3A. Governance: Anything But a Cold Shower: Incorporating Financial Statements Into Your Board Meetings

CAPLAW 2011 National Training Conference

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Mr. Jack Siegel, Esq., CPA
CEO
Charity Governance Consulting LLC
3400 North Lake Shore Drive
Chicago, IL 60657
773-325-2124
jbsiegel@charitygovernance.com

Handouts:

1. Siegel PowerPoint Slides
2. Financial Statement Questions Handout

Reading the Financials

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JACK B. SIEGEL
MAY 23, 2010

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Bio

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Jack Siegel is an attorney (Illinois and Wisconsin) and CPA (Wisconsin), holding an LLM in Taxation from New York University and a Master's of Management from Northwestern University. Jack provides consulting services through Charity Governance Consulting LLC. He focuses on training, governance, financial management, and special projects. Jack is the author of A Desktop Guide for Nonprofit Directors, Officers, and Advisors: Avoiding Trouble While Doing Good (Wiley 2007), a 750-page book addressing the legal, financial, tax, and governance issues facing nonprofits. He just completed a three-year term as a member of the IRS's Advisory Committee on Tax Exempt and Government Entities (ACT). He is currently authoring a book on the charitable sector and another on the law of photography. Jack is the author of the Charity Governance blog.

Jack B. Siegel

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- Jack Siegel can be contacted at:
  - Tele: 773.325.2124 (United States)
  - E-Mail: jbsiegel@charitygovernance.com
- Follow Jack on Twitter: Charitygovern
- Jack is located in Chicago, Illinois
- Web site and Blog: http://www.charitygovernance.com

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REALITY

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What is A CAA

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- CAA's
  - Help low-income communities
  - Provide social services
  - Recognize the dignity of people
  - Produce lots of heart-warming stories
  - Improve society
  - Do not seek profits to distribute to shareholders

First and Foremost, CAAs Are Businesses

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- Do not kid yourself, CAAs are businesses. They are no different than Exxon/Mobil, Apple, or Citibank. Like all businesses, CAAs
  - Can't survive without "revenue"
  - Borrow money
  - Employ people
  - Purchase property
  - Provide goods and services
- At the end of the day, if revenues don't exceed expenses, the CAA will have to close its doors

A Recent Call From a Reporter

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- In May I received a call from a reporter with a major newspaper organization asking me to comment on the financial problems experienced by the New York City Opera (paraphrased and condensed)
  - Jack: "What's your question?"
  - Reporter: "How could this happen?"
  - Jack: "They don't have enough revenue and endowment. If they can't get more people through the front door or more contributions, they will have to close."

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- Reporter: “But this is the New York City Opera.”
- Jack: “Other arts groups have closed or filed for bankruptcy. Look at the Philadelphia Orchestra.”
- Reporter: “You don’t understand, this is the New York City Opera.”
- Jack: “So what? If they can’t don’t have the funds, they don’t survive”
- Reporter: “No you don’t get it. This is a major arts organization.”
- Jack: “Oh, I get it.”
- Reporter: “Thank you. Goodbye.”

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- The “war horse” operas filled the seats, but the mission was to present “modern” operas
  - Many nights the opera played to a house that was only 40% filled
  - In the arts, ticket prices rarely cover operating costs
- At the end of the day, finances govern policy. Policy does not govern finances. The New York City Opera is now in a state of limbo, which may be the last stop before the end
- Might it have been better to:

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- Stage three war horses and three modern operas—use the war horse ticket sales to subsidize the modern operas, than to
- Stage nothing (as could happen if events play out a certain way)?

- Alternatively, if the New York City Opera wants to be pure of heart, then it needs people who are willing to underwrite the mission through larger contributions
- The New York City Opera's mission is constrained by a financial equation, pure and simple

CAAs Are Like the NYC Opera

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- CAAs may not suffer the problems posed by an aging audience and fewer ticket sales or competition from more socially oriented causes for major donor contributions
- CAAs, however, face their own threats to revenue:
  - Specific cuts in federal government funding that we spent the last four months reading about
  - More general pressure on government resources at all levels
    - Look at the State of Illinois' deferral of payments to social service providers
  - At the same time, CAAs face a population with growing needs, due in significant part to cutbacks in government funding

Implications

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- We may not like what is happening to the City Opera or to CAAs
- But what we like and don't like is irrelevant
- Managing your CAA like a business is more important than ever because
  - Revenue is tight and politicians are looking for examples of inefficient organizations to justify their cuts in funding
  - Need (expense) is up in this bad economy

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MISSION AND FINANCE ARE TWO-SIDES OF THE SAME COIN

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Not Just for Just Bankers and Accountants

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- The Man in the Blue Sweater
  - Jamie Katz, Chief regulator of charities in Massachusetts (at the time)
    - Knows there are nonprofits with operating deficits and the boards don't know it
    - Disaster awaits
  - Man in The Blue Sweater
    - Social service provider decides to challenge Jamie Katz
      - He doesn't know finance
      - He doesn't care
      - Someone else's problem

TRUISM I: Everyone Must be Focused

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- SPAC (Saratoga Performing Arts Center)
  - Decision to get rid of New York City Ballet
  - Question: The problem of hidden agendas make subject matter experts vulnerable
    - Is it finances?
    - Is it mission?

