Financial Management of Not-for-Profit Organizations

Introduction

Financial management of not-for-profits is similar to financial management in the commercial sector in many respects; however, certain key differences shift the focus of a not-for-profit financial manager. A for-profit enterprise focuses on profitability and maximizing shareholder value. A not-for-profit organization's primary goal is not to increase shareholder value; rather it is to provide some socially desirable need on an ongoing basis. A not-for-profit generally lacks the financial flexibility of a commercial enterprise because it depends on resource providers that are not engaging in an exchange transaction. The resources provided are directed towards providing goods or services to a client other than the actual resource provider. Thus the not-for-profit must demonstrate its stewardship of donated resources — money donated for a specific purpose must be used for that purpose. That purpose is either specified by the donor or implied in the not-for-profit's stated mission. The management and reporting activities of a not-for-profit must emphasize stewardship for these donated resources. The staff must be able to demonstrate that the dollars were used as directed by the donor. The shift to an emphasis in external financial reports on donor restriction has made the use of fund accounting systems even more critical.

Budgeting and cash management are two areas of financial management that are extremely important exercises for not-for-profit organizations. The organization must pay close attention to whether it has enough cash reserves to continue to provide services to its clientele. Cash flow can be extremely challenging to predict, because an organization relies on revenue from resource providers that do not expect to receive the service provided. In fact, an increase in demand for a not-for-profit's services can lead to a management crisis. It is difficult to forecast contribution revenue in a reliable manner from year to year. For that reason, the control of expenses is an area of increased emphasis. Budgeting therefore becomes a critical activity for a not-for-profit.

Budgets

Budgets are the organization's operating plan for a fiscal period. They express, in monetary terms, the board's and staff's decisions regarding how the organization will fulfill its stated purpose. The board

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and staff decide what programs will be undertaken for the upcoming fiscal year. The staff then allocates resources to ensure that those programs are delivered. The budget charts a direction for allocating and maximizing the use of resources. Ideally it also identifies any financial problems that could arise in the coming year. In addition, the budget should provide indicators for gauging staff performance and give staff goals to reach and steps to achieve them. Methodical tracking and classification of program expenditures enhance management's ability to report on service efforts and accomplishments.

The budget, once adopted, should be used by the staff as a management tool to gauge operational performance. An effective budget should establish criteria that would signal management if a change is needed or if a course of action should be refined or altered.

Budget planning issues

The scope and size of a not-for-profit's programs and asset base dictate the complexity of its budgets. In its most complete form, a budget is a compilation of the plans and objectives of management that covers all phases of operations for a specific period of time. If a goal of an organization is to build working capital, it might want to project a budget imbalance of revenues over expenses. However, building too much of a surplus too aggressively might indicate to users of financial statements that the organization is not effectively carrying out its stated purpose. Program priorities should be balanced in an effective budget. The not-for-profit's management must allocate its capabilities and resources to impact the maximum number of the intended audience or beneficiaries. Not-for-profit organizations that charge for their services might not be able to easily increase their prices for their programs.

Lead-time for grant requests and multiyear programs must be factored into the budgetary planning process. The financial manager of a not-for-profit must prepare the budget to ensure adequate funds for programs slated to be run over a period of time longer than the average budget cycle. The budget, once adopted, should be used by the staff as a management tool to gauge operational performance. An effective budget should establish criteria that would signal management if a change is needed or if a course of action should be refined or altered. A budget that is updated for new situations enhances its value as a monitoring system. As unforeseen conditions arise, the budget should be tailored to respond to those conditions. Staff and management accountability is an aspect of budgeting; responsibility should be associated with those that are actually capable of realizing the goals. Without active awareness and participation of those carrying out the organizational mission, a budget's usefulness is diminished.

Zero-Based versus Incremental budgeting

Zero-based budgeting incorporates the planning process for setting organizational objectives as part of the budgeting process. An organization starts from zero by assuming that no program is necessary and that no money need be spent. Programs that will be continued have to be proven worthy as well as fiscally sound every fiscal year. Zero-based budgeting involves an orderly evaluation of all elements of revenue and expense. Each program must be examined to justify its existence as well as its effectiveness as compared to alternative programs. Programmatic priorities should be established. Each cost center should be challenged to prove its necessity. Each cost center's contribution to the overall organizational objective should be measured. Goals and objectives should be clear as well as quantitatively measurable.

