (2) the state attorney general may approve sale of some endowment assets. |
| Tier 6: Bankruptcy | The purpose of bankruptcy is to buy time to reorganize by protecting the organization from creditors. Bankruptcy may culminate in reorganization or liquidation. |

*Source:* Adapted from diagram in Gallinger and Healey.

**EXHIBIT 2.2** THE SIX LAYERS OF LIQUIDITY discounts (e.g., 2 percent cash discount if one pays an invoice within 10 days), must delay making payments, or must constantly engage in interfund borrowing.

**(d) FINANCIAL FLEXIBILITY.** Finally, an organization possesses *financial flexibility* when its financial policies (use of debt, excess of revenues over expenses, and relationship of revenues to assets) are consistent with its projected increase in revenues. The Financial Accounting Standards Board (in Financial Accounting Standard 117) defines financial flexibility operationally, indicating that "Financial flexibility is the ability of an entity to take effective actions to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities. Information about the nature and amount of restrictions imposed by donors on the use of contributed assets, including their potential effects on specific assets and on liabilities or classes of net assets, is helpful in assessing the financial flexibility of a not-for-profit organization."[31] We would include in financial flexibility the willingness of board members to meet emergency needs to making above-normal donations or loans to the organizations. Correspondingly, finance staff need visibility into information on restrictions on the use of assets, compensating balances that must be maintained in checking accounts, the maturity structure of long-term assets and liabilities, and designated amounts within unrestricted cash and short-term investments.

## 2.5 IMPORTANCE OF LIQUIDITY MANAGEMENT

The importance of liquidity management is partly self-evident. It makes sense to have enough funds to pay bills; the converse is to be in a cash crunch or, if the shortfall is ongoing, a cash crisis. A cash crisis eventually arises whenever an organization is not bringing in adequate revenues to offset its expenses. The significance of liquidity management to nonprofits seems clear from the ongoing discussion of how to cope with these cash shortfalls.[32] Some believe that cash flow problems might simply be the result of mismanagement in selected, but visible, nonprofits. We disagree. Liquidity management is the single most important financial function in most nonprofits.[33] This is so because of two overlapping sets of factors: institutional factors and managerial philosophy ones.

### (a) INSTITUTIONAL FACTORS.

***(i) Primary Financial Objective.*** Businesses attempt to maximize shareholder wealth as their primary financial objective. This objective drives businesses to constantly increase cash flow, given the amount of risk they wish to take. Liquidity tends to take care of itself, except in the cases in which (1) growth is combined with low profit margins and long product development, inventory, or credit sales-collection periods, or (2) the organization is in decline. In nonprofit organizations, without the shareholder wealth objective, what is the appropriate financial objective, and what are the liquidity implications? Other sources have traditionally advocated as the primary objective striving for financial breakeven (revenues just covering expenses), which implies that the stock of liquid resources remains relatively constant, all other things being equal. Increasingly, calls are made for organizations to attempt to earn a small surplus ("positive net revenue," or "positive change in unrestricted net assets"), which should provide a boost to the organization's liquidity, at least for some seasons of the fiscal year. We agree that this is appropriate as a means to an end – the end being *maintaining a liquidity target* adequate to protect the organization and its mission against seasonal and cyclical cash shortfalls and to build a financial resource base for future program and facility expansion. We will come back to actual practices a bit later.

***(ii) Limited and Volatile Revenue Stream.*** Colleges, hospitals, and other commercial nonprofits are much like businesses, but donative nonprofits have no price lever with which to earn revenue on their core services. Correspondingly, they cannot increase or decrease price – selecting the appropriate change based on how responsive customers' purchases are to price – in order to increase revenue when facing present or potential cash flow shortfalls. (Quantity-cost relationships are important here too in order to define the *net* revenue effects.) Furthermore, the natural and almost automatic coupling between cash outflows to pay for supplies and labor and the ensuing cash inflows from sales is absent in donative nonprofits. To make matters worse, while a slowdown in revenue from sales for a business triggers a quick downward adjustment in cash outflows for production, cash outflows will be difficult to adjust downward for a donative nonprofit, and the cash position may actually be further depleted if the organization ratchets up its fundraising investment to try to offset the recent decline in donations. Even then, human service organizations pursuing various levels or types of donation efforts often are not able to increase the predictability or size of donation revenues.[34] Donations may be volatile and change in unpredictable ways, in spite of intensive development efforts or the existence of natural constituencies (less so in cases of institutionalized relationships, such as United Way or religious federations). Further evidence of the unpredictable stream of donated funds is provided by Kingma, whose research indicates that increased financial risk arises from donation revenue streams. Liquidity thus has greater value for the donative nonprofit.[35] A more recent study by Carroll and Slater also finds that if a nonprofit relies primarily on donations, it will experience more volatility.[36] If an organization raises funds in advance of program and service delivery, it is engaging in a liquidity management strategy that explicitly recognizes the need for and value of a greater degree of liquidity. *For most organizations, this proactive liquidity management approach of prefunding future needs is the advisable approach.* This approach is often ignored as many nonprofits measure their financial success solely by the increase in revenue and support and not by managing their asset positions. We are aware of a private academy in Texas that prefunds almost an entire year of expenses by putting this year's tuition and fees in savings for next year. As it brings in tuition and fees this year, that amount goes into savings for the next academic year.

Organizations may partly offset the revenue limitations by turning to supplemental earned income ventures, but this implies four greater barriers than are commonly recognized: (1) These ventures deploy already-scarce resources (which would actually exacerbate a cash flow crunch or crisis), (2) they may and often do defuse the organization's mission focus, (3) quite often the managerial team and/or board does not possess competencies requisite for profitably managing the ventures, and (4) even when successful, there is a *long time lag* between launching the venture and achieving positive net revenue.[37] Numerous nonprofit organizations attempt these ventures, as noted in studies by La Barbera and by Froelich and Knoepfle, but La Barbera finds that, in the small nonrandom sample studied, raising funds was an objective in only a minority of the faith-based organizations.[38]

***(iii) Inability to Issue Stock to Raise Equity Capital.*** Donative nonprofit organizations face an additional funding constraint in that they cannot issue stock. An important permanent source of financing is therefore unavailable to them. Internal nonborrowed funding (equity) is available to these organizations to the extent they achieve operating surpluses, engage in capital campaigns, or build endowments. On an ongoing basis, the only means of accumulating equity capital is to earn a surplus (profit equivalent) on operations. Yet, some organizations consider financial breakeven to be their chief financial objective, which implies that they are unwilling to earn significant surpluses. Many managers report that it is considered to be culturally inappropriate to plan for a surplus and that neither boards nor funders allow this as a standard practice. The institutional reality that no cash dividends are allowed or expected partly offsets this limit on capital. In this sense, nonprofits operate much like a start-up or other rapidly growing business that reinvests all of its profits in order to self-fund its growth as much as possible. Added assistance comes from the 501(c)(3)'s tax exemption, implying that all "before-tax" net revenue is available as "after-tax" addition to equity.

***(iv) Time-Restricted and Use-Restricted Donations.*** Possibly the most significant impediment to matching cash inflows to cash outflows comes from the large proportion of time-restricted or use-restricted donations. Cash outflows for expenditures that are not easily or currently funded by donors pose a significant threat to the liquidity position of the donative nonprofit. Fullmer estimates that 75 percent of donations to nonprofits are restricted (primarily to a specific use), and in the Lilly study of donative nonprofits, we find a self-reported average of 72 percent of their current/operating fund donations come with donor restrictions.[39] This factor alone accounts for a more difficult management task when comparing liquidity management for donative versus other nonprofits, governmental agencies, or businesses. In fact, US accounting standards setters tacitly recognized the organizational impact of restricted gifts on liquidity, motivating the split-out of unrestricted and (donor) restricted net assets in nonprofit financial statements. Our survey of donative faith-based nonprofits indicates that borrowing from restricted funds is viewed as a necessary evil by those practicing it in many organizations: When asked "How frequently does your organization temporarily transfer funds from its current restricted or other restricted funds to meet a shortfall in your current unrestricted (general) fund?" 13 percent said on a monthly basis (!), 14 percent said on a quarterly basis, 10 percent said once a year, 19 percent said less than once a year, and 44 percent said never.[40] The problem is compounded for those organizations that are striving for financial breakeven as opposed to a positive net revenue (the former should have a smaller cash inflow, all other things equal) or that have small or nonexistent cash reserves (stock of cash), illustrating the overlap and often cumulative effect of these institutional and managerial philosophy factors.

***(v) Operating Characteristics of Donative Nonprofits.*** Financial processes of nonprofit organizations can be accurately characterized as a cash flow system. Many charities and churches receive cash in from gifts and grants, hold onto the cash for a while, and then disburse the cash to other organizations, needy members, clients, or other beneficiaries. Colleges and schools and food and medical care charities, which transform cash into services or products, also benefit greatly from liquidity management, as demonstrated in the cash flow system model (see Exhibit 2.3).

Organizations that primarily transfer funds from donor or grantor to clients or beneficiaries are called *conduits* in our profile. Examples include foundations, religious denomination and association headquarters operations, and international child welfare and other multinational agencies sending personnel abroad to deliver a service. Proficient cash management is absolutely essential to the success of conduits in that they are primarily cash-gathering and distributing machines. *Transformers*, in turn, convert cash into one or more products or services and distribute those outputs to clients and other beneficiaries. Transformers include churches, arts organizations, many healthcare organizations, educational institutions, and most human service organizations and other charities. Cash management proficiency is still important prior to the conversion process, but since the organization is also delivering a product or service to achieve its mission,

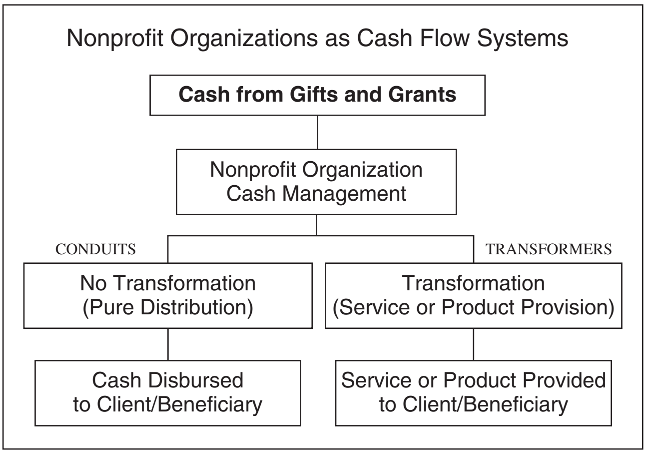



**Exhibit 2.3** Cash Flow Model of Donative Nonprofit Finances

the quality and quantity of product/service delivery assume great importance. Overall working capital proficiency is the appropriate focus in transformers. Net working capital includes cash, receivables, inventories, payables, accrued expenses, and short-term loans. Whether conduit or transformer, management must focus on liquidity management, which encompasses cash management and the broader aspects of working capital management.

#### (b) MANAGERIAL PHILOSOPHY FACTORS.

***(i) Major Reluctance to Earn Surpluses.*** When asked what their main financial goal is, a significant, if diminishing, percentage of donative faith-based organizations have selected financial breakeven.[41] What is not as clear is whether this goal is operative. Intriguing evidence regarding actual surpluses is provided by Chang and Tuckman, who find that charities earned no surplus while other nonprofits were averaging a 10 percent surplus (as a percent of total revenues).[42] By forgoing the accumulation of positive net revenues, charities are bypassing the major source of liquidity in businesses (especially those with high profit margins, such as Apple or Microsoft). Profits are also considered by some to be a nonprofit's most reliable source of cash.[43]

***(ii) Resistance to Engage in Short-Term Borrowing.*** Although Tuckman and Chang indicate that 71 percent of nonprofits included in the 1986 IRS 990 database engaged in some borrowing, we do not know how many of these organizations used short-term debt.[44] Many organizations that use mortgage loans for plant and equipment will resist short-term borrowing, in that it is considered risky to become dependent on borrowed funds to finance operations. Short-term debt, as noted by Kallberg and Parkinson's model, is the second tier of liquidity for an organization. The surveyed donative faith-based organizations are disinclined to use short-term loans:

- Two-thirds of the respondents never do short-term external borrowing.
- 21 percent do short-term borrowing, but not every year.
- 13 percent do short-term borrowing every year.

For the one-third of the organizations that do borrow, the *primary* use is:

- As a regular and constant part of total financing (11 percent)
- As a cyclical part of total financing (15 percent)
- As a seasonal part of total financing (29 percent)
- To meet irregular needs (45 percent)

About 4 in 10 (38 percent) of the borrowing organizations are never asked to provide security (collateral) for their short-term loans, while 34 percent are occasionally required to collateralize and 27 percent must always collateralize the borrowings. Although lenders much prefer to collect loan interest and principal repayment from cash flows realized by the borrower, the security stands as a backup to protect the lender in the event of default.

Finally, although most leasing is long-term in duration, 19 percent of the surveyed organizations arrange leases for financing purposes.

***(iii) Insufficient Liquidity Monitoring, Management, or Projection.*** With one exception, the survey evidence shows that most donative faith-based organizations would benefit from greater adoption of available techniques for liquidity monitoring, management, and projection. As shown in the responses for the survey of donative faith-based organizations, less than one-half of the organizations were doing the minimal tasks necessary to properly monitor, manage, and project liquidity needs.

**(c) LIQUIDITY IMPLICATIONS OF INSTITUTIONAL AND MANAGERIAL PHILOSOPHY FACTORS.** There are two main implications for liquidity management and related financial policies from the foregoing analysis:

- *Implication #1*: The capital structure decision favors reinvested surpluses as the primary means of financing assets. These organizations are obviously quite risk-averse, based on the survey findings reported here, and will use only limited long-term debt to supplement equity. These organizations should be encouraged to operate at a surplus.
- *Implication #2*: Liquidity management is critical to the surviving and thriving of the donative nonprofit. This is true for short-term solvency, liquidity, and financial flexibility as well as for long-term financial sustainability, or what is sometimes termed "strategic liquidity."[45] Strategic liquidity (often evidenced in the form of a "strategic reserve") refers to the ability to seize new strategic opportunities, expand into new services or markets, build infrastructure, or make other large-dollar investments. It focuses on liquidity on a longer-term basis, recognizing the possibility of conceivable risks in the form of unexpected and potentially adverse operating conditions.

To recap, it makes sense for organizations that are constantly pressed for funds and are locked out of equity markets and greatly limited in the use of debt to investigate the behavioral implications of funding sources. Emphasis on funding sources is not new.[46] However, a new and logical implication is a greater value for liquidity, which up to the time of the study of faith-based organizations had only been highlighted by Grønbjerg.

Summarizing our discussion, the advantages to the donative nonprofit of having a high degree of liquidity are the ability to fund disbursements, earn interest revenue, protect against adverse developments, manage funding risk, and seize unforeseen opportunities. That is not to say that more is always necessarily better. Too much liquidity is disadvantageous to the organization because it absorbs funds that could be used in program delivery or expansion. Furthermore, some donors may react negatively and give elsewhere. An organization is considered liquid "if it has enough financial resources to cover its financial obligations in a timely manner with minimal cost."[47] The implication? There is a desirable level of liquidity for each organization that balances benefits and costs. In Chapter 1 we proposed the following as the primary financial objective for most nonprofits: "To ensure that financial resources are available when needed, as needed, and at reasonable cost, and are protected from financial impairment and spent according to mission and donor purposes." The first part of that objective implies that there is a target liquidity level that organizations should set and strive to achieve.

Before addressing your internal view of that liquidity target, it is important to know that outside parties are imposing a one-size-fits-all to externally assess the appropriate liquidity range. These "charity watchdog agencies" have spoken on the topic of liquidity management, so we survey and critique their views.

**(d) WATCHDOG AGENCY STANDARDS ON SOLVENCY AND LIQUIDITY.** Among the three major charity watchdog agencies, only Charity Navigator does not prescribe a maximum liquidity level. In the standards set by the BBB Wise Giving Alliance, a maximum liquidity (actually solvency) standard is applied, and CharityWatch (formerly the American Institute of Philanthropy, formerly AIP) prescribes a maximum liquidity (again solvency) standard that is similar to the BBB standard.

***(i) BBB Wise Giving Alliance Standard.*** In its Standard 10, the BBB Wise Giving Alliance states:

> Avoid accumulating funds that could be used for current program activities. To meet this standard, the charity's unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher.[48]

It is interesting to note that this standard has been revised upward: The BBB standard upon which this standard is based formerly limited organizations to two years or less of liquid funds. Now Standard 10 states that net assets available for use in the following fiscal year are not usually to be more than three times the current year's expenses or three times the next year's budget, whichever is higher. To arrive at available assets, BBB makes this calculation: Available assets = (unrestricted assets + temporarily restricted assets + deferred revenue − liabilities). We underscore the need for BBB to correctly interpret nonprofits' financial health, as there is evidence that meeting BBB standards is associated with increased following-year donations.[49]

***(ii) CharityWatch Standard.*** CharityWatch is very unforgiving of organizations that have more than three years of budgeted expenses on hand. It downgrades organizations to increasingly severe degrees the farther over three years those available assets are (see Exhibit 2.4). Organizations that have been downgraded are shown in Exhibit 2.5.

***(iii) Charity Navigator Standard.*** Of all of the charity watchdog agencies, Charity Navigator has done the most work in evaluating the liquidity needs of various types of nonprofit organizations. We also underscore the need for Charity Navigator to correctly interpret

***Charities with Large Asset Reserves***

AIP strongly believes that your dollars are most urgently needed by charities that do not have large reserves of available assets. AIP therefore reduces the grade of any group that has available assets equal to three to five years of operating expenses. In AIP's view, a reserve of less than three years is reasonable and does not affect a group's grade.

These reductions in grades are based solely on the charities' asset reserves as compared to budget. If you agree with these charities that reserves greater than three years' budget are necessary to enhance their long-term stability, you may wish to disregard the lower grades that AIP assigns on the basis of high assets.

AIP's definition of "years of available assets" includes funds currently available for the charity's use, including investments that the charity has set aside as a reserve but could choose to spend if it wanted to do so.

*Source:* CharityWatch, http://www.charitywatch.org/.

**Exhibit 2.4** CharityWatch Statement on Cash and Investments

nonprofits' financial health, as there is evidence that a "one-star" increase in the Charity Navigator rating (out of five stars possible) is associated with an almost 20 percent increase in the organization's following-year donations.[50]

The most important deficiency in Charity Navigator's framework is its inclusion of long-term investments in its working capital ratio. Charity Navigator recognizes this shortcoming but points out that IRS Form 990 does not allow one to distinguish between short-term and long-term investments. Its comment, regarding this, that it uses this all-inclusive measure consistently and thus treats all organizations fairly, is an overstatement: Consistency when one has an impaired measure of what one is trying to measure (short-term investments) does not guarantee fairness. An organization with all of its investments in 3-month Treasury bills is certainly more liquid than one with all of its investments in 30-year Treasury bonds, but this fact is hidden by the equal treatment in the ratio.

In Charity Navigator's defense, we argue that organizations *should* be able to self-fund capital investments, and at times this includes investing in some longer-term investments – particularly when one begins the funding 5 or 10 or more years in advance of a major capital investment. This fact suggests that the exact breakdown of short-term (one year or less in maturity) and long-term (more than one year in maturity) is not as important as it might at first appear. Second, to its credit, Charity Navigator does not penalize an organization with very large amounts of cash and investments, choosing instead to cap its score on the working capital ratio at a value of 10 no matter how high the organization's working capital ratio (see Appendix 7B.2).

***(iv) Philanthropic Research, Inc. (GuideStar) Standard.*** Although a data provider and not technically a watchdog agency, Philanthropic Research, Inc. (PRI) in conjunction with the Nonprofit Finance Fund publishes financial data useful to and possibly used by the same audiences as those targeted by BBB, CharityWatch, and Charity Navigator.

Philanthropic Research, Inc. publishes its findings on its outstanding Web site (www.guidestar.org). GuideStar and Nonprofit Finance Fund have joined together to provide three ratios (measures) that provide liquidity-related information:[51]

1. **Months of Cash**
   Months of Cash =Total Cash/(Total Expenses / 12)

AIP American Institute of Philanthropy August 2006

| | Grades Reduced for Charities with Large Asset Reserves | % | $ | | BANK in 000's | | |
|---|---|---|---|---|---|---|---|
| 1. | Army Emergency Relief | 93 | 3 | 17.6 | 307,288 | A+ | F |
| 2. | Research to Prevent Blindness | 89–90 | 7–15 | 13.8 | 233,405 | A | F |
| 3. | Shriners Hospitals for Children | 94 | 1 | 12.7 | 8,620,682 | A+ | F |
| 4. | Air Force Aid Society | 93 | 3 | 10.1 | 172,209 | A+ | F |
| 5. | YWCA of the USA-N.O. | 66 | 25 | 8.9 | 63,006 | B- | F |
| 6. | Guide Dogs for the Blind | 79–80 | 8–10 | 8.8 | 253,342 | A- | F |
| 7. | Cal Farley's Boys Ranch and Affiliates | 74 | 30 | 8.7 | 429,738 | B | F |
| 8. | Diabetes Trust Foundation | 82–83 | 9–10 | 8.4 | 5,259 | A | F |
| 9. | Seeing Eye | 82 | 10 | 8.4 | 208,700 | A | F |
| 10. | Hole in the Wall Gang Fund | 86 | 8 | 6.8 | 50,375 | A | F |
| 11. | Give Kids the World | 80 | 7 | 6.3 | 78,659 | A- | F |
| 12. | Southern Poverty Law Center | 51–67 | 20–34 | 6.2 | 152,866 | C- | F |
| 13. | Amer Action Fund for Blind Children and Adults | 59–77 | 18–33 | 5.5 | 19,563 | C | F |
| 14. | Girls and Boys Town/Fr. Flanagan's | 86–88 | 29–36 | 4.9 | 916,494 | B | D |
| 15. | Brookings Institution | 78 | 6 | 4.8 | 248,204 | A- | C- |
| 16. | Navy-Marine Corps Relief Society | 94 | 2 | 4.8 | 158,722 | A+ | C |
| 17. | Omaha Home For Boys | 74 | 48 | 4.8 | 101,873 | C+ | D |
| 18. | Ploughshares Fund | 87 | 10 | 4.7 | 26,033 | A | C |
| 19. | Fresh Air Fund | 75 | 23 | 4.4 | 104,514 | B+ | C- |
| 20. | ACLU Foundation | 81 | 8 | 4.3 | 175,910 | A | C |
| 21. | Accuracy in Media | 85 | 11 | 4.2 | 5,922 | A | C+ |
| 22. | Hadassah | 83 | 9 | 3.8 | 579,425 | A | C+ |
| 23. | Japan Society | 71 | 19 | 3.8 | 90,183 | B | C |
| 24. | Boy Scouts of America - National Council | 90 | 6 | 3.7 | 597,503 | A+ | B- |
| 25. | Human Rights Watch | 75 | 15 | 3.5 | 88,593 | A- | C+ |
| 26. | Rosebud Educational Society (Little Sioux) | 61–68 | 33–42 | 3.5 | 16,941 | C | C- |
| 27. | Asian Relief/World Villages for Children | 44–54 | 27–35 | 3.4 | 33,555 | D | D |
| 28. | Carter Center | 70 | 14 | 3.4 | 286,497 | B+ | C+ |
| 29. | American Printing House for the Blind | 77 | 19 | 3.0 | 83,350 | A- | B- |
| 30. | Resources for the Future | 81 | 16 | 3.0 | 30,066 | A- | B- |

*Source:* American Institute of Philanthropy (AIP). AIP now uses the name CharityWatch.

**EXHIBIT 2.5** ORGANIZATIONS DOWNGRADED BY AIP DUE TO "EXCESS SOLVENCY"

2. **Months of Unrestricted Liquid Net Assets**, where Unrestricted Liquid Net Assets represent that portion of net assets available for operations
Months of Unrestricted Liquid Net Assets = [Unrestricted Net Assets – (PPE – PPE Debt)]/(Total Expenses / 12), where PPE is Property, Plant & Equipment (long-term fixed assets, in other terminology), and PPE Debt is long-term debt up to the amount of PPE, and is presumably arranged to finance PPE.
3. **Working Capital (or, Net Working Capital)**
Working Capital = Current Assets – Current Liabilities

Months of Cash, which is related to the Cash Reserve Ratio (see Chapter 7), is a commonly calculated measure of liquidity. Months of Unrestricted Liquid Net Assets overstates liquidity but gives an interesting and broader view than Months of Cash. Working Capital, more commonly called Net Working Capital in the business world, is a solvency measure that is deficient in that it does not take into account nearness to cash of either current assets or current liabilities. We add here that, as noted elsewhere in this chapter, GuideStar and the Nonprofit Finance Fund offer a fee-based report called the Financial SCAN™ Report that gives much more insight that one might gather from these three ratios.

**(e) ASSESSMENT OF WATCHDOG STANDARDS.** Ideally, the information provided by these charity watchdog agencies and PRI can reduce the unobservability dilemma: Donors cannot observe the effectiveness or efficiency with which their funds are managed. More and better publicly available information affects public image. By doing so, it increases the likelihood that potential effects on an organization's public image and reputation may align the decisions and behavior of the nonprofit's managers with donors' and society's best interests. This is especially important in cases where boards are ineffective because they are weak, disinterested, or uninvolved. Boards can potentially provide an information mechanism to deal with mismanagement. For example, a greater proportion of outside directors and possibly a greater proportion of directors having business experience might thwart opportunistic, self-seeking behavior on the part of managers.

Regardless of possible usefulness, the standards of BBB and CharityWatch, in particular, are open to criticism on five grounds:

1. Three of the four sets of standards or metrics focus on solvency, leaving out the more valuable insights from liquidity or financial flexibility (which includes strategic liquidity) perspectives. Put differently, all of the agencies except GuideStar/NonProfit Finance Fund are using the weakest measures available for what they are trying to measure. In their defense, it is difficult for these agencies to get the necessary information to make their assessments.
2. Apparently the BBB and CharityWatch agencies believe that the agents (managers) are either (a) too risk-averse – and are more risk-averse than typical donors; or (b) prone to take and use excess funds for purposes other than mission achievement. Regarding (a), we counter that the form of backup spending capacity should not be dictated by a charity watchdog agency. Why not hold liquid reserves in the form of cash and marketable securities instead of used or unused borrowing capacity? We view penalizing the former while ignoring the latter as either an unjustified value judgment or an oversight on the part of the watchdog agencies. Possibly the value judgment has not been recognized due to the solvency focus taken. Regarding (b), which relates to managers either pursuing interests dissimilar to those of donors, spending that money later on their own "perks" such as nonsalary benefits or excessive spending on offices or travel and entertainment, or spending that money later

on higher salaries, we counter with these possibilities suggested by Fisman and Hubbard:[52] donors might prefer to have an endowment/cash reserves/precautionary savings rather than annually fund spending needs due to four factors: (1) superior managerial information about present and future investment opportunities, (2) superior managerial information about present and future financial needs that might be faced, (3) the costliness of having to raise additional funds from donors when facing intrayear shortages, and (4) donor establishment of an endowment might stimulate other donors to give more annual gifts due to the "guarantee of permanence" that endowments signal to would-be donors.

3. When donors restrict long-term investments (an endowment fund) instead of the board (quasi-endowment), the result is a lower number for "net available assets," which reduces the probability that the organization will be flagged by BBB or CharityWatch for excess liquidity. However, from a strategic liquidity perspective, it is preferable to have these funds in a board-designated endowment. For some interesting thinking on this, see Ashworth.[53]
4. The most serious indictment is that the BBB and CharityWatch standards are focusing nonprofit managers too much on excessive liquidity when most organizations are grappling with insufficient liquidity. The BBB standard 6D does deal with insufficient liquidity, but again uses the weakest (solvency) type of measure. Even if their organization is never rated by any of the charity watchdogs, most of the nonprofits in the United States, their boards, donors, and local media may utilize these widely available standards to castigate the organization's managerial policies. This possibility alone may provide the wrong signals to financial managers and boards of these organizations.
5. The BBB and CharityWatch organizations indicate that they make exceptions in applying their liquidity standard, but evidently only very rarely. One should look at *present-year* capital investments (which are not shown in the present year's budgeted expenses) as well as future capital investments in determining when to make exceptions in the application of standards. A similar argument is made by a consultant writing anonymously for the National Federation of Nonprofits, who stated that the operating plan should be consulted instead of mindlessly calculating financial ratios to assess the appropriate level of liquidity.[54]

## 2.6 WHAT IS THE APPROPRIATE LEVEL OF LIQUIDITY?

It is very helpful to have a bird's-eye view of the organization's liquidity, solvency, and financial flexibility. The actual and potential sources of cash flow are identified in Exhibit 2.6. Projections of anticipated cash position to six-month, one-year, three-year, or five-year horizons will provide strong indications of the adequacy of the organization's current liquidity situation. Two diagnostic tools to assist in this assessment will be presented shortly.

We advocate considering the role of environmental uncertainty in setting liquidity targets. As an aside, faith-based organizations, because of their trust in divine provision, may not be as concerned about outcome uncertainty relative to other donative nonprofit organizations, so they might select lower levels of liquidity. An organization receiving a high proportion of restricted gifts will want to establish higher liquidity targets. An organization that is also donative (highly donation-dependent) will have to ratchet the liquidity target even higher.

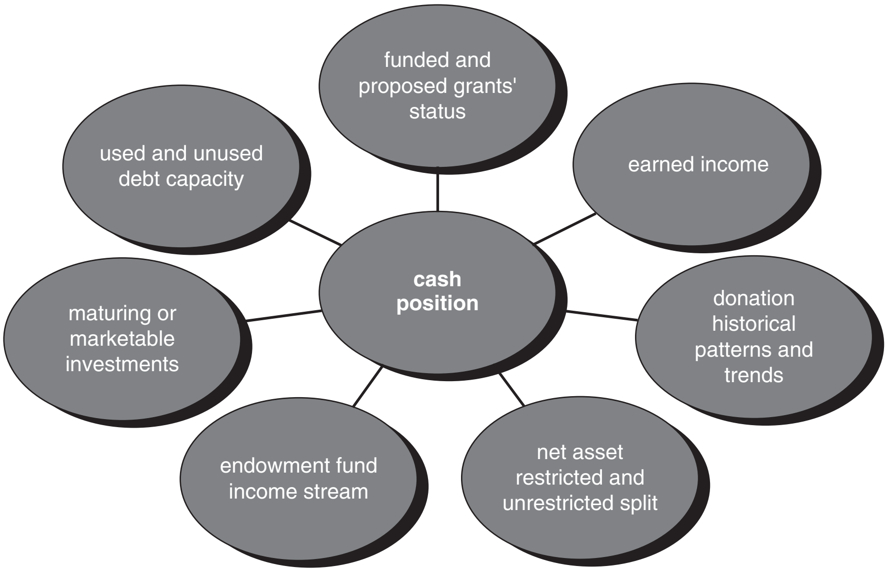



**Exhibit 2.6** Financial Manager's View of the Cash Flow and Revenue Stream

**(a) ESTABLISHING THE LIQUIDITY POSITION BASED ON FINANCIAL VULNERABILITY.** What factors should help set the appropriate level of liquidity? One way to view this is from a risk avoidance posture. Chang and Tuckman provide a short list in an analysis of financial vulnerability.[55] Their view of vulnerability centers on the ability of the organization to insulate itself from unanticipated financial shocks or financial unpredictability, and includes four dimensions:

- Organization's equity (net assets)
- Level of administrative costs
- Operating margin
- Diversified revenue sources

*Higher* levels of each of these factors give the organization *more* flexibility to cope with financial shocks. For example, an organization with a high level of administrative costs (which, if excessive, might be viewed as a negative by a donor or foundation) has the flexibility to pare those costs to stave off financial exigency. The first item, equity, is somewhat misleading: Actually what should be measured here is equity balances in conjunction with liquid assets. If all of the organization's equity is tied up in fixed assets or endowment principal, the organization will be illiquid even if solvent. We do acknowledge, however, that more net assets means less borrowing, all other things equal, making the organization less vulnerable. Added to this short list, one should ideally measure the variability and co-movement of revenue sources (how closely they move in tandem through time), based on Bruce Kingma's findings.[56]

**(b) DIAGNOSTIC TOOLS TO ASSIST IN SETTING THE APPROPRIATE LIQUIDITY TARGET.** Exhibit 2.7 provides a more exhaustive list of factors helpful in setting your

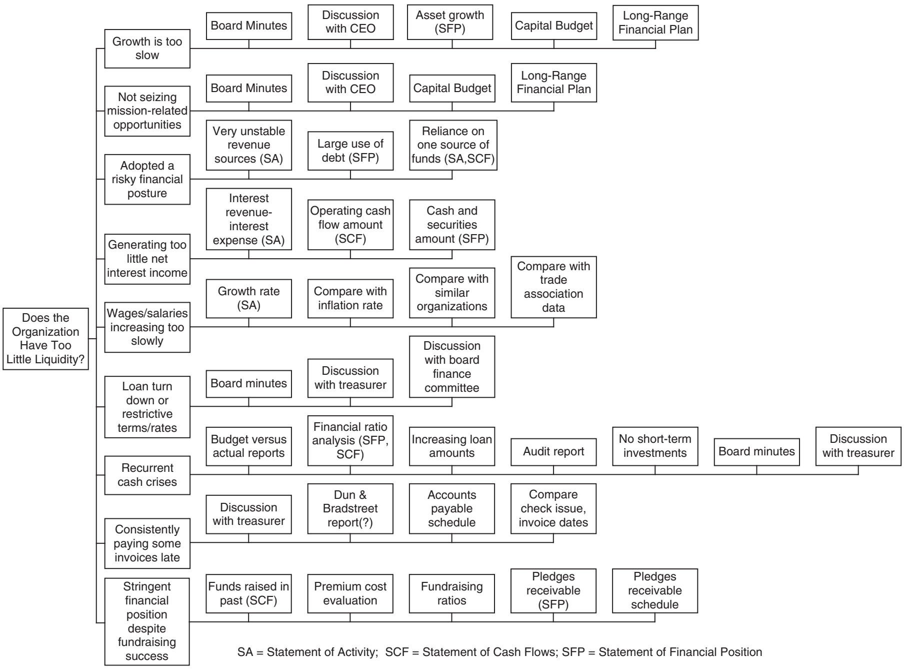



**Exhibit 2.7** Diagnostic Tool for Setting Organization's Appropriate Liquidity Target

organization's target liquidity, using a diagnostic questionnaire we developed. In the exhibit, SA denotes the organization's Statement of Activity, SFP denotes the Statement of Financial Position (or Balance Sheet or Statement of Net Assets), and SCF denotes the Statement of Cash Flows. Financial Statements in nonprofits are generally used by management to comply with reporting requirements and to guide operating budget development, but are rarely used to perform an in-depth analysis of liquidity. By using these statements as *data sets*, improved analysis of liquidity can be attained. Leaders of nonprofits (especially CEOs and CFOs) can add value to the strategic aims of the organization by continually monitoring liquidity and avoid cash shortfalls that often surprise the organization's governing body and senior management. This kind of rigor is recommended.

## 2.7 CONCLUSION

Liquidity policy and practice, so vital for an organization's financial management, has received far too little attention in nonprofit periodicals and textbooks, with the exception of a cash flow management handbook by Dropkin/Hayden and two cash flow management guides by Linzer/Linzer. Despite advances in thinking in this area, often the idea that nonprofit organizations are not businesses, or should be run in a business-like fashion, still prevails. Where the management of cash and short-term investments is discussed, the problem of excess liquidity is the focus. In this chapter we have provided our insights regarding the financial standards developed by watchdog agencies. We showed that these standards do not recognize the relative liquidity of an organization's asset holdings, use an inferior balance sheet or solvency approach, and are more appropriate for commercial nonprofits than donative nonprofits. We provide compelling reasons why your organization should build up large amounts of solvency, liquidity, and financial flexibility. We provide a checklist to determine if your organization has too much or too little liquidity. Our view of proficient nonprofit financial management suggests that the primary financial objective appropriate for most nonprofits is: "To ensure that financial resources are available when needed, as needed, and at reasonable cost, and are protected from financial impairment and spent according to mission and donor purposes." The first part of that objective implies that there is a target liquidity level that organizations should set and strive to achieve.

Many organizations have too little liquidity. Many nonprofits are either setting their liquidity targets too low or not reaching their liquidity targets (if they are setting these targets at all). We do not share the view of some critics that nonprofits are too risk averse. To other observers who would argue that cash reserves should be minimized in order to maximize current service provision, we respond with this observation made by Carl Milofsky: There may be management practices that appear objectionable to some – "pointless, cumbersome, and inefficient" – but that "actually serve to protect important styles of practice that run against the grain of traditional management practice."[57] We are delighted that, in the most recent and most broadly-based survey of nonprofit financial managers, financial flexibility and earning surpluses to have money on hand in a difficult economy are the two most popular primary financial objectives.[58] In Chapters 5 and 15 we provide an approach to crafting financial policies and in Appendix 6B following Chapter 6 we profile the new accounting standard update that shall prompt more disclosure of liquidity relative to an organization's expenditures in the next 12 months.

## Notes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13. "GuideStar/NFF Financial SCAN Report for Local Youth Group," https://learn.guidestar.org/products/nonprofit-data-solutions/financial-scan. Accessed 12/29/2017. GuideStar and NFF describe the product as follows: "Financial SCAN[SM] helps you better understand or communicate a nonprofit's financial health and resource needs. It combines GuideStar's IRS Forms 990 data and Nonprofit Finance Fund (NFF) expert analysis in an easy-to-use tool with shareable formats that bring insight to financial information and support mission-driven decisions."
14. Kallberg and Parkinson, *Corporate Liquidity*, 17.
15. Andres Ramirez, "Nonprofit Cash Holdings: Determinants and Implications," *Public Finance Review* 39, no. 5 (2011): 675.
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30. Kallberg and Parkinson, *Corporate Liquidity,* 17–19.
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32. Hall, "When Cash Doesn't Flow."
33. If the fundraising function is considered as a financial function, this statement would have to be altered to say that the single most important financial management function is liquidity management. Development offices are separate from the finance department in almost all nonprofits of which we are aware.
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donor-restricted net assets to cover operating expenses … Nonprofits are legally required to spend restricted net assets to further the intent and purposes expressed by the donor. Therefore, loans from restricted net assets should be avoided. Intraorganizational loans are often more troublesome than other types of loans. State laws generally require that a charity must demonstrate that a loan (an investment transaction from the standpoint of the restricted fund) is prudent. If the loan is simply to fund operating shortfalls or reflecting the organization's financial difficulties, the charity's board will generally have trouble demonstrating that a loan from restricted net assets is prudent as viewed from the restricted fund's vantage point."

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CHAPTER 3

# MANAGING MISSION, STRATEGY, AND FINANCIAL LEADERSHIP



Thirty years ago a nonprofit financial management guide would have scarcely mentioned strategy or strategic management. In their expanded roles as strategic business partners, however, financial managers and board finance committees are increasingly involved in strategy development, evaluation, and implementation. According to the Association for Financial Professionals' 2016 benchmark survey of high-level corporate finance professionals regarding financial planning and analysis (FP&A):

> FP&A is becoming a forward-looking operation. What began as a function that reported merely on past events is now transforming into one that focuses on why those events occurred as well as what is likely to happen next. FP&A is working hand in hand with business units to create realistic business plans. Consequently, it must stay tuned in to the organization's overall strategic objectives, assess risks and identify growth opportunities. FP&A is evolving into the analytics hub at an increasing number of companies – becoming the "brains" of the organization.[1]

This ongoing development requires that financial professionals are in fact an integral part of planning and strategy development, regardless of the sector in which they work.



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

This chapter first develops an understanding of mission, vision, and strategy. It then profiles a major shortcoming of management practices: failure to implement strategic decisions properly. Using information from some of the best available sources, the chapter next provides an overview of strategic planning. The last part of the chapter presents some of the performance management systems that may be used to diagnose current strategies and how well they are being executed by the organization. The balanced scorecard, which is being used by more organizations each year, is prominent within these performance management systems. However, several portfolio models are also available to use, and both types of models offer great promise to financial managers and boards wishing to make better strategic decisions and better meet the mission, vision, and goals of their organizations. We also advocate the use of dashboard reports to monitor the achievement of key metrics. Finally, this chapter places financial leadership in a more prominent place in strategic planning.

## 3.1 VALUE OF STRATEGIC PLANNING

Before delving into the specifics of strategic planning, let us consider some motives for engaging in planning. The process of strategic planning and evaluation is as important, or more important, than the plan itself. Expect your organization to glean these benefits from the planning process. Successful strategic planning:

- Leads to action
- Builds a shared vision that is values-based
- Is an inclusive, participatory process in which board and staff take on a shared ownership
- Accepts accountability to the community
- Is externally focused and sensitive to the organization's environment
- Is based on quality data
- Requires an openness to questioning the status quo
- Is a key part of effective management[2]

Regrettably, while almost all nonprofits say that they are involved in strategic planning when asked, too often the planning that is practiced is mired in the budgeting process. This is not strategic thinking; it is merely bean counting. To plan successfully, an organization must have a strategic thinker at its helm and an environment that infuses strategic thinking into all of its endeavors. Regardless of line and staff relations, everyone from the executive director down must adopt a planning philosophy. Planning is not merely an extension of the budgeting process; good planning identifies the key issues to which the appropriate numbers can later be attached.

Being strategic, rather than simply devising a strategic plan, is the key to effectively reaching the organization's mission. We concur with the findings of the "Strategy Counts" initiative conducted by the Kresge Foundation, and this chapter is framed in the following context:[3]

> An early observation suggests that there is no lack of compelling vision or of worthy aspirations by nonprofits. More often, the challenge is in the effective deployment of strategy … While multiyear strategic plans remain useful, the value diminishes if

> organizations take an episodic approach to strategy. Instead, strategy leaders, from the [20] pilot sites and beyond, are taking a more continual approach to strategy in which the strategy is aligned with and guides daily operations.

In your role as strategic business consultant and financial educator, we encourage you to see yourself as an essential part of the team that aligns strategy and ensures that the strategy is implemented.

## 3.2 WHAT IS STRATEGIC PLANNING?

"Strategic Planning is a systematic process through which an organization agrees on and builds key stakeholder commitment to priorities that are essential to its mission and responsive to the organizational environment. Strategic planning **guides the acquisition and allocation of resources to achieve these priorities.**"[4]

Strategic planning involves deciding how to combine and employ resources. It is not a one-time exercise but rather an ongoing process and finance managers play a prominent role. The numerous objectives and customers in the strategic decision-making environment of a nonprofit often disorient business professionals who join nonprofit boards.

Why do nonprofit organizations present unique managerial problems? Six complex factors affect decision making in nonprofit organizations:

1. Intangibility of services
2. Weak customer influence
3. Strong professional rather than organizational commitment by employees
4. Management intrusion by resource contributors
5. Restraints on the use of rewards and punishments
6. The influence of a charismatic leader and/or organizational mystique on choices[5]

Nonprofit decision-making complexity certainly contributes to the primary cause of failure in at least one-half of strategic decisions: poor decision-making processes.[6] Together these six influences weaken decision making and augur inefficiency and ineffectiveness for the nonprofit. Financial managers and finance-oriented board members may improve decision making by ensuring that, at a minimum, financial aspects of decisions are included and properly appraised. Less obvious is the tendency for some nonprofits to lose their program focus and overemphasize revenue generation: The joint effect of (1) constantly needing to seek resources, (2) not having a profit motive, and (3) not being able to accurately measure service quality is to make nonprofit organization managers concentrate more on fundraising than on the needs of service users.[7] It is a struggle that the typical organization with too little liquidity will constantly have to grapple with. That tendency is compounded when the vision and mission of the organization are unclear, unfocused, or forgotten.

## 3.3 WHAT ARE THE ORGANIZATION'S MISSION, VISION, AND GOALS/OBJECTIVES?

We will use these definitions of mission, vision, and goals/objectives:[8]

- *Mission* communicates purpose (why the organization exists, the end result the organization is striving to accomplish), the "business" the organization is in as it tries to achieve its purpose, and possibly a statement of guiding values or beliefs; this is captured in the "mission statement."

- *Vision* is a mental image of what successful attainment of the mission would look like or how the world would be different if and when the organization's mission is accomplished.
- *Goals/Objectives* are either (1) program goals/objectives – program-by-program statements of the organization's plan of action, telling what it intends to do over a several-year period; or (2) management goals/objectives – organization development plan of action for each function or area within the organization for which there is a strategic initiative being implemented.

An organization's **mission statement** should clearly communicate what it is that it does. Many mission statements succumb to an overuse of words in general, but especially of jargon. Good mission statements should be clear, memorable, and concise. Some examples of concise mission statements are:[9]

**TED:** Spreading ideas.
**The Humane Society:** Celebrating animals, confronting cruelty.
**Smithsonian:** The increase and diffusion of knowledge.
**Wounded Warrior Project:** To honor and empower wounded warriors.
**Public Broadcasting System (PBS):** To create content that educates, informs and inspires.
**USO:** Lifts the spirits of America's troops and their families.

**Vision statement** (Desired End-State): A one-sentence statement describing the clear and inspirational long-term desired change resulting from an organization or program's work. Some examples are:

**Oxfam:** A just world without poverty.
**Feeding America:** A hunger-free America.
**Human Rights Campaign:** Equality for everyone.
**National Multiple Sclerosis Society:** A World Free of MS.
**Alzheimer's Association:** Our vision is a world without Alzheimer's.
**Habitat for Humanity:** A world where everyone has a decent place to live.[10]

Peter Drucker indicates that there are three "musts" when you develop your organization's mission; consider whether your organization has incorporated these items into its mission development:

- Study your organization's *strengths* and its *past performance.* The idea is to do better those things you already do well – if those are the right things to do. The belief that your organization can do *everything* is just plain wrong. When you violate your organization's values, you are likely to do a poor job.
- Look outside at the *opportunities* and *needs.* With the limited resources you have (including people, money, and competence), where can you really make a difference? Once you know, create a high level of performance in that arena.
- Determine what your organization *really believes in.* Drucker notes that he has never seen anything being done well unless people were committed. One reason why the Edsel failed was that nobody at Ford believed in it.[11]

We will cover some specifics of strengths-weaknesses-opportunities-threats (SWOT) analysis later in the chapter. In implementing your organization's mission, you should ask several questions when viewing possible activities and programs to get involved with. Determine what the opportunities and needs are. Then ask if they fit your organization. Are you likely to do a good job at meeting them? Is there organizational competence in these areas? Do the opportunities and needs match the organization's strengths? Do the board, the staff, and the volunteer contingent really believe in this?

**(a) STRATEGY AND THE "BOTTOM LINE".** Historically, nonprofit organizations have not considered themselves to have a "bottom line." They seem to consider everything they do to be righteous and to serve a cause, and so they are not willing to insist that if a program does not produce results, then perhaps resources should be redirected. Nonprofits need the discipline of organized abandonment and the critical choices that are involved. **Organized abandonment** involves a carefully planned reevaluation of programs and activities, with a pruning process applied to certain of those programs in order to free up resources for reapplication. Later in the chapter we provide a tool to guide these organized abandonment decisions.

In addition to overall strategic direction, functional, area-specific strategies are necessary. In his studies of nonprofit organizations, Drucker noted a critical missing ingredient: the lack of a fund development strategy. He notes that the source of money is probably the greatest single difference between the nonprofit sector and business and government. The nonprofit institution has to raise money from donors. It raises its money – at least, a large portion of it – from people who want to participate in the cause but who are not beneficiaries or clients. Money is scarce in nonprofits. In fact, many nonprofit managers seem to believe that their difficulties would be solved if only they had more money. Drucker mentions that some of them come close to believing that raising money is really their mission! As an example, he cites the presidents of private colleges and universities who are so totally preoccupied with raising money that they have neither the time nor the thought for leading their organizations. What happens then? In his words:

> But a nonprofit institution that becomes a prisoner of money-raising is in serious trouble and in a serious identity crisis. The purpose of a strategy for raising money is precisely to enable the nonprofit institution to carry out its mission without subordinating that mission to fund-raising. This is why nonprofit people have now changed the term they use from "fund-raising" to "fund development." Fund-raising is going around with a begging bowl, asking for money because the need is so great. Fund development is creating a constituency which supports the organization because it deserves it. It means developing what I call a membership that participates through giving.[12]

Innovative organizations, both businesses and nonprofits, generally look outside and inside for ideas about new opportunities. A primary example, cited by Drucker, is the megachurch. The pastoral megachurch looks at changes in demographics, at all the young, professional, educated people who have been cut off from their roots and need a community, assistance, encouragement, and spiritual strength. The change seen outside is an opportunity for organizations that are observant. Look *within* the organization and identify the most important clue pointing the way to strategic venturing: Generally, it will be the unexpected success. Most organizations feel that they somehow deserve the unforeseen major successes and engage in self-congratulation. What they should be doing is seeing a call to greater outreach and action. As an example, Drucker references how The Girl Scout Association discovered that the social phenomenon of "latchkey kids" became a tremendous opportunity, which spawned the Daisy Scouts.

When doing anything new, do not leap directly from "idea stage" to "fully operational stage." Test the idea, possibly with a limited rollout (often called the pilot stage). A great idea can be labeled a failure when tiny and easily correctable flaws destroy the confidence of your clients, volunteers, or employees.

As a final note, Drucker has noted how persistence can breed improved performance and yet sometimes the best thing to do is cut your losses:

> When a strategy or an action doesn't seem to be working, the rule is, "If at first you don't succeed, try once more. Then do something else." The first time around, a new strategy very often doesn't work. Then one must sit down and ask what has been learned. "Maybe we pushed too hard when we had success. Or we thought we had won and slackened our efforts." Or maybe the service isn't quite right. Try to improve it, to change it and make another major effort. Maybe, though I am reluctant to encourage that, you should make a third effort. After that, go to work where the results are. There is only so much time and so many resources, and there is so much work to be done.[13]

**(b) WHAT ARE STRATEGIC DECISIONS?** Examples of strategic decisions are:

- Deciding to offer a new product line or service
- Deciding to serve a new clientele
- Deciding to deliver services abroad for the first time
- Deciding to affiliate with another organization

Whenever organizations significantly alter their activities, the strategic management process is at work.

Three factors distinguish strategic decisions:

1. Strategic decisions deal with concerns that are essential to the livelihood and survival of the entire organization and usually involve a major portion of the organization's resources.
2. Strategic decisions involve new initiatives or areas of concern and usually address issues that are unusual for the organization rather than issues that are easily handled with routine decision making.
3. Strategic decisions could have major implications for the way other, lower-level decisions in the organization are made.

Henry Mintzberg, one of the great management thinkers of our day, views strategy as a pattern in a stream of decisions.[14] There are two ramifications for the organization:

1. Strategy is not one decision but must be viewed in the context of a number of decisions and the consistency among them.
2. The organization must be constantly aware of decision alternatives.

Think about strategy as the reasoning that guides the organization's choices among its alternatives.

Is an organization's strategy always the result of a planned, conscious effort toward goals that results in a pattern, termed a *deliberate* strategy? *Not at all*. Many times, *emergent* strategy emerges from the bottom levels of the organization as a result of its activities. Or it may come out of the implementation process – in which changes in goals and "reorienting" may produce strategies that are quite different from what the organization originally intended. As a starting point in diagnosing an organization, study the decisions themselves and infer strategy from the strategic decisions.

## 3.4 STRATEGIC MANAGEMENT PROCESS

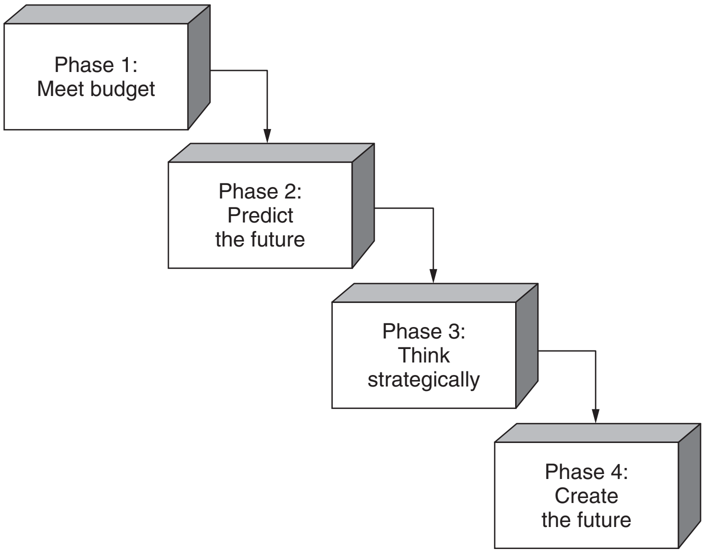
*Strategic management* refers to the entire scope of strategic decision making in an organization; as it can be defined as the "set of managerial decisions that relates the organization to its environment, guides internal activities, and determines the long-term performance of the organization."[15]

There are three steps in the strategic management process; thus far in this chapter, the first step has been our focus:[16]

- *Step 1. Strategy formulation.* The set of decisions that determine the organization's mission and establishes its goals/objectives, strategies, and policies
- *Step 2. Strategy implementation.* Decisions that are made to put a new strategy in place or to reinforce an existing strategy; includes motivating people, arranging the right structure and systems (see Chapter 4), establishing cross-functional teams, establishing policies, and maintaining the right organizational culture to make the strategy work
- *Step 3. Evaluation and control.* Activities and decisions that keep the process on track; include following up on goal accomplishment and feeding back the results to decision makers.

In their studies of organizational development, Stahl and Grigsby have noted regularities that help us understand the progression of strategic management. The organization will likely have to go through the phases, with each one showing increasing effectiveness, shown in Exhibit 3.1.

- *Phase 1*: Basic Financial Planning: Meet Budget
  - Controlling operations
  - Setting annual budget
  - Focusing on the various functional areas (such as development) in the organization
- *Phase 2*: Forecast-Based Planning: Predict the Future
  - Improved planning for growth
  - Environmental analysis
  - Multiyear forecasts
  - Static resource allocation
- *Phase 3*: Externally Oriented Planning: Think Strategically
  - More responsive to markets and competition
  - Better analysis of situations and assessment of competition




*Source:* Adapted and reprinted by permission of Harvard Business Review. From "Strategic Management for Competitive Advantage," by Frederick Gluck, Stephen Kaufman, and A. Steven Walleck, July–Aug. #58 1980 by the President and Fellows of Harvard College. All rights reserved.

**Exhibit 3.1** Strategic Management Phases

- Evaluate strategic alternatives
- Dynamic resource allocation

- *Phase 4*: Strategic Management: Create the Future
  - Create competitive advantage using all resources as a group
  - Strategically select planning framework
  - Planning process is creative and flexible
  - Value system and culture support planning and plans

You may immediately apply this framework to your organization in two ways:

**1.** In which phase do you find your organization? Based on where your organization is, how will this help or hinder strategic decision making?

**2.** What step(s) might you take to help move your organization and its leadership to the next phase?

**(a) SWOT ANALYSIS.** When formulating your organization's strategic plan, the board and management team must analyze conditions inside the organization as well as conditions in the external environment. This analysis is now so conventional in strategic management that it is referred to as analysis of internal *strengths* and *weaknesses* and external *opportunities* and *threats* (or *challenges*) – in a word, *SWOT*. Exhibit 3.2 provides the worksheet that includes all components of SWOT analysis. You may wish to duplicate it and use it to diagnose your organization's present situation.

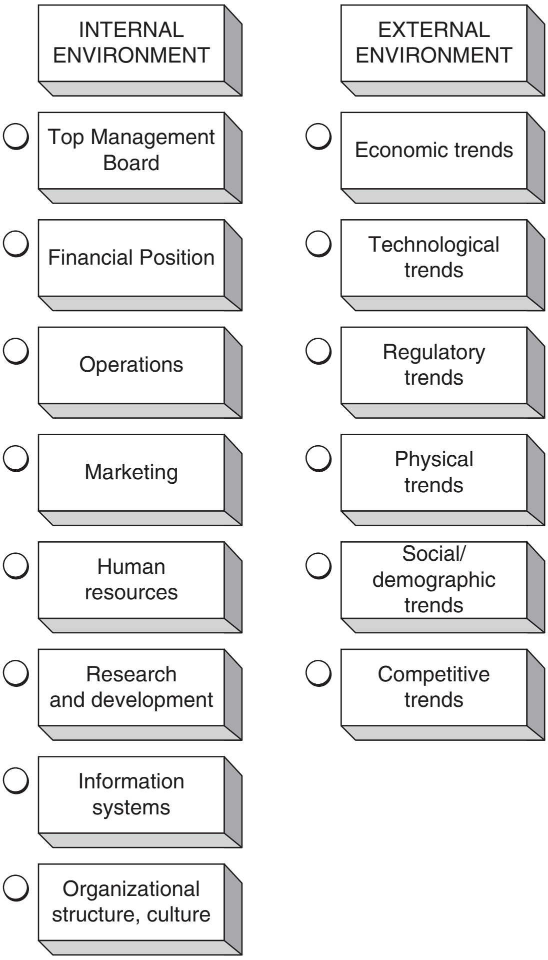



**Exhibit 3.2** Worksheet for Strength, Weakness, Opportunity, and Threat (SWOT) Analysis

**(b) WHAT ARE INTERNAL STRENGTHS AND WEAKNESSES?** Issues that are within the organization and usually under your management's control are internal strengths and weaknesses. A *strength* is anything internal to the organization that may lead to an advantage relative to your funding or service competitors and a benefit relative to your clients. A *weakness* is anything internal that may lead to a disadvantage relative to those competitors and clients. These internal items may have been inherited from past management teams or were operational in the past but are currently less relevant.

A talented and experienced top management team is a great internal asset, especially when the organization is in a rapidly changing or very competitive environment. If your board brings a fresh and questioning perspective to strategic issues, instead of rubber-stamping management's ideas, as so many boards do, count your board as an internal strength.

Financial management is an area in which possessing strength can advance most decisions management might implement. But a weak financial position (usually signaled by very low levels of liquidity and/or very high levels of debt) severely hampers the organization. A weak financial position can prevent an organization from responding to even the most attractive, mission-enhancing external opportunities.[17] Weaknesses often give rise to functional (management) strategies.

**(c) USING ENVIRONMENTAL SCANNING TO DETECT EXTERNAL OPPORTUNITIES AND THREATS.** External opportunities and threats (or challenges) are social, economic, technological, and political/regulatory trends and developments that have implications for your services, your clients, your donors, or other key parts of your organization.

Your organization should be continually engaging in *environmental scanning* to recognize these trends and developments and how they will affect revenues and expenses as well as risks. The terrorist attacks of September 11, 2001, meant a significant decline in donations for many organizations, as monies were donor-directed to the rescue effort and organizations like the American Red Cross. Hurricanes Katrina and Rita in 2005 and, to a lesser extent, hurricanes Harvey, Irma, and Maria in 2017 had much the same effect, with the Salvation Army, World Vision, and the American Red Cross seeing revenues and expenses shift upward, while many organizations experienced donation declines. The "Great Recession" that began in late 2007 had a negative effect on many nonprofits, especially those human services organizations whose donations and grants did not keep pace with exploding demand for their services. Organizations holding larger liquidity were very glad they had built up their liquidity positions above those levels of most organizations and above the commonly given advice of only three months of operating expenses. (Refer to Chapter 2 for reasons to hold larger cash reserves and operating reserves and Chapter 14 on development of risk reserves.)

**(d) STRATEGIC MANAGEMENT IS AN ONGOING PROCESS.** Strategic management is a process, not just a one-time product of some long meetings. It is more of a management philosophy than a simple methodology. Yesterday's ideal plan will sometimes become substandard due to some changed or just-discovered internal factor (a strength or weakness, possibly a technological innovation helping you in a key service area) or by a difference in the external environment (such as a new service provider moving into a key service arena or changing funding requirements). A good manager not only plans but also continually reassesses those plans while maintaining openness to opportunities. The manager then evaluates these opportunities evaluated against the manager's honest appraisal of the company's strengths and weaknesses, resulting in a well-founded decision on whether to pursue the opportunity or not, and, if so, in what time span. Do not even begin this procedure until you have asked yourself this basic question: What is our organization?

**(e) FINANCIAL LEADERSHIP, SUSTAINABILITY, AND THE BUSINESS MODEL.** Kate Barr and Jeanne Bell identify an important distinction regarding *financial leadership*.[18] They describe financial management as collecting data and producing reports. They state that financial leadership is guiding the nonprofit to sustainability. This is a key distinction, as many people simply ignore finances as something that is performed by experts. The financial management element requires specialized education and experience, but financial leadership is an element of fiduciary responsibility that cannot be delegated to an expert.

They go on to list eight guiding principles:

1. **Activate the Annual Budget**. This is where the annual budget process is aligned with the annual plan (which in turn is the current element of the strategic plan).

This aspect involves a desired financial outcome and engaging staff in taking responsibility for that outcome. Budget variance is emphasized and future focus is the hallmark; rather than simply hitting the current year target, recognize that the current budget is an artifice, a slice of a longer financial horizon. Use rolling forecasts as a way to shift into a future focus. Engagement and financial literacy is at the core of this principle.

2. **Income Diversification**. The authors emphasize that income diversification needs will differ based on the type of funding streams that are already in place and that a risk determination should be made on any particular revenue stream. Will a particular revenue stream yield a surplus, or produce a deficit? The organization's capacity needs to be analyzed. Multiple payers of the same type might be a better approach than payers of different types.[19] This alternate view of income diversification provides the opportunity for the nonprofit organization to sharpen its focus on core competencies and capacity and decide more strategically on funding development efforts. We shall return to this important element of an organization's "business model" later.
3. **Prioritize Cash Flow**. In order to look forward, cash flow projections can provide a future focus, keeping the seasonality of cash flow in mind as well as the target liquidity that the organization has already set. This function may be beyond the knowledge base of the accounting department and the authors recommend that executive leadership should engage in this process. Timing of shortfalls is critical in order to control payments and in obtaining lines of credit. And, we would add, cyclical changes (changes that are multi-year in nature, ebbing and flowing with the business cycle changes of recession, trough, expansion, and peak) also require additional liquidity planning
4. **Plan for Reserves**. The authors note that organizations that had a cushion of reserves during the recession had options and opportunities and could operate more in line with their strategic intent. Creating a reserve goal, budgeting for surpluses, and proactive planning for reserves is key. While there are rules of thumb about how much a reserve should be (we note here, formerly three-six months of expenses, but now as much as one year of expenses held in "liquid unrestricted net assets"),[20] a more analytical approach is to take the organization's particular variables into account. Reserves should be used to solve temporary problems, not to fix structural deficits. Otherwise, each year's deficits are funded with amounts held in reserve, draining reserves down until they are wholly inadequate.
5. **Rethink Restricted Funding**. There is a false dichotomy built into the idea of focusing on unrestricted funding. If restricted funding covers cost for programs that are central to your organization's mission, that funding stream acts as unrestricted funding; it is funding the core. When grant proposals are created, care should be taken to include costs that are critical to the outcome of the program and enter into a dialogue or negotiations about inclusion of those costs.
6. **Staffing the Finance Function**. The authors describe three functional aspects of the finance function: *transactional* (clerical, attention to detail, knowledge of basic accounting principles); *operational* (range of accounting functions such as paying bills, producing financial reports, etc. – this might require a strong foundation in nonprofit accounting); and *strategic* (systems development, analysis and planning and communications – all CFO-level skills). Staffing might include not only employees but also contractors for organizations that have limited resources.

7. **Board Involvement.** Provide the board with the right level of reports and analysis to keep the board high level and strategic in their thinking about finances. This includes report design (covered in Chapter 7 of this book), and creating reports that help the board with their fiduciary responsibility as well as planning and evaluation of the finance component of the organization (covered in Chapter 15).
8. **Managing the Right Risks.** Risk assessment (covered in Chapter 14) is a critical part of financial leadership. This incorporates the idea that risk is endemic and should be prioritized by leaders. The authors advocate using an Enterprise Risk Management (ERM) system to determine current and strategic risks to the organization, looking at them from a whole systems perspective.

**(f) SUSTAINABILITY.** Our emphasis on target liquidity is underpinned by our belief that setting this as the primary financial objective will inevitably lead your organization to make decisions that will foster financial sustainability. At this point, it is useful to define financial sustainability since it is the essential outcome of our primary financial objective.

In their book *Nonprofit Sustainability*, Bell, Masaoka, and Zimmerman define financial sustainability as the ability "to ensure that the organization has adequate working capital; that is, its financial goal is to have enough money to do its work over the long term."[21] In their model, financial outcomes and mission impact form a matrix for decision making and strategic development. They describe sustainability as having two aspects: "financial sustainability (the ability to generate resources to meet the needs of the present *without compromising the future*) and programmatic sustainability (the ability to develop, mature, and cycle out programs to be responsive to constituencies over time)."[22] This dual emphasis aligns with the notion of developing strategic directions that will ensure financial viability over time while continually assuring that the mission is being fulfilled and modified for maximum impact. The second component, programmatic sustainability, is closely tied to how sustainable the organization's business model is, in our view.

This methodology calls for a concerted effort in the planning process to engage top management and program managers with financial managers in an effort to collaborate in order to set strategic directions that align the programmatic needs of the organization with the financial requirement of ongoing liquidity (assuring cash flow over time) with maximum mission impact. This engagement strategy, if well executed, can lead to the avoidance of silos and it can result in financial leadership exercised across the organization, and not solely in the hands of financial managers.[23] In many nonprofits the ED/CEO is also the functioning CFO, but even where this is not a joint function the ED/CEO must grapple with the financial and programmatic sustainability of the organization's business model.

**(g) BUSINESS MODEL.** We welcome the increased focus on organizational *business models* seen in many nonprofits. The goal is to achieve and maintain a business model that is financially and programmatically sustainable. Pursuing the primary financial objective of maintaining an approximate liquidity target is the key element of managing toward financial sustainability. Need motivation to dive in here? Consider this pitch from three former nonprofit CFOs, which links the business model together with the underlying strategy:[24]

> Develop an explicit nonprofit business model statement. Every nonprofit has a business model, whether or not it has articulated its strategy as such. Each program and fundraising line must be managed individually, but this must be done in the context of

> an overall integrated business strategy. Leadership's role is to develop and communicate that overall strategy as one that brings together all the activities – which will have different financial goals – into a viable business model.

We define *business model* broadly and include several factors that are not normally considered in business model presentations we have seen. In a business, "… business model refers to the logic of the firm, the way it operates and how it creates value for its stakeholders. Strategy refers to the choice of business model through which the firm will compete in the marketplace. Tactics refers to the residual choices open to a firm by virtue of the business model that it employs."[25] We propose a more specific and usable definition for a nonprofit. Your business model is comprised of your organization's:

1. revenue and support amounts, mix (donations, grants, fees, other earned income, dues, investment income) trend, autonomy, reliability/variability (including length and certainty of contracts and whether these are protected by an insurance or future/option/swap contract), and cash yield;
2. expense amounts (which relates to your infrastructure), trend, nature (program-by-program breakdown and whether each program has revenues or support to fully cover its expenses, fixed or variable, controllable or uncontrollable, management/general/fundraising[26]or program-related), variability (degree of fluctuation within years and across years, hedging) and cash drain;
3. asset amount, mix (liquid versus illiquid, current versus noncurrent, financial versus physical) intensity (whether growth in your operation and outreach necessitates investing in significantly more working capital, such as receivables and inventories, or fixed assets, such as buildings, equipment, and land), riskiness (environmental hazards, property and casualty risk, interest rate risk and default risk on financial assets), and cash flow implications;
4. liability (loans, bonds, leases, and other forms of borrowing) amount, mix (short-term versus long-term, variable rate versus fixed rate), flexibility (early retirement or repayment without penalty, additional borrowings under agreements, presence or absence of overly restrictive covenants), riskiness (overlaps with mix factor, including interest rate risk, ability to protect against adverse developments via guarantees or a future/option/swap contract), and cash flow implications; and
5. customer/client/funder value proposition. (You might consider a sixth dimension, capacity, which is defined as "the resources, skills, and functions … organization needs to fulfill its mission across multiple domains."[27] This is a subjective but important dimension.)

Every one of these five dimensions of your business model implies either a stronger, more financially sustainable organization or a weaker, more financially vulnerable organization. Correspondingly, each has implications about the ability of your organization to achieve and maintain its target liquidity level. We are not able to drill down into detail on each of these dimensions, but since we are offering two new terms not normally used in business model presentations we will define "cash yield" and "cash drain." Think of *cash yield* as the amount of cash coming from your revenues, support, and gains. *Cash drain* would be the amount of cash that is absorbed or drained from your expenses. A great way to see the combined effects of cash yield and cash drain is to compare the operating cash flow amount from your Statement of Cash Flows to the change in net assets or change in unrestricted net assets from your Statement of Activities (see Chapters 6 and 7). The customer/client/funder value proposition is what your service or product offers to a customer or client or funder that is valued by them and that, ideally, is unique to your organization relative to other organizations with which the customer, client, or funder might contract.

The size and type of your organization and presence or absence of a sizable endowment all influence your organization's financial sustainability and health. While donative nonprofits are rightly concerned about the increased difficulty of raising funds, commercial nonprofits are not immune to threats to sustainability. A survey of private nonprofit 501(c)(3) college and university presidents finds that 73 percent of the presidents strongly agreed that the business models of the elite private universities offering doctoral and/or master's programs and having an endowment in excess of $1 billion are sustainable over the next 10 years.[28] The percentage of presidents strongly agreeing with this statement for elite private liberal arts colleges having an endowment in excess of $500 million dropped to 51 percent. When asked about "other private four-year institutions," the percentage strongly agreeing with ongoing sustainability dropped to zero (and was also zero when asked about ongoing sustainability for baccalaureate-only "other private four-year institutions"). When asked about their own college's situation, only 16 percent of presidents of baccalaureate-only private nonprofit colleges and only 24 percent of doctoral/master's private nonprofit colleges strongly agreed with the statement, "I am confident my institution will be financially stable over the next 10 years" (30 and 37 percent agreed, respectively). How do you view your organization's business model? A great topic for your next finance committee meeting, with your top paid finance staffer (if you have paid finance staff), would be to delve into the effect of your organization's size, type, and reserves and endowment levels on the financial and programmatic sustainability of its ongoing operations.

To apply the business model concept, we urge that you devote a finance committee meeting to fleshing out the five dimensions of your organization's business model. Have this exercise conducted by your organization's management team, and possibly separately by the overall board as part of your next board retreat, then compare notes. Some preliminary work needs to be done before you do the deep dive into these dimensions and their various elements. Have each finance committee member and each senior management team member answer the question, "What is our business model?"[29] Then, after feeding back those statements to each participant, have them answer this question: "What is our organization's strategy for financial sustainability?" We believe that having your ED/CEO craft a "business model statement" for internal use is also a valuable exercise. We quote below three statements that focus mostly on revenues and expenses that have been crafted by Jan Masaoka:[30]

- *Latino Theater:* We produce Spanish and English plays supported by ticket sales and foundation grants, and supplemented by net income from youth workshops and an annual gala.
- *Childcare Center:* We provide high-quality child care for children with diverse racial, cultural, and economic backgrounds, by combining government subsidies for low-income children with full-pay tuitions, supplemented with some parent fundraising.
- *Food Bank:* We obtain donated food from businesses (85 percent) and individuals (15 percent), sorted and distributed largely by volunteers, and financially supported by individual donors and the community foundation.

After doing the preliminary thinking about your business model and its financial and programmatic sustainability, you will be ready to apply our five-element framework.

Have your finance committee and management team try to rate each of the elements within our five dimensions as to whether that is a positive or negative factor. Agree on a summary statement for each of the five dimensions (for example, "The asset dimension represents a financially sustainable and programmatically sustainable business model because … ") for your organization. Have the finance committee chairperson and someone from your management team present their thoughts to the board for discussion and deliberation.

Once your organization's managers and board members are aware of and in agreement with the business model statement and the profile that comes out of addressing the five elements above, use the framework to assist in evaluating any proposed new program. Pose these two questions to decision makers: "Would this program help drive the delivery of our mission? Does investing in this project strengthen the success of our business model?"[31] In doing so, consider whether your organization has built risk capital (for funding new product/service extensions, significant growth, new audience-broadening marketing campaigns, earned income ventures, or a new strategic direction) and whether this program is facility-intensive and therefore requires more permanent capital for funding.[32] Also, measure the present organizational financial health and anticipate the after-implementation organizational financial health of the proposal.[33]

## 3.5 IMPLEMENTING THE STRATEGIC PLAN

**(a) THREE STEPS IN IMPLEMENTATION.** Many nonprofit organizations plan but very few excel when it comes to the implementation of those plans. Many times politics or board–chief executive dynamics, which may be disguised as "organizational realities," get in the way. Three vital ingredients increase the likelihood of working the plan:

1. Unqualified and vocal top management and board support
2. Communication
3. Teamwork

Both top management and the board must continue their overt support of the plan. Change is almost always resisted, so any plan that alters the status quo must be championed and the reasons for change clearly articulated.

Communication of the plan and its related program initiatives and related support elements is also essential. Most important, all volunteers, staff, donors, and regulatory authorities must remain confident that strategic initiatives are consistent with the mission and the organization's tax-exempt purpose. Also, service delivery and staff personnel must be aware of both continuing and new program directives. Gaining a sense of relative importance of the various program activities will enable people to concentrate their efforts on the key areas.

Teamwork is fostered by top management and board support as well as careful and consistent communication. In addition, teamwork can be bolstered by setting up teams. Effective use of project teams and use of employee suggestions for continuous service delivery improvement are illustrative of what can be done to harness the best elements of teamwork.

**(b) CUTBACK STRATEGIES.** Many times, often as a result of having set an inadequate target liquidity level, organization revenues decline and/or expenses increase, and a cash crunch occurs. Or perhaps a major funding source stops supporting the organization permanently, triggering a cash crisis – an ongoing imbalance between revenues and expenses. Either event spurs the financial management team (chief executive officer, chief financial officer, and board) to initiate cutback strategies. Illustrating, one would think that 2014, being five years beyond the "Great Recession," would be a good year for nonprofits, right? In fact, the Nonprofit Finance Fund finds that the single greatest challenge nonprofit executives say that they are facing is "achieving long-term financial sustainability (32 percent), and documents the following financial outcomes for 2014 in its broad-based survey of nonprofits:[34]

- Service demand increased for 76 percent of organizations and 52% of organizations could not meet the demand with services provided;
- Almost one-half (47 percent) of organizations had a surplus (revenues and support exceeded expenses), while about one in four (24 percent) had a deficit;
- Regarding "months of expenses held in cash," 12 percent had less than one-month worth, 35 percent had less than the minimal benchmark amount of three months' worth, and only 36 percent had the standard benchmark amount of six months' worth or more;
- For organizations selecting only one method of dealing with delays in government payments (grants or contracts), 39 percent used their own cash (reserves), 20 percent budgeted for delays in advance, and one in six organizations (17 percent) used a loan or line of credit.

Exhibit 3.3 profiles numerous strategies for coping with either a temporary cash crunch or more serious ongoing cash crisis. Notice that many of these are functional strategies – such as purchasing, facilities-related, or fundraising – rather than changes in product or service strategies.

***Authors' notes:***

We offer this checklist, excerpted from *Coping with Cutbacks*, as a thinking tool and as a route to direct action. A more in-depth list is in the book. We hope that you can use this list to help you think creatively about your organization, its culture, its mission, its future, its response to immediate financial crises, and its long-term preparation for the changing culture.

Use these suggestions as a starting point for your own brainstorming, and use the categories to help you organize your thinking and analyze your current approach to fulfilling your mission. But don't get locked into any one strategy – cut them up, pull them out of a hat, mix and match them. Do whatever helps you spur new ideas that fit your specific situation.

Here's our caveat: Just because we've listed a strategy, don't think we endorse it [in an unqualified manner]. In fact, we dislike some [or, question a few of these items], and some may conflict with your mission, values, or human resource policies. [For example, *less-costly does not always mean cost-effective*.]

**FINANCIAL STRATEGIES A: CUT OR CONTROL COSTS**

**Analyze purchasing**

**1.** Improve purchasing procedures
**2.** Seek in-kind contributions
**3.** Network to get better prices on supplies

**Exhibit 3.3** Cutback Strategies

4. Seek new competitive bids and new suppliers
5. Analyze purchases to see if they are necessary
6. Simplify paperwork and forms; use electronic files
7. Refurbish and reuse supplies

**Adjust payables**

1. Consolidate or restructure debt
2. Negotiate delayed or reduced payments
3. Barter for needed services

**Evaluate facilities and infrastructure**

1. Share space or maintenance costs
2. Delay maintenance
3. Save space by moving, reducing size, using home offices, or using split shifts
4. Negotiate a decreased rent with your landlord
5. Find a cheaper phone system; eliminate toll-free lines
6. Eliminate or consolidate newsletters and brochures
7. Eliminate vehicles or shift to less costly vehicles
8. Save energy

**Modify staffing and related costs**

1. Reduce hours or work week
2. Cut, freeze, or delay wages
3. Lay off staff; offer voluntary separation; offer unpaid leave; remove poor performers
4. Freeze hiring
5. Share jobs, consolidate staff, increase workload
6. Use volunteers and graduate interns
7. Hire temporary staff or consultants
8. Remove management layers; don't funnel high performers into management merely to reward them
9. Reduce benefits, staff training, and staff development
10. Limit or eliminate travel
11. Cancel subscriptions; use the Internet and libraries
12. Cancel professional association memberships
13. Switch to a direct reimbursement status for unemployment compensation
14. Ask board not to submit expenses for reimbursement
15. Convert some paid staff to volunteers
16. Share staff with other organizations

**Reduce services**

1. Analyze your programs and services against your mission and financial goals
2. Reduce or eliminate non-core programs
3. Limit eligibility for programs; reduce the number of clients served
4. Reduce or eliminate core programs
5. Temporarily shut down some or all services
6. Plan to go out of business humanely

**FINANCIAL STRATEGIES B: INCREASE REVENUES**

**Manage money differently**

1. Speed the inflow of cash by invoicing promptly or offering incentives
2. Try to get grants in the door earlier than the promised date
3. Change management of cash reserves to improve unearned income

**Exhibit 3.3** Cutback Strategies (*continued*)

4. Sell assets
5. Spend down reserves
6. Borrow money
7. Diversify your sources of income

**Increase fees**

1. Analyze all the costs of providing a service
2. Change fee structure to result in increased income

**Initiate or accelerate fundraising**

1. Research the larger community and current donors to improve response
2. Hire development director or staff
3. Add special events, fund drives, [bingo or raffles]
4. Increase board involvement in fundraising
5. Increase planned giving
6. Build an endowment
7. Find new donors and diversify funding base
8. Reach out to under-asked populations
9. Collaborate on fund drives; join a federated fund drive
10. Mobilize everyone in the search for new resources
11. Link with a business or credit card company to receive a percentage of sales
12. Seek in-kind contributions that can be converted to cash
13. Increase the search for foundation and government grants

**Expand or add services**

1. Boost enrollment in or expand offerings of successful services
2. Sell staff expertise and time
3. Add income-generating product or service that fulfills mission
4. Rent office space or equipment to others
5. Sell valuable information that others need
6. Seek related niche markets
7. Charge others for a service you also use (for example, maintenance)
8. Develop a catalog of products used by your organization and other nonprofits
9. Charge a fee to serve as the fiscal agent for other organizations

**Increase productivity**

1. Provide incentives for productive staff
2. Simplify production or service without loss of quality
3. Invest in an educated staff; provide training as needed
4. Research and implement "best practice" in all functions
5. Upgrade staff while cutting back
6. Invest in technology that improves productivity

**STRUCTURAL STRATEGIES**

**Modify the mission**

1. Reexamine the mission and realign the organization accordingly
2. Modify the mission to build clients' capacity to solve their own problems
3. Change the mission to enable the organization to respond to rapidly changing conditions

**Exhibit 3.3** Cutback Strategies (*continued*)

4. Move out of direct support services and into prevention services
5. Be a pilot site for some foundation, academic, or government program

**Modify the organization's structure**

1. Eliminate programs that are redundant with those of other organizations or combine them to improve services
2. Position yourself higher in the "food chain" when intense competition accompanies a changing environment
3. Respond to a changing environment by changing programs
4. Spin off a struggling or "orphan" program to another organization where it has a better chance to thrive
5. Merge with or acquire a competitor's or an ally's program
6. Relocate with a group of related organizations to form a one-stop shop
7. Become a for-profit; add a for-profit subsidiary; be acquired by a for-profit

**Modify the organization's culture**

1. Enlist the support of potential funders as you modify your programs, and then request funds to support changes
2. Share resources and expenses with other organizations that have similar needs
3. Make your services more culturally sensitive
4. Educate the board of directors to make them more effective
5. Mobilize everyone in the organization to help market its mission, message, services, and needs
6. Tear down bureaucracies that interfere with the creative flow of ideas
7. Replicate rather than reinvent
8. Link with a complementary but different organization to bring resources into the organization
9. Take a more entrepreneurial approach to accomplishing your mission

**ENGAGEMENT STRATEGIES**

**Engage other nonprofits**

1. Work with state and national nonprofit associations
2. Form associations to negotiate with contracting agencies as a block
3. Establish cooperative programs with other nonprofits to increase the number of stakeholders in each other's organization
4. Collaborate with like-minded nonprofits; seek funding to support collaboration
5. Develop a bartering resource system among nonprofits
6. Create a nonprofit organization to insure nonprofits; return surplus income to policyholders
7. Pool funds with other nonprofits to get a better return on the investment of capital
8. Acquire or merge with another nonprofit whose services complement yours
9. Establish national goals and standards for nonprofits to increase sector quality, public awareness, and public support
10. Form a consortium with other nonprofits to take advantage of federal block grants
11. Facilitate networks and collaboration by making your space available for such activities
12. Find ways to work with local providers of educational services at all levels

**Engage the community**

1. Seek funding to help those constituents least able to represent themselves have a voice

**Exhibit 3.3** Cutback Strategies (*continued*)

2. Involve all members of the community in teaching children the value of community involvement and philanthropy
3. Connect with local media to inform the community about issues related to your mission
4. Show the community that your crisis is a community crisis
5. Hold community issues forums; discuss community goals

**Engage the business community**

1. Form partnerships with businesses; find a host that will provide space, staff, funds, resources, or technical assistance
2. Advocate for your organization's values and goals while seeking business involvement
3. Know the people, values, and goals of the businesses you are engaging
4. Share your vision of the future with businesses so they can see how they and their community will benefit
5. Link with businesses that will benefit from the positive public relations your organization's cause will generate
6. Network with small and midsize businesses with a personal stake in the local community
7. Show businesses how to get involved in community issues that affect them
8. Collaborate with businesses and other nonprofits to create "incubators" for new, innovative organizations
9. Form nonprofit/for-profit partnerships to advocate for common interests

**Engage the public/government sector**

1. Advocate for tax incentives that encourage businesses to be involved in community efforts
2. Use the public schools to teach philanthropy; set up student-operated philanthropies at schools and universities
3. Seek ways to work with educational institutions at all grade levels, public and private, nonprofit and for-profit
4. Advocate for a nonprofit contribution checkoff on tax forms
5. Advocate for making charitable giving a tax credit rather than a deduction
6. Use publicly owned facilities as a site for delivering nonprofit community services

*Source:* Reprinted from Emily Angelica and Vincent Hyman, *Coping with Cutbacks: The Nonprofit Guide to Success When Times Are Tight* (St. Paul, MN: Fieldstone Alliance, 1997): 73–75. Used with permission.

EXHIBIT 3.3 CUTBACK STRATEGIES (*continued*)

Next we examine the areas in which financial managers and financially oriented board members may contribute to strategic decision making and implementation.

## 3.6 PERFORMANCE MANAGEMENT SYSTEMS

Managers need techniques to enable them to diagnose the fit and appropriateness of programs and service offerings. Organizational inertia in many nonprofits, particularly educational institutions and hospitals, means that programs take on a life of their own, which necessitates a disciplined method for diagnostic evaluation. As Peter Drucker notes:

> All organizations need a discipline that makes them face up to reality … All organizations need to know that virtually no program or activity will perform effectively

> for a long time without modification and redesign. Eventually every activity becomes obsolete … Hospitals and universities are only a little better than government in getting rid of yesterday … All organizations must be capable of change. We need concepts and measurements that give to other kinds of organizations what the market test and profitability yardstick give to business. Those tests and yardsticks will be quite different.[35]

Action point: Make sure your nonprofit organization has rigorous tests and yardsticks to measure performance. A performance management system (such as the balanced scorecard, which is the most popular one) or strategic management system consists of "ongoing organizational mechanisms or arrangements for strategically managing the implementation of agreed-upon strategies, assessing the performance of those strategies, and formulating new or revised strategies."[36]

We first provide several performance tests and yardsticks, especially financial ones, in our presentation of the balanced scorecard. We then introduce measurement tools to assist in your evaluation of service and program offerings. These tools go under various names: portfolio model, matrix, or grid. *The financial manager should have a central role in helping to apply and interpret a scorecard or diagnostic model and to integrate either into the organization's strategic decision making.*

**(a) BALANCED SCORECARD AND DASHBOARD.** The balanced scorecard is a strategic planning and management system used extensively in business and industry, government, and nonprofit organizations worldwide to align business activities to the vision and strategy of the organization, improve internal and external communications, and monitor organization performance against strategic goals. It was originated by Robert Kaplan (Harvard Business School) and David Norton as a performance measurement framework that added strategic nonfinancial performance measures to traditional financial metrics to give managers and executives a more "balanced" view of organizational performance.[37] Strategies need to be reassessed from time to time for one of four main reasons:

1. Even though the strategy was originally sound, insufficient resources were allocated to its implementation, so the goal/objective has not been achieved.
2. The problem being addressed by a strategy has changed, necessitating a revised strategy
3. The policies and strategies being implemented by this and other organizations may be interacting in unanticipated ways, prompting a review and possible revision of strategies.
4. The political and cultural environment may change, causing a loss of stakeholder support and/or loss of leadership support and zeal in strategy implementation.[38]

In addition, we cannot manage strategies by simply reviewing past financial results. We need a method that enables us to monitor and manage the financial and nonfinancial indicators that together will drive our future operating and financial results. In short, we need a performance management system – and the balanced scorecard fits the bill.

***(i) What is a Balanced Scorecard?.*** Businesses face the dilemma of how to manage to produce tomorrow's desired operating and financial results. Robert S. Kaplan and David P. Norton developed the balanced scorecard in response to this need. Kaplan revised the corporate balanced scorecard to meet the needs of nonprofit and public sector organizations that have only slightly different operating and financing objectives.

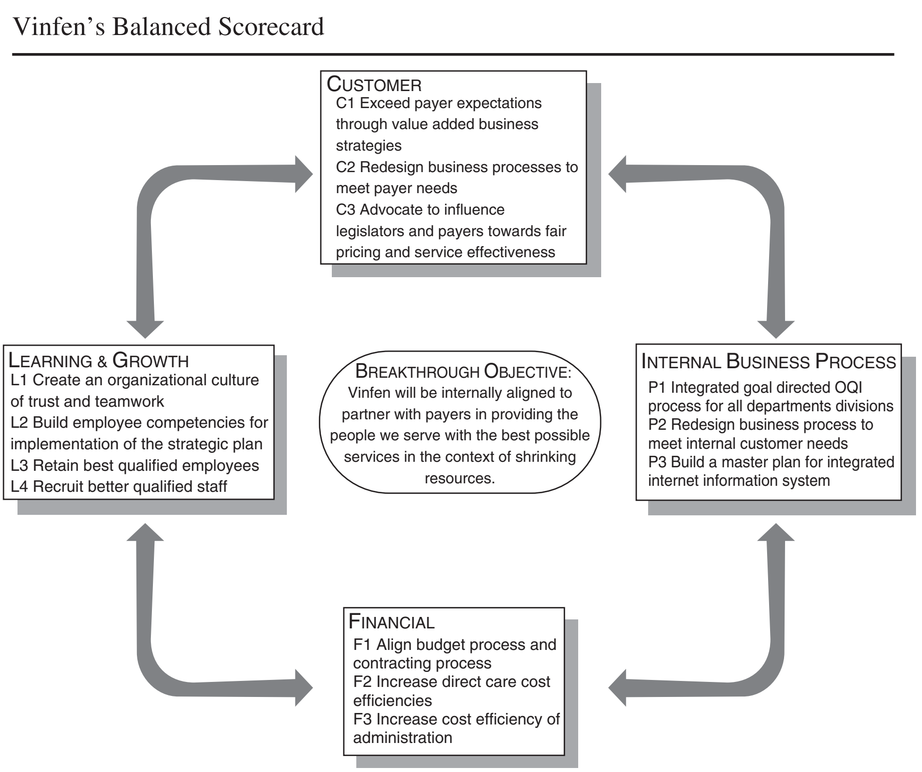
The essential principle behind the balanced scorecard system is this: *Only by maintaining organizational focus on four perspectives can the organization survive and thrive in the* *future.* These four perspectives, in turn, must have measures or metrics that are monitored and managed by decision makers to ensure that the organization stays on course.

The four perspectives are: customer, internal business systems and processes, employee learning and growth, and financial. Each of these is tied to the others by the vision and strategy of the organization, and each addresses a different question:

1. *Customer:* "How can we create value for our donors and clients?"
2. *Internal Business Processes:* "To satisfy our donors and customers, which business processes must we excel at?"
3. *Innovation and Learning:* "How can we improve and change to better meet our mission?"
4. *Financial (or Stewardship):* "How do we add value for our clients and donors while controlling costs?"[39]

We would rephrase the financial/stewardship perspective as: "How do we accomplish revenue enhancement and cost control while achieving our target liquidity?" Any organization that does so clearly adds value for both clients and donors.

Exhibit 3.4 illustrates a nonprofit balanced scorecard with a human services organization. The scorecard shows the objectives that this organization attached to each of the




*Source:* "Vinfen Corporation's Strategy Map as Part of the Organization's Balanced Scorecard." http://www.balancedscorecard.org/portals/0/pdf/vinfen_fy06_scorecard.pdf. Accessed: 1.4.2018. Vinfen is a leading human services nonprofit headquartered in Cambridge, MA. For related objectives, measures, and targets, see http://www.balancedscorecard.org/Portals/0/PDF/Vinfen_FY06_Map.pdf.

**EXHIBIT 3.4** EXAMPLE OF HUMAN SERVICES ORGANIZATION BALANCED SCORECARD four perspectives. Beyond this, and not shown in the exhibit, the management team should develop measures, targets, and initiatives for each of the four perspectives. Paul Niven, whose book serves as the standard source for nonprofit balanced scorecards, recommends no more than 8 to 10 objectives and no more than about 20 measures.[40]

***(ii) Financial Objectives and Measures/Metrics Useful for a Balanced Scorecard.*** The financial team's primary area of balanced scorecard development is selection and communication of the financial objectives and measures, or metrics, to gauge progress in reaching those objectives. As Robert Anderson, balanced scorecard consultant and former chief financial/chief operating officer of Prison Fellowship Ministries, notes: "Properly communicated measurements that support the [strategic] plan become powerful tools to achieve dramatic results in bringing organizational alignment, motivation and greater customer satisfaction."[41] Before developing or revisiting your organization's financial objectives and measures, collect or construct records of your organization's cash flows, reserves, financial position statements, revenue-expense statements, and endowment. Then compile a brief history of budgets, income growth, key events (including capital campaigns and large one-time gifts), and liquidity levels.[42] These items will provide a backdrop for financial objective and measure development or refinement.

While some of the nonprofit scorecards or dashboards do include a liquidity target, many do not, and this is probably the single largest deficiency in scorecard implementation to date. In arts organizations, for example, the push by executive directors to achieve the artistic mission has caused some organizations to deplete almost all available liquid funds to finance short-term artistic thrusts, threatening the survival of their organizations.[43] Significantly, this problem is compounded by the fact that many non-profits are very illiquid. Most nonprofit professional theaters, for example, have little endowment or cash reserves.[44] Not having adequate liquid resources puts added pressure on the CEO who is already facing funding concerns:

> … the most fundamental problem facing many of the leaders of nonprofit organizations is the continuing effort needed to fund and sustain financial resources sufficient to carry out the mission of the organization during a time of declining government support and intensifying competition for available funds.[45]

Financial objectives indicate what your organization must do well, related to finances and financial management, in order to implement your strategy. Financial measures or metrics are specific indicators that track or measure strategic success related to these financial objectives. We have already seen a social service agency's objectives; Exhibit 3.5 provides seven additional examples of scorecard financial objectives of nonprofits.

We include the first organization shown in Exhibit 3.5 to illustrate a public sector, not private nonprofit, agency. The slightly different management environment and objectives of public sector agencies possibly justifies the balanced budget target as an objective.

As far as specific measures/metrics go, here is the set of measures articulated by the fifth organization shown in Exhibit 3.5, New Profit Inc.:

1. Raise $4.5 million.
2. Maintain operating cash flow with 3-month surplus.

The second measure used by New Profit is clearly an approximate liquidity target (refer to Chapter 2 for more on this). Regardless of the ebb and flow of operating cash flows, the organization strives to achieve a liquidity level of three months of expenses. For many nonprofits, six months or more is ideal, depending on prefunding of maintenance expenses or new programs.

| | |
|---|---|
| Naval Undersea Warfare Center Newport | • Balanced budget.<br>• Revenue sources.<br>• Value. |
| Dallas Family Access Network | • Secure adequate funding to operate the organization. |
| United Way of Southeastern New England | • *External growth:* Increase net amount of funds raised.<br>• *Internal stability:* Balance internal income and expenses to maintain our 100 percent guarantee to others.<br>• *Community building:* Increase amount of funds that go to services; increase amount of funds that go to proprietary products. |
| Duke Children's Hospital | • Achieve continued improvement in net assets and liquidity to support new service development.<br>• Effectively link clinical and financial data systems and decisions.<br>• Effectively link staff compensation, performance, and service delivery.<br>• Sufficient funding support for all programs/services |
| New Profit Inc. (a venture capital philanthropic fund) | • *Fund capitalization:* Secure $5 million in fund commitments from investors using pyramid strategy.<br>• *Operating revenues:* Secure $500 thousand operating funds from foundations and friends for next two fiscal years.<br>• *Sustainability:* Manage cash flow to maintain an operating surplus with 3 months' cash on hand.<br>• *Efficiency:* Maintain ratio of 1:4 staff $/pro bono $, optimize pro bono and volunteer resources. |
| Hood College | • Survive.<br>• Succeed.<br>• Prosper. |
| American Society of Mechanical Engineers (ASME) | • Grow revenue through new products and global growth.<br>• Sunset lower-value programs.<br>• Run a cost-effective operation. |

**Exhibit 3.5** Nonprofit Scorecard Financial Objectives

Hood College, the sixth organization portrayed in Exhibit 3.5, had these progressively aspirational measures to monitor achievement of its general objectives:

1. *Survive:* Budget excess (deficit) as a percent of total revenues.
2. *Succeed:* Percent increase in enrollment of students.
3. *Prosper:* Percent increase in the quality of students of students (as measured by a quality index).

While Kaplan asserts that financial perspective items are almost always constraints rather than objectives, we believe that the two most essential financial perspective objectives are funding the mission – however stated – and achieving target liquidity levels. We agree with Kaplan that balancing the budget and achieving a slight surplus are not true effectiveness measures. Anderson documents how a short-term budget focus tends to spawn incremental thinking by staff and tends to put a ceiling on growth hopes and a floor under cost reductions.[46] The Capital Care Group, one of the largest public continuing care organizations in Canada, adopted four "Healthy Finances" and "Donor Commitment" organization-level measures embodying both a short-term and long-term perspective: Sustainability, computed as ((building costs – depreciation)/annual amortization), Total cost per resident day (long-term care only), staff overtime hours, and number of donors contributing annually for the past three years.[47] It then established the following Healthy finances and Donor commitment measures for each care center: total cost per day for long-term care, drug costs per day, and occupancy (in percent), total donations to sites (number, excluding corporate campaigns).[48] Finance staff and board finance committee members are uniquely positioned to champion adoption of a scorecard and the appropriate financial objectives and long-term and short-term measures for it.

***(iii) What Is a Dashboard?*** Dashboard reports provide a one-page, graphical, usually colorful, "early warning device" for senior staff and the board, including key performance indicators and other measures of the organization's status.[49] Compared to the balanced scorecard, dashboards are more user-centered (less high-level), compiling data based on organizational problems, important functions (such as development), or critical operational or business processes.[50] They might be designed to deal with a single problem, may display a large number of detailed or summary measures, and might be updated hourly, daily, weekly, or monthly.[51] For example, an organization's balanced scorecard could include measures such as percent donations increase and percent of development budget spent on direct mail, with the dashboard report having a development "homepage" dashboard giving a pie chart showing the percent of development budget spent on direct mail and another direct mail dashboard page with a graph on quarterly direct mail campaigns as well as percentage of premiums responded to per direct mail in each quarter. Many of the operational measures on your dashboard will not be strategic items, and therefore not show up on your balanced scorecard. That said, we have seen many of the same measures show up on dashboards as show up on balanced scorecards. You might craft, say, 20 to 35 different measures for a given balanced scorecard objective, put one or two of those measures in your balanced scorecard, then place the rest for a set of dashboards.[52]

To get a mental picture of a dashboard report, think of how your car dashboard provides important indicators such as gas level, speed, engine temperature, and warning lights. Indicator values are usually compared to previous values, highest and lowest values over a time period, and/or goal or benchmark (perhaps desired) values of the indicators. Arrows or traffic-signal colors (red means act now, yellow means continue to monitor, green means celebrate, you're doing great) highlight the most important changes or over- or underperformance areas. Indicators shown on your dashboard might include:

- Financial indicators such as liquidity target (maybe expressed as days of cash on hand), revenues and expenses (or maybe net surplus or deficit year-to-date compared with year-to-date budget figure), cash flow, budget projections and contributions, and days from end of month to your financial statement is completed
- Program indicators such as client/customer involvement, satisfaction measures, client progression/graduation
- Quality control indicators such as number of accidents, complaints, or mistakes
- Human resources indicators such as turnover rate, staff size and growth, and compensation[53]

For a college, one might include applications, campus visits, enrollments, retention, new majors or programs started, student body profile, academic quality measures, overall college financial position (cost coverage, liquidity, debt, and endowment), and development results.[54] The dashboard report is a conversation starter for your executive team and board, and so needs to be inclusive of the right indicators[55] (organizations use, on average, 29 indicators on their dashboards),[56] present reliable and up-to-date data, and be supplemented with a brief interpretive narrative to help in sense-making.[57] Develop the indicator set based on your strategic plan and unique organizational characteristics.[58]

**(b) PORTFOLIO APPROACHES.** Because of their multiple, often conflicting, objectives, nonprofits benefit greatly from diagnostic tools that help them map their programs or services in a rows-and-column format. It could be something as simple as the "BSC SWOT Analysis" grid, developed by Patricia Bush and her colleagues at the Balanced Scorecard Collaborative. Exhibit 3.6 shows the grid, as used by Niven in his consulting work. Niven contends that it highlights many potential issues and opportunities that may be translated into balanced scorecard objectives. Furthermore, by having to place each strength, weakness, opportunity, and threat into one of the four perspective boxes, the exercise provides real-time learning regarding the differences as well as overlap between the perspectives on the scorecard. The fifth column, termed "wild card," is for any item that does not appear to fall neatly into one of the SWOT categories but is an important strategic issue.

***(i) Generic Portfolio Modeling.*** Using some type of grid of rows and columns to visually compare an organization's various services is especially helpful for any organization that operates multiple programs or two or more earned income ventures or "businesses." In general terms, one can place programs or services into a grid that has contribution to the mission on the vertical axis and contribution to financial viability on the horizontal axis. An example of a basic type of product portfolio map is provided by Sharon Oster in her nonprofit strategic management textbook.[59] Two others that we recommend are Allen Proctor's Linking Money to Mission® Grid and The Matrix Map developed by Steve Zimmerman and Jeanne Bell.

***(ii) Diagnosing the Services Portfolio.*** Chris Lovelock and Charles Weinberg were the first to take the concept of business product portfolios and modify them to make them useful for service strategy evaluation.[60] Their model is useful for commercially oriented nonprofits, such as hospitals and universities. Every service program can be placed in one of four categories:

1. Raise more funds or cut costs to support it.
2. Maintain the program or spin it off as a for-profit corporation.

| | Strengths | Weaknesses | Opportunities | Threats | Wild Card |
|---|---|---|---|---|---|
| Customer | | | | | |
| Internal | | | | | |
| Learning & Growth | | | | | |
| Financial | | | | | |

*Source:* Adapted from Exhibit 8.7, BSC SWOT Analysis, in Paul R. Niven, Balanced Scorecard Step-By-Step for Government and Nonprofit Agencies (Hoboken: Wiley, 2003): 173.

**Exhibit 3.6** Balanced Scorecard SWOT Analysis Grid

3. Phase out the program in total.
4. Phase out parts of the program.

One factor is "profitability" or cost coverage. Revenues from general fundraising campaigns are not included here, as they help offset nonspecific overhead (fixed) costs. If a cost can be linked to a specific service program, even if it is a fixed cost, it is included in the cost for purposes of this analysis. The other indicator is the extent to which the service offering contributes to the advancement of the organization's mission.

To help classify products or services as to their degree of mission advancement, it is helpful to distinguish among three distinct types: core products, supplementary products, and resource-attraction products.

Core products or services are those that have been created to advance the organization's mission. Supplementary products are often added to either enhance the appeal of the core products or to facilitate their use. A restaurant in a children's museum illustrates this.

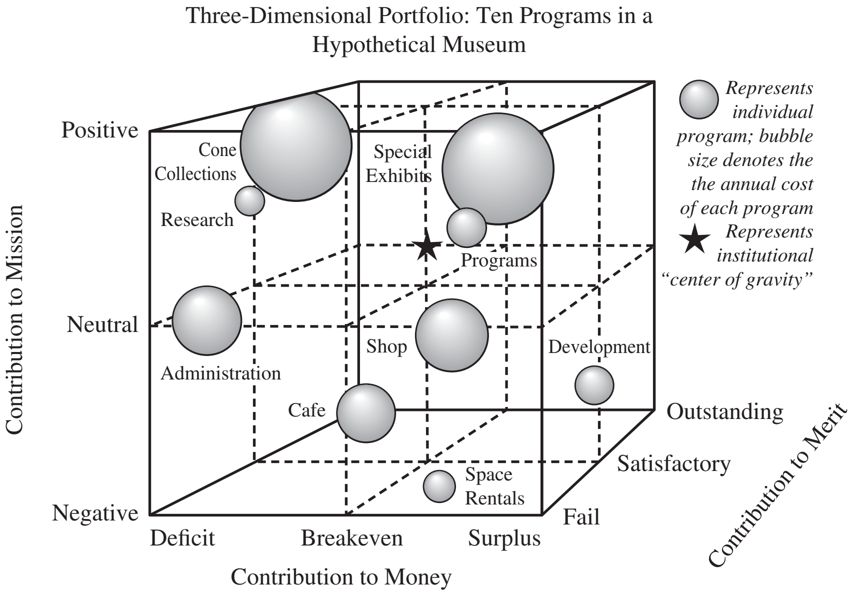
Resource-attraction products may be developed to foster the organization's ability to attract added funds, volunteers, and other donated resources. These products are started and developed to contribute to the organization's financial solvency or liquidity. Sometimes these are called social ventures or social enterprises, or comprise activities that go under the heading "social entrepreneurship." If an organization opens a food stand in a location other than one of its normal facilities, with the goal of making a significant amount of net revenue, this would be a resource-attraction "product."

If an organization is operating with persistent deficits, it would try to add a venture that would support the mission at the same time that it brings in adequate revenues so that costs are covered to a greater degree. Quite often, the dual achievement of these objectives is not so easily accomplished.

***(iii) Financial Return and Financial Coverage Matrix.*** The Financial Return and Financial Coverage Matrix (FRFCM) that we have developed is another portfolio approach. It is primarily useful for diagnosing the financial dimensions of new earned income ventures and their likely effect on the organization's liquidity target.[61] For any organization having or considering adding social entrepreneurship ventures that may be mission-related and will add net revenue financially, this framework may prove helpful. As it involves financial calculations in support of capital allocation decision making, we cover it in Chapter 9, on capital project analysis. At this point, we simply note that other portfolio models share a common deficiency: None specifically incorporates the effect of programs or services on the organization's liquidity. Because liquidity is the critical component of sustainability, this is a serious deficiency that you will want to address subjectively if you use one of these models.

***(iv) Three-Dimensional Portfolio Model.*** A recent modification and extension of the Lovelock and Weinberg services portfolio model is the Three-Dimensional Portfolio developed by Krug and Weinberg.[62] Shown in Exhibit 3.7, this is an elaborate and fascinating model of nonprofit program effectiveness. In addition to the mission and financial contributions of a program, the model assesses a third dimension of "merit" – how well our organization does at performing the program.

The first dimension, at the left of the diagram, is "Contribution to Mission" – or: Is the organization doing the right things? The second dimension, on the horizontal axis at the bottom of the diagram, is "Contribution to Money," or the degree to which a program covers all direct and indirect expenses associated with it. This is also termed "revenue/cost coverage." Finally, the third dimension, shown extending toward the back directionally, on the far right of the diagram, is "Contribution to Merit." This measures whether the program




*Source:* "Mission, Money, and Merit," by Kersti Krug and Charles Weinberg, *Nonprofit Management & Leadership*, Spring 2004, pp. 325–342.

**EXHIBIT 3.7** THREE-DIMENSIONAL PORTFOLIO

is high quality, with failing assigned a zero score, satisfactory a score of 5, and outstanding a score of 10. The size of the bubbles for the various programs reflects the amount of cost, or resources invested, in the program. The star that appears near the middle of the diagram is an overall composite measure encompassing all programs for this hypothetical museum.

The model's developers have interpreted it in their account of actual field experience.[63]

Ideally, the more programs that are located toward the back, top, and right of the cube, the better off the organization (although it is very unlikely that a program would be in this location). In organizations observed by the model's developers, subjectivity among program staff and managers regarding likely revenues and costs was an issue, and the CFO had the authority to overrule the estimates made by program staff of revenues and costs. The dialogue engendered by the application of this model to an actual museum proved valuable, as differing perceptions were brought to light.

***(v) Organized Abandonment Grid® (Boschee).*** A final tool for enabling disciplined evaluation of ongoing programs is provided by social entrepreneurship pioneer Jerr Boschee. This Organized Abandonment Grid® is motivated by Peter Drucker's observation of inertia and the need to "sunset" obsolete programs. Exhibit 3.8 shows the grid.

For each product or service, the management team must ask two questions:

1. Regardless of who pays for it or whether anyone can pay for it, how many clients in the community truly need the product or service, and how critical is their need? A "critical need" is scored a 5, "significant need" is a 4, "some need" is a 3, "minimal need" is a 2, and "no need" is a 1.
2. What are the financial implications of offering this product or service? Will it result in losses, or can it be profitable?[64]

*The Organized Abandonment Grid®*

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*Notes: "Profits" and" losses" are for annual operations and include all direct and indirect costs; "profits" are pre-tax and prior to capital re-investment*

| FINANCIAL IMPACT | | | SOCIAL PURPOSE: CRITICAL 5 | SIGNIFICANT 4 | SOME 3 | MINIMAL 2 | NONE 1 |
|---|---|---|---|---|---|---|---|
| PROFITS | 21% OR MORE | 7 | DEFINITELY | DEFINITELY | DEFINITELY | PROBABLY | MAYBE |
| PROFITS | 11% – 20% | 6 | DEFINITELY | DEFINITELY | DEFINITELY | MAYBE | MAYBE |
| PROFITS | 0% – 10% | 5 | DEFINITELY | DEFINITELY | PROBABLY | MAYBE | PROBABLY NOT |
| LOSSES | 1% – 10% | 4 | PROBABLY | PROBABLY | PROBABLY | PROBABLY NOT | DEFINITELY NOT |
| LOSSES | 11% – 40% | 3 | PROBABLY | PROBABLY | MAYBE | DEFINITELY NOT | DEFINITELY NOT |
| LOSSES | 41% – 70% | 2 | MAYBE | MAYBE | PROBABLY NOT | DEFINITELY NOT | DEFINITELY NOT |
| LOSSES | 71% – 100% | 1 | MAYBE | PROBABLY NOT | DEFINITELY NOT | DEFINITELY NOT | DEFINITELY NOT |

*Source:* "Keep or Kill? Score Your Progress" by Jerr Boschee, *Nonprofit World,* Sept/Oct. 2003. Used by permission. © The Institute for Social Entrepreneurs.

**Exhibit 3.8** The Organized Abandonment Grid®

The grid does allow for some judgment call decisions regarding whether more resources should be allocated to the program, less resources, or none at all (eliminate the program). For those boxes labeled "probably," for example, these programs probably deserve more resources because they are high on either their social purpose or their financial impact scale. Boschee notes that more nonprofits are now looking to earned income ventures as a primary funding source for the overall organization.

## 3.7 STRATEGIC PLANNING PRACTICES: WHAT DOES THE EVIDENCE SHOW?

There have been several studies of actual strategic planning practices in the nonprofit sector. A brief survey of their key findings follows.

Melissa M. Stone, Barbara Bigelow, and William Crittenden synthesized the nonprofit strategic management literature from 1977 to 1998, focusing on any real-life findings (sometimes called empirically based research studies).[65] Here are their findings, beginning with the adoption and usage of formal strategic planning methods:

- Many nonprofits have not adopted formal strategic planning.
- Organizational size, board and management characteristics, prior agreement on organizational goals, and funder requirements regarding planning all correlate with whether the organization does formal strategic planning.
- Mission, structure, and board and management roles may change after formal planning occurs.
- The relationship between formal planning and organizational performance is not clear but is often associated with who takes part in the planning process (board, CEO, and possibly others) and with the occurrence of growth.

Regarding strategy content, the real-world findings were:

- Resource environments and existing funder relationships had much to do with strategic plan content.
- Nonprofits engage in cooperative and competitive strategies, with varying outcomes.

Regarding strategy implementation, Stone, Bigelow, and Crittenden found evidence that:

- External shocks cause the organizational structure to change.
- Leader behavior, the structure of authority, values, and the interaction among these items affected implementation activities.
- Interorganizational networking was important for gaining good implementation outcomes

William Crittenden also studied the strategic processes, funding sources, and growth and financial strategies used by 31 nonprofit social service organizations.[66] He noted that most of these organizations were very small and very resource-constrained. His findings included:

- Organizations typified by the use of marketing and high competitor awareness tended to do better at gaining increased funding.
- Formal planning processes tend to coincide with high levels of donation funding.

- Organizations balancing their budgets and reaching their funding goals tended to also have strong marketing and financial orientations (the latter evidenced by evaluation of sources and uses of funds, revenue and expense forecasting, and predecision detailed financial projections).
- Organizations with no clear funding strategy and without strategic direction tended to falter financially.
- Nonprofit founders play an important role in an organization's strategic decisions.
- Staying focused in product/service offerings and avoiding the addition of many related or unrelated offerings are both strategically important, as was a willingness to move away from the past as direction became refocused.

More recently, Crittenden, Crittenden, Stone, and Robertson surveyed 303 nonprofit organizations to determine the linkage, if any, between strategic planning and various measures of performance. Strong relationships were not evident in the data, but the study did come out with two significant findings:

> The findings also have implications for board members and executives. First, governing bodies can foster management satisfaction by formalizing the processes involved with forecasting, objective-setting, and evaluation and ensuring that the executive director is involved with these activities. Providing latitude for executives to utilize their personal leadership and decision-making style regarding non-strategic issues will also enhance management satisfaction. However, broad participation by external constituencies is needed for strategic issues involving expanding the volunteer base or adding programs. Managers can deal with external interdependence issues by using planning boards to gather and share information among outside agencies and clients. Such boards provide a buffer between managers and what might be perceived as undue intervention.[67]

Finally, LeRoux and Wright surveyed several hundred nonprofit social service organizations in the United States to assess the extent to which relying on various performance measures improves strategic decision making. They found evidence of a positive relationship between the range of performance measures used by nonprofits and the organization's level of effectiveness in strategic decision making. Strategic decision making was also found to be enhanced by effective governance, funding diversity, and the education level of the executive director.[68]

## 3.8 CONCLUSION

Strategic planning is a vital part of ensuring a prosperous and mission-achieving future for your organization. We have focused on the role of financial staff in the development, evaluation, and implementation of these plans. Financial personnel will stand as the first line of defense to avert financial catastrophes when the organization attempts to move too quickly or when necessary funds do not come in on a timely basis. Equally important, financial strategies and policies can be developed or revised by the finance staff. In addition, while finance staff play a central role in financial management, financial leadership incorporates the board, executive leadership, and line staff. It requires a concerted effort and an open dialogue across the organization to assure mission achievement as well as sustainable financial practices.

We conclude with a warning about balancing the role of financial position in strategic planning:

> Nonprofits must resist as much as possible the tendency to make the financial situation the most important determinant of the organization's capabilities. Financial matters are an important element of the strategic plan, but they need to be balanced with other elements. At times, this may mean narrowing the scope of operations. Fulfillment of the mission is of primary importance. If the organization is on a constant treadmill of financial crises, it can easily compromise the mission in the interests of survival. But survival is meaningless if the mission is forgotten. Nonprofits should not hesitate to use the mission to say no.[69]

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CHAPTER 4

# MANAGING STRUCTURE, ACCOUNTABILITY, AND ETHICS



## 4.1 FINANCIAL TOOLS AND SUPPORT STRUCTURE

The success of a nonprofit organization is dependent on its workforce and the governing body and structure it assembles to accomplish its mission.

Achieving organizational alignment is critical to the success of the organization; the various elements of the organizational structure need to operate efficiently and effectively. The passage of the Sarbanes-Oxley Act in 2002 has revolutionized governance and internal controls in the business world, and its effects are rapidly being integrated by many



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

nonprofits into their processes. Nonprofit organizations provide unique challenges in this area. In the story that unfolded after the Washington, DC, United Way scandal and forced resignation of the chief executive officer (CEO)/executive director (ED), a task force was convened with the charge to "help formulate a code of ethics and a set of financial and other business procedures that reflect best practices among not-for-profit organizations."[1] Key attributes for nonprofits surfaced: ethics, governance, transparency, and the constant building of trust. An important enabler of each of these is your organization's financial structure. Recently, Grant Thornton diagnosed nonprofit governance practices and highlighted a culture of ethics as a primary driver of organizational success and sustainability.[2] In this chapter we build an understanding of governance and the board, accountability and how it may be fostered, organizational structure with a special focus on the chief financial officer (CFO), and ethics.

**(a) ELEMENTS OF THE FINANCIAL STRUCTURE.** In order to be useful, the financial structure of both nonprofit and for-profit organizations must reflect the nature and needs of the organization. It consists of these components, some of which are accounting issues and others of which we cover in other sections of this volume:

- Organizational structure is established to support (see the next section)
- Financial component of the organizational structure
- Chart of accounts created to record financial transactions
- Financial plan
- Fundraising plan
- Cash-flow plan
- Systems to support the processing of financial transactions and internal controls
- Financial reporting system
- Distribution system for financial reports
- System for producing all financial and management reports
- System for reviewing financial results
- Communication of roles, responsibilities, and accountabilities related to the financial activity
- System for evaluating and adjusting the system to coincide with organizational goals and objectives
- External reporting and relations

***(i) Importance of Financial Structure.*** Financial resources allow organizations to accomplish their missions and achieve their goals. They are needed to raise funds, hire and reward people, acquire property and equipment, and cover many types of expenses incurred in pursuit of the organization's mission.

Resources can be maximized by planning, recording, and reporting the financial activities, financial position, and cash flows in a manner that is meaningful and useful to the organization. Technical expertise as well as managerial and communication skills are required to design a financial system which serves all the organization's constituents.

***(ii) Development of Financial Structure.*** The board of directors of a nonprofit organization is responsible for ensuring that its financial structure is appropriate and meets the organization's needs. Generally, the board treasurer or chief financial officer (CFO) develops a proposed structure and presents it to the board for review and approval. After this occurs, the financial structure is periodically reviewed to ensure its continued ability to meet the internal and external requirements of the organization. It is the responsibility of the board to ensure that these periodic reviews are conducted.

***(iii) Financial Structure Soundness.*** A financial structure is sound when it serves the needs of all internal and external constituents of the organization, including primarily the following:

- Board of directors
- Program directors
- Fund managers
- Staff
- Volunteers
- Grant agencies
- Donors
- Internal Revenue Service
- Banks and Bondholders
- Auditors
- Investment service providers
- Suppliers
- Independent contractors
- Academic institutions and consultants that study and advise nonprofit organizations

**(b) INTERNAL CONTROLS.** Internal control is defined as "a process effected by [a nonprofit's] board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."[3] It is essential for the financial structure of the nonprofit organization to be safeguarded by a system of internal controls, which requires the delegation of roles and responsibilities in such a way that no one person has control over more than one function. This segregation of duties is a central tenet of internal controls. Internal control as a system goes beyond fraud prevention, however. Pertinent to financial managers is the risk assessment component. The Committee of Sponsoring Organizations of the Treadway Commission (jointly sponsored and funded by three professional accountants' associations, an auditor association, and Financial Executives International) explains:[4]

> Risk affects an entity's ability to succeed, compete within its industry, maintain its financial strength and positive reputation, and maintain the overall quality of its products, services, and people. There is no practical way to reduce risk to zero. Indeed, the decision to be in business incurs risk. Management must determine how much risk is to be prudently accepted, strive to maintain risk within these levels, and understand how much tolerance it has for exceeding its target risk levels.

Businesses and nonprofits are now broadening their score to view internal control within the parameters of enterprise risk management (ERM). ERM's perspectives include "strategy-setting, governance, communicating with stakeholders, and measuring performance. Its principles apply at all levels of the organization and across all functions."[5] We return to this important topic in Chapters 5, 10, and 14.

**(c) FINANCIAL POLICY.** Every nonprofit organization that raises and expends financial resources should have written financial policies readily available to those who carry out roles and responsibilities on behalf of the organization and its mission. These policies are determined by the board of directors or its designee and are statements of the nonprofit organization's requirements in the financial areas of managing cash, investing, fundraising, budgeting, expending funds, arranging for and discharging debt, and reporting financial results. Related policies should also include, at a minimum, document retention, whistle-blower, and conflict of interest policies. We detail the types and nature of these policies in Chapter 5.

**(d) FINANCIAL PROCEDURES.** The financial structure of the nonprofit organization should be supported by written financial procedures (sometimes called standard operating procedures) that provide detailed descriptions of how financial transactions are to be processed to ensure compliance with the organization's financial policy. Examples are documented procedures for handling cash, making deposits, managing funds, and developing budgets.

Financial procedures provide information on what is required to process various types of financial transactions successfully within the financial structure and system of the specific nonprofit organization. They contribute to the ongoing integrity of financial data and reports and ensure the correct processing of financial transactions with existing and/or new staff, volunteers, boards, committees, and other constituents. They provide detailed information in order to orient new staff members and assure that knowledge transfer takes place in the event of staff turnover. We shall deal with these in later chapters.

## 4.2 ORGANIZATIONAL STRUCTURE AND GOVERNANCE

One person should be placed in charge of the financial health and integrity of a nonprofit organization. However, financial responsibility is ultimately shared by everyone in the organization with decision-making responsibilities: the board of directors/trustees, councils and committees, ED/CEO, CFO, and other managerial and program staff. This is what we referred to in Chapter 3 as financial leadership, where knowledge and responsibilities are distributed throughout the organization. According to IRS laws governing nonprofit organizations, any of the above-mentioned persons can be held *liable* for financial errors as long as there is sufficient evidence to presume that they should have known about the errors and could have acted to avoid them. It is therefore important to have a clear definition of responsibilities for different roles in the organization, with an accompanying set of checks and balances (part of the organization's internal controls) and detailed written policies and procedures. The topics of this chapter – organizational structure and governance, the finance function, financial and accountability structures, and ethics – will help to ensure an organizational focus on accountability, ethical conduct, and trust building, while enabling the nonprofit to carry out its financial management in an effective and efficient manner.

Vulnerability to fraud is an issue that motivates the importance of governance, structure, accountability, and ethics. Nonprofits are especially vulnerable to employee-perpetrated fraud because of these six characteristics:

1. An environment of trust, implying that the guard may be down
2. Large degrees of control by a founder, CEO/ED, or substantial donor
3. Failure to include individuals with financial oversight expertise on the board of directors/trustees

4. Nonreciprocal transactions (contributions) that are easier to steal than other forms of income because when fraudulent they are more difficult to detect
5. Failure to devote sufficient resources to financial management
6. Program and financial reports, particularly with respect to government grants, may determine job security and possibly even compensation[6]

We shall develop fraud issues more completely in Chapter 10, but note that items 2, 3, and 5 each bear on governance and organizational structure issues. *Governance* is the set of responsibilities that ensures accountability, achieves legitimacy with all key internal and external constituencies, and establishes the mission as well as sustains the organizational well-being necessary to pursue that mission.[7] We provide a brief glossary of governance terminology in Exhibit 4.1. The central players in governance are the members of the board.

**(a) BOARD OF TRUSTEES/DIRECTORS.** The board of trustees/directors of a nonprofit organization determines the mission and sets the parameters under which the organization operates. The board's major areas of responsibility are

- Determine the organization's mission and establish policies for its operation, ensuring that its charter and bylaws are written and being followed (see Appendix 4A for more on bylaws)
- Develop the organization's overall program on an annual basis and engage in long-range and strategic planning to establish its future course
- Establish financial policies and procedures, and set budgets and financial controls
- Provide adequate resources for the activities of the organization through oversight of the revenue portfolio, direct financial contributions, and a commitment to fundraising
- Select, evaluate, establish compensation for, and if necessary, terminate the CEO
- Develop and maintain a communication link to the community, promoting the work of the organization

The board of trustees/directors must keep the nonprofit organization focused on its mission. Board members do not ordinarily participate in day-to-day operational decisions – although the board's level of participation has changed slightly since 2002 when Sarbanes-Oxley (SOX) was enacted – but they approve operating budgets and may assess the productivity of the operational managers. Increasingly, nonprofit organizations are voluntarily adopting the provisions of SOX.[8] Ordinarily, board members receive no compensation (except for private foundation board members), whereas operational managers are usually on the payroll of the organization.

Yesterday's board practices and today's best practices in a Sarbanes-Oxley world are quite different. Orientation regarding financial documents and the strategic plan, importance of the financial viability of the organization, ability to read and analyze financial statements, the unethical nature of conflicts of interest, and the increased importance of an audit or financial review conducted by a CPA firm are key differences. *Consult Exhibit* 4.2 *for more on these differences and how they can usher in an improved culture in your organization.* Today's regulatory environment, in which fines and penalties for self-dealing appear to be increasing and the IRS is honing in on certain other violations by private foundations, as well as excess benefit transactions by public charities, makes these issues even more pressing. Compliance with ethical standards is now an implied requirement on the Form 990 where questions about conflict of interest policies as well as whistle-blower protections are attested to. What was a series of best practices has now become enshrined in

These are some of the most commonly used terms used in the nonprofit sector, with working definitions:

| | |
|---|---|
| **Board of Trustees** | Governing board of the nonprofit corporation (trust or charity); see Board of Directors |
| **Articles of Incorporation** | Legal document used to create a nonprofit organization |
| **Bylaws** | Set of rules that govern a nonprofit organization's internal affairs (see Appendix 4A for a sample) |
| **Board of Directors** | Two or more individuals who serve as the governing body of an organization, with responsibility and oversight of mission, organizational leadership, and strategic direction |
| **Tax exempt** | Not subject to income taxes |
| **501(c)(3)** | Section of IRS code that defines this charitable type of tax-exempt, nonprofit corporation, almost all of which are eligible to receive tax-exempt donations (testing for public safety organizations are not eligible); includes public charities and private foundations |
| **Nonprofit** | Corporation that is not allowed to distribute profits or surpluses to its board or those in control of the organization |
| **Treasurer** | **Board Treasurer:** Officer of nonprofit board responsible for overseeing the organization's financial management and reports. The bylaws give specific responsibilities for the Treasurer. Some states require that a board treasurer or staff Chief Financial Officer serve as an officer of the organization. Oversees financial policies, bank relationships, budgets, financial reports, and serves as a liaison between finance staff and board members.<br>**Non-Board Chief Financial Officer:** In smaller organizations may not be one, but in many organizations, Chief Financial handles day-to-day financial management and reporting duties and in larger organizations may have a staff treasurer (not to be confused with board treasurer) oversee cash and other treasury management duties while a staff controller oversees the accounting and reporting functions. |
| **Secretary** | Officer of nonprofit board responsible for preparing board agendas, minutes, and other documentation of business of nonprofit board |
| **Officer of Corporation** | Legal representative of the board of nonprofit corporation; President, Vice President or Treasurer, Secretary |
| **Chair of Board** | Person selected by board to be its leader, presiding over meetings and informing other board members of their obligations |
| **Volunteer** | One who does meaningful, but unpaid, work for the nonprofit organization |
| **Fiduciary** | One who is legally bound to oversee the affairs of another using the same standards as one would employ to look after his or her own assets |
| **Stewardship** | Holding something in trust for another |
| **Philanthropy** | Goodwill, active effort to promote human welfare |
| **Endowment** | An accumulation of contributions that is held for investment; earnings, if any, can be distributed to programs unless restricted by endowment donor(s) |
| **Deferred giving** | A charitable gift made before one's death |
| **Restricted fund** | A fund that has been contributed to a nonprofit organization for a specific, designated purpose and cannot be used for general operations |
| **Unrestricted fund** | A fund contributed to a nonprofit organization whose use is determined by the board of directors; more broadly, monies that are earned via sales or dues would also be considered as unrestricted |
| **Fund accounting** | Technical accounting term that refers to a system of accounting for funds by project; this is not required by accounting standards but is often used for internal recordkeeping purposes |
| **Permanent fund** | A fund in which the principal is never spent, such as an endowment fund |
| **Conflict of interest** | State of affairs that looks suspicious and raises questions of appearance |

**Exhibit 4.1** The Language of Nonprofit Governance

| Yesterday's Board Practices | SOX Best Practices for Today's Board |
|---|---|
| Board members selected without screening process. | Nominating committee rigorously screens prospective members and submits nominations to full board for vote. |
| Either board members do not receive orientation or the orientation is a social gathering. | Board members receive extensive orientation, including job description, performance expectations, bylaws, complete financial documentation, strategic plan, and other relevant documents. |
| Board members are expected to be passive at board meetings; agenda is primarily staff-driven. | Board members are expected to review all materials in advance of the board meeting and come fully prepared to analyze, deliberate, and debate, if necessary, the issues at hand. Board members know how to read and analyze financial reports and spot important trends. |
| Board culture reflects belief that the nonprofit is a "Mom and Pop" operation governed by well-meaning volunteers. | Board culture reflects the reality that the nonprofit is a financially viable business enterprise governed by competent directors and their leaders whose primary allegiance is to the mission of the organization. |
| Board members are known to have profited from their position on the board through the nonprofit's contracts with their businesses. | Board members are required to sign a conflict-of-interest statement on an annual basis for the purpose of identifying any existing, or possible, conflicts of interest. Board members are prohibited from having contracts of any kind with the nonprofit or other types of self-dealing. |
| Board members are the nonprofit's "aristocracy" and are permitted to order the staff about and/or demand favors. | The board orientation clearly articulates that the board's only employee is the executive director (ED) and stipulates that all board members will conduct themselves in a professional manner at all times. |
| Directors' and officers' insurance is only for large nonprofits. | All boards are indemnified through the purchase of D&O insurance. |
| Audits are only for large organizations. | An audit or financial review is required on an annual basis. An audit may be stipulated depending on the organization's budget and relevant state legislation. However, smaller nonprofits should arrange for a review of their financial statements. |

*Source:* Exhibit 6.1, pages 90–91, of Peggy M. Jackson and Toni E. Fogarty, *Sarbanes Oxley for Nonprofits: A Guide for Building Competitive Advantage* (Hoboken, NJ: Wiley, 2005). Used by permission.

**Exhibit 4.2** Best Board Practices in a Sarbanes-Oxley Environment

publicly-available reports. We recommend that your organization's ED/CEO, board executive committee, and board finance committee self-evaluate your board's practices using Exhibit 4.2 once every three years. Then, a summary report should be presented while in executive session to the full board.[9]

Since the board of trustees/directors can be held responsible for the operations of the nonprofit, it is vital for each member to fully understand the oversight role and for the organization to protect all members through the purchase of board liability insurance. We discuss liability management in greater detail in Chapter 10 and insurance more fully in Chapter 14.

***(i) Choosing Trustees/Directors.*** It is critical for nonprofit organizations to choose trustees who have the experience, skills, and knowledge base needed for the board to carry out its fiduciary and programmatic responsibilities. The board, as a whole, must work well together and demonstrate strengths in these areas:

- Vision
- Strategic thinking and planning
- Program high-level decisions
- Oversight of but not intrusion into day-to-day operations
- Organizational development
- Fundraising
- Financial management
- Accounting and auditing
- Human resources management
- Legal and risk management issues related to nonprofits, contracts, human resources
- Conflict-of-interest avoidance
- Public relations
- Community representation
- Organizational dynamics and development

***(ii) Board Financial Responsibility and Liability.*** Accountability is an important concept for members of nonprofit boards of trustees to understand, and they should be well informed about the full extent of the liability, both personal and organizational, resulting from their service. Since accountability laws vary from state to state, legal advice should be sought by all boards of trustees to ensure that they have the correct information for their organization in their particular state. Nine general guidelines follow.

1. The standards established for the conduct of trustees (board of directors members) of nonprofit organizations are found in corporate law rather than trust law and are therefore less strict than those governing other types of trustees. Because nonprofit boards do not have the wide range of delegation powers and outside resources found on corporate boards, they are required to exhibit "prudent man" behavior in carrying out their responsibilities and are only liable for gross negligence.
2. Trustees are not likely to be held liable for business or financial decisions, provided they are made through informed judgments. However, they can be found liable if they never attend meetings, approve financial or business transactions with no background information, or engage in illegal financial or business activity.
3. Liability claims can be filed against trustees who place their personal financial interest above that of the nonprofit corporation, use corporate property for personal gain, take advantage of a financial opportunity at the expense of the nonprofit corporation, or self-deal without appropriate disclosure.

4. Trustees are liable for ensuring that the corporation is carrying out its mission, as documented by federal and state law. Trustees are accountable for ensuring that donors' funds are used for the purposes of the organization, as prescribed by the donors.
5. Liability for ensuring that their nonprofit organizations comply with the rules and regulations set by federal, state, and local governments that have jurisdiction over them rests with the board of trustees. These organizations must file tax returns with the IRS and applicable state agencies. Fulfilling legal requirements as an employer, including the payment of payroll taxes for the organization's employees, is the ultimate responsibility of the board of trustees.
6. The financial health of a nonprofit organization also rests with its board of trustees, but it can best be achieved when all stakeholders are assigned some segment of responsibility and accountability. The trustees fulfill this obligation within the context of their broader set of responsibilities, noted earlier in this chapter.
7. Trustees should avoid these types of activities:
   - Engage in the day-to-day operations of the organization.
   - Hire staff other than the ED/CEO.
   - Make detailed programmatic or financial decisions without staff consultation.
8. The financial plan of an organization must be properly aligned with the organizational structure and program needs in order to be meaningful and useful. Since all organizations require resources to operate, it is critical for the financial development, implementation, monitoring, and reporting activities to involve the program stakeholders.
9. In the process of addressing its financial responsibilities to the nonprofit organization, the board should pursue these tasks:
   - Create a vision.
   - Raise funds.
   - Communicate.
   - Set policy and include the rationale.
   - Assign responsibility.
   - Establish a budget.
   - Project cash flow.
   - Monitor and amend the budget.
   - Review financial statements.
   - Report results.
   - Watch the trends.
   - Develop long-range plans.
   - Evaluate results.
   - Ensure internal control.
   - Develop and monitor key performance indicators.

The board's financial responsibilities should be taken seriously. New York's assistant attorney general notes that the "duty of care requires that trustees, directors and offices … be attentive to the organization's activities and finances and actively oversee the way in which its assets are managed … This includes … insuring that funds are properly managed, asking questions, and exercising sound judgment."[10] Board members have a fiduciary responsibility for the organization's finances. This means that board members remain objective, responsible, honest, trustworthy, and efficient. Board members need not be experts in financial management but it is essential that they be "financial inquisitors."[11] They are required *by law* to exercise financial leadership.

**(b) OFFICERS OF THE NONPROFIT ORGANIZATION.** State laws vary, but they generally require a nonprofit organization's board of trustees to have at least three officers: a chair (or president), a treasurer (or chief financial officer), and a secretary. Some organizations include additional officers. The number of officers and their titles, powers, and duties are spelled out in the bylaws (see Appendix 4A for an example), along with the timetable and process by which officers are elected.

The selection of the right individuals to serve on the board of a nonprofit organization is a critical task. Only the most qualified persons should be considered for officer positions, with no one appointed on an honorary basis.

***(i) President/Chair of the Board.*** The president/chair of a nonprofit board should be a person of authority who is respected by the other board members, the organization, the staff, and the community and who has the time and other resources needed to complete the required work. Ordinarily, the president has previously served in several other board positions and is familiar with and informed about the mission and operation of the organization.

***(ii) Treasurer/Chief Financial Officer.*** The treasurer must be a person with financial experience related to the operation of nonprofit organizations. Accountants and business professionals are generally preferred for these jobs; however, many lack experience with nonprofits and may not be sensitive to the special needs and characteristics of financial management in this sector. It is most advantageous for these organizations to find a treasurer with nonprofit experience. Also, many accountants are lacking in training in cash and treasury management topics, due to a deficiency in most accounting curricula in colleges and universities. This shortcoming may be partially corrected as new accounting graduates take more finance courses to reach the revised 150-hour CPA educational requirement, although the majority of collegiate finance programs nationwide do not teach cash and treasury management topics (courses may be labeled "working capital management" or "short-term financial management"). In any case, ongoing education in nonprofit governance (financial and otherwise) should be included in any governance development initiatives.

In smaller organizations, the treasurer also serves as the CFO. (The role and responsibilities of the CFO are discussed more in section i, "Finance Function.") Quite often, as organizations grow, they split the board treasurer role from the CFO role. A qualified and dedicated CFO is a great asset to the organization and indispensable to the proficient financial management advocated in this book. As an example of this arrangement, notice in our example in Appendix 4A that "The vice president–finance shall serve as chief staff officer of the executive committee and chief financial officer of the foundation, and act as the foundation's secretary and treasurer."

***(iii) Secretary.*** The secretary must be well organized and able to record information accurately since this position is usually responsible for maintaining all records of the nonprofit, including the preparation of board meeting agendas and minutes. Since minutes serve as the official record of board deliberations and decisions, they must reflect the actual motions, who made and seconded them, and how they were voted. Board minutes are considered to be legal documents and are generally reviewed by independent CPAs during financial audits.

The secretary should draft the board meeting minutes and distribute them to board members in advance of the next meeting for review and correction, as necessary. After all corrections are noted, the board votes to accept the minutes and make them part of the corporate record. Their importance cannot be overstated because, when the minutes are approved, the board's action is official and binding.

**(c) BOARD COMMITTEES.** When a nonprofit organization reaches a certain size, its operation becomes more complex and its board may experience difficulty in meeting all of its responsibilities. When this occurs, the board may decide to pursue its work in smaller groups or committees, permitting a more detailed analysis of specific functions or areas, such as executive, finance, staff, development (or fundraising), investment management, property management, and planning. The role of these committees is to delve into the issues in their respective areas in a detailed way and to bring the results of these activities to the full board for discussion. The board may require a recommendation for action from the committee, based on its in-depth review.

Advantages of a committee structure are the division of workload and the promotion of a more informal discussion of the pros and cons of matters before the board. It also allows an organization to bring experts into the deliberation process without appointing them to the board.

In general, such committees should be chaired by a trustee or board member and have a majority of board members serving in combination with outside resource people and staff members, who are assets to the process.

The committees listed next are common in nonprofit organizations. The actual number of committees depends on the size of the organization.

- *Executive Committee*. Mandated to strengthen the efficiency and effectiveness of the governing board
- *Trustee Committee*. Reviews recommendations from the nominating committee and makes final recommendations to the board for new trustees
- *Development Committee*. Develops sound policies and tasks that support successful fundraising and related programs
- *Nominating Committee*. Identifies potential trustees for the board of directors and may also focus on getting people involved in the nonprofit organization (see also *Trustee Committee*)
- *Planning Committee*. Develops long-range strategic plans for the organization
- *Building and Grounds Committee*. Makes policy for the physical plant and addresses issues, such as deferred maintenance
- *Marketing/Public Relations*. Determines policy for how the organization will be marketed and presented to the public
- *Program Committee(s)*. Assumes general responsibility for one or more major events that may involve mobilizing volunteers to plan and work the event
- *Personnel/Human Resource Management Committee*. Sets human resource management policies

In schools, colleges, and universities, two additional committees are common:

- *Student Affairs Committee*. Deals with issues related to the welfare of students
- *Academic Affairs Committee*. Ensures that an institution's actions and policies reflect its priorities, mission, and character

We have reserved the three committees deserving most of our attention for last: the finance committee, the audit committee, and the investment committee.

***(i) Finance Committee.*** This committee determines how the board should oversee the fiscal operations of the institution most effectively. The finance committee is responsible for providing a detailed review of financial statements and audit reports, internal as well as external, and reporting the results to the board of directors. The committee also makes recommendations to the board on policy matters such as target liquidity, debt, and other issues related to the financial management functions of the organization. A competent, dedicated, and high-performing finance committee is key to the board meeting its fiduciary responsibilities. Finance committee members should be well versed in nonprofit financial matters and the financial affairs and standing of the organization.

***(ii) Audit Committee.*** The audit committee is responsible for overseeing audit functions of the nonprofit organization. A well-managed audit committee, which some argue should not be a board committee at all in order to ensure total independence, oversees regular audits of financial activities and adherence to laws and regulations and monitors the organization's conflict of interest policies. The wave of the future for nonprofits is now on the horizon in the form of Securities and Exchange Commission (SEC) rules for business audit committees. Pursuant to the charge given by Sarbanes-Oxley to develop improved audit committee rules, SEC rules include stipulations that the audit committee

- Must have "direct responsibility for the appointment, compensation, retention, and oversight of the work of the company's independent auditor… "
- May have the company pay for any experts or advisers that it determines are necessary
- "Is also responsible for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, as well as for establishing appropriate procedures to handle any anonymous employee complaints about questionable accounting or auditing issues"
- Be made up of truly independent members, meaning that no member may directly or indirectly (including through any family member) accept any compensatory fee related to consulting or advisory services[12]

Organizations such as the Red Cross have adopted Sarbanes-Oxley guidelines, even though they are not mandated for nonprofits (with the exception of whistleblower protection and document destruction). KPMG, a "big four" accounting firm, prescribes five "Basic Principles for Audit Committees," which are worthy of quoting:

1. Recognize that the dynamics of each organization and its board are unique – one size does not fit all.
2. The board must ensure that its audit committee comprises the "right" individuals to provide independent and objective oversight.

3. The board and audit committee must continually assess whether the "tone at the top" embodies insistence on integrity and accuracy in financial reporting.
4. The audit committee must demand and continually reinforce the ultimate accountability of the external auditor to the audit committee as the board's representatives of external stakeholders.
5. Audit committees must implement a process that supports their understanding and monitoring of the
   - Specific role of the audit committee in relation to the specific roles of the other participants in the financial reporting process (oversight)
   - Critical financial reporting risks
   - Effectiveness of financial reporting controls
   - Independence, accountability, and effectiveness of the external auditor
   - Transparency of financial reporting[13]

Related to the fourth point, the external auditor should report to the board through the audit committee.

***(iii) Investment Committee.*** Financial management and leadership constitute a series of sub-disciplines and investment management is a specialized discipline requiring specialized knowledge and skills. The investment committee should be created with this is mind. It develops strategies and guidelines to support the board's short-term and long-term investment programs. The investment committee is responsible for reviewing and managing all the organization's investments, developing or revising and gaining full board approval of the investment policy statement, ensuring full compliance with policies and guidelines applying to nonprofit organizations, and reporting its findings to the board.

An outstanding source of board information, with broad coverage of nonprofit organizational types, is BoardSource:

BoardSource
Address: 750 9th Street NW, Suite 650 Washington, DC 20001-4793
Phone: (202) 349-2580
www.boardsource.org

Three more important and useful printed resources geared to educational institutions are (1) "The Role of the Board Professional," on the roles and responsibilities of board members and committees, (2) "The Board's Role in Financial Oversight," and (3) "The Finance Committee." Each of these is available from:

Association of Governing Boards of Universities and Colleges (AGB)
1133 20th Street N.W., Suite 300 Washington, DC 20036
Phone: (202) 296-8400
www.agb.org

Exhibit 4.3 profiles a quick check on board effectiveness that you should use to evaluate your board's governance periodically – at a minimum every two years. Items 4 and 6 are financial effectiveness gauges. Item 4 may be measured by the degree of achievement of the appropriate liquidity target as well as the establishment of and board concurrence on a cash flow plan of 12 to 18 months that shows no impairment of that liquidity target. Item 6 suggests some comparison of benefits to costs for the various programs and services

Rating Scale: Agree Strongly (5); Agree (4); Agree Somewhat (3); Disagree Somewhat (2); Disagree (1); Disagree Strongly (0)

1. This organization's orientation for board members adequately prepares them to fulfill their governance responsibilities.
2. This board is actively involved in planning the direction and priorities of the organization.
3. The board does a good job of evaluating the performance of the ED/CEO (measuring results against objectives).
4. This organization is financially sound (viable and stable).
5. Board members demonstrate clear understanding of the respective roles of the board and ED/CEO.
6. The organization's resources are used efficiently (good value for money spent).
7. The board has high credibility with key stakeholders (e.g., funders, donors, consumers, collateral organizations or professionals, community, staff).
8. Board members demonstrate commitment to this organization's mission and values.
9. Board members comply with requirements outlined in key elements of the governance structure (bylaws, policies, code of conduct, conflict of interest, traditional/cultural norms, etc.).
10. The board's capacity to govern effectively is not impaired by conflicts between members.
11. There is a productive working relationship between the board and the ED/CEO (characterized by good communication and mutual respect).
12. I am confident that this board would effectively manage any organizational crisis that could be reasonably anticipated.
13. Board meetings are well-managed.
14. The board uses sound decision-making processes (focused on board responsibilities, factual information, efficient use of time, items not frequently revisited, effective implementation).
15. This organization has a good balance between organizational stability and innovation.

Total of the 15 items

Overall Score (Total divided by 15)

*Source:* Mel Gill, Robert J. Flynn, and Elke Reissing, "The Governance Self-Assessment Checklist," *Nonprofit Management & Leadership* 15 (Spring 2005): 271–294. Based on the 32 organizations the authors studied, the mean overall score was 4.06, out of a possible maximum score of 5.00, with a standard deviation of 0.3. The authors also administer a proprietary instrument that has 144 different questions; the 15 items included here correlate highly with those 144 items, and represent the items in the board literature that are especially linked to effective board governance. Used by permission.

**Exhibit 4.3** The Governance Effectiveness Quick Check delivered, not merely balancing or running a slight surplus in the budget. Additionally, one might compare costs element increases, year over year, to the inflation rate for that year (as measured by the CPI: specifically, gather the number for the Consumer Price Index for All Urban Consumers [CPI-U] for the US City Average for All Items, 1982–84=100; select the first check box at http://data.bls.gov/cgi-bin/surveymost?cu, then select “Retrieve Data.”).

**(d) EXECUTIVE DIRECTOR/CHIEF EXECUTIVE OFFICER.** The character of every nonprofit organization is largely determined by its executive director/chief executive officer, who speaks for the organization publicly and hires the staff who deal with the organization’s constituents on a daily basis. Because this position is crucial to the nonprofit, the selection process should follow the next guidelines:

- Board members should agree on the kind of person they are seeking, the special qualifications desired, and their expectations of the executive director prior to the actual selection.
- The board must outline everything that needs to be accomplished by the ED/CEO in managing the day-to-day operations of the nonprofit organization by responding to these four questions:

    **1.** What tasks are being performed now, and are they necessary?
    **2.** What tasks are not being performed now that should be?
    **3.** What new activities are being added that will require additional work?
    **4.** What specific tasks are required to accomplish the new work?

The ED/CEO is charged with reviewing and understanding the financial operations of the nonprofit organization as part of his or her overall responsibility for day-to-day operations.

The ED/CEO should appoint individuals who are responsible for various components of financial management, such as internal control, reviewing the financial statements, and monitoring all of the financial details in the organization to ensure their accuracy and integrity. She or he should ask questions until satisfied that answers make sense and are in sync with the mission and related activities of the organization. Individuals with these responsibilities will be held accountable.

**(e) STAFF.** The ED/CEO is responsible for hiring the staff. Before doing so, he or she must determine the tasks to be performed and distribute them among the salaried employees, volunteers, independent contractors, and outside service providers. The best workforce mix is one that achieves the organization’s mission in the most effective and efficient way. Usually a number of configurations will achieve the goal, and each has its own set of advantages and disadvantages.

In addition to financial support functions for the board, assistance from the financial function is needed to support the staff program managers and operational directors in their financial responsibilities. We consider separately the program/fund managers, marketing director, development director, and strategic/long-range planning staff.

***(i) Program Managers.*** Program managers are responsible for the financial management functions of their programs including budgeting and expending resources and raising funds for their programmatic activities as well as the delivery of the program as a whole within the organization.

The treasurer/CFO helps program managers by providing the financial and nonfinancial information needed to develop and maintain their programs. The treasurer is also responsible for sharing interrelated program information that can be used to benefit the entire organization.

Financial operations and expertise play an integral role in a number of other critical functions within the organization. Some of these contributions and interrelationships are discussed later.

***(ii) Marketing Director.*** The financial and marketing functions of an organization are separate and distinct. According to one leading scholar in marketing, a marketing professional uses research and understanding of the client to develop an offering to meet the client's needs in a way that the client would value, communicates this to the client, and offers it to the client at the proper time and place. Proficiency in doing this means the marketing staffer has a keen understanding of the service and the organization delivering the service. Applied to donor marketing, marketing involves knowing the various ways in which gifts can be made and selecting the best alternative for each potential donor. The main marketing function of the CFO in this context is to assist in the crafting of a convincing case statement on the best vehicle for making a gift.

In an organization that has a separately identified marketing director, this marketing director is concerned with making the services of the nonprofit organization attractive to the client, developing client awareness, distributing information to stimulate new clients and contributions, and designing programs to attract new constituencies. The financial function is responsible for ensuing money flows.

The financial function serves the marketing director by providing information and services needed to determine a final marketing budget. Finance also assists in pricing programs, products, services, and contract offers to be presented in the marketplace, in developing effective fundraising strategies, and in helping to construct valid fundraising effectiveness analyses after the fact.[14]

***(iii) Development Director.*** Most nonprofit organizations also have a development function which includes one or more of these types of fundraising: annual campaigns, grant writing for corporate and government grants, special events, capital campaigns, planned giving, endowment campaigns (if separate from annual or capital campaigns) and donor relations. Organizational alignment and efficiency depends on a good working relationship between the development director and the finance director. This sounds good, but in practice it requires a lot of communication and learning across both disciplines.

Development and finance have different views on gift recognition, pledges, income projections, and expectations about performance. Finance directors naturally have a more compliance-based approach to these matters where development directors operate more on relationship development. These behavioral concerns can be overcome through tightly coordinated activities, a close working relationship where assumptions are explicated, and where trust is established.[15]

***(iv) Strategic Management/Long-Range Planning.*** Planning for the future is critical to the success of a nonprofit organization. We profiled the growing role of the finance function in assisting in the strategic thinking and planning process in Chapter 3, and we cover long-range planning in Chapter 9. CFOs are typically called on to be internal business consultants because of their ability to analyze situations and to perform numerical and financial analyses. By providing *accurate* information that is *useful*, the finance staff becomes more highly valued by other organizational units. For an example from the business world, Intel's CFO asks participants from outside finance to evaluate the contribution the finance area has made in strategic decisions after those decisions have been made; if that contribution is equal to 25 percent or greater, that is considered "on target." Arbitrary? Unquestionably. A good first step toward ensuring finance's strategic contribution? Absolutely.

Businesses now expect their CFOs to (1) understand the markets their companies work within, (2) take part in general management, (3) help construct business strategy, and (4) work hand-in-hand with operating personnel.[16] These attributes apply equally to educational and healthcare organizations, and if we restrict the markets in (1) to "labor markets" and "donor markets," all four attributes may be applied to any nonprofit CFO. A key finance educator role for any CFO includes helping all employees understand that tying up funds has a cost, and that the lost interest revenue or added interest expense reduces the organization's net revenue. Just as importantly, using these funds impairs the organization's liquidity position. Explaining how other staffers' decisions affect cash flow is an ongoing task for finance staff.

Every organization needs to be financed before it can accomplish its mission, and nonprofits are no exception. Programs have short-, mid-, and long-range financial needs to be used for salaries, benefits, supplies, travel, space, furniture, buildings, and other resources. Nonprofit organizations raise the money to support their activities through strategic, financial, and programmatic planning.

**(f) VOLUNTEERS.** Volunteers are a source of uncompensated labor that can be extremely useful to the nonprofit organization. The process of recruiting, training, and retaining volunteers is complex, and volunteer interaction with paid staff must be handled with care. Many nonprofits would be unable to function without volunteers, who want meaningful responsibility. Smaller organizations often rely on a volunteer treasurer to serve as the organization's CFO. A volunteer may also do the bookkeeping/accounting work in the nonprofit. Unpaid interns (or interns paid by a third party) from a local college or university may gain valuable work-related experience while providing the organization with assistance on financial data entry, reports, and receipting and other record keeping. Providing ways to reward and recognize volunteers is one of the significant challenges of the nonprofit organization calling for a professional approach to volunteer management.

**(g) INDEPENDENT CONTRACTORS.** Independent contractors are often retained to perform work for the nonprofit organization because they have special expertise that is not available in existing staff, provide that expertise at a cost lower than hiring additional long-term staff to fill a short- to medium-term need, enable organizations to focus on core activities, and increase organizational flexibility.

Outsourcing to independent contractors initially began as a strategy used solely by large corporations, but the practice has become widespread among organizations of all types and sizes. Services commonly outsourced include payroll, taxes, employee benefits, claims administration, investment services, graphic services, organizational restructuring, and organizational development. Accounts payable, remittance processing, and new donor development are areas in which outsourcing is growing. There are organizations that actually take this to the level of using outsourced CFOs, sometimes labeled "rent-a-CFO."

**(h) CONSTITUENTS.** Constituents are responsible for requiring and reviewing financial reports and asking the right questions. They also have a fundraising role which includes making contributions of time and money as well as using their networks to provide additional support of all kinds to the organization. Some define their constituency as any stakeholder of the organization. It is very common for private school or college faculty, staff, and administrators to join board members in giving to annual or capital campaigns.

### (i) FINANCE FUNCTION.

***(i) Chief Financial Officer.*** In larger organizations, the CFO is typically responsible for selection of those assigned responsibility for the day-to-day financial operations. In midsize organizations, the finance chief may carry the title of controller, with a large accounting and reporting focus. In smaller organizations, the CFO may have the title of business director or finance director, and must perform many of the finance-related functions rather than delegating them and also perform some responsibilities not normally considered to be part of the finance function. In the smallest organizations, there may only be a bookkeeper or accountant, possibly only part-time (or outsourced or volunteer), and the board treasurer must wear the CFO hat.

Adding a CFO as your organization grows involves adding a significant, fixed expense. Before doing so, your organization will likely move down a path involving these phases, according to Thomas McLaughlin:[17]

1. Do-it-yourself, in which you are the ED/CEO and the bookkeeper as well. (We note here that as many as one-half of nonprofits in the United States are all-volunteer organizations;[18] the difficulty of getting a separate person to volunteer to handle the financial affairs and bookkeeping implies that the founder and/or ED/CEO of the organization will have these responsibilities.)
2. Do-it-yourself with a bookkeeper. This individual will help you set up a "real accounting system" and is best contracted for as an independent contractor, not an employee, and works part-time in this bookkeeper role.
3. Part-time accountant working a few hours each month. Your organization might have several employees working for it at this point and perhaps gaining a few grants.
4. Retain an audit firm.
5. Hire a chief accountant.
6. Hire a chief financial officer (CFO). This person should be committed to your organization's mission, possess a high skill/competency level, as well as be adept at communicating financial data. This person will also be able to help you and your other managers discern the financial implications of major decisions. This person may have worked his/her way up from part-time accountant to chief accountant to CFO (see #3 and #5 above).
7. Senior vice president of finance. Tends to be found in an established organization, joined by other members of a strong executive team, and piloting a complex funding system (business model).

The migration through these phases cannot be pinpointed to a certain number of months or years, but is more closely based on the growth of the organization and the complexities of managing financial matters. Once you get a CFO or senior vice president of finance, you will want that individual to possess these attributes, ideally:

- training and experience in financial management (including basic elements of treasury management), generally accepted accounting principles, and internal control systems;

- knowledge about the organization's mission and programs and their relationship to financial requirements and components; and
- technical expertise and procedures for developing budgets and preparing financial statements.

We next detail the CFO's role and activities, noting the differences in small and large organizations.

**1.** The role of the CFO in nonprofits is to:
   - Make and enable others to generate prudent and appropriate decisions regarding program and asset investments.
   - Safeguard financial and other assets.
   - Arrange for financing and provide helpful evaluation for fundraising efforts in support of the mission.
   - Optimize the level and uses of cash and other forms of liquidity.
   - Help ensure that funds providers' wishes are honored.
   - Report financial results.

**2.** The CFO is traditionally responsible for these activities related to that role:
   - Maintaining financial records
   - Preparing timely, meaningful, and accurate financial statements
   - Budgeting
   - Safeguarding organizational assets
   - Providing effective internal controls
   - Complying with external reporting requirements
   - Anticipating financial needs through development of cash budgets, capital budgets, and long-range financial plans
   - Reacting to operational changes that affect finances
   - Maintaining appropriate communications with the ED/CEO and board of trustees/directors[19]

**3.** In the small- to medium-size organization, these roles are often expanded; for example, in a private school or college they may include such activities as:
   - Fundraising
   - Management of physical plant
   - Building planning and renovation/expansion project management
   - Information technology (including cyber security)
   - Food service management
   - Theater management
   - Human Resource Management (HRM)

**4.** All these functions, and more, have impacts on the finances of the institution and are required to meet the institution's volunteers' expectations and its mission. Much depends on the size of the nonprofit organization and on the skills of the individual in the position. There is no single best way to distribute functions to finance staff members. These assignments should be constantly evaluated and changed when it makes sense to do so. In large organizations, many of the responsibilities are delegated to a controller or accountant.

**5.** The role of a CFO in today's nonprofit corporations is in a constant state of flux. Over the past two decades we have seen these developments for this position:

- Operational expertise is one of the primary criteria in the selection process.
- Skills in interpersonal communication, influencing others, and related areas have become as important as technical skills.
- Principles and values are used to define appropriate standards of behavior and the finance function in the organization.
- While numerical integrity and the corporate audit process remain a priority, there is an increased emphasis on employee empowerment and softer controls (although this has been offset somewhat by Sarbanes-Oxley initiatives) as long as employees understand that a level of control is needed and does not constitute a negative reflection on their integrity or capabilities.
- Empowerment has implicit boundaries and demands greater responsibility and accountability.
- Finance people transcend their functional identities within the organization by serving as key participants in teams engaged in addressing multifaceted organizational problems. This is a key management strategy as finance people bring analytical skills and organizational knowledge that are sometimes lacking in program or development staff.
- Remaining competitive in today's global market requires internal and external information sharing and the development of systems to empower people with the information they need.
- While cultural change is most effective when it begins at the top of the organization, the finance function may serve as a catalyst because it interacts with every other function. The finance function may also initiate cultural change in organizations experiencing financial difficulty.
- Finance people play an integral role in organizational decision making and focus their efforts on finding creative solutions to issues and problems.
- Organizations depend on finance people to clarify the business impacts during every step of the planning and budgeting process and to act as advocates rather than merely naysayers. While finance people have compliance responsibilities, they also have knowledge that is useful in many other situations in a nonprofit organization. Their early involvement in the decision-making process prevents unnecessary surprises.
- Beyond providing financial reports, the CFO should present to the ED/CEO and board a balanced picture of what is happening, where the problems lie, and what actions need to be taken. The person in this position is also responsible for working with program heads in order to represent their interests and explain the story behind the numbers. It is not a stretch to call the CFO a "financial educator." This calls for enhanced communication and relational skills.

- ○ The finance function (in larger organizations) is largely decentralized and matrix managed (e.g., use of multidisciplinary project teams with a finance representative along with individuals such as a program director and someone from the fund development office).[20]

Over the coming years, Tom McLaughlin expects these developments:

- More equality in ED/CEO and treasurer/CFO roles because of the growing insistence by government forces (especially IRS and state attorneys general) to have accurate and reliable IRS informational tax returns (Form 990); there seems to be a bit less distance between CEO and CFO types, quite often
- A respectful distance that grows between the ED/CEO and treasurer/CFO as the ED/CEO requires assurance of financial report integrity and accuracy and as the finance person adheres more and more to professional (such as CPA or CTP) behavioral norms; however, when there is a sudden departure of an ED/CEO, the CFO often temporarily steps into that role, implying there has been a tacit acknowledgement of the CFO's unspoken "number two" role
- More technology focus for the CFO (and staff treasurer, if there is one) because of growing insistence and possible ensuing legislation regarding electronic financial control standards and the need for the finance director to document effectiveness and accuracy of electronic financial information flows; there appears to be an emerging assumption that technological proficiency and involvement constitutes an increasingly important role for the CFO
- More emphasis on long-range strategic input and analysis (documented in Chapter 3 of this book)[21]

Financial managers find their position increasingly important and more complex in today's nonprofit environment. Several developments explain why:

- Increased role for the CFO in strategic initiative evaluations
- Reduced governmental grant or aid provision, necessitating alternative revenue development and/or cost reduction
- Increased competition for donor dollars and "donor fatigue," accompanied by increased demands for accountability regarding efficiency and effectiveness
- Increased availability of new financial instruments, enabling risk management to better contribute to fiscal stability
- Enhanced information technology and increased opportunities for automation, such as electronic information and cash management systems, with a proper emphasis on using these developments to make better decisions on a timely basis – with many nonprofits housing (locating) the information technology (IT) function in the finance office
- Related to the IT revolution, the increased harnessing of information to create and maintain competitive advantage and further mission accomplishment for the nonprofit
- Increased ability of CFOs to document proper control over information flows

Notice the common thread running through each of these forces – information: information about the impact of proposed strategic initiatives on the organization; information about the decline of traditional revenue sources and the availability of alternative revenue sources; information about cost-reduction opportunities; information provided to present and potential donors; information-producing and processing technologies; information provided to program directors and senior management; information security; and the harnessing of information to expand the organization's programs, flexibility, and resourcefulness. Information gathering and dissemination must be coordinated, and the financial and accountability structures enable the nonprofit to do just that. In other words, these structures are not only for cash-flow management but for information-flow management as well. Using IT tools, particularly the newer cloud-based software services, enables one to meet both objectives simultaneously.

Information management is also a cornerstone of a turnaround strategy in struggling organizations. Business turnarounds have CFOs engage in these practices, which can be adapted to the nonprofit situation:

- *Shift the information mode*. Involve operating managers in financial analysis and reporting so that they will acknowledge financial problems usually brought to their attention by the CFO and so that they have a better feel for the implications of the financial information (financial leadership).
- *Improve the reporting system*. Making small, hardly noticeable changes to the information system may conserve financial resources at this critical time, while providing faster and more accurate operating and financial data.
- *Communicate with candor*. Since employees, donors, clients, and suppliers will learn the truth sooner or later anyway, gain support of the stakeholders by publicly working through the difficulties, enhancing your chances of success as you gain support of critical constituencies.
- *Form a "tiger team" in larger organizations*. This small, motivated group of middle managers can make suggestions and help implement them; it should focus on major plans and permanent solutions, not quick fixes.
- *Be creative in tapping sources of cash*. Tax refunds, restructuring of bank debt, asset-based financing (e.g., selling receivables), negotiating with suppliers, aligning with sympathetic donors or customers, and selling off idle assets are all sources of cash in tight times.
- *Enlist employees' aid*. In difficult times, employees may be enlisted to accept work rule changes, temporary compensation reductions or deferrals, or benefit reductions.
- *Protect earned income and grant and fundraising sources*. It is tempting to engage in across-the-board spending reductions, but this may be tantamount to a high-tech company eliminating its research and development budget: Maintain or even increase your investment in revenue-augmenting activities.
- *Eliminate or automate administrative functions*. Assuming you have already done everything possible to reduce overhead expenses, look for administrative functions that may be trimmed or eliminated: using outside fundraising counsel and out-sourcing payroll are two examples. A key question is whether volunteer resources are already doing some of these tasks, or whether they are required.[22]

Recapping this section, the financial manager may have any of a number of formal titles. In smaller organizations, the person holding the title "finance director" or "director of finance" often holds a part-time position, sometimes voluntary. That individual is often also the CEO/ED. In larger organizations, the finance director or treasurer may make many of the financial policy decisions, with executive director guidance and agreement and board committee or entire board approval.

| Controller's Role | Treasurer's Role |
|---|---|
| Financial Accounting | Capital Budgeting |
| Operating Budgeting (shared) | Long-Range Financial Planning |
| Financial Reporting | Cash Management (including forecasting) |
| Payroll | Bank Selection and Relationship Management |
| IT | Tax Management |
| Payables | Fundraising |
| Receivables | Employee Benefits |
| Audit and Internal Control | Pension Fund Management |
| Regulatory Compliance | Insurance and Risk Management |
| | Foreign Exchange |
| | Investing |
| | Borrowing Capital |
| | Operating Budgeting (shared) |
| | Strategy Involvement |

**Exhibit 4.4** Controller's Function Versus Treasurer's Function

***(ii) Treasurer's Office and Controller's Office.*** In larger organizations, separation of controllership and treasury functions is possible and desirable. The structure might result in the organizational chart in Exhibit 4.4.

Some of these areas, such as capital budgeting or IT, can be found in either the controller's office or treasurer's office, depending on the organization's preferences. There are two noteworthy differences in the focuses of the two offices: (1) the controller's office assumes responsibility for most of the bookkeeping, reporting, and compliance issues; and (2) the treasurer's office handles most of the areas requiring management decisions, such as when and how much money must be raised (this timing and amount determination may be delegated to and surely is executed by the development office); how to best manage cash inflows, mobilization, disbursement, and forecasts; how to invest pension funds and manage those funds (or who will do the investing, if outsourced); whether to self-insure risks, which bank(s) to use and how to compensate the bank(s); which capital projects to accept; whether to hedge foreign exchange exposure; and whether a fundraising event provides enough additional revenue to repeat it, even when taxes must be paid on the net revenue. Our useful oversimplification is then:

- *Controller's focus*: Get the financial numbers right and conserve the organization's resources.
- *Treasurer's focus*: Plan, increase, and manage financial resources

Many organizations deviate from the just-described organizational structure in two significant ways:

1. The organization may try to combine the controller and treasury functions into one office.
2. The organization may divorce fundraising from the finance function altogether.

Apparently, organizations view fundraising vis-à-vis finance in the same way a business would view marketing and finance. However, finance may aid and help evaluate the fundraising function, which is typically housed in a "development office."

*Why not* consolidate the controller's and treasurer's offices? In smaller organizations (up to $1 million in annual revenues), it is necessary to combine the controller's office and treasurer's office. However, larger organizations that merge their activities often end up with a "second-best" setup that does not allow the organization to work at its full capacity. There are eight reasons why combining the offices, while commonplace, puts larger organizations at a disadvantage:

1. The control focus ends up dominating, leading to ever-stronger financial reporting and internal control (e.g., use of internal auditors), and more detailed financial reports.
2. The "reports in search of a user" phenomenon may surface; conciseness is sacrificed for level of detail, with no improvement in usefulness. Very few of the reports are true management accounting outputs, such as break-even analyses. Operating personnel may receive larger and more frequent requests for data and explanations to feed the exception reporting (variance analysis) process. On the positive side, management may gain a better idea of corrective actions to take, and there may be more protection against employee fraud.
3. The treasury function invariably suffers, as financial management tasks are important but less urgent than getting the monthly, quarterly, and annual statements compiled, and keeping up with recurring grant reporting, payroll, and payables tasks.
4. Capital projects that place ruinous financial burdens on the organization are approved.
5. Planning is sacrificed in favor of overemphasis on financial reporting and auditing. The problem area is not so much budget development, except to the extent (1) budgets are not linked to carefully developed long-range strategies and plans, and (2) the budget development and approval cycle is too long. What suffers is long-range financial planning (see Chapter 9).
6. Short-term financial management (treasury management) areas suffer from benign neglect: Cash management procedures are outdated and inefficient, bank relationships are never reevaluated and rebid (costing anywhere from $1,000 to $200,000+ in unnecessary fees annually), idle funds are left in noninterest-bearing accounts or accounts paying well-below-market interest rates.
7. Risk management is overlooked due to inadequate time and expertise: Interest rate and exchange rate exposures go unhedged, and the organization overpays for or has inadequate insurance coverage.
8. Financial investments are made in inferior or inappropriate vehicles: Some organizations invest in overly conservative vehicles, short-changing employees due to underfunded and/or inadequate pension fund coverage for its employees. Other organizations have invested in extremely risky mortgage-backed securities because they did not have the in-house expertise to evaluate these investments and have not retained outside counsel.

Why do so many nonprofits suffer from these easily avoidable predicaments? *One of the main reasons for the consolidation of controller and treasury functions is the selection of* *accountants for the CFO position.* This strengthens the bookkeeping and financial reporting aspects and possibly regulatory compliance. The emphasis in academic accounting programs at colleges and universities in the United States is financial reporting. However, due to separation of accounting and finance in the academic world, accounting students get very little financial management training—many accountants have had only one finance course, and it was geared to business financial management. The result? The graduates of these types of programs rarely get any training in the financial aspects of cash management, banking selection and relationship management, receivables management, investments, borrowing, or pension or endowment fund management. The expectation seems to be that they will learn these functions on the job.

Because of the historical inattention to the treasury function, additional guidance will be provided regarding what treasurers can contribute. Birkett and Sharpe have identified five treasurer competencies in the corporate sector, which provides a checklist for you to evaluate your own organization. These competencies and our added commentary for nonprofits' unique situations are provided in Exhibit 4.5.

A visual and compelling argument for moving beyond accounting/reporting/control overemphasis and bringing treasury staff and expertise and financial management proficiency onboard has been developed by Kaufman, Hall and Associates and is shown in Exhibit 4.6. This framework, shown in Panel A, portrays our Chapter 3 financial leadership emphasis as well as this chapter's emphases on CFO as financial educator, strategic business partner/consultant, and liquidity captain (or "Chief Liquidity Officer"[23] when there is not a salaried treasurer on staff). While this graphic is particularly applicable to budgeting and financial planning, we see it as applicable to most financial decision-making and financial management activities. In the second panel of Exhibit 4.6, Panel B, we have taken the strategic leadership role graphic, combined it with Charles Kim's take on what he sees in practice, and then inserted our own thoughts. The "Strategic Partner" role (Quadrant 4) is an aspiration for all nonprofit CFOs in our view. It is a long-term climb for a finance director in a young and small nonprofit, but gives a goal for which to strive.

Charles Kim of Kaufman, Hall and Associates pinpoints the broader role that the CFO (or finance director) at colleges, and we believe all nonprofits, must play to be an indispensable member of the mission-centric leadership team:[24]

> In this complex business environment, senior finance professionals are on the front line and will need to add a strategic role to existing operating relationships. The demands will be great as they are expected to shift from a focus on revenue planning toward an emphasis on expenditures, cost modeling, and benchmarking. They must be advocates for finding resources to support the institution's strategic plan while ensuring ongoing dialogue about financial implications and realities. They also must continue to be involved with the strategic plan at the institutional and program level, helping faculty and staff assess the ongoing feasibility of budget requests. "(W)hen the world changes around you and when it changes against you—what used to be a tail wind is now a head wind—you have to lean into that and figure out what to do because complaining isn't a strategy." (Jeff Bezos)

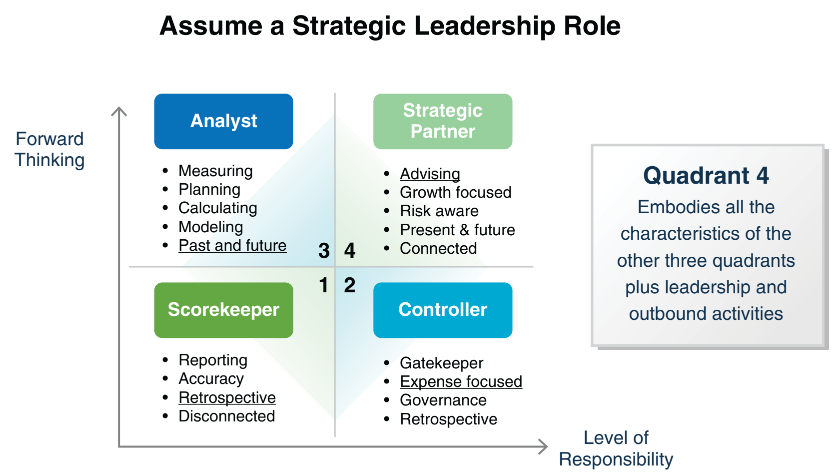
***(iii) Financial Function: Service Center or Profit Center?*** Traditionally, departmental or other units in the organization have been identified as responsibility centers. Managers are then held responsible for the results of their units. This generally meant that departments were considered cost centers or service centers, although some organizations also designated some units as profit centers or investment centers. The distinction has to do with what the unit has control over and responsibility for. Cost or service centers cannot generate

| Competencies | Nonprofit Implementation |
|---|---|
| **1.** Must understand domestic and international financial market institutions, processes, linkage to governmental economic policies, and the legal/regulatory environment | **1.** Engage in a study of interest rates and foreign exchange rates (if have global operations), and how changes in them affect your organization's statement of activity and statement of cash flows. Recognize the linkage of gross domestic product (GDP) and your donors' local economies with your donations and earned income. |
| **2.** Must understand how financial instruments and financial markets are shaped by the legal environment | **2.** Study the trends in nationwide banking and electronic payment methods. Project their impact on your cash collections (e.g., of mailed donor checks) and your methods of paying bills and collecting funds. Conduct a feasibility study of electronic debits for donor remittances and as a means of stimulating donor retention and upgrading. |
| **3.** Must understand how investment and financing interrelate | **3.** Projected financial statements are the key here. Your financial needs are closely linked to program expansion, and the projected statements will depict this clearly. Statements to forecast: the statement of activities and statement of (financial) position to start with, then add the statement of cash flows. The cash flow statement will show to what degree operational surpluses fund investment needs, negating the need to borrow money. |
| **4.** Must understand the strategic aspects of the organization's activity, and how strategy links to the organizational structure and management processes | **4.** Revisit your organization's mission statement to start with. Is it still applicable? If not, revise it. Then, convene the board and top management to detail strategies (see presentation in Chapter 3). Consider how to build organizational structure to facilitate the implementation of your strategies. Is bureaucracy the best approach, or should participative decision making be facilitated with a flat organization? |
| **5.** Must possess the necessary intellectual and instrumental skills for carrying out treasury activities | **5.** Hire carefully for both top-level and support staff. Then, train and empower, providing resources necessary to carry out the responsibilities professionally and efficiently. Provide training at regional or national Association for Financial Professionals conferences. Provide the technology infrastructure (primarily PCs and cloud-based systems) to financial personnel. |

*Source:* Competencies in the left column are from W.P. Birkett and Ian G. Sharpe, "Professional Specialisation in Accounting VIII: Treasury," *Australian Accountant* (February 1997): 49–52.

**EXHIBIT 4.5** TREASURY PROFESSIONAL COMPETENCIES

Panel 1




Panel 2

| **Characteristics of Role:** | **Nonprofit Benefits From:** |
|---|---|
| Treasury Analyst (or Financial Analyst) | <u>Relative to Scorekeeper:</u><br>**1.** Provides valuable metrics.<br>**2.** Plans cash and target liquidity for short-term and long-term.<br>**3.** Calculates financial ratios and provides implications.<br>**4.** Models benefits versus costs and returns versus investment amounts while providing visibility into cash and cash flow effects.<br>**5.** Informs development function of its financial efficacy.<br>**6.** Informs present and future by comparing to past.<br>**7.** Informs of relative cost coverage of programs or product lines, along with needed subsidy from development or earned income. |
| CFO as Strategic Partner | <u>Relative to Controller:</u><br>**1.** Not so focused on costs/expenses.<br>**2.** Brings risks into picture.<br>**3.** Internal business consultant.<br>**4.** Interacts more with nonfinancial executives.<br>**5.** More focused on cash and liquidity versus accrual-based results.<br>**6.** Sees big picture of financial investment, capital investment, and financing cash flows.<br>**7.** Focused on mission- and program-outcome achievement. |

*Source:* Panel 1 from Charles Kim and Tony Ard of Kaufman Hall. "Financial Outlook: 2018 Report for Higher Education," webcast, November 29, 2017.  Used by permission. Panel 2 developed by authors.

**Exhibit 4.6** Treasury Analyst and CFO as Strategic Partner revenue directly, so they are held responsible for the level of cost they incurred. They are doing something necessary for the organization's survival but are consuming scarce resources, which must be conserved. The telecommunications area in a private school or college would be a cost center. "Physical plant" or "buildings and grounds" activities function as cost centers in most organizations.

To control costs, manufacturing businesses determine benchmarks (standard costs) for labor and material, which indicate costs on a per unit basis. The benchmark cost of a unit of output is often based on time studies or engineering estimates. It represents what the cost of production should be under attainable good performance, and thus serves as a basis for measurement or comparison.[25] Cost overruns are then identified, the cost or service center made aware of them, and the manager of the cost or service center is expected to implement corrective action(s).

If the unit also generates revenues and has a high degree of control over the amount of revenue generated, it may be treated as a *profit center*. Net revenues are then the focus of periodic evaluations. A copy center at a college is an example. An *investment center* is held responsible for net revenues *and* the amount of resources (usually measured as assets) used by the area. Think of its results as "return on investment."

Why discuss profit centers in a book about nonprofits? Because there is some disagreement over whether the treasury area in either a company or a nonprofit should be treated as a profit center. Advocates argue that it is legitimate to assume that the treasury department can be held responsible for net interest revenue. First, note the calculation of net interest revenue:

Net interest revenue = (interest revenue − interest expense)

Investments generate interest revenues, while amounts borrowed result in interest expense. The treasury area controls interest revenue by choices on short-term versus long-term investments, the instruments chosen for investment, and the interest rates earned (see Chapter 12). Treasury controls interest expenses by their choices on amounts of short-term versus long-term borrowing, the degree of utilization of credit lines, and the interest rates negotiated when borrowing money. Therefore, the argument is to hold the treasurer's office responsible for net interest revenue, particularly in an investment foundation or endowment.

The counterargument is that treasury should be a service center. Proponents of this idea are concerned that the treasurer will take undue risks by investing in inappropriate instruments (such as the now-infamous Orange County bond-and-derivatives debacle that landed the County in bankruptcy) or simply not arrange enough financing. It also is argued that treasurers cannot control the overall level of interest rates earned or paid. The service center approach has been the accepted approach for most nonprofit treasury operations to date.

Profit center advocates' rejoinder is that (1) the investment policy controls risk, and (2) the absolute level of net interest revenue may not change much because investment and borrowing rates move up and down together.

There are reasons for and against the profit center approach to treasury management. As a profit center or a service center, the function should maintain accountability so that idle funds are invested and prudent risks are taken to enhance returns. Normally, the service center is the most prudent, but for conduit organizations such as investment foundations, a profit center approach is defensible.

*Focus on activities.* Nonprofit organizations may not be able to develop standard costs, but they may still *estimate* what good cost performance on an *activity* should be. Using a three-pronged approach, your organization can find innovative ways to increase contributions and accomplish its mission for less cost instead of using the current period's performance as a barometer of success:

1. Tackle the fundamental problems and eliminate "nonproductive structured cost."
2. Redesign services, activities, and business processes to reduce cost.
3. Make major improvements in effectiveness.[26]

Organizations should focus on streamlining business processes and activities and managing and reducing the *workload,* not just the workforce. Other fundamental activities include asking clients' and donors' advice, continually improving every process (e.g., donor communications), eliminating wasteful activities, reducing workload in each area where feasible, classifying items as utilized or unutilized (as opposed to fixed and variable cost splits), and controlling the process instead of the results. Involving the individual who performs the activity means one is able to tap that person's expertise. Wherever possible, set a target as a minimum level of performance. What may be the most important idea, and most challenging, is to focus on outputs and outcomes, not inputs. While outputs and outcomes are difficult to measure and quality is complex, effort should be made to quantify outputs and outcomes where possible. Automate, simplify, and computerize processes wherever possible to reduce human error and mistakes.

*Correctness of your cost analysis.* Evaluating cost center performance depends closely on a correct appraisal of costs. An example of mistaken cost analysis is the evaluation of fundraising events. Are all of the costs incorporated into the evaluation? Quite often, even in organizations that computed and reported the event's net revenue (revenue less expenses), the cost of staff time and services necessary to put the event on was not included in the expense total. Instead, only rent, music, food, and prize expenses were considered.

Let us consider another activity: paying a supplier's invoice. The activity cost includes all resources used (e.g., people, equipment, travel, supplies, computer systems) in paying that invoice. The cost of the process of "payables" would be narrowed down to the cost per invoice paid. Quality, cost, and time would be looked at jointly, so as to prevent a myopic cost-only approach to managing the payables function. Always look for a measure that should capture costs directly for the particular activity you are studying. "Per invoice" works well as the key measure for payables. The activity focus enables one to spot "cost drivers," in which you identify a root cause or an earlier activity that has a great impact on an important activity's cost, such as the processing and payment of an incorrect invoice. Identification of these cost drivers can lead to prevention rather than costly rework. One is always on the lookout for non–value-added cost, which means some amount above the minimum amount of time, supplies, or space absolutely essential to add value to the organization.

So how does this "activity management" approach differ from traditional cost accounting? When each organizational unit accumulates costs by cost category and controls costs on this basis, we have traditional cost accounting. When costs are accumulated and controlled by activity, we have progressed to activity-based management. Partially processed "works-in-progress," such as opened but undeposited donation checks, or invoices that have not been sent out, tie up funds that would otherwise be available.

***(iv) How Can Finance and Accounting Activities Be Evaluated?*** Consider the finance and accounting function and the activities it is involved in. Effective organization of that function can reduce waste and provide impetus to the rest of the organization to engage in activity analysis. For example, the accounts payable area engages in these activities: answering inquiries, receiving invoices, and paying vendors. Calculating a cost per activity for each of these is a logical starting point for more effective management of the payables area. "Cost per bill paid" is one such measure. Similarly, the payroll area collects/maintains employee data and issues checks. Those two activities provide a logical focus for cost analysis and cost management.

**(j) INTERFACE OF CFO WITH CEO.** Close and regular communication must take place between the CFO and the CEO. As partners in the overall management of the organization, a good working relationship is also vital. As a strategic business partner and internal business consultant, the CFO is an important part of the CEO's support team. The CFO is also in the best position to question assumptions as well as to rein in a free-spending culture where it exists.

**(k) INTERFACE OF CFO WITH THE BOARD.** Occasionally the CFO is an *ex officio*, non-voting member of the board of directors. In all organizations, the CFO should serve as a financial advisor, financial educator, and sounding board for the directors. Well-run non-profits have CFOs whose board-facing role is not merely dumping financial reports in the lap of the board treasurer and disappearing until the next meeting's reports are due. Explaining what the numbers mean, why they are at these levels, and what possible means the organization may pursue to achieve and maintain its liquidity target are all key responsibilities of the CFO. The CFO does not inherit the board's financial responsibility, but is an invaluable ally in enabling the board to carry out that responsibility. The best CFOs also help board members perceive the risks that the organization faces, and how those risks may impede programmatic and financial objective accomplishment.

This concludes our discussion of financial structure. Next we turn to a discussion of accountability structure, in which individuals are held accountable for their duties and responsibilities.

## 4.3 ACCOUNTABILITY STRUCTURE

**(a) ACCOUNTABILITY STRUCTURE.** Accountability may be defined as "the acknowledgment and assumption of responsibility for policies and decisions, including the obligation to be answerable for resulting consequences."[27] The greater demands for accountability, as well as the many changes in the ways organizations transact business today, require new financial policies, procedures, and techniques. An accountability structure is a way of documenting and clarifying the responsibilities everyone has in this new environment.

***(i) Definition.*** An *accountability structure* details each of the tasks or processes within a unit and identifies the roles of each person in accomplishing the task or process. Our focus is on the accountability structure for the finance office.

***(ii) Purpose.*** Businesses are reviewing how they give authority to their units and their staff, with an eye to empowering and streamlining operations. One important aspect of an accountability structure enables the movement toward giving a unit full responsibility and accountability for its business transactions, by removing the middleman as much as possible. In addition, an accountability structure:

- Eliminates any confusion about roles and responsibilities
- Details for all parties within the unit how the work is performed

- Verifies compliance with company, government, and any other regulatory agency regulations and guidelines
- Provides a method of reviewing the accountabilities in the unit to ensure they are kept current and accurate
- Serves as a guide for measuring performance

**(b) ESTABLISHING AN ACCOUNTABILITY POLICY.** To set up an accountability structure, you first need to be clear about your objectives and goals, and have a method of sharing and conveying those goals to the company, staff, donors, customers, regulatory agencies, and others. Developing a formal policy about accountability can achieve this objective. As with any policy, your policy on accountability should include a general policy statement, core principles, and an interpretation of policy.

***(i) General Policy Statement.*** A policy statement presents a brief description of the goal of the policy, such as:

> The President/CEO delegates the accountability for the financial management of resources to functional units. Consequently, each unit is responsible for properly managing the financial resources of the unit for which they have been provided jurisdiction to include identifying a designee (normally the Chief Administrative Officer) responsible for formulating an accountability structure for each area. This structure depicts the delegation to initiate, process, and review business transactions by only qualified individuals in accordance with the guidelines put forth by the President/CEO and monitored for compliance by various other units (to be specified).

***(ii) Core Principles.*** Core principles further define the policy statement. They are the rules or practices adhered to in order to comply with the policy statement, such as:

> Setting the appropriate accountability delegations to conduct business transactions affecting nonprofit organization funds begins with the core principles listed below.

***(iii) Interpretation of Policy.*** Policy is often written in a language that is technical and not easy for everyone to understand. Policy is a legal document; however, an interpretation of the policy can assist others in applying the policy properly. A policy interpretation can look like this:

**A.** Individuals delegating accountability can do so only to the extent that this same accountability has been delegated to them.

**B.** Individuals delegating accountability are responsible for ensuring the qualifications of the individuals to whom they delegate as well as the proper fulfillment of their responsibilities.

**C.** Qualified individuals are those who:

1. Are actively involved with the activities being conducted
2. Possess a working knowledge of the budget, an adequate level of technical skills required to use the various application systems involved, and an awareness of policies, rules, laws, regulations, or other restrictions on the use of funds sufficient to either ascertain compliance or seek additional assistance
3. Have sufficient authority to fulfill their responsibilities so they can disallow a transaction without being countermanded or subjected to disciplinary action

**D.** Each organizational head must officially record all accountability delegations as well as any cancellations or modifications of such delegations, once established.

**E.** Each business transaction (including commitments) must be reviewed on a timely basis by the individual accountable for the affected accounting unit(s). In instances where this individual prepared the transaction, a second qualified individual must review that transaction and, in so doing, accepts responsibility for the accuracy of the transaction and compliance with all applicable policies, rules, and regulations.

**F.** Each organizational head (or designee) must regularly review its official record of accountability delegations and related maintenance procedures, to ensure that it remains secure, accurate, and current.

**G.** Each organizational head (or designee) must monitor the effectiveness of the accountability delegations to ensure that all accountable individuals are performing their functions in accordance with all policies, guidelines, laws, regulations, and related training instructions.

The chief administrative officer (or perhaps a program officer) is responsible for the financial resources within his or her operating unit. This officer may delegate responsibility to others. These delegations must be recorded in a document that specifies:

- The kind or type of work the employee performs (e.g., purchasing, accounts payable, payroll, personnel)
- The qualifications, training, and/or credentials of the individual that justified the assignment of their duties
- The individuals responsible for reviewing work (including type and conditions) performed by others (e.g., review all Purchasing transactions performed by the department, or all Purchasing transactions for a specific account)
- An alternate to serve when an individual normally assigned to perform this work is not available (vacation or other absences)
- The accountability structure must reflect universally accepted business practices:
  - Separation of duties (the person who receives cash should not also deposit it or reconcile the transaction)
  - No conflict of interest
- Individuals must understand to whom and where they go when they suspect irregularities. In addition, management must set a tone that encourages and supports individuals contacting superiors and others when suspicious of irregularities.

**(c) CHECKLIST FOR ASSIGNING RESPONSIBILITY.** The list that follows details the tasks and responsibilities in the financial arena. Each item on the list that is performed at your organization needs to be assigned to a specific individual.

| Task or Responsibility | Performed By |
|---|---|
| ❒ Collect past-due accounts | |
| ❒ Design and maintain cash management systems | |
| ❒ Determine appropriate financing vehicles and techniques | |
| ❒ Determine return on investment (ROI) on technology | |
| ❒ Develop and train staff | |
| ❒ Develop long-term organizational financial strategies | |

| Task or Responsibility | Performed By |
|---|---|
| ❒ Distribute expenses to subsidiaries and other units | |
| ❒ Establish and monitor service provider performance standards | |
| ❒ Establish borrowing policies and strategies | |
| ❒ Establish communication strategy | |
| ❒ Establish contingency plans | |
| ❒ Establish corporate objectives and strategies | |
| ❒ Establish credit policies of the organization | |
| ❒ Establish employee benefit, pension, and other funds | |
| ❒ Establish financial policies | |
| ❒ Establish investment policies | |
| ❒ Establish lending limits of the organization | |
| ❒ Establish policies and standards for technology | |
| ❒ Establish pricing and compensation | |
| ❒ Establish reporting standards | |
| ❒ Establish risk-management policies | |
| ❒ Establish service quality of the organization | |
| ❒ Establish technology policies with respect to security and standards | |
| ❒ Evaluate industry standards/benchmarks | |
| ❒ Evaluate outsourcing opportunities | |
| ❒ Evaluate technological solutions | |
| ❒ Evaluate the financial strength of the organization | |
| ❒ Forecast cash flows | |
| ❒ Forecast international cash flows | |
| ❒ Implement security and fraud prevention programs | |
| ❒ Implement technological plans | |
| ❒ Implement technological solutions | |
| ❒ Initiate fund transfers | |
| ❒ Initiate loans | |
| ❒ Maintain relationships with creditors | |
| ❒ Manage accounts payable | |
| ❒ Manage accounts receivable | |
| ❒ Manage bank balances | |
| ❒ Manage brokerage relationships | |
| ❒ Manage cash | |
| ❒ Manage collections | |
| ❒ Manage compliance with audit requests and recommendations | |
| ❒ Manage corporate liquidity | |
| ❒ Manage daily cash position | |
| ❒ Manage disbursements | |
| ❒ Manage insurance | |
| ❒ Manage foreign exchange | |
| ❒ Manage fund assets | |
| ❒ Manage general ledger | |
| ❒ Manage interest rates | |
| ❒ Manage international financial institution relationships | |
| ❒ Manage international investments | |
| ❒ Manage lease requirements | |
| ❒ Manage leases | |
| ❒ Manage long-term investments | |
| ❒ Manage mergers, acquisitions, and divestitures | |
| ❒ Manage property | |
| ❒ Manage relationships with analysts and investors (if have for-profit public unit) | |
| ❒ Manage risks | |
| ❒ Manage tax and legal issues | |
| ❒ Manage trade financing | |

| Task or Responsibility | Performed By |
|---|---|
| ❒ Monitor donor relationships | |
| ❒ Monitor compliance with financial policies | |
| ❒ Monitor compliance with corporate objectives and strategies | |
| ❒ Monitor compliance with risk management policies | |
| ❒ Monitor compliance with technology policies | |
| ❒ Monitor employee benefit payments | |
| ❒ Negotiate acquisitions and mergers | |
| ❒ Negotiate credit arrangements | |
| ❒ Perform float analysis/cash optimization reviews | |
| ❒ Prepare financial reports | |
| ❒ Reconcile and submit corrections for errors | |
| ❒ Report on significant industry changes and directions | |
| ❒ Select technology vendors | |

**(d) DESIGNING AN ACCOUNTABILITY STRUCTURE.** There are six steps to designing a structure:

**Step 1.** ***Determine which tasks or processes are performed in your unit.*** To determine which tasks or processes are performed in your unit, you may need to survey the staff concerning what they do. Other potential resources are job descriptions, job cards, products, and reports.

These major categories might include:

- Purchasing
- Accounts payable
- Payroll
- Personnel
- Accounts receivable

**Step 2.** ***Determine where and how these tasks or processes can be divided into steps among individuals to enable appropriate separation of duties.***

- Purchasing
  - Price quotations/bids
  - Order placement
  - Document preparation
  - Receiving
- Accounts payable
  - Document preparation
  - Document review
  - Invoice matching
  - Reconciliation
- Accounts receivable
  - Receipt of cash or other monies
  - Tally sheets

| | Jeff | Michael | Tricia | Jenny | Maria |
|---|---|---|---|---|---|
| **Purchasing** | | | | | |
| Price quotations/bids | X | X | | X | |
| Order placement | X | | X | | X |
| Document preparation | X | X | X | X | X |
| Receiving | X | X | X | X | X |
| **Accounts payable** | | | | | |
| Document preparation | | X | X | X | |
| Document review | | X | | X | |
| Invoice matching | | X | X | | |
| Reconciliation | | X | X | | |
| **Accounts receivable** | | | | | |
| Receipt of cash or other monies | | | X | X | |
| Tally sheets/counting | | | | X | X |
| Document preparation | | X | | | X |
| Transport to bank | X | X | | | X |
| Reconciliation | | X | | | X |

EXHIBIT 4.7 DETERMINING STAFF MEMBERS' STRENGTHS AND WEAKNESSES

- Document preparation
- Transport to bank
- Reconciliation

**Step 3.** ***Determine which staff members have the skills necessary to perform the tasks, processes, or steps.*** An example of this process is presented in Exhibit 4.7.

**Step 4.** ***Determine which role the individual will perform as well as the preparer/ performer or reviewer/auditor of the action or process.*** When determining the role an individual will play in a process or action, the person with the most knowledge should generally be given the responsibility to review the entire action. The decision is often based on the supervisory or management position the individual holds. While it may appear contrary to tradition, the best reviewer of an action is the person with the most knowledge, regardless of his or her ranking within the area.

Establish guidelines or rules that each role requires. After establishing these rules and guidelines, detail how individuals should properly perform their functions, to whom they go for advice or training, and how they can properly question a transaction, process, or action without fear of reprimand. A primary (denoted PP) and a backup (noted PB) should be assigned to each step (see Exhibit 4.8).

**Step 5.** ***Determine whether the workload is distributed appropriately or reasonably.*** After determining who has primary responsibilities and backup responsibilities, review the structure to assure that work is distributed evenly across the unit and make adjustments as necessary. Be sure to factor in work schedules, seasonal fluctuations, and attrition (impacts of retraining and cross-training).

**Step 6.** ***Review the structure for accuracy.*** Before implementing your accountability structure, review it carefully to make certain that all tasks or processes have been included and that the staff assignments are consistent with the individual's abilities. (Cross-training may be necessary.)

| | Jeff | Michael | Tricia | Jenny | Maria |
|---|---|---|---|---|---|
| **Purchasing (review)** | PP | | | PB | |
| Price quotations/bids | | PP | | PB | |
| Order placement | | | PP | | PB |
| Document preparation | | | PP | | PB |
| Receiving | | PP | | PB | |
| **Accounts payable (review)** | | PP | PB | | |
| Document preparation | | | PB | PP | |
| Document review | | | | PP | |
| Invoice matching | | | PB | | |
| Reconciliation | | | PB | | |
| **Accounts receivable (review)** | | | | PB | PP |
| Receipt of cash or other | | | PP | PB | |
| Tally sheets/counting | | | | PB | PP |
| Document preparation | | PP | | | PB |
| Transport to bank | PP | PB | | | |
| Reconciliation | | PP | | | PB |

**Exhibit 4.8** Determining Task Preparer and Auditory

**(e) MONITORING AN ACCOUNTABILITY STRUCTURE.** After you have developed an accountability structure, begin to monitor its effectiveness. Initially monitor the structure to determine that the initial design works in principle. You may need to make adjustments to the initial design.

