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Nonprofit Financial Setup

Scope of Program

This program will teach you:

- Financial first steps needed to set up the new, small nonprofit, and
- Basic information to facilitate looking ahead to the next year or two in the nonprofit's development.

Disclaimer: Linnea is not an accountant! Consult an accountant for help with your specific organizational situation.

Potential Risks

Lack of care in setting up the nonprofit's financial systems and procedures at the outset can lead to a multitude of expensive problems in the future:

- Fraud
- Theft, embezzlement
- Scams
- Insidious/pernicious loss of the nonprofit's assets over time, resulting in poor cash flow, no reserves for contingencies, and ultimate collapse.

Board Members' Role

Fiduciary Duty of Care

Board members' Duty of Care requires them to attend to the finances of the nonprofit.

- Ensure adequate resources for the nonprofit, now and for the future;
- Steward the nonprofit's assets to ensure their availability to support the mission.

Board Members' Role

In practical terms, the fiduciary duty of care requires board members to know financial details:

- Budget
- Sources of income
- Largest expenses
- Size of reserve fund
- Financial risks

The rest of the cast

- Treasurer, bookkeeper, accountant
  - Should not all be same person!
  - Treasurer is board member, with oversight responsibility.
  - Bookkeeper is operational, may be staff or contracted out.
  - Accountant, independent professional. May have accountant on Board, but if so, should not do review or audit.

Start-up Tasks

Incorporation requires initial steps, for inclusion in Articles of Organization:

1. Establishing Nonprofit's name & purpose;
2. Naming the founding Board members;
3. Establishing the principal office location;
4. Adopting bylaws;
5. Setting the Fiscal Year ("FY").

Start-up Tasks

Consent in lieu of Initial Meeting

The Consent ensures that formation is complete by:

- Acknowledging the filed Articles of Organization;
- Electing Directors & Officers;
- Ratifying selection of principal office location & mailing address;
- Adopting bylaws; and
- Authorizing opening of the bank account at a certain bank and appointing the signatories.

A Consent signed by all Directors allows these formalities to be handled without an actual in-person meeting.

Fiscal Year

The Fiscal Year (FY) is "a discrete time period used by an organization to account for its operations"* usually 12 months. Also known as the "tax year" or "accounting period".

- Calendar year most common;
- Should encompass a full cycle of operations.

*Source: Scot, *The Simplified Guide to Not-for-Profit Accounting, Formation, & Reporting* (see Resources).

Fiscal Year

To set, consider:

- Should ORG tie its FY to another entity's FY? For example, if ORG will rely on govt grants, can set FY in accord with govt FY.
- ORG's cycle; when is it most/least active? Do not want to close books in midst of heavy financial activity.

FY is not set in stone, can be changed if necessary, but cumbersome to do so.

EIN

EIN is the *employer identification number* assigned by IRS upon application by ORG; it is strictly an identifier. ORG must have EIN if:

- Banking;
- ORG will have employees;
- ORG will apply for tax-exempt status;
- ORG changes entity form; new EIN is required.

EIN is NOT a "tax-exempt number"!

EIN

EIN is obtained by applying to IRS

- Electronically via online application. This is quickest; receive number immediately in pdf.
- By fax;
- By postal mail using SS-4
- To apply online, go to www.irs.gov and, under Tools menu, choose "Apply for EIN online".

Corporate Bank Account

Once the corporation is formed and EIN obtained, next major step is opening the corporate bank account. Choose ORG's bank carefully!

- Many banks offer reduced or no fees to nonprofit organizations.

To open corporate account, bring to bank:

- Articles of Organization;
- EIN (*never* use a personal SSN);
- Resolution of Board (Secretary prepares certificate, based on Consent) but Bank may have its own resolution; be sure to read!

Corporate Bank Account

Signatories

Generally, law provides for President & Treasurer, as agents of the corporation, to be signatories; however, the Board can authorize others as well.

- Executive Director is usually a board-authorized signatory (with constraints).
- Do not have too many signatories.
- If signatory drops out, be sure to remove quickly from bank's record; bank may require Board resolution.

Corporate Bank Account

Follow basic rules to protect corporate status:

- Use EIN for corporate account.
- Use full corporate name as shown on Articles of Organization for corporate account.
- Never use corporate account for personal expenses.

Corporate Bank Account

Initial account is usually a checking account; show on checks:

- Corporate name
- Principal office address
- One or two signature lines. But NOTE, banks will not generally honor ORG's two-signature requirement! (That is ORG's policy, not Bank's.)

Corporate Bank Account

Maintain some type of check register & be clear about whose responsibility it is. At start-up (while accounts are simple), options are:

- **Old-fashioned paper & pencil**;
- **Excel** or other spreadsheet software– avoids math issues, but must be sure formulas are correct!
- **Quicken** – does it all (register + reconcile), easy to learn & use, but more oriented to home finance.
- **QuickBooks** – best for business & nonprofits, but may be too much at outset; expensive, requires training.