CAA Example

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Assume a CAA is considering a new program to combat gang activity in a neighborhood. Some on the board oppose the proposed approach. Rather than arguing the merits, they may look to the numbers if the proposal's proponents are afraid or intimidated by finance and accounting. The opponents may ask an accountant to prepare a financial forecast that uses an overhead allocation method that arguably overstates the overhead that should be allocated to the program. Unless the program's proponents are willing to challenge a dubious financial proposition, they may yield to the claim that the program will produce a large and unacceptable deficit. But to mount that challenge, the program's proponents must be willing to examine the numbers, recognizing that the same financial facts and figures can be viewed through different prisms.

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- Bottom line:
  - Financial issues are fundamentality issues of governance
  - Everybody in the organization needs to be focused on financial issues

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TRUISM II: Not Rocket Science

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- Common sense goes far
- Addition, subtraction, division, and multiplication are the only tools you need
  - No need for calculus, quantum mechanics, or matrix algebra
- If you don't get it, ask the question

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The Board's Role

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The Meeting

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- The financial statements should be discussed at each regular board meeting
  - At one meeting, the board will be discussing the year-end audited financial statements
  - At all the other meetings, the board will be discussing interim financial statements
- This discussion
  - Should not be relegated to the finance committee
  - Should not be cursory

A Five Step Process

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- Step 1: The finance committee should meet in advance of the full board meeting to review the financial statements in detail
  - This discussion should be more detailed than the one at the board meeting
  - Major issues for discussion at the board meeting should be identified
  - The presentation to the board should be planned
- Step 2: The financial statements, schedule of budget variances, and any other relevant material should be distributed to each board members at least one week in advance of the meeting

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- Step 3: The discussion of the financial statements should be on the formal agenda. At the meeting, the following matters should be discussed:
  - The overall financial condition of the CAA and its results of operations
  - Any major issues revealed by the financial statements
  - Budget variances
  - An assessment and review of organizational liquidity
  - Key financial ratios/metrics
  - Stability of the CAA's grants and revenue
  - Any other matters involving finance warranting discussion

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- Step 4: At least once a year, the board should discuss
  - The auditor's annual report and management letter
  - The CAA's annual budget
  - The CAA's system of internal controls
  - The CAA's long-term financial plans and needs
  - These discussions can take place at regular board meetings or be reserved for a special meeting or retreat
- Step 5: Plenty of time should be devoted to a Q & A session, with the leaders encouraging a robust discussion of these issues

The Process

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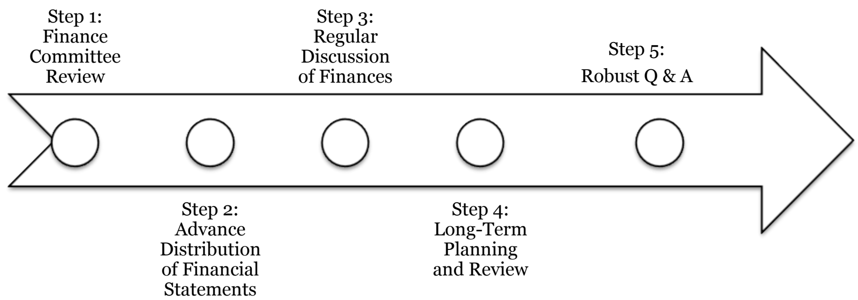

Budget Variances

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- What is a budget variance?
- Assume a calendar year CAA

Item	Feb Actual	Feb Budget	Variance	YTD Actual	YTD Budget	Variance
Wages	$150,000	$100,000	$50,000	$275,000	$200,000	$75,000

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- Why review at each board meeting?
  - In February of this year, the board knows that it has what appears to be a growing problem--$25,000 variance in January and $50,000 variance in February, then remedial action can be taken immediately
  - If the board waits to think about this issue until the audited financial statements are issued, the problem has had a year to get out of control.
- But isn't monitoring variances from budget management's responsibility? Absolutely

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- An important lesson: Just because management reviews certain information doesn't mean that the board can ignore that same information

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- Variances raise policy issues that the board should be addressing. A variance in wages paid could raise any one of the following possibilities/questions:
  - The organization needs to add several full-time employees to reduce overtime.
  - Those working on the energy-assistance program require greater training
  - The class size for Head Start programs needs to be increased or the Head Start program needs to be eliminated if class size can't be increased without irreparable harm to the program
  - Several employees are falsifying their time sheets