***(i) Types of Reviews.*** After the basic structure has been implemented and determined to be reasonably accurate and functional, periodic reviews of the structure should be performed. Several types of reviews or factors that should be performed or included follow:

1. Determine whether additional processes or tasks have been added to the units' responsibilities.
2. Determine whether changes in workload have affected the quality of the work performed.
3. Determine whether individuals are performing their role and responsibilities as intended.
4. Determine that policies and procedures are being followed.

***(ii) Schedule of Reviews.*** The accountability structure should be reviewed at regular timed intervals and as necessary. The uniqueness of your organization will determine how often changes in workload or responsibilities occur. Use these guidelines:

- *Monthly*: Review or scan products, reports, and output to determine that all tasks and processes are being performed.
- *Quarterly*: Review or scan products, reports, and output for quality, accuracy, and compliance with policy.
- *Annually*: Provide performance reviews to all staff members detailing how effective their work has been during the previous year. Where necessary, make changes to the individual's performance objectives and responsibilities, and provide counsel and training where needed.

As you implement these reviews, you are achieving a solid internal control structure. Notice that our accountability structure discussion has focused on things that the CFO and others can do internally to better ensure effectiveness, efficiency, and adherence to policies and procedures. Together these goals should enhance external accountability to stakeholders. We return to some specifics that your organization can implement in our chapter conclusion. First, though, we delve further into the arena of ethics.

## 4.4 ETHICS

A thorough discussion of business ethics is beyond the scope of this book. However, ethical conduct is interwoven with governance and accountability and is the first principle of an internal control system. Principle 1 (of the 17 internal control principles in the COSO framework) states, “The organization demonstrates a commitment to integrity and ethical values.” The four “Supporting Points of Focus” are (1) Sets the tone at the top, (2) Establishes standards of conduct, (3) Evaluates adherence to standards to conduct, and (4) Addresses deviations in a timely manner.[28] In the following section we provide a brief overview of ethical guidelines.

Operating and financial decisions are often subject to interpretation. Consequently, a decision maker may often find himself or herself in a quandary over how to ensure compliance. Our best advice is to do your best to thoroughly understand the rules and regulations that apply to the particular issue at hand. Use this information, along with your best judgment and possibly another’s opinion, to make your decision. Guard against the tendency to rationalize and apply “situational ethics,” which simply means engaging in dishonesty or other unethical behavior “because this case is different.” The accounting scandals in the corporate sector have forcibly reminded us that there are moral absolutes of right and wrong that need to be adhered to in personal and organizational decision making.

A simple example illustrates the point that judgment must be combined with an understanding of rules and policies:

> A problem is discovered in the way the organization is accounting for planned gifts. The chief administrative officer must determine how broadly to make adjustments without impacting future gifts or embarrassing people and/or the institution. Questions that must be answered in the process of determining corrective action are: What is the responsible person’s duty to inform, to fix, to improve, and to control? The ability to make these hard calls comes from a strong base of experience.

Another challenge is red tape, because bureaucracies are inherently complex and confusing. When faced with the realities of the red tape affecting the ability to get things done, individuals may feel it is their ethical responsibility to cut through it. This dilemma places the individual in a gray area between the ethical responsibilities of complying with the regulation or law and our society’s push to cut through red tape. Being professional, though, implies doing what is in the client’s best interests and what adheres to the mission, above even loyalty to the organization and its norms.[29] In many such cases one is best served by getting a superior’s view of the ethics of a decision before forging ahead with it.

**(a) ETHICS CHECK.** As indicated in the audit and audit committee sections of this book, audit as a means of assuring compliance is necessary when reviewing all business transactions. Exhibit 4.9 reinforces the fact that a decision that is not illegal or fraudulent may still be unethical.

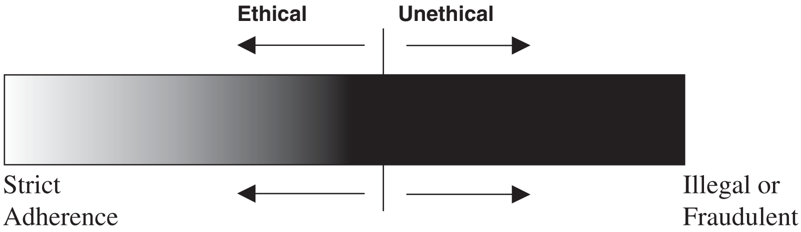



**Exhibit 4.9** Range of Ethics

It is also necessary to perform an audit of decision making within your organization. Constantly review and monitor the interpretations of regulations and laws and assist individuals forced to make these difficult ethical decisions with the stress that this creates. Further, the manager should be certain that individuals have not determined they can decide arbitrarily to ignore all laws, rules, and regulations out of habit because of "special circumstances." Once an individual has seen a possible need to make an exception, will the individual know how far he or she may go before the action becomes immoral or illegal?

Discussions about ethics do not occur often. Many times the ethics issue is ignored for fear that even broaching the subject might cause or raise suspicion. Certainly formal, established policy on how far an individual can go in deviating from internal rules and regulations would be unreasonable, but a discussion or pamphlet outlining the company's attitude toward compliance is certainly advisable. It is also possible to teach or monitor company ethics using analogies. Most important, individuals within the company must understand the basic assumption that all rules, laws, and regulations must be adhered to and that only when the situation or task makes it absolutely necessary to deviate from the strict interpretation are they to consider such an option, and that they need to seek the advice of the department head, CFO, or ED/CEO when making these decisions.

**(b) MAKING ETHICAL DECISIONS.** It is especially tempting to break the rules when the organization is financially strapped. One recurring problem for businesses and nonprofits alike is stretching payables beyond their due date. How can boards and top management instill a culture dedicated to integrity in the organization? A starting point is instruction on the three tiers of ethical standards by which employees and volunteers can judge their actions, as shown in Exhibit 4.10.

In the first tier, the concern is whether the action is legal or at least consistent with the relevant law's intent. This requirement would be the minimal one of all employees and volunteers. The middle tier moves beyond this to ask whether an impartial observer would judge the organization's decisions, way of conducting business, and reasons for its actions to be both prudent and mutually beneficial to all parties. The Golden Rule applies here. It is clear that stretching payables violates the middle-tier standard. Going beyond this, the top tier requires a commitment to enhancing the well-being of the people with whom business is conducted, even if there is a cost to the organization. As one moves from lower to higher tiers, a greater commitment to relationship enhancement is necessitated. Summarizing, do what is legal, but always strive to make decisions that build and strengthen relationships rather than tear them down.[30]

**TOP TIER**

Make a commitment to enhance the well-being of our neighbors, even when it requires some self-sacrifice.

**MIDDLE TIER**

Subject all decisions and actions to the "sunlight test" and ask, Would both interested and impartial observers of the decisions and actions find them to be mutually beneficial to all affected parties, and prudent, practical, sound, discreet, circumspect, wise, informed, etc.?

**LOWER TIER**

Does this decision obey the intent and letter of the law and respect the cultural mores that bear on this action?

*Source:* Adapted from Richard Chewning, *Biblical Principles and Economics: The Foundations* (Colorado Springs, CO: NavPress, 1989), 278.

**EXHIBIT 4.10** TIERS OF ETHICAL STANDARDS

Individuals within the organization need to be reminded constantly that compliance with regulations, rules, and laws (lower tier) is consistent with the mission of the organization. The development and periodic review of an accountability structure, as a regular, integral part of day-to-day business, provides a mechanism for accomplishing this.

**(c) ETHICAL CHALLENGES FACED BY NONPROFITS.** We are all familiar with the episodes of abuse of power by those in the ED/CEO role at nonprofit organizations. Many times these involve shirking of responsibility (in effect, over-delegating roles and responsibilities to subordinates) or subverting organizational resources to private benefit. Organizations diverting funds raised for one purpose to a different use represent another obvious ethical breakdown.

Although we do not wish to minimize these scenarios, the three categories we focus on here should be of special interest to the CFO and to the board:

1. *Conflicts of interest*. A conflict of interest exists in any "situation in which a person has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties as, say, a public official, an employee, or a professional."[31] Such conflicts corrode the trust donors, volunteers, and clients have in the organization. Board members may wish to steer business to their banks, insurance companies, or law firms. The nonprofit organization may spawn a for-profit subsidiary and then wish to use the parent organization's tax-exempt status to build a brand that is capitalized on to aid in the marketing of the products/services delivered by the for-profit. Conversion from nonprofit to for-profit status is alleged by some to represent a similar ethical breach. Allowing an association's name and/or logo to be placed on a company's product packaging – apparently endorsing this company's product over competitors' offerings – and affinity credit cards appear to some to represent similar misuse of the organization's brand name. Earned-income ventures bring with them ethical conflicts along with the incremental revenue stream.
2. *Fundraising*. In order to maintain the trust that comes from cultivating and maintaining donor relationships, fundraisers have an ethical obligation to understand the donor's intentions and obligations as well as to provide assurance that donations

are used as and where intended. Accordingly, many organizations now subscribe to the "Donor's Bill of Rights," which includes a number of items of which both the finance staff and the board finance committee should be aware and supportive:

- Donors should be informed of the donation's intended use and the organization's capacity to use the monies effectively for that use.
- Donors should reasonably expect the board to exercise prudent judgment in its stewardship responsibilities.
- Donors should have access to the organization's most recent financial statements.
- Donors should have assurance that all gift-related information is handled with respect and confidentiality.
- Donors should feel free to ask questions and receive prompt, truthful, and forthright answers.[32]

At the time of this writing approximately 2,200 faith-based organizations hold voluntary membership in the Evangelical Council for Financial Accountability (ECFA), which indicates that the organization subscribes to seven standards, including the following:

> **7.1 Truthfulness in Communication:**
>
> All representations of fact, description of financial condition of the organization, or narrative about events must be current, complete, and accurate. References to past activities or events must be appropriately dated. There must be no material omissions or exaggerations of fact or use of misleading photographs or any other communication which would tend to create a false impression or misunderstanding.[33]

**3.** *Budgeting*. The "fixed performance contract" built into the budget-setting and budget-approval processes may lead to gaming and deception, especially in commercial nonprofits, such as healthcare and educational institutions. Higher-level managers may push hard to get better financial results, while lower-level personnel may attempt to gain easier targets to reduce stress and increase the chance of gaining favorable performance evaluations and even performance-based incentives. (We address budget ploys in more detail in Chapter 8.) Awareness of this conflict is an important first step; some organizations have gone to a "Beyond Budgeting" approach that includes several changes in managerial principles:

- Replace goals with targets, focusing on relative improvement instead of incremental numbers, and disconnect goals from evaluations and rewards.
- Adopt a two-year to five-year time frame rather than the traditional one-year time frame.
- Base goals on relative performance improvement that is ethical and sustainable.
- Give out rewards based on teams' relative success as compared to external benchmarks, and do this in hindsight based on a formula.
- Link any bonus pool to key performance indicators that are consistent with goals and strategies.
- Engage in action planning as a continuous and inclusive process, not as an annual top-down event.

- Make resources available as required rather than being allocated in advance and base allocations on key performance indicators that serve both as goals and controls (often in ratio format).
- Establish internal agreements for service provision within the organization that facilitate spending coordination, with the agreements being demand-driven.
- Base controls on key performance indicators, rapid information updates, and a "coach and support" leadership style.[34]

**(d) AN EFFECTIVE ETHICS AND COMPLIANCE PROGRAM GOES BEYOND A CODE OF ETHICS/CONDUCT.** One thing businesses and nonprofits have learned in recent years it that it is not enough to have a code of ethics, or what some call a code of conduct. This is partly due to the day-to-day behavior that employees see around them, which they assume to be rational and normal.[35] A code communicates a clear set of expectations to employees but does not prevent ethical lapses. Enron had a wonderful code of ethics. Realistically, no organization can prevent every conceivable instance of unethical behavior, but it can greatly reduce the chance of such behavior occurring and possibly forestall repeated occurrences.

Joan Dubinsky, drawing on work done with Dawn-Marie Driscoll and W. Michael Hoffman at the Center for Business Ethics at Bentley College, has devised steps and related diagnostic questions that comprise an effective ethics and compliance program. These steps follow a values-oriented rather than a rules-focused approach. We have adapted the framework slightly in Exhibit 4.11. Notice that having a code of ethics/conduct is only one of the 10 steps. Your management team and board should run through the questions periodically to ensure the steps are being implemented.

**Step 1: Conduct a Rigorous Self-Assessment**

- What are our organization's espoused core values?
- What do employees believe are our real values?
- What elements of an ethics and compliance program are already in place?
- What must we create anew?

**Step 2: Ensure Commitment from the Top of the Organization**

- What outcomes does senior management want to achieve?
- How do they describe what will be different once this program is in place?
- How does senior management demonstrate its dedication?
- Are our leaders ethically neutral or ethically committed?

**Step 3: Publish and Distribute**

- Do we have written guidance that explains our rules and expectations for all employees and stakeholders?
- Do employees know what they can expect from their organization?
- Can employees find, read, and apply this guidance?
- Are the policies and procedures that employees need to do their jobs readily available?
- Are these procedures written at the average employee's reading level?

**EXHIBIT 4.11** TEN STEPS TO AN EFFECTIVE ETHICS AND COMPLIANCE PROGRAM

**Step 4: Communicate, Communicate, and Communicate Once Again**

- ○ How are our messages communicated?
- ○ Do employees hear and believe us?
- ○ What are the key messages that must be repeated over and over?
- ○ How well do we handle change?
- ○ Are we using multiple channels to get our messages across?

**Step 5: Training**

- ○ How are our messages reinforced?
- ○ Do employees get timely training that helps them use our rules and values?
- ○ Are we building a capacity among all employees to exercise moral judgment?

**Step 6: Provide Confidential Resources**

- ○ Where can employees go with problems, concerns, and allegations of misconduct?
- ○ How reliable and trusted are those resources?
- ○ Must employees channel all concerns through a supervisor, or is there an alternative confidential resource, such as a help line or hotline?
- ○ Are confidences maintained?
- ○ Can reports be made anonymously?
- ○ What happens after a call is made?

**Step 7: Ensure Consistent Implementation**

- ○ Do our processes work smoothly and efficiently?
- ○ Do we work effectively across program and organizational boundaries?
- ○ Are roles and responsibilities clear and well documented?

**Step 8: Respond and Enforce Consistently, Promptly, and Fairly**

- ○ Are we consistent in applying our values, standards, and rules?
- ○ Is appropriate conduct recognized and rewarded?
- ○ How are our internal investigations conducted?
- ○ Is discipline uniformly applied?
- ○ How do we treat high performers who fail to conduct dealings and activities according to our values?

**Step 9: Monitor and Assess**

- ○ How do we measure success?
- ○ Do employees receive feedback on our own internal controls?

**Step 10: Revise and Reform**

- ○ Do we periodically update our values, rules, and program content?
- ○ Are we committed to continuous improvement?

*Source:* Adapted from Joan E. Dubinsky and Curtis C. Verschoor, "10 Steps to an Effective Ethics and Compliance Program," *Strategic Finance* (December 2003): 2, 4.

**EXHIBIT 4.11** TEN STEPS TO AN EFFECTIVE ETHICS AND COMPLIANCE PROGRAM (*continued*)

Every nonprofit manager has a moral responsibility to ensure that the organization's objectives are satisfactorily achieved. Saying "we are nonprofit, therefore not business-like" is not an excuse for ineffectiveness or inefficiency. In his classic management guide, Chester Barnard noted that the ED/CEO is responsible for creating "moral codes for others," establishing morale and employee loyalty, and "the morality of standards of workmanship."[36] As Peter Drucker commented in a 1999 interview, "The vast majority of nonprofits are not so much badly managed as not managed at all."[37] We note increasing professionalization in the sector in the 21st Century, but suspect that Drucker's statement is largely true for many smaller and newer organizations.

The Ethics Resource Center in its 2014 Ethics Survey offers 6 key elements that make an ethical culture.

1. **Formal policies** and procedures which explicitly document ethics policies. They establish an ethical code of conduct and incorporate conflict-of-interest, whistle-blower protection and transparency/disclosure policies.
2. **Monitoring** compliance with procedures that include effective internal controls, periodic signing of acknowledgement of policies and prompt action when an issue arises. They also recommend measuring employee beliefs and attitudes about the ethical culture and publicizing results.
3. **Communications** about ethics should be consistent in internal meetings, speeches, blogs, and other forms of communications.
4. **Leadership:** The CEO, senior managers, and board members all need to lead by example by consistently adhering to the highest standards. This includes being transparent about organizational performance.
5. **Consistency:** Application of policies and practices uniformly (avoid favoritism, special treatment and side agreements).
6. **Accountability:** Everyone must be held accountable for his or her conduct. Take swift and fair action when misconduct occurs and accept appropriate organizational responsibility.[38]

## 4.5 STRUCTURE, ACCOUNTABILITY, AND ETHICS IN PRACTICE

Immediately following the passage of SOX in 2002, several surveys were conducted to help us draw a profile of actual practices in today's nonprofit. We include Grant Thornton's 2004 board governance survey, the Association of Executive Search Consultants senior executive pay survey, a survey of Canadian recreation associations, and a survey of US healthcare executives.

Grant Thornton surveyed 700 nonprofits and determined that:

- Two-thirds of the nonprofits' boards have discussed the implications of Sarbanes-Oxley for their organizations.
- Almost half of the organizations have made changes in corporate governance policies in the past years, largely due to the new law and possible state and local government initiatives.
- 84 percent of the organizations now have audit committees, up from 77 percent in 2003.

- 55 percent of the organizations have a combined committee handling audit and finance, even though this is not a recommended practice due to the different functions that are served by audit committees and finance committees.
- Although it is recommended that the audit committee meet with external auditors at least twice a year, 62 percent of the audit committees met with auditors either once or not at all.
- 83 percent of the organizations maintain a conflict-of-interest policy; of these, 85 percent have board members sign the policy, 49 percent have executive managers sign, and 39 percent have all employees sign.
- The CEO or CFO of 36 percent of the organizations hires the external auditor, even though the best practice is for the audit committee or the board of directors hire and oversee the external auditor.[39]

Nezina and Brudney investigated benefits and costs to nonprofit organizations who adopted key provisions of Sarbanes-Oxley (SOX). Their survey found:

> This study investigated the benefits and costs to nonprofit organizations emanating from the adoption of the Sarbanes-Oxley Act (2002). The Act was intended to stem financial malfeasance in the for-profit sector, nevertheless the study finds that about half the surveyed nonprofits adopted provisions of the Act and experienced effects in proportion to the level of adoption. About one in four of the nonprofits attributed benefits of better financial controls (27.3%) and reduced risk of accounting fraud (24.3%) to the adoption of the Sarbanes-Oxley Act. With regard to the costs of adoption, more than one-third of the nonprofit organizations reported increased fees for external audit (36.5%), and about 15 percent cited "reallocation of resources from program to administrative expenses" (14.8%).[40]

More senior executives now trust for-profit companies more than nonprofit organizations regarding honesty in administering pay practices. This startling finding was unearthed by the Association of Executive Search Consultants worldwide survey: 48 percent of executives state that for-profits have a better reputation for honesty in executive pay practices, as opposed to 40 percent asserting that nonprofits have a better reputation.[41] This study suggested that businesses' stakeholders demand disclosure, unlike those holding a stake in nonprofits, who tend to scrutinize nonprofits less. In our opinion, this is probably less true for larger organizations like the Red Cross or American Heart Association, however.

Malloy and Agarwal surveyed a large Canadian sports federation with 70 affiliates and inquired into the factors driving one's perception of ethical work climate.[42] They found that length of service, existence of ethical codes, organization size, and the degree of peer pressure do *not* effectively influence that ethical perception. Instead, the level of education (more educated workers tended to rate the organization higher on a scale of "Machiavellianism"), decision style (autocratic style led to a greater perception of "Machiavellianism"), and superior and volunteer influence *do* influence one's perception of an ethical work climate. Since climate has been shown to influence ethical conduct, these are important findings.

Jurkiewicz surveyed 1,069 senior and midlevel nonprofit health executives in the United States and discovered that these individuals perceived intense ethical tensions. These tensions were linked to many factors, including the level of care provided by the institution, budget improprieties, lying, and personnel issues. The higher-level executives felt they were unable to change their organizations' ethical environments. The majority (59 percent) stated that they knew of overtly unethical business practices in their organizations. The top five issues they listed when asked what unethical practices they were aware of and would eliminate if they could were: privacy/confidentiality violations, discrimination, hiring and personnel matters, board members' preferential treatment, and lying to clients. These executives also expressed a strong desire to get rid of these practices, but the fact that many of the conflicts arose between them and either higher-level executives or board members may have led to an inability to right the wrongs.[43]

## 4.6 NEW FORMS

Recent years have seen an increase in **cross sector (private, government, and nonprofit) collaboration** working together to solve societal problems that individual organizations cannot solve alone. In a book published in 2013, Eggers and MacMillan introduce the concept of the Solution Economy that relies on cross-sector convergence and new forms of collaboration. The book cites multiple examples of how these collaborations can solve problems that require new ways of thinking and working. They note that in some cases, government acts at cross-purposes (e.g., fighting traffic congestion while subsidizing road use). While this may seem counter-intuitive, the authors provide multiple examples of how this is already at work and realizing some success. Their main theme is that traditional roles for these types of organizations are being re-examined and re-purposed. They identify a growing global movement of organizations joining forces to deliver better social outcomes. This was generally considered to be in the realm of government and nonprofits but commercial organizations have joined in these efforts as well.[44]

A new form of private company engagement is emerging called the **B Corporation**. These organizations look beyond stockholder expectations to stakeholder needs. They are redefining success in business by using their innovation, speed and capacity for growth to help alleviate social and environmental problems in addition to earning a fair return for their shareholders. The "B" in B Corporation stand for benefit, but is not the same as a benefit corporation (L3C discussed below). Sustainability is a primary value in these types of organizations and they must meet a rigorous set of standards to be certified as B Corporations.[45]

**L3C Companies** are limited liability companies (LLC) that are considered to be hybrid organizations. These companies are designed to attract private investments in ventures designed to provide a social benefit. The L3C has an explicit primary charitable mission and only a secondary profit concern.

The L3C Company has a statutory design that matches the requirements of a program related investment (PRI) which is an investment made by private foundations with a socially beneficial purpose that is consistent with the foundation's mission. The L3C form eases the PRI statutory requirements for these types of investments. The L3C is not a nonprofit organization so the IRS tax exemption is not involved. They pay income taxes the same way any company does but this growing trend provides a fair return for owners while serving a societal purpose.[46]

These new forms and initiatives create the need for financial literacy that goes beyond knowledge of nonprofit finance. They provide for new possibilities and enable greater flexibility and creativity in meeting societal challenges. The financial management discipline requires cross-sector knowledge as well as the capacity to engage on a growing edge.

## 4.7 CONCLUSION

Regardless of how well an organization's finance function is managed in areas such as budgeting, strategic decision making, cash management, investing, and risk management, breakdowns in accountability and ethics can do irreparable damage to the organization's reputation and fundraising ability. Wise decisions regarding the organizational structure, accountability structure, and ethics code and oversight reduce the chance of serious problems.

We conclude with several pointers that bring this chapter's material together. Drawing on work done by Sheldon Whitehouse, who argues that Sarbanes-Oxley guidelines serve as a useful benchmark for nonprofits even though most of these provisions do not legally bind the nonprofit, the current Form 990 does require a statement about ethics policies and governance in significant detail. Part VI, Section B lists Whistleblower Protection and Document Destruction Policies which are required for nonprofit organizations.[47] Here is a suggested checklist:

**1.** Ethics statement

- ❒ Are all relevant areas addressed?
- ❒ Do we have it in written form, updated as appropriate?
- ❒ Do all board members read and sign the statement when joining the board, and regularly thereafter?
- ❒ Do board members also sign a statement affirming that they have neither a criminal record nor personal bankruptcy record?

**2.** Conflict of interest

- ❒ Has a thorough policy, including policy planks regarding disclosure, been adopted?
- ❒ Are loans to directors or senior staff forbidden in this policy?
- ❒ (For any conflicts not forbidden) Are any apparent conflicts of interest reviewed and approved through a careful reporting and recusal process?

**3.** Audit review

- ❒ Is the organization large enough to have an annual outside audit? [We would add: If it is not, is a compilation or review done instead?]
- ❒ Is there an audit committee?
- ❒ Does the audit committee meet Sarbanes-Oxley independence and expertise standards?
- ❒ Is the audit committee made up solely of individuals who are not board members?
- ❒ Is at least one audit committee member a financial expert?
- ❒ Does the organization consider rotating its outside auditor every five years or so? [For some organizational types, particularly faith-based organizations, audit firms possess the needed interest and expertise to serve audit, compilation, and review needs.]

**4.** Certified financials

- ❒ Does the ED/CEO sign off to the board on the financial statements?
- ❒ Does the board comprehend, review, and approve the IRS Form 990 through appropriate committees?
- ❒ Does the board have a policy requiring appropriate disclosures?

**5.** Education

- ❒ Is there an education policy for board members?
- ❒ Do policies specify fiduciary and governance obligations and the necessary financial expertise to make prudent decisions in areas pertinent to this organizational type?

**6.** Whistleblowers

- ❒ Has a means been established for whistleblowers [employees having become aware of and now reporting illegal or unethical conduct] to identify problems to management and to the organization's legal counsel?
- ❒ Is the policy communicated clearly and regularly to staff?
- ❒ Has the organization established a non-retaliation policy, and is it communicated to staff and carefully followed?

**7.** Document retention

- ❒ Is there a policy stipulating which documents should be retained and for how long, and for the destruction of documents?
- ❒ Does the policy allow for the protection of the privacy of confidential information, including personal financial or medical information as well as sensitive business information?

**8.** Attorneys

- ❒ Has the board requested and received from the organization's attorney a review of the attorney's reporting and disclosure obligations related to the Rules of Professional Conduct? Does the board understand the contents of this review?
- ❒ Has the board examined the SEC reporting requirements for attorneys and adopted portions deemed appropriate?[48]

Careful attention to the foregoing issues goes a long way toward ensuring that your organization's governance, accountability, and ethical stance will aid its reputation and fundraising ability in the years to come. Appendix 4A provides a sample set of bylaws for an educational foundation. Appendix 4B portrays the responsibilities and qualifications you should look for in your board, board chair, ED/CEO, treasurer/CFO, board secretary, board nominating committee, board finance committee, and volunteers. Appendix 4C provides a listing of some of the best governance and ethics resources should you wish to learn more.

Governance and accountability structures depend on a sound set of financial policies for their implementation. In our next chapter we survey the policies that will support your control and treasury functions in achieving and maintaining financial management proficiency.

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APPENDIX **4A**

# BY-LAWS OF THE ABC EDUCATIONAL FOUNDATION – A CALIFORNIA NONPROFIT PUBLIC BENEFIT CORPORATION[1]

## ARTICLE I. NAME

The name of this corporation is THE ABC EDUCATIONAL FOUNDATION ("the Foundation").

## ARTICLE II. OFFICES

**SECTION 1. EXECUTIVE OFFICE** The executive office of the Foundation is hereby fixed and located at______. The Board of Trustees is hereby granted full power and authority to change from time to time said executive office from one location to another. The location of the executive office of the Foundation need not be in the state of California. Any such change shall be noted in the By-Laws by the Secretary, opposite this section, or this section may be amended to state the new location.

**SECTION 2. OTHER OFFICES** Other business offices may at any time be established by the Board of Trustees at any place or places where the Foundation is qualified to do business.

## ARTICLE III. PURPOSES AND POWERS

**SECTION 1. PURPOSES** The Foundation is a nonprofit public benefit corporation and is not organized for the private gain of any person. It is organized under the California Nonprofit Public Benefit Corporation Law for public and charitable purposes to do the following:

- **a.** Broaden participation in and access to higher education within the State of California.
- **b.** Promote a better understanding of the community's role in improving access to higher education.

**c.** Provide financial assistance to schools and colleges, support groups, faculty, and students in support of activities to improve access to higher education.

**d.** Engage in a variety of activities related to the above purposes.

**SECTION 2. POWERS** In furtherance of the purposes herein above set forth, the Foundation shall have and shall exercise, subject to any limitations contained in its Articles of Incorporation,[2] these By-Laws, applicable law, or applicable policy statements, all powers of a natural person and all other rights, powers, and privileges now or hereafter belonging to, or conferred upon, corporations organized under the provisions of the California Nonprofit Public Benefit Corporation Law, including without limitation, the power to do the following:

**a.** Adopt, make, use, and at will alter, a corporate seal, but failure to affix such seal shall not affect the validity of any instrument.

**b.** Adopt, amend, and repeal By-Laws.

**c.** Qualify to conduct its activities in any other state, territory, dependency, or foreign country.

**d.** Issue, purchase, redeem, receive, take, or otherwise acquire, own, sell, lend, exchange, transfer, or otherwise dispose of, pledge, use, and otherwise deal in and with real and personal property, capital stock, bonds, debentures, notes and debt securities, and money market instruments of its own or others.

**e.** Pay pensions, and establish and carry out pensions, deferred compensation, saving, thrift, and other retirement, incentive and benefit plans, trusts and provisions for any or all of its Trustees, officers, employees, and persons providing services to it or any other subsidiary or related or associated corporation, and to indemnify and purchase and maintain insurance on behalf of any fiduciary of such plans, trusts, or provisions.

**f.** Make donations for the public welfare or for community funds, hospital, charitable, educational, scientific, civic, religious, or similar purposes.

**g.** Assume obligations, enter into contracts, including contracts of guaranty or suretyship, incur liabilities, borrow or lend money or otherwise use its credit, and secure any of its obligations, contracts, or liabilities by mortgage, pledge, or otherwise encumber all or any part of its property and income.

**h.** Participate with others in any partnership, joint venture, or other association, transaction, or arrangement of any kind whether or not such participation involves sharing or delegation of control with or to others.

**i.** Act as a trustee under any trust incidental to the principal objects of the Foundation, and receive, hold, administer, exchange, and expend funds and property subject to such trust.

**j.** Receive endowments, devises, bequests, gifts, and donations of all kinds of property for its own use, or in trust, in order to carry out or to assist in carrying out, the objects and purposes of the Foundation and to do all things and acts necessary or proper to carry out each and all of the purposes and provisions of such endowments, devises, bequests, gifts, and donations with full power to mortgage, sell, lease, or otherwise deal with or dispose of the same in accordance with the terms thereof.

**SECTION 3. DEDICATION OF ASSETS** This corporation is organized and shall be operated exclusively for educational purposes (meeting the requirements for exemption provided for by California Revenue and Taxation Code Sec. 214), within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, and Section 23701d of the California Revenue and Taxation Code, as amended. The property, assets, profits, and net income of this corporation are irrevocably dedicated to said educational purposes (meeting the requirements for exemption provided for by California Revenue and Taxation Code Sec. 214), and no part of the profits or net income of this corporation shall ever inure to the benefit of any Trustee, officer, or to any individual. Upon the dissolution of this corporation, the assets remaining after payment of, or provisions for payment of, all its debts and liabilities, to the extent not inconsistent with the terms of any endowment, devise, bequest, gift, or donation, shall be distributed to an organization which is organized and operated exclusively for educational purposes (meeting the requirements for exemption provided for by California Revenue and Taxation Code Sec. 214), and which is exempt from taxation under Section 23701d of the California Revenue and Taxation Code, as amended (or the corresponding provision of any future California Revenue Law), and Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (or the corresponding provision of any future United States Internal Revenue Law), or to the federal government or to a state or local government.

Notwithstanding any other provision of these By-Laws, the Foundation shall not carry on any activities not permitted to be carried on:

- **a.** By a corporation exempt from Federal Income Tax under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (or the corresponding provision of any future United States Internal Revenue Law) *or*
- **b.** By a corporation, contributions to which are deductible under Section 170(c)(2) of the Internal Revenue Code of 1986, as amended (or the corresponding provision of any future United States Internal Revenue Law)

No substantial part of the activities of the Foundation shall consist of the carrying on of propaganda or otherwise attempting to influence legislation, nor shall the Foundation participate in, or intervene in (including the publishing or distributing of statements) any political campaign on behalf of any candidate for political office.

## ARTICLE IV. MEMBERSHIP CORPORATION

**SECTION 1. MEMBERSHIP** The Foundation shall be a membership corporation as provided in Chapter 3 of the Nonprofit Public Benefit Corporation Law (California Corporations Code Sections 5310 et seq.). One class of voting membership is hereby created and all persons who are eligible and active members of the Board of Trustees or as Advisory Trustees on the date this By-Law becomes effective will constitute the membership of the Foundation for the remainder of the terms to which they were originally elected or appointed.

There shall be no multiple or fractional memberships, nor members who are not natural persons.

**SECTION 2. MEMBERS CALLED TRUSTEES** The members of the corporation shall be called "Trustees" and the membership as a whole the "Board of Trustees" (and are so referred to hereinafter) in recognition of the long association of these terms with the Foundation.

The use of these terms implies no other or different relationship or responsibility than that provided for members in the Nonprofit Public Benefit Corporation Law and these By-Laws.

**SECTION 3. PERSONS ASSOCIATED WITH THE FOUNDATION** By resolution, the Board of Trustees may create any advisory boards, councils, honorary memberships, or other bodies as it deems appropriate. The Board of Trustees may also, by resolution, confer on any persons not already Trustees in such classes all of the rights of a member of the corporation under the Nonprofit Public Benefit Corporation Law other than the right to vote.

**SECTION 4. LIABILITY OF TRUSTEES** Trustees of the Foundation are not personally liable for the debts, liabilities, or obligations of the Foundation.

## ARTICLE V. TRUSTEES

**SECTION 1. POWERS** The Trustees shall have all of the powers conferred by law, the Articles of Incorporation, or these By-Laws on members of nonprofit public benefit corporations. Notwithstanding any other provision in these By-Laws, the Board of Trustees legally has the exclusive and nondelegable power to do the following:

- **a.** Elect the Board of Trustees of the Foundation.
- **b.** Elect the President.
- **c.** Dispose of all or substantially all of the assets of the Foundation.
- **d.** Approve a merger or dissolution.
- **e.** Amend or repeal the Articles of Incorporation or the By-Laws of the Foundation.

**SECTION 2. NUMBER AND QUALIFICATION OF TRUSTEES** The authorized number of Trustees shall be not less than twenty (20), with no upper limit on the number of Trustees.

**SECTION 3. MANNER OF SELECTION OF TRUSTEES** The composition of the Board of Trustees shall be as follows.

***3.1 Elected Trustees*** Trustees (except for ex-officio Trustees as provided in Section 3.2) shall be elected by majority vote of the Trustees in attendance in person or by proxy at the meeting held to conduct such election, provided that there is a quorum (as provided in Section 11 of this Article), or a majority vote of mail-written ballots, provided the requisite number of votes are cast (as provided in Section 12 of this Article), and may be reelected. No more than twenty (20) new Trustees may be elected each year. The election of Trustees shall take place at the last meeting of the Board of Trustees each fiscal year. The Board of Trustees shall vote upon the nominations submitted by the Nominations Committee and such other nominations as may have been submitted by *any* member of the Board of Trustees eligible to vote not later than a date set by the Board sufficiently in advance of the vote to enable the inclusion of such nominations on proxy forms or mail-written ballots.

***3.2 Ex-Officio Trustees*** The following persons shall be ex-officio Trustees: Former presidents of the ABC Educational Foundation

**SECTION 4. TERM OF OFFICE** All elected Trustees shall serve on the Board of Trustees for a term of three (3) years and may be reelected. Terms of office shall commence on the first day of the Foundation's fiscal year.

**SECTION 5. HONORARY TRUSTEES** Subject to the provisions of Section 3 of Article IV (relating to Persons Associated with the Foundation), the Board of Trustees may from time to time invite individuals to serve as Honorary Trustees. Such Honorary Trustees shall serve at the pleasure of the Board of Trustees and shall have all rights and privileges of Trustees other than the right to vote.

**SECTION 6. RESIGNATION AND REMOVAL OF TRUSTEES**

***6.1 Resignation*** A Trustee may resign at any time. Such resignation shall not affect the Trustee's obligation for any liabilities already or thereafter incurred to the Foundation.

***6.2 Expulsion, Suspension, or Termination*** A Trustee may be expelled or suspended, or membership on the Board of Trustees or any of the rights associated therewith may be terminated or suspended, for just cause and upon the delivery of notice to such Trustee no later than fifteen (15) days prior to the date of intent to take such action, by first-class or registered mail, postage paid, addressed to such Trustee's last known address. Such notice shall indicate the reasons for the proposed action to be taken, the proposed effective date thereof, and shall inform the Trustee of his or her right to a hearing, orally or in writing, no sooner than five (5) days before the proposed effective date of this action.

The intent to take such action against a Trustee shall be submitted on the motion of any Trustee to the Nominations Committee at a meeting specifically called to consider such action, and must be approved by the majority of the quorum in attendance at such meeting.

If the intent to take such action is approved by the Nominations Committee and notice is duly mailed to the affected Trustee, the President (or, if the President is the affected Trustee, the Vice President–Finance) shall appoint an *ad hoc* hearing committee of not fewer than ten (10) Trustees who are not members of the Nominations Committee to provide for the hearing, if one is requested, pursuant to Corporations Code §5341. The decision of the Nominations Committee, or, if a hearing is held, of the *ad hoc* hearing committee, shall be final.

**SECTION 7. VACANCIES**

***7.1 Elected Trustees*** There is no limit to the number of elected Trustees, and therefore the resignation, removal, or death of a Trustee shall not cause a vacancy unless the number of Trustees thereby falls below twenty (20), in which case a majority of the remaining Trustees shall fill the vacancy, or all of the vacancies shall be filled by a sole remaining Trustee.

***7.2 Ex-Officio Trustees*** Vacancies created by the removal, resignation, or death of ex-officio Trustees shall be filled by the persons who succeed them in the offices that qualified them as Trustees.

**SECTION 8. REGULAR MEETINGS** The Board of Trustees shall meet at least two times during each fiscal year. Notice of such regular meetings shall be given pursuant to the provisions of these By-Laws.

**SECTION 9. SPECIAL MEETINGS** Special meetings of the Board of Trustees may be called for any purpose at any time by the Chairman of the Board, the President, the Vice President–Development, the Vice President–Finance, or any five Trustees by delivering written notice to the President or Vice President–Finance. Notice of such special meetings shall be given pursuant to the provisions of these By-Laws for notice of regular meetings.

**SECTION 10. NOTICE AND PLACE OF MEETINGS** Meetings of the Board of Trustees shall be held at the place which has been designated in the notice of the meeting, if any; or if not stated in such notice or if there is no notice, at the place designated by resolution of the Board; or, absent any other designation, at the executive office of the Foundation located at — .

Whenever a notice of a meeting of the Board of Trustees is required to be given, the Vice President–Finance shall cause notice of such meeting to be delivered by personal service, first-lass mail, or telegraph to each Trustee. In case notice is given by mail or telegram, it shall be sent, charges prepaid, addressed to the Trustee at his address appearing on the Foundation's records, or if it is not on these records or is not readily ascertainable, at the place where the regular meetings of the Board of Trustees are held. Such notice shall be given not fewer than ten (10) nor more than ninety (90) days before the date of the meeting to each Trustee who is entitled to vote; provided, however, that if notice is mailed, it shall be deposited in the United States mail at least twenty (20) days before the meeting.

Such notice shall state the date, place, and hour of the meeting and, whenever practical, the general nature of the business to be transacted. Any other business which properly comes before a meeting may be transacted, notwithstanding the preceding sentence.

**SECTION 11. ACTION AT A MEETING: QUORUM AND REQUIRED VOTE** One-third of all the Trustees eligible to vote shall constitute a quorum. Only Trustees eligible to vote may hold and vote proxies. A majority of those present in person or by proxy at a duly held meeting with a quorum may perform any act or make any decision vested in the Board of Trustees, unless a greater number, or the same number after disqualifying one or more Trustees from voting, is required by law or the Foundation's Articles of Incorporation or By-Laws, and may continue to transact business notwithstanding the withdrawal of enough members to leave less than a quorum.

**SECTION 12. ACTION WITHOUT A MEETING: MAIL-WRITTEN BALLOTS** Any action which may be taken at any regular or special meeting of Trustees may be taken without a meeting if the Foundation distributes a mail-written ballot to every Trustee entitled to vote on the matter. Such ballot shall set forth the proposed action, provide an opportunity to specify approval or disapproval of any proposal, and provide a reasonable time within which to mail or otherwise return the ballot to the Foundation.

Approval by mail-written ballot shall be valid only when the number of votes cast by ballot within the time period specified equals or exceeds the quorum required to be present at a meeting authorizing the action, and the number of approvals equals or exceeds the number of votes that would be required to approve the action at a meeting at which the total number of votes cast was the same as the number cast by ballot.

Ballots shall be solicited in a manner consistent with the notice requirements of these By-Laws. All such solicitations shall indicate the number of responses needed to meet the quorum requirement and, with respect to ballots other than for the election of Trustees or Directors, shall state the percentage of approvals necessary to pass the measure submitted.

The solicitation must specify the time by which the ballot must be received in order to be counted.

Mail-written ballots may not be revoked. Trustees may be elected by mail-written ballot if the Board so determines, in which case the Board shall also fix a date for the close of nominations a reasonable time before the printing and distribution of the mail-written ballots.

The use of a written ballot at a meeting of the Board of Trustees, which is intended to be voted upon at the meeting where it is distributed, does not invoke the provisions of this section as to mail-written ballots.

**SECTION 13. VALIDATION OF DEFECTIVELY CALLED OR NOTICED MEETINGS** The transactions of any meeting of the Board of Trustees, however called or noticed or wherever held, shall be as valid as though transacted at a meeting duly held after regular call and notice, if a quorum is present and if, either before or after the meeting, each of the Trustees not present or who, though present, has prior to the meeting or at its commencement protested the lack of proper notice to him, signs a written waiver of notice or a consent to holding such meeting or an approval of the minutes thereof. A waiver of notice need not specify the purpose of any regular or special meeting of the Board of Trustees. All such waivers, consents, or approvals shall be filed with the Foundation's records or made a part of the minutes of the meeting.

**SECTION 14. ADJOURNMENT** A majority of the Trustees present in person or by proxy, whether or not a quorum is present, may adjourn any meeting to another time and place. If the meeting is adjourned for more than thirty (30) days, notice of the adjournment to another time or place shall be given prior to the time of the adjourned meeting to the Trustees who were not present at the time of the adjournment.

**SECTION 15. FORM OF PROXY OR MAIL-WRITTEN BALLOT** Any form of proxy or mail-written ballot shall afford an opportunity on the proxy form or mail-written ballot to specify a choice between approval and disapproval of each matter or group of related matters intended, at the time the proxy or mail-written ballot is distributed, to be acted upon at the meeting for which the proxy is solicited or by such mail-written ballot, and shall provide that where the person solicited specifies a choice with respect to any such matter the vote shall be cast in accordance therewith.

In any election, any form of proxy or mail-written ballot in which the Trustees to be voted upon are named therein as candidates and which is marked by a Trustee "withhold" or otherwise marked in a manner indicating that the authority to vote for the election of Trustees is withheld shall not be voted either for or against the election of a Trustee.

**SECTION 16. FEES AND COMPENSATION** Trustees shall not receive compensation for their services as such. Trustees may, however, be reimbursed for reasonable out-of-pocket expenses incurred by them in the performance of their duties as Trustees.

**SECTION 17. COUNCIL OF PRESIDENTS** The president and all the former presidents of the Foundation shall constitute a Council of Presidents whose primary function shall be to recommend to the Nominations Committee a person to be President-elect at the appropriate time. The Council of Presidents shall meet on the call of the President and may serve to advise the President on other matters of importance to the Foundation as the President may from time to time request.

## ARTICLE VI. STANDING BOARDS OF THE FOUNDATION

The Board of Trustees shall have certain Standing Boards as set forth herein.

**SECTION 1. EXECUTIVE COMMITTEE** The Executive Committee is a Standing Board of the Foundation.

***1.1 Composition*** The Executive Committee shall have not fewer than twenty-four (24) nor more than thirty (30) members, the exact number to be fixed from time to time by resolution of the Board of Trustees. All members of the Executive Committee shall be members of the Board of Trustees. Except for ex-officio members, and except as otherwise provided in these By-Laws, the Executive Committee shall be elected annually by the Board of Trustees in accordance with the nomination and election procedures for Trustees in these By-Laws. Vacancies of elected members on the Executive Committee arising during the term of office may be filled by the Board of Trustees at a special election to be held at the discretion of the President, unless such vacancies reduce the number of Executive Committee members below twenty-four (24), in which case the President shall call for a special election to be held at the next regularly scheduled meeting of the Board of Trustees. The remaining members of the Executive Committee may temporarily fill vacancies until an election is held.

Any other provision of these By-Laws notwithstanding, at no time shall more than forty-nine (49) percent of the persons serving on the Executive Committee be any of the following: (i) persons compensated by the Foundation for services rendered within the previous twelve (12) months (whether as an employee, contractor, or otherwise) other than reasonable compensation paid to a member for his service as an Executive Committee member, or (ii) the spouse, an ancestor, sibling, or descendent to the first degree of consanguinity, or any person married to such relative of any person so compensated.

***1.2 Ex-Officio Executive Committee Members*** The following Trustees are designated ex officio as members of the Executive Committee, to serve until their successors are named:

- **a.** The Chair of the Board of Trustees
- **b.** The President of the Foundation (who shall serve as the Chief Executive Officer and Chair of the Executive Committee)
- **c.** The President-elect of the Foundation (when one exists)
- **d.** The Vice President–Finance of the Foundation (who shall serve as Chief Staff and Financial Officer of the Executive Committee)
- **e.** The Vice President–Development of the Foundation
- **f.** The General Counsel of the Foundation

Any other provision of these By-Laws notwithstanding, at no time shall more than one-third of the persons serving on the Executive Committee be ex-officio members as designated herein.

***1.3 Term of Office*** Elected members of the Executive Committee shall serve for a one-year term and may be reelected for not more than six consecutive one-year terms. Ex-officio members of the Executive Committee shall serve so long as they hold the positions that qualify them as members

***1.4 Duties and Powers*** The Executive Committee shall manage the activities and affairs of the Foundation and have the full authority to act thereon except as limited by law, the Articles of Incorporation, and except as certain functions may be reserved to the Board of Trustees or may be delegated by the Board of Trustees to Standing Boards or special committees of the Foundation pursuant to these By-Laws.

Notwithstanding any other provision of these By-Laws, the Executive Committee is vested with the full fiduciary responsibility for the following:

**a.** The prudent investment of and accountability for the assets of the Foundation.

**b.** The adoption of the Foundation's annual budget.

**c.** The power to approve self-dealing transactions, the power to issue checks, drafts, and other orders for the payment of money, notes or other evidence of indebtedness and to receive the same on behalf of the Foundation, with such signature or endorsement authority as the Executive Committee determines.

**d.** The power to authorize any officer or officers, agent or agents, to enter into any contract or execute any instrument in the name of, and on behalf of, the Foundation. Such authority may be general or confined to specific instances and, unless so authorized by the Board of Trustees, no officer, agent, or employee shall have any power or authority to bind the Foundation by any contract or engagement or to pledge its credit or to render it liable for any purpose or any amount, except for contracts or commitments in the regular course of business of the Foundation executed by an officer within the scope of his authority.

Subject to any limitations of law, or the Articles of Incorporation, the Executive Committee shall manage and carry out the fiduciary responsibility vested in it by these By-Laws and in so doing shall have all the rights, powers, and authority of the Board of Trustees.

***1.5 Regular Meetings*** Meetings of the Executive Committee shall be held at such times and at such places as the President may determine, but in no event fewer than three (3) times during each fiscal year of the Foundation. Notice of such meetings shall be given in the manner set forth in Section 8 of Article V of these By-Laws (relating to Notice and Place of Meeting), except that notice may be given by telephone not less than twenty-four (24) hours prior to the meeting and that notice sent by mail shall be given not less than forty-eight (48) hours prior to the meeting.

Actions may be taken without a meeting of the Executive Committee if all members individually or collectively consent thereto in writing. Such consents shall be filed with the minutes of the proceedings of the Executive Committee, and shall have the same force and effect as an action taken at regularly noticed meetings of the Executive Committee.

***1.6 Quorum*** Twelve (12) members present in person shall constitute a quorum for the transaction of business, except as expressly provided otherwise in the Articles of Incorporation, these By-Laws, or by resolution of the Board of Trustees. The Executive Committee shall not conduct business by proxy or mail-written ballot.

***1.7 Meetings by Conference Telephone*** Members of the Executive Committee may participate in a meeting through use of conference telephone or similar communications equipment, so long as all members participating in such meeting can hear one another. Participation in a meeting in this manner shall constitute presence in person at such meeting.

***1.8 Special Committees and Organization*** In discharging its responsibilities, the Executive Committee will establish appropriate policies for the investment and management of funds, for the conduct of audits, for the acceptance and management of planned gifts, for the grants and allocations of Foundation funds, and for the nomination of persons for election to the various posts established in these By-Laws for election by the Board of Trustees. The Executive Committee shall create special committees on investment, audit, grants and allocations, and nominations for the exercise of these respective responsibilities and may delegate to these committees such responsibility to act on behalf of the Executive Committee, to the extent permitted by law, as it deems appropriate, and each such committee shall report all actions taken to the next regular meeting of the Executive Committee. The Executive Committee from time to time may create such other committees and delegate to each such authority as the Executive Committee deems appropriate.

The Executive Committee shall, by resolution, establish the number of members, responsibility, title, and rules governing any special committees established hereunder. The members, and Chair, of all such special committees shall be appointed annually by the President, subject to approval by the Board of Trustees. The President, the Vice President–Development, and the Vice President–Finance shall be ex-officio members of all special committees (except the Audit Committee); all other members of the special committees shall be appointed from the membership of the Board of Trustees, provided that the majority of each committee is comprised of Trustees who are not ex-officio members.

The President shall appoint the Chairs and members of such committees established by the Executive Committee and shall assure that each committee shall have representatives of the Executive Committee and other groups represented on the Board of Trustees as a whole.

The Executive Committee shall establish rules and procedures for the conduct of its business and, except as already provided for in these By-Laws, appoint such officers as it deems appropriate for the conduct of its business.

***1.9 Removal with Cause*** The Board of Trustees may remove from office by majority vote an Executive Committee member who has been declared of unsound mind by final order of a court, or convicted of a felony, or found by final order of a court to have violated a duty under Article 3 of the Nonprofit Public Benefit Corporation Law.

***1.10 Removal without Cause*** Any Executive Committee member may be removed from office without cause by the vote of a majority of the Trustees then in office.

**SECTION 2. BOARD OF DEVELOPMENT** A Standing Board to be known as the Board of Development shall be vested with the Foundation's authority to raise private funds and other gifts to support its mission.

The composition of the Board of Development is intended to reflect the breadth of the development effort, with representatives from diverse areas of the community as well as central development activities. Its purpose is to serve as the senior advisory and volunteer management body for development. The President shall be Chair of the Board of Development.

***2.1 Ex-Officio Members of Board of Development: Term of Office*** The following persons are designated ex officio as members of the Board of Development, to serve so long as they hold the position designated below, or as otherwise provided herein:

1. The Chairman of the Board of Trustees
2. The President of the Foundation (who shall serve as Chair)
3. The President-elect of the Foundation (when one exists)
4. The Vice President–Development of the Foundation
5. The Vice President–Finance of the Foundation
6. The General Counsel of the Foundation

***2.2 Other Members of the Board of Development: Term of Office*** The President may appoint other members of the Board of Development who may or may not be Trustees, to serve at the pleasure of the President. Consideration in making such appointments should be given to the person's strong history of financial support for the Foundation or whose experience, ability, and leadership would be of great value to the Board of Development.

## ARTICLE VII. OFFICERS

The Foundation shall have certain officers as set forth herein. The Foundation may also have such other officers as the Executive Committee may from time to time establish in order to conduct the business of the Foundation. Each officer of the Foundation shall have such authority and perform such duties as provided in the By-Laws or as the Executive Committee may from time to time prescribe.

**SECTION 1. CHAIR OF THE BOARD** The Chair of the Board shall be the immediate past President of the Foundation. He or she shall preside at meetings of the Board of Trustees, the Executive Committee, and the Board of Development in the absence of the President.

**SECTION 2. PRESIDENT** The President shall be an elected Trustee of the Foundation and is elected by the Board of Trustees as provided in these By-Laws for a term of two years, and may not be reelected to a second consecutive term. The President shall be the Chief Executive Officer and shall preside at all meetings of the Board of Trustees, the Board of Development, and the Executive Committee. A vacancy in the presidency will be filled by the President-elect or, if there is none, by special election of the Board of Trustees. An ex-officio Trustee shall not serve as President.

**SECTION 3. PRESIDENT-ELECT** The President-elect shall be an elected Trustee of the Foundation and is elected by the Board of Trustees at the last meeting of the fiscal year before the anniversary of the President's assumption of office, and shall take office as President at the expiration of the President's term of office, or upon a vacancy in the office of President. The President-elect shall preside at meetings of the Board of Trustees in the absence of both the President and Chairman of the Board and shall perform the other duties of the President in the President's absence.

**SECTION 4. VICE PRESIDENT–DEVELOPMENT** The Vice President–Development shall serve as Chief Staff Officer of the Board of Development.

**SECTION 5. VICE PRESIDENT–FINANCE** The Vice President–Finance shall serve as chief staff officer of the Executive Committee and Chief Financial Officer of the Foundation, and act as the Foundation's Secretary and Treasurer.

**SECTION 6. GENERAL COUNSEL** The General Counsel shall be the legal advisor to the Foundation and all of its boards and committees, and shall exercise such other powers and perform such other duties as the Board of Trustees may from time to time determine. The President shall appoint the General Counsel, who shall serve at the pleasure of the President.

**SECTION 7. REMOVAL AND RESIGNATION** Any officer elected by the Board of Trustees or appointed by the President may be removed at any time with or without cause either by the Board of Trustees, by the President, or by any officer upon whom the power of removal has been conferred by the Board of Trustees, subject to the rights, if any, of the officer under a contract of employment with the Foundation. Without prejudice to the rights, if any, of the Foundation under any contract to which the officer is a party, any officer may resign at any time by giving written notice to the Foundation. Unless otherwise specified therein, any such resignation shall take effect at the date of the receipt of such notice.

**SECTION 8. VACANCIES** A vacancy occurring in any office shall be filled in accordance with the procedure for the regular selection or appointment of that officer under these By-Laws, although the President may appoint a person to act as that officer in the interval of time reasonably required before a regular appointment can be made.

**SECTION 9. COMPENSATION** Officers may receive such compensation for their services or such reimbursement for their expenses as may be determined by the Executive Committee to be just and reasonable. The Board of Trustees may, at the Foundation's expense, bond any officer and employee for the faithful performance of his duties in such amount and with such surety or sureties as it may determine.

## ARTICLE VIII. PROCEDURES

The Board of Trustees, the Executive Committee, and the Board of Development may each prescribe appropriate rules.

**SECTION 4. STANDING ORDERS** Standing orders and rules of practice consistent with the Articles of Incorporation and the By-Laws may be prescribed from time to time by the Board of Trustees in order to facilitate and expedite the carrying on of the business of the Foundation. The Vice President–Finance shall keep such orders and rules, if any, in permanent written form, properly indexed, and same shall be part of the permanent records of the Foundation and shall govern and control the administration of the activities and affairs of the Foundation as far as applicable.

**SECTION 5. INDEMNIFICATION OF AGENTS OF THE CORPORATION: LIABILITY INSURANCE**

***5.1*** Subject to any limitations contained in the Articles of Incorporation and to the extent permitted by the California Nonprofit Public Benefit Corporation Law, the Foundation may indemnify any person who was or is a party or is threatened to be made a party to any proceeding by reason of the fact that such person is or was a Trustee, officer, employee, member of a committee, or other agent of the Foundation, against expenses, judgments, fines, settlements, and other amounts actually and reasonably incurred in connection with such proceeding and the Foundation may advance expenses in connection therewith.

*5.2* The Foundation may purchase and maintain insurance on behalf of any Trustee, officer, employee, or other agent of the Foundation against any liability asserted against or incurred by such person in his or her capacity or arising out of his or her status as such, whether or not the Foundation could indemnify such person against such liabilities under the provisions of Section 5.1 of Article IX. Notwithstanding the above, the Foundation shall not purchase and maintain such insurance for a violation of Section 5233 of the California Nonprofit Public Benefit Corporation Law (with respect to self-dealing transactions).

*5.3* Section 5 of Article IX (relating to Indemnification of Agents of the Corporation: Liability Insurance) does not apply to any proceeding against any Trustee, investment manager, or other fiduciary of any employee benefit plan in such person's capacity as such, even through said person may also be a Trustee, officer, employee, or other agent of the Foundation for purposes of Sections 5.1 and 5.2 of Article IX. The Foundation may indemnify such Trustee, investment manager, or other fiduciary to the extent permitted by Subdivision (f) of Section 207 of the California General Corporation Law.

**SECTION 6. SUPPORT GROUP POLICY** Notwithstanding any provision of these By- Laws to the contrary, the Foundation shall comply with policies relating to support groups as set forth in policy statements in effect from time to time.

## ARTICLE IX: MISCELLANEOUS

**SECTION 1. INSPECTION OF CORPORATE RECORDS** Every Trustee shall have the absolute right at any reasonable time to inspect and copy all books, records and documents of every kind and to inspect the physical properties of the Foundation. Such inspection may be made in person or by agent or attorney and the right of inspection includes the right to copy and make extracts.

**SECTION 2. REPRESENTATION OF SHARES OF OTHER CORPORATIONS** The Chair of the Board, the President, the Vice President–Finance or another Trustee designated by the Executive Committee is authorized to vote, represent, and exercise on behalf of the Foundation all rights incident to any and all shares of any other corporation or corporations standing in the name of the Foundation, unless the Board of Trustees designates another person to exercise such rights, or unless the By-Laws of the other corporation otherwise provide. The authority herein granted may be exercised either in person or by proxy or power of attorney duly executed.

**SECTION 3. FISCAL YEAR: AUDIT** The fiscal year of the Foundation shall be from July 1 to June 30. The financial books and records of the Foundation shall be audited at least once during each fiscal year by reputable and independent certified accountants.

## ARTICLE X. AMENDMENTS TO BY-LAWS

The Board of Trustees may adopt, amend, or repeal these By-Laws. Any proposed amendment, repeal, or revision of these By-Laws shall be submitted in writing to the Vice President–Finance not fewer than fifteen (15) or more than ninety (90) days prior to the meeting at which the same is to be considered. At least ten (10) days prior to such meeting, the Vice President–Finance shall mail or cause to be delivered copies of any such proposal to each Trustee in the manner provided in Section 10 of Article V (relating to Notice and Place of Meetings) of these By-Laws.

## Notes

1. For a similar and recent set of by-laws, see https://www.uclafoundation.org/docs/UCLA%20Foundation%20Bylaws%20-%20CURRENT%20(Approved%20March%2014,%202017).pdf.
2. For an example of educational foundation articles of incorporation, see https://www.uclafoundation.org/docs/Articles%20of%20Incorporation%20-%20UCLA%20Foundation%20%281983,%201984%29.pdf.

APPENDIX **4B**

# SUMMARY OF TRUSTEE RESPONSIBILITIES AND QUALIFICATIONS

## BOARD OF TRUSTEES

**SUMMARY OF RESPONSIBILITIES** Members of the board of trustees of a nonprofit organization must assume their role with a full understanding of the accountability and liability, both personal and organizational, resulting from their service in their particular state. Specific responsibilities include but are not necessarily limited to:

- Determine the organization's mission and ensure that it is being carried out, as documented by federal and state law.
- Set policies for ensuring that the organization operates according to its bylaws, the law, and ethical standards.
- Ensure compliance with the rules and regulations set by federal, state, and local governments that have jurisdiction over it (e.g., filing tax returns with the IRS).
- Make certain that donated funds are used for the purposes of the organization, as prescribed by the donor.
- Fulfill the legal requirements of the organization as an employer, including the payment of payroll taxes for the organization's employees.
- Develop the organization's overall program and engage in long-range strategic planning to establish its general course for the future.
- Oversee the financial health of the organization and establish fiscal policy and boundaries with budgets and financial controls.
- Provide adequate resources to operate the organization through direct financial contributions and a commitment to fundraising.
- Select and evaluate the performance of the executive director/chief executive officer.
- Develop and maintain a communication link between the organization and the community in promoting its work.
- Monitor the performance of the organization to maximize the welfare of the public.
- Represent the organization and its mission to the public.

**QUALIFICATIONS** Trustees must possess these qualifications:

- Strong commitment to the mission, goals, and objectives of the organization
- Time, energy, and expertise required to make a significant contribution

- Skills and experience in organizational, financial, and human resource management and strategic planning
- Ability to address issues and problems analytically, creatively, and decisively
- Strong leadership, interpersonal, and networking skills
- Familiarity with federal, state, and local laws and regulations governing nonprofit organizations
- Honesty, integrity, dedication, and positive attitude

## BOARD CHAIR

**SUMMARY OF RESPONSIBILITIES** The chair's overarching responsibility is to lead and motivate the board of trustees in concert with the ED/CEO. Specific responsibilities include:

- Focus the board on fulfilling its short- and long-term responsibilities and developing a clear vision for the future.
- Provide strong leadership and direction to the board, and develop ways to enhance its effectiveness.
- Represent and speak on behalf of the board concerning its decisions, actions, and related activities in interactions with the media, donors, and other constituencies of the nonprofit organization.
- Serve as the board's conscience and disciplinarian in order to control inexperienced or misguided trustees, prevent factionalism and other practices harmful to the board's reputation, promote teamwork and collegiality, and uphold ethical standards.

**QUALIFICATIONS** The chair must demonstrate these qualities:

- Exemplary record of service and contributions to the board that has earned the respect and trust of the membership
- Clear understanding of the respective responsibilities of the chair and the ED/CEO, and the ability to work cooperatively with the ED/CEO toward common goals
- Excellent command of all aspects of the nonprofit organization, including strengths and weaknesses, and the ability to focus the board's attention on both short-term needs and a long-term vision
- Close ties with business leaders, potential donors, government agencies, and others who can be of assistance to the nonprofit organization
- Strong organizational, communication, listening, motivating, decision-making, and public speaking skills
- Sensitivity, objectivity, foresight, loyalty, and discretion

## EXECUTIVE DIRECTOR/CHIEF EXECUTIVE OFFICER

**SUMMARY OF RESPONSIBILITIES** The ED/CEO of a nonprofit organization is appointed by and reports to the board of trustees and has primary responsibility for the day-to-day operations. Specific responsibilities are to:

- Manage the financial operations of the organization to include internal control, review of financial statements, and monitoring of all financial details to ensure their accuracy and integrity.
- Ensure that all programs, services, and activities contribute to and are in sync with the organizational mission, goals, and objectives.
- Implement and monitor compliance with policies related to the organizational bylaws, the law, and ethical standards.
- Select, supervise, and evaluate the performance of key positions, including the treasurer/chief financial officer.
- Develop and maintain close working relations with trustees, staff, donors, and the community at large.

**QUALIFICATIONS** The ED/CEO must possess these qualifications:

- Master's degree in business or the equivalent in a related field
- Extensive skills and experience in providing leadership and direction for all aspects of a large, complex nonprofit organization
- Proven ability to effectively manage financial, human, capital, and other organizational resources
- Excellent organizational, motivational, and interpersonal skills
- Familiarity with federal, state, and local laws and regulations governing nonprofit organizations
- Honesty, integrity, dedication, and positive attitude

## TREASURER/CHIEF FINANCIAL OFFICER

**SUMMARY OF RESPONSIBILITIES** The role of a nonprofit treasurer, or chief financial officer where that individual serves as the officer in lieu of the treasurer, entails these responsibilities (assuming that the organization does not have both a board treasurer and a separate chief financial officer; if it does have both, these responsibilities would be split between the two individuals):

- Develop a financial structure for the review and approval of the board of trustees.
- Safeguard the financial assets and maintain the financial records.
- Define appropriate standards of behavior for fulfilling the finance function within the organization.
- Prepare timely and meaningful financial statements.
- Plan and implement fundraising programs and explore planned giving opportunities.
- Comply with external reporting requirements.
- Develop and implement appropriate budgeting practices and procedures.
- Respond to operational changes affecting financial needs.
- Report financial results to the ED/CEO and board of trustees.
- Supervise and empower employees engaged in the organization's financial activities.

- Serve as a key participant in teams engaged in addressing multifaceted organizational problems.
- Play an integral role in organizational decision-making and creative problem solving.
- Develop and implement systems for internal and external information sharing related to the organization's finances.
- Work with program heads to represent their interests, explain the story behind the numbers, and clarify the business impacts during every step of the planning and budgeting process.
- Present to the ED/CEO and board of trustees a balanced picture of what is happening with the liquidity, financial position, and degree of cost coverage of major programs as well as for the organization as a whole, where the problems lie, and what actions need to be taken.

**QUALIFICATIONS** The treasurer/chief financial officer must possess these qualifications:

- Training and experience in financial management and knowledge of the treasury function, generally accepted accounting principles, and internal control systems
- Knowledge about the organization's mission and programs and their relationship to the financial requirements and components
- Technical expertise in developing budgets and preparing financial statements
- Operational expertise
- Interpersonal communication and decision-making skills
- Honesty, integrity as evidenced by background check and ability to be bonded, and commitment to the organization's mission, values, and goals

## SECRETARY

**SUMMARY OF RESPONSIBILITIES** The responsibilities of the secretary are reflected in the nonprofit organization's bylaws and standing orders and include these major functions:

- Plan board meeting calendar and individual meetings, develop and distribute agendas, and provide for the staffing needs of the board and its committees.
- Prepare and disseminate minutes, resolutions, policy statements, and board correspondence.
- Review and maintain bylaws and standing orders.
- Serve as custodian of official corporate documents and records.
- Coordinate and facilitate all board meeting arrangements, including travel, hotel, meals, and other logistical details.
- Foster effective communication and good personal relations between the board of trustees and the ED/CEO.

**QUALIFICATIONS** The secretary must possess these skills/strengths:

- Understanding of the secretary's unique role and commitment to developing and enhancing it
- Experience in managing and organizing all aspects of the work environment

- Knowledge of the history and mission of the nonprofit organization
- Familiarity with the legal and ethical issues of concern to trustees
- Superior writing, coordinative, and interpersonal skills
- Efficiency, flexibility, and attention to detail

## NOMINATING COMMITTEE

**SUMMARY OF RESPONSIBILITIES** Members of the nominating committee must devote their efforts to ensuring that the board of trustees possesses the optimal mix of skills, experience, and influence needed to meet the board's wide-ranging challenges. Particular responsibilities include:

- Assist the board in determining the desired composition with respect to skills, abilities, experience, diversity, and influence and in making periodic adjustments to meet the changing needs of the organization.
- Develop and cultivate a list of top-notch candidates who possess the desired qualities and are willing and able to serve.
- Design, implement, and oversee a program for orienting, educating, and motivating new trustees.
- Oversee the successful integration of new trustees onto board committees and other activities.
- Assess the effectiveness of individual board members at the end of their terms, and determine their reelection status.
- Identify and acknowledge meritorious contributions to the board on the part of individual trustees.
- Coordinate periodic reviews of the overall performance of the board.
- Nominate the officers of the board, and evaluate their performance on an annual basis.

**QUALIFICATIONS** Members of the nominating committee must possess these qualifications:

- Track record of strong, effective, and dedicated service on the board
- Access to prominent individuals in the business, financial, and other communities who are prospective recruits
- Clear understanding of the board's role and the importance of its composition to the organization's future
- Excellent planning, networking, and persuasive skills
- Patience, perseverance, and commitment to the task at hand

## FINANCE COMMITTEE

**SUMMARY OF RESPONSIBILITIES** The finance committee is charged with these tasks:

- Undertake a detailed review of all proposed budgets, financial statements and audit reports (unless the latter is done by a separate audit committee), and convey the results to the board.

- Take ownership for achieving and maintaining adequate liquidity and financial health/sustainability of the organization.
- Make recommendations to the board on policy matters and issues related to the financial management function of the nonprofit organization.
- Provide assistance and support to the treasurer/chief financial officer in the development of long-range plans for raising, managing, and safeguarding organizational funds in an optimal manner.

**QUALIFICATIONS** Members of the finance committee must have these qualifications:

- Clear understanding of the mission, goals, primary financial objective, and respective roles of the finance committee and treasurer/chief financial officer for the nonprofit organization
- Skills and experience in the areas of financial management, communication, and planning
- Integrity, good judgment, and adherence to sound financial principles

## VOLUNTEERS

Volunteers are invaluable resources who contribute to the mission of nonprofit organizations in a variety of important ways. They can assist in an optimal manner under these conditions:

- All volunteers are required to participate in an orientation program in order to gain a thorough understanding of the mission, goals, and activities of the nonprofit organization as well as to learn about available involvement opportunities.
- Volunteers are assigned to activities that match their particular experience, talents, and areas of interest.
- Staff members are assigned to oversee specific tasks performed by volunteers as well as to provide guidance and answer any questions that may arise.
- Job descriptions are used to clarify the specific tasks, duties, responsibilities, expectations, chain of command, and other details of the various volunteer positions.
- Background checks are administered where appropriate.
- Liability insurance coverage is held where appropriate.
- Periodic meetings with volunteers are held to solicit feedback on the progress made, problems encountered, and changes needed.
- Close working relations between volunteers and professional staff are fostered to ensure maximum effectiveness and productivity.
- Volunteers are treated with the utmost respect and appreciation, and complete their assigned tasks with thoughtfulness, flexibility, enthusiasm, and dedication.

# APPENDIX 4C

# RECOMMENDED GOVERNANCE AND ETHICS RESOURCES

There is a plethora of resources for the nonprofit financial manager to use in all the areas covered in this chapter. BoardSource is our top choice for governance resources. Below is listed a series of recommended resources available in the public domain without charge:

**I.** Suggested Best Practices (BoardSource)

- **A.** Recommended Governance Practices https://boardsource.org/recommended-board-practices/
- **B.** Checklist of Board Roles and Responsibilities https://boardsource.org/wp-content/uploads/2017/01/Checklist-Roles-Responsibilities.pdf
- **C.** Every Board's Must-Have Documents https://boardsource.org/must-have-board-documents/
- **D.** Tips for Developing a Mission Statement https://boardsource.org/developing-nonprofit-mission-statement/
- **E.** Glossary of Nonprofit Governance https://boardsource.org/board-service-glossary/
- **F.** Core Competencies of Nonprofit Chief Executives https://boardsource.org/ceo-core-competencies/
- **G.** Visual Resource Library – BoardSource https://boardsource.org/board-support/training-education/download-resources-tools/

**II.** Surveys of Actual Governance and Financial Management Practices

- **A.** Leading with Intent: A National Index of Nonprofit Board Practices (BoardSource) https://leadingwithintent.org/

  The 2017 Report is available for download at: https://cta-redirect.hubspot.com/cta/redirect/701610/4687469f-3e24-4a49-88d6-911b672538a5
- **B.** Adding It All Up: Nonprofit CFO Study (Steve Zimmerman and Jan Masaoka, *Blue Avocado* and American Nonprofits) http://blueavocado.org/content/adding-it-all-nonprofit-cfo-study
- **C.** Anecdotal Evidence: Chris Gaetano, "Speakers Reveal the Many Hats of the Nonprofit CFO," *The Trusted Professional* (NYSSCPA: February 6, 2017). https://www.nysscpa.org/news/publications/the-trusted-professional/article/speakers-reveal-the-many-hats-of-the-nonprofit-cfo

- **D.** Stanford Survey on Leadership and Management in the Nonprofit Sector http://www.engineofimpact.org/wp-content/uploads/2017/11/Stanford-Survey-on-Nonprofit-Leadership-November-2017.pdf
- **E.** Nonprofit Standards, A Benchmarking Survey (BDO Institute for Nonprofit Excellence, BDO USA) https://www.bdo.com/insights/industries/nonprofit/nonprofit-standards,-a-benchmarking-survey-(1)/nonprofit-standards,-a-benchmarking-survey

**III.** Professional Codes of Ethics

- **A.** Association for Financial Professionals Standards of Ethical Conduct http://ctpcert.afponline.org/certification/ethical-conduct
- **B.** AICPA Code of Professional Conduct http://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf
- **C.** Association of Fundraising Professionals Code of Ethical Standards http://www.afpnet.org/files/ContentDocuments/CodeofEthics.pdf

CHAPTER 5

# DEVELOPING FINANCIAL POLICIES



## 5.1 INTRODUCTION

As a potential incoming board member, I (Tim) wanted to know several things about the organization. I answered “yes” to service because I was interested in the organization’s mission and thought I could make a contribution to this mission. I asked to see its bylaws, its latest audit, and the current budget, as well as minutes, a board list, its latest IRS Form 990, and a set of its financial policies. The organization was able to provide all the requested items, except for its financial policies. Apparently the board and management did not have them but did not seem to think that policies were important enough to prioritize creating them. I responded that I would accept the board position only if there was an effort to create board-approved financial policies, and that I would be happy to lead the effort at creating them. Were policies really that important?

We respond in two ways. First, wisdom is enshrined in carefully developed and well-thought-out policies. Second, policies precede practices, just as beliefs lead to behaviors.

Establishing and complying with policy is the fundamental charge of the director, chief financial officer (CFO), or fund manager. *Internal policies* are your organization’s set of policies. *External policies* are provided by outside organizations and are agreed to as part of the acceptance of their funds.

**(a) WHAT IS POLICY?** Policies precede procedures, which drive practices. There are two general definitions for policy and procedure, one authoritative and the other practical:



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

| | Authoritative | Practical |
|---|---|---|
| Policy | A definite course of action adopted as expedient or from other consideration | A set of guidelines or principles defining an organization's philosophy toward how business shall be conducted |
| Procedure | The act or manner of proceeding in any action or process; conduct | Steps and/or actions to be taken to comply with a specific policy |

It is important to distinguish between policies and procedures as well as the difference between procedures and work instructions. After policies, which are more general rules or guidelines, have been established, the procedures for complying with policy can be developed. Procedures are the steps that must be taken to comply appropriately with policy. Make sure that those who are implementing the procedures will easily understand how to comply with the procedures and how this adheres to the overarching policy. Work instructions are the suggested steps that should be taken to comply with procedures. Illustrating, a conflict-of-interest policy (see example later in this chapter) should provide the purpose of the policy and guidelines for knowing when some action or relationship represents a potential conflict of interest, for determining if an actual conflict might occur, for communicating that conflict of interest, and finally the general approach to assist in resolving or avoiding the potential conflict, including the officer, manager, or staff positions that have a role in providing information regarding these conflicts. The procedures to follow might include when and how to contact the officer in the organization who serves as the point person for questions or to report potential conflicts, the time period within which that contact should occur, the different means of contact, information about recusing oneself from deliberations related to the potential conflict if s/he is the party with the potential conflict, and how long is allowed before follow up or resolution of each stage in the process must be completed. Work instructions, if included in this section, might include specific logs or software or portal locations at which reports and status updates are posted and by what time and in what time zone, and how often and to what location backups of the information must be made. Security precautions might be other specifics included in the work instructions.

Essential financial policies include budget policy, fund development policy, investment policies for short-term as well as long-term investments, debt policy, cash reserves or liquidity management policy, banking/cash management policy, internal control and accountability policy, risk management policy, conflict of interest policy, whistleblower policy, and document retention policy. Beyond these financially oriented policies your organization should also have CEO compensation, personnel, accounting and auditing, code of conduct or code of ethics, board compensation/reimbursement, travel expenditure, and fundraising and gift acceptance policies.[1]

Policy has regrettably been associated with red tape or bureaucracy. Phrases such as "I'm sorry, that's not our policy" as a method of saying no to someone contributes greatly to the perception that policy interferes with productivity, efficiency, and good customer relations. Certainly, in many instances, the negative association with policies is legitimate; many governmental bodies and regulatory agencies are mired in policy that is ineffective and out of date. Also, many policies have become a method of preventing lawsuits rather than what they are intended to be: a set of guidelines (laws, rules) or principles for how day-to-day business should be performed. Negative perceptions might carry some validity but the benefits of well-thought-out and well-communicated policies outweigh the objections. Good policies can lead to more efficiency, not less.

**(b) WHY ARE POLICIES REQUIRED?** Policy is the rule of law for an organization. Policies establish a common understanding of the overriding principles behind all that we do.

Good policies merge all the laws, rules, and regulations from all sources (both internal and external) into a cohesive instrument. Rather than providing new staff members (and board members) with copies of all the various laws, codes, and policies from all of the agencies and organizations that they may work with, policies condense all that information into one set of guidelines, eliminating inconsistencies and redundancies.

Even if policies are not written down, all organizations have policies. Sometimes, to avoid the negative association with the term, organizations may refer to them as guidelines, work rules, or job instructions. Regardless of what they are called or the form they take, they do exist.

If we did not have policies and procedures, a method or plan would have to be established each time someone needed to do something. If we needed to buy something, we would have to find out what rules applied and what procedural steps or actions needed to be taken every single time. In addition, policies enable us to share information by requiring that certain actions be performed and information be gathered in a consistent manner.

Summarizing, we see four benefits to having policies, preferably written ones:

1. Policies and procedures communicate and reinforce valued standard operating procedures (SOP) and philosophies to board members, staff, volunteers, and donors or grant agencies.
2. Policies serve as an orientation tool for new board members and new staff or volunteers. Financial and nonfinancial staff alike benefit from well-crafted policies. One cannot assume that key finance staff have adequate education, training, or background: Zimmerman and Masaoka find in their survey of 906 nonprofit finance professionals that just under one-half of organizations' CFOs have an undergraduate degree in accounting and finance (and we add that an accounting major gets about three weeks of coverage of nonprofit accounting, total), and small organizations' CFOs (annual revenues less than $500,000) indicate their knowledge of nonprofit accounting and finance consists of what they picked up from the board treasurer, articles, books, and technical assistance providers.[2] Staff turnover is also high, with as many as one in five staff people leaving in any given year.[3] Policies might be most helpful to the many smaller organizations: Three-quarters of U.S. nonprofits have annual budgets of less than $1 million, with most even smaller. These smaller organizations often have the executive director handling finances.[4] Policy "knowledge transfer" is also critically important for board members as they generally serve for specific terms and there should be a continual turnover of board members. Without policies, there could be a significant loss of knowledge.
3. Policies help in the management of the organization, as the executive director (ED)/chief executive officer (CEO) cannot be there for every decision that must be made, and policies are the vehicle through which the board influences and governs the organization. (We often hear that boards are "responsible for policy.") Good policies may help prevent micromanagement on the part of the board. A board's fiduciary responsibilities can be directly tied to policy development and approval.
4. Policies build and protect the organization's financial strength, particularly those set for cash reserves or liquidity management, fraud prevention/internal control, risk management, investments, debt, employment (background checks), and employee relations (harassment, confidentiality, discrimination, bonding); as a set, good policies regarding cash reserves or liquidity management, internal control, debt, and investments make an organization more "bankable" as well.

Do your current organizational practices give more or less emphasis to the benefits of policy? Exhibit 5.1 alerts you to 10 board member cautions related to finance. Particularly

1. **Ineffectually scrutinizing the overall enterprise**, from not receiving or reading financial statements, receiving them late or incomplete, not receiving or distributing to other board members the IRS Form 990, unawareness of how functional allocations are made (program, management, and fundraising expenses), or not discussing the auditor's management letter.
2. **Failing to monitor key indicators, allowing the organization to drift into financial trouble**, from not matching revenues and expenses, not monitoring debt ratios [we would add cash reserve and liquidity ratios], overspending some budget categories, or not being informed by the ED/CEO when income is delayed or under budget.
3. **Failing to pay sufficient attention to whether the organization's financial resources are being effectively spent on programs**, from not having documented program results related to outcomes, not merely the clients served or dollars spent.
4. **Being too trusting of staffers who handle money**, meaning that activities are verified and other appropriate internal controls are used, and possibly involving establishment of a financial control committee.
5. **Lacking strong external checks on financial reporting**, including not having a CPA firm conduct an audit (which should be done by many organizations, particularly those with budgets of $350,000 or more), since not all states require registered charities to have an audit.
6. **Emphasizing executive compensation at the expense of other employees**, offering competitive salaries and benefits to top-level executives while offering substandard compensation packages to all other staffers, resulting in poor morale and higher turnover [and, we would add, perceived inequity].
7. **Failing to "bid out" the sale of organizational assets**, such as hospital conversions, and building, camp, and religious television station sales that are made to a single bidder and without the board assessing fairness of the sales price.
8. **Failing to scrutinize outside service contracts sufficiently**, including fundraising, direct mail, and telemarketing consulting services, which should normally be rebid at least every three years [we would add your primary banking and insurance, investments, and other service providers to this list].
9. **Spending funds restricted by time or purpose**, including meeting cash flow shortfalls with special project dollars, capital funds, or even endowment funds, even though temporary uses of restricted funds are technically a violation of law in every state; this situation reveals that the board has allowed the organization to get into a financial hole, linking back to pitfall #2.
10. **Mixing charitable and business interests**, which is arising more and more as a conflict of interest that comes out of a partnership of some kind, and appears to emerge from the very board members who were recruited because of their connections.

*Source:* Jon Pratt, "Financial Malfeasance and Nonfeasance: Ten Pitfalls Boards Should Avoid," *Board Member* (September/October 1996): 3. Used by permission.

**EXHIBIT 5.1** BOARD MEMBER CAUTIONS RELATED TO FINANCES

note items #1, 2, and 9, which touch on liquidity, debt, and spending policies. Your financial control policy might include items #4 and 5. Your conflict of interest policy might embrace items #6–8 and 10. As you read this listing of areas of nonprofit board financial malfeasance (misconduct or wrongdoing) and nonfeasance (failure to perform an official duty), think of how policy could prevent or limit the degree of harm.

**(c) COMPLYING WITH AND ESTABLISHING POLICY AND PROCEDURE.** One of the jobs of the CFO, as well as all the leaders in an organization, is to promote and establish a positive attitude toward the compliance with policy, either external or internal. If there is no support at the top, there will be no compliance at the bottom. Before staff and managers will comply with policy, they need to receive a clear message from executive management that the organization supports and actually insists on compliance with policy.

External expectations have been increasing over time. As of the time of this writing, 23 states now require organizations of a certain size or raising a certain amount of donor funds to have an audit.[5] Depending on the nature of your organization and the specific policy, internal or external noncompliance can range from fraud to poor business management, from felony to raised eyebrows.

#### (d) WHO SETS POLICY?.

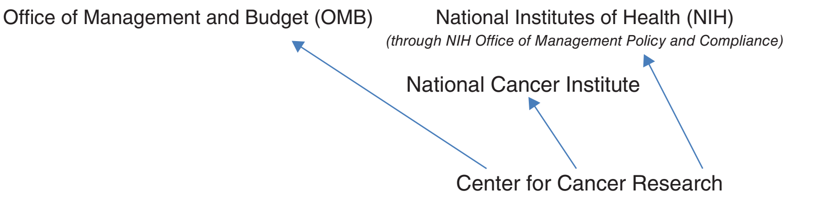
- *Internal.* Internal policies are those that are in effect within your organization. These policies must indicate compliance with external policies. (See Exhibit 5.12 later in the chapter for methods to develop these policies.) The board establishes policy, and each department within the organization develops a set of policies that detail compliance with the policy established by the board.
- *External.* External policies are those that affect day-to-day operations but are in charge of an entity outside the organization, such as the government or other regulatory agency. For financial management, compliance with GAAP standards is necessary and accounting policy and financial policies should reflect this compliance requirement.

Policies are very similar to laws: They have a hierarchical structure. Your organization has some form of hierarchy. The board of directors sets the mission and goals of the institution; it communicates this mission to the executives who, in turn, communicate it to the units under their jurisdiction, and so on. At each step in the process, policy is being established.

Organizations that are part of the US government, or do business with it, are required to comply with all US government policies. Within the US government, there is a hierarchy of policies. A simplified diagram illustrating this hierarchy is shown in Exhibits 5.2 and 5.3.

Exhibit 5.2 illustrates how the Center for Cancer Research (part of the National Cancer Institute, which in turn is part of the National Institutes of Health) must comply externally with the policies in the Office of Management and Budget (OMB) as well as internally with the policies of the National Institutes of Health (NIH) and the National Cancer Institute (NCI). The Center for Cancer Research also has its own set of policies with which it must comply. Any organization doing business with it must comply with this same set of policies.

Hierarchy of Policies for the National Cancer Institute's Center for Cancer Research




*Arrows indicate policy agents to which the Center for Cancer Research must conform.*

**EXHIBIT 5.2** SIMPLIFIED DIAGRAM ILLUSTRATING THE HIERARCHY OF POLICY WITHIN THE US GOVERNMENT

**Office of Management and Budget Mission**

OMB's predominant mission is to assist the president in overseeing the preparation of the federal budget and to supervise its administration in executive branch agencies. In helping to formulate the president's spending plans, OMB evaluates the effectiveness of agency programs, policies, and procedures, assesses competing funding demands among agencies, and sets funding priorities. OMB ensures that agency reports, rules, testimony, and proposed legislation are consistent with the president's budget and with administration policies.

In addition, OMB oversees and coordinates the administration's procurement, financial management, information, and regulatory policies. In each of these areas, OMB's role is to help improve administrative management, to develop better performance measures and coordinating mechanisms, and to reduce any unnecessary burdens on the public.

*Source:* http://www.whitehouse.gov/.

**Exhibit 5.3** OMB's Role

Let's say your organization is contracting with the Center for Cancer Research. If each time your staff members had to decipher all the policies in the hierarchy, they would be hindered in doing anything productively; however, if your organization had a broad set of policies that included the requirements of the Center for Cancer Research as well as any other agency with which they did business, work could be conducted both efficiently and effectively.

When the NIH developed its policies, it interpreted the policies provided by the OMB. In turn, the NCI developed its policies from the interpretation of the OMB policy produced from the NIH. Each time the OMB makes a policy change, it causes a ripple effect throughout the entire US government as well as in all the organizations that do business with the government. To see more about the OMB's oversight role in this structure, see Exhibit 5.3.

Unfortunately, many organizations within and outside of the US government have not devoted the time and resources to maintaining their policies, revising or eliminating outdated policies, or incorporating new policies. Policies within the US government – or any organization – can proliferate and become meaningless. Policy evaluation should be an integral element in policy development. We elaborate on this in Chapter 15.

**(e) WHERE TO START?** Since policies are very often an interpretation of another policy, the core meaning of the policy is often lost after multiple iterations – and the original intent may have been largely forgotten.

With the proliferation of policies without proper maintenance, it is important to start with the original policy statement in developing new policies (or updating of existing policies). Only in the original document, not in the interpretations, can the policies and their underlying philosophy be comprehended. If your organization has dealings with the US government, obtaining copies of the OMB publications is one of the best places to start. (See the most recent listing in Exhibit 5.4.) Even if you do not have business dealings with the US government, the policies from the OMB may be a good model for some of the policies you develop, such as your payables policy.

Of particular interest to the CFO or treasurer is the way in which the federal government has codified and implemented the Prompt Payment Act provisions. The details are included as Exhibit 5.5. We include this not as a model example of the level of detail to which your policy should go – yours will be much briefer and simpler – but to reflect the thoughtfulness and care with which some organizations craft financial policy. Notice how the policy writers included such details as defining the invoice receipt dates and whether to consider cash discounts.

*OMB Circular A-1, System of Circulars and Bulletins to Executive Departments and Establishments (08/07/1952)*
*OMB Circular A-4, Regulatory Analysis (09/17/2003)*
*OMB Circular A-11, Preparation, Submission and Execution of the Budget (8/1/2017)*
*Note: Portions of this policy were modified by M-17-26, Reducing Burden for Federal Agencies by Rescinding and Modifying OMB Memoranda, issued June 15, 2017. Reference that item for details.*
*— OMB Circular A-11, Part 6, Section 270 – Reporting the Results of Annual Strategic*
*— OMB Circular A-11, Part 6, Sections 220 and 250 – Quarterly Reporting of Priority Goals to Performance.gov*
*OMB Circular A-16, Coordination of Geographic Information, and Related Spatial Data Activities (08/19/2002)*
*OMB Circular-019, Legislative Coordination and Clearance (09/20/1979)*
*OMB Circular A-21, Cost Principles for Educational Institutions (05/10/2004) - Relocated to 2 CFR, Part 220*
*OMB Circular-025, Transmittal Memorandum #1, User Charges (07/08/1993)*
*OMB Circular A-34, Instructions on Budget Execution (Rescinded 6/27/2002; superseded by OMB Circular No. A-11, Part 4)*
*OMB Circular-045, Rental and Construction of Government Quarters (10/20/1993)*
*OMB Circular-050, Audit Follow Up (09/29/1982)*
*OMB Circular A-76, Performance of Commercial Activities (05/29/2003) including changes made by OMB Memorandum M-07-02 (10/31/2006) and the technical correction made by OMB Memorandum M-03-20 (08/15/2003)*
*Note: You will want to see OMB Memoranda M-04-12, Performance Periods in Public-Private Competitions (April 30, 2004), M-06-13, Competitive Sourcing under Section 842(a) of P.L. 109-115 (April 24, 2006), and M-08-11, Competitive Sourcing Requirements in Division D of Public Law 110-161 (February 20, 2008) if you are applying the following provisions of OMB Circular A-76: Paragraphs 4.c and 5.d; Attachment B, Paragraphs A.5, C.1.a, C.1.c, D.3.a(7), and D.5.b(3); Attachment C, Paragraphs A.5, A.12, C.3 and Section D.*
*Preamble to the revision to OMB Circular No. A-76, "Performance of Commercial Activities" (05/29/03)*
*Implementing the FAIR Act:*
*— Transmittal Memorandum #20 (06/14/1999)*
*— Transmittal Memorandum #21 (04/27/2000)*
*— Transmittal Memorandum #22 (08/31/2000)*
*— Transmittal Memorandum #23 (03/14/2001)*
*— Transmittal Memorandum #24 (02/27/2002)*
*— Transmittal Memorandum #25 (03/14/2003)*
*Proposed Revised OMB Circular A-76 (November 14, 2002) (for agency and public comment)*
*Preamble to the proposed revision to OMB Circular No. A-76, "Performance of Commercial Activities" (11/19/02)*
*Docket of Comments to Proposed Revised OMB Circular A-76*
*Email Comments on the Revision of Circular A-76*
*Fax Comments on the Revision of Circular A-76*
*Historical Circular A-76, Performance of Commercial Activities, (08/04/1983) (Revised 06/14/1999)*
*Supplemental Handbook (04/01/1996) (Revised 06/14/1999)*

**Exhibit 5.4 OMB Circulars in Numerical Sequence**

*OMB Circular A-87, Cost Principles for State, Local and Indian Tribal Governments (05/10/2004)*

*Relocated to 2 CFR, Part 225*

*OMB Circular A-89, Catalog of Federal Domestic Assistance (08/17/1984)*
*OMB Circular A-94, "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs" (10/29/1992)*

*Appendix C: Discount Rates for Cost-Effectiveness, Lease-Purchase, and Related Analyses for OMB Circular No. A-94 (11/2016).*

*Table of Past Years Discount Rates from Appendix C of OMB Circular No. A-94 (12/15/2016)*

*Memorandum, 2017 Discount Rates for OMB Circular No. A-94 (12/12/2016)*

*OMB Circular-097, Rules and Regulations Permitting Federal Agencies to Provide Specialized or Technical Services to State and Local Units of Government Under Title III of the Intergovernmental Cooperation Act of 1968 (08/29/1969)*

*Transmittal Memorandum #1, Specialized or Technical Services for State and Local Governments (03/27/1981)*

*OMB Circular A-102, Grants and Cooperative Agreements With State and Local Governments (10/07/1994) (further amended 08/29/1997)*
*OMB Circular A-108, Federal Agency Responsibilities for Review, Reporting, and Publication under the Privacy Act*
*OMB Circular A-110; Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations (11/19/1993) (further amended 09/30/1999, Relocated to 2 CFR, Part 215)*
*OMB Circular A-119, Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities*
*Federal Register Notice on Revision of OMB Circular No. A-119, "Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities" (01/27/2016)*
*OMB Circular A-119, Federal Participation in the Development and Use of Voluntary Consensus Standards and in Conformity Assessment Activities (01/27/2016)*
*OMB Circular A-119, Transmittal Memorandum, Federal Participation in the Development and Use of Voluntary Standards (02/10/1998)*
*OMB Circular A-122, Cost Principles for Non-Profit Organizations (05/10/2004), Relocated to 2 CFR, Part 230*
*OMB Circular A-123*
*Note: Portions of this policy were modified by M-17-26, Reducing Burden for Federal Agencies by Rescinding and Modifying OMB Memoranda, issued June 15, 2017. You will want to refer to that memorandum for more details.*

*— Chapter 5 of Appendix B:*

*— Government Charge Card Reporting pursuant to Appendix B*

*Management's Responsibility for Enterprise Risk Management and Internal Control (Revised 07/15/2016)*

*Management's Responsibility for Internal Control (Effective beginning with Fiscal Year 2006) (Revised 12/21/2004)*

**Exhibit 5.4 OMB Circulars in Numerical Sequence** (*continued*)

*Appendix A Implementation Plans (08/01/2005)*

*Appendix A Implementation Guide (07/2005)*

*Appendix A Frequently Asked Questions (04/13/2006)*

*Issuance of Revised Appendix B to OMB Circular A-123 (01/15/2009)*

*Management's Accountability and Control (Effective through Fiscal Year 2005) (Revised 06/21/1995)*

*Appendix C, Requirements for Effective Estimation and Remediation of Improper Payments (10/20/2014)*

*Appendix D, Compliance with the Federal Financial Management Improvement Act (09/20/2013)*

*Conducting Acquisition Assessments under OMB Circular A-123 (May 21, 2008)*

*Note: Portions of this policy have been paused by M-17-26, Reducing Burden for Federal Agencies by Rescinding and Modifying OMB Memoranda, issued June 15, 2017. You will want to refer to that memorandum for details.*

*OMB Circular A-125, was rescinded and replaced by the Prompt Pay regulations at 5 CFR Part 1315*

*OMB Circular A-126, Improving the Management and Use of Government Aircraft (05/22/1992).*

*Note: Portions of this policy were paused by M-17-26, Reducing Burden for Federal Agencies by Rescinding and Modifying OMB Memoranda, issued June 15, 2017. You will want to consult that memorandum for details.*

*Attachment A*

*Attachment B*

*OMB Circular A-127, was rescinded and replaced by Circular No. A-123 Appendix D.*

*OMB Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables (Revised 01/2013)*

*Transmittal Letter*

*Policies for Federal Credit Programs and Non-Tax Receivables*

*Attachment: Write-Off/Close-out Processes for Receivables Appendix A: Program Reviews Appendix B: Model Bill Language for Credit Programs Appendix C: Management and Oversight Structures*

*Appendix D: Effective Reporting for Data-Driven Decision Making*

*Appendix E: Communications Policies*

*OMB Circular A-130, Managing Federal Information as a Strategic Resource*

*Federal Register Notice on Revision of OMB Circular A-130, "Managing Federal Information as a Strategic Resource" (07/28/2016)*

*OMB Circular A-130, "Managing Federal Information as a Strategic Resource" (7/28/2016)*

*OMB Circular A-131, Value Engineering (12/26/2013)*

*Note: Portions of this policy were paused by M-17-26, Reducing Burden for Federal Agencies by Rescinding and Modifying OMB Memoranda, issued June 15, 2017. You will want to consult that memorandum for details.*

*Proposed Revision to OMB Circular A-131*

**Exhibit 5.4 OMB Circulars in Numerical Sequence** (*continued*)

*OMB Circular A-133, Audits of States, Local Governments and Non-Profit Organizations (includes revisions published in the Federal Register 06/27/2003 and 06/26/2007)*

*August 2017 Compliance Supplement*

*Federal Register Notice for the 2017 Compliance Supplement*

*OMB Circular A-134, Financial Accounting Principles and Standards (05/20/1993)*
*OMB Circular A-135, Management of Federal Advisory Committees (10/05/1994)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (8/15/2017)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (10/7/2016)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (8/4/2015)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (9/18/2014*
*OMB Circular A-136, Financial Reporting Requirements – Revised (10/21/2013)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (8/3/2012)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (10/27/2011)*
*OMB Circular A-136, Financial Reporting Requirements – Revised (09/29/2010)*

*Source:* Adapted from "Office of Management and Budget Circulars: OMB Circulars in Numerical Sequence" n.d. Available at: https://www.whitehouse.gov/omb/circulars/. Accessed: 1/10/2018. PDFs of some of the items referenced here are available at that site.

**Exhibit 5.4 OMB Circulars in Numerical Sequence** (*continued*)

*Sec. 1315.4 Prompt payment standards and required notices to vendors.*

Agency business practices shall conform to the following standards:

**(a)** Required documentation. Agencies will maintain paper or electronic documentation as required in Sec. 1315.9.

**(b)** Receipt of invoice. For the purposes of determining a payment due date and the date on which interest will begin to accrue if a payment is late, an invoice shall be deemed to be received:

**(1)** On the later of:

**(i)** For invoices that are mailed, the date a proper invoice is actually received by the designated agency office if the agency annotates the invoice with date of receipt at the time of receipt. For invoices electronically transmitted, the date a readable transmission is received by the designated agency office, or the next business day if received after normal working hours; or

**(ii)** The seventh day after the date on which the property is actually delivered or performance of the services is actually completed; unless –

**(A)** The agency has actually accepted the property or services before the seventh day in which case the acceptance date shall substitute for the seventh day after the delivery date; or

**(B)** A longer acceptance period is specified in the contract, in which case the date of actual acceptance or the date on which such longer acceptance period ends shall substitute for the seventh day after the delivery date;

**Exhibit 5.5** Federal Agency Prompt Payment Policy

**(2)** On the date placed on the invoice by the contractor, when the agency fails to annotate the invoice with date of receipt of the invoice at the time of receipt (such invoice must be a proper invoice); or

**(3)** On the date of delivery, when the contract specifies that the delivery ticket may serve as an invoice.

**(c)** Review of invoice. Agencies will use the following procedures in reviewing invoices:

**(1)** Each invoice will be reviewed by the designated agency office as soon as practicable after receipt to determine whether the invoice is a proper invoice as defined in Sec. 1315.9(b);

**(2)** When an invoice is determined to be improper, the agency shall return the invoice to the vendor as soon as practicable after receipt, but no later than 7 days after receipt (refer also to paragraph (g)(4) of this section regarding vendor notification and determining the payment due date). The agency will identify all defects that prevent payment and specify all reasons why the invoice is not proper and why it is being returned. This notification to the vendor shall include a request for a corrected invoice, to be clearly marked as such;

**(3)** Any media which produce tangible recordings of information in lieu of "written" or "original" paper document equivalents should be used by agencies to expedite the payment process, rather than delaying the process by requiring "original" paper documents. Agencies should ensure adequate safeguards and controls to ensure the integrity of the data and to prevent duplicate processing.

**(d)** Receipt of goods and services. Agencies will ensure that receipt is properly recorded at the time of delivery of goods or completion of services. This requirement does not apply to interim payments on cost-reimbursement service contracts except as otherwise required by agency regulations.

**(e)** Acceptance. Agencies will ensure that acceptance is executed as promptly as possible. Commercial items and services should not be subject to extended acceptance periods. Acceptance reports will be forwarded to the designated agency office by the fifth working day after acceptance. Unless other arrangements are made, acceptance reports will be stamped or otherwise annotated with the receipt date in the designated agency office. This requirement does not apply to interim payments on cost-reimbursement service contracts except as otherwise required by agency regulations.

**(f)** Starting the payment period. The period available to an agency to make timely payment of an invoice without incurring an interest penalty shall begin on the date of receipt of a proper invoice (see paragraph (b) of this section) except where no invoice is required (e.g., for some recurring payments as defined in Sec. 1315.2(dd)).

**(g)** Determining the payment due date. (1) Except as provided in paragraphs (g)(2) through (5) of this section, the payment is due either:

**(i)** On the date(s) specified in the contract;

**(ii)** In accordance with discount terms when discounts are offered and taken (see Sec. 1315.7);

**(iii)** In accordance with Accelerated Payment Methods (see Sec. 1315.5); or

**(iv)** 30 days after the start of the payment period as specified in paragraph (f) of this section, if not specified in the contract, if discounts are not taken, and if accelerated payment methods are not used.

**Exhibit 5.5** Federal Agency Prompt Payment Policy (*continued*)

## 5.2 FINANCIAL POLICIES

Financial issues are among the greatest sources of stress for your organization's CEO/ED. According to an Illinois statewide survey of all types of arts organizations, finances/fundraising is the single most frustrating aspect of being a CEO/ED, and finances (apart from fundraising) have the most adverse effect on these individuals in their current position, as seen in Exhibit 5.6.[6] We cannot help but wonder how many of these organizations are underfunded and possibly understaffed in the finance function, partly due to the lack of appropriate financial policies and financial strategies. Financial policies are absolutely essential to organizational health and well-being in your organization.

**(a) ROLES OF BOARD, BOARD TREASURER, AND CEO/ED.** The board treasurer is a key resource in enabling your organization as it devises or revises financial policies. The board as a whole is responsible for setting policy. Whether or not your organization has adopted John Carver's policy governance model, an underpinning philosophy for your policies is that the board governs the organization and is the sole voice overseeing the CEO/ED. The key is not to put more authority in the board treasurer than is warranted, as Carver notes:

> Board Treasurers, as commonly used, threaten CEO accountability as well as the one voice principle. Treasurers are typically expected to exercise individual judgment about the financial dealings of the organization. But Policy Governance boards do not allow Treasurers to exercise authority over staff. (Rendering an official judgment of performance against one's own individual criteria has the same effect as exercising authority.) By creating a role with supervisory authority over the CEO with respect to financial management, the board cannot then hold the CEO accountable for that topic. The board should accept responsibility for financial governance (setting policy, then comparing performance) and require the CEO to be accountable for managing finances so that performance compares favorably to policy. The typical use of a Treasurer, when a Policy Governance board is required by law to have one, is to assist the board in making financial policy, never to judge CEO compliance against the Treasurer's own expectations.[7]

**Question: What Are the Two Most Frustrating Things About Your Current Job as Executive Director?**

Finances/fundraising: 50%; Staff problems: 40%; Overworked/stress: 36%; Board conflict/complacency: 23%.

**Question: To What Degree Are These Factors Adversely Affecting You in Your Current Position?**

Scale of 1 = not much at all to 5 = very much.
Mean: 2.8

| | |
|---|---|
| Finances | 3.6 |
| High stress/long hours | 3.4 |
| Funding requirements | 3.0 |
| Audience | 3.0 |
| Fundraising | 2.8 |
| Personnel problems | 2.8 |
| Isolation | 2.7 |
| Low compensation | 2.5 |
| Conflict with the Board | 1.8 |

**Exhibit 5.6** CEO/ED Frustrations with Financial Position of the Organization

Unfortunately, many boards are handicapped when it comes to setting policy. Partly this is due to their limited understanding of the dynamics of the organization and the markets in which it operates – especially donor and grantor markets. However, even in businesses, many of which have compensated boards, key decision-makers may not comprehend the risks. Evidence gathered by consulting agency McKinsey finds that 44 percent of directors only partly understand the main drivers of value for their organizations, and 43 percent cannot state what the organizations' key risks are.[8] We project even lower percentages for nonprofit boards based on our field observations and the studies we have read. Accordingly, the template of policies we offer here may serve as a valuable starting point for board members. As their understanding of their organization grows, they can modify and amplify various aspects of these policies.

**(b) FINANCIAL POLICIES: PRESCRIPTIVE OR RESTRICTIVE?** A natural tendency, but one that must be resisted, is to prescribe what the organizational management can or should do in many conceivable scenarios. This *prescriptive* approach to policy is doomed to failure for two reasons:

1. One can never anticipate all the important future scenarios or their probability of occurrence (witness the donation fall-offs in late 2001 and 2002 after 9/11, after the tsunami and after Hurricanes Katrina and Rita in 2005, after the "Great Recession" that began in late 2007, the wealth effect that emerged after the election of Donald Trump to the presidency in 2016, the "Trump Rally" in the stock market, and the major revision to the tax code that affected the relative value of charitable deductions due to the doubling of the personal exemption in late 2017).
2. One would not wish to limit the flexibility of managers because new solutions become available over time for dealing with given scenarios.

A better approach is to have a *restrictive* set of policies, limiting to a prudent degree the responses that may be taken for generic events, such as funding shortfalls. Again, the goal is to put some limits on response categories, not prescribe exact measures to take in each future eventuality. This becomes much clearer with an example; Carver offers a good one:

> … consider an Executive Limitations policy in which the board is putting certain financial conditions and activities "off limits." At the broadest level, the board might say: "With respect to actual, ongoing financial condition and activities, the CEO shall not allow the development of fiscal jeopardy or a material deviation of actual expenditures from board priorities established in Ends policies [about the changes for persons to be made outside the organization, along with their cost or priority]." That covers the board's concerns about the organization's current financial condition at any one time, for there is likely nothing else to worry about that isn't included within this "large bowl" proscription.
>
> However, most boards would think such a broad statement leaves more to CEO interpretation – even if reasonable interpretation – than the board wishes to delegate. Hence, the board might add further details, such as saying the CEO shall not:
>
> (1) Expend more funds than have been received in the fiscal year to date except through acceptable debt. (2) Indebt the organization in an amount greater than can be repaid by certain, otherwise unencumbered revenues within 60 days, but in no event more than $200,000. (3) Use any of the long-term [strategic or capital] reserves. (4) Conduct inter-fund shifting in amounts greater than can be restored to a condition of discrete fund balances by unencumbered revenues within 30 days. (5) Fail to settle payroll and debts in a timely manner. (6) Allow tax payments or other government ordered payments or

filings to be overdue or inaccurately filed. (7) Make a single purchase or commitment of greater than $100,000, with no splitting of orders to avoid this limit. (8) Acquire, encumber or dispose of real property. And (9) Fail to aggressively pursue receivables after a reasonable grace period.

A given board might go into less or more detail than in this example.[9]

We recognize that there are general areas of guidance that are part of policy statements, as we will illustrate when we get into policy specifics. To the extent possible, though, try to state policy statements restrictively, providing needed boundaries and board oversight.

**(c) CATEGORIES OF FINANCIAL POLICIES.** For organizations not already having policies, we shall provide categories for these policies and some examples. Larger organizations may wish to establish a second level of policies for operating units. Exhibit 5.7 provides a sample of core financial management policies for operating units.

We focus mainly on the first two categories in our presentation of organizational policies, but note that many nonprofits are viewing Sarbanes-Oxley legislation as a good guide for the "Regulatory Compliance" category, even though most of the legislation is nonbinding

| | |
|---|---|
| Accountability Delegations | The <Chancellor/Board/President> delegates the accountability for the financial management of resources to functional units within <Organization>. Consequently, each unit is responsible for properly managing the financial resources of the <Organization> for which they have been provided jurisdiction (e.g., earnings from sales and services, appropriations into accounting units assigned to their departments, etc.) to include identifying a designee (normally the Chief Administrative/ Financial Officer) responsible for formulating an accountability structure for each area. This structure depicts the delegation to initiate, process, and review business transactions by only qualified individuals. |
| Financial Management | Each operating unit requires financial resources in order to conduct their respective role in the <Organization>'s overall mission. Each organizational head or their designee is responsible for ensuring that the units under their direction manage <Organization> funds in an efficient and cost-effective manner by adopting proven financial management practices. |
| Data Integrity | Financial management decisions affect each organizational unit, the <Organization>, and interested outside parties. In order to make these decisions appropriately, timely, accurate, and complete data is imperative. Additionally, systems must be in place that contain and generate reliable financial information to help facilitate this decision-making process. Each unit must adopt proven data-integrity practices which provide reasonable assurance that transactions which occur are in accordance with management's general and specific authorization, and that all financial activities which occur are recorded in the financial records of the <Organization>. Each organizational head or their designee is responsible for establishing a system that ensures data integrity. |
| Regulatory Compliance | All individuals conducting business transactions affecting <Organization> funds must comply with all laws and regulations as well as any restrictions on the use of those funds. Each organizational head or their designee is responsible for ensuring that these units under their direction commit funds only in accordance with legal and regulatory requirements. |

**EXHIBIT 5.7** SAMPLE OF CORE FINANCIAL MANAGEMENT POLICIES FOR OPERATING UNITS

for nonprofit organizations. Accordingly, we will group "Regulatory Compliance" with "Accountability" in our presentation.

**(d) ACCOUNTABILITY AND REGULATORY COMPLIANCE POLICIES.** Public perception of nonprofit ethics today requires that your organization works on adopting policies that promote and convey an accountable, ethical organization that merits trust on the part of all stakeholders and complies with appropriate legislation and regulation. A Michigan survey finds that only 75 percent of people agree with the statement "Most charitable organizations are honest and ethical in their use of funds.[10] Another nationwide donor survey finds that 49% of donors indicate they do not know how nonprofits use the money they donate, 34% of them feel hassled by the frequency of solicitations, 20% of them are not sure who benefits from the work a nonprofit does, 15% had concerns about "enabling" others, and 13% said both that nonprofits always seem to be in a crisis and that as donors they did not have enough information to make a good decision.[11]

***(i) Accountability Policies.*** Your policy here may be as simple as "using all appropriate communication media to demonstrate XYZ organization's adherence to mission and efficiency." For example, this may be evidenced by how well the organization meets "charity watchdog" or charity ratings organizations' standards – although, as suggested in Chapter 2, some of these standards may be dysfunctional for your organization's financial health and development. As an example of an accountability disclosure, Exhibit 5.8 is a screen capture from humanitarian organization Convoy of Hope's website. (To review the financial standards promoted by these charity ratings agencies, refer back to Chapter 2.)

Here are some questions to ask yourself as you and your staff prepare your organization for accountability and for establishing your accountability policies:

- Are our Form 990 reports easily available?
- Do we publish our annual reports with financial data and outcomes measures?
- Do we rely on annual independent audits (if appropriate)?
- Do we create necessary policies and enforce them regularly?
- Do we avoid and manage conflicts of interest?
- Do we understand our board's role and responsibility? Does our board review the Form 990 and financial statements?
- Are we familiar with intermediate sanctions, and do we have policy to prevent situations that would cause them to be levied?
- Do we keep accurate, timely, and well-organized records?
- Do we know applicable federal regulations and our state's laws?[12]

Conflicts of interest are a huge front-burner issue today; in Exhibit 5.9 we provide an example of a conflict of interest policy.

***(ii) Regulatory Compliance Policies.*** Some of the items here overlap with accountability, as you will see in the next list of items to consider in your policies:

- *Form 990 and other financial reports.* Although you may not formally address this aspect of your external financial reporting in a policy statement, your organization may show accountability and market itself at the same time through the Form 990. Nonprofit auditing and consulting firm Capin Crouse LLP offers some wise counsel in this regard, which we have included as Exhibit 5.10.

CONVOY OF HOPE®

As a faith-based, nonprofit organization Convoy of Hope has helped more than 80 million people throughout the world by sharing food, water, emergency supplies, agricultural know-how, and opportunities that empower people to live independent lives, free from poverty, disease and hunger.

Convoy of Hope does this through:

Mobilizing tens of thousands of volunteers each year.

Partnering with churches, businesses, individuals and other humanitarian organizations who are intent on doing good work among the impoverished and suffering.

Transparency — we have received the prestigious Four Star Charity Award from Charity Navigator for 14 years.

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**Exhibit 5.8** Accountability and Charity Watchdog Standards Compliance

The standard of behavior at the _____ Organization is that all staff, volunteers, and board members scrupulously avoid conflicts of interest between the interests of the _____ Organization on one hand, and personal, professional, and business interests on the other. This includes avoiding potential and actual conflicts of interest, as well as perceptions of conflicts of interest.

I understand that the purposes of this policy are to protect the integrity of the _____ Organization's decision-making process, to enable our constituencies to have confidence in our integrity, and to protect the integrity and reputations of volunteers, staff, and board members. Upon or before election, hiring or appointment, I will make a full, written disclosure of interests, relationships, and holdings that could potentially result in a conflict of interest. This written disclosure will be kept on file and I will update it as appropriate. I understand that the purposes of this policy are to protect the integrity of the _____ Organization's decision-making process, to enable our constituencies to have confidence in our integrity, and to protect the integrity and reputations of volunteers, staff and board members. Upon or before election, hiring or appointment, I will make a full, written disclosure of interests, relationships, and holdings that could potentially result in a conflict of interest. This written disclosure will be kept on file and I will update it as appropriate.

In the course of meetings or activities, I will disclose any interests in a transaction or decision where I (including my business or other nonprofit affiliations), my family and/or my significant other, employer, or close associates will receive a benefit or gain. After disclosure, I understand that I will be asked to leave the room for the discussion and will not be permitted to vote on the question.

I understand that this policy is meant to supplement good judgment, and I will respect its spirit as well as its wording.

Signed:
Date:

*Source:* From "Boardroom Dancing," a handbook for nonprofit boards written by Jan Masaoka and Jude Kaye of CompassPoint Nonprofit Services (February 2000). Used by permission.

**Exhibit 5.9** Sample Conflict-of-Interest Policy

Your annual Form 990 is now a higher profile document than ever before. The fact that anyone can get a copy of your Form 990 from sources such as GuideStar.org has long frustrated many charities, because these forms include personal information about key employees and board members. But Form 990 also allows you to market your organization, because it gives details about your mission and program service accomplishments. Nonprofits vary dramatically in the amount of data they provide here, but this is definitely an opportunity to shine.

Form 990 asks for your primary exempt purpose and specific information for each of your four largest programs, including a description of programs' service accomplishments using measurements such as the number of clients served, units of service or publications issued. It also requires that you describe the activities, as well as current and long-term objectives.

Don't feel constrained by the few lines of space on the form. You may simply state "see attached" and provide more detailed information about your activities, accomplishments, staff expertise and innovations. Volunteer services don't get included as expenses, but you can report them on the form. You may also attach an explanation about everything that you've accomplished thanks to volunteers' generosity. Clearly, a detailed Form 990 can be a great marketing tool for your organization.

*Source:* http://www.capincrouse.com/.

**Exhibit 5.10** Marketing Your Organization through Your Form 990

- Audits
- Outcomes measures (that these will be developed, measured, and managed)
- Human resource management policies (see Chapter 14)
    - IRS tax withholding from wages and salaries.
    - Hiring policy, including use of background checks (e.g., credit checks or criminal record checks).
    - Performance review and promotion policy.
    - Sexual harassment policy.
    - Nepotism policy.
    - Diversity and nondiscrimination policy.
    - Exclusion to discrimination on religious grounds if faith-based organization.
    - Grievance policy.
    - Other relevant laws, statutes, guidelines.

Internal control policies and procedures bridge accountability and regulatory compliance, enabling your organization to reduce the potential for fraud. As an illustration, here are the guidelines for internal control for National Endowment for the Arts (NEA) grant recipients:

> **Internal Control Standards**
>
> Organizations must provide safeguards for all grant property, whether cash or other assets, and assure that it is used solely for authorized purposes. Control will be enhanced if the duties of the members of the organization are divided so that no one person handles all aspects of a transaction from beginning to end. Although a complete separation of functions may not be feasible for the small organization, some measure of effective control may be obtained by planning the assignment of duties carefully.

Many of the most effective procedures for providing internal control are very simple. Some examples are:

- Cash receipts should be recorded immediately and deposited daily.
- Bank accounts should be reconciled monthly by someone other than the person who signs the checks.
- A petty cash fund should be entrusted to a single custodian and used for all payments other than those made by check.
- Checks to vendors should be issued only in payment of approved invoices, and the supporting documents should then be canceled.
- The person who is responsible for the physical custody of an asset should not also have responsibility for keeping the records related to that asset.
- The person who has authority for placing employees on the payroll and establishing wage rates should not be the same person who signs the checks.[13]
- *Optional items*. These items are not mandatory but are consistent with "best practices." Sarbanes-Oxley legislation mandates whistleblower protection and document retention, but other aspects of the legislation such as having the ED/CEO and CFO certify the accuracy of annual financial statements are also prudent.

We recognize that human resource management policies are not financial policies *per se*, yet they have important financial repercussions, and someone in the organization will have to ensure that these policies are developed, communicated, and enforced.[14]

**(e) FINANCIAL AND FINANCIAL MANAGEMENT POLICIES.** We strongly believe that a well-articulated set of financial policies will be your organization's key driver to achieve maintenance of its target financial position – the primary financial objective of a nonprofit, as noted in Chapter 2 – and a contributory driver for mission achievement as well as accountability substantiation.

Here are the areas for which we would like to see policy established. Some of these are board-level policies, others are functional or operating unit policies:

- Cash reserve/liquidity management policy (see Section 2.6 in Chapter 2 and Section 15.8 in Chapter 15)
  - Lower-bound limitation on number of months of expenses held in operating reserves (typically a minimum of three months, but many consider at least six months as prudent)
  - Limitations on use(s) of cash reserves, including purpose(s) and dollar target and basis for establishing that target (e.g., prefund one-third of the forthcoming church building capital expenditure in a separate building/capital project reserve)
  - Limitations on use of quasi-endowment (if a board-designated quasi-endowment is held), basis for that quasi-endowment, and how large it should be
- Accounting policies (see Chapter 6)
  - Cash basis or generally accepting accounting principles (GAAP) accounting?
  - Audit policy

- Cash management policies (see Chapter 11)
  - Cash collection and receivables, including cash handling policies
  - Cash mobilization, including cash access and wire transfer policies
  - Cash disbursement and payables, including fraud and payment method policies
- Cash forecasting policies (see Chapters 8 and 11)
  - Horizon – how far out in months will we forecast cash inflows and outflows?
  - Interval – smallest unit of time shown in forecast (daily? weekly? monthly? quarterly?)
  - To whom forecasts are disseminated and in what time frame.
  - Allowable forecast error
- Banking relations policies (see Chapter 11):
  - Limitation on how depository bank(s) is (are) selected (e.g., competitive bids must be used)
  - Limitation on maximum number of depository relationships
  - Limitation on target balance or fee compensation (if any)
  - Limitation on maximum account balance (usually for FDIC insurance purposes)
  - Preference for relationship approach or transactional approach
- Insurance and risk management policies (see Chapter 14)
  - Specific identification of all the risks that the organization faces, how these will be monitored, and how a "global" or comprehensive risk profile shall be developed, monitored, and managed
  - Limitations on types of insurance that will be used or coverages that will be carried
  - Use of background checks and other pre-screening of potential employees
  - Use of employee bonding
  - Use of directors' and officers' liability policies
  - Use of other liability policies
  - How volunteer risk exposures will be handled
  - Use of property and casualty policies
- Purchasing policies
  - Restrictions on minimum number of vendors from which bids must be solicited
  - For what services will organization use requests for information (RFIs) and requests for proposals (RFPs)
  - Restrictions on how final vendor decision and pricing may be established
  - Restrictions on how quickly vendor contracts can be negotiated or renegotiated
  - Restrictions on how long before a contract must be rebid

    - Restrictions on board or manager relationships with service providers used
    - Maximum dollar expenditure that various positions can authorize without higher-level, including board, approval(s)

- Budgeting and financial planning policies (see Chapters 8 and 9)
    - Development of operating budget and frequency of board review of budget versus actual results
    - Whether and how often will operating budget and cash budget projections be compared
    - Capital budget development and limitations on evaluation techniques (e.g., must have at least 15 percent return on invested capital for new earned income venture to be approved)
    - Use of windfalls (e.g., midyear unexpected bequest comes in)
- Investment policies (see Chapter 12)
    - Internally managed or outside management preference
    - Short-term investment policy
    - Long-term investment policy
    - Endowment policies (if applicable)
    - Pension policies (if applicable)
    - Limitation on use on derivatives and swaps
- Debt/borrowing policies (see Chapter 10)
    - Limitation on short-term borrowing
        - Allowable uses
        - Disallowable uses
    - Arranged financing (e.g., bank loans)
    - Spontaneous financing (e.g., accounts payable and accrued wages)
    - Debt reduction policy
    - Limitation on long-term borrowing
        - Allowable uses
        - Disallowable uses
    - Use of swaps and other derivatives to manage bond principal and interest
- Internal controls and reporting policies
    - Conflict-of-interest policy
    - Whistleblower policy
    - Document retention policy
    - Fraud prevention policy
    - Audit policy
    - Others

- External reporting policies
  - Donors
  - Grantors
  - Community
  - Other stakeholders
  - State attorney general and/or secretary of state
  - IRS
  - Other
- Fundraising policies
  - Donation use and receipting
  - Use of restricted funds for restricted period or restricted purpose
  - Policy to solicit unrestricted donations
  - Policy in event donor intent cannot be honored
  - Gift conversion policy (e.g., will stocks or bonds be sold immediately upon receipt of ownership?)
  - ECFA (or similar ethical fundraising standards compliance)
  - Others

For more specifics on a number of these policies, consult the online sources listed in Appendix 5A.

Because the primary financial objective for most nonprofits is achieving an appropriate liquidity target, we provide further guidance on how to do this in Exhibit 5.11. In that exhibit, we clarify the distinctions that we draw between operating cash, operating reserves, cash reserves (which we see as including operating reserves but also incorporating strategic reserves and other reserves), appropriate liquidity target, and your long-term funding targets. While we do not claim to have the last word on these measures, we believe you will find careful study of this exhibit to be helpful. We provide further guidance in our more advanced treatment of different ways to calculate and measure your appropriate liquidity target in Appendix 5B. Finally, you will also find the material presented in Chapters 7 and 8 helpful (as noted earlier, also see Section 2.6 in Chapter 2 and Section 15.8 in Chapter 15).

Reinforcing the importance of a liquidity management policy (or liquid reserve policy), you no doubt hear of the many underfunded organizations and how severe the effects of underfunding are. Related to mission and program, we hear often of service cutbacks due to financial shortfalls. Yet if organizations had sufficient liquid reserves, current-year funding shortfalls would not necessitate service cutbacks. The reality is that many organizations are cutting back on programs and laying off staff due to such shortfalls. Study Exhibit 5.12, noting these effects on New York City nonprofits, and how few of the actions were a matter of strategic choice.

**(f) DATA INTEGRITY POLICIES.** Areas that you may wish to cover in your policies related to data and data integrity include:

- Privacy
- Confidentiality
- Records (document) retention

**Operating Cash, Operating Reserves, Cash Reserves, and the Appropriate Liquidity Target**

| "Bucket" (type of call on cash) | How to Establish Policy and Dollar Amount | Suggested Starting Points / How to Estimate | Part of Which Type of Reserves? | Part of Appropriate Liquidity Target? |
|---|---|---|---|---|
| Operating Cash ("Transactions") | Use one, two, or all three of these methods:<br>**1.** Conduct a "Checkbook Study."<br>**2.** If using cash-basis accounting, and your cash inflows are steady during the year, estimate operating cash based on 1.5 months of expenses. If using accrual accounting, and your cash inflows vary significantly, you might set operating cash as 2 months' worth of (expenses – depreciation).<br>**3.** Base amount on some multiplier of payroll and accounts payable. | Looking at the last 12 months. For each month: (a) what was the low balance? (b) what was the high balance? (c) were there transfers in or out? (d) what was the average balance? Now do two estimates, compare them, and use the higher of the two, and adjust upward if expenses will be higher:<br>(1) Oper. Cash = Low Balance + Transfers In – Transfers Out<br>(2) Oper. Cash = Average Balance x 1.5.<br>Divide your total annual expenses by 12 and multiply by 1.5 to get 18 months of operating cash. Oper. Cash = (Annual Expenses/12) x 1.5.<br>If payroll is bi-weekly and most of your payables are due within 30 days, multiply payroll by 3 and add accounts payable. | Some would say this is not a form of savings, so it should *not* be considered as *any* form of reserves. The reason for *not* considering it as "Operating Reserves" is that the concept of an operating reserve represents cash held *beyond* transactional needs that is, or should be, board-designated and not tapped except in unusual situations. In that view, transaction cash amounts might be labeled "undesignated, available, unrestricted net assets."<br>Since, in total, Cash Reserves = Operating Reserves + Other Reserves, your view on whether to include it as part of overall "Cash Reserves" comes down to whether you consider Operating Cash to be part of "Operating Reserves."<br>Others would consider this as part of Operating Reserves. Pragmatically, for our purposes it is easier to consider transaction cash as part of operating *and* total cash reserves due to the difficulties in segregating transaction cash and cash held for an operating reserve physically and in financial reporting. | Yes |

| | | | | |
|---|---|---|---|---|
| Operating Reserves<br>Savings<br>Seasonal<br>Emergency<br>Rainy-Day Fund<br>("Precautionary") | 1.5–9 months of operating expenses | Might use one or both of these methods:<br>(1) Reserve Cash = (Operating Expenses – Depreciation) x (desired # of months/12); this amount would be held in cash and short-term investments, excluding that amount held in permanently restricted cash and short-term investments, and we would add the unused portion of a credit line, if any<br>(2) Reserve LUNA = Liquid Unrestricted Net Assets x (desired # of months/12), where Liquid Unrestricted Net Assets = Unrestricted Net Assets + Property, Plant & Equipment – Long-Term Debt used for Property Plant & Equipment | Operating Reserves. | Yes |

**EXHIBIT 5.11** CASH RESERVES OPERATING RESERVES STRATEGIC RESERVES ALT (*continued*)

**Operating Cash, Operating Reserves, Cash Reserves, and the Appropriate Liquidity Target (*Continued*)**

| "Bucket" (type of call on cash) | How to Establish Policy and Dollar Amount | Suggested Starting Points / How to Estimate | Part of Which Type of Reserves? | Part of Appropriate Liquidity Target? |
|---|---|---|---|---|
| Strategic Reserves<br>Cyclical<br>Nonoperating<br>Growth Capital<br>("Speculative") | 9–12+ months of expenses<br>Establish each nonoperating reserve except the debt service reserve and the risk reserve based on estimated dollar need. Set debt service reserve based on funder requirements. Set risk reserve based on either (a) an additional three months' of expenses, or (b) your "pessimistic scenario" in your long-run financial planning process. | Examples of reserves that you might consider (very few nonprofits would have all of these):<br>(1) Maintenance reserve<br>(2) Capital expansion or replacement reserve<br>(3) New initiatives or new programs reserve<br>(4) Debt service reserve<br>(5) Risk reserve | Cash reserves. | No. However, the CFO or Treasurer must ensure that s/he has the funds in place to ensure that, in each year through at least Year 5, a sufficient amount of funds will be made available. "Sufficient" is defined as enough to cover the sum of operating cash, operating reserve, strategic reserves, anticipated debt service (unless you have this fully funded through your debt service reserve), and financial plan requirements (to the extent not already included in one of your reserves). The formula is:<br>Total Unrestricted Available Funds Held at Year-End = Cash Reserves = Appropriate Liquidity Target + Period Operating Cash Flow + Added Arranged Funds (Capital Campaign, Borrowing). The new qualitative and quantitative liquidity disclosures required in accounting standard ASU 2016-14 will help here. |



**Exhibit 5.11** Cash Reserves Operating Reserves Strategic Reserves ALT (*continued*)


*Source:* New York City Nonprofit Executive Outlook Survey. Baruch College, Spring 2005. Used by permission.

This survey was conducted by Jack Krauskopf and Gregg Van Ryzin at Baruch College, and co-sponsored by the Nonprofit Group and Survey Research Unit in the Baruch College School of Public Affairs, Human Services Council of New York City, Federation of Protestant Welfare Agencies, UJA-Federation of New York, and United Neighborhood Houses of New York.

**Exhibit 5.12** Results of Inadequate Liquid Reserve Policy for New York City Nonprofits

- E-mail
- Access and sharing limitations
- Cybersecurity (also known as information technology security)
- Data backup
- Disaster recovery
- Separation of duties

Consult Chapter 13 for more on these topics.

Appendix 5B also provides guidance on crafting your organization's liquidity target.

Financial policies are not a one-size-fits-all concept; each organization will have different needs at different times and as these needs change, policy updates are essential in order to maintain relevance.

## 5.3 PUTTING POLICIES INTO PLACE

After collecting required copies of external policies, such as those imposed by grant agencies or governmental agencies, we must determine which internal policies will be developed or modified. Then the process of developing internal policies can begin, as we detail in Exhibit 5.13. In cases involving high-level policies, which are largely our focus in this chapter, the committee (step 1) would be either a board committee or an advisory

1. Establish a small committee with individuals who have a thorough understanding of existing internal policies within your organization and have the insight and knowledge necessary to understand the essential elements of these policies.
2. Charge this committee with the responsibility of simplifying existing policies.
3. Provide the committee with all of the existing rules, laws, policies, and other external documents that affect your business operations.
4. Present these new policies to your organization for review and approval and make changes as necessary.
5. Submit a draft of the policies to your regulatory bodies, large funders, and investment managers and financial institutions, if applicable, to seek their acceptance of your new policies; based on their feedback, incorporate changes if necessary.
6. Distribute the new policies to your organization.
7. Establish training to assure compliance and understanding of the new policies.
8. Monitor compliance of the new policies.

**Exhibit 5.13** Steps to Develop and Introduce New Policies

committee, and the approval would come from the entire board (step 4), not organizational management. Clearly, the board would want to gather input on proposed policies from some managers before voting new policy into place, but it should be clear that this is just that – input – and the board is the body making high-level policy decisions.

For policies that are not high-level in nature but address accountability and financial management for monies that have been allocated to operating units, an internal committee of management and staff can work on policy review. At one university, a policy review committee was established to produce a new streamlined set of policies as well as to reconcile the inconsistencies and redundancies in their existing policies. The charge of the review committee was to develop policies that were true to the original spirit of the policies established at the OMB and to comply with all of the various agencies within the government and nongovernmental organizations. After several months, the committee found that these departmental/program financial management policies could be divided into four main categories, as shown earlier in Exhibit 5.7.

## 5.4 ESTABLISHING PROCEDURES

The purpose of policies is to combine all rules (external and internal) into one set of rules that do not conflict with one another. After policies have been established, the procedures for complying with policy can be developed.

It is important to distinguish between policies and procedures as well as the difference between procedures and work instructions. Procedures are the steps that must be taken to comply appropriately with policy. Work instructions are the suggested steps that should be taken to comply with procedures.

Very often, individuals feel constricted by procedures because they confuse the literal procedure with the work instructions they have been taught. They are unable to respond dynamically to changes within the organization or special needs of constituents because they are attempting to comply with outdated job instructions.

At one nonprofit institution, a seminar was presented in contract and grant accounting. One of the attendees had been performing her duties in the same manner for more than 20 years. She had always saved a copy of each invoice and packing slip she received and filed

1. Establish a committee who will be responsible for developing procedures. The group should include individuals who perform the work as well as individuals who must audit the work.
2. Review each policy and determine if a procedure needs to be established. Some policies may not require an associated procedure.
3. Detail the requirements for compliance as indicated by the policy.
4. Verify that the steps outlined in step 3 can be performed. If not, review the steps or consult with the policy makers to better understand their intent.
5. Submit the procedure draft to your organization for review and acceptance. Make changes or modifications, as necessary.
6. Submit a copy of the procedures to your regulatory agencies, if applicable.
7. Incorporate changes and modifications.
8. Distribute procedures.
9. Develop training and/or work instructions (e.g., job aids).
10. Audit compliance.

**Exhibit 5.14** Developing and Maintaining Procedures

it with the original purchase order documents. During the delivery of the course, the use of a new technology was introduced that would allow her to maintain a checklist of this same information, allowing her to throw the invoices and packing slips away. Visibly upset, she confronted the instructor, claiming that this change was not appropriate and violated policy. What had happened was this:

The institution had a procedure that specified that all invoices, prior to payment, must be reconciled to the original purchase order. In addition, the merchandise must be received in good condition and as ordered (reconciling the packing slip to the order).

Her department had complied with this procedure by saving a copy of the invoice and packing slip. The stapling of the documents indicated that they had been reconciled.

The woman had confused the procedure with the steps with which she had been taught to comply; therefore, she refused to believe that a log would suffice as a method of complying with the procedure. This example illustrates how staff may interpret work rules as procedure and also how careful an institution must be about mandating how work should be performed.

Procedures should contain only those steps that are required by policy. If work rules or job aids are produced, staff members need to understand that those rules or aids are not policy or procedure, but only a method of compliance. Refer to Exhibit 5.14 for the steps to develop procedures.

## 5.5 FINANCIAL POLICIES AND PROCEDURES IN PRACTICE

The Johns Hopkins Listening Post Project, which is regrettably no longer active, served as a good source for current practice in relation to policies and procedures. Over 200 respondents provided evidence of fairly widespread implementation of board-level oversight and policy making. "Highly" or "significantly" involved boards were found engaged in these practices:

1. Board roles.
   - Reviewing auditing and accounting policies and practices (83 percent).
   - Approving significant financial transactions (81 percent).

2. Financial disclosure. The overwhelming majority (97 percent) of sampled organizations have undergone an independent audit within the past two years and comparable proportions (95 percent) regularly distribute their financial reports to their boards.
3. Ethics protections. The overwhelming majority of responding organizations also already have other policies and procedures in place to promote accountability and ethical behavior. This includes:
   - Internal controls on finances and financial accounting (98 percent);
   - Records retention policies (84 percent);
   - Conflict of interest policies (83 percent);
   - Travel expense policies (81 percent);
   - Compliance programs for regulation (81 percent); and
   - Codes of ethics for board and staff (73 percent).

Even among smaller organizations, a majority have such policies in place.[15]

We offer a caution regarding interpreting some other results from this survey. The study noted that 83 percent of the boards were heavily involved in reviewing auditing and accounting policies and practices, and we would surmise that accounting policies and practices would include many of the policies addressed in this chapter. No doubt, respondents were not entirely sure about what is meant by "basic management policies"; some respondents would interpret this as program-level or unit-level policy. As a result, only 40.5 percent of all organizations reported having boards "highly" or "significantly" involved in setting basic management policies. Here are several other pertinent findings about the differences seen in board practices at large organizations versus small organizations:

> Boards at large organizations (expenditures over $3 million) were more involved in organizational finances than those at small organizations (expenditures under $500,000). Included here were functions such as establishing, reviewing, and approving compensation for the executive director (96 percent of large organization boards highly involved vs. 72 percent of small organization boards); and approving significant financial transactions (81 percent vs. 60 percent).
>
> On the other hand, the boards of the smaller organizations tended to be more heavily involved in some of the more detailed managerial functions, such as setting basic management policies (72 percent of small organization boards highly or significantly involved vs. 42 percent of large organization boards); setting program objectives (56 percent vs. 38 percent); setting program performance measures (56 percent vs. 34 percent); setting compensation for staff other than the CEO (48 percent vs. 23 percent). Clearly, as organizations grow in size and complexity the capacity of the board to remain intimately involved in organizational management declines.[16]

Significantly, one of the main conclusions from the University of Wisconsin-Milwaukee study of Milwaukee-area nonprofits is that boards limit their policy-making prerogative mainly to auditor engagement and conflicts of interest. Although those two items constitute a good start, the study advocates that boards go beyond these areas to construct policies in other areas. The authors' findings are insightful:

> Setting policy has long been associated with good governance, and the majority of local Boards have determined that policies are critical with regard to engaging an external

> auditor and protecting against conflict of interest. Yet, many other aspects of risk management or protecting the public's interest should also be addressed with guidance from policies. *Recommendation: Produce templates and offer consultation to assist Boards in developing policies suitable to their level of sophistication*.[17]

Finally, Melanie Lockwood Herman, executive director of the Nonprofit Risk Management Center, offers the following "best practices" advice for you and your executive team and board as they are confronted with governance issues:[18]

- Ask questions such as, What's the purpose? What does it mean? How does it work? What is my responsibility?
- Always listen to the small voice saying to speak up.
- Keep in mind that it's okay to change an answer. [We would add here, do so openly and explicitly, and give the reason for the change.]
- Have the courage to ask tough questions, rather than boasting about having all the answers.

We have endeavored to help your organization to construct a useful set of policies to better enable it to achieve its mission. By restricting management's actions appropriately and establishing an adequate liquidity reserve, your organization will be well on its way to achieving financial management proficiency. Consider the guidance in Appendix 5B as you craft or refine your organization's liquidity management/cash reserves policy.

## 5.6 ADDITIONAL RESOURCES

The development of effective policies and procedures is not a simple task. If you do not have the resources to devote to this effort, networking with other similar organizations may yield a solid set of policies that can be modified.[19] In addition, government institutions must provide copies of their policies. Many policies of government and private organizations may be found in your local library and on the Internet. Appendix 5A lists some of the best policy Websites available at the time of this writing. If you are crafting a target liquidity policy, have a look at Appendix 5B. We provide guidance on various ways you might express your organization's Appropriate Liquidity Target. In our book's companion website, we provide Tim's complete set of sample financial policies.

## Notes

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11. Cambria Collective, “Money for Good 2015,” (2015): 23. Available online at http://static1.squarespace.com/static/55723b6be4b05ed81f077108/t/56957ee6df40f330ae018b81/1452637938035/$FG+2015_Final+Report_01122016.pdf. Accessed: 1/10/2018.
12. Adapted from Board Member, Special Edition, *Accountability: The Buck Stops Here* (Washington, D.C.: BoardSource, Publication #322).
13. National Endowment for the Arts, Office of Inspector General, *Financial Management Guide for Non-Profit Organizations* (September 2008): 2. Available online at https://www.arts.gov/sites/default/files/FMGNPO.pdf. Accessed 10/28/2017.
14. An excellent source of information on human resource policies is Kathleen Fletcher, *The Nonprofit Policy Sampler*, 3rd ed. (Washington, DC: BoardSource, 2013).
15. Lester M. Salamon and Stephanie L. Geller, *Nonprofit Governance and Accountability*, Center for Civil Society Studies at the Johns Hopkins Institute for Policy Studies Listening Post Project, 2005.
16. Id.
17. Stephen L. Percy and Patricia Wyzbinski, “Nonprofit Board Governance in Milwaukee: Operation, Diversity and Challenges,” *Research and Opinion* 18, no. 3 (July 2005): 6.
18. Herman, “Risky Governance Questions and Policies.”
19. See, for example, Calvin Edwards and Company, *Sources For Nonprofit Policies* (2011). Available at http://calvinedwardscompany.com/Sources%20for%20Nonprofit%20Policies.pdf. Accessed 1/10/2018. Also refer to Appendix 5A for a number of example policies and sources offering generic policy guidance.

APPENDIX 5A

# NONPROFIT FINANCIAL POLICY EXAMPLES ON THE INTERNET

**Financial Policies – General and Other Than Investment Policies**

- Financial Policy Guidelines and Example (Propel Nonprofits)

  https://www.propelnonprofits.org/wp-content/uploads/2017/10/financial_policy_guidelines_and_example.pdf

- Sample Financial Policies and Procedures (CompassPoint Nonprofit Services)

  https://www.compasspoint.org/sites/default/files/documents/Guide%20to%20Fiscal%20Policies%20and%20%20Procedures.pdf

- Operating Reserves and Multiple Reserves Policy Guidelines and Examples (Propel Nonprofits)

  https://www.propelnonprofits.org/wp-content/uploads/2017/11/nonprofit_operating_reserves_and_policy_examples_2017.pdf

- ASEE Financial Policies

  http://www.asee.org/about-us/policy/financial-policy

- ASEE Budgeting and Planning

  http://www.asee.org/about-us/policy/financial-policy/part-2

- ASEE Internal Controls

  http://www.asee.org/about-us/policy/financial-policy/part-2#14

- ASEE Risk Management

  http://www.asee.org/about-us/policy/financial-policy/part-2#15

- ASEE Liquidity Management Policy

  http://www.asee.org/about-us/policy/financial-policy/part-1#Reserve_Fund

- ASEE Unrestricted Funds Policy, including Board-Designated Funds

  http://www.asee.org/about-us/policy/financial-policy/part-1#Unrestricted_Funds

- Church basic financial policies example

  http://www.bcidot.org/chu/5005-01.html

- Guidance on Financial Policies & Procedures from Ontario Ministry of Agriculture, Food, and Rural Affairs

  http://www.omafra.gov.on.ca/english/rural/facts/01-047.htm

- A professional honor society financial policy example (Sigma Theta Tau)

  http://www.sigmanursing.org/docs/default-source/chapter-documents/2015-2017-international-bylaws.pdf?sfvrsn=0
  (See Article XI)

- Trade association example (Amer. Assoc. of Law Libraries; includes some nonfinancial policies)

  http://www.aallnet.org/about/policy_financial.asp

- National Conference of Catholic Bishops Diocesan Internal Controls

  http://www.usccb.org/about/financial-reporting/diocesan-internal-controls-framework.cfm

- Charlotte Diocese Parish, Mission, and School Financial Policies & Procedures

  https://1z1bef2t6k8q3w96xp2i4xwi-wpengine.netdna-ssl.com/wp-content/uploads/2016/02/FMan171027.pdf

- Indiana Youth Soccer Association Financial Policies & Procedures Manual

  https://usys-assets.ae-admin.com/assets/986/15/IYSA_Financial_Policies_and_Procedures_11-021.pdf

- Society of Environmental Journalists Financial Policies (see especially C, D, and E)

  http://www.sej.org/about/financial_policies.htm

- Community Foundation of Greater Fort Wayne (IN) – Reserve Funds Policy (great illustration of various types of reserve policies)

  http://cfgfw.org/wp-content/uploads/2016/06/Reserve-Policy.pdf

- Downloadable sample policy (Word format) – Operating Reserves (AICPA)
  Website includes this copyright notice and use permission:
  Copyright © 2015. AICPA Inc. All rights Reserved. Permission is granted to download the tools and tailor or customize for internal use.

  http://www.aicpa.org/InterestAreas/NotForProfit/Resources/GovernanceManagement/DownloadableDocuments/not-for-profit-operating-reserve-policy.docx

**Investment Policy Statements (IPS)**

- Guidance on Nonprofit Investments (Kate Barr of Propel Nonprofits)

  https://www.propelnonprofits.org/blog/jittery-about-investments/

- American Society for Engineering Education investment policy

  http://www.asee.org/about-us/policy/financial-policy/part-1#Investments

- American Society for Engineering Education endowment policy

  http://www.asee.org/about-us/policy/financial-policy/part-1#Endowments

- IEEE Investment Operations Manual

  http://www.asee.org/about-us/policy/investment-policy

- Description of Quasi-Endowment purpose (Harker School)

  http://www.harker.org/giving/endowment-planned-giving/endowment-policy

- Guidance on Investment Policies (Council of Nonprofits)

  https://www.councilofnonprofits.org/tools-resources/investment-policies-nonprofits

- "Should Our Nonprofit Have an Endowment?" (Mark Hager)

  http://www.nonprofitquarterly.org/management/639-should-your-nonprofit-build-an-endowment.html

- Endowment Policy (Catholic Diocese of Wichita)

  http://catholicdioceseofwichita.org/policies/endowment-program/480-endowment-policies-1/file

APPENDIX **5B**

# GOOD, BETTER, AND BEST MEASURES OF TARGET LIQUIDITY

The following seven measures of target liquidity may be used by a nonprofit organization, with the higher-numbered measures being best (but recognize that if you are using supplemental information you could use a lower-numbered measure to arrive at a liquidity position approximately consistent with #7). We do not include any permanently restricted cash or short-term investments in these calculations. For background and development of these measures and related concepts, see Chapters 7 and 8. The authors acknowledge their debt of gratitude to Lilly Endowment, Inc., for its funding of the original study by John Zietlow, from which the concept and primacy of target liquidity emerged.

1. **Target cash** = Amount in checking account
2. **Target cash and equivalents** = Amount in checking account + Short-term investments up to 3 months in maturity
   *or* = Target cash + Investments up to 3 months in maturity
3. **Target cash and equivalents and short-term investments** = Amount in checking account + Short-term investments up to 3 months in maturity + Short-term investments from 3 months to 1 year in maturity
   *or* = Target cash and equivalents + Short-term investments from 3 months to 1 year in maturity
4. **Target liquid reserve** = Amount in checking account + Short-term investments up to 3 months in maturity + Short-term investments from 3 months to 1 year in maturity + Available portion of credit line
   *or* = Target cash and equivalents and short-term investments + Available portion of credit line
5. **Target net liquid balance** = Amount in checking account + Short-term investments up to 3 months in maturity + Short-term investments from 3 months to 1 year in maturity – Credit line balance* – Current portion of long-term debt
   *or* = Target cash and equivalents and short-term investments – Credit line balance – Current portion of long-term debt
6. **Target net liquid reserve balance**** = Amount in checking account + Short-term investments up to 3 months in maturity + Short-term investments from 3 months to 1 year in maturity + Total amount of credit line – Credit line balance – Current portion of long-term debt
   *or* = Target liquid reserve – Current portion of long-term debt

7. **Target lambda-based liquid reserve***** = Amount in checking account + Short-term investments up to 3 months in maturity + Short-term investments from 3 months to 1 year in maturity + Available portion of credit line
   *or* = Target cash and equivalents and short-term investments + Available portion of credit line

*Note:* This liquid reserve measure differs from the target liquid reserve in that it is determined mathematically from the target liquidity level lambda (TLLL) instead of judgmentally (subjectively).

**Notes:**

* Credit line balance is typically listed as either the credit line or as short-term notes payable on the Statement of Financial Position (or Balance Sheet).

** Not a previously developed measure; derived by taking the net liquid balance and adding the total amount of the credit line to the current financial assets before subtracting the credit line amount used and the current portion of long-term debt.

*** Derived and calculated as follows from the lambda measure, renamed the target liquidity level lambda in John Zietlow, Jo Ann Hankin, and Alan G. Seidner, *Financial Management for Nonprofit Organizations* (Hoboken, NJ: John Wiley & Sons, 2007), 217–219:

Lambda = (Liquid reserve + Projected operating cash flow) / Uncertainty of operating cash flow

Rephrasing to denote target amounts, abbreviating operating cash flow as OCF, and rearranging terms on the right-hand side:

$$\text{Target liquidity level lambda} = \frac{\text{Target liquid reserve}}{\text{Uncertainty of OCF}} + \frac{\text{Projected OCF}}{\text{Uncertainty of OCF}}$$

To solve for target liquid reserve, multiply all terms on both sides by uncertainty of OCF, then subtract projected OCF from both sides:

$$\text{Target liquidity level lambda (Uncertainty of OCF)}$$
$$= \text{Target lambda} - \text{based liquid reserve} + \text{Projected OCF}$$
$$\text{Target liquidity level lambda (Uncertainty of OCF)} - \text{Projected OCF}$$
$$= \text{Target lambda} - \text{based liquid reserve}$$

For example, if the organization targets a lambda value (target liquidity level lambda, or TLLL) of 3.09 (representing a 1/10 of 1 percent probability of running out of cash within the selected one-year time horizon), the annual operating cash flow's standard deviation (uncertainty) is $30,000, and its projected operating cash flow is $20,000, the organization's target liquid reserve (cash plus short-term investments plus unused credit line) is determined as follows:

$$
\begin{aligned}
\text{Target lambda} - \text{based liquid reserve} &= \text{Target liquidity level lambda} \\
&\quad \times (\text{Uncertainty of OCF}) \\
&\quad - \text{Projected OCF} \\
&= 3.09\ (30,000) - 20,000 \\
&= 92,700 - 20,000 \\
&= \underline{\underline{\$72,700}}
\end{aligned}
$$

The implied cash and short-term investments target may then be calculated. First, note that the liquid reserve is cash plus cash equivalents plus other short-term investments plus unused credit line. If the organization has a credit line of $50,000 presently carrying a $0 balance, it would need cash and short-term investments of only $72,700 – $50,000 = $22,700. Recognize that the lambda measure is based on variability of annual cash flows but does not reflect the possibility of additional upward or downward spikes within the year. To the extent that the organization's cash inflows and cash outflows are unmatched during the year, due to heavy seasonal or within-month outflows, the organization might choose to override this estimate and hold most of the $72,700 in cash and short-term investments.
Alternatively, one could measure lambda for a shorter time horizon; one must adjust the projected operating cash flow to match that horizon, as well as calculate the standard deviation per that same period (if one uses the next month's projected operating cash flow, the standard deviation of monthly cash flows must be used in the denominator). If an organization has a credit line, it is logical to use an annual time horizon, as credit lines are negotiated annually.

CHAPTER 6

# UNDERSTANDING FINANCIAL ACCOUNTING BASICS AND FINANCIAL STATEMENTS



## 6.1 INTRODUCTION

Financial statements communicate the most important financial information to your organization's stakeholders. Financial statements and ratio analysis based on those statements are very valuable. For example, they can be used to predict financial "vulnerability" (three-year decline of 20 percent or more in net assets), as noted in one study.[1] Another



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

study determined that the amount of assets financed by borrowed money, the reliance on a single source of revenue, the "profit margin" (revenues less expenses divided by total revenues), the size, and which sector a nonprofit organization is in all help to predict the chances the organization will become financially vulnerable.[2] Liquidity target measures are also based on the information contained in the financial statement as well as the notes to those statements.

Before we can analyze and make decisions using a nonprofit's financial information, we need to gain a basic understanding of the statements. In this chapter, we survey the major financial statements, what they show, how accurately they portray the financial situation, who uses them and for what, and some differences across organizational types. In Chapter 7, we show how to develop metrics and summary reports and conduct financial ratio analysis using these financial statements and the data they contain.

One very important reminder before we launch into financials: Your organization's most important outcomes are *nonfinancial* (unless your organization is a financial institution such as a foundation, endowment, or credit union or other financial cooperative, in which mission achievement is intertwined with financial outcomes). *Mission accomplishment is the single reason why your organization exists*. Having said that, financials *do* give a reading on your organization's financial health and indicate whether and how it is meeting its primary financial objective of achieving a target liquidity level. *Financial management supports and enables mission accomplishment*. Mission and finance are closely aligned and financial leaders ensure that financial information is provided in a timely and accurate manner. We begin our presentation by profiling who uses financials and for what purposes. We then profile the major financial statements: the Statement of Financial Position, the Statement of Activities, the Statement of Cash Flows, and the Statement of Functional Expenses. At the conclusion to the chapter, we return to the topic of mission-related outcomes.

## 6.2 FINANCIAL STATEMENT USERS AND USES

Let us start with the results of a fascinating survey conducted by the Maryland Association of Nonprofit Organizations. In the survey (see Exhibit 6.1), which was made of the general public and not donors or other stakeholders of specific organizations, respondents were asked what factors would increase their confidence in charities.

The response percentages changed very little over the period in which the two identical surveys were administered (1999 and 2001) to the 800 randomly selected respondents from the general public residing in Maryland. Most important, notice two things about this survey response:

1. According to this survey, program outcomes and effectiveness – as we alluded to earlier – were ranked most important for the public to increase its trust in charities.
2. All of the remaining top-five factors for trust-building have to do with your financial records, financial administration, and financial policies.

Failing to disclose and be accountable for financial records, items 2 and 5, costs an organization a greater level of public trust. This risk must be weighed against the increasingly significant costs of developing, auditing, and disseminating that information. For example, the Salvation Army is exempted from having to file financial reports with the IRS as it is part of "houses of worship and affiliated organizations," yet it invests resources in developing and getting audits of its financial reports and makes them available at its regional headquarters offices for those who may be interested in viewing them. We view financial disclosure

| Impact of Standard on Confidence in Charities | | | |
|---|---|---|---|
| 2001 % Reporting that Standard would increase trust in charities | 2001 Rank | Standard | 1999 % Reporting that Standard would increase trust in charities |
| 90% | 1 | Standard requiring charities to evaluate programs in relation to mission to see if they are working | 85% |
| 89% | 2 | Standard requiring charities to have their financial records audited yearly | 89% |
| 87% | 3 | Standard requiring charities to have a conflict-of-interest policy | 87% |
| 85% | 4 | Standard requiring charities to set limits on how much is spent on fundraising and administration | 81% |
| 84% | 5 | Standard requiring charities to publish and distribute financial information | 85% |

*Source:* Maryland Association of Nonprofit Organizations, "Protecting the Trust: Revisiting Public Attitudes About Charities in Maryland," 2002. www.marylandnonprofits.org.

**Exhibit 6.1** Public Desire for Financial Statement Disclosure

as a "best practice," prudent, and a key principle of management. We have yet to see a defensible fundraising and administration expense limitation (item 4). A "one size fits all" fundraising and administration expense is unworkable because start-up organizations necessarily will have high ratios, and many donative organizations prefund large expenditures for a series of years. Disclosure of these funding dynamics is often lost in the analysis. In those "building capital" years the fundraising (and possibly administrative) expenses appear abnormally high relative to current-year program expenses.

We see some level of interest in nonprofits' financials from each of the following groups; the breadth and diversity of interested parties is noteworthy:

- Board members
- Clients
- Funding and other resource sources
  - Donors, especially major ones making deferred gifts
  - Donors' representatives: GuideStar, BBB Wise Giving Alliance, Charity Navigator, CharityWatch, Wall Watchers, Excellence in Giving
  - Trade associations (such as the Evangelical Council for Financial Accountability)
  - Lenders and bondholders
  - Investors (e.g., social enterprise venture funds, some program-related investments)
  - Foundations and government grant agencies
  - United Way and other federated campaigns

  - Large contractors or suppliers/vendors (particularly when an organization is buying on credit terms from them)
- Workforce
  - Volunteers
  - Potential and current employees
- Regulators and tax authorities
  - State attorneys general offices
  - IRS
  - Public officials (e.g., the Senate Finance Committee)
  - Courts (e.g., in excessive compensation cases)
- Lilly Family School of Philanthropy (formerly the Indiana University Center on Philanthropy), Independent Sector, Urban Institute Center on Nonprofits and Philanthropy, Urban Institute National Center for Charitable Statistics Data Archive, National Council of Nonprofits (these institutions have interest mostly for research purposes, but they are also called on to share their expertise by public policy makers)

**(a) WHAT DO DONORS' REPRESENTATIVES SAY?** Donors often delegate their financial evaluations to others. This delegation can happen in many ways. They may tap the expertise of trust officers, knowledgeable acquaintances, magazine ratings (e.g., Kiplinger, Forbes, *Money* magazine), a trade association, advisory service such as Excellence in Giving, or the ratings of the charity watchdog organizations – GuideStar, BBB Wise Giving Alliance, Charity Navigator, CharityWatch, or Wall Watchers. Religious donors and grant agencies may look favorably on organizations that meet the accountability and management standards of the Evangelical Council for Financial Accountability (ECFA). We limit our coverage of these standards primarily to the portions of the BBB Wise Giving Alliance and ECFA standards that are relevant to financial reporting and financial outcomes.

***(i) BBB Wise Giving Alliance Standards.*** We see in the "Measuring Effectiveness" section of the BBB standards (Exhibit 6.2) that program effectiveness *internal reporting* is an issue that is evaluated. In the "Finances" section, notice that relative expenses for program, fundraising, and management are scrutinized. Be careful in interpreting these numbers as well as in estimating what your organization's ratio might be if your organization is not yet rated or if you are looking at changing your revenue mix. For example, "total related contributions" includes a number of items that you might not immediately assume would be in this figure:

> Related contributions … is not intended to refer only to annual gifts and can include donations, special event income, bequests, fund raising event revenue, federated campaigns, donated goods, donated services, and grants including foundation and government grants, etc. Other types of revenue (for example, membership dues) may be included under certain conditions.[3]

Standards 8, 9, and 10 do allow an organization to supply information indicating it was recently started (resulting in relatively higher fundraising and/or administrative costs), faces abnormal levels of donor restrictions, had exceptional bequests, funds a cause with a stigma, or has dealt with environmental or political events beyond its control in the most recent period. Any of all of these exceptional factors might keep the organization from being downgraded in its Alliance scoring even if it does not spend at least 65 percent of its total expenses on programs, if its ratio of fundraising expenses to related contributions exceeds 35 percent, or it appears to keep on hand too much in unrestricted funds.

We shall address the issue of allocations of fundraising expense later in this chapter and the calculation and interpretation of ratios in the next chapter. We have already profiled our disagreement with Standard 10 in Chapter 2. Although we disagree with the specifics of the implied definition of liquidity and with the ceiling amount stated in BBB Standard 10, the upside is that at least this standard motivates boards and management teams to discuss and set policy in the area of liquidity, solvency, and financial flexibility.

***(ii) ECFA Standards.*** The ECFA standards of financial accountability and integrity are voluntarily subscribed to by approximately 2,200 faith-based 501(c)(3) organizations, including religious, missionary, social, and educational organizations. Observe in Exhibit 6.3, which includes only the parts of the standards relevant to our discussion, the requirements for financial statements to be prepared by an independent CPA, with the CPA approved by the board, as a key element in informing donors and other constituencies regarding the organization's financial affairs and its worthiness to receive support. Financial statements are to be developed in line with generally accepting accounting principles (GAAP), and if an audit is required (only for larger organizations), it is to be done in adherence with generally accepted auditing standards (GAAS). Organizations are required to provide financial disclosure of current audited, reviewed, or compiled financial statements as well as project financial information when soliciting funds for a project, as well as current, complete, and accurate presentation of the organization's financial condition if that aspect of the organization is included in fundraising appeals. Regarding Standard 3, in 2005 the ECFA as a standard-setter caught the eye of the Panel on the Nonprofit Sector, a group of 175 experts convened by Independent Sector. In particular, in its report to the Senate Finance Committee the panel cited the guidance the Evangelical Council for Financial Accountability (ECFA) gave at that time to its member organizations regarding having an audit done by a CPA firm: "Organizations with less than $500,000 in annual revenues may periodically obtain a compilation and review of financial statements in lieu of an audit."[4] ECFA has since moved its "audit requirement" threshold to $3 million or more in annual revenues, as we shall discuss later. Notice in Exhibit 6.2 that the BBB Wise Giving Alliance at the time of this writing expects that organizations with $500,000 or more in revenues and support will pay for their financial statements to be audited, rather than reviewed or compiled. We delineate between these three forms of outside accountant attestation—audit, review, and compilation—in a later section.

**(b) EXTERNAL AND INTERNAL FINANCIAL STATEMENTS.** Our primary focus in this chapter is external financial statements. However, these statements are also used internally by the board, chief executive officer (CEO)/executive director (ED), chief financial officer (CFO), other top managers, and program managers. In Chapter 7 we consider additional internal reports that your board and management team will find useful.

**(c) WHO DOES THE ACCOUNTING?** One of the issues each organization must face is who will do the bookkeeping work, which involves recording financial transactions as they occur, as well as who develops external financial reports and whether the organization will contract for an annual audit of its financial statements.

**MEASURING EFFECTIVENESS**

An organization should regularly assess its effectiveness in achieving its mission. This section seeks to ensure that an organization has defined, measurable goals and objectives in place and a defined process in place to evaluate the success and impact of its program(s) in fulfilling the goals and objectives of the organization and that also identifies ways to address any deficiencies. To meet these standards, a charitable organization shall:

6. **Have a board policy of assessing, no less than every two years, the organization's performance and effectiveness and of determining future actions required to achieve its mission.**
7. **Submit to the organization's governing body, for its approval, a written report that outlines the results of the aforementioned performance and effectiveness assessment and recommendations for future actions.**

**FINANCES**

This section of the standards seeks to ensure that the charity spends its funds honestly, prudently and in accordance with statements made in fund raising appeals. To meet these standards, the charitable organization shall:

**Please note that Standards 8 and 9 have different denominators.**

8. **Spend at least 65% of its total expenses on program activities.**

   **Formula for Standard 8:**

   Total Program Service Expenses
   ........................................................................ should be at least 65%
   Total Expenses

9. **Spend no more than 35% of *related* contributions on fund raising.** Related contributions include donations, legacies, and other gifts received as a result of fund raising efforts.

   **Formula for Standard 9:**

   Total Fund Raising Expenses
   ........................................................................ should be no more than 35%
   Total Related Contributions

10. **Avoid accumulating funds that could be used for current program activities. To meet this standard, the charity's unrestricted net assets available for use should not be more than three times the size of the past year's expenses or three times the size of the current year's budget, whichever is higher.** An organization that does not meet Standards 8, 9 and/or 10 may provide evidence to demonstrate that its use of funds is reasonable. The higher fund raising and administrative costs of a newly created organization, donor restrictions on the use of funds, exceptional bequests, a stigma associated with a cause and environmental or political events beyond an organization's control are among factors which may result in expenditures that are reasonable although they do not meet the financial measures cited in these standards.
11. **Make available to all, on request, complete annual financial statements prepared in accordance with generally accepted accounting principles.** When total annual gross income exceeds $500,000, these statements should be audited in accordance with generally accepted auditing standards. For charities whose annual gross income is less than $500,000, a review by a certified public accountant is sufficient to meet

EXHIBIT 6.2 BBB WISE GIVING ALLIANCE STANDARDS RELEVANT TO ACCOUNTING AND FINANCIAL REPORTS this standard. For charities whose annual gross income is less than $250,000, an internally produced, complete financial statement is sufficient to meet this standard.

12. **Include in the financial statements a breakdown of expenses (e.g., salaries, travel, postage, etc.) that shows what portion of these expenses was allocated to program, fund raising, and administrative activities.** If the charity has more than one major program category, the schedule should provide a breakdown for each category.
13. **Accurately report the charity's expenses, including any joint cost allocations, in its financial statements.** For example, audited or unaudited statements which inaccurately claim zero fund raising expenses or otherwise understate the amount a charity spends on fund raising, and/or overstate the amount it spends on programs will not meet this standard.
14. **Have a board-approved annual budget for its current fiscal year, outlining projected expenses for major program activities, fund raising, and administration.**

**FUND RAISING AND INFORMATIONAL MATERIALS**

A fund raising appeal is often the only contact a donor has with a charity and may be the sole impetus for giving. This section of the standards seeks to ensure that a charity's representations to the public are accurate, complete and respectful. To meet these standards, the charitable organization shall:

15. **Have solicitations and informational materials, distributed by any means, that are accurate, truthful and not misleading, both in whole and in part.** Appeals that omit a clear description of program(s) for which contributions are sought will not meet this standard.

    A charity should also be able to substantiate that the timing and nature of its expenditures are in accordance with what is stated, expressed, or implied in the charity's solicitations.
16. **Have an annual report available to all, on request, that includes:**
    a. **The organization's mission statement,**
    b. **A summary of the past year's program service accomplishments,**
    c. **A roster of the officers and members of the board of directors,**
    d. **Financial information that includes (i) total income in the past fiscal year, (ii) expenses in the same program, fund raising and administrative categories as in the financial statements, and (iii) ending net assets.**
17. **Include on any charity websites that solicit contributions, the same information that is recommended for annual reports, as well as the mailing address of the charity and electronic access to its most recent IRS Form 990.**

*Source:* Excerpted from http://www.give.org/. See that website for the complete set of standards. Used by permission. Accessed: 8/11/2017.

**Exhibit 6.2** BBB Wise Giving Alliance Standards Relevant to Accounting and Financial Reports (*continued*)

***(i) In-House versus Outsourced.*** Small organizations typically have a bookkeeper, who is either a part-time employee or a volunteer – possibly the board treasurer. The expenses of the bookkeeping/accounting function are kept to a minimum, but accuracy, timeliness, and report usefulness may and often do suffer as a result. Another alternative is to outsource some or all of the bookkeeping and accounting report function to an accounting or consulting firm that specializes in doing this work. The greater expense of outsourcing is often more than offset by the quality and timeliness of the record-keeping and report-generation

**STANDARD 3—FINANCIAL OVERSIGHT**

Every organization shall prepare complete and accurate financial statements. The board or a committee consisting of a majority of independent members shall approve the engagement of an independent certified public accountant, review the annual financial statements, and maintain appropriate communication with the independent certified public accountant. The board shall be apprised of any material weaknesses in internal control or other significant risks.

View Commentary: http://www.ecfa.org/Content/Comment3

**STANDARD 5—TRANSPARENCY**

Every organization shall provide a copy of its current financial statements upon written request and shall provide other disclosures as the law may require. The financial statements required to comply with Standard 3 must be disclosed under this standard.

An organization must provide a report, upon written request, including financial information on any specific project for which it has sought or is seeking gifts.

View Commentary: http://www.ecfa.org/Content/Comment5

**STANDARD 7—STEWARDSHIP OF CHARITABLE GIFTS**

7.1 TRUTHFULNESS IN COMMUNICATIONS

In securing charitable gifts, all representations of fact, descriptions of the financial condition of the organization, or narratives about events must be current, complete, and accurate. References to past activities or events must be appropriately dated. There must be no material omissions or exaggerations of fact, use of misleading photographs, or any other communication that would tend to create a false impression or misunderstanding.

View Commentary: http://www.ecfa.org/Content/Comment71

*Source:* Excerpted from www.ecfa.org/. See that website for the complete set of standards. Used by permission. Accessed: 4/15/2017.

**Exhibit 6.3** Evangelical Council for Financial Accountability (ECFA) Financial Standards

functions, and there is less chance of fraud because small organizations have difficulty in placing record-keeping and cash-handling or bank reconciliation functions in the hands of different individuals. In some cases, when the accounting functions are outsourced, it enables proper internal control by having an outside entity review transactions and perform bank reconciliations. It is rare to find midsize and large organizations without at least one full-time staff person handling accounting and possibly including some financial functions as well within his or her work responsibilities. Even so, outsourcing finance is an alternative here as well. Or the small or midsized organization may outsource the CFO position, saving in annual expense $60,000 to $150,000 in salary, and as much as 40 percent more in benefits and support expenses.

Businesses outsource for four reasons, each of which also pertains to nonprofits, according to a Hewitt Associates survey: (1) to increase a process's cost-effectiveness, (2) to reduce administrative costs, (3) to capitalize on a third party's technology and/or expertise, and (4) to focus on core business functions.[5] The three possible outsourcing options include: (1) replace the accounting department in its entirety with an accounting/consulting firm's people; (2) replace the CFO with an accounting/consulting firm's person; (3) replace the entire accounting and finance functions (not including the board treasurer, of course) with an accounting/consulting firm's people. Many of these outsource providers will work on a per-hour basis; those that do so typically charge a one-time setup fee, then an annual fee. The Girls Scouts of Chicago, for example, pays an accounting/consulting firm $400,000 per year (above the one-time set-up fee) to handle the accounting, budgeting, and financial analysis needs of the organization's entities.[6]

***(ii) Accounting Software.*** Nonprofit accounting software continues its impressive evolution at the low end, significantly improving both in terms of becoming less expensive and easier to use for bookkeeping and financial statement and report generation. QuickBooks may be the most popular accounting software used by nonprofits. In 2016, Intuit opened its QuickBooks online products to nonprofit organizations at a greatly reduced rate. We also mention Intuit's Pro (three simultaneous users), Premier (up to five simultaneous users, has job costing), and Enterprise (subscription based, hosted on external website, with payroll and inventory capabilities) not as a product promotion, but simply as an example of how a business software product (QuickBooks) has been developed and now migrated into a fairly powerful nonprofit accounting package.

For those wanting more advanced features, companies such as Blackbaud, Sage Intacct, Serenic, Cougar Mountain, Logos Management, and Shelby Systems (for churches) are software providers. Your organization should thoroughly investigate all of the options before making purchase decisions. Getting a broad overview of the software available entails the need to network with others in your industry (e.g., museums have collections accounting needs that are specialized) and also consult software reviews to compare software features, including: ease of use; installation/training/upgrade/license costs; allowable number of users; upgrade frequency; customer support; web interface; payables/receivables; bank account, vendor, donor receipting, and customer interfaces; and other important buying decision criteria.[7] See sources of software reviews at the end of the chapter.

Enterprise resource planning (ERP) systems are now being used by private colleges and some other nonprofits, so prudent larger organizations would find out what vendors such as PeopleSoft can offer them to tie accounting and other business process systems together as seamlessly as possible.

**(d) ROLES OF THE CONTROLLER AND TREASURER.** In today's environment emphasizing efficiency and doing more with less, is the controller still chief accountant? Yes, but that is not the only role the controller plays. The paradigm shift is for the CFO, the controller, and the treasurer to all see themselves as servicing the organization and helping it to meet its goals, financial and nonfinancial. Clearly, this implies that the CFO, controller, and treasurer shoulder both an educational role and an internal strategic/business consultant role. At the risk of being redundant, bookkeeping and reporting have long been primary emphases in nonprofits, and we believe the heightened awareness of accountability from Sarbanes-Oxley legislation, stakeholder use of charity ratings agency websites, and today's regulatory environment will intensify that emphasis. As important as these critical roles are, the downside is that treasury duties may receive too little attention. Accounting education at the undergraduate and masters' levels focuses on financial transactions, recording, reporting, budgeting, and analysis but not necessarily on treasury or investment management and decision-making.

What role should the board treasurer have, if the organization does not have a staff person serving as head over the treasury function (say, as director of treasury operations)? In this case, the board treasurer must help staff interpret financial data and statements, guide establishment and ensure maintenance of the organization's liquidity target (and that this gets calculated correctly, as noted in Chapter 2, and featured prominently on internal financial reports), and project cash flow (perhaps using the statement of cash flows or another organization's quantitative liquidity disclosure format as a forecasting template). This is in addition to the normal expectation that he or she ensures that the finance committee understands the financials, including the Form 990 or Form 990-PF where applicable, and is carrying on its other roles, as profiled in Chapters 4 and 5.

## 6.3 ACCOUNTING BASICS

In our overview of accounting basics, we look first at financial standards and who sets these standards for external financial reports. We then briefly discuss fund accounting and consolidation. Cash basis and accrual basis accounting approaches are touched on next. We close this section with a comparison of an audit, a review, and a compilation.

### (a) FINANCIAL STANDARDS AND STANDARDS SETTERS.

***(i) Financial Accounting Standards Board.*** The Financial Accounting Standards Board (FASB) sets the standards that nonprofits are expected to adhere to in their accounting. Its guidelines are called standards, including two especially important ones for most nonprofits, Standard (or SFAS or FAS) 116 and Standard (or SFAS or FAS) 117. Standard 117 is updated with ASU 2016-14, which we cover in Appendix 6A. By having all nonprofits abide by FASB's standards, users are more certain of the information being conveyed in financial statements and comparisons between organizations are facilitated. Yet there is some discretion or judgment allowed in the application of the standards, and different organizations sometimes differ in important ways – meaning that such comparisons must be made carefully and conclusions tempered by the discretion and differences.

The American Institute of Certified Public Accountants (AICPA) provides guidance to accountants and auditors through technical practice aids, and accounting and auditing guides. The AICPA does not issue authoritative guidance, authoritative guidance is issued by the FASB as set forth in the Financial Accounting Standards Board (FASB) Accounting Standards Codification®. The Codification includes guidance previously issued by the AICPA such as SOP 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities that Include Fund-Raising. Consult this for guidance related to joint fund-raising activities; it is now incorporated into FASB ASC Subtopic 958-720, Not-for-Profit Entities-Other Expenses. Healthcare finance staff should be aware of SOP 02-2, Accounting for Derivatives and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator. At this time of this writing, FASB planned 2020 nonprofit implementation of an update to SOP 02-2 guidance as part of Accounting Standards Update (ASU), Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities.

Nonprofits are also expected to account for operating leases to show the present value of the upcoming 12 months' operating lease payments as a current liability and present value of the following years' operating lease payments as a long-term liability (on February 25, 2016, the FASB issued Accounting Standards Update No. 2016- 02, Leases (Topic 842), requiring organizations to recognize lease assets and lease liabilities on the balance sheet and disclose key information about leasing transactions). The new treatment of operating leases will result in lower values for the current ratio and debt ratio (see Chapter 7).

For users accustomed to business financial statements, the biggest difference in nonprofit accounting is in accounting for contributions, which we take up in our later discussion of Standard 116. At the time of this writing, it appears likely that FASB will implement Accounting Standards Update—Not-For-Profit Entities (Topic 958): Clarifying the Scope and Accounting Guidance for Contributions Received and Contributions Made.

***(ii) Generally Accepted Accounting Principles.*** The Financial Accounting Standards Board Codification® is the sole source of authoritative generally accepted accounting principles (GAAP) to be applied to nongovernmental entities, including nonprofit organizations. The Codification comprises the entire content of GAAP, organized into general topics (numbered 105-899) and industry topics (numbered 905-999). Nonprofit organizations follow the industry-specific guidance in Topic 958, *Not-for-Profit Entities*, as well as all the standards in the general topics, unless the specific topic explicitly exempts nonprofit organizations from its scope or the subject matter precludes such applicability (such as stock dividends). Nonprofit health care organizations also follow the industry-specific guidance in Topic 954, *Health Care Entities*. Also, faith-based ministry organizations are or will be expected to adhere to FASB Statements 116, 117, the update to 117 in ASU 2016-14, 124, 136, the AICPA Audit and Accounting Guide for Not-for-Profit Organizations, and SOP 98-2 at the time of this writing.

Also useful to individuals preparing, auditing, or using financial statements of nonprofit organization is the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Not-for-Profit Entities*. Although not an authoritative source of GAAP, it provides helpful guidance to assist management of nonprofit organizations in the preparation of their financial statements in conformity with GAAP and to assist auditors in performing and reporting on their audit engagements.

Many nonprofit organizations must provide audited financial statements prepared in accordance with GAAP to comply with requirements from government agencies, state regulatory authorities, or granting entities. An audit is an examination of an organization's accounting records and financial statements by an independent auditor-a certified public accountant (CPA). The auditor tests the organization's internal controls and the accuracy of its accounting records. At the conclusion of the audit, the auditor issues a report in the form of a letter stating whether, in the auditor's professional judgment, the financial statements fairly represent the nonprofit organization's financial position, the changes in its net assets and its cash flows in accordance with GAAP. The auditor's letter is included with the financial statements to indicate that the organization is reporting in a responsible manner. Smaller organizations may not be required to present financial statements in accordance with GAAP (for example, they might present only cash receipts and disbursements) or may need only a review or compilation instead of an audit, as discussed later in this section.[8]

**(b) FUND ACCOUNTING VERSUS CONSOLIDATION.** Before 1995, organizations typically reported financials internally and externally using an approach called "fund accounting." This method of accounting was firmly grounded in the stewardship principle: If the donor restricted donations, these restricted amounts were being provided to the organization on the presumption that the organization would be careful to use them as directed by the donor. The way to ensure that the organizations adhere to those wishes and then to evidence this fidelity is to use separate, self-balancing accounts or sets of accounts called "funds." Many organizations continue to use funds for internal bookkeeping purposes – for example, the current operating fund, plant fund, scholarship fund, endowment fund – but when doing external financial reports, the organization must report a more combined, consolidated picture of the organization as a whole. The new requirement, enshrined in FASB Statement 117, must be followed in order for your external financial statements to receive an unqualified opinion from your CPA audit firm. FASB made the change partly because fund accounting reports were just too difficult for nonaccountants to understand and use. The change provided the opportunity for all nonprofits to present their financial statements in a standardized format thereby making comparability between nonprofit agencies much easier.

Organizations are now required to focus on the entity as a whole, not merely report separate fund groups. Fund balances (assets less associated liabilities; see below in the discussion of the Statement of Financial Position) are now called "net assets." Again, fund accounting can still be used for internal purposes, but GAAP requires external reporting be presented on the overall entity.

**(c) CASH BASIS VERSUS ACCRUAL BASIS ACCOUNTING.** It is fine to use cash basis accounting (perhaps your organization has insignificant receivables, payables, and inventories, and no depreciable assets) during the year, as long as you or your accountant restates the results to accrual basis at year-end when presenting your external financial reports. In cash basis accounting, revenues are recorded when cash comes in and expenses are recorded when cash is expended. The problem is that revenues and expenses are not properly matched during the year. This mismatch becomes serious whenever your organization has significant dollar amounts of payables, receivables, inventories, or depreciable assets. Multiyear grants and contributions make cash accounting highly inaccurate in terms of understanding revenues.

Accrual basis accounting better shows a period's operating results by virtue of the fact that it has revenues recorded when earned (e.g., when you ship a product or perform a service), and expenses are recorded when incurred. The biggest downfall of accrual basis accounting, which is mandated by GAAP, is that it may not portray how your organization's cash position is changing. It is for this reason that we place so much emphasis in this chapter on the statement of cash flows, even above the statement of activities. We return to this important distinction later.

**(d) AUDIT, REVIEW, OR COMPILATION?** Does your organization need to pay the $20,000 or possibly much more for a full-blown audit? We will use the ECFA model to illustrate the differences between audit, review, or compilation as well as to explain how your organization's size is a key driver to determine which might be the most appropriate for you. The larger organizations are required to have an audit done by an independent CPA firm each year.

> ECFA Members with annual revenue of $3 million or more for the most recent accounting period are required to submit accurate and complete financial statements prepared in conformity with US GAAP and audited by an independent certified public accounting firm in conformity with US GAAS. Members with annual revenue of less than $3.0 million for the most recent accounting period may voluntarily submit an annual GAAP/GAAS audit.[9]

ECFA then has a requirement of a review done by an independent CPA firm for organizations falling into the next-smaller size bracket.

> ECFA Members with annual revenue of more than $2 million and less than $3 million for the most recent accounting period, not electing to voluntarily submit an annual GAAP/GAAS audit, are required to submit complete and accurate financial statements (with disclosures) prepared either in conformity with US GAAP or the modified cash basis of accounting, reviewed by an independent certified public accounting firm, and apply certain financial controls. For purposes of this paragraph, the term "modified cash basis of accounting" means a comprehensive basis of accounting that includes recognition of property and equipment as assets, depreciation as expense, and debt, other than trade payables and ordinary accruals, as liabilities. Notwithstanding these provisions, ECFA may require any member to submit audited GAAP/GAAS financial statements as a condition of membership.[10]

The smallest organizations are then steered to a compilation of financial statements, again to be done by an independent CPA firm.

> Members with annual revenue of less than $2 million for the most recent account period, not electing to voluntarily submit an annual GAAP/GAAS audit or review, are required to submit complete and accurate financial statements (with disclosures) prepared either

> in conformity with US GAAP or the modified cash basis of accounting compiled by an independent certified public accounting firm, and apply certain financial controls. Notwithstanding these provisions, ECFA may require any member to submit audited GAAP/GAAS financial statements as a condition of membership. Obtaining an audit may be required to comply with state law. Accountant's review is acceptable when an organization's annual revenues are between $250,000 and $1 million. That audit threshold is higher than that recommended by some other sources. Notwithstanding these provisions, ECFA may require any member to submit audited GAAP/GAAS financial statements as a condition of membership.[11]

An *audit* is the broadest in scope, with an auditor expressing an opinion that the financial statements fairly present activities, financial position, and cash flows of the organization in accordance with GAAP. An auditor may help your organization express its financials in the most clear and understandable way, including statements about the adequacy of internal controls. Your organization may send a request for an audit proposal to several CPA firms that would seem to have the appropriate industry experience and interest. Meet with members of each firm so that they better understand your management team and organizational culture and context prior to submitting their bids. The final selection of the auditor should be done by the board or audit committee, not by management.[12]

A *review* involves less than an audit but more than a compilation. It means that the accountant reviewed the financial statements, but all information in those statements is the representation of management. The review is based primarily on inquiries made of company personnel; some analytical procedures are applied to financial data, but the review is substantially less detailed in scope than an audit done in accordance with GAAS. The accountant performing the review will not express any opinion regarding whether the financial statements are in accordance with GAAP. The accountant will state whether he or she is aware of any material modifications that should be made to the statements to bring them into conformity with GAAP. The accountant may comment about the likelihood of misstatement and inadequacies in the underlying data upon which the statements are based. However, it is not an audit and may not be called an audit, regardless of what accounting firm does the review. No statements will be made about internal controls since no intensive analysis of the internal control environment is performed.

A *compilation* is the most limited of engagements, and involves assembling financial statements in good form. It is not an audit and may not be called an audit, regardless of the identity of the accounting firm doing the compilation.

## 6.4 THREE FINANCIAL STATEMENTS

At the time of this writing, you have three financial statements to present to external users unless yours is a voluntary health and welfare organization, in which case you will also have a fourth statement to present. The three statements are the statement of financial position, statement of activities, and statement of cash flows. They also are called the balance sheet, statement of net revenues, and cash flow statement, respectively. It is important to note here that although the three statements are similar and contain some of the same information, use of the correct nomenclature is important to aid in the financial literacy of board and staff. As a financial manager or board finance committee member, you would want to devote serious attention to the statement of financial position and the statement of cash flows, because they depict how and why your target liquidity position is changing and whether you are achieving that target. Your ED/CEO and program managers will key in more on the statement of activities, in that it most closely mirrors their operating budget. Part of your financial education agenda for these managers is to convince them to "watch the cash flow," not merely a certain period's revenues and expenses. We shall use the financial statement presentation format that is current at the time of this writing, which is based on the guidance in FASB Statement 117. In the appendix to this chapter, Appendix 6A, we provide adequate detail on the changes coming in 2018 and forward years, based on the update to FASB 117 known as Accounting Standard Update (ASU) 2016-14.

**(a) STATEMENT OF FINANCIAL POSITION OR BALANCE SHEET.** The *statement of financial position* (SFP), often called the *balance sheet* by businesses and some nonprofits, shows what resources the organization owns or has control of and how those are being financed, all at a certain point in time. *Assets* are the items such as cash, inventories, and equipment that the organization possesses, with which it carries out its programs and services. *Liabilities* are amounts of borrowed money, or debt, that the organization has used to finance some of those assets. The remainder of the assets are financed by *net assets* (*called equity in a commercial organization*), in the nonprofit world; these are funds that were used to establish the nonprofit at its inception or monies "earned" by the nonprofit through subsequent years as it brought in more money than it paid out for expenses. Often, in donative nonprofits, the lion's share of assets is funded by net assets that represent contributions made through the years in response to annual campaigns (and perhaps also capital campaigns).

Consult our SFP example, shown in Exhibit 6.4, as we work through some of the important accounts on that statement. The accompanying notes are an integral part of these consolidated financial statements. We selected a real organization, and one that would have a statement of functional expenses – Sacred Heart Community Service.

***(i) Assets.*** *The assets are listed in order of decreasing liquidity*. This means that the farther down the listing one goes, the farther from cash that item is, or the slower it would be expected to turn into cash. *Cash and cash equivalents* include bank deposits and any investment made with an original maturity (at the time your organization purchased them, how long until the issuer pays back the amount of the investment) of less than three months. This is a form of solvency, as noted in Chapter 2, and may also be a key part of your organization's liquidity. Smaller organizations may look at trying to hold larger cash reserves, having a bank credit line, or identifying donors (i.e., often board members) who may step in when cash does not flow.

Recapping, "cash equivalents" (listed along with cash) are typically short-term investments in which you get your interest and principal (amount invested) back *within three months*. The financial policy idea behind investing reserves in cash equivalents or other short-term financial investments instead of 30-year bonds is that you may need the money on short notice and cannot afford to take a loss on the investment. Looking at the organization as a whole, a liquid organization is one that has a ready ability to pay its bills without incurring undue cost.

A target liquidity measure (see Chapter 7) is a numerical measure of this ability, but the analyst must still apply judgment as to whether the number calculated constitutes adequate liquidity. Since there are no short-term investments listed on Sacred Heart's SFP, it is using cash and cash equivalents as well as a credit line to reach its target liquidity (implicitly if not formally part of a liquidity management policy). For that reason, we are encouraged by the trend of cash increasing from $116,415 in 2013 to $518,201 in 2014. We are assuming, but would want to verify this with management, that much of that cash is unrestricted—note, under "Other assets," that Sacred Heart has "Restricted cash for facility improvements" of $547,747 in 2013 and $485,679 in 2014. We would also want to check the "Notes to the Financial Statements" to see what the credit line total is (limit, or maximum amount). Sacred Heart had borrowed, or "taken down," $500,000 from its credit line in 2013 and then paid down $350,000 of that to end with $150,000 borrowed under its line in 2014. We show in Chapter 7 how the *unused portion* of the credit line is added to the amount of

**Sacred Heart Community Service**
**Statement of Financial Position**
**June 30, 2014 and June 30, 2013**

| | 2014 | 2013 |
|---|---|---|
| **Assets** | | |
| **Current assets:** | | |
| Cash and cash equivalents | $ 518,201 | $ 116,415 |
| Grants receivable | 910,373 | 1,392,108 |
| Current portion of Pledges Receivable, net | 17,276 | 1,424 |
| Inventory | 323,624 | 265,792 |
| Prepaid expenses and Other | 132,721 | 148,973 |
| Total current assets | 1,902,195 | 1,924,712 |
| **Property and Equipment, net** | 4,494,202 | 4,607,504 |
| **Other assets:** | | |
| Long-term portion of Pledges Receivable, net | 30,000 | – |
| Restricted cash for facility improvements | 485,679 | 547,747 |
| Investments held for endowment purposes | 816,408 | 792,379 |
| Total other assets | 1,332,087 | 1,340,126 |
| **Total Assets** | $ 7,728,484 | $ 7,872,342 |
| **Liabilities and Net Assets** | | |
| **Current liabilities:** | | |
| Accounts payable | $ 121,017 | $ 129,349 |
| Accrued liabilities | 410,404 | 462,329 |
| Deferred revenue | 317,377 | 273,744 |
| Line of credit | 150,000 | 500,000 |
| Total current liabilities | 998,798 | 1,365,422 |
| **Net assets:** | | |
| Unrestricted net assets: | | |
| Board designated operating reserve | 384,833 | 150,045 |
| Board designated endowment | 242,116 | 234,989 |
| Property and equipment fund | 4,494,202 | 4,607,504 |
| Total unrestricted net assets | 5,121,151 | 4,992,538 |
| Temporarily restricted net assets | 1,147,090 | 1,052,937 |
| Permanently restricted net assets | 461,445 | 461,445 |
| Total net assets | 6,729,686 | 6,506,920 |
| Total liabilities and net assets | $ 7,728,484 | $ 7,872,342 |

*Source:* Downloaded from Sacred Heart Community Service website, www.Sacredheartcs.org. Used by permission.

**Exhibit 6.4** Example of a Statement of Financial Position (or Balance Sheet)

cash and cash equivalents and the amount of short-term investments in arriving at a basic measure of the liquidity target ("appropriate liquidity target," more formally).

Finally, while we are addressing liquidity and organizational saving for the future, take note of the "Board designated operating reserve" of $384,833 in 2014 as well as the "Board designated endowment" of $242,116. These are not additional to the cash and cash equivalents and "Investments held for endowment purposes"—in fact, it is those two places within the organization's assets that the reserve and board's endowment set-aside would show up—but we learn that (1) cash and investments were not funded by borrowing, and (2) the board is on task with setting aside certain amounts of the organization's assets to serve if/when needed. This represents a best practice in nonprofit financial management.

Returning to our current assets, one of the biggest financial management issues is hinted at in the items just below "cash" – Grants Receivable and Pledges Receivable. Nonprofits may have one or both of these two types of receivables, as well as accounts receivable, dues receivable, and possibly notes receivable. *Accounts receivable* are sales an organization makes on credit to its customers (gave them 20 days to pay, perhaps), but it has not received the check or electronic payment yet. Accounts receivable refer to monies due from *exchange* transactions. *Grants receivable* (or *Grant revenue receivable*) refer to amounts that you expect to receive from a granting foundation or agency—you have done the work for which the grant contract was awarded, and money has been spent which the granting foundation or agency will reimburse. At this point there is no doubt you will receive the money. These might be government grants to your organization, you have delivered contracted services under those grants, and you are awaiting payment. You might combine contributions or pledges with grants when reporting your receivables. Illustrating, Habitat for Humanity does so, and then has this note to its financial statements to explain the government grant receivable portion:

> Grant revenue on cost-reimbursement grants is recognized after the program expenditures have been incurred. As such, Habitat recognizes revenue and records a receivable for the reimbursement amount from the granting agency. Such grant programs are subject to independent audit under the Office of Management and Budget's (OMB's) Uniform Guidance (2 CFR 200), as well as review by grantor agencies. Such review could result in disallowance of expenditures under the terms of the grant or reductions in future grant funds. Based on prior experience, Habitat's management believes the costs ultimately disallowed, if any, would not materially affect the consolidated financial statements.[13]

*Pledges receivable* are pledges that have been made (promises to give that are unconditionally promised) but not yet collected. Pledges receivable are the result of *nonreciprocal* transactions (contributions), and are sometimes listed as Contributions receivable. Since these pledges are listed as current assets, the assumption is that they will be received within one year and are considered fully collectible (or, if not, the statement would show the allowance for uncollectible pledges, and then the "net amount" that is thought to be collectible). The similarity among accounts receivable, grants receivable, and pledges receivable is that none of them is cash yet. In plain terms, you cannot cover payroll with either form of receivables. The same would hold true if your organization makes loans to a third party and has *notes receivable* shown on its SFP or is a membership organization and has *dues receivable*.

Pledges receivable will be listed as either short term (expect these to be collected within one year) or long term (collected next year and years following, and someone will have to estimate the present value of the future pledges or what these are worth if expressed in today's money). This is an important concept; many times organizations are unsure on how to record multi-year pledges or do not recognize the present value of future receivables. Most well-run organizations are careful to set up a best-estimate reserve for pledges deemed not likely to be collected, in order to more accurately record on the balance sheet the "true" pledges receivable (net realizable value).

Many receivables transacted during the current period count as revenues and support this period – so an organization can grow its revenues and support rapidly and suddenly find itself in a cash flow crisis even though its budget is balanced and its net revenue (revenue less expense) positive. If someone unconditionally pledges you $10 million payable to you in a lump sum 10 years from now, the present value of that—maybe \$6.8 million—is considered part of your revenue this year. Yet you have \$0 in cash coming in this year from that pledge. You will want to develop updated cash flow forecasts for this reason.

As a financial manager, always ask yourself two sets of questions about your receivables: (1) how fast are we collecting them, is that changing over time, and can we do anything to appropriately and judiciously speed their collection? and (2) are any amounts within these receivables to be considered risk with regard to their ultimate collection, and if so, what might we do to reduce that risk?

Some organizations have *classified* financial statements, in which current and noncurrent or long-term assets are separated and subtotals are shown. If done for assets, it should also be done for liabilities (current and long-term liabilities). We strongly recommend this method in order to ease the calculation of working capital and other liquidity measures.

If an organization does not develop a classified SFP, the financial statement user must try to determine which asset listed is the last of the current assets (usually prepaid expenses, deferred charges or expenses, or "other current assets") and which asset begins the listing of long-term, or fixed, assets (often mortgages or other long-term borrowings). It is for this reason that experts usually recommend that organizations develop and report classified financial statements.

Of course, property, plant, and equipment, the last asset, represents a very large investment for some charities and most churches. It is generally the least liquid (most illiquid) asset and is therefore listed last.

***(ii) Liabilities.*** For every \$1 of assets, you must have \$1 of financing from somewhere – which leads us to liabilities and "net assets." *Liabilities* represent a category of items that is equivalent to debt, which is equivalent to money borrowed. Every new board member, executive director/CEO, and finance staff member, in his or her orientation, should be asked to repeat this slogan slowly, with emphasis: "D – debt, D – dangerous!" The flip side of the financial vulnerability concept of being undercapitalized is being overleveraged, which simply means that sooner or later, the organization takes on too much debt given its risks and operating characteristics.

Debt, used properly, can be a good financial tool, but too much debt can be detrimental if not fatal. Think of it this way: Debt equals borrowing equals liability equals obligation equals financial risk. Policy governing debt is recommended to avoid becoming overleveraged.

Every dollar in the liability section is a dollar that will have to be paid back – with current liabilities paid back within the year and long-term liabilities paid back over a series of years. The more debt, the riskier the nonprofit is considered to be.

Consider first *current liabilities*. Just as current assets, other than cash and cash equivalents, are expected to be converted to cash within one year, current liabilities are expected to drain cash from your organization within one year. The often-overlooked liabilities that we need to focus on briefly are accounts payable and accrued expenses.

Accounts payable (A/P) are amounts borrowed from your suppliers; they are the mirror image of the supplier's accounts receivable. They gave you 30 days to pay, and you will take it! The great thing about A/P it is that it is interest-free (unless you pay late, in which case you may owe an additional 1.5 percent per month, which annualizes to 18 percent per year, ignoring compounding). So take the 30 days to pay unless you are offered a cash discount (say 2 percent taken off the invoice) for early payment, say within 10 days.

Accrued expenses are monies owed (think "borrowed") from employees, bondholders, or Uncle Sam – money you know you owe but you do not have to write a check for just yet. Realize that, ethically, the organization does not want to be in the position of maximizing accruals (by, say, paying its workforce consistently three months after work was completed). Used appropriately, as a normal course of business, however, accrued expenses improve the organization's cash position (deferring cash outlays) and constitute interest-free financing.

