



What Board Members Need to Know About Not-for-Profit Finance and Accounting

JACOBSON JARVIS
CERTIFIED PUBLIC ACCOUNTANTS & CO. PLLC

www.jjco.com

Table of Contents

Introduction	2
Role of Board Member in Financial Oversight	3
Understanding Financial Statements	4
Financial Statements: Review Checklist	12
Reviewing the IRS Form 990	13
Key Financial & Governance Policies	17
Evaluating Funding Sources	18
Roles and Responsibilities	20
Glossary of Terms <i>(words and terms found in glossary are italicized throughout)</i>	26
Other Resources	30
Our Services/Contact Us	34

Introduction

Thank you for agreeing to serve on the board of a not-for-profit organization. Without your dedication and commitment, we would not enjoy the thriving not-for-profit community we do.

As a board member, you are probably very familiar with some aspects of not-for-profit management. You understand the basic need to raise money to support the activities of the organization for which you volunteer, and you probably have seen the fundamental challenge every not-for-profit management team faces – to make the dollars raised go as far as possible.

However, in addition to addressing funding challenges, as a board member you now have a legal responsibility to protect the organization’s assets by overseeing its financial activities and implementing “best practices” to protect the organization. For board members without experience in not-for-profit accounting, and especially for those without any formal accounting training, it is easy to neglect this important responsibility and bear some liability for the outcome.

This booklet is designed to help you perform your financial responsibilities more effectively. It outlines some of the key indicators that we, at Jacobson Jarvis, find that board members sometimes overlook when they are exercising their fiduciary duties to the organization. It should not be considered as a substitute for continued education or professional advice. Rather, this booklet was produced as a service to our clients and friends of the firm, and their board members.

Role of the Board Member in Financial Oversight

As a board member, your fundamental role is to oversee the implementation of the not-for-profit organization's mission. This includes exercising your fiduciary duty to ensure that the organization's financial resources are effectively managed and sufficient to assure the organization's long-term financial viability.

In Washington State, exercising fiduciary duty incorporates three basic duties: the duties of good faith, loyalty and care. The **duty of good faith** requires that you act in good faith, in a manner that you reasonably believe to be in the best interests of the organization. The **duty of loyalty** requires that you act in a manner that furthers the interest of the organization and that you refrain from engaging in personal activities that could be construed to injure or take advantage of the relationship to the organization.

As a board member exercising duty of good faith and duty of loyalty you should:

- Maintain confidences
- Identify and disclose conflicts of interest
- Never use information obtained as a board member for personal gain

The **duty of care** requires that you exercise diligence in the oversight of corporate officers, seeking and reviewing all necessary information in order to make informed decisions. As a part of that duty you must make reasonable inquiries and exercise independent judgment using the skill, caution and diligence that a prudent person would use in handling corporate affairs.

As a board member exercising the duty of care, you should:

- Regularly prepare for and attend board meetings
- Read all the information provided to you
- Actively participate in board discussions, exercising independent judgment in decision making
- Ask questions so that you have a complete understanding of the organization's financial picture

- Review your organization's *Form 990* prior to filing
- Consider going beyond public disclosure requirements to increase transparency
- Adopt and implement appropriate financial governance policies to protect your organization
- Understand the impact of various revenue and fund development approaches on your organization's financial health
- Understand the roles of the board treasurer and the finance and audit committees, and actively participate in identifying and recruiting qualified board members to fill those roles

The next several sections of this booklet review some of these points in more detail.

Understanding Financial Statements

One of the most critical requirements of the duty of care is to read and review the financials, and ask questions about the content.

While you may rely upon the information provided by the organization's management team and external consultants, including CPAs, that reliance does not release you from the due diligence required by the duty of care.

If you do not have a financial background, reviewing the financial information provided and understanding which questions to ask may be a daunting assignment. This section provides some guidance about where to begin.

If you do have financial expertise but have not previously focused on not-for-profit financial management, this section will point out some important differences.

How are financial statements used?

As you review your organization's financial information it is helpful to understand who uses the financial reports, and what information they may be seeking. Common types of financial statements include budgets and financial projections, internal (unaudited) financials, external (unaudited) financials, audited financials and the IRS *Form 990*.

Common users include:

Management team members. Management team members prepare budgets and financial projections, as well as internal (unaudited) financial statements for their own internal use in managing the organization's operations. These are often formatted in a different way than the statements prepared for external use, and may include comparisons of budgeted figures against actual results, changes relative to a prior period and notes about variances. They also prepare unaudited financials for use by the organization's auditors.

Auditors. Auditors use unaudited financials prepared by the management team to conduct their *audit* of the organization's financial statements. The *audit* process consists of an assessment of the potential risk of material error, consideration of internal controls and a series of tests designed to evaluate whether the management-prepared statements conform to *generally - accepted accounting principles (GAAP)*. Upon completion of the *audit*, auditors express an opinion via an independent auditor's report on the accompanying financial statements. The auditor's independent report expresses their opinion about whether the financial statements are fairly presented in all material respects.

Donors/Funders. Donors/funders use external unaudited and audited financials and the organization's *Form 990* to evaluate whether or not they believe the organization will use their funds wisely. In addition to questions about the general financial health of the organization, more sophisticated donors use the financial statements and the *Form 990* governance questions to review management performance, assess risk and evaluate the results the organization has achieved.

