10 THINGS EVERY BOARD MEMBER NEEDS TO KNOW

Essential Keys to Nonprofit Finance

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**Mission**
Our mission is to foster effective risk management practices and the overall development and advancement of nonprofits through unique, creative initiatives.

**Ten Things Series for Nonprofit Boards**
Welcome to this series of short briefing papers for nonprofit board members. Whether a seasoned leader or first-time trustee, there is a continual need to revisit the expectations and demands of the critical board member roles in steering, supporting and safeguarding nonprofit organizations. In this series, First Nonprofit Foundation has identified topics of particular interest to board members and will provide digests of time-tested wisdom, emerging thought, and the insights of highly experienced practitioners. We trust these papers will succeed in helping nonprofits to develop and advance. As always, we welcome your comments and suggestions.

**Booklets in this series**
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*A Winning Board: Steps That Bring Out the Best*
*Champions with a Cause: The Nonprofit Board Member’s Role in Marketing*
*Strong Partners: Building an Excellent Working Relationship between the Nonprofit Board and its Chief Executive*
*Evaluating the Executive Director: Your Role as a Board Member*
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*Fundraising: A Partnership between Board and Staff*
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*Risk Management: Your Role as a Board Member*
*Shaping the Future: The Board Member’s Role in Nonprofit Strategic Planning*
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The quote “we haven’t got the money, so we have to think” describes the condition of almost every nonprofit. As leaders and fiduciary guardians of their organizations, board members must learn to think, and think hard, about the finances of their organization. The good news is that though this responsibility is daunting, the right preparation enables even the financially unsophisticated board member to effectively oversee the organization’s finance function.

This booklet identifies and describes ten things your board should know about an organization’s finance function. The list is not all-inclusive and is not intended to establish a general standard of operation, but we hope it will generate productive discussion on the board and with management. These ten things are:

1. Reading Internal Financial Statements
2. Understanding Budgets and Forecasts
3. Understanding Your Sources of Revenue
4. Understanding Fiscal Year-End Financial Statements
5. The External Audit Process
6. Executive Compensation
7. Internal Controls—Fraud Prevention and Detection
8. Accounting Procedures and Policies Manuals
9. Annual Tax Filings
10. Other Financial Reporting
Board members' responsibility includes reviewing financial information and making decisions in the best interest of the organization. To fulfill this duty, management typically supplies reports on a schedule that fits with board meetings. This financial information may be used by board members to:

1. Monitor revenue, support, and expenses, and compare results to prior periods or to budgeted amounts.
2. Assess the financial condition of the organization to determine if it is appropriate to expand or contract programs and services.
3. Determine whether additional fundraising events or activities are needed to fill the gaps from shortfalls in revenue.
4. Analyze the results of a particular program, activity, or grant.
5. Determine management's ability to use funds effectively to meet the organization's mission.

Board members must determine the type and form of financial information they need and require management to provide it on a timely basis—usually within 20 days of the most current reporting period. Internal financial statements typically do not consist of a complete set of financial statements. Common statements include the *Statement of Financial Position* and the *Statement of Activities*. These are typically unaudited. They help create a complete picture of the organization's financial condition and status of resources that are available for use.

The board should plan meetings shortly after the receipt of financial reports in order to make timely decisions in the best interest of the organization. Board members should review the reports prior to meeting and prepare questions such as:

- What are the components of an account?
- How does this compare to last year’s performance, and why?
- Why are there variances in the actual versus budgeted numbers?

Management should be prepared to address these questions and should consider providing a narrative to the board when submitting the internal financial statements to explain conditions and variations. This analysis may also assist in identifying errors that require adjustments on the financial statements. Timely monitoring of financial results is especially important if the organization is experiencing cash flow problems.

If different reports and accounting methods are used on an interim basis than used on the year-end financial statements, the board should be educated on the differences and the reasons for the variations in reporting. In addition, the board should
obtain an understanding of any adjustments that are needed in order to prepare year-end financial statements in accordance with Generally Accepted Accounting Principles (GAAP). A significant number of adjustments or large dollar adjustments to the internal financial statement at year end may indicate that the statements the board has been receiving are not very reliable. The board should monitor this on an ongoing basis to determine if further action is warranted.