Whatever method, best to track according to reporting requirements, especially if no bookkeeper or accountant involved.

Corporate Bank Account

Always ***reconcile*** corporate account promptly!

Reconciliation is "the matching or comparing the details of two or more written statements, reports or listings, and identifying all differences."*

Reconciliation:

- Detects errors;
- Exposes uncollected, lost, or stolen funds, and unpaid bills;
- Prevents misreported financial activity.

*Source: Scot, *The Simplified Guide to Not-for-Profit Accounting, Formation, & Reporting* (see Resources)

Role of Treasurer

Treasurer:

- Statutory agent of corporation & overseer of finances:
  - May select the corporate bank, sign checks;
  - Knowledgeable about transactions, access to corporate accts
  - Ensures systems & procedures in place to manage funds
  - Stays abreast of financial issues and trends.
- Reports to Board regarding ORG's financial picture;
- Ensures annual financial reports to state/fed agencies filed timely;
- Develops budget or leads budget development;
- Chairs Finance Committee (if any).

In new/small nonprofit, may have greater hands-on responsibilities.

Role of Treasurer

When choosing a treasurer, seek a person with:

- Financial literacy, but not necessarily an accountant or bookkeeper;
- Attention to detail, strong record-keeping skills;
- Punctuality;
- Assertiveness, willingness to ask tough questions, question assumptions.

Financial Reports

Financial reports should be presented to the Board of Directors at every meeting; quarterly at minimum.

Since most new/small nonprofits are on a cash basis, simple report might look like this:

Financial Reports

Starting Balance 7/1/13	**$1,000**
<u>Income</u>	
Gifts	$ 150
Grants	$ 2,000
Program Fees	$ 100
Other	$ 33
TOTAL Income	**$ 2,283**
<u>Expenses</u>	
Rent & Utilities	$ 570
Insurance	$ 200
Office supplies	$ 32
Postage	$ 46
Telephone & Internet	$ 72
Program supplies	$ 140
TOTAL Expenses	**$ 1,060**
Ending Balance 7/31/13	**$2,223**

(rounded – unaudited)

At its most basic!

A + B – C = D

Where A = Starting Balance
B = Total Income
C = Total Expenses
D = Ending Balance

Ending Balance should equal checking acct balance on date shown.

Types of Financial Reports

- **Balance Sheet**—snapshot of ORG's financial situation showing what ORG owns, what ORG owes, and what ORG is worth.
- **Statement of Activities** (aka P&L, profit & loss, operating statement, revenue & expense statement)—"bottom line" shows net income or net assets.
- **Cash Flow Projection**—Cash expected in, cash expected to flow out; highlights trouble spots over time.
- **Budget Comparison**—tracks actual income & expense against budget.

Books listed in Resources offer sample reports, or check with your accountant.

Internal Controls

Internal controls refers to various safeguards put in place to secure organizational assets. A basic internal control system includes:

- Climate of control;
- Segregation of duties; and
- Clearly communicated policies & procedures.

Internal Controls

Climate of control results when organizational culture underscores the value of control; for example:

- Staff doesn’t put personal mail in stack to go through ORG’s postage meter;
- Petty cash is religiously documented with receipts;
- Physical controls protect petty cash, passwords, credit card numbers, etc.

Internal Controls

Segregation of duties divides up responsibilities and tasks among several people, to ensure a system of preventive checks and ensuring no one person has total financial control.

- Challenging in the one-person shop, requiring some hands-on involvement from Treasurer.
- When two or more staff are available, divide duties, and Treasurer has oversight.

Internal Controls

Simple process for one-person shop with assist from Treasurer:

1. Staff person handles receiving and writing checks, making deposits, etc.
2. Staff person provides check register to Treasurer; bank statement is mailed to Treasurer.
3. Treasurer reconciles account.

Internal Controls

If no staff, divide tasks among two or three board members:

1. Board member A prepares checks to pay bills and records payments; maintains spreadsheet or register.
2. Board member B signs checks and makes deposits.
3. Board member C (Treasurer) receives bank statement direct from bank & register from A, performs reconcile, and reports to Board.

If two or more staff, A & B become staff roles, where A is bookkeeper, B is Exec Dir, and C is Treasurer.

Internal Controls

Clearly communicated ***policies and procedures***:

- Board develops policies & procedures to govern financial activities.
- Policies and procedures are written, reviewed regularly, and all board and staff are trained on them; includes requirements for:
  - Consistent record-keeping;
  - Regular reporting.

Financial Policy

Financial Policy should include at a minimum:

- Who signatories are;
- When second signature on a check is required;
- Who authorizes expenditures, and at what levels;
- Staff & Director responsibilities
- Asset protection, including how reserve fund will be developed & maintained;
- How budget will be developed.

