Revised Edition

Financial *Responsibilities* of Nonprofit Boards

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1 Financial Issues Board Members Should Address

All nonprofit board members share certain financial concerns that involve the basic health and welfare of the organization. An effective board member should raise the questions at the end of the chapter at least annually.

Financial Planning

Many nonprofits try to do too much. A sound strategic plan linked with a realistic financial plan will ensure that the organization is using its resources effectively. As part of the planning process, the board should work with the staff to define the organization's mission, develop a strategic plan to fulfill that mission, and identify and implement programs to achieve the chosen strategic goals and objectives.

The planning process should include

- an evaluation of existing and potential financial resources
- an examination of internal and external environmental forces affecting the organization and its funding
- a review of the cost and effectiveness of existing programs
- an examination of alternatives and their financial implications

Once the board has determined programs, time lines, and basic costs, those responsible for implementing the programs should be assigned the task of developing the budgets needed to get the job done. Budgets should cover at least one year, and preferably two or more. The benefits of multiyear budgeting easily offset the time required to implement it. Given the great importance of this process, sufficient time and training should be provided to see that the job is done right — six months is not too long to develop a sound budget. This process should not be hurried — too much is at stake.

Sufficient Available Cash

The availability of sufficient cash is critical to any nonprofit operation — cash is the fuel on which the economic engine runs. Although wide variations are found in practice, typically, many nonprofit organizations find it satisfactory to hold sufficient cash in a checking account to pay salaries and expenses for one month. If there is not

sufficient cash in the bank, having available very liquid investments (ones that can readily be converted into cash), or assurance from a reliable donor or two can allay concerns. Some organizations also maintain a line of credit or other borrowing ability to ensure they have enough cash available.

If an organization is short of cash, it should project the amount of cash that should be on hand at the start of each future period, how much will be received or spent during that period, and what will remain at the end of the period. Cash-flow projections should usually be done on a monthly basis for the ensuing 12 months, although some organizations will project weekly or even daily for a while if they are truly cash poor.

Cash-flow projections also enable the organization to plan for the purchase of new equipment, possible expansion of operations, increased staff compensation, and other essentials.

Satisfactory Reserves

Nonprofit organizations should monitor their financial strength to be certain they can continue to perform their important services no matter what problems the organization faces or what happens to the economy as a whole. One gauge of financial strength is the level of reserves of the organization.

Reserves can be defined in different ways. The simplest definition is assets (or things of value) the organization owns, minus the organization's liabilities (or debts). The remainder is the fund balance, or reserve.

There are problems with this simple approach. Reserves are useful for such planned events as launching new programs, but they are required when a financial crisis occurs. Inventory and fixed assets, such as furniture, equipment, or buildings, while useful, usually cannot be quickly converted to cash, and thus are likely not going to be available to help avert a crisis. On the other hand, long-term debts, such as a mortgage on a building, do not necessarily make a current crisis worse, because they are paid off over a long period of time. Also, certain amounts held by nonprofits are restricted in how they may be used and will not be available in a crisis unrelated to their restricted purpose, or must be kept intact in perpetuity.

Reserves might best be defined as those unrestricted assets that are reasonably liquid, minus those liabilities that must be paid off fairly soon. Therefore, a more conservative definition of reserves would be the organization's current assets (minus inventory) less its current liabilities.

Nonprofit organizations can build their reserves only by running at a surplus, whether the surplus is a result of regular operations or special fundraising efforts. An organization with accumulated reserves will have funds available to invest in equipment and property, apply to program expenses, and protect the organization during periods when revenue falls below expenses. Net income builds a surplus, sometimes quickly from such events as a major fundraising campaign, but usually slowly over time.

The level of reserves that is appropriate varies from organization to organization. Most experts agree that if one year's operating expenses are in reserve, the organization is in a strong financial position. Most organizations, however, are not able to achieve this level. Each organization should take into account its own circumstances, considering cash flow, capital requirements, availability of outside funds in a pinch, etc., and set a target reserve level that the board and management are comfortable with. Obviously, a grant-making foundation will require far greater reserves than many 501(c)(3)s. A small or newer operating nonprofit might well be lucky to have 10 to 20 percent of a year's expenses in reserve. Practically speaking, 35 to 40 percent of a year's expenses should provide sufficient breathing room for nonprofits with reasonably stable sources of income. Whatever target level is selected, the organization should build to this level over five to ten years by funding reserves as a line item in the budget.

