Fiduciary Financial Management in Nonprofit Organizations

By Walter Primoff

The volunteer service of CPAs who join nonprofit boards and committees is central to nonprofit success; however, many volunteers arrive unfamiliar with the differences between commercial and nonprofit financial environments. Organization executives running nonfinancial programs can often benefit from a better understanding of their financial challenges.

The following is a practical overview of the nonprofit financial environment and its key financial oversight challenges, which differ from those in commercial enterprises. It is intended to highlight major issues affecting most nonprofits, regardless of size or type. For readers seeking further guidance, a select list of resources is included, along with a glossary for non-CPAs.

Accountability Forces

Today, nonprofit governing boards are faced with the dual challenges of an ailing economy and the increased concern, voiced by legislators, regulators, and other stakeholders, that they are not fulfilling their fiduciary duties. As a result, nonprofits have a growing need for CPAs, attorneys, investment professionals, and other experts to provide guidance on fiduciary financial management.

This evolving area has grown in importance due to questions about the quality of board governance in general and financial management in particular. The catalyst for improved governance has been the Sarbanes-Oxley Act of 2002 (SOX); though primarily aimed at public companies, SOX's extensive financial governance rules have been widely adapted as best practices for nonprofits.

The Madoff fraud, which severely harmed a number of nonprofit endowments, created new urgency for improved investment best practices. New York and Mississippi passed the Uniform Prudent Management of Institutional Funds Act (UPMIFA) in 2010 and 2012 respectively, leaving Pennsylvania—which has its own rules—as the sole holdout among the 50 states. UPMIFA broadly governs the investing and endowment spending of most U.S. nonprofits, but many boards remain unaware that it applies to them.

In 2008, the IRS brought CPAs directly into the conversation with a revised Form 990 that requires many disclosures about an organization's financial and other governance. Now widely available on nonprofits' websites, Form 990 has become a document of broad public accountability.

The Nonprofit Profile

U.S. nonprofits are a major economic force. They enable the approximately 63 million people who donate their time to address a wide range of public benefit concerns. Federal, state, and local governments contract with nonprofits to benefit from their expertise. The National Center for Charitable Statistics lists some 1.5 million nonprofits with about $4 trillion in assets. Approximately two-thirds are Internal Revenue Code (IRC) section 501(c)(3) charitable, educational, religious, and similar organizations. The remainder are tax-exempt under one of the nearly 30 other IRC section 501(c) or other IRC subsections, each of which carries unique rules.

Nonprofits typically fall into one of three financial profiles or their hybrids: organizations funded largely by donations, investment income, grants, and service revenue; entities (such as charitable hospitals) whose service revenue is so great that their operations resemble their commercial counterparts; and associations, clubs, and fraternal entities funded principally by member support.

The Financial Management Environment

Although governing boards of the smallest nonprofits retain fiduciary oversight responsibility, these entities usually have few financial complexities. As nonprofits reach the $200,000 revenue or $500,000 asset threshold for filing Form 990, or as they receive endowment or noncash contributions, they face unique financial oversight challenges. These can include the following:

- Operational and regulatory issues arising from the sheer variety of potential funding sources, including private donations, investment income, government grants, and service revenue (e.g., ticket sales, tuition, advertising, service contracts).
- Complexity arising from a broad range of donation types (e.g., cash, securities, pledges, trusts, real estate, privately held business interests, collectibles, automobiles). These may come with donor restrictions, regulation, unrelated business income tax, and other issues.
- The obligation to follow UPMIFA's fiduciary investment rules.
- The need to balance the level of mission-based program spending with sound financial management, which can take continuous effort to meet.

Balancing Spending and Fiscal Oversight

Many staff and volunteers become involved with a nonprofit because of their commitment to its mission, which can lead to natural tension between the potentially competing goals of building programs and maintaining budget discipline. Properly managed, this tension is healthy. But it sometimes creates a serious behavioral "culture gap" between those seeking to expand programs regardless of their affordability and those entrusted with fiscal oversight.

It is incumbent upon governing boards to create an environment that balances innovative programs with financial restraint. Too much restraint can lead to anemic programs; too little restraint can put programs beyond an organization's means, seriously weakening its financial health.

In the current economic climate, hardly a week goes by without reports of nonprofits of all types—including iconic institutions that survived the Great Depression—severely curtailing operations or even going bankrupt. In some cases, the poor economy and government budget cuts were the cause. But often, a lack of adequate financial oversight enabled severe overspending and underplanning for reasonably foreseeable risks, leading to the following:

- Building major facilities with borrowed money in anticipation that funding would come, when there was simply no reasonably certain revenue source
- Accepting real estate or other noncash gifts that came with impractical donor restrictions and unaffordable construction, maintenance, regulatory, tax, or other costs
- Creating an organization with contractual charitable obligations lasting for decades, without a proper means of funding near-term administrative operations
- Regularly operating on the "financial edge," even when the potential to build reserves and endowment was there in the "good years"
- Taking an organization in new directions that alienated key portions of its traditional donor base without identifying replacement donors.