Finance Committee

When should the nonprofit establish a Finance Committee?

- Board size consideration: If the Board is small—5 or fewer—not needed; if the Board is larger, cmte useful.
- Organizational complexity: more complex, larger budget (e.g., >$200K+), more useful.

Finance Committee role includes:

- Review of financial reports;
- Explain financials to full board;
- Choose auditor & review audit (if required);
- Developing long-term financial goals, investment strategies, etc.

Finance Cmte should work closely with Development Staff.

Audit

Terminology

- **Compilation**—gathers financial records into standardized, readable format; accountant expresses no opinion on material presented, performs no tests.
- **Review**—records are presented in standardized format, with only simple analysis to determine internal consistency.
- **Audit**—intense examination of books, including testing of transactions.

Audit

Federal and state agencies, as well as grant-makers may specify audit requirements; for example, Massachusetts AGO requirements:

- Total gross revenue < \$200,000, no review or audit required.
- Total gross revenue ≥ \$200,000 but < \$500,000, ORG must file either reviewed financial statements OR audit.
- Total gross revenue > \$500,000, ORG must submit audit.

Audit committee

An Audit Committee is a separate committee from the Finance Committee consisting of independent directors that:

- Selects the independent auditor;
- Interacts with the auditor;
- Receives & reviews audit report;
- Presents audit report to Board.

Small organizations generally don't need an audit cmte, but those on borderline financial thresholds should have cmte to assess need for audit.

Annual Reports

- Annual Report to Secretary of Commonwealth, due November 1 every year (non-financial).
  - Failure to report for 2 consecutive years may result in revocation of corporate status.
- Annual Report to AGO Nonprofit/Charities Division due 4 ½ months after close of fiscal year.
  - Form PC and attachments (990-EZ or 990);
  - Penalties apply for failure to submit.
- Annual Report to IRS due 5 ½ months after close of fiscal year.
  - Form 990, 990-EZ, or 990-N.
  - Failure to submit 3 consecutive years results in automatic revocation of tax-exempt status.

Budget

- Budgets are planning documents.
  - How much money do we need to do our work well?
- Budgets are policy documents.
  - What do we value?
- Budgets are aspirational documents.
  - Where do we want to go from here?

Budgets

- First budget for many new orgs is developed for IRS Form 1023 Application for Tax-exempt Status, Part IX Finances.
  - Projected, "good faith estimates".
  - IRS evaluates budget adequacy.
- Begin with the cost of doing the work of ORG's mission; work backwards to identify income requirements.
- Be realistic & specific! Do your homework!
- After several months of operations, realistic numbers available, revisit budget.

Budgets

- Begin working on budget 3-4 months before end of fiscal year depending on ORG's size & complexity.
- Who prepares budget?
  - Board or Board committee, if no staff.
  - Staff, if available.
- Present budget to Board for adoption before FY start.
- Compare budget to actual periodically through year; use data for next budget.

Best Practices

Adapted from “Strong Financial Oversight”, principles #21-26, ***Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations***

- Keep complete, current, and accurate financial records.
- Board should receive and review timely reports of the organization’s financial activities.
- Have a qualified, independent financial expert audit or review books annually consistent with ORG’s size and scale of operations.

Best Practices

- Institute policies and procedures to ensure ORG manages and invests its funds responsibly.
- Full board should review and approve the organization's annual budget and monitor actual performance against the budget.
- Should not provide loans (or the equivalent) to directors, officers, or trustees.
- Spend a significant percentage of its annual budget on programs that pursue its mission.

Best Practices

- Budget should provide sufficient resources for effective administration of the organization, and for appropriate fundraising activities.
- Establish clear, written policies for paying or reimbursing expenses incurred by anyone conducting business or traveling on behalf of ORG, including the types of expenses that can be paid for or reimbursed and the documentation required.

Best Practices

- Policies should require that travel on behalf of the organization is to be undertaken in a cost-effective manner.
- Should neither pay for nor reimburse travel expenditures for spouses or others who are accompanying someone conducting ORG's business unless they, too, are conducting such business.

Resources

- Laurence Scot, ***Simplified Guide to Not-for-Profit Accounting, Formation & Reporting***, Wiley & Sons, 2010.
- Andy Robinson & Nancy Wasserman, ***The Board Member's Easier Than You Think Guide to Nonprofit Finances***, Emerson & Church, 2012.
- Thomas A. McLaughlin, ***Streetsmart Financial Basics for Nonprofit Managers***, Wiley & Sons, 2002.
- Panel on the Nonprofit Sector, ***Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations***; panel convened by Independent Sector, October 2007. Available from BoardSource.

Resources

- CompassPoint, ***Nonprofit Fiscal Policies & Procedures: A Template & Guide***, PDF, available at online.
- National Council of Nonprofits, "***Financial Management***", available at http://www.councilofnonprofits.org/resources/financial-management/