2. **Understanding Budgets and Forecasts**

The budget is a financial plan that serves as a guide for month-to-month operations. It is a roadmap that tells where an organization has been, where it is going, and how it is expected to reach its goals from a financial perspective. The budget is a financial expression of the short- and long-term goals of the organization. It is also a financial control that sets spending limits and attempts to keep costs in line with revenues.

Budgets are connected to the availability and timing of financial resources. Cash forecasts project when cash will be received and when it will be disbursed. Thus the forecast is essential to understanding whether the cash necessary to carry out the plan will be available. Budgets and forecasts go hand-in-hand.

Board members should understand the budget and forecast process. They should be directly involved with approving the budget and cash forecast; monitoring actual to budgeted results; and approving actions taken when budget revisions are required.

The board should require a budget that is:

- **Realistic.** It should be well-reasoned and reflect current conditions. Unsubstantiated revenue projections and “guesstimates” of costs render a budget ineffective.
- **Consistent.** It needs to align with and express the organization’s short- and long-term strategic plans.
- **Flexible.** It should allow for adjustment and approval when considering revenue shortfalls or windfalls and unexpected expenses.
- **Measurable.** It must be based on the same figures and accounting system used to maintain the organization’s books and records.

**The Budget Process**

Depending on the size of an organization, the budgeting process should include the knowledge and expertise of board members, finance committee members, the trea...
surer, and the executive officers. The budgeting process should commence well before the start of the fiscal year. It begins as the staff determine the programs and activities for the coming budget period. Expenses and revenues tied to these activities should be carefully projected based on good data—usually historical data for existing activities and fact-based projections for new activities. It should take into account economic conditions, possible changes in service demand, and other factors that affect program utilization.

The board’s finance committee usually reviews budget drafts and makes recommendations before a final draft is presented to the board for approval. When reviewing the proposed budget, board members should look for signs that the numbers involve wishful thinking or guesstimates rather than defensible estimates. An approved budget becomes the final budget for the coming year. The budget should show prior year actual and budgeted amounts by month, the current year budgeted amount, and a month-to-month breakdown of the projected budget amounts.

Once the new budget year begins, the board’s job is to monitor actual activity against the budget. This should be done monthly so as to react to results and cash flow effects. This process acts as a deterrent to mismanagement of funds and misrepresentation of information.

**Cash Flow Forecasts**

Lack of cash to cover expenses at the right time is detrimental to the organization. Many factors affect cash flow—for example, disasters, economic changes, and dramatic swings in cash revenue caused by annual fundraising events, membership, and pledge drives.

Cash forecasts generally project cash receipts and disbursements for each month of the year, based upon historical financial reports, experience, past budgets, and informed estimates. Board and committee members should know as soon as possible when cash shortfalls or excesses will be projected so as to plan for how to fund the shortfall or invest the windfall.

Budgeting and forecasting is only as useful as it is accurate, complete, and current. A well thought out budget is one of the keys to financial stability growth. This is simply good management, good stewardship of your supporters’ money, and a major step toward the board’s involvement in fulfilling the organization’s mission.

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**2. Understanding Budgets and Forecasts**
Board members should have a general understanding of the types of revenue sources an organization receives and how those transactions are recorded for financial statement purposes. The most common revenue sources for a nonprofit are typically revenues and support from contributions, grants, special events, and investment income. When you review the organization’s Statement of Activities, you should be able to tell where the revenues were derived and have a basic understanding of how those transactions should be recorded.

For many nonprofits, contributions and grants are a major source of revenue, the accounting for which can be fairly complex. It is important to have an understanding of some basic concepts that impact the accounting for these transactions.

Contribution transactions are voluntary transfers of assets where the donor is asking for nothing in return. Donations of cash and property are examples of contribution transactions. Such transactions are recognized in the financial statements when the donor makes the promise to give to the organization. The promise to give can occur at the same time the cash or other asset is given to the organization, or in the form of a pledge to give cash or other assets at a future date. Contributions can come from a number of sources, including individuals, corporations, government agencies, special events, program service revenue allocations and federated fundraising organizations.