Explicit interest is paid when your organization borrows from a bank or other lender. Amounts owed within the year on these short-term loan arrangements are called *notes payable*. (Sacred Heart does not have any short-term notes payable.) Study the notes accompanying the financial statements to see to what degree a credit line that the organization has arranged is fully used ("taken down") – as we noted earlier, this becomes important when evaluating liquidity and the achievement of the target liquidity level. In the notes to the financial statements not shown, Sacred Heart indicates that it has a $1 million revolving line of credit, to be used for operating purposes if and when needed. Its statement of financial positon shows that it has borrowed $150,000 at the end of 2014, and $500,000 at the end of 2013. Sacred Heart also reports *deferred revenue* in both years reported on the statement of financial position. This indicates that it has received monies, now either in the form of cash or receivables, that cannot be recorded as income as of the date of the statement. These funds are reclassified to income when they are earned. This is according to GAAP rules related to income recognition (income is recognized as such when it is earned).

Bonds and other *long-term liabilities*, such as capital leases (the organization may prefer to lease a piece of equipment rather than issue debt to buy it outright), long-term notes payable, and mortgage loans comprise the remaining liabilities that you may see on the statement of financial position. Long-term operating leases will now also be accounted for as long-term liabilities based on a change to accounting standards. Notice that Sacred Heart does not have any long-term liabilities at this point in time, which gives it a great deal of financial flexibility for possible future funding of property, buildings, or acquisitions. So, while the approximately $1 million in current liabilities comes due within the year, representing financial risk, the fact that there are no loan or bond or mortgage payments coming due after one year signals relatively low financial risk. The long-term, or permanent, capital comes in the form of "net assets," which is organizational capital that does not need to be repaid (see below). We return to the management aspects of borrowing and debt policy in Chapter 10.

***(iii) Net Assets.*** Now what about this idea of "net assets"? We call it equity in the business world. Equity however denotes ownership and there is no ownership concept in a nonprofit organization. Think of it, policy-wise, as less risky to use this type of financing because you never have to repay it. Unlike business equity, which is technically permanent financing but has implicit requirements to eventually pay dividends or perhaps repurchase shares of stock when the organization generates a great deal of cash and may not have profitable avenues in which to deploy it, a nonprofit gains permanent use of net asset amounts with no requirement to repay it (ignoring net asset amounts related to certain annuities or pensions, of course). Think of this as the seed capital the organization started with, plus any "profit" (change in net revenue that is positive) accumulated through the years the organization has been in existence. Note that the net result of the statement of activities is called "change in net assets." Net assets recorded on the statement of financial position therefore change based on operating results reported on the statement of activities. This fact connects the two statements.

The whole bottom part of the statement of financial position (liabilities plus net assets) is what we call "capital structure." The strong statement of financial position is one with much more net assets and much fewer liabilities in the financing mix. This reflects that the organization is financing its assets through net revenues that have accumulated over time.

Briefly, when people donate money, they may restrict it for a particular use (use restriction) or time period (time restriction). Unrestricted means you can spend it as you desire.

Temporarily restricted items are typically donations given for a special project, and in the period in which that money is spent the money moves from "restricted" to "unrestricted." Other donations may never become unrestricted. For example, endowment giving and museum pieces (normally) are permanently restricted. Note that unrestricted net assets can then be *designated* by the board for specific purposes. The board cannot restrict funds, only the donor has that power. The board can, however, designate unrestricted funds for a variety of purposes.

One more caution: "Net assets" is *not equivalent* to cash. There is way too much confusion on that – even among sources that should be knowledgeable. That is, you cannot immediately spend even the total amount of the unrestricted net assets – that amount has already been distributed ("invested") across the assets of the organization, some in equipment. How much can you spend now? Only the amount of unrestricted cash and cash equivalents that is on the asset side of the balance sheet.

For Sacred Heart, net assets finance $6.7 million of the total assets of $7.7 million in 2014 and net assets finance $6.5 million of the $7.9 million of total assets in 2013. This means that only about $1 million of the total assets are financed with borrowed money in 2014 and about $1.4 million in 2013. As long as the organization has adequate liquidity to cover the current liabilities, it has established a relatively low-risk capital structure. Further, recognize that some or all of these current liabilities, as they come due in the coming year, are sure to be replaced by new current liabilities of the same category, such as accounts payable.

To summarize, every asset is financed by some mix of liabilities and net assets. Consider a car owned by your organization. The car is a long-term, fixed asset, possibly financed by borrowed money (liability) or possibly by money donated or "profit" made in the past (net assets, in either case). The point is, your net assets are already invested in various assets, some of which are very illiquid, such as that used car or your building.

***(iv) Financial Strength and Target Liquidity.*** Recapping the Statement of Financial Position discussion, a "financially strong" organization has a relatively large amount of cash and investments (preferably short term, meaning they mature within a year) and little debt (borrowed money). The most "liquid" (nearest to cash, or immediately spendable funds) assets are listed first. Then assets are listed in order of decreasing liquidity as you move downward under assets.

How would we compile a measure of target liquidity from a statement of financial position? Let us consider a simple hypothetical example. Generic Charity has $450,000 in cash, $500,000 in short-term investments, and an unused credit line of $1 million. It therefore has target (where actual amount held is assumed to equal its targeted figure) liquidity of $1,950,000 (sum of the three components). Without knowing more about upcoming bills and cash flow patterns, it is tough to know whether this is adequate. Someone familiar with the organization should be able to make that call, however (see Chapter 7 on how they might do this). Girls, Inc. posts on the financial part of its website that it has cash reserves of nine months of expenses, twice the industry standard. Can you do the same calculation for Sacred Heart? Looking at Sacred Heart's SFP, cash and cash equivalents are $518,201 in 2014, and $116,415 in 2013. In 2014, it shows $150,000 outstanding on a $1,000,000 line of credit (reported in the Notes to Financial Statements) and $500,000 outstanding in 2013. Target liquidity increased significantly in 2014, from $616,415 in 2013 to $1,368,201 at year-end 2014.

**(b) STATEMENT OF ACTIVITIES OR STATEMENT OF NET REVENUES.** The statement of activities (SA) indicates to what extent an organization's revenues exceeded its expenses in a given period, resulting in a change in its net assets. Exhibit 6.5 has our example, showing Sacred Heart's 2014 and 2013 operating results. (As with the statement of financial

## Sacred Heart Community Service
## Statement of Activities
## Year ended June 30, 2014 with Comparative totals for the year ended June 30, 2013

| | 2014 | | | | 2013 |
|---|---|---|---|---|---|
| | Unrestricted | Temporarily Restricted | Permanently Restricted | Total | Total |
| **Support and revenue:** | | | | | |
| Contributions in-kind | $ 9,371,243 | $ – | $ – | $ 9,371,243 | $ 9,592,398 |
| Government grants—cash | 4,576,628 | – | – | 4,576,628 | 5,029,116 |
| Contributions | 2,494,761 | 373,769 | – | 2,868,530 | 2,549,317 |
| Government Grants—food | 862,936 | – | – | 862,936 | 1,664,385 |
| United Way | 183,800 | – | – | 183,800 | 125,118 |
| Endowment investment income, net | 29,745 | 70,554 | – | 100,299 | 59,353 |
| Operating interest income | 6,549 | – | – | 6,549 | 6,789 |
| Miscellaneous income | | – | – | – | 1,500 |
| Loss on disposal of equipment | (942) | – | – | (942) | – |
| Special events, net of expenses of $18,679 | (13,751) | – | – | (13,751) | – |
| Total support and revenue | 17,510,969 | 444,323 | – | 17,955,292 | 19,027,976 |
| Net assets released from restrictions | 350,170 | (350,170) | | – | – |
| Total Support, revenue, and net assets released from restrictions | 17,861,139 | 94,153 | – | 17,955,292 | 19,027,976 |

| | | | | | |
|---|---|---|---|---|---|
| Expenses: | | | | | |
| Program services: | | | | | |
| Essential services | 11,172,229 | | | 11,172,229 | 12,262,999 |
| Self-sufficiency | 1,383,704 | | | 1,383,704 | 1,287,368 |
| Policy and organizing | 333,775 | | | 333,775 | 343,147 |
| Community outreach and education | 360,665 | | | 360,665 | 369,644 |
| Financial and energy assistance | 3,230,113 | | | 3,230,113 | 3,589,817 |
| Total program services | 16,480,486 | – | – | 16,480,486 | 17,852,975 |
| Supporting services: | | | | | |
| Management and general | 746,046 | | | 746,046 | 821,688 |
| Fundraising | 505,994 | | | 505,994 | 434,760 |
| Total supporting services | 1,252,040 | – | – | 1,252,040 | 1,256,448 |
| Total expenses | 17,732,526 | – | – | 17,732,526 | 19,109,423 |
| Change in net assets | 128,613 | 94,153 | – | 222,766 | (81,447) |
| Net assets, beginning of year | 4 ,992,538 | 1,052,937 | 461,445 | 6,506,920 | 6,588,367 |
| Net assets, end of year | $ 5,121,151 | $ 1 ,147,090 | $ 461,445 | $ 6,729,686 | $ 6,506,920 |

**Exhibit 6.5** Sacred Heart Statement of Activities (*continued*)

position, this is presented in accordance with FASB 117 guidance; the new format for several items that is coming in 2018 is presented in Appendix 6A.) Revenues consist of contributions, grants, gifts-in-kind (e.g., donated foodstuffs, clothing, and supplies), interest income, appreciation in investments, and other income. Notice that some of these are unrestricted, some are temporarily restricted, and some are permanently restricted. In the case of Sacred Heart Community Service, it does not report permanently restricted contributions in 2014.

Another accounting mechanism that is reflected on this statement is a revenue account titled "Net assets released from restriction." We might assume that in the previous year, Sacred Heart had net assets that were not yet used; in the subsequent year however, the restriction was met and expenses were recorded in the unrestricted column. An entry is made that moves the funds expensed from the temporarily restricted column to the unrestricted column to cover those expenses. The *total* release from restriction equals zero in that we are simply moving funds from one category to another. All expenses are always shown as unrestricted items. This makes sense, because it is donor-stipulated restrictions that lead to the three categories of revenues (and net assets), and donations are revenues, not expenses. Notice the breakdown of expenses into program expenses and supporting services – and the further breakdown of supporting services into the two components of "management and general" and "fundraising." In essence, there are two types of expense categories: (1) program and (2) everything that supports program.

Sacred Heart experienced an increase in net assets in 2014, as its change in net assets (total contributions and revenue less total expenses) was $222,766. This amount is further broken down to an increase in temporarily restricted net assets of $94,153 and an increase of unrestricted net assets of $128,613. It is important to have an increase in net assets, or surplus, in most years. The 2014 surplus is even more significant when we recognize that Sacred Heart had a negative change in net assets, or deficit, of $81,447 in 2013.

The columnar presentation in the SA is important in that the reader can follow the flow of net assets in the unrestricted and restricted categories. Tracking the changes in net assets, especially the unrestricted net assets, provides information on the organization's financial stability outside of restricted funds. An organization can show a strong flow of total net assets, but be struggling to survive because its unrestricted net assets are in decline. (In the upcoming change to the SA presentation format, you may not see this distinction on the face of the SA but it still has to be shown somewhere for the reader to view. See Appendix 6A for an example.)

Not to confuse you, but some organizations have yet another name for this statement: "the statement of revenues, expenses, and changes in net assets." Businesses call it their income statement or their P&L (profit and loss statement), but since changes in net assets are not identical to income in a business, and are more like equity, one can think of this statement as being like a combination of the business income statement and the business statement of retained earnings.

Here is a handy formula to help you navigate, and guide your users, through this statement:

$$\text{Net Revenue} = \text{Revenue minus Expenses}$$

Notice we are not separating out contributions from other revenues, as was done in the statement in Exhibit 6.5.

Income, technically, is the same as profit (revenue minus expense), even though many in the nonprofit world incorrectly say "income" when they really mean revenues. We prefer "surplus" and "deficit" to "income" or "loss" when referring to the change in net assets results for a nonprofit.

In our Sacred Heart example, there are contributions and public cash and food commodity grants plus a significant amount of "Gifts-in-kind" (food, bedding, toys, etc.) making up the revenue. Without going into a lot of detail, often you will see a nonprofit reporting significant revenue, but a large chunk of that is either not for operations (money for buildings but not specifically restricted by the donor) or it is noncash. In the case of Sacred Heart, we then recognize that a large part of its operations involves accepting and subsequently distributing these items. The amount recorded for revenue for in-kind items will also be recorded for expense.

Compared to the SFP, which profiles an organization's financial strength at a point in time (a snapshot), the SA looks at the nonprofit's ability to cover its expenses. Instead of a snapshot at the end of a time period, it measures the flow of revenue over (under) expense during a time period.

We looked in our Lilly study (Appendix 1A and Chapter 2) at organizations striving to break even – that would imply a $0 increase (or decrease) in net assets. We would call it "$0 profit" (revenues just cover expenses) in business.

You see in Exhibit 6.5 that many donors have restricted their contributions. And the accountability function of the finance department includes ensuring that those wishes are honored.

Notice again that expenses are broken into two (really three) categories, and all expenses are always "unrestricted." Program expenses (that one could put you on the cover of *Money* magazine if it's high relative to other expenses) is shown first, then management and general (your salary!), and finally fundraising expenses are listed. The sum of management and administrative and fundraising is "Total supporting services."

So-called efficiency experts will scrutinize your program expenses compared to your supporting services expenses.

Notice one final thing from this SA: At the bottom right of the SA, the increase or decrease in net assets ties directly to net assets recorded on the SFP (Exhibit 6.4). Compare the bottom right of this statement with the total net assets on the SFP.

**(c) STATEMENT OF CASH FLOWS.** Astute financial managers, we believe, manage cash flow first, not net revenue or balances. They do so knowing that the only way to ensure an approximate liquidity target will be achieved and maintained over time is to carefully manage cash inflows and cash outflows. Unfortunately, neither the SFP nor the SA shows cash flows. To get that picture, let's go to the statement of cash flows. Once again, for guidance on any changes made in 2018, see Appendix 6A.

The statement of cash flows (SCF) shows us how the cash and cash equivalents amount changed from one year (or quarter) to the next. Our example is again Sacred Heart, and its SCF is shown in Exhibit 6.6.

Refer for a moment back to the SFP (Exhibit 6.4). Note the cash and cash equivalent dollar amounts for 2014 and 2013. Now turn back to the SCF and see the bottom line: same numbers! And the SCF shows how your cash position changes by breaking down cash flows into three categories: O = operating, I = investing, F = financing. This is not a case where one category is as good as another – for most years an organization would strive to have positive operating cash flow, by and large.

Some organizations may not have any financial cash flows for the period. And if the organization does not like to borrow, that implies that increases in its plant and equipment (such as "Additions to furniture and equipment") have to be self-financed. If the organization has a nice positive operating cash flow this year, which Sacred Heart does for 2014, it can "self-finance" capital expenditures during the same period or during subsequent periods. Sacred Heart had a positive operating cash flow of almost $700,000 in 2014. You will also

**Sacred Heart Community Service**
**Consolidated Statement of Cash Flows**

| | 2014 | 2013 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Change in net assets | $ 222,766 | $ (81,447) |
| Adjustments to reconcile change in net assets to net cash provided by (used in) operating activities: | | |
| Depreciation | 177,742 | 191,546 |
| Government grants—Food | (862,936) | (1,664,385) |
| In-kind contributions of food, clothing, toys, bedding, educational materials and gift cards | (9,371,243) | (9,592,398) |
| Distribution of donated food, clothing, toys, bedding, educational materials and gift cards | 10,214,476 | 11,182,620 |
| Net realized and unrealized gain on investments | (83,012) | (41,556) |
| Loss on disposal of equipment | 942 | — |
| (Increase) Decrease in assets: | | |
| Grants receivable | 481,735 | (66,599) |
| Inventory | (38,127) | (6,380) |
| Prepaid expenses and other | 16,250 | (41,100) |
| Unconditional promises to give | (45,852) | 1,968 |
| Deposits | — | 9,874 |
| Increase (Decrease) in liabilities: | | |
| Accounts payable | (8,332) | (162,066) |
| Accrued liabilities | (51,925) | 115,473 |
| Deferred revenue | 43,633 | 39,486 |
| Net cash provided by (used in) operating activities | 696,117 | (114,964) |
| **Cash flows from investing activities:** | | |
| Decrease in restricted cash for facilities improvements | 62,068 | 22,839 |
| Purchase of property and improvements | (65,382) | (41,379) |
| Proceeds from sale of endowment fund investments | 111,345 | 169,893 |
| Purchase of endowment fund investments | (52,362) | (187,691) |
| Net cash provided (used) in investing activities | 55,669 | (36,338) |
| **Cash flows from financing activities:** | | |
| Proceeds from line of credit | 300,000 | 925,000 |
| Payment of line of credit | (650,000) | (700,000) |
| Net cash provided by financing activities | (350,000) | 225,000 |
| Net change in cash and cash equivalents | 401,786 | 73,698 |
| Cash and cash equivalents, beginning of year | 116,415 | 42,717 |
| Cash and cash equivalents, end of year | $ 518,201 | $ 116,415 |
| **Supplemental disclosure of cash flows information:** | | |
| Cash paid for interest | $ 8,518 | $ 4,857 |

**EXHIBIT 6.6** CONSOLIDATED STATEMENT OF CASH FLOWS

notice that Sacred Heart lists restricted cash for facility improvements in the other asset section of its classified statement of financial position. If it were not for this asset, it might need to sell off some investments (see "Investment held for endowment purposes") amounting to $816,408 in 2014, only $461,445 of which is "permanently restricted net assets." Or, it would need to engage in external financing through, say, a mortgage loan or bond issuance.

When looking back at the statement of financial position, an item's *change* from one period to the next represents a cash inflow or outflow. Increases in asset investment represent a *use* of cash (you are using up cash to buy the asset), and increases in liabilities or net assets represent a *source* of cash (as when you draw down part of your credit line).

Some organizations also look at the match-up between how much they have in receivables, at a point in time, and how much they have in payables. This figure shows the degree to which your suppliers (payables are unpaid credit purchases) are financing your receivables. More generally, we look at the degree to which each dollar of assets is financed by borrowed money (liabilities) versus permanent contributed capital and accumulated past "profits" or surpluses.

Depreciation is a noncash charge that causes operating cash flow to be larger than the change in net assets for that period, *all other things being equal*. The FAS 117 accounting standard has almost all nonprofits showing depreciation on their SA. It shows up, also, on the SCF to help one see that the period's net revenue *understates* the amount of cash generated by the operations. By adding back an expense that is noncash (you do not write a check for the depreciation expense amount recorded in that period), it gives a truer picture of cash from operations.

We show changes in receivables and payables on the SCF because some revenues have not been collected in cash yet (so receivables are building up), and as accounts payable increase, they provide us with cash (we did not write a check for the amount owed yet, so we have more in our cash account for a while).

Finally, note the supplemental disclosure at the bottom of the SCF, indicating that the organization paid out $8,518 in interest in 2014, and $4,857 in 2013.

**(d) STATEMENT OF FUNCTIONAL EXPENSES.** The statement of activities provides detailed information on income and summarized information on expenses. The statement of functional expenses, however, provides detailed information on the distribution of expenses throughout the organization. This statement shows expenses by their natural category (salaries, donated items, office expenses, etc.) as well as by functional categories (programs, management and general, and fundraising). This more detailed look at expenses provides the reader with an understanding of expense distribution and what those expenses consist of in terms of direct and allocated expenses. In the case presented in Exhibit 6.7, Sacred Heart receives and distributes a large amount of donated items. Many outside observers focus on the proportion of total expenses going for programs, and here (see the "Percentage of Total" line) that program expense ratio comes out to 92.9 percent (this means that 92.9 percent of all expenses are program expenses). While this might seem to be a very good ratio, donated items should be excluded to determine what the program ratio is based on other more normative transactions. Disclosing this information provides the reader with the understanding that the program expenses ratio is actually 83.3 percent, which is a more reasonable value. We further caution that administration and fundraising are important expenses for the sustainable nonprofit, and minimizing them to maximize the program expense ratio is shortsighted.

**Sacred Heart Community Service**

**Statement of Functional Expenses**

**Year Ended June 30, 2014 with Comparative Totals for the Year Ended June 30, 2013**

| | Program Services | | | | | | Supporting Services | | | Totals | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Essential Services | Self-Sufficiency | Policy and Organizing | Community Outreach and Education | Financial and Energy Assistance | Total | Management and General | Fundraising | Total | 2014 | 2013 |
| **Expenses:** | | | | | | | | | | | |
| Salaries | $ 548,746 | $ 888,343 | $ 229,871 | $ 235,257 | $ 1,493,001 | $ 3,395,218 | $ 427,417 | $ 2 48,545 | $ 675,962 | $ 4,071,180 | $ 4,104,331 |
| Employee Benefits | 96,245 | 155,807 | 40,317 | 41,262 | 261,858 | 595,489 | 74,963 | 43,592 | 118,555 | 714,044 | 671,363 |
| Payoll Taxes | 40,840 | 66,115 | 17,108 | 17,509 | 111,116 | 252,688 | 31,810 | 18,498 | 50,308 | 302,996 | 305,382 |
| Total Salaries and Related Expenses | 685,831 | 1,110,265 | 287,296 | 294,028 | 1,865,975 | 4,243,395 | 534,190 | 310,635 | 844,825 | 5,088,220 | 5,081,076 |
| Donated Food | 6,245,844 | | | | | 6,245,844 | | | – | 6,245,844 | 6,760,593 |
| Donated Clothing | 3,711,741 | | | | | 3,711,741 | | | – | 3,711,741 | 4,099,751 |
| LIHEAP and Weatherization | | | 558 | | 813,485 | 814,043 | | | – | 814,043 | 891,371 |
| Assistance to Individuals | 163,312 | 67,300 | 3,393 | 2,283 | 159,740 | 396,028 | | | – | 396,028 | 676,420 |
| Professional Services | 259 | 14,993 | 2,038 | 10,301 | 155,427 | 183,018 | 89,237 | 12,554 | 101,791 | 284,809 | 216,260 |
| Donated Toys, | | | | | | – | | | – | – | |
| Bedding, Educational Materials | | | | | | – | | | – | – | |
| and Gift Cards | 256,891 | | | | | 256,891 | | | – | 256,891 | 322,276 |
| Office Expenses | 11,229 | 19,163 | 4,704 | 4,814 | 41,936 | 81,846 | 9,142 | 7,126 | 16,268 | 98,114 | 85,711 |
| Postage and Shipping | 34 | 656 | 14 | 67 | 20,380 | 21,151 | 761 | 59,988 | 60,749 | 81,900 | 58,358 |
| Utilities | 10,079 | 16,316 | 4,222 | 4,321 | 27,421 | 62,359 | 7,850 | 4,565 | 12,415 | 74,774 | 62,438 |
| Supplies | 10,419 | 38,753 | 700 | 2,745 | 11,258 | 63,875 | 4,691 | 5,446 | 10,137 | 74,012 | 72,179 |
| Printing and Publications | 224 | | | 223 | | 447 | 3,913 | 63,706 | 67,619 | 68,066 | 59,041 |
| Repairs and Maintenance | 11,686 | 14,850 | 2,952 | 3,022 | 19,176 | 51,686 | 5,492 | 3,192 | 8,684 | 60,370 | 60,932 |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Insurance | 4,990 | 8,077 | 2,090 | 2,139 | 13,575 | 30,871 | 14,484 | 2,260 | 16,744 | 47,615 | 35,579 |
| Telephone | 5,167 | 8,365 | 2,165 | 2,215 | 14,058 | 31,970 | 4,025 | 2,340 | 6,365 | 38,335 | 55,199 |
| Bank Charges | | | | | | – | 18,037 | 17,974 | 36,011 | 36,011 | 32,129 |
| Technology Support | 3,596 | 5,821 | 2,406 | 4,842 | 9,784 | 26,449 | 2,801 | 1,629 | 4,430 | 30,879 | 17,418 |
| Miscellaneous | 866 | 4,613 | 5,432 | 1,164 | 1,242 | 13,317 | 13,465 | 2,527 | 15,992 | 29,309 | 19,643 |
| Subcontracts | 21,965 | 5,000 | | | | 26,965 | | | – | 26,965 | 24,435 |
| Temporary Help | | 12,174 | | | 3,180 | 15,354 | 7,051 | | 7,051 | 22,405 | 124,737 |
| Travel and Transportation | 202 | 10,398 | 2,241 | 484 | 2,413 | 15,738 | 3,095 | 191 | 3,286 | 19,024 | 27,766 |
| Professional Development | 2,260 | 5,463 | 2,827 | 1,581 | 1,320 | 13,451 | 2,674 | 201 | 2,875 | 16,326 | 25,222 |
| Volunteer Expenses | | | | 15,447 | | 15,447 | | | – | 15,447 | 29,432 |
| Office Rent | 1,676 | 2,713 | 702 | 718 | 4,560 | 10,369 | 1,305 | 759 | 2,064 | 12,433 | 31,088 |
| Membership Dues | | | | | | – | 2,814 | | 2,814 | 2,814 | 8,612 |
| Conferences and Meetings | | | | | | – | 1,555 | 50 | 1,605 | 1,605 | 1,457 |
| Bad Debt | | | | | | – | 804 | | 804 | 804 | 38,754 |
| Total Expenses before Depreciation | 11,148,271 | 1,344,920 | 323,740 | 350,394 | 3,164,930 | 16,332,255 | 727,386 | 495,143 | 1,222,529 | 17,554,784 | 18,917,877 |
| Depreciation | 23,958 | 38,784 | 10,035 | 10,271 | 65,183 | 148,231 | 18,660 | 10,851 | 29,511 | 177,742 | 191,546 |
| Total Functional Expenses | $ 11,172,229 | $ 1,383,704 | $ 333,775 | $ 360,665 | $ 3,230,113 | $ 16,480,486 | $ 746,046 | $ 505,994 | $ 1,252,040 | $ 17,732,526 | $ 19,109,423 |
| Percentage of Total | 63.0% | 7.8% | 1.9% | 2.0% | 18.2% | 92.9% | 4.2% | 2.9% | 7.1% | 100.0% | |
| Donated items Excluded | (10,214,476) | – | – | – | – | (10,214,476) | – | – | – | (10,214,476) | (11,182,620) |
| Total Functional Expenses Excluding Donated Items | $ 957,753 | $ 1,383,704 | $ 333,775 | $ 360,665 | $ 3,230,113 | $ 6,266,010 | $ 746,046 | $ 505,994 | $ 1,252,040 | $ 7,518,050 | $ 7,926,803 |
| Percentage of Total | 12.7% | 18.4% | 4.4% | 4.8% | 43.0% | 83.3% | 9.9% | 6.7% | 16.7% | 100.0% | |

**Exhibit 6.7** Sacred Heart Statement of Functional Expenses

### (e) FINANCIAL ACCOUNTING STANDARDS 116 AND 117.

***(i) SFAS 116.*** Some of the key aspects of this standard for financial managers and users are:

- Contributions are "unconditional, nonreciprocal transfer of assets," so if a donor imposes a condition, such as the amount needed to be matched before gifted, no recognition of the contribution should be made until the match is achieved.
- Contributions are recorded when pledges are made, not just when cash is received. (Record pledge receivable and contribution revenue before getting the cash.)
- Even if donor restrictions have not been met for unconditional contributions, record the contribution then as revenue. (The related expenditure to satisfy the restriction may yet occur in a future time period.)
- There are restrictions on volunteer time contributed services being recorded – if that time is spent building an asset for the nonprofit or the volunteer has a legal or accounting skill, for example, that the nonprofit would have had to have paid for otherwise, this contributed service may be recorded.[14]

The entire text can be found at www.fasb.org/pdf/fas116.pdf. At the time of this writing, there is a proposed Accounting Standards Update (ASU) that would help nonprofits become more consistent in determining if a transaction represents a contribution or an exchange (Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made; at the time of this writing, the text is available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage&cid=1176169225224). Some organizations are treating grants or contracts from the federal or state government differently than how they treat similar items received from a nonprofit funder or private donor. There is further guidance on whether a contribution is condition or unconditional and how to distinguish between a donor-imposed condition and a donor-imposed restriction.

***(ii) SFAS 117.*** Statement 117 indicates how nonprofits are to present financial statements and that organizations need to show the SCF (and voluntary health and welfare organizations must show the statement of functional expenses). The entire text may be found at www.fasb.org/pdf/fas117.pdf.

Some of the key aspects of this standard for financial managers and users are:

- Contributions and net assets are separated into three categories, with the distinction simply based on donor-imposed restrictions, if any. If there are no donor-imposed restrictions, the funds are considered to be, and reported as, "unrestricted." If the funds are donor-restricted as to time ("may not be spent until ... ") or use ("must be spent on capital since given to the capital campaign," which might be pledges), they are classified as "temporarily restricted." When the restriction expires or is met, the amounts are reclassified, which means they are subtracted from the temporarily restricted category and added to the unrestricted category (as discussed above). If a donor stipulates that a donation is to go to an endowment, in which the principal is never to be spent but income from that principal may be spent for operations, the gift amount goes into "permanently restricted" net assets.
- All expenses are listed in the unrestricted category even if the source of funds may have been restricted.
- Pledges payable in later periods need to be reported as "temporarily restricted."

- If donors restrict contributions that are also spent in the same period, these may be reported as unrestricted support. (There is no need to reclassify across period, in other words.)
- All board-designated unrestricted amounts ("quasi-endowments": board designated for some purpose but not donor-restricted) must be shown as unrestricted net assets – only donors may restrict monies.
- Unless donor-stipulated otherwise, capital gains on investments are reported in the unrestricted net assets.
- Show support "gross," or not having the expenses associated with raising those funds subtracted before reporting as revenues. (Show those expenses separately.)[15]
- In 2016, FASB issued an Accounting Standards Update that provides guidance on two areas of nonprofit reporting:

  There are now two classes of Net Assets rather than the three classes that have been in use since 1995. Beginning in 2018 or 2019 (see Appendix 6A for more details), financial statements will report Net Assets as either donor restricted or without donor restrictions. This change in effect consolidates the donor restrictions into one class instead of temporary and permanent restrictions. Disclosures, typically in the notes accompanying the financial statements, will denote the type of restriction.[16]

Disclosure requirements on liquidity are a new feature for nonprofit reporting that you do not see reflected in Exhibits 6.4–6.7 (see Appendix 6A for an example). These disclosures are intended to provide the reader with improved decision usefulness to assess the effects of limits on use of resources by the governing body, grantors, laws, or contracts that impact liquidity. Liquidity may be evaluated by the following formula to present a quantitative view:

**Liquidity Disclosure Formulas (in order of operation)**

Financial Assets Formula

Total Assets
– Fixed Assets
– Prepaid Expenses
– Inventory
– Other Illiquid Assets

= Financial Assets

Available Financial Assets Formula
Financial Assets
– Board Designated Funds
– Endowment Principal
– Temp. Restricted Net Assets

= Available Financial Assets

Financial Assets Available within 1 Year
Available Financial Assets
– Time Restricted Temp. Restr. Net Assets > 1 Year
– Receivables > 1 Year

= Financial Assets Available within 1 Year

*Source:* Fiscal Management Associates (FMA)/Nonprofit Quarterly (NPQ) Webinar on FASB Changes, July 2017. Used with permission.[17]

These changes to GAAP reporting and disclosures (to be implemented by 2018 or 2019) for nonprofit organizations are intended to simplify reporting as well as to provide more detailed information on liquidity. This model is particularly useful for understanding short-term liquidity. We provide extended information on this in Appendix 6A.

**(f) WHAT ABOUT THE IRS FORM 990 TAX RETURN?** First, why should we care? Because in evaluating charities, the public primarily works from Form 990s. The public is considered to be the ultimate overseer of nonprofits, and the Form 990 is the mechanism that is to be used to exercise this oversight. Despite its weaknesses, the Form 990 will continue to get much scrutiny from users. Second, there are many nonprofits that do not voluntarily disclose their audited financial statements, and stakeholders are forced to rely on this "second-best" source of information.

***(i) Who Files a 990 or 990-EZ?*** Other than small organizations (less than or equal to $50,000 in annual gross receipts) and houses of worship and specific related institutions, it is standard procedure for nonprofit organizations that are exempt from federal income tax to file either a Form 990, Form 990-EZ, or Form 990-PF (for private foundations) information "tax return" with the IRS each year.

***(ii) Do 990s Have the Same Financial Statements as GAAP?*** In a word, no. Some information is present in the Form 990 but not in your SA or SFP. Other information is in the SA or SFP but not in the Form 990. GuideStar (http://www.guidestar.org/rxg/help/faqs/financial-scan/metrics-and-data-faqs.aspx#faq4257) notes the following differences:

- Forms 990 are often self-reported. A financial audit is prepared by an outside accounting firm and contains extensive testing of transactions.
- The financial data reported in the 990 is not required to follow Generally Accepted Accounting Principles (GAAP), whereas audits generally conform to GAAP.
- Sources of discrepancy may include:
    - Form 990 does not provide detail about donor-imposed restrictions on revenue (e.g., temporarily restricted vs. unrestricted revenue)
    - In-kind donations of services are generally not recognized in the 990
    - Sales of merchandise, special events, and rental activities are generally shown on the 990 net of expenses, whereas they may be separated in the revenue and expenses sections of audited financial statements

We find the "notes to the financial statements" to be of primary value in the audited statement presentation, but these are not available as part of the Form 990. There are also significant differences in the way in which amounts are compiled or reported as compared to GAAP practices. These are summarized in Exhibit 6.7.

***(iii) Problems with 990s.*** Researchers from Urban Institute and the Indiana University Center on Philanthropy conducted a study of 1,500 nonprofit organizations' Form 990 filings and found the following items which the researchers labeled as "implausible":

- Of IRS Forms 990, 37 percent reporting over $50,000 in private contributions report zero dollars in fundraising or special event costs.
- Zero fundraising or special event costs were also reported for about 25 percent of nonprofits reporting $1 to $5 million, and 18 percent reporting over $5 million, in contributions.

- About one-fourth of nonprofits reporting some fundraising costs report over $15 in contributions for each dollar spent; this implies a fundraising expense ratio of less than 7 cents per dollar raised.
- About one in eight Forms 990 report zero dollars in management and general expenses.[18]

When the study authors did nine follow-up case studies, they discovered after-the-fact yearly allocations of personnel expense and suspect accuracy due to, to use their wording:

- "Glaring functional expense reporting errors."
- "Nonprofits responding to pressure to keep real and reported overhead low."
- "Capital gifts and in-kind donations create unique reporting problems."
- "Form 990 offers a different picture than GAAP for conglomerates and those leveraging donated space and services."[19]

One might logically conclude that these pitfalls and inaccuracies drives users away from any reliance on Form 990 data. In actuality, usage is high and increasing. The revised Form 990 that was instituted in 2009 was designed to overcome some of these deficiencies.

***(iv) Continued Reliance on 990s by Users.*** Despite these shortcomings, the Form 990 informational return continues to be the primary financial disclosure made by nonprofits in the United States. As a board member, ED/CEO, or financial manager, knowing these shortcomings and being able to steer information users to the information they need that is accurate and timely are the keys. One decision to make: Should our organization use the new "e-Docs" feature at GuideStar to voluntarily make audited financials available to the 20,000 inquirers who visit GuideStar's website daily and are otherwise finding primarily just Form 990 data available?[20]

Organizations such as Maryland Nonprofits emphasize the importance of accurate Form 990s and critique how costs are allocated to fundraising. They provide "The Standards of Excellence: An Ethics and Accountability Code for The Nonprofit Sector" in order to address the shortcomings that have been noted about Form 990. Their published tools can be accessed by members at https://standardsforexcellence.org/home-2/code/. The Guiding Principle for "Finance and Operations" follows:

> Guiding principle: Nonprofits should have sound financial and operational systems in place and should ensure that accurate records are kept. The organization's financial and non-financial resources must be used in furtherance of tax-exempt purposes. Organizations should conduct periodic reviews to address accuracy and transparency of financial and operational reporting, and safeguards to protect the integrity of the reporting systems.[21]

**(g) HEALTHCARE AND HUMAN SERVICE AGENCY FINANCIAL STATEMENTS.** FASB Statement 117 requires a voluntary health and welfare organization to present, as part of its external financial statements, a statement of functional expenses. See Exhibit 6.8 for an example. Users find the natural expense categories to be helpful in assessing expense control and expense trends. With the new statement presentation format (ASU 2016-14) applying to all nonprofits, we will now be able to see similar breakdowns for all nonprofits. See Appendix 6A for more on the standard update.

**PRESENT IN FORM 990 BUT NOT REQUIRED FOR AUDITED FINANCIAL STATEMENTS:**

- Information on officers, directors, and compensation
- Description of mission and program services (optional in audited financials)
- Responses to yes/no questions about compliance with legal requirements
- Analysis of income-producing activities (used to determine whether the firm is fulfilling operational tests required to maintain exempt status)
- Ownership information on taxable subsidiaries

**PRESENT IN AUDITED FINANCIAL STATEMENTS BUT MISSING FROM FORM 990:**

- Information about whether the statements are audited and received a qualified or unqualified opinion
- Accounting principles used to prepare the statements
- Description of the entity being audited
- Cash-flow statement
- Amounts, timing, and conditions associated with restricted funds

**PRACTICES IN FORM 990 THAT ARE NOT CONSISTENT WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES:**

- Accounting method for many accounts not disclosed
- Use of an indeterminate basis for allocating joint costs to program activities rather than to administrative or fundraising activities
- Unrealized gains and losses on investments and the equity in the audited financial statements
- Recognition of most contributed goods and services cannot be included, while certain noncash contributions can be included in the audited financials
- Limited or no information is disclosed about revenues and expenditures associated with restricted funds
- Indirect costs of selling merchandise (such as selling, general and administrative costs) can be included in cost of goods sold
- The 990 requires that nonprofits carry revenues from sales of merchandise, special events, and rental activities net of expenses as a gain/loss included in revenue rather than as separate components shown in revenues and expenses. GAAP accounting allows netting only for incidental or peripheral activities.

*Source:* Elizabeth K. Keating and Peter Frumkin, "Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation," *Public Administration Review* 63 (January/February 2003): 3–15. Used by permission.

**EXHIBIT 6.8** HOW DOES FORM 990 DIFFER FROM AUDITED FINANCIAL STATEMENTS?

**(h) EDUCATIONAL INSTITUTION FINANCIAL STATEMENTS.** As with other types of organizations, there are some college-specific or academy/school-specific financial reporting standards that accreditation or certification agencies will require or strongly recommend for the reports you file with them. Representative of these is Standard 7, part of which we reproduce in Exhibit 6.9, from the Northwest Commission on Colleges and Universities. This commission oversees, for the states of Alaska, Idaho, Montana, Nevada, Oregon, Utah, and Washington, educational quality and institutional effectiveness of colleges and universities. Notice that some information beyond what the organization may have provided in its audited financials must be provided, and also that calculated ratios of some of the statement items are also required. We will include the latter in Chapter 7.

This accrediting body also requires, as part of its standards, a general policy requirement related to liquidity, which it has placed in Standard 2:

> 2.F.1 The institution demonstrates financial stability with sufficient cash flow and reserves to support its programs and services. Financial planning reflects available funds, realistic development of financial resources, and appropriate risk management to ensure short-term solvency and anticipate long-term obligations, including payment of future liabilities.[22]

**(i) CAUTIONS FOR FINANCIAL STATEMENT INTERPRETATION.**

***(i) Accounting Standards Issues.*** Accounting standards are in a state of flux, so always be sure that the most recent standards and pronouncements are available to your organization. Consult with your accounting firm on this issue periodically.

More serious for users is the fact that there are judgment calls in the application of accounting standards. For example, how much in pledges should be considered uncollectible? Unconditional pledges must be recorded as assets, but "condition" is defined as "future and uncertain" – and there is judgment involved in determining whether an event is uncertain or not. (When the donor pledges based on "if X happens," the accountant must assess the likelihood of X actually occurring in the future.) Also, how certain information gets presented may vary across organizations even in the same industry. For example, comparative financial statements are not required, but it is most helpful to see two years together, as we saw with the example financial statements.

***(ii) Cost Allocation Choice Issues.*** From a joint Urban Institute and Indiana University Center on Philanthropy study, we have these statistics regarding nonprofit accounting practice, related to Form 990:

- Of the two-thirds of nonprofit organizations under $500,000 in annual revenues, 16 percent reported no management and general expenses and 3.4 percent reported 100 percent of their expenses as management and general expenses.
- 12 percent of all nonprofit organizations reported all staff expenses as management and general expenses, while 13 percent reported all staff expenses as program expenses.
- Less than half of nonprofits report salaries for officers in Line 25; of those that do, 12 percent reported it as all program expense, and about one-third as all management and general expense.
- About 7 percent of the nonprofits charged all accounting fees to program expense, and about 20 percent split accounting fees across categories.

**TABLES FOR PRIVATE INSTITUTIONS**

… most private colleges and universities [are] required to report financial conditions according to Financial Accounting Standards (FAS) 116, Accounting for Contributions Received and Contributions Made, and FAS 117, Financial Statements for Not-for-Profit Organizations. These standards, *which are not applicable to public institutions*, significantly affect the appearance of the audited financial statements that accompany institutional self-study reports. In order to enable the Commission to interpret these new financial reports, the Commission modified its financial reporting forms for private institutions and requires additional materials to be submitted with audited financial statements.

**ADDITIONAL REQUIREMENTS FOR FINANCIAL REPORTING FOR PRIVATE/INDEPENDENT INSTITUTIONS:**

All member and candidate institutions submitting audited financial statements under FASB are also required to supply:

1. A breakdown of all net assets; for example, unrestricted, plant, loan, life income funds, endowment funds, and agency funds.
2. A breakdown of all pledges by year of expected collection.
3. Data, if not already contained in the audited financial statement, on:
   a. Net investment in plant
   b. Unappropriated net gain on endowment
   c. Scholarship and fellowship expense funded from tuition revenue
   d. Cumulative unrealized appreciation (depreciation) of investments
   e. Annual excess of endowment total return over (under) spending policy
   f. Maximum aggregate annual debt service
4. Copies of the institution's Federal Form 990 (required of tax-exempt organizations).
5. For purposes of internal comparisons, certain ratios for each of the three years prior to the year of the comprehensive evaluation. These ratios are important to the Commission in determining the financial health of the institution.

… [Section partially omitted.]

If the institution's internal financial reporting system does not accommodate an item in any of the ratios, the institution is advised to calculate the ratio using data as approximate as possible and to indicate where and how modifications have been made in the calculations.

*Source:* http://www.nwccu.org/.

**Exhibit 6.9** Financial Tables Required by Education Accreditation Body

The investigators concluded that "underreporting of overhead spending nonprofits is significant and widespread." They also noted that:

- "Comparisons based on reported numbers can easily lead to flawed conclusions."
- Reporting problems come from:
  - "Weak accounting staff and systems."
  - "Intentional underreporting."
  - "Unique nonprofit accounting issues."[23]

***(iii) Comparison Data and Issues.*** When different organizations use different cost allocations and varying conservatism in their judgments, it is difficult for users to compare numbers across these organizations. Yet data are now becoming available to compare organizations' Form 990 results.

## 6.5 THE AUDIT AND THE AUDIT COMMITTEE

We addressed audit policy in Chapter 5 and earlier in this chapter we contrasted the differences among an audit, a review, and a compilation. One additional decision your organization must make is whether and how often to change audit firms or rotate audit partners. You should also know about the single audit, or OMB-133 Audit, if you are a federal government contractor.

First, what about rotating audit firms? Even though Sarbanes-Oxley legislation has only two provisions applying to nonprofits at the time of this writing, many nonprofits are adopting some provisions from its governance platform. Regarding audit partner rotation, we concur with this advice:

> Sarbanes-Oxley requires mandatory rotation of audit partners after five years, with a five-year timeout period during which the former audit partners can have no decision-making authority with respect to the audit. However, the limited availability of audit firms with knowledge of nonprofit organizations, and of experienced partners within those firms, could make a five-year rotation difficult to implement. In addition, because nonprofit organizations do not typically have the same frequency or intensity of partner involvement as public companies, it is reasonable to consider a longer time period before rotation. Consequently, NACUBO and other national associations recommend rotation of the lead partner every seven years, with a two-year timeout provision. For organizations that use high quality single-partner firms, rotation is impossible, in which case manager or staff rotation is advisable.[24]

Single audits are important for you to know about if you receive federal grant funds. The single audit is also known as the OMB-133 Audit. To simplify and standardize audits of organization who receive federal grant funds, the United States Office of Management and Budget issued OMB Circular A-133. The single audit provides the federal government with assurances that the funds are being used for their intended purpose and within compliance guidelines. Single audits are required for any organization that expenses $500,000 in federal funds in one year. The single audit encompasses an examination of the organization's financial records, financial statements, federal award transactions, general management of the organization's operations, internal control systems. The single audit is divided into two areas: Compliance and Financial.

Compliance covers the study and understanding as well as testing and evaluation of the organization with respect to the federal funds, and compliance with regulations. The Financial Component is exactly the same as for nonfederal grant recipients in that the auditor performs tests on the organizations financial reports and accompanying notes.

Auditors are required to make a determination if the organization is high or low risk (what is the risk level that the grantee will be able to comply with federal laws and regulations?). This determination affects the amount of testing that the auditor must perform.[25]

## 6.6 FINANCIAL STATEMENT USERS AND USES IN PRACTICE

Earlier we mentioned the public's desire to know about your mission achievement and have access to your financial statements.[26] We also addressed user needs and how the financial statement could be interpreted to address those needs. To recap, organizations need to consider internal and external needs.

Internally, your management team and board needs good financial data in order to assess liquidity and set and monitor the target liquidity level, as well as to balance cash inflows and outflows over the near future and longer-term future. The SFP and the SCF, including projections of the latter into the future, are instrumental in accomplishing these objectives. Interim reporting can use the same formats but is not limited to these standardized reports. An analysis of interim reporting is covered in Chapter 7.

Externally, you will need to satisfy three major categories of interested parties with your external financial reports: donors and grantors, lenders, and investors (for organizations issuing bonds or launching earned income ventures, particularly social entrepreneurship ventures). We are disheartened to hear that about one-half of the 300 largest nonprofits, when asked to voluntarily provide their audited financials, declined to do so in 2001. More organizations are now making these available on their websites, a very positive development.

One fascinating finding from the academic literature (Kitchling[27]) is that donors appear to favor charities that use "high quality auditors," when controlling for the charities' reputation. Charities are thus advised to use the services of these higher quality auditors in order to signal credibility to their present and potential donors.

What about disclosing your financial and program performance information on your organization's website? Your organization might be viewed as more open, trustworthy, and accountable by the general public, according to Lee and Joseph. They studied nonprofit websites and found that the majority of the sites lacked high quality financial and performance information.[28] Saxton, Neely, and Guo find a positive relationship between the level of charitable contributions and the amount of disclosure provided by the organization on its website. However, they also find that performance and annual report disclosure are more important than financial disclosure. Finally, they find that organizations less reliant on donations find that performance disclosure has the biggest impact.[29] Behn, DeVries, and Lin find that access to outside stakeholders of organizations' audited financial statements is more probable if the nonprofits are larger, have more debt, have a larger contribution ratio (see Chapter 7 for a definition and formula) – think donative organizations, are classified in the higher education industry (NTEE classification), or have a higher compensation expense ratio (compensation as a percentage of total expenses).[30] A nice survey synthesis of relevant research is provided by Hofmann and McSwain if you would like further information on financial disclosure management.[31]

Calabrese studied whether nonprofits to public audit mandates submit financial reports in compliance with GAAP. The evidence was supportive of GAAP-compliance, but a significant minority of organizations required at the state level to be audited provided information not fully GAAP-compliant. For those organizations not subject to public audit mandates, he investigated whether donors monitored or demanded accrual-based financial information. He found that nonregulatory external oversight significantly influenced organizations' use of accrual-based accounting.[32]

The good news from available survey data is that CFO self-perception of effectiveness is the highest for financial reporting (self-rated at 4.24 on a scale of 1–5, with 5 being the highest), according to the ECFA Nonprofit Management Survey 1.0 (ECFA, 2015).[33]

## 6.7 SOCIAL ACCOUNTING

We can only briefly introduce *social accounting*, the inclusion in financial reports of program inputs and outcomes in nonmonetary terms. These report items might include information about volunteer contributions and social benefits, as well as environmental and sustainability outcomes.[34] There are various approaches to constructing social account measures, none of which is well developed at this time. These approaches include social return on investment (SROI), socioeconomic impact statements, and a reformulated statement of activities called an "expanded value-added statement."[35] In our experience, the SROI is a difficult concept to apply.[36] However, it is noteworthy that the balanced scorecard, presented in Chapter 3, fits nicely with this framework if you are ready to go beyond financial results in your standard external reports.[37] One might think of it as an extension to the program outcome reporting that you already have added to your Form 990 information return.

## 6.8 ADDITIONAL RESOURCES

**(a) SOURCES FOR NONPROFIT ACCOUNTING AND ACCOUNTING STANDARDS.** There are a number of online resources on nonprofit accounting.

https://www.aicpa.org/interestareas/notforprofit/resources/financialaccounting.html (some of the materials are not publicly available)

The best presentations on nonprofit accounting methods are found in books and manuals. The single best guide, in our opinion, is:

John H. McCarthy, Nancy E. Shelmon, and John A. Mattie*, Financial and Accounting Guide for Not-for-Profit Organizations*, 8th Edition (Hoboken, NJ: John Wiley & Sons, 2012). (ISBN: 978-1-118-08366-6).

Our top recommendation for a place to start for someone with no accounting background or training would be this guide:

Warren Ruppel, *Not-for-Profit Accounting Made Easy, 2nd edition* (Hoboken, NJ: John Wiley & Sons, 2011).

Our nod for the best "user-friendly" guide to reading and understanding financial statements, and one that includes the new requirements in ASU 2016-14, is:

Andrew S. Lang, William D. Eisig, Lee Klumpp, and Tammy Ricciardella, *How to Read Nonprofit Financial Statements: A Practical Guide* 3e (Hoboken, NJ: John Wiley & Sons, 2017).

For more guidance on GAAP accounting and its application, see this outstanding source:

Richard F. Larkin and Marie DiTommaso, *Wiley Not-for-Profit GAAP 2018: Interpretation and Application of Generally Accepted Accounting Principles*, 2nd Edition (Hoboken, NJ: John Wiley & Sons, 2018).

For more on nonprofit accounting and audits, see these sources:

AICPA, *Not-for-Profit Entities – AICPA Audit and Accounting Guide* (New York: AICPA, 2017). This guide is updated annually around March 1st, so be sure to get the most recent version.

Religious Organizations Accounting Committee, *Accounting and Financial Reporting Guide for Religious Organizations*, 2018.

*PPC's Guide to Religious Organizations*, annual. Available at: http://store.tax.thomsonreuters.com/accounting/Audit-and-Accounting/PPCs-Guide-to-Religious-Organizations/p/100200000.

David W. Young, *Management Control in Nonprofit Organizations,* 10th ed. (Cambridge, MA: The Crimson Press, 2015), Chapter 3, "Analyzing a Nonprofit's Financial Status." Send E-mail to CrimsonCenter@TheCrimsonGroup.org to order the book.

The FASB standards are available online; the two standards and one update that are most essential to study are:

FASB 116: www.fasb.org/pdf/fas116.pdf

FASB 117: www.fasb.org/pdf/fas117.pdf

The ASU 2016-14 update to FASB 117 is here: http://www.fasb.org/cs/ContentServer?cid=1176168381847&d=&pagename=FASB%2FDocument_C%2FDocument Page

**(b) SOURCES FOR NONPROFIT ACCOUNTING SOFTWARE REVIEWS.** Some of the sources providing reviews and evaluation of nonprofit accounting software also sell the software, so "buyer beware" on these sources.

Overview of Accounting Software and its Value

http://www.thenonprofittimes.com/news-articles/accounting-software/

Who are the Current Vendors of Accounting Software and What Does the Future Hold for Accounting Software?

http://www.thenonprofittimes.com/news-articles/channeling-wants-needs-users-prominent-applications-roundup-future-hold-nonprofit-accounting/

What to look for when purchasing accounting software – Jim Simpson:

http://www.ftmllc.com/wp-content/uploads/sites/6382/2017/12/Why-Consider-Nonprofit-Accounting-Software.pdf

White Paper: Starting the Search – A Nonprofit's Journey to New Accounting Software

http://www.thenonprofittimes.com/white-paper-starting-search-nonprofits-journey-new-accounting-software/

NPT Special Report: Accounting Software

http://www.thenonprofittimes.com/wp-content/uploads/2014/12/1-1-15-SR_AccountingSoftware.pdf

Nonprofit Accounting Systems – Reviews and Guidance

http://www.wallacefoundation.org/knowledge-center/resources-for-financial-management/pages/2013-reviews-of-nonprofit-accounting-systems.aspx

http://www.msae.org/Portals/0/PDF/FARResources/top_10_nonprofit_accounting.pdf

http://www.cpapracticeadvisor.com/article/12162170/2016-reviews-of-nonprofit-accounting-software-systems

https://www.softwareadvice.com/nonprofit/accounting-software-comparison/

https://www.crowdreviews.com/best-non-profit-accounting-software

https://blog.capterra.com/top-free-accounting-software-for-nonprofit/

https://www.saimgs.com/imglib/other_pages/FrontRunners/FrontRunners-Accounting-Report-Oct2017.pdf (for small business but nonprofits are served by some of the same software vendors)

**(c) SOURCES FOR NONPROFIT ACCOUNTING FIRM CONTACTS.** With the trend by the big four accounting firms to focus only on the largest nonprofit clients, finding accounting and auditing firms can be a challenge. For faith-based clients, ECFA helps by offering this link for accounting and auditing: http://www.ecfa.org/BusinessDirectory.aspx?Category=2. Another "Auditor Selection Guide" is here: http://www.wallacefoundation.org/knowledge-center/resources-for-financial-management/pages/nonprofit-auditor-selection-guide.aspx. Other resources are also available; see the FASB and AICPA websites: www.fasb.org and www.aicpa.org. The AICPA also has a listing of state CPA associations: https://www.aicpa.org/research/externallinks/associationsstatecpalinks.html.

**(d) SOURCE FOR NONPROFIT AUDIT COMMITTEE TOOLKIT.** The AICPA makes available a number of resources for free download. The newest edition of the nonprofit auditing toolkit may be purchased through the AICPA online resources center.[38]

**(e) SOURCES FOR SOCIAL ACCOUNTING INFORMATION AND TECHNIQUES.** Two articles and two books on this topic are worthy of your consideration:

Betty Jane Richmond, Laurie Mook, and Jack Quarter, "Social Accounting for Nonprofits: Two Models," *Nonprofit Management & Leadership* 13(2003): 308–324.

Patrick W. Ryan and Isaac Lyne, "Social Enterprise and the Measurement of Social Value: Methodological Issues with the Calculation and Application of the Social Return on Investment," *Education, Knowledge and Economy* 3, no. 2 (2008): 223–237.

Jack Quarter, Laurie Mook, and Betty Jane Richmond, *What Counts: Social Accounting for Nonprofits and Cooperatives* (Upper Saddle River, NJ: Prentice-Hall, 2003).

Laurie Mook, ed., *Accounting for Social Value* (Toronto: University of Toronto Press, 2013). Those interested in a stewardship approach might consult Chapter 2, "Developing Techniques for Stewardship," a case study by Massimo Contrafatto and Jan Bebbington.

Online resources include:

REDF: Good introductory paper (PDF): Carla I. Javits, *REDF's Current Approach to SROI* (May 2008): 1–3. Available for download at: http://redf.org/app/uploads/2013/10/REDFs-Current-Approach-to-SROI-Opinion-Paper-2008.pdf.

More detail on REDF's approach is found here: http://www.redf.org/publications-sroi.htm#ship.

REDF: Listing of a number of SROI reports, including SROI model, documentation, and actual applications to social enterprise ventures is located here: http://www.redf.org/publications-sroi.htm.

New Economics Foundation (NEF): (Builds on the REDF framework) Well-Being Evidence for Policy: A Review (April 2, 2012). Available for download at: http://neweconomics.org/2012/04/well-evidence-policy-review/?sf_action=get_results&_sf_s=Social+audit&_sft_latest=research&sf_paged=18.

Jenny Cameron, Carly Gardner, and Jessica Veenhuyzen, *Social Accounting: A Practical Guide for Small Community Organisations and Enterprises, Version 2*. The University of Newcastle, Australia Centre for Urban and Regional Studies, (July 2010). Available online at: http://www.communityeconomies.org/site/assets/media/Jenny_Cameron/Social_Accounting_Manual_Version_2_July_2010.pdf.

The Centre for Social and Environmental Accounting Research (CSEAR), housed in the School of Management at the University of St. Andrews in Scotland, has a number of resources on its website. Start with some of the discussion papers to get an overview and idea of some of the newest social accounting developments: https://www.st-andrews.ac.uk/management/csear/researchresources/dps-socenv .html. For example, see there the briefing on "What Is Social and Environmental Accounting? (https://www.st-andrews.ac.uk/csear/what-is-sea/).

The Social Audit Network (U.K.) also has some helpful resources: http://www.socialauditnetwork.org.uk/ See there "What Is Social Accounting and Audit?" - http://www.socialauditnetwork.org.uk/getting-started/what-is-social-accounting-and-audit/

## Notes

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2. Janet S. Greenlee and John J. Trussel, "Predicting the Financial Vulnerability of Charitable Organizations," *Nonprofit Management and Leadership* 11 (Winter 2000): 199–210. Additional, more recent studies, have built on the Trussel and Greenlee studies and are documented in our treatment of financial ratios in Chapter 7.
3. BBB Wise Giving Alliance, "How We Accredit Charities." N.d. Downloaded from: https://www.give.org/for-charities/How-We-Accredit-Charities/. Accessed 1/11/2018.
4. Panel on the Nonprofit Sector, "Interim Report Presented to the Senate Finance Committee," March 1, 2005. Available online at www.nonprofitpanel.org/interim/PanelReport.pdf. Accessed 12/20/2005. Other studies are cited in Chapter 2 and in Chapter 7.
5. Stuart Kahan, "Outsourcing Nonprofits' Financials," *Practical Accountant* 33 (May 2000): 53–55.
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7. See Jeanne Peters, "Accounting Software: A Buyer's Guide" and "Directory of Nonprofit Accounting Software," *Nonprofit Quarterly* 11 (Winter 2004).
8. We thank Sue Budak, CPA for her expertise in crafting these paragraphs on GAAP. Sue is an independent consultant and author that has worked closely with the AICPA on various projects, including two task forces focused on the implications of FAS 157 and work performed to revise the Audit and Accounting Guide, Not-for-Profit Entities. Prior to becoming a consultant, Susan worked for the FASB and GASB, where she served as a project manager. She has also served as an assistant controller and director of accounting services at Northwestern University in Illinois and was a senior accountant at Deloitte & Touche in Chicago, Illinois. You will also want to consult the Religious Organizations Accounting Committee, *Accounting and Financial Reporting Guide for Religious Organizations*, 2018.
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19. Id.
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26. For more about donor and other stakeholder information preferences and nonprofit financial statement presentation practices, including cost allocations, see the research done by Robert Yetman and others; for example, consult www.newyorkfed.org/research/conference/2004/governance papers/desaiyetman0925.pdf. Also see Robert Yetman, "Tax Motivated Expense Allocations by Not-for-Profit Organizations," *Accounting Review* (2001); Michelle Yetman and Robert Yetman, "The Effect of Nonprofit's Taxable Activities on the Supply of Private Donations," *National Tax Journal* 16, no. 1 (2003); Tom Omer and Robert Yetman, "Near-Zero Taxable Income Reporting by Nonprofit Organizations," *Journal of the American Taxation Association* 25 (Fall 2003); Robert Yetman, "Nonprofit Taxable Activities, Production Complementarities, and Joint Cost Allocations," *National Tax Journal* 56 (December 2003): 789–799; and Michelle H. Yetman and Robert J. Yetman, "The Effects of Governance on the Accuracy of Charitable Expenses Reported by Nonprofit Organizations," *Contemporary Accounting Research* 29 (Fall 2012): 738–767. The latter study (Yetman and Yetman, 2012) finds more accurate Form 990s filed by nonprofits that do not outsource their management functions, have more voting board members (up to a point), have audits done of their financial statements, have audits done by larger CPA firms, have more donor-imposed restrictions, have issued municipal bonds, are engaged in taxable activities (implying more federal oversight), and are located in states with stronger regulation and enforcement.
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35. Jack Quarter, Laurie Mook, and Betty Jane Richmond, *What Counts: Social Accounting for Nonprofits and Cooperatives* (Upper Saddle River, NJ: Prentice-Hall, 2003). Also see the review of this book by Elizabeth K. Keating, *Nonprofit and Voluntary Sector Quarterly* 32 (2004).
36. For more on the topic of SROI, see Alison Lingane and Sara Olsen, "Guidelines for Social Return on Investment," *California Management Review* 46 (Spring 2004): 116–135.
37. Laurie Mook, "Social Accounting for the Social Economy," Chapter 1 in Laurie Mook, ed., *Accounting for Social Value* (Toronto: University of Toronto Press, 2013): 17. Chapter 7 in that book, "Measuring the Performance of Convention and Visitors Bureaus," by Timothy J. Tyrrell and Robert J. Johnston, applies a triple bottom line framework to provide economic, social and environmental attributes.
38. At the time of this writing the nonprofit audit committee toolkit was available for purchase at https://www.aicpastore.com/AST/Main/CPA2BIZ_Primary/ManagementAccounting/Management/AuditCommittee/PRDOVR~PC-991004/PC-991004.jsp.

APPENDIX **6A**

# REVISED FINANCIAL STATEMENT FORMAT – ACCOUNTING STANDARDS UPDATE 2016-14

We provide in this overview of the new financial statement presentation format standard a briefing on what is in the standard and why it matters to financial managers, executive directors, board members, staff and other stakeholders. Your organization will first implement the new standard in 2018 or 2019, depending on when your reporting year ends. We have drawn on several published resources for our survey, and we refer the reader to them for more on the technicalities and accounting aspects of the new standard. Chief among those resources are two from which we have drawn heavily: (1) another Wiley publication, *How To Read Nonprofit Financial Statements,* ASAE and Wiley, 2017, by Lang, Eisig, Klumpp, and Ricciardella; and (2) a presentation by Dale Larson, CFO of the Dallas Theological Seminary (an early adopter of the standard). Other resources we used and recommend for your review are the AICPA's Audit & Accounting Guide, *Not-for-Profit Entities,* published by AICPA and put out March 1 each year, the accounting standard update itself (FASB, source provided below), white papers and briefs put out by major accounting firms with a strong nonprofit focus (including BDO, CapinCrouse, Grant Thornton, BlumShapiro, and Aldrich), webinars done by BDO and CapinCrouse, and resources provided by trade and professional associations (including NACUBO, CACUBO, and ECFA). We first discuss the "why" behind the changes and provide a summary of the changes, followed by a tabular comparison of the new reporting format versus the FASB Statement 117 ("current GAAP") format, and an example of how the new financial reports will appear. Finally, we wrap up with several interpretations and takeaways.

## REASON FOR AND SUMMARY OF STATEMENT PRESENTATION CHANGES

First, why change the way things are presented after 20 years? The idea is to make financial statements more (1) understandable, (2) comparable, and (3) useful. This update to accounting standards is particularly designed to make net assets (Assets – Liabilities) more understandable by slimming the three categories (unrestricted, temporarily restricted, permanently restricted) down to two (without donor restrictions, with donor restrictions). It is

Note: The authors wish to express gratitude to Gregg Capin, CPA, of CapinCrouse LLC, for his review of this appendix.

also requiring more information from nonprofits so users can better assess liquidity, financial performance, and cash flows.

**KEY METHOD: MORE DISCLOSURE** Rather than simply divulging what donors have restricted, nonprofits will now have to specify what amounts of their funds are board-designated (and for what purposes(s)) as well as any constraints on funds that come from laws or regulations.

As we discussed in Chapter 6, your organization's assets are either financed with liabilities (debt, borrowed money) or net assets (money invested in the organization and start-up along with monies earned through surpluses or gained via gains in asset values over the lifespan of the organization). Prior to the new standard, the amount of nonborrowed funds (called "net assets") is presented in three categories – unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. That will change to two classes: "net assets without donor restrictions" and "net assets with donor restrictions." There will be some disclosure by the nonprofit within that latter category so one can still get visibility into how/why/how much is restricted. *We note that in some cases your figure for unrestricted net assets will not be the same as your figure for net assets without donor restrictions. There are two reasons for this: (1) some of your property may be reclassified to net assets without donor restrictions more quickly because of the change in capital restriction requirements (see below); and/or (2) a movement of "underwater" endowment amounts out of unrestricted net assets into net assets with donor restrictions (see below).*

Unrestricted net assets are sometimes thought by financial statement readers to be "spendable funds." Not so. Sometimes much of this amount is tied up in buildings or land, much of which is not being financed with borrowed money. Other times, and this is where the new added disclosure comes in, there are laws, regulations, and contracts such as bond indentures (contractual agreements specifying restrictions on funds perhaps to pay down the borrowing) that may mean that unrestricted net assets are not all in the form of spendable funds.

The purpose of board-designated amounts (sometimes in the form of a "quasi-endowment" or "board-designated endowment") must also now be disclosed in the footnotes to the financial statements if not indicated on the face of the statements.

**"UNDERWATER" ENDOWMENT AMOUNT** If the organization has a permanent endowment (think college endowment), and the fair value of the assets the organization is maintaining in perpetuity is less than the original gift (or less than the legal or donor-stipulated amount required), this "underwater" amount (difference between the fair value and one of the other three amounts) must now be shown as part of net assets with donor restrictions. The disclosures must also include ...

- Funds' original gift amounts;
- Fair values of the amounts; and
- Any governing board policy or decision to reduce or not spend from these funds.

**CAPITAL RESTRICTION EXPIRATIONS** The only item in the new standard that actually changes the accounting – measurement and recognition – rather than the presentation of data involves capital restriction expirations. All nonprofits will have to use the "placed-in-service" method of recognizing gifts that donors have restricted for either the acquisition or construction of buildings or equipment or property (unless the donor stipulates differently). Previously, a nonprofit could follow an alternative recognition method of gift recognition by using the gift's implied time restriction, recognizing revenue as it depreciated the asset if that was its accounting policy.

**MORE DETAIL ON EXPENSES AND COST ALLOCATIONS** Expense detail will expand in the new presentation of the Statement of Activities. Not only voluntary health and welfare organizations but all nonprofits will now have to show expenses both by function (which shows expense by purpose such as program services or supporting activities, where supporting activities typically include management and general activities, which in the new ASU means not including direct conduct or direct supervision of program or other supporting activities), fundraising activities, and membership development activities (which involve retaining existing members and soliciting new members) and also by nature (which points to the type of economic benefit received when the nonprofit incurs those expenses, with examples being total salaries, rent, and utilities). Organizations will also be required to disclose the methods used to allocate costs among the program category and the supporting services category. To do so, their staff will have to think through which specific activities might constitute "direct conduct" or "direct supervision" of program or of a supporting service—these activities necessitate a cost allocation.

**NET INVESTMENT RETURN** Since users had difficulty comparing across organizations with respect to their investment returns (due to varying presentations and the difficulty of identifying all costs, as well as an inability to gain an accurate measure or understanding of performance without more information), all nonprofits are now required to present only the net investment return on the face of the Statement of Activities. External investment expenses and direct internal investment expenses will be subtracted from investment returns to get net investment returns. And there is no longer a requirement to disclose the components of investment return, although it is not prohibited.

**VISIBILITY INTO LIQUIDITY AND AVAILABILITY OF FUNDS** From our perspective, the most important addition in the new standard is the improved visibility into how much liquidity an organization has and how it plans to ensure that all general expenditures will be covered in the upcoming year. Added disclosures must now be made regarding liquidity and asset availability.

First, a nonprofit must make a *qualitative disclosure regarding liquidity* (including credit lines and reserves) so the reader has a better grasp on how the organization manages its "liquid available resources" and its "liquidity risk" in the footnotes to its financial statements.

But that's not all. Your nonprofit will also have to provide *quantitative (numerical) information that conveys the availability of the organization's current financial assets* (think cash, short-term investments, and less obviously, receivables) as of the date of the financial statements with respect to how well able can the organization use these resources to meet general expenditure cash needs within the upcoming one year. This information can be on the face of the financial statements or in the footnotes.

Here are the specifics included in the ASU regarding liquidity and availability:

> **958-210-50-1** A **not-for-profit entity** (NFP) shall disclose in notes to financial statements relevant information about the **liquidity** or maturity of assets and liabilities, including restrictions and self-imposed limits on the use of particular items, in addition to information provided on the face of the statement of financial position, if shown, in accordance with paragraph 958-210-45-8. Specific disclosure requirements to meet that objective include the requirements in this Subtopic.

**958-210-50-1A** An NFP shall disclose the following:

**a.** Qualitative information in the notes to financial statements that is useful in assessing an entity's liquidity and that communicates how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the date of the statement of financial position.

**b.** Quantitative information either on the face of the statement of financial position or in the notes, and additional qualitative information in the notes as necessary, that communicates the availability of an NFP's financial assets at the date of the statement of financial position to meet cash needs for general expenditures within one year of the date of the statement of financial position (see paragraph 958-210-45-7(c)).

Availability of a financial asset may be affected by:

**1.** Its nature

**2.** External limits imposed by donors, laws, and contracts with others

**3.** Internal limits imposed by governing board decisions. See example note disclosures in paragraphs 958-210-55-5 through 55-8 and 958-205-55-21.

**958-210-50-2** An NFP shall disclose all of the following, if applicable, in the notes to financial statements and may include that information in qualitative disclosures on the availability of an NFP's financial assets in accordance with paragraph 958-210-50-1A(b):

**a.** Unusual circumstances, such as special borrowing arrangements, requirements imposed by resource providers that cash be held in separate accounts, and known significant liquidity problems

**b.** The fact that the NFP has not maintained appropriate amounts of cash and cash equivalents to comply with donor-imposed restrictions (see paragraph 958-450-50-3)

**c.** Information about significant limits resulting from contractual agreements with suppliers, creditors, and others, including the existence of loan covenants.

**958-210-50-3** Section 958-210-45 discusses the following items that are required to be included in the notes to financial statements if they are not provided on the face of the statement of financial position:

**a.** A description of the kind of asset whose use is limited (see paragraph 958-210-45-6)

**b.** Information about the nature and amount of limitations on the use of cash and cash equivalents (see paragraph 958-210-45-7(a))

**c.** Contractual limitations on the use of particular assets (see paragraph 958-210-45-7(b))

**d.** Information about the nature and amounts of different types of permanent restrictions that affect how and when, if ever, the resources (net assets) can be used (see paragraph 958-210-45-9)

**e.** [This] Subparagraph [from FASB 117 is] superseded by Accounting Standards Update No. 2016-14.

**f.** Information about additional limitations placed on net assets, such as information about the amounts and purposes of board designations of *net assets without donor restrictions* required in accordance with paragraph 958-210-45-11.[1]

Regrettably, nonprofits may continue to present either a classified or unclassified Statement of Financial Position. A classified SFP provides a delineation of which assets are current and which liabilities are current, whereas an unclassified SFP merely shows assets in decreasing order of liquidity and liabilities in decreasing order of when they might trigger a draw on cash (or the nonprofit might disclose this type of information in footnotes). When a SFP is not classified, it is much more difficult for an outside stakeholder to calculate the current ratio, the cash ratio, and the cash flow ratio (see Chapter 7 and Appendix 7B), especially when the nonprofit does not provide a separate line item for short-term investments in its SFP.

**DISCLOSURE ON AN OPERATING MEASURE AND STATEMENT OF CASH FLOWS PRESENTATION** We shall not provide details on this one, but the accounting standard does require additional disclosure for any nonprofit providing an "operating measure" in the Statement of Activities. See the link to the full ASU at the end of this appendix for more details.

Finally, nonprofits can continue to present their Statements of Cash Flows using the indirect method (most common now, will continue to be most common) or the direct method. If using the direct method, the organization will no longer have to reconcile the net change in net assets to the cash flows from operating activities. An example of a SCF using the direct method is presented later in this appendix.

**PARTIAL OR FULL IMPLEMENTATION AND EFFECTIVE DATE OF ASU 2016-14** You may implement some of the provisions just mentioned (optionally) before "formally adopting" the accounting standard in its entirety. Other provisions can only be implemented if you implement the full accounting standard.

Last, when is this effective? It is effective for financial statements for fiscal years beginning after 12/15/2017 and for interim periods within fiscal years beginning after 12/15/2018. If your organization uses a calendar year (so the year ends 12/31 on its financial statements), unless implementation is delayed by FASB (which is not anticipated at the time of this writing), you will be using the new financial statement format for your 12/31/2018 full-year financials. If you are on a fiscal year ending, say June 30, 2018 or September 30, 2018, adoption of the new reporting format would be required for your full-year financials reported in 2019.

## COMPARING THE NEW FORMAT TO THE OLD FORMAT

You will grasp the new format more easily when you view the same Statement of Financial Position with the FASB 117 presentation format ("Current Guidance"), the adjustments that would be made to that to get numbers into the new format, and then the new format presentation. Delta Education and Cultural Development Agency (Delta) is a nonprofit that operates educational and cultural programs. Delta elected to adopt ASU 2016-14 for its fiscal year ending on June 30, 2018. Exhibit 6A.1 shows how Delta's 6/30/2017 SFP would change under the new format.

We would prefer that, as shown in Exhibit 6A.1, cash and equivalents be split out from restricted cash on the face of the Statement of Financial Position. This also requires the reconciliation to the combined cash and cash equivalents and restricted cash amount on the Statement of Cash Flows, lending greater understanding to the user who wishes to understand the interplay between SFP cash and SCF cash and cash flow amounts.

Conversion of the Statement of Financial Position under Current Guidance ASU 2016-14, as of July 1, 2017

| **Assets** | **Current Guidance** | **Adjustments** | **ASU 2016-14** |
|---|---|---|---|
| Cash and cash equivalents | $1,530,000 | N/A(2) | $1,530,000 |
| Restricted cash | 3,050,000 | N/A(2) | 3,050,000 |
| Short-term investments | 6,450,000 | N/A(1) | 6,450,000 |
| Accounts receivable—net | 1,140,000 | N/A(1) | 1,140,000 |
| Contributions receivable | 3,200,000 | N/A(1) | 3,200,000 |
| Prepaid expenses and other assets | 630,000 | N/A(1) | 630,000 |
| Long-term investments | 15,500,000 | N/A(1) | 15,500,000 |
| Property and equipment | 2,500,000 | N/A(1) | 2,500,000 |
| **Total assets** | **$34,000,000** | | **$34,000,000** |
| **Liabilities and net assets** | | | |
| **Liabilities** | | | |
| Accounts payable and accrued liabilities | $9,200,000 | N/A(1) | $9,200,000 |
| Deferred revenue | 1,050,000 | N/A(1) | 1,050,000 |
| Notes payable | 1,000,000 | N/A(1) | 1,000,000 |
| **Total liabilities** | **$11,250,000** | | **$11,250,000** |
| **Net assets** | | | |
| Unrestricted | $3,700,000 | (3,700,000) | |
| Without donor restrictions | | 6,200,000(3) | $6,200,000 |
| Temporarily restricted | 10,050,000 | (10,050,000) | |
| Permanently restricted | 9,000,000 | (9,000,000) | |
| With donor restrictions | | 16,550,000(3) | 16,550,000 |
| **Total net assets** | **22,750,000** | | **22,750,000** |
| **Total liabilities and net assets** | **$34,000,000** | | **$34,000,000** |

**Notes:**

(1) ASU 2016-14 has no effect on this line item.

(2) Delta may elect to combine cash and cash equivalents and restricted cash into one line item on the statement of financial position and disclose the components in a note. If it chooses not to combine these items, ASU 2016-18 requires a reconciliation of the line items and amounts of cash, cash equivalents, and restricted cash reported within the statement of financial position to cash, cash equivalents, and restricted cash in the statement of cash flows. This reconciliation can be presented in the statement of cash flows or in the notes to the financial statements. Delta elected to present these items separately because restricted cash represents 2/3 of total cash and cash equivalents, which could mislead users on the amount of unrestricted cash and cash equivalents. A sample disclosure is presented in Note A below.

(3) Changes in net assets as a result of adopting ASU 2016-14 are as follows:

| | **Without Donor Restrictions** | **With Donor Restrictions** | **Total** |
|---|---|---|---|
| Unrestricted | $3,700,000 | | $3,700,000 |
| Temporarily restricted | | $10,050,000 | 10,050,000 |
| Permanently restricted | | 9,000,000 | 9,000,000 |
| **Total** | **$3,700,000** | **$19,050,000** | **$22,750,000** |
| Adjustments required by ASU 2016-14 | | | |
| Property reclassified as without donor restrictions(4) | 2,000,000 | (2,000,000) | – |
| Underwater endowment(5) | 500,000 | (500,000) | – |
| **Total per ASU 2016-14** | **$6,200,000** | **$16,550,000** | **$22,750,000** |

**Exhibit 6A.1** Changes in the Statement of Financial Position Using New Format

(4) ASU 2016-14 requires that contributions restricted to acquire long-lived assets be released from restrictions and reclassified to net assets without donor restrictions when the asset is acquired and placed into service, unless the donor placed a time-restriction on the use of the asset.
(5) ASU 2016-14 requires an underwater donor-restricted endowment fund to include any accumulated losses with that fund in net assets with donor restrictions.

**Note A:**
The following table provides a reconciliation of total cash, cash equivalents, and restricted cash within the statement of financial position to the same amount on the statement of cash flows:

| | 6/30/17 |
|---|---|
| Cash and cash equivalents | $1,530,000 |
| Restricted cash | 3,050,000 |
| **Total cash, cash equivalents, and restricted cash shown in the statement of cash flows** | **$4,580,000** |

Amounts included in restricted cash are a $2.8 million matching fund related to a donor-restricted gift of $1 million and $250,000 to be used for major repairs and replacements of a facility purchased with a gift. The matching fund restriction lapses at $200,000 per year. The major repairs and replacements restriction lapses at June 30, 2022.

*Source:* Exhibit 1 in Travis Carey and Robert A. Dyson, "Implementing ASU 2016-14 on the Presentation of Not-for-Profit Financial Statements," *CPA Journal* (April 2017): 28, www.cpajournal.com/2017/04/24/implementing-asu-2016-14-presentation-not-for-profit-financial-statements/. Used by permission. Accessed 10/4/2017.

**Exhibit 6A.1** Changes in the Statement of Financial Position Using New Format (*continued*)

## ILLUSTRATING THE NEW FORMAT FOR STATEMENT OF ACTIVITIES, STATEMENT OF CASH FLOWS, LIQUIDITY AND AVAILABILITY DISCLOSURE

We will use early adopter Dallas Theological Seminary for our portrait of the new format for the Statement of Activities, Statement of Cash Flows, and disclosure of liquid and available funds.

**STATEMENT OF ACTIVITIES** The Statement of Activities for the seminary is shown in Exhibit 6A.2.

Notice in this example that Dallas Theological Seminary (DTS) has an operating measure, Change in Net Assets from Operations (some might call it operating income). As an aside, this amount, roughly $1.9 million, is soundly "in the black," but it is notable that DTS's operating income declined significantly from 2016, with the decline being $1.3 million. Also notice that below that split-out, Non-Operating Change in Net Assets Without Donor Restrictions is shown. The total of Change in Net Assets from Operations in 2017 ($1,928,209) and Non-Operating Change in Net Assets Without Donor Restrictions ($1,738,509) is then presented (a total of $3,666,718). This total is labeled Change in Net Assets Without Donor Restrictions. The Change in Net Assets With Donor Restrictions section is presented next, and for 2017 that amount is $3,020,858. Finally, adding the Change in Net Assets Without Donor Restrictions ($3,666,718) to the Change in Net Assets With Donor Restrictions ($3,020,858), one arrives at the overall Change in Net Assets of $6,687,576 in 2017.

**DALLAS THEOLOGICAL SEMINARY**
**Consolidating Statement of Activities**
**Year Ended June 30, 2017**
**(with comparative totals for 2016)**

| | 2017 | 2016 |
|---|---|---|
| CHANGES IN NET ASSETS WITHOUT DONOR RESTRICTIONS: | | |
| Operating Revenues and Other Additions: | | |
| Tuition and fees, net | $ 15,556,692 | $ 15,008,697 |
| Contributions | 12,513,846 | 14,945,333 |
| Investment return appropriated for spending | 1,086,569 | 759,501 |
| Educational activities and other income | 796,917 | 716,748 |
| Auxiliary enterprises | 3,221,329 | 3,171,122 |
| Total Operating Revenues | 33,175,353 | 34,601,401 |
| Net assets released from restriction: | | |
| Satisfaction of program restrictions | 3,761,820 | 3,446,525 |
| Appropriation from donor endowment and subsequent of any related donor restrictions | 1,928,370 | 1,849,666 |
| Total Operating Revenues and Other Additions | 38,865,543 | 39,897,592 |
| Expenses: | | |
| Salaries and wages | 17,047,765 | 16,268,578 |
| Employee benefits | 4,937,925 | 5,357,658 |
| Services, supplies, and other | 6,314,236 | 6,089,625 |
| Occupancy, utilities, and maintenance | 2,170,897 | 2,987,822 |
| Grants to others | 3,498,599 | 2,696,718 |
| Depreciation and amortization | 2,308,899 | 2,572,531 |
| Interest | 659,013 | 689,145 |
| Operating Expenses | 36,937,334 | 36,662,077 |
| Change in Net Assets from Operations | 1,928,209 | 3,235,515 |
| Non-Operating Change in Net Assets Without Donor Restrictions: | | |
| Other components of net periodic pension cost | (1,854,647) | (1,708,765) |
| Pension-related changes other than net periodic pension costs | 4,163,531 | (3,560,167) |
| Investment return net in excess of amounts appropriated for spending | (666,066) | (126,738) |
| Change in value of split-interest agreements | 95,691 | (328,031) |
| Net assets released from restrictions due to acquisition of long-lived assets | – | 12,234,065 |
| Change in Net Assets from Non-Operating Activities | 1,738,509 | 6,510,364 |
| Change in Net Assets Without Donor Restrictions | $ 3,666,718 | $ 9,745,879 |

See notes to consolidated financial statements

**Exhibit 6A.2** Statement of Activities Using New Format

**DALLAS THEOLOGICAL SEMINARY**
**Consolidating Statement of Activities**
**Year Ended June 30, 2017**
**(with comparative totals for 2016)**
**(continued)**

| | 2017 | 2016 |
|---|---|---|
| CHANGE IN NET ASSETS WITHOUT DONOR RESTRICTIONS: | | |
| Operating revenues and other additions | $ 38,865,543 | $39,897,592 |
| Operating expenses | (36,937,334) | (36,662,077) |
| Change in Net Assets from Operations | 1,928,209 | 3,235,515 |
| Change in Net Assets from Non-operating Activities | 1,738,509 | 6,510,364 |
| Change in Net Assets Without Donor Restrictions | 3,666,718 | 9,745,879 |
| CHANGES IN NET ASSETS WITH DONOR RESTRICTIONS: | | |
| Contributions | 4,750,511 | 6,624,540 |
| Investment return, net | 3,732,659 | 106,504 |
| Change in value of split-interest agreements | 227,878 | 185,865 |
| Net assets released from restrictions: | | |
| Release of appropriated endowment amounts | (1,928,370) | (1,849,666) |
| Releases from restrictions due to acquisition of long-lived assets | - | (12,234,065) |
| Release of other restrictions | (3,761,820) | (3,446,525) |
| Change in Net Assets With Donor Restrictions | 3,020,858 | (10,613,347) |
| Change in Net Assets | 6,687,576 | (867,468) |
| Net Assets, Beginning of Year | 87,667,024 | 88,534,492 |
| Net Assets, End of Year | $ 94,354,600 | $ 87,667,024 |

*Source:* Dallas Theological Seminary Consolidated Financial Statements With Independent Auditors' Report, June 30, 2017 and 2016. Used by permission.

**Exhibit 6A.2** Statement of Activities Using New Format (*continued*)

**STATEMENT OF CASH FLOWS AND DISCLOSURE OF LIQUID AND AVAILABLE FUNDS**

We will again use early adopter Dallas Theological Seminary for our portrait of the new format for the Statement of Cash Flows, and disclosure of liquid and available funds.

***Statement of Cash Flows*** The DTS 2017 and 2016 Statements of Cash Flows are shown in Exhibit 6A.3.

Notice first that DTS presents its Statement of Cash Flows using the direct method, which is thought generally to present users with a better view of what is providing or using cash. The indirect method (see Chapter 6) starts with Change in Net Assets and them makes adjustments for current asset or current liability changes as well as gains or losses, but does not show the operating activities that actually provide or consume cash. Cash received from students via tuition and fees and from donors are seen to be the two dominant operating cash sources. Cash paid to employees and to suppliers/vendors are clearly the two dominant operating cash uses. This format also lends nicely to a long-term cash source and use

**DALLAS THEOLOGICAL SEMINARY**
**Consolidated Statement of Cash Flows**
**Year Ended June 30, 2017**
**(with comparative totals for 2016)**

| | 2017 | 2016 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Cash received from tuition and fees | $ 15,989,828 | $ 15,324,808 |
| Cash received from donors | 14,862,952 | 14,981,883 |
| Cash collected from contributions receivable | 1,059,871 | 2,162,147 |
| Cash received from auxiliary enterprises | 3,207,568 | 3,157,109 |
| Interest and dividends received | 1,241,133 | 1,071,499 |
| Miscellaneous receipts | 801,271 | 948,238 |
| Cash paid to employees | (17,038,182) | (16,294,206) |
| Cash paid for benefits | (6,341,991) | (6,802,595) |
| Cash paid to suppliers and vendors | (10,276,191) | (10,112,733) |
| Interest paid | (660,774) | (690,825) |
| Grants paid | (3,529,742) | (2,696,718) |
| Net Cash Provided (Used) by Operating Activities | (684,257) | 1,048,607 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (865,814) | (3,942,721) |
| Proceeds on sale of investments | 17,454,664 | 24,039,681 |
| Purchase of investments | (15,070,557) | (25,950,085) |
| Net Cash Provided (Used) by Investing Activities | 1,518,293 | (5,853,125) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from contributions restricted for: | | |
| Investment in perpetual endowment | 1,339,295 | 3,224,386 |
| Investment in term endowment | 24,675 | 14,830 |
| Investment in property and equipment | 68,968 | 661,925 |
| Proceeds from note receivable collection | 34,610 | 31,988 |
| Other financing activities: | | |
| Payments on annuity and trust obligations | (777,232) | (958,589) |
| Payments on notes payable | (658,669) | (628,618) |
| Net Cash Provided (Used) by Financing Activities | 31,647 | 2,345,922 |
| Change in Cash and Cash Equivalents | 865,683 | (2,458,596) |
| Cash and Cash Equivalents, Beginning of Year | 7,592,473 | 10,051,069 |
| Cash and Cash Equivalents, End of Year | $ 8,458,156 | $ 7,592,473 |

*Source:* Dallas Theological Seminary Consolidated Financial Statements With Independent Auditors' Report, June 30, 2017 and 2016. Used by permission.

**Exhibit 6A.3** Statement of Cash Flows Using New Format forecast (see Chapter 8). As an aside, the operating cash used for 2017 of –$684,207 stands in stark contrast to the operating income of $1,928,370 that we saw earlier in the Statement of Activities. We again underscore the importance of managing cash flow, noting here that operating cash flow is about $2.6 million less than accrual-based operating income for 2017.

We emphasized earlier the potential value to the manager, board member, donor or grantor of the new liquidity and availability disclosure. Our final picture of DTS's financial health comes from its disclosure, shown in Exhibit 6A.4.

This is a very interesting and helpful disclosure on the part of DTS. First, a (very) naïve approach to estimating DTS's ability to meet near-term obligations as of June 30, 2017, would be to add Cash & Cash Equivalents to Investments. This would signal that DTS has about $102 million on hand to meet the upcoming year's obligations. Let's see how far from reality this is by following the remainder of the disclosure. First, some $77,203,471 of that cash, cash equivalents, and investments is tied up in investments held by others, investments held for others, held in endowments, held in trusts, and (a relatively small amount) held in board-designated endowments. We are already down to about $25 million in liquid and available funds. To this we add the contributions and accounts receivable that DTS figures to collect within the year (but maybe late in the year?), then subtract cash and equivalents held as board-designated reserves. DTS ends up with about $26.7 million liquid and available funds.

For one's own personal appraisal of the numbers, one can then make his or her own conservative-leaning adjustments to this figure (we might subtract all the receivables, noting the uncertainty of their timing, their collectibility, and the fact that accounts payable and near-term notes payable are not being subtracted in the ASU framework), and also subtract out $5.54 million or more for transactions cash that would have to be held at all times for an organization of this size regardless of incoming expenditure amounts (we prefer 15% of annual operating expenses to cover at least two bi-weekly payrolls plus monthly payables), then add the unused credit line (amount of credit line available to draw down) of $5,000,000, landing at our own estimate of adjusted liquid and available funds of roughly $23.5 million.

Our adjustments:

| | |
|---|---|
| DTS Estimate of Liquid and Available Funds | $26,653,269 |
| − Accounts and contributions receivable | 2,604,027 |
| − Transaction cash (minimum on hand) | 5,540,600 |
| + Amount of credit line currently available | 5,000,000 |
| **= Adjusted Liquid and Available Funds** | **$23,508,642** |

## INTERPRETATIONS AND IMPLICATIONS

We have made several interpretive comments in the presentation above, but would like to summarize with a brief discussion of the new disclosure regarding liquid and available funds. You may be responsible to help in writing your organization's liquidity and availability disclosures or perhaps in evaluating the amount so disclosed by your organization or another organization. As you get ready for the liquidity and availability disclosures, Tammy Ricciardella of BDO recommends that you prepare the following specifics regarding quantitative (that must be provided on the face of the financial statement or in the note) and qualitative disclosures of liquid and available resources:[2]

**10. LIQUIDITY AND FUNDS AVAILABLE:**

The following table reflects the Seminary's financial assets as of June 30, 2017, reduced by amounts not available for general expenditure within one year. Financial assets are considered unavailable when illiquid or not convertible to cash within one year, state required annuity reserves, trust assets, assets held for others, perpetual endowments and accumulated earnings net of appropriations within one year, or because the governing board has set aside the funds for a specific contingency reserve or a long-term investment as board designated endowments. These board designations could be drawn upon if the board approves that action.

| | June 30, | |
|---|---|---|
| | **2017** | **2016** |
| Financial assets: | | |
| Cash and cash equivalents | $ 8,458,156 | $ 7,592,473 |
| Accounts and contributions receivable | 4,163,630 | 4,256,405 |
| Investments | 93,608,836 | 86,604,473 |
| Perpetual trusts held by others | 511,721 | 519,218 |
| Financial assets, at year-end | 106,742,343 | 98,972,569 |
| Less those unavailable for general expenditure within one year, due to: | | |
| Investments and perpetual trusts held by others not convertible to cash within next 12 months | (2,998,357) | (2,954,525) |
| Contribution and accounts receivable collectible beyond one year | (1,559,603) | (1,593,323) |
| Investments and other financial assets held for others | (28,404,703) | (18,671,223) |
| Perpetual and term endowments and accumulated earnings subject to appropriation beyond one year | (35,191,761) | (35,479,448) |
| Investments held in trusts and various state required annuity reserves | (9,976,066) | (9,714,640) |
| Investments in board designated endowments | (632,584) | (604,086) |
| Board designated reserves for future contingencies | (326,000) | (326,000) |
| Board designated reserves for debt retirement | (1,000,000) | – |
| Financial assets available to meet cash needs for general expenditures within one year | $ 26,653,269 | $ 29,629,324 |

The Seminary has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. The Seminary also has an unsecured $5,000,000 line of credit, which it could draw upon in the event of an anticipated liquidity need. The line of credit matures on December 31, 2017. The interest rate is PRIME (4.25% as of June 30, 2017), with interest due monthly and principal due upon maturity. No funds were borrowed under this agreement during the fiscal year ended June 30, 2017.

*Source:* Dallas Theological Seminary Consolidated Financial Statements With Independent Auditors' Report, June 30, 2017 and 2016. Used by permission.

**Exhibit 6A.4** Liquidity and Availability Disclosure Example

### Quantitative Disclosure of Liquid and Available Resources

- Assess how they manage their liquid resources to ensure they can meet their cash needs for general expenditures as of and within one year, respectively, of the statement of financial position date;
- Evaluate their financial assets to determine their availability to meet cash needs;
- Consider the nature of the assets;
- Examine the external limits imposed by donors, [grantors], laws, and contracts; and
- Account for, analyze, and track any internal limits imposed by governing board decisions.

### Qualitative Disclosure of Liquid and Available Resources

- Special borrowing arrangements or instances whereby the entity has not maintained appropriate amounts of cash as required by donor-imposed restrictions; and
- Limitations that result from contractual agreements with suppliers, creditors, loan covenants and other sources.

Included in the *quantitative* disclosure you might include the amounts of cash and cash equivalents, operating investments (typically short-term investments that are unrestricted and might be sold quickly with no loss of market value), accounts receivable, contributions receivable (perhaps labeled promises to give), split-interest agreement distributions, distributions related to beneficial interests in assets held for others, and endowment spending-rate distributions and allowances. The *qualitative* information you provide will be in the notes to the financial statements.

Should your nonprofit anticipate the possibility of accessing a certain, limited amount of (permanently restricted) net assets with donor restrictions, as permitted by law, this would also be stated in the disclosure. “Possible” does not imply “likely,” however. Your staff, donors, and board may be surprised to see that liquid and available assets may be less than the amount shown as cash and equivalents, as shown in the Foundation for the Carolinas disclosure (Exhibit 6A.5). Subtracting the $7,739,497 of donor-advised funds from the $11,765,592 of “financial assets available” reveals that the Foundation’s spendable funds amount is actually $4,026,095. The Foundation for the Carolinas lists its operating reserve as $3.4 million as of the most recent year-end (Exhibit 6A.5).

You will want to work with your finance committee and the audit committee (if those are separate) to prepare them for the new net asset classification, the liquidity and availability disclosure, and functional expense versus natural expense reporting. Set your target liquidity level (including the operating reserve amount) in light of your organization’s need for liquid and available funds.

For more information and to address any questions you or your stakeholders may have, you may access the full accounting standard update at the FASB website: www.fasb.org (at the time of this writing background information on the development of the standard is available at http://www.fasb.org/jsp/FASB/Page/ImageBridgePage&cid=1176168380111 and http://www.fasb.org/jsp/FASB/FASBContent_C/CompletedProjectPage&cid=1176168381520, and the 270-page standard update itself is located at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168381847).

**NOTE 3—LIQUIDITY AND AVAILABILITY**

Financial assets available for general expenditure, that is, without donor or other restrictions limiting their use, within one year of the statements of financial position sheet date, comprise the following:

| | |
|---|---|
| Cash and cash equivalents | $ 4,427,463 |
| Accounts receivable and other assets | 5,317,606 |
| Short-term investments | 2,020,523 |
| | $ 11,765,592 |

The assets above include $7,739,497 in donor-advised funds. The Foundation generally uses these assets for grant making based on donor recommendations.

Endowment funds consist of donor-restricted endowments and board-designated endowments. Income from donor-restricted endowments that is restricted for specific purposes is not available for general expenditure. As described in Note 14, the Foundation's board designated endowments are subject to an annual spending rate of 5.0% and $4,285,450 of appropriation from the board-designated endowments will be available within the next 12 months. Although the Foundation does not intend to spend from this board-designated endowment (other than amounts appropriated per the Board's annual spending rate approval), these amounts could be made available if necessary.

As part the Foundation's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations become due. The Foundation invests cash in excess of daily requirements in short-term investments and money market funds. Occasionally, the Board will designate a portion of any operating surplus to its operating reserve, which was approximately $3.0 and $3.4 million as of December 31, 2015 and 2016, respectively.

*Source:* Foundation for The Carolinas Consolidated Financial Statements as of and for the Years Ended December 31, 2016 and 2015 and Report of Independent Auditor. Used by permission.

**Exhibit 6A.5** Liquidity and Availability Disclosure Example #2

## Notes

1. FASB Accounting Standards Update No. 2016-14 (August 2016), "Not-for-Profit Entities (Topic 958) – Presentation of Financial Statements of Not-for-Profit Entities," Financial Accounting Standards Board, 88–89. Available online at http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168381847). Accessed 9/27/17.
2. Tammy Ricciardella, "A Deeper Dive Into ASU 2016–14 Implementation Issues," January 26, 2017. Available online at http://www.bdo.com/blogs/nonprofit-standard. Accessed 9/27/2017.

CHAPTER 7

# DEVELOPING FINANCIAL REPORTS AND RATIOS: MAKING SENSE OF THE NUMBERS



## 7.1 INTRODUCTION

How are things going with the finances of your organization? Is there enough financial strength to expand or add new programs? Or will there be another cash crisis this year? Financial reports and financial ratios provide answers to these questions. It is hard to overemphasize the importance of accurate and timely financial reports for *internal*




*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

financial decision making. Additionally, donors, foundations, the IRS, and charity rating services such as the BBB Wise Giving Alliance, Charity Navigator, CharityWatch, MinistryWatch, and Intelligent Philanthropy may scrutinize your financial position and policies and judge your organization as to whether it is "support worthy." When you go to the bank for a mortgage or short-term loan, the lending officer assesses your financial reports before making the lending decision. Bond underwriters and investors will do the same. Because the rating service bureaus, information providers, lenders, and investors will be looking at some of the same things you should be looking at periodically in your internal financial process, we will focus primarily on internal reporting and financial ratios that anyone could monitor. Internal statements can provide the data that adds to your sense-making capacity. The numbers tell a story and are key to the exercise of financial leadership.

Sense-making theory as developed by Karl Weick (2001) involves placing all sorts of stimuli into some kind of framework. It can be defined as a recurring cycle comprised of a sequence of events occurring over time. Individuals form unconscious and conscious anticipations and assumptions, which serve as predictions of future events. Subsequently, individuals experience events that may be discrepant from predictions. These events trigger a need for explanation and, correspondingly, for a process through which interpretations and discrepancies are developed.[1] This theory fits very well with the rationale and development of financial reports. We carry assumptions and expectations that are either verified or refuted by financial reports. The financial reports, if they meet our expectations, create a sense of validation. If the results do not meet our expectations we then engage in a form of inquiry to find out why and then make appropriate corrections.

## 7.2 MAJOR DIFFERENCES FROM FOR-PROFIT BUSINESS REPORTS

Nonprofit financial reports may look much like business reports, but the focus and emphases are different. Business professionals on the board may not be aware of these differences, and it takes some effort on the part of the chief financial officer (CFO) as financial educator to explain why things are different. Financial literacy cannot be assumed, even for business professionals that serve on boards. Accounting rules and the primary financial objective differ for nonprofit organizations and these differences need to be understood by the users of the information.

**(a) FINANCIAL RESULTS ARE NO LONGER THE PRIMARY FOCUS IN MANAGEMENT REPORTS.** In businesses, if the stock price is going up and the organization is profitable, the organization is deemed a success. In nonprofits, financial results no longer have primacy, because shareholder wealth or profit maximizing no longer serve as the overarching objectives. A study of nonprofit effectiveness and excellence, surveying more than 900 staff officers and board chairs from a national sample of nonprofits, found that the mission and related goals dominated in effectiveness assessment:

1. When asked to list characteristics of an effective organization, most gave an answer that indicated a clear sense of mission accompanied by goals to carry out that mission.
2. When asked how a nonprofit can improve, most gave the highest priority to "making mission central."

**3.** A strong mission orientation is the chief criterion used by board chairs to judge the effectiveness of the chief executive officer (CEO).[2]

We drive home this point by relaying part of an interview conducted in the major study of faith-based organizations (our Lilly study, profiled in Appendix 1A). Darryl Smith, CFO of the Church of God Missionary Board, was rated a top performer based on survey response scoring. Prior to coming to the Church of God, Darryl was a plant controller for a chemical company. When we asked him the difference between the mindset and practices of the charitable organization compared to a corporation, he replied:

> I guess the biggest difference is the mission. Even a corporation has a mission orientation – they should. I think the mission direction of the not-for-profit, or at least the Church of God board here, is primarily that of trying to have an impact in people's lives around the world almost at times regardless of the cost. I'm not trying to say that we're not concerned about the finances related to that, but that seems to be an area that the church relies on faith and relies on individuals to support that. So it's not necessarily looking at your one-year plan, your three-year plan, your five-year plan, and trying to implement that. I think in the private sector without question you've got a shareholder that you've got to relate to, you've got an operating board that is held accountable by the shareholders ... and many times the primary focus of the private business sector is the operating results related to that. I know in the chemical industry, maximizing [the management of] your inventories (your turnover rates), your profit and loss statement, those were the biggest areas.... So I think the biggest change, the biggest thing I can see is that the mission is not related primarily to the financial strength. I think it's more related to the vision and the direction that the board or any of the staff feels that needs to be done around the world.

*CFO's role:* Use the financial reports to show how the financial results facilitated and enhanced present and future mission achievement. The CFO needs to make the case that mission is supported by finances. Without a solid financial footing, the organization might do a great job at mission fulfillment – in the short term – but sustaining mission is a strategic consideration that is both enabled and constrained by finance. Achieving and maintaining the liquidity target is essential.

**(b) PRIMARY FINANCIAL OBJECTIVE IS TARGET LIQUIDITY, NOT PROFIT OR SHAREHOLDER WEALTH.** The very different financial dynamics of businesses and nonprofits are highlighted when their life-cycle pattern under financial stringency is considered.

A business that is not making money is closed to conserve shareholder capital; thus the financial reports focus on the organization's ability to make a profit and a positive operating cash flow, with stewardship defined as greater profits and cash flows. This then translates into "total shareholder return," a metric that has each year's stockholder return calculated as stock price increase plus dividends divided by beginning stock price.

A nonprofit, however, will operate until it runs out of cash and is unable to arrange a cash infusion, and can be running deficits (negative changes in net assets) for some years without any corrective action being taken. Thus, the financial reports focus first on the amount of assets which is spendable in the sense of unrestricted cash and short-term investment securities balances that is also available, second on the incoming flow of cash, and then on the organization's unrestricted net assets. Good stewardship means maintaining some target level of liquidity: *too little* jeopardizes the organization's future both in the sense of limiting its ability to respond quickly to new opportunities or to withstand short-term economic challenges and in the sense of providing an insufficient buffer against a bad fiscal year; *too much* might be an indication of "hoarding," which brings into question both why the organization is not spending more on meeting critical societal needs and whether the organization really merits the same level of donor or grantor support. It is very difficult for an outside stakeholder to know how much is too much in that many nonprofits prefund their investments in new buildings, mergers or acquisitions, capacity-building initiatives, and new program launches or program expansions.

*CFO's role:* Use financial reports to show how the organization follows its financial policies, especially its primary financial objective of a target liquidity level, to add stability and further the organization's potential for future mission achievement. Consider this example from the business community: the White Castle restaurant chain ("Buy 'em by the sack") states that it intentionally slows its growth rate in order to finance growth only with reinvested profits "so we can provide a stable company for our 9,500-plus employees." An example from the nonprofit arena: Salvation Army typically includes in its annual report a statement similar to this one: "About 63.4 percent of the Army's net assets consist of land, buildings and equipment ($5.14 billion), plus invested board-designated reserves for future capital expenditures, ongoing facilities maintenance and specific programs ($1.4 billion)."

At the program level, for most programs, strive to meet the secondary objective of *cost coverage* (program revenues cover or more than cover program cost). A program not raising adequate donor funds or receiving other subsidy such as money directed from endowment earnings within a certain time frame must be scaled back or ultimately ended. New programs are always open to consideration; just make sure to begin building financial support as you move toward implementation. In some cases, as we noted in Chapter 3, programs that do not cover their costs should be maintained, with reliance on earned income or subsidization from other programs that more than cover their costs. Some organizations have unethically diverted monies raised for one purpose to another purpose, so maintain accountability over restricted gifts or grants.

**(c) FEWER EXTERNAL USERS, WITH A DIFFERENT ACCOUNTABILITY FOCUS.** Users often have a great deal of difficulty in interpreting nonprofit financial statements. Some years ago, a group of Harvard Business School master's degree students were given typical nonprofit statements to review. After much time and effort, they were unable to analyze and draw correct conclusions from the statements. With the more recent reporting format prescribed by FASB Statements 116 and 117 as modified by Accounting Standard Update 2016-14, the statements are consolidated and look more like business financials, yet the meanings of such terms as "unrestricted," "restricted," "pledges receivable," "board designated" and "net assets" are still confusing to many users. The concepts of quasi-endowment and donor restriction do not exist in the commercial sector, so they are unfamiliar to all but the most astute reader.

Despite the difficulties in gauging nonprofits' finances, the general public and present and potential donors want accountability from nonprofits. As a result, effectiveness and efficiency are often judged from the service delivery observed (or read about in press reports such as those in *Forbes* magazine that are appearing with increasing frequency), or a rating service report. For example, BBB Wise Giving Alliance rates approximately 1,500 charities, CharityWatch rates 600 charities, and Charity Navigator rates 8,000 organizations with respect to their financial health and accountability/transparency. GuideStar has a page of information available on the 1.8 million IRS-recognized nonprofits at www.guidestar.org.[3] You must be prepared to offer a strong case in defense of your organization's financial position if one of the rating service agencies rates the organization's cash reserves as "excessively high." And be ready to justify administrative expenses if they fall above a normal percentage of total expense—16.6% according to one large-scale study.[4] Not that these external groups are mere negative influences: How an outside party perceives an organization often conveys valuable information back to your management team and board. And many times the reports are positive (refer back to Exhibit 5.8 for an example). It is a delicate balancing act based on perception.

One other problem: External reporting requirements or needs may dictate internal reporting and budgeting formats, as nonprofits are too hard-pressed to do two sets of reports.[5]

Stakeholders may raise a number of far-ranging questions about your organization's performance, as noted in Exhibit 7.1. Notice that the first two categories reflect mostly nonfinancial aspects and outcomes, while the last four categories include items that can be assessed by studying financial reports and developing and interpreting financial ratios. Because of the questionable liquidity of net assets ("accumulated wealth"), we modify the last item in Financial Health (#5) of Exhibit 7.1 to say, "Does it have an adequate Target Liquidity Level to sustain it if funding is reduced?"

Internal uses (the reports for which are sometimes called managerial accounting) at times may differ from uses outside the organization. Showing the difference between planned or budgeted amounts and actual reported results is an important input into whether the organization needs to initiate corrective action and whether it is heading toward a financial crisis. Students in nonprofit financial management are trained to use the statements and interpretive methods (such as ratios) as methods of inquiry. The financial statements reveal a lot of information about the organization, but they also provide information that can lead to further inquiry. One of the challenges that nonprofit organizations face is that the financial statements provide much information, but accounting data do not answer questions about mission fulfillment. Program outcomes and mission accomplishment can usually be understood through inquiry of more qualitative data. Both quantitative financial data and quantitative and qualitative nonfinancial data are needed in order to provide rigorous analysis of the organization's efficiency and effectiveness.

*CFO's role:* Establish a workaround to provide helpful internal and external reports. Set up a financial spreadsheet to automatically link your management report form to your external reports. This way, your management forms are automatically updated each month (quarter or year) as you fill in the board, grant agency, state, IRS, or annual financial statement external reports. From there, customize the data into the framework most helpful for your management team. Also, involve the readers of internal statements in creating them in terms of format and content. Readers that have engaged in development of internal reports generally have more buy-in and interest in reading them.

**(d) DIFFERENT FUNDS AND THE (TEMPORARILY OR PERMANENTLY) RESTRICTED VERSUS UNRESTRICTED NET ASSET DISTINCTION.** Fund accounting, still used for internal record keeping by many nonprofits, is not a problem in itself. Essentially, it is no different from divisional or department reporting in a business, including such categories as general operating fund and building fund. A problem arises in cases in which (1) fund accounting reports may be provided to board members or major donors who request additional information, and these external users are not accustomed to the format; (2) internal decision makers do not specify how liquid resources in the building fund or other funds might be tapped by the organization in an emergency; or (3) there are frequent interfund loans or transfers, such as money "borrowed" from the building fund to meet payroll.

We believe that the accounting distinction between temporarily restricted net assets and permanently restricted net assets is more helpful than simply reporting items as

**1.** Mission
- What is your organizational mission?
- Is the mission consistent with the stakeholder's values?
- How does that translate into goals and objectives?
- What is the business model/strategy?
- What are present obstacles to fulfilling the mission?

**2.** Service Delivery
- What is the demand for these services?
- What type, volume, and quality of services are delivered?
- Are these services compatible with mission?
- Are they meeting goals and objectives (are $ spent on right stewardship things)?
- What are present obstacles in service delivery?

**3.** Organizational Management
- What is the experience and expertise of management?
- What is the quality of internal support systems?
- What is the administrative efficiency?
- What is the appropriateness of compensation?

**4.** Organizational Funding
- What cash funds are available?
- What noncash contributions (goods, services, volunteers) are used and available?
- How financially supportive are board and community?
- How financially supportive are commercial activities?
- Is there continuity of support and diversity of income streams?
- How compatible is the funding with the mission?
- How efficient is fundraising and development?
- What are present obstacles in funding and support?

**5.** Financial Health
- What is the cash-flow position?
- How financially stable is the organization?
- Does it have accumulated wealth to sustain it if funding is reduced?

**6.** Financial Management
- What is the quality of internal control system?
- How prudent is the cash and investment management?
- Are nonfinancial assets prudently managed?

*Source:* E. K. Keating and P. Frumkin, "How to Assess Nonprofit Financial Performance." Working Paper, Northwestern University and Harvard University, 2001.

**Exhibit 7.1** Questions Asked to Assess Performance "with donor restrictions." The financial statement presentation format now being implemented (ASU 2016-14; see Appendix 6A) eliminates the split-out of *type* of restriction on the face of the statement of activities and for the statement of financial position there still must be a disclosure of time-restricted and use-restricted net assets but in most cases it will appear in the notes. Furthermore, when your organization does the required disclosure of board-designated net asset amounts, be careful not to classify board-designated funds as *restricted* "endowment" funds. Instead, these funds that the board has earmarked for some purpose such as operating reserves should be reported as "quasi-endowment," unrestricted net assets that could be spent at the board's discretion at any time. What the board has designated for Plan A can be re-designated for any other Plan B at any time. Only donors can restrict net assets from an accounting standpoint.

Regardless of presentation format, there are questions about how "restricted" time- and use-restricted items are, or when they will move from the restricted category to unrestricted and become spendable funds. Furthermore, there is an important distinction that may be masked in the temporarily-restricted classification. Some items are time-restricted, meaning they cannot be spent at the present. Other items are designated for a specific use and cannot be spent for general operations at any time. An accountant or the controller must determine how much fits either category, and when (if at all) funds will be spendable and can be included in the cash budget to cover needed expenditures. The appropriateness of the accountant's determination may be impossible to assess for an outside statement user, however.

## 7.3 OBJECTIVES OF FINANCIAL REPORTS

There are four main reasons why the organization puts together financial reports: (1) to represent the organization's financial situation accurately and on a timely basis, (2) to support mission attainment, (3) to evidence accountability, and (4) to facilitate turnaround management. These reasons overlap, but each has unique aspects the CFO and treasurer will want to emphasize.

**(a) ACCURATE AND TIMELY REPRESENTATION OF FINANCIAL SITUATION.** Ideally, weekly reports should be available one to two business days after the week's close and monthly reports within five business days of month-end. If reports are unavailable, issue control totals without the detail in order to speed the information flow. Use flash reports to get quick readings of key financial performance indicators (KPIs) such as donations, net surplus (deficit) compared to budget, and cash that is not only unrestricted and undesignated but available. Use your financial situation analysis of year-to-date and yearly totals to guide (1) current-year year-end projections, (2) new budget development and (3) your long-range financial plans.

**(b) MISSION ATTAINMENT SUPPORTIVE ROLE.** The financial reports should mirror the role of the finance department: Proficient financial management enhances mission attainment. Remember that in striving for your target liquidity level, the purpose is preserving and providing financial resources for the organization to carry out its mission. The fact that financial results are no longer the primary focus in management reports triggers three action points to guide your financial reporting and analysis:

1. *Serve the mission achievement end, recognizing that the report is not an end in itself.* Although our usual concern is inadequate financial analysis, resist the tendency to make financial affairs the dominant focus of top management and board attention while correcting the deficiency.

2. *Emphasize report usability*. Depth interviews and/or focus groups may go a long way to orient you to the informational needs and information processing capabilities of your financial report "customers." Benchmarking, dashboard reports, and the new reporting metrics that will be discussed later in this chapter have evolved partly in order to see through internal customers' eyes.
3. *Focus your reporting and analysis thrust mainly for internal users*. Necessary IRS and regulatory filings take time and attention from your development of management-oriented, donor-oriented or grantor-oriented financial information.

Many nonprofits are deficient in making the necessary managerial information available in the right form on a timely basis. Recognize that most nonprofits are very small, and few small businesses have strong internal reporting systems either. Focus on a process of continuous improvement. Initially and at periodic reevaluation points, concentrate on the *process* (procedures and methods) of making decision-making information available, and think through the formats of reports carefully before releasing new or modified reports. One of your first objectives, which we will help you with later in the chapter, should be to improve on your presentation format (including graphics and annotations attached to the numbers) and actual-versus-plan analysis. Assemble financial reports that help decision makers make sense of the organization's situation and provide baseline data on which to measure improvement.

**(c) EVIDENCE OF ACCOUNTABILITY.** Organizations must not only be accountable; increasingly they must persuade skeptical regulators, the media, and donors of that accountability. What does "being accountable" mean? Look the word "accountable" up in a dictionary and you will see it is defined as "liable to being called to account; answerable." The financial and ethical scandals over recent years involving Goodwill Omaha, Federation Employment and Guidance Service (FEGS), Mad Cow Theater, Triangle Aids Network, and the Wounded Warrior Project have heightened Society's calls for accountability. In response, charities are becoming answerable to go-between rating service groups, such as the BBB Wise Giving Alliance, Charity Navigator, CharityWatch, and MinistryWatch; we looked at their standards in Chapters 2 and 6. For these standards setters, accountability in philanthropy means providing complete financial statements that are prepared in a standard format with full disclosure both of resources and obligations as well as the expenses for program and administration. These guidelines constitute an excellent start, and you will notice that some of the other standards, even though not labeled as accountability standards by the groups, also bear on the issue. We need a broader framework, though, and one is outlined in Exhibit 7.2.

Who are the key stakeholders in your organization? Are you evidencing accountability as a good steward to each of the stakeholder groups? Can you provide a coherent response to a given stakeholder group that contends you are not doing enough for them (and maybe benefiting another stakeholder group to do so)? If so, your organization, speaking generically, is well on the way to being accountable.

Your key accountability, ultimately, is to the mission founders (upon whose vision the organization received approval to exist as a charity) and the present and potential donors. These stakeholders and their requirements are the boundaries structuring your provision of accountability-related information. In developing your reports, consider two things:

**Exhibit 7.2** Accountability and Your Financial Reports

**1.** What information evidences fidelity to and achievement of the original (or revised) mission? If the mission changed, how did the change mesh with the original vision of the founders? Data to include:

- Program effectiveness, including outcomes data
- Program efficiency
- Program controls (including financial)
- Program resource commitment

In each category, pick one or two key indicators so as not to overwhelm your audience.

**2.** Are donors' desires being honored? Informed donors want all of the items just listed, but also want to know:

- What is your primary financial objective, and how well are you doing in reaching it?
- If you budget for other than breakeven, why? Does the budget include a contingency line item? Did you make budget this year?
- If you did not make budget this year, why not?
- Are you voluntarily providing information to GuideStar ("Update Nonprofit Profile")?
- How are you rated by BBB Wise Giving Alliance, Charity Navigator, CharityWatch, MinistryWatch? If any of these bodies identifies a "problem area," how are you addressing it (or if you do not see it as a problem, have you clearly indicated why not)?
- Designated funds spent as directed
- Waste eliminated
- A process of continual improvement (which usually means you admit some areas of weakness)
- Entrepreneurial and creative initiatives to find new resources and to better use existing ones
- More and better information about your organization's fundraising function:
  - ▷ Some key fundraising ratios
  - ▷ The philosophy and how it is being honored
  - ▷ Integrity first, last, and in between
  - ▷ Evidence that you are not overly dependent on one source of funds, particularly if that source is "expensive" (in terms of costs and in terms of diverting attention from other, preferable sources of funds)

This brief outline gives some ideals that informed donors might hold. They would be delighted to get all of this information, but would not be surprised that you did not provide all of it because at times you do not have the data (yet, anyway) and you realize you don't want to overload them. So, parcel the information out over time in your various communications. Perhaps most important is that your attention to detail and to staying in touch shows a professional, dedicated, and informed management approach.

Note: For more on this topic, see John Zietlow, "Developing Financial Accountability and Control," in *Serving Those in Need: A Handbook for Managing Faith-Based Human Services Organizations*, ed. Edward L. Queen II (San Francisco: Jossey-Bass, 2000).

**Exhibit 7.2** Accountability and Your Financial Reports (*continued*)

Note that accountability starts with staying true to the mission. Next, be able to answer to those asking about effectiveness (doing the right things and doing them in a way that achieves desired end results) and efficiency (doing those right things with a minimum of resource consumption). Is there a viable risk management framework in place? It is much better to *prevent* scandal, fraud, and mismanagement than to *control the damage* after the fact (see Chapter 14). Donors have needs and desires that your organization is also answerable to: They will need to know about your future expansion plans if you have a large stockpile of cash reserves, for example. They will not understand your funding cycle unless you explain it in terms they can understand. What's more, foundations and the larger and more involved and astute present or potential donors will watch your operating administration and policy-setting actions for signs of accountability and proficiency. In the past, the visible nature of an organization's services and meeting of client needs in the community seemed to cover a multitude of financial and managerial sins; few organizations have that sort of community and donor loyalty today. Besides, why wait to be pressed into accountability when you can enhance your image by taking the initiative to be in the forefront of organizational stewardship? We saw in Chapter 5 how Convoy of Hope does this using its website. The stewardship principle is increasingly evidenced in all sectors of the nonprofit economy.

Keating and Frumkin[6] offer us a set of objectives for a financial-reporting and accountability system in which they focus on relevancy: "to be relevant information is timely, helps to make predictions, and helps to confirm or correct users' expectations." This is a precise definition of how the sense-making process takes place.

**(d) TOOL FOR TURNAROUND MANAGEMENT.** One of the best-kept secrets in the nonprofit financial management sector is the role financial reporting plays in the financial turnaround of struggling organizations. In our Lilly study, we were intrigued to find that two of the four top-performing organizations had recruited CFOs from the corporate sector who then radically redesigned financial policies and reporting. Both brought an emphasis on financial control and financial reporting that is rarely seen in nonprofits. Maybe the situation at your organization is not severe, but turnaround management is just a special case of transformational leadership that every organization can adopt. Remember: The process of continuous improvement is the path to take you to proficient financial management and leadership.

***(i) Church of the Brethren.*** The Church of the Brethren, in Elgin, Illinois, recruited its top financial manager from his top finance role at the Dayton Press newspaper. Darryl Deardorff, CPA, who was CFO at the time of the study, had inherited a situation that was almost out of control. The previous CFO had totally given up on a deteriorating financial situation, in which expenses consistently outstripped revenues. The first thing Deardorff did was to convince the top management and board of the necessity to maintain a balanced or surplus budget. Although it took a while to persuade them, the reports he prepared portrayed the seriousness of the situation. Then, on an ongoing basis, he used periodic actual versus budget reports to monitor progress toward meeting the budget goal. In this way, the Church of the Brethren avoided a much more serious crisis that could have jeopardized the survival of the headquarters operation and shaken the confidence of members worldwide.

***(ii) Church of God Missionary Board.*** The transformation at the Church of God Missionary Board, in Anderson, Indiana, is no less impressive. The board had been running deficits for a number of years, with no sign of improvement. Darryl Smith had worked in the chemical industry for 26 years with various organizations, and at the time he was recruited by a Church of God board member he was a plant controller for Mobay

Chemical. Smith, a Certified Management Accountant, had college training in finance and sociology and an MBA in finance. The competitive, profit-oriented focus on the chemical industry turned out to help Smith in his work at the Church of God. In our interview with him, he recounted the relative overemphasis on mission, to the exclusion of financial affairs, at the time he came to the Missionary Board:

Q: Why did you pick financial break-even as your primary financial objective?

A: I think the past has reflected a very difficult financial direction for the board because the primary focus has been to maximize the ministry opportunities and then to determine methods of financing those. I think what is happening now with the organization is that we are saying "Wait a minute, let's not only maximize our ministry but let's also be able to finance that ministry to a point of break-even."

> One of the things we don't want to do is to have a whole bunch of money sitting here to draw interest off of. That's not one of the board's directives. They're saying we can break even, which means that we are maximizing the use of our resources for the ministry, for the needs of the people around the world. So, I believe break-even would be the primary objective.

Interestingly, in the years Darryl had been in the CFO position, he still had not seen break-even achieved, but he felt confident that in one or two years the organization would be there. Once the organization achieves break-even, it is then poised to move toward achieving an annual surplus and with that achievement of an appropriate liquidity target. The moral of this story: Be patient in implementing change. Sometimes the best advice is to take "baby steps" toward financial health and sustainability. Furthermore, there must be buy-in to the mission by the CFO and other financial professionals. The CEO and board must be assured that the CFO is not in a mindless "shut-the-door" mode – even though the CFO and board treasurer both are tasked with maintaining fiscal prudence and do have to maintain spending discipline. Struggling organizations' management staff and board members will need you to give them an understanding of "how finances work," the degree to which all major programs' costs are covered, and encouragement to discover creative ways to bring in revenues to ensure that organization-wide expenses are covered along with a surplus.

We will return to this issue in two later sections of this chapter. Next we turn to a brief discussion of reporting system design and then we survey the main financial reports and financial ratios.

## 7.4 REPORTING SYSTEM DESIGN

For those organizations considering reporting system redesign, here are several developmental principles to follow:

1. Keep the end users in mind, and consider their technical knowledge and time constraints. If at all possible involve the end users in the report creation process. It will help to enable their sense-making apparatus.
2. Either the accounting system provides the needed data, or you must revise it.
3. Provide management information on an accurate and timely basis. There might be a bit of a tradeoff here. Often the desire for accuracy is at odds with timely. Financial information needs to be both.

4. Provide two display formats: program-by-program detail and natural expense elements (e.g., salaries in total).
5. Be able to get data *out of* accounting system and other databases into a financial spreadsheet. Most financial software provides an export feature that enables this. Once the financial data is in a spreadsheet format, it is possible to perform analytics and to format presentation in a customized way.
6. Very important: The finance director or board treasurer must be able to extract liquidity detail including projection of future liquidity. Since target liquidity is our primary objective, projections are a constant activity.

## 7.5 MAJOR REPORTS

When most people think of nonprofit financial reports, they picture the statement of activities, the statement of financial position (or balance sheet), and the statement of cash flows. Donors usually think of the Form 990 information return submitted to the IRS. These reports do double duty, as internal and external users find them helpful for understanding the organization's financial position and how it has changed during the year, and whether the organization can cover costs from all funding sources. However, our primary focus here is managerial: We emphasize the internal reports upon which management decisions will be based. To do this we must talk about variance analysis, in which actual revenues and expenses are compared to budgeted amounts, followed by corrective action when necessary. We begin our discussion with internal reports, looking at the annual reports first, then quarterly, monthly, and daily reports that organizations might use. Within that discussion we talk about the CFO's involvement in overseeing fundraising evaluation. Then we turn to a brief discussion of external reports. Finally, we get into the core of proficient financial management: managing off of the budget and using financial ratio analysis to gain insight from the financial reports. All of these enable sense-making.

## 7.6 INTERNAL REPORTS

Because your chief concern should be with management reports, we start with the internal reports. Even small organizations should develop budgets and do some annual budget comparisons at a minimum (this is developed further in Chapter 8). We will start, then, with some of the annual reports you should prepare for the top management team and for the board. We include financial ratios and fundraising evaluation in our annual reporting framework. Then we move to quarterly reports, monthly reports, and daily reports. Finally, in our internal reporting framework, we turn to internal financial management processes, including how the manager interprets financial reports and financial ratios.

**(a) ANNUAL.** To set up our annual reporting commentary, study Exhibit 7.3. Even the smallest organization should cover the base-level responsibilities, which involve a commentary and possibly graphs explaining why the actual revenues and expenses came in at the levels they did. Included here are highlights of significant dollar and/or percentage differences for the various revenue and expense items. Cause-and-effect discussion is vital, in order for users to assess the likelihood of recurrence for good news and bad news. Recognize that finance staff have a "financial education" role to play here: A CFO survey finds that about 44% of medium-sized and 38% of larger nonprofits' staff was rated as

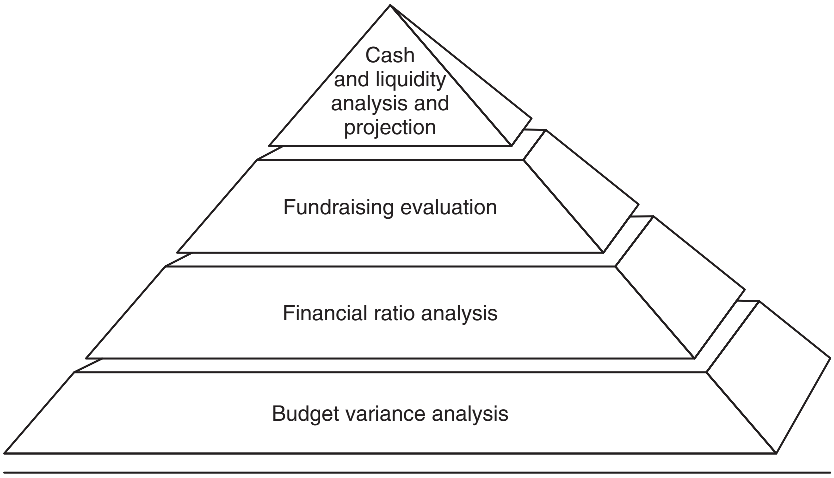


**EXHIBIT 7.3** FINANCIAL REPORTING PYRAMID

not understanding financial health very well.[7] Staff resources and time permitting, then move to the second level of the pyramid, which involves financial ratio analysis. Included here are basic views of net revenue, liquidity, borrowing, and degree of dependence on funding sources. If these ratios are being calculated, you are ready for financial input into the fundraising process, in which you assist and provide accountability to the development office. Finally, and critical for demonstrating the highest level of financial proficiency, conduct refined cash and liquidity analysis. Few nonprofit organizations have made significant progress with level 3 fundraising evaluation, much less the refined, sophisticated analysis represented by level 4.

We should also mention here that you have two separate but overlapping audiences: the top management team (other than the CFO) and the board of directors. How will your presentation differ? Show more detail for the top management presentation, but present the cause-and-effect discussion to the board as well. If yours is more than a policy-making board, such as in the case of local rescue missions, share much of the information that goes to the CEO.

**(b) LEVEL 1: BUDGET VARIANCE ANALYSIS.** First in importance for managerial usefulness is the budget variance analysis (BVA) report. Typically, the BVA is associated only with the operating budget (see Chapter 8), and we begin our discussion with that budget.

***(i) Operating Budget.*** As we discuss in Chapter 8, this process has been ongoing on a monthly basis during the year, so there should be few surprises at year-end. Variances are the difference between actual (what happened) and budgeted (what was expected). A variance is a symptom that may be linked to many different problems, some more severe than others. Someone must identify the reason(s) behind any significant favorable (actual better than budget, which would be revenues greater than budget, expenses less than budget) or unfavorable variance. Budget variance analysis is a primary means of management control in that it provides the discrepancy from expectations that enable sense-making to kick in. If our budgeted assumptions are not validated by actual activity, we need to take some sort of action to remedy. Without the operating budget, this would not be possible.

We provide the specifics of presentation format and what generic actions your organization can take if revenues are below budget or expenses are running above budget in Chapter 8.

***(ii) Capital Budget.*** The capital budget, your spending plan for major land, building, and equipment acquisitions, is presented in Chapter 9. Compile a summary report at year-end to show what projects were totally or partly implemented during the year. Compare that to the capital budget(s) approved in the past year(s). Postaudit the actual project expenditures, by project, to find out if they matched anticipated amounts and if not, why not. What you learn from these postaudits will greatly assist your organization in future capital project analyses. It makes sense to do this analysis, but often it is ignored.

***(iii) Cash Budget.*** The cash budget preparation shows forecasted operating, investing, and financing cash inflows and outflows, with the format provided in Chapter 8. How may it be used to do after-the-fact analysis? Quite simply, it is used to check the accuracy of your year-earlier cash forecast and see if seasonal or trend patterns emerge in the actual cash flows that occurred. Determine in which months your forecast was farthest off, and why. Use that information to guide your development of next year's cash budget. Of chief importance, determine whether the target liquidity should be adjusted based on the past year's variance. It may be that your organization is heading for chronic deficits and a rapidly eroding cash position. Your organization may also need to change its programming, if fees are part of the revenue base, or engage in earned income ventures to supplement donations. If your organization is growing rapidly, the problem is compounded, because quite often funds are disbursed to finance the growth before the donor base responds to the increased outreach. You must anticipate and plan for this lag time. You will gain additional ideas as we work through levels 2, 3, and 4 of the annual financial reporting pyramid.

***(iv) Supplemental Report: Deferred Giving.*** Has the organization ever done a complete report on the status and revised projections of deferred gifts? If not, it's time to start, and your office can give input to the development office or do the projection in your shop. The idea is to bring all funding sources into the picture as you evaluate the significance of your just-completed budget year. As we did with capital projects, compare gifts received with gifts projected. Recognize that bequests are just about the most difficult item to project in the entire spectrum of forecasts, except in the case where an estate is almost settled and you have some basis on which to project a remittance. The other exception is if the organization is large and has a long history of bequests that might allow some form of forecasting.

*Recap of Level 1 Budget Comparisons*. The budget variance analysis you do is extremely important. Too many organizations either do not conduct these comparisons, or seize on an asserted explanation but then do nothing to correct important deficiencies or to build on unexpected success. Work hard at improving your analysis and the clarity of presentation to the executive team and to the board. Involve the end users in developing key indicators by asking them what is important to them.

**(c) LEVEL 2: ANNUAL FINANCIAL STATEMENTS AND RATIOS.** We ordinarily think of the annual financial statements as being prepared for external users. However, there are useful insights to be gleaned from them beyond what you found with the budget variance analysis. First, comparisons can be made with the statements themselves or with a restatement of them ("common-size statements"). Second, financial ratios can be calculated from them that will give added insight.

Let's begin by looking at the statements themselves and their restatement.

***(i) Statements of Activities, Financial Position, and Cash Flows.*** The statement of activities, shows us the degree of cost coverage of the organization's operations during a certain time period. We are interested in the degree to which all costs are covered. If costs are not covered, we find out the shortfall (deficit), and if they are more than covered, the surplus is identified. We want to know whether this was a planned or unplanned outcome, and if unplanned, the reason(s) for the deficit or surplus. We shall use the Durham, N.C., Habitat for Humanity to illustrate financial statements and their interpretation. Study the Statement of Activities for Habitat for Humanity of Durham, Inc., in Exhibit 7.4 carefully before going any further.

Notice that for the 2015 fiscal year (which ended on June 30, 2015), the change in net assets is $593,767, so net revenue is in a surplus position. The unrestricted change in net assets is a small deficit of $(3,291) and there is a significant increase in temporarily restricted net assets for the year 2015. Unrestricted revenue and gains were barely adequate

Habitat for Humanity of Durham, Inc.
**Statements of Activities Years Ended June 20, 2015 and 2014**

| | **Year Ended June 30, 2015** | | | **Year Ended June 30, 2014** | | |
|---|---|---|---|---|---|---|
| | **Unrestricted** | **Temporarily Restricted** | **Total** | **Unrestricted** | **Temporarily Restricted** | **Total** |
| **Support and Revenue:** | | | | | | |
| Transfers to Homeowners | 1,811,500 | | 1,811,500 | 1,756,530 | | 1,756,530 |
| Contributions | 470,857 | 1,502,441 | 1,973,298 | 1,000,037 | 923,436 | 1,923,473 |
| Grants and Contracts: | | | | | | |
| Federal Agencies | 23,550 | | 23,550 | 90,276 | | 90,276 |
| City of Durham | 68,250 | | 68,250 | 78,690 | | 78,690 |
| NC Housing Finance Agency | 70,000 | | 70,000 | 42,000 | | 42,000 |
| ReStore Sales | 1,275,472 | | 1,275,472 | 1,287,713 | | 1,287,713 |
| Mortgage Loan Discount Amortization | 430,382 | | 430,382 | 518,148 | | 518,148 |
| In-kind Contributions | 230,367 | | 230,367 | 333,718 | | 333,718 |
| Interest Income | 1,689 | – | 1,689 | 9,753 | | 9,753 |
| Repairs | 123,809 | | 123,809 | 85,260 | | 85,260 |
| Deconstruction | 70,023 | | 70,023 | 146,163 | | 146,163 |
| Miscellaneous Income | 135,097 | | 135,097 | 130,790 | | 130,790 |
| | | | | | | – |
| Total Revenues and Gains | 4,710,996 | 1,502,441 | 6,213,437 | 5,479,078 | 923,436 | 6,402,514 |
| Net Assets Released From Restrictions | 905,383 | (905,383) | – | 918,391 | (918,391) | – |
| Total Income | 5,616,379 | 597,058 | 6,213,437 | 6,397,469 | 5,045 | 6,402,514 |
| **Expenses** | | | | | | |
| Program Services | 4,957,686 | | 4,957,686 | 4,129,999 | | 4,129,999 |
| Supporting Services: | | | | | | |
| Fundraising | 501,555 | – | 501,555 | 487,672 | | 487,672 |
| Management and General | 160,429 | – | 160,429 | 174,069 | | 174,069 |
| Total Supporting Services | 661,984 | – | 661,984 | 661,741 | | 661,741 |
| Total Expenses | 5,619,670 | – | 5,619,670 | 4,791,740 | – | 4,791,740 |
| Change in Net Assets | (3,291) | 597,058 | 593,767 | 1,605,729 | 5,045 | 1,610,774 |
| Net Assets at Beginning of Year | 8,140,546 | 593,886 | 8,734,432 | 6,534,817 | 588,841 | 7,123,658 |
| Net Assets at End of Year | 8,137,255 | 1,190,944 | 9,328,199 | 8,140,546 | 593,886 | 8,734,432 |

**Exhibit 7.4** Example of Statement of Activities for Interpretation

**Habitat for Humanity of Durham, Inc., Common Size Statement of Activities**

| Item | Dollar Amount | Percent |
|---|---|---|
| Total Revenue | $ 6,213,437 | 100.0% |
| Program Expense | $ 4,957,686 | 79.8% |
| Management and General Expense | $ 160,429 | 2.6% |
| Fundraising Expense | $ 501,555 | 8.1% |
| Total Expenses | $ 5,619,670 | 90.4% |
| Change in Net Assets | $ 593,767 | 9.6% |

**Exhibit 7.5** Common-Size Statement of Activities

to cover all expenses in this fiscal year. It is noteworthy that the organization does not have any permanently restricted net assets, such as permanent endowment funds.

Beyond simply looking at the statement dollar amounts, we would like to compare this year's results to those of recent years, and we would also prefer to know what percent of revenue (technically, revenue and support) is attributable to each cost element. The way to do this is with a common-size statement of activities, as shown in Exhibit 7.5.

In our abbreviated example, we did not show the revenue mix breakdown. To illustrate how you would compute these revenue percentages, contributions represent $1,973,298 of the total revenue of $6,213,437, which equals 31.8 percent of total revenue. This percentage can and should be compared to percentages from previous years. Notice also in our example that the total of the expenses equal 90.4 percent of total revenue and the change in net assets is equal to 9.6 percent of total revenue. Our numbers balance.

The common-size SA is condensed, and a user may wish to know more about the line-item detail. Expressing total revenue as 100 (for 100%), we can then see what percent of total revenue arises from various revenue sources (e.g., Transfers to Homeowners, Contributions, Grants and Contracts, ReStore Sales, etc.) and is taken by the various expense line items (e.g., Construction, Family Services, and ReStore). If we divide program expense of $4,957,686 by total revenue of $6,213,437, we get 79.8 percent. We compare this to other expenses that same year, and also see if that expense category accounted for a larger percentage of revenues or smaller percentage, compared to previous years (2014, 2013, etc.). Further, some organizations calculate a three-year average of each item's expense percentage, to offset one-time spikes that may not be expected to represent a change in trend.

Health benefits expense has constituted one of the larger increases in recent years for many nonprofits, and we do not even see this listed on the SA. We will need to gather that data elsewhere. For voluntary health and welfare organizations such as Habitat for Humanity, we will use the statement of functional expenses, which breaks program, management, and fundraising expenses down into "natural" categories, such as salaries, fringe benefits, office-related, utility, insurance, and so on. (As we saw in Appendix 6A, all nonprofits are now required to provide a breakdown of expenses not only by function, such as management, but also by natural element, such as salaries.) Using the basic functional expense example for the Durham Habitat in Exhibit 7.6, we can readily see how this is done. Again, simply divide each expense amount by total revenue. Not only does this reveal the program, management, and fundraising ratios that philanthropic bureaus closely watch, but also it gives us an idea of relative magnitude of our expenses and can be monitored from year to year and from quarter to quarter. Consult Exhibit 7.6 to see the Statement of Functional Expenses (SFE) for Habitat for Humanity, then Exhibit 7.7 to see the common-size SFE. Because Habitat for Humanity presents comparative statements (showing more than just the most recent year), we can do a more valid and refined analysis.

**Habitat for Humanity of Durham, Inc.**
**Statement of Functional Expenses**
**For year ended June 30, 2015**

| | Construction | Family Services | ReStore | Total Program Services | Management and General | Fundraising | Total Supporting Services | Total |
|---|---|---|---|---|---|---|---|---|
| | $ | $ | $ | $ | $ | $ | $ | $ |
| Cost of Homes Transferred | 2,336,390 | | | 2,336,390 | – | – | – | 2,336,390 |
| Cost of Repair-Program | 91,266 | | | 91,266 | | | – | 91,266 |
| Salaries and Benefits | 68,100 | 132,861 | 533,643 | 734,604 | 97,385 | 310,792 | 408,177 | 1,142,781 |
| Mortgage Discounts | | 833,498 | | 833,498 | | | – | 833,498 |
| Donation to Habitat for Humanity International | 90,000 | | | 90,000 | | | – | 90,000 |
| Other Donations | | | 213,000 | 213,000 | | | – | 213,000 |
| Rent and Utilities | 5,000 | 5,000 | 42,285 | 52,285 | 5,000 | 5,000 | 10,000 | 62,285 |
| Professional Services | 167,342 | 10,109 | 17,165 | 194,616 | 10,109 | 36,109 | 46,218 | 240,834 |
| Office Expenses | 276 | 1,195 | 30,501 | 31,972 | 18,438 | 10,120 | 28,558 | 60,530 |
| Contract Labor | | | 23,734 | 23,734 | | | – | 23,734 |
| Interest Expense | 25,489 | | 64,107 | 89,596 | | | – | 89,596 |
| Tools and Equipment | 189 | 1,989 | 15,791 | 17,969 | 239 | 6,773 | 7,012 | 24,981 |
| Depreciation and Amortization | 20,112 | 2,668 | 58,773 | 81,553 | 4,166 | 2,668 | 6,834 | 88,387 |
| Vehicles | 1,440 | 3,490 | 23,387 | 28,317 | 11,364 | 4,892 | 16,256 | 44,573 |
| Marketing | | | 34,244 | 34,244 | 1,038 | 30,210 | 31,248 | 65,492 |
| Maintenance and Repairs | | | 24,405 | 24,405 | | | – | 24,405 |
| Insurance | 7,114 | 7,114 | 11,362 | 25,590 | 7,114 | 8,574 | 15,688 | 41,278 |
| Staff and Board Development | 25 | 4,086 | 3,857 | 7,968 | 1,450 | 5,368 | 6,818 | 14,786 |
| Telephone | – | 2,041 | 12,324 | 14,365 | 3,131 | 4,621 | 7,752 | 22,117 |
| Fundraising and Special Events | | | | – | | 48,549 | 48,549 | 48,549 |
| Postage | 59 | 1,593 | 86 | 1,738 | 995 | 4,461 | 5,456 | 7,194 |
| Family Selection Expenses | | 2,294 | | 2,294 | | | – | 2,294 |
| Volunteer Expense | 21,681 | | | 21,681 | | | – | 21,681 |
| Purchase for Resale | | | 6,611 | 6,611 | | | – | 6,611 |
| Discount on Pledges Receivable | | | | – | | 23,418 | 23,418 | 23,418 |
| | | | | – | | | | |
| Total | | 1,007,938 | 1,115,275 | 4,957,696 | 160,429 | 501,555 | 661,984 | 5,619,680 |

**Exhibit 7.6** Statement of Functional Expenses for Interpretation

| Habitat for Humanity of Durham, Inc. | |
|---|---|
| Total Expenses | 100.0% |
| Cost of Homes Transferred | 41.6% |
| Cost of Repair-Program | 1.6% |
| Salaries and Benefits | 20.3% |
| Mortgage Discounts | 14.8% |
| Donation to Habitat for Humanity International | 1.6% |
| Other Donations | 3.8% |
| Rent and Utilities | 1.1% |
| Professional Services | 4.3% |
| Office Expenses | 1.1% |
| Contract Labor | 0.4% |
| Interest Expense | 1.6% |
| Tools and Equipment | 0.4% |
| Depreciation and Amortization | 1.6% |
| Vehicles | 0.8% |
| Marketing | 1.2% |
| Maintenance and Repairs | 0.4% |
| Insurance | 0.7% |
| Staff and Board Development | 0.3% |
| Telephone | 0.4% |
| Fundraising and Special Events | 0.9% |
| Postage | 0.1% |
| Family Selection Expenses | 0.0% |
| Volunteer Expense | 0.4% |
| Purchase for Resale | 0.1% |
| Discount on Pledges Receivable | 0.4% |

**Exhibit 7.7** Common-Size Statement of Functional Expenses

We would first survey this common-size statement to see what the major expense categories are for Habitat. Two stand out: house building transfers and salaries and benefits. After this, Mortgage Discounts reflects a large expense (as a reader might expect, based on the mission of the organization). Then we would compare this percentage breakdown with the previous year's as well as the fiscal year two years prior. The key is to look for a trend. For example, for Habitat, salaries and benefits expense for 2015 was $1,142,781/$5,619,680 = 20.3 percent of total expenses, and for 2014 it was $1,155,053/$4,791,740 = 24.1 percent of total expenses. This indicates that not only has salary and benefit expense decreased in absolute terms (from $1.16 million to $1.14 million), but it also decreased in relative terms. As a percentage of total expenses, this one item has decreased from 24.1 percent of total expense to 20.3 percent of total expense. Nonprofits are normally "labor-intensive," so this 20.3 percent figure is unsurprising: large churches average 40 percent and small churches 46 percent on this measure, for example.[8] Management would want to assess the reason(s) for this, and whether the main reason is decreased employee headcount, changes in compensation structure, or benefit cost changes. It is most likely benefit changes, as benefit costs have spiraled at most nonprofits. A caution for your general interpretation of this percentage: This percentage will normally increase in any year when total expenses decline, as salaries and benefits are relatively fixed in dollar amount, and a nonprofit operating with a lean staff has difficulty in reducing headcount or scaling back on benefits when it needs to reduce expenses. Finally, many analysts would average each row's expense for the past three years to get a moving average. To update the average next year, you would drop out the oldest year's value, include the most recent previous year's value, and recompute the

**Habitat for Humanity of Durham, Inc.**
**Statements of Financial Position**
**June 30, 2015 and 2014**

| | 2015 | 2014 |
|---|---|---|
| | $ | $ |
| Assets | | |
| Current Assets: | | |
| Cash and Cash Equivalents | 1,029,448 | 1,092,823 |
| Grants and Other Receivables | 286,452 | 287,324 |
| Promises to Give, Net | 539,988 | 200,420 |
| Non Interest-Bearing Mortgage Receivables (net of unamortized discounts of $416,747 for 2015 and $390,722 for 2014 | 345,951 | 317,843 |
| Land and Construction in progress | 1,700,471 | 1,198,430 |
| Prepaid expenses and Deposits | 8,796 | 13,516 |
| Total Current Assets | 3,911,106 | 3,110,356 |
| Property and Equipment, Net | 2,062,489 | 2,129,223 |
| Other Assets: | | |
| Promises to Give, Net | 222,489 | 105,303 |
| Non Interest-Bearing Loans Receivable (Net of Unamortized Discount of $7,091,977 for 2015 and $6,714,886 for 2014) | 5,156,078 | 5,155,381 |
| Land Held for Development | 1,251,590 | 1,411,367 |
| Loan Fees (Net of Accumulated Amortization of $69,776 in 2015 and $53,332 in 2014) | 80,797 | 98,241 |
| Investment in Joint Venture | 1,922,385 | 1,942,274 |
| Total Other Assets | 8,633,339 | 8,712,566 |
| Total assets | 14,606,934 | 13,952,145 |
| Liabilities and Net Assets | | |
| Current Liabilities: | | |
| Accounts Payable and Accrued Expenses | 399,787 | 229,866 |
| Current Portion of Capital Lease Obligation | 2,940 | 4,303 |
| Line of Credit | 150,000 | 161,587 |
| Deferred Revenue | | 31,500 |
| Current Maturities of Long-Term Debt | 74,569 | 76,400 |
| Total Current Liabilities | 627,296 | 503,656 |
| Capital Lease Obligation | | 3,423 |
| Line of Credit | | - |
| Long-Term Debt | 4,401,498 | 4,460,693 |
| Guarantee Liability | 249,941 | 249,941 |
| Total Liabilities | 5,278,735 | 5,217,713 |
| Net Assets: | | |
| Unrestricted: | | |
| Undesignated | 7,887,255 | 7,890,546 |
| Board Designated | 250,000 | 250,000 |
| Total Unrestricted Net Assets | 8,137,255 | 8,140,546 |
| Temporarily Restricted | 1,190,944 | 593,886 |
| Total net assets | 9,328,199 | 8,734,432 |
| **Total liabilities and net assets** | 14,606,934 | 13,952,145 |

*Source:* Habitat for Humanity of Durham, Inc. Used by permission.

**EXHIBIT 7.8** STATEMENTS OF FINANCIAL POSITION—EXAMPLE FOR INTERPRETATION three-year average for each expense item. These "moving averages" are useful to note trends and to reduce the influence of an abnormal year on the three-year average.

The statement of financial position (SFP) (also called the statement of financial condition [SFC] or balance sheet) shows us items owned or over which the organization has control and how they are financed. Notice the Habitat for Humanity SFP in Exhibit 7.8. You may wish to review the SFP presentation in Chapter 6 to guide your understanding of the line items in the SFP. To a layman, some of the line item labels here are unclear, and reading the "Notes to the Financial Statements" will be necessary to make sense of them.

To the extent the organization uses borrowed funds to finance assets, it is in a riskier position due to the necessity to pay interest and ultimately repay principal. The use of past surpluses (which are shown as net assets) to finance assets reduces risk because this amount represents permanent financing that does not have to be repaid. We will return to these issues in Chapter 10 on liability management.

Once again, as we did with the SA, we will also prepare a common-size statement of financial position (Exhibit 7.9) to see the relative magnitude of each asset item (divide each line item by the total assets dollar amount) and for each liability or net asset item (again dividing each item by total assets). Compare the percentages over several years to see how much is being invested in each asset, how assets are being financed, and the trends affecting your organization. Especially note any reductions in cash and equivalents as a percentage of total assets (remember our liquidity target and the key role cash and equivalents has in liquidity) or an increasing reliance on borrowed funds when analyzing an SFP common-size statement.

Exhibit 7.9 shows the common-size SFP with both the most recent year and the prior year (2015 and 2014 in this case). Immediately, we note that cash and equivalents has experienced a decline of almost 1 percent of total assets, going from 7.8 percent of total assets in 2014 to 7.0 percent of total assets in 2015. Promises to give increased from 1.4 percent to 3.7 percent, land and construction in progress increased from 8.6 percent to 11.6 percent. Temporarily restricted net assets increased from 4.3 percent to 8.2 percent. Reviewing the common-size statement aids in the sense-making process by showing these percentage changes so that the reader can ask if the changes make sense and do they reflect progress or difficulties with the organization's financial position.

The Statement of Cash Flows (SCF) is critically important but still not well understood by most nonfinancial managers or board members in nonprofits. It shows how cash was received to support operations, how cash was disbursed to provide programs, and it reconciles the change in cash on the SFP. In our view, it is probably the most valuable of the three statements for showing how target liquidity was met. Because that is the primary financial objective of the proficient organization, we will want to tap into the usefulness of this statement. Once again, we look at the line items by themselves to observe the big-dollar amounts. Beyond that, we look (1) at the sign of each of the three categories (operating, investing, financing), and (2) the operating cash-flow dollar amount relative to both the investing dollar amount and relative to the financing dollar amount. Study the Habitat for Humanity SCF, shown in Exhibit 7.10.

Before interpreting the SCF, it is instructive to compare the operating cash flow dollar amount to the change in net assets from the SA for the same year. Referring to the SA in Exhibit 7.4, we see that Habitat had a surplus of $593,767 for 2015. However, its operating cash flows, $18,459, are much lower. Furthermore, its decrease in cash and equivalents in 2015, $(63,375), is not reflective of this surplus (see the "Increase in Cash and Cash Equivalents" near the bottom of the SCF). In this case, then, the surplus was a very poor indicator of the change in the organization's cash position. In 2014, Habitat had a surplus

**Habitat for Humanity of Durham, Inc.**

| Common-Size Percentages | 2015 | 2014 |
|---|---|---|
| Total Assets | 100.0% | 100.0% |
| Cash and Cash Equivalents | 7.0% | 7.8% |
| Grants and Other Receivables | 2.0% | 2.1% |
| Promises to Give, Net | 3.7% | 1.4% |
| Non Interest-Bearing Mortgage Receivables, Net | 2.4% | 2.3% |
| Land and Construction in Progress | 11.6% | 8.6% |
| Prepaid Expenses and Deposits | 0.1% | 0.1% |
| Property and Equipment, Net | 14.1% | 15.3% |
| Promises to Give, Net | 1.5% | 0.8% |
| Non Interest-Bearing Loans Receivable, Net | 35.3% | 37.0% |
| Land Held for Development | 8.6% | 10.1% |
| Loan Fees, Net | 0.6% | 0.7% |
| Investment in Joint Venture | 13.2% | 13.9% |
| Accounts Payable and Accrued Expenses | 2.7% | 1.6% |
| Current Portion of Capital Lease Obligation | 0.0% | 0.0% |
| Line of Credit | 1.0% | 1.2% |
| Deferred Revenue | 0.0% | 0.2% |
| Current Maturities of Long-Term Debt | 0.5% | 0.5% |
| Capital Lease Obligation | 0.0% | 0.0% |
| Long-Term Debt | 30.1% | 32.0% |
| Guarantee Liability | 1.7% | 1.8% |
| Unrestricted Net Assets: | | |
| Undesignated | 54.0% | 56.6% |
| Board Designated | 1.7% | 1.8% |
| Temporarily Restricted Net Assets | 8.2% | 4.3% |

**Exhibit 7.9** Statement of Financial Position Common-Size Statement

of $1,610,774 but operating cash flow increased by $718,713, less than half of the amount of the surplus. Habitat's cash position grew by a much smaller $422,119.

Clearly, one cannot base a prediction on how the cash position will change from operating results simply on whether a surplus or deficit is achieved in that year. The cash and equivalents amount may also change from investing activities and financing activities, neither of which is captured by the SA for that period. We again note that financial managers in nonprofits are cash and cash flow managers, and earning a surplus is important but secondary to ensuring adequate liquidity now and in the future. This also motivates our study of cash forecasting, which we present in Chapter 8.

If the sign of the operating cash flows is negative, your operations have reduced your cash and liquidity during the year. To meet the reduction, either your organization drained cash and cash equivalents (and you will see that change at the bottom of the SCF) or it funded this amount by selling assets (literally liquidating part of the organization's asset base, possibly by selling off some short-term investments that were not accounted for as cash equivalents) or taking on additional financing. *None of the three mechanisms for covering operating cash deficits is sustainable*. Take a negative operating cash flow *very* seriously if you have one. Be vigilant to eliminate this situation quickly.

Looking at the operating cash flow dollar amount relative to the investing or financing cash flow can also be instructive. A brief discussion will show what we mean. Let's assume that the operating cash flow is zero or positive. If zero, your operations "broke even" on

**Habitat for Humanity of Durham, Inc.**
**Statement of Cash Flows Years Ended**
**June 30, 2015 and 2014**

| | 2015 | 2014 |
|---|---|---|
| | $ | $ |
| **Operating Activities** | | |
| Change in Net Assets | 593,767 | 1,610,774 |
| Adjustments to Reconcile Change in Net Assets to Net Cash Provided by Operating Activities | | |
| Transfers to Homeowners | (862,303) | (726,823) |
| Amortization of Mortgage Loan Discounts | 836,570 | 485,295 |
| Depreciation and Amortization | 89,454 | 89,629 |
| Gain on Sale of Property and Equipment | (3,913) | |
| Changes in Operating Assets and Liabilities: | | |
| Grants and Other Receivables | 872 | 378,793 |
| Promises to Give, Net | (456,754) | (14,005) |
| Land and Construction in Progress and Land Held for Resale | (342,264) | (1,116,194) |
| Prepaid Expenses and Deposits | 4,720 | 4,043 |
| Investment in Joint Venture | 19,889 | 19,890 |
| Accounts Payable and Accrued Expenses | 169,921 | (25,354) |
| Deferred Revenue | (31,500) | 12,665 |
| **Net Cash Provided by Operating Activities** | 18,459 | 718,713 |
| **Investing activities** | | |
| Proceeds from Sale of Property and Equipment | 4,622 | |
| Purchase of Property and Equipment | (5,985) | (39,512) |
| **Net Cash Used in Investing Activities** | (1,363) | (39,512) |
| **Financing activities** | | |
| Net Payments on Line of Credit | (11,587) | (250,000) |
| Proceeds from Issuance of Long-Term Debt | 7,850 | 1,904,679 |
| Principal Payments on Capital Lease Obligation | (4,786) | (4,400) |
| Principal Payments on Long-Term Debt | (71,948) | (1,907,361) |
| **Net Cash Used by Financing Activities** | (80,471) | (257,082) |
| Increase in Cash and Cash Equivalents | (63,375) | 4 22,119 |
| Cash and Cash Equivalents, Beginning of Year | 1,092,834 | 670,704 |
| **Cash and Cash Equivalents, End of Year** | 1,029,459 | 1,092,823 |
| **Supplemental Disclosures** | | |
| Interest Paid | 62,152 | 77,756 |

*Source:* Habitat for Humanity International, Inc.

EXHIBIT 7.10 STATEMENT OF CASH FLOWS FOR INTERPRETATION

a cash basis. If positive, you will want to compare the operating cash flow (OCF) to the investing cash flow (ICF): Simply divide the dollar amount of the operating cash flow by the dollar amount of the investing cash flow. For a healthy business, this generally results in a positive numerator divided by a negative denominator, as the growing business uses some of its surplus cash from operations to finance growth in plant and equipment investments. If such is the case for your organization, you might have this situation:

$$\text{OCF} = \$50; \text{ICF} = -\$25;$$

$$\text{Then, OCF/ICF} = \$50/-\$25 = -2.0.$$

We take the absolute value of the investing cash outflow when we make this calculation, yielding a ratio value of 2.0. What this means is that you generated enough cash to cover the investing needs twice over. Many nonprofits, especially faith-based organizations (FBOs) and conservatively managed nonprofits, self-finance investing outflows with one or more years of positive operating cash flows. This comes largely due to a financial policy stance regarding debt and the risk it entails. Referring back to Habitat's SCF, it covered its net property and equipment purchase of $1,363 over 13 times over ($18,459 of OCF divided by the absolute value |($1,363)| of ICF). However, we would supplement the OCF/|ICF| measure in this case by taking OCF/Purchase of Property and Equipment, since Habitat would not normally be able to rely on property and equipment sales to help finance investment in property and equipment. Using our modified formula, Habitat's SCF covered its property and equipment purchase 3.1x over: $18,459 of OCF divided by the absolute value |($5,985)|. In 2014, Habitat's $718,713 of OCF covered its $39,512 ICF cash outflow by more than 18 times. It is worth noting here that for-profit business firms cover two-thirds to three-fourths of their capital expenditures in a given year out of additions to retained earnings (surplus less cash dividends). Caution: If OCF is negative or ICF is positive, do not calculate the ratio because the interpretation would be nonsensical; in neither case would operating cash inflows be covering investing cash outflows. Another SCF ratio we have seen is to take OCF and divide by current liabilities from the SFP (see Appendix 7B). This gives an indication of the organization's ability to cover its near-term obligations. We have more to say about ratios in the next section.

We might also determine the degree to which positive OCF covers, or extinguishes, debt repayments. Illustrating, for 2014 Habitat's $718,713 of OCF covered the financial cash flow (FCF) repayments of credit lines, capital lease obligations, and net long-term debt principal payments almost three times over (2.80 = $718,713/|($257,082)|). We can do a similar analysis by comparing operating cash flow to financing cash flow (FCF) in cases in which OCF is negative and FCF is positive. A *one-time* use of financing to fund a deficit might be allowable in your financial policies, which might result in this situation, hypothetically:

$$\text{OCF} = -\$25; \text{FCF} = \$25;$$

$$\text{Then OCF/FCF} = -1.0.$$

The ratio value of −1.0 tells us that the operating cash outflow was just covered by a financing cash inflow. One year or at most two years of this pattern might be acceptable for a rapidly-growing nonprofit, but we would not want this pattern to persist because we are experiencing ever-greater reliance on restricted gifts (which cannot be tapped to meet cash crisis needs) and/or borrowed money.[9]

***(ii) Financial Ratio Analysis.*** Financial ratios are relative measures of an organization's financial position. We compute a financial ratio by taking an amount from the SA or SFP and dividing it by a different amount from either of those two statements. Ratios are useful for seeing (1) where our organization has been over time financially, (2) the organization's financial strength at this point in time, and (3) how it compares to other organizations in the same industry of the same approximate size. It is an important part of understanding the organization's financial health.

Despite their value, we found that only 4 of 10 organizations use ratios as part of their financial management process (Lilly study), and our contacts with nonprofits suggest that many charities outside of the education and hospital sectors still do not develop and utilize ratios. Most students and other individuals who work in the sector are unaware of ratios or how they are used. Students and seminar participants have reported feeling empowered by understanding ratios and how they help the sense-making process.

We present basic ratios and their calculation formulas next.[10] If you have never computed ratios before, start with these ratios and work with them until you and your management team and board are comfortable with them. We show an example of their calculation in Appendix 7A for the Durham Habitat for Humanity SFP and SA presented earlier. We will primarily use the set of financial ratios highlighted by Chris Robinson in his pioneering work with faith-based organizations. Robinson focused on a set of ratios that includes 11 ratios and one level (dollar amount) measure. To that we will add three target liquidity level measures. In Appendix 7B we briefly cover several other ratios that have been presented by analysts over the past 15 years. In Appendix 7C we profile some ratios important to bond ratings agencies, with a special focus on those applicable to educational institutions. In process (but not detailed here) is a financial health index, in which 15 separate indicators are calculated, then they are combined to provide readings on immediate-term, short-term, medium-term, and overall financial health. Access information for those interested is provided in the chapter notes.[11]

The basic ratios fall into three categories: liquidity, funding, and operating. One of the difficulties that has plagued the nonprofit sector is the absence of industry standards (average values for other organizations serving the same clientele as your organization) or other valid comparative data. We profile here several sources of industry standards or benchmarks that you may find useful.

Robinson, a pioneer in the field, calculated standards for faith-based organizations spanning organizations from churches to radio/TV stations, social welfare organizations, colleges and private secondary schools, associations, and camps and conference centers; however, as these numerical measurements are quite dated, they may or may not serve as good benchmarks today. Arts and healthcare organizations are advised to check with their respective trade association, one of the Big Four accounting firms, or private debt rating organizations such as Moody's, Standard & Poor's, or Fitch Ratings, for comparative data. Charity Navigator makes ratio distributions available online, but it is unclear for how long these will be publicly available. The study, "Passion & Purpose Revisited Massachusetts Nonprofits and the Last Decade's Financial Roller Coaster," researched by Elizabeth Keating and Geeta Pradhan for the Boston Foundation (June 2012) makes available state-level data for many nonprofit industries and for several financial ratios.[12] For your organization, the best approach might be to develop a network with five or six similar organizations and then share data in order to develop your own comparative data and standards.

**Liquidity ratios.** Maintaining liquidity is crucial for your organization, because cash is the lifeblood of your organization's finances. Liquidity ratios *gauge your survivability/sustainability* from tomorrow to a couple of years from now. Ideally, you will include a liquidity projection in all your long-range financial plans (see Chapter 9). Running a donative nonprofit is especially risky, in that you are basically raising your financing from a zero starting point each and every year. Having liquid resources helps you bridge the dry seasons and gives some breathing room when contributions resulting from your fundraising shows year-over-year declines. These resources also provide the fuel for program expansions and provision of emergency needs such as natural disaster relief aid, one-time or short-term opportunities, and acquisitions or strategic alliances.

The basic liquidity ratios are cash ratio, cash reserve ratio, current ratio, asset ratio, and target liquidity level. An advanced liquidity ratio, target liquidity lambda, is also introduced here. Each measure we will look at gives us a slightly different perspective on the spendable funds of the organization.

$$\text{Cash ratio} = \frac{\text{Cash and cash equivalents}^*}{\text{Current liabilities}}$$

$$\text{Cash reserve ratio} = \frac{\text{Cash and cash equivalents}^*}{\text{Total annual expenses}}$$

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Asset ratio} = \frac{\text{Current assets}}{\text{Total assets}}$$

$$\text{Target liquidity level} = (\text{Cash and cash equivalents}^* + \text{short-term investments} + \text{total amount of credit line}^{**} - \text{short-term loans})$$

$$\text{Target liquidity level lambda} = \frac{\text{Target liquidity level} + \text{Projected OCF}}{\text{Uncertainty of OCF}}$$

Where:

Projected OCF is the operating cash flow amount expected for the next year.

Uncertainty of OCF is the standard deviation of the organization's historical OCFs for at least the past three years.

For the first four ratios, all items in the numerator and denominator are found in the SFP, except total annual expenses, which is in the SA.

**Cash ratio.** The *Cash ratio*, cash and cash equivalents divided by current liabilities, shows us the organization's coverage of near-term financial obligations with its cash and near-cash investments. It is a solvency ratio. The financial obligations you might see listed under current liabilities on the SFP are accounts payable, accrued interest, accrued wages, accrued salaries, possibly a small amount of accrued taxes, and principal repayments due within one year as you pay back previous borrowings. However, we are quick to add that, depending on the sample, as many as two-thirds of nonprofits do not have any current liabilities. A benchmark value used by creditors such as banks making short-term loans when evaluating businesses is 0.25 or above for adequacy.[13] Faith-based organizations' median cash ratios ranged from 0.78 for colleges to 1.43 for churches (Appendix 7B.5). When an organization has no current liabilities, the ratio value is undefined, which we interpret as added financial flexibility for an organization to take out a credit line or arrange a working capital loan to cover them until receivables are collected. Put another way, if you divide cash by smaller and smaller amounts of current liabilities the quotient or ratio value approaches infinity. Reversing the process, if you add a small amount of borrowing your cash ratio may still be very high and indicate a very solvent organization. Please consult Appendix 7A to see a numerical illustration of the calculation and interpretation of the cash ratio and our other financial ratios for Habitat.

We usually interpret a ratio value by expressing it per unit of whatever item is in the denominator. For example, if the ratio value is 2.0, and both numerator (here, cash and cash

*Use unrestricted and temporarily restricted cash and cash equivalents from the SFP in any case in which organization has a portion of its cash and equivalents that is permanently restricted. If the amount of temporarily restricted cash and cash equivalents is not available and the organization has no permanently restricted net assets, use the cash amount shown on the SFP.

**This item is not included in the SFP, but should be in the notes accompanying the financial reports.

equivalents) and denominator (here, current liabilities) are in dollars, we interpret the ratio as \$2 of cash and equivalents per \$1 of current liabilities.[14]

A slightly different ratio that you can also calculate is what we will call a "*Modified cash ratio*," calculated as (Cash and Cash Equivalents + Short-Term Investments + Accounts Receivable) / Current Liabilities. Stevens suggests a benchmark value for this ratio of 1.0 or higher as adequate.[15]

A second different but related ratio expresses cash and cash equivalents as a percent of total assets, which we will call the *Cash-to-assets ratio*. Unfortunately, we do not have benchmark data drawn from audited financial statements for this ratio. And, the Form 990 does not have cash and cash equivalents either. What it does have is a separate amount for cash (petty cash along with non-interest-bearing checking account amount) as well as an amount for savings. We developed approximate benchmarks using a study by Andres Ramirez who tabulated Form 990 data covering the period 2000–2006. Overall, for the 2000–2006 period, the cash-to-assets ratio using non-interest-bearing cash for all nonprofits was 0.084, suggesting that nonprofits are holding cash constituting about 8.4% of total assets (Ramirez 2011).[16] (When adding in the amount held in savings accounts and other short-term interest-bearing accounts, including Treasury bills up to but less than one year in maturity, the overall nonprofit cash plus short-term investments to assets ratio jumps to 0.3911 (=0.084 for the cash-to-assets ratio + 0.3028 for the cash plus short-term investments to assets ratio), meaning about 39% of total assets are held in the two most liquid forms, cash and all forms of savings and short-term investments vehicles.)

When interest rates move higher, recognize that your organization is giving something up by having more money in the cash and cash equivalent category. Interest rates on cash (most of this would be in interest-bearing checking accounts) and on cash equivalents (investments purchased with original maturities of three months or less, which would include some treasury bills, commercial paper, money market mutual funds, and certificates of deposit) are normally lower than on longer-term investments such as one-year Treasury bills or two-year Treasury notes. This is a reason not to have too much of your liquidity in cash and cash equivalents, and also a reason your organization's target liquidity level will include all short-term investments.

**Cash reserve ratio.** The cash reserve ratio uses the same numerator as the cash ratio, cash and cash equivalents, but compares it to a year's worth of operating expenses instead of what liabilities happen to be listed as current at this moment of time. Not only does it avert seasonality of liabilities recorded by accountants in your SFP (you may be measuring liabilities at a low point in the year), but it also provides a "time to ruin" measure for the organization. It tells us how long, as a fraction of a year, the organization could meet operating expenses if revenues were totally shut off. For example, a ratio value of 0.75 tells me that my organization can operate for nine months without additional revenues. This measure provides a very conservative measure of liquidity, but the key point is that it is giving you another perspective on your organization's liquidity. Your organization can compare its figure to past values, to other similar organizations, to a policy target set by the board (if any), and to the widely cited rule-of-thumb of three-to-six months (some are now suggesting nine months) level.[17] Overall, for the 2000–2006 period, the cash reserve ratio for all nonprofits was 0.25, measured conservatively (excluding cash equivalents), suggesting that nonprofits are holding cash ample to cover at least three months of expenses (Ramirez 2011). Though most types of nonprofits have cash reserve ratios between 0.20 and 0.30, science and technology (0.12), mental health organizations (0.17), human services organizations (0.17), international foreign affairs organizations (0.17), and civil rights organizations (0.19) fall below that range, while housing and shelter (0.34), environmental quality (0.37), religion related (0.42),[18] public society benefit (0.50), recreation and sports (0.51), public safety (0.56), and social science research (0.67), exceed the nonprofit norm. Median values of this ratio for faith-based organizations ranged from 0.06 for colleges to 0.13 for churches, with an overall median of 0.09 (Appendix 7B.5).

While limited to nonprofits in Massachusetts, Form 990 data from 2010 provides a median benchmark value for days' cash on hand (Cash / (Total Expenses/365)) of 100.9, which converts to a cash reserve ratio of 0.2764 (Keating and Pradhan)[19] – very close to the 91.25 days (91.25 days = 0.25 × 365 days) mean value observed by Ramirez in the 2000–2005 timespan. The Massachusetts data revealed much variation depending on industry: lower values were observed for human services (61), healthcare & medical (60), housing and shelter (78), and social services (85). Close to the median value were community capacity (101) and other societal benefit (111). At the higher end were "other nonprofit" (119); arts, culture, and humanities (120); education, science, technology, and social science (125); youth, sports, and recreation (127); philanthropy (186); and environment and animal related (188).

How do these benchmark days' cash on hand values relate to our cash reserve ratio? It is simple to calculate the equivalent cash reserve ratio by dividing each value by 365. Illustrating, the 61 days of cash held by human services nonprofits in Massachusetts implies that their median cash reserve ratio is roughly 0.17 (0.1671 = 61/365). Similarly, if you have data expressed in "months' of cash," convert that to the cash reserve ratio by dividing it by 12. Three months of cash implies a cash reserve ratio of 0.25 (= 3/12).

While it would be extremely rare to experience any month in the year in which you receive *no* revenues, there are months when donations trickle in, and your organization is plunged into a cash crunch because it drifts down to a too-low level of cash as compared to daily expenses. Preferably, measure expenses for this ratio on a cash basis when doing this calculation. However, you will have to use the accrual-based SA total expense amount minus depreciation and amortization expenses if that is the only data you have available. Finally, note that this ratio measures the amount of cash held by the organization at a point in time. Where a board of directors has designated a reserve to hold, that reserve (assuming some or all of it is held in cash) would be included in the cash amount that appears in this ratio. We caution that some of the cash amount shown on the SFP is needed for expected, ongoing transactions needs, and is not going to be there for unexpected revenue shortfalls or expense spikes. The new accounting treatment that started in 2018 or 2019 for your organization (ASU 2016-14) requires financial disclosure of the amount of monies that a board has designated as a reserve, if one is held. Even more helpful, there is to be a disclosure as to the purpose for that reserve – and, of value here, we will gain insight into the breakdown of cash holdings (cash reserves, loosely speaking) – how much of it is for transactions versus to serve as an operating reserve, maintenance reserve, capital reserve, growth reserve, or other purpose.

Many nonprofits also hold near-cash investments (cash equivalents or short-term investments) as a backup source of liquidity to augment their cash holdings. Consider benchmark data that includes non-interest-bearing cash, as before, and also savings and temporary cash investments, as a broader measure of liquid funds. Taking cash plus these savings sources as a percent of total expenses, nonprofits hold almost one year of cash and near-cash holdings to meet their expenses (cash plus savings divided by total expenses averages 0.99 across all nonprofit types when measured as an average of industry ratios). At the low end of the spectrum we find mental health organizations (0.43), employment and job-related nonprofits (0.61), civil rights organizations (0.62), human services organizations (0.64), and international and foreign affairs organizations (0.77). Relatively more liquid nonprofit industries include animal related (1.48), social science research (1.54), public safety (1.75), religion related (1.86), environmental quality (2.05), public society benefit (2.44), and community improvement (2.51).[20] See an example of how we calculate the cash reserve ratio for Durham Habitat for Humanity in Appendix 7A.

A related measure, the *operating reserve ratio*, looks more broadly at all assets other than property, plant, and equipment and also "nets out" all restricted net assets and long-term borrowing done to finance property, plant, and equipment. Making those refinements results in an adjusted unrestricted net assets measure that is presumed to measure an organization's operating reserve. This measure is then compared to the number of months' of cash expenses, in which cash expenses is equal to total expenses minus depreciation. The operating reserve ratio measure is typically calculated from Form 990 data, but may also be calculated from audited financial statements. We have two observations regarding this measure: (1) many nonprofits use cash-basis accounting (see Chapter 6), providing a very different measure than the same organization using accrual-basis accounting (and the measure does not adjust for different treatment of receivables, payables, and accrued expenses); and (2) organizations cannot tap pledges receivable, accounts receivable, prepaid expenses, or inventories (if held) to pay unanticipated expenses or make up for a slow donation month – making this a fair indicator of liquidity, at best. Measurement error if using Form 990 or other cash-basis financial statements and lack of validity because of reliance on unrestricted net assets as the numerator both hamper us in measuring what we wish to measure. Furthermore, survey evidence compiled by Sloan, Charles, and Kim (2016) tells us that practicing nonprofit leaders do not view this ratio as an accurate indicator of whether their organizations hold reserves.[21]

**Current ratio.** The current ratio is a solvency measure and measures the coverage of near-term obligations, again, but with a broader measure of "ability to pay." This ratio includes near-term pledges receivable, accounts receivable, inventories, and prepaid expenses in the numerator. The ratio is not as conservative as the cash ratio, which also has current liabilities in the denominator, but more correctly matches up near-term obligations with the resources that will be available to meet those obligations. A ratio value of 3, for example, means the average organization had \$3 of cash and other resources which should turn into cash within one year with which to pay each \$1 of its obligations coming due within the next year.

The 2010 Massachusetts study of nonprofits finds that nonprofits have a median current ratio of 4.0, with housing and shelter, social services, and other societal benefits organizations very close to this median value.[22] Below-median industries include healthcare and medical (2.33); human services (2.70); and education, science, technology, and social sciences (2.85). More solvent industries include community capacity (5.26); other nonprofits (10.0); arts, culture, and humanities (11.11); environment and animal-related (14.29); youth, sports, and recreation (16.67); and philanthropy (50.0). This extreme value occurs due to very low levels of payables and accrued expenses in foundations.

Benchmark data from a nationwide sample of nonprofits, using Form 990 data from 1998–2003 (but including organizations using cash-basis accounting as well as accrual-basis accounting, so not as accurate) indicates nonprofits have a mean current ratio of 1.75, with nonprofits at the 99th percentile (top 1 percent) holding a current ratio of 2.74 (Gordon, Fischer, Greenlee, and Keating 2013).[23] Again, a current ratio of 2.74 indicates strong solvency, with higher values signaling more solvency (and of greater liquidity, broadly viewed).

For faith-based organizations, we find median current ratios ranging from 2.14 for churches to 6.28 for independent mission agencies, with an overall median of 3.94 (Appendix 7B.5). We would want to compare our organization's current ratio against other organizations of the same type and approximately the same size. There is a significant amount of variation in this ratio across the spectrum of nonprofit organizations.[24] Remember, many nonprofits have no current liabilities, so would not be able to use this ratio for a gauge of their solvency (see discussion under cash ratio, above).

Do you include current ratio as one your dashboard indicators? Bell and Schaffer classify your organization's financial health as a green light if the current ratio is greater than 3.0, a yellow light if the ratio value is between 1.00 and 3.00, and a red light if its ratio is less than 1.00.[25] If yours is a commercial nonprofit, with a high percentage of fee-for-service or earned income in your revenue and support mix, consider benchmarking as if yours was a small business. A current ratio value of 2.0 or above is generally thought to signal adequate solvency in *for-profit* small businesses and for all sizes of businesses in some business industry segments – although many businesses now are amply liquid with a current ratio of 1.0 or even less because of reliable backup credit line availability and very sophisticated cash management. If funds are being held on a semi-permanent basis, such as in a capital fund for a building project, they might be invested in longer-term investments (and these investments are not accounted for as current assets). See an example of how we calculate the current ratio for Durham Habitat for Humanity in Appendix 7A.

**Asset ratio.** The asset ratio, current assets divided by total assets, serves as both a solvency ratio and an investment strategy ratio. It looks at the asset investment as a whole and asks what percent of the total asset "pie" is placed in current assets (near-term assets that are either in cash or should turn into cash within the year). To the extent that *more* of the assets are placed in the current items (cash and cash equivalents, accounts receivable, inventories, short-term investments, prepaid expenses, contributions receivable), they are nearer to cash; therefore, the organization is more liquid, in a broad sense. But if *less* is invested in current assets, this implies greater long-term assets such as plant and equipment or pension assets. These assets cannot be readily turned into cash to pay bills that come due or to meet unexpected emergencies.

Beyond the liquidity aspects, though, lies the investment strategy element. As we said, short-term investments are sometimes made when longer-term investments are more appropriate. The organization enhances its liquidity at the price of the higher interest revenue and overall net revenue it could have had, based on the normally higher interest rates of the longer-term investments. Furthermore, nonfinancial long-term assets such as plant and equipment can often be rented or leased out or used otherwise to generate earned income. This income might far exceed the low interest rates paid on interest-bearing checking accounts or near-term investments.

Lower values for this ratio signal greater capital intensity, typically bringing with it higher fixed operating costs and (usually) higher debt levels to finance those long-term assets. Higher values signal less capital intensity, fewer fixed operating costs, and (usually) lower debt levels to finance the long-term assets. They are also a sign of more liquidity as the current assets are nearer to cash, and should soon be converted to cash. We find median asset ratio values for faith-based organizations to range from 0.12 for colleges to 0.46 for "other mission agencies," which include denominational domestic and foreign missions agencies as well as homeless shelters ("rescue ministries"). The overall median for faith-based organizations is 0.28 (Appendix 7B.5).

For a similar ratio that you might also calculate, a broad-ranging study of nonprofits finds a median ratio of net working capital to assets (where net working capital is current assets minus current liabilities) of 0.41, while the mean or average ratio value is 0.39.[26] See Appendix 7A for a numerical illustration of the calculation and interpretation of the asset ratio for Habitat for Humanity.

**Target liquidity level.** The Lilly Study revealed a key best practice, that of targeting an adequate liquidity level as the organization's primary financial objective. We call this the "target liquidity level." The target liquidity level shows us whether we have reached our goal for liquid resources, and may be measured in several ways. Our formula (cash and cash equivalents + short-term investments + total amount of credit line − short-term loans) is one way of measuring the target liquidity level. Many nonprofits do not have an established credit line with a bank or other financial service provider, so the third term in the formula is often $0. The fourth term, short-term loans, may represent either the amount of an established credit line that is currently borrowed (or "taken down"), or it could be another type of note payable (even a loan from an affiliated organization or national umbrella organization, or a working capital loan received from a nonprofit loan fund or foundation). Include only short-term loans in this formula; mortgage loans and other long-term borrowing are not part of our target liquidity calculation, as they do not normally affect our liquidity in the near future. We presume that you have arranged alternate means, ideally a debt reserve, of paying current maturities of long-term debt that you will pay within the year. (If there is no separate savings or reserve to pay it, long-term debt that has now come due within one year may be included in a modified formula calculation to show the impact of financing-related calls on cash.)

Other than the values we calculated for faith-based organizations (Appendix 7B.5), we are not aware of any benchmark data for the target liquidity level ratio to which you might compare your liquidity level. We found target liquidity medians to range from $725,469 for (mostly larger) churches to $2,409,082 for (fairly small) colleges, with an overall median for faith-based organizations of $1,751,855. To evaluate your calculated liquidity level conduct trend analysis to assess year-over-year changes. Best practice would be to then include projected target liquidity level in your budget narrative and as a supplemental metric when you present your long-range financial plan.

Our guidance regarding setting the amount for your target liquidity level is offered in Chapters 2, 5, 8, and 15. As a starting point, a donative nonprofit might set its target at six-months of operating expenses, with an interim target of three-months of expenses as you work toward the six-month target. A commercial nonprofit, especially a larger one with $10 million or more in consistent annual revenues and support, might opt for 2.5 months as a near-term target and an eventual target of 4 months. A small, young arts or human services organization might see a one-month "baby step" target as a stretch. Start where you are and focus on reaching your target with intentionality. We have seen an organization do a special-purpose "reserves campaign" (with a matching grant for the amount raised from a local foundation) and others incorporate reserves additions into a capital campaign case as part of that campaign's "working capital" goal. See Appendix 7A for a numerical illustration of the calculation and interpretation of the (assumed) target liquidity level for Habitat for Humanity.

An alternate formula for target liquidity for you to consider might include only the first two terms, leaving setup of a credit line or other short-term loans as one of several *ways* of providing the liquidity desired. We'll call this "target liquidity level-alternate." The reason we prefer the earlier formula is that it shows us how much liquidity we have *after* paying back arranged financing as well as how much financial flexibility it has when considering the amount of unused short-term borrowing capacity.

We can see how these two measures differ with a hypothetical example. Let's say that when the liquidity of World Symphony Orchestra (WSO) falls short of its target level, it uses short-term loans to increase the liquidity. Would the two measures give the same number when the amount of arranged financing is held in cash or short-term securities? Let's assume WSO's desired target liquidity level is $300,000, but at present it has $175,000 in cash and cash equivalents, $50,000 in short-term securities, either no credit line yet or an arranged credit line for up to $75,000 which it has not previously tapped, and no other short-term loans. Assume WSO takes out a single-payment loan for the $75,000 needed to get liquidity (cash and securities) up to $300,000. Calculating our formula and the alternate measure for WSO, we get a different result:

$$\begin{aligned}\text{Target liquidity level} &= \$175{,}000 + \$50{,}000 + \$75{,}000 \text{ addition} - \$75{,}000 \text{ loan}\\ &= \$225{,}000\end{aligned}$$

According to our measure, WSO's liquidity has not really increased, because the increase is not permanent. The loan (and interest) will have to be repaid. Short-term borrowing may be fine to provide for *temporary* needs, such as a seasonal buildup in inventories or receivables, but should not be seen as a source of permanent liquidity financing.

$$\begin{aligned}\text{Target liquidity level} - \text{Alternate} &= \$175{,}000 + \$50{,}000 + \$75{,}000 \text{ addition}\\ &= \$300{,}000\end{aligned}$$

According to this alternate measure, WSO's liquidity has increased to the organization's predetermined target level. It will have to plan carefully to have enough funds to pay back the loan at maturity, or if it is a credit line, to pay it down in its entirety during the bank's "clean-up period," when it must pay the loan down to zero.

For many nonprofit organizations, the two measures would give the same reading because their financial policy is to use no short-term debt. Two-thirds of the organizations in the Lilly study never do any short-term borrowing, and only one in eight has short-term loans each year. If you plug a value of $0 in for short-term loans in our proposed formula, you get the same result as you would with the alternate formula.

One last point before we leave the target liquidity level. The post-recession experience of Massachusetts-based charities, 58.4% of which have annual expense budgets of $250,000 or less (and 78.2% have budgets under $1 million), gives caution to us if we are assuming that (1) a calculated liquidity level that stays constant is probably reason to celebrate, and (2) that *not* having a credit line is likely a wise, risk-averse financial policy:

> The economic downturn had little to no effect on cash on hand throughout the sector. However, this result demonstrates the sector's resilience rather than its financial health. Due to the lack of access to short and long-term credit, nonprofits are pursuing all means possible to preserve their cash resources, including foregoing fixed asset [buildings, land, and equipment] purchases, selling investment securities and delaying paying bills.[27]

We will provide more detail on evaluating liquidity when we get to the level 4 analysis, and we address short-term borrowing do's and don'ts in Chapter 10.

**Target liquidity level lambda.** There are a number of more sophisticated solvency, liquidity, and financial flexibility measures that may be adapted from the corporate sector for our purposes. Chief among these are the cash conversion period and lambda.[28] For hospitals or other entities having significant inventories and credit sales, the cash conversion period may prove useful; we introduce it in Appendix 7B. For all nonprofits, comparing how long it takes you to collect on your receivables versus how long you get to delay payment on your credit purchases is a valuable metric. For example, if your government contracts pay you in 120 days but the supplies you purchase and use in related contract work have to be paid in 30 days, that implies a 90-day period over which you have to use your own cash to pay for those supplies.

Lambda is a measure of liquidity that will help you determine if your organization has enough liquidity. It also brings into the picture, to some degree, the organization's near-term financial flexibility. (When you evaluate this ratio, make sure to address a fuller picture of financial flexibility that includes all aspects of your organization's ability "... to take effective actions or alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities."[29]) We believe that target liquidity level lambda (TLLL), our modified version of lambda, may prove a useful measure for you to add to your financial analysis toolkit. Let's take a closer look at the formula:

$$\text{TLLL} = \frac{\text{Target liquidity level} + \text{Projected OCF}}{\text{Uncertainty of OCF}}$$

Where:

Target liquidity level (as defined earlier):

$$\begin{aligned}\text{Target liquidity level} = (&\text{cash and cash equivalents} + \text{short-term investments}\\ &+ \text{total amount of credit line} - \text{short-term loans})\end{aligned}$$

Projected OCF is the operating cash flow amount you predict for the next year.

Uncertainty of OCF is the standard deviation of the organization's historical OCFs for at least the past three years.

Notice that two estimates are required here to calculate TLLL:

1. Someone must forecast your organization's OCF. You may wish to look at last year's SCF to see what the OCF amount was and perhaps plug that in as a naïve forecast. A second approach is to reduce that amount by some arbitrary factor (say, 25 percent) for a more conservative estimate. A third option is to take the average of your organization's past three years of OCFs. A fourth option, if your organization has been growing, is to project a somewhat higher level of OCF. (But be careful: often growth causes higher investment levels in receivables and perhaps in inventories or prepaid expenses, so OCF will not grow as much as revenues and may actually decline somewhat.) Careful study of the relationship between past years' changes in net assets and OCF (as we contrasted with Habitat for Humanity earlier) is very helpful here.
2. The uncertainty of OCF reflects the financial vulnerability your organization faces. It only makes sense, if your organization has large fluctuations in its cash revenues and/or cash expenses, to need a higher level of liquidity. Placing risk of your operating cash flows in the denominator, TLLL indicates through the resulting

lower calculated value (quotient) that you have less liquidity. Two ways to estimate this uncertainty: Calculate the standard deviation of the past 7 to 10 years of OCFs, perhaps using the STDEV function built into Microsoft Excel; or take the highest OCF in the past 7 to 10 years, subtract from it the lowest OCF in that same time frame, then divide that amount by 6. The latter is an approximation of the standard deviation of your organization's OCFs, based on the idea that there are six standard deviations of numerical values in an entire range (or distribution) of numbers.[30]

Calculating TLLL is extremely helpful to your understanding and analysis of liquidity, broadly measured, for three reasons:

1. It demonstrates to your policy-making team that steady, dependable cash flows require holding less liquidity and that highly risky cash flows may be offset by having more cash and equivalents, more short-term (unrestricted) investments, a higher unborrowed credit line, the ability to borrow quickly for working capital on an as-needed basis (rare for nonprofits), or a positive and high inflow of funds over the upcoming period. (But watch for seasonality – if yours is a donative organization, much of that is likely to materialize between Thanksgiving and Christmas, when a very high percentage of cash donations are made.).
2. If your calculated TLLL number turns out too low for comfort (see #3) – meaning it is below your financial policy for target liquidity, as discussed in Chapter 2 – you can plug in different numbers for credit line amounts or short-term investment amounts, and then see the impact. Doing this helps you to know how much is enough for liquidity-filling investing or borrowing actions.
3. Used with a standard normal table (we advocate the Excel NORMSDIST function), the TLLL tells you the probability of running short of cash over the forecast period. A particular value for TLLL is associated with a 5 percent chance of running out of cash, a different value for TLLL matches to a 1 percent chance, and so on. No other liquidity measure provides decision makers with this type of information.

Let's illustrate TLLL with our earlier WSO example. Assuming that WSO was successful in taking out the loan for $75,000, we found the actual value for TLL was $225,000. We need two additional pieces of information: the forecasted OCF for the next year and the uncertainty of WSO's OCF amounts over time. The treasurer tells us that she is looking for OCF of $8,500 in the upcoming year. The past five years, OCF has been shown, according to the table provided to us by WSO's bookkeeper:

| Year | OCF |
|---|---|
| 1 | ($30,500) |
| 2 | ($75,000) |
| 3 | 15,000 |
| 4 | 7,000 |
| 5 | ($15,000) |

Just looking at the numbers, it is apparent that WSO has experienced significant fluctuation in its annual cash flow. We need to convert that variability into a statistical measure, called standard deviation. We will do it using both techniques listed earlier; we'll call the first measure $SD_1$ and the second measure $SD_2$.

**Standard deviation using a financial spreadsheet ($SD_1$).** We keyed the data into an Excel spreadsheet, selected the Formulas tab, then used the [$f_x$] key to pull up the functions menu. We selected, from the statistics functions, STDEV. This function will calculate a sample standard deviation from numbers in the spreadsheet. Doing so, we got a standard deviation of \$35,755. (Note that we have very little data, and preferably we would have a minimum of 7 to 10 years of operating cash flows to use in this calculation.)

**Standard deviation using a range estimate ($SD_2$).** We took the highest OCF in the series, \$15,000, and subtracted from it the lowest value, −\$75,000. We got \$90,000 (= \$15,000 − −\$75,000). Next, we divided this by 6, and arrived at \$15,000 (= \$90,000/6) for our estimate of standard deviation. Notice that our standard deviation estimates are quite different here; this spread arises both because of the small sample of OCFs and because OCF does not follow a nice bell-shaped curve (is not normally distributed).

Now let's calculate TLLL using each of these standard deviation estimates; we'll call these ratio values $TLLL_1$ and $TLLL_2$:

$$\begin{aligned}
TLLL_1 &= (\$225{,}000 + \$8{,}500)/\$35{,}755 \\
&= \$233{,}500/\$35{,}755 \\
&= 6.53 \\
TLLL_2 &= (\$225{,}000 + \$8{,}500)/\$15{,}000 \\
&= \$233{,}500/\$15{,}000 \\
&= 15.57
\end{aligned}$$

What is the probability of running short on cash for each of these calculated values for TLLL?[31]

$$\text{Probability of running short of cash for } TLLL_1 = 0.00\%$$

$$\text{Probability of running short of cash for } TLLL_2 = 0.00\%$$

In WSO's case, then, the probability of financial vulnerability is insensitive to the uncertainty estimate. In other words, regardless of which standard deviation we used, WSO does not face even a 1 percent chance of running out of cash in the upcoming year. The target liquidity level is sufficient *for covering likely operating cash outcomes*. This does not mean that the target liquidity is sufficient to cover maintenance, new programs, very large negative cash flow spikes (as you might have seen for your organization in 2008 or 2009), or large plant and equipment outlays. Any of these that apply to WSO would have to be subtracted out of the target liquidity level, then the analysis redone, to get an accurate picture of financial vulnerability. Only the historical pattern of OCF and the best estimate of next period's OCF is taken into account in our analysis.

**Funding ratios.** The second group of ratios is funding ratios. We believe this set of ratios best assesses your organization's *dependence risk* from borrowing money or depending on a single source of revenue and support. While liquidity issues show up quickly and repeatedly, funding issues show up later but can also be serious threats to your organization's survival.

This group includes a ratio that indicates the dependence on donated funds (contribution ratio) as well as one that measures the degree to which we use borrowed money to finance assets (debt ratio). Risk is the central focus here. First, using the contribution ratio, how "donation dependent" is our organization for each year's expenses? Second, based on the debt ratio, are our assets in place funded with borrowed money, which has to be paid back with interest? Or, are the assets funded mostly by net assets, which are permanent contributions or earned income retained in the organization? The greater the value of either the contribution ratio or the debt ratio, the more risk we have in the organization's structure. In the corporate sector, the first measure would be called *operating risk* or *business risk* and the second measure would be labeled *financial risk*.

$$\text{Contribution ratio} = \text{Total contributed revenue}/\text{total revenue}$$

$$\text{Debt ratio} = \text{Total liabilities}/\text{total assets}$$

**Contribution ratio.** We calculate the contribution ratio by dividing total contributed revenue by total revenue. We do not include in-kind contributions or grants in this formula's calculation. See Appendix 7A for a numerical illustration of the calculation and interpretation of the contribution ratio for Habitat for Humanity. Projections of donations for donative organizations drive the financial planning process for these organizations. High levels of donation dependence, resulting in contribution ratios of 0.65 or above, imply risk because of vulnerability to possible donor fatigue or high-profile humanitarian crises that drew great donor interest in recent years. If donations are expected to taper off, the organization must move quickly to replace the lost funds or face a financial crisis. Fundraising is obviously very critical for these organizations, and we emphasize in the level 3 discussion later in this chapter the vitality of having the CFO involved in the fundraising management and evaluation process.

When we calculate the contribution ratio we do not include in-kind contributions or grants. A study by Fisman and Hubbard finds, using Form 990 data, an average contribution ratio of 0.14, or 14 percent for a broad spectrum of 4,500 nonprofits (but skewed toward healthcare and educational organizations).[32] Bear in mind that Form 990-based data sources include relatively few of the many faith-based organizations, yielding a lower-than-expected benchmark value. Many faith-based organizations get a high percentage of their revenues and support from donations (churches, for example, are in the 90%+ category, although faith-based colleges are at a much-lower median value of 17%; see Appendix 7B.5).