Lenders/Bankers. Lenders generally focus on external unaudited and audited financial statements, budgets and financial projections. They are interested in how well your organization performed against its projections, as this will give them some ideas as to how reliable future projections are. They will also review the organization's cash flows, liquidity and the ratio of *current assets to current liabilities* (the current ratio).

The IRS and other governmental agencies. Governmental entities are looking for evidence of compliance with tax-exempt status and other laws, and for inconsistencies that may indicate fraud or a lack of transparency in operations. They rely most heavily on the audited financials and *Form 990*, but may review other tax-related filings or public information. Interestingly, the revised 990 now asks a series of questions about

governance not within the jurisdiction of the IRS. The IRS is using this information to assess risk and prioritize audits.

Board of Directors. As a member of the board of directors, you should be requesting and reviewing all of these financial documents. The next sections review the most common financial statements, the types of data they represent and the kinds of questions you should ask.

The Statement of Financial Position

The Statement of Financial Position (or *Balance Sheet*) summarizes the *assets and liabilities* of an organization at a point in time. Many of the asset categories will seem similar to those on a for-profit company's *Balance Sheet*. The biggest difference is the *Net Assets* section, which appears where the equity section would be on a for-profit *Balance Sheet*.

Not-for-profit *net assets* are classified based upon donor restrictions as follows:

- **Unrestricted:** These funds have no donor-imposed stipulations, but may include *board-designated funds*. For example, if the board is setting aside funds for reserves or capital improvements, those funds would be reported here.
- **Temporarily restricted:** These are assets with time and/or purpose restrictions stipulated by a donor. Common examples include *contributions* from a capital campaign, donations designed to cover a specific expenditure or fund services of a particular type, or donations designed to cover expenses for a pre-determined period in time.
- **Permanently restricted:** The corpus of these gifts is maintained in perpetuity with income to support either general operations or a specific purpose based upon the donor's stipulations. For example, the corpus of a scholarship fund in which the principal is retained and the income is used to fund scholarships would fall in this category.

As a board member, you should pay particular attention to these four issues relative to the Statement of Financial Position:

Trends. One of the first places to check for financial issues involves year-to-year trends. As you compare your current Statement of Financial Position to the one produced for the previous month or the previous year, you should look for any unusual trends. For example, does the current ratio seem to be decreasing, or have you had a significant growth in restricted *assets* that may affect your operating budget?

Liquidity. Liquidity refers to the organization's ability to tap into the cash required to pay immediate and routine obligations. One of the key indicators is the Current Ratio. The Current Ratio, *current assets* divided by the *current liabilities* of the organization, should be greater than 1.0. In addition, you should know your financial reserve targets for loans, long-term asset replacement and other uses, and check to make sure you are meeting these targets.

Debt. Many not-for-profits have a lending relationship with a bank or other financial institutions. As a board member, you should be familiar enough with the terms of the loan to understand whether you can access the capital required to cover emergencies. You should also review the Statement of Financial Position to ensure the loan balances are consistent with expectations. Rapid growth in debt might foretell an impending financial crisis.

Unrestricted Net Assets. Planning for a significant economic downturn, natural disaster or other crisis is an important board function. As a part of that planning, you should anticipate the financial demands that could result from such a situation and ask whether or not your organization has enough liquid unrestricted *net assets*, and/or access to credit to protect the organization.

The Statement of Activities

The Statement of Activities is similar to the *Income Statement* prepared by for-profit entities. Not-for-profits have two key sources of income: revenue and support. Revenue includes resources that resulted from an exchange transaction, such as program or service fees, grants and contracts from governmental agencies or other sources, ticket sales or event income, and investment return. Support includes resources for which no services, goods, or reciprocity is received by the donor/funder. This includes *contributions*, private grants and in-kind donations.

The Statement of Activities shows the results of the organization's financial operations for a period of time. Not-for-profits have many of the same expense categories that other entities do, but they must also show expenses by their functional classification: Program Services, Administrative and Fundraising.

Change in *Net Assets*, like the net income in for-profit statements, is the difference between revenue (including support), and expenses. However, activity must also be shown for each of the three classifications of *net assets*:

unrestricted, temporarily restricted and permanently restricted. Release of restrictions results in a reclassification between temporarily restricted and unrestricted when time and/or purpose restrictions are met.

As a board member reviewing the Statement of Activities, you should consider these four critical areas:

Budget versus Actual. Throughout your term, you will often have access to management's internal Statement of Activities, outlining budget versus actual expenses. As you review the document, look for significant variances, especially those that negatively impact the organization, and ask questions so that you better understand both the cause and the effect. If there are large variances, you should understand the reasons for the variances and what management's plans are for addressing the variances to determine whether you feel confident that management's plan will be effective.

Revenue & Support. While the Statement of Activities identifies revenue or support, it may not always indicate how dependent the organization is on any one source. Heavy reliance on a single source can be risky. For example, if the organization receives 80% of its funding from a single donor or foundation, the organization could be at significant risk if that funding is decreased or discontinued.

Board members should understand management's contingency plans to address unexpected drops in income. Remember, as a board member you are responsible for ensuring the long-term viability of the organization, and for ensuring sound operational and financial planning for a crisis situation.

Trends. When reviewing actual expenses, look for expenses that are rising more rapidly than the corresponding revenue or support source. Also, look for longer-term trends in both revenue and expenses. Such trends may signal a need for increased attention to fund development or tighter expense management.

The Bottom Line (Net Income or Loss). The bottom line is just as important to a not-for-profit as it is to a for-profit organization. The audited format of the Statement of Activities shows not only the total change in *net assets* for the year, but also how the change is distributed between restricted and unrestricted *net assets*.