There are a number of factors to consider when a contribution is given or a promise has been made to give to an organization. These include:

Did the donor place restrictions on how or when these funds can be used? An example of this would be when an individual donates $10,000 and explicitly states that the funds are to be used for program personnel salaries during the next fiscal year. When this occurs, the organization has received a contribution that includes a donor restriction. Contributions are classified on the financial statements as unrestricted, temporarily restricted, or permanently restricted. Unrestricted indicates that the amounts are currently available for the organization’s use. Temporarily restricted means that the donor has specifically stated how and/or when they would like their contribution to be used. Contributions are permanently restricted when the donor stipulates that the funds are to be held by the organization in perpetuity. Only the donor is able to place restrictions on funds that are given. Often times, the board may designate funds to be set aside to be used for a future expenditure. These board designations are voluntary and may be reversed by the board at any time. Because of the ability to remove the designation, the board designated net assets are included in unrestricted net assets.
Has the donor made a promise to give a sum of money to the organization over multiple fiscal years? An example of this would be if an individual promises to give a total contribution of $50,000 to your organization and will pay this contribution over the next five years in $10,000 installments. The organization should be recording the full contribution of $50,000 at the time the donor makes the promise. The receivable will be reduced by a discounted amount in order to record the pledge at its present value.

Has the donor made a promise to give that includes conditions on when or if the organization would receive the contribution? For example, a donor promises to give a contribution that matches the amount they are able to receive from other donors. If there are conditions placed on a contribution, the timing and/or dollar amount to be received is uncertain. When this occurs, a “conditional” promise to give is not recorded as revenue until the uncertainty is removed.

Grant revenue can come from variety of sources, but most commonly from government agencies, corporations and foundations. Grant revenue can take on the characteristics of either a contribution transaction or an exchange transaction. Exchange transactions typically involve an organization’s efforts to provide goods or services to members, clients, customers, or other beneficiaries for a fee. It is important to distinguish whether a grant is an exchange or contribution transaction, as it could impact when the revenue is recognized. Contrary to the accounting treatment for contributions as previous discussed, grant revenues that are considered exchange transactions, are recognized when the revenue is earned, such as when the goods are delivered or services are performed. It is important that as grant agreements are received, they are reviewed in detail by management and your accountant to ensure that the transactions are properly recognized in the financial statements.
4. Understanding Fiscal Year-End Financial Statements

When reviewing an organization’s year-end financial statements, ask the following questions, all of which will be discussed in further detail:

1. Who are the users of the organization’s financial statements?
2. What basis of accounting was used to prepare the financial statements?
3. What are the basic financial statements and what are they telling me?
4. What financial performance measurements are important for our organization?

**Who are the users of the organization’s financial statements?**

Board members should understand that they are not the only group relying on the information that is provided to them. Often, the year-end financial statements are provided to other entities such as funding sources, regulatory agencies, and creditors or potential creditors. In addition other agencies or watchdog groups will review financial information through other means, such as review of the organization’s tax return.

**What basis of accounting was used to prepare the financial statements?**

An organization should prepare year-end financial statements in accordance with generally accepted accounting principles in the United States of America (GAAP). GAAP provides the authoritative guidance on how transactions should be accounted for and what is required to be disclosed in the financial statements. Statements that depart from GAAP could result in the user losing confidence in the information or could result in inappropriate conclusions about the organization’s financial condition. GAAP financial statements are prepared on the accrual basis of accounting, which recognizes revenues and expenses in the period when they are earned rather than in the period collected, as with the cash basis of accounting. The accrual basis provides a more accurate picture of how an organization is performing.

**What are the basic financial statements and what are they telling me?**

A complete set of financial statements includes the following components:

- **Statement of Financial Position (Balance Sheet).** The statement of financial position reports an organization’s assets, liabilities, and net assets as of a specified point in time. The statement of financial position should focus on the organization as a whole and provide information about an organization’s liquidity, financial flexibility, and the relationships between assets and liabilities.

- **Statement of Activities (Revenues and Expenses).** The statement of activities is designed to provide information about changes in an organization’s unrestricted, temporarily restricted, and permanently restricted net assets.

- **Statement of Cash Flows.** The statement of cash flows provides information about an organization’s cash receipts and disbursements. All receipts and payments are classified as operating, investing, or financing activities. Cash flows from operating activities provide the reader with information on the cash effects from the organization’s normal operations of providing services or making and receiving contributions.
Statement of Functional Expenses. The statement of functional expenses is required for voluntary health and welfare organizations. This statement provides information about an organization’s service efforts by presenting expenses by their functional (i.e. program service or supporting service expenses) and natural (i.e. payroll, occupancy, professional fees, etc.) classifications.