Such actions often result from the best intentions to further an organization's mission. But they also represent a programmatic "bridge too far" from reasonably assured resources. For nonprofits, the cliché "no money—no mission" has never been truer. The challenge is for organizations to run quality programs within the bounds of sound financial management; nonprofit stakeholders increasingly want both.

Elements of Sound Financial Governance

The financial role of most governing boards is to oversee a nonprofit's ability to achieve its mission over the long term. The nature of a financial management and governance system appropriate to achieve this goal is based on an entity's size and complexity. But even small nonprofits need to be financially accountable and comply with legal requirements.

In the post-SOX world, fiduciary financial management consists of the following four major interrelated elements:

- The nonprofit legal framework and related oversight by state and federal regulators
- The identification and management of financial risk
- Financial management and fiduciary oversight
- The communication of financial transparency.

Sidebar for "Budget and Financial Managment Elements" on P.53.

FINANCIAL STATEMENTS UNDER NONPROFIT GAAP

Key differences exist between the financial statements of nonprofits and those of commercial entities. Readers may want to follow along with the statements of a voluntary health and welfare organization; those of the American Red Cross are readily accessible at http://www.redcross.org at the end of its "governance" page.

Instead of profit, the performance measures with which most nonprofits are concerned are those pertaining to the efficiency and effectiveness of their mission-based programs. Most information on program effectiveness is found in sources other than financial statements. The statements speak to efficiency—the maximization of spending on mission-based programs.

The statements are also a report card on the quality of a nonprofit governing board's financial oversight. They help portray the degree to which an organization has long-term viability. They provide significant information about fundraising success, revenue sources, costs and expenses, investment management, and the allocation between program expenses and those devoted to administration and fundraising.

Nonprofit Financial Statements

FASB's accounting principles for nonprofits are found in Accounting Standards Codification (ASC) Topic 958, "Not-for-Profit Entities." Charitable healthcare entities receiving most of their revenue from providing services also come under ASC Topic 954, "Health Care Entities" (see https://asc.fasb.org).

Under ASC 958, nonprofit financial statements include a statement of financial position, a statement of activities, a statement of cash flows (the same as a for-profit entity), and notes to the statements. Voluntary health and welfare organizations add a statement of functional expenses, unique to nonprofits.

The statement of financial position is a balance sheet showing the difference between assets and liabilities as "net assets" instead of equity, and it is allocated between three classes:

- *Unrestricted net assets,* which are under the governing board's control
- *Temporarily restricted net assets,* on which donors have placed restrictions either on the purpose for which contributions can be spent or the time in which they must be spent
- *Permanently restricted net assets,* which are assets that cannot legally be spent, such as perpetual endowments.

When governing boards establish board-designated endowments or other funds, they are considered unrestricted because they remain under the board's discretion.

The statement of activities, like a commercial income statement, shows annual revenue and support—but for all three net asset classes. Expenses are charged against unrestricted net assets. When this statement is shown in a common table format with separate columns for each net asset class and a total column, the difference between revenues and expenses appears under "Change in net assets," which may resemble, but is different than, "Commercial net income." So the change in unrestricted net assets is the operating surplus or deficit, not the amount in the total column. Rather than being a performance measure, it is a reflection of the quality of the governing board's budget oversight.

If the entity shows a material repeating surplus without purpose, it might be able to spend more on mission-based programs. If it shows a material repeating deficit, it likely needs to cut expenses. It is normal for a financially well-managed organization to often show near break-even operations. Increases in the permanently restricted column are generally a measure of endowment fundraising prowess.

The statement of functional expenses is a matrix. It shows total expenses classified in natural categories, such as salaries, rent, and utilities for each major mission-based program category, and then for nonprogram administration and fundraising expenses. The ratio of total program expenses to total expenses is a key measure of efficiency—when properly understood. It is best at identifying clearly inefficient entities, such as those that spend just 25% of resources on programs. This issue is discussed further in this article's section on financial transparency.

Endowment GAAP Issues

Under endowment GAAP, donor restrictions or specific state law control the treatment of investment gains, losses, and income. Absent such restrictions or law, prior to a state's enactment of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), nonprofit GAAP generally called for endowment gifts of perpetual duration to be classified as "permanently restricted net assets" using the value as of the date of the gift. That value stayed in place permanently. Gains and losses in value were charged to "unrestricted net assets," even though the gains were often still legally restricted.

