10 Finance Questions Board Members Are Afraid to Ask

TEN FINANCE QUESTIONS BOARD MEMBERS ARE AFRAID TO ASK

2014 MCN Annual Conference
November 6-7, 2014
10 Finance Questions Board Members Are Afraid to Ask

Your Presenters

Faith Nutz, Senior Manager, Schechter Dokken Kanter

Emily Robertson, Attorney, Robertson Law Office, LLC

Kris Kowitzoh, Executive Director, Charities Review Council
Learning Objectives

- Understand fiduciary duties of board members
- Share with each other how to address governance issues.
- Be able to provide board members information to better facilitate governance and decisions-making
10 Finance Questions Board Members Are Afraid to Ask

**Question:** Is the board aware of and acting in line with their fiduciary duties? Do they even know what they are?

**Ensure board members understand their fiduciary duties.** *(During board orientation. Board orientation required to meet standards)*
- Duty of Care
- Duty of Obedience
- Duty of Loyalty

**Conflict of Interest Policy** (Also required to meet standards)
- State law requirements
- Intermediate Sanctions/4958/tax law requirements
- Court of Public Opinion

**Tip:** Include declaration of conflict of interest as part of board meeting agenda.

990 requires disclosures about independent board members
10 Finance Questions Board Members Are Afraid to Ask

---

**Question:** Has the board reviewed their 990? What do I even look for on this form? What should I pay attention to?

**At Worst:** Public document, widely available on Guidestar for donors, funders, prospective employees, volunteers, etc. Many questions that are triggers for an audit.

**Key Points:**
- **Everybody reads it because it tells you:**
  - What the organization did during the year
  - How much it cost and where the funds came from
  - Who was overseeing it (Directors/Trustees, Officers, and Key Employees)
  - Who were the highest paid employees and contractors that helped accomplish it
  - Any transactions with certain insiders or related organizations
  - Lets the world know if you comply with myriad IRS requirements

- **What should board members pay attention to on the IRS Form 990**
  - Think about who is reading it: What would potential volunteers care about? Potential employees? Donors/Funders? Regulators (IRS/AG)? Media?

- **What types of governance disclosures are required?**
  - Number of board members, including how many are independent
  - Whether any TDOKEs have a family or business relationship (more info than above)
  - Any changes to governing documents
  - Significant diversions of assets
  - Whether there are members and what types of powers they have
  - Whether they keep minutes of board meetings and committee meetings
  - How they keep track of chapters/affiliates
  - Whether they provide the 990 in advance to the board and a description of the review process
  - Do they have certain policies: Conflict of Interest (and did they regularly and consistently monitor compliance); Whistleblower Policy, Document Retention and Destruction Policy
  - Is there a process for setting compensation of officers/key employees
  - Did the organization enter into a joint venture with a for-profit entity, and if so, does it have a joint venture policy
10 Finance Questions Board Members Are Afraid to Ask

Question: Why are we paying taxes if we're a nonprofit?

At its worst: Not knowing you have it and financially penalized. Could ruin an organization if audited by State (or IRS)? Could also result in loss of tax-exempt status.

Key Points:
Unrelated business taxable income (UBTI) - income from an activity that is
from a trade or business
that is regularly carried on
and is not substantially related (apart from the organization’s need for funds) to an organization’s
tax-exempt purposes
Does not fall into certain exceptions or modifications, some examples:
work substantially all provided by volunteers, or
a business carried on for the convenience of members, students, patients, etc., or
a business consists of selling donated goods, or
royalties, or
corporate sponsorship payments

• It is intended to eliminate unfair competition by tax-exempt organizations with for-profit businesses
• Generally the only penalty for carrying on for-profit activities is the payment of a tax on revenue from the activity. However, if the activity becomes substantial, then it can result in loss of tax-exempt status.
• Know where revenue comes from -- does the organization receive income from something other than
gifts or grants: Does it charge a fee for services? Does it have income from the sale of goods of some sort? Does it sell advertising? Does it rent space out to others? Does it conduct charitable gambling?
    If the answer is yes, has the organization reviewed the activity (with a competent professional) to be sure that it does not produce UBTI?
• Is the organization continually monitoring its revenue-generating activities to ensure that it avoids UBTI?
Question: Why are we talking with the auditors and what do we need to talk about?

At Worst: Board has never met the auditors and is unaware of a negative relationship between management and the auditors and/or significant audit or financial issues.

Key Points:
- Board responsibility with respect to auditors
- Closed Session to enable board to ask questions without staff present.
- What are the questions for board members to ask auditors?

Board (or finance/audit committee) has the responsibility to hire, terminate and evaluate the external auditor.
- Board is the client; auditor reports to the Board.
- Auditor’s responsibility is to express an opinion on the financial statements. Also to be an advisor, sounding board, partner to the board but remaining independent of management.

Importance of Executive session - Provides opportunity to ask questions of the external auditors in a safe environment

Ask questions both prior to and after the audit
Auditors are required to communicate certain information to the Board

Audit vs. Finance Committee
- Oversight of process vs. Oversight of finances
- Oversight of policies and practices vs. better and more effective management of finances
10 Finance Questions Board Members Are Afraid to Ask

**Question:** Do we really need to see monthly financial reports? What if we only meet quarterly? What should we be reviewing/seeing?