Naturally, organizations that have restrictions on the use of certain funds, such as an endowment fund that allows use of only the income and not the principal, would not count such amounts as part of their available reserves.

Relationship between Revenue and Expenses

If the organization's expenses are rising or falling at the same pace as its revenue, then the expenses are said to be "in line." Problems generally arise when expenses are rising more quickly than revenue; if the organization is not already running at a deficit (and consuming its reserves), then at some point in the future, it will be.

Similarly, certain items of expense are directly related to certain sources of income. For instance, it is important to ensure that publication expense is not running far ahead of publication revenue (unless it is the board's stated intention to subsidize publications from other resources). Keeping an eye on related revenue and expense lines is very important.

There are two different and valuable perspectives to keep in mind. The first is a programmatic perspective: Does this program's income exceed

its expense? This analysis can be done at a broad level (total meeting income versus total meeting expense) or at a more specific level (annual meeting income versus its expense). To be able to obtain this type of information, the organization's accounting system must be set up to produce it. Care should be taken in this regard, because many organizations believe they are making a profit in areas where they actually are not.

The other perspective involves what are called natural items of income and expense. These items are more difficult to compare because they do not relate to a specific product or program but to the organization as a whole. (Dues, interest income, and professional and maintenance expenses are examples of natural classifications of income and expense.)

Nevertheless, it is valuable to monitor the larger of these income and expense items in relation to each other. For instance, because salaries and other personnel costs such as payroll taxes and fringe benefits are usually one of the largest expense areas for nonprofit organizations, special attention must be paid to keep them in line. A useful comparison can be obtained by dividing total personnel costs by total income for both current and historically comparable periods. The idea is that this ratio should either improve (get lower) between periods, or stay in a range appropriate to the organization.

Meeting the Budget

This question goes to the heart of the difference between for-profit and nonprofit organizations. A for-profit's financial success is measured by how much profit it earns — the more the better. The same cannot be said for a nonprofit organization.

Although a nonprofit does need to build and maintain its reserves, too great a surplus may imply that it could have provided more services or products for the good of the community, or that it needed to raise less revenue. Neither conclusion is good for the image of the organization.

Nonprofit organizations measure their success not only by the good they do for the community, but also by how well they managed to meet (or make) their budgets. Fulfilling the mission is the bottom line; balancing the budget makes it possible. Board members should be aware that making either more or less than the amount budgeted can result from a variety of circumstances. For example, if the organization makes more than was budgeted, it is possible that it spent too little on programs, or that it padded the budget with extra expenses just to be on the safe side. It can also mean, of course, that the organization was more successful than anticipated in enlisting grants or other revenue.

Similarly, making less than was budgeted can occur for a variety of reasons. The organization might have taken on unanticipated tasks, or allowed expenses to go out of line, or revenue might have fallen short of expectations. Both the income and the expenses that were budgeted need to be compared with actual income and expenses, and explanations obtained for significant differences, for the full story to be told and appropriate action taken in response.

If a nonprofit organization does not have a budget, then it is exceedingly difficult to determine whether it is being managed effectively (most would conclude that the lack of a budget is itself a clear indication of poor management). Simply breaking even — running at a very small gain or loss — is not enough. Expected performance (i.e., a budget) should also be projected, both to create a goal for volunteers and employees and to create a measuring device for success and failure.

Propriety of Expenditures

All organizations exist at the will of the constituents they serve. If they behave in a fashion that seems wasteful or inappropriate, the public can turn against them. Sources of funding dry up, and the organization can be hurt or put out of business.

What exacerbates this situation is that nonprofits operate in a fishbowl. Their activities are open to the scrutiny of volunteers, members, and the public. The federal government, through the Internal Revenue Service, requires that the nonprofit make its annual reporting document (Form 990) available for inspection or duplication to anyone who requests it. Thus, it is critical not only that a nonprofit appear to be acting appropriately, but that it actually is acting appropriately.

The appearance of propriety extends not only to fulfilling the organization's exempt purpose, but also to how efficiently it is perceived to be achieving its ends. Each organization must look to others in its field to determine that its operating and fundraising costs are reasonable in comparison. Although there are no true nationwide or industrywide standards, each entity can be compared to its peers.