Under UPMIFA, the value as of the date of a perpetual gift often remains the amount classified as "permanently restricted," but it does not have to be. Absent explicit donor restrictions, GAAP calls for this determination to be made by the board rather than accountants (ASC 958-205-45-28). The determination is best made with the coordinated guidance of both the nonprofit's auditor and knowledgeable legal counsel. Gains are now classified as "temporarily restricted," while losses continue to be treated as "unrestricted." The reclassification of gains can impact liquidity ratios and other factors that in turn affect loan covenants, bond issuance, and other transactions. FASB's reasoning is found in Staff Position FAS 117-1, *Endowments of Not-for-Profit Organizations.*

The Nonprofit Legal Framework

U.S. nonprofits are generally subject to the laws in their state of incorporation, usually overseen by that state's attorney general. State nonprofit statutes typically define governing board duties, the structure and content of organization bylaws, responsibilities of officers and directors, rights of organization members, and other rules of governance and procedure. It is important for organizations to retain competent legal counsel to determine which laws apply to them in all of the jurisdictions where they operate.

At the federal level, the IRC requires each exempt organization to be organized for nonprofit purposes described in its relevant section 501(c) or other code subsection, and then operate accordingly. Once these organizations are granted tax-exempt status, the IRS can impose various sanctions on those that fail to meet the organizational and operational tests. The strongest sanctions are reserved for serious wrongdoers. These include individuals and entities that enable or receive improper private inurement, anyone using a tax-exempt entity to further a tax shelter scheme, and those spending tax-exempt assets for lobbying or other prohibited purposes.

Unlike most IRS forms designed to raise revenue, Form 990 is designed to demonstrate compliance with these tax law requirements. The IRS has found a positive correlation between quality nonprofit governance and tax law compliance. In response, questions about financial governance have become a major Form 990 staple. Answers showing poor governance might lead to increased IRS scrutiny (B. Anthony Billings, William H. Volz, and Antonie W.Y. Walsh, "Reporting the Governance, Management and Disclosure Policies of Nonprofits in the Redesigned Form 990," *The CPA Journal*, July 2011, pp. 38–45).

This legal framework is complemented by CPAs, attorneys, investment advisors, and other specialists who serve as both volunteers and paid professionals in this arena.

The Identification and Management of Financial Risk

In order to maintain long-term financial health, nonprofits require an effective process for identifying and managing risk. Specific nonprofit risks include volunteers, liability from noncash contributions, a lack of working capital, and unexpected shortfalls in charitable donations.

This last risk is especially common. In businesses, revenue comes from the same people that receive a business's products and services. Sudden product sales declines can generally be matched with specific production cuts. Nonprofit revenue declines often cannot be matched to specific expenditures. Timely action requires advance preparation, such as a plan detailing specific program cuts or tapping contingency reserves.

Managing Risks in the New Economy, a joint report of the AICPA and the Canadian Institute of Chartered Accountants, poses four risk management questions that nonprofits should regularly ask about each major process, program, unique activity, and transaction:

- What might go wrong?
- What would happen if it did?
- How can it be prevented or contained?
- What should be done if it happens?

One analysis approach is to match opportunities with their associated risks in a format resembling an accounting T-account:

Opportunity	Risk
Attract new donors/ members through new programs.	Donors/ members do not materialize to cover new program costs.
Donation of commercial building.	Potential for environmental liability, unfunded operational expenses, or other costs.

Once risks are identified and quantified, decisions must be made to determine which to accept; which to insure, hedge, or otherwise transfer; and which to avoid. In addition to unique risks, nonprofits encounter many risks also witnessed by businesses; these risks involve internal control, conflicts of interest, and the six universal categories of risk: political, economic, social, human resource, technological, and legal.

Financial Management and Fiduciary Oversight

Governing board's role. In a notable quote, Admiral Hyman Rickover said, "Unless you can point your finger at the person responsible when something goes wrong, then you have never had anyone really responsible." Under most nonprofit laws, that "person" is the organization's governing board. The board might hire managers to run operations, but the buck stops with the board.

The board's responsibilities include setting strategic direction, having stewardship over the organization's resources, approving and overseeing mission-based programs, holding managers accountable, ensuring legal compliance, setting the budget, and performing related fiduciary oversight. Nonprofit laws generally impose three fiduciary duties on board members:

- *A duty of care*—requires directors to prudently use "diligence, care, and skill" in carrying out their governance responsibilities.
- *A duty of loyalty*—requires directors to act in the best interests of the organization rather than private purposes. Disclosure of conflicts of interest, and sometimes freedom from them, is central to this duty.
- *A duty of obedience*—requiring compliance with applicable laws and the entity's own governance polices.

In a conversation with the author, nonprofit lawyer Barbara B. Lindsay noted that the duty of care does not hold directors accountable for the results of their decisions, but requires directors to follow sound processes in making them; this includes regularly attending and properly preparing for meetings and decisions. She believes that thoughtful directors following quality risk management and oversight processes are far more likely to make sound decisions.

In the area of financial oversight, the board is typically responsible for the following functions:

- Fundraising and development
- Setting staff compensation
- Finance, budget, and accounting
- Investment management
- Financial statement audit.

In financially complex nonprofits, much of the hands-on work is assigned to a separate committee for each function; however, not every organization needs this structure. When finances are not complex, many or all of these functions are handled by the board itself, with the help of appropriate CPA, legal, investment, and other professional advisors who can be volunteers, staff, or paid external advisors.