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- Management should prepare a report on budget variances in a format that is acceptable to the finance committee.
- At the meeting the board should demand specific solutions for problems from management
  - Changing the budget (papering-over the problem) is not an effective solution. Organizations have done this.
  - If management knows that it will be asked for a solution, it will take a proactive approach to problems. "We were aware of the 10% variance in electrical costs. We have seen this for several months in a row. We called the electric company and they are working with us on reconfiguring our systems to reduce the cost of energy. They estimate that we could bring our costs down 30%." The result: A problem becomes an opportunity

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- The board should follow up with management at the next board meeting
- Program-by-program analysis as well as entity-wide analysis
  - You don't want one program's subpar performance masked by above-average performance from three other programs

Assessing Liquidity

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- A CAA's balance sheet may include far more assets than liabilities, but that doesn't necessarily mean that it can timely pay its bills. Why?
  - The CAA may have a reimbursement receivable from the State of Illinois for $200,000. It can't pay the electric bill or wages with a receivable
  - The CAA's balance sheet may show that it owns a building with a book value of $500,000, but is the CAA going to sell its headquarters?
  - The CAA may have $15,000 of inventory, but it may be giving the food away rather than selling it

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- There is a five-step process for assessing liquidity
  - Step 1: Ask the fundamental question: "We have this much cash on hand and we have these liabilities [which typically far exceed the cash balance], how are we going to satisfy those liabilities? This forces the board to look at:
    - Accounts receivable
    - Marketable securities
    - Inventories
    - Debt maturity dates
  - Step 2: Review the statement of cash flows, focusing particularly on cash provided/used by operations
  - Step 3: Review an accounts receivable aging schedule
  - Step 4: Review key financial metrics that assess liquidity. Has there been a material change in those metrics?

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- Step 5: Review current credit facilities
  - Is the organization relying heavily on credit cards?
  - Has the organization maxed out its revolving line of credit?
  - Is a significant payment due under a long-term debt?
  - Is the organization in compliance with financial covenants in borrowing agreements?

The Process

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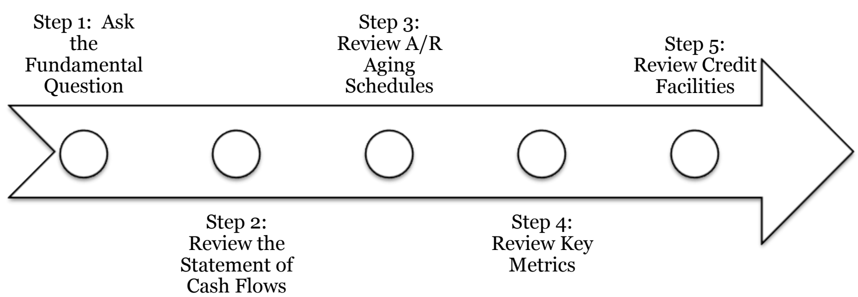

Reviewing Financial Ratios

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- Financial ratios are nothing but a way to summarize or make-sense of the financial statements
- Here are two keys ones:
  - The Defensive Interval Ratio =

$$\frac{\text{Cash + Marketable Securities + Receivables}}{\text{Average Monthly Expenses}}$$

The resulting number represents the number of months that the organization could continue to cover its expenses if it had no more revenue

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- The Accounts Payable Indicator =

$$\frac{\text{Accounts Payable}}{\text{Average Monthly Expenses}}$$

If the indicator is getting larger, that could be a sign that the organization is unable to timely pay its bills, or it could be a sign of good cash management (creditors aren't pressing for payment). The critical point: Whenever there is a dramatic change, management and the board both need to ask why. Ratios are similar to gages on your automobile dashboard. The gas warning light comes on:

- You have a big problem if the next gas station is 150 miles away and there are no exits
- You don't have a problem if you are driving the car to the dealer to trade it in on a new model

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- There are thousands of ratios
  - What is a good number for an electric utility may be a bad number for a software company
  - Ratios should never be applied blindly. You need to think about whether modifications are appropriate. For example, many liquidity ratios assume inventory will be sold for cash. If the organization has inventory, but it gives the inventory away as part of its mission, there may need to be an adjustment to how the ratio is constructed.
- The numbers generated by a ratio are meaningless until used comparatively

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- Compare against the ratio for other similarly-situated organizations
  - Management's job is to collect the comparable data and prepare a schedule. It is critical that the comparison be to like organizations.
    - Rural vs. urban
    - Same programs
    - Relatively same asset and revenue size
    - Relatively same mix of employees/volunteers
  - GuideStar and industry trade associations are a good place to start
- Compare with the ratio for the organization over time. Has the Defensive Interval ratio changed during the last ten years?