Other areas of special concern invariably include compensation and benefits to senior staff, especially the chief executive, and to officers and board members. (See "Avoiding Conflicts of Interest," page 7.) Due to substantial attention by the press, Congress, and the IRS, there are stringent new rules in intermediate sanctions in place for excessive compensation or unreported benefits. Nonprofits affected by these rules

must be especially careful to operate within these rules if they wish to avoid penalties and appear to be acting appropriately.

Benefits to officers or board members may not come as cash compensation, but may instead be hidden in such items as an above-market rental agreement by the nonprofit for property owned by the board member. This and similar types of arrangements can result in severe penalties, and even loss of the organization's exempt status and must be avoided at all costs. The damage resulting from even the appearance of such a relationship would be quite substantial.

Insuring against Risks

Even with the greatest vigilance on the part of the board and staff, problems may arise that threaten the financial health of the organization. Board members should make sure that the organization is managing, either with insurance or with other means, to protect itself against risks. The organization's assets should be insured, and everyone involved with cash and securities should be bonded. If being open for business is critical to the organization, business interruption insurance can provide income lost if the organization is forced to close for a time.

To help protect the organization from risks, the board should ask for an update of the insurance the organization is carrying. If the organization has an independent auditor, the board should ask the auditor for a formal or informal opinion on whether the insurance carried appears satisfactory.

Meeting Guidelines and Requirements Set by Funders

Organizations that receive funding from the federal government, foundations, individual donors, or other entities must usually follow specific rules and guidelines or face suspension or retraction of funding, public censure, and, in extreme cases, possibly other penalties. The board is ultimately responsible for ensuring that this income is managed properly.

Recipients of private grants or contributions — Frequently, donors provide funding for a restricted purpose, such as research in a specific area, a particular project, or a specific program. These restricted funds must be spent for their designated purpose. Nothing is more certain to damage a nonprofit organization's ability to attract funds than for it to be found using restricted funds for purposes other than those specified by the donor.

An organization that receives restricted gifts must account for the funds carefully so that it can prove their use for the purpose intended. Nonprofit organizations have developed a system called fund accounting to address the need for accountability to donors and funders and to ensure that funds are spent for their designated purpose.

Recipients of federal funding — Strict rules apply to recipients of federal funds. Any organization expending $300,000 or more per year in federal funds is required to conduct a special audit of its handling of those funds. This is called an A-133 audit because it was communicated to the public in the Office of Management and Budget's (OMB's) Circular A-133.

OMB A-133 requires that outside auditors review and report on whether the funds provided were spent for the precise purpose intended and were spent in a fashion appropriate to all federal guidelines. It also requires that the outside auditor report on the effectiveness of the system of internal controls in ensuring compliance with federal rules and grant terms.

Avoiding Conflicts of Interest

Nonprofit board members must remain vigilant in their efforts to avoid conflicts of interest — real or perceived. The appearance of conflict must be avoided as well, since even this can cause significant damage to an organization's reputation.

Some of the clearest and most serious conflicts of interest occur when a staff member or volunteer receives an inappropriate financial gain resulting from association with the organization. This type of conflict, mentioned earlier in the section on propriety of expenditures, is known as private inurement. Examples include a board member renting space that he or she owns to the organization at more than fair market value, or a senior staff member receiving excessive compensation. The IRS looks for private inurement when it audits nonprofits. If there is any evidence of personal gain, the individual receiving the excessive financial benefit must return it and pay penalties. Board members and managers can also be penalized if they knowingly approved the transaction or contract.

Another example occurs when a board member is involved with a competing or potentially competing organization, either for-profit or nonprofit. It is a clear breach of fiduciary responsibility for a board member to intentionally, or even accidentally, convey confidential information to such an organization. If a situation presents the possibility that this might occur, the board member should resign one of the board positions.

Questions the Board Should Ask

Planning, available cash, and reserves

1. Is our financial plan consistent with our strategic plan?
2. Is our cash flow projected to be adequate? Are our cash-flow projections reasonable, objective, and not overly optimistic (how accurate have past projections proved to be)?
3. Do we have sufficient reserves? Has the board adopted a formal policy for the establishment of reserves?
4. If we have permanent endowments, has the board considered a spending rate policy (where a set percentage of the principal is spent each year) to help protect the principal?