Committees typically become necessary

Sidebar for "Investment Managment" on P. 53.

INVESTING UNDER UPMIFA

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) has been called "the least-known law involving more money than any state law in the country." Almost nationwide, it regulates billions in investments and endowment spending by educational, religious, and other charitable nonprofits.

UPMIFA was developed and released to state legislatures in 2006 by the Uniform Law Commission (ULC), the commissioners of which are generally appointed by state governors. It is the successor to 1972's UMIFA, which created the first broad legal guidance on investing by nonprofits. UPMIFA has passed in every state except Pennsylvania, which has separate endowment rules. Many states have adopted the ULC language largely intact; others (including New York) have added stricter homegrown rules.

Under the "prudent investor rule," UPMIFA does not require positive investment results. It does require following sound investment and endowment spending processes within the act's boundaries, which includes four primary elements:

- Standards for prudently managing and investing "institutional funds," defined as funds "held for charitable purposes"
- Standards for expending "endowment funds," defined as institutional funds "not wholly expendable on a current basis"
- Rules for delegating investment functions to outside advisors and managers that also require such delegatees to meet the fiduciary duty of care
- Rules for lifting or modifying donor restrictions placed on charitable gifts.

Under UPMIFA, the fiduciary duties applicable to governing boards, investment committees, and others who manage nonprofit funds include the following:

- Duty of loyalty to act in the best interests of the organization
- Duty of care to act in good faith and with prudence
- Duty to minimize costs
- Duty to investigate the accuracy of information used in making investment decisions.

The act expressly considers diversification a prudent practice, except in exceptional circumstances. It also calls on organizations to decide whether to retain or dispose of gifts within a reasonable time after receipt and to perform any related rebalancing.

The goal of UPMIFA's expenditure provisions is to set spending at a level enabling endowments to retain purchasing power over time. Unlike prior law, if market declines bring an endowment's value below the value of the original gift, amounts from the endowment may still be spent. But spending decisions should take into account the ability to return to the gift's initial purchasing power.

UPMIFA creates an "overarching duty" to comply with donors' investment, spending, and other restrictions. Absent such restrictions, eight investing and seven expenditure factors must be considered to meet the fiduciary duty of care. The following table shows these factors in the order presented by UPMIFA and highlights the shared ones, as well as New York's additional spending factor.

UPMIFA Management and Investment Factors	**UPMIFA Endowment Expenditure Factors**
General economic conditions	The duration and preservation of the endowment fund
The possible effect of inflation or deflation	The purposes of the institution and the endowment fund
The expected tax consequences, if any, of investment decisions or strategies	General economic conditions
The role that each investment or course of action plays within the overall investment portfolio of the fund	The possible effect of inflation or deflation
The expected total return from income and the appreciation of investments	The expected total return from income and the appreciation of investments
Other resources of the institution	Other resources of the institution
The needs of the institution and the fund to make distributions and to preserve capital	*New York Only*—Where appropriate and circumstances would otherwise warrant, alternatives to expenditure of the endowment fund, giving due consideration to the effect that such alternatives may have on the institution
An asset's special relationship or special value, if any, to the charitable purposes of the institution	The investment policy of the institution

For governing board and investment committee members who previously had questions about what the duty of care covers, these statutory factors define a prudent process. UPMIFA essentially calls for aligning fiduciary duties and modern portfolio investment theory with a nonprofit's mission.

New York's version of the law (NYPMIFA), adds unique provisions, including the following:

- It applies to almost all of New York's nonprofits, not just charities.
- It requires all nonprofit corporations to have an investment policy statement.
- It expressly places responsibility on an organization's governing board for NYPMIFA decisions.
- It requires regular review and written records of reasons for not diversifying.
- It offers the optional UPMIFA provision, deeming average endowment spending exceeding 7% to be imprudent, which acts as a brake, not a safe harbor.
- It requires permission from "available donors" before spending pre-UPMIFA endowments below their initial value.
- Contemporaneous documentation of compliance with several NYPMIFA requirements is required.

UPMIFA also led FASB to revise endowment accounting rules, addressed in the sidebar, *Financial Statements under Nonprofit GAAP*. For more extensive UPMIFA materials, see the sidebar, *Resources*.

when the work would bog down the board with detail and take it away from its strategic oversight function. It is important that the board and any finance-related committees include members who understand the organization's mission, programs, and stakeholders—regardless of their level of financial expertise. Otherwise, financial discussions can easily become removed from the nonprofit's mission.

When a committee structure is in place, cross-communication between the committees and the board is essential, especially to assess risks before taking action. An organization's treasurer often oversees this process, ensuring that information flows to the board in a timely manner so that decisions can be made.

Budget and financial management elements. For most nonprofits, the main elements of financial management and control are the budget and the process and policies surrounding both its development and execution. They define an organization's ability to fund its mission over the long term, in good times and bad.

