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Ensuring Sound Financial Management

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chapter
SEVENTEEN

Ensuring Sound Financial Management

By Elizabeth Norton-Schaffer

Your organization is a mission-based business, not a charity.

—Peter Brinckerhoff, *Mission-Based Management*

As an Executive Director, you are constantly balancing the pursuit of the mission and the financial sustainability of your organization. Financial oversight cannot be delegated; it lies at the heart of your accountability to your Board, your stakeholders, and your nonprofit's legal requirement to uphold the public trust.

Your specific financial tasks will vary based on your organization's history, culture, and resources, so it isn't possible to cover all the details. However, this chapter addresses some key financial management activities and questions that Executive Directors typically ask as they work their way through financial details:

- What are the major differences between for-profit and nonprofit finances?
- Who takes the lead in fulfilling the various financial management roles in a nonprofit?

- What financial reports do the Board, staff, and volunteers need to see and how often?
- What is the Board's role in the budgeting process?
- After the Board passes a budget, what authority does the Executive Director have to implement programs or contracts?
- If there is a financial crisis, what does the Executive Director tell the Board and staff?

Before trying to answer these questions, it is helpful to define the key activities of nonprofit financial management: budgeting, implementation, reporting, and analysis.

SOME KEY DEFINITIONS

Budgeting: The budget is simply your plan for the coming year expressed in terms of income and expenses. In many organizations, the budget cycle represents the bulk of the annual planning effort. Budgeting activities include creating an annual program plan, estimating expenses, and forecasting revenue.

Implementation: Once a budget is in place, you'll begin implementing programs, raising and spending money as approved, and recording financial transactions.

Reporting: At the end of each month and quarter, your accounting staff or service will create reports that reflect all of the month's financial activity.

Analysis: Using the reports, you, the Treasurer, and other Board and staff members will monitor financial performance and assess whether the original plan (and budget) is still the best course.

WHAT ARE THE MAJOR DIFFERENCES BETWEEN FOR-PROFIT AND NONPROFIT FINANCES?

Good financial systems and accounting practices in nonprofit organizations are, for the most part, very similar to those used in the for-profit world. Nonetheless, those new to the nonprofit sector—both staff and Board members—often struggle with how nonprofit financial information is presented. The key differences are the classification of net assets, accounting for contributions, recording of functional expenses, and sources of revenue.

Classification of Net Assets

The difference between a nonprofit's assets (property) and liabilities (debt) is known as its *net assets.* Nonprofit accounting conventions require that (audited) financial statements segregate net assets into three categories:

- *Unrestricted net assets:* Net assets that are not subject to donor-imposed restrictions and can be used at the discretion of Board and management.
- *Temporarily restricted net assets:* Net assets that are subject to donor-imposed stipulations that may be met by actions of the organization or will be met by the passage of time. When the restriction expires, temporarily restricted net assets are reclassified as unrestricted. For example, say a foundation gives you a two-year grant (time restriction) targeted to the youth development program (purpose restriction). As you implement the program and spend money hiring staff, creating marketing materials, you will release these funds from restriction.
- *Permanently restricted net assets:* Net assets subject to donor-imposed stipulations that they be maintained permanently by the organization (endowments). The organization can spend the income these assets generate, but cannot dip into the principal sums.

Accounting for Contributions

Nonprofits fund their activities with either earned revenue (client fees, ticket sales, government contracts, and so on) or support (grants and contributions). Accounting for contributions is unique to the nonprofit sector and often misunderstood.

The level of restriction associated with a grant or contribution determines how it is recorded. According to generally accepted accounting principles for nonprofit organizations, support is reported in the following three categories:

- *Unrestricted support:* Grants and contributions given by the donor without reference to a specific purpose or use within a specific time period are recorded when pledged and increase the unrestricted net assets of the organization.

- *Temporarily restricted support:* Grants and contributions that are to be spent for a specific purpose or during a restricted period of time are also recorded when pledged and increase the temporarily restricted net assets. Once any restrictions have been met, the grant or contribution will be released (or transferred) into unrestricted net assets, with a corresponding reduction in temporarily restricted net assets.
- *Permanently restricted support:* These are grants and contributions whose principal is to be invested according to the donor's wishes and are added to the permanently restricted net assets when pledged.