Another category of funding that is considered "soft money" is grants. A high degree of reliance on grants also places the organization at risk. You might calculate a "contribution and grants ratio," combining these two items in the numerator of the ratio. Ramirez (2011) finds that 33 percent of the yearly revenue and support of the average nonprofit comes from indirect and direct donations from the public along with government grants.[33] The Massachusetts study indicates that nonprofits get an average of 25 percent of their revenues and support from gifts and grants, with the lowest segment being healthcare and medical (14%) and the highest industries being environment and animal-related (63%) and philanthropy (81%). A national sample, using older 2001–2003 data, locates the median nonprofit contribution ratio (including grants other than those that would be considered to be contracts for services grants) at 58 percent (Gordon, Fischer, Greenlee, and Keating 2013).[34]

**Debt ratio.** The debt ratio measures the degree to which our assets are funded with borrowed money rather than equity capital ("net assets") amounts that were contributed or accumulated through past years' operating surpluses. We divide total liabilities by total assets to determine the debt ratio, and we express it in percent. See Appendix 7A for a numerical illustration of the calculation and interpretation of the debt ratio for Habitat for Humanity. A ratio of 0.25, or 25%, indicates that one-fourth of all assets are funded by borrowed funds; a ratio of 0.50, or 50%, indicates more risk, as one-half of the assets are financed with borrowed money, which often has to be repaid with interest. What gives rise to higher reliance on borrowed money? Often it's the longer-term asset investment in plant and equipment, which drives the long-term mortgage loans that figure largely in these higher ratio values. Asset intensity turns into financial leverage risk as the long-term fixed assets are financed with borrowed funds. Borrowing puts a strain on the organization as it has to pay interest and repay principal. We return to this subject in Chapter 10. It is best to express the debt ratio in percent, to two decimal places.

The Massachusetts study provides a debt ratio benchmark for all nonprofits *that use debt* (many organizations do not) of 34%, and "other nonprofit" organizations (33%) and other societal benefit organizations (32%) match that closely. However, segments "playing it safe" with much lower debt ratios include philanthropy (4.3%); environment and animal-related (12%); arts, culture, and humanities (17.3%); youth, sports, and recreation (22%); and education, science, technology, and social sciences (27%). Not having interest payments and repayments of amounts borrowed allows these organizations to more easily bear other risks (such as declines in contributions, grant funding, or endowment payout). Higher risk comes in the community capacity (41%), healthcare and medical (50%), human services (53%), social services (58%), and housing and shelter (79%) industries. We believe the oft-experienced cash crunches and cash crises experienced in human services and social services industries are closely related to these high debt levels. Additional benchmark data from the 1998–2003 period yields a median debt ratio benchmark of 9 percent (the mean is 21%; Gordon, Fischer, Greenlee and Keating 2013). Our compilation of faith-based organizations' debt ratio medians shows a range of 0.14 (14%) for churches to 0.28 (28%) for colleges, with an overall median of 0.21 (21%), as shown in Appendix 7B.5.

Finally, note that almost 5,000 nonprofits became "insolvent" from an accounting insolvency perspective in the United States in the 2001–2003 period, meaning that their debt ratios went over 100 percent (total liabilities exceeded total assets). While nonprofits cannot be forced into bankruptcy, many insolvent organizations close their doors or are merged into other organizations. This concern is heightened by the even greater preponderance of "technical insolvency," or illiquidity, in which organizations are unable to pay their bills in full on time.

**Operating ratios.** Our final category of ratios is a set of six operating ratios that gives insight into the *returns/efficiency* from the recent past, mostly. Your organization needs to maintain the ability to more than cover costs in order to be around for the long haul. Furthermore, to achieve your liquidity target and to prevent long-run liquidity and funding problems, it is wise to manage operating values within a "safe zone." You will want to assess the cost coverage, expense composition, and "return on investment" in your operations. To do that we shall use the return ratio, the net operating ratio (what some call "surplus margin"), the net asset reserve ratio, the program expense ratio, the support service expense ratio, and the net surplus level.

$$\text{Return ratio} = \frac{\text{total revenues}}{\text{total assets}}$$

$$\text{Net surplus} = \text{total revenues} - \text{total expenses}$$

$$\text{Net operating ratio} = \text{net surplus} / \text{total revenue}$$

Net asset reserve ratio = net assets / total expenses

Program expense ratio = program expenses / total expenses

Support service expense ratio = support service expenses / total expenses

**Return ratio.** The return ratio is calculated by taking total revenue (and support) and dividing it by total assets. See Appendix 7A for a numerical illustration of the calculation and interpretation of the return ratio for Habitat for Humanity. The return ratio is generally considered to be an efficiency measure. The term "efficiency" here is used not in the sense of being cost-effective, but in how well our asset investment translates into revenues and gains, or financial resources, brought into the organization. In a business, it is called "total asset turnover" because it shows how often the investment in total assets "turns over" into sales. For nonprofits, we are measuring the ability of an organization to generate or raise revenue from its asset base. In another sense, it is a "return on investment," where the return is revenues flowing into the organization each year per dollar invested in assets. Another way to view it is a size-adjusted measure of revenue-generating ability, because organizations of different sizes (asset bases) will all be measured on a "per dollar of assets" basis. If the ratio value is 1.25, the organization receives \$1.25 in revenue per \$1 invested in assets. For donative organizations, you are largely measuring the efficiency of the fundraising function. For schools or healthcare organizations, you are mainly gauging the efficiency of earned income ventures. In any case, you are also measuring asset intensity; an organization with a small (large) fixed asset investment due to larger amounts of land, property, and equipment, will tend to have a higher (lower) ratio. We again emphasize: Measure yourself against similar organizations (type of service, location, revenue mix, mix of services offered, cost structure) or against your trend of past values. The Massachusetts study benchmarks all nonprofits at a median value of 0.42 (42%), but only one industry, other societal benefit, has a median ratio value close to that (0.41). At the low end are education, science, technology, and social sciences (0.19); arts, culture, and humanities (0.23); housing and shelter (0.27); and philanthropy (0.28). Ranging at the high end are other nonprofits (0.57); social services (0.67); youth, sports, and recreation (0.69); community capacity (0.82); healthcare and medical (0.90); and human services (1.00). Additional benchmark data for typical nonprofits finds much higher values covering the period 1998–2003: a median return ratio of 1.15 (Gordon, Fischer, Greenlee, and Keating, 2013). For faith-based organizations, we find median values ranging from 0.43 for colleges to 2.77 for independent mission agencies, and an overall median of 1.32 (Appendix 7B.5).

**Net surplus.** Net surplus is the "profit," or total revenues minus total expenses, for a given period. If it turns out to be negative, we call it a "deficit." See Appendix 7A for a numerical illustration of the calculation and interpretation of Habitat's net surplus/(deficit). For a business, profit is a primary measure of effectiveness and success. Nonprofits don't like to talk about profit, so they call it net revenue or surplus/(deficit). On the SA, it is identified as the change in net assets. There is a strong move to split out "operating" profit/(loss) so that changes in investment values do not obscure the ongoing ability of mission-related revenues to cover mission-related expenses. The manager views surplus/(deficit) as the relative cost coverage by revenues for the period. If positive, then revenues more than covered costs. If zero, the revenues just covered cost, a situation most call "financial break-even." Recall from Chapter 2 that most respondents in the Lilly study selected this as their primary financial objective, even though we advocate target liquidity level as a better objective, and one that is practiced by the best-managed organizations. To build and maintain target liquidity implies that your organization normally should run a surplus of 2 to 10 percent of revenues annually. Obviously, a negative value suggests that in this period the revenues did not cover costs. The key question to ask: Was it planned? If so, no problem. If not, we have to go back to the budget variance analysis to find out why not and how to avoid the situation next year. Or, was it due to unrealized or realized losses on financial investments that the organization has held?

Many data sources look at samples of nonprofits, both magazine-published lists and academic research lists, and find that many nonprofits are running surpluses. A quick look at the financial results of the 200 largest charities published annually in *Forbes* magazine reveals that very few large charities run a deficit, and those that do typically only have a very small deficit (as a percentage of revenues). The 2000–2006 period saw nonprofits running surpluses in the neighborhood of $4,212, on average (Ramirez 2013), but the standard deviation was $44,048 and the range was large: housing and shelter organizations earned a surplus of only $209 whereas education organization earned $8,892 and medical research organizations made $8,916. We found median surpluses for faith-based organizations ranging from $232,188 for "other mission agencies" (denominational missions and homeless shelters) to $1,639,383 for independent mission agencies, with an overall median surplus of $695,159 (Appendix 7B.5). Because many organizations do raise money in advance of planned expansion or to build up to the target liquidity level, running surpluses in some periods may simply show good managerial foresight. Yale University became famous for its inability to properly plan for renewal of its crumbling infrastructure, and we again urge you to put into practice the strategic and long-range financial planning tools presented in Chapter 9.[35] Finally, persistent large surpluses by a no-growth organization with reliable revenue sources may reflect hoarding and inadequate provision of much-needed services.

**Net operating ratio.** The net operating ratio gives us the same information as the net surplus, except in relative terms. We take the surplus (or deficit) and divide it by total revenue and support. See Appendix 7A for a numerical illustration of the calculation and interpretation of Habitat's net operating ratio. In a business it is called the net profit margin. For an organization pricing its services, such as schools/colleges and camps/conference centers, we get insight into pricing and its degree of cost coverage. For all organizations, it gives cost coverage feedback as scaled to the total revenue. Again, as we saw with the return ratio, you can view the denominator as a scaling factor to put different-size organizations on an equal footing: Surplus or deficit is expressed per dollar of revenue. One of the largest studies finds that, over many years, charities earn a median surplus that amounts to a net operating ratio of 6 percent of revenues; relative to assets, the median surplus equals 5 percent of assets.[36] A broad study of nonprofits finds a median value for the net operating ratio of 4 percent, with an average, or mean, ratio value of 3 percent.[37] We determined that the median net operating ratio for faith-based organizations ranged from 3 percent for colleges to 8 percent for churches, with an overall median value of 5% (Appendix 7B.5). The consensus median net operating ratio value across nonprofits that we use for comparison purposes is 5%.

**Net asset reserve ratio.** The net asset reserve ratio is very similar to the cash reserve ratio we discussed in the liquidity section. It is calculated by taking total net assets and dividing that by total expenses. See Appendix 7A for a numerical illustration of the calculation and interpretation of Habitat's net asset reserve ratio. We can therefore view it as both an operating ratio and a liquidity ratio. The difference between this ratio and the cash reserve ratio is that we are looking at what would be similar to equity in a business and asking in relative terms how it compares to total yearly expenses. We're not thinking that we would "liquidate" net assets to pay a year's expenses, but instead are wondering how much of a cushion of permanent financing we have built up relative to annual expenses. From the flip side, a combined view of the cash reserve ratio and the net asset reserve ratio provides us with another view of *operating risk*. The larger the cash reserve ratio and the net asset reserve ratio, the less risky the operating posture of the organization. A broad sample of nonprofits finds a net asset reserve ratio median value of 0.71.[38] Our compilation of median net asset reserve ratios for faith-based organizations ranges from 0.32 for independent missions to 1.62 for colleges, with the overall median being 0.88 (Appendix 7B.5).

**Program expense ratio and support service expense ratio.** Program expense ratio and the support service expense ratio show the split of expenses into program and the sum of management/general and fundraising. We are asking if most of our annual expenses are program-related or if too much of our resource allocation is going to "overhead" activities that are necessary but are not providing services to our clientele. We calculate the program expense ratio by dividing total program expenses by total expenses. See Appendix 7A for a numerical illustration of the calculation and interpretation of Habitat's program expense ratio. Similarly, we calculate the support services expense ratio by adding up all support service expenses (management, fundraising, and membership development expenses) and then dividing that sum by total expenses. See Appendix 7A for a numerical illustration of the calculation and interpretation of Habitat's support service expense ratio. The program expense ratio and support service expense ratio are complementary: Added together, they equal 100 percent. So, if we calculated the program expense ratio as 80 percent, the support service expense ratio would be 20 percent. Recognizing the arbitrariness of accounting allocations, we still have two interesting indicators when comparing this year's values for a specific organization to its prior year values, and *possibly* when comparing to other organizations using similar accounting practices.[39]

Almost all nonprofit industries have program expense ratios between 75 and 83 percent (Ramirez 2013), implying support service expense ratios of 17 to 25 percent. Our tabulation of median program expense ratios for faith-based organizations ranged from 71% for colleges to 82% for independent missions. For these same organizations, support service expense ratio medians are from 18% for independent missions to 29% for colleges. The overall median was 78% for the program expense ratio and 22% for the support services expense ratio. We again caution that there are widely varying practices for cost allocations, and are hopeful this will change with the added disclosure coming with natural expense disclosure as well as basis for allocation disclosure (ASU 2016-14).

Be aware that your organization may get positive or negative publicity based on your ratios for these categories. Periodicals such as the *Chronicle of Philanthropy, Forbes* (www.forbes.com), *Consumers Digest*, and *Worth Magazine* annually report on expense ratios for large nonprofits, along with statements that those organizations with higher program expense ratios are more efficient. Implicitly, these higher program expense ratios suggest that these organizations are more worthy of donor support. We now call this the "*overhead myth*." Nonprofits are achieving the lower support service expense ratios mostly through reductions in nonadministrative staff wages and professional fees (see an excellent analysis of the overhead myth in Lecy and Searing 2015).[40] Several academic studies seem to support the notion that higher management expenses (the largest component of support services expenses, which includes management, fundraising, and membership development expenses) reduce donors' donation amounts, but other studies find no reduction and the single studies of foundation giving and government grants each find no reduction when management expenses are higher.[41] There is also evidence of incorrectly done functional expense reporting by many nonprofits on their Form 990. FASB accounting guidance is requiring that the auditors affirm that nonprofits are using the cost allocation methods that the organizations state they are using (ASU 2016-14). Even for someone who believes this ratio provides a credible ratio of efficiency, it is important to remind them that organizations getting government grants and large quantities of donated goods will look better on their support services ratio, unless adjustments are made for those two items.[42]

**Ratios as a way of assessing financial vulnerability.** We introduced target liquidity level lambda as one measure of financial vulnerability. Some interesting multiple-ratio attempts have been made recently in modeling a nonprofit's vulnerability to financial exigency. One study finds that these four financial statement items and financial ratios are helpful in predicting financial vulnerability:

- Size (larger organizations had a lower risk of insolvency)
- Debt ratio (higher debt ratio increases risk of insolvency)
- Negative change in net assets (when negative in a given year, this increases the risk of insolvency a year later)
- Two-year difference in change in net assets, scaled by the average change in net assets in the prior and current years (larger relative changes in change in net assets amounts in consecutive years increase the probability of insolvency in the subsequent year).[43]

The authors of this study noted that they did not have a highly accurate way of predicting year-ahead financial vulnerability, however.

A recent study identified a compact set of three financial indicators that would enable one to predict whether an organization would become insolvent (accounting insolvency, in which total liabilities exceed total assets) in the following year. In Exhibit 7.11 you will see the three indicators and the multipliers (coefficients) used to predict insolvency. The danger zones differ slightly based on the industry of the organization.

The variables we need are as follows: NA/TR is net assets divided by total revenues.

NA/TA is net assets divided by total assets, which is very similar to the debt ratio (TL/TA) in that TA – TL = NA. This is a leverage ratio, indicating the degree to which total assets are financed by *nonborrowed* funds.

Finally, INTWO is coded as 0 (zero) if the organization has *not* run deficits both of the most recent two years, and 1 if it *has* run deficits both of these years.

The vulnerability of our organization depends on where it stands, financially, relative to these three indicators. Specifically, this model indicates how likely that the organization will become insolvent within the next year.

Illustrating, let's say that our organization is a museum and has net assets of \$35,000, total revenues of \$240,000, and total assets of \$550,000. It has run deficits in each of the most recent two years.

Calculating the two ratios, we have:

$$NA/TR = (\$35{,}000/\$240{,}000)$$

$$NA/TR = 0.1458 \text{ or } 14.58\%$$

$$NA/TA = \$35{,}000/\$550{,}000$$

$$NA/TA = 0.0636 \text{ or } 6.36\%$$

We then compare these ratio values to the tabled values for museums in Exhibit 7.11. The most financially vulnerable museums, those falling into the bottom 5 percent of all

**Panel B: Detailed Industry Insolvency Patterns**

| Industry | NA/TR (5th percentile) | NA/TA (5th percentile) | % with Deficits in the Two Prior Years | Estimated Probability of Insolvency (5th percentile) | Average Insolvency Rate |
|---|---|---|---|---|---|
| Amateur & Professional Sports Associations | 5.35% | 43.28% | 10.27% | 3.52% | 0.93% |
| Animal Shelters and Zoos | 14.28% | 51.07% | 11.46% | 3.15% | 0.58% |
| Botanical & Environmental Centers | 12.32% | 45.06% | 10.36% | 3.56% | 0.74% |
| Camps & Facilities | 10.00% | 42.53% | 11.84% | 3.78% | 0.91% |
| Children-Focused Human Services | 2.35% | 15.72% | 13.34% | 12.60% | 2.74% |
| Colleges and Universities | 13.05% | 33.22% | 8.62% | 4.59% | 0.78% |
| Community Development | 5.50% | 16.00% | 12.05% | 10.08% | 1.60% |
| Conservation & Pollution | 7.85% | 31.78% | 8.79% | 7.78% | 1.42% |
| Crime, Legal & Civil Rights | 7.39% | 30.85% | 11.42% | 6.52% | 1.26% |
| Diseases-Focused Associations | 8.12% | 29.83% | 12.58% | 6.55% | 1.27% |
| Employment Services | 3.03% | 15.59% | 11.88% | 8.02% | 1.38% |
| Family-Focused Human Services | 5.36% | 28.32% | 12.00% | 7.32% | 1.44% |
| Food & Agricultural Human Services | 4.37% | 34.50% | 9.15% | 3.84% | 0.82% |
| General, Social & Science Organizations | 7.02% | 25.49% | 12.36% | 10.27% | 1.75% |
| Historical Societies | 27.13% | 58.60% | 10.35% | 1.88% | 0.47% |
| Hospitals | 9.93% | 16.95% | 11.10% | 8.23% | 1.60% |
| Housing Development | 9.35% | 4.55% | 15.50% | 15.61% | 2.50% |
| Human Services | 5.56% | 22.91% | 14.30% | 5.76% | 1.06% |
| Humanities | 6.75% | 33.84% | 12.85% | 8.41% | 1.51% |
| K–12 Schools | 4.43% | 16.51% | 9.66% | 10.48% | 1.80% |
| Libraries | 19.15% | 60.28% | 9.24% | 1.15% | 0.22% |
| Media & Communications | 7.40% | 26.39% | 14.92% | 11.52% | 1.83% |
| Mental Health | 4.83% | 17.56% | 12.16% | 10.08% | 2.05% |
| Museums | 24.21% | 48.69% | 12.56% | 2.81% | 0.68% |
| Nursing | 5.12% | 7.33% | 15.25% | 15.81% | 2.95% |
| Other Health Organizations | 7.20% | 24.26% | 12.65% | 6.52% | 1.47% |
| Performing Arts | 3.97% | 24.64% | 11.88% | 19.74% | 3.38% |
| Residential Care | 5.42% | 14.69% | 13.47% | 6.28% | 1.33% |
| Shelters | 7.43% | 10.47% | 12.77% | 10.04% | 1.65% |
| Student and Educational Services | 10.56% | 45.38% | 8.41% | 3.08% | 0.75% |
| Support Services | 4.26% | 19.78% | 9.38% | 11.55% | 1.96% |
| Youth Centers | 7.78% | 41.23% | 12.89% | 6.90% | 1.23% |

Notes:
The estimated probability of insolvency is computed based on the coefficients generated by the size-based regressions using parsimonious model presented in Table IX.
The insolvency rate is the percent of solvent firms that become insolvent in the coming year.

*Source:* Gordon, Fischer, Greenlee, and Keating, "Warning Signs: Nonprofit Insolvency Indicators," *International Research Journal of Applied Finance* IV, no. 3 (March 2013): 376. Used by permission.

**EXHIBIT 7.11** PREDICTIVE MODEL FOR NONPROFIT INSOLVENCY museums, have NA/TR ratio values of 24.21 percent (or less) and NA/TA ratio values of 48.69 percent (or less). Furthermore, 12.56 percent of museums have run deficits in the two most recent years (as has our organization), another indicator closely related to imminent insolvency. Comparing our NA/TR ratio to 24.21 percent, we see it is substantially below that value – bad news. Our NA/TA ratio of 6.36 percent is also well below the danger zone threshold of 48.69 percent. Our museum has lost money each of the past two years. We therefore predict that our organization *will likely* become insolvent within the next year. This is another way of saying that the organization is not financially healthy, and it gives us a reading on how financially vulnerable our organization is. We could monitor our predicted score over time to gauge changes in our financial vulnerability.[44] Another use of the tabled ratio values in Exhibit 7.11 is a comparison of how near our ratio values are to these "danger zone" ratio values, although we do not know how much better our ratio values should be to qualify our organization as "financially healthy." We remind the reader that there are a number of organizations that limp along at or very near accounting insolvency but which remain open because they continue to make partial or late payments on their bills and lay off employees to try to conserve cash.

As we bring our discussion of ratio analysis to a close, we remind you to *always exercise caution when drawing conclusions*. Ratios are but one piece in your overall evaluation, and you must look at what is special or unique about your organization or those to which you are comparing yourself.[45] Furthermore, even with the growing standardization of accounting treatment and financial statement presentation, there are still judgment calls to be made, and some organizations disclose more about their policies and financial estimates than others.[46] It is usually safest to begin with a trend analysis of your own organization, which studies how your organization has changed from year to year. Then find a group of similar organizations to which to compare your organization. Ideally, put both comparisons on the same graph, so you have a given ratio for your organization and others plotted for at least three years. Once you get comfortable with that, you are ready to move to level 3, involvement in fundraising management and evaluation. Some CFOs and board treasurers have no choice but to get involved, regardless of their mastery of levels 1 and 2, because of their expanded job responsibilities.

**(d) LEVEL 3: FUNDRAISING MANAGEMENT AND EVALUATION.** Fundraising management and evaluation is an area in which financial personnel who are not part of development staff can and should be involved. It is an area in which the organization may be forced to rely on the CFO, because it cannot afford and chooses not to hire a development officer. Or, although rare, we have seen situations in which the CFO may also hold the title of development officer. We contend that it is also an area in which nonprofits can learn from businesses. First, recognize that in businesses, the treasurer is the fundraiser. The treasurer is responsible for arranging funding, typically from leases, debt, and equity. Second, she or he has a global view of many interlocked facets of the organization:

- Organizational strategy
- Long-range financial plans
- Present and anticipated financial position
- Cash flow characteristics
- Alternate sources of revenue and liquidity
    - Investments maturing
    - Investments ready for sale

- ○ Debt financing
- ○ Grant proposal and status
- ○ Business income
- ○ Historical pattern and trends of donation revenue
- ○ Split of restricted and unrestricted funds
- ○ Time until temporarily restricted funds become unrestricted (i.e., until certain time period elapses or certain use of funds as expenses occurs)

We show the global viewpoint of the treasurer in Exhibit 7.12. It is apparent that the financial manager has a panoramic, integrated perspective that no one else in the organization has – at least at this level of detail and with this degree of comprehension.

Third, we contend that the organization benefits from having the nonprofit CFO increase his or her involvement in fundraising objectives, planning, execution, and post-campaign evaluation. Doing so:

- Better integrates the entire spectrum of financial resource utilization
- Assists the fundraising office in communicating its objectives, methods, and resource needs across the organization
- Provides improved strategic direction and continuous improvement to the fundraising office/function

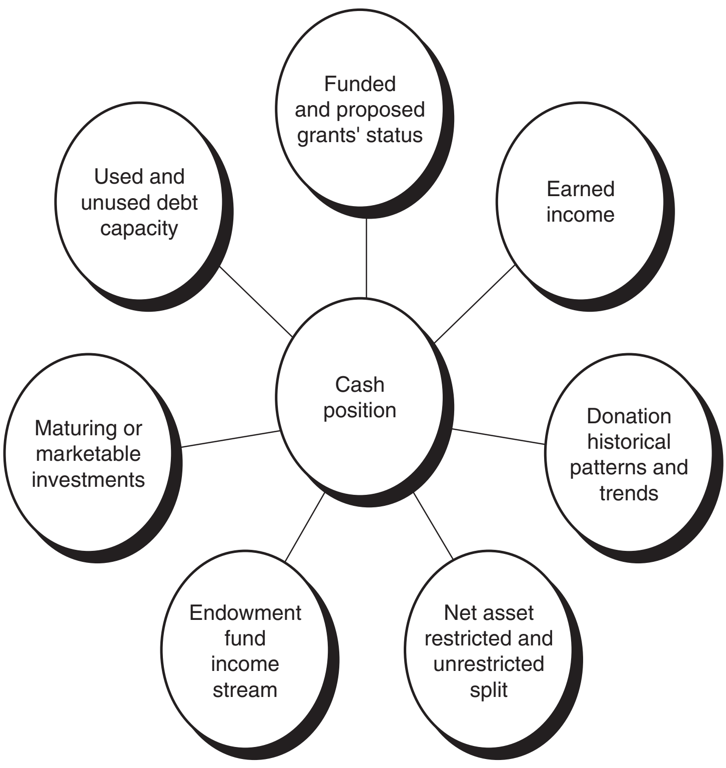


**Exhibit 7.12** Financial Manager's View of the Cash Position and Revenue Stream

Summarizing, proficient organizations have CFOs with hands-on authority and/or oversight over the organization's revenue stream. How can we put these ideals into operation? The CFO should pursue four strategic involvements, in this order of priority: (1) ensure adherence to the correct philosophy and major objective of fundraising; (2) plan and then schedule the campaign expenditures; (3) assist in the midcampaign evaluation and redirection; and (4) oversee postcampaign effectiveness and efficiency ratio analysis. We will expand on each of these briefly.

***(i) Setting the Philosophy and Major Objective of Fundraising.*** The fundraising expenditure must be viewed as an investment, like other capital expenditures, not as an expense. An appropriate philosophy for the annual campaign may be to proactively raise money *this* year for *next* year's operations, instead of scrambling this year to try to fund this year's operations. While this may seem to be easier said than done, the overall stance is important. Failure to recognize this explains why so many nonprofits are living hand-to-mouth and experiencing recurrent cash crises. A major objective of fundraising is to do its part to help meet the service provision objective, which is spelled out in its budget (see Chapter 8) and in its long-range financial plan (see Chapter 9). Remember: The investment in annual campaign fundraising is derived from the anticipated service provision spelled out in the budget and is a direct output of the budgeting process.

There is one important modification/amplification: Looking back at our hub and spokes diagram (Exhibit 7.11), we must adjust up or down the annual campaign dollar goal and fundraising investment based on the relative revenue contributions of those other revenue sources. Our ultimate goal is to achieve a liquidity target that is based on transactions needs for cash, which increase along with service activity. See the cash management discussion in Chapter 11 regarding setting the liquidity target to see how you might account for other factors that may reduce the liquidity target, such as improved cash forecasting, reengineered bank relations and/or using controlled disbursement account.

Your organization should have fundraising policies that spell out its philosophy of fundraising to prospective donors. While details of such policies are beyond the scope of our presentation, we suggest checking with other organizations to find out what they are doing. Prison Fellowship, the Washington DC–based organization founded by Chuck Colson to provide outreach to prisoners, has an outstanding set of policies that might serve as a model for your organization.[47]

***(ii) Plan and Then Schedule the Campaign Expenditures.*** Instead of prolonging the start of the annual campaign or doing it at the development office's convenience, use your knowledge of the organization's cash-flow cycle and current cash position to provide direction to the effort. Also recognize and help others on the management team understand the timing of the underlying cash flow cycle in an annual campaign:

Cash outflow for materials and labor → Cash inflow from campaign

The annual campaign is a cash-draining activity for some period. The financial implications? Expenditures must be anticipated, and enough cash must be on hand prior to the campaign to fund the campaign. The most important reason for not achieving their organization's financial objective, according to financial officers surveyed in the Lilly study, was inadequate and/or ineffective fund raising. We emphasize: Fundraising must be looked at as an investment, not as an expense, regardless of the accounting treatment. It is vital that you work with the development officer to convey this mindset to your CEO and board and ultimately your donors or grant sources. Some CFOs or board treasurers counter: "But we don't have the cash to do the level of fundraising that we really need to undertake." Maybe Bill Levis, a fundraising expert associated with Baruch College in New York City, was thinking of these especially when he recommended that organizations go one step further with the cash-flow cycle analysis and raise funds this year to fund next year's expenses. Think about that: Takes a planning mindset, doesn't it? It also requires in-depth understanding of the organization's financial posture, position, and overall health. What are some likely repercussions of such a policy? It results in having the equivalent of one year's operating expenses in unrestricted liquid assets (in addition to the money for a rainy day you already hold in cash reserves) by the end of this year.[48] In turn, that may require educating the donors, and it will also in some cases result in a red flag raised by one of the philanthropic oversight bureaus – particularly if you have sizable reserves saved up for a planned program expansion or for a merger/acquisition.

***(iii) Assist in the Midcampaign Evaluation and Redirection.*** Here is an example of using reports gathered within the year to help guide management for the remainder of the year. As results start coming in, the financial office can work with the development office, if separate, to interpret the results to management and the board. With its global view of the organization, the finance office knows how critical a shortfall is at any given point in time and can provide guidance as to the best use of a surplus when positive results are achieved. It is also helpful that development staff whose primary focus is relational (building donor relationships) work in tandem with finance staff whose primary focus is more analytical. It is a combination that can work well. Synergies can be attained by developing this team approach.

***(iv) Oversee Postcampaign Effectiveness and Efficiency Ratio Analysis.*** In the past, it was very difficult to find good information on measuring fundraising efficiency and effectiveness, but this is changing.[49] Here are some of the general guidelines offered by expert James Greenfield:[50]

| Activity | Reasonable Cost Guideline |
|---|---|
| Direct mail acquisition | \$1.00 to \$1.25 per \$1.00 raised |
| Direct mail renewal | \$0.20 per \$1.00 raised |
| Membership organization | \$0.25 per \$1.00 raised |
| Donor club program | \$0.20 per \$1.00 raised |
| Benefit events | \$0.50 per \$1.00 raised |
| Volunteer-led annual giving individual major gift programs | \$0.10 to \$0.20 per \$1.00 raised |
| Capital campaigns | \$0.10 to \$0.20 per \$1.00 raised |
| Planned giving/estate planning | \$0.10 to \$0.20 per \$1.00 raised |
| | \$0.20 to \$0.30 per \$1.00 raised |

A three-year study of 51 American colleges and universities found that on average it costs 16 cents to raise a dollar, with a median cost of 11 cents and the middle 50 percent of campuses experiencing costs of between 8 and 16 cents.[51] This figure covers all direct fundraising staff and programs, but does not include any allocation for president or dean's salaries or space or utility overhead costs. The study was conducted by CASE and the National Association of College and University Business Officers and funded by Lilly Endowment, Inc. It also found that, on average, colleges spend just over 2 percent of their educational and general (E&G) budgets for raising money, with gifts raised for operations meeting 10 percent of that budget.[52] The report made an important observation: "The objective of an institution's program should not be to spend as little as possible each year to raise money, but to maximize the net. A program that annually produces $2 million at a cost of $160,000, or 8 percent, may look good and is indeed efficient, but one that produces $3 million at a cost of $300,000, or 10 percent, is presumably of more help to the institution – it is bringing in $860,000 more."

As a financial officer, offer assistance to the development office in developing cost standards and efficiency and effectiveness reports. You may wish to discuss with your chief development officer and development staff the document, "Measuring Fundraising Effectiveness," that has been jointly developed by BoardSource, the Association of Fundraising Professionals, BBB Wise Giving Alliance, and GuideStar.[53] This framework includes these ratios:

*Total Fundraising Net*

$$\text{Total Amount Raised} - \text{Total Fundraising Expenses} = \text{Total Fundraising Net}$$

*Dependency Quotient*

$$\frac{\text{Sum of Contributions from Five Largest Donors}}{\text{Organizational Expenditures}} = \text{Dependency Quotient}$$

*Cost of Fundraising*

$$\frac{\text{Total Fundraising Expenses}}{\text{Total Fundraising Net}} = \text{Cost of Fundraising}$$

A benchmark value for a ratio similar to the "Cost of Fundraising" ratio, using Form 990 data and for organizations having only donations for their fundraising income (and without "netting" out fundraising expenses) is 8.2%.[54]

Offer assistance to the CEO and board in interpreting those reports and making resource allocation decisions related to fundraising. Fundraising analysis is most effective if it is relevant (your organization may need to hire a consultant or marketing agency to do a file audit to see if your annual campaign donors are segmented and grouped appropriately), measures of efficiency and cost effectiveness are clearly understood and reviewed quarterly, and benchmarks such as those provided above are used to gain context, perspective, and reprioritization of future fundraising goals.[55] Above all, help your management team and board understand the concept of return on fundraising investment.[56] We concur with the "Measuring Fundraising Effectiveness" consensus, that "Investments in effective fundraising strategies should be made not despite our need to fund our missions and work, but because of it."[57] Once you are making the contribution that finance staff can and should make to the development team, you are ready to embark on the final achievement: level 4.

**(e) LEVEL 4: CASH AND LIQUIDITY ANALYSIS AND PROJECTION.** Moving to the next level is not too difficult once the financial manager gains the global perspective we viewed in the fundraising involvement in level 3. The tasks we have in mind here are:

**1.** Refine the analysis of cash and liquidity that you did in levels 1, 2, and 3. Specifically:

- Look at your historical cash flow patterns to see which months have the highest net cash inflows (cash receipts minus cash disbursements), the lowest net cash inflows, and the longest period within a fiscal year for which you are in a "net borrowed position" (i.e., showing a bottom-line cash shortage that persists across several months).

- ○ List all of the sources of cash your organization has tapped in the past, and to what degree, to weather cash crunches.
- ○ Estimate the variability of net cash flow by statistical estimation of the range and standard deviation of your historical figures.[58]

**2.** Work through a review of factors that should cause your organization to have a higher or lower level of liquidity. (We offer a diagnostic questionnaire in Chapter 8 in our cash budgeting discussion.) Use the results of your analysis to determine if your target liquidity level is set too low or too high.

**3.** Develop a refined cash projection model by incorporating your findings from steps 1 and 2. Begin to use this model alongside your present forecasting method until you gain confidence in it. If funds are available, check into advanced forecasting computer software such as Forecast Pro (Business Forecast Systems; http://www.forecastpro.com/products/overview/which.htm).

**4.** Once you are comfortable with your model in step 3, go beyond the single-case model to develop scenarios. The ability to construct these is built in to Microsoft Excel. If you have the capability, or can arrange a college internship with a business student from a local college or university, also utilize simulation analysis to simulate your monthly cash budget.

**5.** Attempt to revisit and possibly "retune" your organization's target liquidity level based on your findings in steps 1 to 4 (refer to Chapter 2, Section 2.6, for further guidance).

**6.** Develop a prioritized listing of cash sources that your organization will tap when it faces its next anticipated or unanticipated cash shortfall. Indicate dollar amounts for your first source, second source, and so on. Be sure to contact your banks to prescreen them for availability of funds if you intend on using credit lines to cover some or all of a shortfall.

**7.** Strategize with your executive director (ED)/CEO and board on potential strategic alliance or merger partners that would be able to provide funding for expanded or new program initiatives that are the most "cash-intensive" of all your anticipated program offerings.

As for the optimal level of target liquidity, you will have to do the analysis yourself because we would not prescribe a universal benchmark (even one relative to revenues and support or assets). As a starting point, take a look at the low point for the target liquidity level in your fiscal year, which for many nonprofits is between mid-August to early October. Set a liquidity level for your peak season, probably early January, that is sufficient to cover your organization through the dry season. This is where your annual cash budget reevaluation, covered as part of level 1, is so helpful. Study past cash-flow patterns carefully and note when the cash crunches came as well as how much liquidity should have been held earlier in the year to prevent each cash crunch. The degree of flexibility your organization has in managing the budget (see Chapter 8) will also help you determine the size of your safety buffer of liquidity.

We now conclude our internal reporting coverage with brief discussions of monthly or quarterly reporting, daily or flash reporting, and a final reporting checklist.

***(i) Monthly or Quarterly Reports.*** Much of what we have to say here is redundant with the annual reporting cycle. Obviously, you will not have as much time to do thorough analysis of the monthly or quarterly data. And you will not need to do as much thinking about the impact of variances on next year's budget or the long-range financial plan. However, some boards meet monthly, especially for nonprofits with a localized scope of service provision. Others meet quarterly or semiannually, and they will require a concise and insightful presentation from you. At a minimum, provide:

- Budget reports (BVAs)
- Financial ratio analysis
- Statement of activities
- Updated cash forecast

Ideally, these reports are the same as the annual reports in scope and coverage, but practically they are more limited. Include:

- Variance analysis and the likelihood of meeting full-year budget target
- Capital campaign and deferred giving reports, if applicable, to give the bigger picture
- Target liquidity scorecard to show how you are doing in maintaining or reaching the target liquidity level

Graphs and explanatory comments are very much appreciated by report users. The ED/CEO may also ask for information regarding nonfinancial data (meals served, persons housed) that you will need to merge or have someone else merge with this financial data.

***(ii) Daily or Flash Reports.*** What kinds of information should be provided to you or others on a daily basis? Some reports that would serve a useful purpose on a daily or weekly basis include:

- Cash position, including bank deposits and withdrawals
- Donation report
- Receivables (accounts receivable and contributions receivable) and payables updates (use to give a better picture of near-future cash receipts and disbursements)

As with the monthly or quarterly reports, the ED/CEO or board may also request information regarding nonfinancial data (meals served, persons housed) that you will need to merge or have someone else merge with this financial data.

## 7.7 EXTERNAL REPORTS

**(a) STATEMENTS OF ACTIVITIES, FINANCIAL POSITION, AND CASH FLOWS.** Organizations are already well aware that they must provide financial reports adhering to the appropriate financial accounting standards. Because we already addressed internal uses of these statements earlier, we provide a brief review of the financial statements here. As noted in Chapter 6, Financial Accounting Standards Board (FASB) Statements 116 and 117, as updated by ASU 2016-14, guide the reporting for most of the organizations we are addressing in this book. As discussed, the three required statements for all types of 501(c)(3) organizations, per FASB 117, are the statement of activities, the statement of financial position (or statement of net assets), and the statement of cash flows. The intent and purpose of FASB 117 was to bring uniformity to the financial statements of nonprofits, mostly for the benefit of external users. Statement 117 and ASU 2016-14 also require voluntary health and welfare organizations and now other nonprofits to prepare an additional financial statement or disclosure that portrays expenses in natural classifications (e.g., salary expense), as well as the functional (program, fundraising, etc.) classifications required of all nonprofits. The two classes of contributions recognized in Statements 116 and 117, as modified by ASU 2016-14 (donor-restricted net assets and unrestricted net assets) should give readers a better idea of the organization's liquidity and financial flexibility.

**(b) FORM 990 AND OTHER PUBLIC REPORTS.** Briefly, your external reports should be accurate, timely, show the appropriate level of detail, and provide supplemental commentary if done in the context of an annual report. A survey of 75 large nonprofits finds that 21 of the 75, or 28% of the nonprofits, include reviewed or audited financial statements in their annual reports – which is considered a "best practice."[59] Graphs are also helpful, as we discussed earlier.

***(i) Forms 990, 990-EZ, 990-N, and 990-T.*** In addition to the three reports just mentioned, most sizable (gross receipts of $200,000 or more or total assets of $500,000 or more) non–church-related nonprofits are required to file a Form 990 (or if gross receipts during the year are between $50,000 and $200,000 *and* total assets at year-end are less than $500,000, Form 990-EZ) with the IRS each year. Because one in three paper-filed 990-EZ forms had errors, in early 2017 the IRS posted on its website a Form 990-EZ with "assistive pop-up information" for 29 fields that will enable filers to enter more accurate forms. If the organization normally has annual gross receipts of $50,000 or less and does not file Form 990 or Form 990-EZ it is required to submit Form 990-N (the so-called "e-Postcard," which only has eight items of data, most notably confirmation that the organization has annual gross receipts of $50,000 or less). If nonprofit organizations, including churches, have unrelated business income (gross income, or gross receipts minus cost of goods sold, of $1,000 or more) from a "regularly conducted unrelated trade or business (see Regulations section 1.6012-2(e)), they must also file Form 990-T with accompanying payment of taxes owed. It is generally advised that a nonprofit organization earn no more than 20 percent of its overall net income from the unrelated activity.[60] Information on filling out these forms out is beyond our scope, but extensive information is now available at the IRS website.[61]

***(ii) Donor Mailings and "Publicly Available" Reports.*** Another outside party that has great interest in your organization is the base of present and potential donors. Accountability is provided by the organization that supplies useful and accurate information to donors on a timely basis. Scandals and charity watchdog ratings (see Chapter 2) have had a positive effect on organizational accountability, but there are still some organizations that have not been forthcoming with their financial reports when requested. Form 990 should be made available *freely* to anyone interested. Clearly, many organizations in the nonprofit sector have room to improve in their reporting to donors.

**What should we tell donors?** Donors want to know about effectiveness (results attained with their money), efficiency (including waste and how you're eliminating it), and steps of progress (innovation, new initiatives, creative approaches). They are especially interested in high-level indicators such as the program expense ratio, discussed earlier. Because the results attained are sometimes difficult to quantify, they may use your financial data to infer effectiveness – much as a stockholder would look at a company's profits.

**Annual report.** There are five best practices for your annual report, according to Gordon, Khumawala, Kraut, and Neely.[62] First, include your complete audited (or reviewed or compiled) financial statements with both the notes and the audit firm's opinion letter as part of the report. Second, post the most recent five years of annual reports on your website in a place that is easy to locate. Third, your statement of financial position should be on a classified basis (showing subtotals for both current assets and current liabilities), appropriate subtotals should be shown on your statement of activities, you should include a statement of functional expenses (recognize that this information, shown in some form, is mandated starting in 2018 by ASU 2016-14), and you should show clearly the changes in year-over-year restricted net assets. Fourth, fully disclose all related-party and other transactions not clearly related to your organization's mission. Fifth, do include narrative discussion of achievements, but also show in tabular form relevant nonfinancial performance data, since your organization's whole story cannot be conveyed with just financial results.[63] Using pie charts or bar graphs to portray financial data to donors is very helpful. You may wish to refer back to Exhibit 5.8. The key idea is to focus on the main ideas, without overwhelming your nontechnical audience.

**Mail appeal "stuffer" reports.** Don't overlook the opportunity to use your mail appeals as an opportunity to showcase your main accomplishments and financial results. You may wish to include in your mailouts a pamphlet or single-page summary in which you present key elements of your financial policy, your sources of support, your budget situation (possibly including charts for both funds received and funds distributed), and your statement of financial accountability.

***(iii) State Requirements.*** State reporting requirements vary tremendously. Check with your secretary of state or attorney general's office for the specific requirements in your state and each state in which you raise funds. At a minimum, raising funds in a state generally requires that you register and receive authorization to solicit charitable funds with the appropriate state agency. We noted in Chapter 6 that a number of states require larger organizations to also provide audited financial statements if raising funds in those states. In some states, there are also requirements to file within counties.

***(iv) Granting Agency Reports.*** Again, granting agencies have specialized formats that they want to have used for grant requests and periodic follow-up reports. The key point is to follow the format and provide the necessary information, just as you would to donors in general.

One final caution on external reporting: Guard against the tendency to evaluate performance based only on easily measured input measures (hours worked) or output measures (clients served). Go the extra mile to define the appropriate measure(s) of effectiveness, then educate donors and grantors on how you will be presenting that information to them. Especially work on informing stakeholders on (1) why you are holding the liquidity level (or reserves) you have targeted—incorporating the specific qualitative and quantitative disclosures you are now providing (subsequent to ASU 2016-14 implementation; see Appendix 6A), (2) how your financial position is guided by board-approved policy, and (3) the rationale for all board-designated funds.

## 7.8 CONCLUSION

In this chapter, we have presented the major internal financial reports and how they might be compiled. We focused on usefulness and practicality. We recognized that although your reporting might now be geared primarily to the IRS or grantor needs, the greatest benefit comes to the organization that harnesses its financial reporting to management and board decision-making needs. External reports usually must be presented in GAAP format, but the same data can be used for internal, management reports that can and should be customized for internal use. The emphasis should be on budget variance analysis, financial ratio analysis, and constant vigilance over the target liquidity level. Once financial strains begin to appear, take steps to ward off the problems, and use stopgap measures when necessary. Begin benchmarking treasury management performance and processes now. Exhibit 7.13 presents a final reporting checklist that you may apply to your organization's reporting cycle, as provided by the Alliance for Nonprofit Management. A proactive approach to financial management is the best stance to take; be vigilant against surprises.

**WHAT REPORTS SHOULD WE PREPARE AND HOW OFTEN?**

The answer will depend on several factors, including the extent to which the organization is financially stable, the degree and extent to which the financial picture changes during the period, the availability of cash to meet financial obligations, the availability of staff or other professionals to prepare reports, etc.

A mid-sized human service organization in reasonably good shape financially might consider the following schedule of reports:

**MONTHLY REPORTS**

- ❒ Statement of Position (Balance Sheet)
- ❒ What is our financial health? Can we pay our bills?
- ❒ Statement of Activities (consolidated) showing budget to actual information
- ❒ What has been our overall financial performance this month and to date?
- ❒ Departmental Income and Expense Statement showing budget to actual information
- ❒ How does actual financial experience compare with the budget? Is specific action called for, such as limiting expenses in certain areas? Does experience indicate a change in the budget is appropriate?
- ❒ Narrative report including tax and financial highlights, important grants received, recommendations for short-term loans, or other means of managing cash flow
- ❒ An executive summary of financial highlights, analysis, and concerns.

**QUARTERLY REPORTS**

- ❒ Fundraising Reports; actuals versus projections for donations; status report on all foundation proposals.
- ❒ Are fundraising results on track?
- ❒ Cash-flow projections for the next six months
- ❒ Do we anticipate a cash surplus or shortage?
- ❒ Payroll tax reports
- ❒ Have payroll tax reports been submitted on time and tax deposits been made?
- ❒ Fee for service report showing number of fee-paying clients and revenue against projections
- ❒ Are we servicing approximately the same number and type of clients as we had anticipated? If not, what action or change is appropriate?

**Exhibit 7.13** Final Checklist of Items for Financial Reports

**ANNUAL REPORTS**

❒ Annual Federal forms, including 990 and Schedule A; State Reports
Has the organization fulfilled its reporting responsibilities to federal and state governments?

❒ Draft financial statements for year: Statement of Activities; Statement of Position; Income Statement for each program. Aggregated financial statements with narrative showing key trends
Focus: Internal management decision making. What was our financial performance over the past year? In what ways and for what reasons was performance different from the budget? What financial implications must be taken into account when planning the upcoming year?

❒ Audited financial statements for the entire organization, including Statement of Position, Statement of Activities, Statement of Cash Flows, Statement of Functional Expenses
Focus: External accountability and financial disclosure to funders and the public

❒ Management letter from the auditor
What recommendations has the auditor made related to the accounting system, internal controls, and financial planning?

*Source:* http://www.allianceonline.org/, FAQ/financial management/what financial statements 1.faq. Used by permission.

**Exhibit 7.13** Final Checklist of Items for Financial Reports (*continued*)

## Notes

1. Karl Weick, *Making Sense of the Organization* (Malden, MA: Blackwell Publishers, 2001).
2. E. B. Knauft, Renee A. Berger, and Sandra T. Gray, *Profiles of Excellence: Achieving Success in the Nonprofit Sector* (San Francisco: Jossey-Bass, 1991).
3. For more on these charity rating services, including a critical evaluation, see Stephanie Lowell, Brian Trelstad, and Bill Meehan, "The Ratings Game," *Stanford Social Innovation Review* (Summer 2005): 38–45. They argue that (1) the financial data upon which these reports are based needs to be improved, made more reliable, and evaluated in a more sophisticated manner; (2) the strength of the organization's reputation, management team, human resource function, and board should be included; and (3) the organization's social impact (mission achievement) should be quantified.
4. Peter Frumkin and Elizabeth K. Keating, "Diversification Reconsidered: The Risks and Rewards of Revenue Concentration," *Journal of Social Entrepreneurship* 2, no. 2 (2011): 157.
5. Richard S. Wasch, "Budgeting in Nonprofit Organizations," in *Handbook of Budgeting*, 3rd ed. (New York: John Wiley & Sons, 1993).
6. Elizabeth Keating and Peter Frumkin, "Reengineering Nonprofit Financial Accountability: Toward a More Reliable Foundation for Regulation," *Public Administration Review* 63, no. 1 (January 2003): 3–15.
7. Steve Zimmerman and Jan Masaoka, "Adding It All Up: Nonprofit CFO Study," (2013). Available at: http://blueavocado.org/content/adding-it-all-nonprofit-cfo-study. Accessed 1/15/2018.
8. From a study of 277 US churches by Christianity Today International. See "The Finances of Faith," *Church Business* (September 2005). Available online at: www.churchbusiness.com/articles/591feat10.html. Accessed 12/30/05.

9. An exception here is the case in which equity is issued for a for-profit subsidiary, which shows up as a financing flow for the consolidated organization.
10. Many of the ratios we present here were first applied to nonprofit organizations for benchmarking purposes by Chris Robinson. His study of 479 audited financial statements, done as part of his master's thesis at the University of San Francisco, is the finest we have seen because of its careful study of ratios and their interpretive value. Robinson was also controller at Partners International, a faith-based organization located in San Jose, CA, while conducting this study.
11. See John Zietlow, "A Financial Health Index for Achieving Nonprofit Financial Sustainability" (September 26, 2012). Available at SSRN: https://ssrn.com/abstract=2049022 or http://dx.doi.org/10.2139/ssrn.2049022.
12. Massachusetts nonprofit "industry average" financial ratio values are available online at the time of this writing at: https://www.tbf.org/~/media/TBFOrg/Files/Reports/PP2012Final.pdf.
13. Cited in Tom Courtney, "Financial Statement Ratio Standards For the California Nonprofit Rehabilitation Industry: An Empirical Study," Master's Thesis, The University of San Francisco (April 25, 1986): 31.
14. Overall, Robinson found faith-based organizations had a cash ratio of about 1.4; this implies that every $1 of near-term obligations was covered by $1.40 of cash or near-cash investments, which is quite good. The mean (average) and median (midpoint value, with one-half of the organizations having values above or below it) were quite different for some industry groups, however: Medians ranged from 0.72 for schools and colleges to 2.41 for foreign missions and social/medical agencies.
15. Susan Kenny Stevens, *All the Way to the Bank: Smart Nonprofit Money Management*, Second Edition (Minneapolis: Larson, Allen, Weishar and Company, LLP, 2002): 10.
16. Andres Ramirez, "Nonprofit Cash Holdings: Determinants and Implications, *Public Finance Review 39, Issue 5(2011)*: 666-667. We approximated these by (1) calculating Cash as Cash Reserve Ratio x Total Expenses, then dividing Cash by Total Assets for each industry, and (2) calculating Savings as Savings Ratio x Total Expenses, then dividing Savings by Total Assets for each industry. This was done to minimize the effect of several very large industry mean values. To avoid having healthcare organizations (26,180 observations) and educational organizations (20,822 observations) dominate our estimates based on 100,324 total observations, we figured industry means, then computed the median of these industry mean values. Finally, to best estimate the median of the combined ratios in a way that would not be affected by several large industry ratio values, we added the medians of the two ratios' industry means. We emphasize that this estimate is only an approximation of the true overall values.
17. The median ratio across the groups studied by Robinson was 0.09, which implies that these organizations could last only 33 days (0.09 × 365 days) if their revenues were cut off. Based on this indicator, liquidity is very poor. In his sample of faith-based organizations, only professional associations (0.19, or 69 days) had a median ratio value above 0.13 (47 days). Again, while we would not expect a complete shutdown of the revenue stream, we have evidence here of relatively low levels of liquidity. We add that, subsequent to the time of his study, many nonprofits are more liquidity-aware and have built their cash positions as they establish appropriate/adequate target liquidity levels.
18. ECCU, a lender and cash management service provider to faith-based nonprofits, advocates 2-3 months as a minimum cash reserve ratio for churches, private schools a minimum of 3-4 months at the beginning of the school year, and 3-6 months as a minimum for parachurch ministries. ECCU gives a strong rationale for the different levels. ECCU, "Cash reserves: How much is enough? White Paper, n.d., page 3. Available at: https://www.eccu.org/community/ministryresources/liquidity-how-much-is-enough. Accessed: 1/16/2018. ECCU also counsels nonprofits to use the cash reserve ratio, rather than the cash, cash and savings, or target liquidity level in donor communications: "… when you give financial updates, rather than communicating that there is, for example, $750,000 in reserve—which can seem like a great deal of money—it's better to say, "We have 90 days of expenses in reserve." This communication helps donors understand that without their continued giving, expenses would not be paid after 90 days." Id., p. 3.

19. Elizabeth Keating and Geeta Pradhan, *Passion & Purpose Revisited: Massachusetts Nonprofits and the Last Decade's Financial Roller Coaster* (Boston: The Boston Foundation, 2012): 50–52.
20. Id. Note #16.
21. Margaret F. Sloan, Cleopatra Charles, and Mirae Kim, "Nonprofit Leader Perceptions of Operating Reserves and Their Substitutes," *Nonprofit Management & Leadership* 26, no. 4 (Summer 2016): 417–433.
22. Id. Note #19.
23. Teresa P. Gordon, Mary Fischer, Janet Greenlee, and Elizabeth K. Keating, "Warning Signs: Nonprofit Insolvency Indicators," *International Research Journal of Applied Finance* 4, no. 3 (March 2013): 343–378.
24. Elizabeth K. Keating, Mary Fischer, Teresa P. Gordon, and Janet S. Greenlee, "Assessing Financial Vulnerability in the Nonprofit Sector," KSG Working Paper No. RWP05-002 (Harvard University), January 2005. The overall average for the current ratio in that study was 4.08, but the overall median value was 3.09 (some high numbers skewed the average). The sector is important here: In Robinson's study, the church median current ratio was 0.97 but denominations/denominational groups had a median value of 10.85. Most sectors he studied had medians of 2 or 3, which corresponds closely with what we see in business enterprises. The very large value for denominations is partly linked to inventory held for churches and outreach ministries, but it also reflects the pooling of liquid assets as funds are "upstreamed" from member congregations. These funds are held longer than they should be, in some cases, prior to being disbursed or invested in pensions or buildings.
25. Jeanne Bell Peters and Elizabeth Schaffer, *Financial Leadership for Nonprofit Executives* (Saint Paul, MN: Fieldstone Alliance, 2005): 62.
26. Id. Note #24. Robinson's study finds the overall mean and median for the asset ratio of about 0.35, meaning that 35 percent of the assets were in the current asset category, with the remainder of 65 percent in long-term assets. The organization's industry matters greatly: Churches had a median current asset investment of only 6 percent of total assets and camps and conference centers only 14 percent, while foreign missions had 51 percent, denominations had 62 percent, and professional associations had 78 percent in short-term assets.
27. Keating and Pradhan, 21.
28. See Chapter 3 of John Zietlow, Matthew Hill and Terry Maness, *Short-Term Financial Management*, 5th ed. (San Diego: Cognella, 2017). Lambda was developed by Kenneth Cogger and Gary Emery; further information and interpretation of this measure are provided in the referenced chapter.
29. AICPA, *Audit & Accounting Guide: Not-for-Profit Entities* (New York: AICPA, 2017): 618.
30. This range approach to estimating standard deviation assumes a normal distribution, or the familiar bell-shaped curve, for your organization's operating cash flows. Since your cash flows are most likely not normally distributed, this estimate must be viewed as a rough approximation.
31. We calculated these by using the NORMSDIST function built into Excel: Probability of cash shortfall = [1 – NORMSTDIST(TLLL)]. For $TLLL_1$, this gives us: Probability of cash shortfall = [1 – NORMSDIST(6.53)] = [1 – 1] = 0.00. Use the percent format in Excel to turn this into a percent, which gives us 0.00% chance of running out of cash in this case.
32. Raymond Fisman and R. Glenn Hubbard, "The Role of Nonprofit Endowments," in *The Governance of Not-for-Profit Organizations*, ed. E. Glaeser (Chicago: University of Chicago Press, 2003).
33. Id. Note #16.
34. Id. Note #23. George Morris, Dylan Roberts, John MacIntosh, and Adrian Bordone (in "The Financial Health of the United States Nonprofit Sector" (January 2018): 5) indicates philanthropic support by industry and also notes that 7-8% of nonprofits have a debt ratio of over 100%, 30% of nonprofits have a current ratio of less than 1.0, 30% of nonprofits have a negative three-year net operating ratio, and half of nonprofits have less than six months of cash (Source: learn.guidestar.org; Accessed 2/14/2018).
35. Consult the Nonprofit Finance Fund survey data for recent statistics on surpluses and deficits (www.nff.org). Robinson's data indicate that regardless of espoused objectives, most faith-based organizations were running surpluses. The median was $16,000, with only one

subgroup (professional associations) running a deficit (median loss of $3,000). Organizational types running surpluses were publishers and radio/TV ($2,000), domestic missions ($5,000), foreign missions ($10,000), and churches ($16,000). At the high end, again using median values, were social/medical ($34,000), camps/conference centers ($40,000), denominations ($46,000), and schools/colleges ($75,000). One caution: At the time of Robinson's study many organizations were not depreciating assets, and surpluses would be in some cases deficits were restatements made.

36. Id. Note #24.
37. Id. Note #23.
38. Id.
39. The overall median for FBOs is 75 percent for program expenses and 25 percent for support services. The highest program percentages were achieved by denominations (81 percent) and foreign missions (79 percent); the lowest were camps/conference centers (71 percent) and social/medical (73 percent). Camps and conference centers battle the limited-year phenomenon, in which they generally receive revenues and provide programs for only part of the year, and yet have administrative and fundraising expenses pretty much year-around.
40. Jesse D. Lecy and Elizabeth A. M. Searing, "Anatomy of the Nonprofit Starvation Cycle: An Analysis of Falling Overhead Ratios in the Nonprofit Sector," *Nonprofit and Voluntary Sector Quarterly* 44, no. 3 (2015): 539–563.
41. These studies are summarized in Shena R. Ashley and David M. Van Slyke, "The Influence of Administrative Cost Ratios on State Government Grant Allocations to Nonprofits," *Public Administration Review* 20, no. 20 (Special Issue, 2012): s47–s55. Ashley and Van Slyke provide results of the study of government grant allocations in that paper.
42. This bias, which the American Institute of Philanthropy (AIP) adjusts for in its calculations, may have a significant effect. See "AIP's Method Better Judges Charity Efficiency: Why Oxfam Compares Better and UNICEF Worse," 2005. Available online at AIP's website: www.charitywatch.org/articles/airpmethod.html. Accessed 11/5/2005.
43. Id. Note #24.
44. Id. Note #23.
45. See Chuck McLean and Suzanne E. Coffman, "Why Ratios Aren't the Last Word" (June 2004). Available online at: https://trust.guidestar.org/why-ratios-arent-the-last-word. Accessed 5/31/2017.
46. For example, organizations may or may not separate out operating and nonoperating activities in their SA presentation, allowing them to report a measure of operating income. See a study of private college practices in this regard in Mary Fischer, Teresa P. Gordon, Janet Greenlee, and Elizabeth K. Keating, "Measuring Operations: An Analysis of U.S. Private Colleges and Universities' Financial Statements," *Financial Accountability & Management* 20 (May 2004): 129–151. The authors noted that: "Among the schools that chose to display operating income and operating revenue we found wide differences in definition and computation" (p. 147). We believe that this statement generalizes well to all nonprofits even today.
47. See the pamphlet "The Ministry of Fund Raising," by Whitney Kuniholm, pp. 39–47; it is published by Prison Fellowship, P.O. Box 17500, Washington, DC, 20041-0500.
48. Your organization may already be there without consciously planning such a strategy. Does it have both (1) cash reserves significantly greater than next year's anticipated operating expenses (and will you still have it at the end of the fiscal year) and (2) a policy that allows the organization to draw down cash reserves to some minimum level in order to fund operations? If so, it is in the same financial position as an organization that consciously adopts this forward-year annual campaign strategy.
49. We gratefully acknowledge the assistance of Philip M. Purcell, J.D., Director of Planned Giving and Development Counsel, Rose-Hulman Institute of Technology, Terre Haute, IN, on this section. A very helpful beginner's guide for those wishing to conduct self-assessment of fundraising is *Fundraising Cost Effectiveness: A Self-Assessment Workbook*, by James M. Greenfield (New York: John Wiley & Sons, 1996). Information on fundraising efficiency percentages is available in James M. Greenfield, *Fund Raising: Evaluating and Managing the Fund Development Process* (AFP/Wiley Fund Development Series), 2nd ed. (Hoboken, NJ: John Wiley & Sons, 2001); James M. Greenfield, ed., *The Nonprofit Handbook: Fund Raising*

(AFP/Wiley Fund Development Series), 3rd ed. (Hoboken, NJ: John Wiley & Sons, 2001); and James M. Greenfield, ed., *The Nonprofit Handbook: Fund-Raising 2003 Cumulative Supplement* (Hoboken, NJ: John Wiley & Sons, 2003).

50. Greenfield, *Fundraising Cost Effectiveness*, 676.
51. Ellen Ryan, "The Costs of Raising a Dollar," CASE *Currents* (September 1990): 58–62.
52. Id., 58.
53. BoardSource, "Measuring Fundraising Effectiveness." Downloaded from https://boardsource.org/research-critical-issues/measuring-fundraising-effectiveness/. Accessed: 10/31/2017.
54. Frumkin and Elizabeth K. Keating, "Diversification Reconsidered: The Risks and Rewards of Revenue Concentration," *Journal of Social Entrepreneurship* 2, Issue #2 (2011): 157.
55. From Mary Beth McIntyre of the Target Analysis Group; cited in "Benchmarking … Understanding how all data works together," NPT Instant Fundraising e-newsletter, January 5, 2006. McIntyre suggests that organizations compare their fundraising results to industrywide resources available from Giving USA, Target Analysis Group National Index, Paradyz Matera Performance Watch, Campbell Rinker, and industry surveys.
56. For more on this, see Adrian Sargeant, Elaine Jay, and Stephen Lee, "Benchmarking Charity Performance: Returns From Direct Marketing In Fundraising," *International Journal of Nonprofit and Public Sector Marketing*, 16, Issue 1 (2006); 77–94.
57. Id. Note #53.
58. Once you have your daily cash receipts and cash disbursements in a financial spreadsheet, use the statistics functions to do this for you.
59. Teresa P. Gordon, Saleha B. Khumawala, Marla Kraut, and Daniel G. Neely, "Five dimensions of effectiveness for nonprofit annual reports," *Nonprofit Management & Leadership* 21(2, Winter 2010): 209–228.
60. Judah I. Kupfer, "Does My Nonprofit Need to Pay Tax? Understanding Unrelated Business Income Tax," NonProfit Quarterly (December 2011), https://nonprofitquarterly.org/2011/12/25/does-my-nonprofit-need-to-pay-tax-understanding-unrelated-business-income-tax/. Accessed 1/17/2018.
61. Instructions for Form 990 and Form 990-EZ are located at: https://www.irs.gov/uac/about-form-990 and https://www.irs.gov/uac/about-form-990ez.
62. Id. Note #59, 225.
63. Id.

APPENDIX **7A**

# EXAMPLE FINANCIAL RATIO CALCULATIONS

In this appendix we show how to calculate each financial ratio, provide the financial ratio sources for each ratio's numerator and denominator, and then show you how we would interpret the ratio's value and its year-over-year trend. We illustrate using a publicly-available set of financial statements from Habitat for Humanity – Durham (N.C.) Inc.

The first panel shows the Liquidity Ratios.

**Sample Ratio Calculations**

**Habitat for Humanity, Durham, Inc.**
**Sample Ratio Calculations (Appendix 7A)** **Liquidity Ratios**

*Here are snapshots of the worksheet in which we calculated the financial ratios from Chapter 7 for Habitat for Humanity - Durham's financial statements.*

| | 2015 | Interpretive Comments for 2015 | 2014 |
|---|---|---|---|
| **Liquidity Ratios** | | | |
| **Cash Ratio** | | The organization can cover from | |
| Cash & Equivalents/Current Liabilities | | cash the upcoming year's known obligations 1.6 times. | |
| Cash & Equivalents | 1,029,448 | Trend is negative regarding liquidity. | 1,092,823 |
| Current Liabilities | 627,296 | Cash and equivalents are from SFP; | 503,656 |
| Ratio | 1.64 | Current Liabilities also from SFP. | 2.17 |
| **Cash Reserve Ratio** | | More conservative measure than | |
| Cash & Equivalents/Total Annual Expenses | | cash ratio. We can cover only 18% (2.2 months) of the year's | |
| Cash & Equivalents | 1,029,448 | expenses with cash. | 1,092,823 |
| Annual Expenses (from SA) | 5,619,670 | Trend is negative regarding liquidity. | 4,791,740 |
| Ratio | 0.18 | Cash and equivalents are from SFP; | 0.23 |
| % | 18.32% | Annual Expenses, Total, from SA. | 22.81% |
| **Current Ratio** | | The organization can cover current liabilities 6 times over with current | |
| Current Assets/Current Liabilities | | assets. | |
| Current Assets | 3,911,106 | Trend is neutral for liquidity, but level ample. | 3,110,356 |
| Current Liabilities | 627,296 | Current Assets are from SFP; | 503,656 |
| Ratio | 6.23 | Current Liabilities also from SFP. | 6.18 |

| | 2015 | Interpretive Comments for 2015 | 2014 |
|---|---|---|---|
| **Asset Ratio** | | This reveals that nearly 27% of assets are short-term (working capital). | |
| Current Assets/Total Assets | | | |
| Current Assets | 3,911,106 | Trend is positive for liquidity. | 3,110,356 |
| Total Assets | 14,606,934 | Current Assets are from SFP; | 13,952,145 |
| Ratio | 26.78% | Total Assets also from SFP. | 22.29% |
| **Target Liquidity Level** | | This would be compared to a management target for liquidity, which is not evident in the statements or the notes. | |
| Cash & Equiv. + ST Investments + Line of Credit- Short-Term Loans | | | |
| Cash & Equivalents | 1,029,448 | Trend is slightly negative; might subtract other near-term financial obligations: capital leases and long-term debt due this year. | 1,092,823 |
| ST Investments | 0 | | 0 |
| Line of Credit (Notes) | 700,000 | | 700,000 |
| Short-Term Loans | 150,000 | All items from SFP or Notes to Fin. Statements. | 161,587 |
| Target Liquidity Level | $ 1,579,448 | Absent policy, this is implied target liquidity. | $ 1,631,236 |

The second panel shows the Funding Ratios.

**Sample Ratio Calculations**

**Habitat for Humanity, Durham, Inc.**
**Sample Ratio Calculations (Appendix 7A)** **Funding Ratios**

*Here are snapshots of the worksheet in which we calculated the financial ratios from Chapter 7 for Habitat for Humanity - Durham's financial statements.*

| | 2015 | Interpretive Comments for 2015 | 2014 |
|---|---|---|---|
| **Funding Ratios** | | | |
| **Contribution Ratio** | | All information is from SA. Nearly 32% of rev. & support is derived from contributions. | |
| Total Contributed Revenue/Total Revenue | | | |
| Contributions | 1,973,298 | Trend for funding slightly positive (bus. model). | 1,923,473 |
| Total Revenue | 6,213,437 | Could also do "contribs. + grants ratio." | 6,402,514 |
| Ratio | 31.76% | The higher the %, the higher the risk; under 40% is considered good (less risky). | 30.04% |
| **Debt Ratio** | | | |
| Total Liabilities/Total Assets | | All information from the SFP. This indicates that 36% of assets are | |
| Total Liabilities | 5,278,735 | financed by debt and conversely that 64% of assets are financed by | 5,217,713 |
| Total Assets | 14,606,934 | net assets (a healthy mix). | 13,952,145 |
| Ratio | 36.14% | Trend slightly positive for funding. | 37.40% |

The third panel shows the Operating Ratios.

**Sample Ratio Calculations**

**Habitat for Humanity, Durham, Inc.**
**Sample Ratio Calculations (Appendix 7A)** **Operating Ratios**

*Here are snapshots of the worksheet in which we calculated the financial ratios from Chapter 7 for Habitat for Humanity - Durham's financial statements.*

| | 2015 | Interpretive Comments for 2015 | 2014 |
|---|---|---|---|
| **Operating Ratios** | | | |

*Note: Other than the return ratio (which is analogous to total asset turnover in the business world) and net asset reserve ratio, the numerator and denominator for each ratio comes from the SA.*

| | 2015 | Interpretive Comments for 2015 | 2014 |
|---|---|---|---|
| **Return Ratio** | | | |
| Total Revenue/Total Assets | | The organization brings in $0.43 | |
| Total Revenue | 6,213,437 | for every $1.00 in assets. The | 6,402,514 |
| Total Assets | 14,606,934 | higher the ratio, the more efficient, given the asset base. | 13,952,145 |
| Ratio | 0.43 | Trend slightly negative for operating efficiency. | 0.46 |
| **Net Surplus (Deficit)** | | Taken from SA. The surplus is then brought to the SFP, adding to or | |
| Total Revenue-Total Expenses | | reducing | |
| Total Revenue | 6,213,437 | Net Assets. Note that while overall net assets increased, unrestric. net | 6,402,514 |
| Total Expenses | 5,619,670 | assets decreased slightly in 2015. | 4,791,740 |
| Net Surplus | $ 593,767 | Trend negative for cost coverage. | $ 1,610,774 |
| **Net Operating Ratio** | | This is similar to profit margin on sales in a business. The organization made 9.6 cents per | |
| Net Surplus/Total Revenue | | $1.00 in revenue in 2015, which is | |
| Net Surplus | 593,767 | good. | 1,610,774 |
| Total Revenue | 6,213,437 | The trend is concerning; we would guess at 2014 being unusual, and | 6,402,514 |
| Ratio | 9.56% | 9.56% is good target. | 25.16% |
| **Net Asset Reserve Ratio** | | | |
| *Note: Net Assets are taken from the SFP* | | | |
| Net Assets/Total Expenses | | | |
| Net Assets | 9,328,199 | This shows that the organization has 165% of expenses covered by | 8,734,432 |
| Total Expenses | 5,619,670 | accumulated surplus. | 4,791,740 |
| Ratio | 1.66 | The question is: What is truly spendable? | 1.82 |
| % | 165.99% | Trend is slightly negative, but see cash ratios. | 182.28% |

| | 2015 | Interpretive Comments for 2015 | 2014 |
|---|---|---|---|
| **Program Expense Ratio** | | | |
| *Note: This is a visible ratio. The higher the percentage, the more funds are being expended on program.* | | | |
| *Higher values are desired here although if the values are too high, the organization might not be spending enough on capacity development.* | | | |
| Program Expenses/Total Expenses | | | |
| Program Expenses | 4,957,686 | Often compared to 65% or 75% as a minimum threshold. Leads to | 4,129,999 |
| Total Expenses | 5,619,670 | "starvation cycle" if too high. | 4,791,740 |
| Ratio | 88.22% | Trend seen by some as good. | 86.19% |
| **Support Service Expense Ratio** | | | |
| *Note: This ratio provides insight into how much the organization spends on management and general and fundraising.* | | | |
| 100% minus program expense ratio | 11.78% | Trend good only if previously overspending for management or fundraising/member development. | 13.81% |

The fourth panel shows an alternative presentation format for all of the ratios, showing how you might present the data to your management team or to a finance committee or board committee in order to help the committee members assess the ratio trend and significance. We typically use a +/− 10% change as a sign of a significant change.

**Financial Ratio Analysis Worksheet**

*Habitat for Humanity - Durham - 2015 and 2014*

| RATIOS: | 2015 | 2014 | Absolute Change | Percent Change |
|---|---|---|---|---|
| *Liquidity* | | | | |
| Cash Ratio | 1.64 | 2.17 | −0.53 | −24.37% |
| Cash Reserve Ratio | 0.18 | 0.23 | −0.04 | −19.68% |
| Current Ratio | 6.23 | 6.18 | 0.06 | 0.96% |
| Asset Ratio | 0.27 | 0.22 | 0.04 | 20.11% |
| TLL | $ 1,579,448 | $ 1,631,236 | $ (51,788) | −3.17% |
| *Memo: Credit Line Available, Total* | *700,000* | *700,000* | *0.00* | *0.00%* |
| TLL - Modified | $ 1,501,939 | $ 1,555,533 | $ (48,594) | −3.13% |
| *Memo: Other ST Financial Obligations* | *77,509* | *80,703* | *$ (3,194)* | *−3.96%* |
| *Funding* | | | | |
| Contributions Ratio | 31.76% | 30.04% | 1.72% | 5.71% |
| *Memo: Contributions & Grants Ratio* | *34.36%* | *33.34%* | *1.03%* | *3.07%* |
| Debt Ratio | 36.14% | 37.40% | −1.26% | −3.37% |
| *Operating* | | | | |
| Return Ratio | 42.54% | 45.89% | −3.35% | −7.30% |
| Net Surplus / (Deficit) | $ 593,767 | $ (1,610,774) | $ (1,017,007) | −63.14% |
| Net Operating Ratio | 9.56% | 25.16% | −15.60% | −62.02% |
| Net Asset Reserve Ratio | 1.66 | 1.82 | −0.16 | −8.94% |
| Program Expense Ratio | 88.22% | 86.19% | 2.03% | 2.36% |
| Support Service Expense Ratio | 11.78% | 13.81% | −2.03% | −14.70% |

APPENDIX **7B**

# ADDITIONAL FINANCIAL RATIOS

We presented our core financial ratios in Chapter 7. However, there are additional ratios that you may wish to calculate to better evaluate the financial position and operating results of your organization. Or, you may have an earned income venture or for-profit subsidiary, and you wish to apply some business ratios to that venture's or subsidiary's operating results. We will present some liquidity and operating ratios that are commonly used by businesses, and many of these could be applied by health care organizations, colleges, and the for-profit subsidiaries of other nonprofits. We then look at some ratios calculated by charity rating agencies and information providers (Charity Navigator and GuideStar). We follow this with some ratios making use of the information in the Statement of Cash Flows. We then profile some Form 990 ratios that have benchmark data available for your comparison. Finally, we present some of our own faith-based organization benchmark data compiled from audited financials.

## 7B.1 BUSINESS LIQUIDITY, FUNDING, AND OPERATING RATIOS

**(a) LIQUIDITY RATIOS.** We briefly list average collection period (ACP), inventory conversion period (ICP), average payment period (APP), operating cycle (OC), and the cash conversion period (CCP) here. For more details, see Chapters 2 and 3 of Zietlow, Hill, and Maness, *Short-Term Financial Management*, Fifth Edition (consult the Notes following Chapter 7 for full citation).

ICP (also called Days Inventory Held, or DIH) measures the length of time it takes to convert your inventory into sales. Again, shorter is better, because inventories also tie up your cash. The denominator has Cost of Goods Sold, not sales, because inventories are accounted for at cost. To use sales there would also distort the measurement because it includes the mark-up added to your cost.

$$\text{ICP} = (\text{Inventory} \times 365)/\text{Cost of goods sold}$$

ACP (also called Day Sales Outstanding, or DSO) measures the length of time it takes to collect credit sales. You want this to be as close to your offered credit period (commonly 30 days) as possible, and higher numbers tie up more of your cash.

$$\text{ACP} = (\text{Accounts receivable} \times 365)/\text{Total sales}$$

Your operating cycle (OC) is the sum of the elapsed times for converting inventories to sales and then collecting on those sales (so that you once again have cash):

$$\text{OC} = \text{ICP} + \text{ACP}$$

Fortunately, you are not out-of-pocket for cash that long, normally. This is because you buy inventories on credit, normally. We adjust for this by first calculating the average payment period (APP), then subtracting that from the operating cycle to get the cash conversion period.

APP (also called Days Payable Outstanding, or DPO) measures the length of time it takes to pay for your credit purchases. You want this to be as close to your suppliers' offered credit periods (commonly 30 days) as possible, but some businesses stretch payables unethically because higher numbers tie up less of their cash as it ties up more of their suppliers' cash.

$$\text{APP} = (\text{Accounts payable} \times 365)/\text{Total purchases}$$

Many times purchases data are not available to an external analyst, and cost of goods sold is used in the denominator instead.

We may now calculate the cash conversion period (CCP), which shows us for how long the organization has its cash tied up in its operations:

$$\text{CCP} = \text{OC} - \text{APP}$$

or

$$\text{CCP} = \text{ICP} + \text{ACP} - \text{APP}$$

Illustrating, if ICP is 70 days, ACP is 45 days, and APP is 30 days, CCP would be:

$$\text{CCP} = 70 + 45 - 30$$

$$\text{CCP} = 85 \text{ days}$$

We can use this information to estimate minimum operating cash (MOC; a misnomer since we are really estimating "working capital" here) for an organization. First, we calculate cash turnover (CT), which measures how many times per year cash cycles through the organization:

$$\text{CT} = 365/\text{CCP}$$

In our example, since CCP = 85 days:

$$\text{CT} = 365/85$$

$$\text{CT} = 4.29$$

Think of this as similar to inventory turnover, but the turnover is in your inventory of cash. Some organizations estimate their minimum cash by taking some percent of their sales (for example, if set to 8% of sales, and sales are $2 million annually, minimum cash = $160,000 = .08 × $2,000,000). Our CT data, coupled with annual cash expenses, gives us another way to estimate minimum operations-related cash, or MOC (you would hold cash for other reasons, as well, as noted in Chapter 2):

$$\text{MOC} = \text{Annual cash expenses}/\text{CT}$$

If annual cash expenses are $1,600,000, using our CT of 4.29, we get MOC:

$$\text{MOC} = \$1{,}600{,}000/4.29$$

$$\text{MOC} = \$372{,}960.37$$

To monetize the effect of this on your annual interest expense, multiply this by your annual cost of capital (this concept is covered in Chapter 10). Assuming your cost of long-term funds is 10%, or 0.10 in decimal form, we get an annual interest expense related to our cash conversion period of $37,296:

$$\text{Annual interest expense of MOC} = \text{MOC} \times \text{Annual cost of capital}$$

$$\text{Annual interest expense of MOC} = \$372{,}960.37 \times 0.10$$

$$\text{Annual interest expense of MOC} = \$37{,}296$$

If we could convert our inventories more quickly, collect our receivables more quickly, or renegotiate more favorable payment terms, we could reduce our CCP, increase our CT, reduce our MOC, and thereby reduce the interest expense related to our operating cycle. When the CCP increases, we get the opposite effect, as shown in the following chain reaction diagram:

***Longer Cash Cycle Ties Up Funds, Lowers Interest Income***


**(b) FUNDING RATIOS.** The two funding ratios we present here are times interest earned (TIE) and the current liquidity index (CLI). Both ratios reflect on our organization's ability to cover its fixed, financing-related obligations. Higher ratio values are better as they reflect a greater ability to cover those obligations:

$$\text{TIE} = \text{Earnings before interest and taxes}/\text{Interest expense}$$

$$\text{CLI} = \frac{(\text{Cash and equivalents} + \text{Short-term investments} + \text{Projected OCF})}{(\text{Short-term notes payable} + \text{Current portion of long-term debt})}$$

**(c) OPERATING RATIOS.** Several profitability ratios that businesses use are return on assets (ROA), return on invested capital (ROIC), and return on equity (ROE). Each measures profits (or what nonprofits call net revenue, typically measured by change in net assets, which may be adjusted by the analyst) relative to an important variable: assets invested in the business (ROA), long-term capital invested in the business (ROIC), or stockholder equity invested in the business (ROE). Higher values show greater profitability, and this is positive so long as a company is not underinvesting in training, advertising, new product development, and other forms of research and development:

$$\text{ROA} = \text{Net income}/\text{Total assets}$$

$$\text{ROIC} = \text{Net income}/(\text{Long-term debt} + \text{Stockholders' equity})$$

$$\text{ROE} = \text{Net income}/(\text{Stockholders' equity})$$

## 7B.2 OTHER RATIOS USED BY CHARITY RATING SERVICES

**(a) CHARITY NAVIGATOR.** Charity Navigator (CN) assigns scores to charities' financial condition based on numerous financial ratios. The pros are: (1) great ratios selection; (2) great scaling of ratio values based both on logic and on the industry (e.g., daycare centers have a different scaling than food banks); (3) its reports draw from a database of peer data that provides good benchmark data (although charities, like businesses, are sometimes diversified and therefore not purely operating in one industry, so the benchmark may be partly inapplicable for comparison purposes); and (4) its scoring system rewards, rather than penalizes, organizations for holding higher cash reserves (see our discussion of liquidity and CN in Chapter 2).

The primary con is: CN's reports and scoring are based only on one year of data, and this is based on the organization's most recently filed, sometimes inaccurate (and non-GAAP), Form 990.

Especially helpful for us in our focus on liquidity, solvency, and financial flexibility is Charity Navigator's focus on "organizational capacity," which it measures with three ratios:

1. Average annual growth of program expenses for the most recent four years.
    - This is what many would call a compound annual growth rate of program expenses.
    - You may calculate this with a financial calculator or in Excel or using one of the free Internet online calculators.
2. Debt ratio.
3. Working capital ratio.

    *Numerator:* (Unrestricted Net Assets + Temporarily Restricted Net Assets).

    *Denominator:* Average Total expenses, including payments to affiliates, for the last three years.

Details on Charity Navigator's methodology are available at its website (https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=35).

**(b) GUIDESTAR.** GuideStar, an information provider that gives ratios and other financial data, has revamped its financial ratio presentation and now markets a Financial SCAN$^{SM}$ report that is jointly developed with the Nonprofit Finance Fund. This is an outstanding resource, as it includes (1) a "Financial Health Dashboard" that gives some financial data and financial ratio trend data for up to five years, (2) a "Peer Comparison Dashboard," which enables the user to search for, select, and then compare the financial data and ratios from up to five peer nonprofits with its own data and ratios, and (3) a "Graphical Analysis" that includes 13 multi-year graphs as well as brief interpretations of the line and bar graph trends in the organization's finances.

GuideStar presents the following ratios, a number of which we presented in Chapter 7:

Growth rate of Total Revenue, Total Expenses, and Personnel
Each major revenue source as a % of Total Revenue & Support
Change in Unrestricted Net Assets, both in $ and as a % of Total Expenses
Accumulated Depreciation as a % of Land, Buildings, and Equipment
Debt Ratio

Months of Expenses held in Cash
Months of Expenses held in Cash and Investments
Months of Expenses held in Estimated Unrestricted Liquid Net Assets

These ratios are not only available for a single organization but are also compiled if you do a "Peer Comparison Dashboard" report. In the "Graphical Analysis" report, there are four bars provided in a bar graph for each of the most recent five years: Cash, Receivables, Land, Buildings & Equipment (LBE), and Investments and other. In this way one can see at a glance how the organization's asset composition has changed over those five years. Subscription options and fees as well as a brief video explaining the Financial $\text{SCAN}_{\text{SM}}$ product offering are available at the GuideStar website (https://learn.guidestar.org/products/nonprofit-data-solutions/financial-scan).

## 7B.3 STATEMENT OF CASH FLOWS RATIOS

Notice that almost all of the other ratios we present in Chapter 7 and the appendixes take information from the Statement of Activities and Statement of Financial Position, but not the Statement of Cash Flows (SCF). The ratios in this section take information from the SCF as well as the SA and SFP, and are helpful for lenders, rating agencies, and other analysts doing evaluations of businesses. Some of these ratios, such as the OCF ratio, will be helpful for all organizations. The others may be helpful in your evaluation of health care and education nonprofits, as well as earned income ventures. (These are presented by John R. Mills and Jeanne H. Yamamura, in "The Power of Cash Flow Ratios," *Journal of Accountancy* (October 1998).)

**Liquidity and Funding Ratios**

**1.** Operating cash flow (OCF) ratio:

$$\text{OCF ratio} = \text{OCF}/\text{Current liabilities}$$

where OCF is taken off of the SCF (the subtotal that you will see at the end of the first category of items on the organization's SCF). Current liabilities are on the SFP, but many nonprofits do not classify their SFP, so take A/P + Accrued expenses + Deferred revenue + Short-term portion of N/P to get CL in this case. Compare to similar organizations.

**2.** Funds flow coverage (FFC) ratio:

$$\text{FFC ratio} = \text{EBITDA}/(\text{Interest expense} + \text{Debt repayment})$$

EBITDA is earnings (or change in net assets) before interest, taxes, depreciation, and amortization. So add back the latter items to the change in net assets to arrive at EBITDA. Interest expense should be the cash amount of interest paid (which may be provided as a supplemental disclosure below the SCF) and debt repayment is the sum of short-term debt and any current maturities of long-term debt (which may represent bonds issued 19 years ago with an original 20-year maturity, so they are now within one year of repayment).

In our presentation here, we have modified the original FFC ratio for nonprofits' tax-exempt status. Done for a business, this ratio has both debt repayment and preferred dividends in the denominator, and each must be divided by (1 − marginal tax rate) to "gross up" the amount to enable the organization to both pay taxes and meet the financial obligation.

Rationale for this ratio, relative to SCF ratio: OCF has interest and taxes already subtracted out; EBITDA does not. Compare the calculated value to that of similar organizations.

**3.** Cash interest coverage ratio:

$$\text{Cash interest coverage ratio} = (\text{OCF} + \text{Interest paid} + \text{Taxes paid})/\text{Interest paid}$$

Again, use cash interest paid and if the ratio value is less than 1.0, there is an immediate risk of potential default on debt obligations.

**4.** Cash current debt coverage ratio:

$$\text{Cash current debt coverage ratio} = (\text{OCF} - \text{Cash dividends})/\text{Current debt}$$

where, since nonprofits do not have dividends, the numerator is just OCF, and the denominator is all debt maturing within one year, just as in the funds flow coverage ratio (#2 above). Higher ratios are better, but an appropriate minimum value depends on the industry (health care would differ from education, for example).

**Measures of Ongoing Financial Health**

**5.** Capital expenditure ratio:

$$\text{Capital expenditure ratio} = \text{OCF}/\text{Capital expenditures}$$

This ratio is similar to our OCF/ICF measure in Chapter 7. It separates out from ICF the line item representing additional investment in property, plant, and equipment. If the ratio value is greater than 1.0, the organization has enough cash to cover all capital expenditures and has money left over to meet debt obligations.

**6.** Total debt (cash flow to total debt) ratio:

$$\text{Total debt ratio} = \text{OCF}/\text{Total debt}$$

where total debt includes all short-term and long-term arranged debt. This gives the amount of time it would take to pay off all debt from the organization's operating cash flow, assuming all OCF was to be dedicated to debt repayment. Lower ratio values signal less financial flexibility and potential problems in the future. Compare value to those of similar organizations.

**7.** Total free cash (TFC) flow ratio:

*Numerator:* Total free cash = (Change in net assets + Accrued and capitalized interest expense + Depreciation and amortization + Operating lease and rental expense − Capital expenditures)

*Denominator:* Total fixed obligations = (Accrued and capitalized interest expense + Operating lease and rental expense + Current portion of long-term debt + Current portion of capitalized lease obligations)

$$\text{Total free cash (TFC) flow ratio} = \text{Total free cash}/\text{Total fixed obligations}$$

The numerator is some definition of free cash, and net-free cash flow is defined differently by different analysts. The denominator is the sum of many fixed financial and operating obligations. Because there are so many items in the numerator and denominator, we show them separately. We modified the numerator slightly to change "Net income" to "Change in net assets" and to eliminate dividends. This ratio looks much like a fixed-payment coverage ratio, with the numerator using mostly SA items. The capital expenditures number may include only those capital expenditures necessary to maintain the organization's operating assets (maybe some percentage of total assets, such as 2%, or some percentage of property, plant, and equipment, such as 5%). For assessing long-term growth, you may use actual capital expenditures from the SCF, however.

**Organizational Credit Quality**

**8.** Cash flow adequacy (CFA) ratio:

$$\begin{array}{c}\text{Cash flow}\\ \text{adequacy}\\ \text{(CFA) ratio}\end{array} = \frac{\text{(EBITDA} - \text{Taxes paid} - \text{Interest paid} - \text{Capital expenditures)}}{\text{(Average annual debt maturities scheduled over next 5 years)}}$$

EBITDA is the same as in the FFC ratio (ratio # 2 above). A high ratio value means the organization has good cash flow relative to upcoming debt obligations, and is therefore a high credit-quality borrower from the vantage point of a lender or bond-rating agency.

## 7B.4 RATIOS WITH COMPARATIVE BENCHMARK DATA AVAILABLE (BASED ON FORM 990)

Greenlee, Randolph, and Richtermeyer (using Form 990 data) have developed a very helpful set of financial ratios, and along with it, benchmark data by industry. In this section we include several exhibits from their analysis.

In Exhibit 7B.1, you see the ratios used for determining whether the nonprofit has adequate resources. PPE refers to property, plant, and equipment. Notice that these are liquidity and funding ratios.

In Exhibit 7B.2, we see the ratios used for evaluating the uses to which funds are put.

In Exhibit 7B.3, we see the industries into which nonprofits were categorized for purposes of displaying benchmark ratio standards for your resource adequacy comparisons.

Finally, in both tables in Exhibit 7B.4, we have the comparative ratio benchmarks for resource utilization. Compare your organization's Form 990–based ratios to these benchmarks to give a sense of how your organization matches up.

**Ratio Definitions: Adequacy of Financial Resources**

Defensive interval (DEI) = (end-of-year: cash + savings + accounts receivable + grants receivable + receivables due from officers and directors + prepaid expenses) ÷ (total expenses − depreciation and depletion)

Liquid funds (LF) = (end-of-year: cash + savings + accounts receivable + prepaid expenses) ÷ [total expenses − (depreciation + depletion)]

Accounts payable aging (APA) = (end-of-year: accounts payable + accrued expenses) ÷ [total expenses − (depreciation + depletion) ÷ 12]

Savings (SAV) = total revenue ÷ total expenses

Contributions and grants (CNG) = (government grants + total contributions) ÷ total revenue

Debt (DEB) = end-of-year total liabilities ÷ end-of-year total assets

*Source:* Janet S. Greenlee, David W. Randolph, Sandra B. Richtermeyer, "Better Analytical Reviews of Charitable Organizations," *The CPA Journal* (July 2011): 32–36. Used by permission.

**Exhibit 7B.1** Greenlee, Randolph and Richtermeyer Resource Adequacy Ratio Definitions

**Ratio Definitions: Use of Financial Resources to Execute the Charity's Mission**

Fund-raising efficiency (FE) = (direct public support + cash contributions) ÷ total functional expense, fund raising

Fund-raising expense (FX) = fund-raising expense ÷ total expense

Management expense (MX) = management and general expense ÷ total expense

Program service expense (PX) = program service expense ÷ total expense

Program service expense to average total assets (PA) = program service expense ÷ [(beginning-of-year total assets + end-of-year total assets) ÷ 2]

Return on investment (ROI) = (interest + dividends) ÷ [(beginning-of-year investments in securities + end-of-year investments in securities) ÷ 2]

*Source:* Janet S. Greenlee, David W. Randolph, Sandra B. Richtermeyer, "Better Analytical Reviews of Charitable Organizations," *The CPA Journal* (July 2011): 32–36. Used by permission.

**Exhibit 7B.2** Greenlee, Randolph and Richtermeyer Resource Utilization Ratio Definitions

| | Ratios: Adequacy of Financial Resources<br>Median by Sector and Quartile | | | | | | |
|---|---|---|---|---|---|---|---|
| | Revenues | DEI | LF | APA | SAV | CNG | DEB |
| **Arts, Culture, Humanities (AR)** | | | | | | | |
| 1. | <$371,256 | 6.4426 | 6.4191 | .3232 | 1.0416 | .5759 | .0687 |
| 2. | $371,256–$2,801,306 | 4.1503 | 3.8862 | .5443 | 1.0466 | .6475 | .0593 |
| 3. | $2,801,307–$11,692,850 | 4.7207 | 4.1535 | .9006 | 1.1768 | .6224 | .0870 |
| 4. | >$11,692,850 | 4.3348 | 3.7558 | 1.4940 | 1.1742 | .6130 | .1407 |
| | Number of Charities | 1,018 | 1,018 | 831 | 1,021 | 969 | 896 |
| **Education (ED)** | | | | | | | |
| 1. | <$1,011,853 | 7.3704 | 7.1821 | .3881 | 1.0957 | .4909 | .0830 |
| 2. | $1,011,853–$5,256,342 | 5.1615 | 5.0615 | .6699 | 1.0997 | .4960 | .1874 |
| 3. | $5,256,343–$16,815,517 | 4.9639 | 4.8577 | .9589 | 1.1278 | .2813 | .2422 |
| 4. | >$16,815,517 | 4,3907 | 4.2631 | 1.1198 | 1.2540 | .3293 | .2210 |
| | Number of Charities | 1,990 | 1,988 | 1,610 | 2,018 | 1,761 | 1,728 |
| **Hospitals (EH)** | | | | | | | |
| 1. | <$53,984,502 | 3.4751 | 3.4146 | 1.4472 | 1.0435 | .0101 | .4113 |
| 2. | $53,984,502–$130,000,000 | 2.9060 | 2.8991 | 1.4809 | 1.0393 | .0060 | .4659 |
| 3. | $130,000,001–$277,000,000 | 2.6718 | 2.6605 | 1.4945 | 1.0407 | .0054 | .4812 |
| 4. | >$277,000,000 | 2.6168 | 2.6048 | 1.5121 | 1.0548 | .0096 | .4748 |
| | Number of Charities | 2,052 | 2,052 | 2,034 | 2,055 | 1,786 | 2,053 |
| **Environment (EN)** | | | | | | | |
| 1. | <$333,660 | 10.9358 | 8.1989 | .3446 | 1.0492 | .7566 | .0483 |
| 2. | $333,660–$1,797,858 | 5.8867 | 5.4327 | .4115 | 1.0795 | .6682 | .0297 |
| 3. | $1,797,859–$8,794,508 | 4.5703 | 4.1595 | .6909 | 1.1557 | .7519 | .0539 |
| 4. | >$8,794,508 | 4.6026 | 4.0636 | 1.1933 | 1.1402 | .8181 | .1311 |
| | Number of Charities | 418 | 418 | 337 | 423 | 399 | 364 |
| **Health (HE)** | | | | | | | |
| 1. | <$1,791,674 | 8.7627 | 8.4565 | .5777 | 1.0877 | .6553 | .0876 |
| 2. | $1,791,674–$7,728,327 | 4.1113 | 3.8563 | .9509 | 1.0761 | .4748 | .1746 |
| 3. | $7,728,328–$21,921,284 | 3.3515 | 3.1256 | 1.0637 | 1.0655 | .3135 | .2679 |
| 4. | >$21,921,284 | 2.9931 | 2.8116 | 1.2643 | 1.0412 | .0919 | .4475 |
| | Number of Charities | 2,052 | 2,051 | 1,826 | 2,089 | 1,625 | 1,938 |
| **Human Service (HU)** | | | | | | | |
| 1. | <$525,222 | 5.2200 | 5.0460 | .8334 | 1.0048 | .7024 | .1956 |
| 2. | $525,222–$2,543,398 | 4.3086 | 4.0494 | .7855 | 1.0201 | .5890 | .3044 |
| 3. | $2,543,399–$10,920,557 | 3.4256 | 3.1380 | .9538 | 1.0393 | .3127 | .3260 |
| 4. | >$10,920,557 | 2.8956 | 2.7839 | 1.2606 | 1.0358 | .0833 | .5740 |
| | Number of Charities | 4,033 | 4,028 | 3,534 | 4,065 | 3,334 | 3,752 |

**Exhibit 7B.3** Greenlee, Randolph, and Richtermeyer Resource Adequacy Ratio Benchmarks

| | Ratios: Adequacy of Financial Resources<br>Median by Sector and Quartile | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Revenues** | **DEI** | **LF** | **APA** | **SAV** | **CNG** | **DEB** |
| **Public and Social Benefit (PU)** | | | | | | | |
| 1. | < $687,956 | 7.3913 | 7.2192 | .5074 | 1.0724 | .6922 | .1592 |
| 2. | $687,956–$4,230,047 | 7.4127 | 6.4111 | .5370 | 1.1908 | .7935 | .1392 |
| 3. | $4,230,048–$18,324,309 | 5.8485 | 5.2439 | .5053 | 1.3695 | .7738 | .1592 |
| 4. | >$18,324,309 | 4.8516 | 4.4807 | .7470 | 1.1820 | .8217 | .1866 |
| | Number of Charities | 1,457 | 1,455 | 1,124 | 1,503 | 1,173 | 1,238 |
| **Religion (RE)** | | | | | | | |
| 1. | < $169,014 | 2.3442 | 2.3442 | .3074 | 1.0246 | .9996 | .2514 |
| 2. | $169,014–$754,205 | 3.4724 | 3.4100 | .1184 | 1.0654 | .9090 | .2566 |
| 3. | $754,206–$2,875,491 | 3.7834 | 3.7761 | .3931 | 1.1039 | .6679 | .3952 |
| 4. | >2,875,491 | 4.0632 | 4.0632 | .9023 | 1.2170 | .5545 | .1473 |
| | Number of Charities | 344 | 344 | 215 | 355 | 299 | 251 |

*Source:* Janet S. Greenlee, David W. Randolph, Sandra B. Richtermeyer, "Better Analytical Reviews of Charitable Organizations," *The CPA Journal* (July 2011): 32–36. Used by permission.

**Exhibit 7B.3** Greenlee, Randolph and Richtermeyer Resource Adequacy Ratio Benchmarks (*continued*)

| | Ratios: Use of Financial Resources to Execute the<br>Charity's Mission Median, by Sector and Quartile | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Revenues** | **FE** | **FX** | **MX** | **PX** | **PA** | **ROI** |
| **Arts, Culture, Humanities (AR)** | | | | | | | |
| 1. | < $371,256 | 23.8293 | .0383 | .1690 | .8226 | .2260 | .0465 |
| 2. | $371,256–$2,801,306 | 13.6292 | .0668 | .1700 | .7500 | .1748 | .0356 |
| 3. | $2,801,307–$11,692,850 | 13.4409 | .0743 | .1582 | .7609 | .1202 | .0366 |
| 4. | > $11,692,850 | 17.7102 | .0600 | .1371 | .7921 | .1635 | .0302 |
| | Number of Charities | 724 | 730 | 997 | 1,003 | 1,003 | 608 |
| **Education (ED)** | | | | | | | |
| 1. | < $1,011,853 | 23.0391 | .0419 | .1235 | .8832 | .2353 | .0378 |
| 2. | $1,011,853–$5,256,342 | 21.2065 | .0366 | .1416 | .8390 | .2154 | .0403 |
| 3. | $5,256,343–$16,815,517 | 14.3380 | .0367 | .1472 | .8179 | .2154 | .0389 |
| 4. | > $16,815,517 | 15.8052 | .0433 | .1218 | .8326 | .1845 | .0328 |
| | Number of Charities | 1,160 | 1,169 | 1,864 | 2,000 | 1,998 | 1,239 |
| **Hospitals (EH)** | | | | | | | |
| 1. | < $53,984,502 | 8.6281 | .0043 | .1520 | .8571 | .6397 | .0473 |
| 2. | $53,984,502–$130,000,000 | 8.7257 | .0019 | .1537 | .8463 | .7716 | .0495 |
| 3. | $130,000,001–$277,000,000 | 7.5654 | .0020 | .1340 | .8656 | .8455 | 0470 |
| 4. | > $277,000,000 | 13.4050 | .0015 | .1279 | .8702 | .7902 | .0425 |
| | Number of Charities | 477 | 498 | 1,996 | 2,030 | 2,029 | 1,383 |

**Exhibit 7B.4** Greenlee, Randolph and Richtermeyer Resource Utilization Ratio Benchmarks

| Ratios: Use of Financial Resources to Execute the Charity's Mission Median, by Sector and Quartile | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Revenues** | **FE** | **FX** | **MX** | **PX** | **PA** | **ROI** |
| **Environment (EN)** | | | | | | | |
| 1. | < $333,660 | 33.4627 | .0383 | .1212 | .8631 | .3446 | .0483 |
| 2. | $333,660–$1,797,858 | 22.9503 | .0593 | .1466 | .8019 | .1538 | .0297 |
| 3. | $1,797,859–$8,794,508 | 20.3131 | .0760 | .1184 | .8013 | .1962 | .0539 |
| 4. | > $8,794,508 | 18.2616 | .0571 | .0969 | .8118 | .2203 | .1311 |
| | Number of Charities | 297 | 298 | 406 | 419 | 419 | 242 |
| **Health (HE)** | | | | | | | |
| 1. | < $1,791,674 | 18.2403 | .0624 | .1339 | .8517 | .2288 | .0386 |
| 2. | $1,791,674–$7,728,327 | 18.8132 | .0528 | .1354 | .8365 | .3136 | .0360 |
| 3. | $7,728,328–$21,921,284 | 16.2440 | .0229 | .1299 | .8550 | .6083 | .0376 |
| 4. | > $21,921,284 | 18.2270 | .0121 | .1073 | .8767 | .9028 | .0448 |
| | Number of Charities | 792 | 807 | 1,956 | 2,033 | 2,032 | 1,158 |
| **Human Service (HU)** | | | | | | | |
| 1. | < $525,222 | 23.3920 | .0344 | .1325 | .8896 | .2604 | .0392 |
| 2. | $525,222–$2,543,398 | 18.4174 | .0432 | .1241 | .8583 | .2907 | .0460 |
| 3. | $2,543,399–$10,920,557 | 16.8319 | .0321 | .1185 | .8598 | .3969 | .0474 |
| 4. | > $10,920,557 | 17.1286 | .0117 | .1104 | .8771 | .4447 | .0453 |
| | Number of Charities | 1,722 | 1,748 | 3,670 | 4,000 | 3,997 | 1,666 |
| **Public and Social Benefit (PU)** | | | | | | | |
| 1. | < $687,956 | 19.3500 | .0588 | .1493 | .8551 | .1177 | .0361 |
| 2. | $687,956–$4,230,047 | 24.8112 | .0591 | .1216 | .8475 | .0990 | .0350 |
| 3. | $4,230,048–$18,324,309 | 42.9367 | .0348 | .0998 | .8645 | .1133 | .0338 |
| 4. | >$18,324,309 | 48.6445 | .0293 | .0773 | .8842 | .2314 | .4052 |
| | Number of Charities | 697 | 703 | 1,420 | 1,478 | 1,478 | 924 |
| **Religion (RE)** | | | | | | | |
| 1. | < $169,014 | 63.2568 | .0198 | .1270 | .9155 | 1.0535 | .2514 |
| 2. | $169,014–$754,205 | 30.0097 | .0283 | .1464 | .8101 | .2681 | .2566 |
| 3. | $754,206–$2,875,491 | 30.0097 | .0283 | .1464 | .8101 | .2681 | .2019 |
| 4. | >$2,875,491 | 24.4025 | .0394 | .1382 | .8407 | .2585 | .1473 |
| | Number of Charities | 145 | 146 | 307 | 345 | 345 | 160 |

*Source:* Janet S. Greenlee, David W. Randolph, Sandra B. Richtermeyer, "Better Analytical Reviews of Charitable Organizations," *The CPA Journal* (July 2011): 32–36. Used by permission.

**Exhibit 7B.4** Greenlee, Randolph, and Richtermeyer Resource Utilization Ratio Benchmarks (*continued*)

## 7B.5 COMPARATIVE BENCHMARK DATA FOR FAITH-BASED ORGANIZATIONS (BASED ON SA AND SFP)

**(a) RATIO MEDIANS: FAITH-BASED ORGANIZATIONS.** Here are some ratio medians we have compiled with the assistance of Capin Crouse LLP for faith-based organizations. All of them are based on audited financial statements, not Form 990 data.

**Median Ratio Values - 2004 Fiscal Year**

| Median Ratio Values - 2004 Fiscal Year | | | | | |
|---|---|---|---|---|---|
| ***Organizational Type:*** | **Churches** | **Faith-Based Colleges** | **Independent Missions** | **Other Mission Organizations** | ***All Organizations: Avg. of Medians*** |
| *Number in sample:* | *10* | *9* | *8* | *21* | |
| *Ratio Categories:* | | | | | |
| *Liquidity Ratios* | | | | | |
| Cash Ratio | 1.43 | 0.78 | 1.16 | 1.00 | *1.09* |
| Cash Reserve Ratio | 0.13 | 0.06 | 0.07 | 0.09 | 0.09 |
| Current Ratio | 2.14 | 2.72 | 6.28 | 4.62 | *3.34* |
| Asset Ratio | 0.13 | 0.12 | 0.43 | 0.46 | 0.28 |
| Target Liquidity Level | $725,469 | $2,409,082 | $1,873,769 | $1,999,101 | $1,751,855 |
| Liquid Funds Indicator | −1.18 | 2.02 | 3.09 | 3.56 | 1.87 |
| Cash Flow to Total Debt | 0.06 | 0.08 | 0.42 | 0.13 | *0.17* |
| Cash Flow from Operations | $415,897 | $892,510 | $569,218 | $151,790 | $507,354 |
| Cash Cycle | −177.80 | 6.39 | 90.90 | −8.39 | *−22.23* |
| Cash Turnover | −0.90 | 9.21 | 2.86 | 0.95 | 0.03 |
| Net Liquid Balance | $725,469 | $308,871 | $980,177 | $944,478 | $739,749 |
| Working Capital Requirements | ($230,843) | $420,435 | $3,304,002 | $497,681 | $997,819 |
| Current Liquidity Index | 26.28 | 15.78 | 2.14 | 13.04 | *14.31* |
| Lambda | NA | NA | NA | NA | *NA* |
| Defensive Interval | 74.31 | 95.60 | 74.87 | 114.77 | *89.89* |
| *Funding Ratios* | | | | | |
| Contribution Ratio | 0.92 | 0.17 | 0.70 | 0.75 | *0.64* |
| Debt Ratio | 0.14 | 0.28 | 0.17 | 0.26 | 0.21 |
| Self-Funding Ratio | 0.53 | 0.38 | 2.51 | 1.27 | *1.17* |
| Operating-Funding Balance Ratio | 0.11 | 0.64 | −1.23 | 3.53 | 0.76 |
| Times Interest Earned | 4.56 | 3.94 | 36.15 | 17.55 | *15.55* |
| Long-Term Debt to Capital | 0.35 | 0.21 | 0.08 | 0.09 | 0.18 |
| *Operating Ratios* | | | | | |
| Return Ratio | 0.61 | 0.43 | 2.77 | 1.44 | *1.32* |
| Net Surplus | $514,382 | $394,683 | $1,639,383 | $232,188 | $695,159 |
| Net Operating Ratio | 0.08 | 0.03 | 0.06 | 0.04 | *0.05* |
| Return on Assets (ROA) | 0.08 | 0.02 | 0.14 | 0.06 | 0.07 |
| Return on Equity (ROE) | 0.11 | 0.02 | 0.16 | 0.09 | *0.10* |
| Net Asset Reserve Ratio | 1.09 | 1.62 | 0.32 | 0.50 | 0.88 |
| Unrestricted Net Asset Reserve Ratio | 0.85 | 1.10 | 0.33 | 0.39 | *0.67* |
| Program Expense Ratio | NA | 0.71 | 0.82 | 0.80 | 0.78 |
| Support Service Expense Ratio | NA | 0.29 | 0.18 | 0.20 | *0.22* |

*Note: NA means not available; lambda requires a forecast of the new period's operating cash flow.*
*Source:* © 2006 Capin Crouse LLP and John T. Zietlow. All rights reserved worldwide.

APPENDIX 7C

# CREDIT RATING AGENCIES AND DOE RATIOS

Education organizations have a number of specialized financial ratios by which they are evaluated. Bond rating agencies and the U.S. Department of Education (DOE) use these specialized ratios in order to assess creditworthiness. Many of these were developed originally by accounting firm Peat Marwick, now part of KPMG LLP. Bank lenders may also use some of these ratios in evaluating your loan requests. We include here a summary done by Fischer, Gordon, Greenlee, and Keating, as well as website information for your further study.

In Exhibit 7C.1, note the key ratios that the DOE, KPMG, and the three largest ratings agencies (S&P, Moody's, and Fitch) use in their analysis of private colleges and universities. Exhibit 7C.2 gives the definitions of the items in the ratio numerators and denominators. We begin our presentation by providing the web addresses for the three nationally recognized statistical ratings organizations (NRSROs) rating nonprofits' debt issues in the United States.

## WEBSITES FOR CREDIT RATING AGENCIES

Educational institution and healthcare bond ratings are based largely on financial ratios, and credit ratings agencies have specialized ratios on which they rely. Each credit rating agency has a website with information about its ratings criteria and definitions or ratings guidelines. Several of these require a free registration, and each may limit advanced research materials to paid subscribers. The following three credit ratings organizations have been rating public sector (or "public finance") organizations for a number of years:

1. Moody's (www.moodys.com)
   Public Finance page:
   https://www.moodys.com/researchandratings/market-segment/u.s.-public-finance/005003/005003/-/-1/0/-/0/-/-/en/global/rr Public Finance Rating Methodologies (requires registration):
   https://www.moodys.com/researchandratings/viewall/methodology/rating-methodologies/003006001/003006001%7C005003/-/0/0/-/0/-/-/-/-1/-/-/-/en/global/pdf/-/rra
2. Standard & Poor's (S&P) (www.standardandpoors.com)
   Public Finance Rating Criteria:
   https://www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/governments/filter/us-public-finance

| | Liquidity Ratios | Operating Performance Ratios | Debt and Leverage Ratio |
|---|---|---|---|
| US Department of Education | $\frac{\text{Adjusted Expendable Net Assets}}{\text{Total Expenses}}$ | $\frac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenue}}$ | $\frac{\text{Modified Net Assets}}{\text{Modified Assets}}$ |
| KPMG et al. (1999) | $\frac{\text{Expendable Net Assets}}{\text{Total Expenses}}$ | $\frac{\text{Change in Unrestricted Net Assets}}{\text{Total Unrestricted Revenue}}$ | $\frac{\text{Expendable Net Assets}}{\text{Long-Term Debt}}$ |
| | | $\frac{\text{Operating Revenues – Operating Expense}}{\text{Total Unrestricted Operating Revenue}}$ | |
| Standard&Poor's (2002a) | $\frac{\text{Expendable Resource}}{\text{Total Operating Expenses}}$ | $\frac{\text{Change to Unrestricted Net Assets}}{\text{Total Unrestricted Operating Revenues}}$ | $\frac{\text{Expendable Resources}}{\text{Total Debt}}$ |
| | | | $\frac{\text{Maximum Annual Debt Service}}{\text{Total Operating Expenses}}$ |
| Moody's (2002) | $\frac{\text{Expendable Financial Resources}}{\text{Annual Operating Expenses}}$ | $\frac{\text{Adjusted Unrestricted Income}}{\text{Total Adjusted Unrestricted Revenues}}$ | $\frac{\text{Expendable Financial Resources}}{\text{Debt}}$ |
| | | | $\frac{\text{Adj. Unrest. Income + Interest + Depreciation}}{\text{Annual Principal + Interest Payments}}$ |
| | | | $\frac{\text{Available Funds}}{\text{Total Debt}}$ |
| Fitch (2001) | $\frac{\text{Available Funds}}{\text{Unrestricted Expenses}}$ | $\frac{\text{Change to Unrestricted Net Assets}}{\text{Unrestricted Operating Revenues}}$ | $\frac{\text{Maximum Annual Debt Service}}{\text{Unrestricted Revenues}}$ |

*Source:* Mary Fischer, Teresa P. Gordon, Janet Greenlee, and Elizabeth K. Keating, "Measuring Operations: An Analysis of U.S. Private Colleges and Universities' Financial Statements," *Financial Accountability & Management* 20 (May 2004): 129–151 (Table 1). Used by permission.

**Exhibit 7C.1** Key Ratios for Evaluating Private Colleges and Universities

**Definitions**

Adjusted expendable net assets = (unrestricted net assets) + (temporarily restricted net assets) – (annuities, term endowments, and life income funds that are temporarily restricted) – (intangible assets) – (net property, plant and equipment) + (post-employment and retirement liabilities) + (all debt obtained for long-term purposes).

Adjusted unrestricted income = Adjusted unrestricted revenues – Adjusted unrestricted expenses. Adjustments to revenues include removing sponsored and unsponsored scholarships, including 1.5% of beginning cash and investments instead of investment income and gains, and removing net assets released from restrictions if related to gifts for capital projects. Expenses are adjusted by removing scholarships and fellowships.

Available funds = unrestricted and temporarily restricted cash and investments. Fitch says it does not use net assets because of the uncertainty related to the liquidity and value of some assets.

Expendable net assets = expendable resources = expendable financial resources = (total net assets) – (permanently restricted net assets) – (net investment in plant).

Net investment in plant = (net property, plant, and equipment) – (long-term debt).

Modified net assets = (unrestricted net assets) + (temporarily restricted net assets) + (permanently restricted net assets) – (intangible assets) – (unsecured related party receivables).

Modified assets = (total assets) – (intangible assets) – (unsecured related-party receivables).

Total unrestricted operating revenue includes only investment income to the extent of the school's endowment spending policy. If there is no policy, investment gains and losses are excluded.

Unrestricted operating revenues (Fitch) = Total unrestricted revenues less investment gains (if investment income is a significant source of revenue).

*Source:* Mary Fischer, Teresa P. Gordon, Janet Greenlee, and Elizabeth K. Keating, "Measuring Operations: An Analysis of U.S. Private Colleges and Universities' Financial Statements," *Financial Accountability & Management* 20 (May 2004): 129–151 (Table 1, Continued). Used by permission.

**Exhibit 7C.2** Definitions for Key Ratios for Evaluating Private Colleges and Universities

Recent Public Finance Ratings Actions:
https://www.standardandpoors.com/en_US/web/guest/ratings/ratings-actions (set menus to Public Finance / United States / All Actions)

3. Fitch Ratings (www.fitchratings.com)
Public Finance Outlooks and New Developments:
https://www.fitchratings.com/site/uspf
Public Finance Rating Criteria:
https://www.fitchratings.com/site/search?content=research&filter=1237+1215+363+4294288214+1198

Exhibit 7C.1 provides key ratios that might be used by a credit rating agency to evaluate private colleges and universities. That lens is valuable to you as a manager or board member as you get to see how creditworthy your organization is, whether or not you are thinking about issuing bonds or taking out other long-term debt.

Exhibit 7C.2 defines several of the key financial ratios that a credit rating agency might calculate and use to assess a 501(c)(3) college's financial strength.

Finally, we note that financial analysis is not limited to financial ratios. For example, let's say that your organization is not in the healthcare or education industries. Moody's (see reference above) considers a nonprofit's market position as a very important rating factor. To assess market position, Moody's scrutinizes your operating revenue performance. To score highly, your organization would have large as well as diverse activities (such as programs) that have favorable outlooks relative to its ability to generate revenue and support, a brand that is well-known and viewed positively, and diverse revenue sources.

CHAPTER 8

# DEVELOPING OPERATING AND CASH BUDGETS



## 8.1 INTRODUCTION

A primary responsibility of nonprofit leadership is planning. At the core of proficient *financial* leadership and management is the budget. A *budget* is a plan stated in dollar terms. The budgeting process is important because it allocates resources, in turn revealing the program preferences of the parties involved in budgeting. After the budget is developed,



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

a nonprofit organization should use periodic reports to compare budgeted revenues with actual revenues and budgeted expenses with actual expenses. This process is key in engaging in sense making that we outlined in Chapter 7. Improving your budgeting and financial reporting processes is a key part of achieving financial management proficiency. Consider that your business model's revenues (and support) and expenses are identified and managed using the budget. Budget-related considerations are at the core of some of your greatest financial management challenges. We quote some excerpts from a study of New York state human services organizations' budgets:

- Among New York's largest nonprofit human services providers, 80 percent have budgets that are 90 percent or more dependent on government funding.
- While charitable contributions have risen over the years, they rarely account for more than ten percent of service providers' budgets.
- An extensive 2015 survey of nonprofit service providers found that 44 percent say that State contracts never cover the full cost of providing contracted services and another 16 percent said the State rarely covered the full costs. Only seven percent reported that State contracts always covered full costs.
- Another survey tied the systemic underfunding of government contracts to the fact that 18 percent of New York human services nonprofits are financially insolvent.
- The low pay and paucity of fringe benefits translate into high and costly turnover for nonprofit organizations ... Pay is so low that 60 percent of those working in the sector were utilizing or had a family member utilizing some form of public assistance benefit such as Medicaid or food stamps. As the $15 minimum wage for fast-food and other workers is phased in [in New York], recruitment and retention of dedicated and caring human service professionals will become an even greater challenge for nonprofits struggling under the weight of severely underfunded state government contracts.[1]

Is there any good news regarding the potential for the budget process? The highest award for excellence in management in the Chicago area in 2003 was for an organization that revamped its budgeting and financial reporting processes and then began to solicit foundation grants:

> The move toward greater fiscal responsibility is just one of a series of steps taken in the last year by . . . [Ivan Medina, executive director of Onward Neighborhood House, a Chicago social-services group] and the board of Onward Neighborhood House, which provides day care and other programs to low-income immigrants in a Chicago neighborhood that is in the midst of gentrification.
>
> In addition to soliciting foundations in order to reduce its reliance on government funds, the group also revamped its accounting and budgeting systems and trimmed costs. The settlement house, founded in 1868, posted deficits for 7 of the 10 years before Mr. Medina arrived in 2002. However, in the fiscal year ending in June, the charity had a surplus of about $3,337 on a budget of $1.9-million, says Frank Arredondo, Onward's director of finance. A massive leap in Onward's foundation grants – up more than ninefold in the 2003 fiscal year – is largely responsible for closing the gap.
>
> The turnaround garnered an award for financial-management excellence from the Nonprofit Financial Center, a Chicago group that helps charities improve their management. Onward distinguished itself by adopting a new budgeting system with good financial reporting and accounting controls, says Kenneth Tornheim, a director at the Chicago accounting firm of Ostrow Reisin Berk and Abrams, which sponsored the award. Such

> solid financial management, Mr. Tornheim says, is particularly important in today's difficult economic times. "If organizations are watching expenses and budgeting properly," he says, "they can stay on course."[2]

Each new year brings new challenges: Onward Neighborhood House reported a deficit (negative change in net assets) of almost $42,000 in its 2016 fiscal year.[3] Proficient financial managers expertly integrate budgeting into their financial policies and financial management practices. Tara Parson, Vice-President of Administration and Chief Financial Officer at Southwest Baptist University, pursues two financial goals in her role: (1) a positive budget margin (budgeted surpluses), and (2) financial health, with capacity to fund initiatives, facilities, existing program needs, and increases in salaries and benefits. Finance executives across a number of business and nonprofit industries highlighted budgeting and forecasting as the top area where it is most important for board members "to receive critical information and decision-support data from the CFO," with strategic decision-making as the next most important area.[4]

There are actually three major types of budgets: operating budgets, cash budgets, and capital budgets. When we use the word "budget" without stating which type, we are referring to the operating budget. An *operating budget* shows planned revenues and expenses for a period of time, usually one year. The operating budget is most familiar to most people who work in the nonprofit field. Proficient managers manage not only revenues and expenses but also cash flows, so a cash budget is developed. A *cash budget* shows planned cash inflows, cash outflows, and the amount and duration of cash shortages or surpluses for a certain period of time, usually the next 12 months. Its main value is highlighting the periods of imbalance between cash coming in and cash going out, so that the manager can take early action to manage the cash position and target liquidity. As we saw in Chapter 3, a *capital budget* shows planned fixed asset outlays and other large-dollar, long-lived capital acquisitions such as mergers and acquisitions. This chapter will assist you with the key aspects of the operating and cash budgets. In Chapter 9 we take up capital budgets and long-range financial planning.

## 8.2 OVERVIEW OF THE BUDGETING PROCESS

Before any budgeting takes place, your organization should have formulated its mission, objectives, and strategic plan. In Chapter 3, the basics of these processes were presented. Even if your organization does no formal planning, inertia alone places your organization in a strategic path for specific programs and initiatives. These are translated into operating plans. Those plans, and donors' and other funders' willingness to support them, give rise to revenues and expenses.

The development of the cash budget is a little more complex. Exhibit 8.1 shows that in addition to operating plans and policies and plans arising from liability management (see Chapter 10), current asset management (see Chapters 11 and 12), and fixed asset management (land, buildings, and equipment; see Chapter 9) are key inputs.

These same policies and the just-prepared operating budget and cash budgets, along with the current-period statement of financial position (SFP) (or balance sheet), provide the input for projecting the upcoming balance sheet. *If the projected SFP (balance sheet) is unacceptable based on inadequate liquidity or overly high use of borrowed monies this should trigger a revised operating plan.* A projected balance sheet that is "too weak" may arise when an organization's capital budget outlays are partly self-funded (reducing cash)

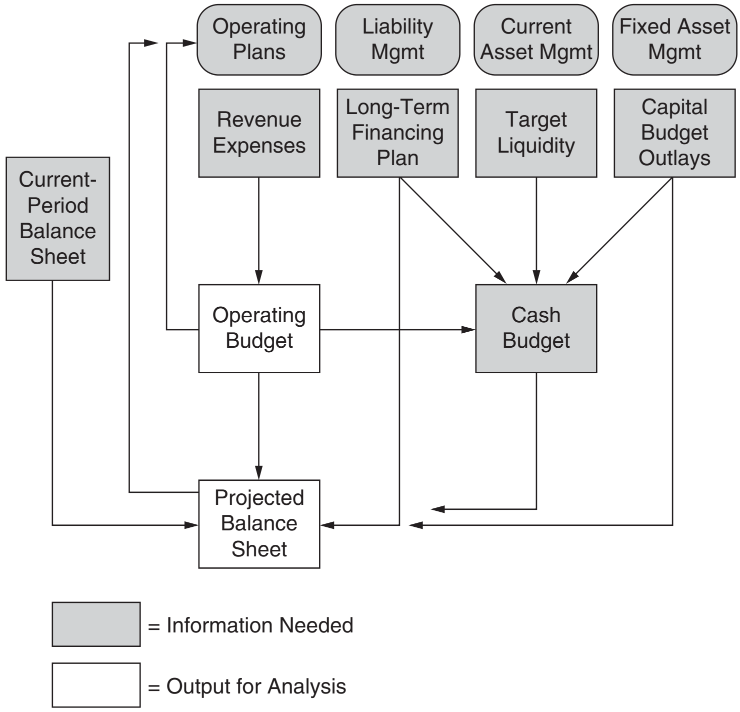


**Exhibit 8.1** Budgeting Process

and partly financed (increasing borrowing, leading to a high debt ratio). The remainder of this chapter outlines the context and actual development of the operating and cash budgets.

## 8.3 ARE NONPROFIT ORGANIZATIONS DOING THEIR BUDGETING PROPERLY?

There is much room for improvement in nonprofit budgeting. In a classic in-depth study of 17 large nonprofit arts, educational, and healthcare agencies, the authors concluded that the budgets were developed in a very basic, even simplistic fashion, and the budgets were not used for control. Briefly, the study established that budget development and use were deficient.[5]

**(a) OPERATING BUDGETS IN PRACTICE.** In Chapter 1 and Appendix 1A, the performance of financial management in faith-based charities was outlined as part of the Lilly study. Although 85 percent of responding organizations in the study develop and use an operating budget (showing revenues and expenses), the concern is that 15 percent do not. Budget revisions occur within the fiscal year by 60 percent of the budget-using organizations. This is good practice when uncontrollable external events make previously budgeted amounts useless as standards, but may indicate that budgeting control is largely absent in some organizations. The use of supplemental financial data other than "budget versus actual" variances is seriously lacking. Only 53 percent of budget users monitor their current asset amount on a monthly basis (and merely 12 percent have a target for their current assets), and 41 percent evaluate financial ratios periodically. The fact that roughly 60 percent, or three out of five, do not utilize the insights of ratios points to the significant opportunity for improved financial management in the nonprofit sector. There is no good reason for these deficiencies with the advanced information technology we have today. A basic ratio that we should have at our fingertips is the percent of our operating budget that goes to salaries and benefits. Illustrating, most museums spend between 41–60 percent of their operating budgets on payroll-related expenses.[6]

**(b) CASH BUDGETS IN PRACTICE.** Nonprofit organizations were rated only fair in their cash forecasting. The most reliable indicator of how an organization rated overall (in all short-term financial management areas) was whether the organization used a computer to monitor or forecast its cash position. Seventy-eight percent of the organizations *did use* the computer for one or both of these purposes. Using a computer facilitates cash forecasting, which is one of the ways to implement daily active cash management – a practice of most of the Fortune 500 corporations. Short-term investing and borrowing decisions are improved because of a better understanding of how much excess cash exists now and in the future. With longer maturities yielding higher interest rates, the organization is rewarded for knowing how long it can tie excess funds up. Furthermore, we noted that the organization's cash control is facilitated by computer use, because now it may tie its records via personal computer to its bank(s), regularly updating balances and being able to check yesterday's closing balances at the beginning of today's workday.

Only 8 out of 288 organizations developed daily cash forecasts, whereas 22 projected cash using weekly intervals, and 94 developed monthly forecasts. At a minimum, your organization should attempt a weekly forecast and larger organizations should set their end-of-day cash position by late morning. The higher short-term interest rates go, the greater the rewards for your effort.

## 8.4 DEVELOPING AND IMPROVING YOUR BUDGETING PROCESS

This part of the chapter provides guidance on how to develop or improve the budgeting process. It starts with what is needed to prepare an organization for budgeting, then moves to actual budget development, and finally concludes with comments about budget refinements such as zero-based budgeting (ZBB), program budgeting, and rolling budgeting.

**(a) PREPARATION FOR BUDGETING (OPERATIONS).** The chief financial officer (CFO) (or board treasurer in small organizations) should attend to the organizational and procedural prerequisites before launching into the actual budget development.

The budget director's function shows us what must happen organizationally to get ready for the budget process. The procedural prerequisites show us how the organization mobilizes specific information to ensure successful budget development.

***(i) Function of the Budget Director.*** The individual heading up the budgeting process, whatever his or her title, is generally the CFO of the organization. It is the budget director's responsibility to ensure that a comprehensive oversight system be set up to include these four areas:

1. Make sure everyone involved gets the information he or she needs. This includes any and all forecasts, organizational goals and policies, guidelines, performance data and standards, and any organization-unit plans that impinge on budget items. This may also include a broader approach to financial literacy, using the budget process as a teaching tool for responsible program, fundraising, and administrative staff.
2. Set up and maintain the appropriate planning system. The necessary information package includes channeling of appropriate information, plan formulation scheduling, and subunit as well as organization-wide checking of adherence to economic and financial guidelines and to organizational goals. Certainly you would not want one group using an inflation rate of 2 percent for its forecasts while another assumed a 5 percent rate.
3. Set up and oversee use of models. These models test for the effect of inside and outside forces on achievement of organizational goals. For example, what would happen if interest rates suddenly went up by 2 percent? Down by 2 percent? One multinational nonprofit had to scale back its headquarters operation by 20 percent during a two-year period due to an unexpected *decline* in interest rates; interest revenue earned on cash reserves was funding a significant portion of those operations. Poor endowment performance in the early 2000s and the 2007–2009 period brought new reminders to endowed organizations of the value of considering the downside of investment performance.
4. Collect and analyze performance data. For each organizational responsibility center, data should show how plans are or are not being attained over time, and that analysis is made of variances, especially for large expense overruns or large revenue shortfalls. (See the section on managing off the budget in Section 8.8 later in this chapter.)[7]

Ultimately, the budget director may assume responsibility for each of these four tasks. Indeed, in smaller organizations, he or she may perform each task himself. The organization suffers as the latter two tasks are often left undone due to time constraints. Furthermore, department heads may view the budget negatively because it is imposed on them without adequate input on their part.

***(ii) Procedural Prerequisites.*** Before "budget time" rolls around each year, there are three preparatory steps that you may need to take.

1. *Establish budget policy*. This step does not need to be done annually, but if your organization has never thought these concepts through, it is time to do that before setting another budget. This element engages the board in their fiscal governance role, providing guidelines and oversight into the budget process.
2. *Gather archival data*. This step involves assembling necessary documents from the financial reporting system, treasury management, and fund development office.
3. *Initiate data collection*. We perform this step to get the appropriate offices working on collecting data that are not normally part of the financial reporting process.

Please study Exhibit 8.2 to set in your mind the sequence of these activities as a framework for our discussion.

**(b) STEP 1: ESTABLISH A BUDGET POLICY.** Every organization should have a budget policy that spells out the purposes of its operating budget, the uses for that budget, guidelines for budget development, revision policy, and the frequency and nature of budgetary reports.

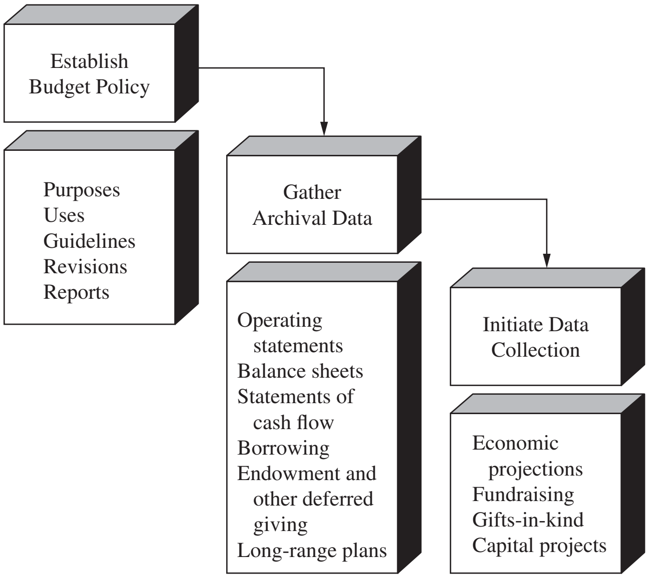


**EXHIBIT 8.2** STEPS PRIOR TO BUDGET DEVELOPMENT

***(i) Purposes of a Budget.*** Reviewing the purposes of an operating budget will convince financial and nonfinancial personnel of the indispensability of budgets. Recall that your operating budget sets out your organization's plan, expressed in monetary terms. Both revenue and expense budgets should be carefully developed and detailed. Some funders will even address budget preparation in their legal contracts.

Budgets are also necessary administrative, financial, and program management tools for nonprofit managers. In most cases, there should be individual budgets for each program or separate activity, and they fold into a single, consolidated budget for the organization as a whole.[8] In general, the main purposes for operating budgets are

1. Priority control
   - Budget setting should follow mission and program establishment and should not be done simultaneously with those activities.
   - Budgets reveal priorities because they indicate resource allocations and real locations.
2. Fiscal control
   - Limited funds mean need for effective controls over revenue and expenses.
   - Budgets serve this purpose best, in that they allow for regular comparison of budgeted to actual expenditures.
3. Administrative control
   - Nonprofit organizations are established to serve public purposes that are often intangible or expensive to measure.

- ○ Detailed budgets provide administrators with monetary control where traditional for-profit controls (price-less-cost profit margin targets) are neither possible nor practical.

**4.** Program control

- ○ Outside funders may require separate budgets for each program they support.
- ○ Funding sources may limit spending flexibility by restricting expenditures to specified categories and line items, and they may request that written budget modifications be approved in advance.

**5.** Audit control

- ○ Outside funds often have specific expenditure restrictions and compliance requirements.
- ○ These restrictions and requirements apply particularly for organizations receiving government funds, where budgets are utterly essential to ensure that the annual audit will determine that the nonprofit organization complied with funding-source guidelines.

**6.** Survival

- ○ If the organization makes unallowable expenditures that must be repaid to the funding source, liquidity problems will ensue.
- ○ How will you know if expenses are going to be covered until it is too late, if you have no budgetary projection? Not having a solid budget process puts the organization at great risk.

***(ii) Uses of the Budget.*** Lack of a budget has several negative repercussions; the organization may face one or more of these situations:

- *Overspending*. This leads to the situation in which the organization is hit with unexpected operating deficits and a cash crunch, as spending quickly outruns incoming revenues.
- *Underspending*. This results in the need to return unspent funds to funding sources.
- *Mistimed spending*. Mistimed spending is the failure to meet required program or activity goals on time, possibly resulting from the fear that revenues are inadequate to cover expenses.
- *Misappropriated spending*. This includes spent funds outside allowable cost categories, or when spending is audited it is discovered that questioned costs may have to be repaid to funding sources.

**(c) BUDGET PREPARATION PHILOSOPHY AND PRINCIPLES.** Several decisions related to budget philosophy and principles are to be made in revising and reporting budget-related data. *Budget philosophy* involves what approach will be taken, what level of aggregation to use, and the "bottom-line" target to strive for.

*The budget approach may be top-down or bottom-up, or a combination of both.* The approach used will drive the assignment of budget development responsibilities and level of participation. We advocate the combination approach. When organizations impose budgets on departments, the approach is definitely *top-down.* When department heads submit their budgets, and these are added together to arrive at a consolidated budget, we have a purely *bottom-up* approach. *A combination approach* involves communication of economic and organizational assumptions to be made by all budget participants (to ensure consistency), but department heads have great latitude in establishing budgetary amounts. These are subject to review and mutually agreed adjustment. You may wish to assemble a *budget committee*, even if yours is a small organization and relies on volunteers.[9] Regardless, participation and involvement of budget managers is essential, and the absence of their involvement leads to budgets that are weak and ineffective as control tools. Without input from the operating managers, the organization loses the engagement process, which in turn can lead to lack of attention and even cynicism. The goal should be to work with department heads in their budget preparation and encourage staff involvement and subsequent review of actual activities.

The budget's *format and level of aggregation* also must be determined. The minimum requirement here is to have a *consolidated budget* (organization-wide). This budget, sometimes called *a line-item budget,* should list the major sources of revenues and the expenses by type. The expenses are listed by what are sometimes called "natural expense elements": rent, utilities, salaries and wages, insurance, and so forth. Budgets done at this aggregated level of detail help prevent overspending or underspending and provide the minimal planning, coordination, and control functions. In the revenue and expense budget illustration later in this chapter (Exhibit 8.5), we will show how an organization develops a consolidated budget.

As organizations grow and add support staff and accounting and software systems, they begin to develop a *subunit budget* for each program, department, or activity. Let's take a look at two logical subunit budgets that you may wish to develop: program budgets and functional budgets.

*Program budgets* spell out revenues and expenses for each of the organization's major programs. Having information in this format is tremendously helpful for two reasons: it makes program allocations and reallocations obvious, and it makes cost-benefit comparisons for individual programs much easier. We will return to program budgeting later in the chapter. If each program is operated by a different division or department within the organization, the divisional or departmental budgets accomplish the same thing as program budgets.

*Functional budgets* show revenues and expenses for each separate functional area. In a business, the major functional areas are marketing, finance, and production. In a nonprofit, these might be development, finance, and services. The services subunit can then be further broken down into program subunits, if desired. The main advantage is that each area can be held responsible for costs, revenues versus costs (net revenue), or net revenue versus investment. After-the-fact comparisons not only can pinpoint efficiency or inefficiency in areas such as fundraising, but also provide needed input for redeployment of resources for the following year. Although they are not considered major functional areas, support areas such as human resources and information systems can also be budgeted for separately in the functional budgeting system.

*Consider as your budget target the level of net revenue the organization strives for.* On a consolidated budget, should we budget a surplus, break-even, or deficit? Peoria Rescue Ministries, the highest-rated homeless shelter in our Lilly study, strives for and achieves a budget surplus each year. This provides internal funding for program expansion and related capital projects.

Some other organizations project a "balanced budget," even though operating revenues exceed operating expenses. The "plug figure" that balances the budget is called something like "Contingencies," which may be a means of forced savings to help build up cash reserves over a period of several years. If all goes as planned, these organizations will report a surplus for the year (positive change in net assets) on its statement of activity (SA), assuming there are not nonoperating items such as capital campaigns or investment losses.

Here is another way of having a balanced budget but saving for known future expenditures: Assuming that your organization includes an expense account for depreciation, it could be using a balanced budget target, and the amount reported as depreciation expense (which is a noncash charge, merely a bookkeeping adjustment to match the using of equipment with the revenues it helps generate) could be set aside each year in a special fund. When new capital equipment must be purchased, the monies saved in the fund can provide the financing. If all goes as planned, your organization would be reporting a break-even ($0) SA at the end of the year, using accrual-based accounting, since depreciation expense will be shown on the SA.

In some years, you may actually budget a deficit. An organization with long-term financial problems, but one that has a significant liquid reserve built up, may continue its essential programs while it repositions itself over a period of several years. Eventually, it should plan to break even and then run a surplus.

Anthony and Young in their budgeting presentation, provide some excellent guidance on the subject of how to set a budget target.[10] They argue that in most years we should plan spending to match the available resources, by not overspending or underspending. Therefore, they assert that a balanced budget should be the rule, with some acceptable exceptions. (It is assumed that the nonprofit is recognizing the depreciation of fixed assets.) They offer five reasons why most organizations *should not consistently* plan a sizable budget *surplus*, because that *may* indicate:

1. To clients that are probably not getting the service quality or quantity they might desire.
2. To clients that the organization is charging too high a price, in cases where it is charging for services.
3. To donors that possibly they gave too much.
4. To all stakeholders a lack of achievement on the part of the organization, rather than good management, given that most nonprofits have much greater demand on services than they can possibly meet.
5. To management that it may need to consider the possibility of the organization becoming a for-profit business.

*We understand the rationale offered here and see the balanced budget approach as an excellent starting point but we disagree with final approval of a balanced budget, generally speaking.* None of the five reasons should preclude your organization from planning a small surplus of up to 8-12 percent of revenues, which we view as a superior target as compared to a balanced budget. We do recognize that some organizations present a "balanced budget" that has in it a line item for either additional savings (not an expense; budget a surplus, then show as an addendum item the amount going to savings) or for "contingencies." Contingencies may represent a tacit admission of forecast uncertainty, and a buffer to reflect conservatism in the planning process. We agree with a conservative approach to forecasting, but why not budget a surplus with the recognition that the actual amount may come in closer to breakeven? Use some portion of your liquidity target, an amount you call an "operating reserve," to handle the uncertainty rather than introducing error in your budget projections or mislabeling a budget as a "balanced budget." In a 2015 survey by the Evangelical Council for Financial Accountability® (ECFA), organizations were asked if they budget for reserves: 38 percent responded never or rarely, the remaining respondents answers were always (22.5%), frequently (16.5%), or sometimes (22.8%).[11] Calabrese studied the relationship between accumulated wealth (net assets) and donations, and found that "... future contributions actually increase as available [organizational] wealth increases." Only when the accumulated surpluses reach very large levels do donors tend to reduce support.[12]

What about consistently projecting a deficit? On the surface, it appears that many nonprofits are in a perpetual financial squeeze, using their revenue shortfall as an effective fundraising ploy. Budgeting a deficit is not advisable as a normal practice, with some years being exceptions. For one thing, if budgeted amounts are realized as actual amounts, you are reducing the flexibility you would have had for spending the income from your endowment, or draining cash from your liquid reserve, which you must replenish (i.e., run a surplus or do extra fundraising appeals) later. Some faith-based organizations and some nonsectarian nonprofits operate under what Peter Drucker terms the "God will provide" mind-set. Certainly events can turn out better than expected, and God does provide – but as a principle, we should prefer receiving God's provision of the funds *beforehand* in response to faith to receipt after/during a certain period. "God will provide" is a valid mindset underpinning the ultimate cause of your organization's well-being as well as a valuable tool for reflection, but it should not be a budget line item.

Overoptimism and inaction regarding revenues, expenses, and cash flow are seen in many nonprofits, secular as well as faith-based. We find it sobering that the CEO of the Hull House thought that since the organization had always survived cash crunches and cash crises over its previous 120 years that same resilience would continue—but the organization closed permanently in 2012. As one writer put it, "The warning signs were all around Hull House, but it appears that no one could really come to grips with the problems."[13] The board chair at the time of the close stated that he thought the management team was providing the board with a rosy financial picture, adding that "The charity's staff members kept a positive attitude, he says, and the board took its cues from them."[14] See the profile of "the promoter," below.

Second, we note that some colleges have had to retrench and even close down because of a failure to recognize the need to prefund expenditures. If an organization is impelled to initiate or expand programs for which it does not have anticipated revenues to cover, it can build a preventive mechanism into place. As the organization moves toward the end of its fiscal year, and if it has not received sufficient funds to meet the shortfall, it needs to immediately (1) reduce spending on the new program(s), and (2) recognize that it has suffered from a misdirection. Turnaround management might be necessary.

The practical reality for many organizations is that they have not fully exploited their fundraising ability, either through underinvestment in fundraising or unfocused fundraising. This underinvestment issue came out loud and clear in our Lilly study. Most organizations indicated that the main reason they do not do better in reaching their financial objective is "insufficient or ineffective fundraising." If new opportunities arise that match potential donors' desires to help, the development office may be able to raise additional funds to cover the added program expenses. This ability to raise additional funds is plausible, despite the "full mailbox" and "donor fatigue" syndromes, and appears to be more characteristic of faith-based organizations than of other charities. In 2016, only 7 in 10 surveyed U.S. charities met their fundraising goals.[15]

In technical terms, think about your organization having a "fundraising net revenue function" – although there are "diminishing returns" to additional expenditures for fundraising, certainly the funds raised are almost always greater than the costs to raise them. The implication: Your organization can often raise more money if particular opportunities present themselves, in particular, one-time "golden opportunities." Fundraising experience shows that people give more freely to great opportunities than to great needs. However, this is much easier done over a long period of time, not on an emergency, late-in-the-fiscal-year basis.

Anthony and Young do recognize these exceptions to their recommendation that organizations propose a balanced budget:

- *Discretionary revenue*. Basically, this refers to occasions when intensified fundraising can raise more funds. The key is not to rely on this too often or for large amounts (unless you are really thinking about doing this to fund a one-time opportunity).
- "*Hard money" versus "soft money*"
    - Revenue from annual gifts or short-term grants for research are both considered "soft money" in that onset of recession or other factors may cause severe declines; a recent survey of nonprofits in the Philadelphia metro area found that donations were their single most risky source of funds. Another survey of Oregon nonprofits found: "despite successful fund-raising efforts, 30 percent of nonprofits reported they have reduced services to meet operational costs."[16]
    - One implication might be to budget surpluses during economic booms.
    - Another implication is to build up loyalty and close relationships with clients and/or donors.
- *Short-run fluctuations*. Count on cash reserves to tide you through any unexpectedly lean years, in which a proposed deficit might be budgeted; this is why it is not somehow immoral or unethical to run a surplus in some years as well.
- *The promoter*. This is the idea of budgeting more expense than revenue, knowing hotshots can make up the difference; probably not wise, as nothing goes up forever!
- *Deliberate capital erosion*. Part of your permanent capital is being depleted by operational overspending. This approach is acceptable in limited circumstances, e.g., a cure has been found, so this program can be dissolved. But this is the rare exception and for organizations that plan to exist in perpetuity, capital needs to be protected.

We would add this: If an organization is really program-driven, it might see unfunded needs and foresee anticipated new service delivery several years ahead. It will then build up a "critical mass" of financial resources in the form of a strategic or new initiatives reserve with which to launch the new service(s). Doing so implies running surpluses for several years.

***(i) Budget Revisions.*** Your organization should have a policy on what circumstances occasion a budget revision. Your organization may already have a policy in its bylaws. If not, consider this advice: (1) as you review budget-versus-actual variances each month (and your board does each month or quarter), do a full-year forecast to year-end, using this to determine if your budget is OK as is or if events might require that your board adopt a new budget; and (2) allow small changes to be made by the executive officers but require that changes greater than a certain threshold amount be approved by the entire board.[17]

Strike a balance here – don't make it so easy to get a revision approved that you lose the expense control of a budget, but recognize that environmental changes make some budget plans unreasonable. The mere fact that you are experiencing budget-versus-action variances is not unusual but it is to be expected. Consequently, feed the reasons why you are experiencing those budgets into your management processes for the remainder of the year rather than automatically revising your budget. The budget serves well as a control device when targets are difficult but achievable. If a revised budget is used, the original budget assumptions should be maintained in order to keep them in the mix as an aid to future budgeting. Make sure to require compliance with budgeted amounts by having consequences for not making budget amounts, assuming those amounts are reasonable. And resist the urge to revise the budget often to be able to assert that "we've made budget every year for the past X years." We address how to best use the budget as a management and control tool later.

***(ii) Interim Reports.*** Again, you should prescribe what reports will be made to compare actual revenues and costs to budgeted amounts, and with what frequency. Financial reports are also covered in the next chapter.

To recap our discussion of the first step preparatory to budget development, establishing budget policy, we addressed the purposes of its operating budget, the uses for that budget, guidelines for budget development, the budget revision policy, and the frequency and nature of budgetary reports. Not every organization thinks these issues through, but your budgeting process will be more valuable in supporting program delivery and it will run more smoothly if you have done the groundwork. We move into the data collection phase next.

**(d) STEP 2: GATHER ARCHIVAL DATA.** You will consult a number of data sources in your budget development. Here are some of the basic ones:

- Strategic plan and long-range financial plan
- Operating statements: past budgets and statements of activities
    - Revenues
    - Expenses
- Statements of financial position (also called balance sheets)
- Statements of cash flows, if any have been completed
- Mortgage and other borrowing data
- Endowment and deferred giving data
- Previously done projections

**(e) STEP 3: ASSIGN OR BEGIN COLLECTION OF OTHER AREA DATA INPUT OR PROJECTIONS.** The degree of delegation possible in getting necessary economic, labor, fundraising, gifts-in-kind, and capital budget data will depend on the budget approach profiled earlier (top-down, bottom-up, or combination). Allow some lead time for this step in the process; some organizations start this process six months before the budget approval date.

- Economic projections[18]
    - Income and discretionary income, such as local information if your scope is localized (e.g., you operate single local symphony, homeless shelter, retirement center, or "meals on wheels"). Maybe the best you can do is extrapolate, so get recent historical buying power index data from a recent issue of *Sales & Marketing Management* (buying power indexes are published in a special issue once a year).
    - Interest rates, including short-term bank rates,[19] mortgage rates, and charitable gift annuity rates (if applicable).[20]

- Inflation, such as economy-wide inflation rates and key input (e.g., value of the dollar, commodity) price trends.[21]
- Labor cost and productivity, including wages and salaries, nonprofit differentials, local differentials, and productivity.
- Charitable giving (gives check on fundraising, covered below), including national data, regional or state data (if available), and trends.[22]
- Exchange rates if your organization operates internationally.[23]

- Fundraising
  - Projected annual campaign receipts
  - Projected special appeal receipts
  - Projected capital campaign receipts
  - Projected bequests and other deferred gifts
- Gifts-in-kind
- Capital projects

Once the appropriate assignments for these vital inputs are made, it is important to follow up to ensure that the worksheets are finalized on a timely basis. If the preparatory work lags, the whole budget process is held up. Budget preparation is stressful enough without having analysts working excessive overtime.

## 8.5 SETTING THE BUDGETARY AMOUNTS

**(a) WHAT DO I NEED TO KNOW ABOUT FORECASTING?** A budget is a plan, and any plan involves an implicit forecast. How much in donations and other revenues will we take in next year? How much should we project for expenses, given our operating plans? These questions motivate the planner to gain a basic understanding of forecasting techniques. We use Exhibit 8.3 to profile the basic forecasting methods. Space does not permit a thorough treatment of these techniques, but we present the basics.[24]

Quantitative, or statistical, forecasting methods may be divided into causal (or regression) methods and time series methods. A *causal method* is one in which the analyst has

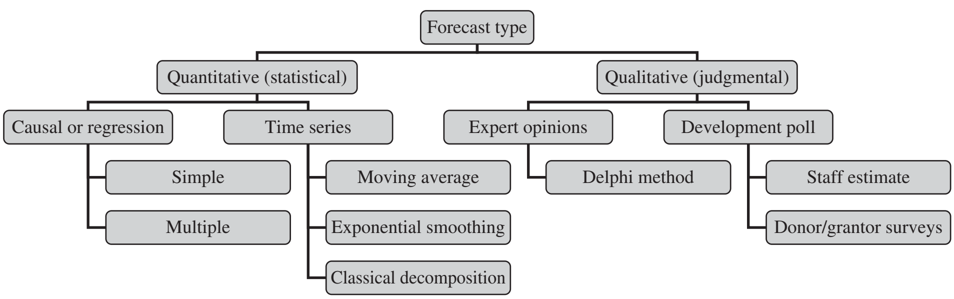


**Exhibit 8.3** Forecasting Methods

identified a cause factor for the item he or she is trying to forecast. In the case of simple regression, we have only one causal variable. For example, donations (forecast variable) may be linked to personal income (causal variable). *Regression analysis* may be used to "fit" an equation to make the relationship precise and usable for generating a forecast. In our example, we might find that the following relationship for donations and disposable income, if we measure donations and (average household) disposable income in thousands of dollars:[25]

$$\text{Donations} = \$500 + 1.2\text{ (disposable income)}$$

Let's say that disposable income is \$40,000. Donations would then be:

$$\text{Donations} = \$500 + 1.2(40) = \underline{\underline{\$548}}$$

Our forecast for donations would be \$548,000. Notice that because we are forecasting current donations based on current disposable income, the only way to generate a forecast for donations is to get a (hopefully accurate) forecast of disposable income.

A *multiple regression model* illustrates the case of multiple causal factor models. Here, instead of one causal variable, we have two or more. Donations might now be linked to the number of individuals in the "empty nest" stage of the family life cycle, along with our original disposable income variable.

*Time series models*, in which a pattern from the past is extended into the future, are often more complex. Of the group, a *moving average* is the easiest to understand. A three-month moving average is just the arithmetic average of the most recent three actual values. If your donations for the past three months are \$45,000, \$50,000, and \$60,000, then the moving average forecast would be:

$$\begin{aligned}\text{3-month moving average} &= \frac{(\$45{,}000 + \$50{,}000 + \$60{,}000)}{3}\\ &= \underline{\underline{\$51{,}666.67}}\end{aligned}$$

When the next month's actual value comes in, you update the moving average by adding the new value and dropping the oldest value. In our example, if the new value is \$65,000, the 3-month moving average becomes:

$$\begin{aligned}\text{3-month moving average} &= \frac{(\$50{,}000 + \$60{,}000 + \$65{,}000)}{3}\\ &= \underline{\underline{\$58{,}333.33}}\end{aligned}$$

The moving average forecast has increased by \$6666.66 (=\$58,333.33 − \$51,666.67), as the most recent number (\$65,000) is significantly higher than the earlier number that has now dropped out of the calculation (\$45,000).

*Exponential smoothing* and *classical decomposition* models are beyond our scope, but information on them may be found in a forecasting book.[26] As with moving average methods, these time series methods basically extrapolate the past into the future.

There are three occasions in which to use times series models. One is when you cannot figure out what logical causes affect your forecast variable. Another is when whatever causes your forecast variable to change in value also steadily increases or decreases with the passage of time. The time variable (e.g., 2019 is year 1, 2020 is year 2) tends to capture the ongoing effects of the undetected cause variable(s), so in this situation you might use a time series model. Finally, time series models make sense when you have many small-dollar items to forecast, making the application of causal or qualitative modeling too time-consuming and expensive.

**(b) REVENUES.** *Before budgeting expenses, a reasonable amount for revenues should be estimated to set the revenue budget.* An accounting definition of revenues is "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."[27] Be careful, though, when laying out the revenues for the operating budget. The items included are slightly different from the Statement of Activities (SA) we presented in Chapter 6. *Excluded* from the SA are increases in the entity's net assets that result from "peripheral or incidental transactions." These are considered "gains," not revenues. However, *do include* both revenues and anticipated gains or losses when estimating budgetary sources of funds to cover expenses. We will reinforce the importance of including both of these later in the section on cash budgeting.

Many organizations budget for revenues and other inflows an amount some percentage above last year's, if that's been the pattern of growth historically. This policy is dangerous in recession or when important drivers of your operating results change. Besides, as we have shown in the forecasting section, you may gain accuracy with the aid of computer-based statistical forecasting models. Applying statistical modeling is one of those projects that are ideal for a college intern or for college course consulting, as most college and university business schools offer business statistics courses to provide basic training to their students in the art and science of forecasting.

**(c) EXPENSES.** Technically, "expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations."[28] When arriving at budget amounts, look at inflationary increases, those changes in the environment that you can foresee, program changes you anticipate, additional resources required, and labor cost increases. Remember that labor-related expense is usually your big-ticket item and should be estimated carefully.

Because the budget may have to be adjusted when significant environmental changes occur within the year or when establishing flexible budgets, we need to understand variable, semivariable, and fixed costs.

- *Variable costs*. Costs that vary with each unit of activity – labor in manufacturing process (if production increases 10 percent, total labor costs will increase 10 percent because labor cost per unit does not change). Of course, when the cost of the labor increases, total labor costs will rise proportionally.
- *Semivariable costs.* These costs increase as activity increases, but not in direct relationship to it; for example, (1) maintenance costs – machinery may have some base level of maintenance that must be performed regardless of how intensively it is used, and beyond that maintenance expense varies with machinery usage; the latter component may not be proportional – doubling the usage may only increase the maintenance expense by 1.5 times; (2) adding a daycare worker for each four pupils.
- *Fixed costs*. These costs remain the same regardless of the level of activity: for example, rent, insurance, top management salaries, property tax for a facility, depreciation expense on previously purchased fixed assets. Even if service delivery is doubled, the amount of this cost element will not change. It is important to note

that fixed costs are fixed within the short term – say, one year. Over the long run, there are no fixed costs. In areas experiencing high inflation rates, even those costs considered to be fixed costs may spiral upward quickly (as in the case of rent or salaries).

What is the relevance of these cost types to expense budgeting? We have already noted that a budget is a plan. When laying out the planned expenses, our method is simple:

- State expected level of activity (number of units of items produced or delivered).
- Then estimate how much the costs will be based on this activity level, so that the budgeted amount accurately reflects whether this item is a variable, semivariable, or fixed cost. Overhead costs are especially important to estimate if your budget development is in support of a grant proposal.[29]
- This whole process takes on added importance when doing *flexible budgeting,* because in that method of budgeting one must calculate the amount of each expense element for various levels of activity – not just the "most likely" or projected level of activity (see Section 8.6).

**(d) EXTENDED EXAMPLE OF ACTUAL BUDGET DEVELOPMENT.** We use the actual budget development of Peoria Rescue Ministries (PRM) to illustrate revenue and expense projections. PRM was one of the top financial management performers identified in the Lilly study.[30]

Before portraying the operating budget, we first demonstrate PRM's capital budget worksheet in Exhibit 8.4. (See Chapter 9 for more on capital budgeting.) We include the capital budgeting template (Exhibit 8.4) to show how the capital budget is incorporated into the operational budgeting process. Exhibit 8.5, the operating budget, shows the prior year (year-to-date actual plus prior December's actual amount), the current budget, and the projected budget. The "rationale" column is especially helpful for your study: It gives background or the person responsible for developing the figure, as well as factors considered in developing the budgeted amounts. Information from both the operating budget and capital budget will be necessary for development of the cash budget, which is discussed next.

Note from our example schedule several things that will help you develop an operating budget.

1. Some items are *estimated,* others are *calculated*. Estimations involve subjective judgment. Calculations involve (a) finding a historical relationship between one variable (some measure of activity) and the expense element, or (b) simply extrapolating the historic growth rate.
2. The feedback from this year's year-to-date actual (which is annualized by adding in the remaining months' prior year actual amount) is used to help estimate the new year's proposed budget. That is, we do not simply make a mindless adjustment based on a historical growth pattern, but adjust up or down the calculated amount where appropriate.
3. PRM budgets for a surplus. Notice that PRM does not show depreciation expense, so some of this surplus will be eventually be used for plant and equipment replacement. Other portions are for (a) intrayear cash receipts versus cash disbursements imbalances, (b) to offset any negative developments on either the revenue (unfavorable variance being less-than-budgeted amounts) or expense fronts (unfavorable variance being greater-than-budgeted amounts), and (c) to fund anticipated

Peoria Rescue Ministries

*practical christianity in action*

Rev. Jerry Trecek
Executive Director

**CAPITAL BUDGET 20XX**

| MINISTRY MONTH | PURPOSE FOR ITEM | PRIORITY* | AMOUNT |
|---|---|---|---|
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*PRIORITY 1 = MUST HAVE TO CONTINUE MINISTRY

2 = NOT ESSENTIAL IN THIS YEAR, BUT WILL NEED NEXT YEAR

3 = MINISTRY EXPANSION

prm www.peoriarescue.org

**EXHIBIT 8.4** PEORIA RESCUE MINISTRIES CAPITAL BUDGET TEMPLATE

growth. PRM is growing, in total revenues, at double-digit percentage rates from year to year.

This example also verifies one of our main points in this chapter: The main uses for operating budgets are to set out a plan in monetary terms, anticipate possible problems, explicate assumptions, and benchmark actual performance.

**(e) BUDGET APPROVAL.** Once a budget is agreed on by all parties, assuming some participation has been allowed, a commitment is fostered. The budget agreement itself

Peoria Rescue Ministries - Peoria IL - Operating Budget Development

| DESCRIPTION | DEC 2006 PLUS YTD/NOV 2007 | RATIONALE | *Memo: BUDGET 2007* | BUDGET 2008 |
|---|---|---|---|---|
| **INCOME** | | | | |
| **(Revenue & Support)** | | | | |
| Individual Contributions | 758,756.14 | Development and General Director Plans based upon Previous Year | *775,000* | 825,000 |
| Special Appeals Indiv. Contribs. | 201,834.04 | In House Special Appeals Planned Using Last Year as a Guide for 2008 | *275,000* | 260,000 |
| Church Contributions | 131,303.91 | Development and General Director Plans based upon Previous Year | *125,000* | 140,000 |
| Special Appeals Church | 1,038.92 | Same as Immediately Above | *2,000* | 1,000 |
| Bus/Org. Contributions | 88,116.61 | Dev. Dir. & Gen. Director Plans based upon Previous Year and new Bus. Contacts | *68,000* | 90,000 |
| Bus/Org. Contributions Special Appeals | 5,073.68 | Dev. Dir. & Gen. Director Plans based upon Special Projects that Bus. Would Support | *5,500* | 5,000 |
| Memorials | 26,226.87 | Past History Guidelines | *30,000* | 30,000 |
| Education Contributions | 1,308.00 | Based upon Past History and Planned Appeals. Gen Director & Dev Director | *500* | 1,000 |
| Evening Offerings | 7,876.05 | Based Entirely on Past History with Alterations for Additional/Fewer Services | *8,000* | 8,000 |
| Speaking | 4,258.97 | General Director Input based upon Previous Years and New Contacts for 2008 | *8,000* | 5,000 |
| Special Events | 131,754.90 | Dev Director, Gen Director & Events Coordinator on plans for 2008 | *145,000* | 140,000 |
| Grants | 1,000.00 | Dev Director on Grant Applications Pending and Proposals for New Year | *1,000* | 1,000 |
| Wills & Estates | 634,543.18 | Dev Director estimate for 2008 Plus New Estates based upon History | *200,000* | 250,000 |
| Trusts | 104,837.72 | Dev Director Known Trust Payouts and New Trusts to Start in 2008 | *12,000* | 40,000 |
| Life Insurance | 100.00 | Gen Director Input based upon Current and New Projected Policies | *300* | 300 |
| Interest Revenue | 19,376.92 | Business Manager Interest based on Current Rates and Bank Balances | *11,000* | 14,000 |
| Book Sales | 2,523.63 | Development Director Plans for 2008 Book Sales based upon His Plan of Events | *1,500* | 2,000 |
| External Appeals | 57,704.27 | Dev Director Bus Mgr and Gen Director on Planned Acquisition Appeals Contract | *84,000* | 60,000 |
| International Ministries | 37,258.96 | Budgeted Known Entities That Support Our Intl. Min. - Gen Director Provides Guidance | *65,000* | 40,000 |
| Sale of Pallets (Earned Income) | 773,160.24 | Based Upon Past History and Planned Appeals - Past History is for Guideline Only | *795,000* | 825,000 |
| Sale of Livestock (Earn. Inc.) | 555.13 | Farm Director Provides based on Projected Cattle for Sale | *1,000* | 1,000 |
| Sale of Wood Chips (Earn. Inc.) | 65,694.61 | Pallet Production Mgr. Provides on Known History and New Contracts | *85,000* | 65,000 |
| Delivery (Earn. Inc.) | 9,481.84 | Pallet Production Mgr. Provides on Known History and New Contracts | *14,000* | 10,000 |
| Vending Income | 1,573.58 | Based upon Our Vending Machines, New Additions, and Projected Prices | *3,000* | 2,000 |
| Designated Gifts | 141,465.51 | Special Projects Planned for Coming Year. - Dev. Director with Bus. Mgr. Input | *140,000* | 100,000 |
| Gifts In Kind | 131,000.00 | Past History and Planned or Known Gifts Coming | *125,000* | 140,000 |
| Emergency Assistance Fund | 2,600.00 | Budgeted based upon Past History | *2,500* | 2,000 |
| Miscellaneous | 4,251.00 | Provides For all Items Not Specifically Budgeted - Business Manager | *4,200* | 7,000 |
| **Total Income (Rev. & Support)** | **3,344,674.68** | | ***2,986,500*** | **3,064,300** |

**Exhibit 8.5** Peoria Rescue Ministries Total Ministries Budget for a Given Year (*continued*)

Peoria Rescue Ministries - Peoria IL - Operating Budget Development

| DESCRIPTION | DEC 2006 PLUS YTD/NOV 2007 | RATIONALE | *Memo: BUDGET 2007* | BUDGET 2008 |
|---|---|---|---|---|
| **EXPENSES** | | | | |
| Payroll | 976,535.12 | Staffing Needs & Review Wage Costs for Budget Year - Bus. Mgr., Gen Dir. Review | *993,000* | 1,035,000 |
| Employee Benefits | 202,176.42 | General Director & Business Manager Review Benefit Costs to Set Budget | *196,000* | 228,000 |
| FICA Tax | 73,960.82 | Bus. Manager Factors Payroll Taxes based upon Payroll Amounts | *75,000* | 78,000 |
| Stipends | 38,385.00 | Ministry Directors based Upon Client Needs and Projections for Year | *41,000* | 40,000 |
| Equipment Purchase & Repair | 83,212.00 | General Director with Consultation of Equipment Needs With Ministry Directors | *90,000* | 90,000 |
| Postage | 14,945.91 | Business Mgr. based upon Expected Usage and Mailing Plans | *17,500* | 17,500 |
| Office Supplies | 37,549.16 | General Director/Bus. Manager Review Needs and Project 2008 amount | *34,000* | 37,000 |
| Program Materials | 10,782.55 | Ministry Directors based Upon Client Needs and Projections for Year | *17,600* | 10,000 |
| Medical Client Expense | 2,901.41 | Ministry Directors and General Director Review Client Expectations for New Year | *3,500* | 3,500 |
| Bad Debt Expense | 1,334.00 | Business Manager based upon Receivable Conditions and Expectations | *4,000* | 1,000 |
| Promotional Material & Exp. | 138,684.14 | Development Director and General Director based on New Year Plans on Promotion | *130,000* | 140,000 |
| Travel & Transportation | 41,383.95 | General Director and Bus. Mgr. based on Mileage Allowance and Vehicle Expense | *42,000* | 44,000 |
| Insurance | 77,421.14 | General Dir and Bus. Mgr. based upon Ins Needs and Projected Coverage | *75,000* | 70,000 |
| Building Maintenance | 61,790.51 | Routine Maintc Ministry Directors/Gen Director and Maintenance Mgr. based on Need | *55,000* | 50,000 |
| Building Improvements | 6,232.26 | General Director based On Planned Improvements | *15,000* | 6,000 |
| Client Expense | 9.911.53 | Ministry Directors Budgeted for Each Ministry | *14,000* | 12,000 |
| Mission Support | 58,300.00 | Approved by Gen Director and Board Approval | *50,000* | 65,000 |
| Mission Staff Support | 6,735.00 | Approved by Gen Director and Board Approval | *6,000* | 7,000 |
| International Aid-IM | 5,791.99 | Approved by Gen Director and Board Approval | *18,000* | 6,000 |
| International Ministries | 247,400.68 | Approved by Gen Director and Board Approval | *135,000* | 140,000 |
| Conferences | 10,812.05 | General Director Provides By Approving Planned Conference for Employees | *15,000* | 12,000 |
| Electricity | 63,500.07 | General Director/Bus. Mgr. Determine based on Current and Future Contract Rates | *72,000* | 75,000 |
| Natural Gas | 37,560.45 | Same as Above | *65,000* | 40,000 |
| Water | 14,857.38 | Same as Above | *25,000* | 16,000 |
| Telephone | 39,364.14 | Same as Above | *39,000* | 38,000 |
| Janitorial Supplies | 17,468.60 | Ministry Directors Provide per Ministry with Approval of General Director | *20,000* | 18,000 |
| Food | 8,048.45 | Determined After Total Revenue & Support Budgeted - Determined by General Director | *10,000* | 10,000 |
| Emergency Assistance Exp. | 4,759.82 | Each Ministry Director With Consultation of General Director | *2,000* | 2,000 |
| Livestock | 2,801.01 | Farm Director Provides based on Projected Cattle for Sale | *1,000* | 3,000 |
| Pallet Production | 60,481.10 | Ministry Director with Consultation of Bus. Mgr. and General Director | *60,000* | 44,000 |
| Shop Expense | 32,358.42 | Farm Director based upon Shop Income and His Assessment of Needs | *38,000* | 34,000 |
| Special Events | 54,967.92 | Dev. Director based upon Events Planned for Year | *68,000* | 60,000 |
| Special Appeals | 119,589.62 | Dev. Director based upon Special Mailings Planned for 2008 | *62,000* | 95,000 |
| Book Sales Expense | 2,403.53 | Dev. Director based on Planned Book Events | *2,500* | 2,000 |
| Professional Fees | 22,857.43 | Business Manager based on Contracts for Professional Organizations | *10,000* | 14,000 |
| Memberships/Subscriptions | 10,998.45 | General Director on His Approval on Memberships for Directors | *9,000* | 12,000 |
| Miscellaneous | 2,650.00 | Business Manager based on Unclassified Bills | *2,500* | 3,000 |
| Gain/Loss Sale of Assets | (114,787.17) | Bus. Mgr. and General Director on Planned Sale of Unused Assets | *(100,000)* | (65,000) |
| **Total Expenses** | **2,486,124.86** | | *2,412,600* | 2,493,000 |
| **Net Income/Deficit** | **$ 858,549.82** | | ***$ 573,900*** | **$ 571,300** |

*Source:* Reprinted, by permission, from David L. McFee of Peoria Rescue Ministries.

**Exhibit 8.5** Peoria Rescue Ministries Total Ministries Budget for a Given Year signals bilateral commitment between an operating unit and top management. The PRM budget approval process is indicative of good practice.[31] After the initial preliminary budget amounts are determined, a budget meeting is set with the PRM board's finance committee. This meeting includes an intensive line-by-line ministry analysis – with input to modify or change programs and budget amounts if warranted. At that meeting, the general/executive director and the business manager are present, and a financial spreadsheet is "live" on a computer screen so the preliminary figures can be adjusted immediately and a new "bottom line" for the consolidated budget can be arrived at. In this way, the finance committee members can conduct what-if scenarios and see readily how a change to the budget affects the overall budget. We will examine scenario planning later in this chapter. At the conclusion of this meeting, each person is given a copy of the proposed budget for further review preparatory to its consideration by the overall board. Copies are mailed to all board members who are not on the finance committee. The overall board receives the proposed budget at its December meeting, which is usually at least two weeks after the finance committee meeting. PRM also prepares its capital budget in conjunction with the operating budget, in order that program personnel may plan for program needs as they develop their future programs.

**(f) BUDGET VARIANCE REPORTS AND RESPONSES.** We noted in Chapter 7 that the first level of your financial reporting, done for internal users, is the budget variance analysis (BVA) report. This report is first in importance for managerial usefulness. Typically, the BVA is associated only with the operating budget, and we begin our discussion with that budget.

***(i) Operating Budget.*** This process should be ongoing on a monthly basis during the year to avoid surprises at year-end. Variances are the difference between actual (what happened) and budgeted (what was expected). A variance is a symptom that may be linked to many different problems, some more severe than others. Someone must identify the reason(s) behind any significant favorable (actual better than budget, which would be revenues greater than budget, expenses less than budget) or unfavorable variance. This is where the engagement of the responsible manager comes in. The manager that works with the intricacies of the day-to-day operations of their department is best suited to flag problems and offer potential solutions. It is a good practice to consider the responsible manager as a part of the financial management system, reviewing and critiquing accounting reports and seeking clarity. Being alerted to ongoing or emerging *significant* problems enables the manager to initiate corrective action. Sometimes the cause of the variance implies an obvious correction: Uncollected pledges receivable suggests more and firmer follow-up contacts and better front-end donor education. Other times the variance springs from uncontrollable factors, such as a change in exchange rates (for which no protection was provided through a hedge, such as a currency swap), or a drop in interest rates earned on cash reserves, and the organization will have to make offsetting adjustments in controllable areas. Of course, information from this year's results feeds back into new budget development even before the year is closed. Generally, the variance reports should conform to the checklist shown in Exhibit 8.6, with some pointers applying to monthly variance reports and others applying to weekly, quarterly, or annual variance reports.

In some organizations, the budget development and variance analysis processes are highly political. What can be done to eliminate political conflict? The following five precautions, some of which must be taken at the time the departmental or program budgets are developed, may be helpful:

- Weekly or daily variance reports should be prepared for selected items over which management has control and that are vital to the success of the organization. Waiting until month-end is sometimes too late. For example, radio and TV stations conducting telethons give constantly updated totals for management use and for prompting donor response.
- Show month's variance (both % and $) to the left of the revenue line item, and the year-to-date or full-year variance to the right of the account information. A brief explanation can be included to the right of the tabulated variances if space permits; otherwise provide the information below the table.
- Implement management-by-exception by highlighting variances that pass threshold tests – say, greater than 10 percent of the budgeted amount or greater than $500.
- Highlight positive variances as well as negative ones. Usually, show unfavorable variance numbers (lower revenue or higher expense amounts) within brackets; favorable variances should not be bracketed.
- Include in the written explanations not only variance cause(s), but also what will be done to correct the problem.
- Show enough detail so that offsetting variances within an expense category does not disguise underlying problems. For example, if "donations" is shown only in total, a mail campaign positive variance may be offset by a negative variance on face-to-face fundraising, and no corrective action gets triggered for the latter.
- Highlight controllable items for special management attention.
- Recognize that a variance may signal a faulty budget or a change in the environment, which should trigger the development of a revised budget to guide the remainder of the fiscal year.

**Exhibit 8.6** Variance Report Checklist

1. Have final budgets prepared by a cross-departmental committee, and then have everyone affected by the budgets review them.
2. Have the manager that prepared the budget explain the variance. Whoever oversees the reporting process should make sure actuals are not massaged to hit budgeted amounts.
3. Include and retain budget development assumptions in the final budget documentation.
4. Do not blame departments or individuals for variances, but focus attention on positive ideas for reversing the problems. Blame should be eliminated as it doesn't solve problems, not does it aid in responsibility setting.
5. Find the causes of the variances, and to the extent they are linked to a faulty budget, ensure that the next budget that is developed is done on a more accurate basis. Also, instead of blaming someone for the inaccurate budget, develop a revised budget (refer back to our earlier discussion on when to revise a budget). Some organizations persist in estimating expenses and then writing down a revenue figure to match total expenses. This practice makes revenue variance analysis almost useless – unless the organization sets within-year targets that serve as control points if and when the revenue forecast is not realized.[32]

We will return to the specifics of presentation format and what generic actions your organization can take if revenues are below budget or expenses are running above budget in the later section in this chapter entitled "Managing Off the Budget."

***(ii) Capital Budget.*** We showed an example of a capital budget request template earlier in Exhibit 8.4. The capital budget evaluation techniques are presented in Chapter 9. Compile a summary report at year-end to show what projects were totally or partly implemented during the year. Compare that to the capital budget(s) approved in the past year(s). Postaudit the actual project expenditures, by project, to find out if they matched anticipated amounts and if not, why not. This will greatly help your organization in future capital project analyses.

***(iii) Cash Budget.*** The cash budget preparation is demonstrated in Section 8.7. The variance analysis is similar to that used for the operating budget. How is it to be used to do after-the-fact analysis? Quite simply, it is used to check the accuracy of your year-earlier forecast and see if seasonal or trend patterns emerge in the actual cash flows that occurred. Determine in which months your forecast was farthest off, and why. Use that information to guide your development of next year's cash budget. Of chief importance, consider whether the target liquidity should be adjusted based on the past year variance. Let's consider the two cases of positive and negative variances in the net cash flow, which we define as:

$$\text{Net cash flow} = \text{Cash receipts} - \text{Cash disbursements}$$

*Case 1: Net cash flow comes in above budget.* In this case, the cash position is growing, unless the trend was spotted during the year and additional expenses incurred or assets purchased. Possibly, the liquidity target should be adjusted downward, but whether you do so depends on several considerations. Some of the factors you should look at are:

- If the trend is temporary and is about to be reversed (possibly because of special factors such as one-time undesignated gifts to the organization), do not change the liquidity target, because your cash position will return to its normal level in the near future.
- If some of the cash receipts were simply proceeds from borrowing,[33] the amount must be repaid, bringing the cash position back to its normal level.
- If the trend is permanent, and you do not anticipate increasing service provision, you may reduce the amount of liquidity because you have a level of operations that brings in cash revenues more than covering expenses.
- If you are not sure about the cause or permanence of the change, gain interest income and retain flexibility by parking some of the cash buildup in slightly longer-term securities, say with one-year or two-year maturities, making sure to choose those that are readily marketable.
- If your organization is growing rapidly, sit tight with the higher level of liquidity until you have a better idea of how much liquidity you need.

*Case 2: Net cash flow comes in below budget.* In this case, cash expenses are outstripping cash revenues, and you have less cash at the end of the year than you originally anticipated. Possibly, you borrowed some money to meet the shortfall. To the extent possible, you will probably want to rebuild the drained cash reserves. Recognize now that you will need to discuss increased fundraising activity to meet that target. In some cases, taking the flip side of the list we just looked at, the change is temporary, and possibly self-correcting. More often than not, nonprofit executives and board members blithely assume that such events are self-correcting, but you should take the change seriously. It may be that your organization is heading for chronic deficits and a rapidly eroding cash position. Your organization may also need to change its programming, if fees are part of the revenue base, or engage in earned income ventures to supplement donations. If your organization is growing rapidly, the problem is compounded, because quite often funds are disbursed to finance the growth before the donor base responds to the increased outreach. See additional ideas in Levels 2, 3, and 4 of the annual financial reporting pyramid presented in Chapter 7.

**(g) CAUTIONS.** Anthony and Young note four aspects of budget review that you should recognize:

1. You will face time constraints. Count on it! You won't have time to go into sophisticated budget procedures, or be a perfectionist.
2. There are budget review effects on behavior: Problems arise because so much of nonprofit spending is discretionary. This fact suggests that negotiation be used and that ability, integrity, and forthrightness are not soon forgotten.
3. Politics and gamesmanship often occur.
4. Watch out for the "budget ploys."[34]

***(i) Budget Ploys.*** The following four budget ploys are prevalent in the nonprofits we have observed:

1. *Foot in the door*. Here, a modest program is sold initially, but once the constituency has been built and the program is under way, its true magnitude is revealed. Sometimes this is triggered by "resource hunger" in which the budgetee's motivation is to acquire as many resources as possible, especially when output cannot be reliably measured and the output-input relationship is unclear. Your best hope is to detect this ploy up front and disapprove the program. Failing that, force the program advocates to hold to the original cost estimate.
2. *Reverence for the past*. This ploy is used to maintain or increase an ongoing program. The argument goes that the amount spent last year was necessary to carry out last year's program, so the only thing to negotiate is the increment to add to that base for this year's program. Time for careful consideration is often lacking, so try to implement selective zero-based budgeting (ZBB) over a period of several years; we address ZBB in greater detail later in the chapter.
3. *Make a study*. Users of this ploy are trying to avoid having their program's budget slashed. The advocate tries to buy time or block the action by demanding that all repercussions of such an action be studied. Sometimes the best response is to make the study and be persistent in cutting the program, assuming the study verifies the original reasoning. Other times, stick with your guns and cut the budget without further delay.
4. *We are the experts*. Here again, the goal is to forestall cuts. Budgetees are arguing that they have superior knowledge that the supervisor or budget director does not have. Professionals (teachers, scientists, physicians, and clergy members) are especially adept at this. The best answer is to insist that the "experts" phrase their reasoning in terminology and expression understandable to all.

***(ii) What Hinders an Effective Budget System?*** Methods and techniques used in the budget system have only limited impact on budget system effectiveness.[35] Of course, organizational personnel should understand methods used, budgets need to be done on time (and often are not), and variance reports showing actual-versus-budget differences should be prepared regularly, accurately, and on a timely basis. The key determinant of success or failure is the use made *after* the budget is in place. And the use made is primarily aided or hindered by communication. Communication problems arise in the following relationships:

- Between the budget department and operating management
- Between the different levels of the management hierarchy (e.g., top and middle management)
- Between the manager responsible for the budget and his or her direct supervisor[36]

Budgets are yardsticks, and sometimes they are taken seriously and operate effectively. At other times there is political maneuvering to escape the restraint of the budget. Breakdown in verbal communication is more often the culprit than written communications such as budget variance reports. The way you *use* the budget and the attitudes of top-line management are most important. Some of these problems can be prevented by the budget guidelines, others by the engagement process described earlier.

***(iii) Is the Finalized Budget Consistent with Financial Targets and Policies?*** This reality check is essential before publishing the budget. There should be a direct tie between your strategic plan and the budget as well as between your long-range financial plan and your budget. If done at the same time, there should be a very close correspondence between the first year of your five-year financial plan and your operating budget for next year. If the financial policy is to run surpluses for the next three years, obviously your budget should show revenues exceeding expenses. Your budgets and five-year plans should both show achievement and maintenance of your target liquidity level. The importance of this consistency cannot be overstated. Organizational alignment cannot be achieved without it. Finally, your budget should follow a very similar format to the operating revenues and operating expenses part of your Statement of Activities, assuming you segregate operating items to show an operating measure on your SA.[37]

## 8.6 BUDGET TECHNIQUE REFINEMENTS

Although technique is not the most important indicator of operating budget effectiveness, some organizations have found value in using newer, refined budget techniques, including nonfinancial targets, flexible budgets, program budgets, ZBB and scenario planning.

**(a) NONFINANCIAL TARGETS.** Many businesses include nonfinancial targets in their annual budget reports. We strongly advocate that you consider doing this, assuming your budget development process is running smoothly. What nonmonetary budget targets might you include? Anthony and Young recommend three output measures: (1) workload or process measures, (2) results or "objective achievement" measures, and (3) a framework for the objective achievement measures.[38] The latter framework might be the use of a management philosophy known as management by objectives (MBO), which is defined as the use of quantitative measures for measuring planned objectives, possibly including objectives to maintain operations, objectives to strengthen operations, and objectives to improve operations. In this situation, benchmarking and reengineering studies are helpful. This aligns with recent trends where funders are seeking more objective data regarding programmatic outcomes. We might think of financial resources as an input, and program delivery as an output.

**(b) FLEXIBLE BUDGETING.** Sometimes called variable budgeting, *flexible budgeting* is particularly useful for organizations operating in an uncertain environment, where you plug in the expense budget only after you find out exactly what level of output you're going to be producing or how many clients you plan on treating in a time period. On the expense side, flexible budgeting works well, you might have guessed, only for variable costs. Organizations that do not develop flexible budgets must adapt to changes in the environment "after the fact" – scrambling to prepare a revised budget to fit the new realities. You'll live with the original budget? Not if you want the budget to serve as a control and coordinating device, in which managers are held responsible for meeting or exceeding budgetary amounts.

Let's use a greatly simplified example, which builds on our earlier classification of variable, semivariable, and fixed costs. Recall that labor expense is the major cost to be managed by nonprofits. This is really a semivariable expense in many organizations: New staff and laborers do not have to be added for each additional client served, but perhaps one laborer must be added for each additional five clients. Salaried workers basically represent a fixed cost. Utilities, insurance, and mortgage payments are fixed costs. Supplies used in client engagements are a variable cost; the more clients served, the more supplies used.

Let's start with a base case budget for the year 20XX, based on the "most likely" figure of 1,000 client engagements. We have annotated it to show the cost type for each item in Exhibit 8.7.

To develop a flexible budget, we need to have a way to figure the amount for each variable and semivariable cost expressed as a percent of activity level (services delivered). Recall that the "base case" budget (the one you would have used if you did not go the extra step to develop a flexible budget) was based on 1,000 client engagements. This implies that client supplies cost \$40 per client engagement:

$$\begin{aligned}\text{Variable cost per unit} &= \text{Total cost divided by number of units}\\ &= \$40{,}000/1{,}000\\ &= \$40\end{aligned}$$

Expressed as a formula:

$$\text{Client supplies expense} = \$40 \times (\#\text{ of client engagements})$$

| (1,000 Client Engagements) January 1–December 31, 20XX | | |
|---|---|---|
| **Expense Element** | | **Amount** |
| Variable costs: | Client supplies | \$40,000 |
| Semivariable costs: | Labor expense | 120,000 |
| Fixed costs: | Salary expense | 60,000 |
| | Utilities | 5,000 |
| | Insurance | 4,000 |
| | Mortgage payments | 15,000 |
| Total expenses: | | **\$244,000** |

**Exhibit 8.7** Base Case Budget Worksheet

Semivariable costs have both a variable component and a fixed component. To get the fixed component, you need to determine how much of this cost element would be necessary to have a minimal service delivery (say, one or a very few clients). For labor expense, our organization projected $120,000 based on 1,000 client engagements. The staff director suggests that even if the organization had only 20 client engagements (the smallest number it could have and still remain open), the labor expense would be $20,000. What that tells us is that for the remaining 980 clients (1,000 clients assumed in the base case budget, less the 20 minimal-level clients), there would be $100,000 of labor expense ($120,000 base case budget less the $20,000 minimal level). This data implies that the variable component is:

$$\text{Variable cost per unit} = \text{Total variable cost}/\text{number of units}$$

$$\$102.04 = \$100{,}000/980$$

Let's express the relationship we have just discovered in a format we can use to calculate the semivariable cost for *any* level of clients. We saw that labor expense is $20,000 plus $102.04 per client engagement. Our formula is:

$$\text{Labor expense} = \$20{,}000 + \$102.04 \times (\text{\# of client engagements})$$

The easy part is estimating the fixed cost. By definition, a fixed cost does not change regardless of the amount of services delivered. So all we have to do is add all fixed costs:

| | |
|---|---|
| Salary expense | 60,000 |
| Utilities | 5,000 |
| Insurance | 4,000 |
| Mortgage payments | 15,000 |
| Total fixed costs | $84,000 |

Our formula for fixed costs is very simple: Total fixed costs = $84,000.

And now, the grand finale: Let's add the three formulas together to get one overall formula to simplify our flexible budgeting:

$$\text{Client supplies expense} = \$40 \times (\text{\# of client engagements})$$

$$\text{Labor expense} = \$20{,}000 + \$102.04 \times (\text{\# of client engagements})$$

$$\text{Total fixed costs} = \$84{,}000$$

$$\text{Total costs} = \$104{,}000 + \$142.04 \times (\text{\# of client engagements})$$

Using this formula, we can determine the expense budget for any level of activity we desire. For example, if client engagements double to 2,000, total costs could be:

$$\begin{aligned}\text{Total costs} &= \$104{,}000 + \$142.04 \times (2{,}000)\\ &= \$104{,}000 + \$284{,}080\\ &= \$388{,}080\end{aligned}$$

As actual figures for client engagements begin to come in, we can compare actual amounts to an adjusted "flexible budget" amount, which correctly states what the budget is at that particular activity level. This way, managers are not penalized for expenses that are running higher due to a higher caseload. Further, budget revisions based on environmental changes are no longer needed. The change in caseload due to environmental changes is automatically reflected in budget expense levels. In more technical terms, we no longer have to concern ourselves with a "volume variance" – an actual versus budget difference that is strictly due to changes in service activity. We can then limit our concentration on "price variances" that are due to changes in the unit cost of an input, such as a change in the minimum wage, or "mix variances" that are due to a changing composition in the types of clients we serve. One other benefit of doing the extra work involved in flexible budgeting: When cutbacks or expansion of your organization are being considered, you will already be prepared to pinpoint the likely financial effects. Prepare staff ahead of time by identifying by priority the spending allocations during the budget development process.

**(c) PROGRAM BUDGETING.** Recall that with line-item budgets, the focus is on expense elements. We noted earlier that program budgets may be a type of subunit budget. A program budget may also be your organization's primary budget format as well. With program budgets, instead of concerning ourselves with the type of expense, we focus on programs and their associated expenses. Essentially, think of it as having subunit budgets, one for each program. By directing our attention to individual programs instead of the overall organization, the manager is aided in allocating the right amount of financial and human resources to each activity. Furthermore, from a control and coordination perspective, program budgeting links spending directly to planned activity levels of the organization's product(s) or service(s). Furthermore, if revenues are shown with programs (for those charging fees or for which donations are raised to support them, specifically), one can see the degree to which the programs are self-supporting or require subsidization. An organization with a well-developed strategic planning process will find that it has already done some of the work necessary to establish the program budgets.[39]

**(d) ZERO-BASED BUDGETING.** Budgets, whether line item, flexible, or program, are usually arrived at by changing the past year's budget slightly, perhaps based on new economic assumptions or based on noted actual versus budget variances from this year's experience. A more radical, and some would argue superior, approach is to force each program or other subunit to justify its existence and budgetary allocation "from the ground up." This approach to budgeting is known as zero-based budgeting (ZBB). ZBB has five key components:

1. Identify objectives.
2. Determine the value of accomplishing each activity or program.
3. Evaluate different funding levels.
4. Establish priorities.
5. Evaluate workload and performance measures.[40]

The idea here is to look at all the organization's discretionary activities and priorities in a fresh way, and then to redo the budget allocations accordingly. Particularly important is the review of all support allocations. Basic or necessary operations are separated from discretionary or optional tasks. Every dollar of discretionary cost must be justified. The finalized money allocation must be based on a cost-benefit comparison of each competing activity's goals, program for attaining those goals, expected benefits and how one will know if they have been attained, alternatives to the program, consequences from *not* approving the activity and its corresponding budgetary allocation, and who will carry out the activity's program(s). We emphasize that you would not typically do this every year and you might select certain line items to be developed from a zero base, say, every four years.

Once the supporting data have been put together, it is time to rank the various activities. This ranking may be done first by program directors for all activities within their programs, then higher-level managers may assemble rankings of organization-wide alternatives. Management must rank order all of the alternatives from most beneficial to least beneficial, then decide how to allocate the overall budget to achieve the greatest good. For example, a charity might decide that for the coming year, computer software training will do more good than the usual in-service client relations training.

Some proponents of ZBB argue that it can actually simplify the budgeting process and bring about better resource allocation of funds. It does so by making managers consider the various priorities and how funds should be allocated to them. With the list of ranked activities, managers have an additional tool for augmenting or reducing activities as the allowable expenditure level changes as the budget year begins.

Deloitte Consulting has identified that successful ZBB can lead to significant savings and can help organizations overcome entrenched departments and methodologies. Deloitte lists these advantages and disadvantages in ZBB:

**Advantages**

- Resulting budget is well justified and aligned to strategy
- Catalyzes broader collaboration across the organization
- Supports cost reductions by avoiding automatic budget increases, often resulting in savings
- Improves operational efficiency by rigorously challenging assumptions

**Disadvantages**

- Costly, complex, and time consuming
- May be cost prohibitive for organization with limited funding
- Risky when potential savings are uncertain
- Execution challenged by budget cycle timing constraints
- Requires specialized training
- May be disruptive to operations
- Could harm organizational culture or brand[41]

Very few nonprofits are using this technique, but it would be an excellent technique to use once every four or five years because of the disciplined look at expenses that it forces on the organization. In some cases, graduate students report that organizations for which they work, or those that they have heard about, use this method every year, or at least periodically. We recognize the effects of politics and other budget ploys that must be overcome to make this exercise truly effective, however. We recommend that organization elect to do this periodically in order to leverage the advantages, and avoid or mitigate the disadvantages.

**(e) ROLLING BUDGETS.** Rolling budgets involve redoing the budget within the year and projecting at least the following 12 months (some businesses project out for 18 months). Technically, unless you are updating data and forecasts on a real-time basis based on new financial, operational, and economic information, you are using modified rolling budgets. Exhibit 8.8 provides the rationale and some specifics of rolling budgets that have been gleaned from their use by businesses.

- Many companies are recognizing that the conventional static budget – produced near year-end and then used as a guide for the following year even though it's out of date – is just not good enough.
- Instead, they are turning to rolling budgets – forecasts that are updated every few months – in effect, reassessing the company's outlook several times a year.
- The result: an always-current financial forecast that not only reflects a business's most recent monthly results but also any material changes to its business outlook or the economy.
- Implementing rolling budgets doesn't necessarily require any fundamental change in the way a company has been doing its budgets – except, of course, it no longer does the job just once a year. However, companies that decide to step up to rolling budgets may want to take advantage of the decision to make changes in the way they approach the task. They may search for new ways to speed up the budgeting process and make it more useful.
- In the view of many accountants, traditional budgets too often are useless because they are hopelessly out of date soon after they are assembled.
- When a company uses a traditional static budget process and finds that it misses its sales targets in the first month, it typically pushes those projected sales into subsequent quarters, acting as if the outlook for the full year remains unchanged.
- For rolling budgets to work, management must access and process information more quickly, and that often means acquiring special software that does the job.

*Source:* Randy Myers, "Budgets on a Roll," *Journal of Accountancy* 192 (December 2001): 41–46.

**Exhibit 8.8** Features and Advantages of Rolling Budgets

We believe that rolling budgets keep the organization's eyes on a full-year-ahead horizon, not merely what will happen between this point in the year and the end of the fiscal year. Furthermore, we see rolling budgets as taking advantage of advances in information technology, including web-based budgeting and planning software, web-based banking, improved accounting and record-keeping systems, and more rapid availability of information. They also enable larger nonprofits to decentralize budget setting (after assumptions have been handed down from the main office), as has been done by two nonprofits, International Missions and Mercy Health Partners.[42] A study being conducted by two accounting groups in England and Wales reached this conclusion, which also applies in the United States:

> Part of the reason budgeting has changed and why budgets can be more flexible . . . is that information can be gathered much more easily now than was possible even a decade ago. Because data is collected, stored and analyzed more readily, frequent reforecasting and adaptation is possible if an organization is willing to invest the time to set up the systems. This allows the budget to be forward looking and more strategic, and forecasts can be more precise. Some participants in the . . . budgeting forum actually suggested that forecasts are more important than budgets in their businesses.[43]

Reforecasting into the next 12 months is a good discipline for any organization, and a best budgeting practice.

Once the operating budget is finalized, it needs to be *calendarized* (distributed across months, as some months are higher-revenue or expenditure months than others). That concludes the operating budgeting process; now, the cash flow ramifications need to be spelled out. The process for showing when cash comes in and goes out is called cash budgeting, which we profile below.

**(f) SCENARIO PLANNING.** If we think of the annual budget that is prepared, approved, and disseminated to stakeholders, we might think of this budget as the most likely scenario. During this intensive planning process we should also develop scenario budgets. We might think of these as the "what if" plans.

Global Business Network (GBN) develops a model of planning that is based on examination of scenarios other than the most likely scenario. Scenario thinking and planning can be used to examine a variety of possible outcomes, challenging the status quo (as we do in ZBB). Scenarios are hypotheses, not predictions, that capture a range of future possibilities and help the organization plan for them in advance. This method can be used in strategic planning as the organization examines driving forces that organizations must navigate in order to remain viable in a change environment. It can be brought into the budget process by asking what if: revenues come in lower or higher than our most likely scenario? How would the scenario affect our operations, financial position, and especially our target liquidity?[44]

## 8.7 CASH BUDGET

If your organization's accounting is done on a cash basis, your operating statement provides the input for the cash budget. The cash budget differs in purpose, in that it highlights the cash available to the organization at various points in the future. It is very revealing, especially the first time it is constructed, because nonfinancial managers typically are unaware of just how unsynchronized cash inflows and cash outflows are.