Notes to the Financial Statements. The footnotes are an integral part of the financial statements. The notes provide additional qualitative and quantitative information to support financial statement amounts. The notes to the financial statements also provide information on matters that are not included on the face of the financial statements. Such information includes detail on related party transactions, pension plans, commitments and contingencies, compliance with debt covenants, subsequent events and accounting changes.

What financial performance measurements are important for our organization?
It is important for board members to analyze year-end financial statements to determine how the organization’s financial results compare to other similar-sized organizations. For-profit companies can evaluate overall performance by measuring profitability, but this method is not really suited to nonprofits, whose goal is mission delivery rather than profit. Common financial measures to evaluate a nonprofit’s success include the following:

1. Level of public support to total revenues
2. Total public support
3. Total program service expenses as a percentage of total
4. Fundraising expenses as a percentage total

Tracking the historical trends of these financial measures as well as comparing information against industry averages for similar size organizations will assist the board in evaluating the organization’s performance and in identifying areas of opportunity.

Over this past decade the auditing and accounting profession has undergone significant changes in response to some highly publicized audit failures. (An audit failure occurs when the audit process fails to uncover financial statement errors or significant fraud.) New auditing standards and accounting principles seek to prevent future audit failures and improve the transparency of financial reporting. Board members or their representative committees are now expected to be more active in the audit process and to understand how it works.
Selecting the Auditing Firm
Auditors are meant to report directly to the board. Therefore, the board (or its selected committee) typically selects the external auditors.

Auditing firms often offer a variety of services including assurance work, tax preparation, and various types of consulting. Fees charged vary widely, generally in line with the size of the auditing firm. In trying to find the best fit for their organization board members should try to balance the fee with the benefits sought. For example, some audit firms also serve to advise on business issues, making them a more valuable asset than a lower-cost barebones provider. Seek a firm that has a strong background in nonprofit work, and that can support both current and projected needs as the nonprofit expands.

Some organizations rotate their auditors after a certain number of years and have even made the requirement a part of their bylaws. Other organizations stay with the same auditing firm for many years because their existing relationship works well. Some organizations use this latter approach but have the auditing team, including the partner or senior manager, rotate off of the engagement. Regardless of the approach, evaluate the relationship annually and document any actions taken with respect to firm selection within the board minutes.

The Phases of the External Audit
The external audit generally follows three phases: planning, execution, and reporting. The participation of the board is essential.

Planning Phase. During planning, decisions are made concerning where the risk of misstatement lies within the financial statements and the general approach to be taken for the various audit areas. Auditors are required to clarify their audit responsibilities with the board. This may occur in a formal meeting with the board or audit committee and it would address:

- The auditor’s responsibility for expressing an opinion on the fair presentation of the financial statements in accordance with generally accepted accounting principles;
- Acknowledgment that the audit is not a substitute for the governance responsibilities of the board;
- That the audit is designed to provide reasonable but not absolute assurance that the financial statements are free of material misstatement;
- That the audit includes consideration of the organization’s internal control over financial reporting as a basis for designing appropriate audit procedures and not for the purpose of expressing an opinion on the effectiveness of internal control;
- That the auditor is responsible for communicating significant matters pertaining to the audit that are relevant to the board in overseeing the financial reporting process;
• That, when applicable, the auditor is responsible for communicating particular matters to the board required by laws, regulations, or by agreement with the organization.

During the meeting, board members should address their concerns about the audit plan, where they feel additional risk may exist, and how the auditors should focus their procedures.

**Execution Phase.** During this phase, auditors work on-site or remotely to check account balances and transactions to gain assurance that the financial statements are fairly stated. Board members need to be available to assist the auditors in the event of disagreements with management, the detection of a potential fraud, or other unusual circumstance. A board member typically is appointed as contact person, reporting to the full board on any issues, keeping the audit on track, and helping to resolve conflicts.

**Reporting Phase.** As fieldwork concludes, preparation of the required auditing reports begins. Depending upon the level of sophistication of the organization's financial staff, the financial statements will be drafted either solely by management, the auditors, or in combination. In addition, auditors draft a letter to the board communicating internal control matters identified as part of the audit (sometimes referred to as the management letter) and a formal board communication addressing audit performance issues. Draft reports go to management and the board (or its committee) for review and comment. The review process should ensure that the reports accurately present and communicate the organization's financial results and reporting issues.