As you review the data, consider whether or not the net change met expectations, both overall and across different fund types.

The Statement of Cash Flows

The Statement of Cash Flows converts accrual-based activity into a cash-basis format so that you can see the actual flow of cash into and out of the organization. Even when an organization's Statement of Activities and Financial Position look strong, an organization can go out of business because they don't have sufficient cash. The Statement of Cash Flows can reveal problems in this area as they surface. For this reason, it may be the most valuable of the three statements, particularly for smaller organizations.

Cash flows are categorized into operating, financing and investing activities. Each section shows both the cash sources and uses for that particular category. The operations section shows all of the day-to-day activities of your organization. The investments section shows the purchases and sales of investments and capital *assets*, such as property and equipment. The financing section shows the flow of cash to and from debt or other funding sources, including support received for long-term purposes such as endowment gifts and capital project funding. The three net cash figures, when totaled, represent the change in cash from beginning to the end of the fiscal period represented in the Statement of Activities.

When reviewing the Statement of Cash Flows, start with these areas:

The Bottom Line (Total Change in Cash). Organizations that consistently show a decrease in cash over several periods are quite likely to fail. If your organization is using more cash than it is generating, ask yourself whether this was expected. Is the organization using its reserves? What is the plan to reverse the cash outflow?

Trends. As with the other statements, looking at trends in the Statement of Cash Flows is important. How does your overall cash activity compare to the prior year? Are there any unexpected variances? Are your cash balances or reserves growing over time? If so, do you have an anticipated use for the cash? The answers you get from these questions can guide your short-term and long-term investment strategies.

Cash Flow from Operations. In most organizations, your objective should be to secure positive cash flows from operations. This indicates that you are not relying on debt or investments to fund your organization's day to day operations.

Days Operating Cash. One of the most critical indicators of the financial health of an organization is its cash reserve. This is the money that the organization could tap into if, in a crisis situation, all sources of funding stopped but expenses continued. In general, we recommend having a minimum of 60 days of operating cash on hand. To calculate your Days Operating Cash, divide cash balances by the sum of all cash expenses (exclude *depreciation* and in-kind), divided by 365 days per year.

The Statement of Functional Expenses

The Statement of *Functional Expenses* is only required for voluntary health and welfare organizations, however, many organizations find this statement to be useful. It classifies expenses according to their nature (payroll, rent, supplies), and function (programs, administration and fundraising). *Functional expenses* are allocated between program and supporting services categories based upon a reasonable system that can involve a variety of metrics, such as FTE or square footage.

Other Sources of Information in the Financial Statements

Your review of the financial statements should include all attachments, including footnotes and, if audited, the auditor's opinion. When reviewing these sources of information, be sure to include:

Auditor's Reports. When the auditors complete the audit of an organization's financial statements, they issue a report identifying their level of confidence in the financial statements prepared by management. In general, there are four possible opinions they can provide. 1) A "clean," or unqualified, *audit* opinion states that the financial statements present fairly, in all material respects, the financial position, and the changes in net assets and cash flows in conformity with accounting principles generally accepted in the U.S. ("GAAP"); 2) an "except for" or qualified opinion means that the auditors disagree with the accounting treatment of a specific transaction, or are unable to determine what the outcome might be of a material uncertainty; 3) a disclaimer opinion indicates that the auditor cannot give an opinion due to the inability to gather certain relevant facts; and 4) an adverse opinion indicates that the auditors do not believe the financial statements prepared by management are fairly presented. As a board member you want to see a "clean" audit opinion.

In the course of planning for the audit engagement, the auditor assesses the design and implementation of key financial statement internal controls

in order to evaluate risk and design the audit approach. In the process of performing this assessment, if the auditor notes any significant deficiencies or material weaknesses, they are to report these to the Board of Directors in a written report. Board members should inquire to the status of any such findings.

Footnotes. The key as you review the footnotes is to look for information that might alter your perception of the organization's financial health. For example, do the footnotes disclose a significant increase in rent or a balloon loan payment within the next few years? If so, does the management team have a plan to address the resulting financial issues?

Other Things to Consider

Banker's Perspective. If your organization has a lending relationship, pay particular attention to the footnotes that review compliance with loan and other legal covenants. Lack of compliance can cause a lender to withdraw future credit, leading to a significant cash crisis. Consider the impact a sudden downturn in the economy or another crisis would have. Will you still be able to comply with those covenants? Even if your not-for-profit organization does not currently have debt, you may need a lending relationship in the future, and the best time to prepare for a loan is when you don't need it. As you read through the financial reports, is there anything that would concern you as a prospective lender? Do your financial statements paint a true picture of strong fiscal management? If not, it is your duty as a board member to ensure these weaknesses are addressed.

Donor's Perspective. One of the most important, and often overlooked, audiences of financial statements and the IRS *Form 990* are donors and prospective donors. As you review the financial statements as a whole, including the footnotes, look for items that might make donors have second thoughts about how well the organization would handle their *contributions*. Remember to consider the information in isolation, not given the additional information you have as a board member. Frequently, published financials and the *Form 990* are the only tools available to donors to evaluate whether an organization is worthy of a significant gift.

In the next section of this booklet we'll review the *Form 990*, paying particular attention to the sections most likely to be of interest to donors and regulators.