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READING NONPROFIT FINANCIAL STATEMENTS

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Financial Statements are Important

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- Assess sufficiency of and allocate resources
- Argue mission
- Internal financial control

Basics

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- Historic perspective: fund accounting
- GAAP/FASB
  - Audit opinion
  - Lenders and grant makers
  - Regulators

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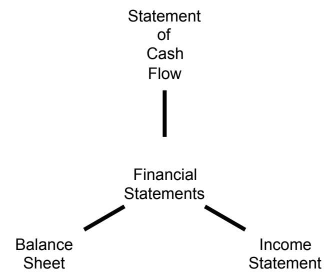
Three Basic Statements

- Statement of financial position
- Statement of activities
- Statement of cash flow

- Functional expenses: statement or footnote
- Notes to financial statements



Statement of Financial Position

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- Balance sheet: "as of"
- Historical values (with exceptions)
  - Inventory: lower of cost or market
  - Receivables: allowance for doubtful accounts
  - Marketable securities: For our purposes market value (but valuing investment securities is more complex—museums and colleges face the complexities most often)
  - Buildings and equipment: valued at cost, with an allowance for depreciation
- Ordering: Assets are listed by placing the assets that are most readily convertible into cash higher in the order. The order follows a traditional inventory to cash cycle

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- The balance sheet also lists liabilities
  - Liabilities are divided into two categories
    - Current (payment due sometime during the next year)
    - Long-term (payment due following the current year)
  - Many contingent liabilities are not listed. A pending lawsuit against the organization is a good example of a contingent liability. Rules define when a contingent liability must be included in the balance sheet as opposed to described with a reference in the footnotes to the financial statements
  - To understand liabilities (payment terms and conditions), you must read the footnotes to the financial statements
- Do not ignore long-term liabilities just because they are not an immediate issue. The organization must generate sufficient surplus to meet the day of reckoning

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- The balance sheet does not list
  - Organizational know-how
  - Workforce in place
  - Goodwill
  - Going-concern value
  - Any number of other intangible assets
- Rules for mergers may create an exception

BALANCE SHEET

Asset	2009	2010
Current Assets		
Cash	$253,007	$258,390
Investments	$725,000	$725,000
Revenue Receivable	$3,958,475	$4,406,070
Inventories	$245,709	$594,234
Prepaid Expenses	$475,890	$634,342
Total Current Assets	$5,658,081	$6,618,036
Long-Term Assets		
Furniture	$24,345	$34,468
Land	$102,345	$102,345
Building	$1,450,000	$1,850,000
Grant-Funded Assets	$3,245,469	$3,245,469
Less Accumulated Depreciation	($1,899,270)	($2,307,066)
Total Long-Term Assets	$2,922,889	$2,925,216
Total Assets	$8,580,970	$9,543,252
Liabilities		
Currrent Liabilities		
Cash Overdraft	$124,567	$1,107,068
Accounts Payable--Vendors	$2,200,897	$2,800,000
Accounts Payable-Others	$42,100	102,034
Current Portion of LT Debt	$25,000	$25,000
Line of Credit	$1,240,342	$1,000,345
Unemployment Compensation Reserve	$245,890	$135,000
Total Current Liabilities	$3,878,796	$5,169,447
Long-Term Liabilities		
Notes Payable	$256,789	$356,900
Mortgage Payable (Less Current Portion)	$1,938,495	$1,876,796
Total Long-Term Liabilities	$2,195,284	$2,233,696
Total Liabilities	$6,074,080	$7,403,143
Net Assets	$2,506,890	$2,140,109

Change in net Assets = -$366,781

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Liquidity: The Big Question

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With $258,390 in cash on hand,

How will the BCA pay $$5,169,447 in current liabilities?

The board should focus on this issue as a device for having a discussion

Liquidity: The Big Answer

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$725,000 in investments (but is that available or restricted?)

$4,406,070 in revenue receivables

$594,234 in inventories

$634,342 in prepaid expenses

$6,359,646 in other potentially liquid current assets

We will assume these are all unrestricted assets

Spinning Plates

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- In all likelihood, the liabilities will be satisfied by collection of receivables and sale of the inventory (assuming it is sold rather than given away).
- While the existing current liabilities are being paid off, new current liabilities are being created
  - Spinning plates from an old circus clown act
  - Sisyphus—rolling the rock up the hill
- Suppose BCA is located in Illinois and the state stops paying its payables to social service agencies? Nobody suspends the requirement that BCA's liabilities be paid

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- Why do we care about earning a surplus, or why no nonprofit is truly a nonprofit?
  - Excess earnings provide protection against the State of Illinois
  - BCA also has $2,233,696 in long-term liabilities that will become due some day
    - Read the footnotes to the financial statements for details about the debt (interest rate, maturity, etc.)
  - Surplus can be used to invest in new programs