**(a) USES OF THE CASH BUDGET.** We start our presentation on cash budgeting with a definition: The cash budget shows the timing of cash inflows and outflows, usually on a monthly basis for the next 12 months. It is sometimes called a cash plan or cash forecast. Exhibit 8.9 shows the value of a cash budget. The cash budget has five major purposes; it shows the:

1. Unsynchronized nature of inflows and outflows (e.g., see October figures in historical cash flow table in Exhibit 8.10)
2. Seasonality of these flows (e.g., donations run high around Easter and especially between Thanksgiving and Christmas)
3. Degree of mismatch (surplus or shortfall)
4. Duration of these surpluses or shortfalls (how long they last, in months)
5. Necessary inputs for short-term investment or borrowing planning (together degree and duration of mismatch provide this, with the output being amounts and maturities of short-term investments or borrowing)

**(b) STEPS IN CASH BUDGETING.** The four steps in developing a cash budget are:

1. Determine which measure of cash to manage and forecast:
    - General ledger cash balance (checkbook balance if that's your only accounting)
    - Bank balance (preferred)

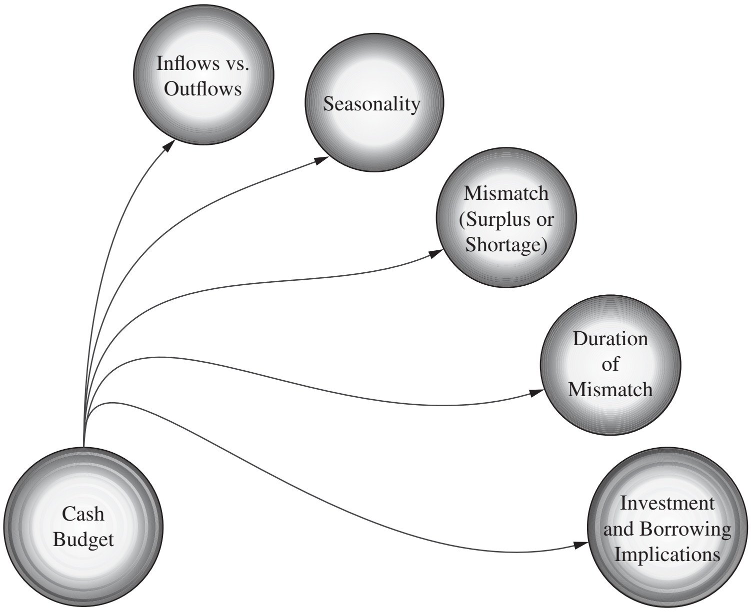


**EXHIBIT 8.9** CASH BUDGET: USES

2. Decide on presentation format.
3. Collect historical information (see Exhibit 8.10 for an actual nonprofit's prior year cash flows).
4. Develop cash forecast.

**(c) FORECASTING YOUR CASH POSITION.** When actually laying out your cash budget, you may choose one or more of several formats. Because you already are probably developing a statement of cash flows (SCF), one alternative is to use the SCF format. You would then show projections for cash from/(to) operating activities, cash from/(to) investing activities, and cash from/(to) financing activities. This works well for an annual consolidated projection but is unnatural for monthly or daily projections. An alternate format, which you may decide to use for your daily or monthly projections, is the cash receipts and disbursements method (see Exhibit 8.11).

To operationalize this method, we would need to provide the necessary detail for each category of cash flow and for the minimum necessary cash:

- Categories of cash inflows
- Categories of cash outflows
- Needed minimum cash (may be transactions cash, may be all cash and equivalents that are part of your target liquidity)

Basically, all we are doing here is looking back to see what items provided our cash inflows and outflows in the past, and deciding how much detail to show for each category.

Let's look more closely at projecting our cash receipts, and then we'll comment on cash disbursements.

| Month | Oct. | Nov. | Dec. | Jan. | Feb. | Mar. | Apr. | May | June | July | Aug. | Sep. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Line item: | | | | | | | | | | | | |
| Cash Receipts (Total Deposits) | $1,373,317.26 | $1,495,458.64 | $2,296,298.05 | $1,600,345.48 | $1,585,682.34 | $1,455,742.97 | $1,474,501.30 | $1,410,048.27 | $1,528,613.80 | $2,872,784.74 | $1,928,010.02 | $1,405,515.21 |
| –Cash Disbursements (Total Pymts/ Withdrawals) | 1,866,433.15 | 1,358,838.60 | 2,191,922.40 | 1,826,944.39 | 1,598,544.96 | 1,516,459.75 | 1,417,947.23 | 1,360,117.18 | 1,469,020.89 | 3,064,544.94 | 1,715,130.63 | 1,459,922.01 |
| Net Cash Flow | ($493,115.89) | $136,620.04 | $104,375.65 | ($226,598.91) | ($12,862.62) | ($60,716.78) | $56,554.07 | $49,931.09 | $59,592.91 | ($191,760.20) | $212,879.39 | ($54,406.80) |
| +Beg. Cash (Beginning Balance) | $626,414.41 | $133,298.52 | $269,918.56 | $374,294.21 | $147,695.30 | $134,832.68 | $74,115.90 | $130,669.97 | $180,601.06 | $240,193.97 | $48,433.77 | $261,313.16 |
| =Ending Cash (Ending Balance or New Balance) | $133,298.52 | $269,918.56 | $374,294.21 | $147,695.30 | $134,832.68 | $74,115.90 | $130,669.97 | $180,601.06 | $240,193.97 | $48,433.77 | $261,313.16 | $206,906.36 |

**Exhibit 8.10** Collecting Historical Information

| | January | February |
|---|---|---|
| Beginning cash | $250 | $175 |
| + Cash receipts | 100 | |
| − Cash disbursements | 175 | |
| = Ending cash | $175 | |
| − Minimum cash | 200 | |
| = Cash surplus | — | |
| *OR* | | |
| Cash shortage | ***($ 25)*** | |

**Exhibit 8.11** Basic Cash Budgeting/Forecasting Template

***(i) Determine Cash Receipts.*** The determination of cash receipts proceeds in a logical and orderly, six-step fashion:

1. The operating budget is your starting point.
2. Accrual versus cash basis adjustment may need to be made (if necessary – if already on cash basis, don't worry about adjustments).
3. Watch out for the common oversights:
   - Don't forget prearranged financing inflows.
   - Don't forget (formerly) restricted net assets, such as deferred giving or time-restricted or purpose-restricted prior gifts that will become unrestricted this period.
4. Calendarize the full-year receipts and disbursements by putting the amounts expected in each month.
   - Study history to see seasonal patterns.
   - Consider special factors that may have caused numbers to appear in a different month or quarter in the past than they will most likely occur in the upcoming period.
5. Anticipate changes in the forthcoming 12 months.
6. Show quarterly totals to provide one checks-and-balances monitoring sequence.

***(ii) Determine Cash Disbursements.*** Again, the operating budget expenses are the starting point. Because of accounts payable, you may have to make an accrual-to-cash basis adjustment (if necessary) to show exactly when the payables are paid. *Do not include depreciation expense*. Watch out for the capital budget outlays; many organizations forget to include them in the cash budget. Then calendarize the cash outlays correctly, recognizing seasonal or other ups and downs. Pull together quarterly subtotals to use down the road for comparisons with actual cash flows.

***(iii) Put It All Together.*** Now we are ready to bring the cash receipts and disbursements together to find the difference ("net cash flow" [NCF]) for each month. Once we have that, we will add it to beginning cash to arrive at ending cash. We compare ending cash to minimum cash required (by subtracting the latter), and see if we have a cash surplus anticipated for the month's end or a cash shortage. Summarizing, we have a three-step sequence that you should carry out at least monthly and probably weekly or even daily.

1. Compute NCF (Cash inflows – cash outflows), ending position, cash surplus/(shortfall) for each month.

2. Analyze pattern(s). Are there distinct seasonal highs or lows for either cash receipts or cash disbursements? How will this feed back into our cash planning (i.e., building up larger reserves) or fundraising appeal timing?
3. Make recommendations with regard to not only cash reserve buildup (how does the sum of the forecasted amounts of cash, cash equivalents, and short-term investments compare to your target liquidity level) and fundraising campaign timing or frequency, but also for short-term investments (amount and maturity of securities) and short-term borrowing (amount and anticipated maturity of any short-term borrowing, if such borrowing is used).

The cash forecasting exercise is valuable in assisting with your implementation of financial policies, particularly your target liquidity level, and with carrying out your financial management processes.

***(iv) Use the Cash Budget to Help Set Target Liquidity Level.*** For background on our discussion of how much liquidity an organization should have, you may wish to refer back to our discussion of the target liquidity level in Chapter 2. We also noted, in Chapter 5, some pointers on the optimal liquidity level, which we recap here. As for the optimal level of target liquidity, you will have to do the analysis yourself because no technique will give you that specific target level.

As a starting point, take a look at the low point in your fiscal year, which for many nonprofits is late September or early October. Set a liquidity level for your peak season, probably early January, that is sufficient to cover your organization through the dry season. *This is where your annual cash budget reevaluation is so helpful.* Study past cash flow patterns carefully and note when the cash crunches came as well as how much liquidity should have been held earlier in the year to prevent each cash crunch. Determine if there were anomalies in cash balances (i.e., one-time events such as unexpected areas of expenditure or revenue) and adjust for these. It is helpful to review more than one year's cash patterns in order to determine trends and causality.

The degree of flexibility your organization has in managing off of the budget (see Section 8.8) will also help you determine the size of your safety buffer of liquidity.

In addition, consult Exhibit 8.12, which provides you with a road map to determine whether your organization has too little liquidity. Work through it carefully, providing answers to the areas listed. Notice the key considerations: slow growth, missed opportunities, risky financial posture, small or zero net interest income (investments income less interest paid on borrowed funds), wage/salary freezes or minute increases, loans turned down or received on unattractive terms, recurrent cash crunches (or cash crises), late invoice payments (or lateness on other amounts paid), and ongoing stringency in financial posture despite successful fundraising campaigns. Once you have worked through these diagnostic questions from the vantage point of evaluating illiquidity, consider the opposite of each of these factors, in order to determine whether your organization might have *too much* liquidity. Readjust your target liquidity level according to your answers.

## 8.8 MANAGING OFF THE BUDGET

We have provided much information on budgetary reports, but up to this point we have not given very much guidance on what to do when the BVA shows a deteriorating financial position. In this section, we will provide some pointers.

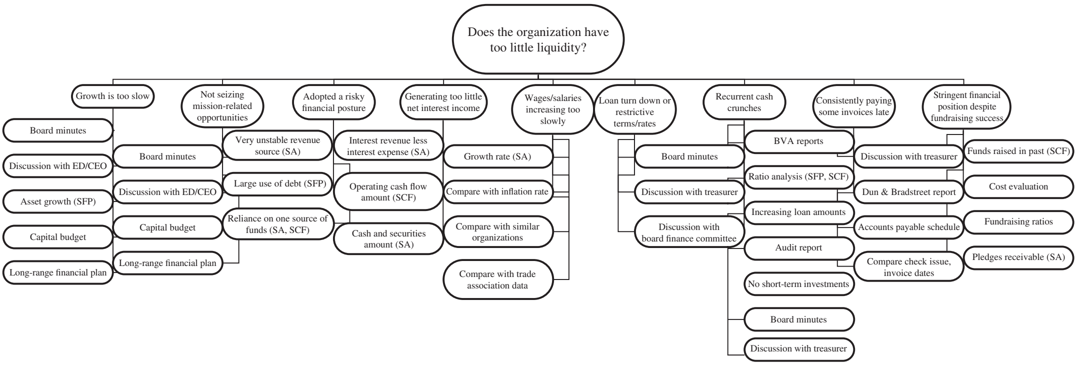


**Exhibit 8.12** Determining Whether Organization Has Too Little Liquidity

**(a) BUDGET VARIANCE ANALYSIS REVISITED.** Some organizations either ignore their target liquidity levels or never set them in the first place. An example is the Midwest Finance Association; the association continued to experience operating budget deficits for a series of years without taking any correction action. As it continued to run deficits, what do you suppose happened to its liquidity? Right! The cash reserves continued to dwindle, until the viability of the organization was in jeopardy. Although this should not have been a surprise, it often is because no sense-making mechanisms have been built into planning. Finally, the president of the MFA wrote the members of the chronic deficits and notified them that the dues were being almost doubled in order to bring the organization back to a breakeven or surplus position and, more important, to preserve and rebuild the cash reserves. In the MFA's case, the corrective action took place after annual results were evaluated to see how they fit into the past years' established trends. Most organizations can react more quickly by harnessing their ongoing financial reports.

Three reporting principles will help you manage off the budget:

1. An exception reporting focus will help shine light on the large-dollar or large-percentage items that contribute most to the problems and therefore the likely solutions. Many organizations provide guidance in their budget policy in terms of variances that require narrative explanation and plans to remedy.
2. Inclusion of year-to-date (YTD) variances, as well as the last month and/or last quarter, will give the needed perspective for decision making.
3. If possible, include actual versus forecast as well as actual versus budget (two comparisons) in your variance analysis reports.

The third principle necessitates more management time for preparation, because each month or quarter you not only have to review the past performance but also do a new forecast, which possibly varies from the budgeted amounts. Organizations that use flexible budgets, if recalculated, may eliminate the need to do an actual versus forecast because the revised budget may have been a new forecast based on how things have changed.

Progressive organizations are moving beyond mere financial reporting and including nonfinancial items in their periodic reports. Let's face it: Your financial results three or five years from now are going to be closely linked to nonfinancial factors and trends. If we keep in mind that finances are mission supportive, we can better connect money to mission.

Accordingly, universities and businesses are adopting a new approach in their monthly or quarterly meetings, in which they highlight key financial performance indicators (KPIs) and possibly cost drivers. KPIs include contacts made by the admissions office, follow-up letters written by academic unit heads, and the like. Indiana State University board members receive a report of KPIs at each board meeting based on consultation provided by business students and a faculty member, as refined by the internal auditor.[45]

The focus in a KPI report is on selected areas of performance in which satisfactory results will ensure the organization's competitive success, meriting top management time and attention.

Several other success factors seem to enhance the potency of your budget reporting and its usefulness to the organization. One is the importance of doing your variance analysis and situation analysis in conjunction with ratios and other indicators. As we saw in Chapter 7, ratios taken as a group provide a composite picture of the organization's financial health. We illustrate with a ratio that expert Vonna Laue, who audited and consulted churches for 20 years while at CapinCrouse LLP and now serves as Executive Vice President at ECFA, recommends that churches monitor:

> [There are several] important indicators every church should understand and monitor . . .
>
> Debt to Unrestricted Contributions [determined by dividing Total Debt by Unrestricted Contributions] . . . measures how many times your debt is greater than annual unrestricted gifts. Lenders expect debt to be funded through unrestricted contributions. They determine what debt load a church will be able to handle on top of other required expenditures (salaries, benefits, facility expenses, mission expenses, and so on).
>
> The lower the ratio, the less the debt will strain the church's budget. A ratio that is too high indicates your church's debt levels are placing an excessive burden on the budget. It also indicates your debt may be at a level that lenders consider too great for your church to support.[46]

There are a number of other indicators that can be used beyond what has been presented here, and all the important indicators should be assessed. Gross, McCarthy, and Shelmon provide five classes of indicators of impending financial trouble: (1) reduced community support, (2) decreased financial independence, (3) declining productivity, (4) deferred current costs, and (5) ineffective management practices (i.e., a pattern of budget cost overruns, revenue shortfalls, lower investment returns, higher interest charges, and delayed/unclear/incomplete reports to board or top management).[47] A second success factor we noted in our Lilly study is the importance of the "1,000-word picture," in which graphs or charts are used to depict to top management or the board what is happening to the organization's financial position. For example, in our field study, we observed that two board members who were employed as engineers at Caterpillar in Peoria, Illinois, drew up trend-line charts to show revenue and expense trends for the Peoria Rescue Ministries CEO and other board members. Related to this, a third success factor is to include not only trends but also comparative data if available (peer analysis). This gives a more balanced view of the present situation. Fourth, we noted in the Lilly study the importance of the verbal presentation accompanying the reporting of financial results. Learn to walk your management team and board through the maze of financials that they might not have the time, energy, or expertise to wade through. Finally, you might be surprised at the importance of annotating the financials with brief interpretive comments (because your listeners will forget the verbal presentation and possibly misinterpret the graphs and ratios).

**(b) CASH POSITION.** As your cash position changes, you will be in the position of advising management and the board of the seriousness of the change and what corrective actions, if any, are needed. You will want to provide this guidance each quarter or, if warranted, more often. Some organizations take a new look at the liquidity weekly or even daily. As cash manager of the organization, assuming you have enough cash to make it worth your while, look each day at the checking account balance to determine whether and how much to transfer to overnight or longer investments.

Now that we have an idea of the role of analysis and reports in "managing off of the budget," we turn to some of the responses you might consider in coping with financial difficulties. You also may wish to look at these as ways to fine-tune your already healthy financial position.

**(c) RESPONSES TO FINANCIAL DIFFICULTIES.** Many organizations within and outside of the nonprofit sector are engaging in reengineering. This happens when service delivery and internal management processes are opened up for radical redesign instead of just incremental improvements. The approach is much like zero-based review or zero-based budgeting, except it is applied to efficiency of service delivery and internal management processes.

Some organizations are noting the difficulties that similar organizations are getting into and are moving ahead of time to build an endowment income stream or their cash reserves as money for the rainy days. Related to this, financial analysts are planning for the overhaul of aging plant and equipment so as not to be caught short when the time comes for refurbishment or replacement. Residential colleges, churches, and museums must be especially careful to plan for the fixed asset needs for which they will have to plan internal funding or arrange funding. Other organizations are noting the need for pension funding or benefits funding.

But what if it's too late to plan ahead? Let's profile some responses to financial shortfalls:

- Quickly eliminate deficit spending.
- Quickly increase internal control.
- Quickly increase the role and prominence of the finance department. (It sounds self-serving, but it certainly helped the Church of the Brethren and the Church of God Missionary Board, as well the organization highlighted in the beginning of this chapter.) It also aids in enhancing financial literacy throughout the organization.
- Quickly reorient the organization to a more deliberate program expansion (whether new programs or expansion of existing ones):
  - Managed growth, which means a measured, manageable rate of growth (practiced a number of nonprofits, including Cedarville University, Cedarville, Ohio)
  - Sustainable growth rate[48]
  - Internal growth rate[49]

In addition to these stopgap measures, there are some internal and external measures you can take to stem a long-term decline.

**(d) INTERNAL MEASURES.** There are six major financial strategies to embark on *within* your organization. Briefly, they are:

1. *A new emphasis on cash forecasting with shorter horizon (month) and interval (weekly)*. 3M's policy is to accurately forecast cash sources and uses and take whatever actions are deemed appropriate so that adequate cash is on hand at all times and so that daily and long-term liquidity needs are met at the best price. Consider adding a statement similar to this to your liquidity management/cash reserves policy.
2. *Asset sales*. This might be called "strategic disposition" in order to focus better on core areas of operation. This can be a red flag however, so narrative needs to be developed in order to communicate this activity.
3. *Expansion strategy*. Land purchase, lease to builder/leaseback to the nonprofit organization: This strategy enables the builder to utilize the depreciation (40-year) expense deduction against income taxes, whereas the nonprofit would be unable to.
4. *Asset redeployment*. Place scarce labor and volunteer resources in critical areas.
5. *Cost reduction/containment*. This is the "downsizing" or "rightsizing" we hear so much about.
6. *Treasury strategies*. Much of what is in mind here involves revising your treasury management approach and operations based on benchmarking. We provide techniques in Chapter 11 and benchmarks to begin using to gauge your treasury operation in Chapter 15.

**(e) EXTERNAL MEASURES.** The external measures that organizations may take to cope with financial problems fall into three major categories:

1. *Fundraising*. Increase the intensity and focus of your fundraising efforts. Many smaller organizations do not receive grants simply because they do not apply for them: According to the most recent GrantStation "State of Grantseeking Report," despite the fact that three-fourths of organizations that only submitted one grant application won an award, but only about three in five small organizations submitted at least one application in the last six months of the survey year.[50]
2. *Bank borrowing*. Document future cash flow improvements to merit short-term financing to bridge the gap.
3. *Merger/acquisition partner or strategic alliance.* Join hands with a partner that has deep (or deeper) pockets.

Budgeting practices are most valuable when they are well planned and carefully executed, and include the types of control and follow-up we have discussed.

## 8.9 CONCLUSION

In this chapter, we have shown how to develop operating and cash budgets. We show the sequence of steps that should be followed, so you can set up the process. We provide warnings of the pitfalls that many nonprofit organizations face along the way. Most notably, budgets are rarely tied to long-range financial plans and strategic plans. Budget enhancements are also discussed; ZBB and flexible budgeting, in particular, might merit further study on your part. Budgets are valuable management tools for planning and coordinating your service delivery, despite the weaknesses inherent in the budget process and the way it gets implemented in organizations.

Organizations that do not budget are losing financial control and cannot enable sense making. Organizations that do budget find the budget system most effective when it is tied to the strategic plan. Once in place, the budget may be compared to actual dollar amounts as the budget year progresses, with management taking action on the corrective actions that are signaled by the budget variances.

We conclude our budgeting discussion by taking a look comparing nonprofit and governmental budgeting practices with corporate budgeting practices to see what conclusions we can draw from and adapt to use as best practices. Our data comes from the Association for Financial Professionals nationwide survey of over 600 finance professionals, including 73 nonprofit respondents.[51] We compare nonprofit and governmental responses (they were combined in the reported findings) to publicly-held businesses with less than $1 billion in sales. Relevant findings include (note that the rounding of some of the percentages means the responses may not add up to exactly 100% of each group of respondents on any given question):

- Less than half (46%) of nonprofit/government respondents rate their budget as "very effective" or "extremely effective" in delivering on its primary purpose, versus 49% of business respondents giving those ratings;
- When asked about the flexibility of their budgets, 25% of nonprofit/government respondents (and 10% of business respondents) indicated they were "iron-clad,"

27% of nonprofit/government respondents (and 40% of business respondents) said "tight," 42% of nonprofit/government respondents (and 33% of business respondents) said "loose," and 5% of nonprofit/government respondents (and 16% of business respondents) said "non-binding";

- Asked for their agreement with the statement, "In actual practice, budgets are managed based on the company's top line (revenue) and/or the bottom line (Earnings Before Interest, Taxes, Depreciation, and Amortization, income, etc.)," 45% of nonprofit/government respondents (and 72% of business respondents) indicated "true," and 56% of nonprofit/government respondents (and 28% of business respondents) said "false";
- Asked whether they agreed with the statement, "Managers have authorization to manage their budgets as long as they meet their top and/or bottom lines," 71% of nonprofit/government respondents (and 65% of business respondents) indicated "true," and 29% of nonprofit/government respondents (and 35% of business respondents) said "false";
- When asked whether "operational targets matter equally or more than financial budget targets," 55% of nonprofit/government respondents (and 62% of business respondents) indicated "true," and 45% of nonprofit/government respondents (and 38% of business respondents) said "false";
- When asked about the frequency of use of the budget by various potential users during the year, nonprofit/government respondents in 70% of the organizations surveyed said "The Board of Directors" (versus 69% responding this way for businesses), and in 63% of the nonprofit/government organizations "line management" used the budget during the year versus in 56% of the businesses;
- For government/nonprofit respondents, of the time spent discussing finances during "past performance finance reviews" (overall organizational performance), about one-fourth (22% in nonprofits/governments, 26% in businesses) of the time is spent on comparison to prior-year actuals, roughly one-half of the time spent is on budget versus actual (60% for nonprofits/governments, 50% for businesses), and the remainder is spent on comparing actual to prior forecast (18% for nonprofits/governments; 24% for businesses);
- Both groups spent time, about equally distributed, on current forecast versus prior forecast (about one fourth of the time spent related to discussing forecasts), current forecast versus budget (about one-half of the forecasting discussion time), and current forecast versus prior year actual (about one-fourth of the time allocated to forecast discussions);
- When asked if the budget represented a valuable tool, 75% agreed or strongly agreed (no breakdown of organizational type was provided), with 16% saying "somewhat agree," 8% "disagree," and 2% "strongly disagree";
- Roughly one-third of nonprofit/government organizations spent 9-12 weeks developing their budgets (the same as businesses), but 36% of nonprofit/government organizations spent more than 12 weeks on this versus only 16% of businesses (41% of businesses spent 4–8 weeks developing their budgets);

- There was considerable attention paid to reforecasting the finances to year-end: None of the nonprofits/governments did so weekly (versus 3% of businesses), 21% of nonprofits/governments did so monthly (27% of businesses), 35% of nonprofits/governments did so quarterly (40% of businesses), 35% of nonprofits/governments did so semi-annually (22% of businesses), and 9% of nonprofits/governments did so on a different interval (versus 8% of businesses).

We see reason for optimism in these findings as well as several small concerns. When we think about whether the budget serves as an "iron-clad" revenue and expense instrument, and see that nonprofits are more prone to use it that way, this can signal good discipline on funding and on keeping costs under control. Or, it could mean there are more budget revisions. We believe the finding on whether budgets were managed based on the top line (which for us would be revenues and support) or the bottom line (which could be taken as surplus or deficit, or change in net assets), fewer nonprofits responded affirmatively. We would like to think they are, instead, managing to their liquidity targets in such cases, but cannot be sure. We find the lesser emphasis on the part of nonprofits on operational targets (which for us would be program outcomes and mission-related achievements) versus financial targets surprising (but acknowledge that the government respondents might account for some of this). This does confirm what we noted in our Lilly study findings in Chapter 2, that nonprofits at times manage their level of programmatic expenditure based on meeting their financial objective. We were pleasantly surprised by the amount of intrayear forecasting being done by nonprofits; we noted this as a best practice earlier in the chapter. We were also pleased to see the amount of comparison being conducted: this included budget-versus actual being supplemented with budget-versus forecast, new forecast versus previous forecast, forecast versus last year's actual for the same period. Perhaps the increased use of budgeting software, covered in Chapter 13, will bring the budget development time down for nonprofits.

## Notes

1. James A. Parrott and Brent Kramer, "Undervalued and Underpaid: How New York State Shortchanges Nonprofit Human Services Providers and their Workers," (March 2017): 4. Available online at: http://fiscalpolicy.org/undervalued-and-underpaid-fpi-releases-report-on-human-services-workforce. Accessed: 1/19/2018.
2. Maura Webber, "Turning Red Ink into Black: A Chicago Settlement House Commits to Fiscal Responsibility – and Wins Grants," *Chronicle of Philanthropy,* November 13, 2003. Available online at: http://philanthropy.com/free/articles/v16/i03/03003001.htm. Accessed 8/14/2017.
3. "Onward Neighborhood House Financial Audit 2015 – 2016," (June 30, 2017). Available at: https://onwardhouse.files.wordpress.com/2017/08/onwardhouse_fy2016-audit.pdf. Accessed 1/19/2018.
4. CFO Research, "The Six Key Areas Where CFOs Fail to Deliver for the Board of Directors," White Paper (November 2017): 2–3. Available at: http://info.kyriba.com/the-six-key-areas-where-cfos-fail-to-deliver-for-the-board-of-directors?_ga=2.33823335.795980067.1516378843-1892432173.1493909222. Accessed 1/19/2018. Respondents were able to select multiple areas. The research was from a survey conducted by CFO Research in collaboration with Kyriba. Three areas tied for third in ranking: cost control/reduction, growth strategy support, and compliance and reporting. In sixth place was strategic/operational risk management, which we take up in Chapter 14.
5. Anthony J. Gambino and Thomas J. Reardon, *Financial Planning and Evaluation for the Nonprofit Organization* (New York: National Association of Accountants, 1981), 21–35.

6. Association of Art Museum Directors, "2017 Salary Survey," n.d. Available at: https://aamd.org/sites/default/files/document/2017%20AAMD%20Salary%20Survey_0.pdf. Accessed 1/19/2018. Size is important: The smallest museums spent, on average, 65% of their operating budgets on payroll-related expense.
7. Budget Executives Institute, "Statement of Duties and Responsibilities of the Budget Director," reprinted in *Readings in Cost Accounting, Budgeting and Control*, 5th ed., ed. William E. Thomas (Cincinnati: South-Western Publishing Company, 1978), 82–83.
8. Most of this section and the next are based on the insights of Gregg Capin, of CapinCrouse, LLP, Atlanta, GA, from a seminar entitled "Financial Management for Nonprofit Leaders," sponsored by the Christian Management Association, Indianapolis, IN, May 12, 1992.
9. Volunteers best suited to serve on your budget committee "should have the following qualities: (1) A familiarity with prior years' activities and the changes that are contemplated in the year(s) to come, particularly the objectives in the strategic plan; (2) A desire to serve the organization as a whole rather than to lobby for a particular project; and (3) A knowledge of ordinary budgeting, whether on the personal or business level." There may be some volunteers not having all of these qualities that are motivated to learn and they might also be valuable budget committee members. This material quoted from Virginia Society of Certified Public Accountants, "Budgeting: A Guide for Small Nonprofit Organizations," (September 2012): 2.
10. David W. Young, *Management Control in Nonprofit Organizations,* 10th ed. (Cambridge, Massachusetts: The Crimson Press, 2016), Chapter 10.
11. ECFA, "Top Ten Highlights from the 2015 Nonprofit Financial Management Survey 1.0," (2015): 5. Available online at: http://www.ecfa.org/PDF/TopTen_NP_FinanceManageSurvey.pdf. Accessed 1/19/2018.
12. Thad D. Calabrese, "Do Donors Penalize Nonprofit Organizations with Accumulated Wealth?" *Public Administration Review* 71, no. 6 (November/December 2011): 859–869.
13. Rick Cohen, "Death of the Hull House: A Nonprofit Coroner's Inquest," *NonProfit Quarterly* (August 2, 2012). Available online at: https://nonprofitquarterly.org/2012/08/02/hull-house-death-nonprofit-coroners-inquest/. Accessed 1/19/2018. See also Irv Katz, "Reality Time for Human Service Organizations," *Stanford Social Innovation Review* (February 15, 2012). Available online at: https://ssir.org/articles/entry/reality_time_for_human_service_organizations.
14. Maureen West, "Some Fear Hull House Closure Is an Omen for Struggling Charities," *Chronicle of Philanthropy* (February 2, 2012). Available online at: https://www.philanthropy.com/article/Collapse-of-Famous-Hull-House/157181. Accessed 1/19/2018. One of the most befuddling comments we have seen, hopefully quoted accurately, is this one: "Clarence Wood—a former chief executive of Hull House who retired last year—criticized the board for not understanding the idea of 'living on the edge.' According to Mr. Wood, 'the reason the staff members like me were staying positive in attitude was that we are very used to social-service agencies always being on the brink of destruction.'" (Rick Moyers, "Hull House Collapse Is a Cautionary Tale for Boards and Executives," *Chronicle of Philanthopy*, (February 27, 2012)). Available online at: https://www.philanthropy.com/article/Hull-House-Collapse-Is-a/190601. Accessed 1/19/2018.
15. Nonprofit Research Collaborative, "Winter 2017 Nonprofit Fundraising Study (NFS)," (May 1, 2017). Available online at https://npresearch.org/images/pdf/2017_reports/NRC-W2017-FINAL.pdf. Accessed 1/19/2018.
16. The survey was jointly conducted by Portland-based Collins and Technical Assistance for Community Services, with over 450 responses. "Survey: Nonprofit Contributions Insufficient to Cover Rising Overhead," *Portland Business Journal,* December 16, 2005. Available online at: http://portland.bizjournals.com/portland/stories/2005/12/12/daily34.html. Accessed 10/31/2017.
17. Id. Note # 9, p. 7. This source offers four examples of actions that could be taken rather than developing a revised budget when an expected large contribution (or, we add, grant) that is in your budget does not come through (1) seek other sources of funds, perhaps using the CRM module in your accounting system to identify donors that might support you in this case; (2) cut expenses; (3) rearrange expenses, perhaps using a gifted asset to offset the expense budgeted for its purchase; and (4) move a scheduled new program launch to another period. The authors further advise that such decisions in light of the current cash and financial picture.

18. Here are some online sources to help you gather economic forecasts and data: Economic Forecasting Survey (60 economists): http://projects.wsj.com/econforecast/#ind=gdp&r=20; Recession Probability (60 economists): http://projects.wsj.com/econforecast/#ind=recession&r=60; Wells Fargo economic commentary (to help you keep up with the economy): https://www.wellsfargo.com/com/research/economics; https://www.northerntrust.com (then select Insights and Research, then Economic Update, U.S. Economic Outlook, or Weekly Economic Commentary); https://www.bloomberg.com/markets/economics; Comerica Bank's economic commentary: https://www.comerica.com/insights; and the Federal Reserve's explanation of its current monetary policy: http://www.federalreserve.gov/monetarypolicy/default.htm.
19. Current interest rates are available online at: http://www.wsj.com/mdc/public/page/2_3020-moneyrate.html?mod=wsj_mdc_additional_interestrates; https://www.bloomberg.com/markets/rates-bonds/government-bonds/us; you may sign up for a free weekly newsletter, "The Fix," at https://www.bloomberg.com/markets/fixed-income. For actual and forecast values of a very short-term interest rate forecast (60 economists), the federal funds rate (which serves as the base for all U.S. short-term interest rates): http://projects.wsj.com/econforecast/#ind=fed_funds&r=16 and http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html/; for actual and forecast values of the 10-year Treasury note rate (60 economists): http://projects.wsj.com/econforecast/#ind=tenyear&r=16.
20. Annuity rates are available from the American Council on Gift Annuities, which posts "Suggested Rates": http://acga-web.org/gift-annuity-rates.
21. Information on inflation is available online at https://www.sifma.org; search for the most recent U.S. Economic Outlook. (Example: https://www.sifma.org/resources/research/economicoutlook20172h/.) Compilations of professional economic forecasters' inflation forecasts are located at https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/historical-data/inflation-forecasts. The Cleveland Fed's inflation expectations data is at https://www.clevelandfed.org/our-research/indicators-and-data/inflation-expectations.aspx; set up an email alert for when that estimate gets updated at https://www.clevelandfed.org/en/newsroom-and-events/subscribe.aspx (select Inflation Expectations, then subscribe; you may also wish to select Inflation Central, then subscribe; for actual inflation data, select Median CPI, then subscribe).
22. Information on giving trends is available online at the Association of Fundraising Professionals website: http://www.afpnet.org/Audiences/ReportsResearchList.cfm; some data is only accessible for AFP members.
23. Information on exchange rates is available online at: http://www.wsj.com/public/page/news-currency-currencies-trading.html; and https://finance.yahoo.com/currencies.
24. Although not tailored to nonprofit applications, an excellent source for understanding and applying forecasting methods is Jae K. Shim and Joel G. Siegel, *Handbook of Financial Analysis, Forecasting, & Modeling,* 2nd ed. (Englewood Cliffs, NJ: Prentice-Hall, 2001).
25. Financial spreadsheet software will do the trick to analyze the raw data numbers to arrive at an equation of "best fit." Microsoft Excel is very adept at this, and one does not have to be a "techie type" to do the analysis.
26. Regression, moving averages, exponential smoothing, and classical decomposition time series techniques are also presented in a cash forecasting framework in Chapter 11 of John Zietlow, Matthew Hill, and Terry Maness, *Short-Term Financial Management: Text and Cases,* 5th ed. (San Diego: Cognella, 2017).
27. Paragraph 3.28 of Financial Statements, *Statement of Activities,* as cited in AICPA, *AICPA Audit and Accounting Guide, Not-For-Profit Organizations* (New York: AICPA, 2017), 70.
28. From paragraph 3.40 of Financial Statements, *Statement of Activities,* as cited in AICPA, *AICPA Audit and Accounting Guide, Not-For-Profit Organizations* (New York: AICPA, 2017), 73.
29. For help in estimating grant proposal overhead, see Elizabeth K. Keating, "Is There Enough Overhead in This Grant?" *Nonprofit Quarterly* 10 (Spring 2003): 41–44.
30. For more on budgeting, consult David C. Maddox, *Budgeting for Not-for-Profit Organizations* (New York: John Wiley & Sons, 1999).

31. For another example of how a nonprofit may develop a budget see this excellent guide developed by Hilda Polanco and John Summers and made available by the Wallace Foundation: http://www.wallacefoundation.org/knowledge-center/resources-for-financial-management/pages/planning.aspx#result1. A video guide showing how to build your overall budget by first projecting program budgets is here: http://www.wallacefoundation.org/knowledge-center/resources-for-financial-management/pages/program-based-budget-template.aspx; an Excel budget template for doing your revenue scenarios is here: http://www.wallacefoundation.org/knowledge-center/Resources-for-Financial-Management/Pages/Revenue-Analysis-Worksheet.aspx; an Excel budget template for doing your program budgets is here: http://www.wallacefoundation.org/knowledge-center/resources-for-financial-management/Documents/Program-Based-Budget-Template.xlsx.
32. Michael C. Thomsett, *The Little Black Book of Budgets and Forecasts* (New York: AMACOM, 1988).
33. This should not be the case if you followed the recommended format offered at the end of this chapter. In that format, each month gives a cash surplus (if positive) or cash shortage (if negative), with the cash shortage reflecting the cumulative shortfall and therefore the borrowed balance at that point in time. So the loan amount does not appear in cash receipts at all.
34. Robert N. Anthony and David W. Young, *Management Control in Nonprofit Organizations*, 7th ed. (Boston: McGraw-Hill Irwin, 2003): 204–209.
35. Geert Hofstede, *Uncommon Sense about Organizations: Cases, Studies, and Field Observations* (Thousand Oaks, CA: SAGE Publications, 1994), 140–153.
36. Id., 232, 620–626.
37. On operating measures see NACUBO, "FASB Takes Preliminary Steps to Define NFP Operating Measure," (November 14, 2013). Available online at: http://www.nacubo.org/Business_and_Policy_Areas/Accounting/Accounting_News/FASB_Takes_Preliminary_Steps_to_Define_NFP_Operating_Measure.html. Also see NACUBO, "Defining an Operating Measure for Independent Colleges and Universities-Revised March 2011," (March 31, 2011), available online at http://www.nacubo.org/Business_and_Policy_Areas/Accounting/Advisory_Reports/Advisory_Guidance_Defining_an_Operating_Measure_for_Independent_Colleges_and_Universities_Revised_March_2011.html. Both resources accessed 1/19/2018.
38. David W. Young, *Management Control in Nonprofit Organizations,* 10th ed. (Cambridge, MA: Crimson Press, 2016).
39. For a comparison of a line-item budget to a program budget, see David W. Young, *Management Control in Nonprofit Organizations,* 10th ed. (Cambridge, MA: Crimson Press, 2016). For more on program budgeting, see Jerry Soto, "Is Your Program Budget a Monster in the Making?" *Nonprofit Quarterly* 8 (Fall 2001): 54.
40. Tom M. Plank, Lois Ruffner Plank, and Donald Morris, *Accounting Desk Book with CD,* 24th ed. (Riverwoods, IL: CCH, 2015).
41. Deloitte Consulting (2015). *Zero-Based Budgeting: Zero or Hero.* www2.deloitte.com/us/em/pages/operations/articles/zero-based-budgeting.html. Accessed 4/28/2017.
42. Marie Leone, "Rolling Budgets, with a Twist," www.cfo.com (June 3, 2003): 1–4. Available online at: www.cfo.com/article.cfm/3009422. Accessed 8/14/2017.
43. Robert Colman, "Better Budgeting," *CMA Management* (October 2004). Available online at: www.managementmag.com/index.cfm/ci–id/2014/la–id/1.htm. Accessed 12/31/2005. Also see Hilary Johnson, "Rolling Budgets Catching On," *Crain's New York Business* (July 31, 2011). Available online at: http://www.crainsnewyork.com/article/20110731/SUB/307319999/rolling-budgets-catching-on. Accessed: 1/19/2018.
44. Diana Scearce and Katherine Fulton, *What If?: The Art of Scenario Thinking for Nonprofits* (Emeryville, CA: Global Business Network, 2004).
45. The key performance indicator approach, sometimes referred to as "key financial success indicator" approach, is documented in Mary M. Sapp and M. Lewis Temares, "A Monthly Checkup," *NACUBO Business Officer* (March 1992): 24–31. For a deep dive, see David Parmenter, *Key Performance Indicators for Government and Non Profit Agencies: Implementing Winning KPIs*, (Hoboken, NJ: John Wiley & Sons, 2012). We strongly advocate

that you evaluate using this approach in your management reporting, regardless of your organizational type.

46. Vonna Laue, “Six Debt Ratios and Measurements Your Church Should Monitor,” *Church Law and Tax*, (March 2015): 1. Web-only publication available at http://www.churchlawandtax.com/web/2015/march/six-debt-ratios-and-measurements-your-church-should-monitor.html. Accessed 1/19/2018.
47. Malvern J. Gross, John J. McCarthy, and Nancy E. Shelmon, *Financial and Accounting Guide for Not-For-Profit Organizations,* 7th ed. (Hoboken, NJ: John Wiley & Sons, 2005): 425–426.
48. For information on the sustainable growth rate, see Hill, Zietlow, and Maness, *Short-Term Financial Management*, Chapter 3.
49. The internal growth rate is profiled in most introductory corporate finance texts.
50. GrantStation, “The Spring of 2017 State of Grantseeking™ Survey and Report,” (Spring 2017): 8.
51. Association for Financial Professionals, “2017 FP&A Survey: How Relevant is Your Budget?” (August 2017). Available online at: https://www.afponline.org/trends-topics/topics/articles/Details/fp-a-survey-is-your-budget-relevant. Accessed: 1/19/2018.

APPENDIX **8A**

# CASE STUDY: THE CASH CRISIS AT THE CHILDREN'S TREATMENT CENTER*

Loan payments, government contracts, United Way money – sometimes running the nonprofit Honolulu Children's Treatment Center was nothing but one big headache, thought Ron Williams, executive director of the Center. So many children needed help, and yet more and more time seemed to be spent on a growing number of financial problems. Ron saw that there wasn't enough cash to pay for the services provided by the parent agency, and payments were several years overdue. The temporary bank loan of $100,000 would need renewal soon and interest rates were moving up. The bank was unhappy that a so-called temporary loan had to be refinanced again, and was not inclined to renew the loan. The United Way would reduce its support dollar for dollar if the center had an operating surplus of more than $5,000, but without an operating surplus it might not be possible to take care of the overdue payables and the bank loan. Actually, an operating surplus was unlikely to occur. The forecast for 2005/06 was a deficit of $19,000. And if that wasn't enough, today's mail brought yet another letter from the Center's board of directors in California that said "if you just managed things properly, you should be able to pay off the bank loan, eliminate the operating deficit, and get current on payables." The letter ended with the request: "Please explain." The March annual meeting with the board of directors was coming up soon and they would be expecting some answers. "'Managed things properly' indeed," thought Ron. "What did they think he was trying to do?" Life certainly had been simpler in the early days when he was merely a child psychiatrist.

## THE HONOLULU CHILDREN'S TREATMENT CENTER

The Center was a nonprofit organization founded in the 1920s to provide a home for dependent and neglected children. Over the years it evolved into a fully accredited residential psychiatric facility with a complete range of professional staff providing care to over 50 emotionally disturbed children. As the only fully accredited and licensed residential setting for the treatment of children with psychiatric disabilities in the Hawaiian Islands, children were received for care from anywhere throughout the entire state. Their length

*This Case was written by Steven Dawson, Professor of Finance, Shidler College of Business, University of Hawaii, and W.R. Cozens, Honolulu Children's Treatment Center. Used by permission.

of stay, depending upon the severity of their problems, ranged from 5 to 24 months, with the average being l6 months. During this time, in addition to treatment for their emotional problems, they received a range of supportive services including special education, medical care, social services, recreation, room and board, and structured leisure time activities.

The Center is a subsidiary of a California-based nonprofit corporation and operated with its own board of directors that was responsible for reviewing the budget and setting general policy. The directors meet quarterly in California and then hold a meeting each March in Hawaii to review the budget for the fiscal year beginning on July 1.

As a nonprofit organization, the Center's basic objective was to render services. Success was measured by how much service was provided and by how well available resources were used. The Honolulu Children's Treatment Center thus differed markedly from a profit-oriented organization where decisions were intended to increase, or at least maintain, profits or to maximize the value of the firm. This was not to say that nonprofit organizations did not report profits – there were years when reported revenues exceeded expenses. If this happened over several years, however, it might be perceived not as a sign of good management but rather a warning signal that the organization was not accomplishing its objective of providing as much service as possible with available resources. Common thinking was that either it should cut the price charged for services or it should provide more services. The Board as well as management believed that a nonprofit organization's usual policy should be to break even in the long run. The equity interests involved would have little incentive to build up an operating surplus since they could not sell or trade their ownership to others and no part of the assets, income, or profit would be distributed to them.

In financial reports for this organization a clear distinction is made between capital charges and operating costs. Capital charges refer to the acquisition of fixed assets, equipment, and real property from which benefits will accrue over a long period of time. Operating costs include labor, materials consumed, and services purchased as part of operating an organization for a given period of time. The two types of expenditures are handled separately as are the revenues associated with them. Depreciation is not a part of operating expenses and so was not subtracted along with operating expenses when determining whether the organization operated with an operating surplus or deficit.

## SOURCES OF REVENUES

The Center's operating income would be close to $1.8 million in the next fiscal year, 2005/06. Income was expected to come from two primary sources, government agencies and charitable groups. Both of these sources set strict limitations, typically of a line-item nature, for the use of the funds they provided. One of the most stringently enforced rules was the prohibition against the accumulation of an operating surplus. The intent was to have as much as possible of the funds go to the ultimate beneficiary. The income received each fiscal year for funding operations should equal the allowable operating expenses incurred in providing services. Increases in working capital and funds to cover past operating deficits were not an allowable expense. If income was greater than operating expenses, the center would run into considerable difficulty with its funding agencies. If income was less, the Center would soon find its ability to continue operating impaired.

During fiscal year 2005/06, payments from the federal and state governments would constitute the largest sources of operating income, as shown in the following table:

| Expected Distribution of 2005/06 | Operating Revenues by Source |
|---|---|
| Federal government | 35.8% |
| State government | 34.2 |
| Aloha United Way | 14.4 |
| Parents | 6.8 |
| Contributions | 6.5 |
| Other | 2.3 |
| Total | 100.0% |

Payment was usually received one to three months after billing. At the end of the federal fiscal year, federal regulations required an end-of-contract accounting report to be submitted. Payment for the last month was usually delayed an additional one or two months. The State government was the other major source of income. It, as well as parents who paid a portion of their children's expenses, was billed at the end of the month in which the service was provided and payment was generally received within the next 30 to 60 days:

| Sources of Income (%) —Fiscal year ends June 30 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1997/98 | 1998/99 | 1999/00 | 2000/01 | 2001/02 | 2002/03 | 2003/04 | 2004/05 |
| State of Hawaii | 58 | 41 | 38 | 38 | 35 | 34 | 31 | 34 |
| U.S. government | 0 | 25 | 27 | 33 | 36 | 38 | 40 | 37 |
| United Way | 32 | 25 | 21 | 18 | 18 | 15 | 15 | 14 |
| Other* | 10 | 9 | 14 | 11 | 11 | 13 | 14 | 15 |
| Total | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

*Local foundations, parents, and other sources.

Aloha United Way was the largest nongovernmental source of funds, providing over 14 percent of the Center's revenue in 2004/05. United Way funds were allocated annually and distributed at the start of each month in 12 equal payments. Although the Center had to apply for funds each year, experience had shown that these funds could be counted on in the future as long as the Center did not make an operating surplus. The United Way reduced its payments, dollar for dollar, for any nonprofit agency with an operating surplus of more than $5,000 at the end of each year. They reasoned that funds were provided to pay for services, and if any recipient did not need them for that purpose, there were many other recipients who would use them for worthwhile purposes.

Over the years the Center's sources of income had changed dramatically. Starting in the 1980s, payments from the State of Hawaii for children placed at the Center began a slow but steady rise. By 1997/98, the year after Ron Williams became executive director, State payments were 58 percent of total income with no income at all coming from the Federal government. Without federal dollars, the Center was locked into trying to maintain a semblance of quality care for a very small portion of the total number of children needing help. Thus it was with great excitement that Ron and his co-workers viewed the availability of federal funds beginning in 1998. This new source of funds allowed the center to expand rapidly and to more adequately service the pressing needs of the community. A further advantage of federal funds was that they came in the form of signed contracts negotiated each year, which provided a guaranteed source of funding for a specific number of children.

A lot of forms and government red tape were involved but Ron and his staff had learned how to handle the administration of the contracts.

From zero in 1997 the federal funds soared to 25 percent of revenues in 1998/99 and 37 percent in 2004/05. The growth of federal money, however, was not matched by a similar rise in funds from other sources. Most of the growth in the center's budget, $682,000 in 1997/98 to $1.6 million in 2004/05, came from the buildup of federal contract dollars.

## EXPENSES

In simplest terms the Center collected funds from its various sources and used them to pay for the services it provided for the children in its care. In the projected 2005/06 operating budget approximately two-thirds of all outlays would go for payroll expenses (see Exhibit 8A.1). The remaining one-third would be allocated to other operating expenses such as supplies, travel, occupancy/utilities, and equipment. Like many service-oriented businesses, the Center was labor intensive. Payroll outlays were made in the month the services were provided and the other operating expenses typically were paid later – 60 percent in the month following purchase and 40 percent the month after that.

The parent agency provided many direct and indirect support services to the Honolulu Children's Treatment Center, and the Center in turn paid 10 percent of its total gross income to the parent agency. These payments, called the "centage" fee, were due the month following billing for the services provided. The centage fee was a major source of operating funds for the parent agency. Principal among the services it provided to the center were program consultation, employee retirement and health plan provision and

| Honolulu Children's Treatment Center — 2005/06 Fiscal Year | |
|---|---|
| *Revenue:* | |
| Federal | $640,350 |
| State | 612,600 |
| Aloha United Way | 257,500 |
| Parents' payments | 121,600 |
| Contributions | 116,300 |
| Other | 40,947 |
| Total revenues | $1,789,297 |
| | |
| *Expenses:* | |
| Personnel | $1,207,000 |
| Field service ("centage") | 178,870 |
| Professional consultation | 45,500 |
| Supplies | 90,300 |
| Occupancy | 87,100 |
| Awards and grants | 54,500 |
| Travel | 44,200 |
| Equipment | 30,000 |
| Other* | 70,905 |
| Total expenses | $1,808,375 |
| Operating Surplus/(Deficit) | ($19,078) |

*Includes $10,000 for payment of interest on the $100,000 bank loan.

**Exhibit 8A.1** Projected Statement of Expected Operating Expenses And Income administration, a full range of insurance coverage, auditing services, legal services, public relations, federal-level governmental contract negotiations, fundraising for major capital expenditures, long-range fiscal and program planning, and centralized purchasing.

## THE BANK LOAN

The first signs of impending financial problems came in 2003, with the situation becoming critical a year and a half later. In July 2004, there wasn't enough cash available to meet the payroll. The Center took out a bank loan of $75,000 for three months at 8.25 percent interest secured by federal government receivables. The interest rate was based on the bank's rate for similar-risk organizations, which was calculated as the prime rate plus 4.00 percent. Everyone, including Ron, thought it was just a temporary problem. As soon as the delayed end-of-fiscal-year payments were received, the loan could be paid back. This was done but to everyone's dismay a similar cash shortage almost immediately reappeared, necessitating another loan. This time the loan was for $100,000 at 8.75 percent interest and a term of six months with similar collateral. This loan was still outstanding, and it was only with some difficulty that the monthly interest payments had been made.

The size and cause of the loan had been a major source of concern to Ron. The Center was not against borrowing for short-term needs but it was against having a loan that never seemed to get repaid. Although it had been renewed several times, the bank might decide not to renew it again since it had now become obvious this was not just a temporary need for funds. In any case, bank loan interest rates had risen in recent months with the prime reaching 5.50 percent, up 1.25 percent from when the original loan was made. The expectation was for even higher rates as the Federal Reserve Board was tightening credit after a long period of low interest.

To compound the problem, state and federal contract negotiators would not accept interest charges on the loan as a reimbursable expense. Nongovernmental sources expected that their contributions would go toward providing services, not to pay loan costs. The United Way was of no help, either. Since the Center was funded as a nonprofit organization, it would drop its support, dollar for dollar, for any nonprofit agency that showed more than a $5,000 operating surplus at the end of the fiscal year. Interest payments were not an allowable operating expense in the UWA's calculations. To date, about half the interest expense had been met by income received from nongovernmental sources and the remainder had shown up as an increase in the operational deficit, which was projected to reach close to $19,000 for 2005/06. Although this was not high in terms of the projected 2005/06 budget of $1.8 million, it was still unacceptable to Ron as well as to his board of directors.

Of even greater concern to Ron and the board was the rise in payables, particularly the amount of payables that was owed to the parent agency. The unpaid centage fee was almost $400,000 at the end of 2004. There was no penalty for late payment to the parent agency but most of the other creditors had a discount for early payment, a 1.50 percent per month charge on overdue bills, or both. In 2004 no discounts were taken and late payment penalties were over $1,000.

These overdue payments had become an increasing source of friction with the parent agency in California and were the cause of a series of letters of concern from the board of directors requesting more information and early repayment of the bank loan and the payables. In their latest letter the board pointed out that they knew the centage collections were now coming in from the Center at the rate of 15 percent during the month service was provided, 60 percent the month after, 20 percent the third month, and 5 percent the

| Balance Sheets and Total Revenues: 1997, 2001, and 2004 Calendar Year-End | | | |
|---|---|---|---|
| | 12/31/97 | 12/31/01 | 12/31/04 |
| *Assets:* | | | |
| Cash | $ 5,067 | $24,221 | $20,521 |
| Accounts receivable | 22,204 | 81,036 | 266,267 |
| Prepaid expenses | | 6,840 | 11,850 |
| Reserves held by headquarters* | 46,649 | 94,905 | 47,535 |
| Total assets | $73,920 | $207,002 | $346,173 |
| *Liabilities:* | | | |
| Accounts payable – trade | $17,484 | $137,971 | $117,322 |
| Accounts payable – headquarters | 31,438 | 32,819 | 396,896 |
| Bank loan | — | — | 100,000 |
| Accrued expenses and payables | 8,314 | 21,526 | 22,033 |
| Loan from headquarters | — | 15,000 | 15,000 |
| Total liabilities | $57,236 | $207,316 | $651,251 |
| *Net assets* | $16,684 | $(314) | $(305,078) |
| Total liabilities and net assets | $73,920 | $207,002 | $346,173 |
| Total revenues (Calendar Year) | $682,090 | $1,439,651 | $1,566,602 |

*These reserves are restricted for capital improvements and are not available to the center for operations.

**EXHIBIT 8A.2** HONOLULU CHILDREN'S TREATMENT CENTER CALENDAR YEAR-END FIGURES

fourth month. "Agreeably, this should have some initial effect," they wrote, "but surely if you manage things properly you should be able to catch up after four months, and then you can pay the loan and begin to reduce your payables."

Before preparing a response to the board, Ron decided to once again go over the budget for 2005/06 (see Exhibit 8A.1) and the 2004 calendar year-end balance sheet (see Exhibit 8A.2), both previously submitted to the parent agency and the United Way. The formats were mostly consistent with the generally accepted standards of accounting as applied to nonprofit agencies. Since there were no substantive changes in services provided or purchases forecasted for 2005/06, aside from a somewhat larger volume and cost increases due to inflation, the projections were believed to be reasonably accurate.

As Ron Williams thought about the Center's financial problems and the request from the parent agency, he realized the irony of it all. Ten years ago, when a lower level of services was being provided, there were few financial problems. Now that he had successfully increased the Center's funding, the financial situation seemed to be falling apart. Perhaps in coming up with a response to the parent agency's "please explain" request, he would be able to find a way to resolve the potentially crippling financial situation. There was at least one consoling aspect to all this: With federal funding many more children were receiving much better care than was previously possible. The governmental third-party payments at about 70 percent of total operating revenues were, from all expectations, here to stay.

## QUESTIONS

1. What are the financial and nonfinancial causes of the situation that the CTC currently faces?

2. How serious are the causes you identified in question 1, and do these arise from internal policies and practices or from external sources? Use any appropriate tools from Chapters 1–8 to assist you in answering this question, using financial analysis where appropriate.
3. What is the most serious problem facing CTC? Are there any other problems that you perceive? Support your answer.
4. Is the Center's California board (which communicates with the parent agency and oversees the Honolulu CTC) right in its assessment of the ability of this situation to self-correct if "things are managed properly"? In addressing this question, for your forward year (05/06 fiscal year) cash planning you may assume the following:
    a. The organization starts with no cash, no bank loan, no receivables, and no trade or parent agency payables.
    b. Revenues equal expenses and there is no operating deficit or surplus.
5. What is (are) the alternative solution(s) to the problem(s) you identified in question 3?
6. What are your top three recommendations for CTC? Give any implementation specifics (actions, timing) that you can provide to help the board and management team.

APPENDIX **8B**

# CASE STUDY: TRI-CITY ACADEMY

This case study involves the completion of a cash budget worksheet and a written analysis that interprets the completed cash budget. Your help has been requested on both parts of the case study – a cash budget worksheet and an interpretation write-up. The worksheet template follows this situation description, based very closely on a real-life organization and the difficulties it faced.

*Purpose*: This case study requires completion of a partially completed cash budget worksheet, as well as interpretation of the completed cash budget. (Purchasers of this book may access an Excel worksheet to use at the website that accompanies this book.) All individual line items of cash inflows and cash outflows for a private 501(c)(3) nonprofit pre-K–12 school, Tri-City Academy, have been completed. (These data are from a real organization, but the name has been changed.) Remaining to be done are some subtotals, totals, and then transferring the totals to the master cash budget worksheet in order to complete the cash budget (see generic template in Section 8.7 of Chapter 8). By completing this worksheet and an interpretive write-up indicating what the cash budget shows us, you are demonstrating your understanding of the mechanics and interpretation of a cash budget.

## CASH BUDGET

**CONSTRUCTION** First, complete the boxes that are left blank on the cash receipt template at the bottom of the next page. (If you are working from the Excel file, click on left tab in the Excel file.) You will see the specific locations of those boxes that you need to fill in listed underneath the table, near the bottom of that template/worksheet. Second, fill in the blank items in the cash disbursements worksheet (if working from the Excel file, click on the middle tab to go to that worksheet). Finally, go to the cash budget template (rightmost tab if using the worksheet file), and fill in the numbers or formulas there. Near the top, you will mainly be entering "copy and paste" numbers (or enter a formula and copy it across the remainder of the row if using the computer spreadsheet) to pull numbers from your now-completed cash receipts and cash disbursements worksheets. [If using the computer spreadsheet, begin your formula by pressing = (the equals key) and then you can click on the appropriate tab (e.g., cash receipts tab) and on the appropriate totals cell within that worksheet (you will see the referenced cell address show up in the formula bar near the top of the Excel screen once you do so).] Do the same for other cash receipts items in your cash budget template. The first total has been completed for you. (In the computer spreadsheet as well, the first total has been completed, so you can view that cell formula to see how the formulas look once complete.)

Now work downward in your cash budget by summing columns to calculate each month's net cash flow. Then, as shown in the template in Chapter 8, add this to beginning cash to get ending cash. Subtract the "minimum cash required" – the same amount each month – to get the adjusted cash position. If that number is *negative*, this implies a *shortfall* of cash, and if the organization cannot increase revenues or decrease expenses, this amount would be total dollar amount of the credit line "drawdown" (credit line balance borrowed). If that number is *positive*, a cash *surplus*, this amount would presumably be invested in a savings account, interest-bearing securities, or a money market mutual fund. Note that the number shown in each month's column, for either a shortfall or a surplus, is cumulative. For two consecutive surpluses, say $40,000 one month and $50,000 the next month, this implies that the organization has invested an additional $10,000 in short-term investments or its savings account.

## CASH BUDGET

**ANALYSIS** For each of the questions in (a) through (d), write one short paragraph to answer the question:

**a.** What is the largest surplus cash amount, *if any*, over the four months, and in what month does it occur?

**b.** What is the largest shortage cash amount, *if any*, over the four months, and in what month does it occur?

**c.** If there is a cash surplus in one or more months (refer to your answer in (a)), what could Tri-City Academy do with the surplus (after reviewing pertinent sections of Chapters 7 and 8, give some recommendations for how to utilize or deploy those funds)? If there is no month with a surplus, just answer "not applicable" for part (c).

**d.** If there is a shortage in one or more months (refer to your answer in (b)), what could Tri-City Academy do to deal with the shortfall (after reviewing Exhibit 3.3 in Chapter 3 as well as pertinent sections of Chapters 7 and 8, give some recommendations for how to obtain or free up the needed funds, bearing in mind that your recommendations have to be done in the middle of a school year and must have an effect on cash inflows or cash outflows within the next several months)? If there is no month with a shortage, just answer "not applicable" for part (d).

**Projected Cash Receipts for Tri-City Academy (Feb–May 2020)**

| Item \ Month | Feb | Mar | Apr | May | TOTAL |
|---|---|---|---|---|---|
| **Tuition** | 63600 | 80000 | 63600 | 63600 | 270800 |
| **Athletic Fees** | 500 | 500 | 500 | 500 | |
| **Late Fees** | 300 | 300 | 300 | 300 | 1200 |
| **Telethon Income** | 0 | 0 | 0 | 17000 | 17000 |
| **Foundation Grant** | 0 | 0 | 0 | 0 | 0 |
| **State Grant** | 0 | 0 | 0 | 0 | 0 |
| **Registration Fees** | 30000 | 10000 | 0 | 0 | 40000 |
| **Club Donations** | 2000 | 2000 | 2000 | 2000 | 8000 |
| **Pre- & Post-Care** | 1900 | 1900 | 1900 | 1900 | 7600 |
| **Store Certificate Sales** | 0 | 0 | 0 | 0 | 0 |
| **Other** | 0 | 0 | 0 | 0 | 0 |
| ***TOTAL:*** | 98300 | | | | |

**Projected Cash Disbursements for Tri-City Academy (Feb–May 2020)**

| Item \ Month | Feb | Mar | Apr | May | TOTAL |
|---|---|---|---|---|---|
| **Payroll Expense: Faculty & Staff** | $72,000 | $72,000 | $72,000 | $72,000 | |
| **Substitute Teachers** | 0 | 2,656 | 0 | 5,000 | |
| **Retiremt. Withholding** | 700 | 700 | 700 | 700 | |
| ***Subtotal: Payroll & Other Empl. Exp.*** | 72,700 | | | | |
| **Payment to Church** | 6,250 | 6,250 | 6,250 | 6,250 | 25,000 |
| ***Other Expenses:*** | | | | | |
| **Copier** | 500 | 987 | 750 | 750 | |
| **PSI & IN Gas** | 220 | 562 | 350 | 350 | |
| **Misc.** | 500 | 5,001 | 1,000 | 1,000 | |
| **Repair & Mainten.** | 300 | 100 | 100 | 100 | |
| **Fundraising Expenses** | — | 6,625 | — | — | |
| **Office Supplies** | 1,600 | 5,560 | 3,000 | 3,000 | |
| **Postage** | 300 | 616 | 450 | 450 | |
| **Athletic** | 1,000 | 1,800 | 1,200 | 1,200 | |
| **Phone** | 400 | 272 | 300 | 300 | |
| **Supplies** | 3,000 | 1,080 | 2,250 | 2,250 | |
| **Yearbooks & Ribbons** | — | 8,500 | — | — | |
| **Sports Banquet** | — | 2,400 | — | 2,400 | |
| **Testing Evaluation** | — | — | 1,800 | — | |
| ***Total Other Exps.*** | 7,820 | | | | |
| **Store Certificate Remittances** | 0 | 0 | 0 | 0 | 0 |
| ***TOTAL REGULAR EXPENSES:*** | 86,770 | | | | |
| **Capital Expenditures:** | 0 | 43,000 | 0 | 0 | 43,000 |
| ***TOTAL CASH DISBURSEMENTS:*** | 86,770 | | | | |

**Projected Cash Budget (Feb–May 2020)**

| Item \ Month | Feb | Mar | Apr | May | TOTAL | |
|---|---|---|---|---|---|---|
| **BEGINNING CASH** | $5,000 | | | | — | |
| *CASH RECEIPTS* | 98,300 | | | | | <--total |
| *CASH DISBURSEMENTS* | 86,770 | | | | | <--total |
| **+ NET CASH FLOW** | 11,530 | | | | | <--total |
| **= ENDING CASH** | 16,530 | | | | — | |
| **– Minimum Cash Balance** | 25,000 | 25,000 | 25,000 | 25,000 | 25,000 | |
| **= CASH SURPLUS / (SHORTFALL)** | -$8,470 | | | | — | |

Note: The Feb beginning cash was January's ending cash, which was told to us by treasurer.

CHAPTER 9

# LONG-RANGE FINANCIAL PLANNING AND CAPITAL BUDGETING



## 9.1 INTRODUCTION

If we consider that nonprofit boards carry a primary responsibility for the fiscal life of the organizations that they govern, then it follows that long-range financial planning is a primary method for carrying out that responsibility.[1] Very often, the fiscal responsibility role is viewed within the frame of the annual budget but we postulate that nonprofit organizations need to reframe this to incorporate long-range planning.[2] This chapter outlines the



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

financial leaders' role in the long-range financial planning and capital allocation processes. Managing growth is one of the reasons organizations plan and do financial evaluations. The chapter begins by developing the financial plan for existing and already approved programs, then shows how the financial evaluation of new program alternatives such as new ventures are made. We then demonstrate how you may evaluate individual capital expenditures made as part of program implementation. A financial approach to evaluating mergers and acquisitions, partnerships, joint ventures, and strategic alliances follows. We conclude with a survey of actual practices in the areas of long-range financial planning and capital budgeting, to help you see what your peer organizations are doing.

Rhode Islanders Sponsoring Education (RISE) learned the value of long-range financial and program planning when its service demands outstripped its ability to meet those demands. A private nonprofit agency established in Rhode Island to educate the children of imprisoned women as a means of attacking the intergenerational cycle of poverty and violence, it established an 8-member committee (from its 25-member board of directors) to revisit its mission, vision statement, and goals. Then the committee established a long-range plan, which included goals, objectives, and action plans for RISE's future finances, as well as for its evaluation strategies, its role in the network of local nonprofit service providers, its public relations, and its staff and board structure. The six-page long-range plan specifies a cap on how many new students can be admitted each year to the program, with the cap based on the amount of funds raised from sponsors.

Before developing the plan, RISE (as would many nonprofits) took as many students as applied and hoped to later raise the needed funds. Equally important, the plan specified what would and would not be its core services. One of its board members, whose school also partners with RISE, praises it: "One of the beautiful things about RISE is that it doesn't try to be all things to all people."[3] Notice from this example that the strategic plan and the long-range financial plan should be consistent. As a side note, RISE also created a new associate director position, hiring an experienced Salvation Army manager who professionalized the agency by installing new systems and procedures.

Despite such success stories, some nonprofit managers and board members continue to devalue the planning process, perhaps because of (1) a philosophy that planning techniques are corporate-world methods that do not fit the values and philosophies of the nonprofit sector, (2) the often-changing nature of the environment within which they operate, (3) ignorance, or (4) a simple breakdown in their implementation of planning and evaluation techniques. Many nonprofit organizations create strategic plans but do not incorporate long-range financial planning along with program and fundraising plans. Faith-based organizations, for example, devalued planning skills in the early 1990s, partly because these techniques appeared to go against biblical admonitions to have faith and not be overly concerned about the future. Recent evidence, however, indicates this is changing, as more churches and other ministries are using long-range planning techniques.[4]

Executive directors/chief executive officers (EDs/CEOs) from a broad range of nonprofits indicate that, after fundraising, grant writing, and volunteer administration, the areas that they rate the highest for training needed are planning – which would include program and financial planning – and cooperative ventures.[5] We address both of these topics in this chapter. Partly to deal with these sorts of knowledge/skill gaps, the Panel on the Nonprofit Sector (convened by the Independent Sector) recommends that organizations have individuals with some financial literacy on their boards.

Nonprofit financial planning was formerly limited mostly to the single-year budgeting process. This is neither strategic nor wise, but mere "bean counting." To plan successfully, an organization must have a strategic thinker at its helm and an environment in which it infuses strategic, long-range thinking into all of its endeavors. Regardless of line and staff relations, everyone from the executive director down – and especially the chief financial officer (CFO) – must reframe their understanding of financial leadership and adopt a planning philosophy.

Planning is not just an extension of the budgeting process. It starts with good strategic planning, which identifies the key issues to which the appropriate numbers can later be attached, as we noted in Chapter 3.

We focus on formal planning, in that most business-sector studies have documented that organizations using formal plans tend to outperform those using informal plans. In the nonprofit arena, a recent study of churches indicates that those engaging in formal planning experienced greater growth in both attendance and finances.[6]

As nonprofits begin contracting with governmental agencies, they find that government oversight places emphasis on planning and reporting. Yet, as noted in the Indiana nonprofit survey done by Grønbjerg and colleagues, 30 percent of nonprofits refer to strategic planning as a major challenge, and 43 percent say that obtaining adequate funding is a major challenge.[7] Considering these results, it is no surprise that long-range financial planning is a difficult task, one that many nonprofits choose not to undertake. But it is a vital part of proficient financial management. With that backdrop, let's turn to the long-range financial planning and capital project evaluation techniques.

## 9.2 PLANNING FOR THE FUTURE

**(a) IMPORTANCE OF LONG-RANGE FINANCIAL PLANNING.** A best practices study of community associations documented the importance of long-term financial planning, listing both a plan for major assets (*long-term financial plan*) and for revenues and expenses (*long-term operating budget*) in its profile of best planning practices:

- Establish a long-term financial plan for the association's assets (cash, accounts receivable, replacement fund, investments, etc.) that is reviewed and revised annually.
- Develop written, board-approved investment policies and procedures.
- Commission a reserve study and/or update current reserve study at least every three years and review the report annually.
- Prepare a long-term operating budget covering the next three to five years.
- Include reasonable reserves for future major repairs and replacement of common facilities in assessments as determined by the association's most recent reserve study.[8]

Businesses call the plan for major assets a *pro forma balance sheet*, and the long-term operating budget is *a pro forma income statement*. Think of pro forma as "projected"; its literal meaning is "as a matter of form."

One financial policy that should be addressed periodically, as a best practice, is the specification of the levels of cash reserves held as operating reserves and as strategic reserves. Operating reserves represent money for a rainy day, and buffer against revenue shortfalls or unanticipated expense spikes. Strategic reserves may be called a building reserve in your organization – 44 percent of surveyed Denver-area nonprofits have a building reserve, for example.[9] We highlight the needed total cash reserves in our discussion of the target liquidity level, one of the outputs of a well-constructed financial plan.

In addition to helping you establish the appropriate level for your target liquidity level, consisting primarily as cash reserves (including short-term investments), we see at least four other advantages for organizations that engage in long-range financial planning:

1. It enables them to better determine the appropriate amount of net assets, or equity, in the organization's capital structure (which also implies how much debt the organization may carry; see Chapter 10).[10]
2. They more fully benefit from strategic planning, and are able to mesh the strategic plan with financial policies and decisions and with yearly operating budgets. This is key in producing plans that are achievable and can lead to sustainability.
3. It enables them to portray themselves as well-managed organizations to banks, bond investors, and foundations and agencies providing government grants; in fact, one consultant counsels philanthropists that one way to reduce the risk of their investment in nonprofits is to ensure that recipient organizations are implementing "financial plans for the long-term health of the organization."[11]
4. These organizations are better able to determine a reasonable growth rate for the organization's activities.

A late 2005 survey of Oregon-based nonprofits found that, even though fundraising efforts were deemed successful, 30 percent of the nonprofits were forced to reduce services to meet operational costs, and most nonprofits were concerned about rising healthcare costs for employees, increased costs of other insurance, and increased regulation for nonprofits.[12] Anticipating negative trends such as these, by including their likely effect on the organization's financial position, would not only cause the nonprofit to hold a higher target liquidity level (to avert service cutbacks), but also help the organization prepare itself for the possible cost increases that lie ahead. The financial plan helps your organization see the effects of these trends on its financial position.

**(b) CFO'S ROLE IN FINANCIAL PLANNING AND CAPITAL BUDGETING.** In his classic article "Strategy for Financial Emergencies," Gordon Donaldson declares, "[T]he financial executive's primary managerial responsibility is to preserve the continuity of the flow of funds so that no essential decision of top management is frustrated for lack of corporate purchasing power." Although written for business financial executives, Donaldson's assertion applies equally to nonprofit finance officers. The board treasurer and the organization's CFO share responsibility for ensuring that the nonprofit plans its financial future and allocates scarce capital to the best uses. Regardless of whether the treasurer is the CFO, he or she retains ultimate responsibility for these processes, so at a minimum the treasurer must oversee this important aspect of proficient financial management. As we have emphasized, doing this includes projecting the organization's liquidity and accumulation of or maintenance of the target liquidity level. It also entails working closely with your chief development officer, assuming your revenues include annual or deferred giving. Beyond this, there are several key components to the CFO's responsibility:

> The CFO's role seems to be threefold. First, as part of the senior management team, the CFO contributes fully in overall strategic planning for the organization, always with an eye on the financial ramifications. The second role is to drive the capital planning process, maintain the rigor around assessment, keep everyone honest, and serve as "quarterback" of the capital planning team. The third role is the quantitative role: understand debt capacity, provide a consistent methodology for assessing return on individual projects, and generally support the decision-making process.[13]

We developed the strategic planning role in Chapter 3, and we shall return to evaluating debt capacity in the next chapter. Our focus in this chapter is to spell out the long-range financial planning process and the capital budgeting process.

**(c) DEFERRED MAINTENANCE: A CAUTIONARY TALE.** Before entering into the long-range planning process, the CFO should evaluate the issue of deferred maintenance. The pressure on annual budgets to reduce costs often creates conditions where the organization decides to continue to operate aging assets while deferring maintenance costs and investments in new assets. This deferral may provide short-term budget relief, but an assessment of the risk involved in such a deferral should be undertaken in order to understand the long-term implications.[14] The financial evaluation of risk looks at the annual operating costs as well as the potential fixed asset investment all within the more strategic context. In any case, deferred maintenance can have a detrimental outcome that must be carefully evaluated before such a decision is made.

**(d) LONG-RANGE FINANCIAL PLANNING PROCESS.** Financial projections covering the next five years are developed in an exercise called *long-range financial planning.* These projections should be done periodically as part of the organization's strategic planning process. The main financial planning document should be based on all current programs as well as those future programs already approved. Later, planning scenarios can be developed to bring possible new programs or ventures into the picture. The purposes of the long-range financial plan are:

- To tie financial resource requirements to the strategic plan (recalling both the enabling and constricting functions of finance)
- To identify any future period with fund surpluses or, much more commonly, fund shortfalls
- To determine approximate funding needs for the shortfall periods, which is the essential information the executive needs for planning capital campaigns, other special fundraising appeals, and endowment building
- To identify the seasonal and cyclical aspects of the organization's cash flows
- To bring together in one place all the interacting sources and uses of funds experienced by the nonprofit organization: operating, investing, and financing cash flows (which reflect your organization's "business model" – refer back to Chapter 3)
- To build a financial contingency plan, or what Donaldson terms "a strategy for financial mobility"

We cannot emphasize too strongly the importance of doing a long-range financial plan. Not only will such a plan help a strong organization to become stronger, but it may spell the difference between survival and financial failure and dissolution for your organization. Often nonprofit organizations do a good job of selecting programs, but then fail to plan for the financial requirements of implementing those programs, leading a number of these organizations – especially private colleges – to fail.[15]

Averting a financial crisis from too-rapid or ill-advised expansion is well worth the expense and effort of long-range financial planning. An example to emulate here is Cedarville University (Cedarville, Ohio), which uses its strategic planning process to implement "managed growth." Our chapter-opening vignette of RISE is another positive example.

Further, where programs are vital to the organization's mission but the financial plan indicates significant shortfalls, the ED/CEO is stimulated to search for other organizations to help share the load. Resource sharing may take place through a merger, acquisition, joint venture, or strategic alliance.

The degree of sophistication and level of detail in nonprofit organizations' financial planning varies. Many small organizations, and quite a few larger ones, do no formal long-range financial planning; this situation tends to indicate an organization whose overall financial administration process is poorly managed. Our Lilly study found that organizations not using "present and anticipated financial positions" to guide programmatic decisions tended to be those deficient in overall financial management.

Some of these organizations may even engage in strategic planning, but are in the dark about the funding feasibility of these plans and whether they need to begin arranging financing now or whether they can self-finance the program. Capital campaigns cannot be initiated and executed quickly. Other organizations have sophisticated, computerized financial models. Mostly these are larger organizations that can afford to devote staff and computer resources to the task or hire an outside consultant to develop the model. Many organizations, even those otherwise proficient in their financial management processes, fail to anticipate key events that could alter the future financial position of the organization. As a result, these organizations have no strategy for dealing with those events if and when they occur and no financial model with which to project cash flow. At bottom, proficient financial managers anticipate *what could be*, not merely what they think is the most likely financial future.

**(e) FINANCIAL PLANNING BASICS.** Here's a simple approach to use to get started in financial planning. It is based on three vital inputs:

1. The most recent three years of financial statements
2. The capital budgets for the next five years, insofar as they are known. This should also include a lease-versus-purchase analysis for all assets under consideration. Leasing and alternative financing sources are covered in Chapter 10.
3. Management and board financial policies regarding investments, debt, and minimum necessary liquidity

How might your organization assess its future capital spending needs? The best general approach is to first specify several categories of the external environment that will affect your organization's future (e.g., competition or regulations), then identify the specific external drivers that will be at work within those categories and that have relevance to your industry (e.g., youth services or performance arts). Then specify the internal goals that will best suit your organization to meet those anticipated developments in the external environment. Finally, detail the capital responses that your organization will have to make to achieve those internal goals: new or refurbished plant or equipment, enhanced information technology, renovation, expansion, upgrades to systems, training investments, increased research and development expenditures, multiyear brand- and image-building investments, and so on. Consult Exhibit 9.1 for a filled-out schematic for the hospital industry. The "shifting regulated and negotiated payment incentives" fits in the Technology/Regulation section as well, particularly regarding the dynamics around Medicaid.

Armed with these inputs, the financial manager can obtain or develop operating forecasts that will enable the formulation of simple long-range financial plans. Although the next year may be somewhat detailed (depending on whether the operating budget has been developed yet), years 2 to 5 will show little detail – possibly only total revenue and total expense of operations.

**Responses to External Drivers of Capital Need**

| Category | External Drivers | Internal Goals | Capital Responses |
|---|---|---|---|
| Competition | • Strategic efforts by other area hospitals<br>• Emergence of specialty providers<br>• Shift of volume to physician offices and other outpatient centers<br>• Payer shifts of volume to lower-cost providers<br>• Scarcity of medical professionals<br>• Shifting regulated and negotiated payment incentives | • Protect existing volume and market share<br>• Create opportunities to expand market share<br>• Avoid loss of profitable programs to specialty providers<br>• Attract and retain valued employees and physicians<br>• Retool programs that become unprofitable as a result of shifts In reimbursement | • Facilities renovation or construction<br>• Equipment purchases and upgrades<br>• Automation and digital capabilities<br>• Information systems upgrades |
| Technology/ Regulation | • Advances in technology<br>• Advances in pharmaceutical therapies<br>• Shift in procedures to outpatient settings<br>• Bioterrorism preparedness<br>• Privacy and security | • Retain key physicians<br>• Improve physician and patient satisfaction<br>• Enhance quality of care and patient safety<br>• Comply with regulatory mandates<br>• Maintain community safety net services for health emergencies | • Equipment purchases or upgrades<br>• Process redesign around new equipment and treatment modalities<br>• Renovations and expansion of ambulatory capacity<br>• Joint ventures around ambulatory capacity<br>• Implementation of digital capabilities |
| Consumers | • Rise of consumerism in selection of healthcare providers<br>• External reporting of quality and safety data<br>• Extension of life expectancy<br>• Aging population that uses more services<br>• Shifting regional demographics | • Invest in programs and services for the changing needs of an aging population<br>• Communicate quality externally<br>• Report external information accurately | • Facilities renovation or construction<br>• Equipment purchases or upgrades<br>• IT/IS enhancements to reporting |

*Source: Financing the Future*, Healthcare Financial Management Association, Used by permission.

**Exhibit 9.1** Capital Planning Example Using the Hospital Industry

The example that follows illustrates the long-range financial plan and the fact that the planning process, when used properly, takes at least two passes or iterations. The first pass takes the strategic plan and preexisting funding strategies as givens and determines each future year's funding surplus or shortfall. The feedback from this exercise provides the organization's managers and board with needed input for possible revisions of the strategic plan and/or the funding strategy, which is the second pass.

To the extent surpluses appear in forward years, the management team can choose whether to:

- Develop program initiatives (expand present programs or add new ones)
- Reduce debt
- Increase investment in existing staff or technology
- Build liquidity (if appropriate, based on financial policies)

Where shortfalls appear, organizations can choose whether to

- If they have large cash reserves, draw these down
- Reduce discretionary expenses
- Redirect funds from noncore to core (essential to mission) programs
- Sell investment securities from portfolio
- Initiate capital campaign (if capital spending is the reason for the shortfall)
- Increase interest revenue through the use of appropriate investment vehicles and/or building of endowment
- Increase rental and/or unrelated business income revenue
- Increase investment in fundraising for operations – annual campaign

If there are perpetual problems with shortfalls, permanently reduce expenses and work to initiate or increase investment in planned giving fundraising or make other business model changes.

At a minimum, do a projection of the statement of cash flows (SCF) (you may wish to refer to Chapter 6 for a review of this statement). To keep things even simpler, enter the last five or six years of statement of activities data into a computer spreadsheet. Then let the spreadsheet program do a straight-line projection of total revenue (income) and expenses. Exhibit 9.2 shows such a projection using the actual financials of an anonymous ministry organization.

Notice the deteriorating trend; if the trend had continued, the organization would have ended up out of business. Simply knowing that this is what will occur if corrective action is not taken is well worth the time and effort of the entire planning exercise. If you were the CFO of this organization, and its financial policies rule out the use of short-term debt, how might you close the gap in future periods?

As you reflect on the situation, you will likely identify three situational factors that generally act as constraints on your actions:

1. You cannot draw down liquidity without violating the minimum liquidity financial policy (target liquidity level).
2. Short-term debt is forbidden (not uniformly but commonly, in nonprofits).
3. All programs are core (so no program may be eliminated or severely curtailed).

| Statements of Activities of a Nonprofit Organization | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | Projected 2018 | Projected 2019 | Projected 2020 | Projected 2021 | Projected 2022 |
| *Income:* | | | | | | | | | | | |
| Contributions | $5,121,652 | $5,088,913 | $5,721,854 | $5,725,263 | $5,852,144 | $6,618,502 | $6,665,790 | $6,945,143 | $7,224,496 | $7,503,849 | $7,783,202 |
| Net gain on disposal of fixed assets | 29,733 | 214,717 | 85,714 | 34,816 | 42,641 | 78,749 | | | | | |
| Investment income | 193,319 | 194,318 | 227,973 | 275,187 | 279,756 | 364,352 | | | | | |
| Sales less cost of goods sold | — | — | — | 128,116 | 142,991 | 149,530 | | | | | |
| Total Revenue & Support | $5,344,704 | $5,497,948 | $6,035,541 | $6,163,382 | $6,317,532 | $7,211,133 | $7,286,914 | $7,627,449 | $7,967,985 | $8,308,520 | $8,649,055 |
| Expenses: | | | | | | | | | | | |
| Program Activities: | | | | | | | | | | | |
| Church growth, evangelism | $1,618,616 | $ 1,409,014 | $ 1,526,571 | $ 1,678,493 | $ 1,873,124 | $ 2,456,467 | | | | | |
| Media, translation | 548,411 | 469,713 | 575,519 | 697,491 | 875,791 | 785,726 | | | | | |
| Theological, church leadership training | 404,940 | 356,640 | 414,600 | 410,305 | 360,691 | 289,019 | | | | | |
| Education | 272,770 | 199,141 | 217,979 | 246,747 | 334,175 | 302,764 | | | | | |
| Field administration | 207,196 | 192,317 | 228,145 | 297,591 | 347,325 | 291,803 | | | | | |
| Appointees | 206,719 | 209,831 | 133,666 | 108,690 | 108,726 | 94,001 | | | | | |
| Homeland ministries, furlough | 671,830 | 760,737 | 726,156 | 615,136 | 743,129 | 866,198 | | | | | |
| Relief | 96,276 | 44,915 | 118,758 | 192,541 | 133,910 | 434,442 | | | | | |
| Service to missionaries | 71,872 | 59,049 | 137,027 | 135,292 | 182,386 | 137,644 | | | | | |
| Medical | 40,448 | 41,616 | 38,114 | 27,428 | 57,871 | 40,639 | | | | | |

**Exhibit 9.2** Financial Projection Providing Early Warning of Financial Deterioration

| Statements of Activities of a Nonprofit Organization | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2012** | **2013** | **2014** | **2015** | **2016** | **2017** | **Projected 2018** | **Projected 2019** | **Projected 2020** | **Projected 2021** | **Projected 2022** |
| Subtotal: | | | | | | | | | | | |
| Program exps. | $4,139,078 | $ 3,742,973 | $ 4,116,535 | $ 4,409,714 | $ 5,017,128 | $ 5,698,703 | $ 5,712,065 | $6,052,459 | $ 6,392,852 | $ 6,733,246 | $7,073,639 |
| Supporting activities: | | | | | | | | | | | |
| Management and general | $ 814,414 | $ 996,659 | $ 864,530 | $ 1,046,032 | $ 1,149,552 | $ 1,210,873 | | | | | |
| Fundraising | 81,585 | 140,880 | 193,685 | 188,453 | 199,089 | 172,759 | | | | | |
| Subtotal: | | | | | | | | | | | |
| Support exps. | 895,999 | 1,137,539 | 1,058,215 | 1,234,485 | 1,348,641 | 1,383,632 | $ 1,501,193 | $1,593,985 | $ 1,686,778 | $ 1,779,570 | $1,872,363 |
| Total expenses | $5,035,077 | 4,880,512 | 5,174,750 | 5,644,199 | 6,365,769 | 7,082,335 | 7,213,258 | 7,646,444 | 8,079,630 | 8,512,816 | 8,946,002 |
| Excess (deficiency) of income over expenses | 309,627 | 617,436, | 860 791 | 519,183 | −48.237 | 128.798 | 73.656 | (18,995) | (11 1,6 451) | (204,296) | (296,947) |
| Unadjusted net assets — end of year* | $4,388,295 | $ 5,005,731 | $ 5,866,522 | $ 6,385,705 | $ 6,337,468 | $ 6,466,266 | $ 6,539,922 | $6,520,927 | $ 6,409,282 | $ 6,204,985 | $5,908,039 |

*Shows what net assets would be without adjustments or transfers.

*Source:* This table uses actual data for a ministry organization, but the organization's name has been withheld and the years changed. Projections were done by author using Microsoft Excel. This is done by simply entering the numbers shown for contributions, then highlighting the range, and clicking and holding down the drag handle on the bottom right of the range and dragging it to the right over several cells.

**Exhibit 9.2** Financial Projection Providing Early Warning of Financial Deterioration (*continued*)

The financial manager might recommend these possible courses of action to the ED/CEO and the board:

- Reduce discretionary expenses.
- Increase the investment in fundraising.
- Increase rental and unrelated business income.
- To the extent possible, shift investment portfolio to higher-yield investment vehicles (within risk parameters) and/or, once you get large enough, build endowment.
- Revisit the minimum liquidity target to see if it should be set higher in the future.

The planning exercise is valuable because when shortfalls are projected, they provide early warning of impending financial shortages, and when surpluses are expected, we may consider opportunities to expand or enhance the mission or build endowment. Furthermore, as noted earlier, you may engage in contingency planning, selecting for further study events that are not expected. Although they are not considered "most likely," and therefore are not incorporated into your normal financial plan, these events may still be quite probable and they could have a significant impact on your revenues, expenses, assets, or liabilities. High-profile natural disasters would be a prime example. These typically siphon off significant donation funding from many non-relief US nonprofits, especially food banks, homeless shelters, and after-school programs.[16]

**(f) DEVELOP A FINANCIAL MODEL.** The next phase in your financial planning process is to develop a full-blown financial model of your organization, its operations, its asset requirements, and how these will be financed. A financial model may be defined as "the financial representation or model of how an organization works and functions, created in such a way that it can productively be used as a means to simulate the real world."[17] This more complete portrait of your organization's financial future adds significant value to the simple forecast we profiled earlier by:

1. Showing asset requirements of growth (or scale-backs), along with the need for financing those asset requirements, by projecting key aspects of the statement of financial position (SFP).
2. Incorporating relationships between the various financial accounts into cause-and-effect relationships, which is easily done even in a financial spreadsheet model.
3. Showing the true effects of revenue, expense, liability, and net asset changes on the target liquidity level, by backing out noncash effects of depreciation, amortization, and other accounting adjustments such as losses on discontinued operations or restructuring charges.
4. Identifying knowledge and information gaps that must be addressed for the organization to have a better understanding of its financial interrelationships and cash flows – some of which will be discovered in the processes of modeling points 1, 2, and 3. Others will be unveiled as banking, payment system, and regulatory policies and constraints (Chapter 11) are built into the model and as loan covenants (Chapter 10) and restricted cash and other restricted net assets are identified in the model.
5. Allowing a view of the financial position, funding need, and revenue coverage of expense changes when any single input to the model changes in value. This what-if scenario analysis function is the most valuable feature of a financial model, in the view of most users. See Appendix 9A for an example.

It is beyond our scope to go into detail on the hows of financial modeling, and there are print and Internet sources to help you to develop a model.[18] We use a publicly available financial planning model developed by PricewaterhouseCoopers for service businesses to show you the level of detail and interaction between your forward-year projections.[19]

Exhibit 9.3 shows the set of assumptions that go into the financial model. Many items are computed as a percent of sales, or total revenues.

Next we see our first projected financial statement, the Income Statement (Exhibit 9.4). It is similar to the nonprofit statement of activities. As you study it, note the level of detail that is appropriate for your long-range financial plan. You may wish to customize it with your organization's Statement of Activities captions, or use it as is if you are projecting for a for-profit subsidiary that is involved in generating unrelated business income.

Note that the Net Income would be the Change in Net Assets for a nonprofit organization and that tax expense (Tax Exp) will most likely be zero for tax-exempt nonprofits (unless they have to pay some use or excise taxes or taxes on unrelated business income).

Next, we need to project the SFP, or balance sheet. Notice in Exhibit 9.5 the service business projected balance sheet developed by PriceWaterhouseCoopers. Again, you would modify it to the account categories for your organization, including a breakdown in "Cash" for unrestricted cash and restricted cash. The caption "A/R" is an abbreviation for accounts receivable, which would fit commercial nonprofits but might instead be pledges receivable for the donative nonprofit or grants receivable for other nonprofits.

We modified the business format slightly. For Equity, we use Net Assets, and you may also wish to split out Unrestricted Net Assets, Temporarily Restricted Net Assets, and Permanently Restricted Net Assets rather than Net Assets with Donor Restrictions and Net Assets without Donor Restrictions.

Finally, and for many organizations possibly the most important projection, is the sources and uses of funds projection. It is similar to a projected SCF, and you may opt to use your SCF format rather than the sources/uses template shown in Exhibit 9.6. Regardless, study it carefully, noting how the financial plan details the needs for funds and the anticipated funding sources. You may leave one category in the latter blank (zero value), using this as the "plug figure" for your projected long-range financial plan. Then strategize on how to meet that shortfall as you view the first-pass projection of your sources and uses. That leads us directly to the target liquidity level assessment, our next topic.

What is the bottom line on the sources and uses of funds projection? Ending cash. If the total of the anticipated sources of cash are inadequate to cover anticipated uses of cash, your ending cash will be eroded over time. Move now to arrange additional sources of funds or reduce anticipated uses of funds to bridge the gap between sources and uses. Furthermore, many organizations will want to intentionally plan to have a smaller total-*uses*-of-cash figure, in order to build toward higher values of ending cash as it targets a higher liquidity level.

**(g) PROJECT AND REEVALUATE TARGET LIQUIDITY.** Earlier in this book we profiled evaluating the necessary level of liquidity (Chapters 2, 5, and 8) and how to measure liquidity (Chapters 2 and 7). Equally valuable is an analysis of the target liquidity level that is based also on the projected financial position several years in the future. In this way, we not only know what level of operating reserves to hold, but also the level of strategic reserves to hold. Strategic reserves include amounts accumulated to prefund capital expenditures, funds for unanticipated strategic options (such as new programs or large one-time service needs that may arise), and funds for a board-designated endowment, or quasi-endowment, the income from which may help fund program expenses. These additional funds are

| Financial Model: Assumptions |
|---|

**SALES**

| UNIT SALES | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|
| Project Revenues | - | - | - | - | - |
| Service Two | - | - | - | - | - |
| Service Three | - | - | - | - | - |
| Service Four | - | - | - | - | - |

| AVERAGE FEES PER UNIT | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|
| Project Revenues | - | - | - | - | - |
| Service Two | - | - | - | - | - |
| Service Three | - | - | - | - | - |
| Service Four | - | - | - | - | - |

| BALANCE SHEET |
|---|

| | | |
|---|---|---|
| Accounts Receivable (adjustable up to 360 days).................. | *(in days)*........................................ | 45 days |
| Accounts Payable (fixed at 30 days)...................................... | *(in days)*........................................ | 30 days |
| Salaries Payable (fixed at 15 days)......................................... | *(in days)*........................................ | 15 days |
| Taxes Payable (fixed at 90 days)............................................ | *(in days)*........................................ | 90 days |
| Available Credit Line............................................................ | *(as a percentage of net accounts receivable)*......................... | 0% |
| Maximum Credit Line Used................................................. | *(amount borrowed not to exceed)*........................................ | $0 |
| Capital Equipment Lease Term (1 year minimum).................. | *(in years)*........................................ | 3 years |
| Long-Term Borrowings Term (1 year minimum)..................... | *(in years)*........................................ | 5 years |

**EXHIBIT 9.3** FINANCIAL MODEL ASSUMPTIONS – SERVICE BUSINESS EXAMPLE

| DEPRECIATION | Hardware | Software | Furn & Fixtures |
|---|---|---|---|
| Production Process | 3 years | 3 years | 3 years |
| Sales & Marketing | 3 years | 3 years | 3 years |
| Administration | 3 years | 3 years | 3 years |

**Financial Model: Assumptions**

**EXPENSES**

| HEADCOUNT | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|
| Production Process | - | - | - | - | - |
| Sales & Marketing | - | - | - | - | - |
| Administration | - | - | - | - | - |
| **TOTAL** | - | - | - | - | - |

| PER PERSON EXPENSES | Supplies | Travel & Meals | Phone/Postage |
|---|---|---|---|
| Production Process | - | - | - |
| Sales & Marketing | - | - | - |
| Administration | - | - | - |

| EQUIPMENT PURCHASES | Hardware | Software | Furn & Fixtures |
|---|---|---|---|
| Production Process | - | - | - |
| Sales & Marketing | - | - | - |
| Administration | - | - | - |

| | | |
|---|---|---|
| Benefits & Taxes | *(as a percentage of salaries)* | |
| Salary Increases | *(as an annual percentage)* | |
| Sales Commissions | *(as a percentage of sales)* | |
| Total Sales through Commissions | *(as a percentage of total revenue)* | |
| Business Insurance | *(as a percentage of total revenue)* | |
| Anticipated Bad Debt | *(as a percentage of collections)* | |
| Interest Revenue | *(as a percentage of cash balance)* | 4% |
| Interest Expense on Credit Line | *(as a percentage of outstanding balance)* | 10% |
| Interest Expense on Capital Equipment Lease | *(as a percentage of outstanding balance)* | 10% |
| Interest Expense on Long-Term Borrowings | *(as a percentage of outstanding balance)* | 10% |
| Combined Federal & State Tax Rate | *(as a percentage of positive cumulative income)* | 0% |
| Office Rent | *(per square foot)* | $3.00 |
| Minimum Office Space | *(square footage per person)* | |
| Term of Office Lease | *(in months)* | |
| Utilities Expense | *(per square foot)* | |
| Maintenance Expense | *(per square foot)* | |

Expenses for advertising, tradeshows, and collateral are budgeted as indicated in the DETAIL worksheet.
Consultants, Contractors, & Professional Services are employed at market rates and are indicated as needed. Salaries are based on competitive compensation.
Bonuses and other incentives are paid out as indicated in the income statement. www.pwcv2rform.com. Accessed 1/21/06. Used by permission.

**Exhibit 9.3** Financial Model Assumptions – Service Business Example (*continued*)

**Income Statement (SA) ($)**

| | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|
| Revenue | $0 | $0 | $0 | $0 | $0 |
| Project Revenues | | | | | |
| Total Revenues | $0 | $0 | $0 | $0 | $0 |
| Operating Expenses | $0 | $0 | $0 | $0 | $0 |
| Production Process | | | | | |
| % of Revenues | 0% | 0% | 0% | 0% | 0% |
| Sales & Marketing | $0 | $0 | $0 | $0 | $0 |
| % of Revenues | 0% | 0% | 0% | 0% | 0% |
| Administration | $0 | $0 | $0 | $0 | $0 |
| % of Revenue | 0% | 0% | 0% | 0% | 0% |
| Total Operating Expenses | $0 | $0 | $0 | $0 | $0 |
| % of Revenue | 0% | 0% | 0% | 0% | 0% |
| Interest Expense | $0 | $0 | $0 | $0 | $0 |
| Interest Revenue | $0 | $0 | $0 | $0 | $0 |
| Income Before Taxes | $0 | $0 | $0 | $0 | $0 |
| Tax Expense | $0 | $0 | $0 | $0 | $0 |
| Net Income (or Surplus) | $0 | $0 | $0 | $0 | $0 |
| % of Revenue | 0% | 0% | 0% | 0% | 0% |

*Source:* PricewaterhouseCoopers.  PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. Downloaded from: www.pwcv2rform.com. Accessed 1/2/06. Used by permission.

**Exhibit 9.4** Projected Revenues and Expenses – Service Business Example

necessary because nonprofits typically do not earn enough of a surplus ("profit") of revenues over expenses to self-fund such expenditures on a timely basis.[20]

The beginning point for this analysis is the Ending Cash projection we looked at in our sources and uses projection (refer to Exhibit 9.6). Recall, from our ratios presentation in Chapter 7, the definition of target liquidity level and also a related ratio, target liquidity level lambda:

$$\text{Target liquidity level} = (\text{Cash and cash equivalents} + \text{Short-term investments} + \text{Total amount of credit line} - \text{Short-term loans})$$

Total amount of credit line is the ceiling amount approved for the bank, or the maximum amount that may be borrowed at any one time. It is similar to the credit limit on a credit card.

$$\text{Target liquidity level lambda} = \frac{\text{Target liquidity level} + \text{Projected OCF}}{\text{Uncertainty of OCF}}$$

where:

Projected OCF is the operating cash flow amount for the next year
Uncertainty of OCF is the standard deviation of the organization's historical operating cash flows (OCFs) for at least the past three years

**Balance Sheet (SFP) ($)**

| | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|
| ASSETS | | | | | |
| Current Assets: | | | | | |
| Cash | $0 | $0 | $0 | $0 | $0 |
| Net Accounts Recv | $0 | $0 | $0 | $0 | $0 |
| Total Current Assets | $0 | $0 | $0 | $0 | $0 |
| Gross Fixed Assets | $0 | $0 | $0 | $0 | $0 |
| Less Accum Depreciation | $0 | $0 | $0 | $0 | $0 |
| Net Fixed Assets | $0 | $0 | $0 | $0 | $0 |
| TOTAL ASSETS | $0 | $0 | $0 | $0 | $0 |
| LIABILITIES | | | | | |
| Current Liabilities: | | | | | |
| Accounts Payable (30 days) | $0 | $0 | $0 | $0 | $0 |
| Salaries Payable (15 days) | $0 | $0 | $0 | $0 | $0 |
| Taxes Payable (90 days) | $0 | $0 | $0 | $0 | $0 |
| Line of Credit (X% of net A/R) | $0 | $0 | $0 | $0 | $0 |
| Current Portion of Cap Equip Lease | $0 | $0 | $0 | $0 | $0 |
| Current Portion of Long-Term Debt | $0 | $0 | $0 | $0 | $0 |
| Total Current Liabilities | $0 | $0 | $0 | $0 | $0 |
| Long-Term Liabilities: | | | | | |
| Capital Equipment Lease (3 years) | $0 | $0 | $0 | $0 | $0 |
| Long-Term Debt (5 years) | $0 | $0 | $0 | $0 | $0 |
| Total Long-Term Liabilities | $0 | $0 | $0 | $0 | $0 |
| TOTAL LIABILITIES | $0 | $0 | $0 | $0 | $0 |
| Net Assets | | | | | |
| Without Donor Restriction | $0 | $0 | $0 | $0 | $0 |
| With Donor Restriction | $0 | $0 | $0 | $0 | $0 |
| Total Net Assets | $0 | $0 | $0 | $0 | $0 |
| LIABILITIES & NET ASSETS | $0 | $0 | $0 | $0 | $0 |

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**Exhibit 9.5** Projected Assets, Liabilities, and Net Assets —Service Business Example

The first thing we add to Ending Cash is the amount held in short-term investments. Notice on our projected balance sheets (refer to Exhibit 9.5) that no line item was listed for short-term investments. If your organization has short-term investments (beyond cash and cash equivalents, with cash equivalents being very short-term investments with a maturity at the time of purchase of three months or less), you should list those on your projected balance sheet immediately below the cash row. Then determine the total amount of your organization's negotiated credit line, if any, and add this to the total you had for (Ending Cash + Short-term investments). This amount *will not be shown on your projected balance sheet except in the special case in which you plan to have borrowed up to the limit of that credit line at the balance sheet date, say, 12/31/2022.* Your organization will find that one

**Statement of Sources & Uses ($)**

| | 2022 | 2023 | 2024 | 2025 | 2026 |
|---|---|---|---|---|---|
| **BEGINNING CASH** | $0 | $0 | $0 | $0 | $0 |
| **Sources of Cash** | | | | | |
| Net Income | $0 | $0 | $0 | $0 | $0 |
| Add Depr/Amort | $0 | $0 | $0 | $0 | $0 |
| Accounts Payable (30 days) | $0 | $0 | $0 | $0 | $0 |
| Salaries Payable (15 days) | $0 | $0 | $0 | $0 | $0 |
| Taxes Payable (90 days) | $0 | $0 | $0 | $0 | $0 |
| Additions to Line of Credit | $0 | $0 | $0 | $0 | $0 |
| Additions to Cap Equip Lease | $0 | $0 | $0 | $0 | $0 |
| Additions to Long-Term Debt | $0 | $0 | $0 | $0 | $0 |
| **Total Sources of Cash** | $0 | $0 | $0 | $0 | $0 |
| **Uses of Cash Less Changes In:** | | | | | |
| Net Accounts Rec | $0 | $0 | $0 | $0 | $0 |
| Gross Fixed Assets | $0 | $0 | $0 | $0 | $0 |
| Reductions to Line of Credit | $0 | $0 | $0 | $0 | $0 |
| Reductions to Cap Equip Lease | $0 | $0 | $0 | $0 | $0 |
| Reductions to Long-Term Debt | $0 | $0 | $0 | $0 | $0 |
| **Total Uses** | $0 | $0 | $0 | $0 | $0 |
| **CHANGES IN CASH** | $0 | $0 | $0 | $0 | $0 |
| **ENDING CASH** | $0 | $0 | $0 | $0 | $0 |

*Source:* PricewaterhouseCoopers.  PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. Downloaded from: www.pwcv2rform.com. Accessed 1/2/06. Used by permission.

**Exhibit 9.6** Projected Sources and Uses of Funds – Service Business Example

of the primary benefits of projecting a balance sheet is to know how much of a credit line to request from a bank. For comparison purposes, if you need to determine what another peer organization has arranged in a *past* year for its credit line you would have to search the notes that accompany the financial statements to find the total amount of the credit line. Finally, subtract also from your projected balance sheet any amount shown under current liabilities for "Credit line" or an equivalent current liability entry, normally "Notes payable." This represents amounts borrowed under a credit line or similar short-term borrowing arrangement with a bank or other short-term lender.

For example, let's say you project Ending Cash of $5,000, short-term investments of $15,500, have arranged a credit line for $100,000, and project a borrowed amount of $45,000. Your projected target liquidity level would be $75,500 (= $5,000 + $15,500 + $100,000 − $45,000).

If your organization typically has significant across-year variability in its operating cash flows (consult your last five SCFs to check this), you will also want to calculate the projected TLLL, or projected target liquidity level lambda, which involves two modifications to the formula: (1) add the next year's projected operating cash flow to projected TLL and then (2) divide the sum from step 1 by the standard deviation of your organization's historical operating cash flows.

Revisiting our previous example, let's say your organization expects an operating cash flow for the next year of −\$35,000 and has these historical operating cash flows for the *past* five years:

| PAST YEARS | OPERATING CASH FLOW |
|---|---|
| 1 | \$45,000 |
| 2 | −25,000 |
| 3 | 5,000 |
| 4 | −15,000 |
| 5 | 10,000 |

Clearly, your organization has experienced significant variability in its OCFs. We need to calculate the standard deviation of this sample of cash flows to use in our calculation of projected TLLL. Let's illustrate that calculation by using Microsoft Excel and the built-in function for sample standard deviation:

Sample standard deviation = $\boxed{\mathbf{27,018.51}}$ (Using STDEV function built into Excel.)

Using this sample estimate for our OCF variability, we get this projected TLLL:

$$\text{Projected TLLL} = (\text{TLL} + \text{Projected OCF})\big/\text{Variability of OCF}$$

$$\text{Projected TLLL} = (\$75{,}500 + -\$35{,}000)\big/\$27{,}018.51$$

$$\text{Projected TLLL} = \$40{,}500\big/\$27{,}018.51$$

$$\text{Projected TLLL} = 1.50$$

If your organization's OCFs are approximately normally distributed (appearing as an almost symmetrical, bell-shaped curve when graphed), we can use this information to estimate our probability of running out of cash.

First, let's assume that "out of cash" is a negative cash balance. This implies we exhaust our Ending Cash, then exhaust our short-term investments, then use up any previously unused credit line availability, and finally burn through any positive OCF that comes in the next period.

Second, in our illustration, next year's projected OCF is forecasted to be a negative \$35,000, which we noted should drop our TLL to \$40,500. Based on historical OCF variability (a standard deviation of \$27,000 plus), what is the chance we will drop below \$0 in cash next year? We take the difference between \$0 and our forecast of \$40,500 (= TLL + Projected OCF), and divide that by \$27,018.51. This gives us how many standard deviations \$0 falls below our \$40,500 forecast, which is actually called a "z score" in statistics:

$$z = (\$0 - \$40{,}500)\big/\$27{,}018.51$$

$$z = -\$40{,}500\big/\$27{,}018.51$$

$$z = -1.50$$

Notice that this figure is exactly the same as our projected TLLL.

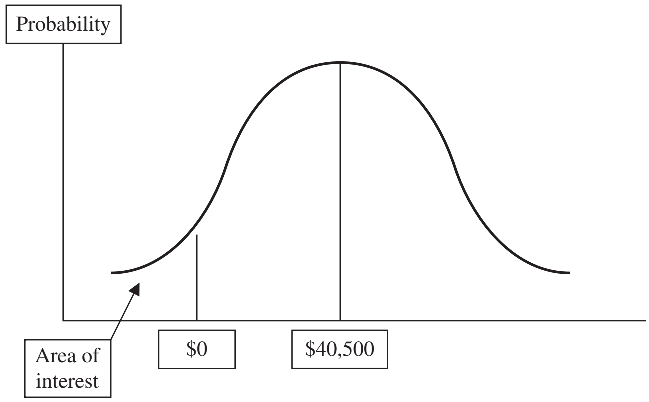



**EXHIBIT 9.7** DISTRIBUTION OF TARGET LIQUIDITY LEVEL OUTCOMES USING HYPOTHETICAL EXAMPLE

The question is now: What is the probability of our liquidity dropping not just below \$40,500, but below \$0, in the forthcoming period? The TLLL number of 1.50 tells us that \$0 is 1.5 standard deviations below the expected value of \$40,500. Visually, looking at Exhibit 9.7, one-half of the possible outcomes fall above \$40,500, so these would represent 50 percent of the outcomes, or a 50 percent likelihood. To determine how likely an outcome below \$0 is, we need to determine the likelihood of an outcome falling between \$0 and \$40,500, then add that to the 50 percent likelihood of an "above \$40,500" outcome, and finally subtract this sum from 100 percent. We can consult a standard normal table to get the likelihood of the \$0 to \$40,500 outcome, or use the NORMSDIST function to do this for us, using Excel. We start by getting the probability of getting an outcome above \$0:

$$\begin{aligned}\text{Area under the likelihood curve to the right of \$0} &= \text{NORMSDIST (1.50)}\\ &= 0.933059584\end{aligned}$$

Therefore:

$$\text{Area under the likelihood curve to the left of \$0} = (1 - 0.933059584)$$

$$\text{Area under the likelihood curve to the left of \$0} = \underline{\underline{0.0669 \text{ or } 6.69\%}}$$

Interpretation: This calculated value for the area suggests that the chance of our organization running out of cash is less than 7 percent for the upcoming year.

We may decide this probability of running out of cash is too high. If we were to plan based on a slightly larger credit line, say \$123,000 instead of \$100,000, our TLL jumps \$23,000 to \$63,500. That gives us a TLLL of 2.35 = \$63,500/\$27,018.51.

Let's see how this revised credit line amount affects our probability of running short on cash.

$$\begin{aligned}\text{Area under the likelihood curve to the right of \$0} &= \text{NORMSDIST(2.35)}\\ &= 0.990619356\end{aligned}$$

Therefore:

$$\text{Area under the likelihood curve to the left of } \$0 = (1 - 0.990619356)$$

$$\text{Area under the likelihood curve to the left of } \$0 = \underline{\underline{0.00938 \text{ or } 0.94\%}}$$

The board and CFO may find a probability of less than 1 percent to be acceptable. We see here the value of iterative and interactive financial planning, whereby different values can be plugged in for target liquidity and the preferred policy decision selected. In this case, the organization decided its original TLL was too low and bumped it up by $23,000. It would not have necessarily done this by increasing the credit line amount, however, and may have (given sufficient lead time in the planning process) built up the level of short-term investments instead.

***(i) Scenario Analysis and Sensitivity Analysis.*** Running various scenarios through your financial model to see their likely effect on revenues, expenses, assets, liabilities, and the target liquidity level is very helpful. If you are not prepared to do this scenario analysis, at least vary your revenues up and down by 5, 10, and 15 percent to see the effect on your financials, and do the same with expenses. You may wish to develop or use an Excel revenue scenario template to help you see the results of varying revenue and support levels.[21]

We agree with Donaldson that an organization needs a database for a strategy of funds mobility in order to cope with unexpected changes. The advice of consultant Hilda Polanco is on point: "Discuss and develop plans for mitigating any financial risks demonstrated by the scenarios, including specifying "triggers" for implementing plans."[22] In Exhibit 9.8 we present a template modified from Donaldson's business template. It lists items as uncommitted reserves, reduction of planned outflows, and liquidation of assets. This template is related to the tiers of liquidity that we presented in Exhibit 2.2 in Chapter 2; you may wish to review that diagram before going any further. In Exhibit 9.8, we see an estimate of funds that could be made available from both internal and external sources. Note that these are funds that have not already been committed for use in the next three years. These include:

- *Uncommitted reserves.* This includes instant reserves and negotiable reserves:
  - Instant reserves (unrestricted cash balances, unrestricted short-term marketable securities, and the unused portion of the bank credit line, if any) are instantly available for any purpose. Buy time for the organization in order that it can mobilize other resources – implying that the size of the instant reserves should be larger the larger an unexpected cash deficit might be and the longer it takes the organization to tap other resources.
  - *Negotiable reserves* (new short-term bank loans, new long-term debt issues, new fundraising approaches or intensity) involve some form of negotiation and are therefore less certain. Also, the amounts depend on the degree and type of previous use of these items (long-term debt issues depend on previous use of long-term debt and short-term debt). Consider the sequencing and interrelationships in this category of funding sources.
  - Collateral for short-term loans is typically inventory and accounts receivable (ruling out this form of borrowing for many nonprofits), although at times grants and contracts receivable may serve as security for loans.
- *Reduction of outflows.* Here the view is toward what existing commitments to planned outflows may be reduced and a consideration of whether an unexpected

| Available for use within: | | | |
|---|---|---|---|
| **Resources** | **Three months** | **One year** | **Three years** |
| I. Uncommitted reserves | | | |
| Instant reserves | | | |
| Surplus unrestricted cash | $ | | |
| Unused line of credit | $ | | |
| Negotiable reserves | | | |
| Additional bank loans | | | |
| Unsecured (no collateral) | $ | | |
| Secured (have collateral) | $ | | |
| Additional long-term debt | | $ | |
| Additional funds raised* | | $ | $ |
| II. Reduction of planned outflows | | | |
| Volume-related | | | |
| Change in production or service schedule | $ | | |
| Scale-related | | | |
| Marketing/promotion program | | $ | |
| R&D/New program development budget | | $ | |
| Administrative overhead** | | $ | |
| Capital expenditures | | $ | |
| Value-related | | | |
| Fundraising expenditure** | | $ | |
| Capital campaign** | | $ | $ |
| Endowment campaign** | | $ | $ |
| III. Liquidity of assets | | | |
| Shutdown (temporary) | | $ | |
| Sale/divestiture of unit | | | $ |
| SUBTOTAL | $ | $ | $ |
| TOTAL RESOURCES | | | $ |

*It is unusual to be able to raise more funds the same fiscal year when increasing fundraising efforts, although some organizations (especially faith-based organizations) are able to do this at times.
**Generally, pare back or defer, but do not eliminate entirely. If "Additional funds raised" is a Level I objective, this will preclude cost reductions in one or more of the fundraising categories.
*Source:* Adapted from Exhibit I in Gordon Donaldson, "Strategy for Financial Emergencies," *Harvard Business Review* (November/December 1969): 67–79. Used by permission.

**Exhibit 9.8** Inventory of Resources for Financial Mobility—a Template

need that arises might better be met through one of these reductions rather than drawing on uncommitted reserves – the wisdom of which depends on how large and pressing the need is, the size and accessibility of the organization's reserves, and the special circumstances related to the unexpected need.

- Value-related expenditures are not directly related to the organization's services, but do affect the donor franchise and donors' perceived value (such as expenditures on an ongoing capital campaign).

- The largest potential fund source here is usually the scale-related outflows, in that they offer the most flexibility regarding expenditure timing.
- Volume-related cuts are best done if service demands are also declining.
- New and unexpected needs are golden opportunities to revisit the organization's priorities, which is a reason that selective budget cuts may be appropriate as an organizational response.
- "Defending the remaining financial reserves may be more important than defending the budget" – so keep these intact to protect against future totally unexpected and urgent needs whenever possible.[23]
- If your organization is already very lean, and few if any cutbacks are possible without causing service provision cutbacks, rely more on a larger instant reserves level and less on reduced outflows for meeting unexpected needs.
- At times reductions or deferrals in annual campaigns or deferred giving campaigns may be necessary, but recognize the effect on this on your donors and their perceptions, including the loss of additional opportunities to solidify your organization's value proposition in their minds.

- *Liquidation of assets.* Temporary suspension of the use of property or eventual sale of property, facilities and plant, equipment, and land.
  - Recognize that there is a great deal of uncertainty here if assets are sold off, both with respect to amount and length of time to consummate the disposal.
  - This requires an estimate of "liquidation value." What amount would you realize if you had to sell the assets quickly?
  - It is best to identify in advance which operations are least "mission-central" and which would have the smallest effect on the organization's revenue stream.

Even more valuable, once you have completed Exhibit 9.8, is to do a second inventory of funding resources based on a projection of what you think they are likely to be a year from now. Especially important in that second inventory is the anticipated change in instant reserves: If an erosion in instant reserves is anticipated, take action now to tap negotiable reserves and/or a reduction planned outflows in order to restore your instant reserves. Remember that your primary financial objective as a nonprofit is to maintain your target liquidity level.

***(ii) Other Financial Goals and the Organization's Life Cycle.*** If yours is a commercial nonprofit (can price its services to more than cover costs), you may also adopt some profitability goals for some of your lines of business. Or your organization may be at the point in its life cycle to start or build your endowment fund. For example, the University of North Florida planned a new student union (cost: $30 to $35 million) but is also building its endowment to $100 million by a certain point in time in order to (1) increase operations funding with a more predictable annual income, (2) improve its standing in the academic community, and (3) decrease its dependence on the state legislature's funding allocations.[24] Stevens notes that different stages in your organization's life cycle may occasion different financial priorities; we quote here only the ones that are part of your financial planning objectives.[25]

| STAGE IN LIFE CYCLE | FINANCIAL CHALLENGE |
|---|---|
| Idea Stage | Obtain funding or financing |
| Start-Up Stage | Create a breakeven budget |
| | Manage cash flow |
| Growth Stage | Diversify program revenues |
| | Obtain line of credit or working capital loan |
| | Recognize that each program has different costs; some will produce surpluses, some will not |
| | Thoroughly understand and budget administrative costs |
| | Budget depreciation as an operating expense |
| | Set aside cash surpluses for working capital reserves |
| Maturity Stage | Develop net asset (equity) balances |
| | Create operating reserves from unrestricted income |
| | Continue to develop working capital reserves to internally finance cash flow and growth |
| | Set up "repair and replacement" reserves, funded by depreciation allowances |
| | Possibly develop an endowment, take on a mortgage, or consider other forms of permanent capital |
| Decline Stage | Use reserves only for regenerating activities, not for deficit spending |
| | Examine the budget for top-heavy administrative expenses |
| Turnaround Stage | Create a financial plan to pay off creditors and restore organizational credibility |
| | Consider and obtain a debt reconsolidation loan to allow you to focus on the future while responsibly handling past debts |
| | Cut back to minimal expense levels |
| | Train on new mindset: "Just because it's in the budget doesn't mean there's cash available" |
| Terminal Stage | Establish an orderly way to go out of business |

Smaller organizations, especially those with $1 million in annual revenues and support or less, will find this life-cycle framework valuable for prioritizing their financial strategies and long-term financial plans. A key concern that we have not yet addressed, however, is how fast our organization can grow.

**(h) BASED ON OUR FINANCIAL POLICIES AND STRUCTURE, HOW FAST CAN WE GROW?** If you make some simplifying assumptions, you can determine the approximate rate of growth of activity for your nonprofit organization. This framework works much better for a commercial nonprofit (in which revenues tend to bear a direct, causal link to asset investment) than for a donative nonprofit, but it will give insight in either case. The nonprofit version of this "sustainable growth model" was developed by Marc Jegers.[26] We base our presentation on his model, beginning with the data inputs needed to estimate the maximum growth rate in service provision. Your organization's maximum rate of growth in service provision jointly depends on its profitability (degree to which revenues more than cover expenses), capital structure (relative use of debt financing), and efficiency. There are two sets of inputs: operating variables and financing variables.

***(i) Operating Variables.*** The operating variables in this model are the year-beginning and year-ending service levels, the growth rate of that service provision, the efficiency of service delivery, and profitability relative to asset investment.

Level of service provision at the beginning of the year, $X_0$.
Level of service provision at the end of the year, $X_1$.
Growth rate in service provision, $g = (X_1 - X_0)/X_0$.

The efficiency (labeled as $\alpha$) with which the organization "produces" $X$, relative to total assets, which we represent as $T$: $\alpha = X/T$, and the change in $\alpha$ (labeled as $\alpha'$) is:

$$\alpha' = \alpha_1 / \alpha_0$$

The profitability of the organization, or the change in net assets, is represented by $P$. Your organization might normally refer to this as your surplus. $P$ would be equal to total revenues (whether restricted or unrestricted, whether gathered through fees, dues, donations, grants, or sales) less total expenses. Express this profit in relation to total assets (with the ratio labeled as $m$):

$$m = P / T$$

***(ii) Financing Variables.*** On the statement of financial position (SFP) every dollar of assets must be financed by either debt (borrowed money, liabilities) or net assets. Therefore, we have the SFP identity:

$$T = D + NA$$

The capital structure is the relative use of net assets (what some call equity or used to call fund balance) and debt in financing assets, with $d$ being the ratio of debt to net assets:

$$d = D / NA$$

For consecutive years, just include the year as the subscript:

$$d_0 = D_0 / NA_0$$
$$d_1 = D_1 / NA_1$$

***(iii) Projection Model.*** What we wish to determine is $g^*$, the maximum growth rate in service provision. If you calculate this model using your year-end numerical values, it will tell you the ability to grow your service levels for the upcoming year. (For example, if you do it at the end of 2022, you will see what your maximum growth rate is projected to be for 2023.) You will have to specify, as an input to the model, how your relative use of debt financing will change during the year ($d_1$) compared to the beginning-of-year (which is, of course, the end of the last year) relative use of debt financing ($d_0$). The model calculates the maximum growth rate of service provision to be:

$$g^* = \frac{(1 + d_1)\alpha'}{(1 + d_0)(1 - (1 + d_1)m)} - 1$$

Your growth rate is limited by the use of debt financing for this year and next year ($d_0$ and $d_1$), the relative efficiency from this year to next year ($\alpha' = \alpha_1/\alpha_0$), and the "return on assets" ($m$).

For example, let's say that our charity has a 0.50 debt-to-net-assets ratio that will not change during the upcoming year; its ratio of service provision to total assets is 0.70 and is expected to increase to 0.75; and its ratio of profit (or surplus) to total assets is 0.05. The maximum growth rate of service provision for the upcoming year is:

$$g^* = \frac{(1 + 0.50)(0.75/0.70)}{(1 + 0.50)(1 - (1 + 0.50)0.05)} - 1$$

$$g^* = \frac{(1.50)(1.07143)}{(1.50)(1 - 0.075)} - 1$$

$$g^* = \frac{1.607145}{(1.50)(0.925)} - 1$$

$$g^* = \frac{1.607145}{1.3875} - 1$$

$$g^* = 1.1583 - 1$$

$$g^* = 0.1583 \textit{ or } 15.83\%$$

***(iv) Interpretation.*** The level of service provision for our charity can grow during the upcoming year at a maximum rate of 15.83 percent unless one or more of these events occur: (1) it uses more debt for each dollar of net assets; (2) it increases its efficiency more than the 7.143 percent increase in efficiency already projected (which was based on increasing *X/T* from a 70 to 75 percent ratio); or (3) it increases its "profit" (change in net assets) as a percent of assets.

***(v) Special cases.*** Three special cases allow you to simplify this formula:

**Case 1: Capital structure and efficiency do not change.** In this case, the formula simplifies to show the effect of financing growth strictly through profits and just enough additional debt to keep the *D/NA* ratio unchanged:

$$g^* = \frac{(1 + d)m}{(1 - (1 + d)m)}$$

**Case 2: Capital structure does not change and there are no profits (m = 0).** In this case, the formula simplifies to show the effect of a change in efficiency on growth:

$$g^* = \alpha' - 1$$

Here the growth rate simplifies to being the rate of growth in efficiency.

**Case 3: Efficiency does not change and there are no profits ($m = 0$).** In this case, the formula simplifies to show the effect of a change in the capital structure on growth:

$$g^* = \frac{(d_1 - d_0)}{(1 + d_0)}$$

***(vi) Minimum required profitability.*** A very helpful planning formula can be developed from the sustainable growth model. For starters, we know the growth rate in service provision that we desire. We project our anticipated capital structure and efficiency level. The question is: What rate of profit (as a percent of assets) must we generate in order to grow at our desired growth rate? We can solve for that profit ratio with this formula:

$$m = \frac{1}{(1 + d_1)} - \frac{\alpha'}{(1 + g)(1 + d_0)}$$

***(vii) Cautions.*** We offer four cautions as you apply this sustainable growth model:

1. If you use revenues as your measure of service provision, make sure to subtract any "in-kind gifts," because these will distort the revenue to assets relationship for planning purposes.
2. Because of the permanently restricted nature of endowments, we recommend that you subtract any endowment-related amounts from revenues, expenses, assets, and net assets.
3. Because of the long-term restrictions on most trusts, either modify your trust-related revenues, expenses, assets, liabilities, and net assets, or subtract any trust-related amounts from these accounts.
4. Related to point 3, a messy issue for nonprofits is the degree to which revenues and net assets are restricted versus unrestricted. Particularly, to what degree your organization's gifts restricted versus unrestricted, and what are the revenue implications of this?

If these amounts are insignificant for your organization, you may ignore them in your growth calculations. If any of them are significant, you may either modify your numbers as recommended or ignore these issues but consider the sustainable growth rate as only a very rough approximation of the true sustainable growth rate.

## 9.3 FINANCIAL EVALUATION OF NEW AND EXISTING PROGRAMS

Up to this point, we have assumed that you knew what programs you would plan for and on what scale you would operate those programs. Now let's shift our focus to how to do program evaluation of the portfolio (or set) of programs your organization offers or could offer. Deciding which activities to engage in and how much in resources each activity will receive is sometimes called *programming*.

An illustration of this concept is a listing (in Exhibit 9.9) of some of one organization's 158 different human services *program elements*, subactivities within the three similar groups of activities called *programs*.

The remainder of this chapter will highlight four interrelated issues: (1) how to determine which programs to engage in, (2) how to determine how much in organization resources (if any) to devote to each program on an ongoing basis, (3) how to evaluate

**Program Structure (Partial Listing)**

| Program | Program Elements |
|---|---|
| Human services | Adoption agencies |
| | Day care centers |
| | Food banks |
| | Meals-on-wheels services |
| | Foster care for abused and neglected children |
| | Drug and alcohol recovery |
| Housing | Apartment complex development for low-income families and the elderly |
| | Specialized housing for disabled persons |
| Health care | Nursing care facilities (four states) |

**EXHIBIT 9.9** PROGRAMS AND PROGRAM ELEMENTS FOR A SOCIAL SERVICES ORGANIZATION

the possible addition of new activities (program elements), and (4) how to evaluate the ongoing investment of organizational resources in the various activities. We begin by analyzing the financial manager's role in programming.

Programming involves four steps:

1. Identifying program alternatives
2. Analyzing program alternatives
3. Making the programming decisions
4. Developing program support

In programming, some major finance-related responsibilities in both the analysis of program alternatives and programming decisions fall on the financial manager. In analyzing program alternatives, the financial manager might assist in four activities:

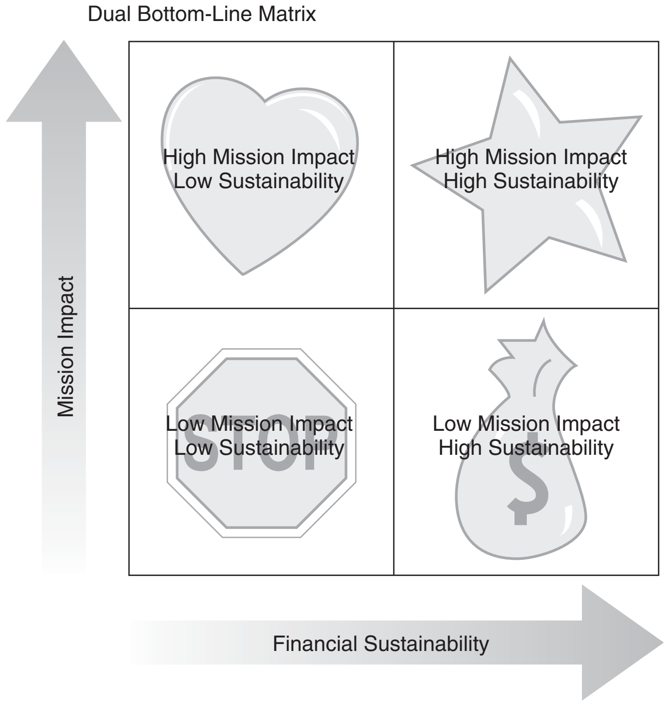
1. Specify resource (including financial) requirements. Nonfinancial resources include equipment, facilities, materials, and supplies, and staff and professional time.
2. Develop a financial plan, which provides a summary of all the financial consequences of the programming decisions: sources of funds, costs of resource usage (program expense budgets for multiple years), any surplus or deficits to be expected, and a need for special fundraising campaigns or borrowing.
3. See that discounted cash flow analysis is conducted when the projects have revenues associated with them.
4. As profiled earlier in this chapter, determine financial feasibility for the organization by projecting cash flows in a long-range planning study. The study might result in an estimate of the additional grants or donated funds that must be obtained for the organization to remain financially viable if it pursues a given program alternative.

At times the analysis of program alternatives involves consideration of new programs and/or larger resource commitments than usual. The financial manager provides the same kind of assistance as before, but additionally must help the ED/CEO and board see the big picture in financial terms. We need to learn about service portfolios and relative cost coverage to see specifically how the financial professional can contribute to the discussion.

**(a) SIMPLE PORTFOLIO ANALYSIS.** A good starting point for your program diagnosis that about any ED/CEO, board, and CFO might use is the Dual Bottom-Line Matrix developed by Peters and Schaffer.[27] It is provided in Exhibit 9.10.

Programs in the lower left quadrant, "stop signs," should be closed down soon. At the opposite extreme, "star" programs at the top right are keepers to which you will want to increase resource allocations. Bottom-right programs are "money signs" that may help to fund those "star" programs. Finally, "heart" programs should normally be kept and work should be done to improve the sustainability of these programs.

**(b) ADVANCED PORTFOLIO ANALYSIS.** We presented some more advanced portfolio models in Chapter 3, which we will not duplicate here. One weakness of most of these models is the failure to include liquidity and financial flexibility. Appendix 9B provides one view of how to evaluate "social enterprises" from a financial perspective. In that model, liquidity is a key driving factor in the evaluation, corresponding to our view that achieving and maintaining a target liquidity level is the single most important financial objective of a noncommercial nonprofit and one of the most important variables in commercial nonprofits.




*Source:* Reprinted from Jeanne Bell Peters and Elizabeth Schaffer, *Financial Leadership for Nonprofit Executives: Guiding Your Organization to Long-Term Success*, p. 51. Copyright 2005 CompassPoint Nonprofit Services, published by Fieldstone Alliance, Inc. Used with permission of the publisher.

**Exhibit 9.10** Dual Bottom-Line Matrix Portfolio Analysis

**(c) ANNUAL NECESSARY INVESTMENT.** If a program is growing but funding resources are not growing more quickly, the manager is faced with the situation in which that program will be draining an ever-increasing share of investable monies over time. The implication is clear: Other programs being offered or considered will have to have funding cut over time. Very few nonprofit managers foresee this type of situation, and equally few study past financials (laid out by program) to even see this in retrospect. This is just the type of contribution you can make to assist your board and top-management team in diagnosing and strategically positioning an organization for a desired future in which top-priority programs and mission achievement are secure. Compare the organization's future position to its present position.

Once your management team and board have agreed on a set of programs, conduct a final check on the structure of selected programs before making financial and personnel decisions:[28]

- Are the operating plans well developed?
- Have nonfinancial resources been identified?
- Have financial constraints been considered?
- Are the desired results from the program well defined?
- Does the program have a detailed list of objectives?
- Will the program achieve the organizational goals?

It is at this point that a set of pro forma balance sheets and statement of activities should be drawn up for one to five years in the future. You might lay out a set of four scenarios for each year. Include the status quo (no change in present situation), as well as optimistic, most likely ("base case") and pessimistic scenarios. This will greatly assist in answering the third question ("Have financial constraints been considered?").

The financial manager may also assist in the development of program advocates within the funding sources. The idea here is to procure some stability over the funding source. By demonstrating how the source's funding is critical to a program's long-range financial viability, the organization may be able to gain a deeper, more permanent degree of commitment.

The final duty is budgeting. Financial managers have primary responsibility for the budget process, with approval authority resting with the board. Our concern here is to ensure that programming decisions are translated into budget line items. (Chapter 8 is dedicated largely to budgeting.) Ideally, as each year progresses, use last year's strategic and long-range financial plan to be the starting point not only for the new strategic and long-range financial plan, but also for the development of next year's operating and capital budget. Consider it a warning signal when the long-range financial plan is not used to help develop budgets. Possibly the plan is too inaccurate, or the organization is unaware of the tie between programming and budgeting. Obviously, those organizations updating long-range plans less frequently than yearly have less direct correspondence between plans and budgets. Plans are most likely to be implemented when they drive the resource allocation embodied in the annual operating and capital budgets. Finally, the process of planning is invaluable, forcing discussion and resolution of the trade-offs and prioritization involved in spending decisions.

## 9.4 CAPITAL BUDGETING: FINANCIAL EVALUATION OF PROJECTS THAT ARISE FROM EXISTING PROGRAMS

Programs spawn projects, and these projects often involve large capital allocations with multiyear cash flow effects. These will affect your organization's target liquidity level for years to come. Consequently, the next key question when evaluating a capital project is: Will the capital expenditure cover all of its costs *and* provide an adequate return on invested capital? This is a pivotal question for evaluating capital expenditures that bring in revenues as well as for selecting between alternative expenditures that involve only costs. Even donative nonprofit organizations may have to consider both capital expenditure types. Any expenditures bringing in multiyear cash revenues should be evaluated in the way we show next. Not doing so could lead to a faulty decision for projects providing cash revenues (revenue would increase, but with an extremely low return on invested capital) or when selecting between two or more alternatives that have different up-front costs or different life spans. Two simplified examples illustrate this point.

**(a) EXAMPLE 1: NET PRESENT VALUE AND BENEFIT-COST RATIO ILLUSTRATED.** Youthsave, Inc. occupies a building that is much larger than it needs in the foreseeable future. Youthsave has fixed up the part of the building it occupies, but the other parts of the building are in disrepair and would need major remodeling in order to be usable. Youthsave has received repeated inquiries from other nonprofit organizations wishing to rent the space it has not renovated. Several have indicated that Youthsave's prime central business district location would lead them to pay $1,000 per month, payable in a lump sum at the end of each year, for an office area of 2,500 square feet. The rental prospects would also pay all utilities used by them. Youthsave has received three sealed-bid remodeling estimates from contractors having strong track records of high-quality work. The lowest bid is $95,000. Assuming it would be 15 years both for the lease and before the area would have to be remodeled again, and ignoring any leasehold improvement considerations, should Youthsave engage in the revenue enhancement project? (Assume the organization will not have to pay tax on the rental income.)

***(i) Approaching a Capital Expenditure Analysis.*** Because the remodeling is an up-front expense and the rent is paid on a monthly basis in the future, it is *incorrect to merely multiply* the revenue per month by the number of months and then subtract the up-front cost. A dollar received or paid today is worth *more* than a dollar received or paid 1, 2, or 12 years from now because it can be invested to earn interest. This fact is recognized as the *time value of money.* It implies the need for these three steps:

1. Specify the project's anticipated cash flows: What cash outflows will result and when, what cash inflows will result and when?
2. Select a discount rate to reflect the time value of money: What rate of return could you have earned per year if you did not tie funds up in this capital project?
3. Apply the discount rate to future cash flows (those anticipated next year and in following years), then subtract any up-front costs to determine the ROIC and project acceptability.

**Step 1.** Let's show a cash flow timeline. Cash outflows are shown as spikes below the horizontal axis, cash inflows are represented by spikes above the axis. We have an initial ("period 0") outflow of $95,000 followed by 12 end-of-year inflows of $12,000 (each end-of-year $12,000 is 12 × $1,000):

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** | **$12** |
| 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
| **–$95** | | | | | | *Period* | | | | | | |

**Step 2.** The organization can invest long-term funds at about 10 percent, and the mortgage rate is about 10 percent. So we will use an interest rate of 10 percent to determine the present value (present dollar equivalent) of each of the future cash flows.

**Step 3.** We will compute two measures of project acceptability. The first, *net present value (NPV)*, represents the surplus of revenue over expense, if any, after stating all cash flows in today's terms. We "discount" each future cash flow back to today's value by dividing it by (1 + interest rate) raised to a power representing how many years away the flow occurs. Equivalently, multiply the cash flow by 1/(1 + interest rate) raised to the appropriate power.

For example, to discount a cash flow that will occur two periods from now, using a 10 percent discount rate, multiply it by: $1/(1+0.10)^2 = 1/(1.1)^2 = 1/1.21 = 0.8264$. Then subtract the initial remodeling outlay, which does not need to be adjusted to present value because it occurs at present. A table can be set up to show the calculations:

| YEAR | CASH FLOW | PRESENT VALUE FACTOR | PRESENT VALUE OF CASH FLOW |
|---|---|---|---|
| 0 | −$95,000 | 1.0000 | −$95,000.00 |
| 1 | $12,000 | 0.9091 | 10,909.20 |
| 2 | $12,000 | 0.8264 | 9,916.80 |
| 3 | $12,000 | 0.7513 | 9,015.60 |
| 4 | $12,000 | 0.6830 | 8,196.00 |
| 5 | $12,000 | 0.6209 | 7,450.80 |
| 6 | $12,000 | 0.5645 | 6,774.00 |
| 7 | $12,000 | 0.5132 | 6,158.40 |
| 8 | $12,000 | 0.4665 | 5,598.00 |
| 9 | $12,000 | 0.4241 | 5,089.20 |
| 10 | $12,000 | 0.3855 | 4,626.00 |
| 11 | $12,000 | 0.3505 | 4,206.00 |
| 12 | $12,000 | 0.3186 | 3,823.20 |

When we sum up the right column, we get a negative value for NPV: $\underline{\underline{-\$13{,}236.80}}$.

Because the time value factors in our table are rounded to four decimal places, this estimate is slightly inaccurate.

We could key these numbers into an Excel spreadsheet and use Excel's built-in NPV financial function to get a more exact NPV. The formula looks like this: =NPV(0.10, range of inflows)–Initial Investment cell. The range of inflows is merely the cell address range in which you entered the year 1–12 cash inflows, which would each be $12,000.

We have to subtract the outflow (or add it, if we entered it as a negative number) to have Excel handle it properly. In Youthsave's case, the exact NPV turns out to be negative:

$$\text{NPV} = -\$13,235.70.$$

***(ii) Making the Capital Expenditure Decision.*** What should Youthsave do? After we have calculated NPV, these decision rules tell us what to do:

- If the NPV is positive, the project more than covers all costs, including financing costs (or forgone investing revenues). Approve it.
- If the NPV is zero, the project just covers all costs. Approve it.
- If NPV is negative, revenues do not cover all costs. Because the rental contract does not cover all costs in this case, it should be turned down.

If you prefer to think in terms of benefit-cost ratios, you could have expressed the data somewhat differently. Add up the present value of all the cash inflows (in the "Present Value of Cash Flow" column), which equal $81,763.20. This is your financial benefit amount. Then divide this by the amount of the initial investment, expressed as a positive amount. The resulting *benefit-cost ratio*, also called the *profitability index*, signals a good project if greater than 1, benefit equivalent to cost project if equal to 1, and a poor project if less than 1:

$$\text{Benefit–Cost ratio} = \text{PV of all Cash Inflows}/\text{Initial Investment}$$

Inserting the numbers for our example:

$$\text{Benefit–Cost ratio} = \text{PV of all Cash Inflows}/\text{Initial Investment}$$

$$\text{Benefit–Cost ratio} = \$81,763.20/\$95,000$$

$$\text{Benefit–Cost ratio} = \underline{\underline{0.86}}$$

In this case, the project would be turned down because the benefit-cost ratio is less than 1. The benefit-cost metric is consistent with the NPV metric when making an individual project go/no-go decision. Again, we are looking at the project in purely financial terms, and there may be nonfinancial reasons why you still might implement it. Be aware that you are causing a financial drain on your organization to do so, however.

Now compute a complementary measure that is easier to interpret because it is expressed in percent. This measure, *ROIC*, or *return on invested capital*, indicates the financial return per year, after adjusting for the timing of project cash flows. Some organizations call it the time-adjusted rate of return. It tells us what interest rate that the initial investment earns per year when generating the cash inflows forecasted for the project. You can use the IRR function built into Excel in order to calculate ROIC.[29] In our example, the ROIC is relatively low:

$$\text{ROIC} = \underline{\underline{7.06\%}}$$

This return is clearly less than the 10 percent annual rate Youthsave can earn if it leaves that money invested. Additionally, the 7.06 percent return is less than the annual interest rate Youthsave would pay a bank to borrow money for a real estate loan to be able to purchase rental property.

Is it worth the effort to calculate NPV or ROIC? What if Youthsave ignored the time value of money? In that case, the analyst would have multiplied the annual inflow of $12,000 by 10 years to get a total project revenue of $120,000. Then the analyst would have subtracted the initial investment of $95,000 to get a $25,000 net return, and the organization might have made the investment. Properly evaluated, this is not a good investment; the ROIC is too low and the investment in remodeling is not cost beneficial.

This same approach of discounting cash flows can be used when evaluating mergers, joint ventures, strategic alliances, or other strategic investment decisions.

Before considering these, let's illustrate a common capital investment scenario: How do we evaluate capital projects that involve only costs?

**(b) EXAMPLE 2: EQUIVALENT ANNUAL COST ILLUSTRATED.** Compared to a business, the nonprofit organization encounters many more capital projects that generate no revenues. Some of these projects are "independent" projects that are undertaken in support of service delivery: buying a new van, adding capacity, buying office furniture, and so on. The key here is in getting multiple sealed bids on construction projects or comparing among various vendors for a vehicle or equipment to find the one with the best combination of quality, price, payment terms, warranty, and service after the sale. In some purchasing situations, however, the analyst must select one from between two clearly identifiable alternatives.

Assuming quality, service after the sale, and other nonquantifiable factors are roughly the same, the analyst can find the project having the lowest "cost per year" by once again discounting cash flows. The technique is very similar to the discounting we just illustrated, but is a bit more involved. Called *equivalent annual cost (EAC)*, it may be applied to alternative projects having different life spans and that will be repeated indefinitely (once a machine wears out, it is replaced with another identical machine).

The Trinova Soup Kitchen is considering which of two commercial stoves to purchase. The first, the Everlast model, costing $41,500, would cost $300 per year to operate (including electricity, cleaning, and maintenance) and would last approximately eight years. The second, the Value Miser, costs only $25,000, would cost $450 per year to operate, and would last only five years. Which should Trinova buy, assuming each is equally reliable within its expected lifespan?

First, let's see how someone might do a rough analysis in this example, not taking the time value of money into account.

$$\begin{aligned}\text{Annual Cost of Everlast} &= \frac{\$41{,}500 + (\$300 \times 8)}{8} \\ &= \frac{\$43{,}900}{8} \\ &= \underline{\underline{\$5{,}487.50}}\end{aligned}$$

$$\begin{aligned}\text{Annual Cost of Value Miser} &= \frac{\$25{,}000 + (\$450 \times 5)}{5} \\ &= \frac{\$27{,}500}{5} \\ &= \underline{\underline{\$5{,}450}}\end{aligned}$$

Based on this approximation method, *which ignores the fact that $1 of cost today is not the same as $1 of cost in later years*, Trinova would select Value Miser because its cost per year is $5,450 (compared to Everlast's $5,487.50). Clearly, however, the advantage is almost insignificant—about $38 a year.

Let's redo the analysis with a correction: (1) discount the annual operating costs to today's present dollar equivalent ("present value"), then (2) spread the sum of all acquisition and operating costs over the life span to arrive at a correct cost per year. The appropriate discount rate is again 10 percent.

**Step 1.** Calculate each alternative's NPV.

| Year | EVERLAST Cash Flow (CF) | Present Value of CF | VALUE MISER Cash Flow (CF) | Present Value of CF |
|---|---|---|---|---|
| 0 | $(41,500) | $(41,500.00) | $(25,000) | $(25,000) |
| 1 | (300) | (272.73) | (450) | (409.09) |
| 2 | (300) | (247.93) | (450) | (371.90) |
| 3 | (300) | (225.39) | (450) | (338.09) |
| 4 | (300) | (204.90) | (450) | (307.36) |
| 5 | (300) | (186.28) | (450) | (279.41) |
| 6 | (300) | (169.34) | | |
| 7 | (300) | (153.95) | | |
| 8 | (300) | (139.95) | | |
| **NPV** | | **$ (43,100.48)** | | **$ (26,705.85)** |

**Step 2.** Convert the NPV into an equivalent "cost per year." The formula used to make this conversion is beyond our scope,[30] but essentially converts the NPV to an equivalent equal amount ("annuity") for each of the years of the project's life span, using a 10 percent interest factor.

| Everlast | Value Miser |
|---|---|
| Cost per yr. = $8,078.93 | Cost per yr. = $7,044.94 |

Notice the much larger advantage now demonstrated by Value Miser. Taking into account the time value of money – the fact that costs occur in different amounts at different times and the return on investment given up by the much larger (if less frequent) outlay for Everlast – the annual cost savings jump to about $1,000. Much of this comes from the opportunity to repeatedly invest the difference in the two stoves' initial outlays ($41,500 − 25,000 = $16,500) in securities yielding 10 percent, generating investment income (or avoiding interest expense) that would not be received if Trinova buys the Everlast model. The additional funds can be directed into new programs or into existing program expansion.

Discounted cash flow analysis is a technique used daily in thousands of businesses. One area that we see overlooked in many capital budgets is deferred maintenance. Consider this observation from Grant Thornton's "State of the Nonprofit Sector" report:

> An organization-wide inventory of maintenance needs for all facilities is a good starting point. Work with your facilities management team to identify all capital projects that require immediate attention (e.g., leaky ceilings in a child care center). By soliciting input from across the organization and communicating how projects and their related costs fit into the organization's strategy and goals, and health and safety laws, the totality of projects and how limited resources must be allocated and projects prioritized can be fully understood.[31]

Once again you can see the difference that proficient financial management can make in your organization. Even when you are evaluating capital investments that must be made regardless of the financial attractiveness, draw up a cash flow table. Doing so provides the numbers that you will need to do an overall cash budget for your organization, a topic we covered in Chapter 8.

**(c) HOW TO MANAGE THE TOTAL CAPITAL BUDGET.** The *capital budget* is the listing of all capital projects that the organization wishes to invest in, typically ranked from best to worst or from most necessary to least necessary. Although a business can "in theory" always raise funds when it has a project that will provide an adequate return for shareholders, a nonprofit organization is often limited by the total dollar amount it can invest in capital projects in a given year. This situation, known as *capital rationing,* arises from the inability to raise funds from any kind of stock issue, the unwillingness or inability to borrow funds, and a limited ability to generate funds from revenue-providing activities or capital campaigns. Special capital campaigns work superbly for periodic building or expansion programs, but cannot be utilized for every year's capital project funding. Some organizations are now experiencing success in raising relatively large unrestricted commitments such as one for $100 million the University of Notre Dame received using a "Philanthropic Succession Partnership."[32]

**(d) CAPITAL BUDGET AND CAPITAL RATIONING.** Example: There is $150,000 in funds available for capital projects in 2019 at Charity First. First, list the desired capital expenditures from best (or most necessary) to worst (least necessary). The dollar amount of each investment should be included along with a grand total. Projects that generate revenues should have the computed ROIC number listed next to them. To ensure that later year cash flows are included in the long-range financial plan, another column may be included to signify such flows. Exhibit 9.11 provides a sample listing for an organization.

The total capital budget in Exhibit 9.11, $178,000, is then compared to capital available for projects. The "capital available" amount is based first on a portion of the cash reserves, which will be listed on the balance sheet as cash.[33] Second, there may well be some

| Charity First Capital Budget | | | |
|---|---|---|---|
| **Project** | **Cost** | **ROIC** | **Future Year Cash Flows?** |
| New central air conditioning unit | $120,000 | N/A* | Y |
| Repair roof | 25,000 | N/A* | N |
| Renovate, rent office space | 30,000 | 12 percent | Y |
| Buy another copier | 3,000 | N/A* | Y |
| | Total $178,000 | | |

* N/A means not applicable; usually this means that the project generates no revenue or cost savings.

**Exhibit 9.11** An Organization's Overall Capital Budget

short-term marketable securities that are not included in the cash account. However, some of the total in cash and marketable securities is temporarily restricted (for a certain time period or until some action is taken by the organization) or permanently restricted (permanent endowment or revolving loan funds). The temporarily restricted portion may include funds restricted specifically for the purpose of fixed assets, so some or all of this should be included in capital available. Your board may have also designated some longer-term investments for this purpose, and you would include this. Much care must be applied in arriving in the "capital available" figure because, in many organizations, three-fourths of monies raised from donors and foundations are restricted as to purpose or time of availability.

Let's say that the amount of capital available for Charity First is $150,000. Which project(s) should be funded?

**(e) RATIONING THE CAPITAL.** The way to ration scarce capital, assuming the organization cannot free up or raise funds to meet the shortfall, is to consider which set of available projects best utilizes capital available. With the four projects in our example (Exhibit 9.11), there are only 12 combinations available that would keep us within our $150,000 capital limitation:

- 1 only
- 2 only
- 3 only
- 4 only
- 1 and 2
- l and 3
- 1 and 4
- 2 and 3
- 2 and 4
- 3 and 4
- 1, 2, and 4
- 2, 3, and 4

For each of these combinations, check to verify that the combination's total capital budget would not exceed capital available. At the same time, make sure donor or fund restrictions are adhered to. This process can be tedious and very time consuming when there are many projects and consequently multiple combinations to evaluate.

If one or more of the top-ranked projects are "must-haves," the analyst's job is considerably simpler because now only the amount of capital available *after* subtracting the cost(s) of the must-have project(s) need be allocated to remaining project combinations.[34] Returning to our example, the first two projects might be must-haves. Together they would use up $145,000 of the available $150,000. Only the copier purchase could be funded with the remaining $5,000.

One very important caution: There is an assumption in the foregoing analysis that each of the proposed projects has roughly equal program or mission benefits; that is, each contributes to the organization's mission to roughly the same degree. Looking back at our list of projects, each is a general office-related investment, and it is not necessary to pinpoint the benefits of the various projects. We are not looking at allocation between various programs, some of which contribute more to mission achievement than others, with these projects.

## 9.5 FINANCIAL EVALUATION OF MERGERS, JOINT VENTURES, AND STRATEGIC ALLIANCES

**(a) MERGERS AND ACQUISITIONS.** Some, but not all, mergers and acquisitions in the nonprofit sector are financially motivated. In these, the financial manager's role is pivotal. Either the CFO must do the financial analysis of the proposal, or locate a fellow staff member or consultant or board member who can do it. The CFO must translate the financial ramifications of the proposal to top management and the board in either case.

**(b) MOTIVES FOR MERGERS AND ACQUISITIONS.** There are numerous reasons why organizations merge with or acquire other organizations, but most fall into one or more of these categories:

- Synergy-programmatic
  - Geographic or service-offering extension
  - Competitive threat
  - Survival
- Synergy-financial
  - Revenue enhancing
  - Cost reducing

***(i) Programmatic Synergy.*** Synergy is commonly defined as "two plus two equals five," or the whole is greater than the sum of the parts. The combined organizations are in the same or closely related industries. The key in *programmatic synergy* is in program accomplishment – quality and/or quantity. To illustrate, perhaps Alphanumerics has a widespread distribution network and Betaphonics has an advanced and very effective donor acquisition program. Together, the Alphabeta organization can expand the mission achievements beyond what either organization could do on its own.

***(ii) Financial Synergy.*** When the efficiency of the combined organizations is such as to reduce costs or increase borrowing power, we have *financial synergy.* The enhanced financial strength that results is what propels the merger or acquisition. Quite often, programmatic synergy and financial synergy go hand in hand because effective service delivery

**Financial Synergy**

| Revenue-Enhancing Factors* | Cost-Reducing Factors |
|---|---|
| New fundraising methods (e.g., face-to-face meetings) | Sale of unneeded assets |
| Shared expertise | Economies of scope (eliminate overlapping service networks) |
| Larger resource base to invest in fundraising | Shared expertise |
| Initiation of business ventures | Bring fundraising in-house if one or both of the organizations formerly relied exclusively on outside fundraising counsel |
| Increasingly risky business ventures can be initiated (due to larger net asset base, less-than-perfectly correlated cash flows) | |
| Initiation or expansion of planned giving | |

*For this profile, "revenue" and "income" are used interchangeably.

**Exhibit 9.12** Ways to Bring About Financial Synergy through Combinations

and enhanced program achievements usually result in increased donations and the organization's borrowing power increases correspondingly. The factors that bring about financial synergy may be from revenue enhancement or from cost reduction. Exhibit 9.12 illustrates some of these factors.

You should be aware of a couple of issues here. Earned income may be increased not only because of the initiation of ventures related to the core mission of either preexisting organization, but also because existing ventures may be expanded. Additionally, the new organization may take on riskier program activities and ventures (which typically offer greater revenue-expense differentials) due to the facts that (1) the new organization has a larger net asset base, and (2) the overall cash flows of the merged organization are more stable.[35]

Over on the cost reduction side, we key in on economies of scale and economies of scope. *Economies of scale* refer to lowered costs per unit of service delivered as the service quantity increases. Every organization faces some costs that are fixed (e.g., CEO salary), and the greater the output the less the fixed cost per unit of output (e.g., cost per meal served in a rescue shelter). One study in England and Wales finds that most nonprofits are currently too small to fully take advantage of available economies of scale,[36] and we believe this is the case in the United States as well.

Illustrating, let's say salaries are \$200,000 at Alphanumerics and \$350,000 at Betaphonics; they would not be \$550,000 (\$200,000 + \$350,000) at the combined Alphabeta. Duplicate workers would be let go in some areas (e.g., you don't need two fundraising directors), and as Alphabeta grows, the increased volume of service would not necessitate a proportional increase in workers. Specialization and division of labor account for much of the increased efficiency. Similarly, the land and building requirements of the merged organization might be 50 or 60 percent of the sum of the separate organizations. One area of savings is in the headquarters facilities. Reengineering opportunities have larger payoffs in bigger firms, generally. Summarizing, an organization experiences economies of scale whenever costs per unit fall as the scale of options is expanded.[37]

*Economies of scope* refer to sharing of costs across various programs. Computer resources can be shared by unrelated programs that two merging nonprofit organizations may offer. Fundraising efforts can be shared. The key is that the *total* costs of producing the products or delivering the services are less when joined in one organization rather than carried out by two separate organizations. Distribution and marketing costs are often given as prime examples of cost elements that can be shared, making the *overall* cost of delivering a given service lower. One example of this, elimination of duplicate service networks, is so important we have pulled it out as a separate item in Exhibit 9.12.

Commercial ventures are appealing not only for the revenues they bring in, but also because they often share costs with core service programs. Mergers and acquisitions often promise lower costs both because of scale economies and scope economies. However, businesses have tried to exploit these economies for much longer than nonprofits. Some of the spectacular failures come from unrelated diversification. We can learn three things from the lessons learned from the relative success of the many corporate mergers and acquisitions:[38]

1. *Trying to gain stability through a merger with or acquisition of an organization whose cash flows are high when your cash flows are low is extremely difficult.* The goal here is to find an organization whose cash flows follow a different cycle due to economic risks that are quite different from the merger partner. The combined cash flow stream is more predictable, a safety factor that enhances financial viability for both entities when they join together. This is similar to the pooling-of-risks concept that underlies insurance. When one sector is hitting the skids, the story goes, the other should be doing famously well.
2. Why has this concept been so difficult to apply? One reason is that it is most difficult to find organizations with cash flow streams exactly opposite to each other (see Exhibit 9.13). Instead, one may find an industry whose economic cycle turns a little sooner or later than the economy as a whole, or a "defensive" industry, such as soft drinks, which experiences less cyclicality of sales and cash flows. Graphically, the offsets in most cases are not as dramatic, as shown in Exhibit 9.14.

   On top of this, it takes considerable skill to put the right mix of business together to achieve a stable cash flow "portfolio" (set of companies or organizations). The ideal merger or acquisition target organization may not be the right size for a matchup with yours, and even if it were, its growth rate may be quite different than that of your organization, meaning the combined mix is out of balance in a year or two.
3. *Related mergers or acquisitions may not be safer.* Although it would seem to be less risky to deal with business and markets you already know, reaping the benefits

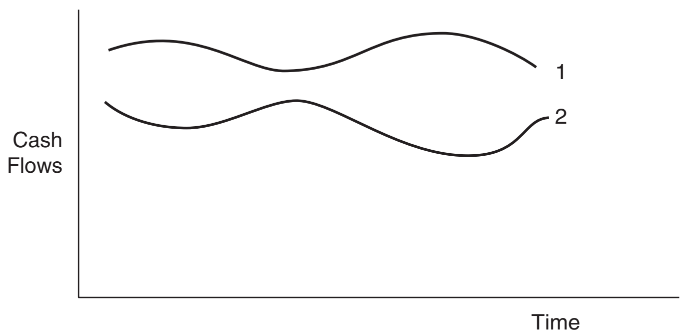



**EXHIBIT 9.13** PERFECT OFFSET FOR TWO ORGANIZATIONS' CASH FLOWS OVER TIME

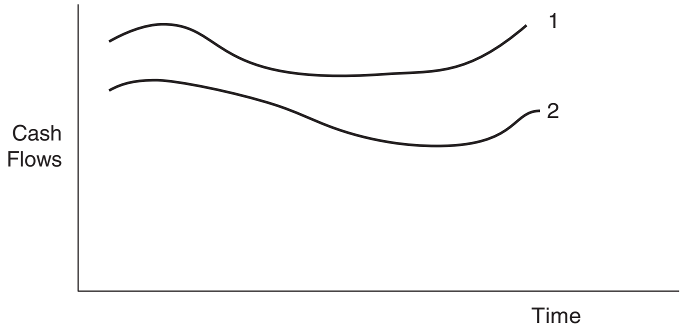



**Exhibit 9.14** Partial Offset for Two Organizations' Cash Flows Over Time

may be elusive. The quality of the individual entities, how much integration it takes to gain the benefits of synergy (e.g., can the cultures be merged), how real the perceived "relatedness" is, and whether the combination provides improved competitive advantage are all key success factors.

4. *A strong management team at the acquired company is not sufficient.* Having a strong management team at the target company may seem important, but in fact it is the acquiring company's management skill and resources that are essential for realizing merger-acquisition benefits. They must have the financial talent and managers that can conduct strategic analysis of diverse industries and markets.

On the positive side, two basic strategies have been found to work for businesses, and these guidelines should prove helpful to nonprofit organizations as well. Under each we see specific road maps.

Strategy 1: Increase the cash flow stream through synergy.

**A.** Special skills and industrial knowledge of one partner can be used to solve competitive problems and opportunities the other partner is facing.

**B.** In the long run, cost per unit can be reduced by investing in markets closely related to current markets. Associations have found this true in their mergers.[39] They are able to benefit from:

1. Scale effects
2. Rationalizing of product and other important management tasks
3. New opportunities for technical innovation

**C.** Expanding business in an area of competence can lead to the development of a "critical mass" of resources necessary to do well in a market as a threshold size is reached (e.g., banks must be money centers or super-regional banks in order to have the size necessary to offer a broad range of cash management services).

**D.** Transfer cash from cash-rich to cash-poor units to avert outside borrowing.

1. Some businesses are always cash-rich (Microsoft); in a nonprofit organization, some programs always need to be subsidized. These may be core programs.
2. Each area may have different cyclical or seasonal patterns of cash surpluses or cash shortages.

**E.** If a company is diversified, direct cash-rich areas to provide funding to areas that are currently cash-poor, but soon to be cash generators – increasing long-run profitability (cost coverage) for the organization as a whole.

  **1.** Low-growth area sends funds to high-growth area.

  **2.** Internal market intelligence of diversified company can be valuable as information is shared.

**F.** Through pooling of risks, the diversified company can have lower borrowing costs and do more borrowing, if it so desires.

  **1.** It gains a larger debt capacity.

  **2.** It requires a smaller target liquid reserve (not including debt).

Strategy 2: Decrease risk.

**A.** Reduce variability of the cash flow stream so that it is less than just the average of the variability of the two separate entities. This refers to the offsetting cash flow patterns we graphed in Exhibits 9.13 and 9.14. Down cycles in Organization 1 are partly offset by the up cycles in Organization 2, so that Organization 1 + 2 is on more solid footing than either organization was independently. This feeds back to lower borrowing costs in Strategy 1.F.

**B.** By acquiring or merging with a unit that consistently generates positive operating cash flows, the organizational self-funding of core programs whose cash expenses exceed cash revenues becomes possible. Funding risk is reduced.

What is the bottom line in many business combination failures? Failure comes because companies (1) merge with or acquire what is readily available, not what "meets sound strategic and economic criteria"; (2) pay too high a price for the acquisition; (3) do not necessarily have the resources and management commitment to exploit the potential advantages; or (4) have too-different cultures.

**(c) PARTNERSHIPS, JOINT VENTURES, AND STRATEGIC ALLIANCES.** Cross-organizational strategic alliances, partnerships, and joint ventures provide a less costly or significant change than mergers or acquisitions, while enabling some of the same resource-pooling benefits. We begin our discussion with partnerships and joint ventures.

A formal *partnership* is defined as an association of two or more entities or persons to carry on a business for profit as co-owners.[40] Because it is looked upon by the IRS as a pass-through entity, a partnership is not taxed. Instead, the partners are liable for income tax.[41] A *joint venture* does not involve an ongoing relationship among the two parties but is a one-time setup of at least two persons or entities in a business undertaking. However, a joint venture is treated as a partnership when it comes to federal income taxation. The motives for these combinations are usually to expand and/or diversify program activities.

Often the nonprofit does not have the financial resources to launch or expand some program or service that it wishes to provide. Yet the managers may not want to start a social enterprise or be able to get ongoing grant funding. By setting itself up as the sole general partner in a limited partnership, it can tap the limited partners (e.g., cash-rich pension funds or profit-sharing plans) for needed capital. Most joint ventures have involved healthcare or university organizations. These organizations mostly cite the need to raise capital as the motive for engaging in joint ventures. The primary caution to be noted is that the nonprofit as general partner may jeopardize its Section 501(c)(3) exempt status if the joint venture conducts an activity unrelated to its charitable purpose. The IRS is watching healthcare joint ventures to ensure that the nonprofit partner does not cede control to the for-profit partner.[42] The joint venture should be structured to allow the nonprofit to further exclusively its charitable purposes, protect its exempt assets, and not allow for private individuals' benefit and inurement. Instead of being part of a joint venture itself, the nonprofit may form a subsidiary or affiliate to serve as general partner. Another alternative is for the nonprofit to serve as a limited partner in the joint venture when the partnership does not further the organization's exempt purpose.

Another possible setup, having partnerships with other exempt organizations, must further the exempt purpose of *each* organization in order for each organization to be exempted from paying tax on its share of the income earned. Otherwise, the organization must pay unrelated business income (UBI) tax based on its share of income and expenses.

Why should your organization be interested in partnerships and joint ventures? First, some non–income-producing informal partnerships can be established that help your organization better achieve its mission without added financial or manpower drains. A great example is the Minnesota Housing Partnership, which has seen its role in ensuring that Twin Cities' affordable housing expand in services offered (including financing), geographic scope, and coordination benefits to partner organizations.[43] Another example is in higher education: Colleges and universities may contract with for-profit distance learning providers in order to be able to offer online classes to their students. Second, consider the reasons healthcare organizations give for engaging in joint ventures:[44]

- Raise needed capital.
- Grant service providers (physicians) a stake in a new enterprise or service, thereby increasing physician loyalty and patient referrals.
- Bring a new service or facility to a needy area.
- Share new enterprise risk.
- Pool various areas of medical competency.
- Attract new patients.
- Induce physicians not to refer patients elsewhere.
- Prevent physicians from establishing a competing healthcare operation.

Some of these motivations will pertain to any nonprofit arena, particularly the need to raise capital, the desire to bring a new service or facility to a needy area (such as the low income housing joint ventures that have sprung from the low-income housing tax credit),[45] risk sharing on a new enterprise, and competency pooling. The finance office can make a special contribution to the managerial discussions regarding the need to raise capital, and in fact may have originally surfaced the need for a joint venture by documenting a funding shortfall in the long-range financial plan. At a minimum, the financial manager can assist in determining the amount of capital that should be raised. Also, regarding risk sharing, through the use of scenarios, the finance staff can show the financial effects of uncertain future outcomes of a proposed new venture, helping top management to see the benefit of engaging in a joint rather than a sole venture. Recall that target liquidity is the primary financial objective of the nonprofit, and when there is evidence of a high probability that a go-it-alone venture will financially cripple the organization one has a strong impetus to investigate and properly structure a joint venture.

**(d) STRATEGIC ALLIANCES.** When two or more organizations agree to pool resources and skills in order to achieve common goals, as well as goals specific to each organization, the pooling creates a *strategic alliance.* These cooperative arrangements are often multi-year – when businesses enter into joint ventures these may last for 30–50 years – and may encompass just one functional area or activity (e.g., marketing) or more than one functional area (e.g., manufacturing and marketing). Let's consider two examples. First, the Fox Cities Children's Museum in Appleton, Wisconsin, was given a collection of dolls. The museum did not know how best to exhibit the dolls, so it allied with a local business. The owner of the business, Roxanne's Doll Shop, first volunteered as curator of the doll collection and then came aboard as manager of the museum's gift shop when that shop was later revitalized.[46] Another example is the alliance between the Stairstep Initiative, a grassroots organization committed to building up the African American community on the north side of Minneapolis, and Glory Foods of Ohio. The Stairstep Initiative hopes to bring jobs to an economically distressed area of Minneapolis through economic development. It wanted to start up an inner-city manufacturing partnership, and after initially partnering with General Mills to develop a food packaging factory, it came into contact with Glory Foods of Ohio. Based on mutual interests, the two companies formed an alliance creating a manufacturing plant called Siyeza. This plant employs 60 people from the northside of Minneapolis and produces a family-size meal product line for Glory Foods.[47]

Strategic alliances encompass equity joint ventures, in which two organizations both contribute capital to a third organization, and share in profits and risks. Given our focus on nonprofits, we will focus in this section on nonequity ventures, another form of strategic alliance. Nonequity ventures include initiatives such as a joint service development team or a cooperative advertising campaign. The latter types of ventures are more flexible and can be revised, restructured, or ended more easily. Note the word "strategic"; if a vendor and a customer are simply tying their purchasing and supply systems together, this is an operational partnership as opposed to a strategic alliance. The purpose of strategy is to advance mission achievement through selection of markets served, new service development, and similar activities.

***(i) Motives for Strategic Alliances.*** Adapting from the excellent review of business strategic alliances compiled by Varadarajan and Cunningham,[48] nonprofits may benefit for several reasons. They:

**1.** Broaden service line/fill service offerings gaps

- Fill gaps in current service offerings
- Broaden present line of services
- Differentiate or add value to the service

**2.** Enter new services domains/gain a foothold in emerging industries or industry segments

- Diversify and take advantage of growth opportunities in new services domains (due to traditional market stagnation)
- Gain foothold in areas where alternative, substitute technologies are developing by allying with organizations already exploiting those technologies

**3.** Enhance resource use efficiency, lowering costs by taking advantage of:

- Scale, scope, and experience effects
- Differential costs of labor, raw materials, or other inputs

**4.** Extend resources, particularly when a merger (and loss of corporate identity) is unacceptable but the organization cannot manage the internal development or acquisitions

- Especially for smaller organizations that do not have the resources to invest in research and development (R&D), capital equipment, new products or services, and other activities necessary for meeting the needs of clients

We are most interested in same-industry, or intra-industry strategic alliances. Why would a nonprofit wish to form an alliance with another organization currently competing for resources in the same geographic market(s) or with another organization which constitutes a potential competitor? By pooling product or service development costs, production/delivery costs, and/or marketing resources, the two (or more) organizations may be able to seize new service or market opportunities that neither organization could seize on its own. Many times, however, the perceived competitive threat may not be large because the services provided are geared toward different clienteles or the organizations are separated far enough geographically that their service areas do not (and will not) overlap. Most nonprofits are already members of a trade association (e.g., the homeless shelters holding membership in the Association of Gospel Rescue Missions [AGRM] or the many foundations comprising the Council on Foundations) and understand what the benefits are of banding together when there is no competition between the vast majority of the members.

***(ii) Financial Aspects of Strategic Alliances.*** Joint fundraising alliances, such as the new donor development program coordinated for faith-based rescue missions by the AGRM, illustrate that the function that a nonprofit alliance is built around may be fund development. Fundraising is part of the treasury function in corporations, and is therefore legitimately characterized as a finance function strategic alliance.[49] In a case such as this, the first task for the finance office should be ready to make the argument for cooperative fundraising, showing the efficiencies (real cost savings) involved as well as the commonly noted potential for more funds to be raised.

Second, the finance office will have to be ready to project the needed financial resources that are the driving force between most strategic alliances (as well as for partnerships, joint ventures, and mergers). Management teams will be naturally reluctant to enter into such arrangements. Management might fear donor attrition, to the extent the alliance partner is either (1) a potential draw to this organization's donors, or (2) viewed negatively by this organization's donors, who will in turn react negatively when hearing of the alliance.

Furthermore, their management may not want to give up operating autonomy. Varadarajan and Cunningham make the point that whenever an organization has financial resources to either acquire or internally develop the skills and other resources needed to exploit a market opportunity, it is quite unlikely to enter into a strategic alliance due to a loss of operational control. The desired resources include assets, capabilities, organizational characteristics and processes, information, and expertise. So alliances are not necessarily cost related; business alliances have been predominant for achieving market or sales growth and for gaining access to new markets.

Third, the financial manager should highlight the risks of strategic alliance, because she or he has ultimate responsibility for asset protection. Two major risks are the possible "stealing" of skills by the alliance partner and the possibility of becoming overly dependent on alliances. Both of these are lesser issues to nonprofit organizations than for businesses trying to protect and build manufacturing and R&D capabilities.

***(iii) Financial Projections of Mergers, Acquisitions, or Joint Ventures.*** Financial spreadsheet software is ideally oriented for projecting the before-and-after financial positions of an organization. Spreadsheets have built-in scenario (or version) managers to assist the analyst in quickly generating optimistic, most likely, and pessimistic cases for a proposed merger, acquisition, or joint venture.

As an example, let's look at the before-and-after situations of a private school considering a merger with another private school. After projecting combined enrollments and cost savings due to the larger size and the ability to share costs, the analyst ends up with the data shown in Exhibit 9.15.

Why the cost reductions from a merger? Salaries are fixed up to a point, meaning they do not change with small changes in enrollment. Administration costs (principal's salary and benefits) are fixed, and only one principal is needed for the merged institution. Registration and/or certification fees that the school must pay are fixed. Labor, energy, and maintenance expenses are not totally fixed but are, rather, step-function or semivariable costs. Some expenses will vary by headcount but are also partly controllable—travel, supplies, and technology.[50] The combined school can order maintenance and office supplies in larger quantities, gaining quantity discounts. Other administrative costs – office related, financing, and purchasing – also decline on a per-student basis as enrollment increases due to the merger. As the number of students increases, these fixed costs, *when figured on a per-student basis*, decline.

The proposed merger is a winner, financially, from the vantage of the merger partner doing this financial analysis. Using scenario analysis (Exhibit 9.16), even the worst-case

| **Item** | **Present Statement of Activities ($)** | **Proposed Merger Statement of Activities ($)** |
|---|---|---|
| Revenues: | | |
| Tuition | $300,000[a] | $920,000[f, g] |
| Fundraisers | 25,000 | 65,000 |
| Meal revenue | 15,188[b] | 40,500[h] |
| Other | 3,200 | 5,000 |
| **Total revenue:** | 343,388 | 1,030,500 |
| Expenses: | | |
| Salaries and wages | 225,000[c] | 325,000[i] |
| Employee benefits | 48,000 | 72,000 |
| Insurance | 30,000 | 32,000 |
| Materials | 35,000 | 45,000 |
| Rent | 20,000[d] | 20,000 |
| Utilities | 14,400 | 16,400 |
| Interest | 6,000[e] | 6,000 |
| Other | 3,250 | 5,000 |
| **Total expense:** | 381,650 | 521,400 |
| **Surplus/(Deficit):** | $(38,263) | $509,100 |

[a]Based on 150 students × $2,000 tuition
[b]Based on $1.25 × 60 students eating on average × 5 days per week × 9 months × 4.5 weeks per month
[c]Based on faculty/administration of eight
[d]The main school building is rented
[e]Offices (with a multipurpose room) constructed with borrowed money
[f]Enrollment projection w/merger: 400
[g]Tuition projection w/merger: $2,300
[h]Meal revenue w/merger: $32,400
[i]Based on faculty/administration of twelve

**EXHIBIT 9.15** MERGER ANALYSIS WORKSHEET

| Scenario Summary | Most Likely | Worst Case | Best Case |
|---|---|---|---|
| Changing cells | | | |
| Enrollment projection with merger | 400 | 325 | 500 |
| Tuition projection with merger | $2,300 | $2,000 | $2,400 |
| Surplus or deficit | $509,100 | $231,506 | $799,225 |

**Exhibit 9.16** Scenario Summary

scenario from our school's perspective is (1) better than the current situation, and (2) a generator of a fiscal surplus, which can be used to replace aging plant and/or build endowment reserves.[51]

## 9.6 FINANCIAL PLANNING AND CAPITAL BUDGETING IN PRACTICE

We review here some evidence regarding program evaluation capital budgeting and long-range financial planning.

Evaluation may be built into existing programs and can benefit from the use of an external evaluator who brings credibility without adding significant cost. Such program evaluations contribute to organizations' planning efforts, based on a study done by mail, telephone, and on-site investigation.[52] Nonprofits believe they are ill-equipped to conduct program outcome assessment in many cases. Very few nonprofits have received training in outcome measurement, outcome data analysis, or service improvement strategies based on outcome results. This study noted that "most organizations performing outcome measurement are just beginning to become comfortable with it and to use the information to improve programs and support other activities such as marketing or fundraising."[53] Strategic and long-range financial planning have no doubt been hampered by measurement inadequacies, but should improve over time as this information gets used in planning processes.

Those organizations deemed successful based on meeting two financial goals – having a balanced budget without borrowing from an endowment or tapping cash reserves – were more likely to evaluate sources and uses of funds, forecast revenues and costs, and prepare detailed financial projections before making major decisions. This was discovered in a small-sample strategic planning study conducted by William Crittenden.[54]

A major study of hospitals' capital expenditures indicate that there is a significant gap between "have" and "have-not" hospitals: Hospitals with strong balance sheets (good liquidity, reasonable debt) and a "successful strategic capital planning process" are investing enough to more than offset depreciation. Struggling hospitals, however, become less creditworthy, losing access to capital, and struggle to keep current with today's demands but seem unable to build for tomorrow's needs.[55] Another survey finds that 41 percent of hospitals' capital budgets went for major modernization, 14 percent for new programs, 14 percent for medical equipment, 14 percent on information systems, 5 percent on other equipment, and 5 percent on code compliance.[56]

Most of the 254 nonprofits surveyed in the Denver and Boulder areas foresee significant capital expenditures in future years. Of the 254 surveyed nonprofits, 88 percent foresee client population growth within the next five years, 60 percent asserted that current facilities would be unable to meet those needs within five years, and most said that the reason for this would be inadequate space for future programs. There was also considerable concern regarding the quantity, cost, location, and quality of space available.[57]

Most surveyed Indiana nonprofits *do not* have financial reserves dedicated to projected capital needs or to facility maintenance. These reserves could be used to cope with unexpected outlays for repair or replacement, but only 44 percent of Indiana nonprofits have reserves for maintenance needs and only 35 percent have reserves for capital needs. Faith-based nonprofits were the most likely to have these types of reserves, and arts/culture/humanities and mutual benefit nonprofits were the least likely to have reserves.[58]

With respect to capital budgeting evaluation techniques, an early study indicates that the payback method (how many years to recover the initial investment) was used by 45 percent of faith-based respondents, and 30 percent used cost-benefit analysis. A mere 7 percent used ROIC, and 4 percent used NPV in project evaluation.[59] A recent study, not of nonprofits but of Canadian municipal governments, finds a minority use formal capital budgeting evaluation techniques, and those that do tend to use the payback techniques despite the fact that it ignores the time value of money. More emphasis is placed on quantitative/financial factors than on qualitative/intangible factors.[60] The best news, though, comes from a recent study of US nonprofit agricultural coops: Over 50 percent used NPV, ROIC, or the benefit-cost ratio (profitability index) in their capital project evaluations.[61] We expect to see wider adoption of sophisticated techniques as proficient financial management becomes valued more highly by nonprofits. In a study of arts organizations' investments in facilities, Woronkowicz finds that when they used some debt financing, (1) 93 percent experienced one or more years of deficits in the years after facility completion, with most of the organizations (63.6 percent) running one or two years of deficits, and the remainder running at least three years of deficits; (2) on average nonprofits that invested in facilities experienced increases in expenses while revenues remain unchanged; (3) a primary reason for #2 is that borrowing-related costs contributed to higher expenses (the majority of the organizations used at least some debt financing).[62]

Perhaps the ultimate scorecard for long-range financial planning and capital budgeting practices is whether or not an organization monitors impact and performance against its strategic plan. At the board level, the evidence shows room for improvement. When 381 nonprofit board chairs and 1,379 chief executives were asked "Is the board is good at monitoring performance and impact against strategic plan?," only 54% of the respondents gave their board an A or B grade (BoardSource "Leading With Intent" study).[63] Clearly this finding is linked to whether or not a balanced scorecard or dashboard indicators are used (see Chapter 3), but performance-against-financial plan should also be a valuable tool for monitoring performance against strategic plan. Asked whether "Board members appropriately balance short-term and long-term needs," directly relevant to our topics in this chapter, 64% of executives and 74% of board chairs agreed or strongly agreed, which leaves around 25% or 35% of the organizations seeing a need for improvement in this regard.[64] Long-range financial planning will enable organizations to reset and manage toward a liquidity target while anticipating and arranging the funding necessary to achieve financial sustainability.

## 9.7 CONCLUSION

Long-range financial planning and proper capital allocation are vital parts of ensuring a prosperous and mission-achieving future for your organization. Making sure you have a business model that positions your organization for financial sustainability, as we suggested in Chapter 3, is vital. We have focused on the role of financial staff in the development, evaluation, and implementation of these plans. Occasions that make long-range financial planning especially critical include these observed by consultant Hilda Polanco:

- Increasing personnel costs, especially associated with medical insurance
- Relocation costs as a property lease nears expiration

- Conclusion of a significant multi-year grant
- Possibility of reduced revenue from public sources as government budgets shrink
- Demographic or other social shifts that may affect the scope and nature of an organization's programming[65]

The power of financial spreadsheet software and newer special-purpose planning software for forecasting and proposal evaluation has been demonstrated. We have also seen that nonprofit organizations are increasingly turning to interagency collaborative arrangements including partnering, strategic alliances, and mergers in order to leverage scarce resources. Informal partnerships, often labeled strategic alliances, abound. These may involve many organizations, underscoring the importance of having all organizational personnel work together as team members to communicate and implement the strategic plan. Financial personnel will be the first line of defense to avert financial catastrophes when the organization attempts to move too quickly or when necessary funds do not come in on a timely basis. Finally, financial strategies and policies can be developed or revised by the finance staff, with appropriate approvals by senior management and the board of directors.

## Notes

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29. The format for the IRR function is *=IRR(range of cash flows)*. Make sure your initial investment is in the first cell of that range and has a negative sign, the final cash flow is the last cell in that

range, and there are no blank cells in the range. It does not matter whether you data are all in single dollars or all in thousands of dollars, as long as all of the numbers are consistent.

30. This can be done for an EAC calculation in Excel by: *=PMT(rate, years, NPV)*. However, you must change the sign of the NPV to a positive sign first.
31. Dennis Morone and Elizabeth Ireland, "Planning Ahead for Deferred Building Maintenance," Grant Thornton, White Paper, (2017): 20-21. Available online at www.grantthornton.com/nfp2017. Accessed: 1/23/2018.
32. Notre Dame News, "Notre Dame Receives First-of-its-kind $100 Million Unrestricted Commitment from Entrepreneur Kenn Ricci," (October 25, 2017). Available at https://evp.nd.edu/news/notre-dame-receives-first-of-its-kind-100-million-unrestricted-commitment-from-entrepreneur-kenn-ricci/. Accessed 1/22/2018.
33. Refer to discussion of liquidity analysis and how to calculate the appropriate liquid balance for your organization in Chapters 2, 5, and 8.
34. A mathematical programming computerized worksheet makes the process much simpler. You may do this using the "Solver" function that is part of the Tools menu in Microsoft Excel. If you are unfamiliar with this, you might contact a finance professor at a local college or university; this makes an ideal paid or unpaid student internship project.
35. Statistically this is true because the cash flow streams of the two organizations are less than perfectly correlated. When one organization is experiencing a down year, the other may be neutral or up, or vice versa. In fact, the less closely associated the two organizations' cash flows, the better.
36. Noel Hyndman and Donal McKillop, "Conversion Ratios in Charities in England and Wales – An Investigation of Economies of Scale," *Financial Accountability and Management* 15 (May 1999): 135–153.
37. For more on economies of scale, see Sharon M. Oster, *Strategic Management of Non-profit Organizations* (New York: Oxford University Press, 1995), 32–34.
38. See Malcolm S. Salter and Wolf A. Weinhold, *Diversification Through Acquisition: Strategies for Creating Economic Value* (New York: The Free Press, 1979), 38–42.
39. Bronislaw Prokuski, "Anatomy of a Merger," *Association Management* (February 2002): 42–48.
40. Uniform Partnership Act, Section 6(1); Henry Campbell Black, *Black's Law Dictionary: Definitions of the Terms and Phrases of American and English Jurisprudence, Ancient and Modern*, 6th ed. (Minneapolis: West Publishing, 1990): 120. For more on this topic, see Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations*, 4th ed. (Hoboken, NJ: John Wiley & Sons, 2017) and the annual supplements to that text. We drew on this information for this section.
41. If income is earned on an unrelated business activity, each member is taxed based on his or her distributive share of income, gain or loss, expenses, or credit.
42. This is a major concern with "whole hospital" joint ventures, in which a charity and a private entity each contribute one or more hospitals to a third organization called an operating limited liability company. The nonprofit can lose its tax-exempt status if the nonprofit does not retain control in a joint venture. Private inurement is also a concern because of the financial agreements that are crafted as part of these joint ventures. See Sanders, Chapter 11.
43. For more information on the Minnesota Housing Partnership, refer to www.mhponline.org/About%20MHP/history.htm. Accessed 8/15/2017.
44. Reasons offered to the IRS when seeking IRS approval for joint venture arrangements.
45. For information on these low income housing ventures, see Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations*, 4th ed. (Hoboken, NJ: John Wiley & Sons, 2017), Chapter 13.
46. Peter F. Drucker Foundation for Nonprofit Management, Meeting the Collaboration Challenge: Developing Strategic Alliances Between Nonprofit Organizations and Businesses Video, May 2002, Jossey-Bass. This video is referenced at http://leadertoleader.org/collaboration/challenge/appendixe.html. Accessed 8/15/2017.
47. Id.
48. We draw heavily on the Varadarajan and Cunningham analysis in our discussion of strategic alliances. Refer to P. Rajan Varadarajan and Margaret H. Cunningham, "Strategic Alliances:

A Synthesis of Conceptual Foundations," *Journal of the Academy of Marketing Sciences* 23 (Fall 1995): 282–296.
49. See section on finance structure in Chapter 4 for discussion of greater role for the finance area in fundraising planning, implementation, and evaluation.
50. Hilda Polanco, "Board Leadership: Financial Projections Help to Flesh Out Scenario Plans," *The Dodge Blog* (April 11, 2017). The Dodge Blog is published online by The Geraldine R. Dodge Foundation. Available online at http://blog.grdodge.org/2017/04/11/board-leadership-financial-projections-help-to-flesh-out-scenario-plans/. Accessed 1/23/2018.
51. Note that depreciation is not included in the expenses listed.
52. Allison Fine, Colette Thayer, and Anne Coghlan, "Program Evaluation Practice in the Non-profit Sector." Working Paper. Nonprofit Sector Research Fund (The Aspen Institute), 1998. In a recent study, Salvatore Alaimo finds that about two-thirds of executive directors indicate that their nonprofit organization uses evaluation information to alter its programs. For more on this study and how to apply it, see Patrick Rooney, "Evaluation Process," *The NonProfit Times* (June 1, 2011). Available online at http://www.thenonprofittimes.com/news-articles/evaluation-process/. Accessed 1/22/2018. An online survey conducted by Usable Knowledge in 2017 found that nonprofits "… use evaluation to assess program implementation, participant satisfaction, and program outcomes; are proactive in using evaluation internally for program improvement, new program planning, in proposals for new funding, and in communicating results via conference presentations and writing; reported that their funders require evaluation, but less than half indicated that they support evaluation financially or in other ways. Many in fact were uncertain as to how their evaluation reports are being used." (Eric Graig, "Survey Results: Nonprofits and Evaluation," (November 3, 2017)). Available online at: http://www.usablellc.net/survey-results-nonprofits-and-evaluation. Accessed 1/22/2018.
53. Elaine Morley, Elisa Vinson, and Harry P. Hatry, *Outcome Measurement for Nonprofit Organizations: Current Practices and Recommendations* (Washington, DC: Independent Sector, 2001).
54. William F. Crittenden, "Spinning Straw into Gold: The Tenuous Strategy, Funding and Financial Performance Linkage," *Nonprofit and Voluntary Sector Quarterly* 29, Issue 1 supplement (2000): 164–182.
55. HFMA, *How Are Hospitals Financing the Future?*
56. Ingrid Singer and Betsy Carrier, *Capital Investment in America's Safety Net: Results of the NAPH Capital Expenditure and Financing Survey for FY 2001* (Washington, DC: National Association of Public Hospitals and Health Systems, September 2003).
57. Nonprofit Finance Fund and Technical Development Corporation, *Survey Results.*
58. Grønbjerg and Clerkin, *Indiana Nonprofits*.
59. John T. Zietlow, "Capital and Operating Budgeting Practices in Pure Nonprofit Organizations," *Financial Accountability & Management* 5 (Winter 1989): 219–232.
60. Yee-Ching Lilian Chan, "Use of Capital Budgeting Techniques and an Analytic Approach to Capital Investment Decisions in Canadian Municipal Governments," *Public Budgeting Finance* 24 (June 2004): 40–58.
61. John B. White, Morgan P. Miles, and Linda S. Munilla, "An Exploratory Study into the Adoption of Capital Budgeting Techniques by Agricultural Co-operatives," *British Food Journal* 99, no. 4 (1997): 128–132.
62. Joanna Woronkowicz, "Is Bigger Really Better? The Effect of Nonprofit Facilities Projects on Financial Vulnerability," *Nonprofit Management and Leadership* 27, no. 1 (Fall 2016): 79–94.
63. BoardSource, "Leading with Intent: 2017 National Index of Nonprofit Board Practices" (2017). Available online at https://leadingwithintent.org/. Accessed 1/23/2018.
64. Id.
65. Quoted from Polanco (2016).

APPENDIX 9A

# CASE STUDY: KIAWAH ISLAND COMMUNITY ASSOCIATION*

**Size:** 4115 properties
**Age:** 26 Years
**Location:** Kiawah Island, SC

Kiawah Island is a National Community Association of the Year Award (NCAYA)–winning community in South Carolina. In addition to the board and management's dedication to community spirit and service, they also pay particular attention to financial operations.

**Governing Documents.** The community's governing documents provide certain guidelines related to the association's financial activities. Financial statements are prepared per the accrual basis of accounting and prepared according to the fund reporting method. Using the accrual method ensures observance of limitations and restrictions on the use of financial resources that the governing documents require. The association board and staff also prefer to have an annual audit conducted because it gives the members a level of confidence that is not possible with a review or compilation. When all is said and done, the board and the staff want their work scrutinized to the fullest extent.

**Bank Statements.** As per the association's *Financial Controls Manual*, the association's treasurer and controller's assistant reconcile Kiawah Island's bank statements monthly. This allows the association to regularly monitor its assets. The individuals responsible for reconciling the bank statements do not have check-signing authority. Authorized signatories on all bank accounts are the board treasurer, the general manager, the controller, and the assistant general manager. Regular checking transactions require two of the aforementioned representatives' signatures. Access to the association's reserves accounts requires the board president's and treasurer's signatures.

**Financial Statements.** Association financial statements are produced monthly to keep the board up to speed on operations. The financial statements are discussed every six weeks at a board meeting. Board meeting minutes are posted on the association's website for membership review. Financial statements (and annual financial audits) are always available at the association office for members' review and the financial audit is provided once per year as part of the annual meeting packet materials.

**Write-offs.** Further, the association has a set process by which "write-offs" (delinquencies) are approved – the controller approves accounts with a balance of less than $100,

**Source*: http://www.cairf.org/research/bpfinancial.pdf. Accessed 1/14/06. Used by permission.

the manager approves accounts with a balance of more than $100 but less than $500, the treasurer approves accounts with a balance of more than $500 but less than $1,000, and the board must vote and approve write-offs for accounts with a balance of more than $1,000.

**Budgeting.** Kiawah Island's board and staff also work to develop and follow a comprehensive budget each fiscal year. Budget items are allocated to the month during which expenses occur. For example, the pool contractor provides a specific annual schedule for the coming year listing the services and personnel he is providing each month and their cost. These monthly allocations are included into the annual budget because it makes sense to match expenses with income. For example, during the months that the pool contractor is providing services, the pool is open and income is being generated.

Unbudgeted expenditures more than $2,000 must have prior board approval. Approval may be obtained either at regularly scheduled board meetings, or by mail vote, when necessary.

Unanimous approval is needed for a mail vote to pass. Also, the Finance Advisory Committee is informed of such expenditures and makes their recommendations to the board prior to the meeting or mail vote.

To facilitate association operations when unbudgeted expenses of a serious nature arise, the budget may contain a line item for contingencies, not to exceed the limit approved by the board. The guidelines for the use of these funds are: (1) an unanticipated emergency (e.g., hurricane, flood, fire, etc.), (2) the replacement or repair of equipment that either fails or is destroyed unexpectedly and is considered by the general manager to be critical to the efficient operation of the association, or (3) for the protection of association property from imminent damage. The reason for this line item is that time required to obtain board approval for unbudgeted expenditures may, under certain conditions, cause significant unnecessary expense to the association, or that approval may be unattainable due to the unavailability of board members, and so on. The use of this line item, within the guidelines above, is to be in the operating committee's discretion only. When expenditures are made, the general manager is to seek board ratification immediately, of both the expenditure and his or her justification for the use of the contingency funds versus the regular process for advance approval of nonbudgeted expenditures more than $2,000. Once approved by the board, the expense will be moved to the correct line item and/or department. The board has the authority to suspend use of the contingency line item at any time, by written notification to the general manager.

**Competitive Bids.** The general manager, at the direction of the board, is the contracting agent for the association. The general manager will sign all bilateral contracts. The general manager may delegate purchasing authority and the ability to sign purchase orders to various department heads. However, the general manager may not delegate authority to sign general insurance or employee benefit contracts. Where feasible, all contracts and purchase orders will be in the association's standard format appropriate to the type of purchase. The general manager reserves the right to have the contract reviewed by legal counsel and/or insurance representatives. Whenever a form of contract or purchase order other than the association's standard is used, appropriate review will be exercised. The general manager reserves the right to require that the standard format be used. All contracts valued annually at $25,000 or more require competitive bidding. Competition for contracts less than $25,000 is not precluded and is recommended when time and cost for obtaining quotes is reasonable. Staff is expected to perform due diligence in obtaining bids, when required. Contracts with fewer than three responses must contain a certification from the requesting manager that all available responsible bidders were sought and suitable follow-up performed to get as many bids as possible, with explanations of unusual circumstances. The board must approve any sole-source award in advance. Similarly, any contract to be awarded to other than the lowest bidder must have prior approval by either the board or, for reserve projects, the Major Repair & Replacement Committee.

Any contract in excess of $25,000 must either be approved in the annual budget or have specific prior board approval, except in the case of emergency or contingency purchases. Additional board approval is required in cases where conditions change, before or after the contract is let, which significantly affect the scope or cost of the contract (more than 20%). No service contract may be automatically renewed for more than 12 months without additional approval sought from the board. There will be no contracts between the association and one of the association's employees, board members, committee members, or their respective relatives, regardless of dollar value.

