Streetsmart Financial Basics for Nonprofit Managers

Third Edition

Thomas A. McLaughlin

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To Gail, Paul, and Emily

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Preface

Over the past two decades the nonprofit sector has grown at an astonishing pace. Today there are more than one million nonprofit public charities and hundreds of thousands of other nonprofit entities, and they are found in every community in this country. As important, the sector is beginning to figure prominently in public conversations as an acknowledged source of innovation and solutions to various social issues, especially in areas where government at all levels was formerly more active. This trend seems likely to continue and even accelerate in the years to come.

With greater prominence and more widespread acceptance come greater attention and more scrutiny. Nonprofit management is becoming a recognized specialty, and there is a growing recognition that nonprofit financial management is not just for profit financial management with a different name. The number of individuals and entities specializing in nonprofit financial management is growing as well.

With this growth in numbers comes a comparable growth in the demand for sophisticated management. The problem is that few nonprofit managers have any formal training in financial management. Almost everything they know is from on-the-job training, with a liberal amount of assumptions and conventional wisdom that may or may not be helpful. In some cases, these managers can rely on native instinct and clarity of thought, but most often they simply wing it and hope for the best.

Nonprofit organizations—and the users and funders of their services—deserve better, and they are getting it. It is not much of a stretch to say that the increased emphasis on financial management in nonprofits reflects a laudable striving for greater accountability. No longer is it enough just for one's financial records to be in order; one must be able to demonstrate good financial systems in order to meet all the other rising demands on today's nonprofit.

In my work as a nonprofit management consultant, graduate program faculty member, and nonprofit board member, I continue to find a widespread hunger for practical, immediately helpful financial information. That was the initial stimulus for this book, and it remains so today.

In this volume I tend to steer away from technical compliance-related matters, for two reasons. First, others can cover financial compliance subjects better than I. And second, my vision of financial management goes far beyond simple compliance to a stage that I fervently hope will be characterized by thoughtful, creative, and persistent management actions.

To support those who share my vision, I have tried to make this book as practical as possible. For example, most of my financial calculations and many examples are based on the IRS Form 990, the nonprofit "tax return." By using the only common financial reporting form, I hope to bridge the gaps between different types of nonprofit organizations so that the content will work equally well for a broad audience.

This third edition also contains many new items. I have added material on the proper financial roles of boards of directors ("Assets Are for Boards, Activities Are for Managers"), the Sarbanes-Oxley law, charity watchers, and many other subjects. New to this edition, I have told brief stories of nonprofit financial success (or lack thereof) at solving common problems. I have also double-coded and cross-walked all line items from both the old and the new IRS Form 990s, recognizing that the new version starting in 2009 will mean that for many years into the future analysts and students will have to work simultaneously with both forms.

In recent years I have seen a growing interest in the American nonprofit sector by people from other countries. From conversations with my consulting and academic colleagues, I know I am not alone. Foreign students and managers face the double challenge of learning financial concepts while also familiarizing themselves with cultural matters that are uniquely American. This is why I added an appendix designed to be a kind of cultural primer on practices, institutions, and policies that most Americans take for granted but that would be stumbling blocks to non-Americans' understanding.

As with the first edition, this book is not intended to be primarily a textbook. There are hundreds of thousands of people involved with nonprofits who need to know about financial management but who don't need another textbook in their lives. It is to them that I speak through these pages. At the same time, I have been flattered that many professors and academic programs throughout the country have adopted the book for use in the classroom, and I thank them. I only hope that their students do, too.

As a rookie executive director many years ago, I never dreamed that I might one day write a book that so many would find useful. Mainly, I was consumed with trying to figure out what seemed like a gargantuan task rapidly enough to avoid appearing foolish. In some very real way this book is a record of my personal journey through a sometimes confusing topic. The existence of this third edition is pleasing validation that many people have found my approach to nonprofit financial management helpful. I hope only that that will continue to be the case.

—*Tom McLaughlin*
December 2008

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As before, I want to thank my wife, Gail Sendecke, and my children, Paul and Emily, for sharing me with this ongoing project.

Note to Reader

Throughout this book, a Web icon ( ) indicates that you should go the accompanying Web site for corresponding templates or examples. The Web site address is:

www.wiley.com/go/basics3E

Refer to Appendix C, "Using the Web Site," for the table of contents and detailed instructions for use of these templates.