Statement of Activities

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- Income statement (for a period)
- Linkage: The income statement explains how last year's balance sheet became this year's balance sheet. The net change in assets shown on the balance sheet is the bottom line number in the income statement
- Historical rather than predictive
  - Everybody wants to say, "If it was $100,000 last year, it must be at least $100,000 plus something next year."
  - Do not fall into that trap

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- Accrual vs. Cash Accounting
  - Accrual looks at economic events and legal rights
  - Cash looks at receipt and expenditure of cash
- Grant revenue (income statement) and revenue receivable (balance sheet)
- In-kind income
- Depreciation (Organizations don't expense the total cost of the asset when they purchase it)

	2009	2010
Revenue		
Grant Revenue	$20,100,300	$22,405,222
Program Service Fees	$1,234,897	$890,000
Formula Sales	$4,000,890	$4,200,000
Interest Income	$22,890	$23,000
Rental Income	$350,000	$375,000
Contributions	$234,000	$450,678
In-Kind	$567,000	$789,000
Total Revenue	$26,509,977	$29,132,900
Expenses		
Salaries and Wages	$10,345,673	$14,987,536
Payroll Taxes and Fringe Benefits	$2,508,740	$2,956,789
Interest Expense	$236,931	$243,630
Legal and Professional	$12,000	$225,698
Cost of Formula	$3,489,456	$375,903
Depreciation	$390,768	$407,796
Weatherization Materials	$345,000	$650,000
Equipment Lease	$24,679	$98,976
Property Taxes	$34,543	$43,567
Office Supplies	$65,786	$76,578
Communications (Phone and Internet)	$21,567	$45,986
Fundraising	$4,000	$8,658
Miscellaneous	$6,734,567	$9,378,564
Total Expenses	$24,213,710	$29,499,681
Net Income/Increase in Net Assets	$2,296,267	-$366,781

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- Very straightforward
- Major sources of income are listed first, and then major categories of expenses
  - Generally no breakdown in the income statement by programs or functional areas (i.e., program services, administration, and fundraising)
  - See statement of functional expenses
- I do not like the way the expenses are shown in this statement. I saw one CAA that included one and one-half pages of expenses. In my opinion, that level

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of detail is not appropriate in an audited financial statement, but it may be appropriate information for the board to see. On the other hand, dumping so large a portion of overall expenses in Miscellaneous is not helpful, either

Statement of Cash Flows

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- Conceptually the most difficult statement
- Arguably the most meaningful
- Three categories of focus
  - Cash [provided by or used in] operations
  - Cash [from sale of or used by acq.] investments
  - Cash [from borrowings or repaid] financing
- The statement of cash flows is based on a simple equation: Change in the cash balance = Cash provided by or used in (i) operations; (ii) investment activities; and (iii) financing activities

Example 1

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- Net cash used by operations --$500,000
- Net cash provided by financing--$400,000 (borrowed)
- Net cash provided by investment activities—$75,000 (sold non cash asset)

- Change in cash balance on balance sheet?

Example 2

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- Cash used by operations--$500,000
- Cash provided by financing-- $0
- Cash provided by investment--$500,000

- Change in cash balance on balance sheet?

STATEMENT OF CASH FLOWS		2010
CHANGE IN NET ASSETS		-$366,781
ADJUSTMENTS TO RECONCILE CHANGE IN NET ASSETS TO NET CASH FROM OPERATIONS		
Depreciation		$407,796
(Increase) Decrease in:		
Investments		$0
Revenue Receivable		-$447,595
Inventories		-$348,525
Prepaid Expenses		-$158,452
Increase (Decrease) in		
Cash Overdraft		$982,501
Accounts Payable--Vendors		$599,103
Accounts Payable--Others		$59,934
Current Portion of LT Debt		$0
Line of Credit		-$239,997
Unemployment Compensation Reserve		-$110,890
NET CASH (USED) PROVIDED BY OPERATIONS		$377,094
CASH (USED) PROVIDED FROM INVESTING ACTIVITIES		
Purchase of Furniture		-$10,123
Purchase of Land		0
Purchase of Building		-$400,000
Purchase of Grant Funded Assets		0
CASH (USED) PROVIDED BY INVESTING ACTIVITIES		-$410,123
CASH (USED) PROVIDED BY FINANCING		
Increase in Notes Payable		$100,111
Decrease in Mortgage Payable		-$61,699
CASH (USED) PROVIDED BY FINANCING ACTIVITIES		$38,412
Increase in Cash		$5,383
Beginning Cash Balance	$253,007	
Ending Cash Balance	$258,390	
INCREASE IN CASH		$5,383

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Disregard if you find this confusing

STATEMENT OF CASH FLOWS		2010
CHANGE IN NET ASSETS		-$366,781
ADJUSTMENTS TO RECONCILE CHANGE IN NET ASSETS TO NET CASH FROM OPERATIONS		
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INCREASE IN CASH		$5,383

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What We See

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- If BCA's board stopped at the income statement, it might think that BCA had a $366,781 "loss" for the year
  - From an accounting standpoint, there was a loss.
  - The board should be concerned because in the prior year BCA had a significant surplus ($2,296,267). Is this the start of a troubling trend?
- On a cash flow basis, BCA had positive cash flow from operations ($377,094)
- Question 1: So what did BCA do with this cash?