Revenue and expenses

5. Have we run a gain or a loss? (i.e., are we better or worse off financially than we were a year ago?)
6. Do we have management reports that identify program and non-program revenue and compare them with assigned costs?
7. Are any specific expense areas rising faster than their sources of income?
8. Are we regularly comparing our financial activity with what we have budgeted? What procedures do we use to make sure that the differences between what was budgeted and what actually happened are being appropriately addressed?
9. Does the board provide oversight of contractual agreements to ensure that the organization's exempt status will not be questioned or impaired? Does the board provide for internal controls over expenditures to ensure their propriety?
10. Is the organization acting in accordance with the IRS rules on executive compensation? Is the organization fulfilling its tax-exempt purpose as granted by Congress?

Risk, requirements, and conflicts

11. Is everyone who handles cash, checks, or investments bonded?
12. Do we carry appropriate insurance to ensure that the organization can continue to function under adverse circumstances?
13. Has the board established internal controls to ensure that restricted funding received is appropriately spent and accurately accounted for?
14. Are we providing timely reports as requested by funders?
15. Do we have a policy prohibiting conflicts of interest, and do we periodically monitor compliance with the policy? Do any of our board members have potential or actual conflicts of interest?
16. Have we reviewed compensation packages and fee-for-service arrangements to ensure compliance with the IRS's intermediate sanctions regulations?

2 Systems That Protect Nonprofit Organizations

Certain systems should be in place to protect every nonprofit organization. Management is responsible for making sure that the organization implements and maintains these systems, but the board should ensure that management is following board policies.

The most difficult internal problems to recognize are those that result from gradual accumulation, rather than through gross mismanagement or malfeasance. As an organization grows, seemingly insignificant erroneous activities or behaviors tend to develop incrementally. At first, they are too small to be important. The impact of these errors can grow with the organization, however, eventually resulting in a major problem.

The job of a diligent board member is to make sure not only that management reviews established accounting procedures, but that the board also regularly takes a fresh look at ongoing routines.

All of these systems taken together provide protection, allowing for the safe and efficient operation of the organization.

Internal Controls

Internal controls are those processes and procedures that both protect the assets of an organization and promote its efficient operation. For example, a process to pay bills that is very efficient but occasionally pays invoices that should not be paid sacrifices too much in protection of assets to achieve an otherwise valuable efficiency. The board, with the help of its staff, must insist on the creation of internal controls that will meet the fundamental goal of protection of the assets of a nonprofit organization.

The key to good internal controls is segregation of duties; that is the separation of incompatible elements of certain transactions. For instance, whoever approves invoices to be paid should not prepare checks to pay the invoices, and vice versa. Separating these functions reduces the risk of payment of an inappropriate invoice. Recognize that it is much more difficult to achieve or maintain good internal controls in small organizations. Board members of these organizations must, therefore, work harder to gain as much protection as possible for their assets.

Board members should ask if there is an up-to-date accounting manual detailing correct procedures. If the board has any doubt about the adequacy of the internal controls, it should address questions to the organization's auditors. If the auditors are not reasonably satisfied with the state of the controls, then the board should consider a special internal control study involving a thorough review of the controls and a written report delineating any shortcomings.

Nonprofits of every size work hard to develop whatever assets they have. Good internal controls will ensure that these hard-won assets are not lost or consumed inefficiently.

Accounting Policies and Procedures

Every nonprofit should have written policies and procedures governing how it does business. Two specific documents are most important to have in place:

Accounting manual — This document contains the guidelines for processing transactions and maintaining good internal controls. Each step in the fiscal process should be analyzed, and the appropriate procedure for handling that step should be described in writing.

The resulting document can indicate which staff members are responsible for which steps in the process, and even who is to substitute in case of absence. This manual should be prepared or reviewed by professionals and be kept up to date.

