CAPLAW

Community Action Program Legal Services, Inc.

BEYOND THE BASICS

Strategic Approaches to Organization-wide Compliance, Risk Management, and Resource Development

Webinar Series Schedule

Today	***More than Math: The Board's Role in Financial Oversight and Monitoring***
July 27	***The COSO Internal Control Integrated Framework***
August 17	***Strategic Resource Development: Fundraising and Revenue Creation Plans***
September 7	***Tapping into the Time, Talent, and Treasure of the Tripartite Board***
September 14	***Quality Improvement: The Payoff from Internal Controls***

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More Than Math:
The Board's Role in Financial Oversight and Monitoring

July 20, 2011

Part of the Beyond The Basics webinar series

Presented By Jack B. Siegel

Overview

- CAA reality check
- Mission and finance – Two sides of the same coin
- The board's role
- Reading nonprofit financial statements
- Unique aspects of nonprofit financial statements
- The fallacy of the independent audit

CAAs are Nonprofits

- CAAs:
  - Mission-driven
  - Help low-income communities
  - Provide social services
  - Improve society
  - Do not seek profits to distribute to shareholders

CAAs are also Businesses

- CAAs 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
- If revenues don't exceed expenses, a CAA will have to close its doors
- New York City Opera

Current Environment

- Nonprofits fails all the time, CAA's are no different
- CAAs face threats to revenue:
  - Specific cuts in federal government funding
  - More pressure on government resources at all levels
  - At the same time, CAAs face a population with growing needs, due in significant part to cutbacks in government funding

MISSION AND FINANCE ARE TWO-SIDES OF THE SAME COIN

TRUISM I: Directors Who Ignore Finances Do So at the Mission's Peril

- All board members must be focused on finances
- Example 1: We should get out of Afghanistan because we have already spent $400 billion there
  - Have we spent $400 billion out of pocket?
- Example 2: A CAA should close a particular program because the program is operating at a $559,867 loss.
  - Is that on a cash flow basis, or does some of the loss include depreciation (a non-cash expense)?
  - Does the loss include revenue reimbursements that have not yet been received?
  - Is there a way to reconfigure the mix of part-time/full-time employees and to reduce labor costs, but maintain quality to service recipients?
  - Should the CAA speak with the foundation funding the program about adjusting overhead allocation rates?
- Bottom Line: When you defer to the finance people, you are letting them set policy and define mission

TRUISM II: Not Rocket Science

- 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

The Board's Role

Board Fiduciary Duties

- Each board member has a legal **duty of care**
- This duty requires each board member to:
  - Make informed decisions regarding the CAA
  - Determine how the CAA's financial resources are utilized and to make sure that the CAA is financially viable
- This requires each board member to focus on financial issues
- As a board member, you have a right to review a complete set of financial statements. You should exercise this right.

The Meeting

- 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

Step 1:
The finance committee should meet in advance of the full board meeting to review the financial statements in detail

- More detailed, identify major issues for the board, plan

Step 2:
Distribute financial statements, budget variances to the board at least 1 week in advance

Step 3:
Finance on the formal agenda. Discussion includes:

- The overall financial condition and results
- Major issues revealed by statements
- Budget variances
- Assessment of liquidity
- Key financial ratios/metrics
- Stability of grants and revenue

A Five Step Process (cont.)

Step 4:

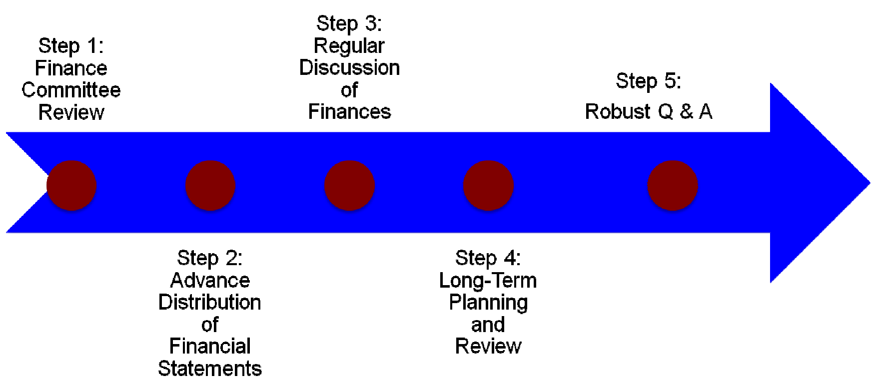
At least once a year, the board should discuss

- Auditor's annual report and management letter
- Annual budget
- System of internal controls
- Long-term financial plans and needs

Step 5:

Q & A session and robust discussion

Board Financial Review: A 5 Step Process



Budget Variances

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

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

Budget Variances (cont.)

- Why review at each board meeting?
  - In February of this year, the board knows that it has a problem-- $25,000 variance in January and $50,000 variance in February. Still time to react
- But isn't management responsible?
- Variances raise policy issues:
  - Add several full-time employees to reduce overtime?
  - More training for energy assistance programs?
  - Head Start class size needs to be increased?
  - Several employees are falsifying their time sheets?

Budget Variances (cont.)

- Management reports to finance committee on variances
- Papering over the variance is not a solution
- Follow up at the next board meeting
- Program-by-program analysis as well as entity-wide analysis

Assessing Liquidity

- 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?
  - Reimbursement receivable from the State of Illinois for $200,000
  - Is CAA going to sell its headquarters building?
  - Is CAA selling inventory or giving it away?

