BOARDSOURCE®

101 BOARD BASICS

FINANCIAL AND FUNDRAISING ISSUES – FAQs

Can a nonprofit organization have too much profit?

Being financially successful is the dream of just about every nonprofit. An operational surplus allows you to do even more with less stress and equips your organization to undertake new activities to accomplish your mission.

But you need to understand what is generating your surplus. If your organization engages in activities outside of its mission, you may be generating unrelated business income. Excessive unrelated business income may create UBIT (unrelated business income tax) or endanger the tax-exempt status of your organization.

A second important issue related to revenue is what you do with it. All surplus has to be invested back in the organization; it cannot go in the pockets of staff or board members. This rule applies whether your nonprofit has revenues of $4,000 or $40,000,000.

If your organization creates unexpected surplus, which cannot be used in operating expenses, you may wish to create an endowment, increase your rainy day reserves, or provide services at a lower cost to customers.

What is private inurement?

Private inurement is prohibited in all nonprofits. It happens when an insider — an individual who has significant influence over the organization — enters into an arrangement with the nonprofit and receives benefits greater than she or he provides in return.

The most common example is excessive compensation, which the IRS condemns through intermediate sanctions (significant excise taxes). Insiders — referred to in IRS parlance as "disqualified persons" — can be high-level managers, board members, founders, major donors, highest paid employees, family members of any of the above, and a business where the listed persons own more than 35 percent of an interest.

Private inurement is an absolute term. There is no de minimis restriction. If a nonprofit is organized to benefit an individual, even while fulfilling its tax-exempt purpose, it cannot be a tax-exempt organization. Under the state law, an organization may lose its nonprofit status.

What is self-dealing?

When a person is on both sides of a financial transaction, he or she is engaged in self-dealing. In a nonprofit organization, this may happen when the organization does business with a board member. The board member is in a position of influence within the organization and he or she may be seen as obtaining personal benefit from a financial relationship.

Any business relationship involving board members, their relatives, or their employers, should be handled with care as it may be perceived as a conflict of interest. A clear conflict-of-interest policy includes a requirement for board members to annually disclose personal and professional affiliations. It also sets forth a process to follow when considering a business relationship with a board member.
Self-dealing in itself is not illegal to all nonprofits. However, private foundations are strictly forbidden to engage in such activities, no matter how insignificant the monetary benefit. An excise tax can be imposed on those involved in the transaction.

What are the key financial questions our board should ask?

- Have we run a gain or loss? (i.e., Are we better or worse off financially than we were a year ago?)
- Are our key sources of income rising or falling? If they are falling, what are we doing?
- Are our key expenses, especially salary and benefits, under control?
- Do we have sufficient reserves?
- Has the board adopted a formal policy for the establishment of reserves? Is our cash flow projected to be adequate?
- Are we regularly comparing our financial activity with what we have budgeted?
- Is our financial plan consistent with our strategic plan?
- Is our staff satisfied and productive?
- Are we filing on a timely basis all the reporting documents we are supposed to be filing?
- Are we fulfilling all of our legal obligations?

What are the top ten questions you should ask your auditor to help prevent fraud?

1. What internal controls are in place to prevent an employee, officer, or outside agent from intercepting checks intended for our organization prior to their being recorded on our books?
2. What controls are in place to prevent the unauthorized disbursement of funds from our bank accounts (general and payroll) by an employee or officer?
3. What controls are in place to prevent one of our vendors from over billing our organization?
4. Are you aware of any forms of compensation or benefits received by our organization's officers, directors, or key employees that were not specifically approved by the board of directors?
5. Are you aware of any inappropriate or undisclosed relationships between officers, directors, key employees, vendors, or donors?
6. Are you aware of any relationships with vendors or contractors that appear to be less than ethical, warranting further inspection, or should otherwise be considered when putting out for competitive bid, (i.e., relationships that have become too casual or close)?
7. Are there any individuals involved in the accounting process who wield excessive control or whose work is not subject to adequate review by another individual?
8. How would you characterize the morale, work environment, and professionalism of accounting personnel and senior management of our organization?
9. Overall, how would you rate our organization in terms of how well we are protected against fraud?
10. What is the most important step we could take to further protect our organization against fraud?

What is an internal audit?

In carrying out its oversight responsibilities, the board should regularly review the organization's policies and procedures on how it does business and manages its financial affairs. This task can be delegated to the audit or finance committee.