Investment policies — The most critical asset of most nonprofit organizations, after their board, leadership, and staff, is cash. Organizations should have procedures for safeguarding cash, for ensuring its liquidity, and for keeping it productively employed at all times. These procedures combine to form the cash management element of the organization's investment policy. A good investment policy will

- delineate a specific philosophy of investment management and establish parameters for investment risk and return
- assist the designated investment manager and protect his or her position by setting up practical guidelines and clear performance objectives
- establish a process for regularly reviewing investment objectives and strategies and reviewing the manager's performance

Some policies, especially those for organizations with smaller reserves, actually indicate which specific investments are allowed. For example, a very conservative investment policy might allow "only FDIC-insured bank accounts with balances under the $100,000 limit and short-term

U.S. Treasuries." Policies for organizations with larger reserves might exclude certain high-risk investments or state what proportion of the reserves may be in stocks (equities) rather than in bonds (debt instruments).

External Audits

The key role of the external auditor is to attest to the accuracy of the organization's financial statements. The principal purpose of an external audit is to keep the board and other key constituent groups apprised of the organization's financial position. Secondary purposes include meeting government regulations, consultation on internal controls, investment policies, and related subjects, and providing information needed to qualify for loans or grants. (Further discussion of audits is in Chapter 4.)

To effectively perform this function, auditors must be absolutely independent of management and must, by the rules of the profession, avoid financial inducements and resist pressure of any kind from management to alter their opinion.

The question of regularly changing auditors often comes up. A truly professional audit firm will maintain its perspective and independence year after year. If the board is satisfied with the audit firm's competence, independence, and perspective, it need not replace it. The audit firm's in-depth understanding of the nonprofit's operation, gained during years of auditing the organization, can be exceedingly valuable, but only so long as it is accompanied by an appropriately high level of ethics and responsibility.

If an organization is too small or financially weak to afford the expense of an annual external audit, alternative solutions are available.

A less-expensive alternative, but which provides considerably less assurance, is a review provided by an external auditing firm. A review is much less thorough than an audit, but it does ensure that the financial statements have been prepared on an acceptable basis and that this year's numbers make sense given the prior year's performance. However, the inability of a review to provide substantial assurance has made it less popular with nonprofit boards and funders.

An organization with financially astute volunteers may ask those volunteers to undertake a members' audit. Two or more members visit the organization and test some of its fiscal activities and records, such as cash disbursements, cash receipts, whether key assets actually exist, and whether the payroll records are in good order.

The key to success in a members' audit is that no area of activity be sacrosanct. It is essential that the members undertaking this effort be free to look where they please and that they be creative in their investigations. Some organizations that use member audits have an external auditor accompany the volunteers to aid or guide their efforts.

Questions the Board Should Ask

Internal controls

1. Do we have the appropriate checks and balances necessary to reduce the possibility of errors, fraud, and abuse to a low level? Are we always alert to the possibility of fraud and abuse?
2. Have we adequately documented our policies and procedures with respect to all of our financial activity?
3. Do we have an investment policy? If so, are we following it?

External controls

4. Do we have an annual external audit?
5. If we do not have an annual audit, what are we doing instead?
6. Are we comfortable with our audit firm?

4 Understanding the Financial Condition

Board members must understand the financial condition of their organization in order to serve and protect it. Financial insight is essential to making wise decisions on the vast majority of board matters — even those that may not appear to deal specifically with finances.

Numerous documents are available to those who are not fully versed in reading and understanding financial reports. For example, BoardSource has published a booklet entitled *Understanding Nonprofit Financial Statements*, which explains the basic language of finance, how to read a financial statement, and how to work with the numbers to gain insight into the organization's financial condition.

Unfortunately, even those skilled at reading financial statements may have difficulty understanding information offered by nonprofit organizations. Accounting for these entities is somewhat different from that for profit-making ventures, and confusion can result. If a board member is not satisfied with his or her understanding of the financial statements and explanations provided, the member should ask questions until the appropriate level of comfort is obtained. Better information can take a variety of forms. For example, because no one can absorb all the details in a financial report, communicating less (but more meaningful) information is sometimes better than simply providing detailed information with no explanation. The staff might write a narrative describing the highlights of the reporting period to accompany the financial report. Charts and graphs can be very helpful in pointing out the most important trends or relationships. Finally, because board members must have the details as well, reports should be standardized so that the board can quickly access the details and compare items with those in previous reports.

Each board member is responsible for gaining a sufficient level of comfort and understanding of the numbers. If any issue, large or small, is not clear, the board should seek clarification. A diligent board member will ask as many questions as are needed to lay to rest any doubt or uncertainty.