Streetsmart Financial Basics for Nonprofit Managers

PART ONE

Analysis

CHAPTER 1

Organizational Structure: Programs and Corporations

The nonprofit industry is enormous. Tens of thousands of such organizations are created every year. Exhibit 1.1 shows the growth curve for the last several years. Nonprofit organizations in the United States spend over $340 billion each year. They employ nearly 7 percent of the total workforce and are responsible for 6 percent of the Gross Domestic Product. Universities, research centers, religious institutions, and museums produce priceless accomplishments. Nonprofit hospitals are major elements of our health care system and in many communities are the largest employer. Social service agencies provide a wide variety of services to those less fortunate citizens. Other nonprofits educate people of all ages and at all levels. Still others develop communities and support our social lives.

There are many ways to categorize this industry. The IRS's way is discussed later in this chapter. The traditional way is by the service provided and, to a lesser extent, the size of the nonprofit organization. This approach may not be particularly useful from a financial management perspective since services and even size alone do not necessarily say much about the nature of the financial management challenge, so we suggest a different way of thinking about the financial management challenge.

Types of Nonprofit Organizations

For financial purposes, a better way of looking at this industry is to sort it into categories according to the primary economic function the

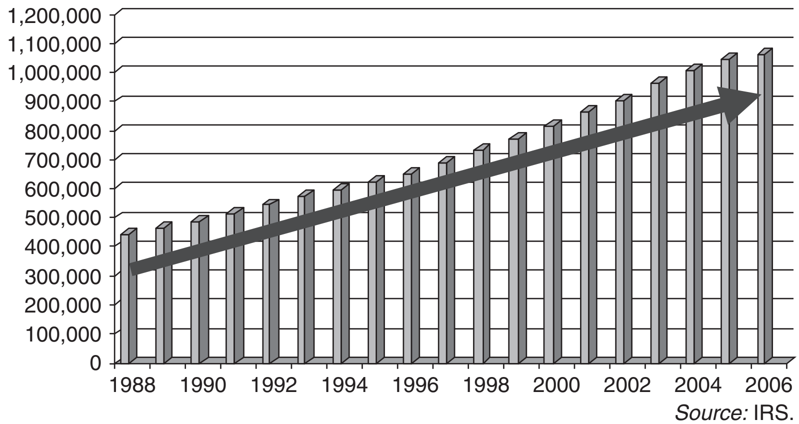

EXHIBIT 1.1 **Numbers of Nonprofit Public Charities 1988–2006**

organizations perform. We suggest that there are six distinct types of nonprofit corporations:

1. Direct service providers
2. Information managers
3. Resource distributors
4. Support and development providers
5. Grant makers or funders
6. Social organizations

Note that these groupings are chiefly for analytical purposes, and that the activities of many organizations can span several categories.

Direct Service Providers

These organizations are the classic nonprofits. Usually public charities, they are the hospitals, clinics, social service providers, and the like that provide some sort of direct and recognizable service to some or all of the public at large. Often major employers of professionals, these corporations provide a "hands-on" service.

Financial issues in direct service providers vary according to size and funding source. One characteristic that many share is the need to assemble a workable mix of funders, and to be careful about managing the relationships between funders' requirements. Complexities abound in their financial management profile because governmental and quasi-governmental entities are often major funding sources. More on that subject later. Due to the limitations of government funding, philanthropy must also often play a role in direct service providers' management, and the stakes are high if money is accounted for inaccurately.

Payment in this field has moved from the traditional reimbursement for costs incurred to a defined price for a defined service such as one often finds in the health care field now. Level funding and cutbacks for many years has been the norm.

Information Managers

Another large category of nonprofits are the information managers—universities, museums, advocacy groups, trade associations, and a variety of similar organizations. Their role is to accumulate information of a predefined sort and share it with selected users, often in the role of broker. A university, for example, can be viewed as a broker between professors and students, or between researchers and consumers of research. Information management agencies range widely in size from the very smallest advocacy group to multibillion-dollar universities with international branches.

Consumers of information management services are multiple and naturally quite independent of each other; their financial systems must be capable of handling unusually massive quantities of information. These types of organizations tend to have memberships; therefore, the financial systems must store information about the same people for retrieval and usage over a period of years. In effect, membership records are the financial data.

In practice this scenario dictates a financial system, especially the revenue tracking component, that is capable of handling large numbers of small or large transactions. Frequently, the financial task is paralleled by the program manager's need to communicate with hundreds or even thousands of people, members and nonmembers. Fast and effective data management often becomes the only thing distinguishing one information manager from another, laying a heavy burden on the administrative infrastructure of each organization.

Resource Distributors

Resource distribution agencies reached their zenith during the Great Society days of the 1960s. For a variety of political, psychological, and logistical reasons, the federal government did a lot of business directly with local nonprofit agencies, positioning them as the last stop before direct contact with eligible clients.