Financial Statements: Review Checklist

Statement of Financial Position

- Are there unusual trends?
- Is the current ratio greater than 1.0?
- Can we access capital in an emergency?
- Are we prepared for a significant economic crisis?

Statement of Activities

- How are we addressing large variances between budget and actual?
- Are we overly dependent on a single funding source?
- Is revenue increasing at least as fast as expenses?
- Did our bottom line meet expectations?

Statement of Cash Flow

- Are we using more cash than we are generating?
- How does the overall cash activity compare to prior year?
- Do we have positive cash flow from operations?
- Do we have at least 60 days of operating cash on hand?

Other Sources of Information

- Did we receive a clean *audit* opinion?
- Do any of the footnotes cause us concern?
- Are we complying with loan covenants?
- What impression would a donor or lender have after reading our statements?

Reviewing the IRS Form 990

The *Form 990* is a not-for-profit organization's required annual IRS tax filing. As a board member you should be asked to review the *Form 990* before it is submitted. Even though you may not be asked to sign the document, you should make sure that the not-for-profit you serve files an annual *Form 990* and that the information in it is correctly presented. Ask yourself, does the document present any red flags to prospective donors or governmental agencies? You should also confirm that the organization you are serving has applied for, and received, tax-exempt status from the IRS.

Understanding What Tax-Exempt Status Means

The U.S. federal income tax code grants an exemption from income tax liability for organizations which satisfy a charitable purpose and which apply for, and receive, tax exempt status. Once this exemption is received, the not-for-profit corporation will not generally have to pay federal income taxes on donations and other funds directly related to its charitable purpose. However, the corporation may be liable for taxes on unrelated business income, and may also be liable for state and local income, business and/or property taxes. In addition, the organization is not excluded from payroll taxes, either at the federal or state level.

Becoming a Tax-Exempt Entity

In order to become a tax-exempt entity, an organization must first file corporate organization documents in its state. In general, this means it must have articles of incorporation, bylaws and a federal employer identification number.

Once the organization has been approved by the Secretary of State, a Form 1023 must be submitted to the IRS. The Form 1023 is the organization's application for tax-exempt status, and must include the approved articles of incorporation, bylaws and an application fee. When the application has been approved, the IRS will issue a determination letter confirming the organization's tax exempt status. Until a favorable determination letter is received, the organization should consider its income to be taxable and file tax returns accordingly.

After the IRS has issued a favorable determination letter, the organization must file with the Secretary of State's Charities Program before soliciting

any donations. Once the IRS and the Secretary of State have both approved your organization's charitable status, the organization is officially a tax exempt entity, and subject to certain routine reporting requirements, as described below.

While this process is complex, and professional expertise is advisable before filing a Form 1023, the IRS website is extremely informative. To find more information on becoming a tax-exempt entity go to www.irs.gov/Charities-&-Non-Profits, and search for the "Life Cycle" information.

Routine Reporting Requirements

As a nonprofit corporation your organization must routinely report activities to: the IRS, Secretary of State, City and State Departments of Revenue, payroll taxing authorities, City and County Assessors (for property taxes) and, in some cases, to the SEC. With the exception of the first two, the other reporting requirements are the same as they would be for a non-charitable organization.

The IRS requires each tax exempt organization to file a *Form 990*. If the organization has limited revenue (*i.e.*, under \$50,000) it may file a *Form 990-N*. Organizations with gross receipts more than \$50,000 and less than \$200,000, and assets of less than \$500,000, may file the *Form 990-EZ*, a simplified version of the *Form 990*. Organizations larger than this size must file *Form 990*. Organizations with assets of \$10 million or more may need to electronically transmit their return to the IRS using "e-file."

If your not-for-profit has \$1,000 or more in revenue unrelated to the organization's exempt purpose you may also need to file a *Form 990-T*. Frequently overlooked unrelated business income (UBI) includes income from activities such as advertising, parking lots and leased space. Organizations that have UBI but report continuing losses that are unreasonable in a business setting or that over-allocate expenses, may also incur penalties.

Washington nonprofit corporations must comply with both the Nonprofit Corporation Act and the Charitable Solicitations Act. The Nonprofit Corporation Act requires that the organization file an annual report with the Secretary of State. The Charitable Solicitations Act regulates organizations that solicit funding from the public and requires those entities to register with the state, whether or not they are corporations.

Not-for-profits in Washington State must also register with the Charities Program unless they are political organizations, churches, 100% volunteer-run organizations raising less than \$50,000 or appeals made on behalf of a specific individual. This registration must be renewed annually based on the fiscal financial reporting period of the not-for-profit organization. The state registration requires that the IRS tax forms be prepared or reviewed by a CPA or other professional third-party for organizations with more than \$1 million in revenue. Audited financial statements are required for organizations with more than \$3 million in gross revenue and cash *contributions* exceeding \$500,000.

The other reporting requirements are largely the same for both for-profit and not-for-profit entities. Washington State's gross receipts tax, the Business & Occupation tax, does exclude most *contributions*. However, sales taxes must be collected and paid by not-for-profits and property taxes must be paid unless the organization files and receives an exemption from the Washington State Department of Revenue.

If your not-for-profit organization has employees it must pay federal and state employment taxes. If it fails to do so, board members can be held liable.

Reviewing the Form 990: Four Key Pages

If your not-for-profit is required to file the *Form 990*, rather than the 990-N or 990-EZ, there are four places you should focus your attention:

Snap Shot: Page 1. The first page of the *Form 990* contains basic information about the organization, and a summary of its financial activities. It should provide the reader with a quick look at your mission, organizational structure, unrelated activities and financial health.