Assessing Liquidity - A Five Step Process

Step 1:

Ask the fundamental question: “We have this much cash on hand and we have these liabilities, 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/payable aging schedules

Assessing Liquidity: Five Step Process (cont.)

Step 4:

Review key financial metrics that assess liquidity.

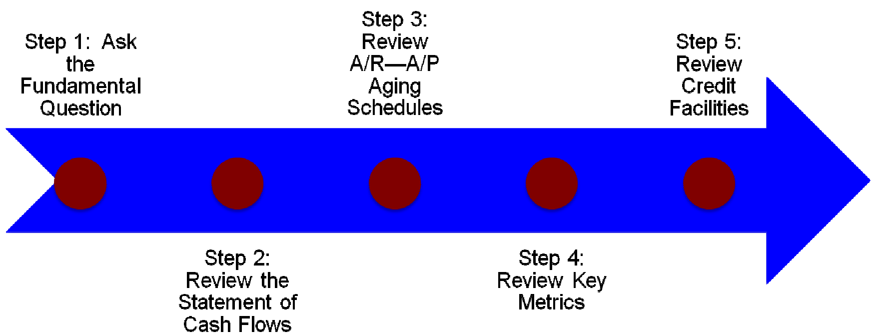
Has there been a material change in those metrics?

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?

Assessing Liquidity: A Five Step Process



Reviewing Financial Ratios

- A way to summarize or make-sense of the financial statements

- Here is one:
  - 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

Reviewing Financial Ratios (cont.)

- 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 used blindly

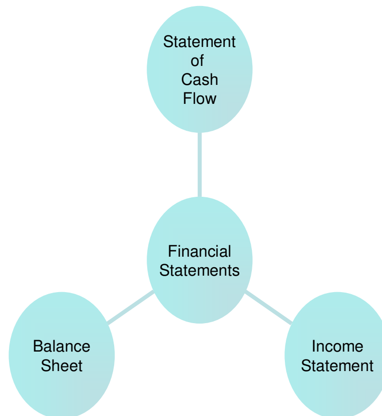
- The numbers generated by a ratio are meaningless until used comparatively: (i) historical; and (ii) other organizations
  - Historical comparisons are fairly easy
  - Comparisons with other organizations will prove difficult in many instances. This is an aspirational recommendation

READING NONPROFIT FINANCIAL STATEMENTS

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

- Balance Sheet: "as of"
- Historical values (with exceptions)
  - Inventory: lower of cost or market
  - Receivables: allowance for doubtful accounts
  - Marketable securities: fair market value
  - 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

Balance Sheet Lists Liabilities

- Two categories:
  - Current (payment due sometime during the next year)
  - Long-term (payment due following the current year)
- Many contingent liabilities are not listed. Pending lawsuits often described in footnotes rather than on the b/s
- 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

Limitations of Balance Sheet

- The balance sheet **does not** list
  - Organizational know-how
  - Workforce in place
  - Goodwill
  - Going-concern value
  - Any number of other intangible assets

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

Liquidity: The Big Question

- 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

$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

Why Surplus Is Important

- 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

- Income statement (for a period)
- Linkage: The income statement explains how last year's balance sheet became this year's balance sheet
- Historical rather than predictive

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Accrual vs. Cash Accounting

- Accrual vs. Cash Accounting
  - Accrual looks at economic events and legal rights
  - Cash looks at receipt and expenditure of cash
- Examples
  - 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)

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	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

(continued)

- Very straightforward
- Major sources of income are listed first, and then major categories of expenses
  - Generally no breakdown by programs or functional areas
  - See statement of functional expenses

Statement of Cash Flows

- 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

- 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?

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**

What We See

- 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?

What We See (cont.)

- 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

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

	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

Example from the American Red Cross

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

The Footnotes to the Financials

- An integral part of the statements
- Many of the disclosures are required. Experienced financial analysts read the footnotes first, or very early on in their review
  - Legal form, purposes, and tax-exempt status
  - Depreciation methods
  - Contingent liabilities
  - Long-term debt
  - Retirement plan liabilities
  - Consolidation (included entities)

UNIQUE ASPECTS OF NONPROFIT FINANCIAL STATEMENTS (Abridged)

Restrictions

- Nonprofit financial statements also must reflect the following three categories of assets:
  - Unrestricted assets (no specific restriction imposed);
  - Temporarily restricted assets (the restriction lapses with the passage of time or the satisfaction of a condition); Permanently restricted assets (never lapses)
- Corresponding distinctions in the income statement
- These distinctions indicate what can be done with assets. E.g., $250,000 of cash on balance sheet

- 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

THE FALLACY OF THE INDEPENDENT AUDIT

Auditors Opinion Letter

- 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
- The auditing standards state that the purpose of an audit is to certify financial statements, not detect fraud

Role or Function

- 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)

Audit Committee

- Move in direction of requiring
  - Select outside auditor
  - Discuss audit plan, audit results
  - Resolve disputes between management and the outside auditor
  - 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)

An Opportunity for a Discussion

- 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

- Financial statements don't indicate
  - Whether the CAA is accomplishing the mission

About Jack B. Siegel

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.

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