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Incremental budgeting treats existing programs and departments as pre-approved, subject only to increases or decreases in financial resources allocated. A not-for-profit's historical costs are the usual base from which budget planning starts. The focus is on the changes anticipated over or under last year's numbers. The planning process is considered complete and program priorities as established. The organization must decide whether its budget is to be based on measurable and predictable statistics or only on good guesses.

Types of Budgets

The basic budget is a comprehensive look at the entire organization's overall projection of the revenues or financial support and its expected expenditures. Specialized or supplemental budgets can provide a specific focus on fragments of financial activity germane to individual programs or revenue centers. An example of a supplementary budget is the quantification of membership goals for a given year. This portion of a budget guides the business office's cash flow projections as well as the development office's annual goals and objectives for fund-raising activities. The program department might be affected throughout the year as membership projections are matched up with the actual membership numbers.

Useful potential budget reports include:

- Annual, quarterly or monthly projections of income and expenses for the entire organization as well as of each of its divisions, departments, and branches
- Revenue projections by type — contributions, tuition, fees for services
- Individual project, department, branch or other cost center projections
- Service delivery costs by patient, student, member or client; potential capital additions — building or equipment acquisition
- Cash flow — short and long term
- Historic and projected fund-raising event revenue and expense
- Book store, pharmacy or resale shop sales if applicable
- Staffing models

A thoroughly planned and implemented budget enhances the likelihood that a not-for-profit will be financially successful. A comprehensive budget is a tool that translates abstract goals into controllable parts. It stipulates performance goals for the upcoming year. The planning and preparation process leading to a budget forces the organization to set priorities and to narrow its choices. A budget can facilitate coordination and cooperation between the various programs and financial departments. Periodic budget comparison to actual financial performance can reveal problems and should allow the board and staff to respond quickly to changing financial conditions. The budget provides a measurement of financial performance in relation to the not-for-profit's expectations; it guides financial decision-making over the course of a fiscal year. There is a natural tendency to emphasize cost control because of uncertainty, and the presence of such controls can

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stifle creative responses to a change in demand for an organization's services. The board and senior staff should provide leadership as to the usefulness and flexibility of the budget. The budgeting process and the subsequent use of the budget as a touch point for financial performance should not overshadow the ability of an organization to respond to the pace of rapid societal change.

The master budget coordinates all of the financial projections in the organization's individual budgets in a single organization-wide set of budgets for a set time period. It encompasses both operating decisions and financing decisions. Operating decisions focus on the acquisition and use of scarce resources. Financing decisions focus on how to get the funds to acquire resources. The use of rolling budgets ensures that a plan is always available for a specified future time period by adding a month, quarter or a year in the future as the month, quarter or year just ended is dropped. A rolling budget continually forces management to think concretely about the coming 12 months regardless of the month at hand.

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Steps in preparing a budget

The revenue budget is generally the starting point in a budget planning process because program delivery will depend on the forecasted level of revenue. The second step is program or project budget — how much should be offered to support the estimated level of service revenue. Fund-raising goals will also determine programmatic service levels because service revenues alone will not necessarily finance all program offerings. How much money the development office plans to raise over the fiscal year will determine the extent of current and future program offerings.

Capital Budgets

Capital budgeting is the process of making long-term planning decisions for investments. Poor long-term decisions can affect the future stability of an organization because it is often difficult to recover money tied up in bad investments. Good long-term decisions help an organization to extend its reach into the community and to expand the services it provides.

The six stages of capital budgeting include identification, search, information acquisition, selection, financing, and implementation and control. The identification stage involves distinguishing which types of capital expenditure projects are necessary to accomplish organizational objectives. The search stage explores several alternative capital expenditure investments that will achieve organizational goals. The information acquisition stage considers the predicted costs and consequences of alternative capital investments. In the selection stage, projects are chosen for implementation.

There are several methods that can be used for the selection process. The discounted cash flow method measures cash inflows and outflows of a project as if they occurred at a single moment in time. This method recognizes the time value of money by discounting the future cash flows back to the proposed date of capital investment. Then the initial cash outlay — measured in today's dollars — is compared to tomorrow's inflows of cash — also measured in today's dollars. Thus the measurement compares apples

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to apples.