It is important for board members to understand that although it may appear that the financial statements are coming from their auditors, the statements are actually the organization's responsibility. The auditors' responsibility extends only to their opinion that accompanies those statements. Board members can help shape the presentation of the statements to the advantage of the organization as long as those statements comply with reporting standards. The management letter and communication to the board are solely the responsibility of the auditors, although within the management letter, management has the option of including their responses to any points that are noted.

Board members should meet with their auditors at the conclusion of the audit for a formal presentation of the draft reports and to discuss any audit issues. The formal presentation is the best way to gain a clear understanding of the of the audit process, the content of the reports, and matters that may affect the organization in the coming year. Since certain members of management are often present at such meetings, board members should also request an “executive session” with the auditors.
absent management. During an executive session, board members should question their auditors regarding management’s cooperation with the audit process and if they have any concerns regarding management and their abilities. When all matters of importance have been covered and the board is comfortable with the current presentation of the drafts, the reports can be finalized by the board’s formal acceptance.

6. Executive Compensation

The board is responsible for annually reviewing the executive’s job performance and setting compensation. Executive compensation includes salary plus fringe benefits, deferred compensation arrangements, and retirement plan contributions. The compensation influences the organization’s reputation.

Executive compensation can be viewed in the organization’s Form 990, which is open to anyone. This increases the importance of the board arriving at compensation carefully and thoughtfully. It should document how compensation was determined for each member of the executive staff.

The Internal Revenue Service (IRS) is also very interested in the compensation of executive and key employees for certain tax-exempt organizations. The IRS states that payments of compensation or assets to an executive are not prohibited unless the executive is paid unreasonable compensation. Executives must be treated in the same manner as other employees and not personally benefit from the operation of the organization. (The term to describe such benefit is private inurement.) Unreasonable compensation could risk the organization’s tax-exempt status. Or, the nonprofit could face intermediate sanctions that penalize those who receive the excess compensation as well as the organization. Therefore, substantiate executive compensation through written documents and checklists.

Research and documentation is the key to supporting your compensation plan. Reasonable compensation is based upon facts and circumstances and no two organizations are alike. Consider the following when determining reasonableness of compensation:

- What are the qualifications of the person holding a particular position, including background, experience, and education?
- Is the individual a founding member or critical to the mission of the organization?
- What aspects of the organization’s size, sources of revenue, complexity, or similar management issues set it apart from other organizations?
- Does the position require special skills or leadership capabilities?
• Is there a compensation policy and is it documented?
• What type of research on comparable compensation paid by other exempt organizations is available? (There are web sites available that show 990 Forms, which would include executive compensation amounts.)
• Has the economy been considered?
• In newly organized nonprofits, the executive sometimes foregoes compensation. Has this been considered as the organization grows and gains history and strength?
• How much time does the executive spend in their position? How many hours do they put in and have these hours been documented? How does the time compare with people in similar positions at other organizations?
• Is the organization successful?

These are a few of the questions that should be on the mind of all board members; they may have others. In the end it is proper research, documentation, and approval of executive compensation that demonstrate to objective outsiders the diligence given this decision.

Bonuses and incentives are allowable, but the IRS will spend more time on these types of arrangements, so be sure to document the research and rationale for them. Bonuses or incentives might include basing part of compensation on a percentage of receipts or income, community served, and increases in those served. If paying such incentives, be sure that no payments are—in fact or in appearance—a distribution of excess revenues over expenses.

As you go through these questions and procedures please keep in mind that even though compensation may be determined by an independent, authorized body and based upon appropriate comparable data and other research, how these compensation levels are reached must still be adequately documented. If the documentation is lacking, compensation amounts may not stand up to IRS scrutiny.

7. Internal Controls—Fraud Prevention and Detection

Board members have a fiduciary duty to safeguard organizational assets. The duty includes protecting from the loss of assets by human error or misappropriation.

Those who commit fraud generally have three common denominators: (1) they have a need—perhaps an addiction or lifestyle to support; (2) they have an opportunity—lack of internal controls and proper oversight; and (3) they have an ability
to rationalize their actions—perhaps a perception of entitlement. Our focus here is on reducing the opportunity in the equation above.

Someone does not normally join an organization intending to commit a crime. Instead, opportunities present themselves, and due to pressures and other circumstances, an individual considers how a fraud may be perpetrated. Eliminating these opportunities reduces the risk of fraud. One way to eliminate opportunities is to establish effective internal controls.