No doubt it was politically useful for these local players to wield ultimate distribution responsibility, thereby shielding the federal government from criticism. It was also smart to graft onto the organizations' existing formal or informal support systems rather than re-creating them from scratch. Community action organizations from the 1960s such as antipoverty programs and heating oil assistance services are good examples of resource distribution nonprofits.

The premiere financial demand of resource distribution nonprofits is strict accountability. In many ways, they serve as the social equivalent of general contractors, assembling a team of benefit or service providers in order to accomplish a coordinated job. In other cases, they act mainly as a final distribution point for transfer payments, usually as part of an entitlement program. Their work typically involves outreach, evaluation, and servicing of eligible clients. From the funders' perspective, however, their real value comes after the client transaction has occurred and they make their reports to the payments' source.

Owing to the demand for accountability, resource distribution nonprofits' financial systems will tend to be shaped by individual transactions and the funding source's rules. Most programs of this sort are expected to track the flow of money, not the effectiveness of the programs. Accountability in this context means careful accounting, not managerial success. Perhaps not surprisingly given their role as intelligent conduits, many resource distribution nonprofits end up looking a lot like the governmental unit that funds them.

Support and Development Providers

The fourth category of nonprofit corporations refers to support and development groups. These organizations are limited in number but play a major role in areas of the health and social welfare sector. In size and focus they are not unlike resource distribution nonprofits, except that they concentrate on leveraging resources rather than simply marshaling them.

Financial management for support and development groups will be unremarkable except when ownership or financing of capital projects is involved. The task in these cases often relates to properly valuing assets, estimating the percentage of a project completed, and properly accounting for and reporting on funds received. The difficult aspect of financial management in the property acquisition or rehabilitation environment is dealing with irregular flows of cash in and out of the corporation and keeping track of which expenses are of the current period and which expenses should be considered part of the capital project.

Grant Makers or Funders

One of the most common of all types of nonprofits, grant makers or funders can range from the very smallest fund-raising agencies to massive private foundations. Their task is to raise money and decide who should get it, and, in the case of private foundations, raising the money may consist chiefly of effectively managing a portfolio of equities.

One of the things that makes the funder's financial management job at least theoretically easier than many in the nonprofit field—foundation CFOs, block your ears—is that things like revenue management may have to be done by outsiders such as investment managers. No financial officer can be expected to have the skills to manage a major chunk of investments, nor would the responsible board expect it. Moreover, there are arguments for accountability that favor separating investment management from operational tasks.

On a broader level, to do the grant-making job correctly, the funder needs to operate in a planned, disciplined fashion. Happily, good financial management can thrive under the same conditions. In effect, a funder is engaged in the business of shaping and directing streams of money over a period of years. This is a profoundly different dynamic than most other nonprofit categories, and it should not be underestimated in the context of designing a financial management system.

For all practical purposes, funders are accountable to no one. While the technical aspects of fund-raising and grant-making must be handled properly, it is relatively easy to hire skilled staff to see to that. Beyond the minimal level of legal compliance in both the public charity and the private foundation worlds, no significant person or authority is in a position to routinely challenge the workings of a funder. Ironically, this can be as much a hindrance to good financial management as anything else, since there is the possibility that complacency will crowd out effectiveness.

Social Organizations

The final entry in the list of major nonprofit types is social clubs and organizations. Whether fraternities, lodges, sporting clubs, quilting associations, or any of a vast array of other entities, they share the common theme that they exist in order to further the social interests of their members. Funding comes almost entirely from members' dues and from business transacted with members (such as restaurant and bar sales at clubs), and occasionally from rents or investments.

Typically, the financial stakes are low in a social club. Members usually have little interest in the details of financial management beyond seeing that the dues are collected and the bills paid on time. As a result, two of the greatest threats to a club's financial health are sloppy record keeping and fraud. The need for fiscal accountability is just as strong as in other categories, but much of the focus is likely to be on cash. One thing that tends to be true for social clubs is that their financial prowess is never any greater than what the membership demands.

Structure of Nonprofit Organizations

Programs

Programs are the most visible and best understood aspect of the nonprofit form of business organization, and its chief means of carrying out its mission. Also called services, projects, clinics, divisions, departments, floors, or any one of a thousand other names, programs are the activities of the nonprofit organization.

Coming up with a fair and workable definition of a program is difficult. Here's an attempt: A program is a coherently packaged group of activities, usually associated with one or more specific physical locations, designed to accomplish a stated result.