Accomplishments: Page 2. The second page of the 990 will catch the attention of governmental agencies and potential donors. It describes in more detail the organization's mission, new programs, three largest programs, and revenue and expenses by program. As you review this information, make sure the activities listed are consistent with the charitable purpose for which the organization has received exempt status. Over time, it is not unusual for an organization to shift to meet the needs of the community it serves. However, an inconsistency between the exempt purpose and the language in this section may prompt an *audit* or, in some cases, the revocation of exempt status. This section is also a significant one for donors. As you review the information, consider whether the statement of accomplishments would persuade you to make a contribution.

Checklist of Required Schedules: Page 3. Thirty percent of the organizations that file the *Form 990* do so incorrectly. In many cases, this is because they fail to file a required form. A quick review of the questions and responses on page 3 should reassure board members that the required forms have been submitted.

Governance, Management & Disclosures: Page 6. At the top of the Governance, Management & Disclosure page, the IRS notes that the page requests information about policies not required by the Internal Revenue Code. However, the answers to these best practice-based questions serve as red flags, and are used to assign audit priorities. More significantly, these questions are receiving increasing scrutiny by savvy donors and granting organizations. As a board member, you should consider the implications of a negative response, and what can be done to remedy the situation.

Maintaining Your Exemption

- Abstain from activities that jeopardize the exemption such as political activity
- Provide written substantiation for cash and non-cash contributions valued at \$250 or more
- Understand donor notification rules for gifts made in exchange for goods and services
- Monitor board independence
- Comply with public disclosure requirements on your exemption application and annual tax return
- Maintain appropriate financial and other records on behalf of the organization

Maintaining your exemption should include a thorough review of the four key ways that well-meaning organizations have lost their tax exempt status. These include:

- **Organized and Operated:** Update your articles of incorporation if your exempt purpose changes
- **Public Support:** Monitor your public support percentage (at least 33% for most charities)

- **Commerciality Doctrine:** Don't operate in an excessively commercial manner in competition with a for-profit counterpart in the marketplace
- **Public Benefit:** Maintain real and substantial operations that benefit public, not private interests. Look at the amount of program expenses in relation to total organizational expenses

For more information about the requirements for maintaining tax-exempt status, visit the IRS website: www.irs.gov/Charities-&-Non-Profits.

Key Financial & Governance Policies

While the Internal Revenue Code does not require the policies identified in Part VI of your organization's *Form 990*, several are important best-practices for the financial health of a not-for-profit organization. If your review reveals weaknesses, as a board member you should consider raising the question about creating policies. Model policies are readily available on websites including www.irs.gov and www.boardsource.org. However, the model policy may not be the best choice for your organization. Consulting an attorney experienced in not-for-profit governance issues is a wise choice.

For newer organizations, these policies can be time-consuming, and often expensive, to develop. We recommend focusing first on the following policies:

Conflict of Interest Policy. A Conflict of Interest Policy defines what an organization and its board members will do when considering a transaction from which a director or officer would benefit either directly or indirectly. These transactions may affect a board member's independence and ability to vote on key board decisions.

Record Retention and Destruction Policy. This policy defines how long each type of record will be retained, and what will happen to those records after that period. It should include electronic and physical records, and should also address how procedures might change if the organization were faced with an official investigation.

Whistleblower Policy. A whistleblower policy is designed to protect employees who report illegal, fraudulent or unethical activity from retaliation. It should also protect the confidentiality of the whistleblower.

Investment & Spending Policies. Written separately or together, these policies define the investment approach the organization will take when investing funds it holds either on a short-term or long-term basis, and its approach to spending both income and principal associated with invested funds.

Executive Compensation Policy. A written Executive Compensation Policy lends transparency to the compensation process, protects board members against potential legal exposure, and helps ensure that the organization and its executives will avoid fines associated with excessive compensation or private inurement. The policy should outline how executive compensation and, if appropriate, board compensation is determined, and should include the three components of the IRS' safe harbor rule as a part of the process: board or committee review, appropriate comparative data and documentation of compensation decision in minutes (including approval before any payment is made).

Gift Acceptance Policy. Many not-for-profits accept gifts that have strings attached, only to find those strings come with significant additional costs. At times, the additional costs outweigh the value of the gift. The next section of this booklet reviews some of the most common gift problems. A written gift acceptance policy helps avert issues by defining the types of gifts an organization will accept. The policy should also reaffirm the organization's commitment to complying with IRS documentation requirements.

Evaluating Funding Sources

During tough economic times an increasing number of not-for-profit boards may feel pressured to accept various types of funding in order to meet their fundraising objectives. This may lead to accounting complexities, donor management issues and other unforeseen costs. Knowing what to expect before your organization pursues more complex funding sources can limit your exposure to unnecessary financial and operational difficulties.

Below is an overview of the most common types of complex funding sources to be aware of:

Restricted Contributions. Individuals, corporations or private foundations may restrict the use of their gifts on a temporary or permanent basis. Such gifts are typically not intended for general operations or administrative

and fundraising costs. As there may be significant costs associated with tracking this income, the gift should be large enough to merit the additional monitoring expense.