Functional Expenses

As defined by the IRS Form 990 and FASB 117, nonprofits must report their expenses by functional classification: program services and supporting services. Exhibit 17.1 provides a detailed breakout of functional expenses. In general, however, program services are "the activities that result in goods and services

Exhibit 17.1
Functional Expense Classifications

Program	Costs resulting in distributing goods and services to clients and fulfilling the mission of the organization
Administration (supporting)	Those costs not identifiable with programs, fundraising, or membership development and indispensable to the organization's existence such as governance (that is, Board-related expenses), finance and accounting, legal, and executive management
Fundraising (supporting)	Costs associated with soliciting contributions from individuals, foundations, and corporations; maintaining donor mailing lists; and conducting fundraising events
Membership development (supporting)	Those costs related to soliciting for prospective members and membership dues, membership relations, and similar activities

being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major output of the organization and often relate to several major programs." Supporting services are "all activities of a not-for-profit organization other than program services. Generally, they include administration, fundraising, and membership development activities."

Revenue Sources

Nonprofit organizations often have more diverse sources of income than for-profit companies. Typical sources of income are contributions from individuals and institutions, earned revenue from clients, government, events, and contracts, and dividends and interest from investments. Nonprofits that rely upon a single source of funding—from an individual donor, a foundation grant, or a government contract—for the majority of their annual income will be more vulnerable than those with diverse sources of income. Further, healthy nonprofits strive to have diversification across income streams—a variety of funding types—and within income streams—a number of sources within a funding type.

WHO TAKES THE LEAD IN FULFILLING THE VARIOUS FINANCIAL MANAGEMENT ROLES IN A NONPROFIT?

Nonprofit financial management is a team process that involves both the Board and staff in planning and implementation, as well as in the reporting and monitoring systems that ensure financial stability and public accountability. While these roles will vary to some degree based on your organization's size, culture, and lines of authority, the chart in Exhibit 17.2 will help guide your organization in determining leadership roles and shared responsibilities. On the staff side, the ED may delegate the responsibility to the appropriate financial or program staff within the organization. On the governance side, the Board often delegates the role to the Treasurer or the Finance Committee. The ED and Board may delegate certain tasks and responsibilities, however, they are still ultimately responsible for the oversight and overall accountability of the organization.

Exhibit 17.2
Fiscal Roles and Responsibilities

Overall: To ensure that the organization has fiscal processes and systems that support appropriate control and oversight.

	Executive Director	Board
Form a Finance Committee.		Lead
Establish meaningful dialogue between Finance, Program, and Development staff and committees.	Share	Share
Establish salary ranges for each job category; ensure that salaries are within approved ranges.	Share	Share
Prepare an annual schedule showing each staff person's category and salary range (for Personnel or Finance Committee).	Lead	

Budgeting and Planning: To ensure that the budget reflects the organization's mission, values, and overall plan.

	Executive Director	Board
Create long-range plan, annual goals, and budgeting parameters.		Lead
Develop annual program plan and estimate costs.	Lead	
Create revenue and fundraising projections.	Share	Share
Propose plan and budget for approval.	Lead	
Approve the plan and budget; give staff authority to make minor changes.		Lead

Record Keeping: To appropriately record all financial transactions and safeguard the assets of the organization.

	Executive Director	Board
Develop a written set of internal policies for handling deposits and payments; follow procedures in spirit as well as to the letter.	Lead	

	Executive Director	Board
Review and approve key accounting policies.		Lead
Authorize bills and invoices for payment; determine expense coding.	Lead	
Determine appropriate revenue coding for deposits.	Lead	

Reporting: To summarize the organization's financial position in an accurate and complete manner, and to comply with all legal and funding requirements.