The net present value method uses the required rate of return that is the organization's minimum acceptable rate of return on an investment. It is the interest rate organizations could expect to receive elsewhere for the same level of risk. The present values of the cash inflows and outflows are calculated at the organization's cost of capital. These values are then summed to determine the project's net present value. If the value is positive, the project should be accepted. If an organization is considering more than one capital investment, the projects with the highest net present value should be chosen.

The third option is to measure the internal rate of return. The internal rate of return is the discount rate at which the present value of the cash inflows equals the present value of the cash outflows on a particular project. The internal rate of return is that discount rate that makes the net present value equal zero. The three calculations — the discounted cash flows, the net present value and the internal rate of return — tell an organization something slightly different about the proposed capital investment. When evaluating such an investment, all three methods should be used on each alternative investment. The organization should select the investment that provides the greatest rate of return across all of the measurements.

Project funding is obtained in the financing stage. Sources of funding can be internally generated cash or through debt from the capital markets. The implementation and control stage puts the project in motion and provides for ongoing monitoring of investment performance.

Asset Management

A not-for-profit's resources or assets are best managed from the going concern perspective, which assumes no limitation on the organization's future existence. Management must be sure that the organization has sufficient liquid assets available to finance current operations. The goal is to maintain an optimum balance between available assets and invested or growing assets. Operating in a fiscally solvent fashion means that the organization must be able to pay its debts in a timely manner and meet other financial responsibilities. After the budget is developed, the not-for-profit must focus on smoothly financing current operations by making the most efficient use of current or liquid funds, and by maximizing available and obtainable resources to enhance return on the resources or capital. Maximizing resources involves analyzing the costs and benefits of various sources of not-for-profit revenues. Two possible sources of income are business income and planned gifts. Business income earned by a not-for-profit must be segregated between that earned in pursuit of its mission and that from activity undertaken simply to make money.

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Cash flow planning

Cash is a vital resource for a not-for-profit organization. To maintain financial viability, the organization must have enough cash to pay its bills. Accrual basis financial statements can report an excess of revenues over expenses but this does not necessarily mean that there is cash in the bank. Cyclical and

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seasonal fluctuations also have an impact on an organization's cash. Cash inflows and outflows for most not-for-profits typically fluctuate throughout the year. This increases the importance of the budgeting process because obligations must be met on a timely and consistent basis. The organization must plan ahead for those periods when cash inflow tends to be less than cash outflows. Postponing expenditures or accelerating constituent billings are two options for solving the problem.

The total return concept is a relatively new concept in endowment management. Any appreciation in asset value used to be treated as an addition to principal; it is now thought of as income.

Once the annual operating and capital budgets are authorized, they can be converted into cash flow budgets to verify the availability of resources and to highlight times of lower than expected cash flow. The process includes estimating when collections on year-end receivables will occur; calculating the normal time lag between invoicing or billing for services or pledges and the actual receipt of cash; and charting the expected expenditure of cash according to the month payment is due. Then factor in the expected capital expenditures, sales of assets, borrowing, debt repayment and other financing transactions. A model cash flow budget reflects a policy decision to maintain a minimum cash level. Organizations need to plan from day one to build working capital reserves equivalent to at least several months of operating expense. When excess cash reserves have accumulated, the organization must plan for temporary cash investments to maximize the return on those resources. As much money as possible should be kept in federally insured, interest bearing accounts to maximize an organization's yield on its cash. Short term investments of excess cash should be chosen to balance maximization of interest earned with emergency access to the invested cash. Some options are certificates of deposit, treasury bills, and money market accounts.

Once cash reserves exceed the amount needed for one operating cycle, longer-term investments need to be evaluated. Investment policies must weigh the permissible level of risk to the organization's resources in relation to expected returns. Any equity or debt investments chosen will depend on the board's written investment policy. If the not-for-profit is a trustee on a charitable remainder trust, then it is under a duty to the ultimate beneficiary to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements and any other circumstances of the trust.

Under common law, the not-for-profit owes a fiduciary duty to its contributors and grantors to use gifts for the purposes for which the funds are given. A mechanism for tracking donated money and its use must be in place. Many organizations achieve this by isolating restricted gifts. There can be additional accounting expense associated with a restricted gift. Grant expenditures often require very specialized reporting to granting agencies.