Donor-Advised Funds. Some funding organizations allow individual donors to provide advice as to how grants of their funds will be made. This practice can lead to issues with tax-deductibility and appropriate accounting. To avoid these issues, foundations and other funding organizations hosting donor-advised funds should make sure prospective donors understand the limits of their influence after the contribution to the donor-advised fund is made. Organizations that are recipients of grants from foundations and other funding sources using donor-advised funds should make sure that the understanding with donors is clear prior to accepting funding, and should alert the organization to any behavior on behalf of the donor which might impact its tax classification.

Government Funding. While government funds typically come with extensive tracking and reporting requirements, the recipient may also be barred from using grant money to manage or administer the program(s) that the funding was intended to support. In addition, if the organization spends more than \$500,000 in federally-originating funds each year it is required to have a compliance *audit* in addition to its annual financial statement *audit*. This leads to increased *audit* fees, which are not always covered by the funding source.

Pass-Through Relationships. Many not-for-profits receive donations on behalf of another organization that has not yet received its tax-exempt status. There are generally administrative costs associated with these funds for which the host organization may not receive reimbursement. In addition, there are fiduciary responsibilities to ensure that the funds are used for charitable purposes.

Annual Auctions and Other Fundraisers. It is common for not-for-profits (or someone on their behalf) to host fundraising events. However, in addition to requiring a significant time commitment from staff and volunteers (and placing the organization at risk for fraud if they are not properly supervised), there are numerous other accounting and donor perception issues that can diminish the returns these events deliver.

In addition to the above, there are other enticing revenue streams such as land grants and stock gifts that may contain unanticipated tax consequences. Your organization should be aware of the tax and accounting implications before accepting revenue from sources such as advertising, parking fees, rent and retail sales.

Fortunately, there are ways to protect your organization, including the following:

- Read the fine print on grants and federal funding programs
- Implement a comprehensive gift acceptance policy that establishes gift evaluation, acceptance and acknowledgement processes
- Before hosting a fundraising event, evaluate the tangible and intangible against required costs and resources
- Always consider how funding sources may or may not align with your mission

Not all money is good money, but with the right set of tools and procedures for evaluating the appropriateness of funding sources, your organization will be better prepared to proactively assess risk and to simplify decision-making in the future.

Roles & Responsibilities (Treasurer, Audit Committee & Finance Committee)

While having a board treasurer, *audit* committee and finance committee does not absolve other board members of their fiduciary duty or responsibility to actively understand and proactively question the financial operations of the organization they serve, having experienced advisors in these roles can help ensure the organization focuses more effectively on its mission.

The Treasurer's Role

Serving as the treasurer of a not-for-profit board is an important and often time-consuming responsibility. Ensuring that the organization has a succession plan and is proactively recruiting board members to serve in this role is extremely important. To be most successful, we recommend developing a job description that outlines the expectations and responsibilities of the treasurer position. As you recruit individuals to serve, we suggest searching for candidates who share your passion for the organization's mission and who have:

- Not-for-profit financial management experience

- An understanding of contract and grant terms and implications
- Familiarity with investment practices
- An understanding of best practices for not-for-profit policies and procedures
- Familiarity with the requirements of the *Form 990* and the organization's tax-exempt status

It may be difficult or even impossible to identify someone with all of these skills. If that is the case, you may recommend that the board invest in training for the board treasurer through the Washington Society of CPAs or a similar organization. For more information about classes available through the Washington Society of CPAs, visit www.wscpa.org.

If you have been asked to serve in the treasurer's role we recommend that you:

- Ask for a written job description
- Schedule a meeting with the CFO/CEO to review the organization's financial statements, most recent budget and its *Form 990*
 - Review the financial statements thoroughly in advance of the meeting
 - Ask how any internal control issues identified in the previous *audit* were addressed
- Identify the budget development process and understand when a budget should be submitted to the board
- Identify the organization's bank, legal counsel and auditors
- Review the policies and processes identified earlier in this booklet to ensure compliance
- Meet with the Board Chair/President to identify any particular issues s/he would like you to address, and to review expectations for the treasurer's report

At each board meeting you should be prepared to give a treasurer's report. The treasurer's report typically includes:

- A full set of financial statements, including the Statement of Financial Position and the Statement of Activities
- A summary of budget-to-actual financial data, generally with a copy of the budget

- You should understand the reasons for any significant deviations
- Recommendations relative to policies or procedures for the board's consideration and/or vote
- A report on the finance committee's activities, if appropriate

In general, your report should be simple and systematic. One of the most important responsibilities of any treasurer is to educate fellow board members, as they have fiduciary responsibilities but may not have substantial financial experience.

As a board treasurer, particularly for a larger organization, we also recommend that you review (or consider creating) the committee charters for the finance, *audit* and governance committees.

The Finance Committee's Role

A finance committee can improve the treasurer's effectiveness, reduce risk, and increase board oversight by adding perspective or experience a treasurer does not have, and by providing additional people to assist with an important and time-consuming board need. Finance committee members may be potential treasurer candidates for the future.

The committee should consist of three to five board members and may include non-board members with expertise in financial matters. It is generally chaired by the board treasurer.

The finance committee's responsibilities include:

- Reviewing and monitoring financial reports
- Reviewing the annual budget and recommending it to the board for approval
- Reviewing major grants and associated terms
- Recommending financial policies and procedures, including the organization's investment policy

The Audit Committee's Role

Not-for-profit organizations must be accountable to donors, members, federal and state agencies, and others who seek assurance about the organization's underlying financial health. A well-informed, responsible *audit* committee provides accountability and helps instill public confidence in an organization.

The *audit* committee usually includes three to five directors, none of whom are employees of the not-for-profit organization. Unlike the finance committee, it is generally not chaired by the treasurer.