Typically, both budget and financial statement preparation fall under the responsibility of the finance committee, chaired by the treasurer. Business budgets project profit and loss; nonprofit budgets reflect the board's judgment about how much revenue should be allocated to each mission-based program, and how much should be allocated to administrative expenses and other purposes, such as maintaining reasonable reserves to preserve long-term financial stability. When reserves are sufficient, the budget might be set to break even. The format of nonprofit financial statements differs from that of commercial ones in order to reflect such differences. (See the sidebar, *Financial Statements under Nonprofit GAAP*.)

Budgeting expenses is generally straightforward—projecting revenue is the challenge. It may be reasonable to assume that contributions will match those from the previous year, that dedicated members will not drop out during a recession, and that grants will be renewed. But the uncertainty surrounding such assumptions requires the actual receipt of revenue to be continually monitored. A material revenue shortfall requires corrective steps to be taken quickly if assumptions prove wrong.

A budget's effectiveness depends upon the quality of the people and processes involved in its preparation and execution. Successful execution requires the board to receive, monitor, and act on timely (often monthly) reports that show the variances between budgeted and actual amounts for each revenue and expense item. The number and type of staff, and the accounting system necessary to produce the reports, are based on an organization's size and complexity.

There is no universal budget process; however, most well-managed ones have the following qualities:

- There is regular communication between those charged with budgeting and those who manage fundraising and development, investments, and programs.
- The finance committee, staff, and others who work on the budget timely receive all of the necessary inputs to project revenue and expenses, as well as assess budget risks.
- The budget team has a strong understanding of the organization's mission, programs, and stakeholders, including funders, members, staff, and service recipients.
- Budget team members have the combined technical expertise to develop a sound mission-oriented budget, designed both to fund current operations and look to the future.

Aside from these shared qualities, budget processes vary among successful organizations. Differences are typically based on such factors as an entity's history, size and type, location, stakeholder interests, and internal politics. With transparency now seen as a best practice, many nonprofits that had closed budget processes have opened them to increased participation.

Most nonprofits share one central budget challenge: there are always more worthy programs to be run and more people to be helped than the limits of funding allow. Boards seeking to provide mission-based programs for the long term need a finance committee that can say no to unaffordable programs. The best-run organizations have finance committees and program managers that find a way to soundly adapt the budget to changing circumstances.

Investment management. Most nonprofits operate in a distinct investment management environment defined by UPMIFA, the successor to 1972's Uniform Management of Institutional Funds Act (UMIFA). UPMIFA's major provisions, including those unique to New York, are discussed in the sidebar, *Investing Under UPMIFA*. Related implementation issues are addressed below.

Governing boards have significant decisions to make regarding the investment function's organization, the acceptance of donor-restricted endowments, the endowment spending rate, and the delegation of investment functions to external professionals. Absent conflicting law, nonprofits that are not subject to UPMIFA might find it prudent to follow its processes as best practices.

UPMIFA integrates fiduciary duties requiring legal interpretation with investing under principles of modern portfolio theory (MPT). Under MPT, assets are broadly diversified and managed for *total return* of income and capital appreciation, based on an organization's goals and risk profile. When UPMIFA was released to the states, FASB revised endowment accounting rules. As a result, it may be wise for affected entities to seek advice from a multidisciplinary advisory team whose members include a nonprofit specialist attorney, a professional investment advisor, and a CPA. It is helpful for each to be knowledgeable both about UPMIFA and the role of the other members. Their advice is especially important when nonprofits first come under the law's jurisdiction because it is too new to have been tested in the courts and presents unique legal, investment, and accounting challenges.

In the legal area, UPMIFA imposes fiduciary duty on virtually everyone involved in managing investments and making endowment spending decisions. Boards and their investment committees are permitted to delegate functions requiring investment expertise to outside investment advisors and managers, as long as a sound due diligence process is followed in choosing them. UPMIFA expressly imposes fiduciary duty on such delegatees.

Delegation can only be given to investment firms permitted to accept fiduciary responsibility; others can only make recommendations. Nonprofits with the necessary expertise often tactically use both types. Boards in smaller nonprofits, however, are often unaware of the difference; if the board retains a nonfiduciary firm, its members might believe that they have delegated investment management functions when they have not. Boards must also determine if conflicts of interest exist, and how independent investment custodians are being used to hold assets. Such due diligence has grown in importance since the uncovering of the Madoff scheme.

UPMIFA requires boards to follow donor restrictions that come with endowments. Absent specific restrictions, the act's intent is for endowments to be managed to retain their purchasing power over time. This requires professional investment skill and spending discipline. It calls for an alignment of several factors—including fiduciary responsibility, MPT-based endowment spending, the endowment's purpose, and the organization's mission—when making endowment spending decisions.

