Arizona State University
Lodestar Center for Philanthropy and Nonprofit Innovation

Frequently Asked Question

Financial Management

1. What is financial management?

Financial management for a nonprofit is a combination of several critical functions:

- Stewardship of the organization's assets
- Assurance of adequate resources
- Development and approval of an annual budget
- Current and year to date financial reports
- Assurance the organization is prepared for the annual audit functions.

The primary oversight should be done by a board appointed Finance Committee and the selection of a Treasurer. Combined with a capable financial staff person the organization then has the necessary tools to take on the task of creating and sustaining a financial management system.

2. What is the role of a Finance Committee?

The role of a finance committee is to help the board focus on fiduciary duties, recommend financial policies, help develop and review the budget, take the first look at financial statements, oversee the audit process (unless there is a separate audit committee), draft internal control policies, draft investment policies, and hire/oversee performance of an investment manager. Overall, a finance committee is separate from the board of a nonprofit and focuses solely on the financial aspects of the organization.

No matter how small or large the nonprofit, it is best practice that there be a Finance Committee that reports to the board of directors. This committee should consist of board members and/or outside persons with financial expertise. Those staff members with financial/accounting responsibilities may assist and support the committee, but ought not to be voting members.

Some guidelines for the committee include:

- Assurance of segregation of financial oversight from managerial duties
- Creation of policies for check signing, expense reimbursement, credit card usage, discretionary funds, petty cash, access to confidential documents
- Recommendation to the board of directors of the engagement of an outside auditor who reviews processes and procedures
- Guidance for improving internal controls, accuracy of financial statements and budgeting

3. What is the role of the Treasurer and what are the position's duties?

The role of the treasurer including some requisite skills and duties includes:

- An understanding of nonprofit accounting
- The Treasurer is a volunteer and member of the board while the Chief Financial Officer (CFO) is an employee and officer of the organization.
- Many nonprofit organizations name the CFO as assistant treasurer to accommodate the regular need for signatures, etc.
- May serve as chair of the finance committee

- Utilizing the finance committee, manages the board's regular review and actions required to fulfill budget oversight and other fiduciary responsibilities
- Assures that understandable financial reports are presented to the board on a timely basis
- Assists the CEO with budget preparation involving the finance committee and board in the process of approval
- Recommends to the Finance Committee the engagement an appropriate independent auditor; reviews the audit with the Finance or Audit Committee and presents findings and recommendations to the board

4. Who sets the standards for financial practice and reporting?

First, it is important to note that accounting is not a science with permanently fixed rules. It is a dynamic field dedicated to providing accountability of resources and principles governing its practice. Therefore standards of accountability and methods of reporting change over time.

Financial accounting standards are set by a few organizations.

- Financial Accounting Standards Board (FASB). It establishes basic accounting principles and issues frequent statements on general accounting guidelines. Visit its website at http://www.fasb.org.
- American Institute for CPA's (AICPA). It develops accounting rules that apply to FASB-released statements. Visit its website at http://www.aicpa.org.
- Generally Accepted Accounting Principles (GAAP) is a compilation of opinions and statements from the above organizations. They define principles used to account for the financial activity of nonprofits. This standard is used by auditors, the IRS, many financial institutions, and others to interpret financial activity of an organization. GAAP rules are constantly changing.

5. What types of reports should an organization be using?

Statement of financial position, otherwise known as a balance sheet, reports assets, liabilities, and net worth by fund balances. A statement of position should include:

- Assets
  - Cash & equivalents
  - Invested funds
  - Capital items (land, buildings, equipment)
    - = Total Assets
- Liabilities
  - Accounts payable
  - Debt payments
  - Benefits payable
    - = Total Liabilities
- Equity/Net Assets (Assets less Liabilities)
  - Unrestricted
    - Board designated funds
    - Undesignated funds
  - Temporarily restricted
  - Permanently restricted
    - Endowment
    - = Total Equity/Net Assets

The organization's financial position should be reviewed by the board of directors and management on a regular basis. Some of the questions the board should be asking include:

- Does a comparison of our position at this point in time to prior year-end show growing strength or weakness? What are the changes?
- What is the trend in our accounts receivable (A/R). Is there sufficient allowance for bad debt? Are the A/R increasing and what does an analysis of aging of A/R show?
- What are our liquid assets?
- What is the valuation of our fixed assets?
- What is the state of our current debt?
- What is the state of our current accounts payable?
- What is owed in benefits?
- Is our endowment growing?

b) **S*tatement of activity*** tracks gains and losses to show whether the past period was healthy and also shows actual operations in relation to the budget. This report includes income by fund and by source, expenses by both function and natural classification, and a comparison to both prior periods and to prior budgets. This will show the surplus or deficit for the current period. In addition the statement of activities should show the same year to date information.

Some questions boards of directors and management should ask related to a statement of activity are:

- What are the components of our income? What of each are restricted in some manner? What of each are transfers from the temporarily restricted fund and why?
- Are we earning interest on our funds and what are their uses?
- How do they compare to prior year and to budget?
- How do our expenses compare to last year and to budget?
- Are the variances within specific parameters approved by the board?
- Do the explanations of variances make sense? Are there warnings? Bases for celebration?
- What are management's concerns?

c) ***Cash Flow Statement*** reports on the availability of cash for operations. This statement provides a key indicator of the ability of the nonprofit to meet its current cash flow needs as well as projecting those needs for the year.