The committee should guarantee that an adequate internal control mechanism is in place to ensure that the organization is

- using generally accepted accounting methods
- complying with applicable laws and regulations
- providing reliable financial information
- operating effectively and efficiently

More specifically, an internal audit ensures that proper policies are in place to segregate financial duties, protect cash receipts, require second signatures on large checks, keep track of inventory, require an efficient bidding process, produce timely reports, and maintain accurate recordkeeping. Appropriate internal controls create a firm base for an effective outside financial audit.

What is the auditor's role in ensuring financial propriety?

Why didn't the auditors catch it? That's the first question many people ask when confronted with a case of financial wrongdoing at a nonprofit organization.

Answering that question requires an understanding of the auditor's role. An auditor is an outside accountant engaged by the board of a nonprofit to review the financial statements prepared by the organization's staff. The auditor's main job is to judge the accuracy of the financial statements and report back to the board. To do this, auditors usually examine some typical transactions and review internal controls, accounting procedures, and financial reporting systems. Through the management letter, auditors also help nonprofits develop effective financial controls.

An audit is a spot check of information, not an exhaustive review of all financial transactions. Further, auditors are charged with determining the accuracy of the financial statements only "in all material respects." A clean bill of health from an auditor means that the auditor is convinced that the financial statements do not misrepresent the organization's financial position in any significant way; it does not guarantee 100 percent accuracy.

Auditors are not charged specifically with uncovering fraud. Since they rely heavily on management to provide information and documentation, small-scale fraud is extremely difficult for auditors to detect, particularly if it is being perpetuated by more than one key staff person within the organization.

An important final point: all firms are not equally qualified to audit a nonprofit organization. Nonprofits follow accounting conventions that are distinct from those of business and government. A firm that is unfamiliar with these guidelines or has little experience auditing nonprofits will be especially unlikely to uncover financial malfeasance.

Who is responsible for hiring the auditor?

An independent audit is one the most valuable tools the board relies on as the fiduciary for the nonprofit. The board oversees the functioning and the financial health of the organization. To provide additional security, objectivity, and accountability, usually the audit committee of the board recommends an outside professional to give an impartial judgment on the accuracy of the financial statements and how well the organization is adhering to generally accepted accounting standards.

The auditor reports to the board — not to the staff — even if the staff is working closely with the auditor by providing the necessary documents.

What are intermediate sanctions?

Traditionally, revocation of tax exemption was the IRS's only tool for punishing a nonprofit that exploited its status in some way. The revocation of tax exemption not only disciplined the organization but also penalized its customers and clients by discontinuing the services. Also, this disciplinary action lacked any built-in warning mechanism or intermediate steps, which would allow the organization to correct its performance.

In 1996, the IRS installed intermediate sanctions, a system of excise taxes that are levied directly on the organization, as well as on those making the inappropriate decisions. Since then the IRS has expanded its focus on misconduct to include any type of financial transaction that benefits those in positions of influence within the organization.

How can a board protect itself from intermediate sanctions?

The IRS's intermediate sanctions rules provide a safe harbor mechanisms for directors serving on nonprofit boards when they determine compensation for the chief executive or engage in other financial transactions with a "disqualified person." The safe harbor has three steps, and all of them must be satisfied:

1. Reliance on appropriate, objective comparability data (for organizations with revenue under $1 million, the IRS recommends three data points; for organizations with revenue over $1 million, five data points). Comparability data may come from the nonprofit or for-profit sector, when appropriate. The board may also rely on advice from independent experts, such as attorneys, CPAs, compensation consultants, and valuation experts. There is no requirement that comparability data come only from the nonprofit sector; there may be many circumstances where the appropriate data include for-profit comparisons
2. Approval of the transaction by disinterested board members, with the interested person absent during debate and voting
3. Adequate documentation by the board of the basis for its decision in its corporate records

What constitutes excessive compensation for chief executives?

Excessive executive compensation receives a lot of attention. Those who believe that the nonprofit sector has become too professionalized and "corporate" cite excessive compensation as an example of how many organizations are losing sight of their mission and their distinctiveness as nonprofits.

Because revelations of inordinately high compensation can erode donor confidence and cause increased public skepticism, board members should pay close attention to compensation decisions. The compensation of board members, officers, and key employees of the organization is included on the IRS Form 990, an informational tax form that most nonprofits must file each year. The 990 is a public document that must be made available when requested by members of the public — including journalists. For this reason, compensation can't be considered a private matter, and all board members should be aware of its implications.

The compensation of nonprofit executives usually lags behind the compensation of leaders in business and government. The real challenge many boards face is not how to reign in excessive compensation but rather how to find the resources to pay appropriate salaries.

To evaluate the appropriateness of executive compensation, consider:

1. The size and complexity of the nonprofit.
2. The mission area, geographic location, and financial condition of the organization.
3. The qualifications required for the job.
4. Compensation at comparable organizations.