Using judgment supported by technical analysis, investment professionals can determine the probability of maintaining long-term purchasing power at given levels of endowment spending. Future results can differ from past experience, but the underlying principles have been long tested in bull and bear markets. What cannot be quantified are subjective elements related to spending. For example, an organization with a 5% endowment spending policy might spend $50,000 on programs when the endowment is $1 million. But if a market decline reduces the endowment to $800,000 the next year, the board must decide if it is prudent to continue spending $50,000 for a period in hope that the market recovers, or whether spending should immediately decrease for the endowment's long-term health. There will usually be difficult trade-offs in balancing the goals of maintaining endowment purchasing power and maximizing spending for mission-based programs.

Private foundations, which have a 5% charitable spending requirement under federal tax law, are also subject to IRC section

RESOURCES

A wealth of free or low-cost resources on nonprofit financial management and oversight is available online. Many CPA, law, and other firms in the nonprofit area also offer high-quality newsletters and other aids. The primary sources from which CPAs purchase professional research materials (e.g., CPA2Biz, CCH, FASB, PPC, RIA) all have major technical publications in the nonprofit and tax-exempt organizations areas.

The following list is an excellent starting point for nonprofit volunteers and others who seek a more in-depth of understanding of the financial management and governance issues addressed in the article. Most are free or low cost.

Audit Oversight

■ *The AICPA Audit Committee Toolkit for Non-for-Profit Organizations*, Reviewed by Julie Floch, *The CPA Journal*, February 2006 http://www.nysscpa.org/cpajournal

A review of the excellent nonprofit audit committee tools available from the AICPA's Audit Committee Effectiveness Center, adaptable to nonprofits of all sizes and types. Individual tools are available at no cost. The set plus helpful practice aids are available for a modest fee.

■ *Audit Guide for Audit Committees of Small Nonprofit Organizations*, Virginia Society of CPAs, http://www.vscpa.com

How the smallest nonprofits can maintain fiduciary oversight with an audit committee.

Board and General Governance

■ *The Best of Boards: Sound Governance and Leadership for Nonprofit Organizations*, 2011, by Kimberly Strom-Gottfried and Marci Thomas, AICPA, 2011, http://www.cpa2biz.com

A moderately priced and wide-ranging guide and reference, with comprehensive best practices and related processes and tools in many areas of nonprofit governance and fiduciary management.

■ *Nonprofit Governance and the Work of the Board*, Midwest Center for Nonprofit Leadership, http://www.bloch.umkc.edu/mwcnl

An overview of the role of nonprofit boards and the duties of nonprofit directors. It has examples of reckless fiduciary breaches in which directors have been held personally responsible.

■ *Right from the Start—Responsibilities of Directors and Officers of Not-for Profit Corporations*, Office of the New York State Attorney General, Charities Bureau Guides & Publications, http://www.oag.state.ny.us

A free practical best-practices guide that is relevant well beyond New York State.

■ *The Sarbanes-Oxley Act [SOX] and Implications for Nonprofit Organizations*, by BoardSource and Independent Sector, January 2006, http://www.boardsource.org and http://independentsector.org

A joint paper on the relevance of each of the major SOX provisions for nonprofit organizations.

Budget and Financial Management

■ "Reporting Financial Information to the Board," Nonprofits Assistance Fund, http://www.nonprofitsassistancefund.org

Based in Minnesota, the Nonprofits Assistance Fund has a wealth of tools and information related to nonprofit financial management and oversight, especially for smaller entities.

Financial Risk Management

■ Nonprofit Risk Management Center, http://www.nonprofitrisk.org

A resource that broadly covers nonprofit risk management, including direct financial risk, volunteer risk, employment risk, and a number of other risks that often turn into financial ones.

General Nonprofit Resources:

■ *Chronicle of Philanthropy*, http://philanthropy.com

A major source of news, opinion and resources for the philanthropic community.

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4944 regulations prohibiting investments that jeopardize a foundation's charitable mission. Issued decades before MPT became the standard, the regulations conflict with UPMIFA in material respects. For example, the regulations single out straddles, commodity futures, and certain other investments for special scrutiny without considering their role in the portfolio, which might be to reduce risk. In private letter rulings where nonprofits have requested to use these instruments within a sound MPT approach, the IRS has generally approved the request. Integrating these regulations with UPMIFA and the 5% spending mandate is one of many complexities faced by foundations that often require the guidance of knowledgeable CPAs, attorneys, and investment advisors.

In states where UPMIFA has been enacted, GAAP leaves it to the board to determine the amount of a perpetual endowment that should be legally restricted, absent explicit donor restriction. (See the sidebar, *Financial Statements under Nonprofit GAAP*.) It is important to recognize that GAAP rules for financial statements are not the same as legal requirements under UPMIFA. Maintaining and coordinating both legal and GAAP compliance is an important responsibility of an UPMIFA professional advisory team.

Audit oversight. Many nonprofit stakeholders see parallels in the role that effective audit oversight plays for both public companies and nonprofits. As a result, SOX rules for public company audit committees have been adapted as best practices by many nonprofits. State law or other mandates might even require that nonprofits form an audit committee or have audited financial statements.