	Executive Director	Board
Create monthly financial reports within three weeks of month-end.	Lead	
Distribute financial statements before Board and committee meetings.	Lead	
Prepare brief, written narrative analysis to accompany financial reports.	Lead	
Determine whether an audit is required; select the auditor; receive the audit letter directly from the auditor; meet with the auditor with no staff present (at least once per year).		Lead
Ensure that the audit is completed within four months of fiscal year-end; prepare a written response to comments in the management letter.	Lead	
Complete or verify that all legal and funding requirements are completed in an accurate and timely fashion.	Share	Share

Monitoring: To ensure adequate fiscal oversight.

	Executive Director	Board
Carefully review organization's financial information.	Share	Share
Compare actual results to budget; propose revised plan or budget.	Lead	
Propose items for ad hoc investigation.	Share	Share

WHAT FINANCIAL REPORTS DO THE BOARD AND MANAGERS NEED TO SEE AND HOW OFTEN?

The only report that nonprofit organizations are required to file (and then, only those with receipts of more than $25,000) is IRS Form 990. Unfortunately, although satisfying legal requirements is essential, most organizations cannot use the Form 990 as a management tool. Regardless of the organization's income level, Board and staff need other financial information to let them know how things are going. Typically, the Board and staff will want answers to these questions:

- Do we have enough money?
- Are our results consistent with our plan or budget?
- Do we need a new plan?
- What's our cash flow situation?
- Do we have sufficient reserves?

You'll need to be able to answer these questions as frequently as things change in your organization. When you can't locate an answer in your head, it is time to find the answer elsewhere. For most organizations, a small group—such as the staff leadership team or the Board's Finance Committee—reviews data on a monthly basis. Other organizations find that it works well to have a more comprehensive quarterly presentation to the full Board with an update for all staff. Typically, the organization's external constituencies—funders, members, donors, and so on—expect an annual financial update. Most important is to create a schedule and stick to it. When people expect data and don't receive it, they tend to think the worst.

The chart in Exhibit 17.3 provides a list of the reports required in the typical nonprofit organization. The Executive Director's key role in financial reporting is to ensure that everyone—ED, staff leadership, and Board members alike—upholds the public trust. All parties must be educated consumers of financial data and accountable to the organization's stakeholders.

WHAT IS THE BOARD'S ROLE IN THE BUDGETING PROCESS?

The best budgeting process is a partnership between Board and staff. The first and most important step of the budgeting process is for Board and ED to jointly

Exhibit 17.3
Financial Statements for Leaders

Statement of Financial Position	Also known as the balance sheet in the for-profit world, this statement summarizes assets (what the organization has and uses), liabilities (what the organization owes), and net assets (what the organization truly owns) as of a specific date.
Statement of Activity	Also known as the income statement or profit and loss statement in the for-profit world, this statement reports financial activity by function over a period of time.
Budgeted Statement of Activity—Unrestricted	This statement compares the organization's unrestricted financial activity to the budget—see sample statement in Exhibit 17.4.
Statement of Functional Income and Expenses	This report matches income and expense by function—for example, key programs, administration, and fundraising—and is used to evaluate surplus or deficit for each activity.
Restricted Funds Detail	This report includes information on each restricted grant: the amount raised, the amount released from restriction, and the remaining balance available for current and future fiscal years.
Updated Cash Flow Projection	This forecasting tool details the planned cash receipts and disbursements for the coming months.
Updated Projection	This forecasting tool details the year-to-date financial performance and the planned activity for the balance of the fiscal year—see sample projection in Exhibit 17.5, later in this chapter.

Source: Bell, J., and Schaffer, E. *Financial Leadership for Nonprofit Executives: Guiding Your Organization to Long-term Success.* St. Paul, Minn.: Fieldstone Alliance, 2005.

develop a set of overall assumptions about funding and expenses and to clarify fiscal goals for the upcoming year. If you have a strategic plan in place, it may be simple to agree on these goals. Without a strategic plan, developing the annual goals can be a time-consuming and highly iterative process.