A wrinkle exists to the challenge of determining appropriate compensation. The Intermediate Sanctions regulations enable the IRS to impose excise taxes and other penalties

on nonprofit executives who are over-compensated. When determining appropriateness, the IRS evaluates whether the compensation was decided by an independent board, if appropriate comparable compensation data was obtained, and if the basis for determining compensation was documented. This power will allow the IRS to penalize individuals receiving more compensation than their positions warrant, rather than resorting to revoke the tax-exempt status of the organizations.

What is Unrelated Business Income Tax (UBIT)?

A major benefit to being a nonprofit is the exemption from federal and state income taxes. However, certain activities, considered unrelated to the organization's core mission, are subject to taxes. This tax is called Unrelated Business Income Tax (UBIT).

In order to be subject to UBIT, the profit-making activity must be regularly carried on, constitute a generally recognized trade or business, and not be an activity that is substantially related to the organization's tax-exempt status — meaning the activity does not further the mission of the organization.

Normally, royalties are not taxed. Income from selling membership lists to a for-profit organization and from affinity programs are subject to UBIT.

Even though unrelated, profit-making activities are permissible, but they should not consume too much of the nonprofit's resources. In extreme cases, the IRS may determine that the organization has abandoned its tax-exempt purposes and may seek to revoke its exempt status.

What level of reserve funds is appropriate for a nonprofit?

Nonprofits — like businesses, families, and individuals — need to save for a rainy day. While few would dispute that assertion, disagreements sometimes arise over what level of reserves is appropriate. Often the level of reserves depends on the mission and type of organization. Nonprofit organizations created to run a specific event or those that do not intend to operate in the long-term may not be as concerned with developing reserve funds.
Those who argue for a very low level of reserves point out that an organization with a particularly imperative mission — the eradication of a disease, for example — has an ethical and moral obligation to use all its resources to carry out that mission as swiftly as possible. Others have questioned the ethics of an organization soliciting the public for donations while maintaining reserves that would allow it to operate for many months, or even years, without any additional public support. Many of the national watchdog organizations have standards that specify the level of reserves they find acceptable. The BBB Wise Giving Alliance, for example, suggests that charities should not have more than three years' expenses in reserve — a level that very few nonprofits attain.

The distinction between reserves and endowment is significant. An endowment is a pool of money that is invested so that the income can be used to support the nonprofit. Often, donors have restricted these funds so that the principal cannot legally or ethically be used to cover day-to-day expenses. Reserve funds are more flexible. Reserves come from the accumulated surpluses of the organization over time, and can usually be designated or allocated by the board. Reserves can be spent to expand programs and run the organization, while endowment usually can't. Many large institutions, such as universities and museums, have endowments that are many times their annual budgets. Harvard University, for example, has an endowment of more than $30 billion, several times its annual budget.

What should our nonprofit investment policy include?

Any organization that has assets to invest should also have appropriate policies to guide these investments. One set of policies does not fit every organization but each organization needs to define its own goals and understand its own fiduciary responsibilities. Here is a list of the basic points to cover. Any investment policies should

- be developed with the advice of a financial professional or be reviewed by legal counsel
- define general objectives (preserve and protect the assets; chieve aggressive growth)
- delegate day-to-day asset management to an independent finance committee or a professional manager
- set asset allocation parameters (include diversification)
- describe asset quality (itemize quality ratings for stocks, bonds, or short-term reserves based on your risk tolerance)
- define the investment manager's accountability (include risk in transactions, social responsibility, reporting requirements, and coverage of cash flow needs)
- establish a system for regular review of the policies

How could we benefit from an endowment?

Endowments can serve numerous purposes. Here are some ways your organization might benefit from an endowment.

- Financial stability. A healthy endowment mitigates insecurity and eases financial pressures.
- Regular income. Through smart investing an endowment provides reliable revenue for programs or overhead.
- Emergency funds. An endowment serves as a safeguard against major disasters. However, it should not be considered as a tool to counterbalance bad financial management.
- Future opportunities. An endowment — within the framework of spending policies — provides funding for new ventures or sudden opportunities.
- Generational equity. An endowment allows an organization to meet the needs of future generations.
- Donor opportunities. An endowment allows major donors to have a lasting impact.
- Confidence builders. Funders are attracted to successful endeavors. A strong endowment builds donor confidence.

What should an endowment resolution include?

After your board has decided to go ahead and create an endowment, it needs to formulate this decision into an endowment resolution. This resolution should address the following questions:

- What is the purpose of this endowment and how will it tie in with the mission of the organization?
- Who will manage the endowment? Will we have an independent investment committee or will we hire an outside manager?
- What is going to be our investment strategy? How can we ensure that the separate and detailed investment policies remain in accordance with this strategy?
- What will our disbursement policy be? Will the board have the authority to transfer funds under special circumstances?