The scope of oversight will depend on an entity's size, type, and complexity. Larger entities employ a chief audit executive; smaller ones, using volunteers, can still perform procedures to help assure financial accountability. (See *Audit Guide for Audit Committees of Small Nonprofit Organizations*, in the sidebar, *Resources*.) A comprehensive table of potential oversight tasks is found in the AICPA's excellent "Audit Committee Toolkit for Non-for-Profit Organizations." Typical tasks include the following:

- Choosing a qualified firm to audit or review financial statements and prepare tax filings
- Ascertaining that adequate internal control or appropriate workarounds are in place
- Helping ensure that the entity's risks are being identified and managed
- Serving as original receiver of "whistleblower" reports of potential improprieties.

This last task is due to one of two SOX provisions applicable to entities beyond public companies, including nonprofits. The first protects the rights of whistleblowers who report fraud and other criminality; the other prohibits certain forms of document destruction. Nonprofit audit committees are often involved with both provisions because they are independent of management and oversee fraud prevention.

While there is functional similarity between the above tasks in nonprofits and public companies, nonprofits have tax exemption, donation, and other issues not found in commercial enterprises.

When audit oversight is thoughtfully performed, it helps protect both the organization and its board members. Those involved in this activity must be free from conflicts of interest and must maintain an independent state of mind. They should be open to the possibility that a trusted person could be engaged in wrongdoing. It is important that at least one person involved in this function have the financial expertise to assess the quality of the auditor's work, ask probing questions, and understand the findings on a technical level.

The choice of a CPA firm with the competence to perform the required services could be the single most important oversight decision. A CPA or auditor might be commonly asked to perform the following hierarchy of services:

■ Preparation of a cash-basis Form 990

■ Preparation of an accrual-basis (usually GAAP) Form 990

■ Audit or review of GAAP financial statements

■ Audit under the federal Government Accountability Office's (GAO) *Government Auditing Standards* (i.e., "Yellow Book" standards or generally accepted government auditing standards [GAGAS]).

■ Program-specific audits or audits under the federal Office of Management and Budget's (OMB) Circular A-133 for organizations expending $500,000 or more in federal awards (which may increase to $1 million).

When retaining a CPA firm, it is important that the firm have relevant expertise and experience at the appropriate functional level of the hierarchy. Experience in the nonprofit's "industry," such as education or healthcare, can also be important. There are many competent smaller firms that choose not to work in the GAGAS or A-133 areas, which apply primarily to nonprofits receiving federal funding. GAGAS incorporates GAAS, but it also requires the assessment of internal control and other compliance; A-133 incorporates GAGAS but adds requirements concerning compliance with federal grants. Some states have similar requirements.

Nonprofits generally want the least expensive audit possible. Although the vast majority of CPAs avoid performing services outside their areas of expertise, the nonprofit sector is one area where this sometimes occurs. Some CPAs, competent with commercial clients, seek nonprofit engagements without understanding the difference between commercial and nonprofit GAAP, Yellow Book, A-133 or tax law requirements. When error-rich filings

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■ Idea Encore Network, http://www.ideaencore.com

A unique source of free or low-cost tools and other nonprofit resources uploaded by nonprofit staff, consultants, lawyers, CPAs, and other professionals.

Investment Management: Best Practices

■ *Principles of Nonprofit Investment Management*, Commonfund Institute, http://www.commonfund.org; and *Prudent Practices for Investment Stewards*, Fiduciary360, http://www.fi360.com

These two guides clearly lay out nonprofit investing challenges and related best practices. Commonfund's *Principles* concerns the broad issues facing nonprofit investment committees; revised prior to UPMIFA, it remains relevant. *Prudent Practices*, technically edited by the AICPA's Personal Financial Planning Division, details best practices and their legal basis.

Investment Management: UPMIFA and NYPMIFA

■ *UMIFA Becomes UPMIFA*, Uniform Law Commission, http://www.uniformlaws.org (Search for "prudent management" under "acts." The original draft of UPMIFA with detailed commentary is also here.)

Susan Gary's clear explanation of UPMIFA's provisions and how it developed from UMIFA. Gary served as the reporter for the Uniform Law Commission's UPMIFA drafting committee.

■ *A Practical Guide to the New York Prudent Management of Institutional Funds Act*, Office of the New York State Attorney General (AG), Charities Bureau Guides & Publications, http://www.oag.state.ny.us

A plain-English guide laying out the AG's views on UPMIFA and New York's unique additional rules.

Legal Framework

■ IRS, Charities and Non-Profits Section, http://www.irs.gov

This separate section on the IRS website has extensive materials for tax-exempt organizations.

■ National Association of State Charity Officials (NASCO), http://www.nasconet.org

The association of state regulators of nonprofit organizations. It sponsors the Multi-State Filer Project (http://www.multistatefiling.org) for registering nonprofits that solicit contributions across state lines.