The *audit* committee works with external (and, if applicable, internal) auditors to ensure compliance with accounting standards and reviews the adequacy of the organization's internal control structure. This includes:

- Reviewing the adequacy of the organization's internal control structure, ideally using the COSO Model of Internal Control (www.coso.org):
 - Control environment (overall tone)
 - Risk assessment (identification and analysis of risks)
 - Control activities (policies and procedures used by management)
 - Information and communications (systems and reports that enable management to carry out its responsibilities)
 - Monitoring (processes that oversee controls over time)
- Recommending appointment of, and working with, independent accountants
- Monitoring compliance with the organization's code of conduct and conflict-of-interest policy in cooperation with the governance committee
- Reviewing the policies and procedures in effect for the review of executive compensation and benefits
- Reviewing, with the organization's counsel, any legal matters that could have a significant effect on the organization's financial statements
- Reporting to the full board

Selecting an Auditor

Often, the board treasurer and/or *audit* committee are responsible for recommending a CPA firm. If your responsibilities include identifying potential CPA firms, we recommend that you:

- Talk to the organization's banker and attorney, and to fellow board members

- Talk to officers of other not-for-profits
- Ask for recommendations of auditors who have expertise with organizations similar to yours

As you evaluate potential CPA firms, you should:

- Provide copies of financial statements and ask for comments or questions — the amount of expertise will be obvious in the response
- Share accounting records with CPAs so that they can provide an accurate estimate of the time needed to conduct the *audit*
- Ask about the individual CPAs' interest in, and willingness to serve, your organization
- Ask about the size of the firm's not-for-profit practice, and their commitment to the sector
- Ask about their *audit* approach
- Ask how staff are supervised
- Ask how findings are handled
- Call references

The Governance Committee's Role

While not strictly a financial committee, we recommend that every organization establish a governance committee. One of the most important roles a board has is to provide strategic guidance to the organization's management team. A governance committee focuses on core governance and board composition issues, ensuring that the board can fulfill its fiduciary responsibilities through adequate skills, training and knowledge.

The governance committee is generally composed of board members with a variety of backgrounds, including legal and financial experience. In general, the committee is responsible for:

- Conducting an annual evaluation of board & committee performance
- Nominating directors, officers and committee members
- Providing board education and training

- Overseeing CEO evaluation, compensation and succession planning
- Monitoring conflict of interest matters
- Periodically reviewing bylaws, governance structure and practices

The roles and responsibilities of the committees discussed above may overlap, and the finance and *audit* committees are sometimes combined. Well-defined committee charters (*i.e.*, job descriptions for the committee), can ensure that each committee understands its responsibilities and that no important tasks are overlooked.

Glossary of Not-For-Profit Financial and Accounting Terms

We hope you will find this glossary a useful resource when reviewing financial statements.

Accounts Payable: The amount owed to others (e.g., vendors) for services or merchandise received by the organization.

Accounts Receivable: The amount owed to the organization for services or merchandise provided to others (e.g., customers).

Accrual-Basis Accounting: A system of financial recordkeeping in which transactions are recorded as expenses when they are incurred and as income when it is earned, rather than when cash is paid or received. The alternative is *cash-basis* accounting. *Accrual-basis accounting* is more precise but also more complex.

Accrued Expenses: Expenses that have been incurred but have not been paid (e.g., salaries, benefits)

Accrued Interest: Interest costs that have accumulated but have not been paid.

Allocation: A method of dividing expenses among different program, administrative and fundraising categories using a reasonable and consistent basis (common bases include staff time, number of employees and square footage).

Allowance for Doubtful Accounts: An estimate reflecting the portion of accounts or pledges receivable that the organization believes is likely not to be collected.

Assets: What the organization owns or has a right to use.

Audit: An examination, conducted by CPAs retained by the organization's Board of Directors, that provides assurance to internal and external users of the organization's financial statements that the statements are presented in accordance with *generally accepted accounting principles (GAAP)*. The audit results are presented to the Board in the form of an opinion from the CPA.

Balance Sheet: A report showing a snapshot of the financial condition of the organization at a particular moment in time. Also referred to as the Statement of Financial Position.

Board-Designated Funds: Funds earmarked by an organization's Board of Directors for a specific purpose, such as Operating Reserves. For accounting purposes these funds are still considered unrestricted because the condition was not specified by a donor.

Capitalizing an Asset: Recording the cost of land, building or equipment as *fixed assets* (on the Balance Sheet) rather than as an expense (on the *income statement*) when purchased.

Cash and Cash Equivalents: Funds that can be quickly and easily converted to cash (usually bank accounts, money market funds and other investments that mature within 90 days).

Cash-Basis Accounting: A system of financial recordkeeping in which transactions are recorded when cash is received or spent.

Cash Flow Statement: A report showing cash inflows and outflows for a specific period of time.

Chart of Accounts: A list of all accounts used in an accounting system, including *assets*, *liabilities*, equity, income and expenses.

Conditional Promise to Give: A commitment by a donor to make a contribution to the organization if a specific requirement is met.

Contribution: A donation, gift, or transfer of cash or other *assets*.

Current Assets: Cash, investments, receivables and other *assets* that are expected to be available as cash within the next 12 months.

Current Liabilities: Those *liabilities* due to be paid within the next 12 months including the Current Portion of Long-Term Debt (loan principal payments that are due and payable within the next 12 months).