What are tax-deductible donations?

- Tax-deductible donations are contributions to charitable causes and are not taxed because they improve the general public good and do not benefit the taxpayer personally.
- Gifts that are given to a qualified nonprofit organization, for which the donor receives no premiums in return, are considered tax-deductible. If the donor receives something in return for the donation, the difference between the amount of the donation and the value of the item received in return is deductible.
- All charitable 501(c)(3) organizations (churches, hospitals, universities, arts institutions, and so on) can receive tax-deductible donations. Contributions to 501(c)(4) organizations (civic leagues and many social welfare organizations), except to veterans organizations, and 501(c)(6) organizations (trade associations and business leagues) generally are not tax-deductible, but can usually be considered a business expense.

What funding resources are available for our organization?

Take advantage of all the helpful references at the Foundation Center site. Among other things, you will find directories of foundations by mission area, free tutorials on grant writing, and numerous sample documents relating to funding and fundraising.

Your community foundation may be a good place to contact. Community foundations generally serve local organizations through funding and special programs. To find your community foundation, use the locator on the Council on Foundations Web site, or search GuideStar.

Your local United Way chapter may be a resource as well. Equally, numerous local businesses are interested in building the community and providing resources. Major companies have their own foundations dedicated to assist nonprofits or specific causes.

What are restricted grants?

Restricted grants refer to contributions and donations that arrive with strings attached.

These restrictions can determine for what purpose the money can be spent, by when it can be used, or whether matching grants are required to make the funds available.

What is one of the most common misperceptions about fundraising?

One of the most common misperceptions about fundraising is that it is begging.

Fundraising is not begging! Start by dissipating the common belief that asking for money for an important cause is beseeching. No organization is able to function without money. Raising funds is one of the most natural

activities a board member can engage in to show his own enthusiasm about the organization and its programs. Giving money to a cause is equally natural. However, most people do not give unless someone asks them to give.

What do the funders want to know about your board?

More and more funders pay special attention to the governance of the organizations they consider funding. In the eyes of funders a good board adds value to the organization by improving its accountability, demonstrating leadership, and ensuring proper oversight of the funds. In addition to providing a list of your board members, you might do the following:

- Emphasize the diversity and inclusiveness of your board.
- Indicate that your board has a good sense of the mission and direction of the organization.
- Show how board members are personally involved in promoting your organization.
- Demonstrate that the board has chosen a strong chief executive to manage the organization.
- Show how the board and the chief executive form a solid partnership.
- Point out that your board financially supports the organization (e.g., 100 percent of the board's members contribute).
- Have a board member sign a thank-you letter to a major funder.

Should all board members be required to make an annual contribution?

Every board member candidate should be made aware of your organization's policy on personal contribution. Most board members understand how important personal contributions can be to carrying out their fundraising responsibilities. It is difficult to ask for a gift if you yourself have not contributed. Usually board members have differing giving abilities, so a standard gift for all board members is not necessarily appropriate. One option is to establish a minimum gift amount, and be sure that every board member is aware of it, in addition to the responsibility to give in the first place.

What do the nonprofit board acronyms 3 Ds, 3 Gs, 3 Ts, and 3 Ws mean?

Using catch phrases or acronyms makes it easy to remember certain principles or guidelines. Here are a few that will remind board members what their organization expects of them.

3 Ds refer to the legal obligations of board members. They are the duty of care, duty of obedience, and duty of loyalty. These duties require that a good board member makes prudent decisions, respects laws and the organization's legal documents, and puts the interests of the organization above personal interests.

3 Gs mean give, get, or get off. Many boards expect their members to bring in money by making a personal contribution or participating in fundraising, or both. If a board member does none of these, he or she may be asked to leave.

3 Ts and 3 Ws take a more holistic approach to board service. The Ts refer to treasure, time, and talent, and the Ws refer to wealth, work, and wisdom. Besides participating in securing finances (treasure and wealth), board members are expected to participate in activities (time and work), and contribute their knowledge and expertise (talent and wisdom.)

What is a case statement?

It is probably easier to first define what a case statement is not. It is not an annual report, a grant proposal, a list of the organization's financial needs, or the history of a nonprofit.

A case statement is a document that provides the rationale and justification of a fundraising effort. It can make a case for a specific program or project, or it can advocate for general operating support. It focuses on a dilemma that needs to be fixed and explains the organization's proposed resolution.