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- Purchased furniture ($10,123)
- Purchased a building ($400,000)

- Question 2: BCA spent more than $377,094 (its cash flow), so how did it finance the remaining $33,029 in asset purchases?
  - It borrowed $38,412
- Question 3: What happened to the $5,383 from the financing that was not used to purchase furniture or a building?
  - It increased the cash balance

Statement of Functional Expenses

66

- Statement or footnote disclosure
- Where is the revenue?
  - Always ask
- Beware of allocations

(continued)

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Category	Program Services	General & Administration	Fundraising	Total
Salaries and Wages	$11,240,645	$2,248,130	$1,498,761	$14,987,536
Legal and Professional	$145,000	$75,000	$5,698	$225,698

Notice that the numbers tie back to the income statement totals

Notice that the breakdown in program services does not go to individual programs

Recognize that these breakdowns are subject to manipulation through overhead Allocation formulas

PROGRAM SERVICES	Armed Forces Emergency Services	Biomedical Services	Community Services	Domestic Services	Health & Safety Services	Int'l Relief & Dev. Services	Total
Services & Wages	32,049	877,417	54,068	80,806	100,934	11,545	1,156,819
Employment Benefits	9,127	260,055	14,950	22,122	27,300	3,396	336,950
Total	41,176	1,137,472	69,018	102,928	128,234	14,941	1,493,769
Travel & Maintenance	941	29,831	2,895	27,727	3,321	2,750	67,465
Equipment Maintenance & Rental	971	59,264	5,138	18,311	4,696	782	89,162
Supplies & Materials	2,941	417,655	16,143	17,205	41,111	1,831	496,886
Contractual Services	9,089	459,493	17,881	60,454	32,733	11,909	591,559
Financial & Material Assistance	1,945	4,514	13,067	173,625	2,847	124,292	320,290
Depreciation & Amortization	1,583	52,849	4,406	10,937	7,443	627	77,845
Total	17,470	1,023,606	59,530	308,259	92,151	142,191	1,643,207
Total	58,646	2,161,078	128,548	411,187	220,385	157,132	3,136,976

SUPPORTING SERVICES	Fundraising	Management & General	Total
Services & Wages	44,866	84280	129,146
Employment Benefits	12,250	24882	37,132
Total	57,116	109,162	166,278
Travel & Maintenance	2,326	4457	6,783
Equipment Maintenance & Rental	1,404	4793	6,197
Supplies & Materials	15,775	4546	20,321
Contractual Services	38,323	29940	68,263
Financial & Material Assistance	1,210	1484	2,694
Depreciation & Amortization	2,414	17943	20,357
Total	61,452	63,163	124,615
Total	118,568	172,325	290,893

Example from the American Red Cross

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Observations About Functional Expenses

69

- The American Red Cross does break program services down by program (see prior screen)
- The program expense ($3.136 billion), fundraising ($119 million), and the general and administrative expense ($172) tie back to the income statement

The Footnotes to the Financials

70

- The footnotes to the financial statements are an integral part of the statements
- Many of the disclosures are required by the accounting rules
- Most experienced financial analysts read the footnotes first, or very early on in their review

(continued)

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- The footnotes typically address:
  - The organization—legal form, purposes, and tax-exempt status
  - The methodology used for estimates
  - The depreciation methods (basis for calculation and assumptions)
  - Grants and receivables (amount)
  - Treatment of donated services (type and valuation)
  - Contingent liabilities (e.g., pending lawsuits)
  - Lease commitments (amounts, term)
  - Pension and retirement plans (basic terms and methodology used to arrive at liability and funding estimates)
  - Long-term debt (major loans, amounts, terms)

(continued)

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- Consolidation and affiliation (the organizations included in the financial statements and their relationship to the main entity)
- Other matters

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UNIQUE ASPECTS OF NONPROFIT FINANCIAL STATEMENTS

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Restrictions

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- Nonprofit financial statements also must reflect the following three categories of assets:
  - Unrestricted assets (no specific restriction imposed by donor or the grant);
  - Temporarily restricted assets (the restriction lapses with the passage of time or the satisfaction of a condition); and
  - Permanently restricted assets (the restriction never lapses)
- Corresponding distinctions must be in the income statement

(continued)