Once the Board and Executive Director agree on the overall budgeting direction, the next step is to create program and implementation plans. Next, staff leadership in conjunction with Board committees—Executive, Finance, Program,

Exhibit 17.4

Budgeted Statement of Activity (Unrestricted)

For the Six Months Ending December 31, 2010

	YTD Actual	YTD Budget	Variance B/(W)	Annual Budget	$ Remaining	% Remaining
Contributions	31,477	40,000	(8,523)	80,000	48,523	61%
Fundraising events–net	62,415	67,500	(5,085)	135,000	72,585	54%
Foundation grants	45,000	62,500	(17,500)	125,000	80,000	64%
Total support	138,892	170,000	(31,108)	340,000	201,108	59%
Government contracts	460,887	407,505	53,383	815,009	354,122	43%
Interest and dividends	8,754	5,000	3,754	10,000	1,246	12%
Unrealized gain (loss) on investments	2,251	—	2,251	—	(2,251)	n/a
Total revenue	471,892	412,505	59,388	825,009	353,117	43%
Net assets released from restriction	220,020	225,000	(4,980)	450,000	229,980	51%
Total income	830,804	807,505	23,300	1,615,009	784,205	49%

Shelter services	398,547	401,538	2,991	803,075	404,528	50%
Support groups	194,012	197,098	3,086	394,196	200,184	51%
Administration	98,754	94,913	(3,841)	189,825	91,071	48%
Fundraising	135,214	99,757	(35,457)	199,514	64,300	32%
Total expenses	826,527	793,306	(33,221)	1,586,611	760,084	48%
Change in net assets	4,277	14,199	(9,922)	28,398	24,121	85%
Beginning net assets	298,547	300,000	(1,453)	168,690		
Ending net assets	302,824	314,199	(11,375)	197,088	24,121	12%

Source: Bell & Schaffer (2005).

Exhibit 17.5
Updated Projection—Unrestricted

As of January 20, 2011

	Annual Budget	1st Qtr Actual	2nd Quarter Actual	YTD Actual	3rd Quarter Projected	4th Quarter Projected	Revised Projection	Variance B/(W)
Contributions	80,000	12,540	18,937	31,477	25,741	22,584	79,802	(198)
Fundraising events—net 135,000	21,540	40,875	62,415	–	65,000	127,415	(7,585)	
Foundation grants	125,000	15,000	30,000	45,000	32,500	45,000	122,500	(2,500)
Total support	340,000	49,080	89,812	138,892	58,241	132,584	329,717	(10,283)
Government contracts	815,009	204,580	256,307	460,887	180,000	174,122	815,009	–
Interest and dividends	10,000	5,147	3,607	8,754	8,500	8,500	25,754	15,754
Unrealized gain (loss) on investments	–	2,251	2,251	2,500	2,500	7,251	7,251	
Total revenue	825,009	209,727	262,165	471,892	191,000	185,122	848,014	23,005
Net assets released from restriction	450,000	95,478	124,542	220,020	125,000	125,000	470,020	20,020
Total income	1,615,009	354,285	476,519	830,804	374,241	442,706	1,647,751	32,742

Shelter services	803,075	201,602	196,945	398,547	201,501	200,154	800,202	2,873
Support groups	394,196	102,547	91,465	194,012	98,541	102,584	395,137	(941)
Administration	189,825	55,140	43,614	98,754	48,521	49,587	196,862	(7,037)
Fundraising	199,514	51,478	83,736	135,214	52,410	48,521	236,145	(36,631)
Total expenses	1,586,611	410,767	415,760	826,527	400,973	400,846	1,628,346	(41,735)
Change in net assets	28,398	(56,482)	60,759	4,277	(26,732)	41,860	19,405	(8,993)
Beginning net assets	300,000	298,547	242,065	298,547	302,824	276,092	298,547	(1,453)
Ending net assets	328,398	242,065	302,824	302,824	276,092	317,952	317,952	(10,446)

Source: Bell & Schaffer.