A well-structured case statement is the key document to any grant proposal or a capital campaign.

What is a Donor Bill of Rights?

A Donor Bill of Rights is a set of standards created by a group of professional fundraising societies for nonprofits to generate confidence between donors and donees. Board members of nonprofits should embrace these fundraising standards and make certain that the development staff of their organization is familiar with the Donor Bill of Rights.

A Donor Bill of Rights helps leaders understand donor expectations while bolstering donor confidence. It also outlines the donor's right to receive proper recognition, gain access to the organization's financial statements, obtain information on how funds are being distributed, and stay anonymous if desired.

A full text is available at www.afpnet.org/ethics/enforcementdetail.cfm?itemnumber=3359.

How can we appropriately recognize a major donor?

Thanking the donors to a nonprofit organization is naturally one of the most important tasks during a fundraising campaign. It is also one of the most effective ways of cultivating donor loyalty. Here are ways to show appreciation after receiving a major gift:

- Hand-deliver a plaque or a certificate to the donor.
- Designate a special wall of the office or lobby to recognize major donors.
- Dedicate your conference room, your library, or other fitting area to a major donor (with a ceremony, reception, and a plaque).
- If you have outside space around your office, dedicate trees to your donors; allow your donors to buy decorative blocks on your walkway (with their names on them).
- Profile your new donors in your newsletter.
- If you arrange conferences or special events, invite your donors and give them a special name tag that identifies them; arrange a reception to honor your donors.
- Send out a press release when a major gift arrives.
- Create various categories of donors (gift clubs) and assign specific benefits to each (newsletters, your publications, tickets to your performances, and special events).
- Invite your donors to serve on your board.

What are the benefits of anonymous giving?

People make charitable contributions for many reasons. These include tax benefits and personal satisfaction for doing good. Some donors prefer giving anonymously, asking the charity to keep their identity a secret.

By remaining an anonymous donor, you can

- shield yourself from constant demands for donations
- keep away 'friends' who are attracted to your wealth
- keep living simply without unwanted or embarrassing recognition
- protect the recipient from potential embarrassment
- focus on the effects of doing good without making yourself the focal point
- keep your involvement and personal interests private

What are the most effective ways to ask for donations?

Most fundraisers agree on a particular hierarchy of effectiveness when it comes to soliciting gifts.
When it comes to how to ask for donations, it is not a surprise that the more personal the contact is, the more positive the results are.
The methods, from most effective to least effective, are

- personal: face to face
- personal letter on personal stationery
- personal telephone call
- personalized letter
- direct mail
- phonathon (impersonal)
- special event
- door to door
- media advertising

What should be included on a charitable donation receipt?

The IRS has not created a standard format for contribution receipts, but the following information must be included:

- The donor's name
- The amount of money or a description of the item donated
- A statement indicating whether or not any goods or services were provided in return for the gift; receipts from religious organizations must include a statement indicating that "intangible religious benefits" were provided but they have no monetary value for tax purposes
- A good-faith estimate of the value of goods or services provided in return; insubstantial values need not be recorded

The receipt can be a letter, a postcard, an e-mail message, or a form created for the purpose. Any donations worth $250 or more must be recognized with a receipt. The charity receiving this donation must automatically provide the donor with a receipt.

Should we send a thank-you letter even if our proposal is rejected?

Most large foundations do not expect to receive a thank-you letter if you are part of the rejected group. Your letter would simply increase the volume of mail to be opened each day. Some small foundations might not mind hearing from you if you express your appreciation for being considered as a candidate and you seek an opportunity to keep the contact alive.

Under certain circumstances (always subject to your judgment of "What is appropriate in this situation?") you might use the opportunity to ask questions if the rejection letter was not clear enough. Ask what was missing from your application. How can you be a more valuable partner with the foundation? Is the foundation interested in hearing from you in the future?

Where can I find an accountant who works with nonprofit organizations?

The AICPA (www.aicpa.org/Pages/Default.aspx) can provide references for nonprofit proficient CPAs. It is the professional association for accountants.

References

Charitable Contributions, IRS Publication 526
http://www.irs.gov/pub/irs-pdf/p526.pdf

Ten Basic Responsibilities of Nonprofit Boards
Fundraising Responsibilities of Nonprofit Boards
Fearless Fundraising for Nonprofit Boards
Financial Committees
Who's Minding the Money?
Nonprofit Executive Compensation: Planning, Performance, and Pay
Legal Responsibilities of Nonprofit Boards
Financial Responsibilities of Nonprofit Boards
Managing Conflicts of Interest: The Board's Guide to Unbiased Decision Making

All available at www.boardsource.org or by calling 202-349-2500.