**Long-Range Fiscal Planning.** The board directs the Finance Advisory Committee to develop a five-year fiscal plan, which includes disaster, insurance, and facilities acquisition components. The committee receives information about the capital projects proposed for the future from the Long-Range Planning Committee. In their disaster planning, the committee considers financial disasters (for example, they determine what happens if revenues become reduced). Draft plans are presented to the full membership at open forums and via mailings for comments before the board approves them.

APPENDIX **9B**

# EVALUATING SOCIAL ENTERPRISES

In this appendix, we present a diagnostic tool to assist in evaluating social enterprises (some of which may be referred to as "earned income ventures") from a liquidity perspective. We start with a brief argument for considering liquidity, follow with a numerical example, and then show how the graphical Financial Return & Financial Coverage Matrix (FRFCM) may be used in decision-making.[1]

If the ALT (Approximate Liquidity Target) Theory is approximately correct,[2] and/or liquidity is of paramount importance (say, because the nonprofit is capital constrained and engaging in moderate or extreme capital rationing), then calculated Social Return on Investment (SROI, as presented by REDF and others) might be supplemented with or replaced by a form of Social Return on Financial Coverage Ratio (SROFCR). Regardless, the framework that follows should prove useful to nonprofits considering for-profit business ventures.

Hypothetical Organization XYZ has four possible business ventures to consider: A, B, C, and D. Which one(s) should it favor, and which ones avoid? As input into this, consider the table of relevant data for the ventures (Exhibit 9B.1).

These data plot as the bubble graph in Exhibit 9B.2, which is labeled the Financial Return and Financial Coverage Matrix (FRFCM).

## FRAMEWORK INTERPRETATION AND IMPLEMENTATION

The FRFCM Framework is diagnostic, not prescriptive. In general, managers should invest in projects to the right of the vertical axis, with further right and larger bubble size denoting more desirability. The vertical axis (at the origin) separates projects consuming more than (to the left) or less than (to the right) "organization available funds." Projects to the left are major liquidity drains, while the further to the right a project plots, the more it adds to the organization's liquidity. Large bubbles represent projects with large (projected) social returns. Management and the board may well decide to go out and get funding for "large bubble" projects that plot left of vertical axis. Otherwise, the fact that these projects are to the left, and the further they are to the left, provides indication of need to delay the project until additional funding is in place.

In both the table and the graph, Project A is a significant liquidity drain but a large social return project. B drains less liquidity, but again would put the organization's liquidity into a negative, illiquid posture. C and D would not exhaust current liquidity, and B provides significant social returns. D is most easily funded from the current liquidity position, but provides lesser social returns. The officers and directors are faced with finding funding for A and/or B if they wish to achieve the projects' significant social benefits. It appears that C might be a more logical choice than B, given the fact that it drains the liquidity position less

**Bubble Graph Data**

**Social Return, Financial Return, and Liquidity Analysis for New Nonprofit Business Ventures**

| Project | Social Return (5 year Projected) | Initial Investment* | Target Liquid Funds** | Financial Coverage Ratio: ABS(TLF/II)-1 | Financial Return Present Value | Memo: NPV |
|---|---|---|---|---|---|---|
| A | 300,000 | $(100,000) | $35,000 | –0.65 | $30,000 | $(70,000) |
| B | 75,000 | $(50,000) | $35,000 | –0.30 | $25,000 | $(25,000) |
| C | 45,000 | $(25,000) | $35,000 | 0.40 | $25,000 | $ |
| D | 5,000 | $(5,000) | $35,000 | 6.00 | $10,000 | $5,000 |

*Initial Investment probably best defined as all financial outlays to get venture up and running, including working capital outlays, less restricted funds designated (and restricted) for the venture and monies known with certainty to be forthcoming for the project within the next 6–12 months.
**Target Liquid Funds = Unrestricted Cash & Cash Equivalents

+ Unrestricted ST Investments

+ (Total ST Borrowing Capacity – Used ST Borrowing)

**Exhibit 9B.1** Bubble Graph Data

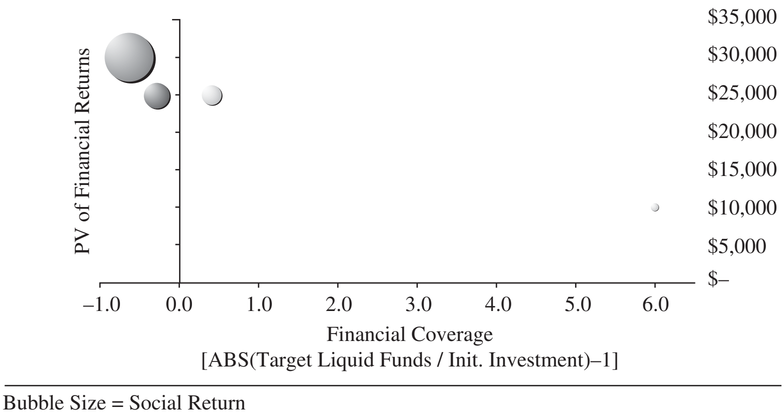



**Exhibit 9B.2** Financial Return and Financial Coverage Matrix

and yet provides almost equivalent social returns. At best, these are difficult decisions, and nonprofits often lack the managerial abilities as well as the financial resources to properly harness the business potential of these ventures.[3]

## CAVEATS

There are several important reasons that this framework should be challenging for managers to implement:

1. Estimation error is inherent in the initial investment, present value of future returns, and social return estimations.

2. Incoming funds specific to the project may be sufficient to allow for investment in a certain project – if known this may be subtracted from initial investment to arrive at (modified) net initial investment.
3. Near-term deficits or other planned capital or financial outlays may dictate turning down even those projects that appear feasible.
4. There may be restricted funds for project(s) that must be used to reduce initial investment or override diagnosis.
5. No obvious accept/reject criteria are presented; merely guidance to board and officers.
6. No clear ranking criteria are provided from either table or graph, especially in light of the varying NPV prospects (see the rightmost memo column).
7. This shows projects' effect on the organization's insolvency risk, but there are other risk types and dimensions.
8. Managers should really supplement this analysis with payback period statistics.

New research currently being conducted should shed more light on the strains placed on organizations that are launching social enterprise ventures.

## Notes

1. This framework is part of a larger paper that was presented in 2000 to two nonprofit conferences. References are as follows: John Zietlow, "Social Enterprise Financial and Nonfinancial Evaluation," paper presented to the *29th Annual ARNOVA Conference* (New Orleans, LA: November 16, 2000); and John T. Zietlow, "Social Enterprise Financial and Nonfinancial Evaluation," presentation to the Alliance for Nonprofit Management (Cleveland, OH: April 21, 2001).
2. See Chapter 2 for our reasoning on why this appropriate liquidity target (here labeled target liquid funds) should serve as the primary financial objective of noncommercial nonprofits.
3. For more on the difficulties involved in these projects, see John T. Zietlow, "Social Entrepreneurship: Managerial, Finance and Marketing Aspects," 2001 special issue of *Journal of Nonprofit & Public Sector Marketing* 9, no. 1–2 (2001): 19–43.

CHAPTER 10

# MANAGING YOUR ORGANIZATION'S LIABILITIES



The nonprofit landscape is littered with failed organizations that presumed on their financial futures by taking on too much debt. Denver aquarium Ocean Journey overestimated its annual visitors and had to declare bankruptcy within two years of opening because it was unable to make payments on its $57 million of debt.[1] The Allegheny Health, Education, and Research Foundation (AHERF) filed bankruptcy with $1.3 billion in debt and 65,000



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

creditors – primarily due to too-rapid expansion, unfulfilled merger operating result projections, and an overload of debt that it accumulated: Debt mushroomed from $67 million to $1.2 billion over a 12-year period. The nonprofit liquidity challenges and ensuing cash crisis we identified in Chapter 2 came to the fore: AHERF tried to grow via acquisition to become a statewide provider, had no ability to tap equity financing (as would a for-profit), and purchased hospitals with negligible operating cash flow.[2] Numerous churches and other religious organizations borrowed too much in the 2000–2010 era, basing their capacity to repay on projected growth of adherents and giving levels, or anticipated asset sales, which never materialized. Largely due to debt-related obligations and a very weak economy with fewer donations of cash or appreciated securities, there were 497 bankruptcy filings made by 454 different religious organizations in the 2006–2011 period.[3] Consequently, many banks no longer make church building loans.

Properly used, debt financing may provide an important piece of the expansion funding and financial flexibility that organizations require. Bonds or loans to fund land or building purchases or renovations are prime examples. Lines of credit provide short-term cash needs, when grant or contract funding is delayed, and they also constitute an important component of the target liquidity level in the form of unused borrowing capacity. The American Red Cross applied for and gained approval of a $1 billion line of credit from its banks, tapping a maximum amount of $340 million during one year. It borrowed and repaid various amounts under this line during the year due to the fact that cash outflows temporarily exceeded cash inflows or due to limited ability to mobilize those inflows to the locations where cash outflows are occurring. Many nonprofits find it prudent to have a seldom-used line of credit available from a bank, so that in the event that revenues drop or expenses spike unexpectedly they do not have to cut back on services and payroll.

This chapter provides guidance for an organization that chooses to borrow with short-term loans, long-term municipal bonds, or mortgage loans. The starting point is a consideration of the balance sheet, as your organization establishes its capital structure. We also profile the lender's view on a borrower's creditworthiness. Furthermore, we mention sources of funds that your organization may tap other than through arranged borrowing. Recall from the Lilly study that two out of three of the organizations surveyed never do short-term borrowing, and only one in eight organizations is a perennial short-term borrower.[4] Yet all organizations benefit from a knowledge of borrowing alternatives and the borrowing process: Many of these same faith-based organizations have mortgage loans. Finally, in this chapter we discuss different liability, or borrowed fund, accounts, and program-related investments (PRIs).

## 10.1 MANAGING THE BALANCE SHEET

Your financing decisions, including whether to and how much to borrow, require a context. That context is the *target capital structure*, or how much of various financing sources your organization shall employ to finance its assets. You should have your philosophy and strategy stated in a *debt and hedging policy.* That requires another look at the balance sheet, or statement of financial position (SFP).

Every dollar of assets on the balance sheet must be financed with either a dollar of debt (borrowed money) or equity (net assets). As we note in Chapter 9, you should use your balance sheet template to forecast assets, which represent a funding need, out to at least three to five years in the future. Then as you project your statement of activity (SA), you will determine your additional equity capital: To the degree your revenues exceed expenses, you will earn a surplus (change in net assets) that will provide "equity capital" to self-fund your assets. Some of these surpluses you may have set aside as strategic reserves or plant and equipment reserves to use for new programs or expansion and the asset investments that these entail. As a nonprofit may not issue stock, you are limited to this net revenue source of equity capital, whether designated as reserves or not. *Any other asset growth will have to be financed by liabilities, or debt. Correspondingly, the upside to using debt is that your organization may grow more rapidly, providing more services, if it chooses to use debt financing*.

The main downside to using debt financing is the additional risk to your organization's stability. *Financial risk* is the possibility that your organization will not be able to meet its fixed, financing-related obligations. We saw examples of this in our chapter-opening examples. One cannot "lay off" interest or principal payments as one lays off workers or cuts back on other discretionary expenses. Arranged borrowing, whether a bank credit line or bonds issued to investors, represents a contractual agreement that must be taken very seriously. Your organization and its stakeholders stand to lose if you are not prudent in your use of debt. *Borrowing to cover structural deficits, when ongoing revenues and support are inadequate to cover ongoing expenses, or without planned known repayment sources, constitutes an imprudent use of debt.*

## 10.2 BALANCE SHEET MANAGEMENT: BENEFITS AND STEPS

**(a) WHAT CONSTITUTES A WELL-MANAGED BALANCE SHEET?** According to Wareham and Majka, a well-managed balance sheet:

- Supports the organization's strategic plan within an appropriate credit context
- Provides the most flexibility, given market expectations and legal considerations
- Reflects the optimal capital framework, given the organization's needs, capabilities, and risk profile
- Provides the lowest overall cost for the risk of the asset and liability portfolios
- Allows for future financing needs[5]

Balance sheet management requires a six-step approach to qualify as proficient financial management. These steps are:

1. Analyze your cash levels and debt capacity – no surprise here. We have emphasized that achieving and maintaining your target liquidity level is your number-one financial objective.
2. Assess your capital needs.
3. Match capital needs with capital sources.
4. Consider alternative capital sources.
5. Mitigate risks.
6. Monitor the balance sheet on an ongoing basis.[6]

Let's look at each of these steps briefly.

Step 1, analyzing your cash levels and debt capacity, involves determining days' cash on hand from all unrestricted sources (unrestricted cash plus unrestricted short-term investments plus unrestricted long-term investments, divided by [(total expenses − depreciation expense)/365], the current ratio, the ability to cover debt service (both interest payments and principal repayments), and days' sales outstanding (if your organization has any credit sales). You may wish to refer to Chapter 7 (including the appendixes) for a review on the relevant measures. Debt capacity may be assessed as the ratio of your operating cash flow to the maximum annual debt service (the highest level of payments that your financing source could charge on your financing), the ratio of debt to total capital (arranged debt plus all net assets), or the balance sheet ratio of cash to debt. Days' cash on hand and the ability to cover debt service stand out as the primary indicators that predict the organization's borrowing ability. For example, a lending bank may require that your church have as much as 50% in unrestricted and undesignated cash as a percent of all borrowing obligations.

Step 2, assessing capital needs, includes internal analysis, external analysis, and your capital budget. Your long-range financial plan (see Chapter 9) should have already provided you with a financial snapshot of future years' needs, so we will not elaborate here. The key is to maintain strategic priorities in your financial plans.

Step 3, matching capital needs with capital sources, includes consideration of multiple factors, which are listed in Exhibit 10.1. Primary attention should be given to cost of capital and to covenants. The mainstream approach to cost of capital must be modified to fit nonprofits, as the cost of equity capital is not easily estimated.

In Chapter 9 we showed how to calculate net present value (NPV) and return on invested capital (ROIC). The discount rate for NPV, and the comparison rate (sometimes called the benchmark, or hurdle rate) for ROIC, is the weighted average cost of capital. Put more

| Criteria Related to Capital Source | Criteria Related to Capital Project |
|---|---|
| Cost of capital | Criticality of the project to the organization's core mission |
| Covenants | Expended life of technology or equipment |
| Rate of return required | Need to partner with key stakeholders (e.g., physicians) |
| Wishes of philanthropic donors | **Criteria Related to Organization** |
| All-in borrowing rate | Tax status or other tax implications |
| Costs of issuance of the debt | Debt capacity |
| Structure of the financing documents and underlying security requirements | Timing of the funding need |
| Maintenance and incurrence covenants | Tax-status implications of the use of proceeds |
| Principal amortization (paydown schedule) | Credit position |
| Interest-rate risk (if variable-rate debt) | Control issues (how much control must your organization give up?) |
| Average useful life of asset versus average maturity of debt | Potential for investment-grade rating |
| Disclosure requirements | Potential to obtain credit enhancement |
| Prepayment penalties and unwind provisions | |
| Accounting treatment | |

*Source: Financing the Future Report*. Copyright © Healthcare Financial Management Association. Used by permission.

**Exhibit 10.1** Checklist of Criteria for Evaluating Appropriate Capital Sources simply, on capital projects that generate revenues or reduce costs, we make the go/no-go decision based on comparing the financial return with the financing costs of the funding required for the investment. To calculate the cost of capital, we take the proportion of financing from a given source and multiply it by its cost, then sum these products. Let's say that your organization has no "permanent" short-term debt (it uses its credit line only occasionally for emergency needs), has issued bonds yielding 6 percent, and has its long-term cash reserves invested at 5 percent. We look at your organization's condensed balance sheet and see:

| Assets | Liabilities and Net Assets | |
|---|---|---|
| | Bonds | \$200,000 |
| | Net Assets | \$400,000 |
| Total = \$750,000 | Total Liabilities & Net Assets | \$750,000 |

The formula for calculating the weighted average cost of capital (WACC) is:

$$\begin{aligned} \text{WACC} = {} & \text{Cost of Net Assets} \times (\text{Net Assets/Total Capital}) \\ & + \text{Cost of Debt} \times (\text{Debt/Total Capital}) \end{aligned}$$

Be careful to include in "Total Capital" only your arranged permanent debt financing, including any permanent short-term and medium-term funding (e.g., a seven-year term loan). Here your organization has \$600,000 of total capital (\$200,000 in bonds plus \$400,000 in net assets, or equity). For the cost of net assets, ideally you should be capturing the riskiness of your assets. Since asset risk is very difficult to estimate for most nonprofits, we recommend using a proxy measure called the "opportunity cost of investment." Technically, this is the rate of return you could earn on long-term investments of similar risk to your assets. Based on the variability of operating cash flows experienced by most nonprofits, we know that the *business risk* of nonprofits is high, and the required return on net assets (equity) should be correspondingly high.

Since the exact amount of risk of your assets is hard to pin down, you might simply use the long-term investment return you could earn if you invested those funds in a well-diversified stock mutual fund or in your endowment fund (if you have one). Note that this is not the same as the rate of return you are earning on your long-term strategic reserves, which should be invested in relatively conservative investments such as governmental obligations. For most organizations, using long-term stock returns would imply an opportunity cost of investment of around 9 or 10 percent.[7] We will use 10 percent for your organization's achievable long-term investment return. Someone may object: "But our equity represents surpluses earned on operations over the years, much of which was based on fundraising, and we expensed all the costs of that fundraising in the past." Nevertheless, those funds could be deployed in an alternate use to those to which they are being invested (on the asset side of your balance sheet at present), and so using them to fund your assets means that you are giving up the investment return that could be earned on those funds.

Substituting your numbers in the formula, we compute your cost of capital (WACC):

$$\begin{aligned} \text{WACC} &= \text{Cost of Net Assets} \times (\text{Net Assets/Total Capital}) \\ &\quad + \text{Cost of Debt} \times (\text{Debt/Total Capital}) \\ \text{WACC} &= 10\% \times [\$400{,}000/(\$400{,}000 + \$200{,}000)] \\ &\quad + 6\% \times [\$200{,}000/(\$400{,}000 + \$200{,}000)] \end{aligned}$$

Expressing the cost percentages in decimal form:

$$\begin{aligned} \text{WACC} &= 0.10 \times [0.6667] + 0.06 \times [0.3333] \\ \text{WACC} &= 0.06667 + 0.019998 \\ \text{WACC} &= 0.086668, \text{ or } \underline{\underline{\mathbf{8.67\,\%}}} \end{aligned}$$

In general, your goal is to *minimize the weighted average cost of capital*. The chief constraint here is to maintain an assured pipeline of financing, which on occasion means you may include one or more long-term sources of funds that cause you to pay more than you would for the minimum-cost mix of long-term capital. One more time, we are made aware that the principal financial objective is not to maximize stockholder value or minimize expenses (including interest expense) in order to maximize profits, but rather to achieve and maintain a target liquidity level. Some healthcare or educational organizations, which could adopt a for-profit status, may view their objectives with an eye toward profitability – and value cost minimization more highly.

Another issue to be careful about is the imposition of covenants when borrowing from a financial institution or when issuing bonds. These normally restrict your organization in some fashion, and may have tough remedies in the event you are not in compliance with one or more of the covenants. A key point to be aware of: In some cases covenants can be negotiated out of loan contracts or bond indentures. *Maintenance covenants* indicate the financial ratio values or other financial requirements your organization must maintain as long as the debt is outstanding. For example, your organization may need to maintain a certain level of days' cash on hand (creditworthy hospitals typically have eight months or more of unrestricted cash on hand) and have a debt service coverage ratio of at least 1.1 times to be viewed as very creditworthy. *Incurrence covenants* indicate what events would be viewed as negatively impacting existing debtholders, and therefore your organization is pledged not to initiate. Examples are issuance of additional debt, merging with another organization, or selling specific assets.

Step 4, considering alternative capital sources, addresses the fact that borrowing may not be your first or best funding source. Consider operating cash flows, fundraising, program-related investments (covered later in the chapter) and leasing as alternatives to bank loans or bond issues. The capital investment size, life expectancy (you may be better off leasing equipment that will become obsolete quickly), time-sensitivity, relation to your mission, and expected return all have a bearing on how you might best finance the investment. *The effects of the capital source selected on both your cash position (or target liquidity level) and your debt burden are important.* A real estate investment trust may buy one or more of your buildings and then lease space back to your organization, enabling your organization to monetize some of its fixed assets and build cash and liquidity. We will return to the topic of alternatives to borrowing in a later section of this chapter.

Step 5, mitigating risks, might include the use of interest rate swaps and other financial derivatives, as interest rate spikes threaten your organization's surplus and cash position.

Newly issued bonds may include interest rate swaps, and if you have existing debt, you may use a swap or perhaps an option to enter a swap ("swaption") as well. We return to this topic in Chapter 14.

Finally, step 6 indicates that setting debt levels and the mix of short-term versus long-term debt are not one-time decisions: You must monitor the balance sheet on an ongoing basis. Here you review changes in asset amounts, current liabilities, long-term liabilities, and net assets. Calculation and review of key financial ratios are essential, along with a look at how these changed year over year. "Get behind the numbers" by interpreting the reasons for those changes. Consider opportunities that may arise, including:

- Have interest rates dropped enough to warrant a look at possibly refinancing? If your organization can reduce its interest rate by 1.75 percent (from 6% to 4.25%) on a $10 million loan balance, the annual savings of $175,000 immediately offsets any prepayment penalty and closing costs that might be incurred and then results in annual savings of significant amounts as you pay the loan down ($157,500 when loan balance is $9 million, $140,000 when loan balance is $8 million, etc.). The River of Life Church in Kent, Washington, saved $30,000 a year in annual debt service and gained a 25-year mortgage in the process (churches often must take five-year commercial loans, and if not able to pay the bullet payment due at the end of five years, find alternate financing).[8]
- Should we change the mix of variable-rate and fixed-rate debt, possibly through a transaction in the swap market?
- Should we obtain a realized cash gain by reversing a swap?
- Have our financials changed enough to discuss a possible rating upgrade with credit rating agencies (Moody's Investors Services, Inc., S&P Global Ratings, Fitch Ratings, Inc., DBRS Inc., A.M. Best Rating Services, Inc., Kroll Bond Rating Agency, Inc. (KBRA), and Morningstar Credit Ratings, LLC)?[9]
- Can we match up asset life spans to liability life spans?[10]

**(b) DETERMINING YOUR ORGANIZATION'S DEBT CAPACITY.** One of the key considerations in your capital structure decision-making is your organization's *debt capacity.* One way to assess this is to "back into" that capacity via calculation of relevant financial ratios. Wareham and Majka, of Kaufman, Hall and Associates, suggest a weighted approach to doing this for healthcare organizations that makes sense for many commercial or partly commercial organizations, as noted in Exhibit 10.2.[11] For donative nonprofits, scale the "indicated capacity" numbers down, because lenders and investors will be reluctant to finance to these levels in cases where the revenues of the organization come from dues, contributions, endowment income, or grants, as opposed to product or service sales. Typical nonprofit revenues and support sources do not make good sources of collateral, or security, on loans or bonds. Applying this methodology, the example organization has a debt capacity of $57.0 million, as shown on the bottom right of the exhibit. If a zoo is using only $40 million of that in its existing debt, it has $17 million (=$57 million − $40 million) in financial flexibility, or unused debt capacity.

As a final note on balance sheet management, not all of your organization's risks and vulnerabilities are captured on the balance sheet. Potential liabilities arise from many sources. Consequently, we will address risk management in Chapter 14.

We now turn to the specific forms of debt financing that your organization may procure. A liability that gets little attention but that can provide an organization much-needed and interest-free financing is discussed first – accounts payable.

**Approaches to Calculating Debt Capacity**

| Ratio | Key Target | Indicated Capacity (dollars in millions) | Weighting |
|---|---|---|---|
| **Debt service coverage**<br>Excess of revenue over expenses + Interest + Depreciation + Amortization/MADS* | 3.0x | 62.3 | 45% |
| **Debt to cash flow**<br>Long-term debt + Short-term debt/Excess of revenue over expenses + Depreciation + Amortization | 4.0x | 60.3 | 15% |
| **Cash to debt**<br>Cash and marketable securities + Board-designated funds/Long-term debt + Short-term debt | 100% | 38.3 | 15% |
| **Debt service to revenue**<br>MADS*/Total operating revenue | 4.0% | 49.1 | 15% |
| **Debt to capitalization**<br>Long-term debt (less current portion)/Long-term debt (less current portion) +Unrestricted net assets | 50% | 68.0 | 10% |
| Weighted capacity | | | 57.0 |

*MADS is maximum annual debt service.
Note: Certain ratio definitions vary a bit by rating agency.
Source: Kaufman, Hall & Associates, Inc. Used with permission.

*Source:* Healthcare Financial Management Association, *Financing the Future II: Report 2: Strategies for Effective Capital Structure Management* (Westchester, IL: Author, 2005). Used by permission.

EXHIBIT 10.2 CALCULATING YOUR DEBT CAPACITY

## 10.3 PAYABLES

Think of the accounts payable function as a source of interest-free financing from suppliers. True, the cost of this credit extension is built into the price of the supplies you are buying. Correspondingly, the seller expects you to take advantage of the credit period offered. Common terms are "net 30," meaning the full amount of the invoice is due and payable 30 days after the date of the invoice. For many businesses, accounts payable are the single largest source of financing used. However, our Lilly study revealed that a minority of nonprofits still think it is commendable if they "pay the invoice the day it hits our desk." Such a policy is simply an unwise use of scarce cash resources. Pay on time, but not early.

It is unethical to "stretch payables" to wring more financing out of one's suppliers. Stretching payables may be the most common unethical practice in corporate America. It is unethical both because one has agreed to pay invoices at the stated terms when beginning to buy from the supplier, and because the buyer is in effect borrowing more from its suppliers without their knowledge or approval. Each dollar of extra interest income put in one person's pocket is taken out of another's pocket – the supplier's. If you foresee problems paying invoices on time, contact your supplier, explain the situation, and ask the supplier for additional time – making sure to communicate your willingness to pay and your proposal for how and when you will pay.

Some credit terms are stated like this: "2/10, net 30." This means a 2 percent cash discount is being offered if the bill is paid within 10 days of the invoice date, or the full amount of the invoice may be paid in 30 days. Should you take the cash discount, paying $98 per $100 invoice amount in 10 days? Almost invariably, the answer is "yes." You are giving up a 37 percent rate of return by foregoing the cash discount. This is demonstrated in the following formula:

$$\text{Cost of foregone discount}$$
$$= \frac{\text{Cash discount percent}}{(100 - \text{cash discount percent})} \times \frac{365}{(\text{normal credit period} - \text{cash discount period})}$$

This formula is used to estimate the cost of a foregone discount (the rate of return you could have had if the cash discount was taken) with 2/10, net 30 terms:[12]

$$\text{Cash of foregone discount} = \frac{2}{(100-2)} \times \frac{365}{(30-10)} = \frac{2}{98} \times \frac{365}{20}$$
$$= 0.3724 \text{ or } \mathbf{37.24\,percent}$$

Surprisingly, many of the nonprofits surveyed in the Lilly study indicated they either chose to or had to forgo cash discounts some or most of the time. Such a policy is unwise – you would be better off using some of your short-term credit line, if necessary, to have the funds to take the discount. The preference for borrowing to take the discount applies as long as the annual interest rate of the credit line is less than the cost of the foregone discount – 37.24 percent in our example. We underscore the wisdom of applying for a credit line with your financial institution, if you do not already have one. If you have been operating for two or more years, have annual revenues of $200,000 or better, and ran a surplus in your most recent year, you are a strong candidate for credit line approval.

## 10.4 SHORT-TERM BORROWING

A nonprofit might borrow money for eight reasons:

1. Borrowing is much faster than grants or fundraising for bringing money into the organization, with funds made available within days or a few weeks.
2. Borrowing can stabilize the organization's cash flow and compensate for temporary revenue shortfalls. For example, borrowed funds can be used to meet payroll when in a temporary cash crunch.
3. Borrowing can prevent costly delays in starting new projects. This "bridge financing" is an important role for borrowing. Government agencies at the state and local level issue bond anticipation notes for this purpose.
4. Borrowing can increase earned income by speeding up the start of a revenue-generating project. Getting income-producing ventures off the ground may necessitate start-up financing or financing to fund the expansion of the new venture.
5. Borrowing can help consolidate bills. The idea here is to enable the organization to take cash discounts or maintain good supplier relationships (by enabling your organization to pay on time).

6. Borrowing can initiate or build on long-term relationships with financial institutions. Individuals know the value of an established credit history, and the same holds true for a nonprofit organization.
7. Borrowing can help improve the organization's financial management. Financial institutions require financial reports with a fair amount of detail and the calculation of key financial ratios. Organizations that previously managed without key financial data will be pressed to improve their financial and accountability structures.
8. Borrowing can help the organization achieve independence. By replacing restrictive donations or grants/contracts, the organization may be freed to pursue the mission it is called to accomplish. The flip side is that your organization may be limited via restrictive loan covenants placed on you by the financial institution. Limiting the borrowing and keeping the loan payments current will enable your organization to avoid becoming the "servant to the lender."[13]

Some nonprofits shun debt, with the justification being that they do not pay interest to solicit donations or grants. However, there is a cost to raising funds through donations and grants. Let's say that $100 is raised for every $10 spent. That amounts to a 10 percent interest rate if $10 is taken as "interest" and $100 as principal. The main difference, of course, is that the donation funding stream must be renewed every year, while the borrowed funds are there until "maturity" – which is when the organization must make the principal repayment on the borrowed funds. (You may opt to pay early on principal or pay down revolving credit line draws in order to save on interest expense.) Our point is that there is a cost of funds, regardless of how you acquire them.

Planning for short-term borrowing must take place within the context of the organization's overall strategic planning process (see Chapter 3) and long-range financial plan (see Chapter 9). Otherwise, borrowings may cost more than they should or funds will be borrowed on the wrong terms, or both. We shall develop the specifics of short-term borrowing in Section 10.10.

## 10.5 STRATEGIC FINANCING PLAN

Financial managers have two different ways with which to plan and manage an organization's debt and capital structure: (1) the *at-whatever-price theory*, and (2) the *strategic planning theory*. The at-whatever-price theory is related to the traditional supply-and-demand concept and is based on the belief that any financial manager can raise enough capital to do business if there is sufficient pressure placed on the potential lender.

Under the at-whatever-price theory, capital is like any other commodity: The greater the need, the higher the cost. Unfortunately, this theory suggests that the most advantageous time for an organization to borrow money is when it does not need to borrow money, and the most advantageous time being when borrowing is least expensive. In some cases, such "market timing" financing can be attractive. It can be less expensive and less restrictive than financing under more pressing circumstances, for instance, when the organization has an acquisition target in mind, has committed to a major construction project, or needs to purchase a major piece of equipment. Bankers are then aware of the urgency of the need to obtain money and may be inclined to dictate stiffer terms.

The more advantageous financial approach is to make capital and debt management crucial parts of the organization's strategic planning process. In fact, capital and debt management should be accorded as important a place in strategic planning as revenue projections, business model changes, cost containment programs, community marketing programs, and expansion plans. If capital and debt management is part of an organization's strategic planning process, its long-range goals and objectives can be considered under all types of financing options.

The basis for your strategic financing plan for financing are your organization's strategic plan, discussed in Chapter 3, and its long-range financial plan, which we discussed in Chapter 9. A *strategic financing plan* should be a specific statement of your organization's financing goals and in accord with your organization's debt policy. A financial manager must become a team member when it is time to establish a plan for the organization's capital and debt strategy. By assisting in this aspect of the strategic plan in advance, your financial manager can ensure that your organization obtains financing on the most favorable terms.

Most important, when setting a strategic financing plan, your organization must ensure that the plan dictates financing requirements; financing requirements should not determine the plan. The plan must include considerations of the organization's present assets and debt, internal funding sources, and management's expansion goals. Other pertinent factors to consider regarding the organization are:

- Mission or charter and bylaws
- Financial and operational goals
- Market and competitive analyses
- Business model
- The target liquidity level
- Debt policy (see Section 10.13)
- Strategies for achieving goals and objectives

No strategic financing plan can answer every question. There is always uncertainty about future business conditions, changes in the competitive environment, government regulations, information technology and other technological advances, and new service delivery techniques. A good plan, however, will include various scenarios, thus adding a degree of flexibility.

The nonprofit organization must develop a strategic financing plan and a debt policy to ensure its long-term financial health. The absence of identifiable shareholders does not relieve your financial manager from operating the organization as a business and strategically planning its financial health. A nonprofit organization exists to serve members of the public, who are its very real, although anonymous, shareholders. Failure to maintain financial health over the long term is the death knell of all organizations, public or private – as the Hull House overuse of debt reminded us in 2012.

**(a) BORROWER'S STRATEGIC FINANCIAL OBJECTIVES.** Answers to these questions will begin the process of identifying your institution's strategic financial objectives:

- How much risk is your management willing to take for various financing alternatives?
- How much interest can your institution afford?
- Does your institution intend to provide collateral to the lender, such as physical assets or your short-term investments or bonds or stock, which the lender could take possession of in the event the loan is not fully repaid?
- Can another party provide a guarantee to secure a loan?

- What type of covenants and restrictions is your management willing to allow?
- How much control does your management want to retain?
- What limitations in other agreements must your institution consider when pledging assets as collateral?

By answering these questions, you can help to clarify the organization's current financial status and to determine the direction in which your management team is moving or wants to move your organization. The answers also help specify financing sources and keep short-term strategy consistent with long-term capital management objectives. The answers also help shape your debt policy (see Section 10.13).

**(b) BORROWING REQUIREMENTS.** A strategic financing plan should evaluate short-term borrowing requirements. Lean periods never can be fully anticipated, so an institution always requires a contingency plan that may include short-term borrowing to tide it over until cash flow resumes. Before a plan can be developed, however, the financial manager must monitor and understand the elements of your organization's cash flow. Cash flow should be forecasted and monitored on monthly, weekly, and daily bases.[14] When studying cash flow, these factors should be considered (refer back to Chapter 8):

- Seasonality of revenues
- Collection periods and timeliness of disbursements
- Regulatory changes and economic trends
- Contingency plans

Seasonality of revenues can have a tremendous impact on your organization's short-term borrowing requirements. By looking at historic seasonal revenue patterns, your financial team can obtain part of the picture needed to plan borrowing strategy. Additionally, you must monitor and measure the lag time between the provision of services and the collection of revenues (whether from donations, grants, or fees charged) as well as predict the amount likely to be collected. Your collection pace on receivables, when slowing, may dictate that the institution arrange a larger credit line to see it through the lean months. By analyzing your organization's cash flow, the financial manager can anticipate this situation and plan accordingly.

## 10.6 STEPS TO SUCCESSFUL BORROWING

Management will be ready to approach potential financing sources after determining strategic objectives and developing a forecast that indicates the amount of money needed, when it must be borrowed, and when it can be repaid. If the need is within the next 12–18 months, the cash forecast will be of paramount importance (see Chapter 8). If the need stretches out from 2 to 30 years, the projected financial statements will be required (see Chapter 9). Before any financial source is approached, however, financial managers must understand:

- Debt and what borrowing involves for the organization
- The loan approval process
- The various short-term borrowing alternatives
- The suitability of financing sources versus strategic objectives
- The preparation and presentation of a loan request

**(a) UNDERSTANDING DEBT.** Debt is a way of life for most consumers and business organizations. It is interesting to note that borrowing and investing are two sides of the same coin. "Capital" can be defined as the resources that an organization needs to attain a financial objective. There are two broad categories of capital: equity and debt. Equity is money belonging to the organization, and debt is money belonging to another person or organization. Borrowed funds carry the borrower's obligation to repay the debt, and lenders furnish money for the sole purpose of earning more money. Our references to the characteristics of equity, or net assets, are to provide a basis for comparison.

***(i) Risk-Reward Trade-Offs.*** Debt capital, in the form of financing received from a lender, generally is priced in terms of an interest rate. A nonprofit founder or donor contributing capital requires an in-kind return, namely service provision in line with the organization's mission – but no interest is charged or other financial return expected.

An important element in the pricing of debt is the relationship between risk and reward: The greater the risk, the greater the reward. The lender or bond investor is willing to risk the possible loss of money in return for monetary rewards. The "junk," or high-yield, bond market that developed during the 1980s illustrates the lender's perspective. An organization that wants to issue long-term bonds but that does not have an investment-grade rating (the top four creditworthiness rating categories, AAA, AA, A, and BBB in Standard and Poor's framework, are considered investment grade) must issue noninvestment-grade bonds and pay a higher return to attract the needed funds than would an investment-grade company. This same relationship holds true when tax-exempt bonds are issued by charities. When managing debt, a financial manager must assess the level of risk that the organization presents to a financing source, the resulting availability of financing, and the cost that the financing will carry. Return to the bond investor or lender represents cost to the borrower.

***(ii) Leverage.*** Leverage is defined as the use of another person's or organization's financial resources. The more leverage (the greater the proportion of debt to equity, or net assets) that an organization has – the greater the risk to the organization and to the lender that the organization will be vulnerable to the impact of external factors. So think of equity, or net assets, as a cushion for the lender or bond investor. The effects of external factors, such as recessions, unemployment, and interest rates, are magnified by leverage, sometimes positively and sometimes negatively.

The amount of leverage that a nonprofit organization can take on without risking future loss of control to the organization's lenders varies. For example, in the nursing home and home healthcare industries, markets must be served; lenders can be instrumental in forcing changes where existing management demonstrates lack of ability. Where the market already is well served, lenders are usually inclined to limit their losses by simply closing down an inefficient or ineffective business. Financial managers can get a good idea of where they stand in the eyes of a lender familiar with the nonprofit industry by studying the financial statements of other nonprofit organizations in similar service arenas. Doing this will also assist financial managers in determining the financial alternatives available. Illustrating, it is much easier to be approved for a short-term loan or credit line if the nonprofit offers collateral such as inventories or receivables in the form of government contract payments (although this might be arguable in some states where government fiscal irresponsibility has severely slowed payments), tuition payments, or grant proceeds. Absent these normal forms of short-term loan collateral, some nonprofits borrow using a personal guarantee from a manager or board member or using the building as collateral. Nonbank sources of loans, including loans from board members, may fill in the gap when bank sources are unavailable.

**(b) LOAN APPROVAL PROCESS.** It is essential that financial managers understand what lenders and bankers consider important in making decisions to provide financing. The decision to lend capital may be partly emotional based on the personalities of the lender and the borrowing organization's officers. Before your financial manager attempts to make a presentation to a lender, he or she should have some idea of the type of personality who will be sitting across the table. Although the stereotype of the banker-lender is not a totally accurate gauge, it does point out some common traits that lenders share. Lenders tend to be conservative, cautious, and pessimistic. They will look at what is wrong with a borrowing proposal and appear to exclude what is right. If a bank makes $100 million of uncollateralized short-term loans at an average interest rate of 5% per year, and only one in 20 (5%) of the borrowers default and do not make payments in the current year, the bank has effectively earned nothing on its loan portfolio for that year.

***(i) Basic Preparation for a Loan Presentation.*** In order to be successful in obtaining financing, a financial manager must distinguish the institution's presentation from all others that lenders evaluate. The financial manager should also try to discern what the lender already emotionally believes about the deal and attempt to reinforce a positive belief and reverse a negative one. To be effective, a financial manager should be aware that lenders, too, think in stereotypes about nonprofit organizations that seek financing. They perceive nonprofit officers who make financial presentations as generally unprepared, hopelessly optimistic, and out of touch with economic reality. When presenting a loan proposal, therefore, the successful financial manager should demonstrate better preparation, greater knowledge about the organization and its financial prospects, and better capability of repayment than any other customer who approaches the lender.

The financial manager can assess the level of preparedness to make a loan proposal by addressing these questions:

- Why would a nonprofit organization borrow money?
- What does a lender want to know immediately?
- How does a lender evaluate a loan proposal?
- How does a borrower generate funds to repay a loan?
- Under what reasonable circumstances would a lender agree to refinance a loan?

None of these questions is particularly easy, but the right answers may very well predict the success of a loan proposal.

***(ii) Reasons for Borrowing.*** The reasons why a person or organization does something are important. Knowing the reasons and, more important, explaining them quickly are crucial when a financial manager must persuade a lender that the nonprofit organization deserves a loan. The three essential reasons for borrowing are to:

1. Buy an asset
2. Pay an expense
3. Make an acquisition

Knowing those reasons, however, is not sufficient. Financial managers also must know how different lenders view these reasons. For instance, leasing firms financing equipment purchases have no interest in funding other investments. Banks are more interested in providing short-term working capital financing for seasonal needs and modest longer-term financing for equipment and construction.

***(iii) Immediate Concerns of Lenders.*** The immediate concerns of a lender are important because they generally dictate the terms and conditions of the loan. These concerns include:

- How much money do you need to borrow?
- How long do you need to keep the money?
- What do you need the money for?
- How do you plan to repay both the principal and the interest?
- What contingency plans do you have in case your intended source of repayment does not work?

The most important of these questions, of course, are the last two, your repayment method and your contingency plan. Above all, your management team must be able to show a lender how the loan will be paid back, in scenarios of both expected conditions and unexpectedly negative circumstances.

***(iv) Evaluating the Application.*** All lending decisions are based on the same classic set of factors known as the "5 Cs of credit":

1. *Character* of management. This measures the willingness to pay.
2. *Capital* available to the organization. This typically is measured as the amount of net assets on the balance sheet.
3. *Capacity* to earn operating cash flow to repay the loan.
4. *Conditions* of the market. This includes the economy, the borrower's industry, and the local client/customer/donor marketplace.
5. *Collateral* that the borrower has available to pledge. For short-term loans, this is typically accounts receivable or inventories, but for many nonprofits, the only receivables that might be acceptable would be those related to grants or contracts.

Of these factors, the two more critical are the character of your management, which may account for as much as 80 percent of a lender's evaluation, and your organization's cash flow. If one of the other factors is inadequate, a borrower can usually obtain the loan, although the source of financing, the approach to obtaining it, and its interest rate may be altered. The borrower will not be able to raise external capital, however, if there are deficiencies in either the character of management or the organization's cash flow.

***(v) How Lenders Are Repaid.*** There are four ways to repay lenders:

1. Use net revenues and cash flow.
2. Borrow more money.
3. Find another lender.
4. Sell existing assets.

Borrowing more to repay a loan is often acceptable, but it can be an expensive proposition. Selling assets also can be acceptable, especially as part of a contingency plan, but the best way to repay a loan is to generate cash flow. *Consequently, a financial manager is wise to keep borrowing plans confined to the capacity of the organization to generate sufficient cash flow to repay the loan within a reasonable period.* Lenders much prefer this method of repayment, even when they tell you they insist on having collateral to back up their loans. They would much rather not have to think about seizing and selling that collateral, especially given the public relations problems that action can cause the lender when foreclosing on a charitable institution. Furthermore, the collateral – such as a church building – may be a "limited use" asset that has questionable market value due to there being few potential buyers.

***(vi) Refinancing.*** Barring a decision to restructure a borrower's total debt, perhaps to save on interest expense due to declining interest rates, a borrower seeks to refinance loans for either of two reasons: The original plan did not work, or the borrower did not use the money for the intended purpose. No lender is sympathetic to a borrower who did not use the money for the purpose stated in the loan proposal. Most lenders, however, understand that not all business plans work as intended. The fact is that most business plans do not work as originally intended, but they do work after they have been modified. Lenders understand that planning is a dynamic process and that flexibility is part of it. Therefore, business plans that did not work as expected are generally considered valid reasons for lending more capital.

**(c) ALTERNATIVE SOURCES OF SHORT-TERM FUNDS.** Before a nonprofit organization commits itself to borrowing money, it should look within. Often there are internal sources of funding that are not immediately apparent. Indeed, one of the objectives of making debt and capital management part of the institution's strategic plan is to identify such internal sources of funds before management seeks funding from outside. Five primary internal financing sources, along with methods to use them, are listed next.

1. Aggressive working capital management (see Chapter 11):
   - Improve collection practices.
   - Extend terms of payables (within terms or with explicit supplier approval).[15]
   - Reduce idle cash (but only modify target liquidity level after careful analysis).
   - Sell unneeded or nonproductive assets.
2. Existing operations:
   - Increase service fees (subject to competitive conditions).
   - Charge for services previously provided free.
   - Increase marketing effort for donations and grants (this takes time).
   - Reduce operating costs.
   - Sell fixed assets unrelated to core mission.[16]
   - Sell and lease back ("monetize") fixed assets related to core mission.
3. Short-term investments:
   - Liquidate securities (see Chapter 12; if balances were part of target liquidity level, quickly replenish those after funding need has been met).
4. Overfunded pension plans:
   - Seek to recapture assets in the plans for the institution's use.
5. Change in business structure or business model:
   - Consider new means of service delivery or greater use of volunteers. Search for those with lower fixed, annual costs.

- Increase investments in technology to achieve cost savings.
- Seek strategic alliance partnerships and joint ventures with other service providers (see Chapter 9).

These internal alternatives will not meet the needs of all organizations. The financial manager is then faced with a long list of creative financing alternatives. Consider, for instance, these financing possibilities for a nursing home or home healthcare agency. It could:

- Obtain a bank loan, either secured by assets (or in a truly desperate situation, we have seen board of directors' personal guarantees as security) or unsecured.
- Sell accounts receivable without recourse. (The nonprofit does not have to stand behind sold accounts that prove to be uncollectible.)
- Sell accounts receivable with recourse.
- Securitize accounts receivable for offering in public or private markets.

The differences among these short-term financing alternatives lie in the source rather than the particular use of the funds, and they are based on the criteria that a lender considers when making a loan decision. There are three basic criteria:

**1.** How much debt capital must be raised?
**2.** How long a term does the borrower need to repay the loan?
**3.** What return will the lender receive for the loan?

## 10.7 MATCHING FINANCIAL SOURCES TO STRATEGIC OBJECTIVES

It is difficult to match the best capital source to the strategic objectives of a nonprofit organization; few financial alternatives provide perfect matches. When attempting to match financial sources to strategic objectives, however, financial managers should:

- List the strategic objectives in the order of their apparent levels of priority.
- Summarize in writing the alternative choices.
- Seek advice from consultants or others who are involved in matching strategic planning and financial sources.
- Consider the decision carefully and preferably without pressure of time.

The first two items listed force your management team to focus on the organization's critical issues, because they involve ranking objectives. By reducing these issues to a one-page summary, you can identify the major financing alternatives. Doing this requires that the major advantages and disadvantages of each alternative be considered. It can be helpful to develop a scoring system to rate financial alternatives, although such a system is only as good as the idea behind it.

The time criterion is also particularly important. Making a final decision a day or a week after completing the list of alternatives is generally a good idea. This provides your financial manager time to reflect on the institution's strategic objectives and whether the alternative choices meet them. All alternatives should be thoroughly evaluated before a decision is made. Yet delay in the name of perfection can be counterproductive. A financial manager can delay a deal so long that interest rates rise before a choice is made. Financial markets also lose interest when they believe that management is only shopping around and is not serious about a deal. It is good to generate competition among financing sources, but not to the point that the borrower is paralyzed and unable to meet its objectives in the most effective manner.

## 10.8 PREPARING THE FINANCING PROPOSAL

After the financial manager has determined what type of financial source is best to meet the institution's particular short-term capital needs, it is time to obtain the financing. The basic tool for this task is the financing proposal package. The financial manager uses this document to present the institution's "story" as well as to anticipate and answer all questions posed by the lender. Of utmost importance in telling that story are the five criteria essential to all lenders, beginning with the character of organization management (see Section 10.6, "Steps to Successful Borrowing").

**(a) TERM SHEET.** One of the most important parts of the proposal is called the "term sheet." In this part of the plan, the financial manager must answer the five basic questions a lender will ask: how much, how long, what for, repayment plan, and contingent repayment plan.

**(b) PLAN OVERVIEW.** A financing proposal must contain a brief overview of the plan. Bankers and other lenders tend to make decisions quickly. Review committees, for instance, generally rely on a subordinate's summary and recommendation when evaluating loan requests. A review committee may spend only two or three minutes looking at what took weeks, even months, for a financial manager to assemble. As a result, when a business plan is turned into a proposal, it must include an "executive summary." This should be the most sparkling part of the package.

The overview must describe the essential nature of the organization's service offerings, list its major services, and characterize its management people. The overview focuses on facts, but the facts should be presented in such a way that a potential investor – that is, after all, what a lender is – gets a positive emotional feeling about the institution.

**(c) PRESENTATION CONTENTS.** The overview can be supplemented with marketing brochures, testimonials, and perhaps even a video presentation to enhance the written word. A full set of financial statements for three years is essential. The financial statements will be used to evaluate the risk of the proposed loan and determine the terms and conditions of any financing deal. The statements should be supplemented with explanations wherever appropriate. For example, the statements of some nonprofits contain quirks that may confuse a lender unless they are explained. When dealing with a lender who is basically unfamiliar with the healthcare field, for example, some explanation of reimbursement methods and the handling of unreimbursed charges is desirable so the lender can understand the inevitable write-offs of receivables. This explanation should extend to both the balance sheet and the statement of activities.

Nonprofit business plans also need to cover the basics of an organization's operations: Delivery of service, marketing, and accounting/finance. The plan should show how the desired financing will enhance these areas. However, the projections should be realistic. Lenders often believe that a borrower is hopelessly optimistic, and aggressive revenue projections will make them even more skeptical. In fact, it is always better for management's position if actual operating results turn out to be higher than anticipated by the projections, rather than using forecast figures that are too rosy. If management really does believe that revenues will grow by 200 percent over five years, however, then substantiating information should be included in the plan along with documentation showing why the projections are realistic. Detail is crucial in a business plan. Any error in calculations, for instance, can threaten a plan's credibility; it gives the impression of sloppy management.

## 10.9 MAKING THE PRESENTATION

Even more important than a detailed business plan is the ability to communicate it with confidence and forcefulness to potential lenders. Your financial manager and board treasurer may not think of themselves as salespersons, but that is exactly what they are when they represent the institution that requires financing. They must sell the entire organization, its operations and service delivery processes, plans, and creditworthiness. Having the would-be borrower ask questions during the presentation is an excellent technique as it focuses the presentation on the needs of the audience, the potential lender. A pointed presentation is important, because it shows that the organization has thought out its financing needs. This distinguishes it from other organizations competing for the same scarce financing dollars.

**(a) IMPORTANCE OF QUESTIONS.** Questions can be the most effective tool for your financial manager in preparing and making the presentation. They provide valuable information and allow the financial manager to focus the presentation. Close scrutiny is avoided until the financial manager has all the necessary information to test assumptions regarding the audience, confirm suspicions, and figure out what the lender considers important, before making the actual request for financing. Consequently, the financial manager is better able to handle objections. It is surprising how good questions will keep the mood relaxed and the conversation flowing.

Financial managers should not feel inadequate when they ask about the lending and loan approval process. Each lender does things a little differently. A financial manager should also ask for a copy of the financial analysis the lender performed on the institution. The analysis can provide valuable information the next time financing must be sought. Asking questions about the process will also show that the borrower is more sophisticated and thus a better credit risk.

**(b) ANSWERING OBJECTIONS.** No matter how controlled and tightly organized the presentation may be, objections will arise and the financial manager will have to answer the lender's questions. Further questions by the borrower can be excellent answers to lender questions. For instance, if the lender's major objection focuses on collateral, the financial manager might ask, "Isn't it the case in bankruptcy that legal fees cause liabilities to increase while the value of collateral generally decreases?" The financial manager might further ask, "Doesn't the organization's real value lie in its ability to generate cash flow rather than its present holdings of assets?" (It does.) And "In a bad loan situation, does the amount of collateral really make much of a difference?" Almost any objection can be handled by turning it around with a simple question. By understanding the motive of the lender in making an objection, the financial manager can gauge what response will be most appropriate.

The importance of questions does not end with the presentation and objections. Questions are even more important when a loan has been turned down; they may even be able to salvage a rejection or make it easier to obtain financing from the same source the next time around. Potential questions should be designed to discover why the proposal was declined, where such financing could be obtained, what would make this financing more attractive, and how the lender who turned down the proposal would respond to inquiries from other lenders. As with the other questions, this information can provide feedback that will help in the next presentation.

**(c) PERSONALIZING THE PRESENTATION.** Finally, anything that will personalize the presentation will usually work to a borrower's benefit. It is also helpful for the financial manager to invite a representative of the potential lender to tour the nonprofit institution's facilities before the presentation. This will get the lender more emotionally involved with the institution and more concerned about its future success. It also provides a more personal and relaxed atmosphere to make initial contact with a lender. The key to obtaining a loan is to connect emotionally with the lender, to persuade the lender that the institution's success is the lender's success as well.

## 10.10 OTHER FACTORS IN BORROWING/LENDING DECISIONS

Borrowing and lending decisions would be easy if the loan criteria just listed were as straightforward as they sound. A financial manager would then choose the alternative that raises the most capital at the least cost over the longest term. Unfortunately, however, one alternative generally raises the most funds, while another has the longest term, and yet a third costs the least. The lender's decisions also would be more mechanical if each element to be considered were based merely on its own merits. Intangible factors, however, often complicate borrowing and lending decisions. These factors include a number of questions involved in loan evaluation:

- Is the transaction flexible enough to be structured to meet the organization's financial needs?
- Does the borrower have confidence that the lender will be able to complete the transaction?
- Can the deal be documented and negotiated within the borrower's time frame?
- How complex is the legal documentation?
- Can the borrower afford the front-end fees associated with the transaction?
- Will the borrower be able to cancel the deal if circumstances dictate, and how much will it cost to do so?
- What requirements does the lender have for credit support?

**(a) BORROWING FROM THE BANK.** Nonprofits borrow short term for seasonal working capital, to cover abrupt changes in payment patterns or unexpected expenses, and when net revenue is not adequate to support continued operations. Banks traditionally have provided most of the short-term and medium-term loans for nonprofits.

About half of short-term bank loans are unsecured (usually in the form of a line of credit), and the others are secured (where collateral is required to ensure an adequate secondary source of repayment; these may be single-payment loans for lines of credit). Like small businesses, nonprofits have found bank lending officers more favorable when a long-standing relationship is in place, as the bank's comfort level with the character of the borrower and likely sources of repayment will be higher.

The following survey of bank credit and credit-related services notes the major domestic and international services offered, and concludes by talking about some lending trends.

***(i) Domestic Short-Term Bank Loans.*** Bank lending alternatives are best described in terms of their maturities, or how long they allow borrowers to use the money. The shortest-term lending generally takes the form of a *line of credit*, which allows the organization to borrow up to a prearranged dollar amount during the one-year term. The maximum amount may be capped as some percent of your accounts receivables or of your grant commitments. Credit lines may be established on an uncommitted or committed basis, and they sometimes have the added feature of overdraft protection. They are typical "revolving," allowing your organization to borrow, pay down, borrow some more, and pay down as it chooses during the year. Examples of when credit lines are especially valuable include eras when states or other funders are slow to pay their obligations. In 2015, numerous banks saw increased applications and/or drawdowns of credit lines by nonprofits when states such as Pennsylvania had budgetary impasses. Almost 60% of 280 nonprofits in Pennsylvania tapped existing credit lines and 42% of nonprofits said they were unable to get an additional credit line (United Way of Pennsylvania).[17] The YWCA tapped a $1.1 million credit line to get the organization through the next three months, along with freezing hiring other than emergency hires.

An *uncommitted line of credit* is technically not binding on the bank, although it is almost always honored.[18] Uncommitted lines are usually renewable annually if both parties are agreeable. These informal arrangements are appealing to organizations that only rarely need to draw down the credit line, maintain a consistently strong financial position, and like the fact that uncommitted credit lines do not normally require a fee to be paid on unused balances. The only charges are interest on amounts borrowed. Banks like the flexibility offered by such arrangements, which free them from providing funds in the event of deterioration by the borrower or due to capital restrictions being imposed on the bank by federal regulators. Some banks will charge a nominal fee for making the funds available. Example: A 15-year old human services nonprofit in the Midwest has $2 million in assets and almost that much in revenues. It obtained a $100,000 credit line with a bank, with collateral being all assets of the organization and an interest rate of "Prime plus 0.75%."[19] It has not drawn on the amount at this point, but keeps the line available as part of its target liquidity (ALT). It is charged $150 per year for the line (plus interest, on a daily basis, if it draws down any amount of the line).

A *committed line of credit* is a formal, written agreement contractually binding the bank to provide the funds when requested. Committed lines usually involve commitment fees of up to 1 percent of unused balances. Whether uncommitted or committed, an *overdraft credit line* has the added feature of being automatically drawn down whenever the organization writes a check for which it does not have sufficient funds. The treasurer is thereby delegating to the bank the need to carefully monitor disbursement account balances and to fund it when necessary. We caution that both uncommitted and committed lines are less than completely reliable as funding sources, as banks can determine not to fund under a line due to a "material adverse change" in your organization's financial health.

A noteworthy trend regarding credit lines is the rapid growth of the *standby letter of credit*, which guarantees that the bank will make funds available if the organization cannot or does not wish to meet a major financial obligation, such as a very large purchase.

The second type of bank financing is intermediate term. The two major forms of intermediate-term bank financing are revolving credit agreements and term loans. A *revolving credit agreement*, or "revolver," allows the borrower to continually borrow and repay amounts up to an agreed-upon limit. The agreement is annually renewable at a variable interest rate during an interim period of anywhere from one to five years. At the end of the interim period, the agreement generally is converted to a term loan for a period of years. The key advantage to the borrower is assured credit availability for the life of the agreement, regardless of overall economic conditions and credit availability. Like on a committed credit line, the bank will charge a commitment fee on unused amounts of revolvers, along with interest on drawn-down amounts. Revolving credit agreements are usually unsecured.

A *term loan* is simply a loan made with an initial maturity of more than one year. Maturities for bank-originated term loans range from over 1 year to 10 years. Like revolving credit agreements, they involve an extensive written loan agreement and an in-depth "due diligence" analysis of the organization's management and financial position. Term loans are generally repaid in equal monthly or quarterly payments and may be fixed or variable rate. Nonprofit organizations use term loans to replace other loans or to finance ongoing investments in working capital, equipment, and machinery. The main advantage is that they provide a stable source of funds.

Some secured bank loans are a form of *asset-based lending*. Like any collateralized lending, such lending has a claim on an asset or group of assets, ordinarily receivables or inventory that could be easily sold if the borrower defaults on the loan. The difference is that while most conventional lending relies on the cash flows from the overall business for repayment, asset-based loans are offered based on anticipated cash flows arising from the sale or conversion of a specific asset or group of assets, such as inventories. These loans are especially attractive to small, growing organizations that may only qualify for this form of borrowing and whose management is willing to pay the higher interest rate necessary to compensate the bank for continuous monitoring of the asset serving as collateral.

One final borrowing-related service that many banks offer is a *swap*. In its simplest form, an organization engaging in a swap exchanges a fixed interest rate obligation for one that has a variable, or floating, interest rate. Nonprofit organizations that qualify for a lower variable rate spread (the amount of extra interest the organization must pay over and above the bank's cost of funds is lower on variable rate loans than on fixed rate loans, or perhaps the bank does not wish to make a fixed rate loan) might enter into a variable to fixed rate swap to eliminate the risk of rising interest rates and the resulting higher monthly payments. Banks usually serve as the opposite side on the swap, called the *counterparty*, but they may later find another counterparty that wants to make the opposite exchange.

***(ii) International Short-Term Bank Loans.*** The nonprofit organization operating in multiple countries must consider a more complex set of bank lending services because operating abroad introduces the treasurer to different economic and banking regulations, the uncertainty about how exchange rates will change in the future, and new customs and cultures. US-headquartered banks provide a valuable service simply by introducing the treasurer to foreign banking officers and to the different payment systems that will be encountered. In addition, three major lending services are offered internationally:

1. Documentary credit
2. Asset-based lending
3. Traditional forms of bank lending

Banks doing business abroad, whether US or foreign banks, offer various forms of *documentary credit*, including sight and time drafts, bankers' acceptances, and letters of credit. The *sight draft* is a formal, written agreement whereby an importer (drawee) contracts to pay a certain amount on demand ("at sight") to the exporter. The bank is not extending credit but simply helping in the payment process by receiving the draft and presenting it to the drawee. A *time draft* does involve a credit element, because the payment obligation agreed to by the drawee is designated as due at a specified future date. A *bankers' acceptance* is a time draft drawn on the buyer, whose bank agrees to pay (accepts) the amount if the buyer does not. In essence, the bank's creditworthiness is exchanged for the buyer's, and there is an active secondary market where these acceptances are traded. The bank charges the buyer a fee for this service. Related to this, a *short-term acceptance facility* allows the selling firm to initiate drafts (bills of exchange) against the buyer's bank instead of against the buyer, which can be discounted at the bank.[20] This facilitates foreign trade, but in the United States and United Kingdom it also is used to finance working capital needed to conduct domestic trade. A *commercial letter of credit* is a guarantee of payment by an importer, made by its bank, which becomes binding when the shipping and other documents related to the goods sold are presented to the bank. Exporters appreciate the bank guarantees involved in acceptances and letters of credit due to the lack of information about foreign customers, as well as the shifting of the complexities and costs that might be involved in collecting on unpaid accounts. Note that most letters of credit used in international business are unconditional, differing from the standby letters of credit we discussed earlier.

Banks increasingly are getting involved in international asset-based lending. As with domestic asset-based lending, lending is done mainly by banks and commercial finance companies, with the collateral and source of the cash flows counted on for debt service usually being inventories or accounts receivable. Asset-based lending has been utilized in the United States for some time, and with the growing unification of European economies, most observers anticipate asset-based lending to expand rapidly in Europe. Banks based in the United States hope to capture a large share of the European secured lending volume.

There also are several traditional forms of bank lending abroad. Nonprofit organizations are offered *overdraft services* that are renegotiable each year, may be secured, and are generally based on some percent above the bank's base rate. For example, a strong organization might be charged 1 percent above the base rate, which is often the London Interbank Offered Rate, or LIBOR. Whether the bank uses LIBOR or not, the base rate is reflective of that bank's cost of funds. Organizations are prohibited by law from overdrafting demand deposit accounts in the United States, although banks have permitted intraday ("daylight") overdrafting (debits to a checking account when it is known that offsetting credits will come later that day).

Another standard lending service seen abroad is an *advised line*, which is very similar to a credit line in the United States. This involves unsecured lending of up to one year in maturity, available on short notice to the borrower. The rate is somewhat less than would be the case for overdraft services, but is still calculated from the base rate.

The foreign parallel to the term loan is called a *committed facility*. The bank charges a fee to compensate it for agreeing to lend upon request for a period of five to seven years. Loan terms and conditions, including whether the funds made available will be in the home currency or some other currency, and the formula for calculating the interest rate, are described in a written agreement.

Our discussion of international bank services up to this point fits the major industrial economies of the world but not developing countries. Recent survey evidence suggests that most undeveloped countries do not yet have connections to the major global cable and payment settlement mechanisms, making it almost impossible for nonprofit organizations operating in those countries to tap international financial lending sources for domestic borrowing.

**(b) TRENDS IN SHORT-TERM LENDING.** More and more banks are going after smaller businesses and nonprofit organizations as part of their client base. For example, Wells Fargo offers small businesses a credit card that acts as a committed line of credit.[21] As a general rule, your chances of getting a short-term loan are higher if you approach a smaller bank in your local market.

Banks' reliance on asset-based lending, term loans, and revolving credit agreements (especially to smaller businesses) has grown largely because of the lack of competition from the commercial paper and loan participation markets. The extent of nonbank penetration into lending is illustrated by the fact that total debt held outside the banking industry is at least equal to that held by banks. Finally, globalization is occurring in lending services.

## 10.11 MUNICIPAL AND TAXABLE BONDS

**(a) MUNICIPAL BONDS.** Nonprofits looking to borrow large amounts of money for 20 to 30 years find it advantageous to issue taxable or tax-exempt bonds. Taxable bonds, like bonds issued by businesses, have investors' interest income taxed as ordinary income for federal income tax purposes to those investors (unless the investors happen to be tax-exempt). However, the interest may be exempt from state and/or local income tax and the issuing governmental entity may also offer other incentives to the nonprofit borrower.[22] Some nonprofit issuers are not eligible to issue tax-exempt bonds, so must issue taxable bonds. When tax-exempt, the interest paid to investors is exempt from federal income taxation and may also be tax-exempt for state or local income tax purposes if the investor lives in the issuer's state. Most municipals, or munis, as they are called, are tax-exempt. Because of the tax-exempt feature, the yields on munis are lower than those on comparably rated (equally risky) taxable securities. Much of the issuance goes to pay for building refurbishment or new construction to keep the institution competitive from a physical facilities standpoint. Many college issuers would rather leave investment funds in their endowments, gaining interest and building larger principal amounts, instead of spending these monies on buildings. Because of their lower interest rates, nonprofits normally have a governmental entity sell these "tax-exempt" bonds (which are also issued by governmental entities for their own funding purposes). These so-called "501c3" or "conduit bonds" are rarely backed by a governmental entity with respect to the interest payments and principal repayments but rather rely on the cash flows (revenues) of the underlying issuer for payment of interest and principal. The issuer may have "credit enhancement" through a bank-issued letter of credit, assuring timely payment of interest and/or principal if the issuer's revenues fall short. A city, state, or city- or state-related instrumentality/agency (the "conduit issuer") issue or sell securities on behalf of nonprofit borrowers such as nonprofit colleges or healthcare organizations. (This is not always required, but before it issues the bond the nonprofit may request and receive an inducement resolution and agreement from the Issuer, indicating that the issuer agrees to sell bonds for the project that will be funded.[23]) As the underlying "conduit" borrower, your organization is funding a building or project and typically agrees to repay the governmental issuer, which in turn pays the interest and principal to the bonds' investors. Those payments are sourced from and predicated on the proceeds from earned revenue that you, as the conduit borrower, pay to the governmental entity solely from the "revenue" provided by your organization as the borrower.[24] As an example, Samford University in Birmingham, AL, issued $46.64 million of "educational facilities revenue bonds" (tax-exempt municipal bonds) through the Educational Building Authority of the City of Homewood (AL). Life University, in Marietta, GA, issued both tax-exempt bonds ($89 million) and taxable bonds ($10.3 million) through the Development Authority of the City of Marietta (Georgia) University Facilities Revenue and Refunding Bonds program.

Fitch Ratings has studied defaults of municipal bonds and found that management practices were more important for predicting credit performance than had been thought in the past. The three most important management practices identified that led to stronger credit and lower defaults were:

1. Superior disclosure
2. Maintaining rainy day funds or operating reserves
3. Implementing debt affordability reviews and policies[25]

We once again strongly reemphasize for your consideration the establishment of target liquidity, the second item, and of a debt policy, the third item. Also, we caution reliance on "new and improved" funding methods. Auction-rate securities, all the rage in 2008, disappeared from the scene when several auctions (in which investors tried to sell their securities) failed.[26] More conventional is to tap the debt markets through the issuance of municipal bonds, our next topic.

***(i) Selection of an Underwriting Firm.*** Because of the limited choice available, a nonprofit organization must be particularly careful in its selection of a capable and experienced underwriting firm. The nonprofit financial manager must first determine that the underwriting firm plans to continue in the municipal bond business for at least a sufficient period of time to market the bond issue. A firm that knows its bond operations will be terminating soon is simply interested in getting the issue sold as quickly as possible without the attention necessary to present it in the market in a proper and competitive fashion, and make a market (buy and sell the bonds) in the bond issue until it becomes seasoned.

If the bond issue is a floating rate, put-option bond (investors can cash out by "putting" the bond back to the issuer) and the investor has the right to redeem it for the return of principal on a one-day or one-week notice, what is known as a "remarketing agent" is required. This agent provides the vital function of accepting bonds tendered, or put, by investors and immediately finding other investors to purchase the bonds. A continuing underwriting responsibility exists to accommodate both investors and the borrower, whose interest it is to see that the issue continually remains in the hands of investors. The remarketing responsibility is usually assumed quickly and efficiently by other institutions.

Although most issues, once sold, do not trade actively in the secondary market, it is important to the nonprofit organization that its bonds receive reasonable secondary market activity, particularly if it expects to sell bond issues in the future. The institution does not want to lose potential investors because they had purchased its previous bonds and had been unable to sell them due to a weak or, worse yet, "no-bid" situation.

After a municipal bond issue has been sold, securities dealers frequently buy the bonds from investors who sell them before maturity to sell them to investors who are looking for secondary (or already-issued) bonds. It is important to maintain a relatively stable market price for the bond issue after its initial sale to the public. Therefore, the underwriting firm or group of firms that brought the issue to the public market should continue to participate actively in buying and selling the bonds in the secondary or resale market.

***(ii) Preparation of Bond Documents.*** After selecting a bond underwriter and other professionals necessary to complete the financing task, including bond counsel, the actual indenture or disclosure statement is one of several documents that must be prepared. Of particular importance is the segment of the borrowing indenture that lists the instruments considered acceptable for investment of the bond issue proceeds prior to their disbursement or ultimate use. In the case of rated nursing home and educational facility debt, the credit rating agencies, such as Moody's Investors Service, Standard & Poor's (S&P), and Fitch Ratings, have their own rating criteria that include specific information about the instruments in which bond proceeds may be invested. However, very often the bond counsel for the underwriters uses a file form for the compilation of indenture clauses, including one listing acceptable investments. This file is often outdated and inappropriate for the listing of acceptable investment instruments.

It is very important for the nonprofit financial manager to submit to the underwriter a list of investments that the nonprofit institution considers safe and appropriate. The list should be broad enough in scope to meet the bond's indenture requirements. Typical instruments that can be listed are US Treasury securities, government agency securities, certificates of deposit and banker's acceptances issued by major creditworthy banks, commercial paper, and other corporate obligations rated in one of the top rating categories by the nationally recognized credit rating agencies. If others involved in the borrowing process disagree with this list, they should make it known, so that the list can be negotiated to one that is acceptable to all parties. However, the financial manager, after researching the appropriate investments to be included, should initiate a list of acceptable investments and not wait until the indenture is essentially complete before submitting it to the underwriter.

Another area of concern with respect to the process of investing bond proceeds is the specific approach of actually implementing these investments within the approved list of instruments included in the indenture. In considering the question of investing the proceeds from a bond issue pending their final disbursement, it is important to recognize the arbitrage provisions of the tax code. Briefly stated, these provisions will not allow the borrowing institution to benefit from any profit received on the investment of funds from a bond issue. Specifically, if the interest earned on the funds from a bond issue exceeds the cost of the interest on the money borrowed by the bond issue, that excess must be returned to the federal government. You will want to get competent legal counsel to help on this issue, as it is not our intent to offer legal advice on this very technical topic. At the time of this writing, Legal Information Institute (Cornell University) and the IRS provide the following information regarding tax code arbitrage provisions:[27]

> Under [26 CFR 1.] section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. The investment of proceeds in higher yielding investments, however, during a temporary period … as part of a reasonably required reserve or replacement fund … or as part of a minor portion … does not cause the bonds of the issue to be arbitrage bonds.

The rules for calculating the rebate interest amount are complex, as shown in Exhibit 10.3 below:[28]

Certain arbitrage rebate restrictions are waived if the amount of the bond issue proceeds is substantially spent down within two years for construction project bond issues (state and local governments and qualified 501(c)(3) organizations). Again, the intent of the provisions is to discourage entities from borrowing at a low interest cost through the sale of municipal bonds and investing the proceeds at a higher return, if the primary goal is to capture a profit from the privilege of being able to use municipal bonds as a borrowing vehicle.[29]

On a computation date, if the issuer determines that it owes rebate, it files a Form 8038-T, *Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate*, with the IRS and pays the required rebate amount generally within 60 days of the computation date. For computation dates other than the final computation date, the issuer must pay at least 90 percent of the rebate owed, taking into account previous rebate payments. The final payment for the final computation date must be 100 percent of the rebate amount less previous payments.

**COMPUTATION OF REBATE AMOUNTS**

The rebate payment is based on the "rebate amount" on the computation date. The rebate amount reflects the investment yield earned on nonpurpose investments in excess of the amount these would have earned if invested at the bond yield. Because payments for, and receipts on, an investment can happen at different times, an issuer must future value the receipts and payments to a single date in making a rebate computation. The rebate amount as of each computation date reflects a snapshot of actual and allowable investment earnings as of those computation dates over the life of the bonds. The past receipts on, and payments for, the investments are future valued at the bond yield to give their value as of the computation date, using the same compounding interval and financial conventions used to compute the yield on the issue. The rebate amount is the amount by which the value of all the receipts exceeds the value of all the payments on the computation date.[1] The rebate payment is determined by reducing the rebate amount by any previous rebate the issuer paid, which is also future valued to that computation date. Amounts the issuer pays as yield reduction payments on nonpurpose investments are treated as payments for the investment that are considered in computing rebate. Other payments that are considered in computing the rebate amount include:

- amounts paid to acquire a nonpurpose investment;
- the value of a previously acquired investment that becomes allocated to an issue; and
- a computation credit on the last day of each bond year during which there are nonpurpose investments subject to the rebate requirements and on the final maturity date.[2]

Receipts include:

- amounts received from a nonpurpose investment, such as earnings and return of principal;
- the value of a nonpurpose investment that is no longer allocated to an issue, or is no longer subject to the rebate requirement, before its disposition or redemption date; and
- the value of a nonpurpose investment held at the end of a computation period.

[1] Regulations Section 1.148-3(b).

[2] Regulations Section 1.148-3(d)(1)(iv) and Regulations Section 1.148-3(d)(4). These regulations provide a computation credit of $1,400 for bond years ending in 2007, with annual adjustments for inflation thereafter, for bonds sold on or after October 17, 2016. An issuer may also apply these regulations to bonds sold before October 17, 2016, with the increased computation credit applying to bond years ending on or after July 18, 2016. A similar credit is available for bond years ending on or after September 26, 2007, under proposed regulations issued in 2007. REG-106143-07, 72 FR 54606, 54611, 2007-43 IRB 861, 887.

*Source: IRS, Complying with Arbitrage Requirements: A Guide for Issuers of Tax-Exempt Bonds,* n.d., IRS: 16. From Publication 5271 (4-2017) Catalog Number 69338P Department of the Treasury Internal Revenue Service www.irs.gov. Available at https://www.irs.gov/pub/irs-pdf/p5271.pdf. Used by permission.

**Exhibit 10.3** Calculating Your Municipal Bond Rebate Interest Amount

Most municipal bond issues are subject to these arbitrage provisions of the tax code. Put simply, arbitrage refers to borrowing at a relatively low interest rate and then investing the proceeds in a higher-rate investment security. It is obvious that an issuing organization will not benefit from any interest earned that is in excess of interest cost unless interest rates fall sharply during the five-year period during which the yield is averaged. This situation certainly will not provide an incentive to earn maximum interest on the proceeds of the bond issue until such time as the funds are finally disbursed. Therefore, it is important that under no circumstances should aggressive investment techniques be used or higher risks taken simply to earn additional interest income. It takes a substantial amount of additional interest income to equal principal lost through unwise investment of bond proceeds.

These limitations on earned interest are referred to as "permitted yield." Although they provide no incentive to earn yield in excess of interest cost, there are other situations that must be considered. The borrowing organization may find itself in a low-interest-rate environment and need to be a competitive investor simply to earn the level of return to equal the cost of money borrowed. In this situation, it is extremely important that you take investment yields seriously to minimize the interest cost incurred on municipal bond borrowing.

Whatever interest conditions prevail at the time the municipal bond issue is brought to market, it is important to be a prudent and efficient investor. There are many alternatives available for the investment of proceeds from the bond issue. In examining these alternatives, your management team should be aware of your organization's needs, not only with respect to arbitrage provisions but also as to internal management capabilities, proper compliance with indenture investment limitations, and sound overall financial practices.

***(iii) Municipal Bond Issuers and Purposes.*** Increasingly, private colleges and schools, nonprofit associations, and even some religious organizations are issuing taxable municipals or tax-exempt municipal bonds. Federal Reserve statistics document over $2 trillion in municipal bonds outstanding, issued by over 60,000 governmental and nonprofit entities. The percentage of nonprofits having tax-exempt bonds outstanding is fairly small – we will cite evidence of the issuance in the "Liability Management in Practice" section later in the chapter. One estimate of the amount of church bonds issued annually is $1 billion, as compared with total church financing of $20 billion to $40 billion annually.[30]

Let's illustrate how your organization can use tax-exempt bonds. In a three-year period, four private nonprofit organizations issued tax-exempt bonds in central Indiana. These were issued through a conduit issuer. Here are some features of those bonds:

- Pleasant Run Children's Home issued bonds "induced" by the city of Indianapolis – meaning that they were issued in the name of Indianapolis but were not a direct obligation of the city. These bonds were 7-day variable rate bonds, or "low floaters" as they are called, and paid between 3.75 percent and 4.25 percent during their first year in the market. The bonds were used to raise funds for facilities. The organization's foundation guaranteed payment on the bonds, and the issue was backed by a letter of credit from Fifth Third Bank of Central Indiana. For a fee of just over 1 percent of the amount of the issue, the bank stands ready to make interest payments or principal repayment if the issuer cannot.
- Archdiocese of Indianapolis issued $48 million in bonds to finance facilities and construction of private schools and cemeteries. The archdiocese did not need a letter of credit and took 18 months to close the deal from start to finish. This issue was the first of its kind in the United States.

- Lutheran Child & Family Services issued bonds to finance a treatment facility for children, also structured as a seven-day low floater, with a letter of credit backing the issue.
- Goodwill Industries issued bonds to pay for construction costs for new thrift stores, instead of getting a 10- or 15-year commercial mortgage on each new store that it opened. The $8.5 million issue refinanced existing mortgages and funded several new retail stores. Again, this issue was backed by a bank letter of credit.

To get these issues induced by the municipality, discussions and presentations were held with the mayor's office and appropriate city offices.

**(b) TAXABLE BONDS.** Many bonds issued by nonprofit organizations are not tax exempt in that the bond investor must pay income tax on the interest received. Church bonds, bonds issued to pay for private schools, and nursing home bonds illustrate the taxable bonds issued by nonprofits. The flexibility of the investment banker structuring the borrowing allows these to be used for bridge financing, working capital loans, or construction. Sometimes the state or city in which the nonprofit operates can lend its tax-exempt status to allow what would normally be a fully taxable bond to be issued as a tax-exempt bond, as noted earlier.

***(i) How Can My Organization Use Taxable Bonds?*** Let's illustrate the use of taxable bonds. BC Ziegler and Company (Milwaukee, WI) is an investment banker that assists many healthcare, retirement, educational, and religious organizations that may not be able to issue tax-exempt bonds.

Ziegler arranges the public sale and distribution of first mortgage bonds, which are secured by a mortgage on the property. These bonds are certificates of indebtedness issued by churches, private schools, and other nonprofit organizations to provide funds for acquisition of property, building expansion, and debt retirement.

For example, Ziegler served as underwriter for Truth Tabernacle of Bakersfield's $1.8 million issue of long-term bonds. Proceeds were used for two purposes: (1) refinancing the existing loan; and (2) funding two other small construction projects. The principal pay-down schedule, or amortization, on the bonds was matched up to the existing bank loan's then-current amortization schedule, and the interest rate on the bonds was comparable to the bank loan. The church's finance team was concerned about interest rate increases, and the bonds offered a long-term, fixed-rate. The bond issue was set up to be "fully amortized," which means it would not have to be renewed nor would there be any balloon payments due prior to or at maturity. Finally, the bonds could be repaid by the church early with no prepayment penalty.[31]

Many of the organizations issuing bonds through Ziegler do so because financing from banks was not available or not available at acceptable terms (interest rate, down payment, or maturity). For churches, many of the bond investors are members or friends of the borrowing organization. The bond issue is normally structured so that some of the bonds mature each six months, with the final set maturing in 15 years (some extend to 30 years). The bonds are taxable, meaning that investors will have to pay tax at the ordinary income tax rate on interest received. Bonds are usually sold in a minimum amount of $5,000 and then in incremental amounts in $1,000 denominations, or in a minimum amount of $2,000 for IRAs. Most of the bonds are not rated by one of the credit rating agencies, because of their size: Most church-bond issue amounts range from $1 million to $5 million, with around $25 million being a maximum amount. Since 1980 Ziegler Investment Bank's "adjusted net default rate on religious lending projects remains at a sub-1% level, even after accounting for the tough environment in the post-2008 world."[32] Ziegler applies the following analytical criteria to evaluate a would-be issuer:

- The church's historic revenue base
- The church's prospects for growth
- Strength of the church/school management
- Number of members
- Value of the assets pledged to secure the proposed bonds
- Analysis of any school operations[33]

***(ii) Can I Also Get Short-Term Financing Through Taxable Bonds?*** Although banks are the primary lenders for short-term funding needs, if a need is construction-related you might use an underwriting organization to help you raise the funds via a bond issue. Let's say you need some money up front to build part of a project. You might do a 36-month revenue bond if your long-term financial track record shows you are reliable in paying your bills on a timely basis. In evaluating your suitability for issuing such bonds, the investment banker will look at:

- Purpose – what you want the money for
- Timing – how soon you need the money
- Insufficiency of other sources – why you need bond financing

**(c) WHAT QUALIFIES MY ORGANIZATION TO ISSUE BONDS?** Investment bankers will look for these facts on mortgage bonds:

- Borrowing amount not to exceed 3.5 times annual gross revenues
- Projected cash flows showing enough excess cash inflow to make interest payments and principal repayment (or a realignment of cash uses to free up necessary cash flows)
- The total amount financed not to exceed 70 or 75 percent of the property's appraised value

Credit checks will also be performed on the borrower's chief administrators, and the investment banker will look for evidence that the organization will stand behind the bonds, even if the administrators depart.

Organizations that have defaulted on their bonds are characterized as lacking in understanding about what they are getting in to and/or resolve about debt repayment.

Interest payments cannot be "laid off" like employees when times get tough. Furthermore, the organization will lose the property if it does not make debt payments. Out of this understanding, and based on members' integrity, should come the resolve to stay current on debt repayment.

**(d) WHAT IF MY ORGANIZATION IS NOT PERCEIVED AS CREDITWORTHY?** When your organization does not have the creditworthiness to receive a high credit rating, what can you do to still issue a bond? Consider credit enhancement, including bond insurance, a bank letter of credit, or a third-party guarantee:

- **Credit Enhancement:** is the use of the credit of an entity other than the issuer to provide additional security in a bond. The term is usually used in the context of bond insurance, bank letters of credit state school guarantees and credit programs of federal and state governments and federal agencies but also may apply more broadly to the use of any form of guaranty, secondary source of payment or similar additional credit-improving instruments.
- **Bond Insurance:** is a guaranty by a bond insurer of the payment of principal and interest on municipal bonds as they become due should the issuer fail to make required payments. Bond insurance typically is acquired in conjunction with a new issue of municipal securities, although insurance also is available for outstanding bonds traded in the secondary market.
- **Letter of Credit:** a commitment, usually made by a commercial bank, to honor demands for payment of a debt upon compliance with conditions and/or the occurrence of certain events specified under the terms of the commitment. In municipal financings, bank letters of credit are sometimes used as additional sources of security with the bank issuing the letter of credit committing to pay on the bonds in the event the issuer is unable to do so.[34]

The majority of municipals are credit-enhanced, and most of that enhancement comes through bond insurance; about half of all new munis are insured. We see many nonprofits, however, using bank letters of credit to provide enhancement. Be open to many avenues for a guarantee. For example, a church may be able to get a guarantee from the state or national denominational headquarters.

## 10.12 LEASING AND NONTRADITIONAL FINANCING SOURCES

A broad definition of leasing is the use of equipment for money.

**(a) THE LEASING PROCESS.** The process you would follow to get equipment or vehicle lease financing from a lease finance company includes these seven steps:

1. Fill out a lease application and mail or fax it to the lease financing company (lessor).
2. Within 24 hours, the lessor will accept or deny the application.
3. Lease documents are prepared (assuming your application was accepted).
4. Documents are then properly executed by your organization (lessee), and equipment or vehicle is acquired.
5. You return the documents, along with the equipment or vehicle invoice, to lessor.
6. You are contacted by lessor via phone to provide verbal acceptance (which authenticates the mailed documents).
7. Lessor pays vendor within 24 hours.

**(b) LEASING VERSUS BORROWING.** There are several advantages to using lease financing, several of which result from the fact that you are not buying the equipment or vehicles as you would under a loan arrangement:

- You may get longer-term and, therefore, lower-monthly-cost financing due to the two- to five-year lease terms (or seven years on certain equipment), possibly longer than what a bank would allow.

- You may get almost 100 percent financing, as opposed to 20 percent down or a compensating balance requirement when using bank financing.
- When squeezed for liquidity, you will appreciate having both your cash and your machines or vehicles for use, as opposed to outright purchase of the items.
- Capital project restrictions on outright purchases (whether using cash or bank borrowing), perhaps due to delays in getting a capital campaign off the ground, will not impede critical purchases that can be made with lease financing.
- It protects your organization against owning computers or other equipment that rapidly become obsolete.
- You may gain flexibility, both on the lease terms and on what your options are at the end of the lease: Renewal, purchase, or return of equipment.

These advantages come at a cost, as you well know if you have considered a personal lease on a car purchase. And, unless you are using the leased items in a for-profit subsidiary, you will not get the tax advantage that motivates some businesses to lease: Lease expense is tax-deductible, and if the lease period is shorter than the depreciation schedule that would apply to a purchase, the lease can lower your tax bill. However, a lease may fit your organization's need to finance copiers, computers, computer software, construction equipment, or an entire office. And as is true of so many other business transactions, you can now apply for an equipment lease right from your computer.[35] Finally, more healthcare organizations are now selling some of their facilities, perhaps to a real estate investment trust, and then leasing them back. This "monetizes" the asset, reducing the balance sheet investment that the organization must make while enabling continued utilization of the facility.

**(c) PROGRAM-RELATED INVESTMENTS (PRIs).** One source of debt financing that you may not have considered is foundation-based program-related investments. Here is some basic information on PRIs from GrantSpace.[36]

Program-related investments (PRIs) are investments made by foundations to support charitable activities that involve the potential return of capital within an established time frame. PRIs include financing methods commonly associated with banks or other private investors, such as loans, loan guarantees, linked deposits, and even equity investments in charitable organizations or in commercial ventures for charitable purposes. Characteristics of PRIs and PRI-making include the following:

- Of the many thousands of grantmaking foundations in the United States, only a few hundred make PRIs. In addition, relatively few PRI funders maintain formal PRI programs or make PRIs on an annual basis (about one out of three).
- Foundations make PRIs to further some aspect of their charitable mission (e.g., in the areas in which they make grants). PRIs are often made to organizations with an established relationship with the grantmaker.
- Foundations commonly make PRIs as a supplement to their existing grant programs when the circumstances of the request suggest an alternative form of financing, when the borrower has the potential for generating income to repay a loan, and as a last resort when an organization – in most cases a charitable nonprofit but occasionally a commercial venture – has been unable to secure financing from traditional sources.
- While a large portion of PRI dollars support affordable housing and community development, they also have funded capital projects ranging from preserving historic

buildings and repairing churches to providing emergency loans to social service agencies and protecting and preserving open space and wildlife habitats.

- For the recipient, the primary benefit of PRIs is access to capital at lower rates than may otherwise be available. For the funder, the principal benefit is that the repayment or return of equity can be recycled for another charitable purpose. PRIs are valued as a means of leveraging philanthropic dollars.

The next time you are considering borrowing funds, consider whether there might be a foundation with a mission consistent with your organization's mission, then approach the foundation to see if it has a program-related investment program.

## 10.13 DEVELOPING A DEBT AND HEDGING POLICY

Few nonprofits outside of the healthcare sector have debt policies. We strongly recommend that you craft and have your board review and adopt a debt policy. A best practice is to include your hedging policy as part of the debt policy, as interest rate risk is a key measure related to the amount of debt you take on. A *debt and hedging policy* should include some or all of these items, according to PricewaterhouseCoopers:[37]

- Short-term debt objectives and approaches
  - Four-week and twelve-month rolling cash forecasts regularly completed and reviewed
  - Liquidity availability at a suitable cost ensured
  - Borrowed funds availability adequate for liquidity requirements assured
  - Alternate sources of funding maintained in order to enhance financial flexibility
  - Costs of short-term borrowing minimized while adequacy ensured
  - Excess cash balances automatically used to pay down credit lines because of the lower interest yield on cash balances relative to the interest rate charged on the credit line
- Short-term debt instrument authorizations for some or all of the following:
  - Commercial paper, bank credit line, revolving credit facility, bank loan syndication or participation, uncommitted credit line, reverse repurchase agreements, intercompany loans
- Long-term debt objectives and approach
  - Consistent supply assured at reasonable cost and terms
  - Present (discounted) value of the debt portfolio minimized
  - Flexible financing of unanticipated future needs assured
  - Reasonable debt covenants negotiated
  - Insolvency and debt default risks minimized
  - Maintaining a target debt-to-net assets ratio
- Long-term debt instrument authorizations (which and how much)
- Who is responsible for debt management (centralized or decentralized)

- Short- and long-term debt management strategies
  - Use of foreign debt sources
  - Importance of cash forecasts
  - Maintaining a good credit rating with credit reporting and credit rating agencies
  - Relatively more short-term borrowing when interest rate outlook is uncertain
  - Match maturity of debt to lifespan of asset being financed
- Interest rate risk management
  - Interest rate risk profile or appetite
  - Creation of a risk committee
  - Objectives and approach
    - Fixed-to-floating rate balance
    - Interest expense minimization
    - Change in net asset threshold amount to be protected against
    - Hedging of interest rate risk through swaps, and so on (see Chapter 14)
    - Developing balance sheet flexibility
  - Hedge program guidelines
    - Active management of risk based on proximity (current quarter and fiscal year more important) and materiality (effect on change in net assets and on organization's growth rate)
    - Feasibility and desirability of actively managing the exposures
  - Responsibility for interest rate risk management
  - Instruments authorized for interest rate hedging
  - Interest rate risk management strategies to be followed
    - Refinance risk
    - Short-term exposures versus long-term exposures
    - Overlap with debt management strategies
  - Interest rate risk management operating controls
    - Identify operational risks
    - Protect against operational risks
    - Who is authorized to execute strategies and trade
    - What authority is delegated and to whom
    - Segregation of duties
    - Approved counterparties
    - Dealing limits and how this is to be monitored
    - Process to manage exceptions
    - How performance will be measured and evaluated

- Use of benchmarks
  - How will market risk be measured and analyzed
  - Management reporting
  - Accounting and disclosure
  - Business continuity planning and plan for disaster recovering

Rules of thumb are sometimes used in implementing risk-management hedging strategies. For example, a number of larger healthcare systems include in their policies stipulation regarding when they will exit an interest hedge (as when interest rates fluctuate a certain amount).[38] You will also want to disclose why your organization uses hedges, if it does, in the financial section of your stakeholder annual report. We will have more to say about hedging and derivatives in Chapter 14's discussion of risk management.

## 10.14 LIABILITY MANAGEMENT IN PRACTICE

In addition to the statistics we have included in this chapter from the Lilly study and other data, we note several studies that shed light on actual nonprofit use of debt. We will also provide evidence regarding the nonprofit use of credit lines.

The earliest study is taken from 1991 to 1994 Form 990 data, and conducted by Woods Bowman.[39] Bowman uses large nonprofits, those with at least $10 million in assets, to study two competing corporate finance explanations for debt usage: the pecking order hypothesis and the static trade-off hypothesis. The *pecking order hypothesis* suggests that nonprofits finance assets first with net revenues, then asset conversion (including selling off short-term investments), then with additional debt. The *static trade-off hypothesis* proposes that the various costs of issuing debt, including transactions costs and higher likelihood of financial distress and bankruptcy, be considered by the financial manager in determining what source of financing to use. Bowman finds limited support for the static trade-off hypothesis. However, in his full-scale model, the effect of liquid asset holdings on the proportion of assets financed by debt is negative, which is at odds with the idea that lower bankruptcy and financial distress costs coincide with a relatively greater use of debt. We believe the pecking order explanation is more realistic for noncommercial nonprofits, in that we see a great degree of self-financing of large capital investments, and this requires a gradual buildup of cash and short- to medium-term investments that may not ever coincide with increased debt usage. Again, the target liquidity objective appears to best explain nonprofit financial behavior in our opinion.

More recently, Geoff Smith studied various forms of borrowing by nonprofits and found the following: organizations that had tangible assets (hence collateralizable assets), were growing more quickly, and larger ones tended to use relatively more debt financing. Younger organizations, more liquid organizations, and more profitable organizations tended to use relatively less debt. Regarding industry, religious organizations tended to borrow from internal sources, education-sector organizations (colleges, particularly) issued tax-exempt bonds, and human services organizations were more prone to borrow using mortgages and notes payable.[40]

Calabrese and Grizzle find some evidence that more highly leveraged nonprofits, those using the most debt relative to their peers, do see drops in donations from their donors.[41] We might conjecture that this links to uncertainty about the future of the organization based

**Summary Statistics of Variables.**

| Variable | *M* | *SD* | Minimum | Maximum |
|---|---|---|---|---|
| Total tax-exempt borrowing / Total financial liabilities | 35.61% | 45.38% | 0.00% | 100.00% |
| Total tax-exempt borrowing / Total liabilities | 9.04% | 16.46% | 0.00% | 75.98% |
| Unrelated business income / Total revenue | 0.56% | 4.99% | 0.00% | 100.00% |
| Total contributions / Total revenue | 42.51% | 42.35% | 0.00% | 100.00% |
| Change in net assets / Total revenue | −2.55% | 64.05% | −35.41% | 87.45% |
| Fixed assets / Total assets | 34.88% | 30.67% | 0.00% | 100.00% |
| Executive compensation / Total expenses | 3.57% | 6.84% | 0.01% | 43.13% |
| Revenue diversity index | 0.32 | 0.30 | 0.00 | 0.89 |
| Estimated endowment / Total assets | 26.63% | 32.41% | 0.01% | 99.82% |
| Age | 30.29 | 22.33 | 0.00 | 243.00 |
| Total assets | US$ 123 million | US$719 million | 0.00 | US$63.6 billion |

*Note*. All financial variables adjusted to 2009 dollars using the Consumer Price Index.
*Source:* Thad D. Calabrese and Todd L. Ely, "Borrowing for the Public Good: The Growing Importance of Tax-Exempt Bonds for Public Charities," *Nonprofit and Voluntary Sector Quarterly* 45, no. 3(2016): 469. Used by permission (STM Permissions Guidelines).

**EXHIBIT 10.4** NONPROFIT FINANCIAL RATIO STATISTICS

on its more tenuous financial health, but more research should be done before firming up this conclusion.

Calabrese and Ely provide us with a number of useful statistics (Exhibit 10.4). They extracted data on over 24,000 nonprofits across various industries from Form 990 data. The average asset size of their sample is $123 million, which is partly a reflection of some very large organizations (we are unsure of the median amount of total assets). On average, the nonprofits were 30 years old. Of interest to us, as noted in Exhibit 10.4, the average nonprofit in the overall sample has 36% of all its financial borrowing from tax-exempt debt and 9% of total liabilities (including accounts payable and accrued expenses) from tax-exempt debt. We also see that almost 35% of total assets is in the form of fixed assets for this sample of nonprofits – and we should expect that these are the organizations that would be most prone to issue tax-exempt bonds or take out mortgages.[42]

Second, as we see in their next table (Exhibit 10.5), hospitals (by far) and colleges/universities have issued the bulk of all tax-exempt bonds ($257/$336 billion, or 76.5% of outstandings). Human services organizations (25.57%) and "Other" nonprofits (15.76%) had the smallest percentages of their financial liabilities constituted of tax-exempt bonds. Notice, however, the relative growth in tax-exempt percentages over the years 2001–2009.

Yan, Denison, and Butler studied revenue structure (a key aspect of your business model; see Chapter 3) and its relationship to debt issuance by arts, culture, and humanities nonprofits. Their study found:

- More revenue diversification is associated with a higher likelihood of issuing some debt

**Tax-Exempt Borrowing by Nonprofit Sectors, 2001–2009.**

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | % change |
|---|---|---|---|---|---|---|---|---|---|---|
| Arts | | | | | | | | | | |
| Ratio | 17.10 | 18.55 | 21.50 | 20.56 | 23.81 | 24.54 | 26.75 | 28.35 | 28.37 | 65.91 |
| Total | US$2.43 | US$3.00 | US$3.47 | US$4.06 | US$4.96 | US$5.44 | US$6.07 | US$6.18 | US$6.44 | 165.02 |
| Number | 81 | 95 | 89 | 93 | 116 | 127 | 134 | 146 | 150 | 85.19 |
| Higher education | | | | | | | | | | |
| Ratio | 53.18 | 55.45 | 58.80 | 60.71 | 62.86 | 64.89 | 66.33 | 68.24 | 69.51 | 30.71 |
| Total | US$35.8 | US$40.7 | US$43.5 | US$47.5 | US$51.7 | US$59.6 | US$67.1 | US$67.5 | US$74.2 | 107.26 |
| Number | 546 | 576 | 542 | 572 | 607 | 647 | 671 | 696 | 707 | 29.49 |
| Education | | | | | | | | | | |
| Ratio | 30.79 | 31.96 | 32.82 | 33.48 | 34.48 | 34.90 | 38.10 | 39.39 | 41.05 | 33.32 |
| Total | US$9.66 | US$11.4 | US$12.8 | US$14.1 | US$18.0 | US$15.2 | US$17.3 | US$18.1 | US$21.5 | 122.57 |
| Number | 294 | 331 | 284 | 313 | 358 | 381 | 436 | 463 | 515 | 75.17 |
| Hospitals | | | | | | | | | | |
| Ratio | 54.91 | 56.42 | 60.85 | 61.64 | 62.85 | 63.90 | 62.79 | 64.68 | 59.05 | 7.54 |
| Total | US$108 | US$118 | US$128 | US$136 | US$146 | US$165 | US$169 | US$169 | US$183 | 69.44 |
| Number | 1,145 | 1,185 | 1,129 | 1,140 | 1,163 | 1,187 | 1,194 | 1,185 | 1,333 | 16.42 |
| Health | | | | | | | | | | |
| Ratio | 22.63 | 22.64 | 23.29 | 23.97 | 24.75 | 24.50 | 25.80 | 26.60 | 27.79 | 22.80 |
| Total | US$7.05 | US$8.66 | US$7.71 | US$8.81 | US$9.53 | US$10.5 | US$10.8 | US$11.2 | US$13.7 | 94.33 |
| Number | 279 | 291 | 212 | 225 | 249 | 254 | 274 | 289 | 354 | 26.88 |
| Human services | | | | | | | | | | |
| Ratio | 18.83 | 19.15 | 20.42 | 20.59 | 22.28 | 22.40 | 24.73 | 26.65 | 25.57 | 35.79 |
| Total | US$15.0 | US$16.7 | US$16.1 | US$16.9 | US$19.7 | US$21.5 | US$25.7 | US$29.0 | US$29.9 | 99.33 |
| Number | 596 | 644 | 509 | 542 | 608 | 649 | 699 | 736 | 771 | 29.36 |
| Other | | | | | | | | | | |
| Ratio | 11.23 | 12.33 | 14.90 | 14.95 | 15.34 | 14.79 | 16.01 | 17.05 | 15.76 | 40.34 |
| Total | US$6.19 | US$7.68 | US$9.56 | US$10.0 | US$12.6 | US$10.8 | US$10.2 | US$10.4 | US$7.79 | 25.85 |
| Number | 104 | 121 | 117 | 127 | 135 | 136 | 159 | 175 | 163 | 56.73 |
| Whole sample | | | | | | | | | | |
| Ratio | 30.94 | 31.51 | 35.04 | 35.08 | 36.14 | 36.39 | 37.90 | 39.28 | 38.60 | 24.76 |
| Total | US$184 | US$206 | US$221 | US$237 | US$263 | US$288 | US$307 | US$312 | US$336 | 82.61 |
| Number | 3,045 | 3,243 | 2,882 | 3,012 | 3,236 | 3,381 | 3,567 | 3,690 | 3,993 | 31.13 |

*Note*: "Ratio" represents the ratio, in percentage points, of tax-exempt borrowing to total financial borrowing in each year and each nonprofit industry. "Total" represents the total tax-exempt debt outstanding in each year of each nonprofit industry in billions of dollars in 2009 real terms. "Number" represents the total number of nonprofits in each year of each industry reporting tax-exempt bonds outstanding. SOI = Statistics of Income.
*Source*: IRS SOI (2001–2009).

*Source:* Thad D. Calabrese and Todd L. Ely, "Borrowing for the Public Good: The Growing Importance of Tax-Exempt Bonds for Public Charities," *Nonprofit and Voluntary Sector Quarterly* 45, no. 3(2016): 470. Used by permission (STM Permissions Guidelines).

**EXHIBIT 10.5** TAX-EXEMPT BORROWING BY INDUSTRY

- More revenue diversification is not necessarily associated with higher debt ratios (long-term financial debt divided by total assets)
- When having a higher percentage of government grants in their revenue mix, arts organizations more likely to have some debt and also to have higher debt ratios[43]

We have little evidence to date on social-impact bonds, an interesting niche in the nonprofit bond market. *Social-impact bonds,* while a small sector of the nonprofit bond marketplace, are an interesting concept that you may wish to pursue. Foundations or other large donors provide money to a social service nonprofit, which in turn puts it to work in one or more of its programs. The funders (investors) then get back their money, plus a bonus, if the nonprofit achieves pre-specified performance goals. Otherwise, the funders (investors)

**Cash Reserves/Lines of Credit**

Cash reserves or lines of credit can help organizations stabilize cash flow fluctuations and meet expenses when funding payments are late or when other unexpected shortages occur. Two-thirds (67%) of survey respondents reported that they had a cash reserve (defined in the survey as an unrestricted amount of funds set aside to provide a cushion against future unexpected cash flow shortages, expenses or losses), and 38% reported having a line of credit.

Among organizations with cash reserves, 34% reported having a reserve of I-3 months of operating funds; 27% reported 3-6 months' worth; and 35% reported over six months of operating funds. Nearly half (49%) indicated that their cash reserve remained relatively constant over the past year, while 24% said it was smaller than one year ago and 27% said that their reserve was larger.

Among organizations with lines of credit, 48% reported having to borrow against the line of credit in 2016; 17% reported that they had to borrow more in 2016 than in the previous year, and 32% reported borrowing less. By comparison, in last year's survey, 22% of respondents had borrowed less against their line of credit than the year before. Fifty-three percent of respondents with a line of credit indicated that it was "essential" or "very important" to their organizations' continued ability to provide core programs and services.

*Source:* Center for Nonprofits (NJ), "New Jersey Nonprofits 2017 Trends and Outlook," April 2017. Available at: www.njnonprofits.org. Accessed 7/12/2017. Used by Permission.

**Exhibit 10.6** Cash Reserves and Credit Lines in Practice

do not get their money back. Early results from social-impact bonds are mixed. At the time of this writing, 11 states had enacted enabling legislation.[44]

Finally, you may wonder about the interplay between two of the key elements of your target liquidity, cash holdings (cash and short-term investments in some organizations) and credit line usage. We have data from a survey of 301 charities in the state of New Jersey. In Exhibit 10.6, we see the results. We would recommend that almost all nonprofits obtain a credit line, versus the 38 percent that we see in the New Jersey experience. We are also concerned by the fact that one-third of nonprofits do not have a cash reserve (unrestricted funds set aside as a cushion against future unexpected cash flow shortages, expenses, or losses) and that an additional 23 percent (34% of the 67% having reserves) have less than three months of operating funds in reserve.

## 10.15 CONCLUSION

Borrowers come in all shapes and sizes, and the astute lender must seek a way to differentiate between good loans and potentially unsuccessful loans. The financial manager must assist the lender in discerning the differences between the good loan represented by the financial manager's organization and all others.

The process begins with the preparation of a strategic financing plan that is part of the institution's overall strategic business plan. Then the financial manager must garner all the relevant facts and information that the lender will require, anticipate the lender's questions, and assemble a presentation to the lender. The presentation is a combination of written information and oral discussion, often including an onsite tour of the nonprofit's facilities. To be successful in the borrowing process, the financial manager must ensure that the selected lender matches the intended use of the funds and the duration of the loan. Banks, leasing companies, and insurance companies all have different objectives. The financial manager must recognize these differences and position itself toward the lender's interests.

Proficient financial managers with significant funding needs investigate bond financing as well as bank or insurance lease financing companies. They will also ensure that the organization pays its bills on time and makes interest payments and principal repayments as required. Because the worst time to contact a lender is when you finally really need them, they plan liquidity and capital project needs well in advance. Their degree of financial risk aversion, limitations on relative amounts or types of debt, allowable occasions for taking on debt, and stance toward liquidating debt are mapped out in a board-approved debt policy.

## Notes

1. Eric Minton, "Staying in the Swim: Why Aquariums Succeed or Fail," *Planning* (June 2003): 14–19. Ocean Journey's long-range financial plan was based on 1.3 million visitors for each of the first three years, but after the first year's 1.4 million visitors attendance dropped in year 2 to 742,000 visitors. We emphasized in Chapter 9 doing scenario and what-if analysis for just this type of situation, and debt service (interest payments and principal repayments) should not require optimistic projections to be realized.
2. Lawton R. Burns and James Joo-Jin Kim, "Lessons from the Allegheny Bankruptcy," *LDI Issue Brief 5* (February 2000).
3. Pamela Foohey, "When Faith Falls Short: Bankruptcy Decisions of Churches," *Ohio State Law Journal* 1319 (February 13, 2015): 76. Available at: SSRN: https://ssrn.com/abstract=2564746. Or https://doi.org/10.2139/ssrn.2564746. Churches and other nonprofit borrowers should monitor compliance with loan or bond covenants on a monthly basis. The CFO should be projecting financials to ensure that each ratio in those covenants is safely "in the zone" to ensure ongoing compliance. For more, consult Obi Chukwumah, BB&T Bank, "Determining Necessary Cash Flow for Religious Organizations and other Nonprofits." Webinar, Salmon Sims Thomas, January 30, 2018. Contact Rebecca DaVee (bdavee@sstcpa.com) or Kristina Rosenthal (krosenthal@sstcpa.com) for more information.
4. See Lilly study results in Appendix 1A.
5. Quoted from Theresa L. Wareham and Andrew J. Majka, *Best Practice Financing* (Northfield, IL: Kaufman Hall, 2003).
6. HFMA, "Competency 2: Managing the Balance Sheet," *Financing the Future Report 5: How Are Hospitals Financing the Future? Core Competencies in Capital Planning* (Westchester, IL: Healthcare Financial Management Association, 2004). This section is based closely on the HFMA framework, which applies most closely to hospitals. Capital structure concepts have been developed more in the hospital sector than any other nonprofit sector, with the possible exception of colleges and universities.
7. An index fund, without any fees, would be a good measure here. Many (possibly most) nonprofits have operating risk at least as high as an average company, and we would argue that donative organizations or healthcare organizations in highly competitive markets experience more risk (see Chapter 2 on the financial risk of donative organizations). An endowment fund that includes alternative investments (see Chapter 12), such as Harvard's, might provide a more accurate picture of returns mirroring the risk of a typical nonprofit than would the more conservatively managed endowment funds commonly observed in the nonprofit sector. Our approach mirrors "Method 2" in HFMA, "Competency 2: Managing the Balance Sheet."
8. Ziegler Investment Banking Case Study: River of Life Fellowship (May 1, 2017). Available at: https://www.ziegler.com/z-media/3540/river-of-life-fellowship-case-study_0517.pdf. Accessed 7/13/17.
9. For more on credit reporting agencies, including the list of those nationally recognized by the US Securities and Exchange Commission (SEC), see https://www.sec.gov/fast-answers/answersnrsrohtm.html.
10. See supra note 6.

11. Wareham and Majka, *Best Practice Financing.*
12. The effective cost formula ignores compounding, and so slightly understates the true cost of not taking a cash discount. See Thomas W. Oliver, Paul Kim, Antonio Que, and Chin W. Yang, "The Calculation of the Effective Annual Cash Discount Rate Revisited," *American Business Review* 18 (June 2000): 50–53.
13. Adapted from Edward Skloot, *Smart Borrowing: A Nonprofit's Guide to Working with Banks* (New York: New York Community Trust, n.d.), 3–4.
14. See Chapter 8 for more on cash forecasting.
15. This may be by negotiating with the supplier, or it may simply mean paying invoices early only when there is a cash discount offered.
16. Woods Bowman points out that businesses, and possibly nonprofits, often have a "pecking order" of long-term financing that consists of using net revenues first, then "asset conversion," or selling off assets prior to issuing external debt or (for businesses) equity. See Woods Bowman, "The Uniqueness of Nonprofit Finance and the Decision to Borrow," *Nonprofit Management & Leadership* 12 (Spring 2002): 293–311.
17. Gary Haber, "Nonprofits Tap Lines of Credit." Available at: www.ydr.com/story/2015/11/05/nonprofits-tap-lines-credit/75108250.
18. The banks give themselves the flexibility to deny some borrowers credit if many requests are received at the same time. Thus, total credit lines for a given bank exceed its ability to finance them simultaneously. Furthermore, material changes in the potential borrower's financial condition might result in the bank's denial of credit for an uncommitted line, although this also is rare.
19. One may access the current prime interest rate at http://www.bankrate.com/rates/interest-rates/prime-rate.aspx.
20. When drawn against the buyer, these drafts are called *bills of exchange*, but when a bank sets up an acceptance facility, the seller draws against the bank, and the resulting instrument is called an *acceptance credit*. The bank will pay the seller the discounted value of the acceptance's face value, with the amount of the discount based on prevailing money market rates.
21. Approximately 35 to 40 percent of small businesses get some form of bank credit assistance. As nonprofits are generally the same size as small businesses but are disqualified from receiving SBA loans, it is likely that a smaller percentage is offered credit lines by banks. We provide a list of banks with strong nonprofit interest and product focus in Chapter 11.
22. Smith, Gambrell, and Russell, LLP, "Taxable Versus Tax-Exempt Bond Financing for Project Financing." Available at: www.sgrlaw.com. Accessed: 7/10/2017.
23. Smith, Gambrell, and Russell, LLP, "Overview of Bond Financing for 501(c)(3) Nonprofit Organizations." Available at: www.sgrlaw.com. Accessed 7/10/2017.
24. Based on current information provided by the Securities and Exchange Commission's Office of Investor Education and Advocacy. See "Investor Bulletin: Municipal Bonds: Understanding Credit Risk" at www.investor.gov and by Financial Industry Regulatory Authority (FINRA – http://www.finra.org/investors/alerts/municipal-bonds_important-considerations-individual-investors). Accessed 7/10/2017.
25. "Municipal Bonds and Defaults." Bondview (n.d.). Available at: https://www.bondview.com/articles/municipal_bonds_and_defaults. Accessed 7/13/17.
26. On the (at least temporary) demise of auction rate securities, see FINRA, "Auction Rate Securities: What Happens When Auctions Fail," November 18, 2008. Available at: http://www.finra.org/file/investor-alert-auction-rate-securities-what-happens-when-auctions-failpdf.
27. https://www.law.cornell.edu/cfr/text/26/1.148-2. Accessed 7/13/17. This information is not to be construed in any way as providing legal advice. Readers should verify current laws with their tax or bond counsel.
28. https://www.irs.gov/pub/irs-pdf/p5271.pdf. Accessed 7/10/2017. Also see a complete description of changes to the arbitrage rules at https://www.federalregister.gov/documents/2016/07/18/2016-16558/arbitrage-guidance-for-tax-exempt-bonds. This information is not to be construed in any way as providing legal advice. Readers should verify current laws with their tax or bond counsel.
29. This information is not to be construed in any way as providing legal advice. Readers should verify current laws with their tax or bond counsel.

30. "A Fund with the Almighty on Its Side," *Dallas Morning News* (November 26, 2005).
31. Ziegler Investment Banking Case Study (November 1, 2015). Available at: https://www.ziegler.com/z-media/2030/truth-tabernacle-case-study_1115.pdf. Accessed 7/13/17.
32. Scott Rolfs, "Church Lending: The Boom, the Bust and the Future." *ABF Journal* (March 2017). Available at: www.abfjournal.com. Accessed 7/10/2017.
33. https://www.ziegler.com/what-we-do/investment-banking-corporate-finance/religious-organizations/church-financing-lending/investing-in-church-bonds/. Accessed 7/10/2017. This information is not to be construed in any way as providing legal advice. Readers should verify current laws with their tax or bond counsel.
34. SIFMA, Municipal Bond Credit Report, First Quarter 2016, page 15. Available online at: https://www.sifma.org/WorkArea/DownloadAsset.aspx?id=8589960464. Accessed 7/13/17.
35. You can now do extensive searches for various kinds of leases by accessing the Equipment Lease and Finance Association search tool at https://apps.elfaonline.org/Directories/FundSource/MembersOnly/seller/index.cfm?fuseaction=display_searchpage.
36. http://grantspace.org/tools/knowledge-base/Grantmakers/pris. Accessed 7/20/2017.
37. Fred Cohen and Timothy T. Hesler, "Debt and Interest Rate Risk Management Policy Guidelines," *AFP Manual of Treasury Policies* (Bethesda, MD: Association for Financial Professionals, 2001).
38. HFMA, "Competency 2: Managing the Balance Sheet."
39. Bowman, "The Uniqueness of Nonprofit Finance and the Decision to Borrow."
40. Geoffrey Peter Smith, "What are the Capital Structure Determinants for Tax-Exempt Organizations?" *The Financial Review* 45 (2010): 845–872.
41. Thad D. Calabrese and C. Grizzle, "Debt, Donors and the Decision to Give," *Journal of Public Budgeting, Accounting, and Financial Management*, 24, no. 2 (2012): 221–254.
42. Thad D. Calabrese and Todd L. Ely, "Borrowing for the Public Good: The Growing Importance of Tax-Exempt Bonds for Public Charities," *Nonprofit and Voluntary Sector Quarterly* 45, no. 3 (2016): 458–477.
43. Wenli Yan, Dwight V. Denison, and J. S. Butler, "Revenue Structure and Nonprofit Borrowing," *Public Finance Review,* 37 (January 2009): 47–67.
44. Chronicle of Philanthropy, "A New Financial Tool: Social-Impact Bonds," *Chronicle of Philanthropy,* (February 20, 2011): 7. Also see Dan Caplinger, "What Are Social Impact Bonds, and Should I Invest in Them?" *The Motley Fool,* June 30, 2017. Available online at https://www.fool.com/investing/2017/06/30/what-are-social-impact-bonds-and-should-i-invest-i.aspx. Accessed 1/26/2018. For in-depth study, see National Conference of State Legislatures, "Social Impact Bonds," (9/22/2016). Available online at: http://www.ncsl.org/research/labor-and-employment/social-impact-bonds.aspx. Accessed 1/26/2018.

CHAPTER 11

# CASH MANAGEMENT AND BANKING RELATIONS



## 11.1 INTRODUCTION

When managing cash and cash flow to achieve your organization's target liquidity, proficiency in cash and treasury management is essential. The organization awarded the 2017 Association for Financial Professionals (AFP) Pinnacle Award Grand Prize for Excellence



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

in Treasury and Finance was World Vision International, a faith-based child sponsorship nonprofit. Your organization may also aspire to excellence in this crucial business function.

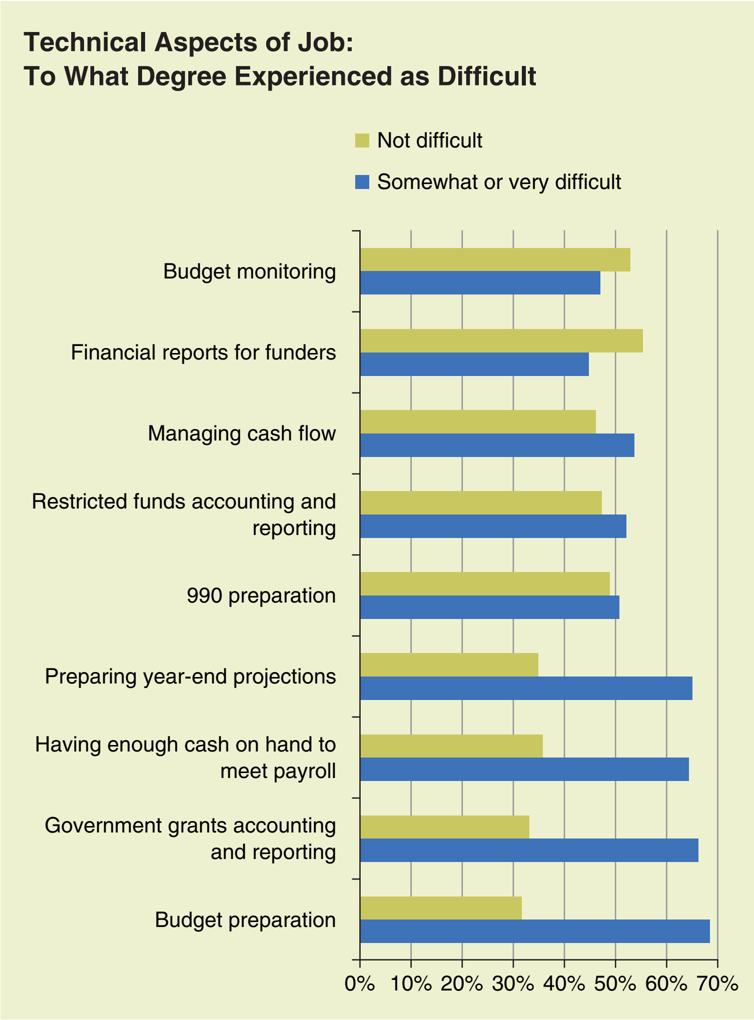
The US cash management environment is one in which check usage and the cost of information technology are on the decline, and interest rates and the use of electronic payments are on the upswing. Consider the opportunities to use cloud-based technologies for accounting, banking, cash forecasting, and investing, and you have a recipe for remarkable improvements in nonprofit cash management. And improvements are needed to help prevent cash crunches and financial crises for many nonprofits: CFOs report that one of their most challenging roles is "having enough cash on hand to meet payroll," with "preparing year-end projections" being almost as challenging, and "managing cash flow" not too far behind in perceived difficulty (see Exhibit 11.1).

Fundraising and foundation or membership relationships are central to many nonprofit organizations. For most outside of education and healthcare, the treasury function primarily revolves around collecting, handling, and managing cash gifts, foundation grants, and membership dues. For education, healthcare, and other nonprofits, managing liquidity to support borrowing and investing decisions is also vital to ensure funding for the nonprofit's varied activities. For yet others, trying to bridge the gap until government grants or contracts get disbursed and received is the primary challenge. Having funder monies restricted to programs further intensifies the cash flow difficulties of many nonprofits.[1] Today it has become increasingly important for these functions to be carried out efficiently to maximize resources and control costs. Treasury responsibilities have evolved from paper-based, manual processes to highly automated and sophisticated systems that interface seamlessly with banks, service providers, and other internal operating units.

Cash management is a subset of treasury management, and it involves the collection, mobilization, and disbursement of cash within a nonprofit enterprise. Moving funds and managing the information related to the funds' flows and balances are fundamental to good cash management. With a strong understanding of the banking system and the products and services offered by banks, the cash manager can achieve effective mobilization of funds, prudent investing of these funds, and cost-effectiveness in services used.

Depending on its size and scope of activities, a nonprofit's financial structure may range from simple to highly sophisticated. In any case, a system needs to be designed to monitor the cash flow timeline that links revenue/cash receipts and purchasing/cash disbursements. For some, transactions can be more complex when cash flows cover large payrolls, sizable inventories, vehicle fleets, and other supplies for an organization like the Red Cross or a major healthcare facility with heavy financing and working capital needs.

A comprehensive understanding of an organization's operational processes is basic to structuring a sound cash management program. Identifying and quantifying the activities, interfaces, and resources that make up the collective cash flow can lead to a better assessment of service requirements for banks and other financial services providers. Significant advances in technology have had an impact on the delivery of cash management services and offered numerous opportunities for managing deposits, funds concentration, disbursements, and information and control. As new applications have emerged, automated and computerized processing capabilities have replaced paper-based information and inquiry systems. Cash managers now use the Internet, cloud-based treasury or bank software services, and/or computerized treasury workstations (which are actually just specialized software packages) to execute transactions and gather information ranging from bank balances to investment transactions and other financial activities. Processes that required manual intervention are now routinely handled by innovative electronic collection, concentration, and disbursement applications. Cash management activities are being carried out better,




*Source:* Steven D. Zimmerman and Jan Masaoka, "Adding It All Up: Nonprofit CFO Study." Located online at: www.blueavocado.org/content/adding-it-all-nonprofit-cfo-study. Accessed: 7/11/17. Used by permission.

**Exhibit 11.1** Nonprofit Chief Financial Officers' Difficult Job Tasks

faster, and more cheaply. With increased productivity through automation and "cloud" systems, there are many opportunities for cash managers to add value and enhance service support to other parts of the organization. With nonprofits expected to do more with less, outsourcing possibilities should be considered alongside traditional approaches. A good example here is establishing a temporary lockbox service with a bank or third-party provider to handle the annual fund donation flow, which then is turned off by the bank after all donations are received.

The primary goal of this section is to identify the trends and opportunities that nonprofits should consider to enhance treasury functions relating to cash management. Our context here, as throughout the book, is to maintain adequate liquidity in order that our organization has the right amount of cash, available at the right time, without overpaying to have that money available, and spends it according to mission and donor purposes. Put more formally, we wish "to ensure that financial resources are available when needed, as needed, and at reasonable cost, and are protected from financial impairment and spent according to mission and donor purposes" (as noted in Chapter 2). We achieve this by adept and prudent cash management. This, in turn, entails using the appropriate collection, concentration, and disbursement tools.

Collection and disbursement mechanics that have benefited from technological advances will be highlighted in this chapter, along with regulatory and banking developments. Identifying electronic systems for accelerating the collection of remittances and controlling disbursements to ensure timely and orderly outflows will be explored. Then, the strategy for identifying, selecting, and working with the right bank or financial service provider will be addressed. What is the bank's breadth of product, systems, and service levels? How committed is the bank to maintaining and improving its product and service offerings? How important is my account to the bank? Will the bank continue to show special attention to our industry? What is the bank's financial strength? With the right financial services provider(s) as partner(s) and the appropriate technology to support operations, many benefits and opportunities can be maximized. Throughout the remainder of the chapter, we will refer to all depository service providers as "banks." Do not limit your selection menu to banks, however. There are credit unions that are pursuing nonprofit relationships, and they are worth a careful look, especially if you have localized financial service needs.

## 11.2 WHAT IS CASH MANAGEMENT?

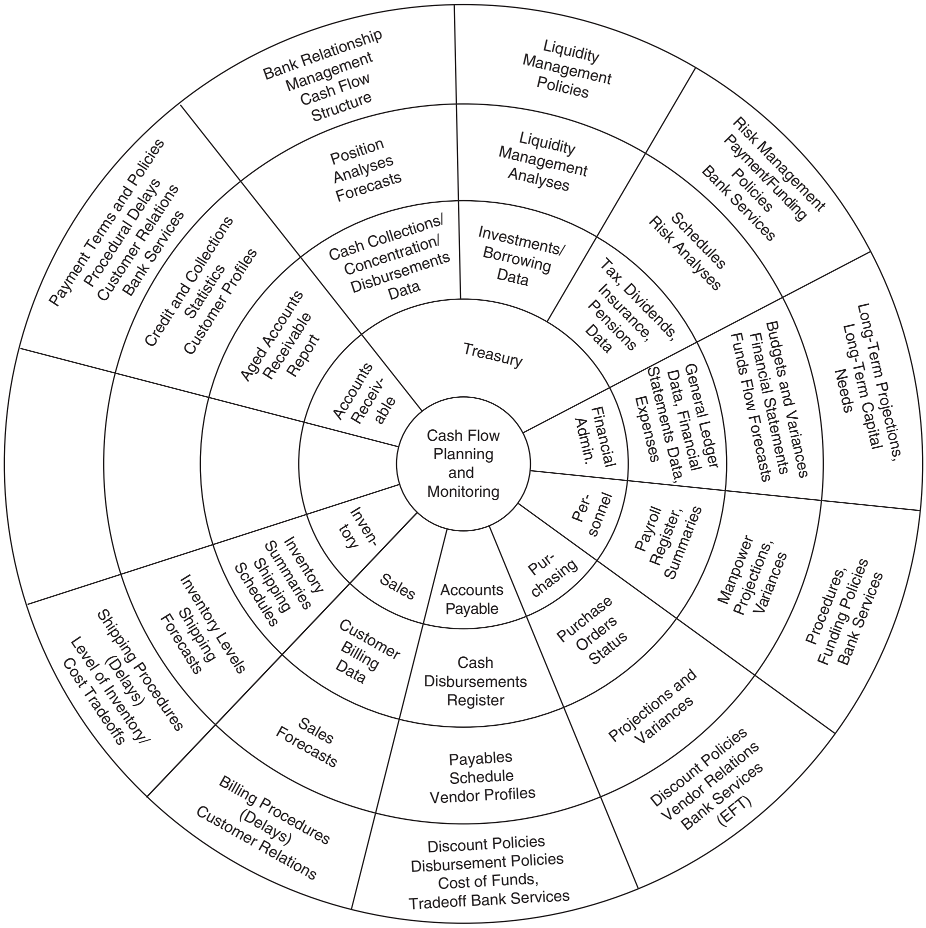
Cash management encompasses a number of activities within these primary functions:

- Cash collection
- Cash concentration
- Cash disbursements
- Investment of surplus cash, if any
- Financing or borrowing, if needed
- Forecasting cash flows
- Managing bank relations

The fiduciary responsibility of nonprofits must be balanced in the way business is conducted. Financial risks should be recognized and appropriate measures taken to safeguard assets. In designing and structuring a good cash management program, distinguishing day-to-day functions from strategic objectives is important. At the same time, focusing on efficiency must take into account control and flexibility in managing cash, based on a strong understanding of organizational cash flows (see Exhibit 11.2).

**(a) BANKING ENVIRONMENT.** Commercial banks serve as depositories for cash and also act as paying and receiving agents for checks and other fund transfers.

Banks have been a traditional source of financing for short- and medium-term needs, providers of investment services, fiduciary/trust services, and global custody.




*Source:* Aviva Rice, "Improving Cash Flow Control Throughout the Corporation." © 1997 by the Association for Financial Professionals, all rights reserved. Used with permission of the Association for Financial Professionals.

**Exhibit 11.2** Comprehensive Cash Flow Management

A number of financial institutions now have dedicated nonprofit departments or groups, and their specialization may be a significant advantage for your organization. Illustrating, the Evangelical Christian Credit Union (Brea, California), the Bank of the West, and Huntington Bank (Ohio) specialize in making facility, equipment, and other loans to nonprofits. SunTrust, The National Bank of Indianapolis, JPMorgan Chase, Bank of America Merrill Lynch, KeyBank, and others have nonprofit departments. It makes sense to find out how extensive the nonprofit client base is: Huntington Bank advertises that it has 700 nonprofit clients in a six-state Midwest region.

Building a good relationship and partnership with the right bank offers many advantages. A growing nonprofit organization will benefit from the right association and could leverage such a relationship to integrate services such as cash management, trust, capital markets, and credit. With few exceptions, a full-service commercial bank can offer a range of cash management services that will meet all the requirements of your nonprofit. Smaller banks such as The National Bank of Indianapolis, sometimes dubbed “community banks,” may value nonprofits more, may offer a special mix of services, and often have better pricing. In certain situations, unbundling services and seeking out multibank relationships may be appropriate where services are required in different geographic regions of the country or even overseas. International banking is offered by many major banks, and specialized needs for foreign exchange, letters of credit, and other international transactions are easily met. Pricing, quality of service, support, and technology are factors that must be considered in deciding on a single or multibank setup. Technology for cash concentration can link multiple accounts in different banking relationships without slowing cash transfers or incurring added expense. What value-added benefits can be realized in a single or multibank relationship is a question that needs to be explored.

**Services Provided by Treasury Management Banks**

| | |
|---|---|
| Account reconciliation | Information reporting |
| Automated clearinghouse (ACH) services | Retail lockbox |
| Check clearing | Wholesale lockbox |
| Positive pay and reverse positive pay | Sweep accounts |
| Controlled disbursement | Treasury management software |
| Demand deposit accounts | Wire transfers |
| Electronic bill presentment and collection | Zero balance accounts |

**(b) PURCHASING BANK SERVICES.** When purchasing bank services, a formalized approach will help you ensure that important decision factors are not overlooked in the evaluation and purchase of cash management services. You may wish to use an informal or partial request for a product or service in certain situations. However, there are potential disadvantages to such a process that can be eliminated through the use of two suggested critical steps: a request for information (RFI) and a request for proposal (RFP). As we prepare to discuss the RFI and RFP, consider the steps involved in changing banks, including implementation, profiled in Exhibit 11.3.

The RFI is part of a structured information-gathering effort to identify potential vendors and their product offerings. Through trade directories, publications, referrals, and annual rankings,[2] this informal process can provide data on banks and vendors that will include such information as experience, technological capabilities, and creditworthiness. This process could potentially eliminate the need for an RFP when there is clearly one superior vendor or when specific service requirements can be met by only one or two vendors. While not optimal, this approach provides a basis for a more informed decision than one based solely on previous relationships and price. At least once every few years, an RFI is helpful in comparing capabilities outside of an existing relationship and staying current with changes in the industry.

An RFP is the next step to take when soliciting bids for several cash services and a comprehensive search is warranted. The process can be fairly involved and time-consuming. Key to an RFP would be a statement of the nonprofit’s objective in soliciting the proposal. This would include:

- A description of the service sought
- The preferred location(s)
- The volume of transactions by service (measure costs under various activity volumes)

**Changing Your Cash Management Bank**

**WHY?**

There are many reasons why a corporate entity may want to change its bank, including:

1. **Change of policy by the bank.** Occasionally, banks pull out of certain countries or decide to focus on another aspect of banking. (It probably also means that they weren't very good at transaction banking.)
2. **Reduction in the bank credit rating.** Most corporates set minimum bank credit ratings for their banks, and if their transaction bank slips below that rating, a change of bank should be considered.
3. **Lending requirements.** Lending facilities offered by a particular bank may depend on moving transaction banking to them.
4. **Dissatisfaction.** This is one of the main reasons for changing banks, and the contrast to the other reasons is that it is discretionary. If this is the case, the corporate entity must recognize that the process is often difficult and the benefits can sometimes be hard to achieve, so that it should be considered only if the dissatisfaction with the existing bank is extreme!

**THE TENDER PROCESS**

When selecting a new bank, it is normal to go through a formal tender process. For that, the corporate entity needs to be clear about its objectives and requirements:

1. These **objectives** may include:
   - Reducing banking costs
   - Reducing liquidity requirements – squeezing unnecessary liquidity out of the system
   - Providing a good transaction banking service
2. **Analyze the requirements.**
   - It is important to understand how divisions, subsidiaries, or departments – in both centralized and decentralized companies – use all of the accounts. This needs to be clear before preparing the request for proposal (RFP).
3. **Identify the potential new banks.**
   - Contact banks beforehand to explain your objectives and to warn them that a tender (RFP) document is being sent to them, so that it will go to the correct person, who will treat it with sufficient importance and in a timely manner.
   - Will the existing transaction banks be included?
4. **Provide information.**
   - Give as much information to the prospective banks as possible, including a description of the corporate's needs, transaction volumes, and values.
   - Describe clearly the corporate's objectives.
5. **Set a realistic timetable for the process.**
   - Allow at least one month for the initial response.
   - Estimate the time for consideration of the proposals and to reach a short list, and proposed dates for presentations, the decision, and implementation (don't be overly optimistic).

EXHIBIT 11.3 REASONS FOR CHANGING BANKS AND HOW TO PROCEED

**6. Specify what the response should include.**

- Description of the service the bank is able to provide, including support and service-level agreement.
- Details of the pricing the bank is offering
- Technical details of their electronic banking system
- Lending and overdraft facilities available (and interest rates)
- Money market and other treasury lines that might be available
- How the bank would handle implementation of the transfer of the business
- Names of similarly sized customers, for reference

**MEETING THE SHORT-LISTED BANKS**

To enable a good comparison of the short-listed banks, it is important to compare them under similar conditions, including:

- A strict timetable and agenda
- Specific areas that are important to the corporate entity, such as pricing, systems, and service

It is sometimes revealing to compare who the banks send to give presentations, such as existing or prospective account managers, their level of seniority and experience, and whether they bring their implementation team.

**IMPLEMENTATION**

Once the decision has been reached, implementation needs to be managed very carefully, involving the operational personnel who will be handling the process.

The process includes:

**1.** Meeting with the successful bank to plan the implementation. This covers:
   - A realistic timetable
   - Regular progress reporting
   - Documentary requirements
   - Agreeing on a training schedule for any new software being provided

**2.** Meeting with the outgoing bank to agree on a hand-over procedure:

It needs to be emphasized that implementation can be a major exercise. In addition to the actions to be taken by the bank, the company will need to consider the various issues, including changing payment instructions for existing customers if they credit your bank accounts electronically, and changing internal systems that have been set up to interface with the existing bank.

Do not underestimate the potential for things to go wrong and to take longer than expected, as the sales teams from the new bank do have a tendency to promise more than their bank can deliver.

**FINALLY**

When the new system has been in place for three or six months, a review needs to be conducted to check that the anticipated savings and benefits are being achieved and that the new systems are working as the bank had promised, and to identify actions to be taken if that is not the case.

*Source:* Brian Welch, "Changing Your Cash Management Bank," *Global Treasury News* (June 23, 2000). Used by permission.

**Exhibit 11.3** Reasons for Changing Banks and How to Proceed (*continued*)

Exhibit 11.4 provides an outline of a sample RFP for lockbox processing. In addition, specific service requirements should also be addressed in an RFP:

- Any special features or customization required
- Level of support service expected (who, hours, level of authority)
- Problem-resolution procedures
- Automation capabilities
- Mechanisms for funds transfer
- Availability of information (cutoff times, cost)
- Level of quality expected
- Pricing information; pro forma account analysis giving total dollar charges based on anticipated usage of each service
- Questions relating to product-specific issues and buyer requirements for special transaction requirements
- Deadline for response
- References (do a thorough check)
- Contact person

Spelling out both general and specific qualifications and requirements will provide a more objective approach and meaningful comparison of service levels. Corporate practitioners recommend meeting with potential banks at the beginning of the process to go over required services and then at the end of the process after the selection is made. When the best bank (or other vendor) is identified, the next step is to secure a commitment in writing and document the details and fees involved. This should also include deviations from the RFP, specific computations, price commitment, change notification periods, cost of uncollected funds, overdrafts, and daylight overdraft provisions. Use of a matrix that scores the responses from banks or vendors is recommended.

In putting together an RFP, questions can be organized from the general to the specific. Exhibit 11.5 contains examples of methods that may be used.

For assistance in preparing RFPs for banking services, Nilly Essaides at the Association for Financial Professionals (AFP) has developed a publication to help in selecting cash management banks. *How to Conduct a Successful RFP for Banking Services*, published by AFP under the sponsorship of KeyBank, provides an outstanding list of tips and practices for conducting an RFP from start to finish.[3] Detailed RFPs are available from AFP (https://www.afponline.org/publications-data-tools/data-tools/rfp-resource-center) for these cash management services for a nominal fee:

- 401(k) Plan Bundled Provider RFP (can be customized to 403(b))
- Automated Clearing House (ACH)
- Controlled Disbursement
- Custody Services
- Depository Services
- Disbursement Outsourcing
- E-Banking and Information Reporting
- Electronic Data Interchange (EDI)
- Global Treasury Services

**GENERAL QUALIFICATIONS**

1. Monthly volume in total and for the three largest customers
2. General work flow description
3. Equipment used in processing
4. Problem-resolution procedures
5. Bank/vendor output records for receivable/payables accounting
6. Methods and timing of data transmission
7. Mechanisms for funds transfer
8. Timing of balance report on daily activity and so on.

**PRODUCT-SPECIFIC ISSUES**

1. Flow of mail through bidder's postal facility
2. Zip code arrangements (unique, zip + 4, other)
3. Schedule of daily and weekend post office collections
4. Delivery site and resulting delay of mail distribution within bidder's premises
5. Staffing and experience of lockbox operation
6. Maximum daily volumes that can be processed for same-day ledger credit
7. Timing/security for transmission of lockbox data, including remittance media
8. Error rate in lockbox processing and so on.

**BUYER'S PROCESSING REQUIREMENTS**

1. Specific volume projections, now and in three years, at peak and average
2. Geographic distribution of customers
3. Processing exceptions as to payee, check date, nonmatching dollar amounts, missing check signature, and foreign items
4. Handling of customer correspondence
5. Anticipated data-capture requirements from scanline or from remittance documents
6. Procedures for charging nonsufficient funds items
7. Delivery procedures for remittance advices, deposit slips, and other materials
8. Data transmission baud rates, timing and security, and so on.

**SUPPLEMENTAL INFORMATION**

1. Product brochures
2. Sample contract or agreement of service
3. Phoenix-Hecht Postal Survey™ data on mail and availability times
4. Sample output from bank or vendor processing
5. Customer references
6. Complete product pricing schedule
7. Chart of service area organization
8. Implementation checklist and so on

*Source:* From James S. Sagner and Larry A. Marks, "A Formalized Approach to Purchasing Cash Management Services," Sagner/Marks, Inc., *Journal of Cash Management* 13, no. 6 (November–December 1993).

**EXHIBIT 11.4** SAMPLE RFP: LOCKBOX PROCESSING

**LIST 1: ORGANIZING QUESTIONS BY FUNCTIONAL OR ORGANIZATIONAL AREAS**

1. Accounting
   - Reconciliation
   - Reporting
2. Cash management
   - Balance reporting
   - Funds transfer: wire transfers, ACH
3. Control
   - Security
   - Audit trail

**LIST 2: ORGANIZING QUESTIONS BY PRODUCT LINE, INCLUDING CURRENT AND FUTURE NEEDS**

1. Controlled disbursement
   - Current needs
   - Future needs
2. Lockbox
   - Current needs
   - Future needs
3. Funds transfer
   - Current needs
   - Future needs

*Source:* From James S. Sagner and Larry A. Marks, "A Formalized Approach to Purchasing Cash Management Services," Sagner/Marks, Inc., *Journal of Cash Management* 13, no. 6 (November–December 1993).

**Exhibit 11.5** RFP Questions

- Merchant Card Services
- Paycard
- Purchase Card Services
- Remote Deposit Services
- Retail Lockbox
- Short-Term Investment Management
- Treasury Technology
- Wholesale Lockbox
- Wire Transfer

Steps should be taken to build and strengthen the relationship once a vendor is selected and a contract signed. Keeping the account officer well informed of activities, changing requirements, operational processes, policies, and future plans is fundamental. Giving honest feedback also ensures a productive partnership. In the long run, negotiations are made easier, and the account officer becomes very knowledgeable about the nonprofit's operations. The account officer's input can be a resource in identifying opportunities for improvement. Developing a consultative partnership can be useful in analyzing treasury functions and getting valuable suggestions for process improvement. An annual review between banker and client completes the process toward constructive relationship building.

What can the cash manager and banker do to get the most from a bank relationship? What are each other's expectations and objectives? Are they attainable and reasonable? Building a relationship requires a real investment of time for all parties involved. Strategies for relationship building are premised largely on trust, open communications, honest feedback, and team building. Setting realistic objectives is fundamental and provides the framework for implementing agreed-on procedures and service requirements. When a client calls a banker only when a problem arises, the relationship stands on shaky ground. Regular meetings and follow-ups ensure open communication. With the rise in bank mergers, takeovers, and consolidations, managing a relationship has become increasingly challenging. The consistency in quality, service, and price that a client seeks in a bank tends to be disrupted as bank cultures change and personnel turnover creates dislocations. When a strong relationship has been cultivated, problems and uncertainties will be more manageable and less stressful to handle. A win-win situation is a likely by-product of a healthy relationship. Finally, we concur with Tom Fraser of First Federal Savings & Loan in Lakewood, Ohio, who notes that there is ample and valuable advice available from your banker:

> Your banker should act as a trusted adviser. For example, bankers have experience with cash flow cycles and expansion opportunities, so they can readily help with early advisory initiatives for financing – and they don't charge hourly like CPAs and attorneys. It's also often more economical to work consistently with your primary bank because you're already sharing information.[4]

**(c) MANAGING BANK SERVICE CHARGES.** What does it cost to do business with your bank? How are balances determined? What are the reserve requirements? What is the basis for calculating the earnings credit rate? Are all the services needed? How should the services be paid – by fees, balances, or a combination of both? Answers to these questions can be gathered from an *account analysis statement*, which presents a clear picture of bank services and account status. This monthly invoice contains two separate sections on balance and service information. It is critical to understand the account analysis statement and its terms and components to verify the accuracy and level of charges. Understanding the services used and relating this usage to the pattern of collections and disbursements could lead to potential cost savings. When multiple banks are used, comparisons using spreadsheets would be necessary on a monthly basis.[5] Basic to the analysis are:

- Cutoff, preparation, and timing of analysis statement by bank
- Bank service charges organized by type of service: depository, remittance banking, reporting, disbursement, lending

The balance section should be reviewed in terms of where the information comes from, the type of activity, and the service charge associated with each activity. Reconciliation helps ensure accurate and timely assessment of balances. How best to compensate the bank can also be answered when investment alternatives offer higher rates of return than the earnings credit rate (ECR; sometimes called an earnings credit allowance or earnings allowance rate) that banks may automatically apply to collected balances. In such a scenario, paying by fees may be more advantageous when one can invest collected balances and earn a higher interest income.

Computation of the ECR may be tied to a market rate, such as the 90-day Treasury bill rate, or a managed rate determined by the bank based on various factors, such as cost of funds and competitive pressures. The formula for calculating an ECR must consider the impact of the reserve requirement on bank charges; the 10 percent reserve requirement reduces the balance receiving the earnings credit by 10 percent. Additionally, deposit insurance may also be charged as a "hard charge" fee based on balances held in the account; when added together, both costs significantly lower balance levels. In considering payment by fees or balances, compensation to banks must be analyzed and negotiated to understand which arrangement is cost-effective. A clear agreement must be in place to identify the method and timing of compensation, especially if a method other than monthly settlement is preferable. Banks prefer monthly settlement, but when balances are used for compensation, quarterly, semiannual, or annual settlements may be appropriate to maximize use of excess balances that occur within the settlement cycle. Carrying forward excess balances must be negotiated, and the time period should be stated. Whenever settlement occurs, deficiencies should be billed and may be debited directly from the checking account.

Auditing and reviewing the account analysis statement could spot price changes and potentially identify cost-cutting opportunities. Working together with the bank relationship manager, a review may suggest ways to cut bank costs that are more directly tied to how the cash management system operates. Examples would include:

- *Payment alternatives*. Paying by ACH is cheaper than wire transfers, and using PC-initiated wire transfers is cheaper than phone-initiated transfers. Organizations are using same-day ACH to make last-minute bill payments or for emergency payroll.
- *Account maintenance.* Combine or eliminate checking accounts, since $4 to $50 can be charged each month per account (and this does not include per-item fees on related services such as for each check paid).
- *Checks deposited.* Consider encoding or sorting checks if volumes are high or doing remote deposit capture if volumes are low. On-site remote scanning with electronic transmission of items to be deposited is cost-effective for most organizations.
- *Stop payments.* Use an automated system.
- *Account reconciliation.* Use a paid-only (partial) reconciliation service instead of a full account reconciliation program.

Refer to Exhibit 11.6 for definitions of terms used in an account analysis statement and Exhibit 11.7 for a description of the components of the account analysis statement. If your organization is not presently "on analysis" ("analyzed checking") at your bank, check with your bank relationship officer to see if being being switched to analyzed checking might reduce your fees or increase your interest income.

## 11.3 COLLECTION SYSTEMS: MANAGING AND ACCELERATING RECEIPT OF FUNDS

Electronic collection, technically called direct payment if the amount is taken out of one's account on an ongoing and preauthorized basis without a card being used, is slowly replacing checks as the payment of choice. Surprisingly, in 2015 there were still 17 billion check payments made per year in the United States (down from almost 20 billion in 2012).[6] Although donations are still collected largely from checks mailed by donors, electronic payment options are gaining acceptance. This acceptance has been influenced by factors such

Average ledger balance: The sum of the daily, end-of-day gross balances on deposit divided by the number of days in the period

Average float: The sum of the daily amount of deposited items that were in the process of collection divided by the number of days in the period

Average collected balance: The sum of the daily ledger balances less uncollected balances (float) divided by the number of days in the period, the amount you can spend

Reserve requirement: The amount that a bank is required to leave on deposit with the Federal Reserve; currently, 10 percent of checking balances

FDIC: Federal Deposit Insurance Corporation – assesses bank's premiums to federally insure deposits

ECR: Earnings credit rate – the rate established by a bank, adjusted for the reserve requirement; applied to collected balances to derive the fee equivalent of balances maintained

Earnings allowance (or credit): The amount available to support services – calculated by multiplying the ECR or earnings allowance rate times collected balances

Service description: Description of the services used

Unit price: The bank pricing for each transaction; may or may not be the bank's standard price

Volume: The number of transactions for each service

Service charge: The results of the calculation of unit price times volume

Collected balance required: The balances needed to completely compensate a bank for services rendered

**Exhibit 11.6** Definitions of Terms Used in an Account Analysis Statement

Customer information: General customer information such as name and address, account title and number, period covered, and bank contact.

Current/historical balance and compensation information: Section containing current and historical ledger, collected and uncollected balances and any adjustments for the period, and current and historical excess/deficit balance positions. The current and subsequent months' ECRs are displayed, along with the earnings allowance and total monthly service charge and, in many instances, the multiplier (collected balance required to support $1 of fees).

Adjustment detail: Any adjustment for a prior period is included in this section, which indicates description, transaction date, date of adjustment, amount, and the number of days included in the adjustment.

Summary of accounts: This section shows all of the accounts included in the account analysis statement, along with selected summary information (e.g., average balances, float, total service charge).

Service description and cost information: This section is usually grouped into categories, and shows services used, monthly volume, unit and total price, and collected balance equivalents that require close scrutiny and can often result in cost savings.

**Exhibit 11.7** Components of the Account Analysis Statement as an increase in comfort with electronic products, personal convenience, and an increased sense of security about the medium. Cash substitutes in the form of debit and prepaid cards, direct payments through the ACH, and ACH debits are growing. The ACH is basically a computerized network for processing electronic debits and credits between banks for their customers through the Federal Reserve System. A dedicated website is now available for nonprofits considering the advantages of direct payment (electronic collection of donations using the ACH system): https://electronicpayments.nacha.org/donor. Appendix 11A provides a Direct Payment for Nonprofits guide, and Appendix 11B provides a nonprofit direct payment case study for you to review. Most US households now use direct payment and, on the whole, are very satisfied with it. In fact, US consumers now pay more than 800 million bills per month using direct payment via ACH.[7]

Credit card and debit card payments are also used increasingly but may cost more than checks or ACH payments, depending on the transaction size. Electronic transmittal of credit card and debit card transactions offers cost advantages over paper-based processing with the potential for a reduced discount rate (the charge levied by the merchant bank) and direct credit to the organization's bank account. Upon transmission, notification is immediately provided on any discrepancy in account information by a payor or disallowed transaction (e.g., credit limit exceeded). As the volume of credit card and debit card payments increases, an annual review should be conducted. Keeping track of card amounts and activity will be helpful in negotiating a lower discount rate since merchant banks base their pricing on average ticket size and volume.

When agreements are in place to collect pledges using an ACH or other electronic payments, the cash forecast is significantly improved. Money becomes available at the agreed-on monthly or quarterly interval. Within hours from initiation of an ACH debit, funds will be credited to the organization's checking account or swept to its concentration account. Credit card transactions can be collected within one to three days. The percentage of collections handled through check substitutes is still low but is gaining acceptance. The experience of nonprofits that have used ACH debits (also called automatic bill payment, automatic debit, electronic bill payment, or direct debit) suggests that a pilot test and survey must first be conducted to gauge the willingness of donors to participate in such a program. One foundation has been using ACH debits for quarterly payment of its annual fund pledge payments. Specifying a cutoff amount that will be cost-effective to handle is also recommended, and it is advisable to start with a focus group or payment type. The process saves staff time, postage costs, and other expenses associated with issuing pledge reminders and invoices. One large ministry organization determined that the average cost of donation processing if made by ACH debit was 22 cents; if made by check, 80 cents; and if made by credit card, $1.42.[8]

Exhibit 11.8 shows that the relatively new ACH same-day payments innovation is meeting competition provided by private parties for immediate or same-day transfers. The second one listed, the RTP system which is run by banks ("The Clearing House"), took only three seconds to settle its first transaction. As noted earlier, organizations are using same-day ACH for last minute bill payment and for emergency payroll. Check with your bank to see whether ACH same-day payments are your best option, or if one of these new entrants offers a cost-effective, secure alternative for collecting from your donors or other payors.

An ACH credit is a payment choice for more and more corporations that have matching gift programs for their employees. The ABC Educational Foundation signed up for a pharmaceutical company's matching gift program and now receives a direct payment to its bank checking account. Like any other automated transaction, the payment is clearly identified and shows up in the bank balance report. For beneficiary distributions to planned giving donors, the foundation makes monthly or quarterly payments by ACH. This replaced check payments that required more staff time to process. A donor's financial institution or bank

**Comparing Attributes of U.S. Faster Payments Solutions**

This represents a sample of the faster payments solutions in the marketplace as of April 2017.

| | Payment Type (Includes only monetary transactions) | Use Cases | Clearing Mechanism | Payment Messaging |
|---|---|---|---|---|
| NACHA Same Day ACH | Credit<br>Debit | P2P<br>B2B<br>B2C<br>C2B<br>A2A | ACH | Same Day |
| The Clearing House Real-Time Payments (RTP) | Credit | P2P<br>B2B<br>B2C<br>C2B<br>A2A | RTP | Real Time |
| Zelle℠ | Credit | P2P<br>B2C | ACH, Debit card networks | Real Time |
| Visa Direct | Credit | P2P<br>B2B<br>B2C<br>C2B<br>A2A | Card | Real Time |
| Mastercard Send | Credit<br>Debit | P2P<br>B2C<br>G2C<br>A2A<br>B2B | Card | Real Time |
| SHAZAM Network | Credit<br>Debit | P2P<br>B2C<br>C2B | Card | Real Time |

*Source:* "Introduction to Faster Payments in the U.S.," NACHA, April 2017. Used by permission. Available at https://resourcecenter.nacha.org/sites/resourcecenter.nacha.org/files/resource/NACHA_Intro_To_Faster_Payments.pdf. Accessed: 7/11/17.

**Exhibit 11.8** Same-Day and Real-Time Payments in the United States

does not charge for ACH remittances, unlike a wire transfer, which could cost $10 to $15 to receive.

Check collections can also be accelerated through pre-encoding the amount in the magnetic ink character recognition line or presorting by drawee bank locally, by city or region. Using these two options, depositors can avail themselves of preferential pricing and better availability from their banks. Furthermore, the Federal Reserve's same-day settlement (SDS) initiative permits a collecting bank to present items to any paying bank directly, without establishing a relationship with that bank or paying presentment fees. SDS has spurred electronic clearing mechanisms.

Electronic check presentment and check truncation have grown rapidly due to legislative provision for an "image replacement document" to be electronically transmitted and be considered the legal equivalent to a paper check when presented to the bank on which the original check was drawn. This has revolutionized check collection by clearing checks and identifying return items using data transmissions rather than moving paper checks. Nearly all the checks received by and then cleared by the Federal Reserve (Fed) in the U.S. are in the form of electronic check images, and the Fed handles all check collections at one location rather than the 45 locations it had at one time. Combined with image processing, information on returned checks and access to gift data can be gathered sooner and at less cost.

**(a) LOCKBOX PROCESSING.** The lockbox system was developed to accelerate check collection and expedite deposit of accounts receivable. The concept began 60 years ago with the recommendation to use a post office box (lockbox) to collect large-dollar remittances. A corporation, through an authorization letter to the postmaster, permits a designated bank to extract mail from the corporation's box around the clock. With frequent pickups throughout the day, a bank can process remittances faster compared to directing mail to company premises. The objective is to minimize mail and processing time so that checks are converted into available funds more rapidly.

Many nonprofits today use lockbox services to process gift checks, membership dues, and other receivables associated with marketing and merchandising activities. You may opt to have the lockbox service opened for only part of the year, when your inflow of mailed checks is highest. In addition to banks, other service providers now offer lockbox processing. Current generations of lockbox services employ automated production interfaces, including bar code technology to receive and sort the mail; automation to encode, endorse, and photocopy checks; high-speed capture of payor bank routing information; and Internet access to confirm balance and receivables information. As noted earlier, checks are converted to electronic images to allow them to be presented quickly for payment to the drawee bank.

If outsourcing collection processing makes sense, a lockbox service should be evaluated. In selecting a vendor, these factors must be considered:

- Types of plans offered
- Vendor's operational capability
- Automation
- Professional staff (years of experience, turnover)
- Quality-control checkpoints (low error rates)
- Number of pickup times per day (but make sure this translates into a better availability schedule and/or later cutoff times)
- Availability schedule (when do deposits become available for investing, for paying down loans, or for funding disbursements?)
- Support and problem-resolution responsiveness
- Cutoff times (how late can you get the checks and still have them count for ledger credit?) and weekend processing
- Pricing
- Reporting capabilities
- Interface with accounts receivable system or an integrated accounting software system
- Disaster and continuity provisions

In using a lockbox service, the cash manager should coordinate with other departments' specifications relating to invoices and other remittance material. These specifications may include image-ready invoice redesign, proper ink colors, background print elimination, proper specifications for window envelopes, use of bar coding, and strategic location of key pieces of information (donor identification numbers, mail zip codes, return address). The cash management account officer of the bank or vendor should be consulted for assistance in designing the remittance document to providing more efficient processing and data capture in an electronic format. Reporting can also be streamlined so that the appropriate service plan can be identified and the pertinent information can be captured. Otherwise, the cost can be high.

Advances in imaging technology allowed replacement of costly printouts for lockbox remittance information that take longer to produce and deliver. Image technology captures details on invoice data, donor name, address, or dollar amount, and eliminate the need for stapling the invoice, envelope, and check photocopy. Information can be captured electronically and the image transmitted over the Internet. Data can be sorted, and users can store large volumes of data. Backup storage can take place to the cloud. The database is accessible from multiple locations, possibly via an intranet or over the Internet, and can automatically route information to various points within an organization. A development officer inquiring about a donor's gift can access a file containing the image of the check and the solicitation document. Both can be transmitted through e-mail or accessed through the organization's database.

Outsourcing through a lockbox service has its advantages and is an option that merits comparison against internal processing. Your finance team must evaluate the cost and staffing associated with internal processing, notably peak-period demands as well as the break-even receivable size. In cases where check or receivables processing is close to full capacity, this limits the internal processing facility's flexibility in bringing in trained personnel at peak periods, and outsourcing may be worth considering.

**(b) CHECKLIST OF COLLECTIONS-RELATED SERVICES AND ACTIVITIES.** This list of collections-related services and activities holds promise for nonprofits, based on our experience and our conversations with banking professionals:

*Get the checks out of the inbox!* Too many nonprofits allow time to elapse between the point when donors or clients mail the checks and when those checks are deposited and become spendable funds at the bank. Changes in the US payment system regarding check processing have greatly reduced the float time for those using electronic deposits, as noted by the Federal Reserve:

> Checks are now effectively all processed electronically once they enter the banking system and are increasingly being scanned and deposited electronically by businesses, often using accounting applications, and individual payees using mobile devices. Some checks are taken out of the check clearing process and converted to ACH payments, but the practice has not grown since electronic check processing took hold.[9]

If you cannot or do not prefer to improve your processes on your own, enlist the help of another organization or a financial institution. ChildFund, an international relief and development agency located in Richmond, Virginia, is a superb example of this. Treasurer Bill Hopkins located a nonbank company that had worked to expedite check collections in-house and had excess capacity. Now ChildFund authorizes the processing company to pick up checks received at ChildFund's post office boxes, pre-encode the checks with the dollar amounts and image those checks, and make the check deposits at ChildFund's bank. For the checks

ChildFund receives at its offices, it scans and images them and transmits the check deposits to its bank daily.

*Use lockbox services.* Many other large nonprofits tap bank or other third-party lockbox services in which donors' checks are received at a dedicated post office box, which is emptied by processor couriers 15 to 20 times a day and then taken to a specialized check processing operations center for automated document and check processing. Organizations get possible reductions in mail float and assured reductions in processing float and availability float in return for the monthly fee the processor charges. SunTrust and some other banks offer a service for organizations that have high check deposit volumes only twice a year during fundraising campaigns, allowing a minimal maintenance lockbox fee to be assessed during the months in which the service is not being used. Your organization may also elect to use a lockbox service during its capital campaign.

*Use check truncation and check conversion.* Check truncation and check conversion (point-of-sale conversion of a check to an electronic debit, being used by some healthcare organizations, and lockbox accounts receivable conversion [ARC] of mailed checks to electronic debits) are cutting the processing delay as well as the availability delay for having spendable funds.

*Learn about image capture.* Here you feed checks into a scanner-like device attached to your PC and convert them to images, which you then transmit as an electronic deposit to your bank from the location and at the time you choose. "Electronic depositing augments the migration toward paperless banking, using remote capture technology to process images as opposed to the actual paper checks," explains Georgette Cipolla, vice president of product development and product management at Fifth Third Bank. "Whether our customers receive checks by mail, in a drop box, or over the counter, they can deposit them from the security of their own office, significantly reducing the time, effort, and resources expended on remittance processing." You may also be able to deposit items later in the day – Wells Fargo allows customers to electronically deposit as late as 7:00 p.m. Pacific time.

*Consider pre-encoding deposits before transporting them to the bank.* This process, in which you imprint the dollar amount of the checks on them in magnetic ink, makes sense for organizations having at least 4,000 or 5,000 checks in their monthly deposits, according to William Michels, assistant vice president of global treasury management sales for KeyBank in Cleveland, Ohio. This gets the organization reduced fees or better availability.

*Utilize banks' deposit reconciliation services.* Here special deposit tickets cause your deposits from various branches in a geographic region to get deposited into one account (discussed in more depth later in the chapter). This gives you automatic funds concentration and location-by-location accounting. Furthermore, check out zero balance accounts (ZBAs), which allow your deposits in various locations to be transferred via bookkeeping entries to a master account at the same bank that same day without individual transfer fees. You may avoid transfer fees as well as multiple investment sweep fees (discussed later) by using ZBAs.

## 11.4 DISBURSEMENTS

Just as speeding collections is a recognized cash management tool, so too is the control of disbursements. Disbursements in the form of checks and drafts typically include all payments a nonprofit makes in the course of doing business. These may include payroll, vendor payments, grants, and distributions, to name a few.

**(a) DESIGNING THE DISBURSEMENT SYSTEM.** A well-planned disbursements system includes well-defined, systematic, and accurate procedures for authorizing, generating, and accounting for payments. Whether a system is paper-based, as with the use of checks, or electronic wire transfers and ACH, the cash manager's task is to orchestrate all the elements of checks, bank services, and the check-clearing process to monitor and control the outflow of funds. A sound disbursement system will help maximize the working capital funds available and enhance overall liquidity.

The disbursement function is handled primarily through bank checking accounts. In the past, delaying payment clearing time has been a technique employed to maximize disbursement float – the amount of time that elapses from the moment a check is released to the moment a check is charged to the issuer's account. This disbursement float consists of the sum of mail float, processing float, and clearing float. Managing float is less relevant in a low-interest-rate environment (but will become more important when interest rates trend upward). Furthermore, with electronic payment mechanisms and image exchange of checks, float is being largely eliminated from the US payments system.

**(b) FRAUD AND INTERNAL CONTROL IN DISBURSEMENTS.** Effective check disbursement practices are important for all organizations since many rely on checks as a payment mechanism. The treasury professional will be well served to have check disbursement controls in place to avoid fraud and potential losses. These recommendations for internal control should be built into treasury operations:

- Implement stringent disbursement approval, release, and stop-pay procedures.
- Ensure that only authorized personnel are performing these functions and that all procedures are documented and kept up-to-date.
- Secure check stock and facsimile signature plates. Remove check stock from printing equipment and store in a locked location when not in use.
- Maintain current signature card and bank agreement files. Update authorized signatories for all organizational and bank network changes. Notify bank of approved signatories on a periodic basis to ensure accuracy of records. Conduct periodic reviews to verify that currently used bank services and all applicable laws are reflected in bank agreements.
- Segregate the disbursement and account reconciliation duties of staff.
- Perform timely checking account reconciliations, preferably before the next month-end.
- Implement stringent voided check procedures. Punch out the signature on the voided check and promptly void the check in the accounts payable system.
- Consider using bank or internal automated account reconciliation, and almost all organizations should use a bank's positive pay services (discussed in more depth later).
- Stay on top of fraud issues related to remote capture of donors' or customers' checks.[10]
- Conduct periodic treasury/internal audit review.

## 11.5 STRUCTURING A FUNDS MANAGEMENT SYSTEM

The use of a general bank account or a set of accounts for deposits and disbursements is a decision that varies from one nonprofit to another. The choice is largely dictated by the type, size, and complexity of transactions associated with the nonprofit organization's activities. A well-designed bank account configuration is needed to maximize flow of funds, enhance earnings, improve efficiency, and facilitate better control of financial resources.

*Cash concentration* and *controlled disbursement accounts* are two cash management structures that separate the collection and disbursement of funds. If multiple locations deposit funds, cash concentration can be accomplished electronically through the Federal Reserve's ACH system. A cash concentration service will transfer funds from any financial institution in the country to a designated bank where the concentration is centralized. Transfers can be prepared at specified cutoff times each day, and funds will be available in one business day. This service offers a number of benefits: It eliminates idle funds in local depository accounts, speeds up identification of available cash, provides the potential for increased earnings on investments or reduced interest costs on debt as a result of funds centralization, enhances control over funds, facilitates quick decision making through timely receipt of deposit information, and provides data for monitoring deposits and balances.

Controlled disbursement eliminates guesswork from daily funding requirements on checks presented for payment. Through a controlled disbursement account, checks are paid through one or more disbursement accounts. Information on checks presented for payment is reported sometime late morning each day, and automatic transfers are made from a checking account to cover the day's disbursement activity. This service can reduce overdrafts and the use of credit lines. With computerized reporting, accurate data collection is possible, and clerical workload can be reduced through automatic funding and reporting.

Another cash management tool for disbursement and concentration is an automated *zero balance account*. The process links any number of disbursement or depository accounts. At the end of business each day, all balances over designated cash levels are transferred to a concentration account. Conversely, all balances below the designated level are automatically covered by transfers from a concentration account. Funds transfers from and to a single concentration account are handled automatically, and balances in disbursement and depository accounts can be set at a target amount or at zero. By eliminating idle balances in accounts and centralizing cash, better control will reduce overdrafts and increase efficiency in managing cash.

## 11.6 MONITORING BANK BALANCES AND TRANSACTIONS

Accurate and timely information on cash balances is essential to managing liquidity and making critical financial decisions about the use of funds. Today information on bank transactions, deposits, payments, return items, and other activities is readily accessible through a wide variety of mechanisms. These range from manual reporting by voice operator and touchtone devices to online access to balance data. Account reconciliation services help your organization "balance its checkbook."

**(a) BALANCE REPORTING AND TRANSACTION INITIATION.** *Bank-balance reporting* is a product that conveniently provides the cash manager access to bank account activity and information. Using a computer, web browser access to a bank's portal can be automatically programmed to gather balance information from as many banks as required or manually initiated. Balance reports include current ledger and collected balances, deposits subject to one- and two-day availability, error adjustments and resolutions, balance history, and average balance over previous time periods. Details of debits and credits, lockbox transactions, borrowing and investments, concentration reports, and other transactions can also be downloaded.

In addition to information retrieval, online initiation of transactions such as wire transfers and ACH payments is now possible. Services can be customized and expanded as needs change. Security features include passwords and multiple levels of identification codes, along with some new handheld devices. The use of cash management and information systems offers many benefits in terms of monitoring and controlling account activity, locating cash surpluses or shortages for more productive use of funds, enhancing cash forecasting, allowing stop payments, and reducing clerical time and expense in tracking cash positions. Investment activity and foreign exchange reporting can also be downloaded using bank information systems.

Automated information systems are widely available and competitively priced. They offer convenience and efficiency in cash management, and nonprofits are well served to use them. Information gathering is significantly enhanced, and the demand for timely information by management and trustees can be satisfied.

**(b) ACCOUNT RECONCILIATION.** Timely and accurate reconciliation of check payments is now effectively handled through account reconciliation services. Many banks offer a full or partial *account reconciliation service* to provide accounting on the status of checks issued. This can include paid, outstanding, exception, stopped, voided, or canceled items. Use of the service helps to balance an account faster, improves audit control, and provides protection against unauthorized, altered, and stopped checks. This service is most advantageous when a significant number of checks is written each month. It can simplify bookkeeping procedures and reduce staff time in balancing accounts.

*Deposit reconciliation* is another application suited to nonprofits with multiple locations depositing into a single account. The service segregates deposits by location and lists nonreporting locations. Through special serial-number groupings, daily reporting, and comprehensive monthly reports, the service facilitates auditing and enhances control over local depository activity. At the same time, the convenience and economy of a single depository account can be retained.

An invaluable service now offered by banks is *positive pay*. This option provides daily access for authenticating check payment by comparing checks issued to checks paid. A bank provides a daily list of nonmatching checks paid, and an exception is submitted to the organization. Instruction for payment or return of checks on the list can be given to ensure payment of legitimate checks only. This service is another tool for controlling fraud and is accessible online with the bank.

Overdrafts are likely to occur without a reliable cash forecasting and balance reporting system. Timely information on the status of disbursing accounts will enable a cash manager to move funds and avoid overdrafts. Monitoring funds availability is also important to minimize ledger overdrafts. When overdrafts occur, there are costs incurred aside from the interest expense charge or one-time fee that is assessed. Opportunity costs arise in terms of income lost from foregone investments, costs associated with transferring funds, and costs of delayed payments on bills (lost discounts, ill will, and other related costs). For a nonprofit institution making distributions to planned giving donors, donor relation issues are very sensitive, and accuracy is critical. Arrangements for overdraft protection or a line of credit would be advisable.

Aside from normal overdrafts, *daylight overdrafts* occur when funds are not sufficient to cover a transfer although the negative balance is covered by the end of the day. With Federal Reserve policy discouraging daylight overdrafts, banks pass charges to their customers. To avoid daylight overdrafts, accounts should be monitored intraday. Wire payment outflows can be timed to correspond with the availability of Fed funds from incoming transactions. Another technique is to match the method of payment with the source of covering funds. For example, wires and ACH payments settle differently, and it would be costly to rely on ACH deposits that may not be available to cover the amounts of outbound wires.

## 11.7 CASH FORECASTING

The cash management practice we see as the most ripe for improvement in the nonprofit world is cash forecasting. An organization is hindered in numerous ways when not having an updated forecast of forthcoming cash inflows, outflows, and the resulting cash position. Three results we observe often are:

1. Spending cash that would have been held had one foreseen that a seasonal "dry period" was ahead
2. Holding minimal cash reserves due to ignorance regarding the cash drain attending program growth
3. Holding large cash reserves and giving up interest yield because too large a portion of the organization's funds is held in overnight investments or a demand deposit account

Treasury Strategies finds that companies that forecast cash positions and also base their investment maturity selection on the forecast earn an additional 31 basis points in yield per year (about 3⁄10 of 1 percent).[11] We expect nonprofits would earn this same additional yield.

Cash forecasting is a valuable treasury tool. It begins with a definition of objectives for the forecast and a realistic assessment of the structure and activities of an organization. Forecasting allows management to evaluate changing conditions and formulate appropriate financial strategies. As a planning tool, cash forecasts (also called cash budgets) have to be monitored and updated to reflect both short- and long-term variables. (See Chapter 8 for more on cash budgeting.)

Depending on a nonprofit's funding and operational needs, cash forecasts can determine optimal borrowing and investment strategies. Many nonprofits rely on gift contributions for funding, and their timing is difficult to project. Accordingly, gathering information from internal sources is more predictable, particularly with the expense side of the equation. Common sources of receipt data are a nonprofit's sales (or program) units and accounts receivable departments. Disbursement data would come from those responsible for purchasing and accounts payable, as well as the human resources area for payroll and benefits data.

**(a) CASH SCHEDULING.** For some organizations, a monthly cash forecast does not give enough detail, and *cash scheduling* may be a more relevant technique in determining the organization's short-term cash position (one day to six weeks). The process begins with a forecast of deposits to plan the timing and amount of funds for cash concentration.

Simultaneously, estimates are made on when checks will be presented. When concentration and disbursement accounts are used, cash scheduling will help the cash manager to mobilize funds without experiencing the opportunity costs associated with excess and idle balances. Ideally, balances can be maintained at target levels in the appropriate concentration or disbursement account.

**(b) DATA ELEMENTS FOR CASH FLOW ESTIMATES.** Receipt and disbursement items vary among nonprofits but mirror treasury transactions in a typical corporate environment. In a broad sense, projecting collections and payables is necessary to determine the timing of each cash flow component, although there may be little control over certain inflows associated with fundraising. Trends and patterns over certain time periods can provide a good basis for arranging financing alternatives during slow months or investing surplus cash longer without risking penalty for early termination of an investment position. Statistical methods of analysis and qualitative techniques may be used in combination to arrive at a reasonable cash forecast.

Estimating the amount and timing of various receipts and disbursements can be time consuming. However, with coordination from various units that have an input to the process, a reasonable forecast can bridge gaps and improve financial planning. Management and marketing/public relations issues must be considered along with payment policies on early-payment discounts and costs that may be unnecessarily incurred due to overdrafts.

| Receipts | Disbursements |
|---|---|
| Lockbox collections | Vendor (supplier) payments |
| Deposits | Payroll, benefits |
| Loans/credit lines | Programmatic expenses |
| Pledge payments | Grants and allocations |
| Debt proceeds | Debt repayments and interest expense |
| Maturing investments | Insurance payments |
| Income from investments | Distributions for planned gifts |
| Endowment fund distributions | New investments |
| Stock gift proceeds | |

## 11.8 SHORT-TERM BORROWING

External financing is an alternative source of funds when no surplus cash is available to meet working capital shortfalls. To account for both short- and long-term financing needs, it is necessary to have a complete picture of the sources and uses of funds, linked to both operational and strategic plans of the organization. Major capital and program expenditures would require a different type of financing, and, typically, loans have to be collateralized.

For liquidity purposes, a bank credit line may be sufficient to fill temporary or seasonal financing needs. This credit line is generally an unsecured loan made on the basis of the borrower's financial strength. The cost to borrow varies and is usually negotiated or reconfirmed annually. Most credit lines carry a variable interest rate based on an agreed base rate. Depending on the perceived risk and the negotiating position of the organization, the interest rate may include a specified spread over the base rate. Interest payments are frequently made monthly or at the maturity of the loan.

Banks usually require compensation for offering a credit line in the form of balances and/or fees. The interest rate on a loan may be negotiated depending on the level of balances held at the bank. Likewise, other activities in the relationship and the overall profitability of the nonprofit's account will affect pricing.

In addition to a bank line of credit, deferring payment on disbursements can be a temporary source of liquidity applying to vendors and other suppliers. However, deferred payments should not be pursued without taking into account the cost of missed discounts in the terms of sale. Implicit costs associated with loss of goodwill and damaged credit rating and explicit costs such as interest charged on late payments should not be overlooked; we strongly advise against delaying payments beyond terms without discussing this first with the party you owe. In certain situations, internal financing may also be an option. For example, borrowing against an endowment portfolio may be possible on an arm's-length basis. For such transactions, careful attention must be given to the terms and conditions of the loan to avoid any potential conflict of interest. For more on short-term financing, see our extended presentation in Chapter 10.

## 11.9 SHORT-TERM INVESTING

Chapter 12 discusses strategies and instruments for short-term investing. This section addresses some basic considerations. When surplus cash is available, it can be managed to meet liquidity needs or invested. The first step is to determine whether funds are cash reserves solely for operating purposes or available over a longer time frame. Understanding this would enable the cash manager to develop an appropriate strategy to maximize earnings and satisfy liquidity requirements.

With funds managed in a fiduciary capacity, the cash manager's foremost investment objective is safety of principal. Many investment instruments are available, and it is important to understand the market and the types of securities that are bought and sold. Whatever the reason for short-term investing, specific policies and guidelines should be defined prior to making any investment. *Investment policies and guidelines should state investment objectives, define tolerance for risk, address liquidity factors, identify the level of return or yield acceptable for different instruments, and identify personnel roles and responsibilities regarding the implementation and monitoring of an investment program.* Poor investment judgment, assumption of imprudent risks, assignment of responsibilities to unqualified personnel, and fraud can lead to opportunity costs and loss of principal.

From a cash management perspective, these suggestions are offered:

- Provide copies of investment guidelines to your banker, money manager, or broker with whom you will trade; this will be a good basis for developing appropriate investment strategies and identifying suitable financial instruments.
- Arrange for safekeeping of securities; this offers added security and control and facilitates the audit of securities held. If safekeeping is maintained with the relationship bank, include cost of service in bank account analysis.
- In the absence of a custody or safekeeping account, document instructions for transfer of funds and designate specific accounts for payment of trade proceeds.
- Institute proper operational procedures and controls for investment activities.
- Provide a list of authorized personnel and their specimen signatures.
- Review all portfolio holdings for compliance with credit quality ratings.

- Determine the value of portfolio holding and marked-to-market securities.
- Assimilate investment activities into funds-flow forecasts to manage liquidity.

In addition to these general recommendations, we have some specific recommendations. Consider this question: What can the organization do once it has the cash in position to invest (assuming it has paid down short-term borrowings)?

First, are you sure you are best served with a "free checking" account? You should be able to do better. Like consumers, nonprofits are eligible for negotiable order of withdrawal (NOW) accounts that pay interest. The interest rate paid on these accounts may be negligible, however, and must be compared to the fees charged by the bank for its banking services. As the organization becomes larger and begins to consistently hold five-digit balances in the account, it is time to be manually moving some of that to savings or money market accounts. For organizations with $60,000 or more in liquid funds, consider automatic sweep accounts, in which monies above a set dollar amount are automatically "swept out" of the account at the close of business and into an interest-earning investment; these funds are then returned to the account the next day to cover disbursements. (We present more information on sweep accounts in the next section.)

If yours is a larger organization having slightly more risk tolerance for some or all of your excess funds, there are "enhanced return" accounts that invest money actively in a menu of options. More will be said about this in Chapter 12.

**(a) BANK SWEEP ACCOUNTS/INVESTMENT SERVICES.** One way you might handle short-term investing is through sweep accounts. It is natural for banks, the location in which your surplus funds build up, to offer fee-based investment services. Banks offer their own securities as well as serve as brokers for other institutions' securities. The bank offers investors its own instruments, or those of its parent holding company, as a means of purchasing funds that the bank can loan out or invest. In addition to offering investment securities, many banks offer corporate agency services to safeguard the company's investments, manage trusts and pensions, and handle record keeping related to bonds your organization has issued.

Popular investments your organization can buy through a bank include repurchase agreements (often as part of a sweep agreement), commercial paper, certificates of deposit, Eurodollar time deposits, and Treasury bills. We will discuss only repurchase agreements and sweep accounts here.

A *repurchase agreement*, or "repo" as it is often called, involves the bank selling the investor a portfolio of securities, then agreeing to buy the securities back (repurchase) at an agreed-on future date. The securities act as collateral for the investor, to protect against the possibility that the bank will default on the repurchase. The difference between the selling price and the repurchase price constitutes the interest.

Quite often, banks will set up a *sweep arrangement* to automate the repurchase decision-making process, sparing the treasurer daily investment evaluations. All balances above those necessary to compensate the bank for services or to fund disbursements are swept nightly into repos or another safe instrument. The bank may also impose a $1,000 minimum sweep amount to eliminate small-dollar transfers. Transfers are accomplished by a set of bookkeeping entries at the bank. Excess balances are invested for one business day, with the principal amount credited to the checking account the following day. An investment report is produced daily, indicating the amount of the daily investment, the interest rate, the amount of interest earned, and what investment security stands behind (is collateralizing) the investment. As an added advantage of such arrangements, some banks

| | Bank A | Bank B |
|---|---|---|
| **Amount Invested** | **Annualized Interest Rate* (%)** | **Annualized Interest Rate (%)** |
| **$0–$999,999** | **4.00** | **4.85** |
| $1–$2 M | 4.25 | 4.90 |
| $2–$5 M | 4.25 | 4.95 |
| $5–$10 M | 4.45 | 5.05 |
| $10 M+ | 4.45 | 5.15 |

*Bank A does not have a minimum transfer amount, and calculates yield using a formula based on the amount invested each day.

**Exhibit 11.9** Examples of Interest Earned on Repos

will not charge the company for an overdraft if the sum of the available balance and the repurchased amounts is sufficient to cover presentments, choosing instead to cover the checks with the bank's funds.

You may wonder what interest rate you can receive on such a short-term investment. Exhibit 11.9 shows the rate structures that existed at one point in time for two large Midwestern banks. Bank A calculates its interest rate in this way:

- Up to $1 million, Fed funds rate minus 1.3 percent
- From $1 million to $5 million, Fed funds rate minus 1 percent
- Over $5 million, Fed funds rate minus 0.6 percent

As the bank implements this tiered rate scheme, it pays 0 percent when the Fed funds rate is close to zero, which it was for a number of a number of years post-2008. The message is clear: If you still have a (NOW) account, you are often better off transferring your money into an overnight investment because the yield pickup may be significant. Finally, you will be charged a monthly fee plus a daily transfer fee for the sweep account, and the automated sweep-account fee is slightly higher than a manually operated sweep. These fees must be weighed against the increased interest revenue to determine if your organization would profit from establishing a sweep account.

As an example of a sweep account and two choices that you may have in establishing one, consider KeyBank's product offering (see Exhibit 11.10). Key's sweep accounts include a monthly fee and a fee if the organization either falls below the minimum balance or exceeds the maximum number of monthly free sweep transactions. Furthermore, bear in mind that (1) you will not be able to sweep all the funds you hold in the bank account, as KeyBank requires that a minimum target balance of $25,000 in collected balances be kept in the bank account; (2) if you use the Repo Sweep investment option, your transfers will be made in increments of $2,500 whereas transfers to the Automatic Investment Sweep or Commercial or Public Interest Sweep investments are made in any amount.

The economics of sweep accounts change as interest rates move up or down. Both Carolyn King (Fifth Third Bank) and Wayne Kissinger (SunTrust Bank) note that a number of their clients' sweep accounts that were inactive were turned back when short-term interest rates rose above 2 percent and continued to rise. The economics are straightforward: Let's say the organization is receiving a negligible interest rate on its checking account and would pay $150 per month to have the sweep service in place. If it can normally sweep $60,000 out on an overnight basis, with interest rates of 3 percent, it is exactly covering that $150

**WHAT TYPES OF INVESTMENT SWEEPS DOES KEYBANK OFFER?**
KeyBank offers three investment sweep products:

1. Repurchase Agreement (Repo) Sweep: A repo sweep is an overnight investment that consists of direct obligations of, or those that are fully guaranteed as to the principal and interest by, the US government or agencies. Repo investments are collateralized at 100 percent of market value. The repo sweep is specifically designed for corporate clients of KeyBank that are seeking security for their funds in line with their investment objectives. Public entities that are eligible for collateralized deposit accounts are not eligible for the repo sweep.
2. Automatic Investment Sweep: An automatic investment sweep is an open term investment in a selection of money-market mutual funds provided by Federated Investors. Investment (fund) selections are limited to those with fixed net asset values (NAVs) and no redemption gates or fees. These fund selections include Government Obligations Fund (CUSIP: GOIXX), Treasury Obligations Fund (TOIXX), and US Treasury Cash Reserves (UTIXX). Investments and earnings remain in the investment account until needed to restore the target balance in the bank account.
3. Commercial or Public Interest Sweep: A commercial or public interest sweep is an open term savings in an interest-bearing deposit account at KeyBank. Investments and earnings remain in the savings account until they are needed to restore the target balance in the bank account. There is no limit on the number of transfers in or out per month.

*Source:* https://www.key.com/corporate/kttu/reporting-research/sweeps/sweeps-faq.jsp. Accessed: 7/11/17. Used by permission.

**Exhibit 11.10** Three Types of Sweep Accounts

monthly cost ($\$150 \times 12 = \$1{,}800$ per year; $\$1{,}800 = \$60{,}000 \times 0.03$); either higher balances or higher sweep investment account interest rates provide an interest income for the organization and make it profitable to use the sweep account.

**(b) INSTITUTIONAL MONEY MARKET FUNDS.** Many sweeps will move your money into an institutional money-market mutual fund. Or you may choose to invest in a money fund via a separate investment decision, done manually. To give a general frame of reference when assessing whether the yield on your money fund is competitive, compare it to Crane Data's or iMoneyNet's published yields.[12] Exhibit 11.11 shows our profile of Crane Data's listing of the highest-yielding large institutional money mutual funds at one point in time.

If you are tilted toward safety, you would want to consider the money funds that invest organization's excess cash in governmental (e.g., Treasury) short-term obligations. When drawing the comparison, consider the fund's weighted-average maturity (WAM). The longer the WAM, the more the yield you earn on the fund will lag further upward movements in short-term interest rates (an advantage if rates are moving lower, but a clear disadvantage as rates move higher). Some observers, notably Capital Advisors Group (https://www.capitaladvisors.com/), propose that separately managed accounts might offer a better short-term investment opportunity than institutional money funds in today's regulatory environment.

If you have operations abroad, the availability of bank-provided overnight investing varies considerably. In many cases, you will want to invest foreign cash flows abroad in order to minimize the need to convert to dollars and back to a foreign currency for later

The following are the highest-yielding institutional money funds, based on 7-day yields, as of 1/25/2018. For reference, the effective Federal Funds (Fed funds) interest rate was 1.42% on that date. The Fed Funds rate serves as a base under all short-term, money market, interest rates in the U.S. We have included the minimum initial investment amount for each of these institutional money funds, which are purchased by businesses, governmental agencies, and nonprofit organizations.

Wells Fargo Heritage Select
($50 million minimum investment)
7-Day Yield: 1.53%

Morgan Stanley Institutional Liquidity Funds: Money Market
Portfolio (Institutional Share Class)
($10 million minimum investment)
7-Day Yield: 1.52%

UBS Select Prime Preferred Fund
($99 million minimum investment)
7-Day Yield: 1.51%

Federated Institutional Money Market Management
(Institutional Shares)
($500,000 minimum investment)
7-Day Yield: 1.51%

State Street Institutional Liquid Reserves Fund (Premium Class)
($250 million minimum investment)
7-Day Yield: 1.50%

*Source:* Adapted from listing provided by Crane Data, "Money Fund Intelligence." Available at: https://cranedata.com/. Accessed: 1/26/2018. You may also wish to consult iMoneyNet's data, available at the time of this writing at https://financialintelligence.informa.com/about/imoneynet-money-fund-averages.

**Exhibit 11.11** High Money Market Yields for Organizations' Short-Term Investments

needs, which incurs charges for you in transaction costs as well as the risk you bear of the exchange rate changing.

## 11.10 BENCHMARKING TREASURY FUNCTIONS

Benchmarking is a process through which an organization compares its internal performance to external standards of excellence. For example, short-term investment performance results are compared by one organization to the Merrill Lynch institutional money fund yield as well as to the London Interbank Offered Rate (LIBOR), which is the rate at which large banks lend and borrow US dollars in the London market. The objective of benchmarking is to achieve and sustain optimum performance through continual process improvement. Unless an effort is made to clearly understand the nonprofit's mission, operations, staffing, and services provided as well as its customers and other stakeholders, improvement will be slow.

**(a) LARGER ORGANIZATIONS.** Total quality management (TQM) is a process that has been applied to treasury functions. TQM views quality as adherence to internal standards or guidelines, an approach that fits well with mission-focused nonprofit organizations. Many times it is simply called "continuous improvement." The four steps involved are: (1) creating a vision and mission statement; (2) understanding suppliers, customers, and the big picture; (3) encouraging cross-functional collaboration; and (4) focusing problem solving on removing root causes in order to produce significant gains. Involving the bank relationship manager and other vendors in assessments will provide valuable feedback to internal staff. Strengths and weaknesses are addressed for various types of processes. The TQM process also relies on quantitative measures and statistical data gathering to evaluate results and monitor process improvement. Through regular reviews and/or audits, fine-tuning can be pursued and changes can be instituted in an organized manner. Nonprofits must approach their business in the same way as for-profit corporations. In so doing, they will be more proactive than reactive, and, ultimately, better efficiency will result in cost savings.

The account analysis statement is a useful source of information for evaluating the quality and cost of various bank services. Transaction volumes can be plotted and analyzed to gauge patterns in lockbox collections, wire transfers, and return items, to name a few examples. Benchmarking can be valuable and should encompass a broad range of activities to provide a meaningful basis for improvement.

**(b) SMALLER ORGANIZATIONS.** We have developed a checklist for the many nonprofits that are smaller (i.e., $2.5 million in annual revenues or less) so that you can compare your practices and policies to what might be considered best practices (see Exhibit 11.12).

## 11.11 UPGRADING THE CALIBER OF TREASURY PROFESSIONALS

Cash managers of nonprofits must stay abreast of regulatory, service, and product changes. Many major cities have regional treasury associations that provide extensive educational opportunities for practitioners. These typically have as part of their organizational name either "Treasury Management Association" or "Financial Professionals." Examples are the Kansas City Association for Financial Professionals (http://www.kcafp.org/) and the Association for Financial Professionals of Indiana (http://www.afp-in.org/). Participation in treasury conferences, such as the Association for Financial Professionals' annual conference (see www.afponline.org)[13] or other forums on electronic payments (the annual AFP Payments Forum, as well as the annual payments conference of the National Automated Clearing House Association [NACHA] or the five-day Payments Institute; see www.nacha.org) will provide exposure to current and emerging technologies and information. Industry publications, bank newsletters, and technical books are additional sources of information.

Likewise, network with peers from organizations similar to yours as well as corporate and governmental treasury professionals to accelerate learning opportunities and implement changes that can be applied in your treasury department. An enlightened treasury professional is an asset to every nonprofit, and management must invest in staff advancement opportunities.

Cross-training of staff should be supported to ensure continuity in operations. Ongoing training is recommended with backup personnel assigned to critical treasury functions. As advances in technology lead to changes in how tasks are performed, it is advisable to document procedures. A manual should be maintained and updated to reflect any organizational, bank, and system changes that may occur in procedures for initiating wire transfers and ACH transactions. Documentation pertaining to banking resolutions, authorized signatories, and investment guidelines should also be included. Centralized record keeping will ensure continuity and minimize disruptions in operations.

This checklist outline, while applicable to nonprofits of all sizes, especially fits the environment in which smaller nonprofit organizations operate.

**CASH MANAGEMENT: GENERAL GUIDELINES AND BEST PRACTICES**

**A.** Organizational Issues

1. Policies are in place for cash management, who is authorized to do what (with dollar limits), short-term investments, and long-term investments.
2. Board has one or more persons with financial expertise and has a functioning and effective finance committee and audit committee.
3. CFO/Treasurer has financial education, training, a heart for the mission, ability to say no persuasively, and (ideally) nonprofit experience.
4. Organization taps service provider expertise:
   - **(a)** Bank or credit union
   - **(b)** Auditor
   - **(c)** Information system provider
5. Organization uses volunteers and college interns effectively.
6. Organization taps the power of Microsoft Excel for financial reports and modeling.

**B.** Cash Management

1. Brings cash in quickly and accurately:
   - **(a)** Donations and dues: collects electronically if possible.
   - **(b)** Loans and advances: doesn't allow delays in related payments.
   - **(c)** Service fees and sales revenue: is assertive, does not allow those buying from it to "stretch payables."
   - **(d)** Uses bank/third-party and/or internal treasury information services as an ally to verify inflow amounts and timing.
2. Mobilizes cash: pooling, employing, protecting, amassing, monitoring funds:
   - **(a)** Pools funds: does not allow small balances to remain in multiple accounts.
   - **(b)** Employs funds: puts funds awaiting investment to work.
   - **(c)** Protects funds: watches for and guards against foreign exchange risk and interest rate risk.
   - **(d)** Amasses funds (some controversy here):
     - **i.** Faith-based organizations do not excuse lack of planning, but exercise collective faith proactively (build now) rather than reactively (scramble once in crisis) to assemble needed cash reserves.*
     - **ii.** Minimum of 3 or preferably 6 to 9 months of expenses in operating reserves for emergencies, rainy-day fund, missed forecasts, unforeseen opportunities.

**Exhibit 11.12** Checklist: Cash and Investment Management Best Practices

- **iii.** As much as 1 to 2 years of expenses in prefunding account for planned needs such as loan repayments, capital expenditures, program expansion, earned income venture launch, and so on; this is driven by inability to issue stock and/or inability or unwillingness to use various forms of debt financing.

**(e)** Monitors funds using bank/third-party and/or internal treasury information services as an ally to help control fund balances.

**3.** Pays out cash slowly and cautiously:

- **(a)** Uses separate disbursement account.
- **(b)** Uses positive pay (provide check issue file to bank, bank contacts organization regarding any item discrepancies) or reverse positive pay (bank forwards file of presented items, awaits okay from organization).
- **(c)** Pays on terms, not before terms, unless receiving cash discount.
- **(d)** Uses bank/third-party and/or internal treasury information services as an ally to verify outflow amounts and timing.
- **(e)** Uses purchasing cards or corporate credit cards where appropriate:
  - **i.** Saving time and expense of purchase order processes
  - **ii.** Possibly gaining quantity discounts or rebates for usage
  - **iii.** Can limit employee purchases to only a certain type of business

**4.** Recognizes value of Internet-based bank and treasury information:

- **(a)** Corporations report significant impact of Internet on treasury:
  - **i.** Finding better access for real-time treasury information
  - **ii.** Finding wider access to bank data, including self-service bank account inquiry abilities, ability to work remotely, less need for treasury staff training, and ability to spend time on strategic issues
- **(b)** But also note possibility of having to shop and negotiate for these services.

**5.** Forecasts cash position and cash needs:

- **(a)** First converts operating budget to cash budget (a.k.a. cash forecast) or develops stand-alone cash budget (translate receivables, payables, depreciation amounts).
- **(b)** Starts with next year by months.
- **(c)** Then develops forecast of next month by weeks.
- **(d)** Then develops next week by days.
- **(e)** Finally ends with setting daily cash position by midday, allowing better bank balance management and possibly authorizing sweep account for automated overnight investing.

*The principle of saving relevant to many faith traditions is taught in the Old Testament (Proverbs 21:20): "Precious treasure and oil are in a wise man's dwelling, but a foolish man devours it." The Holy Bible, English Standard Version. Copyright © 2001 by Crossway Bibles, a publishing ministry of Good News Publishers.

**Exhibit 11.12** Checklist: Cash and Investment Management Best Practices (*continued*)

## 11.12 SECURITY AND RISK MANAGEMENT ISSUES

Nonprofit organizations have a fiduciary responsibility for the gifts and donations that constitute a large percentage of their revenues. Recent events associated with fraud, failed investments, rogue brokers, and other financial losses have created concerns beyond risks normally associated with financial instrument quality or creditworthiness. There are various types of financial risk, and a prudent risk management program is relevant not only for treasury functions, but also throughout the entire organization.

**(a) TYPES OF FINANCIAL RISK.** Here are the significant types of financial risk that may affect your organization:

- *Market risk*. Risk of change in market price of an underlying instrument, which may be due to adverse movements in currency exchange rates, interest rates, commodity and equity markets, as well as time value of money
- *Liquidity risk*. Risk associated with investment illiquidity, which can adversely affect pricing of a security
- *Credit risk*. Risk of counterparty default on an obligation
- *Legal risk*. Loss exposure due to unenforceable contracts caused by documentation deficiencies
- *Funding risk*. Risk from internal cash flow deficiencies
- *Operational risk*. Risk of unexpected loss due to system malfunction, inaccurate accounting and record keeping, settlement failure, human errors, incorrect market valuation, and/or fraud

An effective risk management program begins with identifying and understanding risk. Top management must be knowledgeable about the types of risk that could potentially threaten financial and operational stability. Once identified, appropriate measures can be instituted and tolerance levels defined. The tolerance levels your management and board agree can be assumed by your organization will have a bearing on the limits set for transactional volumes, the means of avoiding fraud, and the proper checks and balances to be instituted in operating setups. Protection against certain risks may translate into higher insurance premiums or be added to the costs of doing business. Hedging strategies using derivatives are helpful in protecting investments or loans against adverse interest rate movement. However, the use of derivatives must be fully understood, and investment guidelines should clearly state which specific transactions are allowed or disallowed.