75

- These distinctions are both helpful and important because they indicate to management and the board limits on what they can do with assets
- For example, assume the balance sheet shows $1,000,000 of cash. Without a designation, the board might think it has $1,000,000 to spend as it likes. But suppose the $1,000,000 represents an advance under a grant to build a limited purpose facility. The board cannot legally use the $1,000,000 for any purpose

(continued)

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- Organizations have some discretion on how they present the restriction in the financial statements.
- The better approach is to use four column balance sheet. Not only must the user read down the balance sheet, but the user must read across

	Unrestricted	Temporary Restricted	Permanently Restricted	Total
Cash	$250,000	$750,000	$1,000,000	$2,000,000
Marketable Securities	$500,000		$500,000	$1,000,000

Pledges: Revenue Recognition

77

- Pledges must be booked as revenue
  - The basic rule: Assume a promise if the pledge does not address issue, which means recognize revenue immediately
  - Remote conditions
    - Identify the contributor in a list of donors. It is likely to be complied with and therefore the pledge must be booked as revenue immediately
    - Contributor is only required to contribute if there are matching or a certain level of donations is obtained (may result in deferred recognition of revenue)

(continued)

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- Benefit of the rule: Forces the board to exercise its fiduciary duties by viewing the pledge as an asset
- Objection to the rule: “Makes us-the charity—look wealthier than we actually are.” That is true if wealth equals cash

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Volunteer Service: Revenue Recognition

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- Certain services by volunteers must be valued and included as revenue
- Mandatory if:
  - Create or enhance a nonfinancial asset; or
  - Specialized skills and those with them provide the services
- Examples
  - Construction company donates labor
  - Lawyers and legal clinic

(continued)

80

- Open to abuse through valuation
  - Fundraising ratios
- Very useful for grants: Certain grants that require the charity to match a portion of the grant with its own funds or impose cost sharing requirements may treat the value of services as satisfying a portion of the requirement
- Put Barber: Shows true cost of nonprofit activity

Revenue Recognition

81

- Three types of transactions
  - Contributions
  - Exchange
  - Intermediary
- Contributions (gift) and exchange (services for money) are just what you would expect
- Intermediary—Bypass income statement (Fed government gives organization $1 million and requires organization to give $2,000 to each of its 500 clients

(continued)

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- The rules are complex. They make technical and fine distinctions. The issue for the board is relatively simple:
  - Whether the funds flow through the organization's income statement or not, the organization is conducting a program that presumably furthers its mission
  - The board therefore needs to understand and evaluate how well the organization is running the program

Cost of Fundraising

83

- Cannot amortize cost of fundraising over life of the associated fundraising campaign
- This poses a problem for campaigns with large upfront costs
  - Capital campaign
  - Brochures, videos, etc.
- Deal with the problem through disclosure

Consolidation of Affiliated Entities

84

- Rules mandate consolidation of affiliated entities
- The problem of the monolith and duty
- Directors should always demand separate financial statements for each entity. The director owes his duties to the entity, not a monolith

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GRAPPLING WITH ALL THOSE NUMBERS: RATIO ANALYSIS

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Theory of Relativity

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- The financial statements provide some sense of what is happening
  - If the income statement shows an organization operating at a $500 million loss, there is a problem
  - If the balance sheet shows an organization with a $500 million negative net worth, there is a problem
  - If the statement of cash flows show an organization with $500 million operating cash flow deficit, there is a problem
- Can we find better metrics
  - Compare same organization over a number of years
  - Compare different organizations in same year

(continued)

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- Example 1: American Red Cross (this is my schedule, not their schedule) It is for illustration only

RATIO ANALYSIS	2002 9/11	2003	2004	2005 Tsunamis	Average
DEFENSIVE INTERVAL RATIO					
Cash + Marketable Sec. + Receivables / Average Monthly Expenses	4.65	3.96	3.51	4.78	4.94
LIQUIDITY RATIO					
Cash + Marketable Sec. + Receivables + Inventory / Total Liabilities	166.94%	110.00%	99.79%	116.60%	121.03%
SAVINGS INDICATOR					
Revenue - Expenses / Total Expenses	15.30%	-3.37%	-3.37%	14.34%	4.38%
DEBT RATIO					
Total Debt / Total Assets	26.96%	34.99%	34.78%	33.30%	26.96%
MANAGEMENT EXPENSE RATIO					
Management Expenses / Total Expenses	4.88%	5.23%	5.42%	5.03%	5.13%
FUNDRAISING EFFICIENCY RATIO					
Contributions (Except Government) / Fundraising Expenses	12.97	5.02	5.35	11.15	12.97
FUNDRAISING EXPENSE RATIO					
Fundraising Expenses / Total Expenses	3.83%	3.65%	3.47%	3.46%	3.61%
PROGRAM SERVICE RATIO					
Program Service Expenses / Total Expenses	91.29%	91.13%	91.10%	91.51%	91.26%
AVERAGE MONTHLY EXPENSES	297,578	280,804	285,656	290,346	282,665