Endowment Management

Not-for-profit managers and board members face numerous questions when making endowment management decisions. How many years must the endowment remain restricted? Can the funds be used for another purpose in a time of crisis? Are realized gains treated as current income? Is the endowment principal defined as its original sum or is it the original sum plus all appreciations less declines in underlying values? Do the original endowment creators wish the original asset to be retained? Can it be

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sold? If sold for cash, is there any restraint on the way the cash may be reinvested? Must it be offered to a particular person first before the not-for-profit can sell the original asset?

The total return concept is a relatively new concept in endowment management. Any appreciation in asset value used to be treated as an addition to principal; it is now thought of as income. The Ford Foundation's study of 1969 — "The Law and Lore of Endowment Funds" stated:

"Prudence would call for the retention of sufficient gains to maintain purchasing power in the face of inflation and to guard against potential losses, but, subject to the standard that prudence dictates, the expenditure of gains should lie within the discretion of an institution's directors."

In addition, many states have adopted the Uniform Management of Institutional Funds Act (UMIFA). The act sanctions the inclusion of gains (realized and unrealized) in currently expendable income alongside dividends and interest. Therefore, total return is now reported on the Statement of Activities. The National Association of College and University Business Officers (NACUBO) advocates this policy. The AICPA Auditing Guide for Not-for-profit Organizations provides that the governing board may make a portion of realized, and in some cases unrealized, net gains available for current use. The unexpended increase or decrease in value (appreciation) of the securities remaining in the investment portfolio is reported as temporarily restricted funds under Financial Accounting Standard 117.

The Use of Fund Accounting

Fund accounting is a method for recording resources whose use may be limited by donors, granting agencies, governing boards, or other individuals or entities or by law. Each fund consists of a self–balancing set of asset, liability, net asset, revenue and expense accounts. Fund balances or net assets should be classified on the statement of financial position as unrestricted, temporarily restricted and permanently restricted net assets based on the existence and type of donor-imposed restrictions. Using a fund accounting system allows an organization to segregate financial resources between those dollars immediately available for ongoing operations and those dollars intended for a donor specified use. In addition, a fund accounting system provides an audit trail as the dollars are spent for their intended purpose and thereby released from the restriction.

Receivables and payables between fund groups are not organizational assets or liabilities. A statement of financial position must clearly label and arrange those interfund items to eliminate their amounts when displaying total assets or liabilities. For external reporting purposes, a fund balance may have to be divided among more than one net asset class.

Operating Fund

Also known as the unrestricted current fund, this fund is used to record organizational activity that is supported by resources over which governing boards have discretionary control. The principal sources

Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the organization's governing board for the purchase, renewal or replacement of property and equipment should be classified as unrestricted net assets.

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of unrestricted current funds are unrestricted contributions from donors; exchange transactions with members, clients, students, customers and others; and unrestricted investment income. Resources are used to help meet the costs of providing the organization's programs and supporting services.

Restricted Current (Restricted Operating or Specific Purpose) Funds

These fund types are used to record organizational activities that are supported by resources whose use is limited by external parties to specific operating purposes. Principal sources of restricted current funds are contributions from donors; contracts; grants and appropriations; endowment income; and other sources whose resource providers have stipulated the specific operating purpose for which the resources are to be used. Fund balances of current restricted current funds represent net assets held for specified operating activities that have not yet been used. A portion of the fund balance that represents amounts contributed with donor-imposed restrictions should be classified as temporarily restricted net assets. Fund balances representing amounts received with limitations other than donor imposed restrictions, such as contractual limitations, should be classified as unrestricted net assets. Any portion of the fund balance that represents an unearned revenue resulting from an exchange transaction should be reported as a liability.

Plant (Land, Building, and Equipment) Funds

Some not-for-profit organizations record plant and equipment (and resources held to acquire them) in a plant fund or funds. A plant fund may be a single group of accounts or may be subdivided into some or all of the following sub fund account groups: unexpended plant funds, funds for renewal and replacement, funds for retirement of indebtedness and investment (or Net investment) in plant funds. Unexpended plant fund balances and renewals and replacement fund balances represent net assets that have not yet been used to acquire, renew or replace plant and equipment. Retirement of indebtedness fund balances represent net assets held to service debt related to the acquisition or construction of plant and equipment. Any portion of those fund balances that represents amounts received with donor imposed restrictions should be classified in the Statement of Financial Position as temporarily or permanently restricted net assets depending on the nature of the restriction.