The most common financial risk for nonprofits may be related to market exposure and volatility for investment assets. Investment guidelines must be formulated to clearly define permitted transactions, credit quality, exposure limits, maturity or duration parameters, safekeeping, and trading authority. See Chapter 12 for more on these considerations.

**(b) FRAUD.** Fraud is another type of risk that confronts many organizations, as we noted in our earlier discussion of internal control. Check fraud has led to mounting losses, with illegal check schemes on the rise. The increase in check fraud is attributed primarily to the widespread availability of inexpensive desktop publishing software and laser printing equipment. Section 11.4 discusses in detail ways to counteract check fraud.

Natural disasters, fires, and other instances of *force majeure* have to be anticipated. Contingency plans for business resumption should be drawn, and recovery measures should be well communicated throughout the organization. Ongoing review and testing are imperative to cover changes in operations, personnel, and procedures. Offsite storage of critical documents, backup procedures for computer applications, emergency banking arrangements, and other key operations must be covered and priorities set. It is also worth looking at out-of-state banking alternatives and utilizing those accounts for emergencies. However, proper authorizations and procedures have to be spelled out. Nowadays, heavy reliance on electronic processing and initiation of transactions using PCs or mobile apps can lead to paralysis in the event of a power failure or system outage. Nonautomated alternatives should be explored, particularly with funds transfer mechanisms (e.g., voice or phone transfers with callback procedures). Another measure includes documenting all account information, contact persons, telephone numbers, and other essential data in both hard copy and storage drive or other media. All should be housed in a separate but secure location. Redundant systems may save tremendous time and expense in the event of a disaster. Being without a contingency plan is risky, and adequate preparation is essential to every treasury operation.

Fraud is also possible with electronic payments. One concern is the fraud in telephone-initiated electronic payments, using the "TEL" format. If you are considering doing one-time pledge collections or other special one-time consumer receivables collections using telephone-initiated debits to individuals' bank accounts, you should be aware of the issue and anticipate possible donor resistance to allowing these debits because of merchants' misuse.

## 11.13 TRENDS IN TREASURY MANAGEMENT

Nonprofit organizations are faced with increasing cost pressures and competition for donated funds. In such an environment, it has become imperative to eliminate inefficiencies and maximize cost savings.

**(a) KEY PERFORMANCE INDICATORS.** Key performance indicators (KPIs) are increasingly used by nonprofits to better monitor and manage their organizations. Exhibit 11.13 provides some advanced KPIs for larger nonprofits.

**(b) AUTOMATION AND TECHNOLOGY.** Technology is replacing many paper-based applications as it becomes more affordable and accessible. However, technology leads to the need for greater security, fraud control, and regulatory requirement. In implementing new processes driven by technological advances, nonprofits should not cut costs at the expense of flexibility and control.

Increased integration of business systems is another trend made possible by advances in technology. Functions such as accounting, accounts payable, accounts receivable, purchasing, and inventory can now be linked. Related financial services, such as cash management, securities, trust, and custody products, are available through computer interfaces and provide significant enhancement to information reporting. Fully integrated enterprise resource planning (ERP) systems will serve as a cornerstone of the financial function of a nonprofit organization, providing control, decision support, and audit trails. Linking systems not only enhances productivity, but also minimizes input errors when rekeying information. Faster availability of financial information is helpful in analyzing and reengineering work flow.

As more of the treasury function becomes automated, the administrative costs savings mount. Up to 88 percent of the annual cost can be saved by automating the treasury function, according to the Treasury Leadership Council Benchmarking & Research report (Jeanne Capachin, IDC).

The KPI groupings used in this analysis are liquidity and cash management KPIs, which support the core objective of cash management operations to ensure that the organization has the cash that it needs, at the right place and at the right time.

**LIQUIDITY AND CASH MANAGEMENT KPIS**

These KPIs span the related disciplines of cash visibility and control, cash forecasting and liquidity management, and cash mobility and in-house banking.

***Percentage of account balances reported daily:*** *This KPI supports the objective of monitoring and measuring the effectiveness of the daily bank account balance reporting mechanism.*

A typical calculation would be:

$$\text{(Daily reported cash balances)}/\text{(Estimated total balance)} \times 100\%$$

The estimated total balance reflects the sum of today's reported balances plus the last reported balances of accounts that were not reported today.

***Percentage of cash transactions reconciled automatically:*** *This KPI measures the degree to which treasury cash book transactions are properly accounted for, and also helps to minimize the necessary effort if it is used to set goals for process improvement and to track progress.*

A typical calculation would be:

$$\text{(Number of automatically reconciled items)}/\text{(Total number of reported transactions)} \times 100\%$$

***Percentage of business units/businesses/regions that miss forecast submission dates:*** *This KPI provides a valuable tool at operational and management levels to monitor the forecasting performance of the operation, helping treasury departments to achieve the elusive goal of receiving accurate and dependable forecasting from the entire global enterprise.*

A typical calculation would be:

$$\text{(Number of forecasts not received at deadline)}/\text{(Total number of forecasts expected)} \times 100\%$$

*Source:* Paul Higdon, "Treasury KPIs: A Powerful Management Tool," February 13, 2012. Available at: gtnews.com /articles/treasury-kpis-a-powerful-management-tool/. Accessed: 7/11/17. Used by permission.

**Exhibit 11.13** Treasury Key Performance Indicators (KPIs)

**(c) TAPPING SERVICE PROVIDER EXPERTISE AND OUTSOURCING.** Partnerships with banks or service providers should be explored. Changes that can benefit treasury practices are oftentimes known in advance by bank officers. A good relationship can be a worthwhile investment.

Outsourcing is another option that has been gaining acceptance. It is best that treasury practitioners focus their resources on their core competencies and outsource tasks that can be handled effectively by external service providers. Notes Wayne Kissinger of SunTrust Bank: "For any bank product your organization is considering, ask yourself two questions: (1) Will this product make me more productive by taking activity and time commitment out of my back office and allowing me to focus on work that is more essential to my organization? and (2) Will this product give me valuable information, such as whether to honor a check that has been presented to my account that was not in my original check issue file?"

**(d) CASH MANAGEMENT IN PRACTICE.** "Challenge in predicting future funding" is the perennial response of Denver-area nonprofits when asked what the top challenge would be for the year.[14] While better cash and cash flow management cannot prevent that issue from arising, it will enable your organization to better navigate times of tight cash. Collecting via direct payments (from ACH debits you initiate or ACH credits your donor or other payor initiates) are a real key; we devote our two chapter appendixes to this important tool. Appendix 11A explains the business case for your use of direct payments, while Appendix 11B provides color with a public radio case study.

In the appendix to Chapter 1 we diagrammed the profile of cash management in the charitable nonprofit sector. Numerous tools have been developed to better steward cash. A notable trend is increased use of purchasing cards (also called procurement cards, or p-cards), which are reducing corporate check payments as well as related account reconciliation services. These cards, which are dedicated-purpose credit cards, greatly reduce costs (no more requisitions, purchase orders, postage, checks, or check reconcilement for many small-dollar payments) and simplify reconcilement of payments. One type of corporate credit card allows the using organization to earn rebates on the dollar volume of purchases made, much like similar personal credit cards.

A second trend is greater usage of positive pay or reverse positive pay check and ACH fraud prevention techniques. Coupled with filter blocks, these services can significantly reduce payment fraud.

In addition to the greater use of direct payments, the future holds more commoditization of cash management services, inexpensive and real-time payments, and the increased use of cloud-based services suggests that even the smallest nonprofits will be able to harness powerful banking services without paying significant fees.

## Notes

1. See Paul Brest, "Smart Money: General Operating Grants Can Be Strategic – for Nonprofits and Foundations," *Stanford Social Innovation Review* (Winter 2003): 44–53; and Nonprofit Finance Fund, "The Flap about General Operating Support: Risk Minus Cash Equals Crisis," 2004. Available online at: https://www.compasspoint.org/sites/default/files/documents/7-Risk_Minus_Cash.pdf. Accessed: 7/11/17.
2. For example, see *Global Finance* magazine's rankings at https://www.gfmag.com/media/press-releases/global-finance-names-worlds-best-treasury-cash-management-banks-and-providers-2017. Accessed: 8/7/17.
3. "Treasury in Practice: How to Conduct a Successful RFP for Banking Services," Association for Financial Professionals, December 2014.
4. Jayne Gest, "How to Get the Most out of Your Local Banking Relationship," *Smart Business*, December 21, 2014. Available at http://www.sbnonline.com/article/get-local-banking-relationship/. Accessed: 7/11/2017.
5. Powerful software is available to compare different banks' account analysis statements. The primary software for this application, branded Weiland BRMedge (from Fiserv), may be reviewed at https://www.fiserv.com/industries/corporate-services/weiland-brmedge.aspx. Now available is a competing software application called NDepth from Treasury Strategies, a division of Novantas: https://www.treasurystrategies.com/ndepth-solution/. Tony Carfang of Treasury Strategies pulled data from almost 70 NDepth clients and determined that the median company was only earning 0.020% on a $1 million balance (as an earnings credit rate)

even though the 90-day Treasury bill rate at the time was 0.80% (Anthony Carfang, "Earnings Credit in a Rising Rate Era," https://www.linkedin.com/pulse/earnings-credit-rising-rate-era-anthony-carfang/, February 18, 2018.) Large organizations can use a different software tool, Weiland BAweb, that facilitates "streamlining the management of your bank, account, legal entity and signatory details. By using the latest SWIFT® electronic bank account management (eBAM) capabilities to electronically exchange conversations with your banking partners, you can complete account openings, modifications and closings in just hours instead of weeks, while enhancing security, accuracy and control." For more on BAweb, reference https://www.fiserv.com/industries/corporate-services/weiland-baweb.aspx.

6. Federal Reserve, "The Federal Reserve Payments Study 2016," Federal Reserve Board, December 2016. Survey findings indicate that about one-half of U.S. businesses still pay their bills by check, despite the fact that it costs a business between $4 and $20 in total to issue each check (Vipal Monga, "CFO Journal: U.S. Companies Cling to Writing Paper Checks," *Wall St. Journal,* (March 10, 2014)). Available online at: https://www.wsj.com/articles/u-s-companies-cling-to-writing-paper-checks-1394494772. Accessed: 1/26/2018.
7. NACHA, "Direct Payment for Religious Organizations," 2017. Available online at: https://electronicpayments.nacha.org/direct-payment/religious-organizations/direct-payment-religious-organizations. Accessed: 8/7/17. Access the nonprofit tool kit at: https://electronicpayments.nacha.org/news/nacha-debuts-nonprofit-toolkit-support-sustaining-donor-programs.
8. Michael Becknell, "Why Electronic Giving Makes a Lot of Sense," *Church Executive* (June 2005): 20–21.
9. Id., note 6, page 9.
10. For more on remote capture check fraud, see the Fiserv report, "Risk Management and Remote Deposit Capture," available online at: https://www.fiserv.com/resources/Remote-Deposit-Capture-Best-Practices-Guide-April-2015.pdf. Accessed: 8/7/17. Also consult Sandeep Dhameja, Katy Jacob, and Richard D. Porter, "Clarifying Liability for Twenty-First-Century Payment Fraud," *Federal Reserve Bank of Chicago Economic Perspectives*, Third Quarter, 2013, available online at: https://www.chicagofed.org/~/media/publications/economic-perspectives/2013/3q2013-part2-dhameja-jacob-porter-pdf.pdf. Accessed: 8/7/17. The bank's perspective of your doing remote deposit capture (RDC) is interesting: "The institution should consider whether the customer is a long-standing client with effective management and close control of financial processes or a new customer whose business characteristics and transaction history are relatively unknown. Many financial institutions offering RDC services require customers to maintain minimum deposit balances to insulate the institution from the risk of fraudulent deposits or items that do not clear owing to insufficient funds. Financial institutions also should consider the customer's business line, geographic location, and client base. In evaluating a customer's client base, the institution should carefully scrutinize those from higher-risk industries, such as mail order or Internet retailers, adult entertainment, offshore businesses, and online gambling. These industries have demonstrated a greater risk of fraud and nonpayment than more traditional, domestic, face-to-face businesses. Customers that serve these higher-risk businesses may not be appropriate candidates for RDC or may be required to maintain higher deposit balances or agree to more stringent on-site audit procedures." (FDIC, "Supervisory Insights: Remote Deposit Capture: A Primer," June 29, 2009.) Available online at: https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum09/primer.html. Accessed: 8/7/17.
11. Treasury Strategies, *2005 U.S. Corporate Liquidity Research Program Participants' Report* (Chicago: Author, 2005). Institutional "prime" money market mutual funds must be analyzed carefully in today's regulatory environment; see https://www.capitaladvisors.com/research/first-annual-checkup-on-reformed-institutional-prime-funds/. One interesting investment alternative you may wish to consider, should your short-term investment policy allow it, is asset-backed commercial paper; on this, see the description at https://www.capitaladvisors.com/research/demystifying-asset-backed-commercial-paper-3/.
12. Available at the time of this writing, iMoneyNet is being merged with another entity. See https://financialintelligence.informa.com/products-and-services/data-analysis-and-tools/imoneynet. Aggregate data graphs on investment amounts in all types of institutional money

funds is located at https://fred.stlouisfed.org/series/WIMFNS. For data on types of money funds, specifically institutional money funds, see https://www.financialresearch.gov/money-market-funds/us-mmfs-investments-by-fund-category/ and select the drop-down menu for "Prime Institutional" (with background information at https://www.financialresearch.gov/briefs/2016/07/20/reference-guide-to-the-ofrs-us--money-market-fund-monitor/). For insightful commentary on institutional investing, see Capital Advisors Group research at https://www.capitaladvisors.com/research1/?_sft_rcat=investment-management. On the lessened appeal of institutional money funds, see https://www.capitaladvisors.com/research/first-annual-checkup-on-reformed-institutional-prime-funds/.

13. AFP holds a "nonprofit industry roundtable" luncheon each year at its annual conference. It is open to practitioners. For more information, see https://www.afponline.org/careers/training/afp-corporate-training/annual-conference.
14. EKS&H, "2017 Nonprofit Outlook Survey: Overcoming Uncertainty with Support, Strategy, and Optimism," page 19. Available online at: https://www.eksh.com/EKSHNew/media/EKS-H/In-page%20images/Resources/Outlook%20Surveys/2017/February/NOS-2017-2-16-17-Final-Digital.pdf. Accessed: 8/7/17.

APPENDIX 11A

# DIRECT PAYMENT FOR NONPROFITS

## SAVE TIME AND COSTS, AND ADVANCE ORGANIZATIONAL GOALS

Direct Payment via ACH can be used to make and receive payments. With Direct Payment, you can simplify the payment process for your organization and your donors, and free up time, money, and energy to devote to your organization's mission.

## INCREASE EFFICIENCIES IN YOUR ORGANIZATION

By implementing Direct Payment in your organization, you can automate your accounts payables by making electronic payments to your vendors and service providers. This can allow for better cash flow management, along with easier reconciliation and reporting.

You also help support environmentally sustainable practices: Electronic payments reduce the use of paper and its impact on the environment.

## INCREASE DONATION DOLLARS AND ENCOURAGE CONTINUED GIVING

With Direct Payment, donors can give to your organization directly from their bank accounts. This can reduce the fees your organization pays for card transactions, lessen donor loss due to expired cards, and increase the donation dollars put toward your organization's cause.

Additionally, Direct Payment can help retain donors by encouraging automatic, recurring gifts. Using Direct Payment, your donors set up and control the timing and amount of a regular donation.

## KEEP YOUR BUSINESS PAYMENTS AND DONATIONS SECURE

Your Direct Payment transactions are safe: Unlike a paper check, which passes through many hands, account numbers remain confidential. You can also consult with your financial institution or payroll provider to learn about additional sound business practices to protect sensitive data.

## CALCULATE SAVINGS

| |
|---|
| Visit our calculator for a quick estimate of the savings your business can achieve using Direct Payment.<br>Direct Payment Calculator: https://electronicpayments.nacha.org/direct-payment/calculator. |

**Exhibit 11A.1** Organizations Benefit with Direct Payment, Saving $1.50 or More per Payment

## GET STARTED

Direct Payment via ACH is easy to set up and use. Simply contact your financial institution or service provider to set up the service. Most payment software packages now include Direct Payment as a standard feature.

Once set up, contact your vendors and service providers directly to authorize the regular electronic transfer of funds, and begin promoting Direct Payment as a new giving option to donors and others you receive payments from to help encourage use.

## RESOURCES

Use these resources to support Direct Payment implementation in your organization and to promote this payment option to your donors.

Note: For the items listed below, navigate to: https://electronicpayments.nacha.org/direct-payment/non-profits/direct-payment-nonprofits#dp-np-resources.

Sample Content
Articles »
Press Releases »
Social Media »
Promotional
Fact Sheets »
Brochures »
Messaging »
Videos »
Tools
Form »
Checklist »
Case Study »

*Source:* Used by permission of NACHA – The Electronic Payments Association.

APPENDIX 11B

# DIRECT PAYMENT CASE STUDY


## A PUBLIC RADIO STATION USES ACH TO BUILD ONE OF THE NATION'S TOP SUSTAINING DONOR PROGRAMS

### THE FUNDRAISING CHALLENGE FOR PUBLIC RADIO STATIONS

Public radio stations generally focus their fundraisers on getting one-time annual contributions from their listeners. Most stations also have sustaining membership programs, but recent analyses reveal that very few of them are effective or successful. For example, a 2014 study by Greater Public found that the average station raises barely $2 of every $10 in membership revenue from sustainers, and sustainers make up only about two in every 10 donors to the average station.

Yet 2015 data from donorCentrics show that sustainers' contributions are worth up to four times more than those from traditional donors over the life of their giving. In addition to donating more frequently and at higher amounts than traditional givers, sustainers continue to give for many years.

> "Our results really highlight the value of ACH for sustaining memberships. Seventy-five percent of our sustaining donors pay with ACH; they're responsible for over 40 percent of all individual donation dollars, and we retain them for up to 20 percent longer than sustainers who use credit/debit cards. Those are pretty remarkable numbers!"

capital public radio

Based in Sacramento, Calif., Capital Public Radio (CapRadio KXPR & KXJZ) airs programming from National Public Radio (NPR) and other public radio producers and distributors, as well as locally produced news and public affairs programs. Over 420,000 listeners tune into classical, jazz, news and public affairs shows each week on one of Capital Public Radio's seven stations serving California's Central Valley and the Sierra Nevada.

NACHA
The Electronic Payments Association

This is why the nation's most successful fundraising stations have implemented comprehensive sustaining giving programs. And one key to making them work is to promote Direct Payment via ACH, as the preferred payment option for ongoing donations.

### BUILDING THE NATION'S STRONGEST SUSTAINING-DONOR MEMBERSHIP

Capital Public Radio in Sacramento exemplifies this dynamic: it's a leader among the nation's public radio stations in sustaining donor dollars, and three-quarters of these funds come via ACH. Today, its success in growing support from monthly ACH donors is unparalleled among public broadcasters, as well as that of most other nonprofits, and some of its sustainers have been giving monthly for over 20 years.

The station launched its sustaining donor program in the late 1990s, but the use of Direct Payment via ACH for donations was not promoted in the early years. In 2010, the station branded the option of monthly giving via ACH as "Evergreen," and started promoting it as the preferred payment option. The growth in donations since then has been consistent and impressive.

In 2010, total donations to the station had amounted to $3,425,097, with 28 percent given by sustaining members. The most recent numbers, from fiscal year 2016, show that donations totaled $4,922,390, with 51 percent coming from sustainers.

### CAPRADIO'S SUCCESS HIGHLIGHTS BENEFITS OF ACH

Initially, CapRadio's decision to focus on donations via ACH reflected changes in its database software due to changes in requirements for credit cards. It was simply easier for the station to use bank account information and ACH payments year after year.

But one benefit of Direct Payment via ACH quickly became clear: people don't change bank account numbers nearly as often as they change credit or debit card numbers.

Jennifer Halm, Director of Membership at CapRadio, says that the benefits have continued to add up. "Our results really highlight the value of using ACH," she explains. "Seventy-five percent of our sustaining donors pay with ACH; they're responsible for over 40 percent of all donation dollars, and we retain them for up to 20 percent longer than sustainers who use credit/debit cards. Those are pretty remarkable numbers!"

### ESTABLISHING EVERGREEN RELATIONSHIPS WITH SUSTAINING DONORS

This success is built on several important decisions taken by CapRadio, beginning with making Direct Payment via ACH its first or default payment option for sustaining members. In fact, CapRadio explains the benefits in all communications, including written, over the phone and on-air. Membership appeals also make it clear that sustainers aren't signing up for an annual gift to be paid in 12 monthly installments, but for a monthly donation that will continue until the member changes the amount or cancels the gift. And the station encourages donations via ACH across all of its communications, including:

- Online donation forms
- Segmented emails during on-air campaigns, asking listeners to either start a sustainer gift or increase their existing sustainer gift
- Direct mail and email renewals to annual donors
- Appeals to former sustainers, asking them to rejoin as a sustainer
- Direct mail, email and telemarketing calls to sustaining donors asking for an increase

NACHA
The Electronic Payments Association

As CapRadio discovered, Direct Payment via ACH donations provide additional benefits: these usually don't come with the processing fees that credit card issuers charge, and memberships can be easily upgraded to increase their contributions via direct mail, email or telemarketing, since no payment information has to be resubmitted.

The station continues to nurture its Evergreen relationships, making sure that sustaining members know how much they are appreciated. "We preface every email and newsletter with our sincere gratitude," says Halm, "and we include our Evergreen donors in all prize giveaways, whether or not they contributed to that specific campaign. We want to use every opportunity possible to thank our sustainers."

## CAPRADIO'S RESULTS

- In fiscal year 2016, CapRadio's total individual donations amounted to **$4,922,390**. Fifty-one percent, or **$2,529,065**, came from sustaining members.
- Of the radio station's 17,543 sustaining members, 13,163, or **75 percent**, pay by ACH.
- **Forty-one percent** of all individual donation dollars are received from sustaining members paying by ACH.
- CapRadio retains approximately **95 percent** of all sustainers paying by ACH. For non-ACH sustainers the average retention is 81 percent.

Learn more about how your organization can benefit from Direct Payment via ACH. Visit **www.electronipayments.org.**

## WHAT IS DIRECT PAYMENT VIA ACH?


Direct Payment via ACH is a payment option processed through the ACH, an electronic network at the center of commerce in the U.S., moving money and information from one bank account to another. It serves as an efficient means of payment for nonprofit organizations and their donors.

DIRECT PAYMENT®
via ACH

## FOUR TIPS For Launching A Sustaining Donor Program Powered by ACH

1 Make Direct Payment via ACH the default or first payment option.

2 Make sure donors understand that they are signing up for an ongoing monthly donation.

3 Include information on how to donate via ACH in all mailings, emails, newsletters, on-air and phone membership campaigns.

4 Don't forget to take every opportunity to express your thanks to these members. Some options are to include sustainers in all giveaways, and to offer sustaining donors premiums annually.

*Source:* NACHA_Nonprofit__CaseStudy_CapRadio.pdf. Used by permission of NACHA – The Electronic Payments Association.

CHAPTER 12

# INVESTMENT POLICY AND GUIDELINES



## 12.1 INVESTMENT POLICY

Over a recent 25-year time span, professional forecasters have lowered their projected rate of return for the upcoming 10 years for a 60 percent equity and 40 percent debt portfolio from 8.7 percent per year to 5.2 percent per year.[1] Let's ignore any possible capital gains or losses on the debt portfolio. You can well imagine what this type of revision in expected returns has done to the business models of nonprofits that depend on endowments and quasi-endowments (board-established endowments) for a significant fraction of a year's revenues. While some nonprofits have decided to take on additional risk to ramp up their returns, we caution that the fundamental principle of finance – the higher the expected return, the higher the risk – continues to hold true. Your investment policy is the place you



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

will spell out your risk-return preferences, including which types of investments you will consider and which you will take a pass on.

A written document containing a statement of investment policy and a set of guidelines – a framework for achieving the investment goals – is absolutely essential for the success of both the short-term and the long-term investing of an institution's funds. Individuals who function as fiduciaries to both the donors and the board have ultimate responsibility for investments for the nonprofit organization. The written *investment policy* and guidelines document forms the bridge of understanding between the board and the person(s) executing the investment program. In a very real sense, the policy and guidelines document, usually called an *investment policy statement (IPS)*, is an agreement between the board and the investment manager and should describe the parameters of that agreement.

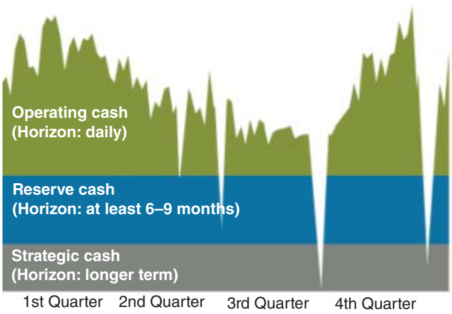
Although these terms are used differently among users, here are typical definitions used within the investment policy area discussed in this chapter.

- *Liquidity (new cash)*. Period of up to 180 days
- *Short term*. Period of up to 2 (or perhaps 3) years
- *Intermediate term*. Period of 3 to 5 years
- *Long term*. Period of 5 years or longer
- *Endowment*. A fund invested to produce a steady flow of income, now and in the future

Notice in this set of definitions the implied concept of different "investment buckets." You could potentially have a separate investment policy for each of these buckets, or maturity ranges, even though we rarely see this in practice. More often, your organization will want to craft a short-term investment policy, a long-term investment policy, and if you have an endowment, an endowment investment policy. Something we recommend as a "best practice" is segregation of your cash into three categories (see Exhibit 12.1).

TYPICAL CASH INVESTMENT POLICY COMPONENTS

SEGMENTING CASH BY LIQUIDITY NEEDS AND PROFILE




**Operating**
- Cash typically used for daily operating needs, may be subject to unforeseen volatility
- Focus on preservation of principal
- Late-day access
- Same-day liquidity

**Reserve**
- Investment horizon of six to nine months or longer
- Fairly static, same-day access not needed
- Cash set aside for possible acquisition, stock repurchasing, and R&D

**Strategic**
- No short-term forecast use
- Cash on balance sheet that has not been historically used
- Investment horizon of one year or longer

For illustrative purposes only.

*Source*: Russell Investments. Used by permission. Accessed 8/8/17.

**Exhibit 12.1** Segmenting Your Cash into Buckets by When You Will Need It

The "Operating" cash meets the daily transactions needs for cash, including within-month shortfalls. "Reserve" cash meets calls on cash during seasonal revenue and support low points as well as anticipated new program launches or volume expansion within the next year or two years. Nonprofits would not have stock repurchases but might have a possible acquisition or research and development or training expenditures planned, and these need to be funded. "Strategic" cash is perfectly suited to the "strategic reserve" that we have advocated throughout our presentation.

The *investment objectives* of an organization should be the first element(s) contained in a written investment policy. The importance of having a written investment policy in your organization cannot be overstated. The current trend toward engaging external professional money managers to provide investment management advice to the board, or its designee, makes this requirement more important than ever.

Without a well-defined investment policy, the *in-house* investment manager will make your organization's investments the way that he or she believes they should be made. In the absence of written policy, an *external* investment manager will probably make your investments in the same way he or she does for other clients. Investment goals and objectives must be documented in a written investment policy in order to ensure that investments are made to meet your organization's requirements; otherwise, the investment manager may make investment decisions that go against your risk-return preferences. Furthermore, your organization might have unique investment screening criteria, as do many faith-based organizations. It may prefer to invest a large percentage of its funds in companies that have a strong track record along environmental, social, and governance (ESG) dimensions or prefer to avoid investing in securities of certain types of companies (such as companies contributing to social ills by selling addictive agents – alcohol, tobacco, pornography, and gambling), and this can be made clear in the policy.

To provide clarity and avoid confusion, we strongly recommend that your short-term investment policy be separate and distinct from the long-term investment policy. One reason is that short-term and long-term investment goals and instruments are clearly separate and distinct; however, intermediate goals and instruments can fall into either the short-term or the long-term policy, depending on the organization. Furthermore, some organizations choose to couple their liquidity target/cash reserve policy wishes with their short-term investment policy, as savings and reserves are destined to be invested in either bank accounts or bank or nonbank short-term investments. *In any case, the investment policy or policies must include a written statement of the investment objectives*. You will want to state these objectives clearly and concisely and set forth the order of priorities if there are multiple objectives.

In a short-term investment policy, investors typically have three objectives:

**1.** Safety/preservation of principal

**2.** Maintenance of liquidity

**3.** Yield

It is important for your organization's policy to state these goals and place them in priority order. In a short-term portfolio, most nonprofit organizations' investment requirements would dictate that preservation of principal and maintenance of liquidity both take precedence over yield. Investment consultant and author William Donoghue coined the term "SLY" to denote safety first, then liquidity, then yield.

**(a) SHORT-TERM INVESTMENT POLICY.** The first part of a typical investment policy statement for a short-term portfolio might read as follows:

> It shall be the policy of this organization to invest its temporary surplus cash in short-term fixed-income instruments and floating-rate government-issued debt securities to earn a market rate of interest without assuming undue risk to principal. The primary objectives of making such investments shall be, in their order of importance, preservation of capital, maintenance of liquidity, and yield.

These two sentences clearly lay out the organization's objectives in priority order. Investing behavior underscores the focus on safety and liquidity. When money market regulatory reform hit the US short-term investments money-market mutual fund space in late 2016, massive outflows from riskier funds found their way into government-only money market funds. Investment Company Institute (ICI) data indicates $881 billion moved out of prime and municipal money market funds and $851 billion in net inflows were invested in government money market funds during the year (ICI Factbook). Return *of* your principal is more important than return *on* your principal when you might need to spend that money next month. See Appendix 12A for a sample of a nonprofit's short-term investment policy and guidelines.

**(b) LONG-TERM INVESTMENT POLICY.** After the short-term cash needs of the organization are met, the growing nonprofit organization will reach a level of maturity and financial condition where capital is available to invest for the long term. The next stage is to build operating reserves to buffer against large-scale revenue declines or expense increases, as noted in Chapter 2. Then many nonprofits will consult their strategic plan and long-range financial plan to determine how soon and to what degree they will self-fund expansions to programs and/or facilities. They will likely set up capital/maintenance reserves and perhaps strategic reserves to prefund some or all of these "calls on cash." Appendix 12B contains Reliant Mission's (Orlando, FL) actual investment policy statement, covering its short-term investments (unrestricted reserves) as well as longer-term investments (restricted reserves and endowments). You will want to be prepared for gifts of appreciated securities, and whether your gift acceptance policy will have your investment manager selling marketable securities soon after receipt.

Eventually a nonprofit organization will likely have the assets to invest for longer periods in the form of an endowment, which by its nature is invested for the long term to provide funds to support the intended programs in perpetuity. Typically, the larger a long-term endowment fund becomes, the more complex the investment decisions become. The fees are typically lower as a percentage of the amount of funds invested.[2]

A typical endowment investment policy is concerned with four areas:

1. Preservation of principal
2. Provision of a reliable source of funds for current and future use
3. A rate of return that maintains or enhances the purchasing power of the endowment over time (growth of principal)
4. Prudent levels of risk

Often the terms "long term" and "endowment" are used interchangeably. For purposes of ease in this chapter, we will use "endowment," which has the most stringent objectives in terms of protecting principal and providing an income stream in perpetuity.

Surplus assets (e.g., accumulated funds being held to fund the future construction of a building), which are *not* endowment, can be invested for the long term. Generally, funds of long-term investment pools and endowment pools follow many of the same investing parameters.

As with short-term investment policies, the long-term endowment policy must state the return objective in very clear terms. Since endowments are intended to exist in perpetuity, a typical return objective seeks to hedge against inflation. The goal is to maintain or enhance the purchasing power of the endowment to maintain the activities it supports. This objective should be stated in terms of the "*real rate of return*," defined as total return ("nominal return") less inflation. Real rate of return is more meaningful since inflation changes from period to period. A spending target stated in terms of fixed "nominal" return, rather than real return, can be misleading. Expressing the approximate relationship among nominal return, inflation, and real return[3] in a formula, we have:

$$\text{Nominal Return} = \text{Real Return} + \text{Inflation}$$

If one is forecasting future returns, the formula would be expressed slightly differently:

$$\text{Expected Nominal Return} = \text{Expected Real Return} + \text{Expected Inflation}$$

Illustrating, if an investor expects (or requires) a 2.5 percent real return for the upcoming year, and inflation is expected to be 3 percent for this period, she would be anticipating receiving at least 5.5 percent on her investment:

$$5.5\% = 2.5\% + 3.0\%$$

Notice that we have not addressed risk, or the additional yield she would require on her investment, known as a *risk premium*. Implicitly, then, we have profiled a risk-free security; US Treasury bills would fit this profile.

To be more precise, we may express our formula as including the expected *risk-free real return*, expected inflation rate, the risk premium, and the expected nominal return.

$$\begin{aligned}\text{Expected Nominal Risk–free Return} = {} & \text{Expected Risk–free Real Return} \\ & + \text{Expected Inflation}\end{aligned}$$

A risk premium is attached to the nominal risk-free return to get the expected nominal return:

$$\text{Expected Nominal Return} = \text{Expected Nominal Risk–free Return} + \text{Risk Premium}$$

This risk premium may consist of several types of risk. Chief among these risks is *credit risk*, also known as *default risk*. This compensates the investor, through higher return, for the possibility that the issuer will not be able to make timely interest payments and/or principal repayments. *Liquidity risk* is posed by the possibility that the investor may not be able to quickly sell (liquidate) a security at fair market value. *Interest rate risk* (sometimes termed *market risk*) refers to the fact that interest rate increases lead to price declines for fixed-income securities, because the interest rate cannot be adjusted to be competitive with the new interest rate. This same risk leads to price increases when interest rates decline.

Unfortunately, it is very difficult to predict when rates might rise or fall, leading investors to require a higher interest rate on longer-term securities.[4]

There are six essential elements of both a short-term and a long-term investment policy:

1. Who is responsible for the investing program?
2. Who does the investing?
3. How are assets to be allocated?
4. How is performance to be measured and reported?
5. What are the maximum risks to be assumed?
6. Who is responsible for the review and modification of the investment guidelines?

Exhibits 12.5 and 12.6, provided later in this chapter, serve as additional checklist of essential elements for all investment policies and for long-term investment policies, respectively. In addition to the two policy examples we have already mentioned (Appendixes 12A and 12B), we provide in Appendix 12C an example of a short-term investment policy for a foundation. Nonprofits' endowment funds as well as foundations have new monies received, monies awaiting reinvestment, and monies purposed for payout to meet part of the operating budget, so maintaining liquidity in these funds is very important.

## 12.2 INVESTMENT GUIDELINES

**(a) WHO IS RESPONSIBLE FOR THE INVESTING PROGRAM?** In a nonprofit organization, the board of directors is ultimately responsible for the investment program. The key principle to bear in mind here is the *prudent man rule*. Judge Samuel Putnam first articulated this principle in 1830: "Those with responsibility to invest money for others should act with prudence, discretion, intelligence, and regard for the safety of capital as well as income." In keeping with its fiduciary responsibility, the board sets policy, selects managers, oversees investment activities, reviews performance, and monitors compliance to guidelines.

In creating and managing an investing program, it is necessary for the board to place continuing responsibility and authority for the conduct of the program with a particular person or a specific committee. Actual investment management may be delegated to a particular person or to external manager(s).

It is customary to establish an *investment committee* and to charge that committee with responsibility for managing all aspects of the investing program. The committee is normally made up of senior financial and administrative executives of the organization and may include representation from the board and other individuals with extensive financial or business expertise.

The investment committee normally drafts the policy and guidelines for board approval. However, the board may also delegate authority and responsibility for implementation to the investment committee. We provide more guidance on this topic later in the chapter.

Responsibilities of the investment committee include:

- Set policy determining how investments are to be managed.
- Make asset allocation decisions.
- Determine a spending policy.
- Select investment manager(s).
- Review the portfolio's performance.
- Provide reports to the overall board on investment results and operations.

The investment guidelines should clearly identify individuals responsible for managing the investing program and their respective levels of authority. The opening of accounts with brokers, dealers, and banks, as well as the establishment of safekeeping accounts, arrangements for ongoing securities safekeeping, and authority to execute documents and agreements needed to implement the program may be delegated. The guidelines should also provide for the investment committee to select and employ independent investment advisors, if deemed advisable.

**(b) WHO DOES THE INVESTING?** The guidelines should clearly delegate operating authority and responsibility to the financial officers who will actually execute transactions, if an external investment manager is not contracted. Commonly, such authority for entering into agreements is granted to the financial manager, or chief financial officer (CFO), the treasurer or controller, and the assistant treasurer or assistant controller. For example, it may provide for the CFO to act together with either the treasurer or assistant treasurer, but neither of the latter two individuals may operate alone.

It is essential, however, for one qualified individual to be available at all times to execute investment transactions. That authority should be strictly and clearly delegated within the limitations defined in the investing guidelines. Typically, such authority is granted to the CFO, who, in turn, may redelegate the authority to subordinates within the treasury function. It is usually required, through copies of corporate resolutions, to notify banks and securities dealers in writing of the scope of authority granted to each authorized person.

**(c) HOW ARE ASSETS TO BE ALLOCATED?** Asset allocation (also known as *strategic asset allocation*) is one of the primary responsibilities of the investment committee. How an organization allocates its assets mainly determines its return: One widely quoted study found that 90 percent of the ups and downs in a pension fund's returns over time could be linked to the normal policy weights for the various asset classes (e.g., 60 percent stocks, 40 percent bonds). Another study found that after accounting for timing, security selection, management fees, and expenses, the typical balanced mutual fund and pension fund were not adding value relative to what their policy benchmarks were earning.[5]

*Asset allocation* has two major components: selection of assets (asset classes, such as stocks, bonds, and T-bills) in which to invest and the normal or policy weights that the portfolio manager will use to divvy up investable funds. A follow-on step is the assignment of those assets to investment managers with delegated responsibility for them.

Asset allocation is the division of an organization's total investable assets (e.g., cash, stocks, bonds, real estate) to provide the best mix of investments in ideal proportions. Asset allocation includes estimating expected returns on investment, risks, and price movements among the various asset classes. It is the most successful investment technique available to investment portfolio managers today.

Asset allocation can be active or passive. *Active allocation* allows a money manager to tactically shift monies from one asset class to another within prescribed limits. For example, if it is determined that the optimum strategy to obtain the best investment performance results entails this mix of assets – 35 percent bonds, 45 percent stocks, 10 percent cash, and 10 percent other – an active allocator could adjust (on a daily basis, if necessary) the mix of assets owned in these and the other categories to try to achieve maximum performance. This reallocation would be done as the outlook for the performance of the asset classes changed.

A *passive allocator*, however, would typically invest the portfolio in a mix of assets (cash, bonds, equities, other) and rebalance the portfolio once a year as changing security values change the asset allocation away from the policy weights. Exhibit 12.2 shows an example of one organization's asset allocation target for a long-term endowment portfolio.

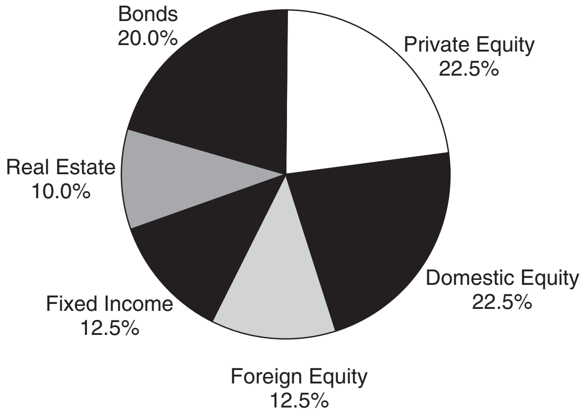



EXHIBIT 12.2 EXAMPLE OF ASSET ALLOCATION

***(i) Investment Instruments.*** The investing guidelines must describe the instruments in which the company will invest. The guidelines should further state that unless specifically permitted under the guidelines, all other investment instruments are prohibited. (A good reason to require an annual review of the investment policy guidelines is because new instruments may be introduced in which the organization is prohibited from investing. The guidelines should be modified to permit such new instruments, if and when warranted.)

Appendices 12E and 12F present brief summary descriptions that should be provided to those who must approve the policy of the most common investment instruments. These listings will be useful in creating or revising investment guidelines. The allocation of dollars among these various instruments is called *asset allocation* or *strategic asset allocation*. Short-term and long-term policies usually call for the inclusion of some element of fixed-income instruments in the investment portfolio. Short-term investment portfolios *do not include equities* due to the risk of price changes – so including equities would be a violation of the "safety-first" notion for short-term investments. Investing guidelines typically permit several kinds of investment instruments.

***(ii) Fixed-Income Instruments.*** Fixed-income instruments include:

- US Treasury securities
- US government agency obligations
- Municipal securities
- Bank obligations
- Certificates of deposit (CDs)
- Fixed-time deposits
- Repurchase agreements involving permitted securities, usually Treasuries and agencies
- Money-market mutual funds
- Banker's acceptances (BAs)
- Commercial paper

- Loan participations
- Corporate notes and bonds

***(iii) Equity Instruments.*** The list of equity instruments, which would be included in most long-term/endowment portfolios but not in short-term portfolios, includes:

- Common stocks
- Convertible securities
- Preferred stocks
- Mutual funds, particularly Index funds
- Exchange-traded funds (ETFs)
- Warrants
- Rights (corporate action)
- Rule 144a stock
- American depositary receipts (ADRs)

***(iv) Alternative Investments.*** Alternatives to fixed-income and equity instruments include:

- Private equity
- Venture capital
- Hedge funds
- Event-driven investment instruments
- Market-neutral instruments
- Real estate investment trusts (REITs)
- Precious metals
- Timberland
- Commodities

Most sizable nonprofit portfolios include hedge funds.[6]

***(v) Socially Responsible Investing (SRI).*** In short-term and long-term investment programs, investable funds offer an organization certain choices and considerations, including using funds to achieve nonfinancial goals. One specific nonfinancial consideration is to lend support to a social cause through the types of investments that are made or not made. The number of socially responsible mutual funds has exploded in the United States and there are now more than 25 socially responsible ETFs available (www.etfdb.com). Some investors have broadened their approach to embrace *impact investing*, which "generally … refers to investments made in companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return."[7]

**Causes to consider.** When making investment decisions, many investors avoid providing indirect support to the alcohol industry for its link to unemployment, underemployment, crime, traffic injuries and fatalities, family break-ups, homelessness, and disease; to the tobacco industry because of tobacco's link to many diseases; and to the pornography and gambling industries because of their links to personal and social maladies. You will see these screens included in Reliant Mission's investment policy statement (Appendix 12B).

Military defense companies are avoided by some investors. Also, a number of socially conscious investment programs for years have refused to invest in companies that conduct business with various oppressive governments. Many organizations believe that doing business in such countries provides support for the economic strength and authority of the nation's government. An example is the decision in 2005 and 2006, as updated in 2013, by the Harvard University endowment and the Yale University endowment to discontinue investments in large oil companies that were aligned with or supportive of the oppressive Sudanese government, which was at that time linked with genocide – more than 180,000 deaths due to militia raids and ensuing diseases linked to food or water – as well as the displacement of 2 million people. "The time-honored principles that Yale observes as an ethical institutional investor have guided us to take this strong action," stated the president of Yale, Richard Levin.[8]

Other social concerns often prompt institutional investors to use their dollars in promoting a better international society by excluding companies that pollute the environment, disregard the ecology of areas where they do business, or disregard child labor laws.

**Developing a socially responsible investing policy.** When an organization has identified the social issues its investment program should or should not support, a method for efficiently implementing an investment policy is needed. If funds will be managed by an external advisor, the investing organization should provide specific instructions. Similarly, if funds will be internally managed, an organization's financial staff should be given a written investment policy reflecting management's views on social issues.

These actions should be included when developing an investment policy with socially conscious objectives:

- Develop a comprehensive set of investment guidelines with a statement of social objectives.
- Provide direction on types of investments to be excluded from the investment program.
- Review investment and social goals of the investment policy and adopt guidelines to validate their accuracy and timeliness on an annual basis.

Taking these steps will help to maintain a socially responsible investing program and to adjust the direction of investment activities as circumstances warrant.

For organizations that internally manage their investments, information will be needed on which investments to avoid. A list should be compiled of corporations that act in a manner contrary to the organization's socially responsible investment objectives. After a list is established, investment staff members should be instructed not to purchase obligations issued by particular organizations. Internally maintaining an SRI program also may require additional time to complete investments, including record-keeping responsibilities.

Before deciding on an investment program that includes socially responsible objectives, an organization's managers should remember that a degree of yield or return on investment may be sacrificed by such a program. From 2000 to 2005, for example, SRI fell behind the market as a whole: As measured by the SRI index called the Domini 400 Social Index, the exclusion of many petroleum and defense stocks hurt the SRI investor's performance relative to the Standard & Poor's 500 index. Wharton business school professors estimate that SRI mutual fund investors were worse off by as much as 3 to 4 percent per year compared to mutual funds that were not limited in their investing.[9] However, this same source indicates that investing on one's own for the future would likely not involve this same compromise, as more and more companies are improving their ethics and practices and would therefore be candidates for the SRI investor. In fact, for the period ending December 31, 2016, a study of responsible investing (RI) funds based on environmental, social, and governance (ESG) criteria finds:

> Ten-year average annual performance for the five U.S. RI indexes ranged from 5.96% to 7.39% versus 6.92% and 7.05% for the S&P 500 and Russell 3000 indexes, respectively. More importantly, statistical analysis showed no meaningful difference in returns when comparing RI indexes with relevant broad market indexes. Any return variations appeared to be random and not systematic. Track records ranged from 14 years for FTSE4Good US Index, to 26 years for MSCI KLD 400 Social Index. Time periods were long enough to ensure results were statistically valid.[10]

The benefits and costs of a socially conscious investment policy must be weighed by an organization's managers – and its course must be set accordingly.

Once the asset allocation decision has been made, diversification strategies should be employed to further enhance the success potential for the long-term investment portfolio. The idea of spreading one's risk by not concentrating investments in one security, industry, geographical location, or asset class is the oldest known investment principle, finding its expression in the Old Testament of the Bible: "Invest in seven ventures, yes, in eight; you do not know what disaster may come upon the land." (Ecclesiastes 11:2, New International Version). Some strategies to be considered are diversification by:

- Investment type
- Manager style
- Type of issuer
- Industry sector
- Geography
- Time
- Foreign versus domestic
- Category

These and other techniques for diversifying the investment portfolio are discussed more fully in our companion guide *Cash and Investment Management for Nonprofit Organizations* (John Wiley & Sons, 2007). The sources referenced in this chapter's endnotes will also prove helpful.

### (d) HOW IS PERFORMANCE MEASURED AND REPORTED?

***(i) Measurement.*** Measurement of investment performance is essential to the investment process. Furthermore, performance measurement criteria are key to the investment policy and guidelines of the institution.

Some elements of investment performance to be measured are:

- Overall results
- Return on investment
- Comparison to historical performance
- Comparison to performance by style
- Effectiveness of communication
- Cost of investing services

Hindsight is not always “20/20” when reviewing performance, especially comparison to “performance by style” (example: a growth stock index). The Raffa Wealth Management, LLC (RWM) Study on Nonprofit Investing (SONI) surveys reveal that nonprofits may have achieved less-than-benchmark returns fairly consistently (see Exhibit 12.3). Raffa offers this disclaimer regarding the underperformance observed:

> Performance results have been compared to a balanced benchmark portfolio comprising four broad market indexes. The indexes were selected because we believe they are the most broadly diversified and/or most well known in each broad category. By segmenting each participant’s performance returns by the respondent’s target asset allocation, we have sought to account for differences in a nonprofit’s risk posture and allow for a meaningful comparison across a variety of investment policy objectives. However, inconsistencies remain that may render comparing any particular association’s performance return to the SONI blended portfolio benchmarks inappropriate. It may be perfectly acceptable for an association to underperform the SONI blended portfolio benchmarks. Underperformance may be reasonable, for example, if an organization has experienced changes in asset allocation policy, if an organization takes a materially different risk posture than any of the SONI blended portfolio benchmarks, or if the asset classes emphasized by the portfolio’s strategy have been out of favor.[11]

**TREND ALERT: UNDERPERFORMANCE GAP**

This is our fifth consecutive year producing SONI and analyzing the results. For the past four years, we have grouped participant responses by their reported asset allocation and compared each asset allocation group’s median performance result to a representative SONI blended benchmark. The construction of the SONI blended benchmarks has not changed. The median nonprofit participant has underperformed the representative blended benchmark with remarkable consistency.

The next logical question is why is this “underperformance gap” happening? Is there something fundamentally wrong with how nonprofits invest? Does the error lie within the methodology of the SONI benchmarks? The short answer is that we don’t know for sure. This time frame is too short to draw hard conclusions. Here are our best Judgments as to why we believe certain nonprofits may have underperformed.

- Pundits have been calling for interest rates to rise over the last four years—and they haven’t. The result is intermediate-term bonds have performed better than shorter-term bonds. Nonprofits that have shifted their bond allocations to cash or shorter-term bonds have underperformed.
- Over the last four years, alternative investments have generally underperformed stocks. A shift out of stocks into alternatives would likely lead to lower returns.
- Investment fees reduce returns—particularly for those paying higher-than-median fees.

We will continue to evaluate SONI participant returns and monitor any performance gaps. In the meantime, the SONI results offer a compelling case for keeping things simple. When it comes to investing, simple means setting and rebalancing to asset class targets, reducing fees, and remaining disciplined.

*Source*: Dennis Gogarty, Raffa Wealth Management, LLC, “2017 Study on Nonprofit Investing.” Available at: http://www.npinvesting.org/wp-content/uploads/2017/05/2017-SONI-Results_Executive-Summary.pdf. Accessed: 7/12/17. Used by permission.

**Exhibit 12.3** Nonprofit Investment Underperformance Compared to Benchmarks

**Blended Portfolio Sample Benchmarks**

| | 30/70 | 40/60 | 50/50 | 60/40 | 70/30 |
|---|---|---|---|---|---|
| **Russell 3000** | 20% | 29% | 38% | 47% | 56% |
| **MSCIAW ExU.S.** | 10% | 11% | 12% | 13% | 14% |
| **BarCap Agg Bond** | 65% | 55% | 45% | 35% | 25% |
| **3-Month US T-Bills** | 5% | 5% | 5% | 5% | 5% |
| **HFRI Fund of Funds** | 0% | 0% | 0% | 0% | 0% |

The Russell 3000 stock index seeks to represent the total return of US stocks—including large, mid, and small cap and value and growth styles. The MSCI ACW ExU.S. stock index seeks to represent the total international stock market, including developed and emerging markets. The BarCap Agg Bond index seeks to represent the total US investment grade bond market. The 3-month US T-bill seeks to represent cash. These indexes were selected for comparison purposes only because we believe they are the most broadly diversified and/or most well-known in each broad category. You cannot invest directly in an index. Indexes do not reflect the fees associated with actual investments and such fees would reduce the performance illustrated.

*Source*: Dennis Gogarty, Raffa Wealth Management, LLC "2017 Study on Nonprofit Investing." Available at: http://www.npinvesting.org/wp-content/uploads/2017/05/2017-SONI-Results_Executive-Summary.pdf. Accessed 7/12/17. Used by permission.

**Exhibit 12.4** Nonprofit Investment Underperformance Compared to Benchmarks

In Exhibit 12.4, you see RWM's blended portfolio sample benchmarks and the indexes upon which they are based. Illustrating, the 30/70 column would be used when your portfolio has 30% of its investments allocated to stocks (20% "invested" in the Russell 3000 index and 10% "invested" in the MSCI All-World, Except U.S. index) and 70% allocated to bonds. We offer this both to color the previous discussion on performance attribution difficulty, but also to convey the value-add you may receive from investment management and investment advisory firms such as RWM, Russell Investments, SEI, Capital Advisors Group, Graystone Consulting (Morgan Stanley), JPMorgan, Bank of America Merrill Lynch, Cambridge Associates, UBS Institutional Consulting Group, Broadmark Capital (the firm at which this book's coauthor Alan Seidner works), and many others.[12]

***(ii) Reporting.*** Operating an investing program can create a nightmare of reports and paperwork. Therefore, it is essential for the investment committee, if not the board, to specify the type and frequency of reports needed. Otherwise, the financial manager who actually executes the transactions may feel compelled to furnish too much information to too many people.

A practical approach is to establish tiers of reports, as in a pyramid. Proceeding upward in an organization, the volume of reported data gets smaller. The financial manager who executes the transactions maintains the bottom tier and must be responsible for total detail concerning these transactions. The financial manager also must be responsible for ensuring that appropriate information is fed to the accounting department to record the transactions properly in the company's books and records.

For the financial manager's own use, it is generally necessary to have a daily or weekly report of securities held and the instruments listed in maturity date order, with the earliest maturity listed first. The manager may also need to have the same information sorted: (1) by issuer, to ensure that there is no undue concentration of funds invested in any one issuer; (2) by type of issuer, such as Treasury or U.S. government agency, bank holding company, industrial company, finance company, domestic issuer, or foreign issuer by country; and (3) by safekeeping agent or other location where the securities are held in custody. The investment manager needs all this information in order to conduct the day-to-day investing operations.

The level of detail that the financial manager needs is not necessary for his or her immediate superior, other senior management, and members of the investment committee. Thus, the investment committee and the board should specify the level of detail and the frequency of reports they require. Typically, these reports contain a listing of all securities held, including maturity dates and yields, as well as a weighted average yield of the entire portfolio. Risk-adjusted returns should be provided as well. The reports are often produced on a monthly basis and may be accompanied by a schedule of transactions conducted since the last report.

By using computerized dedicated software, database management software, or spreadsheets, much of the report data can be handled easily and sorted by different fields to produce the desired results. Dedicated software is available to handle short-term investment portfolio reporting. If an outside investment manager is used, the reports the manager provides should be adequate for your internal reporting needs.

**(e) WHAT LEVEL OF RISK IS TO BE ASSUMED?** Investment guidelines should include a statement about the safeguards required by the investment program of your institution. Risk avoidance techniques should be explained.

***(i) Limitations on Maturity.*** Because the short-term investment portfolio has primary objectives of preservation of capital and maintenance of liquidity, the investing guidelines should contain a statement that limits the maturity of the portfolio to avoid interest rate risk. The limitations can relate to both the weighted average maturity of the entire portfolio and the maximum limitations on maturity of any one instrument. For example, the guidelines might restrict the maturity of any one instrument to not more than five years from the date of purchase, and the weighted average maturity of the entire portfolio may be no more than three years.

Two dimensions of maturity limitation working together can prevent the occurrence of several interesting, but potentially detrimental, activities. For example, if the guidelines address only the weighted average maturity of the portfolio, the financial manager may use a "barbell" strategy. In such a strategy, one-half of the portfolio is invested in very short-term instruments, such as 30- and 60-day maturities, and the other half in relatively long-term instruments maturing in 8 to 10 years. Mathematically, the weighted average maturity of the portfolio could be within the 3-year limitation. Clearly, however, the actual deployment of funds does not meet the safety of principal and liquidity goals that management had set due to the inclusion of longer-term securities.

However, simply limiting the length of maturity of any one instrument may be inadequate. If the guidelines restrict the maturity of any one instrument to two years, for example, the financial manager may feel at liberty to invest virtually all of the portfolio in instruments maturing in about two years. This, too, could work in opposition to the stated objectives of preservation of capital and maintenance of liquidity. Your investment manager will use measures such as "duration" and "convexity" to monitor and protect against out-of-desired-range reinvestment rate risk and interest rate risk. These are beyond our scope in this chapter.

***(ii) Currency Denomination.*** The institution's investing guidelines should clearly stipulate that securities must be denominated in US dollars or the extent to which securities may be denominated in currencies other than US dollars, if permitted. This denomination reporting choice is an important distinction because investments in securities denominated in foreign currencies introduce a new element of foreign exchange risk. Unless an organization understands and accepts that risk, the guidelines should stipulate that all investments be denominated in US dollars. Recalling that our goal with short-term portfolios is "safety first," investments would normally be dollar-denominated. For endowments, however, international investing is a prudent way of reducing risk for a given level of return, or increasing return for a given level of risk.

Consider the home country return that an investor earns, assuming a particular foreign country return and a specific change in exchange rates. The next formula shows this relationship:

$$(1 + \text{Home Country Return}) = (1 + \text{Foreign Country Return}) \\ \times (\text{Current Exchange Rate}/\text{Initial Exchange Rate})$$

For the US investor, the exchange rate should be expressed as \$/unit of foreign currency. For example, let's say our investor earned 7 percent by investing for 1 year in German medium-term notes, which will be denominated in euros (€). He is expecting his interest proceeds soon, as his investment has just matured. He goes online (http://finance.yahoo.com/currency) and determines the year-end exchange rate expressed as \$/€ to be \$1.18524/€1, and the exchange rate 1 year earlier (when he invested) to be \$1.31/€1. What would his return be when converted back into dollars? Put the foreign country return into decimal form (7 percent ⇒ 0.07), and then plug the numbers into the formula:

$$(1 + \text{Home Country Return}) = (1 + 0.07)(\$1.18524/\$1.31)$$

$$(1 + \text{Home Country Return}) = (1.07)(0.90476)$$

$$(1 + \text{Home Country Return}) = 0.9681$$

Subtracting 1 from both sides yields the home country return:

$$\text{Home Country Return} = -0.0319 \text{ or } \underline{\underline{-3.19\%}}$$

For this year, the depreciation of the euro relative to the dollar (the exchange rate depreciation from €1 buying \$1.31 to €1 buying \$1.18524) decreased the 7 percent euro-based return to −3.19 percent in dollar terms. The reverse effect is also possible: The euro could appreciate, leaving the US investor with more than his foreign-currency earnings of 7 percent.

The moral of the story here, though, is that the US investor would have been much better off leaving his money invested in lower-yielding US securities, thereby taking less risk. It would be very unusual for a short-term IPS to permit unhedged foreign investments, and many will prohibit investment in non-US dollar investments.

In the event that the IPS permits some foreign exchange risk, which (assuming no hedging) makes sense only for long-term portfolios, it is important for the amount of the investment, including principal and total interest due at maturity, to be partly or totally hedged with a foreign exchange forward or futures contract. Even though the security is denominated in a foreign currency, this will help ensure that the ultimate proceeds will be converted into a known quantity of US dollars at maturity.

Investments in foreign instruments can be done on a hedged or unhedged basis, both of which have risk/cost implications. For most nonprofits, the institution's investment policy statement should specifically require that all investments be made in US dollars or be fully hedged into US dollars if made in foreign currencies. We return to the subject of hedging in Chapter 14.

**(f) REVIEW AND MODIFICATION OF THE INVESTMENT GUIDELINES: WHO IS RESPONSIBLE FOR WHAT?** Even the best-designed investing guidelines must be periodically reviewed and modified to accommodate changes in the organization's own situation and in conditions prevailing in the securities markets. The guidelines themselves should contain provision for their review and modification.

The investment committee should have the responsibility of initiating additional reviews and modifications and perhaps delegating the responsibility to the CFO for making recommendations for modification as conditions warrant. Many organizations require an annual review of the guidelines. The investment committee also often delegates authority to the CFO, who may, in turn, redelegate it to the vice president (VP) of finance to make the current investing program more restrictive than defined by the guidelines. For example, the guidelines may permit investment of funds in a particular area, such as obligations of foreign banks. It may come to the attention of that VP that the economy of a particular country has suddenly weakened. The VP may choose to restrict investment in obligations of banks domiciled in that country as a temporary measure (see the "Banks" sections of Appendix 12A).

**(g) CHECKLIST OF ELEMENTS FOR ANY INVESTMENT POLICY.** An excellent resource for you to use in establishing your first investment policy or in checking your existing policy for completeness is provided by the SunTrust Foundations and Endowments Specialty Practice. You will want to make sure to include in your policy at least the five sections shown, including overview; delineation of duties/responsibilities (including for an outsourced CIO, or Chief Investment Officer, if your organization contracts with one); a strategic allocation framework (including target allocations, strategic ranges, rebalancing strategy, liquidity policy, and appropriate benchmarks); the manager selection, oversight, and review process; and risk management guidelines and restrictions (see Exhibit 12.5).

## 12.3 CHECKLIST OF ELEMENTS FOR LONG-TERM/ENDOWMENT INVESTMENT POLICY AND GUIDELINES

Does your long-term/endowment policy include clear, concise statements? (See Exhibit 12.6 for 11 essential elements to be included in your long-term/endowment policy.) Spending policies are an advanced topic regarding which you will want to get expert guidance.

UPMIFA laws (based on the Uniform Prudent Management of Institutional Funds Act, 2006) have been enacted in every state except Pennsylvania. Although these laws vary somewhat by state, there are certain items that are common to almost all of the state laws. These laws apply to all organizations operated solely for a charitable purpose. UPMIFA-related

**At a Minimum, Your IPS Should Include All of the Following:**

1. Overview
   - a. Mission
   - b. Goals
   - c. Investment Objective
   - d. Time Horizon
   - e. Spending Policy
2. Delineation of Duties/Responsibilities
   - a. Board
   - b. Investment Committee
   - c. Outsourced CIO (if applicable)
   - d. Investment Managers
   - e. Custodian(s)
3. A Strategic Allocation Framework
   - a. Target Allocations
   - b. Strategic Ranges
   - c. Rebalancing Strategy
   - d. Liquidity Policy
   - e. Appropriate Benchmarks
4. Manager Selection. Oversight, and Review Process (including a description of allowable investment vehicles that are reasonably suited to the institution's needs as referenced in UPMIFA)
5. Risk Management Guidelines and Restrictions

*Source*: SunTrust Foundations and Endowments Specialty Practice, "The Dynamic Investment Policy Statement: How to Craft an IPS That Is Responsive to Change." © 2017 SunTrust Banks, Inc. Used by permission. Available at: www.suntrust.com/foundationsand endowments. Accessed 7/12/17.

**Exhibit 12.5** Minimal Elements for Any Investment Policy Statement

| Element | Location in Appendix 12D (Sample of Investment Policy for Long-Term Endowment Pool) | √ Done |
|---|---|---|
| • Purpose of the endowment | Opening paragraph | |
| • Responsibilities assignment | Opening paragraph | |
| • Investment objectives | I | |
| • Reference to endowment spending policy | I, Paragraph 2 | |
| • Asset allocation | II | |
| ○ Minimums, targets, maximums | | |
| ○ Fixed income vs. equities | | |
| • Guidelines for selection of fixed-income securities | III | |
| ○ Diversification | III.A | |
| ○ Quality | III.B | |
| ○ Duration | III.C | |
| • Guidelines for selection of equities | IV | |
| ○ Diversification of manager | IV.A | |
| • Performance | V | |
| • Permissible and nonpermissible assets | VI | |
| • Selection of investment manager(s) | VII | |
| • Responsibilities of the investment manager | VIII | |

**Exhibit 12.6** Checklist of Elements for Long-Term Endowment Investment Policy and Guidelines

stipulations should be explicitly incorporated into your long-term/endowment investment policy statement and include:[13]

- Clarification of the duties of those who manage and invest your charitable investment funds
- Application of investments modern portfolio theory (MPT), which is now expected for your organization, as it acts in prudence with its investments
- Elimination of the concept of historic dollar value, replacing it with a requirement that spending must be at a rate that will preserve the principal's long-run purchasing power
- Updated requirements for releasing and modifying donor-imposed restrictions on funds given to your organization

Nonprofits are paying close attention to this legislation because of events such as the following:

> [I]n 2012 New York filed suit against a charitable organization to force the removal of its directors and charg[ed] the organization with fiscal mismanagement. The attorney general alleged that the organization improperly borrowed against an endowment to cover expenses. The case settled late last year [2016]. The organization was required to make changes to its board, reduce its expenses and find a new president.[14]

Finally, we note the increasing allocation of long-term/endowment monies to alternative investments. This may be due to the desire to ensure that budgeted spending amounts required/expected of endowments are not exceeding the amount actually available from those endowments for many organizations. We have two comments here. First, consider comparing your actual spending from endowment to the spending implied by using the "Yale Model." If you are spending more than the Yale Model spending amount, you may wish to ratchet down your spending policy to a more reasonable spending rate. The Yale Model spending amount entails making three separate calculations. First, take the prior year's dollar spending adjusted for inflation (using the Consumer Price Index) and then multiply that by 0.70 (70 percent). Second, take the endowment portfolio's prior year's market value (sum total of the market values of all investments in that portfolio), and multiply that market value by 0.30 (30 percent). Finally, add the two products together to get the Yale Model spending amount.

Second, consider "immunizing" part of your endowment portfolio to have enough money to spend out what is needed without selling securities at a loss during a bad market environment.[15]

## 12.4 INVESTMENT COMMITTEE

There are several "best practices" that may be applied to your management of your organization's investment committee. Lee Klumpp of accounting and consulting firm BDO offers these as his list of nine best practices:

> 1. Form a strong investment committee that embraces the "commit" in committee.
> 2. Ensure diversity and experience in committee composition.
> 3. Set a strong Investment Governance and Operational Framework that establishes an Investment Policy Statement – including asset allocation, risk constraints,

performance metrics, and payout. It should be consistent with furthering the organization's objectives and realistic given its resources.

4. Refresh the organizational Investment Policy Statement on a regular basis to make sure that it continues to articulate the organization's long-term objectives and unique needs.
5. Define a realistic target for investment success that is consistent with the organization's resources, and focus on the implementation.
6. Be strategic in asset and investment manager selection and perform regular evaluations.
7. Find an appropriate person or organization that can act as the organization's Chief Investment Officer (CIO), to manage its investment portfolio, be held accountable to the committee and regularly review its performance.
8. Monitor results and make changes as needed.
9. Have regularly structured investment committee meetings and draft minutes from these meetings.[16]

Above all, these best practices, which are fundamental regardless of the nature or size of the organization, can be boiled down to five Cs: commitment, coordination, communication, continuity, and completion.

If you are in a senior finance role and are charged with piloting your investment committee, there are various pitfalls that you should avoid. The mistakes that are made often link to inexperience. Exhibit 12.7 offers excellent guidance on your coaching role.

## 12.5 TRENDS IN INVESTMENT MANAGEMENT

We note several trends in nonprofit investments practice. We profile overall asset allocation, short-term investment allocation, reallocations based on annual performance evaluations, endowments, and money market mutual funds.

Segmentation and asset allocation evidence from RWM's "Study on Nonprofit Investing" reveals the following:

> [R]egardless of size, public charities reported maintaining a roughly even balance between liquid assets held in cash versus those invested toward longer-term objectives. The "normal" long-term portfolio asset allocation range for public charities shows investing between 45% and 75% in a combination of stocks and alternatives invested for growth with the remainder in fixed income.[17]

Survey evidence from the Association for Financial Professionals (AFP) indicates how corporate treasury and finance professionals (representing 75 nonprofits out of the 638 respondents) invest their organizations' short-term investments. AFP reports the "Percentage of Organizations' Short-Term Portfolios Allocated to Specific Investment Vehicles (Mean Percentage Distribution of Cash and Short-Term Investment Holdings)." It finds that 53 percent (versus 25 percent in 2008) of short-term investment funds are placed in bank deposits and 76 percent (versus 73 percent in 2008) of short-term investment funds are placed in the combination of bank deposits, money-market mutual funds, and Treasury bills.[18] The same survey finds that, for organizations having a written cash (short-term [ST]) investment policy, "The Most Important Objective of Organization's Cash Investment Policy" is safety for two-thirds (67 percent) of the organizations, followed by liquidity


*Source*: https://www.suntrustenespanol.com/ResourceCenter/Article/infographic-cfo-handbook-five-steps-to-a-winning-investment-committee#.WWb3yYirqUk. Accessed 7/12/17. Used by permission.

**Exhibit 12.7** Managing Your Investment Committee

(30 percent). Only a few organizations (3 percent) indicated that the most important objective for their short-term investments is yield.[19]

We find it interesting that organizations really do make changes when doing annual reviews of their investment policies. Raffa research finds that the vast majority of public charities have formal investment policies and reviewed them in the past year. About one-half of organizations that reviewed their policies made some change. And most of the charities stipulate policy asset allocation targets. The majority of these charities also include portfolio rebalancing guidelines in their policies. The charities' "normal" long-term asset allocation range was from 45 to 75 percent in a portfolio combining stocks and alternative investments, with the remainder invested in fixed-income instruments (primarily bonds).[20] About one in five have guidelines for socially responsible investing in their policies.[21]

Calabrese and Ely tabulated a number of interesting statistics on endowments using Form 990 filers. Their highlighted findings, as quoted below, include:

- More than 43% of organizations report owning an endowment, and the overwhelming majority of endowment funds are held by higher education nonprofits;
- One third of endowment funds are unrestricted and 41% are permanently restricted, with heterogeneity across subsectors;
- Endowed nonprofits exceed average payout rates each year of 5%; and
- Annual endowment payouts average 4.1% of total organizational expenses, which measures the sector's dependence on endowment revenue for operations.[22]

Finally, a Securities and Exchange Commission (SEC) ruling in late 2016 had a dramatic effect on money-market mutual fund allocations by businesses and nonprofits. We noted the dollar flows earlier in the chapter as money moved out of prime institutional money funds and into government securities money funds. Forty-one percent of organizations that had discontinued investing in prime money funds indicated in late 2017 that they had no plans to consider investing in prime funds.[23]

## 12.6 INVESTMENT POLICY SUMMARY

A written investing policy and set of investing guidelines are essential elements in both the successful short-term (liquidity) and long-term (endowment) investing program of a nonprofit institution. The document is a contract between the board of directors or trustees and the financial manager. The policy statement describes the parameters within which the financial manager shall perform the tasks of investment management. The guidelines can be simple or complex, they can be restrictive or liberal, and they can cover a liquidity portfolio or dedicated proceeds of a bond issue or endowment fund within a single document or multiple documents.

We close with two warnings. First, beware of a mind-set that says "it's different this time," or "it's a new normal," or "it's a new economy." Raffa Wealth Management (RWM) makes this observation:

> The four most dangerous words in investing are "it's different this time."
>
> The markets have withstood countless national and global calamities. Yes, there will come a time when stock prices fall. It's of no use, however, to react after the fact. If you are so fortunate as to sell before the decline, you must also successfully time the move back in. The odds are stacked against consistently timing the markets. Instead,

> keep it simple. Diversify broadly and inexpensively. Rebalance based on predetermined ranges and thresholds. Bring clarity and transparency to reporting. At RWM, we strongly believe that risk and return are directly related. We encourage nonprofits to embrace this fundamental relationship and focus on what matters.[24]

And, we would add, you can and should build these concepts into your investment policy.

Second, always, always, always get a second opinion when you are investing in a new instrument or type of security. An advisor or brokerage may not fully understand the risks or risk-return trade-off of a security, and "safety [and wisdom] is found in the multitude of counselors." If you do not understand an investment type, and your finance committee (or, better, your investment committee if your organization has one) does not have someone with expertise and interest to do due diligence on the investment, is it prudent to have this as an allowable investment in your policy? (We understand that many alternative investments might fall into the questionable category, so if you outsource investments you are also assessing whether your outside investment advisor has the competence and track record with the instrument to make this a part of your portfolio.) Nonprofits that invested in interest-only stripped Treasury debt portfolios in the 1990s could attest to this caution. So, too, would the investors in auction rate securities issued by nonprofits.

A well-structured investment policy and guidelines document clearly places authority and responsibility for management of the investing program and enables modifications to the guidelines within reasonable bounds. The guidelines further set forth the requirements for reporting the investment activities and portfolio condition, and they clearly describe the types of securities that are acceptable for investment. They also address the operational issues of executing and verifying transactions and of holding the investment instruments in safekeeping for maintenance of appropriate security.

The financial manager should never invest in an instrument that he or she does not understand. It is essential for the financial manager to understand the risk-reward relationship and be comfortable with the level of risk assumed when making investment decisions for the nonprofit organization. Some of the newer investment vehicles, such as ETFs, offer unparalleled investments opportunities, often with very low expense ratios that merit your careful consideration.

## Notes

1. This composite forecast is based on the S&P 500 constituting 60 percent of the portfolio and the 10-year constant-maturity Treasury bond constituting 40 percent of the portfolio. The survey form used to collect the forecasts is available at the time of this writing at https://www.philadelphiafed.org/-/media/research-and-data/real-time-center/survey-of-professional-forecasters/form-examples/spfform-14q1.pdf?la=en. The data is compiled and cited at Russell Investments *Focus* 2017, Issue 2 nonprofit newsletter. Available at: https://russellinvestments.com/publications/us/magazine/focus-2ndEdition2017/html/files/assets/common/downloads/publication.pdf. Accessed 7/12/17.
2. The average large (budget size of $25 million and above) public charities in the 2017 Raffa Study on Nonprofit Investing respondents indicated that they paid 0.16 to 0.18 percent less in total fees than small public charities (budget under $25 million).
3. A more exact relationship is: Nominal Return = (1 + Real Return)(1 + Inflation Rate) − 1, with all rates and returns expressed in decimal form.
4. Technically, it is not maturity that dictates interest rate risk, but the duration and convexity of the security. Duration is a measure of a security's interest rate sensitivity. If a security's duration value is 2, for example, a ½ percent (50 basis points) increase in interest rates will

cause a 1 percent price decline, approximately. For more on this, see the excellent explanation in Chapters 12 and 20 of Frank K. Reilly and Edgar A. Norton, *Investments*, 7th ed. (Mason, OH: Thomson South-Western, 2006).

5. On ups and downs in the same investment fund, consult these two studies: Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal* 42 (July–August 1986): 39–46; and Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update," *Financial Analysts Journal* 47 (May–June 1991): 40–48. On performance of balanced mutual funds and pension funds relative to policy returns, consult Roger G. Ibbotson and Paul D. Kaplan, "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" *Financial Analysts Journal* 56 (January–February 2000): 26–33.
6. For more on hedge fund strategies, see Cedric Fan and Lydia Cormier, "Capturing Alpha in a Low-Return Environment: Hedge Funds Can Offer Attractive Risk-Adjusted Returns," *Russell Investments Focus Non-profit*, Edition 2 (June 2017): 3–6.
7. Anna Snider, "Impact Investing: The Performance Realities," Global Wealth & Investment Management White Paper, Bank of America Merrill Lynch (November 2016).
8. Yale Advisory Committee on Investor Responsibility, "Sudan Divestment," n.d. Available online at: http://acir.yale.edu/sudan.html. Accessed 8/8/17.
9. Christopher Charles Geczy, Robert F. Stambaugh, and David Levin, "Investing in Socially Responsible Mutual Funds" (October 2005). Available at SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=416380.
10. Amy O'Brien, Lei Liao, and Jim Campagna, "Responsible Investing: Delivering Competitive Performance," Nuveen TIAA Investments (July 2017). Available at: https://www.tiaa.org/public/pdf/ri_delivering_competitive_performance.pdf. Accessed 7/12/17. A recent survey of asset managers and asset owners practicing ESG investing found that the biggest impediment is determining how well companies are doing in their ESG-related activities. See Robert G. Eccles, Mirtha D. Kastrapeli, and Stephanie J. Potter, "How to Integrate ESG into Investment Decision-Making: Results of a Global Survey of Institutional Investors," *Journal of Applied Corporate Finance*, 29, 4 (December 2017): 125–133.
11. Dennis Gogarty, Raffa Wealth Management, LLC, "2017 Study on Nonprofit Investing," (May 2017): 11. Available at: http://www.npinvesting.org/wp-content/uploads/2017/05/2017-SONI-Results_Executive-Summary.pdf. Accessed 7/12/17.
12. See the *Barron's* magazine listing of top institutional consultants here: http://www.barrons-conferences.com/uploads/5/4/4/3/54430727/top30institutional2016.pdf.
13. SunTrust Foundations and Endowments Specialty Practice, "A Conversation about UPMIFA," November 2016. Available at: https://www.suntrust.com/Static/RC/Documents/MKTG%200358_Conversation%20UPMIFA_final%20020917_updated.pdf. Accessed: 7/12/17. Also see the eight specific factors that fiduciaries need to consider along with a donor's specific intent and the seven specific factors guiding your endowment spending under UPMIFA at Russell Investments, "UPMIFA: A new roadmap for non-profit fiduciaries to manage charitable funds," (November 2017). Available at: https://russellinvestments.com/-/media/files/us/insights/institutions/non-profit/upmifa-a-new-roadmap-for-non-profits-to-manage-charitable-funds.pdf. Accessed 1/29/2018.
14. Id., p. 3.
15. For more on both of these recommendations, see the excellent discussion at SEI Investment Management Corporation, "The Current Landscape of Nonprofit Spending: Methodologies & Investment Strategies for Foundations & Endowments" (2013). Available at: seic.com/institutional. Accessed 7/13/17. Also see an insightful piece on why many endowments failed to achieve returns comparable to Harvard and Yale in Mary Beth Lato and Angie Santo-Walter, "How Non-profits Can Improve upon the Endowment Model—and Make it Work for Them," *Russell Investments Research Viewpoint* (October 2017). Available at: https://russellinvestments.com/-/media/files/us/insights/institutions/non-profit/how-non-profits-can-improve-upon-the-endowment-model.pdf. Accessed 1/29/2018.
16. Lee Klumpp, "Best Practices for an Effective Investment Committee," BDO Nonprofit Standard Newsletter – Spring 2017 (April 2017), 16.

17. This survey covered 460 public charities. Raffa Wealth Management, LLC, "2017 Study on Nonprofit Investing: Executive Summary," 6. Available at www.raffawealth.com. Accessed 7/12/17.
18. Association for Financial Professionals (AFP), "2017 AFP Liquidity Survey: Report of Survey Highlights," 4. Available at: https://www.afponline.org/docs/default-source/registered/2017liquiditysurvey-summary-report.pdf. Accessed 7/12/17.
19. Id.
20. Raffa Wealth Management, LLC, "2017 Study on Nonprofit Investing: Executive Summary," 8. Available at www.raffawealth.com. Accessed 7/12/17.
21. Id., 7.
22. Thad D. Calabrese and Todd L. Ely, "Understanding and Measuring Endowment in Public Charities," *Nonprofit and Voluntary Sector Quarterly* 46, no. 4 (2017): 859–873.
23. AFP, 6.
24. Raffa Wealth Management, 9.

APPENDIX **12A**

# SAMPLE OF SHORT-TERM INVESTMENT POLICY AND GUIDELINES

This example may be best suited for a large organization and may be compared with and used for the development of your investment policy and guidelines.

## INVESTMENT COMMITTEE

Within the spectrum of activities of this organization, it is necessary to provide a framework for the regular and continuous management of investment funds. Because there is currently no formal Investment Committee, the Directors will assume this responsibility.

## INVESTMENT POLICY

The policy shall be to invest excess cash in short-term and floating-rate intermediate-term fixed-income instruments, earning a market rate of interest without assuming undue risk to principal. The primary objectives of such investments in order of importance shall be preservation of capital, maintenance of liquidity, and yield.

## INVESTMENT RESPONSIBILITY

Investments are the responsibility of the Vice President of Finance. This responsibility includes the authority to select an investment advisor, open three accounts with brokers, establish safekeeping accounts or other arrangements for the custody of securities, and execute such documents as necessary.

Those authorized to execute transactions include: (1) Vice President of Finance, (2) Director of Accounting, and (3) Cash Manager. The Vice President of Finance shall ensure that one qualified individual is always available to execute the organization's investments.

## REPORTING

The Treasurer shall be responsible for reporting the status of investments to the Directors on a quarterly basis. Those reports should include a complete listing of securities held, verified (audited) by parties either inside or outside this organization who have no connection with the investment activities.

## INVESTMENTS

**(a) OBLIGATIONS OF THE US GOVERNMENT OR ITS AGENCIES.** Specifically, these refer to the obligations of the U.S. government (Treasury securities and Government National Mortgage Agency, or “Ginnie Mae” securities) and government-sponsored enterprises: US Treasury, Federal Home Loan Bank, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Federal Farm Credit Bank, Federal Agricultural Mortgage Corporation, and Government National Mortgage Association. Note: When-issued items must be paid for *before* they may be sold.

**(b) BANKS – DOMESTIC.** The organization may invest in negotiable CDs (including Eurodollar-denominated deposits), Eurodollar time deposits (with branches domiciled in Cayman, Nassau, or London), and bankers’ acceptances (BAs) of the 50 largest US banks ranked by deposit size. Thrift institutions whose parent has long-term debt rated A by Moody’s Investors Service or Standard & Poor’s are acceptable. Exceptions may be local banks or thrift institutions that have lent the corporation money or that would be appropriate to use for some other reason. (These banks and institutions should be listed, along with the maximum dollar amount of exposure allowable for each.)

**(c) BANKS – FOREIGN.** The organization may invest in negotiable CDs (including Eurodollar-denominated deposits), Eurodollar time deposits (with branches domiciled in Cayman, Nassau, or London), and bankers’ acceptances (BAs) of the 50 largest foreign banks ranked by deposit size. However, the issuing institution’s parent must have a Moody’s or Standard & Poor’s rating of at least A.

***Limitations***

1. The organization’s aggregate investments with foreign entities shall not exceed 50 percent of total investments.
2. No more than 10 percent of total investments shall be exposed to any one foreign country’s obligations, or $X million per country, whichever is greater.

**(d) COMMERCIAL PAPER.** All commercial paper must be prime quality by both Standard & Poor’s and Moody’s standards (i.e., A-1 by Standard & Poor’s, P-1 by Moody’s, and F-1 by Fitch).

**(e) CORPORATE NOTES AND BONDS.** Instruments of this type are acceptable if rated at least A by both Moody’s and Standard & Poor’s credit rating services.

**(f) MUNICIPALS.** Municipal or tax-exempt instruments are suitable only if your organization pays federal income tax. Only tax-exempt notes with a Moody’s Investment MIG 1/VMIG 1 rating, or bonds that are rated by both Moody’s Investors Service and Standard & Poor’s as A, may be purchased. Not more than 15 percent of the total issue size should be purchased, and issues of at least $20 million in total size must be selected.

**(g) REPURCHASE AGREEMENTS.** Repurchase agreements (repos) are acceptable, using any of the securities listed above, as long as such instruments are negotiable/marketable and do not exceed other limitations as to exposure per issuer. The firm with which the repo is executed must be a credit-acceptable bank or a primary dealer (reporting to the Federal Reserve). Collateral must equal 102 percent of the dollars invested, and the collateral must be delivered to the organization's safekeeping bank and priced to market weekly (to ensure correct collateral value coverage) if the repo has longer than a seven-day maturity.

**(h) MONEY MARKET FUNDS.** Acceptable funds are non-prime funds, those whose asset size place them among the 30 largest according to the Morningstar Report and that are rated Aaa by Moody's Investors Service or rated AAA by Standard & Poor's Corporation.

**(i) SAFEKEEPING ACCOUNTS.** Securities purchased should be delivered against or held in a custodian safekeeping account at the organization's safekeeping bank. Exceptions shall be: (1) repos made with approved (see above) banks or dealers for one week or less, and (2) Eurodollar time deposits, for which no instruments are created. This safekeeping account will be audited quarterly by an entity that is not related to the investment function of this organization, and the results of that audit shall be provided to the Vice President of Finance.

**(j) DENOMINATION.** All investments shall be in US dollars.

**(k) DIVERSIFICATION OF INVESTMENTS.** In no case shall more than 15 percent of the total portfolio be invested in obligations of any particular issuer except the US Treasury.

## MATURITY LIMITATIONS

Overall, maximum weighted average maturity shall be two years. However, on "put" instruments, which may be redeemed (or put) at par, the put date shall be the maturity date.

## REVIEW AND/OR MODIFICATION

The Vice President of Finance shall be responsible for reviewing and modifying investment guidelines as conditions warrant, subject to approval by the Directors at least on an annual basis. However, the Vice President of Finance may at any time further restrict the items approved for purchase when appropriate.

*Source:* Alan Seidner.

APPENDIX **12B**

# INVESTMENT POLICY

## Reliant Mission

### INTRODUCTION

It is the policy of the Board of Directors to treat all assets of Reliant Mission (Reliant), including Funds that are legally unrestricted, as if held by Reliant in a fiduciary capacity for the sake of accomplishing its mission and purposes. The following investment objectives and directions are to be judged and understood in light of that overall sense of stewardship. In that regard, the basic investment standards shall be those of a prudent investor as articulated in applicable state laws.

### INVESTMENT ASSETS

For purposes of these policies, "investment assets" are those assets of Reliant that are available for investment in the public securities markets and as accounts at financial institutions: common stock, preferred stock, bonds, cash, or cash equivalents. These assets may be purchased directly or through intermediate structures such as a brokerage or bank investments subsidiary.

Within its holdings of investment assets, Reliant holds both unrestricted and restricted fund reserves.

**Unrestricted reserves** are monies that represent Reliant's unrestricted net assets but not including the Collegiate fund balances.

**Restricted reserves** are monies that represent a combination of both Reliant's restricted net assets and the Collegiate fund balances.

"Illiquid assets" are described elsewhere in Reliant's Gift Acceptance Policies and Guidelines document, and are governed by those rules and not by these investment policies unless and until such assets are converted to cash.

### PURPOSE OF THE INVESTMENT POLICY

In general, the purpose of this statement is to outline a philosophy and attitude that will guide the investment management of investment assets toward the desired results. It is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical.

This statement of Investment Policy is set forth by the Board of Directors of Reliant Mission in order to:

1. Define and assign the responsibilities of all involved parties.
2. Offer guidance and limitations to the investment manager(s), the individual(s) selected to manage the investment assets, regarding the investment of unrestricted reserves and restricted reserves.
3. Establish a basis for performance measurement and evaluating investment results.

## DELEGATION OF AUTHORITY

The Board of Directors of Reliant, in adopting these policies and forming an Investment and Finance Committee, has delegated authority to the Investment and Finance Committee to supervise Reliant investments. The Board reserves to itself the exclusive right to amend or revise these policies, based on input from the Investment and Finance Committee.

The Investment and Finance Committee of Reliant Mission is a fiduciary, and is responsible for directing and monitoring the investment management of assets. As such, the Investment and Finance Committee is authorized to delegate certain responsibilities to professional experts in various fields. These include, but are not limited to, investment management consultants, investment managers, custodians, attorneys, auditors, and others deemed appropriate in fulfilling the fiduciary responsibility of the Board of Directors.

The investment manager(s) will be held responsible and accountable to achieve the objectives stated in this Policy. While it is not believed that the limitations will hamper the investment manager(s), the manager(s) should communicate to the Investment and Finance Committee any modifications that they deem appropriate.

## RESPONSIBILITIES OF THE INVESTMENT AND FINANCE COMMITTEE

The Investment and Finance Committee is charged with the responsibility for the management of the assets of Reliant. The Investment and Finance Committee may be comprised of the Executive Director, Treasurer, at least one Board member who would chair the Committee, up to three total Board members, and up to three non-board members, who serve at the pleasure of the Board. It shall be the responsibility of the Committee to:

1. Prudently and diligently select and hire qualified investment professionals, including investment manager(s) and custodian(s).
2. Establish an investment strategy within 30 days of hiring an investment manager(s).
3. Supervise the overall implementation of Reliant's investment policies by Reliant's executive staff and outside investment manager(s).
4. Communicate Reliant's financial needs to the investment manager(s) on a timely basis.
5. Determine Reliant's risk tolerance and investment horizon, and communicate these to the investment manager(s).

6. Establish reasonable and consistent investment objectives and allocations that will direct the investment of the assets.
7. Monitor and evaluate the investment performance of Reliant's Funds at least quarterly.
8. Meet two times each year with the investment manager(s) to review the performance of the portfolio, evaluate the results, and report back to the Board of Directors.
9. Monitor and evaluate the performance of the investment manager(s) at least annually to assure adherence to Policy guidelines and to monitor investment objective progress.
10. Review all costs associated with the management of Reliant's portfolio, manager fees, trading expenses, custodial charges, and the like.
11. Enact proper control procedures to replace investment manager(s) if necessary due to professional turnover, underperformance, or failure to comply with Investment Policy guidelines.
12. Grant exceptions as permitted in these policies, as required by cash flow needs or market conditions.
13. Recommend changes in approved Policy, guidelines, and objectives as needed.
14. Review and oversee the annual operating budget for the ministry before it is presented to the board for approval.
15. Review the Investment Policy every two years.
16. Execute such other duties as may be delegated by the Board of Directors.

Whenever these policies assign specific tasks to the Committee, the Committee may in turn delegate certain tasks to the Treasurer or other designated staff, with the Committee maintaining full oversight responsibility.

In discharging its authority, the Investment and Finance Committee can act in the place and stead of the Board and may receive reports from, pay compensation to, enter into agreements with, and delegate discretionary investment authority to such investment manager(s). When delegating discretionary investment authority to one or more manager(s), the Committee will establish and follow appropriate procedures for selecting such manager(s) and for conveying to each the scope of that manager's authority, the organization's expectations, and the requirement of full compliance with these Policies.

The Investment and Finance Committee will establish such custodial and brokerage relationships as are necessary for the efficient management of Reliant's Funds. Whenever the Committee has not designated a brokerage relationship, then Reliant investment manager(s) may execute transactions wherever they can obtain best price and execution.

## RESPONSIBILITIES OF THE INVESTMENT MANAGER

Each investment manager must be a registered investment advisor under the Investment Advisers Act of 1940, or a bank or insurance company, and must acknowledge in writing its acceptance of responsibility as a fiduciary. Each investment manager will have full discretion to make all investment decisions for the assets placed under its jurisdiction, while observing and operating within all policies, guidelines, constraints, and philosophies as outlined in this statement and others issued by the Investment and Finance Committee. Specific responsibilities of the investment manager(s) include:

1. Holding discretionary investment management responsibility, including decisions to buy, sell, or hold individual securities, and to alter allocation within the strategic asset allocation and investment asset quality and diversification guidelines established in this statement.
2. Reporting to Reliant management on a timely basis: monthly for investment activity.
3. Reporting on a timely basis to both the Investment and Finance Committee and Reliant management: quarterly for investment performance results, with the reporting to include assistance in interpreting the results.
4. Communicating to the Investment and Finance Committee any major changes to the following: economic outlook, investment strategy, legal or regulatory environment, or any other significant factors that affect implementation of the investment process or the investment progress of Reliant's investment portfolio.
5. Informing the Investment Committee regarding any qualitative change to investment management organization, including changes in portfolio management personnel, ownership structure, investment philosophy, and so on.
6. Reviewing portfolios and recommending actions, as needed, to maintain proper strategic asset allocations and investment strategies for the objectives of each fund type.
7. Executing such other duties as may be mutually agreed.

## RESPONSIBILITIES OF THE CUSTODIAN

The Custodian will be a registered broker/dealer who is a member of the Securities Investor Protection Corporation (SIPC) established by Congress under the Securities Investor Protection Act of 1970. This custodian will provide the first $500,000 of coverage subject to Federal requirements. The remaining coverage is to be provided by the custodian through Lloyd's of London. This membership is understood to insure against impropriety rather than market risk.

The custodian will physically maintain possession of securities owned by Reliant, collect dividend and interest payments, redeem maturing securities, and effect receipt and delivery following purchases and sales. The custodian may also perform regular accounting of all assets owned, purchased, or sold, as well as movement of assets into and out of the accounts.

## CASH FLOW REQUIREMENTS

Reliant will be responsible for advising the investment manager(s) in a timely manner and at least annually of Reliant's cash distribution requirements from any managed portfolio or Fund. Each investment manager is responsible for providing adequate liquidity to meet such distribution requirements.

## GENERAL INVESTMENT PRINCIPLES/ASSUMPTIONS

1. Investments shall be made solely in the interest of Reliant.
2. The assets shall be invested with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in like capacity and familiar with such matters would use in the investments of a fund of like character and with like aims.
3. Investment of the assets shall be so diversified as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
4. The Investment and Finance Committee may employ one or more investment managers of varying styles and philosophies to attain Reliant's objectives.
5. Cash in unrestricted reserves accounts and cash balances in restricted reserves accounts and portfolios is to be employed productively at all times, by investment in short-term cash equivalents to provide safety, liquidity, and maximum return. Safety and liquidity take precedence over return in the investment of cash balances.
6. All purchases of securities will be for cash, and there will be no margin transactions, short selling, or commodity transactions.
7. Investments in limited partnerships or derivatives (including futures, forwards, options, and swaps) may not be utilized without the prior permission of the Committee.
8. Investment asset class allocations that fall outside the permissible strategic asset allocation range shall be rebalanced as frequently as each year, and cannot go longer than every two years before being rebalanced.
9. Reliant's investment philosophy is predicated on the recognition that inflation will continue and will also contribute to the loss of purchasing power of the dollar.
10. Over the long term, equity investments will generally grow faster than fixed-income investments and inflation, and will provide the best protection of the real value of principal and the preservation of purchasing power.

## ASSET DIVERSIFICATION

The investment manager(s) will maintain reasonable diversification at all times in the investment of restricted reserves. The equity securities of any one company should not exceed 5 percent of the overall Reliant restricted reserves portfolio at the time of purchase, and the combined debt and equity securities of any one company should not exceed 10 percent of the overall Reliant restricted reserves portfolio at any time.

Also, a sizable stock gift to the ministry may cause a short-term imbalance, and such an imbalance will be allowed for the prudent timely re-proportioning as the market allows.

## ASSET QUALITY

1. **Common stocks.** The investment manager(s) may invest in any unrestricted, publicly traded common stock that is listed on a major exchange or a national, over-the-counter market, and that is appropriate for the portfolio objectives, asset class, and/or investment style of the fund type that is to hold such shares.

2. **Preferred stock and convertible bonds.** The investment manager(s) may select high-quality standard preferred stocks, convertible preferred stock, or convertible bonds as fixed-income investments. The quality rating of all preferred stock and convertible bonds must be investment grade, which is **BBB** or better as rated by Standard & Poor's, or **Baa** or better as rated by Moody's.

   The investment manager is given discretion regarding evaluating quality in any case in which the preferred stock or convertible bond security has a split rating. The common stock into which either may be converted must satisfy the standard of Section 1, above.

3. **Bonds and notes (fixed income).** The quality rating of individual bonds and notes must be investment grade, which is **BBB** or better as rated by Standard & Poor's, or **Baa** or better as rated by Moody's.

   Any bond or note security that is downgraded to below *both* a **BBB** S&P rating *and* a **Baa** Moody's rating must be sold immediately. In the case where only one of the ratings falls below investment grade, the investment manager is given discretion regarding retention of the bond or note security.

   The average quality of any bond mutual fund shall be **BBB** or better as rated by S&P, or **Baa** or better as rated by Moody's. Any bond mutual fund whose average quality drops below *both* of these ratings must be sold immediately, unless the fund can be included as a part of the 10 percent portfolio high-yield investment limit as outlined next:

   **High-yield investments.** The investment manager may select high-yield bond mutual fund investments that contain an *average* quality that is below investment grade (i.e., below BBB S&P rating). The total of these high-yield investments may not exceed 10 percent of the entire portfolio, for any fund type that allows fixed-income investments.

4. **Unrestricted reserves and cash and cash equivalents in the restricted reserves portfolios:**

   *Certificates of deposit* – CDs may be purchased from financial institutions if they are insured by the Federal Deposit Insurance Corporation (FDIC) and only in amounts up to FDIC insurable amounts.

   *Commercial paper* – The quality rating of commercial paper must be:

   - **A-1** as rated by Standard & Poor's,
   - **P-1** as rated by Moody's, or
   - **F-1** as rated by Fitch.

   No split-rating commercial paper may be held. Any commercial paper that is downgraded below either **A-1**, **P-1**, or **F-1** must be sold immediately.

   *Money market mutual funds* – The assets of any money market mutual funds must comply with the quality provisions for bonds and notes securities and those listed for unrestricted reserves above.

   *Ultrashort bond mutual funds* – The assets of any ultrashort bond mutual fund must comply with the above ratings for bonds, notes, and commercial paper. They must also have [dollar-weighted average] maturities of one year or less.

5. **Other securities.** The investment manager(s) may invest in real estate investment trusts (REITs), REIT mutual funds, and any other publicly traded investments that

the Committee determines to be appropriate. The investment manager(s) may not utilize **derivatives** without the prior permission of the Committee.

## INVESTMENT OBJECTIVES

Reliant's primary investment objective is to preserve and protect its assets by earning a total return for each category of assets (a "fund type"), which is appropriate for each fund type's time horizon, distribution requirements, and risk tolerance.

Reliant currently maintains three fund types:

1. Unrestricted reserves
2. Restricted reserves
3. Endowments

### UNRESTRICTED RESERVES

***Investment Objectives.*** The unrestricted reserves investment objectives emphasize income.

The total annual return for this fund type should meet or exceed the following Weighted Benchmark Index over the same period:

20% – Standard & Poor's 500 Index
80% – Barclays US Aggregate Bond Index

100% – Weighted Benchmark Index

This total annual return is net of any investment management fees.

The total annual return should also meet or exceed the Lehman Brothers U.S. Aggregate Bond Index over longer periods, such as three and five years.

***Calculation.*** Unrestricted reserves will be calculated by the following formula:

Total of all Reliant unrestricted net asset balances (as shown on the Reliant Net Assets Report)
Less: Equity in property and equipment (as shown on the Reliant Net Assets Report)
Less: The total of Collegiate balances (as shown on the Reliant Net Assets Report)

**= Unrestricted reserves available for investing**

The actual balance in an investment brokerage account will be at least 80 percent of the above amount to allow for necessary operating cash flow fluctuations.

This calculation will be updated **quarterly** at the beginning of each quarter.

### RESTRICTED RESERVES

***Investment Objectives*** The restricted reserves investment objective emphasizes strict preservation of capital and liquidity. Over the investment time horizon, these assets are to be protected (i.e., willing to sacrifice some income in order to protect from loss of principal).

***Calculation*** Restricted reserves will be calculated by the following formula:

Total of Reliant restricted and temporarily restricted net asset balances (as shown on Reliant Net Assets Report)
Add: Total of Collegiate balances (as shown on Reliant Net Assets Report)

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**= Restricted reserves available for investing**

The actual balance in an investment brokerage account will be at least 80 percent of the above amount to allow for necessary operating cash flow fluctuations.

This calculation will be updated **quarterly** at the beginning of each quarter.

### ENDOWMENTS

***Investment Objectives*** An endowment's investment objective generally emphasizes ongoing income from invested capital. Each endowment fund's specific objective will be determined separately by Reliant management, the Investment and Finance Committee, or the donor specifications set when the endowment is established or whenever applicable.

***Calculation*** The endowment will reflect the net asset balance of that particular Reliant endowment account.

## ASSET ALLOCATIONS

Actual asset allocations for each fund type will be established and maintained by Reliant on the advice of its investment manager(s), within the ranges provided in the following table:

**Asset Classes**

| Fund Type | Equities | Fixed-Income Securities | Cash and Cash Equivalents |
|---|---|---|---|
| Unrestricted Reserves | 0–25% | 50–100% | 0–50% |
| Restricted Reserves | 0% | 0% | 100% |
| Endowments | 50–100% | 0–25% | 0–15% |

*Unless Reliant is under legal obligations with the endowment to invest otherwise. Reliant may also seek to honor the investment intent or specifications specified by the original endowment donor by exceeding these percentages, if the Investment and Finance Committee deems this necessary, even if Reliant is not legally obligated to do so.

***Definitions of Approved Investments in Asset Classes.*** Approved investments that are allowed to be purchased by the investment manager(s) are the following:

1. **Equities.** These are common stocks, stock mutual funds, equity exchange-traded funds (ETFs), equity closed-end funds, and covered call options (where the underlying common stock is currently owned in the portfolio).
2. **Fixed-income securities.** These are corporate bonds, US Treasury securities (Treasury bills, notes, and bonds), mortgage-backed securities, municipal bonds, zero-coupon bonds, preferred stocks, bond mutual funds, REITs, REIT mutual funds, fixed-income ETFs, and fixed-income closed-end funds.

3. **Cash and cash equivalents.** These are bank deposits, money market funds, certificates of deposit, commercial paper, and ultrashort bond funds (with maturities under one year).

## SOCIAL RESPONSIBILITY

Reliant Mission desires to benefit society generally, and the Investment and Finance Committee has placed certain restrictions on the portfolio. Specifically, direct purchases of individual securities of companies that manufacture or market alcoholic beverages, tobacco products, gaming products and/or facilities, or pornographic, lewd, or obscene materials are prohibited. However, the Committee realizes that indirectly certain investments of exchange-traded funds and mutual funds may contain these kinds of securities, and such indirect investments will be permitted.

## PERFORMANCE EVALUATION AND REPORTING REQUIREMENTS

1. **Monthly.** Management will obtain written monthly custodial statements. Such statements should contain all pertinent transaction details for each account that holds all or a portion of any Reliant investment fund type. Each monthly statement should include:

   - Description of each security holding as of month-end
   - Percentage of the total portfolio
   - Current price
   - Quantity
   - Current market value
   - Income summary
   - Name and quantity of each security purchased or sold, with the price and transaction date

   In addition, if not included in the custodial reports, the investment manager(s) should provide a report for each fund type or portfolio that shows the month-end allocation of assets among equities, fixed-income securities, and cash.

   The monthly review of custodial statements will also be done by a management position within Reliant that is independent of the cash management and investment process.

2. **Quarterly.** The Committee should obtain from its investment manager(s) a detailed review of Reliant's investment performance for the preceding quarter. Such reports should be provided for each fund type and for Reliant investment assets in the aggregate. Each quarterly report should include:

   - Description of each security holding as of month-end
   - Percentage of the total portfolio
   - Current price
   - Quantity

- ○ Average cost basis
- ○ Current market value
- ○ Unrealized gain or loss
- ○ Indicated annual yield at market
- ○ Estimated annual income derived from security
- ○ Consolidated portfolio summary showing total percentage by security type (e.g., common stock, bond funds, corporate bonds, government bonds, money market, etc.)
- ○ Distribution of fixed-income portfolio by maturity, Moody's rating, and S&P rating
- ○ Management fees charged against account

For each account or fund type, the Committee should establish with its investment manager(s) the specific criteria for monitoring each account's or fund type's performance, including the index or blend of indices that are appropriate for the objectives of each fund type and for the investment style or asset class of each portfolio within a fund type.

The quarterly review of the Investment Manager's report will also be done by a management position within Reliant that is independent of the cash management and investment process.

3. **Annually.** The Committee should meet with its Investment Manager at least annually to completely review all aspects of Reliant's investment assets. Such a review should include:

    1. Strategic asset allocation as it compares to the actual asset allocation,
    2. Manager and investment entity performance,
    3. Anticipated additions to or withdrawals from fund types,
    4. Future investment strategies, and
    5. Any other matters of interest to the Committee.

This Investment Policy was formally adopted by vote of the Reliant Board of Directors on 11/28/2006 and was amended on 6/28/2007, 12/12/2008, 6/19/2009, 6/25/2010, and 11/12/2010, and further amended on 2/21/2017.

This Investment Policy was formally amended by vote of the Investment & Finance Committee on 07/12/2012.

This Investment Policy was formally amended by vote of the Investment & Finance Committee on 08/16/2016.

This Investment Policy was formally amended by vote of the Investment & Finance Committee on 01/25/2017.

This Investment Policy was formally amended by vote of the Investment & Finance Committee on 01/25/2017 and was amended on 01/25/2017.

The authors wish to thank Dave Meldrum-Green for sharing Reliant Mission's investment policy.

APPENDIX **12C**

# SHORT-TERM INVESTMENT POLICY FOR HIJ FOUNDATION

*This example of a short-term investment policy is concise and includes all the necessary components that may be used for any size organization.*

The undersigned hereby certify that the following investment policy was duly adopted and approved by the act of a majority of the Directors of the Foundation present at a meeting of the Board of Directors held on the 14th day of March, 2XXX, at which a quorum was present.

RESOLVED, that the purpose of this policy is to define the criteria to be followed by the HIJ Foundation for investment of surplus cash. All investments are to be made in conformance with the following criteria listed in the order of importance.

**1.** Safety of principal
**2.** Liquidity
**3.** Yield

Surplus funds, in excess of short-term future needs, may be invested in the following:

**a.** Short-term CDs, US or Eurodollar time deposits, or bankers' acceptances (BAs) having maturities not exceeding six months with any commercial bank having a combined capital and surplus of not less than $500 million, not to exceed 10 percent in any bank rated A by Standard & Poor's Corporation and Moody's Investors Service, Inc.

**b.** Commercial paper of US industrial issuers maturing no more than 270 days from the date of acquisition thereof and, at the time of acquisition, having a rating of A-1 (or better) by Standard & Poor's Corporation, P-1 by Moody's Investors Service, Inc., or F-1 by Fitch.

**c.** Repurchase agreements entered into with investment banks having shareholders' equity of at least $500 million; such repurchase agreements to be collateralized at least 100 percent by negotiable securities of a type described in (d) below.

**d.** US Treasury bills, notes, and bonds and other marketable direct obligations insured or unconditionally guaranteed by the United States of America or issued by any sponsored agency thereof and having a remaining maturity of five years or less.

**e.** US corporate bonds and medium-term notes having a remaining maturity of five years or less and rated A or better by Standard & Poor's Corporation and Moody's Investors Service, Inc., with diversification in terms of industry concentration.

**f.** Any mutual fund with a net asset value in excess of $100 million that invests solely in US Treasury bills, notes, and bonds (or agencies backed by the US government), and such securities have a remaining life of 13 months or less and the fund maintains a net asset value of $1.00 per share.

The adoption and approval of the foregoing resolution constitutes the act of the Board of Directors of the HIJ Foundation pursuant to Article II, Section 5, of the Restated By-laws of the HIJ Foundation.

APPENDIX 12D

# SAMPLE OF INVESTMENT POLICY STATEMENT FOR THE ABC FOUNDATION'S LONG-TERM ENDOWMENT POOL

The purpose of the ABC Foundation's endowment is to support the educational mission of the ABC University by providing a reliable source of funds for current and future use. Investment of the endowment is the responsibility of the Investment Committee. The Committee establishes investment objectives, defines policies, sets asset allocation, selects managers, and monitors the implementation and performance of the Foundation's investment program. The Committee is supported by the office of the Vice President–Finance, which analyzes investment policies and management strategies, makes recommendations to the Investment Committee, and supervises day-to-day operations and investment activities.

## STATEMENT OF INVESTMENT OBJECTIVES

The endowment will seek to maximize long-term total returns consistent with prudent levels of risk. Investment returns are expected to preserve or enhance the real value of the endowment to provide adequate funds to sufficiently support designated University activities. The endowment's portfolio is expected to generate a total annualized rate of return, net of fees, 5 percent greater than the rate of inflation over a rolling 5-year period.

The Foundation's spending policy governs the rate at which funds are released to fund-holders for their current spending. The Foundation's spending policy will be based on a target rate set as a percentage of market value. This rate will be reviewed annually by the Investment Committee. The spending target rate is 5 percent for fiscal year YYYY–YYYX.

## ASSET ALLOCATION

To ensure real returns sufficient to meet the investment objectives, the endowment portfolio will be invested with the following target allocations in either domestic or global securities:

| | Minimum | Target | Maximum |
|---|---|---|---|
| | (%) | (%) | (%) |
| Fixed Income | 30 | 35 | 40 |
| Equities | 60 | 65 | 70 |

The Investment Committee may appoint equity and fixed-income managers, or select pooled investments, when appropriate. It is the overall objective to be 100 percent invested in equities and fixed income. If at any time the equity manager determines it is prudent to be invested at less than 80 percent, the Committee shall be notified. Equity managers may invest cash positions in marketable fixed-income securities with maturities not to exceed one year. Quality rating should be prime or investment grade, as rated by Standard & Poor's, Moody's, and Fitch for commercial paper, and a comparable rating on bank CDs. The managers are expected to reasonably diversify holdings consistent with prudent levels of risk.

At the discretion of the Committee, the endowment portfolio will be rebalanced annually to target allocations as opportunities permit.

## GUIDELINES FOR THE SELECTION OF FIXED-INCOME SECURITIES

**DIVERSIFICATION** Except for the US government, its agencies or instrumentalities, no more than 5 percent of the fixed-income portfolio at cost, or 8 percent at market value, shall be invested in any one single guarantor, issuer, or pool of assets. In addition, managers are expected to exercise prudence in diversifying by sector or industry.

**QUALITY** All bonds must be rated investment grade (BBB/Baa or better) by at least one of the following rating services: Standard & Poor's or Moody's, except that bonds not receiving a rating may be purchased under the following circumstances:

1. The issue is guaranteed by the US government, its agencies, or instrumentalities.
2. Other comparable debt of the issuer is rated investment grade by Standard & Poor's or Moody's.

The average quality rating of the total fixed-income portfolio must be AA or better. Securities downgraded in credit-quality rating subsequent to purchase, resulting in the violation of the policy guidelines, may be held at the manager's discretion. This is subject to immediate notification to the Investment Committee of such a change in rating.

**DURATION** At the time of purchase, the average duration of the bond pool should be no longer than the average duration of the current BofA Merrill Lynch 3-5 Year US Treasury Index plus one year.

## GUIDELINES FOR SELECTION OF EQUITIES: DIVERSIFICATION FOR EACH MANAGER

No more than 5 percent at cost, and 10 percent at market value, shall be invested in any one company. In addition, managers are expected to exercise prudence in diversifying by sector or industry.

## PERFORMANCE

Performance of the endowment and its component asset classes will be measured against benchmark returns of comparable portfolios as follows:

| | |
|---|---|
| Total Endowment | SEI Balanced Median Plan, BNY Mellon U.S. Master Trust Universe Median Fund – Endowments |
| Domestic Equities | S&P 500 Index, Russell 2000 Index, Dow Jones Wilshire 5000 Total Market Index |
| Global Equities | MSCI World Index, Dow Jones STOXX Global 1800 Index, S&P/Citigroup Global Equity Index: Broad Market Index, Russell Developed ex US Large Cap Index |
| Fixed Income | Barclays Capital 1–5 Year U.S. Treasury Index, BofA Merrill Lynch 3–5 Year US Treasury Index, BofA Merrill Lynch U.S. Corporate Index, Barclays 3 month USD LIBOR Cash Index |

At least annually, the Investment Committee will conduct performance evaluations at the total endowment, asset class, and individual manager levels. At the total endowment level, the Committee will analyze results relative to the objectives, the real rate of return, and composite indices. Further, investment results will be reviewed relative to the effects of policy decisions and the impact of deviations from policy allocations.

On the asset class and individual manager levels, results will be evaluated relative to benchmarks assigned to investment managers or pooled investments selected. These benchmarks are a vital element in the evaluation of individual and aggregate manager performance within each asset class.

The Committee may utilize the services of performance measurement consultants to evaluate investment results, examine performance attribution relative to target asset classes, and perform other functions as it deems necessary.

## PERMISSIBLE AND NONPERMISSIBLE ASSETS

All assets selected for the endowment must have a readily ascertainable market value and must be readily marketable. The following types of assets are permitted:

| **Equities** | **Fixed-Income Securities** |
|---|---|
| Common stocks | US Treasury and agency obligations |
| Convertible securities | Mortgage-backed securities of US government |
| Preferred stocks | Money market funds |
| Warrants | Short-term investment fund accounts |
| Rights (corporate action) | Certificates of deposit |
| Rule 144a stock* | Bankers' acceptances |
| American depositary receipts (ADRs) | Commercial paper |
| Corporate securities | Repurchase agreements |
| Collateralized mortgage obligations (CMOs) | Asset-backed securities/collateralized bond obligations |
| Index funds and exchange-traded funds (ETFs) | |

*This exception assumes the endowment continues to meet requirements specified under SEC Rule 144a. If the endowment does not meet those requirements, it is also expressly prohibited from trading in Rule 144a securities.

Within the mortgage-backed securities and collateralized mortgage obligations sector, investments in CMO tranches with reasonably predictable average lives *are* permitted, provided at time of purchase the security does not exceed the average duration of the current BofA Merrill Lynch 3–5 Year US Treasury Index plus one year. Interest-only and principal-only (PO) securities – or other derivatives based on them – are prohibited, as are securities with very limited liquidity.

Emerging market investments are permitted within the global equity manager's portfolio, subject to a maximum of 10 percent. Likewise, currency hedging as a defensive strategy is permitted in the global portfolio.

The following types of assets or transactions are expressly prohibited without prior written approval from the Investment Committee:

| Equities | Fixed-Income Securities |
|---|---|
| Commodities | Unregistered securities, except Rule 144a securities |
| Margin purchases | Tax-exempt securities |
| Short selling | Any asset not specifically permitted |
| Put and call options | |
| Direct oil and gas participations | |
| Direct investments in real estate | |

## SELECTION OF INVESTMENT MANAGERS

The Investment Committee may choose to select and appoint managers for a specific investment style or strategy, provided that the overall objectives of the endowment are satisfied.

## RESPONSIBILITIES OF THE INVESTMENT MANAGER

### ADHERENCE TO STATEMENT OF INVESTMENT OBJECTIVES AND POLICY GUIDELINES

1. The manager is expected to observe the specific limitations, guidelines, and philosophies stated herein or as expressed in any written amendments or instructions.
2. The manager's acceptance of the responsibility of managing these funds will constitute a ratification of this statement, affirming his or her belief that the endowment's investment objectives are realistically achievable within the guidelines and limitations stated herein.

**DISCRETIONARY AUTHORITY** The manager will be responsible for making all investment decisions for all assets placed under his or her management and will be held accountable for achieving the investment objectives stated herein. Such discretion includes decisions to buy, hold, and sell securities (including cash and equivalents) in amounts and proportions that are reflective of the manager's current investment strategy and that are compatible with the endowment's investment guidelines.

APPENDIX **12E**

# DEFINITIONS OF FIXED-INCOME INSTRUMENTS

## US TREASURY SECURITIES

The US Treasury finances federal deficits by issuing debt instruments called Treasury bills, notes, and bonds. The credit standing of each is the same, and the sole difference is the length of maturity. Treasury bills are issued for periods of one year or less, notes are issued to mature from more than one year but less than 10 years, and bonds are issued to mature from more than 10 years up to 30 years. Because of the credit quality of US Treasury securities, investors from all over the world with all forms of investment needs are attracted to these instruments. As a result, the market for these securities enjoys a depth that provides for substantial liquidity.

## US GOVERNMENT AGENCY OBLIGATIONS

Various agencies of the US government and government-sponsored enterprises (GSEs) issue debt securities to finance various types of public operations. The agencies that issue the most popular securities, and probably issue the largest volume of government agency securities, are the Government National Mortgage Association (GNMA, commonly referred to as Ginnie Mae), Federal National Mortgage Association (FNMA, commonly known as Fannie Mae), Federal Home Loan Mortgage Corporation (FHLMC, commonly known as Freddie Mac), and Federal Farm Credit Banks (FFCB).

With the exception of the Farm Credit Banks, debt instruments issued by the agencies are often in the form of certificates of participation in the ownership of pools of mortgage loans. While the certificates of participation themselves are not obligations of the US government, the underlying mortgages owned by the pools usually are guaranteed by an agency of the government, such as the Federal Housing Administration (FHA) or the Veterans Administration (VA) in the case of Ginnie Mae.

Both FNMA and FFCB are privately owned organizations that perform specific functions in the public interest. There is only implied federal interest in the financial health of the institutions and protection of investors in the debt instruments issued by these institutions.

When an investor is considering a certificate of participation or a debt obligation of a federal agency, the investor should make a diligent investigation into the adequacy of the instrument for its purposes. In some cases, the cash flow emanating from certificates of participation is very good; the certificates provide current income and repayment of principal to the investor. At the same time, however, accounting considerations are complicated because of the combination of both principal and interest in the cash stream. Moreover, before making the investment, the investor in certificates of participation should understand the nature and long maturity of the mortgages or other debt contained in the investment pool.

For example, a GNMA pool of FHA mortgages may have an average maturity of 17 years, but in a period of declining interest rates, many of these loans in the pool may be prepaid by their respective homeowners/obligors as they refinance their home mortgages at lower interest rates. As a result, the investor in the GNMA pool will realize a more rapid return of capital and a smaller total income figure than had been anticipated. This situation may not fit into the investor's plans for providing cash flow over a budgeted period, or the heavier than anticipated stream of cash flow may cause the investor problems in reinvesting the excess funds.

## MUNICIPAL SECURITIES

Municipal securities are instruments issued by various nonfederal government political entities, such as states, counties, water districts, and so on. They provide, in most cases, tax-exempt income to investors who pay taxes. However, increasingly, they are appropriate for investors who have no tax liability. Municipal securities come in a variety of types and maturities, often providing a yield advantage over government securities or corporate instruments of similar credit ratings.

## BANK OBLIGATIONS

Bank obligations are evidenced in the form of either deposits in the bank or instruments that have been guaranteed or endorsed by a bank *and* offered in the secondary (resale) markets, such as banker's acceptances.

There are two basic forms of interest-bearing bank deposits: (1) negotiable time certificates of deposit (CDs) and (2) fixed-time deposits.

**CERTIFICATES OF DEPOSIT** CDs maturing in a year or less are payable to the bearer and therefore, if properly held by a New York custodian, are liquid in the hands of the holder if the CD is issued for at least \$1 million. Many banks and investment dealers establish markets in CDs of the leading banks of the world and offer to buy and sell CDs for their own accounts. This is known as the secondary market. An investor can purchase a CD from one of these banks or dealers in the secondary market. Alternatively, an investor may initiate the bank deposit directly, in which case the CD is known as a primary certificate of deposit. If the investor chooses to sell the primary CD prior to maturity to recoup its cash funds early, it may sell it in the secondary market to another bank or a dealer. A bank is not permitted to repurchase its own CDs; this would be tantamount to early redemption of the deposit and subject to penalties. It is critical to note that a secondary market exists only for CDs issued by better-known banks and savings and loan institutions. Also, the instrument itself must be in correct negotiable form and available for prompt delivery in New York. A CD issued by a bank located offshore – usually London, Cayman Islands, Nassau – is called a Eurodollar CD.

**FIXED-TIME DEPOSITS** Fixed-time deposits are similar to negotiable CDs except that a bearer certificate is not issued. Fixed-time deposits often are issued domestically for amounts a bank wishes to accept. However, amounts of $1 million and more are usually required in London branches of major banks located in London, Nassau, the Bahamas, and the Cayman Islands. These are called Eurodollar time deposits since they are placed in offshore branches. Because these deposits are not represented by negotiable certificates, they are not liquid. Therefore, they often carry a higher yield to the investor than CDs.

**BANKERS' ACCEPTANCES** A banker's acceptance (BA) is a draft drawn by a bank customer against the bank; the instrument is then "accepted" by the bank for the purpose of extending financing to the customer. The bank's acceptance of the draft means that the bank plans to sell the instrument in the secondary market, and it also indicates the bank's unconditional willingness to pay the instrument at maturity. A BA often originates as the result of a merchandise transaction (often in international trade) when an importer requires financing.

As an investment instrument, a BA of a particular bank carries higher credit quality than the same bank's CD, because it is not only a direct obligation of the bank, like a CD, but also an obligation of an importer and usually collateralized by the merchandise itself. However, BAs are not deposits and do not carry the $250,000 insurance coverage of the Federal Deposit Insurance Corporation. Often BAs can be purchased at a few basis points' higher yield than a CD from the same issuing bank, because many investors are not as familiar with BAs as they are with CDs.

## ASSET-BACKED SECURITIES

Asset-backed securities are securities where some type of collateral, or pool of assets, serves as the basis for the creditworthiness of the security. Earlier in this appendix, debt instruments from government agencies such as GNMA were referenced whose underlying collateral was a pool of mortgages. Also, many other nongovernmental securities are issued with collateral such as auto loans or credit-card loan receivables.

## COMMERCIAL PAPER

Commercial paper traditionally has been an unsecured promissory note issued by a corporation. The issuer may be an industrial corporation, the holding company parent of a bank, or a finance company that is often a captive finance company owned by an industrial corporation. Commercial paper is issued to mature for periods ranging from 1 to 270 days. Corporate obligations issued for longer than 270 days must be registered with the Securities and Exchange Commission; therefore, companies needing short-term financing typically restrict the maturities of this debt to 270 days or less. Commercial paper is available to the investor through many major banks that issue the bank's holding company commercial paper or act as an agent for other issuers, and through investment bankers and dealers who may underwrite the commercial paper for their clients. A growing percentage of the commercial paper issued today is now secured, or asset-backed, commercial paper.

## LOAN PARTICIPATIONS

A loan participation as an investment medium is attractive to an investor because it presents an opportunity to invest in a corporate obligation that is similar to commercial paper but normally carries a somewhat higher yield. Banks have invested in loan participations of other banks for decades as a means of diversifying loan portfolios. However, the use of loan participations as an investment medium for corporations was developed during the late 1980s.

The loan participation investment medium begins when a bank makes a loan to a corporation using standardized loan documentation. After the loan has been made, the bank seeks investors to buy "participations" in the loan. The investor in the loan participation has the obligation to investigate the credit of the obligor, since the bank selling the participation offers no guarantee or endorsement, implied or otherwise. Many companies that are obligors of these loans are rated by the commercial paper rating agencies, such as Standard & Poor's and Moody's Investors Service. In some cases, the entire short-term debt of the issuer is rated, while in other cases only the commercial paper of the company is rated. However, if the short-term debt or commercial paper is unrated and an investor must rely on his or her own credit analysis, the investor must use extreme caution due to the difficulty in ascertaining the credit soundness of the investment. Loan participations may have maturities ranging from one day to several months. Occasionally, the investor may be able to obtain a loan participation to suit his or her precise maturity requirements, particularly when large amounts (in excess of $1 million) are available for investment.

The investor should be aware that a loan participation is not a negotiable instrument and, therefore, is not a liquid investment. It does not constitute good collateral for the investor who needs to pledge part or all of his or her investment portfolio to secure certain obligations. A loan participation, however, may be a good investment from the standpoint of yield, subject to appropriate credit investigation by the investor.

## CORPORATE NOTES AND BONDS

Corporate debt instruments with maturities longer than 270 days are considered notes if they mature within 10 years from their original issue date. The instruments are considered bonds if they mature more than 10 years from the original issue date. Notes with maturities up to approximately three to five years can play an important role in portfolios where the objective is to increase yield over what is available from strictly short-term portfolios, and where nearly perfect liquidity is not necessarily required. Because they have a longer maturity than money market instruments, corporate notes are subject to greater market risk due to changes in interest rates. However, because the maturities may be only three to five years, the instruments are not subject to swings in market values as much as bonds are.

Corporate bonds are often included in investment portfolios in which the time horizon is much longer than liquidity portfolios. Bonds are seldom included in liquidity portfolios unless they will mature in one year or less (current maturity, not original maturity).

## REPURCHASE AGREEMENTS

A repurchase agreement is an investment transaction between an investor and a bank or securities dealer in which the bank or dealer agrees to sell a particular instrument to the investor and simultaneously agrees to repurchase that instrument at a certain date in the future. The repurchase price is designed to give the investor a yield equivalent to a rate of interest that both parties negotiate at the time the transaction is initiated.

On its face, a repurchase agreement transaction, commonly referred to as a "repo," appears to place full and complete ownership of the underlying securities in the hands of the investor. However, a number of incidents of default by dealers occurred during the 1980s, resulting in court rulings that brought the fundamental nature of repos into question. Those rulings implied very strongly that a repo was not, in fact, a purchase with a simultaneous agreement to repurchase the underlying securities, but rather a loan made by the investor to the dealer secured by the pledge of the underlying instruments as collateral to the loan. This viewpoint was bolstered by the fact that, in the repo business, the underlying instruments always have been called "collateral." Investors who were previously authorized to invest in instruments subject to repurchase were now faced with making secured loans to banks and brokers.

Because repos traditionally have been a fundamental investment medium used by institutions to invest temporarily surplus funds overnight and for periods of approximately one week, the court rulings seriously undermined the viability of the repo for this important purpose. It was not until Congress adopted the Government Securities Act of 1986 (as supplemented by regulations issued by the Treasury Department early in 1988) that the investment community regained its confidence in the repo as an investment medium. That act, however, addressed only part of the issue. It laid out very clearly the rights, duties, and obligations of the dealer in a repurchase agreement as long as the dealer is not a bank. However, it left hanging in the wind the relationship of the dealer if the dealer is a bank. This void continues to exist.

In order to fill the void, the investor should enter into an underlying written agreement with the dealer or bank as the counterparty to the transaction. The agreement should spell out very clearly the rights, duties, and obligations of each of the parties, particularly in the event of the default of one of them. The agreement should also state clearly that the transaction is intended to be a purchase/repurchase transaction and explicitly is not a loan by the investor to the dealer or bank. The agreement should further provide that in the event of the default of the dealer, the investor has the right to take possession of the collateral, if the investor does not already have such possession, and to dispose of that collateral in order to recover the investment.

The Public Securities Association, an organization of securities dealers, prepared a model agreement that many banks and securities dealers have adopted and that they require their repo customers to execute. This model agreement appears to have been drafted in an even-handed manner and supports the interests of both counterparties in the repurchase transaction. Therefore, if the bank or securities dealer does not offer such an agreement, the investor should ask for the agreement from the bank or dealer.

Because of past history involving the collapse of some investment houses that were heavily involved in repos, an investor should be forewarned that the real risk in entering into a repo is the risk of failure of the counterparty (i.e., either a dealer or a bank) to perform under the agreement. The investor should not place great confidence in this type of investment due only to the collateral for safety of principal. The investor, however, should recognize that the success of the transaction actually depends on the viability and willingness of the dealer or bank to repurchase the securities at maturity of the transaction. Accordingly, the investor must be diligent to investigate the credit standing of the counterparty to the transaction.

As an additional protection, the investor should specify to the dealer or bank those securities that are acceptable as underlying collateral. Investing guidelines should specify that such underlying collateral may consist of only investment instruments permitted by the guidelines. Moreover, the guidelines should require that in a repo transaction, the value of the underlying collateral should exceed the amount of the investment transaction by some small increment, usually stated in terms of 102 percent of the amount of the transaction. This should be monitored by the investor on a regular basis to keep current on the market value of securities used as collateral. One final point to be considered is whether the collateral is set aside for the investor and does actually exist.

## MONEY-MARKET MUTUAL FUNDS

A money-market mutual fund is itself a portfolio of money market instruments. It provides a reasonable vehicle for investing modest sums where the amount may be too small to manage an effective investing program. For example, in managing amounts of less than \$3 million, an investor is hard-pressed to meet the objectives of preservation of capital, maintenance of liquidity, and yield, because money market instruments normally trade in \$1 million pieces. The portfolio loses some diversification because of the large size required. If diversification is necessary, it forces the size of any one investment to be less than \$1 million, and the company will sacrifice liquidity.

One solution to this dilemma is to invest in a money-market mutual fund where the amounts invested may range from a minimum of perhaps \$1,000 (in a retail-oriented money market fund) to many millions of dollars. Various kinds of money-market mutual funds exist. The more popular funds cater to consumers and businesses with modest amounts available, and others serve institutional investors with large amounts of investable funds. Generally, both categories of funds operate similarly, with the institutional funds requiring larger minimum investments and often taking smaller management fees.

The mutual fund affords the investor the opportunity to meet investment objectives of safety of principal, maintenance of liquidity, and yield provided that the investor carefully selects the particular fund. Fund selection should be based on a thorough review of the prospectus, with particular attention paid to the investment objectives of the fund, the experience and investment record of the fund's management, and the quality and liquidity of the investment instruments that the fund maintains in its portfolio.

The investor should inquire about redemption privileges and requirements of the fund and the fund's "pain threshold" for withdrawals. Most money-market mutual funds allow withdrawal virtually on demand either by check (which is actually a draft drawn against the fund) or by electronic funds transfer to the investor's bank account. Electronic funds transfer may be either a wire transfer for value the same day as the withdrawal or an automated clearinghouse transfer with settlement the following day. The pain threshold refers to the size of withdrawal that the fund can tolerate without incurring its own liquidity problems. For some of the very large money-market mutual funds, an immediate withdrawal of \$50 million can be tolerated with little pain because of the fund's size. In contrast, a small fund of less than \$500 million may have a problem meeting a withdrawal request for \$5 million. The size factor should be seriously considered when selecting a money-market mutual fund.

The 2016 changes in the regulations related to money-market mutual funds has caused many institutional investors to reconsider "prime" money-market mutual funds and to either move to government-security-only money funds or move funds to bank deposits. Organizations with higher risk tolerances are also placing some of their short-term funds in separately managed accounts.[1]

## Note

1. For more on separately managed accounts see Lance Pan, "Higher Deposit Rates, Where Art Thou"? Capital Advisors Group (August 11, 2017). Available at https://www.capitaladvisors.com/research/higher-deposit-rates-where-art-thou/. Accessed 1/29/2018.

APPENDIX 12F

# DEFINITIONS OF EQUITY INSTRUMENTS

*American Depositary Receipts (ADRs)* American brokers function as intermediaries in the purchase and sale of foreign issues by acting as conduits for shares that are listed on international exchanges. A broker retains shares in a pool, which are represented by salable depositary receipts.

*Common Stock* A security that represents an ownership interest in a corporation.

*Convertible Securities* Bonds, debentures, or preferred shares of stock that may be exchanged by the owner for common stock or another security of the issuing firm. These issues are particularly useful in new ventures when the founders are seeking capital, and include several types of both convertible equity and convertible bond issues.

*Exchange Traded Fund (ETF)* A type of an investment fund traded on a stock exchange, the assets of which might be in stocks, bonds, or other assets.

*Index Fund* A mutual fund whose portfolio matches that of a broad-based index such as Standard & Poor's 500 Index and whose performance therefore mirrors the market as a whole.

*Preferred Stock* A class of stock with a claim on the company's earnings before payment may be made on the common stock. It usually has priority over common stock in terms of liquidation claims. Its investors are usually entitled to dividends at a specific rate when declared by the board of directors and before payment of a dividend on the common stock, depending on the terms of the issue.

*Rights (Corporate Action)* Rights offerings entitle owners of common stock to purchase shares of new stock issuance at a price somewhat below the current market price; usually the right has a duration of 90 days following the issuance of new common stock.

*Rule 144a Stock* A pool of common shares that has been authorized by a corporation's board of directors that is usually not entirely disbursed or marketed for sale, but is held in an internal pool known as treasury stock. A certain number of shares from this pool is often set aside for internal distribution, and hence is never registered with the Securities and Exchange Commission. Prior to registration, these Rule 144a shares are not used in calculations of a company's worth such as P/E ratios or book value.

*Warrants* A certificate giving the holder the right to purchase a fixed number of common stock securities at a stipulated price within a specified time limit or perpetually. Warrants are created by a corporation to facilitate the sale of debt or preferred stock.

APPENDIX 12G

# GLOSSARY

## American Depositary Receipts (ADRs)

American brokers function as intermediaries in the purchase and sale of foreign issues by acting as conduits for shares that are listed on international exchanges. A broker retains shares in a pool, which are represented by salable depositary receipts.

## Asset-Backed Securities (ABS)

Mostly AAA-rated securities secured by consumer credit card receivables. These issues are credit-enhanced by overcollateralization, letters of credit, and subordination of portions of cash flow to cushion against any losses is the underlying receivables.

## Collateralized Mortgage Obligations (CMOs)

A multiclass bond backed by a pool of mortgage pass-through securities or mortgage loans.

## Common Stock

A security that represents equity ownership in a corporation, although the right to residual claims on corporate assets is subordinated to the rights of debt holders in the event of liquidation. Further rights guaranteed by common stock ownership can generate entitlements that have intrinsic marketable value. These include rights offerings, or preemptive rights, which entitle the holder to purchase shares of a new stock issuance at a price somewhat below the current market price; usually the right has a duration of 90 days following the issuance of new common stock. Warrants provide the holder the right to purchase a fixed number of shares of common stock at a predetermined price during a specific period, though some warrants are perpetual. Warrants are created by a corporation to facilitate the sale of debt or preferred stock.

## Convertible Debt Instruments

These securities act like convertible equity issues, but have fundamental pricing differences. Usually, the conversion on bonds is expressed as a conversion price rather than as a ratio, as is the case with convertible equity issues.

## Convertible Preferred Equity Issues

The convertible preferred equity issue can be exchanged, at the shareholder's option and at any prespecified ratio or at a preestablished conversion price, for shares of a company's common stock. The conversion ratio is the par or stated value of the preferred stock divided by the purchase price; conversions of equity issues usually occur at a conversion ratio as opposed to a particular price.

## Convertible Securities

Debt instruments and equity securities that are convertible into forms of common stock. These issues are particularly useful in new ventures when the founders are seeking capital, and include several types of both convertible equity and convertible bond issues.

## Index Fund

Mutual fund whose portfolio matches that of a broad-based index such as Standard & Poor's 500 Index and whose performance therefore mirrors the market as a whole.

## Investment Ratings

Various ratings services publish analyses on the array of investment instruments currently available on the markets. Among the most widely known fixed-income ratings services are Moody's, Standard & Poor's (S&P), and Fitch. Their investment ratings are as follows:

| Company | High Quality | Quality | Below Investment Grade | Very Poor Quality |
|---|---|---|---|---|
| S&P, Fitch | AAA–AA | A–BBB | BB–B | CCC–D |
| Moody's | Aaa–Aa | A–Baa | Ba–B | Caa–C |

## Preferred Equity Redemption Cumulative Stock (PERCS)

A type of convertible preferred stock, PERCS shares automatically convert to common stock at the termination of a three-year period, unless called prior to that by the issuer. A cap is set on the conversion value, generally at about 30 percent above the common stock price at the time the preferred stock is issued. If at the end of the three-year period the stock is trading at or below the common stock price, holders receive one share of common stock for each PERCS share. PERCS shares are marketable, although, as with all equity securities, a market is never guaranteed.

## Preferred Stock

An equity issue that has fixed-income characteristics; preferred shares have a fixed dividend, which is stated as a percentage of par value. These shares usually do not have preemptive rights or voting rights, though they are senior to common shares in terms of liquidation claims.

## Real Estate Mortgage Investment Conduits (REMICs)

Various mortgage tranches, or classes of bonds, are offered (e.g., planned amortization class, inverse floaters, sequential pay, etc.).

## Rule 144 Stock

A pool of common shares that has been authorized by a corporation's board of directors and that is usually not entirely disbursed or marketed for sale, but is held in an internal pool known as treasury stock. A certain number of shares from this pool is often set aside for internal distribution, and hence is never registered with the Securities and Exchange Commission. Prior to registration, these Rule 144 shares are not used in calculations of a company's worth such as P/E ratios or book value.

CHAPTER 13

# INFORMATION TECHNOLOGY AND KNOWLEDGE MANAGEMENT



## 13.1 INTRODUCTION

Chief financial officers in the business sector are convinced they should be more involved with the financial and operational data they have available: "Improving reporting analysis functions … is a top improvement goal. … More than 70 percent of over 380 finance executives polled [by consulting firm Kaufman Hall] say supporting decision-making is their number-one goal for 2017, a divergence from the more traditional finance and accounting roles. Over 90 percent say they need to do more with the financial and operations data at



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.


*Source:* Robert Hulshof-Schmidt, "NTEN: The Tenth Annual Nonprofit Technology Network Nonprofit Technology Staffing and Investments Report," May 2017. Used by permission.

**Exhibit 13.1** Organizational Structure of IT in Nonprofits

hand to help top management make critical decisions."[1] That ability depends heavily on the information technology, both hardware and software, available to them. Andy Bryant, chief financial officer (CFO) of Intel, leads Intel's human resources, information technology (IT), and procurement, and is heavily involved in strategic decision making. He sees this expansive role as the trend for the future in businesses. For many nonprofit CFOs, such a multifaceted role is normal, not exceptional. Additionally, Bryant believes that Intel's IT is better managed now that it is under finance, and he thinks the finance office acts more appropriately toward the IT staff due to having the reporting relationship.[2] According to survey data from NTEN: The Nonprofit Technology Network, the IT area is housed within the finance department in about 15 out of 259 surveyed nonprofits (see Exhibit 13.1). The most commonly seen organizational structure for the nonprofit IT function is to have it set up as a separate IT department, a relatively recent development.

*Information technology* has been the buzzword for the past three decades. The rush to automate and implement new technologies and better harness data for improved performance and greater effectiveness has yet to slow down. Technology has been seen as the solution to increase productivity, reduce errors, keep up with the increasing demands for more and more information, and improve performance. Information technology is "concerned with all aspects of managing and processing information,"[3] and may be defined as "… the use of hardware, software, services, and supporting infrastructure to manage and deliver information using voice, data, and video."[4] Consider how the Information Technology Department of the State of North Dakota frames IT and the budget implications for its agencies (see Exhibit 13.2).

The top priorities as we enter and move through the third decade in the new millennium are answering questions such as the following:[5]

1. Do you have the right technology to help you manage multiple revenue sources?
2. Do you have technology to help mitigate fraud?
3. Do you have technology to help make the audit process run more smoothly?

Nonprofit board members list cybersecurity (protecting against the criminal or unauthorized use of electronic data; 18 percent) and changing technology (17 percent) as two of their top seven concerns.[6] Your technology acquisition, maintenance, and funding plan will likely be of major interest to your board.

**INCLUDED IN INFORMATION TECHNOLOGY**

- All computers with a human interface
- All computer peripherals that will not operate unless connected to a computer or network
- All voice, video, and data networks and the equipment, staff, and purchased services necessary to operate them
- All salary and benefits for staff whose job descriptions specifically includes technology functions (i.e., network services, applications development, systems administration)
- All technology services provided by vendors or contractors
- Operating costs associated with providing information technology
- All costs associated with developing, purchasing, licensing, or maintaining software

Agencies may wish to include other costs at their discretion. For example, an agency may wish to include digital cameras in their IT budget even though they can be operated standalone. Data entry personnel may be included if they are considered part of the technology staff. Costs that are excluded above may be included if they are an integral part of a computer application or would be difficult to break out because the costs are included with other information technology costs.

**EXAMPLES OF INFORMATION TECHNOLOGY**

- Telephone and radio equipment and switches used for voice communications
- Traditional computer applications that include data storage and programs to input, process, and output the data
- Software and support for office automation systems such as word processing and spreadsheets, as well as the computer to run them
- Users' PCs, tablets, smartphones, and software
- Server hardware and software used to support applications such as electronic mail/groupware, file and print services, database, application/web servers, storage systems, and other hosting services
- Data, voice, and video networks and all associated communications equipment and software
- Peripherals directly connected to computer information systems used to collect or transmit audio, video, or graphic information, such as scanners and digitizers.
- Voice response systems that interact with a computer database or application.
- The state radio communications network
- Computers and network systems used by teachers, trainers, and students for educational purposes
- "Open/integrated" computer systems that monitor or automate mechanical or chemical processes and also store information used by computer applications for analysis and decision making, such as a building management system
- All operating costs, equipment, and staff time associated with supporting the technology infrastructure of the agency, possibly including items excluded above, such as video equipment used for technology training that is included in the information systems cost center for the agency

**Exhibit 13.2** Information Technology Explanation and Examples

**EXCLUDED FROM INFORMATION TECHNOLOGY**

- "Closed/standalone" computer systems that monitor or automate mechanical or chemical processes, such as a fire alarm system.
- Audiovisual equipment that can be operated as a standalone piece of equipment, such as televisions, DVD players, video cameras, and overhead projection devices. Standalone video editing equipment is excluded.
- Copy machines and fax machines.
- Licenses or subscriptions to electronic information provided to users in lieu of books or magazines.
- Salaries of staff who use technology but are not directly involved in developing, implementing or supporting technology as documented on their job description. Data entry staff, staff who digitize drawings, and staff who do desktop publishing are excluded. "Power users" who use advanced features of spreadsheets or word processing software are excluded.
- Data entry services

*Source:* Adapted from listing at http://www.nd.gov/. Used by permission.

**Exhibit 13.2** Information Technology Explanation and Examples (*continued*)

Finance staff is in a key role in regard to IT spending, both because IT spending is largely made at management's discretion and because of the large financial impact of IT expenditures. Notes Michael Blake, a financial officer at nonprofit healthcare services firm Kaiser Permanente, "Finance has to play both an oversight and a consultative role, and play them both well … finance has to be discerning about budget decisions or risk thwarting strategic growth [such as ordering an across-the-board reduction in IT expenses]."[7] About 3 in 10 corporate CFOs believe the IT area should report to the finance area, about 6 in 10 believe IT should not report to finance but that they should work closely together, and the remainder are evenly split on having them collaborate only on matters of spending or work entirely independent of each other.[8] Finance staff should push for adequate technology to assist it in its critical role as risk management captain – with proper data, overall risk exposure to all the different risks the organization faces may be assessed, monitored, and managed.[9] (See Chapter 14 for coverage of risk management and Appendix 14A for coverage of derivatives.)

To properly evaluate the need for technology tools and how to implement them, it is necessary to explore what each can offer and attempt to forecast the future capabilities, direction, and growth of each industry. These tools improve and expand rapidly. They are out of date the moment the purchase order is issued; however, finding some stability in this arena is both possible and necessary before their introduction into the workplace.

When many people hear the term "information technology," the computer is the first tool that comes to mind; however, technology tools have been with us in the workplace since the first abacus was introduced to accounting. The migration to advanced technology tools – personal computers (PCs) that can do just about anything one might wish to do on a computer, tablets, mobile applications, networks, banking and purchasing over the Internet, electronic payments and donation collections (including those made from payors' or donors' digital wallets), e-mail with documents attached, voice mail, and so forth – has been thought to alter radically how we work, when actually it has simply improved on what is familiar by repackaging these tasks and workflow to be smarter, faster, and more efficient.

## 13.2 HOW MUCH TECHNOLOGY AND WHICH TO CHOOSE?

IT tools can dramatically improve performance if they are used appropriately and wisely. They can also be used inappropriately and damage a smooth-running operation. For example, many companies are opting for the use of electronic receptionists, offering their customers a series of questions to direct their calls. This technology can be very useful in the right environment, such as a highly technical customer base; however, if the customer base is nontechnical (more service based) or if the service is not highly dependable, the selection of this technology may damage customer or client relations.

The same is also true with the use of computers, whether tablets, laptops, or desktop PCs. There should be a good, sound reason to automate a task or process, not just a desire to jump on the technology bandwagon. To analyze your organization's need for automation using technology, use the checklist in Exhibit 13.3.

To determine whether a task or process could benefit from automation, use the following checklist:

**WHY DO I WANT TO AUTOMATE THIS PROCESS?**

1. *To handle a redundant process (the same task is repeated over and over).* Any task that is repeated could greatly benefit from automation. Computers are good at doing that same thing repeatedly.
2. *To share or manipulate information.* If there is a need to share information across departments, divisions, or work groups, or a need to have the same information manipulated for different audiences, then maintaining it in a computer or in the cloud is the best way to accomplish the task.
3. *To enable staff to do more work.* This is a common reason for the decision to automate. It, in itself, is not a valid reason for automation, nor will automating for this reason yield the desired results. This is the most common erroneous justification for automation. There must be something specific about the task or process that could be streamlined, simplified, or improved on with the use of an automated technology. This reason is sound only if it is followed by a qualifier, such as, "To enable staff to do more work … by automating the routine tasks they perform, thus reducing their workload."
4. *To reduce errors.* There can be a great reduction in errors with the use of technology if the systems, processes, and rules can be built; however, if the system design is as freeform as the manual process, those same errors will be introduced into the automated process. In addition, since the automated process will be new, more errors will be made as staff members are learning to use the technology.
5. *To produce multiple outputs (e.g., reports, cards, badges, graphs, charts, form letters).* This is one of the best reasons for automation (where the same information is used for different reasons). If done well, automating this type of process can dramatically reduce errors and workload, and increase productivity.

**Exhibit 13.3** Technology Checklist

**(a) WHAT TYPES OF TECHNOLOGY TOOLS SHOULD I CONSIDER?** Before deciding on a specific platform (e.g., PCs or Macs), six questions should be answered:

1. *What software is available for this system that the business will require?* Traditionally, Macs have been used in businesses that produce graphics (e.g., advertising, marketing) and PCs have been used for number crunching (e.g., accounting, forecasting). While the differences between the two platforms are diminishing rapidly, the majority of accounting applications, for example, are available only for the PC, and some design packages are available only on Macs.
2. *Who will need to access the information?* Will a network need to be established linking the computers? If so, there may be a need to standardize around a certain type of architecture and possibly compromise on the financial management needs with that of the rest of the business. If not, a diversity of platforms will not hinder or interfere with your specific needs in the financial management arena. It is also possible to establish two different networks – one for the administrative/business needs of the organization and one for the creative aspects. System compatibility continues to improve, making this less of a concern than it was formerly. There are still issues connecting financial/accounting software with fundraising/donor management software when they come from different vendors.
3. *Are there sufficient resources (financial and staff) to implement a new technology?* It is easy to budget the costs of the equipment, but the less obvious costs of down time, training, installation, maintenance, new supplies, and other factors are not as easy to predict, manage, or forecast.
4. *What does the research of others in a similar industry suggest?* With noncompeting organizations, it is often possible to develop strategic alliances to share expertise and reduce development costs and the risks associated with the implementation of new technologies. Also, TechSoup (http://www.techsoup.org/nonprofitsoftwaresem) and Good360 (www.good360.org) have been valuable sources of free or inexpensive computers, printers, and software (in Good360's case, for 57,000 prequalified nonprofits). Furthermore, Microsoft Office 365 is available to nonprofits for a donation (single user) or small fee (e.g., $10 per user per month) for the full-featured version.
5. *Is there a suitable software product available on the market, or will a customized product be required to meet the need?* Operating system and equipment advancements occur almost annually. If a nonstandard software or hardware is selected, these systems will become obsolete (nonupgradable) almost immediately. Most organizations learned this lesson too late and are faced with the task of reintroducing automation. To avoid this obsolescence, an off-the-shelf package, moderately customized to meet the organization's needs, should be selected by most small and midsized organizations. Selecting the appropriate software package should be done carefully and after checking with staff at organizations similar to your own.
6. *Have the findings and decisions been reviewed carefully?* All decisions, assumptions, and recommendations should be discussed with peers. If possible, a consultant with expertise in this specific area should be contracted to review the plans.

All but the very smallest organizations will also require a computer network to allow data and possibly software sharing. If yours is one of the many one-person nonprofit organizations, you should consider the need for a network as you begin to make plans for onsite volunteers and additional staff. The key items to consider in designing and purchasing your network are:

- Know what you need and what you don't need – get input from staff.
- Consider new functionalities that are available, such as remote access via the Internet to your network (for telecommuters and staff as they travel) and cloud-based applications. Determine responsibilities for various aspects of the new equipment and software (and consider whether having extra features available for in-house use is cost-effective).
- Obtain multiple bids.
- Get referrals from trusted sources, possibly utilizing a freelance technology expert to help with your decision making.[9]

**(b) ARE THEY REQUIRED?** If a task or process can be effectively performed manually, technology tools may not be required; however, the ability to communicate with or pass data to other businesses or individuals may require automation or the introduction of technologies.

If there is a need to communicate and share information with other organizations, businesses, government agencies, bureaus, or the like, technologies should be introduced that will enable compliance with these demands. Implementation strategies should include the immediate need(s) as well as long-term strategies for applying new technology in other areas of the organization.

**(c) DO I NEED THEM?** In a nonprofit organization, technology may not be required for all applications. In the financial arena, however, the capabilities provided by new technologies will dramatically improve the quality of work or at least streamline or simplify the process. The migration from "counting beans" to "analyzing trends and forecasting needs" is the major thrust of automating the process of financial management.

The major focus of financial management is the ability to: review financial information to make decisions; forecast needs, especially cash requirements and the resulting cash position; evaluate performance; and assess progress. The quality of financial management is based on the integrity and timeliness of the information reviewed and evaluated. The manual process of accounting has provided a level of accuracy and quality that for many years was acceptable. The introduction of technology and the automation of the process provide a higher quality of data than can be provided by a manual accounting process. The removal of as much human error as possible from the process is the single most important reason to automate.

**(d) WHAT WILL THEY DO FOR ME?** Many financial software programs on the market resemble easy-to-use checkbooks. While some organization's financial management needs may be much more sophisticated, one of these programs can provide all that is needed to automate the financial operation of many businesses. These software programs, if set up properly, will enable individuals to enter information in a format and style that is easy to understand and use. The ability to produce reports and retrieve information from these systems is quite remarkable. With most of these off-the-shelf programs, a balance sheet can be produced as swiftly and easily as a transaction record.

**(e) WHAT WILL THEY NOT DO FOR ME?** Technology cannot solve the organization's problems that are caused by human resources conflicts, poor organizational structure, or complex or ineffective policies or procedures. In fact, the introduction of technology will bring these problems to the surface and, in many cases, magnify their impacts on the organization. It is not uncommon, when technology implementations are under way, for the technology to be blamed for crippling the organization, when in fact the organization was already crippled by these other factors.

It is important to remember that technology tools automate a predefined task or process. Technology does not define the process. If there are existing problems with the processes, there will be problems in the automation of the process.

**(f) CAN I AFFORD THEM?** Software and hardware technologies can be expensive. The initial costs of the equipment and software are only the beginning of the expenditure requirements. With any decision to purchase, there must be a justification for the expenditure. Exhibit 13.4 illustrates one method of determining if there is a justification for the introduction of a new technology.

Exhibit 13.4 assumes the cost of a typical PC configuration at $3,500. At Line 2 of the data in the bottom panel, a 10 percent increase in productivity (or elimination of an extra position at that percentage) recovers the costs of the typical configuration in the first year. Each subsequent year, a savings of $2,500 ($3,500–$1,000) can be achieved.

The chart ends at 35 percent. However, if one staff person or the need to hire an additional staff member can be eliminated, the costs of the technology are assuredly justifiable.

**(g) WHAT CHANGES WILL THEY INTRODUCE TO MY ORGANIZATION?** All change is dramatic to an organization. Managing the change is the only way to assure that the

| | |
|---|---|
| One-time costs: | |
| Typical PC configuration | $1,250 |
| Software | 750 |
| Printer | 250 |
| Other | 250 |
| **Total setup costs** | **2,500** |
| Annual costs (recurring): | |
| Training | 500 |
| Supplies | 300 |
| Maintenance | 200 |
| **Total Annual Costs** | **1,000** |
| | **$3,500** |

| Average Annual Staff Salary | Productivity Increases (% of Positions Eliminated) | Annual Net Savings |
|---|---|---|
| $35,000 | 5% | $1,750 |
| $35,000 | 10% | $3,500 |
| $35,000 | 15% | $5,250 |
| $35,000 | 20% | $7,000 |
| $35,000 | 25% | $8,750 |
| $35,000 | 30% | $10,500 |
| $35,000 | 35% | $12,250 |

**Exhibit 13.4** Determination of Expenditure Need

introduction of new technologies will provide a desired and positive outcome. Accepting that all change is challenging, the introduction of technology has its own set of change issues and concerns. Many of these issues and concerns are unfounded and are based on myths about technology, but they still need to be addressed and discussed.

Assimilating the new technology will not be automatic. Depending on the level of change, new workflows, diagrams, work rules, policies, and procedures will need to be reviewed and, in most cases, revised or rewritten. Putting a computer on someone's desk will not automatically provide increases in productivity. In most cases, the transition process will yield a decrease in productivity until the training and assimilation process is complete. All support systems and processes need to be reviewed, and your staff members need to be retrained.

***(i) Example 1: Slow Integration.*** In one organization, the use of the computer was widely accepted, and staff learned quickly how to enter the information into the system. Reports were produced, data appeared to be of higher quality, and the staff should have had more time for analysis; however, the support structure for the system had not been redesigned. Staff members were still maintaining all of the paper documents in cross-filed indexes and logs, as they always had. They had learned to provide others with the information they needed but had not yet learned how to use the information themselves, nor did they believe it was their place to make major changes in the way they maintained their records.

***(ii) Example 2: Flawed Integration.*** In another organization, a request was made of one staff member to provide historical information about spending on an item type. The staff member went immediately to her paper files rather than the computer. When questioned about it later, she stated that the individual wanted a specific item rather than information on one of the categories of expenditures. When reminded that this person bought only that item, so that item matched up one-to-one to a single category, she realized she could have retrieved the information from the computer system.

In many other implementation situations, the biggest problem is the dramatic cultural change regarding what is valued in the organization. Rules and regulations that had taken decades to learn and memorize were suddenly programmed into the system. Individuals who had spent so much time learning these rules were suddenly no more qualified or valued than the newest person in the organization. So, in addition to new workflows, ways of positively rewarding and recognizing tenure need to be established in the organization.

Another challenge to the introduction of technology is fear: fear of a machine, fear of losing one's job, fear of not being able to use the software or other technology. The greatest pacifier is open communication.

To introduce technology into an organization:

- Determine what impacts the new technology will have on the organization.
- Develop a strategy for communicating the plan and the change to the staff within the organization.

(Also refer to Appendix 13B for guidance on your implementation strategy.)

The strategy should include:

- Why and how the need for technology was determined
- Management's commitment to the change
- How the technology will be introduced, who will be affected, what it will do

- How training will be handled
- The timeline (schedule) for the implementation
- The support systems that will be available
- How future communication about this change will be administered
- How this technology will be applied within the organization, what manual process or previous technology it will replace, what policies or procedures will be altered, and so forth

## 13.3 KNOWLEDGE MANAGEMENT AND INFORMATION TECHNOLOGY

**(a) HOW CRITICAL IS DATA?** "Bad data, bad decisions." Many nonprofits make poor decisions because they do not have the information available, do not know how to process or analyze the information, or do not have the time to carefully consider the decision alternatives and the information related to each of those alternatives. Furthermore, our Lilly study documented that the use of IT (particularly PC technology) was closely correlated with the proficiency of the organization's overall financial management. Using the information processing power of the basic financial spreadsheet, in particular, is essential to your organization's financial decision making. Facing complex environments and scarce resources, nonprofits must manage the knowledge resource effectively and efficiently.

**(b) KNOWLEDGE MANAGEMENT.** Many nonprofits use knowledge intensively – a prime example is philanthropic foundations. Identifying cutting-edge grantees or grant ideas, evaluating grant proposals, processing grant progress reports, and publishing policy reports are all knowledge-based activities. However, if these organizations do not invest in the proper systems, people, and organizational infrastructure, they will be hampered in their efforts. One foundation, the Casey Foundation, went to the extent of having a team classify everything the foundation had ever learned from the studies it had funded, so this knowledge could be accessed quickly and efficiently.[10]

One of the most exciting prospects for your organization is to begin to teach (or enable the learning of for) your employees and volunteers, as well as your board, the linkages between your organization's activities and its hoped-for outcomes. Researcher Natalie Buckminster[11] argues that this activity-outcome instruction is a tremendous way to promote organization learning; we concur.

***(i) Is Yours a Learning Organization?*** Peter Senge, probably the leading world expert on organizational learning, defines a learning organization as one in which "people continually expand their capacity to create the results they truly desire, where new and expansive patterns of thinking are nurtured, where collective aspiration is set free, and where people are continually learning to see the whole together."[12] How are your staff members' capacities being expanded? Do those with innovative ideas, or who challenge the conventional wisdom, get their ideas dismissed abruptly or shot down by the leaders? Do leaders help team members "see the big picture"? In particular, effective businesses have a "value culture," in which all employees are guided toward the likely effects of their activities and decisions on the company's stock price, or value. In nonprofits, the effect of activities and decisions on mission attainment and the value propositions for clients and donors and other funders are key, but so too is the likely effect on the liquidity position of the organization. Constant training, mostly done informally in "teachable moments," helps your employees see the connection of their tasks to cash inflow and outflow timing, amount, and risk. Working to model the type of culture you wish to create is essential, as noted by Gard Meserve, chief information officer (CIO) of Clarkson University.[13]

***(ii) Steps Toward Building a Learning Culture.*** Senge identified five disciplines that must be harnessed for your organization to become a learning organization:

**1.** Systems thinking: Look at your organization as a whole, including how it fits into its environment, and recognize how all of its parts work together and not independently.

**2.** Personal mastery: There is no way your organization can be a learning organization if individuals are not learning individuals.

**3.** Mental models: Understand or picture how the world works in some specific arena.

**4.** Development of a shared vision: How will the world be different if our organization succeeds in achieving its mission?

**5.** Team learning: Team members must learn to exchange ideas, which necessitates suspending assumptions and regarding others as colleagues, and stimulating this dialogue often requires a facilitator to help the process.[14]

***(iii) Managing Intellectual Capital.*** The more knowledge-based your organization (think educational institution), the more important it is to recruit, select, retain, and tap into your human resources. Beyond that, shepherding great ideas and processes, learning from successes as well as failures, learning from others in similar organizations, protecting unique ideas from theft or piracy, and maintaining a usable "knowledge database" are all key features to effective management of intellectual capital.[15]

## 13.4 INFORMATION TECHNOLOGY IN TODAY'S NONPROFITS

**(a) ELECTRONIC COMMERCE.** Electronic commerce, or e-commerce, is the electronic exchange of information and/or payment flows. It could be between organizations or involve individuals. Some label this process as "e-business," not e-commerce.[16]

***(i) Doing Business Electronically.*** There are many functions that your organization may carry out electronically. Doing business electronically offers the possibility of doing things faster, with less human involvement, and more accurately. We shall expand on specific processes and functions later in the chapter.

***(ii) Your Organization's Website.*** A key component of your IT is your organization's website. Potential board members, employees, volunteers, clients, and donors and other funders all gather information and build an image of your organization from your website. This is also a perfect spot to post annual reports and annual financial statements. Fundraising potential through your website is high, too; we return to this topic in a later section.

**(b) SPREADSHEETS AND BEYOND FOR DATA AND DECISIONS.**

***(i) Spreadsheets.*** Flexible, easy to use, and yet prone to error – this is the way most users view spreadsheets. Almost all businesses and nonprofits find some use for spreadsheets, including their function as a basic database. Because of the almost universal access of Microsoft Excel, it is easy to share data with other staff as well as with your stakeholders using a spreadsheet.

***(ii) Data Warehouse.*** A data warehouse is "a collection of data gathered and organized so that it can easily be analyzed, extracted, synthesized, and otherwise used for purposes of further understanding the data."[17] This warehouse is created by indexing transactions data and setting up a table of contents, chapters, and then paragraphs. Make it available to others in your organization, with password protection, and place it on your network.[18]

***(iii) Bank/Financial Service Provider Online Services.*** We most often think of bank portals or other websites when we consider online services. These are extremely useful for looking up account balances, seeing if items have cleared, finding out if electronic transactions were executed, and viewing the front and back of images of checks that were presented to see if there might be fraudulent activity. However, larger organizations are now moving to the next generation of services, consistent with the outsourcing issue we covered earlier. For example, consider the possibility of outsourcing your disbursements using a form of EDI. "EDI" refers to electronic data interchange, which involves "the electronic transfer of information or data between trading partners and to communications between the company and its bank."[19] An example of a bank's comprehensive disbursements system and how it links to your organization and your payment file is presented in Exhibit 13.5. You may wish to refer to Chapter 11 for greater detail on automated clearinghouses (ACH), wire, and check payment methods.

The most recent survey of banks' commercial payments capabilities finds:[20]

1. Almost all banks offer paper checks, wires, and debit cards;
2. Sixty-one percent offer web-based cash management solutions and credit cards;

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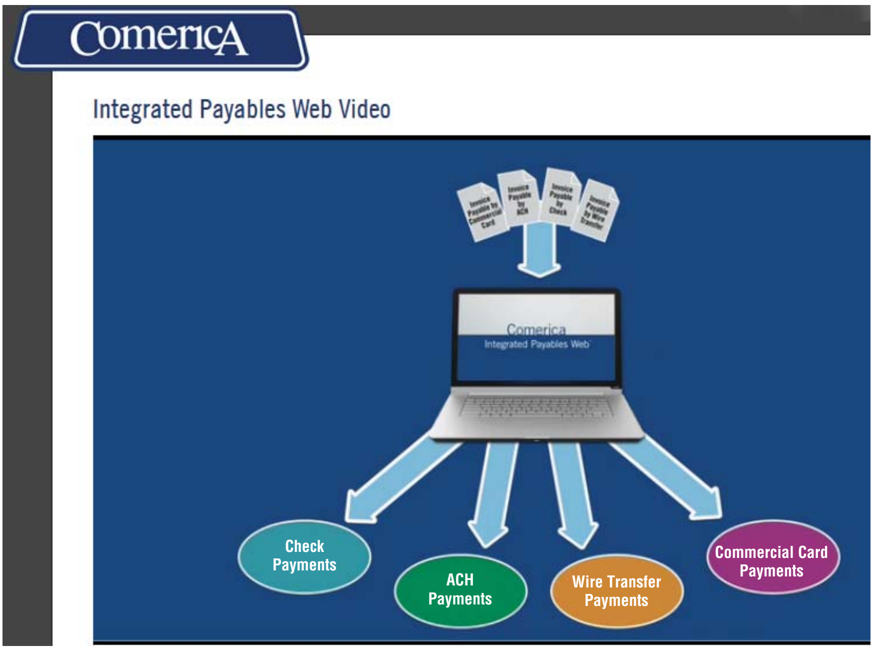
**COMPREHENSIVE OR INTEGRATED DISBURSEMENTS**




1. You send to your bank a computer file, following accepted protocols, including your payment amounts, payees, and associated information.
2. Your bank converts your file into the proper formats for the best payment type, whether ACH, check, or wire transfer.
3. Finally, the recipients of your payments get their payments and whatever details you sent with the payments.

*Source:* Comerica Bank. (https://www.comerica.com/business/treasury-management/payables/integrated-payables.html). Used by permission.

**Exhibit 13.5** Outsourced Disbursements

3. More than 54 percent of respondents indicate that their bank offers same day ACH origination; yet
4. Only a small minority of institutions offer mobile B2B (business-to-business) and B2P (business-to-person) payments capabilities.

***(iv) Application Service Provider.*** Rather than purchase software, why not "rent" software that is hosted on the vendor's website? This is the idea behind application service provider offerings. For example, SunGard offers its AvantGard application service provider (ASP), which is oriented to businesses with between $250 million and $1 billion in sales. Selkirk Financial Technologies, Inc., has a web-based service (Treasury Anywhere) that it sells through banks.[21] We believe that in the near future these platforms will migrate to smaller businesses and to small-to-midsize nonprofits.

***(v) Treasury Workstation or Treasury Management System.*** For midsize and large organizations, there is treasury workstation (TWS) or Treasury Management System (TMS) software. Most large businesses use TWS or TMS software to assist in the treasury function. There are now PC-based systems that may work for midsize or smaller organizations. These enable the user to get detail on changes to cash positions and initiate multibank, multicurrency operations. Add-on modules include an interface to the general ledger, a foreign exchange trading module, and an investment and debt management module.[22] Businesses report that the implementation of a treasury workstation software solution takes between 6 and 11 months, with those having less than $250 million in revenues averaging over 8 months.[23] You should consider the pros and cons of a TWS or TMS software investment. Fully 31 percent of businesses are not convinced that the benefits of such a system are worth the cost.[24] One in three companies indicate they still use Microsoft Excel for their treasury-related tasks. A major concern is the less-than-acceptable TWS or TMS forecasting module, which users deem as "not working properly" or "ineffective."[25] Offsetting advantages of using a TMS include (1) auto-updates to the forecast based on actual data brought into the system each month, (2) integration of bank statement activity, (3) 90%-plus cash visibility on a daily basis coupled with much-simpler and perhaps automated integration of forecast data from ERP systems, financial planning and analysis systems, or internal data warehouses, and (4) inclusion of investment, debt, and currency derivative flows – both principal and interest payments – automatically incorporated in the forecast.[26]

Now for a little help with the jargon. The development of treasury software has generally proceeded from treasury workstations (TWS) to Treasury Management Systems (TMS) to Treasury and Risk Management (TRM) cloud-based platforms. The distinctions are not as clear as we draw here, but generally TWS was software loaded on the desktop PC that tracked cash and investments transactions (and available only to the person(s) using that desktop PC), TMS uses client server technology and focuses more on cash management and helps automate the treasury operation (and is available, potentially, to anyone in the organization), and TRM enables one to manage both cash and risk for the entire organization and can be used by all organization units and be connected to the organization's banks and other third-party systems. The software vendor hosts the TRM software "in the cloud," meaning you no longer absorb the cost and spend time trying to maintain the TWS or TMS software, interfaces, security, and software updates nor the hardware on which these are loaded.[27] Because these terms are not universally used in the way we have presented them, you will still need to clarify with your vendors what the potential software does and how it is made available to your organization. Some in the field use the descriptor TMS to refer to all treasury-related software, including TWS software.

***(vi) Enterprise Resource Planning System.*** Here is a good definition of enterprise resource planning (ERP) systems: "… the systems and software packages used by organizations to manage day-to-day business activities, such as accounting, procurement, project management and manufacturing. ERP systems tie together and define a plethora of business processes and enable the flow of data between them. By collecting an organization's shared transactional data from multiple sources, ERP systems eliminate data duplication and provide data integrity with a "single source of truth."[28] As noted earlier, there is a trend toward hosted ERP systems following the ASP model of software delivery or "pay per user" web-based multiuser offerings known as "Software as a Service" (SaaS), which allows multiple users via one website and usually has been developed as an Internet software application.[29] Cloud-based ERP software, in which the Internet is used to store and access files, is now available and experiencing rapid growth in use. Two large vendors are Oracle and NetSuite. Cloud-based ERP systems are much less expensive compared to the cost when "legacy" ERP systems were first introduced, so cloud-based "SaaS" ERP systems should be considered by some small and all midsize as well as large nonprofits.[30]

**(c) DEDICATED SOFTWARE.** Consider single-purpose software as another option in your IT toolbox. We will briefly discuss five forms of this: dashboards, fundraising, purchasing/e-billing/e-payment, budgeting and planning, and human resource management.

***(i) Dashboards.*** A dashboard is a single interface that gives your management access to "key performance indicators," which are action-oriented measures that help monitor and trigger corrective actions.[31] Your balanced scorecard may have a number of metrics that are monitored via your dashboard, for example. Dashboard design includes these steps, according to Daryl Orts, now executive vice-president of Magnitude Software:

- Refine the user interface and control flow.
- Confirm the data sources for each data element.
- Determine how to "persist" data when historical trending information is desired but unavailable from the transaction database.
- Define the queries needed to retrieve each data element.
- Determine drill paths.[32]

Nonprofits are now finding dashboard functionality in ERP systems as well.[33]

***(ii) Fundraising Software.*** Software from vendors such as Blackbaud (Raiser's Edge)[34] are popular applications in the nonprofit world. What excites most nonprofits, though, is the potential to raise funds via their website. Consider these survey statistics:

- A majority (58 percent) of donor participants reported they use the Internet to search for information, volunteer, donate, and sign petitions for causes or organizations they want to support.
- Three out of four [donor] respondents take some additional action – on-line or off-line – after visiting a charity-oriented website. Some 60 percent stated that had they not visited the charity site, they either definitely would not have taken further action or were unsure that they would have taken additional action. The nonprofits use the Internet to provide information on their missions, goals, issues, achievements, financial data, and to gather support by encouraging website visitors to become members, donate, volunteer, sign a petition, or buy a product.[35]

Your nonprofit will also want to tap the potential for communicating and raising funds through mobile interfaces. More and more donors are giving from their smartphones, including texting amounts to dedicated third-party numbers or clicking through on e-mails they read on their phones. E-mails are now accessed on smartphones or tablet PCs more frequently than on desktop or laptop PCs. E-mails should include a payment button that the reader can tap to donate. Nonprofits send an average of 69 e-mails annually to each e-mail list subscriber, get one donation per 2,000 e-mails sent, and receive an average of $36 in donations per 1,000 e-mails sent, according to M + R Benchmarks.[36] Social media sites (Facebook, Snapchat, Instagram, and others) offer growth potential as your organization can accept payments through this source: in Snapchat, your donors can send digital payments to "Snapchat Friends," and YouTube, Facebook, and Twitter have "donate now" functionality.[37] Your donors may also have and use mobile wallets, by which they store credit card or debit card information in a digital form. They can then initiate donations or payments using their smartphone, tablet, or smartwatch.

***(iii) Purchasing, E-Billing, and E-Payment Software.*** In the business sector, when companies embrace web-based applications, they experience a reduction in total financial transaction costs of as much as 40 percent compared to average firms.[38] Even more impressive, companies that move from paper to electronics in payables areas, including supplier invoicing to vendor payments, experience costs reductions of up to 90 percent, according to Hackett Group research. Comparing top-quartile cost to bottom-quartile cost companies, and factoring in their sizes, this constitutes a $590,000 savings per $1 billion in sales.[39]

***(iv) Budgeting and Planning Software.*** As we discuss in Chapter 8, planning and forecasting software (sometimes called business performance management software) is touted by some as offering a significant analytical advantage. This software is offered by vendors such as Hyperion (now part of Oracle Software), Adaptive Insights, Centage, Prophix, and PowerPlan.[40] Red Cross, Feeding America, and other nonprofits use this software to automate and streamline processes and tasks such as budgeting, forecasting, financial reporting, financial analysis, and project planning.[41] Not only does this increase the efficiency of the budgeting process, but it adds to the flexibility of the process by enabling long-term forecasting while reducing the amount of human error in the budgeting process.[42] Other than financial spreadsheets, budgeting, forecasting/planning, and business intelligence software represent the primary financial (nonaccounting) software tools used by businesses.[43] A Financial Planning and Analysis survey of large businesses and their budgeting processes revealed the following:

- 37 percent of CFOs and finance leaders said that their organizations' budgeting processes needed improvement.
- 25 percent said their companies' budgets quickly become obsolete.
- Only 40 percent described their current financial planning and analysis system as effective.
- 62 percent claimed their staff was too busy in basic duties to make the changes needed to keep their budgets up to date.

Perhaps most important, many companies simply do not rely on technology solutions to make the budgeting and forecasting process more efficient even with the potential to do so.[44]

Of course, the percentages would likely be somewhat different for nonprofits, but we are also aware that coming up with budget estimates is considered to be one of the most difficult tasks in the nonprofit finance function.

***(v) Human Resource Management Software.*** The very first ERP software applications were focused in the area of human resource planning and management. Oracle, SAP, Microsoft, Epicor, and Incor are five of the largest vendors in the marketplace of 100+ vendors. At a minimum, consider having a human resource information system (HRIS) to keep track of your workforce. Most midsized and large organizations now provide all of their benefits information and forms online, often through an employee portal. Self-service not only allows 24/7/365 access but also minimizes human resource staff forms-related request handling.

## 13.5 WHAT SHOULD I KNOW/DO BEFORE INVESTING IN TECHNOLOGY TOOLS?

With the introduction of any new technology, there will be changes and unexpected delays and costs; plan for them. If no other method of allowing for hidden expenditures is possible, an extra line item should be added to the budget for "Unforeseen Expenditures" as a percentage of the total budget.

If a vendor or a contractor promises to deliver a product by a certain date, rewards or penalties for meeting or missing the deadline should be included in the contract.

In addition:

- Budget time for planning the implementation as well as for needed staff training.
- Recognize that not all staff members will agree with the decisions, and some will try to stop or sabotage the implementation, either directly or indirectly.
- Accept that some staff members may not be able to deal with the changes and may leave on their own, or they may need to be removed from the organization or retrained for other positions.
- Seek advice from colleagues and peers from other organizations. Pay careful attention to their experiences, and assume that any problems or obstacles they faced will occur in your organization, no matter how well the implementation plans and strategies are carried out.
- Realize that mistakes will be made along the way.

**(a) PLANNING FOR GROWTH.** The biggest challenge of any new venture is predicting future needs. With technology, this predicting activity can be especially critical. Many technologies are sold in blocks, accommodating a specific number of users, telephones, connections, and the like. While it is never wise to overpurchase, it is also imprudent to replace existing equipment unnecessarily or too quickly.

Predicting future growth does not have to be limited to arbitrary guesswork; however, an accurate prediction of future needs should not be expected. Projections should be conservative, either in terms of growth or investment. The best measurements begin with an analysis of historical growth, plus or minus contributing factors.

Exhibit 13.6 lists the total number of employees for a given organization over a previous 10-year period, with an average of 61 employees. Predicting that the organization will have an average of 61 employees per year would be a misinterpretation of the data. Examining the data more closely shows that a greater pattern of growth occurred during the first five years, with a steady but slower growth in the second five years.

| | No. of Employees |
|---|---|
| 2009 | 15 |
| 2010 | 30 |
| 2011 | 45 |
| 2012 | 47 |
| 2013 | 49 |
| 2014 | 55 |
| 2015 | 89 |
| 2016 | 92 |
| 2017 | 92 |
| 2018 | 97 |
| *Average:* | *61* |

**Exhibit 13.6** Growth Analysis Using Historical Figures

Microsoft Excel includes a handy built-in formula for calculating the compound annual growth rate (CAGR) of a data series. This function, *RATE*, uses this format for our entire 10 years of observations (9 years of growth):

$$= \text{RATE}(9,0,-15,97,0,10)$$

The first item is the number of years of growth, which is nine in our example. The second number is the payment per period, which is 0 in our example. (As an aside, if you also use this function for a loan payment, enter the payment per period.) The third number is the starting value, or "present value" in the series, which is $15 in our case. (You must put a negative sign in front of it.) The fourth number, 97, is the ending value, or future value. The following 0 indicates that the employee numbers are at the end of the respective periods. The 10 is a starting guess for the percent growth rate – if you don't have any idea, 10 is a good number to use.

Excel gives us a result of 23.05 percent for the entire period. However, just as your visual examination of the data suggested, when we use only the first five years or only the last five years (each of which spans four years of growth) in the growth calculation, we get very different growth rates:

| | |
|---|---|
| 2009–2013 | **34.44%** |
| 2014–2018 | **15.24%** |

Clearly, a new trend better characterizes later years, and to the extent "nothing significant has changed" for the future, we would want to extend the data at a 15.24 percent rate of growth, not a 23.05 percent rate of growth. Watch for pattern or trend changes in your organization's revenues and costs, and capture these when doing your projections.

**(b) OUTSOURCING?** Outsourcing of IT comes in various forms. You may outsource your entire IT department, outsource software by using hosted software on a vendor's computer system or through the cloud, or merely outsource certain functions such as payroll processing (many organizations do the latter through ADP or Paychex). It is always a consideration in any IT-related decision that you make.[45] Three "IT Service Models" are available for your consideration: in-house IT staff, hourly services, and managed services. The in-house approach is attractive due to fast response time and familiarity with your organization's workflow and process, but potentially suffers from expense, lack of training and/or oversight, and the minimal amount of redundancy. The hourly service model means you pay only for the time you need, but again might bring a limited skill set, is reactive (a system or service is broken, so call them in), and it is challenging to know how much to allocate in the budget. Managed services contracts are for a flat fee and easy to plan/budget, typically bring a strong skill set, and might proactively bring insightful (and even pro bono) consulting about new/better ways to do things. Downsides for managed services include that they might be more expensive than hourly services and the service personnel are not onsite 40 hours per week like in-house staff would be.[46]

## 13.6 SOFTWARE: DESIGN INTERNALLY OR PURCHASE?

Many software companies are now working with clients to allow them to use the software under a service contract or lease/finance software. Software as a service (SaaS) is defined as " … a software distribution model in which a third-party provider hosts applications and makes them available to customers over the Internet. SaaS is one of three main categories of cloud computing, alongside infrastructure as a service (IaaS) and platform as a service (PaaS)."[47] Paying fees for SaaS or leasing software may cost more than buying but these options are often worth it in the longer term. A typical approach in many organizations who need to purchase computer technology (hardware and software) is to engage in a lengthy process of identifying needs, shopping vendors, and so forth. After identifying the needs, they prepare a request for proposal including all the specifications they want and need.

A shortcut many take is to network with other similar organizations and approach a vendor to design a system that works for everyone. The vendor maintains the right to sell the product to similar organizations. The end result is that the development costs are spread among a greater number of users.

Most nonprofits choose to purchase existing software and tweak it to meet unique needs rather than design their own software. In most cases, at least three major vendors, in any given application area, provide software for a specific task or process. It is easier, cheaper, and safer to purchase (or use for a period based on a service contract) one of these products than to design a new one. In addition, these vendors will also provide (generally free of charge) hardware specifications for the application.

Changing technology requires the technology manager to constantly review what the organization's systems do and do not do, and to modify needs based on current procedures and task flows.

## 13.7 DISCLOSURE, THE LAW, AND SECURITY

There are many laws regarding the disclosure of information. A public institution's financial records may be public record; however, in many instances a portion of the data does not need to be disclosed, and in some cases, disclosure of certain pieces of information is illegal. It is imperative that a thorough investigation of the laws and policies pertaining to the types of data maintained be reviewed (see Chapter 15 for additional resources on maintaining data).

**(a) A COMPANY DATA POLICY.** Establishing a policy regarding the use of company data will also provide a mechanism for training staff about the security requirements of the data.

You as volunteers and staff are involved extensively in fund-raising, governmental relations, and public communications programs. You are acting as agents of <Organization Name> and have been chosen for your abilities to be representatives of <Organization Name> .

In this capacity, you are often provided with personal information on individuals (e.g., name, address, telephone number, employer). This information is maintained on the <System Name> database and its auxiliary systems. We consider the information on these databases protected information that should be handled with appropriate care. Use of this information should be guided by the following policies:

Under existing legal standards, <Organization Name> is able to retain personal information on individuals upon informing them of their rights, that our use of the information will be limited to the furtherance of the <Organization>'s business, and that the information will not be disseminated to others except as required by law. It is proper for <Organization Name> to share with our volunteers and staff a certain degree of personal information on individuals to enable them to carry out their respective assignments. However, we have an obligation to the volunteers, staff, and individuals on whom we retain information to inform them that this is: (1) personal and confidential information that we are allowed to retain under the existing legal framework; (2) only to be used to carry out the <Organization>'s work; and (3) not for dissemination to third parties.

It is our policy not to release address, email and telephone information for any records to a third party either over the phone, email or in person. When asked to verify an individual's involvement with <Organization Name>, you can transfer the request to the <individual/department>.

Information in the form of lists, labels, computer databases, CDs or DVDs, USB flash media, downloads, and reports is available only to authorized <Organization> representatives in support of approved activities and authorized <Organization> business. It is the responsibility of the unit requesting information to maintain the confidentiality of that information.

**Exhibit 13.7** Guidelines for Using Personal Information on Individuals

Exhibit 13.7 provides a sample policy that pertains to maintaining sensitive and/or confidential information. Exhibit 13.8 provides a sample communication policy checklist, which guides you in setting policy governing the increasingly sensitive area of electronic communications, especially e-mail. While written for associations, it generalizes nicely to all nonprofits. We emphasize that this sample policy and the wording therein is not to be construed as legal advice, and you are advised to consult with legal counsel for policy wording based on current state and federal regulations and legislation. Exhibit 13.9 provides a checklist of items to include in your "Acceptable Use" policy regarding use of your organization's computers, e-mail, and Internet access. Because Internet issues are so prevalent and potentially devastating, we also provide in Exhibit 13.10 a checklist of items to include in your employee "Internet Policy."

**(b) SECURITY ISSUES AND TRENDS.** It is hard to overemphasize the importance of security for your IT area. Not only is the number of security breaches growing rapidly, but also the loss of productivity and time involved in correcting problems is a serious issue. Spyware, instant messenger, and peer-to-peer (P2P) threats, as much as 60–80 percent of incoming e-mail being spam or having viruses attached, and "phishing" attacks (e.g., phony bank inquiries that attempt to get employees to divulge sensitive personal or organizational information) are some of the trends organizations grapple with.[48] Losses per company of security breaches are estimated by the companies at about $204,000. A large-scale survey finds that the top three causes of loss are (1) viruses, (2) unauthorized access, and

**WHAT TO INCLUDE**

**Appropriate Use**

- ❒ Explain the extent of personal use allowed (if any).
- ❒ If your association has a unionized workforce, make sure that any personal use restrictions do not infringe upon protected, concerted, activities.
- ❒ Identify types of messages, browsing, and other content that are prohibited.

**Monitoring**

- ❒ State whether, and on what terms, monitoring will occur (periodic, random, content-flagged, or reasonable suspicion, and so on).
- ❒ State that information on the system is not private and passwords and codes do not guarantee privacy.

**Confidentiality**

- ❒ Prohibit electronic transmission of confidential information and trade secrets or define the terms under which such transmission can occur.

**Control and Ownership**

- ❒ State that the association is the sole owner of all systems and all materials created, received, transmitted, and stored on those systems.
- ❒ Advise that the association has copies of all passwords and codes and has access to information on its systems at all times.

**Association Representation**

- ❒ State that electronic communications are tantamount to written documents and require observation of appropriate business etiquette.
- ❒ Remind the sender that an electronic transmission can be forwarded, printed, and otherwise distributed with the sender's (and the association's) name intact, but without their knowledge.

**Discipline**

- ❒ Warn that violations will result in disciplinary action, up to and including termination.

**WHAT EMPLOYERS SHOULD DO**

**Take Appropriate Precautions**

- ❒ Provide advance notice of the policy's implementation (at least two full weeks prior to the policy's effective date).
- ❒ Obtain a signed acknowledgment from every system user, an express consent to monitoring.
- ❒ Investigate and install any necessary blocking, screening, or monitoring software.

**Publicize and Distribute**

- ❒ Publicize and distribute the policy at its enactment and periodically there after (at least annually).
- ❒ Consider adding to the log-in of each user a banner providing notice of possible monitoring.

**Be Wary**

- ❒ Review and update the policy frequently, especially as laws change.
- ❒ Train management on how to properly administer the policy, and assure monitoring is occurring in accordance with the terms of the policy.

*Source:* Victoria L. Donati and Jennifer A. Hardgrove, "The Importance of Being E-Conscious," *Association Management* (June 2002): 59–63. Used by permission.

**EXHIBIT 13.8** SAMPLE COMMUNICATIONS POLICY CHECKLIST

(3) theft of proprietary data. To try to combat these attempts, businesses spend an average of about 6 percent (with a range of 1 to 13 percent) of their IT budgets for IT security and risk management, according to the Gartner Inc. IT Key Metrics Data study.[49] "Best practice organizations" spend between 4 and 7 percent of the IT budget on IT security and risk management, but more important than the allocation is the organization's focus on spending for "IT operations and security that reduce the overall complexity of the IT infrastructure and work toward reducing the number of security vulnerabilities." One of the biggest issues, in our judgment, is the ultimate effect of the privacy and data security concerns of individual donors on their online giving.

**COMPUTER, E-MAIL, AND INTERNET ACCEPTABLE USE POLICIES**

From a legal perspective, to be effective an acceptable use policy should be crafted so that it does the following:

**Consistency**

Promotes use that is consistent with company policies and prohibits use that is in violation of those policies, industry regulations, or other laws with which the company must remain in compliance. It should be clear that computers and other devices are made available for business activities and operations of the company. The use of these devices is permitted for business-related purposes only, and employees are expected to use the devices in a professional manner that does not violate company policies or the law. Where appropriate, specific industry regulations or laws and the conduct they prohibit or restrict should be cited.

**Reduce Liability**

Reduces the occurrence and potential liability of claims by employees such as harassment, discrimination, or defamation. Clear boundaries should be set for employee conduct, specifically with regard to the use of e-mail communications and the Internet. In addition, the policy should encourage, if not require, employees to report any conduct that they believe is in violation of this policy. It should also cross-reference the company's antidiscrimination and antiharassment policies.

**Reduce Privacy Expectations**

Reduces an employee's expectation of privacy regarding the information contained on their computer, e-mails they have sent and received, and their history of online activity. It should be made clear to employees that they should have no expectation of privacy with regard to their use of company computers or other devices. The computer systems and devices are the property of the company and are subject to monitoring at any time, with or without notice, irrespective of whether the information, e-mails, or online activity involves personal information or subject matter.

**Protect Company's Confidential Data**

Serves to protect the company's confidential and proprietary business data. An acceptable use policy should be consistent with and reference the company's policies regarding the use and disclosure of the company's own confidential and proprietary business information or that of its customers. It is important in this day and age that businesses have in place a business information and confidentiality policy.

**Protect Individual's Confidential Data**

Serves to protect the confidential personal information of employees. An acceptable use policy should also be consistent with and reference the company's policies regarding the access and disclosure of the personal and confidential information of its employees. It is also important to have in place this type of policy as well.

**Extends to Personal Devices**

Extends to an employee's use of their personal devices when there is the potential for the use to impact the company or its workplace. Policies should be crafted so that they apply when an employee uses a personal device for company-related business, or even for personal business if it is connected to the company's wired or wireless network.

*Source:* Eric Gunderson, "The Importance of Acceptable Use Policies," July 19, 2017. http://www.howardtechadvisors.com/better-together-newsletter/acceptable-use-policies/. Used by permission.

*Eric W. Gunderson is an attorney and partner at Farrell & Gunderson, LLC. This information is not to be construed as legal advice, and readers are urged to consult with legal counsel before finalizing this type of policy.*

**Exhibit 13.9** Checklist for Acceptable Use Policy for Computer, Internet, and E-Mail Use

**CREATING INTERNET POLICIES FOR EMPLOYEES**

Here are some items to consider in your Internet policy to keep you, your employees, and your customers' data safe.

**Accessing Personal E-Mail**

It is a best practice to restrict access to employees' personal e-mail, including accessing Gmail, Yahoo!, Hotmail, and others through webmail services. This avoids the possibility of an employee accessing personal e-mail during business hours that could contain malicious links, or other insecure items that could breach the company's network security. Most organizations who are taking their security seriously have e-mail software that will scan incoming e-mails and/or files for viruses. If you have antivirus software, it is recommended to download your e-mail attachments to your desktop before opening. Your AV software will scan the file to make sure it isn't infected. This also eliminates the ability for company files to be sent from employee's personal e-mail addresses. It also enforces employees to use company-sanctioned e-mail platforms and company branding.

**Internet Content Filtering**

Along with filtering personal e-mail sites, you should also put restrictions on content. Security appliances such as SonicWALL firewalls offer this level of protection to their users. You can filter by categories, geographic IP addresses. These policies can be enforced for specific times of the day or for only certain groups of users. For example, your Marketing department may need access to social media sites to share company news, but other employees shouldn't be spending time on their own social media networks during company time. Other categories you should consider restricting are:

- Violence
- Weapons
- Mature Content
- Gambling
- Alcohol/Tobacco
- Hacking/Proxy Avoidance Systems
- Malware
- Radicalization and Extremism

**Downloading Software or Applications**

Despite best efforts by IT or management to have the necessary line of business software preloaded on a user's machine, it is not uncommon for additional software to be needed. All employees should be restricted from downloading software and applications to their computers themselves. Unfortunately, there are cyber criminals out there that are waiting for people to download software that may replicate the real thing, such as Adobe Acrobat, but is really a virus. Also, users may not be as mindful if they are downloading a legal version of software and may download an unlicensed or pirated version. Pirated software is illegal and could result in a high fine of $150,000 or more, and even imprisonment of up to five years. Any software or application that needs to be downloaded should require Administrator credentials and IT or manager approval. It is also important to ensure the software is compatible with the machine and will not cause any problems on the corporate network.

**Exhibit 13.10** Checklist for Employee Internet Use Policy

**Company-Owned Equipment**

Although it may be common sense to some, it may not be to everyone. Make sure your policy states that any company-owned equipment, including desktops, laptops, tablets, and cell phones, should be used for company business only. Employees should avoid storing passwords, saving personal files/photos/music, and especially should not be accessing their personal accounts (e-mail, too) from these devices. They are expensive and are ultimately the employees' responsibility if lost, stolen, or damaged. This could also lead to cyber criminals gaining access to company data. Cloud-based accounts can sync to other machines when logged in. If a user logs into a company machine using their own personal Microsoft Live account, they could accidentally sync all of their personal files to that machine without even realizing it.

**Social Media**

It may not be possible for all companies or all employees to be banned from social media sites. The marketing team needs to share content, sales needs to engage with prospects, and Technical teams may need access to IT networks for collaboration. There are ways to word your policy to include social media, such as: "We strongly encourage you to limit your social media to work-related content and outreach only during work hours." Other important points to convey to your employees is their messaging in light of the company brand and reputation.

*Source:* Authored by Michelle Pelszynski. Published in Jason Maeser, "Creating Internet Policies for Employees," July 11, 2017. http://www.howardtechadvisors.com/better-together-newsletter/acceptable-use-policies/. Used by permission.

**Exhibit 13.10** Checklist for Employee Internet Use Policy (*continued*)

One issue requires special attention for healthcare organizations: Electronic records management. Sarbanes-Oxley legislation and the Health Insurance Portability and Accountability Act (HIPAA) both stipulate fines and/or prison sentences for the mishandling of certain kinds of records.[50] HIPAA also requires that healthcare organizations maintain customer information for six years. E-security and retention are consequently vitally important for healthcare organizations.

## 13.8 NEEDS ASSESSMENT AND ANALYSIS

Before deciding on the type of technology, needs and requirements must be determined. The tool the experts use for seeking out this information is a *needs assessment.* There are as many ways to conduct a needs assessment as there are technologies from which to choose. After completion of the assessment, an analysis of the information is performed to evaluate the results. The steps involved in conducting a needs assessment are shown in Exhibit 13.11.

**(a) ASSESS.** In the first portion of the process, after determining what information is needed and choosing a method for gathering the information, the assessment is conducted.

Assess ⇒ Analyze ⇒ Critique ⇒ Decide

**Exhibit 13.11** Needs Assessment Flowchart

The broader the sampling (meaning, the greater the number of people contacted for the assessment), the more accurate the results. Methods of assessment include the following four data collection techniques:

1. *One-on-one interview*. The most effective method of gathering information is using an interview technique. The most important steps with this technique are to develop a pre-established list of questions and to conduct the interview without judgment. The art of interviewing for a needs assessment is not dissimilar to playing poker: wearing a poker face, never letting on what information the interviewer hopes to prove or disprove.

3. *Telephone interview*. This method can be very successful, especially if the questions asked are of a personal nature. The lack of face-to-face contact with individuals may make it easier to ask personal questions. However, it also precludes the interviewer from reading facial clues or gestures that are very valuable in changing the interview's tone to probe further on a particular question.
4. *Meeting*. A meeting can be a very effective forum for gathering information for an assessment, although it can be extremely challenging and taxing for the facilitator. Often a round-table discussion will develop as attendees hear how other people answer the questions. This method is also useful in that it immediately identifies where there is consensus and where there will be conflict.
5. *Questionnaire*. The least effective of the four methods, this is the most commonly used because it efficiently allows a broader audience to be contacted. The ability to survey a larger group can often outweigh the benefits of the time-consuming task of one-on-one interviews.

**(b) ANALYZE.** In this portion of the process, the information collected is evaluated, tabulated, and summarized. You may use a weighting table to give greater emphasis to certain questions in the needs assessment, and you may use return-on-investment analysis to evaluate some investment proposals.

***(i) Weighting Table Analysis.*** Weighting the questions for relevance and applicability to a specific respondent can be very important. For example, if an assessment was conducted with order takers, the response of a person who takes many orders each day or whose only responsibility is to take orders, as opposed to someone who took fewer orders, would have greater relevance. This person's opinions would be more valuable than another's.

When using the weighting table (Exhibit 13.12), answers given by someone who took 1 to 10 orders per day would count one time, whereas the answers of someone who took 51 to 60 orders per day would be counted six times (as if six people had taken the survey).

| No. of Orders Taken per Day | Weight Factor |
|---|---|
| 1–10 | 1 |
| 11–20 | 2 |
| 21–30 | 3 |
| 31–40 | 4 |
| 41–50 | 5 |
| 51–60 | 6 |

**EXHIBIT 13.12** WEIGHTING TABLE TO DETERMINE RELEVANCY OF ANSWERS

Another set of criteria is to weight the answers based on the relevancy of the question itself. Some questions may be much more critical than others. A similar weighting method should be used for each question.

Finally, there may be questions that need to be evaluated against another question, or a combination of questions. For example, if one was asked, "How proficient are you with Microsoft Windows: Excellent, Good, Fair, or Novice?" the question should be balanced with a series of questions specific to Microsoft Windows (e.g., asking specific questions of skills or tasks the person could perform in the program, such as saving a file, opening a file, cutting and pasting). If an individual stated that he or she had excellent skills with Microsoft Windows but answered "no" to the question "Can you open a file in Microsoft Windows?" one could logically assume that the person inaccurately answered the question about proficiency.