Controls can be preventive or detective. Preventive controls aim to keep fraud from occurring. Some examples include locking up blank check stocks, setting authorization limits, and requiring multiple signatures on checks. Detective controls seek fraud after it has occurred. Examples include independent reconciliation of bank statements, board member review of executive corporate credit card charges, and independent employee approval of new vendors. These controls also prevent and detect human error.

Some controls occur through policy. For example, it’s recommended that people who handle finances use their vacation time and rotate duties. This reduces opportunities for the employee to design, commit and conceal fraud. Another policy is to create a whistleblower’s confidential hotline managed by a third party and available 24/7. Studies show that most frauds are initially detected through tips from employees, clients, and outside vendors.

Controls should prevent one individual from performing all functions within an accounting cycle. (This is called segregation of duties.) For example, the same person should not set up a vendor, enter vendor invoices into the accounting system, prepare the check for payment, and sign the check. Most organizations are not large enough to allow for complete segregation of duties, but all organizations can customize internal controls and segregate some duties.

Two simple guidelines should be followed when customizing effective internal controls. First, the same person should not be the preparer and reviewer. Second, these controls should not be overridden. Though simple in concept, the most effective controls will fail without strict compliance. Such compliance should be an institutional cornerstone, which begins with the board, continues to management, and flourishes with every employee. Employees that are not part of the accounting department can serve as very effective independent employees providing strong controls. An example is the receptionist who opens all non-confidential mail and distributes it to the appropriate employees.
To establish an effective set of internal controls to prevent or detect fraud you should first determine the types of fraud to which the organization may be susceptible.

- **Skimming**—for example, taking cash from a special event before it is recorded in the accounting system.
- **Stealing cash on hand**—for example, stealing from a petty cash fund over a long period.
- **Stealing assets**—for example, setting up a personal bank account in the name of the organization and making transfers of cash or investments.
- **Theft of fixed assets**—for example, stealing a laptop computer.
- **Personal use of assets**—for example, using an organizational vehicle for personal benefit.
- **Personal capital improvements**—for example, diverting capital costs for a personal residence.
- **Kickbacks**—for example, purchasing supplies from a low-cost vendor and receiving a payment from the vendor.
- **False or inflated invoices**—for example, setting up a fictitious vendor and invoicing the organization for goods or services not provided.
- **Self-payment**—for example, paying a legitimate vendor invoice twice with the second payment going to the employee.
- **Check theft**—for example, stealing and forging checks.
- **Ghost employees**—for example, setting up a fake employee and having the compensation paid to the employee.
- **Overpayment**—for example, increasing an employee’s pay rate.
- **Credit card fraud**—for example, charging personal expenses on a corporate credit card.
- **Expense report fraud**—for example, submitting personal or fictitious expenses for reimbursement.

Fraud prevention and detection is everyone’s job in an organization and it starts by hiring the right people. Screening should include a candidate’s references, work history, credentials, pre-employment drug testing, and criminal background checks. If nothing else, these actions put prospective employees on notice that the organization values integrity. Board members should ensure the organization has a formal fraud policy and code of conduct, and that policies and controls are reviewed regularly to change as the organization changes.
Accounting procedures and policies manuals accomplish two primary objectives for organizations. First, they provide a formal “play book” for an organization’s accounting function. Second, they provide the transparency that lets outsiders see that the organization is following good processes. On a functional level, accounting procedures and policies manuals:

- Facilitate the consistent application of accounting principles;
- Aid in the preparation and processing of accounting transactions;
- Accumulate a summary of accounting procedures and policies for reference purposes; and
- Provide rules and processes to comply with various internal and external reporting requirements.

The “Play Book”

Sudden loss of an accounting staffer is hard enough. Without good documentation of processes and policies, it means deep trouble. The board should be sure that documentation has taken place, and it should review the documentation annually. Four rules guide the play book. First, it should be put in writing. Second, procedures and practices should be customized to the organization—there is no one-size-fits-all. Third, develop procedures that deliver the end output desired from the accounting function. And fourth, involve all affected staff and stakeholders in the development of the accounting procedures and policies. You know your play book is effective when a competent individual can read it and reproduce the organization’s procedures and practices.