Notes In the first column of this report, the year-to-date (YTD) financial activity is listed. In the next column , the YTD budget (six months) is listed. The third column calculates the variance, or difference between the two. When the performance is better (B) than planned, for example, government contract revenue is higher than planned, the variance is a positive number. When the performance is worse (W) than planned, for example, the fundraising expenses are higher than planned, then the variance is a negative (bracketed) number. The last two columns calculate the dollars and percentage remaining to meet the goal (income) or stay within budget (expenses).

and Development—develop an initial budget draft with a list of budget assumptions. Then the Board or a designated committee discusses and edits the list, and finally the full Board meets to approve the budget. In approving the budget, the Board is taking the following steps:

- Agreeing to the plan
- Authorizing implementation of that plan
- Expecting that staff will report and analyze financial data to ensure alignment with the plan

Unfortunately, most organizations do not begin the budgeting process by developing or clarifying mutually agreed-upon annual goals. More typically people just look at the numbers. As a result, the Board meeting to review the budget often turns into a heated discussion as participants challenge details and dollars without the structure and support of an underlying plan. This scenario is best avoided by involving the Board and staff members at the beginning of the budgeting process.

As Executive Director, your particular budget tasks will vary based on the size of your organization. If your organization is small, you may be crunching the numbers and linking the spreadsheets yourself. Regardless of organization size, you should be expected to create the underlying operating plan and to validate all assumptions that are made in response to economic and financial trends.

AFTER THE BOARD PASSES A BUDGET, WHAT AUTHORITY DOES THE EXECUTIVE DIRECTOR HAVE TO IMPLEMENT PROGRAMS OR CONTRACTS?

With an approved budget, the Executive Director normally has the authority to execute the plan. You can spend and raise the money represented in the plan—as long as your actions are consistent with the explicit and implicit budget assumptions. For example, this year's budget may include a slot for a new program assistant that is to be funded by a new foundation grant. Although it's not an explicit budget assumption, the Board may expect that you won't fill this position until you receive the grant.

It is common and beneficial to have written policies that clarify the Executive Director's authority and any limitations regarding long-term contracts, approval of payments, and unbudgeted expenses.

As you begin to implement your budget, you'll need to continually verify that your original plan is still valid and that the assumptions still work. If you find that your plan or assumptions need updating, be sure to communicate swiftly and clearly about the changes. You'll probably need to engage jointly—with the Board and key staff—in a planning process to update your goals, your program and development plan, the assumptions, and the budget.

IF THERE IS A FINANCIAL CRISIS, WHAT DOES THE EXECUTIVE DIRECTOR TELL THE BOARD AND STAFF?

When the news spreads that an organization is in financial crisis, what does it mean? It might mean that a significant source of funding was cut, and now the available resources are insufficient to maintain programs. It might mean that the organization is unable to meet its financial obligations. It might mean that someone has defrauded the organization. More often than not, it is one of these scenarios coupled with a lack of information about the financial situation. The best advice in a crisis: whether the news is bad or good, use the same reporting process. Stick to the schedule and keep the information flowing.

Unfortunately, in a crisis, there is typically no data at all. In this case, the sooner you get data, the better. As the Executive Director, you will want to model the best practice of making decisions based on data, not assumptions. And no matter how bad the news, the best practice is to be honest with both Board and staff.

When a financial crisis occurs, first tell the Board Chair and Treasurer, and work with them to lay out a plan for informing the rest of the Board and staff. If there is a Finance Director in the organization, include that individual in the conversation as well. The four of you should be able to come up with a realistic communication plan that can be implemented at the same time the crisis is being resolved. While this communication plan will vary from organization to organization, it should include the following components:

- Clear explanation of what the financial crisis is and why it occurred (program being eliminated because funding slashed, several funders reducing allocations at the same time, stock portfolio significantly reduced with a destabilizing effect—these are examples)
- An outline of the steps being taken to regain financial stability in the organization, including who is taking the steps and a time line

- A process for continued communication with the staff and Board about progress being made

As long as Board and staff can see there is a plan to resolve the financial crisis, they will have confidence in the leadership. They may also have good ideas to offer that can be implemented as part of the action plan.

TIPS FOR SUCCESS

- Look for financial leadership partners on staff and the Board. These may be individuals who already understand nonprofit financial reports or who have an eagerness to learn.
- Set a tone of financial transparency throughout the organization.
- Invest in infrastructure to ensure accurate financial information that is managed well and reported on a timely basis.
- Educate your Board to read, understand, and challenge financial statements.