**At Worst:** Board unaware of financial situation and org can’t pay bills. Financial not always understood by all board members.

**Key Points:**
- Reports should compare budget vs. actual
- Review and approve regularly (Required 4 x per year for Accountability Standard)
- What other financial health indicators can be monitored?

**Tip** Nonprofit Assistance Funds has basic videos for board members to review.

Not always understood by every board member.

Work to educate and provide the tools for them to find out more:

**ACCOUNTABILITY STANDARDS**

**Board Fiduciary Oversight**

**Philosophy:** A governing board is responsible and accountable for the financial management of the nonprofit.

**Standard:** The Board of Directors approves an operating budget prior to the beginning of each fiscal year and receives financial reports, at least quarterly, comparing actual to budgeted revenue and expenses.

**Financial Health Management**

**Philosophy:** To pursue its mission, a nonprofit must successfully navigate through different kinds of economic circumstances and be able to demonstrate healthy financial management to donors.

**Standard:** The nonprofit organization manages revenue and expenses to demonstrate financial sustainability.
10 Finance Questions Board Members Are Afraid to Ask

**Question:** What's a fair amount of compensation? How much should we be paying them?

**At its worst:** Donors don’t like overpaid executives. Neither does the IRS or the Attorney General. The Media loves it.

**Key Points:**

990 & Accountability Standard:
Prohibition on private inurement and excess benefit transaction rules

- No private inurement is one of key IRS requirements on many tax-exempt organizations - it essentially means that none of the income or assets of the organization can directly or indirectly improperly benefit certain people in a position to exercise control within the organization
- Enforced by the Intermediate Sanctions excise tax scheme, which imposes a tax against individuals who receive a better than reasonable deal from the organization, and also imposes a tax on the organization managers that approved it
- Compensation needs to be reasonable
- This is demonstrated, in part, by following certain procedures - the so-called “rebuttable presumption of reasonableness”
  - Compensation is approved in advance by independent board members
  - Prior to making the decision, the board reviewed appropriate comparability data
  - The details of the decision and the basis for it are contemporaneously documented

**ACCOUNTABILITY STANDARD: Chief Executive Assessment and Compensation**

**Philosophy:** An important duty of a nonprofit’s board includes regular discussion of chief executive goals and setting the annual compensation of the chief executive. Annual goal setting and year-end assessments against the goals establishes trust and understanding and identifies strengths and areas of opportunity in leadership development. Likewise, it builds public trust to assure that compensation decisions are carefully considered and that pay is reasonable.

**Standard:** The Board of Directors annually sets performance goals with the chief executive or management company and assesses the individual or management company against those goals and other relevant criteria. The board, or a committee to which it has delegated compensation authority, obtains and reviews compensation data for comparable positions and considers whether the compensation is reasonable. Only individuals free of a conflict of interest in the compensation decision may participate. The compensation deliberations are documented in meeting minutes.
Question: What can I be reimbursed for? How do I get reimbursed? Do I need to submit receipts?

At Worst: 1099’s for board members at the end of the year for what they thought were reimbursable expenses or organizations paying for improper expenses.

Key Points:
Reimbursements (when not properly handled) result in automatic excess benefit transactions

Automatic excess benefit transaction is an economic benefit received without contemporaneous documentation indicating that it was intended as compensation or part or an accountable plan

Doesn’t matter if it is reasonable (in light of all compensation)
Reimbursements should be made under an “accountable plan” requiring expenses to have a business connection and where board members have to account for expenses and return excess reimbursements

Expense reimbursement policy has two purposes. A.) To provide guidance for how organizations reimburse board and employees. B.) To demonstrate to the public, the organizations’ philosophy regarding reimbursement.

Travel & Expense Reimbursement Policy
Philosophy: Travel and entertainment expenses should serve a business purpose, be cost-effective, and be properly documented.
Standard: The nonprofit maintains a board and staff policy that describes acceptable travel and entertainment expenses, sets reasonable limits, and sets procedures for reimbursement.
10 Finance Questions Board Members Are Afraid to Ask

**Question:** What are internal controls? When do I need to be involved as a board member? How do we implement segregation of duties?

**At its worst:** Theft; fraud or major errors in financial statements

**Key Points:**
- Awareness of internal controls exist (particularly segregation of duties.)
- Examples of key controls
- Using the Board members to improve controls

**How to Implement Internal Controls:**
- Use as many people as reasonably possible
- Board should monitor controls throughout the year
- Board should review, ask questions about, and understand interim financial statements
- Treasurer can be added as authorized signer, review bank statements, review journal entries, etc
- Segregation of duties
10 Finance Questions Board Members Are Afraid to Ask

Unrestricted & Restricted Funds

Accounting Implications: for restricted and unrestricted funds are often difficult for board members or those from the for-profit world to understand.