Documents the Board Should Receive

There is no single standard for all nonprofits regarding which financial statements the board should receive. The area of greatest diversity is found in the internally prepared financial statements.

Internally Prepared Financial Statements

Larger nonprofit organizations prepare financial reports on a monthly basis. This information is certainly needed for management, but may not be necessary for the board to review. Many boards find quarterly internal financial statements to be sufficient.

In organizations with satisfactory reserves, a finance committee might analyze the monthly or quarterly reports, while the full board reviews only the annual internally prepared statement and the external audit. Boards with no finance committee should consider reviewing the organization's financial statements at least quarterly.

Audited Financial Statements

Much more consistency among boards exists on the matter of reviewing externally prepared financial statements; the board should always review year-end audited financial statements.

These year-end statements should include

- a statement of financial position. Also called a balance sheet, this statement shows the assets and liabilities of the organization at a given point in time, in this case at year-end. Whenever possible, this statement (and the statement of activities described below) should include comparative figures from the previous year.
- a statement of activities. Also called a statement of revenue and expenses, this statement shows revenue and expenses for a specified period of time, in this case one year, and whether there was a net excess or deficit for the period.
- a statement of changes in net assets. Previously called a statement of change in fund balance, this statement is frequently combined with the statement of activities. It reflects the beginning net assets plus the current period's excess or deficit, and may include other adjustments to reach the ending net assets.
- a statement of cash flows. This statement is prepared in a format that focuses on where cash came from and how it was used. (This statement should not be confused with the internal cash-flow statement discussed earlier, which is a tool for managing cash.)

In addition to the statements listed above, every group of audited financial statements must be accompanied by footnotes that help the reader understand the organization's financial situation; board members should read these footnotes carefully. The notes highlight significant accounting

policies, major acquisitions or changes in operations, pension requirements, lawsuits, and details on other significant matters.

On occasion, an organization will want more detailed information than is required in the basic audited statements. In these situations, the auditors will attach to the report a separate opinion, followed by additional statements or supplemental schedules. This opinion will indicate the level of assurance the auditors are providing on this information. Readers should be aware that the level of assurance may not be the same as for the basic audited statements.

There is sometimes confusion about what is being purchased when an audit is performed. An audit is the process by which certified public accountants are able to form an opinion as to whether the organization's financial statements fairly reflect its financial position, the changes in its net assets, and its cash flows. It is a lengthy and thorough study of the organization's financial records and procedures that looks not only at the numbers themselves, but also at whether appropriate accounting principles were used, and, if so, whether they were consistently applied.

An audit does not guarantee that the financial statements are perfectly accurate, because it is concerned only with material or significant amounts. Nor does it ensure the competence, wisdom, or honesty of management.

Various types of opinions may result from an audit. Most organizations receive a "clean" (or unqualified) opinion, but some do not. Listed below are the different types of opinions and why they might be received.

An **unqualified (clean) opinion**, the highest level of assurance the auditor can provide, is used when the auditor is satisfied with the financial statements. The three paragraphs of a typical clean opinion are provided in Appendix I.

This type of opinion sometimes includes a **fourth paragraph** drawing the reader's attention to a particular matter. This fourth paragraph follows the opinion paragraph of a clean opinion. It does not reduce the level of assurance the auditor is expressing; it simply refers to the full disclosure of the matter in question in the footnotes at the end of the financial statements. Examples include opinions based in part on the work of another auditor, or emphasis on a matter such as the unknown outcome of a lawsuit.

A **qualified opinion** is provided when the auditor expresses reservations on a specific issue. Qualified opinions frequently result when the organization is following accounting principles that are not generally accepted, according to the American Institute of Certified Public Accountants. A qualified opinion should encourage board members to direct questions directly to the auditors.

An **adverse opinion** is a negative opinion and is used when the financial statements are misleading and management will not correct them. These are exceedingly rare and should alert the board that strong corrective action is required.

A **disclaimed opinion** indicates that the auditor is unable to form an opinion. It may arise because of a lack of independence or because of a scope limitation, meaning that the auditor has been unable to gather enough information to form an opinion. This type of opinion can also result when the organization's internal controls are unsatisfactory. When a board receives a disclaimed opinion, it should promptly investigate the cause of the disclaimer.