Transparency

The audit failures of the early 2000s and the economic meltdown of the late 2000s led to an outcry for greater organizational transparency, including accounting records and reporting. An accounting manual signals and manifests the organization’s interest in transparency. Some organizations publish their accounting procedures and policies manual on their web site (of course, removing confidential information).

Outdated accounting procedures and policies can impede progress and lead to frustrated employees who feel at the mercy of cumbersome rules. The advent of the paperless (electronic) office demands a fluid set of accounting procedures and policies that are rooted in principles that transcend the mechanical nature of accounting procedures and policies. Every organization should review its accounting procedures and policies, and the documentation thereof, at least annually.
Form 990 (or 990-EZ) is the primary reporting mechanism for exempt organizations. This annual tax filing challenges nonprofit boards to look closely at the whole organization, its governance, compensation, accomplishments, and processes. The form calls for board members to be more accountable for an organization’s reporting practices and procedures, not just the financial information. Though not required, the form clearly implies that it is meant to be reviewed by board members. As a result of this, board members in many organizations are seeing the Form 990 for the first time. Moreover, this form is available for public inspection, so you must ensure that the organization is portrayed to the public in the best possible light.

Form 990 is 12 pages with up to 16 additional schedules that may need to be included. The core form includes the general financial information of the organization—a statement of revenues and expenses in both summary and detailed formats and a balance sheet. It also includes descriptions for an organization’s program service accomplishments during the year. This is an opportunity for an organization to distinguish itself from other similar organizations by highlighting its programs, who and how many people have been served by those programs, and what has been achieved.

Form 990 includes questions and supporting schedules that seek evidence of good practices. Some examples of the scope of information requested include:

- How is executive compensation set by the board? Was it reviewed by an independent compensation committee?
- What is the organization’s expense substantiation policy?
- What types of payments are made to board members and other related parties?
- Does the organization have a written conflict of interest policy, a whistleblower policy, a document retention and destruction policy? Are these policies regularly monitored and enforced?
- What types of fundraising events are held? Was a professional fundraiser utilized?
- What foreign activities has the organization engaged in?

These are not questions that one individual in an organization can or should answer on their own. In some cases the information being requested has been controversial because of its confidential nature, especially in the area of compensation. Answers to even the “yes/no” questions within Form 990 sometimes require reference to the Form 990 instructions to determine how to answer them correctly. If the answer to any question regarding the existence of a policy or procedure is “no”, the implication is that such a policy should exist. As a consequence of these questions organizations have begun to formally adopt such policies, improving their transparency and governance.
The Internal Revenue Service scrutinizes the Form 990, so questions should be answered accurately and completely to avoid further inquiries or audits. Though time-consuming and revealing, Form 990 is part of the “price” of maintaining tax-exempt status. Board members should educate themselves on the complexities of this form by reading it and its instructions and understanding that their oversight of its preparation and filing is part of quality organizational governance.

**Unrelated Business Income and Form 990-T**

A nonprofit may be subject to taxation on income that is not substantially related to its mission. Such income is referred to as unrelated business income. The Internal Revenue Code states that an activity is considered to be unrelated if:

- it is a trade or business, and
- it is regularly carried on, and
- it is not substantially related to the organization’s exempt purpose.

Net profits from unrelated activities are subject to taxation at normal corporate rates and the tax is referred to as Unrelated Business Income Tax or UBIT. A nonprofit organization reports any unrelated business activities on Form 990-T.

Is there such a thing as too much unrelated business income? While the Internal Revenue Service has not established a threshold for unrelated business income where an organization could potentially lose its exempt status, it has sometimes been recommended that unrelated business income be less than 10 percent of an organization’s total gross income. If unrelated business income becomes significant it may be advantageous to create a for-profit subsidiary or limited liability company to manage those unrelated business interests.

There is nothing illegal or unethical about an exempt organization engaging in business activities not substantially related to its exempt purpose. However, failure to adhere to IRS guidelines and properly report and pay any UBIT threatens the organization’s credibility and tax-exempt status. Board members must understand the nature of all revenue sources of their organization and ensure that unrelated activities are appropriately identified. Strict guidelines should be in place for entering into any new business ventures and relationships. Strong accounting practices and documentation should ensure that revenues and costs are clearly delineated between exempt and unrelated activities.
Besides the tax forms and basic financial statements described earlier, a nonprofit may need to prepare other reports and forms. These “special reports” typically stem from funders (such as foundations, government agencies), which often ask for financial information in a certain format or look to address compliance issues that are not included as part of the basic financial statements. Board members should be sure the organization provides timely and accurate reports; they are essential for continued funding.