Legal Implications: Nonprofit are legally required to spend contributed funds as designated by the donors. If funds are not spent as designated, donors may:
- Request the funds be returned
- Pursue legal action
- Contact the Office of the Attorney General

Question: Why do I have to record revenue when the expenses won’t be incurred until next year? Why can’t we use that money to pay our bills until we need it for the program? It didn’t take all of the funding to run the program can we use it for something else?

At its worst: Funds were not spent according to restrictions imposed by the donors, resulting in repayment of the funds, legal issues and brand issues

General Understanding of Restricted vs Unrestricted:
• Restrictions can only be placed on funds by their donors when gifted/granted.
• Generally identified by award letters from foundations and letters from individual donors.

Unrestricted Support - Revenues or gains from contributions that are not restricted by donors. Available for general use. Many individual contributions are unrestricted, as are general operating and unrestricted grants.
• The Board may internally restrict funds. These are still considered unrestricted as the donor did not impose the restriction.

Temporary Restriction - A donor-imposed restriction that permits the donee to use up or expend the donated assets as specified and that is satisfied either by the passage of time or by actions of donee.

Permanent Restriction - A donor-imposed restriction that stipulates that resources be maintained permanently but permits the not-for-profit entity (NFP) to use up or expend part or all of the income or other economic benefits derived from the donated assets. Example: Endowments

Accounting Implications:
• Income is recognized (recorded) in the year when the unconditional commitment for the funds is received, regardless of when the related expenses will occur

Legal Implications: See slide for notes.
○ If it becomes public knowledge, it could hurt the reputation/image of the nonprofit

Management’s Considerations:
• In a statement of activities, the Unrestricted column represents the current year’s operations and is therefore the most valuable tool for monitoring current year financial activities, and planning and making operational decisions
• Be aware that fundraising letters or appeals may inadvertently place restrictions on donations
• Educate the board and staff to understand how restricted funds impact cash flow and availability of funds
10 Finance Questions Board Members Are Afraid to Ask

**Question:** Isn’t it better to make our overhead be as low as possible? Doesn’t that mean we’re helping more people?

**Program Expense Ratio:** A measurement that indicates whether or not a nonprofit is using funds efficiently by comparing expenses spent on program, fundraising and administrative cost to total expenses.

**Use of Funds:** The Council’s Accountability Standard that evaluates the percentage of nonprofit expenses that go to administrative and fundraising costs.

**Philosophy:** A nonprofit should strive to efficiently and effectively use funds to achieve its mission, balancing the need to expend the majority of its funds on current programs with the need to invest in the infrastructure and administrative capacity necessary to carry out its mission over the long-term. The Council recognizes that there is no optimal balance point between program, administrative and fundraising expenses for all nonprofit organizations.

**More importantly though:**
- Is the board monitoring the use of funds ratio?
- Is it appropriate to the organization’s goals?
- An organization can and should **invest in infrastructure**.
- No **optimal balance** of program expense vs. overhead expense that applies to all organizations.
**Program Expense Ratio**: A measurement that indicates whether or not a nonprofit is using funds efficiently by comparing expenses spent on program, fundraising and administrative cost to total expenses.

**Use of Funds**: The Council’s Accountability Standard that evaluates the percentage of nonprofit expenses that go to administrative and fundraising costs.

**Philosophy**: A nonprofit should strive to efficiently and effectively use funds to achieve its mission, balancing the need to expend the majority of its funds on current programs with the need to invest in the infrastructure and administrative capacity necessary to carry out its mission over the long-term. The Council recognizes that there is no optimal balance point between program, administrative and fundraising expenses for all nonprofit organizations.

**More importantly though:**
- Is the board monitoring the use of funds ratio?
- Is it appropriate to the organization’s goals?
- An organization can and should **invest in infrastructure**.
- No **optimal balance** of program expense vs. overhead expense that applies to all organizations.
10 Finance Questions Board Members Are Afraid to Ask

Survey respondents
10 Finance Questions Board Members Are Afraid to Ask
Tables count off and report out on single question but work on all of them in small group discussion.
What one topic does your board need more understanding of relative to key financial and governance issues?
10 Finance Questions Board Members Are Afraid to Ask

RESOURCES

- Minnesota State Attorney General: Fiduciary Responsibilities of Board Members; http://www.ag.state.mn.us/Charity/FiduciaryDuties.asp

- Nonprofit Assistance Fund:
  - https://nonprofitassistancefund.org/resources/item/income-statement-basics-whats-behind-bottom-line

- “Overhead Myth”; www.overheadmyth.com

- “The Way We Think About Charities Is Dead Wrong,” Dan Pallotta
  - http://on.ted.com/Pallotta

- Difference Between An Audit & Finance Committee:
  - http://www.nonprofitrisk.com/advice/face/audit-committee.pdf

- Charities Review Council’s Accountability Standards
  - http://www.smartgivers.org/standards
10 Finance Questions Board Members Are Afraid to Ask

Questions?

Contact us!

Emily Robertson, Robertson Law Office, LLC
emily@robertsonlawofficellc.com or 651/336-2287

Faith Nutz, Schechter Dokken Kanter
fnutz@edkcps.com or 612/332-8308

Kris Kewitsch, Charities Review Council
kris@smartgivers.org or 651/328-6970