***(ii) Return on Investment or Benefit-Cost Analysis.*** To illustrate return on investment (ROI) analysis, or benefit-cost analysis, consider an investment in a treasury management system. There are six treasury information management "value drivers":[51]

1. Information availability
2. Information accuracy
3. Information timeliness
4. Information system cost
5. Automation of information generation, transmission, analysis, and decision making
6. "Electronification" of information and payment systems

If someone in the organization proposes an investment in IT, automation, or moving to electronic data or payment transmission, evaluate this proposal using one or more of the value drivers. Then compare the value added by one or more of these items to the overall costs of the proposal to see if it should be implemented.

More formally, you can calculate ROI, net present value (NPV), or internal rate of return (IRR) on IT projects (see Chapter 9 for more on these calculations). A survey found that evaluating computer security software and services is done with ROI (38 percent of respondents), NPV (18 percent), or IRR (19 percent). However, many respondents also note that IT security is a "must-do" item that is implemented regardless of immediate financial impact.[52]

**(c) CRITIQUE.** After analyzing the information, it should be determined whether there are results that may be in conflict. In this step, an evaluation of the results is made to verify whether they are as expected or completely off the scale as compared to the original assumptions. Do not assume that the original assumptions were incorrect; but also, do not assume that the results of the survey are correct. Following up with a few respondents may determine that they misunderstood the question or had other reasons (sometimes personal or political) for answering in the manner they did. As a general rule, obscure or irregular results may be disregarded. At a minimum, obscure survey answers should be investigated vigorously. It is possible that the person being surveyed misunderstood the question, but that should never be assumed. It is more likely that there is something unique about the individual's work or assignments that caused the obscure answer. It is just these types of issues that the needs assessment attempts to flesh out. If possible, contact the individuals who provided the answers for a follow-up assessment to gather more information to clarify the issue.

**(d) DECIDE.** The last step is to make a decision by reviewing the information collected, so an educated nonbiased decision can be made.

**(e) IMPLEMENT: GETTING PEOPLE TO USE THE NEW TOOL.** It does not matter how wisely the information was evaluated, how successfully the purchase contract was negotiated, or how accurately the needs of the organization were determined, if the staff cannot be trained and motivated to use the tool. If it is not used, the implementation and the tool is a failure. Before making the final decision to purchase or implement, the purpose of the new tool and the willingness or ability of the staff to be trained on it and use it need to be reevaluated. One common complaint of nonprofits regarding technology is that they lack the funds for proper training for staff.

There can be hundreds of reasons why staff in an organization will refuse to use a new tool. Each person may have his or her own specific reasons; however, in general, the reasons a new tool is not used fall into one of the categories described in Exhibit 13.13.

| Reason | Description | Solution |
|---|---|---|
| "I don't know how to use it." | The biggest reason why people will not use a new tool is the most obvious one: They just don't know how to use it. | Provide training in the new tool or system. |
| "I went to the training, but I still don't know how to use it." | After training is conducted, it is likely that staff will not immediately begin using the system, unless a schedule or an assimilation plan for each individual or group has been created. So often in organizations, staff learn to ignore change as a way of making it go away. | Develop an implementation strategy that includes post-training follow-up. Monitor the progress of each individual or group, setting goals or milestones that need to be achieved by a specific time. Establish rewards (or punishments, if necessary) to encourage meeting these targets. |
| "Training was bad." | A common complaint about any new system or tool not being used is that the training was ineffective. While it may be considered as a viable reason, it is more likely that there are other causes or reasons besides the training the individual received. | Evaluate the effectiveness of the training as part of the training process. Avoid the use of "smile sheets" (measurement tools that evaluate only how some liked or felt about the training) as opposed to good measurements that evaluate what they knew before they attended training and what they knew immediately after training.<br>Another important factor in the training program is the relevance to the person's job. If the training examples used are too vague or general, the individual will not be able to assimilate the information. The closer the examples are to the real-life situations or tasks the individual will perform, the more likely the individual will be able to remember (assimilate) the information. |

EXHIBIT 13.13 REASONS/SOLUTIONS FOR REFUSAL TO USE A NEW IT TOOL

| Reason | Description | Solution |
|---|---|---|
| "I forgot what I learned." | Individuals may report that they found the training useful, but it was so long ago that they forgot what they learned. | It is possible that the training was ineffective and the step above should be employed in this example as well. More likely the reason will be that the training occurred too early, before the tool was available. Training should occur no earlier than one month before the tool is available. It is best if the tool is in place before the training is received. |
| "This isn't as good as the old way." | Looking at information or performing a task in a new way may cause some individuals to judge the process as ineffective. This comment should be interpreted not as a judgment but as a request for clarity about why things needed to change. | Make sure that staff have the prerequisite knowledge to successfully use the new tool or complete the training course. If a new computer system is being introduced, and staff have never used a computer before, basic computer training must be provided before beginning training on a specific application or system.<br>This prerequisite training does not need to be time consuming or detailed, but provide a basic level of understanding from which the individual can build his or her knowledge of the new tool. |

**Exhibit 13.13** Reasons/Solutions for Refusal to Use a New IT Tool (*continued*)

## 13.9 POLICIES AND PRACTICES IN KNOWLEDGE MANAGEMENT AND INFORMATION TECHNOLOGY

Howard Tech Advisors (HTA) works with numerous businesses and nonprofits regarding their use of technology. Ananta Hejeebu of HTA notes the following three categories of "top IT mistakes" made by nonprofits:[53]

1. Information Security
2. Disaster Recovery & Backups
3. IT Strategy

Regarding information security, recognize that your organization has confidential data regarding employees, clients, donors, board members, and volunteers. You also have files and photos, intellectual property, bank account data, credit card numbers, passwords, and confidential e-mails that criminals would like to access. Deception comes through fake and/or phishing e-mails, phone calls, access to your laptop when using public wi-fi, or any or your organization's or another party's websites. Security breaches then occur through wire transfers, ransomware (such as Wannacry; ransomware locks down files on your computer and demands that you pay a ransom in Bitcoin before permitting you to regain access to those files), keystroke logging, or data theft with the purpose of selling the data. Consider what data you have, where each type of data is stored, who has access to what data and how might they access that data, and how you can protect your data and reduce your risk.[54] Try to draw the appropriate balance between security and convenience of data access. Since people are your biggest risk (and the biggest growth in data loss or theft is from compromises in insider accounts – commonly due to how many of an organization's employees who have unnecessary access to sensitive or confidential data),[55] it is essential to limit information so that only those who need to know have access to confidential data and there is a "group policy" configuration to enforce that limit. Password change and secrecy policies are also important, as are an employee termination IT process, limit to company data on personal devices, employee training (security, e-mail best practices, performance reviews, paper document shredding), as well as consideration of cyber insurance coverage.[56]

Regarding disaster recovery and backups, consider first the incidents of harm: (1) system failure (hardware, servers, cabling, switches, firewall, phone system or handsets); (2) software or data compromise (applications, ransomware, e-mail, and cloud services); (3) theft or catastrophe (people threats, whether internal or external, loss or theft of computer or mobile device, fire, flood); and (4) loss of connectivity or power (Internet services, cloud services, phone services, office/building electricity). Determine which one(s) of these four incident classes are most important regarding cost and risk, then create a plan to deal with it (them). Data protection can come through eliminating local storage (use server or cloud), laptop hard drive encryption, phone wipe policy for lost/stolen devices, determination and assessment of the disaster recovery plans for your cloud vendors, and gaining a greater understanding of the key backup issues.[57] Know what is being backed up, where it is saved (local? cloud? both?), whether the process is automatic or manual, whether files, images, or both are being backed up, how far back can you restore from a backup, the last time data was restored or tested, and the expectations for restoring a backup.[58]

Finally, your IT strategy should begin with a recognition that your technology systems are "mission-critical," and poor performance may have severe repercussions. View technology as an enabler, not simply a commodity. Strategic thinking entails answers to the following questions:[59]

1. Who in your organization is responsible for technology and is s/he the right person?
2. Does your strategic plan include a section addressing IT? (Survey data indicates that just over one-half of nonprofits always or usually do so.)[60]
3. Might technology be used in new/better ways to increase effectiveness, efficiency (automate tasks), or increase contributions and foundation grants?
4. Is your organization appropriately leveraging IT tools?
5. Might your organization gain more value from its vendors and partners?

Illustrating, in response to #3 you might decide to determine if a cloud offering might be a good fit for your organization. Regarding #5, you might schedule "Tech Business Reviews" every three years with your vendors/partners to review software, your IT plan and goals, your IT budget, and any new capabilities that may have become available.

Regarding budgets and benchmarking, NTEN conducts an annual survey that informs us on nonprofit IT budget amounts for organizations of various sizes. In Exhibit 13.14 we see the results of the most recent NTEN survey. You can compare your organization's IT spending with the spending of similarly sized nonprofits. We caution that "average" does not imply "best practice."

With regard to treasury use of technology, the landscape of available solutions is changing rapidly. As well, there is considerable turnover in nonprofit finance staff. Consequently, expert Dan Carmody offers three key items to implement on an ongoing basis:[61]

1. Create and regularly test a comprehensive treasury disaster recovery plan.
2. Benchmark current treasury technology against other marketplace options.
3. Review treasury technology user permissions (treasury workstations, bank websites, etc.).

| Organization Size | Hardware | Software | Hosting | Networking | Consulting | Outsourced Services | Backups | Other Tech |
|---|---|---|---|---|---|---|---|---|
| Small | $4,109 | $2,503 | $1,234 | $3,109 | $1,971 | $2,975 | $260 | $1,295 |
| Medium | $10,526 | $18,833 | $6,871 | $10,379 | $12,984 | $8,343 | $2,714 | $46,007 |
| Large | $23,742 | $42,972 | $5,593 | $16,593 | $51,906 | $43,654 | $3,945 | $34,650 |
| Very large | $84,079 | $132,450 | $16,508 | $106,307 | $90,517 | $58,495 | $11,454 | $104,652 |
| All | $31,412 | $50,030 | $8,227 | $36,606 | $44,190 | $27,721 | $4,994 | $52,721 |

| Organization Size | Average of Total Tech Salaries |
|---|---|
| Small | $17,246 |
| Medium | $17,246 |
| Large | $71,969 |
| Very large | $330,862 |
| All | $127,313 |

Technology budgets are made up of many parts. These tables help us look at the way organizations distribute their technology spending by category. With only a couple of exceptions (for two Medium organization categories), the larger the organization, the bigger the expenditure.

This also holds true for salaries, which we've separated from all our other budget tables.

While we try to avoid year-over-year comparisons, one change stands out this year. For the first time, three out of four size groups spent more on software than hardware, making that category the overall champ for the first time.

*Source:* Robert Hulshof-Schmidt, "NTEN: The Tenth Annual Nonprofit Technology Network Nonprofit Technology Staffing and Investments Report," May 2017. Used by permission.

**Exhibit 13.14** Organizational Spending on IT by Size of Organization

Your nonprofit may gain much from surveying the IT trends faced by businesses along with how they empower and challenge the business CFO and others on the finance team. Exhibit 13.15 profiles these trends. We believe that large nonprofits already face these same issues, and smaller nonprofits will deal with them in the foreseeable future.

1. **The unbounded IT organization:** For decades, IT has focused on maintenance and support of systems often walled off from other parts of the enterprise. But technologies such as software-as-a-service (SaaS) are increasingly procured and operated without IT intervention, and IT must become faster and more responsive to the business. To meet these new demands, CIOs are transforming IT operations and empowering their employees to go beyond traditional roles and activities and focus more on differentiating innovation.

   **How CFOs will benefit:** As IT builds an integrated view of project objectives and technology implications, CFOs can engage in technology conversations rooted in a balance of risk and return. Instead of maintaining extreme positions to protect the finance function from possible risk, the CFO and CIO can work together to determine probable and acceptable levels of risk and better understand exposures, trade-offs, and impacts.
2. **Dark data analytics:** Advances in computer vision, pattern recognition, and cognitive analytics are shining a light on billions of unexplored structured and unstructured data sources – known as dark data. Deriving insights from this hidden trove of information not only leads to a better employee and customer experiences, but also more accurate, faster, and actionable decision making across the entire business.

   **How CFOs will benefit:** The use of dark data in strategic decision making is an exciting opportunity; however, most organizations are too digitally immature to realistically consider it. Since the finance area manages and uses most of an enterprise's data, the CFO can sign up the team as an early adopter of supporting technology. The function can apply predictive analytics to get a better view of what the information is foretelling, with an in-memory-based digital core to accelerate processing and

**Exhibit 13.15** Technology Trends and Their Impact on Corporate Finance cleansing applications to help ensure data accuracy. More important, it can model, advocate, and guide all other departments to do the same.

3. **Machine intelligence:** Although the business case for artificial intelligence is gaining steam, the bigger story that is getting ready to bloom is machine intelligence. This collection of advances represents an entirely new cognitive era that has evolved rapidly in recent years. As spending on this technology reaches nearly US$31.3 billion by 2019, uses cases will be introduced and refined as companies tap into the power of machines.

   **How CFOs will benefit:** Sophisticated algorithms and analysis techniques enable finance to solve complex scenarios, automate redundant and low-skill tasks, and focus more on delivering strategic and meaningful outcomes. The ability to acquire real-time insights, put them into action, and automate tasks and responses represents new business value for finance.

4. **Mixed reality:** This controlled convergence of augmented reality (AR), virtual reality (VR), and the Internet of Things creates new environments that allow digital and physical objects – and their data – to coexist and interact with one another. By shifting engagement patterns, more natural and behavioral interfaces are supported. These interfaces empower users to immerse themselves in virtual-world sandboxes, while consuming and leveraging digital intelligence generated by sensors and connected assets.

   **How CFOs will benefit:** This technology connects devices to a data platform that centralizes all data throughout the enterprise and documents each step of the process. Plus, adoption of advanced analytics can help predict demand patterns quickly and optimize production.

5. **Open architecture, cloud-first design:** The arrival of open source, open standards, virtualization, and containerization is prompting many organizations to overhaul IT landscapes. This cloud-first model of loosely coupled best practices and platforms helps automate systems to enable self-learning and self-healing.

   **How CFOs will benefit:** On-premise, private cloud, or public cloud capabilities can be deployed dynamically to optimize pricing strategies, operational performance, and supplier engagement. All combined, these elements can help the business move broadly from handling instances to managing finance-driven outcomes.

6. "**Everything as a service" (Xaas):** Transforming existing business products, processes, and legacy systems into a collection of services that can be used both inside and outside the organization can help streamline IT operations and, potentially, generate new revenue streams. XaaS provides an opportunity for enterprises to push beyond traditional boundaries to serve customers, engage business partners, and surpass competitors in new ways.

   Take Amazon, for example. The online giant is extending its internal services for e-commerce operations to customers outside the Amazon organization. This approach encourages customers to remain loyal to the retailer and motivates the company to continue its track record in unparalleled service.

   **How CFOs will benefit:** Evaluating business models, processes, and strategies through an XaaS lens helps spotlight new opportunities to increase revenue and efficiency. By learning new core modernization techniques, CFOs can extract more value from legacy assets while laying the groundwork for a service-oriented future.

7. **Blockchain and the trust economy:** Shedding its reputation as Bitcoin's enabler, blockchain is making it possible to share information selectively with others and exchange assets and contracts safely and efficiently. By baking into each individual's or organization's interactions a reputation of trust, blockchain innovators can move from securing and handling digital rights to transferring them smoothly and immediately without the need for human intervention and full traceability.

**Exhibit 13.15** Technology Trends and Their Impact on Corporate Finance (*continued*)

**How CFOs will benefit:** Blockchain provides CFOs with a distinct path to tapping into the full potential of their digital investments. This capability touches every finance process from real estate management, stock market performance validations, entitlements, and recycle registries to smart contract protocols that digitally facilitate negotiations, verify the agreement, and enforce compliance with terms.

8. **Quantum computing:** Although a business case for quantum computing technologies has yet to be fully defined, there is an active race underway to create a commercially viable solution for harnessing quantum technology. As seen before with a variety of emerging technologies, early adoption could bring competitive opportunities that would surprise even large or fast-growing rivals.

   **How CFOs will benefit:** Supporting algorithms and data modeling, quantum computing could make predictive risk analysis a more valuable component of risk management. As data volume continues to grow exponentially and cyber-risk management becomes more complex, this theoretical computation system could eventually represent a game-changing leap in capacity, detail, and insight.

*Source:* Estelle Lagorce, "CFO Primer: 8 Emerging IT Trends That Will Redefine Finance." *D!gitalist Magazine* by SAP (May 3, 2017). http://www.digitalistmag.com/finance/2017/05/03/2017-cfo-primer-8-emerging-it-trends-redefine-finance-05062986. Accessed: 7/27/17. Used by permission.

**Exhibit 13.15** Technology Trends and Their Impact on Corporate Finance (*continued*)

The 2016 Abila Nonprofit Finance and Accounting Study also unearthed valuable information related to your job and your use of technology. Two of the recommendations that Abila gleaned for us from the survey of nonprofit finance professionals are relevant to IT:[62]

1. Reduce interruptions. These often come from staff in other departments that are requesting bits of information for their planning, budgeting, and reports. You might provide specific times during which they can interrupt your work schedule or provide self-service of often-requested information via customized, role-based dashboards for different departments. You might also consider, especially if you are a part-time finance manager, working from home by using cloud-based fund accounting software.
2. Look more closely at the cloud. Respondents mostly agreed that cloud-based technology is superior with respect to cost-effectiveness, efficiency, and ease-of-use. Cloud-based accounting software may enable you to make the most of the small and lean finance staff that is prevalent in nonprofits.

If you would like to learn more and stay up-to-date regarding technology deployment in nonprofits, a great resource is NTEN (the Nonprofit Technology Network; www.nten.org). NTEN hosts an annual nonprofit technology conference and also has an e-mail newsletter, a listserv, and informal interest groups that meet in numerous cities in the United States.[63]

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APPENDIX **13A**

# GLOSSARY OF BASIC TECHNICAL TERMS

All disciplines have a vocabulary spoken by the experts. In the technology arena, the explosion of terms and acronyms, *tech speak,* leaves many feeling that it is a language they can never understand.

## Accounting

*Accounting* programs perform all the routine and complicated tasks of accounting. Many programs are sold in modules, such as General Ledger, Accounts Payable, Accounts Receivable, and Payroll, while others for home or small business or small nonprofits are available as a complete package. Most businesses, when performing their accounting functions manually, had to choose single-entry accounting as their method of recording transactions. With the use of computers, double-entry accounting is the standard.

## Client/Server

*Client/Server* technology has made it possible to replace or enhance mainframes or midrange computers in a way that peer-to-peer or traditional server-based networks have not. While the increase in PC capabilities has been enormous, the size and requirements of data-processing needs of many larger organizations cannot be handled on a PC and still require the speed and magnitude of a mainframe or midrange computer to store and process their central data. Mainframe technologies were not been as user-friendly as PC technologies, so a bridge between the two, client/server, enabled the two technologies to merge.

## Communication Technologies

Technologies enhancing or replacing the capabilities of the phone line have continued, with VOIP technology allowing long-distance calls over the Internet. These technologies have literally revolutionized the way in which we communicate and have completely changed the dynamic of time and distance. Technology allows voicemail to be autodirected to your e-mail account as a sound file to be listened to at your convenience.

## Database

*Databases* are collections of information in a structured format. Phone books, Rolodex cards, member lists, and date books are examples of databases used every day. The computer handles databases exceptionally well.

## Desktop Publishing

*Desktop publishing* programs automate the manual task of paste-up. What was once performed with typesetting machines, photographs, razor blades, rubber cement, and tape is now performed electronically with desktop publishing software.

## Email

Electronic-mail (*email*) replaces or enhances myriad business communications. First and foremost, electronic mail is used to write and distribute letters or notes. It is also used to deliver phone messages; schedule meetings; and send files, pictures, sounds clips, and so forth to coworkers across the desk or across the globe in seconds.

## Fax

Paper facsimiles (*faxes*) provide a method of sending a copy of a document to another location. In combination with electronic mail attachments, the fax has in many cases replaced the need for telex or wires in the workplace. Emailed attachments are rapidly replacing remaining faxes.

## Graphics

*Graphics* programs replace the paintbrush, pen, chalk, and easel of the art world. In addition, other graphics packages allow the manipulation of photographs, pictures, and any other graphic media.

## Hardware

*Hardware* is the term used to describe any tangible piece of computer equipment, meaning it can be touched or felt. Printers, computers, flash drives, computer boards, chips, and monitors are all examples of computer hardware.

## Internet

The *Internet* is a series of connected computers. The Internet began as a way of connecting government, research institutions, and colleges and universities, but has exploded into the new communication medium. Banking and other financial transactions continue to migrate to the "Net." By searching the Net, using a search engine such as Google, one can find and retrieve information on just about any topic around the globe. A website presence on the net, usually in the form of what is called a "home page," is becoming a standard for all businesses. Donations may be received through various payment media from your website's visitors.

## Midrange Computers

*Midrange computers*, formerly called minicomputers, are medium-sized computers or servers, typically used to host an organization's network.

## Network

*Network is* the term used to describe computers that are connected to one another. A network can be as small as two computers connected by a single wire, or as large as a major network linking thousands of machines through a variety of technologies, including wire, telephone, and cellular or satellite.

## OLE

*OLE* is the acronym for Object Linking and Embedding, meaning an object from one software application (such as a spreadsheet) is embedded (copied) into another application (such as a memo in a word-processing application). Optionally, linking is when the applications are instructed to keep track of the status of each of the documents and to automatically (or with warnings) update the embedded object when the source object is modified or changed. More simply, a spreadsheet can be produced and included (embedded) in a memo or report. If the spreadsheet is changed, it will automatically be updated in the memo (linking).

## Operating System (OS)

The *operating system (OS)* constitutes the basic instructions a computer uses to communicate with the user and how it stores, retrieves, and structures data. Software programs use these common instructions for a variety of functions including how data are stored on disk, how documents are printed, and how files are viewed. MS Windows 10, Macintosh, and UNIX are all examples of standard operating systems. It is important to know that certain hardware systems and software programs may be available for a limited number of operating systems.

## PC

*Personal computer (PC) is* the term used to describe any desktop or laptop computer; however, for many, the term PC is used to describe the IBM/AT technology. Conversely, the term "Mac" is used to describe the Macintosh technology from Apple. Both Macs and PCs are personal computers, but the term PC generally applies to the IBM/AT platform.

## Peer-to-Peer

*Peer-to-peer is* a type of network that connects a series of computers in a continuous chain, rather than a central network server. Each computer can perform its own singular function or can be accessed by others on the chain.

## Server

*Server* networks use one or more computers, as the center of the network, similar to the center of a wheel with each of the connected computers as the spokes. All the other computers are connected to it, allowing communication back and forth from the server. Each computer connected to the server can perform singularly, but access to other computers connected to the server is not possible.

## Software

*Software* is the term used to describe programming instructions to a computer. Any set of instructions that cause the computer to carry out a set of instructions or commands is software; however, most commonly, software is used to describe major sets of programs, such as word processing and database.

## Voicemail

*Voicemail* has provided a personal receptionist for its users. Rather than talking with a person to leave a message, voice mail enables callers to record a message, similar to phone answering machines.

## Word Processing

*Word processing* programs allow the manipulation and storage of text for the production of any printed media. There is a wide diversity of products on the market, ranging from simple to complex. The word processing programs on the market today, costing about $230 (or about one-half of that for an upgrade), are more powerful than the dedicated word-processing machines sold in the late 1970s and 1980s costing over $100,000. Microsoft has a base version of Office 365™ available for "free" (a donation) to nonprofits, with its full-featured version of Office 365™ available to nonprofits at $10/user/year (one year subscription required) at the time of this writing. Office 365™ includes Microsoft Word™, Microsoft Excel™, Microsoft PowerPoint™, and other software titles in the office suite. See https://www.microsoft.com/en-us/philanthropies/product-donations/products/office365nonprofit.

APPENDIX **13B**

# FRAMEWORK FOR AN IMPLEMENTATION STRATEGY

The following information should be included in a communication/implementation strategy provided to all employees affected by a new system or process:

**I.** How did we get here?

- **a.** What is the time line?
- **b.** What are the current conditions?
- **c.** What has historically occurred?

**II.** What were we looking for?

- **a.** Is this a new way of doing business?
- **b.** Is this a new venture?
- **c.** Was this caused by growth?
- **d.** What is the strategy?

**III.** Who was involved?

- **a.** Was this a partnership among units (departments) or what unit (department) was involved?
- **b.** Who were the individuals?
- **c.** Who is affected?

**IV.** What did they do?

- **a.** Did they conduct a series of interviews?
- **b.** Did they hold meetings and discussions?
- **c.** What were the results?
- **d.** What conclusions were drawn?

**V.** What were the guidelines?

- **a.** How did they select appropriate technology?
- **b.** Which requirements were targeted?
- **c.** How will infrastructure be built?
- **d.** Will implementation teams be created?

**VI.** What are we going to have when we're done?

- **a.** What will the system do?
- **b.** What will it provide?
- **c.** What will it replace?
- **d.** How long will it last?

**VII.** How are we going to do it?

- **a.** How will it be introduced?
- **b.** What support will be available?
- **c.** What training will be available?
- **d.** How will we motivate individuals and groups to engage in the training and master the system?
- **e.** How will individual needs and requirements be dealt with?

**VIII.** When will the system be available?

- **a.** What will the system do for me?
- **b.** What will I see?
- **c.** What can I view?
- **d.** What can I produce?

**IX.** What is it?

- **a.** What will it look like?
- **b.** How will it perform?
- **c.** How will I use it?

**X.** Who will use it?

- **a.** In the long term?
- **b.** In the short term?

**XI.** What is my role and responsibility?

**XII.** How do I protect the information?

**XIII.** What support will be available?

- **a.** User guides
- **b.** Reference materials
- **c.** Glossaries
- **d.** Online help
- **e.** Labs to practice using the system
- **f.** Group training when system is updated
- **g.** One-on-one follow-up
- **h.** Support assistance

  Help desk
  Training classes
  Refresher sessions
  One-on-one support on-call

APPENDIX 13C

# CASE STUDY: USING TECHNOLOGY TO IMPROVE CASH AND TREASURY MANAGEMENT*

## THE SAN DIEGO ZOO'S CFO BROUGHT THE RIGORS OF CASH FLOW FORECASTING

What's that elephant doing in my cash flow forecast? For Paula Brock, it's a pretty typical query. As CFO for the Zoological Society of San Diego, which operates the renowned San Diego Zoo, Wild Animal Park, and Center for Conservation and Research on Endangered Species (CRES), she deals with problems when constructing her cash flow forecast that it's safe to say few other finance chiefs need to confront. Last year, some of Brock's most sizable unexpected expenses came in the form of not one but 11 African elephants that had to be transported safely and quickly from Swaziland, Africa, to the United States – four to Florida and the rest to California. Now, those are shipping and handling costs that could make a serious dent in any CFO's working capital projections.

## THE CULTURAL REVOLUTION

But Brock didn't panic. As the former manager of a $3 billion mortgage portfolio at ITT Capital, she learned forecasting in the rigorous shop run by CEO Harold Geneen. Precise forecasting meant professional survival at ITT, where managers were rewarded on their ability to accurately forecast their results no matter how events played out and punished when they failed. "He built a culture of demanding taskmasters," Brock recalls. "In eventful times, managers were expected to manage through unplanned calamities and take advantage of opportunities that arose to optimize results, then reissue new, accurate forecasts reflecting those changes." So it's not surprising that three years ago, when the Zoological Society recruited Brock, she introduced her own brand of forecasting to an organization that had never really done any before. "Forecasting has made a cultural change in how we operate," she observes. "We have about 145 departments, so we're a large, complex organization. We've been able to automate the forecasting process by designing templates that are tailored

*Richard Gamble, "The Wild Life of Working Capital Management," *Treasury & Risk Management* (November 2004). Available online at www.treasuryandrisk.com/issues/2004/treasurymanagement/340-1.html. Accessed 11/23/05. 

to the way each unit or department operates," she explains. "We were able to accomplish all of this in significantly less than a year."

Every 28 days – 13 times a year – each department or unit has to revise its forecast and send the updated template to the finance staff. Finance then aggressively reconciles forecasts against actual performance each period and asks questions when a significant gap occurs, she explains. When facing the prospect of transportation costs for 11 elephants, the unit responsible for acquiring the animals simply reflected the change of events in their template and rolled it up into the consolidated forecast spreadsheet that Brock's team maintains. The Excel-based templates are generated by Timeline Inc. software using a data warehouse. Department figures are populated from the data warehouse into each template, Brock explains. Using the template, each department manager adjusts his or her forecast. Then, the numbers are submitted directly to the data warehouse through Timeline's write-back process, she notes. Reports can then be run, pulling the data from the data warehouse. The current forecasting goes through the end of each year. The plan for 2005 includes converting forecasting into a 13-period rolling forecast, she says.

With practice and corrections has come success. "It's not a perfect process and never will be," Brock concedes, "but we've made it a priority and become pretty good at it. With good forecasts, we can time the maturity of our short-term investments and, more importantly, we can use our credit line efficiently and draw the right amount for the right period of time. It's critical to minimizing our borrowing costs."

For many treasury staffs, a working capital forecast that goes out beyond a week or so worth of cash needs is the metaphoric elephant at the cocktail party – the large presence that cannot be ignored but that somehow doesn't fit into the graceful elegance of an otherwise automated system. Theoretically, long-range forecasting should be a success story, given that the computing power is available to most treasuries through workstations and ERP systems and access to greater and greater amounts of relevant data is possible. Yet, treasuries generally are dissatisfied with their forecasting capabilities and are even reluctant to talk about them. "Companies are pushing to make their longer-term forecasts better. A lot of them have developed some forecasting tools, but there's still a lot of room for improvement," reports consultant Mike Gallanis, a Chicago-based principal at Treasury Strategies Inc. "It's a high priority, but more companies are deficient at this point than are proficient at forecasting."

One reason is that there are no real plug-and-play solutions, Gallanis says, because the factors that affect each business's liquidity forecast (e.g., elephant transport) will be unique. "For some elements of cash flow, regression analysis is very effective. For others, a time series works best. It takes testing and trial and error to find the methodologies that work best with each company's pattern of cash inflows and outflows," he says.

Gallanis and Treasury Strategies work with companies to build customized forecasting models, but he admits it takes effort and time and may prove too expensive for some treasuries. Typically, a company that builds a forecasting model maintains it as a separate application (not part of an ERP system or treasury workstation) and feeds data into it from other systems. But it doesn't need to be that high-powered to produce meaningful results. Certainly, that has been Brock's experience working with cash flow elements that are more manageable than those for most companies.

When forecasting the Zoological Society's revenue of about \$160 million a year, for instance, there are a limited number of revenue streams to take into account: \$5 million from a decades-old tax on San Diego property owners; another \$4 million from grant money; \$24 million from fundraising campaigns; and the remainder from memberships, admissions, and sales of auxiliary items like food and Zoo merchandise, Brock explains. While San Diego is a powerful tourist magnet and the Zoo enjoys a world-class reputation, revenue is not always a straight, upward-sloping line. "Ticket sales depend on people getting here," Brock says. That takes disposable income, so recessions will usually dampen ticket sales. Even more disruptive are disasters like 9/11 and the destructive forest fires that ravaged the San Diego area last year. For instance, the Zoo was forced by security authorities to shut down and evacuate for less than a day shortly after 9/11, for the second time in its 88-year history, she recalls. That was clearly an expense not anticipated in the forecast. "But because of our process, we were able to make the appropriate adjustments necessary to our operations in a timely manner so that we were able to land on our feet," Brock observes. To assure liquidity, the Zoo keeps a credit facility with Bank of America and draws on that line as needed to cover cash shortfalls. Having a viable forecast is "essential" to making efficient use of the bank credit, Brock says. As a result she has been able to significantly reduce borrowings over the last year.

There's plenty of pressure, coming from the CEO, CFO, and the analysts and shareholders who question them, to forecast liquidity further out with greater accuracy, reports Lisa Rossi, head of U.S. liquidity management services for Deutsche Bank Global Treasury Services. And companies are trying to leverage the technology available from banks and from ERP and treasury workstation vendors to help them do this, but progress generally has been mixed, she explains. Companies that have formalized, consistent processes like electronic invoice presentment and payment generally fare best. And of course the job is easier for some companies than others. Companies that get most of their revenue under contracts, for example, can better forecast incoming cash, Rossi adds.

Longer-term working capital forecasts need a data pull that spans and penetrates the organization. "You need clear, timely input from the parts of your organization that interact with your customers and suppliers so you get a sense of what's happening out in the supply chain," Gallanis says.

## ALMOST IN REACH

The simplest way is to parse out the forecasting duties and make each unit or department continually revise its forecast, then let the piecemeal forecasts roll up into a consolidated corporate forecast. But that strategy relies on coordinating lots of pieces, and it can be labor-intensive at the unit level. Treasury doesn't control the process unless senior management mandates participation, and treasury doesn't control the quality except through after-the-fact reconciliations and pressure on units to improve faulty forecasts.

The vision is tempting: forecasting software that mines all the relevant data in a company's ERP system, capturing contract data, purchase orders as soon as they are created, and future receivables as soon as orders are entered. Then it taps external databases to pull in future prices of key commodities. If it ships by truck and its contracts allow carriers to pass on fuel price increases, it factors in oil price projections. If it relies on parts made from aluminum and its contract with its key supplier expires in the next six months, it factors in probable price increases for inventory after that point. And so it goes up and down the supply chain: Elements must be identified that affect cash intake and outflow; historic correlations must be found; and then all of these must be built into the forecasting model. So far, reality falls short of the vision, and no one is confident enough to forecast when that is likely to change.

CHAPTER 14

# MANAGING RISK, LEGAL ISSUES, AND HUMAN RESOURCES



## 14.1 WHAT IS RISK MANAGEMENT?

Is your organization planning on growing, and if so, what is the biggest challenge you face related to risk management? Nonprofit executives who were asked that question spoke about quality control, financial controls, untrained staff, inadequate resources, overreliance



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.


*Source:* Abila, "Nonprofit Finance Study: Managing Growth," 2017, 13. Used by permission.

**Exhibit 14.1** Growth-Related Risk Management Challenges

on grants or government contracts, contract compliance with a multitude of contracts, contingency planning necessitated by shifting governmental priorities, and board member lack of understanding of risk management (see Exhibit 14.1). Regarding risk management, 51 percent of respondents said that growth would make their organization's ability to manage risk somewhat harder, and another 11 percent said it would make their risk management ability much harder.[1] The challenges voiced were grounded in building "capacity for a number of risk management activities, such as creating contingency plans for future funding uncertainty, maintaining compliance with funding requirements, actively assessing internal controls, and training employees."[2] Fraud risk is also in view here: When asked if growth opened up their organization to a greater potential for fraud or accusations of fraud, 4 percent said "Yes, very much," 29 percent said "Yes, somewhat," 27 percent said "Yes, only a little," and the other 40 percent said either "No, not at all" (34 percent) or "I don't know" (6 percent).[3] Interestingly, almost all (98 percent) of those surveyed said that growth is at least somewhat important for their organization, with almost half saying it is extremely important. Four out of five of those surveyed expected their organizations to grow in the next 12–18 months.[4]

Effective risk management is the process of evaluating and guarding against potential losses to the organization. Risk is defined as "the possibility that events will occur and affect the achievement of strategy and business objectives."[5] The chief financial officer (CFO) of a nonprofit organization should be very concerned about risk management issues because they directly affect the use of financial and other resources. Effective risk management can save significant resources, which ultimately translates into money and resourcing the mission. In the corporate world, treasury staff are being given greater responsibility in the area of risk management, and a new and broader approach to risk management is becoming more common: enterprise risk management (ERM).[6] ERM involves "identifying, assessing, quantifying, and mitigating the broad range of strategic, operational, financial and other risks confronting the [organization]."[7] Another definition is "the culture, capabilities, and practices, integrated with strategy and execution, that organizations rely on to manage risk in creating, preserving, and realizing value."[8] Put in practical terms, this approach to risk management brings financial risks (price risk, interest rate risk, foreign exchange risk) together with nonfinancial risks (business risk, insurance, operating risk, contingency planning) in one framework for one group within the organization to oversee. The possible downside to a too-narrow view of risk is identified by consultant Stephen Baird of Treasury Strategies, Inc.:

> While risk compliance is a process of identifying, tracking and mitigating risk … strategic risk management is a process of applying a high-level analytical framework to understand the composition of a company's risk. The former is a tactical approach that misses the connections between risks, addresses risks individually and overlooks some risks entirely. The end result of a successful execution of the latter can be determining the most value-added strategies for accepting, transferring or mitigating risks for an entire enterprise. Treasurers are better equipped than anyone in the organization to develop and apply these frameworks . . . .[9]

We concur with this view. The ERM framework (Enterprise Risk Management – Integrated Framework) recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), while not mandatory for any business or nonprofit organization, provides new impetus to take a broader view of risk and to integrate it into the strategic management process.[10] Treasury Strategies survey data indicates that the most common arrangement for corporate ERM reporting responsibility is to have it housed in the treasury function.

Risk management has two major components:

1. Loss prevention
2. Loss control (reduction of loss)

Many nonprofit leaders and managers fail to understand that risk management involves matters of risk associated with their assets. An asset is "the entire property of a person, association, corporation, or estate applicable or subject to the payment of debts."[11] In financial terms, assets are things owned by the organization and reported on the organization's balance sheet. In more general terms, assets are resources or anything that provides value to the organization, whether tangible or intangible. The major types of assets include:

1. People (employees, members, volunteers, independent contractors, board members)
2. Property and equipment (monies, property, equipment, technology, trade secrets, goodwill)

When viewing assets in this way, initiatives such as an employee retention program – to retain key employees – become a vital piece to the organization's overall risk management program. Risks include many areas, including property, income, liability, people, reputation and mission, volunteers, governance and fiduciary considerations, client relationships, and collaborations. Researchers who study nonprofit fraud reports, including Archambeault, Webber, and Greenlee, find that fraud incidents and the associated losses negatively impact "the organization's reputation, future funding, and ability to advance its mission."[12] In fact, charity watchdog agency Charity Watch explicitly factors in a nonprofit's "disclosures of material diversion of assets" in its rankings.[13] Bear in mind that although disclosure is required as part of the affected nonprofit's Form 990 (Part VI, Question #5), compliance is voluntary and in fact often overlooked.

Leadership sets the tone and demonstrates their compliance.
Leaders stay informed and demonstrate their interest and concern for this area.
Education and training convey policies and procedures as well as organizational attitudes toward the safeguarding of assets.
Risks are known.
Risks are prioritized.
A safety officer is appointed.
Counselors, consultants, and practitioners (private, public, or pastoral) are consulted and used when necessary.

**Exhibit 14.2** Checklist for Setting up a Risk Management Program

Exhibit 14.2 presents a checklist for setting up a risk management program. In order to be effective, your organization's risk management program must be proactive. Proactive steps include:

1. Acknowledge the critical importance of risk management at the highest level.
2. Define risk management roles and responsibilities.
3. Delegate or assign risk management responsibilities and accountabilities.
4. Incorporate a regular inspection where losses could occur.
5. Review the organization's risk management program in detail regularly.
6. Communicate that risk management issues must be considered when evaluating the cost of doing business, including the review of existing and new programs.

For more on these measures, see Herman, Head, Jackson, and Fogarty's *Managing Risk in Nonprofit Organizations*.[14] The CFO has an additional responsibility, one which we give great emphasis to:

7. Communicate *illiquidity risk*, the primary financial risk, regularly, accurately, and in terms that staff can understand.

This ongoing focus on illiquidity risk is embedded in the "post-loss goals" of risk management, which include survival, growth, stability of operations, and required financial results.[15]

The advantages of proactive, enterprise-wide risk management are profiled in Exhibit 14.3. In your involvement in financial decision making, use these to spur strategic, holistic thinking. These items will also bolster your advocacy for integration of risk management in the strategic management process.[16] You may wish to set up a risk management board committee or relabel your finance committee to be the finance and risk management committee.

Motivation to do the hard work of risk management comes from the five "whys" of risk management, as identified by Herman, Head, Jackson, and Fogarty:

1. *Asset stewardship.* Your organization gains from a stewardship focus a stronger position from which to avert erosion of core assets (property, income, liquid assets, goodwill, human resources).
2. *Achieving public accountability.* Every facet of nonprofit management is enhanced when the organization earns a reputation of trust and fidelity as well as prudence in its risk management.

- Aligning risk appetite and strategy – Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.
- Enhancing risk response decisions – Enterprise risk management provides the rigor to identify and select among alternative risk responses: risk avoidance, reduction, sharing, and acceptance.
- Reducing operational surprises and losses – Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.
- Identifying and managing multiple and cross-enterprise risks – Every enterprise faces myriad risks affecting different parts of the organization, and enterprise risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks.
- Seizing opportunities – By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.
- Improving deployment of capital – Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.

*Source:* Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Enterprise Risk Management – Integrated Framework Executive Summary* (September 2004).

**Exhibit 14.3** Advantages of Proactive Enterprise Risk Management

3. *Attracting stakeholders.* If an organization is seen as careless or uncaring, it loses support from volunteers, staff, donors and other funders, and the community.
4. *Freeing up resources for mission.* Accidental or intentional losses are costly, often more so than preventive measures, and absorb valuable staff time.
5. *Staying true to mission.* Any time harm results from a nonprofit's operations or activities, the fallout is detrimental to staff or volunteer focus on mission as well as to the mission-accomplishment image of the organization.[17]

Finally, Lewis and Cummings enumerate six critical factors to consider as you implement and maintain your organization's ERM system:[18]

1. Have a risk management governance structure that includes your organization's risk appetite and a risk policy statement. This should spell out management roles and responsibilities.
2. Follow a framework (e.g., COSO,[19] ISO 31000[20]), making sure to include a focus on "strategic" risks and objective setting, event identification, and risk response.
3. Continuously identify risk and the risk event universe through creation of a "risk register." You can do this by using risk surveys, interviews of board members and management team members; brainstorming; comparing your organization's risks to lists compiled by similar organizations; and focusing on material and realistic risk events;
4. Develop a risk profile, which includes your organization's risk tolerance, the numerical and/or dollar impact of risk events and which of those take a higher priority for management and board attention, and for each significant risk event, identification of that risk's trigger, consequence, and indicator(s).

5. Establish risk responses, which includes whether you will accept, share, or avoid the risk; controls and procedures you will implement to mitigate the impact of the risk; a plan for implementing certain response actions; a "what to do in case of emergency" pre-risk event communication plan; another communication plan regarding implementing a risk response; and an external communications plan using social media and public relations as you respond to the risk event in a way that reduces reputational harm.
6. Develop a risk monitoring and reporting process which includes key risk indicators (KRIs), key performance indicators (KPIs, and reports related to these), and how you will use internal audit (where available) to monitor the risk and its effect on KRIs and KPIs and then report these out to the board, with this whole process done at appropriate time intervals (which are a function of the risk environment in which your organization operates).

### (a) WHO IS RESPONSIBLE FOR MANAGING RISK IN THE NONPROFIT ORGANIZATION?

The board of trustees is responsible for setting policy and assigning responsibility for risk management functions in the nonprofit organization. In the event of a loss and subsequent legal exposure resulting from this loss, it is likely that the board could be held accountable for losses if appropriate policies and procedures do not exist. Risk management issues are broad and pertain to paid staff and volunteers as well as to the general public who may be involved with the organization. Risk management is part of the cost of doing business and should not be ignored by the board of trustees.

***(i) Board Duties.*** As responsible leaders, board members:

- Know the rules in the organization, including by-laws,[21] policies, and procedures
- Understand the risk management process
- See that organizational policies are communicated and implemented
- Stay informed about issues such as law (and the two provisions of the Sarbanes-Oxley Act that apply to nonprofits: see below and the discussion in Chapter 5),[22] litigation, compliance, ethics, and disclosure

We note particularly the whistleblower provisions of the Sarbanes-Oxley Act, which became law in 2002. Many allegations against nonprofits, mostly related to excessive compensation, self-dealing, and ineffective governance, have come from whistleblower disclosures.[23] This fact suggests that your organization, at a minimum, should adopt a whistleblower policy and protection program with these five action points: (1) provide employees multiple avenues to report concerns; (2) establish an ombudsman program; (3) most important, adopt a policy prohibiting retaliation; (4) train managers and supervisors; and (5) take disciplinary action against those who engage in retaliation.[24]

Sarbanes-Oxley also has record-keeping and official proceedings obstruction provisions that apply to nonprofits:[25]

> Record-keeping:
>
> Section 802 of the Act makes it a crime to knowingly alter, destroy, mutilate, conceal, cover up, falsify or make a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter

> within the jurisdiction of any federal department or agency or any case filed under the federal bankruptcy code. Violators may be fined and/or imprisoned for up to 20 years.
> Section 1102 of the Act makes it a crime to "corruptly" alter, destroy, mutilate, or conceal a record, document or other object, or attempt to do so, with the intent to impair the object's integrity or availability for use in an official proceeding. The Act does not define the term "corruptly." Violators may be fined and/or imprisoned for up to 20 years.
>
> Official proceedings:
>
> Section 1102 of the Act also makes it a crime to otherwise obstruct, influence or impede any official proceeding or attempt to do so. Violators may be fined and/or imprisoned for up to 20 years.

The Independent Sector (IS) modified its *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (based on extensive work by the 2014 Independent Sector Ethics and Accountability Advisory Committee) to more carefully address risk management in today's technologically sophisticated environment. Building on our presentation of technology issues in Chapter 13, the additional IS board responsibility regarding "Risk Tolerance & Mitigation in Response to Technology Advances" is stated:[26]

> It is the board's responsibility to decide the level of risk that the organization is comfortable with, including risk regarding its finances, its operations, and its reputation, although there are other areas in which staff are also involved. Updated principles recognize the importance of protecting an organization's data along with its business records, property, program content, integrity, and reputation (Principles #5, 6, & 21). To mitigate risk, an organization should maintain emergency preparedness and disaster response plans; secure and back up data and electronic files; protect against outside manipulation of data; have clear and explicit privacy policies that indicate how data will be used and kept secure; and seek permission to use all individual identifying information (photographs, fingerprints, biometric data, social security numbers, etc.).

***(ii) Leadership Sets the Tone.*** Control cues are the written and unwritten messages sent to an organization by its leadership, management, and staff on what is expected of the entire workforce to safeguard its resources. These messages continually communicate by word and action that the workforce is responsible and accountable for protecting and preserving the organization's assets so that they are available to carry out its mission.

**(b) COMMUNICATE RISK MANAGEMENT POLICY.** In order to be meaningful and effective, risk management policies must be communicated to all who have a reasonable need to know or a role to play in adherence to the policy. Traditionally a policy and procedures manual is developed and distributed to accomplish this task. The manual must be kept updated to maintain its relevance and effectiveness. However, a policy and procedures manual is not the only way to effectively communicate policies, roles and responsibilities, and expectations. Another method of communicating that works effectively for the organization is acceptable.

## 14.2 IDENTIFYING RISK

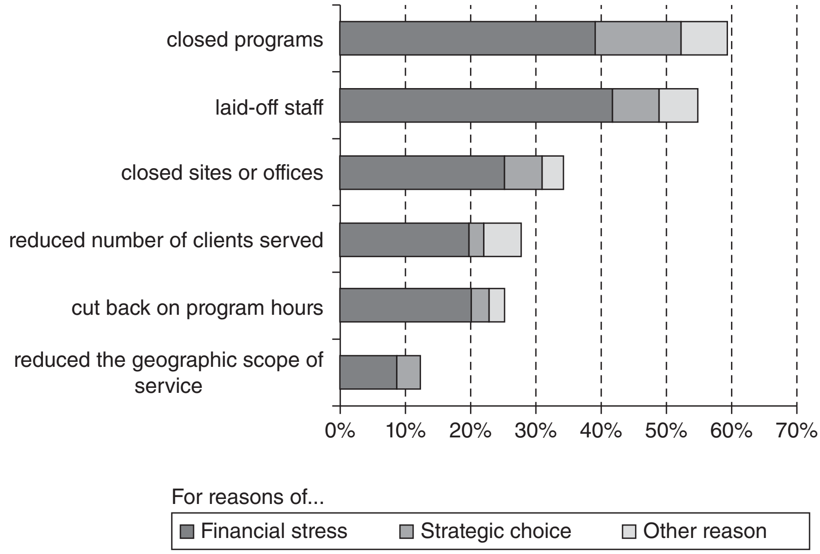
Your organization's people and property invite and cause risks in several distinct areas. Exhibit 14.4 summarizes some major areas of risk with specific examples.

| Major Area of Risk | Examples |
|---|---|
| Legal records | Articles of incorporation |
| | Bylaws |
| | Meeting minutes |
| | List of members |
| Officer's and director's liability | Theft (assets, ideas, credibility) |
| | Compliance |
| | Conflict of interest |
| | Duty of care |
| Members of the nonprofit organization | Loss |
| Employees | Theft |
| | Lawsuits |
| | Safety |
| | Productivity losses |
| Volunteers | Exposure |
| | Space |
| Personnel and payroll | Employee benefits |
| | Sexual harassment |
| | Background checks |
| Financial management | Liquidity level |
| | Budget |
| | Cash handling |
| | Bonding |
| | Confidentiality of records |
| | Loan management |
| | Net assets |
| Investment management | Risk |
| | Image with constituents |
| Child care | Injury |
| Counseling | Liability insurance |
| Insurance | Rates |
| | Ranking |
| Fire protection | Insurance |
| | Fire alarms |
| | Disaster preparedness |
| | Emergency procedures |
| Injury prevention | Unenforced policy |
| Vehicles | Accident |
| | Theft |
| | Inappropriate or personal use |
| Copyrights and publications | Theft |
| | Inadequate protection |
| Programs and activities | Productivity losses |
| | Reputation |
| Miscellaneous | Disasters (any kind) |
| | Ethics |

**Exhibit 14.4** Major Areas of Risk

## 14.3 PRIMARY FINANCIAL RISK: ILLIQUIDITY

We have emphasized throughout this book that managing your organization's liquidity is paramount in your financial management. Further evidence of the effects of your organization's primary financial risk, a situation called "illiquidity" – that of not having enough liquidity – is provided by the *New York City Nonprofit Executive Outlook Survey*




*Note:* The question asked was "In the past few years has your organization ..."

*Source:* Jack Krauskopf and Gregg Van Ryzin, *New York City Nonprofit Executive Outlook Survey* (New York: Baruch College, School of Public Affairs Nonprofit Group and Survey Research Unit, Spring 2005). Used by permission.

**Exhibit 14.5** Financial Problems and Effects on Mission Achievement

(see Exhibit 14.5), which dealt with organization responses in the first few years of the new millennium. Quoting the study's authors, Jack Krauskopf and Gregg Van Ryzin: "More than 60 percent of the [surveyed] agencies have had to close programs, and nearly as many have laid off staff. Overwhelmingly, these reductions are due to financial stress, rather than to strategic choices they have made."[27] Poor cash flow management and underfunded agencies are more characteristic of the nonprofit sector than many recognize.

By regularly communicating the need for a liquidity target, degree of achievement of the target, and how achievement or maintenance of that target strengthens the organization, the CFO or board treasurer enables a greater degree of understanding and buy-in for this objective. Furthermore, nonprofits are beginning to use derivatives to better manage interest expense and the risk of higher interest expense as well as price risk and foreign currency risk. See Appendix 14A for a derivatives checklist, and Appendix 14B for a case study on how to handle foreign currency risk without the use of derivatives.

## 14.4 LEGAL ENVIRONMENT

**(a) SARBANES-OXLEY IN THE NONPROFIT SECTOR.** Elsewhere, we have noted that Sarbanes-Oxley legislation has brought new impetus to governance and control issues. We simply note there that 97 percent of surveyed nonprofits believe corporate governance reforms have impacted their organizations already and that many of these organizations are already implementing such reforms in advance of possible federal or state extensions of such reforms to the nonprofit sector.[28]

**(b) ETHICAL CONSIDERATIONS.** At a minimum, your organization should have a code of ethics that is known by appropriate parties, emphasized by the executive director/chief executive officer (ED/CEO) and the board, and enforced by top management and the board. A model that some organizations have used is the Financial Executives' Institute Code of Ethics, shown in Exhibit 14.6. Refer back to Chapter 4, Section 4.4, for more on ethics.

**(c) RELEVANT AGENCY AND REGULATORY RULES.** One agency you will definitely want to stay on good terms with is the IRS. Unless specifically exempted due to size[29] or religious nature, your organization will want to stay up-to-date regarding your annual "information" return as well as unrelated business income tax, if relevant.[30] Furthermore, your organization will be responsible to remit taxes if it has employees.[31] Remitting employee withholding tax on wages and salaries paid is a serious matter with punitive consequences if overlooked.[32] Correctly classifying your employees (whether they are truly employees or independent contractors) has potential tax withholding and payment ramifications.[33]

**FINANCIAL EXECUTIVES INSTITUTE CODE OF ETHICS**

FEI's mission includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected, and preserved. This Code provides principles to which members are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public, and other stakeholders. Violations of FEI's Code of Ethics may subject the member to censure, suspension, or expulsion under procedural rules adopted by FEI's Board of Directors.

All members of FEI will:

1. Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
2. Provide constituents with information that is accurate, complete, objective, relevant, timely, and understandable.
3. Comply with applicable rules and regulations of federal, state, provincial, and local governments, and other appropriate private and public regulatory agencies.
4. Act in good faith, responsibly, with due care, competence, and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
5. Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
6. Share knowledge and maintain skills important and relevant to constituents' needs.
7. Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.
8. Achieve responsible use of and control over all assets and resources employed or entrusted.
9. Report known or suspected violations of this Code in accordance with the FEI Rules of Procedure.
10. Be accountable for adhering to this Code.

*Source:* Financial Executives Institute (FEI). Available online at: https://www.financialexecutives.org/getattachment/Become-a-Member/join/FEI-Code-of-Ethics.pdf.aspx. Accessed: 8/1/17. Used by permission.

**EXHIBIT 14.6** FEI CODE OF ETHICS

Another item sometimes overlooked by nonprofits is the relevant federal, state, and local regulatory or agency requirement for a particular process. Minimum wages, overtime pay, and whether your organization would be expected to pay an intern[34] are all examples of potential landmines. Another example: If you are doing business with the federal government, be aware of the raft of regulations related to cash management.[35]

At the state level, there also may be requirements regarding having outside audits or reviews done of your financial statements. At the time of this writing, 18 states "require a charitable organization that solicits contributions in the state to submit a copy of an independent audit report or a certified review of financial reports annually if it meets certain financial criteria. The budget thresholds for audit requirements vary substantially."[36]

## 14.5 SAFEGUARDING PEOPLE

A nonprofit organization's most valuable asset is the people who contribute resources (service and monies) in support of its mission. The staff and volunteers in your organization perform these needed activities and tasks, and both groups use and develop resources.

First and foremost, you must provide a safe working environment for your staff and volunteers, regardless of whether work is performed onsite, at your organization's offices, in the field, in a donor's home, or in the staff or volunteer's residence or place of business. While you cannot completely safeguard your staff and volunteers outside your organization's place of business, you may be at risk if you are aware of a potential hazard and do not take action to protect the individual from harm.

**(a) TOOLS FOR EFFECTIVE HUMAN RESOURCE MANAGEMENT.** An ongoing trend regarding liability for nonprofit organizations is related to employment practices liability.[37] Job descriptions, background checks, and notification that bonding is required for finance-related positions are all helpful in reducing the potential for litigation and unfavorable judgments.

***(i) Job Descriptions.*** Job descriptions include the tasks, duties, and responsibilities of a job, along with the minimum education, experience, and skills necessary for the job. They also include the job title, location, whether exempt or nonexempt (for Fair Labor Standards Act classification purposes, with overtime pay implications), position summary, and working conditions (including hazards). Be prepared to defend any education, experience, abilities, and skill requirements you have included.

***(ii) Background Checks.*** More and more organizations are conducting background checks for employees and even volunteers. One form of background check is a criminal history record check. Not only are criminal checks being done as a screening device for positions having significant direct contact with children or clients who might be considered vulnerable[38] (often checked by a third party, with prior consent by the potential employee or volunteer), but for financial positions a credit record check is often conducted as well. Applicants should have an opportunity to challenge the accuracy of information you receive, in that errors may occur in criminal history records and credit histories. Also, do not misuse or negligently handle (e.g., be careful to not accidentally disclose negative items) any information you receive, as you and/or your organization could then be susceptible to civil or criminal penalties.

***(iii) Bonding.*** Bonding is a precaution that a nonprofit organization should consider in its corporate stewardship. Bonding buys insurance on those handling money for the organization and ensures to its constituency that the finances are being handled properly.

Some nonprofit organizations are reluctant to bond money handlers, in the belief that it questions the integrity of the people involved. Unfortunately, irregularities in the handling of money in nonprofits occur often enough that this potential cannot be ignored. Whether or not the money handlers are bonded, the organization should safeguard its money and money handlers by engaging an auditor to conduct an annual audit. There is a wide variety of bonding patterns. In some instances the individual is bonded; in others the position is bonded, so that a change in personnel does not affect coverage. Group bonds cover everyone who handles the money.

Costs of bonding vary widely, depending on the number of individuals involved and the amount of money handled. The insurance carrier for the organization is the best source to begin the process of determining how to meet its bonding needs. We believe that the cost is very reasonable relative to the protection such as policy provides. In some nonprofit arenas, specialized providers offer tailored policies at attractive rates.

#### (b) PHYSICAL AND EMOTIONAL SAFETY.

1. Your facilities (electrical, plumbing, fire sprinklers, etc.) should comply with standard codes for your region. Adherence to Americans with Disabilities Act (ADA) regulations regarding handicap access is vitally important.
2. Doorways and fire exits should be kept clear and accessible.
3. If crime (e.g., assault or theft) is prevalent in your locale, doors should be locked after hours, and individuals should be escorted to parking structures or accompanied to their transportation sites.
4. Emergency service numbers, such as 911 stickers, should be placed on telephones.
5. Basic safety procedures, such as what to do in an emergency, should be included in your staff and volunteer orientation materials.
6. If staff or volunteers use vehicles to conduct work (other than traveling to and from their work site), you need to ensure that they have a good driving record, have up-to-date insurance coverage, and understand their responsibilities with respect to chauffeuring others in their own or company vehicles.
7. If staff or volunteers need to move heavy items, such as furniture, inventory, or stock, these individuals need to be provided with safe lifting instructions, lift belts, and proper tools, such as ladders and hand trucks.

With regard to emotional safety:

8. Employee workplace guidelines specific to sexual harassment should be distributed to all individuals and supervisors, and managers should receive training on how to recognize a potential harassment situation and what steps or actions to take if it does occur. Employees should sign documents indicating what training was received and when it was received. (The latter documents are vital in any case in which the organization is sued in determining whether it is liable.)
9. Staff and volunteers should be instructed on how and to whom to report a potentially harmful situation if a supervisor or manager creates unnecessary stress for their subordinates.

10. When considering expansion, growth, or organizational changes of any kind, the risk, stress, or burden on the staff and volunteers should be appropriately evaluated as one of the costs of the change.

**(c) PROTECTING THE ORGANIZATION FROM LAWSUITS AND GRIEVANCES.** The most obvious way to prevent lawsuits and employee grievances is to comply with all laws, regulations, and policies that pertain to your region and organization. In addition to protecting the organization from lawsuits and grievances, you need to ensure that your staff and volunteers are protected. Going beyond the letter of the law to ensure ethical behavior is only wise.

**(d) DEALING WITH DIFFICULT OR PROBLEM EMPLOYEES.** Regardless of how careful the organization may be in the selection process for hiring new employees ("hire hard, manage easy" is a sound approach for recruitment and selection), eventually it may be faced with terminating a problem employee who does not perform up to standard. To avoid financial risk to the organization, these actions should be taken:

1. Each employee has an up-to-date and accurate job description detailing his or her work assignments and responsibilities.
2. Periodic evaluations should be performed, using only the tasks and assignments on the job description as criteria for evaluating employee performance.
3. Once a problem employee is identified, the supervisor must document in writing all conversations, meetings, job complaints, assignments, errors, omissions, or violations of policy; discuss them with the employee and have the employee sign them; and maintain copies of these documents in the employee's personnel file.
4. The first step to termination is a counseling session to notify the employee that his or her performance is not satisfactory. Reasonable steps to provide additional assistance or training, areas to improve, and other specific information should be discussed with the employee, and a written document detailing the discussion – signed by the employee – should be given to him or her, with a copy maintained in the personnel file. If termination appears to be imminent, a time period (or deadline) within which the employee's performance must be up to standard should be predetermined and discussed with him or her. Interim sessions to monitor progress, or lack of progress, should be conducted and documented.
5. The decision on whether to terminate or ask the employee to resign should be evaluated carefully. Very often problem employees are willing to resign if offered an attractive severance package. The costs of the severance package should be evaluated and compared against the potential risk of lawsuit or grievance, as well as the increase in state unemployment insurance (or reimbursement to the state fund if the nonprofit does not participate in the state program) if the employee is terminated. Often tensions become high when an employee needs to be separated from the organization. The decision to fire someone may seem warranted but may not be the most appropriate action for the organization. In many cases, there will be less of a financial burden and risk to the organization if the employee is willing to resign as opposed to being terminated.
6. Employees can be terminated (fired) only for cause. Separating an employee for lack of work, lack of funds, or change in mission or responsibilities is not considered "termination for cause." This is generally referred to as a "layoff" and will have a financial impact in the form of workers' compensation increases. When a layoff is performed, the only criteria that may be used are seniority, job title or

description, employee skills, and how critical the person's job or responsibilities are to the organization. Performance or specific salary level cannot be used as the reason for selecting one employee over another for layoff. If an employee is laid off out of order of seniority, it is critical that you document legitimate and legal reasons for performing a layoff in this manner.

**(e) GROUNDS FOR IMMEDIATE TERMINATION.** There are instances where it is necessary to remove an employee immediately. Labor relations laws vary from state to state, and a lawyer specializing in human resources issues should be consulted regarding the legality of the termination before any decision is finalized. Generally, the following are grounds for immediate termination when the employee places the organization, its staff, or its volunteers at substantial risk:

1. Theft or fraud
2. Threatening or lewd behavior (sexual harassment) in the workplace
3. Lying about use of sick leave
4. Racial, ethnic, gender, age, or religious discrimination
5. Using illegal drugs or other illegal substances in the workplace
6. Bringing weapons and other dangerous or hazardous items into the workplace

Even with the severity of the examples just listed and the assumption that "everyone should know they cannot do this stuff at work," it is important to document in your personnel policies those behaviors or actions that will warrant immediate termination. It is essential that all new employees receive training on what constitutes sexual harassment and sign a document indicating that they have received this training. Employees in supervisory and recruitment or selection roles should also receive training on ADA-related issues.

Many companies place employees on "investigatory leave" (leave without pay) if allegations of any of the listed activities are suspected. This benefits the organization by removing the employee from the workplace immediately and providing it with time to investigate and confirm the allegations prior to the completion of the actual separation. If it is determined later that the employee was falsely accused, back wages can be paid and the employee can be restored to his or her position. Again, policies and procedures for placing employees on investigatory leave should be documented in the organization's personnel policies, with copies provided to all employees when hired.

**(f) COMPENSATION.** The intangible rewards of working in a nonprofit environment enable organizations to hire qualified individuals who are dedicated to the mission of the organization at wages below the industry or local average for the region. Taking advantage of this situation can greatly aid the organization in keeping its employee compensation rates down; however, there may be hidden costs in using this practice recklessly or assuming that employees will work indefinitely for low wages. These costs include:

1. Eventually, even the most dedicated employee will succumb to offers for better wages. High employee turnover reduces productivity and creates an unstable image in the eyes of donors and a general sense of unease and instability with other staff and volunteers.
2. Ineffective or unqualified staff or volunteers use resources. Often one highly qualified individual can perform the task of several underqualified staff and lower the

overall cost to the organization. In addition, productive staff and volunteers may lose morale if unproductive staff and volunteers are allowed to remain with the organization.

3. A low-paid development staff or director may be less effective at raising money than a higher-paid individual. The net effect to the organization will be a decrease in overall resources: "Penny wise and pound foolish."
4. Specifically in the financial arena, a highly qualified individual may be able to forecast and manipulate resources in a way that greatly benefits the organization and protects it from loss, while a lesser-qualified individual may be careless and less savvy in managing resources. We note that reliance for financial management on someone with training only in accounting leaves important treasury management and risk management issues undermanaged.
5. You may wish to consider pay for performance, a practice that is spreading to many nonprofit organizations. This merit-based pay is seen as more fair by productive employees, who are discouraged when seeing less productive employees get the same pay or pay raise as they get.

**(g) PERSONAL USE OF ORGANIZATIONAL RESOURCES.** Unless there are specific policies and active monitoring of resource use in your organization, a substantial loss can result from the personal use of resources by volunteers or staff in the following ways:

- Phone/smartphone
- Photocopying equipment
- Tablet, laptop, desktop computers (much time theft due to browsing the Internet)
- Office supplies (paper, pens, etc.)

While all of us at one time or another have accidentally placed a pen or pencil belonging to another in our purse or pocket, this practice is theft if done consciously. If your organization has a policy prohibiting its resources from being used for personal use, then staff and volunteers need to be reprimanded when minor infractions, such as those listed, occur. Many organizations adopt a policy that allows staff and volunteers to use organizational resources as long as it does not become excessive (e.g., using the phone to call home, the copier to copy an occasional legal document, the fax machine to send an important document). The difficulty of this type of policy is the definition of *excessive* may vary for each individual. One employee who lives close to his or her worksite and calls home during breaks may not incur a significant cost in long distance charges to the organization; however, another employee who lives much farther away and does the same may result, over time, in a significant cost to the organization. It is important for limits to be established that do not discriminate from one employee to the next. If a policy places a $5 maximum on personal telephone calls per month as opposed to a time limit for personal use, it may be interpreted as unfairly penalizing one employee. *It is important to remember that the organization is not required to allow any of its resources to be used for personal use.*

**(h) CONFLICT OF INTEREST.** A conflict of interest may exist when a decision is made that may personally benefit a board member, an employee, or a volunteer. For example, a staff member may have a spouse who works for a travel agency. Using that particular travel agency may be viewed by potential donors or auditors as unfair. However, if the travel agent agreed to reduce travel expenses by 5 percent, the decision to use this particular vendor might be the most financially advantageous to the organization. Similar scenarios may occur when a board member, staff member, or nonboard volunteer is related to a banker, investment agent, insurance agent, or lawyer.

A potential conflict of interest does not mean that the organization cannot do business with friends or family of its staff or volunteers. It is critical in these circumstances to have full disclosure of the connection to this particular individual and to have someone or a committee other than the individual who may benefit make the final determination. The committee member with the conflict of interest may "recuse" himself/herself from the deliberations and vote involving purchasing, borrowing, or placement of funds.

Development of and compliance with a carefully drafted conflict-of-interest policy will lessen the financial risk to the organization as well as reduce the appearance of impropriety with respect to donors. Refer to Chapter 5 regarding such a policy.

**(i) GETTING THE MOST "BANG FOR YOUR BUCK".** If the organization is not utilizing a resource to its fullest potential or purpose, the organization is actually wasting it. If staff or volunteers have special skills and abilities that are not being utilized, if they are not mentored properly to work to their fullest potential, or if they are not trained or given sufficient flexibility to perform their tasks or responsibilities, your organization is wasting resources. In addition, if staff or volunteers are performing unsatisfactorily, they are consuming resources. Your organization should also consider the human resource management function itself: Should some or all of it be outsourced? Benefits administration, payroll administration, and selection/recruitment are commonly outsourced by organizations of many sizes.[39] Some surveyed nonprofits prefer to limit outsourcing to payroll and bookkeeping and perhaps IT.[40]

**(j) STAFF AND VOLUNTEERS – WHAT MOTIVATES THEM?.** Three qualities of all productive staff and volunteers are listed in Exhibit 14.7. We would add, in the commitment section, that a spiritual commitment is typically seen in employees and volunteers in faith-based organizations.

1. Commitment
   - To their work
   - To their constituents
   - To their customers
   - To their community
   - To themselves
2. Competence
   - In their work
   - In their relationships with other staff and volunteers
   - In dealing with donors
3. Clarity
   - About their roles and responsibilities
   - About the purpose of the organization and its mission

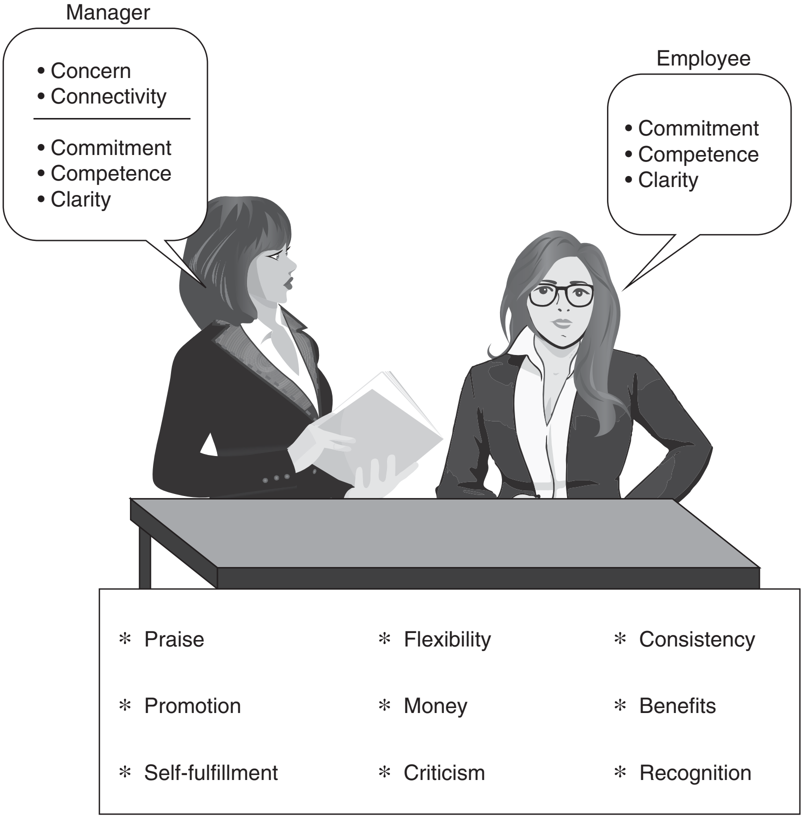
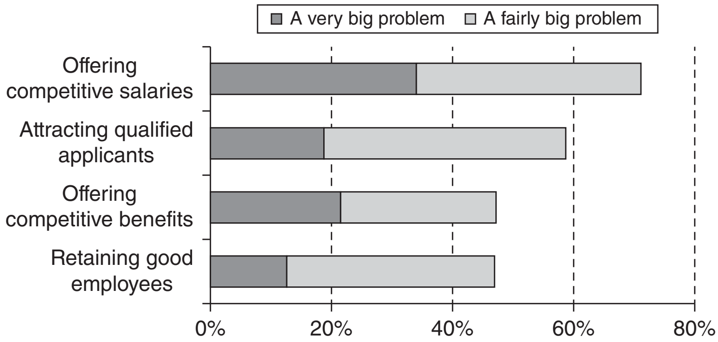



**EXHIBIT 14.7** MOTIVATION FACTORS

As discussed earlier, salaries paid to employees in nonprofit organizations are often below for-profit levels. This means that individuals accept positions with nonprofits because there are motivating factors beyond income. One expert, David Mason, calls nonprofits "values-expressive organizations," and economist Estelle James has documented that workers take below-market wages to dedicate themselves to cause-related nonprofits. This commitment to the organization should be recognized and, wherever possible, acknowledged and rewarded in nonfinancial ways. Exhibit 14.8 demonstrates that pay issues were the single most significant problem faced by most New York City nonprofits. Respondents were asked: "How much of a problem if at all are the following human resource issues for your organization?"

On the negative side, it is also reasonable to assume that some individuals will gravitate toward positions with nonprofits that pay lower wages because they believe the workload and expectations will be lower, commensurate with the pay scales. Thus, an individual's commitment to the organization should be evaluated on a case-by-case basis. It should never be assumed that a willingness to work for lower pay constitutes a high degree of commitment to the organization.

Paying someone below-market wages does not necessarily mean that you will have substandard employees. If wages were the only motivating factor in a person's decision to




*Source:* Jack Krauskopf and Gregg Van Ryzin, *New York City Nonprofit Executive Outlook Survey* (New York: Baruch College, School of Public Affairs Nonprofit Group and Survey Research Unit, Spring 2005). Used by permission.

**Exhibit 14.8** Major Human Resources Issues Faced by NYC Nonprofits

accept or remain in a position, individuals would change jobs much more frequently, as offers for higher pay were offered. In each position, a staff or volunteer also evaluates the intangible rewards:

- Sense of community, relationships with coworkers and friends
- The mission and goals of the organization
- Logistical factors (e.g., proximity from home to workplace)
- Educational or learning opportunities
- Working hours
- Access to other individuals and community (e.g., a museum attracting aspiring artists or a library attracting aspiring writers)
- Feeling of pride and receipt of praise and attention for their efforts
- Flextime
- Telecommuting

Beyond the intangible rewards, individuals also evaluate the tangible rewards that non-profits can offer:

- Benefits (vacation, sick leave, health insurance)
- Discounts or "freebies" (e.g., educational discounts; mentoring opportunities; ability to attend performances, screenings, or presentations at little or no cost)

It is important to remember that each individual has his or her own set of motivators for doing good work:

- Praise
- Recognition
- Promotion of a valued cause or belief system
- Flexibility
- Autonomy

- Criticism
- Consistency
- Personal growth
- Benefits
- Money
- Safety
- Proximity to home or family/children

**(k) WHAT QUALITIES SHOULD LEADERSHIP POSSESS?** Supervisors, managers, and board members must have the qualities, motivators, and skills of all staff and volunteers, as well as concern and connectivity.

***(i) Concern.*** Managers and board members should show concern for the staff and volunteers, donors, community, the integrity of the workplace, and the success and failure of the organization.

***(ii) Connectivity.*** To the infrastructure of the community (global and local), both nontechnological and technological, it is the responsibility of leadership to:

1. Set vision
2. Establish goals and priorities, including financial objectives
3. Motivate and mentor staff, volunteers, donors, and community
4. Establish a personality/culture for the workplace
5. Foster integrity
6. Demonstrate support for ethical standards, rules, laws, fiduciary responsibility, and compliance

## 14.6 DIRECTORS' AND OFFICERS' LIABILITY

A major concern of nonprofit boards is the unprecedented liability exposure faced by their directors and officers. A significant rise in the number of liability suits and in insurance costs has made it increasingly difficult for officers and directors to protect themselves. This situation affects the quality of governance and leadership that nonprofit organizations can attract.[41]

**(a) METHODS BY WHICH BOARDS CAN PROTECT THEMSELVES.** These are the main risk areas boards face:

1. Not exercising due diligence when recruiting/selecting board members
2. Not enforcing term limits (if they exist)
3. Not properly recording board actions/decisions in the board minutes
4. Not giving comprehensive new board member orientations
5. Not requiring or enforcing board member performance expectations (e.g., attending a specific number of meetings over a particular period of time)
6. Not providing board members with the requisite data and background information for informed decisions[42]

It is critical for the nonprofit organization to review its liability coverage for directors and officers and make the required adjustments, if the organization is underprotected. One caution: Insurance companies have very specialized directors and officers ("D&O") policies, so check them carefully to see that they include (1) a requirement to advance defense costs, (2) a broad definition of who is insured (including the organization itself along with any natural person who "was, is or becomes a director, trustee, officer, employee, committee member, or volunteer" in the organization), and (3) broad coverage of employment practices liability (including harassment wrongful termination, and discrimination related to state law and federal laws including Title VII and the Americans with Disabilities Act).[43] Along with obtaining and acting on the liability insurance information, a board can take other actions to protect itself and limit its liability and risk. They include:

1. Ensure board minutes are complete and accurate.
2. Engage paid legal counsel.
3. Expand management information.
4. Review organizational policies.
5. Formulate conflict-of-interest policy.
6. Add and/or recruit new board members to include specific expertise.
7. Form new board committees.
8. Bring in outside experts.
9. Strengthen the finance committee.
10. Strengthen legal expertise.
11. Strengthen insurance expertise.
12. Strengthen audit and accounting expertise.[44]

**(b) CONFLICTS OF INTEREST.** Consider various professionals who may hold membership on your board. A banker who tries to steer the organization's lending to his or her organization, a lawyer who insists that his or her law firm do all the organization's legal work, an insurance agent getting all of the organization's insurance business without any other agency getting to bid, and similar situations all comprise potential conflicts of interest. It is essential to have arm's-length transactions, to have a carefully spelled-out conflict-of-interest policy, and to make sure that any apparent conflicts of interest are approved by the full board with adequate disclosure regarding the precautions taken and reasoning behind the decisions made.

**(c) EXECUTIVE PAY.** Excessive compensation is another hot-button issue to be wary about in your organization. Make sure you find out comparable pay for an ED/CEO in like organizations, and include these data in your board discussions and minutes.[45]

**(d) DUTIES OF CARE, LOYALTY, AND OBEDIENCE.** The three duties that a board should always exercise are care (conducting organizational affairs with competence), loyalty (putting organizational interests above selfish interests), and obedience (adherence to the organization's mission and values in decision making). Prudence, careful decision making, gathering and using facts and data, and paying attention to the organization's financial situation are ways in which these duties are exercised.

## 14.7 SAFEGUARDING YOUR FINANCIAL AND PHYSICAL ASSETS

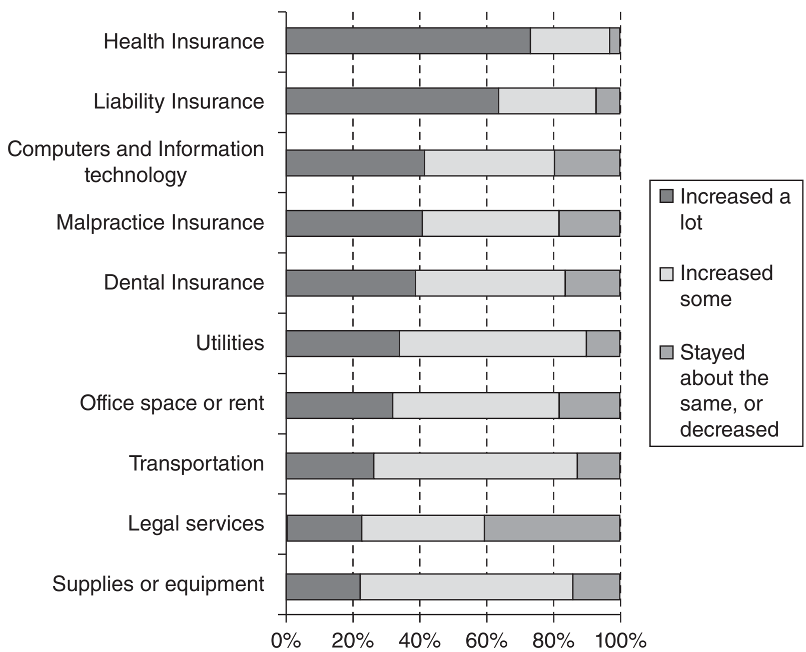
**(a) INSURANCE.** Insurance does not mitigate all risk management issues in your organization. Some of the reasons are:

1. Insurance does not cover every risk.
2. Coverage may be limited.
3. Claims today may raise premiums tomorrow.
4. Claims may be rejected if negligence is discovered by the insurance company.

In recent years, insurance premiums have made insurance less affordable for many nonprofits. The New York City Nonprofit Executive Outlook Survey quoted earlier found that some of the biggest cost increases incurred by nonprofits were in the area of insurance, as noted in Exhibit 14.9.

Risks to an organization can be reduced, but they cannot be eliminated. Fires, floods, thefts, property damage, and earthquakes will occur despite the best efforts of your organization in the area of risk management.

Know what the insurance choices are and why the organization has made them. Exhibit 14.10 presents a checklist of factors to consider when choosing insurance.




*Source:* Jack Krauskopf and Gregg Van Ryzin, *New York City Nonprofit Executive Outlook Survey* (New York: Baruch College, School of Public Affairs Nonprofit Group and Survey Research Unit, Spring 2005). Used by permission.

**EXHIBIT 14.9** FIVE-YEAR PRICE CHANGES EXPERIENCED BY NYC NONPROFITS

**What does the policy cover?**

- ❒ Property or liability risks
- ❒ Risks from all causes
- ❒ Named perils such as earthquake, flood, lightning

**What are you covered for?**

- ❒ Theft by employees and/or others
- ❒ Legal negligence
- ❒ Personal injury
- ❒ Sexual misconduct
- ❒ Negligence of member, employee, or any other person associated with the organization
- ❒ Medical bills
- ❒ Volunteer activities
- ❒ Vehicular-related activities
- ❒ Auto insurance
- ❒ Workers' compensation insurance
- ❒ Inventory

**What do you know about your policy?**

- ❒ Are there exclusions?
- ❒ How much coverage do you carry and based on what? Are these amounts up-to-date?
- ❒ Is actual cost or replacement cost covered?
- ❒ Is replacement cost at 100 percent vs. other percentages?
- ❒ How is depreciation handled?
- ❒ Are the contents or inventory of buildings accurate and up-to-date?
- ❒ Are rare or other especially valuable items covered, such as art or other precious objects?
- ❒ Is your policy contingent upon construction codes in your area? If so, do you comply and have proof of compliance?
- ❒ Do you have a physical inventory, pictures, and other documentation that could be used as proof of loss?

**Exhibit 14.10** Checklist of Factors to Consider When Choosing Insurance

In general, you should know the limitations and exclusions of policies and perform periodic reviews of coverage to verify that they are up-to-date for claims and losses in your region.

Trends for nonprofit liability insurance include: higher limits purchased by some nonprofits ($2 million or more), and coverage for:

1. Punitive damages
2. Defense expenses beyond policy limits
3. Independent contractor claims

4. Third party or leased employee claims
5. Fiduciary duties
6. Employee Retirement Income Security Act of 1974 (ERISA) compliance-related claims
7. Excess benefits claims[46]

Also, consider pooled insurance groups, such as the of Nonprofits Insurance Alliance Group (insurancefornonprofits.org), which at the time of this writing serves over 16,000 nonprofits and operates in 32 states and the District of Columbia.

**(b) RISK RETENTION VERSUS RISK TRANSFER.** Risk retention means just what it says: Your organization either pays a certain portion of each loss or for specific types of losses. This may be done with "funded loss reserves," which are established based on likelihood of future losses. Risk transfer involves either having insurers bear some of the financial results from losses or having other parties absorb losses (as in hold-harmless agreements and indemnification agreements).[47] Your organization must determine to what degree it can retain losses and how it will finance those losses, or transfer the risks it faces. Even if you transfer risk to an insurer, will you purchase as much insurance as you can afford, or merely have catastrophic exposures and losses covered by the policy?

**(c) INTERNAL CONTROLS.** Occupational fraud strikes nonprofits in significant ways: In 2016, there were 52 cases of fraud with a median loss per incident of $82,000 in religious, charitable, or social service organizations, and check tampering, skimming, and expense reimbursement fraud schemes were seen in higher numbers by these organizations.[48] Almost one-half of the nonprofit cases in one year's fraud schemes were billing schemes, which may be largely prevented or caught more quickly by having the proper internal controls. Board responsibility for internal controls in a nutshell includes: "Board members should establish clear policies to protect the organization's financial assets and ensure that the organization has strong internal controls that ensure no one person bears the sole responsibility for receiving, depositing, and spending its funds."[49]

In the broadest sense, internal controls include a large number of systems and business practices combined that, when observed, protect the assets of the organization and thereby reduce the risks associated with loss of resources.

Six important elements of an internal control system are:

1. Setting the tone through leadership (control cues)
2. Communicating the policy
3. Segregating the duties
4. Keeping records
5. Preparing and monitoring budgets
6. Reporting to all stakeholders

Taken together, these policies outline the acceptable boundaries for fiscal decisions, govern the way resources are allocated, provide information for evaluation, and define the processes to be used in carrying out the organization's mission. The annual fraud study conducted by the Association of Certified Fraud Examiners finds: "The most prominent organizational weakness that contributed to the frauds in our study was a lack of internal controls, which was cited in 29.3% of cases, followed by an override of existing internal controls, which contributed to just over 20% of cases."[50] Smaller organizations were "especially vulnerable to check tampering, skimming, payroll, and cash larceny" – these schemes were twice as common in small organizations.[51]

### (d) FUNDRAISING.

***(i) Charitable Solicitations.*** Be careful not to take undue risk when raising money from donors. The Nonprofit Risk Management Center notes five risks:

1. Aggravating a donor by violating his or her privacy
2. Accepting a donation from an individual or organization you don't want associated with your charity, or returning/refusing a donation for the same reason
3. Projecting donations during extreme fluctuations in the economy or stock market
4. Valuing and handling bequests inappropriately
5. Not conducting due diligence on donated property and valuing the benefits and costs of such donations[52]

Also, be aware of each state's charitable solicitations law, as well as all federal regulations.

***(ii) Philosophy and Practice.*** Before delving into the philosophy and practice of fundraising, we note that in general, there are two types of funding:

1. **Unrestricted funds**. These funds may be used at the discretion of the board (or a particular individual within the organization). Unrestricted funds are commonly received as a result of an annual campaign or other general fundraising effort. It is critical for a nonprofit to have a portion of its funding in unrestricted funds. This gives the board the flexibility to direct funds and efforts toward the greatest need.
2. **Restricted funds**. These funds must be used for a specific purpose or project.

Much of restricted funds are received through government contracts or grants, but restricted funds may also be received from donors or foundations.

It is not uncommon for many funding types to fall somewhere between these two definitions. The key managerial requirement is to ensure that all restrictions are honored, whether time restrictions (such as "may not be used until" a certain year) or purpose restrictions. There are also ethical aspects to fundraising, as we noted in our Chapter 5 presentation on ethics. A fundraising philosophy or policy is helpful.[53]

**(e) HOW TO BEGIN THE FINANCIAL ASSESSMENT PROCESS.** Your organization should have an annual financial audit, or if that is not cost-effective, at least a compilation or review (see Chapters 5 and 6). An organization with no history of having an external review of its financial records may want to begin with a compilation and move to a review and audit in the future. If the organization is unable to afford the costs associated with an external review of the entire financial program, it has the option to engage the external examination on important specific parts of the financial statement or program. Examples of specific external examinations to be considered, if a full examination is not possible, are:

1. Review policies and procedures manual for completeness, accuracy, and availability
2. Perform a proof of cash on one, some, or all of the bank accounts of the organization

3. Scan canceled checks and debit entries accompanying the bank statement for any unusual payees or endorsements
4. Confirm contributions made by donors
5. Confirm loan balances with lenders
6. Confirm all payments made during a specific period with some or all vendors
7. Compare annual operating budget to operating expenses, and analyze variances
8. Inquire as to how transactions are processed (e.g., deposits made, bills approved and paid) to ensure proper system of internal controls and detect errors
9. Perform a financial or management review of a specific program
10. Perform an examination to determine the accuracy of inventory
11. Check for control of petty cash funds
12. Check savings accounts for amounts, interest, and conditions
13. Check to determine if designated (restricted) funds are used only for the purpose the board designated (donors contributed, grantors funded)
14. Investigate checks or other debit entries outstanding for more than 30 days
15. Review all bank account reconciliations for timeliness and accuracy
16. Examine payroll records to ensure compliance with government regulations related to payroll, payroll taxes, income taxes, and so on
17. Account for all checks used and all debit entries made to the account
18. If purchasing cards or travel/entertainment cards are issued, review statements promptly and isolate and resolve questionable entries
19. Ensure spending limits are not violated on debit or credit cards

***(i) Due Diligence – Compliance with Policies, Procedures, and Guidelines.*** Documenting your policies and procedures is the first step in managing your risks and establishing a willingness to follow proper business practices. The next step is to verify that, at all times, policies and procedures are being followed.

During an audit of your financial statements, the benchmark used (beyond that of acceptable business practices) is the organization's own policies. Failure to comply with existing organizational rules can cause the most harm.

In the event of a lawsuit or a dispute, the organization's proof of compliance and an opinion by the courts are arbitrators of whether the company showed due diligence with respect to laws, guidelines, regulations, policies, and procedures. To verify that adherence to these documents, a periodic internal review of procedures should be conducted, and the resulting reports or documentation should be presented for review to the board of trustees.

***(ii) Solutions: To Reduce Risk and Stay Out of Court.***

1. Education
    - New resources
2. Training
3. Adequate insurance coverage

4. Loss-prevention programming
   - Videos (including Web-based clips)
   - Books
   - Consultants
5. Conflict resolution
6. Training
7. Arbitration

***(iii) Disaster Preparedness and Business Continuity Planning.*** Is the organization prepared in the event of a disaster? Business continuity planning helps an organization to "develop and document the policies, procedures, activities and protocols necessary to resume essential business operations immediately following a business interruption, no matter the cause."[54] A classic example of such planning is the ability of a charitable foundation that had an office in the World Trade Center to restart operations following the terrorist attacks in 2001.[55] Regardless of whether the organization has liability coverage for such disasters, important documents, records, and other properties need to be protected. While an insurance company may pay for the cost of computers and other office equipment lost in a fire, it cannot restore the data or other vital informational assets lost during the disaster. Liability insurance will not provide the protection from loss of trade secrets, data, contacts, or other business information used by the organization on a day-to-day basis.

To be disaster-prepared, your organization needs to determine which items or information are needed to continue to be a viable operation after the disaster. These items should be replicated, copied, vaulted, or whatever action is necessary to assure that they will be available after a disaster. The manner in which these items and information are protected depends greatly on the type of disaster. The region may have specific types of natural disasters that are not common in other areas. For example, earthquakes are prevalent in the western United States. The aftereffects of earthquakes may include fire as well as access difficulties to the original premises. Offsite backups of items and information are necessary in earthquake regions. In the midwestern United States, floods, fires, and tornadoes are more threatening disasters. Storm shelters and fire- and flood-resistant vault storage are necessary to protect items in these regions (see Exhibit 14.11). Other causes of operation disruption are riots, police action, computer ransomware, virus or worm infestation (see Chapter 13), workplace violence, fire, loss of electrical power, corruption of financial or donor databases, loss of critical funding stream (hence the need for the liquidity reserve), bomb threat, and loss of key staff or executive team members.[56] Put yourself in the shoes of staff, clients, and donors: How would they view your organization if it was closed for several weeks, and they had no way of contacting you or others at the organization?

Your insurance company can be a valuable ally in disaster preparedness. Most insurance companies can provide general guidelines for dealing with and preparing for emergencies in your region.

## 14.8 RISK MANAGEMENT AND HUMAN RESOURCE MANAGEMENT PRACTICES

If your nonprofit is typical, it faces one or more of these common human resource management challenges: relatively small staff size (most nonprofits have six or fewer employees), employee turnover, and volunteer recruitment. These issues make it difficult to manage and conduct programming, and they also contribute to internal control challenges for our organizations.

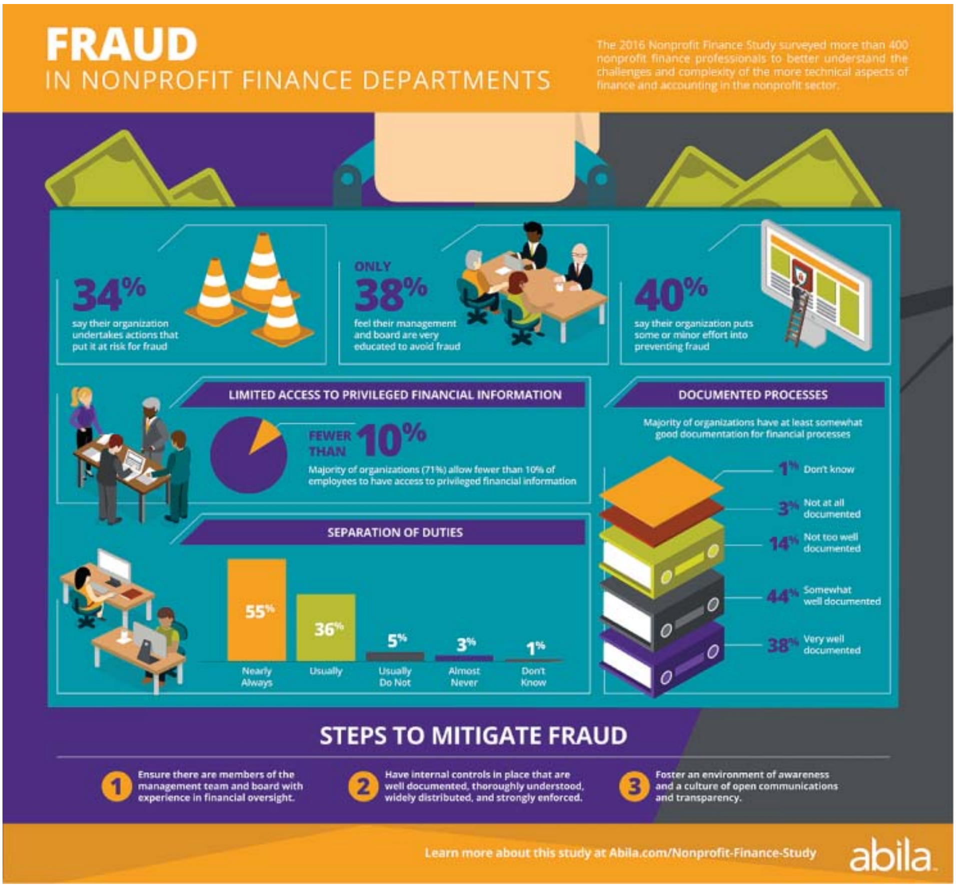
| | |
|---|---|
| Data | In addition to routine periodic backups of computer data to prevent loss from normal occurrences, such as computer shutdowns or power surges, additional copies should be made for off-site backups and/or fire-resistant vault storage. |
| Records, files | Duplicate copies of all important records should be kept in fire-resistant vaults either on the premises and/or in another location. |
| Staff and volunteers | During fire, flood, earthquake, or other disasters that place your workplace at risk, your staff and volunteers should be protected through emergency exit plans and hurricane/tornado/earthquake kits (water, food, etc.). During an actual emergency, the ability to account for all persons on your premises will be vital to assisting emergency workers with locating and rescuing individuals. Team captains or safety officers should be appointed and given responsibility for communicating with emergency workers and assisting them in locating these individuals at the worksite. Provide active shooter preparedness training. |
| Physical inventory | A physical inventory (pictures, lists, bills of lading) that would be used to prove loss in an insurance claim should be duplicated and stored off-site as well as in fire- and flood-protection vaults on the premises. |
| Contact information | During and after a disaster, the ability to contact staff and volunteers should be maintained by assigning specific individuals this responsibility and by maintaining copies of employee and volunteer contact information in their homes and vehicles, so all staff and volunteers can be contacted and/or accounted for after a disaster. |

**Exhibit 14.11** Basic Disaster Preparedness

Abila conducts finance studies each year, and in one of those studies it dialed down to fraud prevalence and vulnerability in nonprofits. The findings are based on a survey of over 400 nonprofit finance professionals. In Exhibit 14.12 we see several fascinating findings regarding internal controls in practice.

1. 46 percent of all survey respondents indicate their organization would not be prepared if a key finance person was to leave the organization.
2. 82 percent of survey respondents say their processes are well documented.
3. Organizations are very aware of issues that lead to fraud, and implement measures that help reduce the likelihood of fraud: Fully 91 percent of organizations nearly always or usually separate financial duties (especially in larger organizations, and finance departments in particular), but concerning is the fact that 5 percent usually do not separate duties, 3 percent almost never separate duties, and 1 percent do not know if financial duties are separated.
4. While 59 percent put "very much effort" into preventing fraud, 35 percent put "some effort," 4 percent put "minor effort," 1 percent put "no real effort," and 1 percent do not know if any effort is put into preventing fraud at their organizations.
5. Not shown in the graphic but of interest to us is why a few organizations "failed an audit": the reasons given were "bad documentation," "ignorance of requirements," and "confusion/mistaken assumptions about requirements."

Perhaps most disconcerting is the prevalence of insider fraud at nonprofits and businesses. Four common mistakes allow "insider fraud," in which current or former employees perpetrate the fraud: no financial oversight, improper reconciliation controls, inadequate




*Source:* Abila, "2016 Nonprofit Finance Study: Compliance, People, and Process Complexities." Used by permission.

**EXHIBIT 14.12** FRAUD IN NONPROFIT FINANCE DEPARTMENTS

bank account management protocols, and easily obtained passwords. Insider fraud may account for one-third of the fraud committed against organizations. Too much power is given to the treasurer or financial officer, allowing this individual to siphon your organization's funds to his or her personal accounts and then forge or falsify documents to avoid detection. Four proactive measures have been found to help reduce the amount of insider fraud:[57]

1. **Begin or enhance financial oversight**. Do not allow one person to initiative, approve, reconcile, or cancel payment-related activity. Have one employee initiate a payment and another employee approve it.
2. **Implement proper reconciliation controls**. Avoid manual reconciliation processing, purchase reconciliation software if possible, have a third party reconcile accounts if possible (verifying transaction amounts and destinations), and avoid partial reconciliation of accounts or too-infrequent reconciliation of accounts (one

school district waited 12 years to reconcile some its accounts, and lost $19 million in a multiyear fraud).

3. **Improve bank account management protocols**. Especially for larger organizations that have multiple accounts and multiple signers, it is essential that the bank account management system be immediately updated when a signer leaves the organization (fraudsters such as someone currently working in your treasury area may use credentials of your former employees to wire transfer funds – and the fraudster could be the only one responsible for updating the system).
4. **Make sure passwords are not easily obtained**. Fraudsters can often access the authorized employees' passwords when they are in a file cabinet, under a PC keyboard, or in a notebook on their desk; there may be a nearby, easily found USB or key fob that is used to access the payment system. Instead, have the authorized employees store these in their phones or in a locked file cabinet.

In the faith-based sector, ECFA's Nonprofit Financial Management Survey provides the following evidence on internal controls and its effectiveness:[58]

1. Over 60 percent of the organizations formally review fraud prevention procedures and checklists at least annually.
2. Almost 80 percent of the respondents have a written whistleblower policy.
3. CFOs rated their effectiveness the highest on financial reports (4.24) and internal controls (4.23), on a scale of 1 to 5 (5 being the highest).

We have given much attention in this chapter to ERM; how are nonprofits faring in implementing this comprehensive approach to risk management, which goes well beyond internal controls? So far, the evidence is not favorable to nonprofits. Survey evidence finds that only 13 percent of nonprofits have complete, formal enterprise-wide risk management processes in place, compared to 52 percent of businesses. Furthermore, 24 percent have no enterprise-wide risk management in place, as compared to only 6 percent of businesses.[59]

What about nonprofit management of directors and officers (D&O) liability? Almost 70 percent of surveyed nonprofits do not purchase D&O liability insurance coverage and more than 40 percent did not know that directors' and officers' personal assets could be at risk if their nonprofit was sued.[60] Another survey indicated that 63 percent of nonprofits reported a D&O claim in the past 10 years, indicating this is a significant risk to consider.[61] The various sources of litigation include breach of duty, misuse of funds, waste of the organization's assets, failure to adhere to and carry out a nonprofit's mission, wrongful employment actions, infringement of trademark or copyright, personal injury, or contract breach.[62]

Insurance purchases are also an area to consider. Survey evidence from Crystal & Company gives a positive finding that most nonprofits having at least $20 million in revenues do consider the potential risks to their organizations and purchase insurance.[63] About 80 percent of nonprofits had procured an independent assessment of their organization's risk and insurance program at least once in the most recent three years, 36 percent had done so within the past year, and nearly 7 percent had never done an independent assessment.[64] Crystal & Company recommends that nonprofits move beyond buying insurance and implement a "more holistic approach that integrates risk management into an organization's daily operations."[65] The survey found that the top three risk management priorities were (1) "identifying and assessing current and future threats to the organization's assets," (2) "reducing insurance premiums," and (3) "business continuity planning." The top three hazards these nonprofits identified were (1) "employment-related risks, including workplace injuries," (2) "acts, errors or omissions in governance and management," and (3) "acts, errors, or omissions in rendering professional services."[66] Crystal & Company notes that corporate risk and insurance oversight/responsibility is assigned to the finance area in most nonprofits, but this area may not have formal risk management experience (or training, we might add).[67]

Finally, based on its research, the Nonprofit Risk Management Center suggests that an effective risk management plan follows these six best practices:

1. Reflects a wide range of views and perspectives in an organization
2. Expresses the nonprofit's belief in and support of risk management
3. States that personnel at all levels of the organization play a vital role in protecting the nonprofit's mission, reputation, and assets
4. Incorporates the existing risk management policies of the organization
5. Reflects the nonprofit's goals and aspirations for its risk management efforts
6. Focuses on priority risks and considers secondary risks[68]

## Notes

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30. For information on the annual return and unrelated business income tax, see https://www.irs.gov/charities-non-profits/exempt-organizations-required-filings. According to Zachary S. Kester and Kylie Schreiber, of Charitable Allies, " … business activities not subject to UBIT include: Passive income, such as dividend and interest income, royalties and rents from real estate property; Any activity in which 85 percent or more of the work is performed by unpaid volunteers is exempt from UBIT, such as a thrift store; and Sales of donated items. Some " … common sources of taxable income include: Sales from advertisements in a newsletter or on a website; Rental income from debt-financed property (i.e. renting out property acquired from a loan for big events like weddings or fundraising concerts for a discounted fee); Investments like hedge funds and private equity funds that function as partnerships (unless a blocker corporation is used); and Fees earned for providing administrative or clerical services to another organization. Considering use of a for-profit subsidiary "blocker corporation" is mentioned by this same advisor. This is not to be construed as legal advice, and you should check with your legal counsel before considering set-up of a blocker corporation. Source: http://charitableadvisors.com/blocker-corporation-avoiding-ubit-for-nonprofit-business-activities/. Accessed: 8/1/17.
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APPENDIX **14A**

# DERIVATIVES CHECKLIST

A derivative is an investment or other financial instrument whose value is dependent on, or derived from, another asset. It is a risk transfer tool. For example, you may protect against an adverse movement in a foreign currency by purchasing a forward contract, futures contract, or an option on that currency. Formally, a financial derivative is:

> … a financial instrument that changes in value in response to an underlying share, interest rate etc. and creates the rights and obligations that usually have the effect of transferring between parties to the instrument one or more of the financial risks inherent in an underlying. For example, a share option allows the holder the option to benefit if the share price of the underlying share increases above the option's strike price, and places an obligation on the issuer of the option to supply the shares at the strike price, if the holder exercises the option. A key characteristic of derivatives is that they require little or no initial net investment and will be settled at a future date. Common examples are options, forwards and interest rate swaps.[1]

Major types of derivatives are options, forwards, futures, and swaps. Although only a modest number of nonprofits outside the healthcare sector have used derivatives as part of their financial management processes – mostly swaps to lower or reduce the variability of interest expense – a number of endowments and foundations have lost money in investment derivatives such as collateralized mortgage obligations (CMOs). The infamous 1994 debacle that bankrupted Orange County, California, also related to derivatives-based investment instruments. Some nonprofits have been charged too much for bond-related derivatives, as well:[2]

> Rather than establishing honest and fair contract terms for the municipal derivative sales, certain Natixis and Societe Generale employees and their counterparts at other institutions rigged bids, submitted noncompetitive courtesy bids and fraudulent certificates of arms-length bidding to government agencies. The misconduct led local and state governments, as well as nonprofits, to enter into municipal derivatives contracts on less advantageous terms than they would have otherwise.

In this appendix a checklist of evaluation factors is provided to guide your organization regarding the use of derivatives.

## WHY DERIVATIVES?

The use of derivatives can actually reduce the riskiness of an organization's cash flows, although the main cases that get into the newspaper are those in which a speculative position was taken (mostly bets on the direction of interest rates or the value of a stock index or of a currency) and the value of the underlying asset (bonds, stock index, currency, respectively) resulted in a large loss to the derivative user. When an organization uses derivatives to reduce risk, it is said to be *hedging*. Organizations such as Orange County were not using derivatives to reduce risk, but to take on additional risks.

Formally, hedging is defined as protecting an existing business position by counterbalancing the position with an exactly offsetting position. The existing business position may be a foreign exchange exposure, meaning the organization's cash flows will be less if a specific currency depreciates or appreciates vis-à-vis the dollar. Or, it may be interest rate risk, meaning the organization's cash flows will be less if interest rates increase or decrease.

For example, one Colorado-based charity had to lay off 20 percent of its headquarters staff because short-term interest rates declined, reducing the cash flow from its investment reserves that it had been depending on earning to pay this portion of its overhead expense.

Two possible hedging positions your organization may wish to consider are the use of interest rate futures or forward contracts and exchange rate futures or forward contracts. A forward contract is "an agreement reached at one point in time calling for the delivery of some commodity at a specified later date at a price established at the time of contracting," whereas a futures contract is "a forward contract traded on an organized exchange with contract terms clearly specified by the rules of the exchange."[3]

The futures of most value to your organization are financial futures, which are based upon underlying financial instruments. Foreign currency futures allow for delivery of a specified amount of foreign currency, at an agreed-upon future date, in return for a specified payment of US dollars. The underlying financial instrument for an interest rate future is a debt instrument such as a Treasury bill or Treasury bond. Correspondingly, the contract is fulfilled by delivering the specified dollar amount of T-bills or T-bonds. With stock index futures, there is no delivery of underlying assets at the contract's expiration, but rather a cash payment linked to the change in the underlying stock index (such as the Standard & Poor's 500 index).

## FORWARDS VERSUS FUTURES

Although very similar, forwards differ from futures in three main ways:

1. **Advantage.** Forward contracts may be customized as to dollar amount and maturity.
2. **Disadvantage.** Forward contracts are not traded on exchanges, and finding a trading partner ("counterparty") wishing to take the exact opposite position to that you wish to hedge may be very difficult.
3. **Disadvantage.** Forward contracts are difficult to reverse, meaning that if your organization wishes to end its hedge before the agreed-upon date, it may be costly or impossible to reach agreement with the trading partner.

Based on these considerations, your organization may be more or less inclined to use forward versus future contracts.

## GUIDELINES FOR DERIVATIVES USE: A CHECKLIST

The following are some of the considerations to be addressed to guide the use of derivatives:[4]

1. Determine at the highest level of policy and decision making the scope of the unit's involvement in derivatives activities and policies to be applied.

**2.** Value derivatives at market, at least for risk management purposes.

**3.** Quantify its market risk under adverse market conditions against limits, perform stress simulations, and forecast cash investing and funding needs.

**4.** Assess the credit risk arising from derivatives activities based on frequent measures of current and potential exposure against credit limits.

**5.** Reduce credit risk by broadening the use of multiproduct master agreements with closeout netting provisions, and by working with other participants to ensure legal enforceability of derivatives transactions within and across jurisdictions.

**6.** Establish market and credit risk management functions with clear authority, independent of the dealing function.

**7.** Voluntarily adopt accounting and disclosure practices for international harmonization and greater transparency, pending the arrival of international standards.

**8.** Have clearly defined policies dealing with interest rate risk and foreign exchange risk, including:

- ○ Clear policy objectives
- ○ Board approval of the policy
- ○ Specified reporting requirements, such as nature and frequency of reports to the board
- ○ Defined exposure definitions
- ○ Limits to exposure
- ○ Specified authority for who may make trades, including annual letters to the banks identifying these individuals
- ○ Segregation of duties, so that traders do not handle the accounting or funds transfers
- ○ Credit limits on counterparties (those with whom the derivatives contracts are made)

**9.** Before entering into derivatives usage, the organization should have an organizational risk management plan meeting three criteria:

**a.** Does it demonstrate to top management that the use of derivatives can produce a reduction in the variability (volatility) of the organization's financial results (as evidenced through the Statement of Activities, Statement of Cash Flows, and/or Statement of Financial Position)?

**b.** Does it include quantitative measures of both the forecast profitability (financial advantage of using the derivative) and risk associated (what is the possible loss to the organization of using the derivative, if any) with derivatives-enhanced activities?

**c.** Are the actual results of derivatives activities identifiable and verifiable by accounting (and internal auditors, if the organization has them) independently of input from the trader? Systems or guidelines should be in place to prevent the trader from making his position look better than it really is.

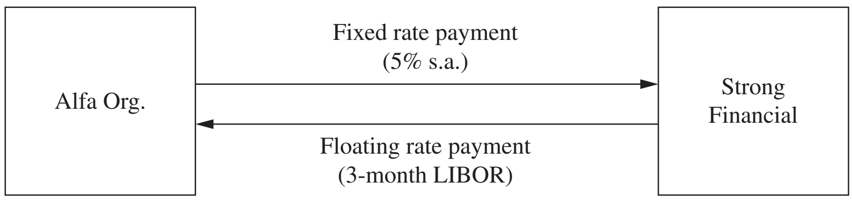
Applying the second and third criteria, an example would be a "synthetic refunding" in which a nonprofit that is unable to refinance debt instead uses a "forward swap" along with a new issue of floating-rate "current-period refunding bonds" that in combination results in a fixed-rate refunding at current lower interest rates.[5]

A few final comments will provide some added guidance. First, not only should the direct user ("trader") of the derivatives be knowledgeable and competent, but your board and senior management should have some background in derivatives. Including in-house accounting, audit, and legal personnel in your organization's derivatives training is essential. Additionally, make sure that the most suitable instrument is used. Many times there are multiple instruments for a particular situation: forward and futures contracts, options, and swaps may be eligible. The swap (exchange of cash flows linked to the movement of interest rates, for example; see Exhibit 14A.1 below) has counterparty risk (risk of nonperformance, perhaps due to financial difficulties, of the opposite party) that is nonexistent with futures or options. These types of considerations are important in determining suitability. Finally, get more than one opinion. If one bank tells you their approach is foolproof, check with

**Terms**

Fixed rate payer: Alfa Organization
Fixed rate: 5 percent, semiannual
Floating rate payer: Strong Financial Corp
Floating rate: 3-month USD LIBOR
Notional amount: US$ 100 million
Maturity: 5 years

*A fixed-for-floating interest rate swap is often referred to as a "plain vanilla" swap because it is the most commonly encountered structure*




- Alfa Org. agrees to pay 5.0 percent of $100 million on a semiannual basis to Strong Financial for the next five years.
    - That is, Alfa will pay 2.5 percent of $100 million, or $2.5 million, twice a year.
- Strong Financial agrees to pay 3-month LIBOR (as a percent of the notional amount) on a quarterly basis to Alfa Org. for the next five years.
    - That is, Strong will pay the 3-month LIBOR rate, divided by four and multiplied by the notional amount, four times per year.
        - ▹ Example: If 3-month LIBOR is 2.4% on a reset date, Strong will be obligated to pay 2.4%/4 = 0.6% of the notional amount, or $600,000.
    - Typically, the first floating rate payment is determined on the trade date.
- In practice, the above fractions used to determine payment obligations could differ according to the actual number of days in a period.
    - Example: If there are 91 days in the relevant quarter and market convention is to use a 360-day year, the floating rate payment obligation in the above example will be (91/360) × 2.4% × $100,000,000 = $606,666.67.

*Source:* Copyright © 2004 International Swaps and Derivatives Association, Inc. Available at: http://www.isda.org/educat/pdf/irs-diagram1.pdf. Accessed: 8/4/2017. Adapted and used by permission.

**Exhibit 14A.1** Interest Rate Swap Example another bank. Shopping around for a better deal is sometimes also prudent, all other things being equal. Having a long-standing relationship with a bank that also has a swap business may lead to the appearance or reality of being charged too much for a swap or a higher interest rate on debt linked to a swap that exchanges floating (or variable) interest rates into a fixed rate.[6]

Bear in mind that few people understand deeply how these derivatives operate, and many of the models upon which the expected performance of these derivatives were based have failed in practice to anticipate real-world market performance. Caution is advisable in the use of any derivative, and your organization will likely limit its use to hedging known risks.

Survey evidence indicates that a small minority of nonprofits use interest rate derivatives – primarily interest rate swaps and caps – to limit their interest rate volatility and interest rate expense. An older study indicates that nonprofit healthcare providers were able to generate an additional 1–2 percent of their operating cash flows through use of these risk management instruments, indicating a prudent and successful use of derivatives.[7]

## Notes

1. KPMG, The KPMG Guide: FRS 139, Financial Instruments: Recognition and Measurement, (2005): 4. Available at https://assets.kpmg.com/content/dam/kpmg/pdf/2016/03/frs139-guide.pdf. Accessed: 1/29/2018.
2. New York Attorney General's Office, "A.G. Schneiderman Announces Settlements with Natixis and Societe Generale Totalling Over $56 Million for Defrauding Governments and Nonprofits Across the Country," February 24, 2016. Available online at: https://ag.ny.gov/press-release/ag-schneiderman-announces-settlements-natixis-and-societe-generale-totalling-over-56. Accessed: 8/4/2017.
3. Robert W. Kolb and James A. Overdahl, eds., *Financial Derivatives: Pricing and Risk Management* (Hoboken, NJ: Wiley, 2010). The most readable textbook on this complex topic in our view is John C. Hull, *Fundamentals of Futures and Options Markets*, 9th ed. (Boston: Pearson, 2017). A glossary to help with the derivatives jargon is available at http://www.isda.org/c_and_a/oper_commit-dcg-glossary.html.
4. The first seven guidelines are quoted from The Group of Thirty (G30) Global Derivatives Study Group, *Derivatives: Practices and Principles* (1993). The eighth is from Greenwich Treasury Advisors, and found in Jeffrey Wallace, "Controlling Derivatives Activities," *TMA Journal* (September/October 1994). The final listing is from James Kurt Dew and Neil Murphy, "Managing the Use of Derivatives," *TMA Journal* (March/April 1997): 57.
5. For the specifics of this and how the financial results may be documented at the beginning of the swap agreement, see Eric Jordahl and Kevin T. Pantan, "Synthetic Refunding: A Financial Tool for a Lower Interest-Rate Environment," *Healthcare Financial Management* (May 2003): 102–104.
6. Audrey Williams June, "University Accuses 2 Banks of Overcharging It on Investment, *Chronicle of Higher Education*, August 2, 2007. Available online at: http://www.chronicle.com/article/University-Accuses-2-Banks-of/39330. Accessed: 8/4/2017. Biola University later filed another case against only Bank of America. According to this article, "In 2002 Biola sold $59.6-million of variable-rate bonds and then bought derivatives from BNP Paribas — at the advice of its longtime bank, Bank of America, the university said. In exchange for floating-rate payments through 2032, the university agreed to pay 5.34 percent on $24.6 million of the bonds and 5.1 percent on $35 million of the bonds, Bloomberg said. The lawsuit says the fixed rates the university agreed to were excessive. Biola also said in the lawsuit that in 2004 it was overcharged for two swaps that totaled $24.6 million, one provided by each bank. The university wants $25 million or more in compensatory and punitive damages, Bloomberg reported."
7. Louis J. Stewart and Vincent Owhoso, "Derivative Financial Instruments and Nonprofit Health Care Providers," *Journal of Health Care Finance* 31 (Winter 2004): 38–52.

APPENDIX **14B**

# CASE STUDY OF ASSOCIATION'S FOREIGN EXCHANGE RISK MANAGEMENT

# GLOBAL EXCHANGE


FINANCE

## The Ins and Outs of Operating in Euros

When the International Society for Pharmaceutical Engineering, Tampa, first entered the European market in the early 1990s, we made a concerted effort to appear international rather than American. One of the key features of this policy was to allow members to pay dues and other fees in their own currency. The result was bank accounts in eight currencies, a horrendously complicated billing system, and useless accounting software. The next stage was to accept membership dues only in the currency of the country where our European office is located and conference fees only in the currency of the host country. We were able to simplify the issue even further with the advent of the euro, which allowed us to deal with only one currency—even though we still do events in Switzerland and the United Kingdom (both of which still use their own currencies).

### The pros and cons

Without question, going with the euro has its benefits. Most obvious, it looks European and is user-friendly for our European members. It also eliminates or reduces wire charges for Europeans, thereby making our dues less expensive for them. Finally, by operating in euros, we can pay for services without having to worry about the exchange rate on the day we pay the bills.

Operating in euros is not without challenges, however. European banks are expensive and not easy to deal with. We are currently enjoying the best success we have had because we have someone in our association management company in Europe reconciling our account almost daily. While it's a nice problem to have, we end up with a number of payments (dues, registration fees, publication payments, and so on) for which we have no idea who should receive credit, since Europeans wire payments into banks without a lot of backup information.

### The conversion choice

One issue that the euro does not eliminate is how to figure currency gains and losses into dues setting and product and service pricing. One option is to set a value that changes regularly—anywhere from daily to weekly to annually—which allows you to reduce your losses from currency fluctuations. We take this route for publications, changing their value annually because they are all printed in and shipped from the United States. On the downside, when you choose this option, dues and prices are constantly increasing or decreasing for European members. (For us, it's been mainly an increase the past few years.)

The other option is to set values that change infrequently. We use this approach with our dues, adjusting them only when we increase our U.S. dues. Euros that we receive from members partially fund operations in Europe; this somewhat levels the effect of currency fluctuations—although we still end up with a sizeable balance of euros that need to be converted because we pay for some of the European membership services in dollars rather than euros. While adjusting U.S. and European dues simultaneously gives equal treatment to all members, the natural downside is that we have had to accept the fact that in terms of U.S. dollars, some of our members are paying below market rate.

*Submitted by Susan Humphreys Klein, executive vice president and chief financial officer, International Society for Pharmaceutical Engineering, Tampa. E-mail: SKlein@ispe.org*

April 2002

*Source:* Susan Humphreys Klein, "The Ins and Outs of Operating in Euros," *Association Management* (April 2002): 73. Used by permission.

CHAPTER 15

# EVALUATING YOUR POLICIES AND PROGRESS



## 15.1 INTRODUCTION

We have presented a variety of information in this book to assist you as the nonprofit financial manager or as a board member in being more effective in your position. Much of the information presented has been tangible: steps, actions, knowledge – facts that a financial manager can apply to produce positive results in an organization.

Some might say that the annual balance sheet, statement of activities, or statement of cash flows constitute the "final exam" for the effectiveness of the financial manager. While any of these or annual shareholder returns may be valid and appropriate measurement instruments in a for-profit organization, none is the end-all in a nonprofit organization. As we have emphasized throughout, liquidity target management and cash flow management are the primary *financial* metrics. You would not want to assess the overall *program* effectiveness or efficiency with these *financial* metrics. Program evaluation, while a critically important task, is beyond the scope of this book.[1]

The overarching measure of success for a nonprofit organization is how well it is able to deliver on its mission. The reviews do not come primarily from the financial statements, but



*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

from a combination of elements, most importantly from the vantage point of the nonprofit's customers and constituents.

In the simplest terms, if your organization was able to deliver on its goals and objectives for the year — perhaps as guided by the strategic plan (Chapter 3) and/or your organization's balanced scorecard (also in Chapter 3) and end the year flush and achieving the liquidity target, a basic level of success has been achieved. The next step is to evaluate how the actions taken this year will affect your organization's ability to perform in subsequent years.

Throughout this book we have presented and examined:

- How to manage your day-to-day operations
- How to achieve short- and long-term financial objectives
- How to establish policies and procedures to streamline the organization
- The unique requirements of the nonprofit's funding sources
- How technology can be best applied in the organization
- How to effect and manage positive external relationships
- Ways to limit liabilities and protect and increase resources

To evaluate the effectiveness of the financial manager in a nonprofit organization, we need to evaluate two very different categories:

**1.** Tangible results
   - Target liquidity
   - Adequate funding
   - Expense control
   - Revenue balance
   - Net asset balances
   - Interest income
   - Resources inventory
   - Assets and so on

**2.** Intangible results
   - Risk taking
   - Working environment
   - Flexibility/adaptability
   - Ethics/integrity

To evaluate the tangible results, a review of the financial well-being of the organization can be performed by reviewing the financial reports (Chapter 6) and calculating appropriate target liquidity and other financial ratios (Chapter 7). In this chapter, we present a checklist of financial health to supplement those indicators.

We subscribe to the view that the CFO is the organization's "chief accountability officer" as well. This implies the CFO might take the following steps to foster a shared accountability toward building and maintaining the organization's financial health:

**1.** Frame *communications* in terms of your organization's mission, as connection with the mission strongly motivates your organization's leaders – showing how proactively managing variances allows more money to go to mission-related activities, otherwise (absent additional fundraising or depleting target liquidity) overspending in one area forces underspending in other areas.

2. Build a *culture* that lends to collaboration and risk-taking, showing how a lack of necessary information leads to underfunding mission-central activities and overfunding less central activities.
3. Guide leaders with appropriate *procedures* and *systems* and well-defined *roles*, as you develop financial systems, policies, and procedures (along with others in the leadership team), define staff roles in finance-related activities, and spot opportunities for interdepartmental communication.
4. Work with the board to *develop financial goals*, including the appropriate level for target liquidity, and *analyze strategic alternatives*, including helping the board or a committee of the board ascertain the financial implications of various strategic priorities, setting the priorities, and then translating the priorities into financial benchmarks.[2]

The interaction with nonfinancial leaders and staff as well as board members that will come with carrying out these four steps will build trust and help foster shared accountability for your organization's financial performance.

As someone involved in managing financial resources, you have taken every care in monitoring the day-to-day activities of your organization. The previous chapters of this book have provided information to assist you in doing your job effectively and measuring the success of that performance. How do you know if you have done a good job? How do you know if your organization is doing well? Here we present tools for evaluating the less tangible skills and characteristics that a financial manager brings to a nonprofit organization. Then we profile some guidelines for assessing policies in the critical areas of governance and accountability, liquidity management and your primary financial objective, investments, fundraising, risk management, and human resources.

## 15.2 EVALUATION

Effective, proficient financial management requires that you are in a constant state of review, remaining fluid in your procedures and priorities and making changes and corrections where needed. These areas for self-review may be used to begin evaluating your own performance as well as the performance of your organization.

- Were your decisions appropriate?
- Have you communicated effectively with others in the organization?
- Are the staff and volunteers performing optimally?
- Your organization may have met payroll and paid expenses, but what is the financial health of your organization in relation to accomplishing its mission and goals?

## 15.3 EVALUATING YOUR DECISIONS AND ETHICS

"Hindsight is 20/20" is a phrase we are all familiar with in evaluating anything that we have done in the past. Certainly there will be new information available that would have had a bearing on a decision you have made. Those considerations are not necessary in

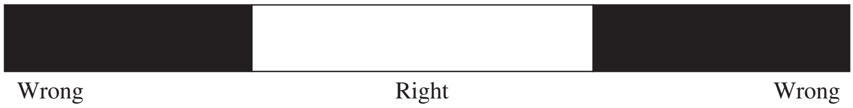



**EXHIBIT 15.1** DECISION CORRECTNESS SCALE

evaluating the effectiveness of your decisions. You cannot foresee all external shocks or dramatic changes, but you can factor in recurring changes in market activity and seasonal changes, and prepare for potential disasters.

Determining whether you made the *right* decision requires an understanding of what *right* is. Often, we confuse the term as meaning either "yes, the decision was correct" or "no, it was wrong," but there is a range of correctness and appropriateness in almost every decision (see Exhibit 15.1). A *risk* continuum might characterize your decision. For example, you could be wrong either because you did not take enough risk (left anchor) or took too much risk (right anchor). Or a *frequency* continuum may best fit your decision context. We see some organizations that do too few direct-mail appeals per year, others that do too many direct-mail appeals. "Degree of *cost coverage*" when setting dues, contract fees, tuition/prices, or premiums, serves as a third example of range or appropriateness. Illustrating, did your organization agree to a lower total cost amount for certain items in order to win a foundation grant?

Within the range of correctness, you can self-evaluate your decisions using these criteria:

- Did the decision stand the test of time?
- Would you make the same decision today?
- What factors, if any, would you have weighted more heavily now than you did then?
- Would you have sought the advice of the same individuals?
- Were reference materials, literature, or any other information available that you did not review but would review now?
- Were there signals, clues, indicators, benchmarks, reports, or advice that you ignored or would have considered more heavily?

We provide additional guidance for your decision-making self-evaluation in Exhibit 15.2.

Evaluating your ethics, and the influence of your ethics on the organization, is more difficult. Your conscience is a guide, but not always a trustworthy one – we all have blind spots, and are capable of being self-deceived. Consider these "everyday lies" identified by Erline Belton, the CEO of the Lyceum Group in Boston:

1. Exaggerating or underplaying the truth
2. Shading the truth – possibly to protect one's self, team, or teammate, or to support one's point
3. Beating around the bush or throwing up a smoke screen – usually a delay tactic, possibly by withholding an opinion or not telling a person where they really stand with you, or you don't say no directly even though that is what you mean
4. Pretending certainty or expertise – which sets your colleagues up for surprises later when things don't pan out as expected

The charts and questions that follow allow you to evaluate your decision-making abilities. Before beginning the evaluation, reflect over your decisions of the last several months. Determine which five decisions you plan to evaluate:

1. ____________________
2. ____________________
3. ____________________
4. ____________________
5. ____________________

For each of the questions below (A–E), consider each of the five decisions you just listed and determine which score most accurately applies in that specific case.

As you answer all the questions below, do not consider new information that was not available at the time you made the decision, unless it was information which you either neglected to consider or chose to ignore.

**A.** Would you come to the same conclusion today and make the same decision?

| Decision | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**B.** With each decision made, there are generally facts and information that conflict. At the time you evaluated those inconsistencies and ruled out specific information. Would you rule out the same information today?

| Decision | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**C.** You sought the advice of others and considered their advice or opinion when making your decision. This information may have been gathered over time and not specifically at the time you made the decision. You either rejected this individual's advice or used their opinion as a major justification for the decision. Would you come to the same conclusions today?

**Exhibit 15.2** Decision-Making Evaluation

| Decision | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**D.** You may have reviewed reports, evaluated literature, or done other types of research when you made your decision. Would you use that same information today as a justification for your decision or weight it as heavily?

| Decision | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**E.** Decisions often have long-term consequences for your organization. A decision that was appropriate in the short term may become detrimental in the long term. When making decisions, you need to consider both the short- and long-term impacts. Considering how this decision has impacted your organization in both the short and long term, would you make the same decision today?

| Decision | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**EXHIBIT 15.2** DECISION-MAKING EVALUATION (*continued*)

**TOTALING YOUR SCORE:**

Copy the scores from each of the above questions into the table below; then, total your score for each question and for each decision:

| Decision | Question A | Question B | Question C | Question D | Question E | Total Score | Average (Total/5) |
|---|---|---|---|---|---|---|---|
| 1. | | | | | | | |
| 2. | | | | | | | |
| 3. | | | | | | | |
| 4. | | | | | | | |
| 5. | | | | | | | |
| Total: | | | | | | | |

**REVIEWING YOUR SCORES:**

For each question and for each decision, there is a maximum total score of 25 and a lowest possible score of 5.

- A score of 25 indicates that you have exceptional decision-making abilities.
- A score of 20–25 indicates that your decision-making skills are very good.
- A score of 15–20 indicates that your decision-making skills are fair but could use some improvement.
- A score of 10–15 indicates that your decision-making skills are in need of improvement.
- A score of 5–10 indicates that your decision-making skills were poor in this particular set of instances.

**GENERAL INDICATORS:**

- If there is a significant difference between the totals in the score column for each decision, it may indicate that you are inconsistent in the effectiveness of your decision making. It may also indicate that you are sometimes forced to make decisions without having the time to appropriately consider or weigh the information to make an effective decision.
- For each of the questions, if there is a low or high score in a particular area, consider what was unique in that instance that caused you to make an inappropriate decision; conversely, in areas where you made a good decision, consider what was unique about that particular situation.

**FOR THE FUTURE:**

When making decisions in the future, you can refer to the following checklist before making your final decision:

❒ I have weighed conflicting information, based on my experience and the integrity of the information in the past, and have chosen to ignore specific information for legitimate and appropriate reasons. Or, I have chosen to weight heavily specific pieces of information.

❒ I have considered the opinions of others and, based on my experience of the soundness of their advice, I am either ignoring their advice or factoring it highly in making this decision.

**Exhibit 15.2** Decision-Making Evaluation (*continued*)

- ❒ I have reviewed all materials that may impact this decision. I have either chosen to follow the advice gleaned from these materials or, based on my experiences in the past, chosen to disregard this advice.
- ❒ I have considered both the short-term and long-term impacts of this decision after carefully weighing the risks and benefits.
- ❒ I have taken the time to carefully consider all the information available to me and am not making this decision in haste without properly evaluating the appropriateness or legitimacy of this decision.

**Exhibit 15.2** Decision-Making Evaluation (*continued*)

5. Not letting others know your true position – especially when there is controversy or ambiguity
6. Consciously withholding relevant information – typically as a power play, and as a form of manipulation of those who should get the information
7. Perceptions of powerlessness – when teams have strong leaders people may feel they do not have a legitimate voice, and may withhold valuable information
8. Perceptions of invulnerability – when successes come easily or consistently, carelessness and information distortion may also come
9. Misplaced loyalty or dysfunctional rescuing – especially when there are long-standing relationships
10. Failing to give due credit – and so engaging in self-promotion
11. Deluding yourself, or self-deception – probably the most common source of everyday lies[3]

The importance of ethics, especially integrity, in the finance function cannot be overemphasized; in fact, a 2004 *CFO* magazine survey disclosed that the number-one personal attribute business chief financial officers (CFOs) look for in hiring entry-level finance recruits is ethics – above communications skills, computer skills, interpersonal skills, or decision-making ability.

One instrument that you may use to self-evaluate your ethics is the "Moral Competency Inventory," or MCI. The four key aspects that are scored are integrity, responsibility, compassion, and forgiveness. After self-scoring your personal ethics using this set of questions (available from Doug Lennick and Fred Kiel, and contained in their book *Moral Intelligence 2.0: Enhancing Business Performance and Leadership Success in Turbulent Times*), you may consult with others who know you well to see if they agree with your self-appraisal.

This inventory and its scoring grid interpretations are available from Wharton School Publishing.[4] Two cautions as you use it:

1. It can easily be "gamed" by someone wanting to get a good score. Do not use it for evaluating others or for comparing scores among people.
2. Take seriously the aspect of getting a reality check from others, probably from those outside your organization, to see whether their perceptions mesh with the scored results.

For more on managing ethics and devising ethics policies, refer to Chapter 4.

## 15.4 EVALUATING YOUR COMMUNICATIONS

Communicating the problems, goals, status, and issues to your management team and staff is one of your main responsibilities. As discussed earlier, we make decisions based on the information available to us. The leaders in your organization base their decisions on the financial information you are providing to them. As one of the individuals responsible for financial management, you have special skills and abilities that allow you to understand the intricate details and nuances of the finances in your organization; others do not. One of your major responsibilities is communicating to others in a manner that matches their ability to understand the financial implications of their decisions (Exhibit 15.3).

Before beginning the evaluation, reflect on your communications over the last several months. These will include meetings, correspondence or memos, e-mail, text messages, instant messenger, and impromptu and telephone conversations.

Choose five instances to evaluate that provide a general sampling of your communications over the last several months:

**1.** ____________________
**2.** ____________________
**3.** ____________________
**4.** ____________________
**5.** ____________________

An effective communication interchange requires that the individuals involved have a willingness to communicate effectively, openly, and honestly. There may be individuals who do not meet these criteria. At any particular time, there also may be other factors that make a meaningful exchange difficult (such as if the person you are speaking to is ill or under considerable personal or work stress at that time). Unless you were insensitive to an individual's specific problems or situation, do not factor these situations in your answers.

**A.** Were you respectful and thoughtful in your communication?

| Interchange | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:** ____________________

**B.** How an individual ranks in your organization may determine the amount of detail or summary you provide. Often, upper management does not require communications with elaborate details, while staff performing clerical-type duties may require

**EXHIBIT 15.3** EVALUATING YOUR COMMUNICATION SKILLS specific details. One of the major skills in communication is providing enough information, without miring an individual with unnecessary details. In each interaction, finding the balance between detail and summary is your main challenge. Did you provide the appropriate level of detail or summary in this exchange?

| Interchange | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |
| **Total:** | | | | | | |

**C.** In order for others to accept and consider your opinions, you need to provide them with your reasoning or logic for coming to a specific conclusion. This requires that you provide information that illustrates how you came to a particular conclusion or assumption. In this exchange, did you provide information that allowed the individual to understand your opinion and point of view?

| Interchange | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |
| **Total:** | | | | | | |

**D.** Your special skills and abilities in the financial arena allow you to understand terminology specific to the discipline. Others may not have this same level of understanding. In order to have an effective communication, you need to use the appropriate level of technical and lay terms to present your information. The use of technical terms and jargon with an individual who does not understand them would lead to an ineffective exchange. In this engagement, did you use the appropriate level of terminology?

| Interchange | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|

**Exhibit 15.3** Evaluating Your Communication Skills (*continued*)

1. ____________________
2. ____________________
3. ____________________
4. ____________________
5. ____________________

**Total:** ____________________

**E.** Often, individuals are giving us cues as to whether they understand the information presented.

There may be obvious cues, such as the individual stating that he or she doesn't understand. There may be less obvious cues, such as the same or similar question being asked repeatedly or closed body language. In this engagement, were you factoring in these cues as a measure of the effectiveness of your exchange and making adjustments in your presentation based on these cues?

| Interchange | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:** ____________________

**TOTALING YOUR SCORE:**
Copy the scores from each of the above questions into the table below; then, total your score for each question and for each decision:

| Interchange | Question A | Question B | Question C | Question D | Question E | Total Score | Average (Total/5) |
|---|---|---|---|---|---|---|---|
| **1.** | | | | | | | |
| **2.** | | | | | | | |
| **3.** | | | | | | | |
| **4.** | | | | | | | |
| **5.** | | | | | | | |

**Total:** ____________________

**REVIEWING YOUR SCORES:**
For each question and for each interchange, there is a maximum total score of 25 and a lowest possible score of 5.

**Exhibit 15.3** Evaluating Your Communication Skills (*continued*)

- A score of 25 indicates that you have exceptional communication skills.
- A score of 20–25 indicates that your communication skills are very good.
- A score of 15–20 indicates that your communication skills are fair but could use some improvement.
- A score of 10–15 indicates that your communication skills or style is in need of improvement.
- A score of 5–10 indicates that your communication skills are poor or your style of communication is ineffective.

**GENERAL INDICATORS:**

- If there is a significant difference between the totals in the score column for each interchange, it may indicate that you are inconsistent in your communications or your style is not always appropriate or effective. There may be other factors that caused this particular exchange to be effective or ineffective, such as information that was not available at the time of the interchange or political issues within your organization that prevent a meaningful exchange.
- For each of the questions, if there is a low or high score in a particular area, consider what was unique in that instance that made that particular exchange effective or ineffective.

**Exhibit 15.3** Evaluating Your Communication Skills (*continued*)

If others in your organization are continually making decisions that have a detrimental financial impact to the organization, these questions should be considered:

- Are your recommendations being ignored? If so, why?
- Is there a thorough understanding of the information you are providing?
- Are your reports, memos, emails, and correspondence easy to understand?
- When presenting your information at meetings or answering questions are you using lay terms or financial jargon?
- When you are presenting your opinion, are you thoroughly explaining your reasons or the facts that you considered when making that decision?
- Does your communication strategy or style need to improve?
- When you speak to individuals or groups, is their body language open and interested?
- Are you respectful and thoughtful in considering differing points of view?

It is helpful not only to diagnose your past communication style and effectiveness, but to also plan your future communication. When interacting and communicating in the future, you can refer to this checklist:

❒ I am sensitive to the unique needs of each individual, including their diversity.

❒ I consider the skill level of the individuals in this exchange and am speaking or writing in a manner that matches their ability to comprehend.

- ❒ I consider the ranking or position of each individual and provide the appropriate level of summary or detail.
- ❒ I present an image and a style that allow others to comfortably question my opinions.
- ❒ I demonstrate a willingness to be wrong, am open to suggestions and differing points of view, and am certain that my motives are appropriate and in the best interest of the organization and my constituents.

## 15.5 EVALUATING YOUR MENTORING AND SUPERVISORY SKILLS

As a leader in your organization, one of your responsibilities is to supervise staff, volunteers, functions, areas, or tasks. One of the ways you can evaluate your own performance is to evaluate the successes of those reporting to you and the areas for which you have responsibility.

When evaluating the performance of other individuals, there are two main factors to consider and evaluate:

1. *Your skills*. This area includes your skills in effectively managing, supervising, and mentoring this individual.
2. *Their skills*. This area refers to the individual's capabilities, skills, willingness to perform and learn, and dedication to the jobs, personal growth, and integrity.

Managing staff and coordinating volunteers require a set of skills unique to these particular disciplines. Some may have exceptional skills in financial management and analysis but may lack the skills necessary to effectively supervise and motivate individuals who report to them. Individuals also may be performing well despite being ineffectively managed. Some people may also have exceptional expertise in a particular subject matter but are ineffective in sharing that information and in training other staff and volunteers.

Exhibit 15.4 highlights the skill set needed to be an effective leader, supervisor, or manager. These skills include:

- *Supervisory and management*. These are traditional skills that we often think are the only skills in managing and supervising others. These skills include the ability to lead with integrity and authenticity, monitor the activity of others, keep proper records of attendance and performance, write and conduct performance appraisals, counsel staff, and so forth. Clear instructions motivate.
- *Subject matter expertise*. A supervisor needs to have a level of competency regarding the tasks or functions that his or her staff members perform in order to accurately evaluate their performance. It is not necessary for a supervisor to possess the same or superior skills as all his or her staff, but he or she must have a general understanding, sufficient to comprehend and communicate effectively with them.
- *Negotiation and problem resolution*. Regardless of how efficiently an organization may function, there will be situations where competent staff and volunteers will have conflicting opinions, goals, or plans. A supervisor will be responsible for resolving these conflicts in a manner that leaves all parties feeling validated and needed.

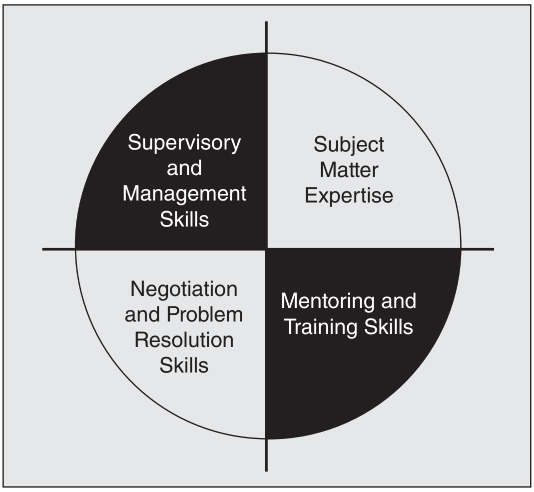



**Exhibit 15.4** Effective Leadership

- *Mentoring and training*. Above and beyond supervising an individual, a manager accepts responsibility for the personal growth of the individuals in his or her area. Whether the organization has formalized programs for career succession planning or training or not, it is the manager's responsibility to foster excellence in his or her staff and assist them with advancement, either within the same managerial area or within the organization.

## 15.6 TESTING YOUR SUPERVISORY AND MANAGERIAL SKILLS

If you do not have supervisory responsibility for staff or volunteers, skip this portion (Exhibit 15.5) of the evaluation. If you supervise fewer than five individuals, limit your evaluation to that number. You may also choose to list a staff member or volunteer who is no longer with the organization.

## 15.7 EVALUATING THE STRATEGIC NATURE OF YOUR ROLE

Proficient financial management requires the CFO and other top financial roles – including the board treasurer – to be strategic in focus. But how does one assess that? Craig Jeffery, founder and managing partner of consultancy Strategic Treasurer, has developed a framework that provides an excellent guide.[5] Given that "strategic" means something "highly important to the intended objective," a strategic financial manager is one whose objectives clearly support the organization's overarching objectives. The financial manager is not merely sought out "after the fact" to procure financing, set up a bank account, or conduct a financial transaction, but is consulted as key decisions are being formulated and made. Consider how well you or your high-level financial managers and board treasurer meet these six criteria:

Select five staff members or volunteers you supervise.

1. ______________________________
2. ______________________________
3. ______________________________
4. ______________________________
5. ______________________________

There may be situations, hopefully rare, when you will be responsible for supervising an individual who may be suffering from severe psychological problems or have an alcohol- or substance-abuse problem, causing a significant impact on his or her ability to function. These individuals may pose a physical threat to the staff and volunteers in your organization. The unique set of skills required to handle this are not typically thought of as a management requirement. Outside experts may need to be called upon (psychologist or psychiatrist, police officer, crisis specialist) to either handle the situation directly or give you guidance in handling the situation. If you are experiencing a situation with this severity, the following questions will not apply.

**A.** Have you maintained proper records of your staff or volunteers' attendance, performance, and job descriptions?

| Staff or volunteer | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| 1. | | | | | | |
| 2. | | | | | | |
| 3. | | | | | | |
| 4. | | | | | | |
| 5. | | | | | | |

**Total:** ______________________________

**B.** Do you possess sufficient knowledge or familiarity with the responsibilities of a staff member or volunteer to determine accurately if he or she is performing the job optimally?

| Staff or Volunteer | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| 1. | | | | | | |
| 2. | | | | | | |
| 3. | | | | | | |
| 4. | | | | | | |
| 5. | | | | | | |

**Exhibit 15.5** Testing Supervisory/Managerial Skills

**Total:**

**C.** When in meetings or conversations with more than one individual, are all individuals given equal participation in the exchange and are each individual's opinions, problems, and issues given equal consideration?

| Staff or Volunteer | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**D.** Assuming that an individual possesses the skills necessary to assimilate new or more challenging responsibilities, has your training (either formal or informal) been effective?

| Staff or Volunteer | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |
| **3.** | | | | | | |
| **4.** | | | | | | |
| **5.** | | | | | | |

**Total:**

**E.** At some point you may become ill, go on vacation, or leave your organization. Is there an individual or group of individuals who has/have sufficient understanding of your job to assume responsibility for it, if you were to be unable to perform your duties?

| Staff or Volunteer | Yes, without reservation Score = 5 | Yes, but with minor modification Score = 4 | Yes, but with reservation Score = 3 | Probably not Score = 2 | Definitely no Score = 1 | Score |
|---|---|---|---|---|---|---|
| **1.** | | | | | | |
| **2.** | | | | | | |

**EXHIBIT 15.5** TESTING SUPERVISORY/MANAGERIAL SKILLS (*continued*)

3. ______________________________________________
4. ______________________________________________
5. ______________________________________________

**Total:**

______________________________________________

**TOTALING YOUR SCORE:**

| Staff or Volunteer | Question A | Question B | Question C | Question D | Question E | Total Score | Average (Total/5)* |
|---|---|---|---|---|---|---|---|
| 1. | | | | | | | |
| 2. | | | | | | | |
| 3. | | | | | | | |
| 4. | | | | | | | |
| 5. | | | | | | | |

**Total or Average**:**

______________________________________________

* If you are evaluating less than five staff members or volunteers, divide your total by the total number of staff members or volunteers listed.

** Calculate the total on this row only if you used less than five staff members or volunteers for your evaluation.

**REVIEWING YOUR SCORES:**

In this summary section, it is possible that some of your totals will not correspond to the total scores listed in the scoring grid below, as you may have evaluated interchanges with fewer than five staff members or volunteers. You can still do the evaluations by using average scores: Base your evaluation on each question by viewing the average of that column's total (shown on the last row) to determine your results. For example, divide that column's total score by three if you had only three staff members or volunteers.

For each question (if you had five staff members or volunteers) there is a maximum total score of 25 and a lowest possible score of 5.

- A score of 25 (column average = 5) indicates that you have exceptional supervisory and managerial skills.
- A score of 20–25 (column average = 4) indicates that your supervisory and managerial skills are very good.
- A score of 15–20 (column average = 3) indicates that your supervisory and managerial skills are fair but could use some improvement.
- A score of 10–15 (column average = 2) indicates that your supervisory and managerial skills are in need of improvement.
- A score of 5–10 (column average = 1) indicates that your supervisory and managerial skills are poor.

**GENERAL INDICATORS:**

- If there is a significant difference between the totals in the score column for each staff member or volunteer, it may indicate that you are inconsistent in your supervisory

**Exhibit 15.5** Testing Supervisory/Managerial Skills (*continued*) and managerial delivery. There may be other factors, such as inconsistencies in staff responsibilities, personal attitudes, political issues, or other unique situations that may cause this fluctuation.

- For each of the questions, if there is a low or high score in a particular area, consider what in that instance made that particular supervisory and managerial situation unique.

**FOR THE FUTURE:**

When managing and supervising your staff and volunteers, you can refer to the following checklist:

❒ All the job cards or descriptions of my staff and volunteers are accurate and up to date.

❒ All my staff and volunteers have received a copy of their job descriptions and have received a performance appraisal, where applicable.

❒ When faced with a conflicting situation or plan, I have considered the opinions of all staff and volunteers when determining which situation or plan to approve.

❒ I have trained or am in the process of training an individual or group of individuals to perform my job in the event I am unable to perform it temporarily or if I decide to leave the organization.

❒ I have carefully documented issues, meetings, and conflicts, and have taken a proactive approach to assuring that the staff and volunteers under my responsibility are performing optimally. I have taken the necessary actions to remove staff or volunteers who are not performing effectively.

**Exhibit 15.5** Testing Supervisory/Managerial Skills (*continued*)

1. *Do you take a partner perspective?* "Think like a partner, not a vendor." Go beyond just meeting liquidity needs to relating with key operating personnel on an ongoing basis.
2. *Are you developing a successful track record?* If you are seen as relevant and effective in the areas over which you wield control or influence, your purview of the order-to-cash or grant/donation-to-cash cycle will cause others to tap your expertise. Your credibility is built on your previous successes and contributions.
3. *Do you use your whole mind?* Assist others in their decision making by helping them simplify complex problems. Synthesize facts, data, and analysis into actionable and sound recommendations. Helping others see the influence of multiple and complex factors on the organization as a whole is very valuable. Leverage your intellectual curiosity to gain a better understand of the "financial/business model" of the organization (specifically, how and why it derives the financial results it does), then translate to others. For example, Home Depot is dedicated to transforming its finance function away from a tasking organization and toward a thinking organization. Your biggest impediment to doing this will be the time pressures arising from operating activities and an understaffed finance function.
4. *Are you stretching your skill set?* Gaining leadership and broader operational acumen will give you a better shot at gaining a seat at the table when big financial and nonfinancial decisions are being made.
5. *Are you making your partners successful?* Do you engage in teamwork with other top-level decision makers in your organization? You must make no excuse for a failure to communicate with others at your level before you or they bring resource

allocation proposals to the ED/CEO (executive director/chief executive officer) or the board.

**6.** *Are you relevant, translating or devising metrics where possible?* Your insights must be placed at a level at which others can understand, and appropriate metrics need to be in place. We have discussed at length in this book the advantages of target liquidity as a primary financial objective rather than striving for breakeven or a small surplus. To stretch your thinking, might you be able to develop a framework such as Dell's "golden triangle" of liquidity, profitability (surplus rather than breakeven or deficit), and growth? Your organization may adapt this to embrace a "golden triangle" of liquidity (including cash flow), cost coverage, and accountability. Then translate this for your board, other leaders and employees so they can see the importance of each metric and how their activities may have an impact on the metric.

You might also consider a revenue and support metric. Home Depot's translation of its sales objective is that sales would increase $1.2 billion if each customer added just one $1 item to his or her shopping cart. Some development offices have translated major gifts into the needed calls and proposals that staff should be developing over time.

The primary revenue sources your organization relies on should be known and understood by all employees. The same is true for the major cost elements. When important things change, communicate clearly the change and the strategic reasoning spurring the change. Finally, translate the views of outsiders so that insiders may understand. For example, guide your employees toward an understanding of the greater emphasis on accountability and outcome measures coming from granters, government contracts, and donors.

## 15.8 EVALUATING THE FINANCIAL HEALTH OF YOUR ORGANIZATION

The previous evaluations have measured the quality of your specific skills. In this section, you will assess the financial health of your organization to evaluate how effectively you are performing in a strategic sense.

**(a) IMPORTANCE AND DEFINITION OF FINANCIAL HEALTH.** Financial health is critical for mission achievement. Consider this finding from a typical nonprofit survey: In spite of the fact that fundraising either was stable or improved for most of the surveyed nonprofits, almost one in three organizations had to reduce services in order to meet financial challenges over the previous two years. Two in five human services organizations had to cut services due to financial shortfalls. And this was in a nonrecessionary period ending in 2005, indicating that even in "good times" cash flow issues are endemic to the nonprofit sector.[6] Service cutbacks were also the experience of many nonprofits during the 2009–2011 period: between 42 and 50 percent of nonprofits could not meet the increased demand that they faced.[7] Survey findings also indicate:

> … an increase in laying off staff from 2009 to 2010 of responding organizations from 25 percent to 36 percent and a slight increase from about 17 percent to 18 percent for organizations cutting salary and wages. In 2011 fewer organizations reported both laying off staff and cutting salary and wages. From 2009 to 2010 there was a slight increase from about 48 percent to 50 percent for organizations implementing a salary freeze. This increased again in 2011. …

The good news is that there was only a small increase in organizational closures during that postrecessionary era.[8] We emphasize again the critical importance of targeting, achieving, and maintaining an appropriate level of liquidity (see Chapter 2). Growing organizations and those with an aging physical plant will need to allocate strategic reserves in addition to the six-to-nine months of expenses they hold in operating reserves.

Defining "financial health" can be somewhat difficult. You may have sufficient resources to cover your payroll and pay your outstanding invoices, but:

- Have you used your resources wisely?
- Have you made purchasing or other financial decisions that may have negative short-term impacts but wise long-term implications (such as ordering a larger quantity of supplies and being able to take a quantity discount that was offered to you by a supplier)? Or, have you taken actions that are harmful in the short-term and long-term due to having inadequate cash on hand (such as not taking a cash discount offered to you by a supplier)?
- Has the amount of debt service – loan/bond interest payments and principal repayments (also include lease payments on leases of at least 12 months in term) – stressed your organization or limited its financial flexibility for the future?
- Has your conservatism in financial matters overly constrained your organization's ability to accomplish its mission and goals?
- Did you fail to take limited risks that might have positioned your organization better for the future or made it better able to accomplish its mission and goals?
- Did you take unnecessary risks that may have put your organization at risk?
- Has your organization limited its administrative and programmatic abilities and achievements by buying in to the "overhead myth" and underinvesting in organizational infrastructure (fundraising, accounting and finance function, information technology, human resources, buildings and equipment)?
- Has your organization been positioned for growth or replacement of major assets for the next five years? Ten years? *Will the organization's target liquidity be intact at both of those points in time?*

### (b) CRITERIA FOR MEASURING YOUR FINANCIAL HEALTH.

- Your bank may determine that financial health means that you have money in the bank and have managed your cash flow between your checking and other short-term or long-term interest-bearing investment accounts.
- Your creditors may determine that you are financially healthy if you pay your invoices on time.
- Your contributors may determine you are financially healthy:
  - If you have the lowest possible overhead[9]
  - If you accomplished or achieved your mission and goals
  - If your expenditures were appropriate and legitimate
- Your board of directors may determine that you are financially healthy if your organization currently has on hand its target liquidity level (or more than that amount),

the organization is positioned well for the future, is balancing the needs of all your constituents, and the finance function has assisted the organization in successfully meeting its mission and goals.

To determine whether your organization is financially healthy, you must consider all the factors just mentioned. The evaluation detailed in Exhibit 15.6 will further assist you in evaluating your organization's financial health. The scoring on Item E reflects our opinion that most organizations are not investing enough in key areas such as accounting, finance, IT, development, and training.

## 15.9 EVALUATING YOUR FINANCIAL POLICIES IN SIX KEY AREAS

We have addressed financial policies in some detail in Chapter 5 and with greater specificity in the various chapters in which we discussed risk management, investments, cash management, and other vital topics. In this chapter on evaluation, we offer some checklists and references for guidance on evaluating your policies and practices in five critically important areas: governance and accountability, liquidity management and your primary financial objective, investments, fundraising, risk management, and human resources.

**(a) GOVERNANCE AND ACCOUNTABILITY.** Although some nonprofits have adopted a head-in-the-sand perspective on the corporate sector Sarbanes-Oxley legislation and the future implications of expanded calls for better governance and accountability, proactive nonprofits are already adopting better internal controls, governance mechanisms, and accountability structures. Two best practices that nonprofit boards have adopted toward improving their oversight are:

1. Conducting periodic training for board members on how to read the organization's audit and financial reports
2. Engaging in financial or business planning to better understand the organization's business model and financial sustainability[10]

Bond rating agencies that rate nonprofit debt to assess the organizations' creditworthiness from the perspective of bond investors (Fitch Ratings, Standard & Poor's, and Moody's) are issuing statements and/or revising their credit ratings criteria for healthcare institutions. Whether or not your organization issues or plans to issue bonds that might be subject to a third-party rating, the insights we can gain from the ratings framework motivate us toward better management and governance. We shall use Fitch as our example of how ratings agencies view your governance as it relates to financial health and sustainability from a long-term funders' perspective. Fitch Ratings highlights three aspects that it deems most relevant to nonprofits, which are items for your organization to consider regardless of whether or not yours is a healthcare organization or about to request a bond rating:

1. Appropriate relationships with outside auditors, particularly regarding rotation of audit teams and limits on nonaudit services
2. Better internal processes, including audit committee charters and documentable financial expertise for audit committee members, certification of financial statements (CEO and CFO both sign off on for-profit statements now), code of ethics adoption, and bonus forfeiture when financial statements are restated
3. Internal control adequacy assessment (including whistleblower and compliance procedures)[11]

**A.** Did you make any financial or purchasing decisions that had short-term benefits but long-term negative impacts to your organization?

| Yes | Probably, yes | Maybe | Probably not | Definitely, no |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**B.** At any time in the evaluation period did you incur expenses (such as bank penalties or charges, short-term loan charges) that could have been avoided if higher levels of cash or credit lines had been available or if expenditures and investments would have been more appropriately delayed or handled differently?

| Yes, often | Yes, occasionally | Seldom | Almost never | Never |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**C.** Did you take unnecessary risks?

| Yes, often | Yes, occasionally | Seldom | Almost never | Never |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**D.** Did you take appropriate and well-calculated risks?

| Never | Almost never | Seldom | Yes, occasionally | Yes, often |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**E.** Is your overhead or percentage of expenditure on overhead versus programmatic expenses consistent with other similar organizations?

| Below average | Slightly below average | Near or matching | Above average | Exceeding average |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**F.** At any point during the evaluation period did you restrict the use of resources that could have been used more appropriately to accomplish the organization's mission and goals?

| Yes | Probably, yes | Maybe | Probably not | Definitely, no |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**G.** At any point during the evaluation period did your actions put the organization at unnecessary risk or were you unable to meet expenses?

| Yes | Probably, yes | Maybe | Probably not | Definitely, no |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**Exhibit 15.6** Financial Health Evaluation

**H.** At any point during the evaluation period did you allow an inappropriate or illegitimate expenditure or transaction without taking necessary action to stop or rectify it?

| Yes | Probably, yes | Maybe | Probably not | Definitely, no |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**I.** During your evaluation period, did you ever fail to pay your invoices on time or take advantage of net discounts and rebates?

| Yes | Probably, yes | Maybe | Probably not | Definitely, no |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

**J.** At any time, did you suffer an increase in loan rates or other negative impacts due to a bad credit rating?

| Yes | Probably, yes | Maybe | Probably not | Definitely, no |
|---|---|---|---|---|
| Score = 1 | Score = 2 | Score = 3 | Score = 4 | Score = 5 |

Transfer your scores and total below:

**A.** ______________
**B.** ______________
**C.** ______________
**D.** ______________
**E.** ______________
**F.** ______________
**G.** ______________
**H.** ______________
**I.** ______________
**J.** ______________

Total: ______________

**REVIEWING YOUR SCORES:**

- A score of 45–50 indicates that your organization tests well and your organization could be considered financially healthy.
- A score of 35–45 indicates that your organization tests well and, while improvement may be needed in specific areas, is relatively healthy.
- A score of 25–35 indicates that your organization did not fare well in this test and there may be cause for concern or changes in managing your organization's financial resources.
- A score of 15–25 indicates that your organization's health may be at significant risk and major changes are indicated.
- A score of 5–15 indicates that your organization is not healthy, and serious changes and a reexamination of priorities need to occur immediately.

**Exhibit 15.6** Financial Health Evaluation (*continued*)

Fitch Ratings states "effectiveness of [your organization's] governance and management is an important factor in assessing an organization's creditworthiness, as management's decisions and initiatives – subject to the oversight and strategic direction of the governing body (such as a board of trustees … ) – can ultimately determine an entity's long-term financial viability. Fitch generally focuses its commentary on management and governance practices where their effectiveness materially influences the rating decision."[12] Fitch's statement on your board's governance is as follows:

> Governance: With a level of analysis tailored to the structural characteristics of the sector, Fitch reviews the effectiveness of the governing body in establishing and implementing the organization's policies and principles. Fitch's assessment may involve developing an understanding of the governing body's mission and strategy, structure, composition, interaction with and oversight of management, knowledge of industry issues and performance standards. [13]

Last, but certainly not least, you will want to perform an annual review of your finance (or finance and accounting) committee. Exhibit 15.7, from material developed by CPA and consulting firm Tate & Tryon, will prove very helpful to you as you conduct your review.

**(b) LIQUIDITY MANAGEMENT AND YOUR PRIMARY FINANCIAL OBJECTIVE.** How may we best assess our achievement of our organization's primary financial objective, that of striving to meet an "appropriate liquidity target" over time? Recall that managing cash flow and the cash position are the keys to accomplishing this, so any measure that shines light on these items will assist us. Further, we rephrased our primary financial objective as: "To ensure that financial resources are available when needed, as needed, and at reasonable cost, and are protected from financial impairment and spent according to mission and donor purposes." The question must then be asked: Have we accomplished this?

Borrowing from corporate treasury management best practices, "the treasurer will always aim to ensure that the organization is funded at all times, the balance sheet is optimized, financial flexibility is maintained, and value-enhancing decisions are made to the benefit of all stakeholders."[14] There are six very important targets (metrics) that you will want to track and manage; we quote Riaan Bartlett in the following listing. Several of these are most appropriate for commercial nonprofits (hospitals and colleges), but all are usable as-is or with some adaptation to all nonprofits:

**1.** Total cash position

- **a.** On at least a daily basis, complete visibility of the total cash within the organization
- **b.** Also know how much cash is immediately available versus not available or trapped (as in a debt reserve account)
- **c.** If you lack daily visibility into your total organizational cash, drill down to determine if it reveals an inefficiency in your cash management processes (inefficient use of technology? poor cash concentration or pooling mechanisms? poor bank account controls? etc.)

## Nonprofit Finance and Audit Committee Best Practices Checklist

TATE & TRYON

| | |
|---|---|
| **Financial Oversight Committee Charter** | ☐ Ensure that all Committee policies, procedures, charter, and other relevant historical information are contained in one living document<br>☐ Update the document at least once annually |
| **Budgeting** | ☐ Ensure that the budget (financial plan) reflects program goals as described in the strategic plan (business plan)<br>☐ Ensure that major assumptions are understood<br>☐ Consider reviewing historical results for major revenue and expense categories<br>☐ Understand the margin for error or unexpected events<br>☐ Ensure that budget revisions are approved |
| **Financial Reports** | ☐ Review monthly statement of financial position (balance sheet)<br>☐ Review monthly statement of statement of activities (income statement)<br>☐ Review monthly statement of changes in net assets by fund category<br>☐ Review monthly statement of cash flows<br>☐ Compare monthly results presented in the statement of activities to the prior year and obtain explanations for major variances |
| **Cash Requirements** | ☐ Ensure that cash flow is adequate in light of the budget (financial plan)<br>☐ Ensure that excess cash is invested prudently |
| **Investments** | ☐ Ensure that the investment objectives are consistent with objectives and time horizons stated in the strategic plan<br>☐ Ensure compliance with a stated investment policy<br>☐ Review investment results and discuss with outside investment advisor |
| **Unrestricted and Undesignated Funds (Reserves)** | ☐ Identify unrestricted and undesignated funds<br>☐ Determine Board policy regarding transfers to the Contingency, Building, or other Board Designated Funds<br>☐ Identify the liquid (cash & investments) and non-liquid component of the funds<br>☐ Ensure that the amount and composition of the fund is consistent with the reserve objectives of the budget (financial plan) and strategic plan (business plan) |



## Nonprofit Finance and Audit Committee Best Practices Checklist

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| **Board Designated Funds (Reserves)** | ☐ Identify Board Designated Funds<br>☐ Ensure that the purpose and use of the funds are in writing and comply with the terms of the Board (internal) designation and that the board approves policy modifications.<br>☐ Determine Board policy regarding transfers from the Operating Fund to the Contingency, Building, or other Board Designated Funds<br>☐ Identify the liquid (cash & investments) and non-liquid component of the fund<br>☐ For non-liquid funds such as the Building Fund, obtain periodic appraisals to determine fund equity (excess of market value over related debt)<br>☐ Determine when capital expenditures are to be transferred from the Building Fund<br>☐ Ensure that the amount and composition of the reserve is consistent with the reserve objectives of the budget (financial plan) and strategic plan (business plan) |
| **Restricted Funds (Reserves)** | ☐ Identify funds that are externally restricted by donors<br>☐ Ensure that the purpose and use of the funds are in writing and comply with the terms of the donor (external) restriction |
| **Revenue** | ☐ Obtain an understanding of the major categories of gross revenue<br>☐ Determine how such major categories are priced and distributed<br>☐ Determine whether such major items are subject to the unrelated business income tax |
| **Expenses** | ☐ Obtain an understanding of the major categories of expense<br>☐ Determine the method used to allocate direct and indirect expenses to functional departments and programs<br>☐ Obtain an understanding of the allocated cost of major programs |
| **Capital Expenditures** | ☐ Review and approve the annual capital expenditures budget<br>☐ Review and recommend financing options<br>☐ Determine Board policy with respect to capital expenditure transfers from Board designated funds |
| **Management Compensation** | ☐ Understand the procedures to establish and monitor management's compensation and benefits<br>☐ Understand the financial drivers affecting management compensation |



**Exhibit 15.7** Finance and Audit Committee Evaluation

## Nonprofit Finance and Audit Committee Best Practices Checklist

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| **Review of Expense Reports** | ☐ Review the employee and volunteer expense reporting policy and related guidelines<br>☐ Review CEO expense reports and changes to Organization credit cards that are not reported on expense reports<br>☐ If significant, review expense reports of other volunteers |
| **Tax and other Informational Returns and Reports** | ☐ Inquire as to whether all tax and information forms have been filed in a timely manner<br>☐ Consider reviewing Federal Forms 990, 990-T, 1120, 1120-POL, and Lobbying Reports in order to gain a better understanding of the Organization's tax issues and other activities |
| **Related Entities** | ☐ Understand the financial relationships among all related entities over which the Organization's Board has oversight responsibility<br>☐ Approve and monitor related entity budgets<br>☐ Review monthly financial statements of related entities<br>☐ Consider having a representative attend related entity budget or finance meetings<br>☐ Review related entity business plan and use of reserves |
| **Internal Controls: The Control Environment** | <u>Control Environment</u>: The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Assess the following factors:<br>☐ Management's integrity and ethical values<br>☐ Commitment to the competence of the staff<br>☐ The attention and direction provided by the board<br>☐ Management's philosophy and operating style<br>☐ Organizational structure<br>☐ Manner of assigning authority and responsibility<br>☐ Human resource policies and procedures |



## Nonprofit Finance and Audit Committee Best Practices Checklist

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| **Internal Controls: The Risk Assessment** | <u>Risk assessment</u>: Every Organization faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Determine if the Organization has identified and analyzed risks to the achievement of its objectives, such as:<br>☐ Changes in the Organization's operating environment<br>☐ New personnel<br>☐ New or revised information systems<br>☐ Rapid growth within the Organization<br>☐ New technology<br>☐ New services, products, or activities<br>☐ Restructuring within the organization<br>☐ Adoption of new accounting principles<br>☐ The management of such risks |
| **Internal Controls: The Control Activities** | <u>Control activities</u>: Control activities are the policies and procedures that help ensure directives are carried out. Obtain an understanding of the financial policies and procedures including the following:<br>☐ Reviews of operating performance<br>☐ Information processing controls<br>☐ Security of assets<br>☐ Segregation of duties, including approvals, authorizations, verifications, and reconciliations |
| **Internal Controls: The Information and Communication** | <u>Information and communication</u>: Information systems produce reports, containing operational, financial, and compliance-related information that make it possible to run and control the Organization. Consider whether:<br>☐ The needed information is provided, and on a timely basis<br>☐ The information is current and accurate<br>☐ The information is easily accessible by the appropriate persons<br>☐ Staff receives a clear message from management that control responsibilities must be taken seriously<br>☐ Staff understands their own role in the internal control system, as well as how individual activities relate to the work of others<br>☐ Staff has a means of communicating significant information upstream<br>☐ There is effective communication with external parties, such as customers, suppliers, and regulators |



**Exhibit 15.7** Finance and Audit Committee Evaluation (*continued*)

**Nonprofit Finance and Audit Committee Best Practices Checklist** TATE & TRYON

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| **Internal Controls: The Monitoring** | *Monitoring*: Internal control systems need to be monitored—a process that assesses the quality of the system's performance over time. Determine the following:<br>☐ Are internal control systems subjected to ongoing monitoring activities, separate evaluations or a combination of the two?<br>☐ Do regular management and supervisory activities occur?<br>☐ Are internal control deficiencies reported upstream, with serious matters reported to top management and the board? |
| **Sarbanes-Oxley Requirements** | ☐ Document destruction policy<br>☐ Whistleblower protection policy |
| **Oversight of External Audit** | ☐ Committee should be free from conflicts of interest and should not receive any compensation for their service on the committee<br>☐ Include at least one "financial expert" on the Committee<br>☐ Select and oversee the auditing company and review the audit<br>☐ Meet at least annually with the auditing company and consider one interim meeting, if not in person then via conference call<br>☐ Meet in an executive session, usually at the conclusion of the regular meeting, with the auditing firm<br>☐ Require Board approval of audit results<br>☐ Consider rotating lead partner or audit firm every five years<br>☐ Avoid any conflict of interest in staff exchange between audit firm and organization<br>☐ Committee pre-approval of non-audit services (other than tax return preparation) provided by auditing firm<br>☐ Require disclosure to the Committee of critical accounting policies and practices<br>☐ Oversee and enforce the following:<br>⇒ Conflict-of-Interest Policy<br>⇒ Document destruction policy<br>⇒ Whistleblower protection policy<br>⇒ Code of Ethics for Senior Financial Executives |



*Source:* Tate & Tryon, "Nonprofit Finance and Audit Committee Best Practices Checklist Oversight of External Audit." Reprinted with Permission by Tate & Tryon. Available at http://www.tatetryon.com/wp-content/blogs.dir/48/files/2016/06/Nonprofit-Finance-and-Audit-Committee-Best-Practices-Checklist-1.pdf.

**Exhibit 15.7** Finance and Audit Committee Evaluation (*continued*)

**2.** Minimum liquidity buffer

- **a.** Do we have cash in the right place? at the right time? in the right currency? Can we meet our payment obligations at all times?
- **b.** Related to (a), do we have a liquidity buffer that may be tapped in the event of unforeseen events or during periods where short-term borrowing typically may not be accessed?
- **c.** Related to (b), is this buffer (ideally) a combination of both cash and an undrawn committed bank funding facility?

**3.** Funding requirement (one of the most important numbers to track for treasurer)

- **a.** Shows the funding required (including the peak funding)
- **b.** Drives the funding strategy and the bank and debt investor strategies as a subset of the funding strategy
- **c.** The period over which the funding is measured should be at least 12 and up to 24 months (covers organization's budgeting cycle as well as the bond rating agencies' evaluation time horizon for your financial profile)

   - **d.** Your target amount required will be a function of factors such as capital intensity (see Chapter 9; especially consider ramifications of growth on working capital, infrastructure, and other fixed asset investment), optimal capital structure (see Chapter 10) and the competitive environment (see Chapter 3)
   - **e.** Avoid overoptimism if you are assuming disposals of assets will reduce the funding required, especially if the timing of those disposals is not certain

**4.** Cash flow at risk

   - **a.** Get used to it: Your "actual cash" will probably never equal what you had forecasted for your cash position – if your operating cash flows fluctuate periodically, actual cash can be significantly different compared to forecasted cash, over even a relatively short period of time
   - **b.** Calculate your "downside cash flow delta," or per-period change in cash flows or net available liquidity
   - **c.** The per-period change in cash flows or net available liquidity affects
      - **i.** The funding strategy
      - **ii.** Under certain circumstances, your bond issues' credit ratings, your organization's relationships with providers of capital, and your organization's ability to grow its operations or, at the extreme, the ability to continue to operate
   - **d.** Estimating the per-period change in cash flows is difficult
      - **i.** You (or your treasurer) must work closely with the organization's leaders and the lead in your forecasting group, if your organization is large enough to have a dedicated group
      - **ii.** A strong understanding of the cash flow drivers and how sensitive your key risk factors are to ups and downs in your labor, commodity, product/service, and credit (interest rate) markets is essential
      - **iii.** It seems that low probability–large impact events ("black swans") are becoming more probable, but it is difficult to assign probabilities to these events

**5.** Projected balance sheet/statement of financial position (see Chapters 6, 9)

   - **a.** Develop this for at least the next two years with the insights and inputs from #3 and #4, as well as other operating and financial data
   - **b.** Assess this projected balance sheet relative to target financial ratios (target liquidity level at end of each quarter or six-month period, debt ratio, cash ratio, and perhaps also target liquidity level lambda) to determine the extent to which your organization's financial strength and flexibility is expected to remain intact
   - **c.** Be careful: Your organization's balance sheet strength must not only be assessed with ratios but equally with inspection of the absolute level of debt that is and will be outstanding
      - **i.** Debt will have to be refinanced in the future (under potentially adverse market conditions)

ii. If the debt is too high, your organization may experience significant financial stress

6. Maximum refinancing risk
   a. Determine the maximum amount to be refinanced in, say, any 12-month period
   b. It is important not to set the maximum amount/limit too high based on past good market conditions, as these conditions can change quickly due to:
      i. Lower investor appetite for debt or short-, medium-, or long-term debt issued by organizations with a certain amount of creditworthiness
      ii. Negative market "supply-side" sentiment towards your organization's sector (e.g., human services)
      iii. Overall lower available liquidity (funding) in the market due to conditions at that point in time
   c. All other things equal, the stronger your organization's issue credit rating, the more refinancing risk you can accept

Market conditions in 2010 will serve as our illustration and allow application of the information regarding liquidity and risk posture. In this case, nonprofits can again learn from corporate practice. KPMG surveyed businesses regarding their liquidity and investment policies following the "Great Recession." We quote from the study's findings: [15]

- Of those respondents indicating their organizations had completed a reassessment, 16 percent revised staff's investment authority so that more of the investment decisions now require board approval.
- Respondents reported that their boards are trying to answer the question, "Are We Liquid?"
- Boards asking for liquidity projections …
  - A forecast horizon from 6 to 12 months
  - Accounting for all significant cash inflows and outflows …
  - Along with what could affect those flows in various scenarios …
  - Then how well the credit facilities would serve to cover shortfalls
- Proactive steps the organizations could take if credit facilities prove inadequate included:
  - Increasing working capital (in advance of period of cash need)
  - Negotiating new/increased credit facilities
  - Cost reductions
- Treasurers were asked by boards to establish multiple liquidity thresholds[16] and contingency plans within each of these "liquidity bands."[17]
- Liquidity issues spurred many businesses to create or update corporate liquidity policies to provide additional clarity regarding corporate objectives, accountabilities, and controls.[18]
- Liquidity policies typically address definitions and scope – key reports, timing and distribution guidelines – thresholds, limits, and contingency plans.[19]

Fortunately, there is evidence from the field to further inform your evaluation of liquidity, how it is measured, of what elements it is composed, whether structures are in place to maintain it, and how it is used by the organization. A survey of 30 nonprofits by Sloan, Grizzle, and Kim is rich with insights that you can tap. The survey used the concept of "operating reserves," defining an operating reserve as "a fund formally set aside by an organization to be utilized in times of fiscal stress, also called a rainy day fund or contingency fund." Nonprofit executives were asked if the organization had a fund that met this definition. Six organizations (20 percent) reported having no operating reserve, with the remaining 24 (80 percent of the organizations in the study) executives stating that they believe their organizations have at least some reserve.[20] Findings regarding the creation or funding of the reserve linked the creation/funding to three major sources including:

1. Excess funds: Those funds that were determined to not be necessary for the basic operation of an organization, either from (a) a reserve being created from excess holdings that had been accumulating for some time and were then transferred to a special reserve account that had not existed before or (b) a decision to transfer what they deemed "excess funds" at the end of a budget year to a designated account that then became their operating reserves. Of the nine organizations following these two strategies, five indicated that the reserve was created from several years of surplus and four began with excess revenue from a shorter period, 12 months or less.
2. Receipt of special gifts/bequests: Seven respondents (29 percent) stated that a special donation or a bequest gave them the funds to create operating reserves … [and] only one indicated that the monies were restricted by the donor to be used to start a reserve fund.
3. Budgeted reserve: Three organizations' respondents (12.5 percent) indicated that they had created their operating reserve by including the fund as an expense line item in their budgets, while five respondents (21 percent) described other processes for creating the reserve (including creating the reserve by using the proceeds from a property sale by one organization and reallocating an existing building fund toward the reserve by a second organization).[21]

Organizations also used a combination of resources for their reserve (liquidity target in our terminology): sources included cash, short-term investments, credit line, and money available from a related foundation.[22]

Regarding how funds are accessed once set up as a reserve, respondents indicated:

- A few organizations (about one in six) with reserves have written policies in place to govern how reserve funds can be used and for what purposes.
- Most of the executives expressed accountability to expectations or accepted practices for their actions relative to accessing reserve funds, with these organizations relying on board approval, contingent board approval, and executive director direction.[23]

**(c) INVESTMENTS.** The six key questions to ask on an ongoing basis regarding your organization's investments are:

1. Are investment policy statement (IPS) prescriptions being followed? If overly inflexible or outdated, is the IPS being updated and revised, with ensuing board oversight and approval to be recorded in the board's minutes?

**2.** Is return sufficient relative to the risk being borne on investments?

**3.** Is "safety first" the guiding principle for all short-term investments?

**4.** Are appropriate performance measurement benchmarks for short-term cash reserves being tabulated and used for comparison purposes? The Association for Financial Professionals (www.afponline.org) makes two short-term benchmarks available to its members for monthly returns.

**5.** Are appropriate performance benchmarks being tabulated and used for comparison purposes for long-term investments (endowments, pooled investments, annuities, donated securities, pensions, trusts)?

**6.** (Assuming the organization has an endowment): Is the endowment spending policy being followed, and it is appropriate?

Careful oversight of outside investment managers is also important. Few nonprofits have board members or staff with sufficient training, expertise, and time to manage properly investments portfolios. More nonprofits are shifting portfolio allocations toward socially responsible investing (SRI).[24] If your organization is not doing so, reasons for not doing so should be known by all top managers and the board of directors. Trade associations are excellent sources of comparative investment return and risk data. If you serve in an educational institution, you will want to access the National Association of College and University Business Officers (NACUBO's) educational organization endowment benchmark data: Navigate to www.nacubo.org and then select the "Research" tab. You may also wish to contact Commonfund – which is itself a nonprofit organization that invests funds for nonprofits in the healthcare, educational, and foundation fields – for its annual "Commonfund Benchmarks Study" covering each of these organizational types.

For more training on endowment investing, consider attending the Commonfund's five-day "Endowment Institute. It is billed as "a rigorous and intensive educational program developed by Commonfund Institute and designed exclusively for trustees and investment officers who wish to enhance their contributions to the nonprofit institutions they serve." The annual conference of the Association for Financial Professionals also has broad coverage of many financial topics and now includes a breakfast "nonprofit industry roundtable" at each annual conference (www.afponline.org).

**(d) FUNDRAISING.** In working with the fundraising function, be cautious to ensure the organization thinks through the effect of being opportunistic and reactive to new funding streams; otherwise the organization's ability to sustain itself may be jeopardized.[25]

Evaluating your fundraising figures is a three-part process, as noted by Mary Beth McIntyre, Vice President of Relationship Management, Target Analysis Group:

**1.** Drive relevance into your annual analysis by carefully determining at the outset how to segment (group) your donors; make sure to discuss your needs for usable information in detail with any outside source assisting you with your review of your fundraising file.

**2.** Derive and comprehend clear metrics and use them on an intrayear basis—as you get the quarterly measures in and study them, use them to reshape remaining-year strategies.

**3.** Use your benchmark data (Giving USA, Target Analysis Group National Index, Paradyz Matera Performance Watch, Campbell Rinker and Industry publication studies) to get a context for understanding, to gain perspective, and to prioritize goals and inform management.[26]

We highly recommend the relatively recent innovative and thoughtful "Measuring Fundraising Effectiveness" framework for fundraising evaluation (see Exhibit 15.8). Once you gain expertise in calculating these metrics and comparing them to previous years' numbers and possibly a peer competitor's numbers, you will have a much better ability to appraise and make recommendations for improvements.

**A MORE HOLISTIC VIEW OF FUNDRAISING EFFECTIVENESS**

While there are many measures that an organization may use internally to evaluate the effectiveness of its fundraising strategy, we propose three primary measures of fundraising effectiveness for both internal and external use, which together, provide a much more complete picture of an organization's fundraising health.

**Total Fundraising Net**

The amount of money available to spend on an organization's mission as a result of its fundraising efforts. This is the bottom line measure of fundraising success. If it's not enough to fund the organization's work, then the other two measures are irrelevant. Here's how it's calculated:

$$\text{Total amount raised}^{*} - \text{Total fundraising expenses}^{**} = \text{Total Fundraising Net}$$

*Example: If an organization raised $1,000,000 and spent $200,000 on staff and other expenses to do it, its total fundraising net is $800,000 ($1,000,000 – $200,000).*

**Dependency Quotient**

A measure of risk, the Dependency Quotient measures the extent to which an organization is dependent on its top donors to fund its work. It's an indicator of how vulnerable the organization could be in the face of changed priorities among its top funders. Generally speaking, organizations would seek to have a lower Dependency Quotient, indicating that they are more resilient to changes in top donor giving. Here's how it's calculated:

$$\frac{\text{Sum of contributions from five largest donors or funders}^{***}}{\text{Organizational expenditures}} = \text{Dependency Quotient}$$

*Example: If an organization's top five donors contributed $250,000 during the past three years, and the total organizational expenditures for the same three-year period were $1,000,000, then its Dependency Quotient is 25 percent ($250,000/$1,000,000), meaning it would have to replace 25 percent of its budget if it lost its top five donors.*

**Cost of Fundraising**

A measure of efficiency, the cost of fundraising measures how much it costs to raise money within your organization. While some calculate it differently, we measure the average amount that it costs to net one dollar across the entire organization.**** Generally speaking, organizations would seek to have a lower cost of fundraising, indicating they are investing efficiently in fundraising. Here's how it's calculated:

$$\frac{\text{Total fundraising expenses}^{**}}{\text{Total fundraising net}} = \text{Cost of fundraising}$$

**Exhibit 15.8** Metrics for Assessing Fundraising Effectiveness

*Example: If an organization spends a total of $50,000 to raise a total amount of $150,000, then its cost of fundraising is 50 percent ($50,000 / ($150,000 – $50,000)). Or, stated in dollars, it spent $0.50 to net $1.00.*

*Many organizations have a mix of earned revenue and fundraising (or contributed) revenue. For the purposes of this measure, we are looking at only the total amount raised, which does not include earned revenue.

** Fundraising expenses should include both the costs of the fundraising efforts (event costs, printing, travel, etc.) and the staffing costs associated with those efforts. When generally accepted accounting principles (GAAP) are followed, joint cost accounting is an appropriate way to handle some fundraising expenses. When using joint cost accounting, organizations should take special care to ensure that they understand the full costs associated with each fundraising tactic and overall fundraising efforts when evaluating the effectiveness of those tactics and strategies.

*** This calculation could be done using any number of "top donors." We recommend five as a reasonable indicator of level of risk, but this could be adjusted to any reasonable number.

**** Because it's entirely appropriate for different fundraising tactics to have different average costs of fundraising, it's important to look at the cost of fundraising across the entire organization versus by individual fundraising tactic. It's only when you look at things in aggregate that you can assess whether or not – overall – the organization is being efficient with its investments in fundraising. For more on this, read "Understanding & Evaluating Your Fundraising Strategy: A Toolkit & Conversation Guide for Boards and Leadership Teams." Available for download at: https://boardsource.org/research-critical-issues/measuring-fundraising-effectiveness/#downloads.

*Source:* Association for Fundraising Professionals, BBB Wise Giving Alliance, BoardSource, and GuideStar, "Measuring Fundraising Effectiveness: Why Cost of Fundraising Isn't Enough," 2017, p. 3. Recommended by BoardSource as part of broader fundraising effectiveness evaluation (beyond merely cost of fundraising). This framework developed by all organizations listed. Used by permission of BoardSource.

**Exhibit 15.8** Metrics for Assessing Fundraising Effectiveness (*continued*)

If you can locate a peer benchmarking group, tap into its expertise. An excellent online source for fundraising statistics, including some benchmark data, is the AFP's Research and Statistics site: www.afpnet.org/research and statistics/fundraising research. For example, the site includes research from the Creative Direct Response Group (Crofton, MD) that indicates best practices for direct mail appeals: (1) 8 to 12 appeals per year for minimizing the cost of funds raised, or more frequent mailings if you wish to maximize the amount of funds raised; (2) most nonadvocacy charities do better using premiums for at least some of their appeals, including a higher return on investment; (3) the best experiences in gaining deferred-giving donors is based on age and frequency of giving to your charity, with simple bequests being the most frequent form of deferred or planned gift.[27]

Finally, try to assist your ED/CEO in addressing his or her concerns with fundraising. These concerns were identified by a 2006 CompassPoint Nonprofit Services and Meyer Foundation survey of CEOs/EDs:

1. *Boards of directors*. The key area in which boards might improve was fundraising (70 percent of respondents listed this), particularly in improving their own efforts and then assisting the executive and the organization.
2. *Institutional funders*. Grantmakers are seen as making the ED/CEO's job more difficult. The biggest improvements that could be made would be more general operating support (restricted funding not as helpful) and more multiyear grants.[28]

3. *Desire to gain more knowledge and skill in fundraising and financial management*. Many EDs/CEOs perceive in themselves a lack of understanding of fundraising or financial management and would like to gain a great understanding in these areas. As financial educator, you have a wonderful opportunity to help fill at least one of these knowledge gaps.

**(e) RISK MANAGEMENT.** A key issue in risk management is the use of internal versus external performance measures.[29] Benchmarking enables you to make internal comparisons and to match your performance up to similar organizations. If you use a new risk management product, you may then compare your performance to the internal baseline you have in your database. Internal data also serve as a basis for comparison when you do new training programs. External benchmarks match your organization to peers, so you can see how you are doing on a relative basis. You should maintain data on how frequent and how severe (costly) your claims are, as a starting point. Higher frequency rates usually point to the need for more emphasis on loss prevention, such as identifying location of incidence and the need for protective equipment or safety training. Claims analysis includes a look at the relative amount of medical expense, legal expense, and claim payout duration. The next step is to identify key cost drivers. Benchmark data then help to see what cost drivers lay behind your severity rates.

**(f) HUMAN RESOURCES.** A major concern in the area of human resources is executive burnout and turnover. With CompassPoint survey data from almost 2,000 executives indicating that as many as 70 percent of EDs/CEOs are planning on leaving their present positions within five years (but most of them staying in the nonprofit sector), succession planning is a vital concern. Furthermore, salary compensation and employee benefits are huge concerns. Salary data is readily available (for example, navigate to http://idealistcareers.org/salary-surveys/), and there is a growing database of benefits data as well.

The buzzword in the for-profit sector today is "human capital metrics." Companies are trying to link people measures to key performance indicators (KPIs), in the spirit of the balanced scorecard approach to performance management (see Chapter 3). Achieving this linkage requires a close working arrangement between human resources (HR) and finance, which should be easier for the typical nonprofit organization since HR is often housed in the finance area. Companies are attempting to focus more on top performers within their employees and also spend more of their HR time and budget on high-return-on-investment activities.[30] Incentives, hiring, and training practices in the organization can then be modified based on the numerical measures being tabulated. The Conference Board survey of 104 HR executives at midsize and large businesses indicates that 12 percent of companies tie people measures to strategic targets or KPIs, but another 84 percent of these companies intend on increasing their use of people measures for these purposes.[31] As people-intensive as service-oriented nonprofits are, this application holds great promise for the future. Care must be exercised in overburdening an already stretched workforce, however. Working smarter, not harder, should be the intended target. Benchmarks may be set for human resource expense (HR department costs), total investment in human capital (total HR expenses plus non-HR staff salaries and benefits), HR expenses by function (e.g., compensation costs as a percentage of operating expenses), HR expenses by process/programming (e.g., operations and maintenance costs as a percentage of total HR), and miscellaneous HR costs (e.g., turnover costs per employee leaving, absenteeism cost as a percentage of average wage rate, healthcare cost per employee).[32]

## 15.10 EVALUATING QUALITY AND OUTCOMES

Quality is notoriously difficult to evaluate in service organizations. Yet you are probably aware of some educational and healthcare providers that are applying "Six Sigma" process evaluation to their organization's processes and services. Determining what root problems are "critical to quality" for an organization's outputs is the key part of those applications. The concern here is "how well a business process, product, or service is meeting the requirements of the marketplace,"[33] and Six Sigma refers to 3.4 defects per 1 million customer requirements. If quality is an issue for your organization, Six Sigma thinking is worthy of your consideration. The metrics should naturally follow your application efforts.

Getting the organization's radar on outcome measures and measuring effectiveness or mission achievement is more difficult. Paul Light, in his study of several hundred high-performing nonprofits, finds they share one thing in common — and it's an item of great relevance to the CFO: These nonprofits achieved their standing by "strengthening their organizational capacity to withstand the uncertainty ahead… [they] have become robust."[34] Light identifies four pillars of robust nonprofit groups: (1) alertness to what lies ahead (reflect on the "environmental scanning" we profiled in Chapter 3); (2) agility, which entails "recruiting, training, retaining, and (if necessary) redeploying a talented, flexible work force"; (3) adaptability; and (4) alignment of all the organization's operations toward the mission. The latter is dependent on strategic planning and "tough conversations about mission."[35] But we single out Light's insights on adaptability, which mesh most closely with our observations over several decades:

> … high performers … manage to build reasonable reserve funds in spite of objections from donors and frequently challenge the assumptions that underpin their missions by asking themselves why they exist, whom they serve, and how they will know when they have succeeded.[36]

Will your organization swim against the tide of default practice in the nonprofit sector and insist on having a reasonable target liquidity level along with a long-range financial planning framework in place, tied to your organization's strategic plan? The mental model paradigm shift this entails is a sea change but worthy of all of your efforts to achieve it. It likely entails having to explain to donors and even board members why it is valuable to have a board-designated endowment with cash reserve set-asides for various purposes. Furthermore, as a primary internal consultant, you may continue to present in discussions and meetings the "why," "how," and "success metric" issues. You can be vigilant to ensure that metrics being used are actually helpful in steering your organization toward mission accomplishment. One danger to be aware of: An organization may fall into a "measures orientation" rather than being oriented toward activities that are most relevant and facilitating of mission achievement.[37] According to Susan Eagan, former executive director of the Mandel Center for Nonprofit Organizations at Case Western Reserve University, an organization is effective "when it consistently achieves its mission, or perhaps put another way, when an organization makes increasing and measurable progress on the issues it was established to address."[38] Eagan notes that this requires a *culture of performance*, which you may assist in promoting by the reports you help to devise and require as part of the reporting cycle in your organization:

> A culture of performance includes continuous learning within the organization, ongoing evaluations of programs and projects, being mindful of what works and what doesn't, and a commitment to innovation – a willingness to try new services and products.[39]

## 15.11 USING EXTERNAL CONSULTANTS AND DATA SOURCES

A full discussion of whether and how to use external consultants is beyond our scope, but we note that outside of fundraising, audits, strategic planning, basic board training, and perhaps IT or ED/CEO search services, nonprofits make little use of consultants. One unscientific survey found the median expenditure on consultants and contractors to be $25,000 in 2004.[40] The good news is, you may be able to get foundation or government grants to pay for fundraising, planning, staff/board training/development, outcomes evaluation, graphic design/copywriting, or IT services.[41]

If you decide to do your own in-house "self-audit," you may wish to review these seven areas (some of which overlap with topics already covered), gaining feedback from your board of directors, staff, volunteers, major donors, and clients:

1. Relationship/connectedness
2. Mission/goals/feedback
3. Current project assessment
4. Effectiveness/efficiency/sustainability
5. Leadership
6. Volunteer management
7. Donor direction of gifts[42]

This list, from consultant Chuck Maclean, is one that you may wish to rotate through—do one or two each year, based on the time and resources you have to devote to the self-review.

As with other major purchases, talk with peer organizations about their experiences with consultants to see who might be available and what experiences they (or someone they know) have had with the potential consultant. While you may not be able to quantify benefits before the fact, quite often the insights gained from an objective outsider are indispensable. "Where no counsel is, the people fall: But in the multitude of counsellors there is safety," as the wise proverb has it.

## 15.12 CONCLUSION

None of the evaluations presented in this chapter should be taken out of context or used as the sole justification or reason for making significant changes in your organization. It is important to use these evaluations as one of many tools for measuring your performance as well as that of your organization. There may be unique factors in these evaluations that cause your scores to be inaccurately high or low. Performing each of these evaluations quarterly or semiannually and averaging your results after a year or two may also provide a better picture of your performance. Performing this evaluation on an ongoing basis ensures that you are as effective as you can be for the organization you serve.

Regarding your organization, we started this guide arguing for financial management proficiency. We end it pleading for organizational effectiveness. The role you can play in tying these two ideals together? You can be the strategic financial manager or treasurer, the internal business consultant, the financial educator, and team player that your organization needs. We close with an aspiration and a promise from Proverbs in the Bible (applying equally to men and women): "Do you see a man diligent and skillful in his business? He will stand before kings; he will not stand before obscure men."

## Notes

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9. The interest on the part of donors or charity watchdog agencies in keeping overhead cost or fundraising cost ratios down is often dysfunctional: The Nonprofit Overhead Cost Project, conducted jointly by the Center on Philanthropy at Indiana University and the Center on Nonprofits and Philanthropy at the Urban Institute, noted that "no organization in our study was an extravagant spender on fundraising or administration. Yet contrary to the popular idea that spending less in these areas is a virtue, our cases suggest that nonprofits that spend too little on infrastructure have more limited effectiveness than those that spend more reasonably." Mark A. Hager, Thomas Pollak, Kennard Wing, and Patrick M. Rooney, "Getting What We Paid For: Low Overhead Limits Nonprofit Effectiveness," *Nonprofit Overhead Cost Project: Brief No. 3* (August 2004). Available at: http://nccsdataweb.urban.org/kbfiles/311/brief%203.pdf. The best article on this topic in our view is Jesse D. Lecy and Elizabeth A. M. Searing, "Anatomy of the Nonprofit Starvation Cycle: An Analysis of Falling Overhead Ratios in the Nonprofit Sector," *Nonprofit and Voluntary Sector Quarterly* 44, no. 3 (2015): 539–563. Finally, an incisive deep-dive on funder dysfunctions in the nonprofit world is available at Clara Miller, "The Looking-Glass World of Nonprofit Money: Managing in For-Profits' Shadow Universe," *Nonprofit Quarterly* 12 (Spring 2005): 48–55.
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16. Liquidity thresholds are formally defined by Jim Negus: "The liquidity threshold typically represents a formal tolerance level (or band) 'triggering' management oversight or remediation. Example liquidity thresholds include maximum credit facilities, downgrade risk (an adverse rating agency activity resulting in increased funding costs and collateral requirements, measured maybe by the debt/EBITDA ratio), capital structure ratios (e.g., debt to equity), short- to long- term debt financing ratios (e.g., <25% short-term financing), and various debt covenant thresholds relevant to cash, credit or capital markets (e.g., interest coverage)." Jim Negus, "Liquidity Management in Turbulent Times," *TMI*, September 2011. Available at: https://www.treasury-management.com/article/4/213/1844/liquidity-management-in-turbulent-times.html. Accessed 8/5/2017.
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*Financial Management for Nonprofit Organizations: Policies and Practices*, Third Edition. John Zietlow, Jo Ann Hankin, Alan Seidner and Timothy O'Brien.

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