Deferred Revenue/Deferred Income: Income for which payment has been received before it has been earned. It is reflected as a liability on the Balance Sheet until it is earned and can be recognized as income.

Deficit: Expenses in excess of income. Also referred to as Net Loss or a negative Change in *Net Assets*.

Depreciation: The recognition of the decrease in value of a fixed *asset* over its expected physical or economic life. This is recorded as an expense each year.

Financial Accounting Standards Board (FASB): The national governing board which sets the accounting standards known as *Generally Accepted Accounting Principles (GAAP)*.

Fixed Assets: Tangible *assets* that have a useful life in excess of one year such as land, buildings, furniture and equipment.

Fiscal Year: A 12-month period which the organization uses for accounting and *Form 990* purposes. This period may be a calendar year but can also be any other 12-month period. A *fiscal year* accounting period should normally coincide with the natural operating cycle of the organization.

Form 990: IRS *Form 990* (Return of Organization Exempt from Income Tax) is the annual tax return document used by most tax-exempt organizations to report information about their finances and operations to the federal government.

Functional Expenses: Categories of expense delineated by the type of expense: program services, management and general, and fundraising. Required for IRS *Form 990* and audited financial statements.

Fundraising Expense: Expenses incurred in soliciting *contributions*, gifts, grants and other funding sources, including volunteer time.

Generally Accepted Accounting Principles (GAAP): The standard framework of guidelines for financial accounting established by the *Financial Accounting Standards Board (FASB)* to help ensure the accuracy and consistency of financial records and reports.

Income Statement: A report that summarizes the organization's activity (revenues and expenses) during a specific period of time. Also referred to as the Statement of Activities, Statement of Changes in *Net Assets* or Profit and Loss (P&L).

In-kind Contribution: A contribution made of goods or services rather than cash.

Letter of Determination: A letter from the IRS to a not-for-profit organization stating that the IRS recognizes the organization as a tax-exempt entity. In this document, the IRS indicates under which section of the Internal Revenue Code an organization is qualified.

Liabilities: What the organization owes to others.

Management and General Expense: Expenses for the general functioning of the organization, but not related to a specific fundraising or program activity.

Net Assets: The difference between the organization's total *assets* and its total *liabilities* on the *Balance Sheet* indicating the net financial worth for the organization (similar to equity in for-profit organizations). Divided into unrestricted, temporarily restricted and permanently restricted net assets, depending on donor-imposed restrictions.

Permanently Restricted Funds: *Contributions* that are to be retained, rather than spent, by the organization. The most common are endowment gifts which are invested and produce income that can be spent each year.

Pledge: A formal commitment to make a contribution of a specific amount. Also called, "promise to give" or "unconditional promise to give."

Prepaid Expense: An expense that is paid before use of the good or service such as insurance paid in advance.

Release from Restrictions: Transfer of *temporarily restricted funds* into the organization's unrestricted accounts when the restriction has been satisfied.

Reserves: An amount set aside by the organization to be used in case of losses, unexpected expense, emergency or planned future events, such as purchase of a building.

Restricted Funds: *Contributions* restricted by the donor for a specific use. These restrictions can be temporary or permanent in nature.

Temporarily Restricted Funds: *Contributions* given for a specific use or for use during a specific period of time. Once funds have been spent for the specified purpose or the period of time has lapsed the funds are released from restriction.

Unrestricted Funds: *Contributions* with no donor restrictions or limitations as to their use, as well as all other revenue sources.

Other Resources

Jacobson Jarvis is proud to offer several additional resources to board members, members of finance and audit committees, and non-profit financial professionals.

What Not-for-Profits Need to Know about Tax Compliance – An Informational Booklet

Written to serve as a more extensive resource for board treasurers, finance and audit committee members, and not-for-profit financial professionals with responsibility for tax compliance, Jacobson Jarvis' newest booklet, *What Not-for-Profits Need to Know About Tax Compliance – An Informational Booklet*, covers tax-exempt basics, routine reporting requirements, unrelated business income and related taxes, employment tax considerations, tax considerations associated with fundraising, political and lobbying activities, and tax audits and inquiries. It also provides a convenient Form 990 Review Checklist designed to help not-for-profits remain compliant with federal reporting requirements.

On Board – Our Board Member Newsletter

As the largest CPA firm in our region focused exclusively on serving the needs of not-for-profits, we understand the value that an engaged board can bring to an organization. That's why we're excited to provide *On Board*, a periodic newsletter geared exclusively towards board members. In addition to finance-related articles written by our team, we have partnered with investment advisors, attorneys, nonprofit consultants and marketing experts who will inform and educate your board about matters crucial to the not-for-profit community.

To sign up for these valuable resources, simply email us at: info@jjco.com, or call 206-628-8990.

Notes

Notes

Notes

Our Services

Jacobson Jarvis provides a full range of tax, audit and consultative services to not-for-profits in the Pacific Northwest. Our services include:

- Audit and other attest services, including compilations and reviews
- Federal tax return preparation and representation
- Consulting services, including:
 - Financial health checkups
 - Training for not-for-profit organization staff and board members
 - Internal controls audits and consulting

Contact Us

We hope that the information provided in this booklet will help you as you fulfill your responsibilities as a board member. For more information, please contact us via email at info@jjco.com, or call our offices at 206-628-8990.

JACOBSON JARVIS
CERTIFIED PUBLIC ACCOUNTANTS & CO^{PLLC}

www.jjco.com
206 628-8990
206 628-0432 fax