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THE FALLACY OF THE INDEPENDENT AUDIT

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Auditors Opinion Letter

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- Issued as the culminating step
- Typically unqualified
  - Comply with GAAP
  - Audit performed in accordance with generally accepted auditing standards (GAAS)
- Boards depend on interim statements: The problem of too many adjustments

Outside Audit

91

- Reliance misplaced
  - SAS No. 1 "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements *are free of material misstatement* whether caused by error or fraud"
  - Read the standard audit opinion
  - SAS No. 99 "Although this Statement focuses on the auditor's consideration of fraud in an audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud"

Role or Function

92

- The financial statements are the nonprofit's responsibility
- CPA does not guarantee
- Audited on a statistical or test basis
- CPA issues an opinion
  - Audit conducted in accordance with GAAS
  - Financial statements present financial condition and results fairly
- Management letter (key document)

Auditor Independence

93

- Yellow Book standards
- California addresses as part of the Nonprofit Integrity Act of 2004
- Generally prohibited (or best practices)
  - Not auditing own work
  - Not performing management functions
  - No executive search
  - No strategic planning

(continued)

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- Non-audit service fees in relation to audit fees
- Big business audit client/director conflict

Audit Committee

95

- Move in direction of requiring
  - Independence of members
  - Financial expertise
    - Members who have it; or
    - Get an outside advisor

Audit Committee Duties

96

- Select outside auditor
  - AICPA peer review Web site at http://www.aicpa.org/centerprp/publicfile01.htm
  - State CPA groups may also perform peer reviews
- Discuss audit plan
- Discuss audit results
- Resolve disputes between management and the outside auditor

(continued)

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- Monitoring the financial reporting process
- Overseeing the internal control system
- Overseeing the internal audit and independent public accounting functions
- Reporting findings to the board of directors
- Whistleblower (financial issues)

OIC-GM, What Can Go Wrong

98

- Facts
  - Kickback scheme
  - Virgin Islands TV station
  - Radio station advertising
  - Real estate dealings
  - W-2 program deficiencies

(continued)

99

- Consequences
  - Jail term
  - Shut down of agency
  - Revisit W-2 effectiveness
- Management letter
  - General discussion of financial review
  - Too many cash accounts
  - Entries needed adjustment
  - Too complex of a corporate structure
  - Controls an issue

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CONCLUSIONS

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An Opportunity for a Discussion

101

- The financial statements provide an organized means to talk about mission
- Because mission cannot exist without money, the financial statements should never be viewed as something apart from mission. Mission and finance are the same thing. If you don't believe that, talk to the City Opera of New York, the Milwaukee Public Museum, OIC-GM, and countless other organizations that found out the hard way what happens when finance is divorced from mission

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- The financial statements are an important tool for management. In a sense, they represent a defensive tool—they permit management and the board to steer the organization clear of financial trouble if the statements are used properly.

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What the Financial Statements Don't Show

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- The financial statements, however, don't solve all of life's problems
- What the financial statements don't demonstrate is whether or how well the organization is accomplishing its mission. A large surplus can co-exist with a failed mission
- Many organizations are not very good at quantifying what are referred to as outcomes. They may be able to point to the teacher/student ratios or the quantity of food given away, but they are unable to quantify the long-term impact of their activities

(continued)

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- Organizations who want to attract new grants and contributions are well-advised to make their case by referring to outcomes
  - Making the case includes heart-warming stories of success
  - But it also includes creating metrics that quantify that success so that it becomes more than just anecdotal accounts

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JACK B. SIEGEL
ANYTHING BUT A COLD SHOWER: INCORPORATING FINANCIAL STATEMENTS INTO YOUR BOARD MEETING
PRELIMINARY QUESTIONS FOR YOUR CONSIDERATION

Please answer the following questions before the presentation. There are no grades. The questions are designed to make you think about some of the issues that will be addressed during the presentation.

On a 1 (Strongly Agree) to 10 (Strongly Disagree) scale, indicate your reaction to each statement:

1. Financial statements are best left to the finance committee. _______

3. A CAA that earns a significant profit during the year is fortunate because it now has more funds available to fund new programs to assist community members. ________

4. A CAA that earns a significant profit during the year is a successful CAA. ________

5. Financial statements sometimes are difficult to understand, but at least they provide an objective insight into a CAA's operations. ________

6. A CAA's annual audit is expensive, but at least it protects the CAA from becoming a victim of financial fraud. _______

7. Most of the time when my CAA's board discusses the financial statements the discussion consists of the board listening to someone report on financial results, followed by one or two questions. ________

8. The discussion of the financial statements at board meetings should be short and sweet. ________