In addition to providing an opinion on the financial statements, auditors are generally required to provide a Management Letter, sometimes called a Letter of Reportable Conditions. This letter should always be distributed to the board because it provides the auditor's observations on any significant deficiencies discovered in the internal control structure of the organization. In addition, this letter may mention other matters that the auditor believes are of sufficient import to require the attention of management. If no reportable conditions are discovered, no written communication is required.

Other Important Financial Reports

In addition to the audited financial statements and the management letter, other financial reports may be required of a nonprofit organization by the federal government or by state governments, grantors, donors, or affiliated organizations. The most important of these is the IRS Form 990, which provides information to the federal government about the organization's revenue and expenses, and its assets and liabilities. For charitable, educational, or scientific organizations, additional information must be provided on Schedule A.

Board members should consider reviewing, or having a committee review, the Form 990 before it is filed, because this document communicates to the IRS how the organization is fulfilling its tax-exempt purpose. In addition, the IRS requires nonprofit organizations to make the Form 990 available for inspection or duplication to anyone requesting access to it. Thus, accurate and effective communication is essential.

Board members should also consider reviewing the reports that result from the OMB A-133 audit, which is required for organizations expending

$300,000 in federal funds. In a series of up to five separate reports, the auditor is required to attest to the fact that there is "reasonable assurance that the organization or institution is managing federal awards in compliance with applicable laws and regulations."

Whether or not board members review other required year-end reports is largely a matter of their significance to the organization. Whenever a report involves the potential of substantially increased or reduced funding, board review is advisable. Reviewing insignificant reports draws time and attention away from other matters, however, and board members should focus their attention where it will do the most good.

Signs of Financial Distress

Certain occurrences portend trouble. Board members should be alert to the following signs of organizational distress.

Critical income sources declining — Every nonprofit organization relies on certain major sources of income. A membership organization may rely on dues, meeting income, education, or publications as its key sources; a charitable organization's revenue may come entirely from contributions. These critical sources should be tracked carefully. Any significant decline in these key sources is a sure sign of trouble.

Certain expenditures increasing — Certain expenses should be watched more closely than others in nonprofit organizations. The most important of these are salary and benefits, because these represent a major portion of the organization's expenditures. Nonprofit organizations use benefits as an incentive somewhat more frequently than do for-profits, and tracking these expenses as a percentage of total expenses can be illuminating.

One expense that tends to indicate problems is the miscellaneous expense account. If this item increases, hidden costs or less-than-adequate bookkeeping may be the cause. In either case, an inquiry is warranted. Another expense to watch is consultants' fees. If this expense goes up noticeably, it may reflect activity that could be better brought in house. In addition, a rise in consulting or legal costs can signal an undisclosed major issue.

Private inurement — Any board member or senior manager who is benefiting financially from the nonprofit organization may pose a substantial threat to the organization's survival. When the IRS audits a nonprofit organization, it invariably attempts to ferret out incidents of private inurement. If it finds any appreciable amount, it can revoke the entity's tax-exempt status. The only individuals who should be gaining financially from a nonprofit organization are those who are employed by the organization (and that benefit should be only in the form of reasonable salary and benefits). All others who receive benefit should do so as a result of the organization's fulfillment of its exempt purpose.

Unplanned auditor turnover — Board members should be curious about an unplanned auditor change, which often signals a substantial disagreement between management and the auditing firm. The board, either directly or through its finance or audit committee, should investigate any unplanned auditor turnover. Any investigation should include a dialogue with the auditors during which management is not present.

Board micromanagement — One of the most serious problems a nonprofit can face is too much detailed operational management by the board. A board that is involved in many small-dollar decisions is creating enormous inefficiencies. Good board members will monitor the board's involvement in management and suggest appropriate corrections.

Questions the Board Should Ask

Financial documents

1. Is our financial staff providing us with accurate and timely financial statements that allow us to understand the financial state of the organization? If not, how could the statements be improved?
2. Does our annual audit have a clean opinion? If not, why not and what is being done about it?
3. Do we regularly review the Form 990? Does it accurately represent our organization?
4. Are we filing on a timely basis all the reporting documents we are supposed to be filing? (See Appendices II and III.)

Financial distress

5. Are our key sources of income rising or falling? If they are falling, what are we doing about it?
6. Are our key expenses, especially salaries and benefits, under control?
7. Have we had unplanned auditor turnover?
8. Are we micromanaging?