Some questions that should accompany a statement of cash flow are:

- Is our cash increasing or decreasing over time?
- How many days of cash are in hand? (Normal daily expense for running the organization divided by the amount of <u>unrestricted</u> cash.)

6. Are there key ratios or 'standards' for tracking finances for nonprofits?

Key ratios are mathematical calculations that provide important indicators of an organization's financial health. For example many organizations indicate they need to maintain a 2:1 "cash ratio (cash and equivalents/current liabilities). Other common ratios to track are the net operating ratio (net surplus/total revenue) and the program expense ration (program expenses/total expenses). However, there are no established "correct" key ratios or standards. These ratios should be determined by each organization and reported regularly to the board of directors with indications of changes in the ratios. Tracking ratios over a period of time will provide the board of directors and management important information about the organization's financial trends and needs. There are a number of nonprofit watchdog organizations that can help provide information regarding important ratios. They include: BBB Wise Giving Alliance; Guidestar; ePhilanthropy Foundation, Guidestar, United Way and the American Institute of Philanthropy.

7. Why is it important to establish a budget for the organization?

The budget is the organization's financial plan for the year. It includes the anticipated fiscal cost of providing programs and services over a specific period of time. The budget is the board of director's fiscal policy for that year and should be approved by the board prior to the time period covered by the plan. It provides the primary control mechanism relative to anticipated income and committed expenses. Management can make necessary decisions, within the budget, to maintain a healthy organization after carefully analyzing income and expenses.

A budget should be a requirement for any nonprofit regardless of size. For the start up organization it might be no more complicated than a family budget using cash as the basis for its control and reporting, but as the organization grows in size and complexity of programs offered it is critical that it move to the accrual method of accounting.

8. How does an organization move from simple accounting to more sophisticated financial management described above?

This is one of the most challenging steps for the growing nonprofit. Hiring an experienced skilled nonprofit accountant to develop and transition to such a system is often beyond the financial means of an organization. The first step would be to recruit one or two persons having such knowledge as volunteers to the board of directors. They along with the CEO should plan the development of the financial management system as one would plan for a new program. One source of assistance might be another strong nonprofit in the community. That is especially true if you can find another nonprofit having a similar mission and array of programs. Consult with a medium to large accounting firm that has nonprofit accounting/audit as part of its practice. There are also many publications and books available. (See Resources, Section 10) The key is to approach this strategically rather than quickly hire a person who you hope will do the job.

9. How public should the finances of a nonprofit be?

Central to a nonprofit's creditability is public trust and therefore its finances should be transparent and available not only to the board in the form of regular statements described above but also to the public in the form of an annual report. Every board member must have full access to financial reports and continued service on the board should be dependent upon getting timely credible reports of the organizations financial position. In addition, the Federal government has stepped in requiring more openness of nonprofit finances through the requirement of filing an annual report entitled Internal Revenue Service - Form 990. Once filed, this Form becomes a public record accessible to the general public on Guidestar.org. and to anyone who asks.

10. If I suspect "irregularities" in the financial statements what should I do?

First, raise your questions with the chief financial officer to determine if you can obtain an explanation that is credible and responds satisfactorily to your questions. If not, the next stop should be the Executive Director. If his/her response is not satisfactory, then discuss the issue with the treasurer and the chair/president of the board of directors. Assuming you do not get answers that satisfy your concerns, you may decide to do one of two things. First, if you are simply uncomfortable and do not believe something inappropriate and unethical is occurring, you might determine you can no long serve on the board. Second, if you believe there is something wrong you can report it to the Arizona Attorney General's office. (In some states the responsible public official is the Secretary of State.)

11. What resources are there that may help my organization better understand its financial management responsibilities:

There are many resources on financial management available both in bookstores and on the Internet. Among them are:

American Institute of Certified Public Accountants (AICPA) www.aicpa.org
Financial Accounting Standards Board (FASB) www.fasb.org

Blazek, Jody, CPA. 2000 Financial Planning for Nonprofit Organizations. John Wiley & Sons, Inc., New York.

Gross, Malvern J. Jr., McCarthy, John H., Shelman, Nancy E., 2005. Financial and Accounting Guide for Not-For-Profit Organizations, 7th ed. John Wiley & Sons, Inc., New York.

Guidestar www.guidestar.org

Hankin, Jo Ann, Seider, Alan, Zietlow, John, 1998. Financial Management for Nonprofit Organizations. John Wiley & Sons, Inc., New York.

Label, Wayne A., 2006. Accounting for
Non-Accountants. First edition, Sourcebooks, Inc.,
Naperville, Illinois

Nonprofit Management Institute, ASU Lodestar Center for Philanthropy and Nonprofit Innovation: Basic Financial Management, Advanced Financial Management
http://nonprofit.asu.edu

(This list of questions regarding Financial Management has been developed by the many persons and organizations seeking assistance from the Lodestar Center. We invite you to add your questions and reactions through Ask the Nonprofit Specialist" section of the center's website so that we might improve and expand these FAQ.)

Updated: May 10, 2010