Transparency Management

■ American Red Cross, http://www.redcross.org/about-us/governance

fter major problems, the Red Cross is now a model of governance transparency. Section 4-I of its "Governance for the 21st Century" report explains the rationale for transparency.

■ Better Business Bureau Wise Giving Alliance, http://www.bbb.org/us/Wise-Giving

The Wise Giving Alliance created a set of best practices, "Standards for Charity Accountability." Nonprofits meeting the standards and paying a fee can have a BBB seal affixed to their websites and other media.

■ Charity Navigator, http://www.charitynavigator.org, and Guidestar, http://www.guidestar.org

The two websites are pioneers in the area of transparency. Guidestar is the best-known repository of nonprofit organization IRS Form 990 filings and has many resources related to nonprofit transparency. Charity Navigator rates charities for the benefit of donors and other stakeholders. Its ratings methodologies are explained and lend themselves to rating charities on efficiency rather than program quality.

University Nonprofit Research Centers

■ Several universities have major nonprofit research centers.

NYU Law School's National Center on Philanthropy and the Law (http://www1.law.nyu.edu/ncpl) has a comprehensive search-engine bibliography of nonprofit legal articles, including taxes, charitable trusts, and related subjects of interest to CPAs. Other universities include Case Western Reserve (Mandel Center), Harvard (Hauser Center), Indiana University (Center on Philanthropy), University of Missouri (Midwest Center for Nonprofit Leadership), Stanford (Center on Philanthropy and Civil Society), and Yale (Program on NonProfit Organizations).

reach federal agencies, these practitioners are often reported to professional ethics committees, and the nonprofits may find themselves under additional government scrutiny.

An audit by a firm with the necessary competence often uncovers legal, compliance, internal control, or other issues in their earliest stages before they become serious problems. This helps protect the board and ensure that fiduciary obligations are being met.

The Communication of Financial Transparency

For nonprofits, transparency is no longer just a best practice; it is unavoidable. Form 990 filings are freely available on websites like Guidestar. Matters once confined to local gossip are now broadcast on Facebook and Twitter. IRC section 501(c)(3) entities are separately affected by sites like Charity Navigator, which use Form 990 data to rate them. By understanding how Form 990s are analyzed, CPAs and others involved in their preparation can often help nonprofits improve web-based charity ratings and tax compliance. They can also help counter misinterpretations of ratings that occur because of the way in which ratings sites typically analyze Form 990 data. Among the most misused statistics is the percentage of a nonprofit's revenue spent on administrative expenses. Properly employed, it exposes abusive entities spending most of their money on fundraising and administration rather than mission-based programs. But the public's interest in this measure has helped foster a general anti-overhead bias among a growing number of donors. Once beyond the abusive extremes, blind use of this ratio can be misleading. An extra 10% spent on overhead may be attributable to quality financial governance systems, and enabling staff to offer more effective programs in a better-run organization.

Beyond Form 990s, nonprofits like the American Red Cross have found increased financial and governance transparency to be an important component of building and maintaining donor trust. Some organizations participate in best practice quality initiatives, such as the Better Business Bureau's Wise Giving Alliance, which issues Standards of Charitable Accountability. CPA, finance, and legal professionals can help organizations prepare to meet such standards.

A Vital Sector

Nearly two centuries ago, Alexis de Tocqueville observed that Americans "constantly form associations … to construct churches, to diffuse books; and in this manner they found hospitals, prisons, and schools." Today, the nonprofit sector remains a vital part of our culture and economy, in no small part because of the CPAs, attorneys, investment advisors, and others who take the time to understand the difference between business and nonprofit financial environments. These volunteers are the key to helping nonprofits run quality programs with the sound financial management that donors and other stakeholders increasingly expect. ❑

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GLOSSARY FOR NON-CPAS

AICPA: The American Institute of Certified Public Accountants is the predominant professional association for U.S. CPAs. It issues GAAS, used by CPAs to perform financial statement audits.

ASC: FASB's Accounting Standards Codification, the source of U.S. GAAP.

FASB: The Financial Accounting Standards Board is responsible for issuing both nonprofit and commercial U.S. GAAP.

GAAP: Generally Accepted Accounting Principles are the professional standards for the preparation of U.S. financial statements. Nonprofit GAAP is found at ASC Topic 958, "Not-for-Profit Entities."

GAAS: The AICPA's Generally Accepted Auditing Standards are the professional standards that govern the performance of U.S. audits by CPAs.

GAGAS: Generally Accepted Government Auditing Standards are issued by the GAO. These standards, commonly called the "Yellow Book," incorporate GAAS and add additional assessment of internal control and other compliance.

GAO: The Government Accountability Office is the nonpartisan audit and investigatory arm of Congress that issues GAGAS.

IRC: The Internal Revenue Code is the federal tax code.

OMB: The President's Office of Management and Budget conducts oversight of organizations receiving federal funding. Organizations receiving more than $500,000 in federal funds must have an audit performed under both GAGAS and additional standards derived from OMB Circular A-133.