**The Single Audit**
When an organization receives funding for its programs through the U.S. Federal Government, a “Single Audit” under the standards contained within OMB Circular A-133 is sometimes required. The Single Audit encompasses the basic financial statement audit as well as an organization’s compliance in operating its federally supported programs according to federal guidelines. Only organizations that expend $500,000 or more of federal support during a year are required to have a single audit.

Acceptance of federal funds directly (or indirectly through a state or other federally supported entity) is in essence a contract to execute the program according to the contracted terms; operate the program in accordance with established federal compliance requirements for the program; and establish internal controls to ensure adherence to the requirements. The single audit tests and reports on each of these aspects. When a Single Audit is performed, the auditor’s opinion on the basic financial statements will be accompanied by other auditor signed reports that will address a variety of issues. The more common compliance requirements that are typically looked at in a Single Audit include:

- **Allowable costs**—ensures that the types of costs charged to a federal program meet federal cost guidelines.
- **Allowable activities**—ensures that the activities engaged in by the organization are in accordance with the goals of the federal program.
- **Cash management**—ensures that federal funds received in advance of services provided are properly managed, minimizing the time between receipt and expenditure.
- **Eligibility**—ensures that those served by the program are the intended beneficiaries of the program.
- **Period of availability**—ensures that federal funds are expended within the required time period.
- **Reporting**—ensures that federal program activities are properly reported.
Deviations in compliance or deficiencies in internal controls detected as part of the audit process may be included in the Single Audit reports as findings. Most Single Audits uncover some findings of deviation from compliance. Many organizations lack the resources to ensure total compliance all the time. In interpreting the Single Audit reports, board members should strive to understand the qualitative nature of any findings that are being reported and determine:

- What do they say about the quality and integrity of the organization’s financial reporting capabilities?
- Is the deviation in program compliance significant in relation to the overall operation of the program?
- Is the deviation in compliance an isolated incident or indicative of a larger problem?

The intended response to a Single Audit finding is that the organization improve or eliminate the condition in future years. The Single Audit report includes management’s response to the individual finding, a corrective plan, a timeframe for resolution, and responsibility for implementation. Board members should review these planned responses with management to ensure the plan is implemented. Repeated failure to correct problems can undermine future funding.

**Other Financial Reports**

State and local funding agencies often require special reports on topics specific to the programs being funded. The information is often derived from the basic financial statements but will be broken out in greater detail to highlight the activities of the programs of interest. These reports usually are created to determine if funds provided are being fully spent. These reports will illustrate revenues and costs associated with a particular program. When revenues exceed costs, a funding agency may request a reimbursement of the excess funds or may reduce subsequent grants. The board should be sure the organization has systems that can tie expenditures and indirect costs to each program.

These types of reports are sometimes not part of a board’s ongoing review and oversight procedures, the primary responsibility for such often being left to management. However, board members should get assurance that the reports are being submitted on time in the form required by the funder, and that the organization has the systems to prepare them.

**Conclusion**

The “ten things” we’ve cited here will get you far in your role and duty as a board member. Of course, there is much more to know about the finances of an organization. The resources below will help. And as you work to steward the resources of your nonprofit, we wish you good fortune—in every sense of the word!
Helpful Resources

*AICPA Audit Committee Toolkit: Not-for-Profit Organizations.* Published by the American Institute of CPAs, the Toolkit is available on their web site (www.aicpa.org) and may be downloaded at no cost by nonprofits.


*Audit Committee Essentials (institute of Internal Auditors)* by Curtis C. Verschoor, Wiley, 2008.
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VINCENT HYMAN, series editor, is an award-winning writer, editor, and publisher. After leading the development of the nonprofit publishing center at Amherst H. Wilder Foundation and the publishing program of Fieldstone Alliance, Inc., he founded Vincent Hyman Editorial Services, with expertise in nonprofit management, foundation effectiveness, policy, marketing, and related issues. He is editor of scores of books, coauthor of Coping with Cutbacks: The Nonprofit Guide to Success When Times Are Tight, author of numerous web and print articles, and has three decades of experience in writing, editing, and organizational communications.