Other fund balances, including those arising under agreements with trustees under bond indentures and those designated by the organization's governing board for the purchase, renewal or replacement of property and equipment should be classified as unrestricted net assets. Unless the organization has a formal policy for recognizing an implied time restriction on long-lived assets, these designated resources would be classified as temporarily restricted net assets.

Investment-in-plant fund balances represent assets invested in plant and equipment less any liabilities related to those assets. These fund balances should be classified as permanently restricted net assets to the extent that donors have imposed restrictions that neither expire by the passage of time nor can be fulfilled nor removed by actions of the organization, or the proceeds from the ultimate sale or disposal

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of contributed assets must be reinvested in perpetuity. Amounts representing property and equipment acquired with unrestricted resources or with resources whose use is limited by parties other than donors should be classified as unrestricted net assets.

Loan Funds

Some not-for-profit organizations use loan funds to account for loans made to students, employees and other constituents and those resources available for loan purposes. The assets initially made available for the loans may be provided by donors or various governmental and other granting agencies or designated by governing boards. Fund balances of loan funds represent net assets available for lending. They should be classified as temporarily or permanently restricted if they carry donor-imposed restrictions. They are classified as unrestricted if they are board designated. Any portion that represents a refundable advance, such as under a governmental loan program, should be classified as a liability.

Some not-for-profit organizations use loan funds to account for loans made to students, employees and other constituents and those resources available for loan purposes.

Endowment Funds

There are generally three kinds of endowment. A permanent endowment refers to amounts that have been contributed with donor-specified restrictions that the principal be invested in perpetuity; donors may also restrict the income from these investments. A term endowment is similar to permanent endowment, except that at some future time or upon the occurrence of some specified future event, the resources originally contributed become available for unrestricted or purpose-restricted use by the entity. Quasi-endowment is a term for resources designated by an entity's governing board to be retained and invested for specified purposes for a long but unspecified period.

Fund balances of endowment funds represent net assets for which various limitations exist on the resources invested and, in some cases, on the income generated by those resources. Fund balances that represent term endowments for which the principal must be maintained for a specific period or must be used at the end of the term for a specified purpose should be classified as temporarily restricted net assets. Fund balances that represent quasi-endowments or other amounts designated by the organization's governing board should be classified as unrestricted net assets unless donor imposed restrictions are imposed on their use.

Annuity and Life-Income (Split Interest) Funds

Annuity and life income funds may be used to account for resources provided by donors under various kinds of agreements in which the organization has a beneficial interest in the resources but is not the sole beneficiary. Examples include charitable remainder and lead trusts; charitable gift annuities, and pooled life income funds. Fund balances of these funds represent a not-for-profit's beneficial interest in the resources contributed by donors under split interest agreements. If any of these resources will become part of the permanent endowment when the agreement terminates, they should be classified as permanently restricted net assets.

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Agency or Custodian Funds

Agency or custodian funds are used to account for resources held by the not-for-profit organization as an agent for resource providers before those resources are transferred to third-party recipients specified by the resource providers. The not-for-profit entity has little or no discretion over the use of these resources. Assets always equal liabilities in agency funds. No net assets are reported.

Summary

The budgeting process and the ongoing management of cash and other assets are two critical areas of focus for not-for-profit financial managers. This focus is dictated by the overarching stewardship obligations of a charitable organization that receives money from the public to meet a perceived societal need. Fund accounting is a method that assists the organization in segregating donated money by time and purpose restriction as stated by external resource providers — donors, granting organizations and governmental entities. Fund accounting systems today can be set up to mimic either traditional fund accounting principles or to categorize transactions along FAS 117 reporting lines. It is a challenge for a for-profit commercial system to track the flows of money between funds as time and purpose restrictions are met. Either way, the management of a not-for-profit using a fund accounting system should consider two things: the reporting needs of day-to-day financial management and the ability to effectively demonstrate stewardship of donated resources.

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