Financial Management for Nonprofits: Keys to Success

by

Peter Konrad, Ed.D, CPA
and Alys Novak, MBA
Introduction

Financial Management for Nonprofits: Keys to Success
Chapter 1
Financial Management—Key to Nonprofit Management

- Vital Services Being Provided
- Expectations of Donors
- Clients unable to pay for services
- Cash binds are likely and recurring
Accountability of Nonprofit Managers

- Must keep track of financial resources entrusted to them
- Responsible for prudent use of financial and other resources
- Accountability is an Ethical Expectation
Definitions

- **Nonprofit Organization**
  - Fulfills a public need rather than generate profits

- **Tax-exempt Organization**
  - Usually exempt from paying income taxes on any excess of revenues over expenses for its regular activities
Definitions

Financial Management
- Process of planning, budgeting, organizing, controlling and evaluating

Financial Analysis
- Process of measuring, analyzing and interpreting the financial effect of resource decisions
Definitions

- **Accounting**
  - System of collecting and analyzing an organization's financial data to determine its financial position and operating results.

- **Bookkeeping**
  - The work of recording transactions in an organized fashion so accurate summaries of transactions may be used for Accounting purposes.
Fiscal Roles of Nonprofit Manager

- Ensure efficient timely operation of bookkeeping efforts
- Understand financial information from accounting system for purpose of making proper decisions
  - Preparing and Monitoring Budgets
  - Ensuring cash is available for payroll and taxes
  - Ensuring grant funds are properly spent
  - Preparing accurate reports to stakeholders
Operating Cycle

- Monthly reporting
- Annual reporting
- Fiscal Year-end
Financial Management for Nonprofits:
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Chapter 2
Similarities to Commercial Entities

- Legal Entities
- Legal Operating Instruments
- Size
- Purposes
- Can earn a profit
- Personal Compensation
- Efficient Business Operations
Similarities to Commercial Entities

- Board of Directors
- Staff
- Competition
- Financial Values
- Expectation of Return on Investment
- Tax Payment and Reporting Responsibilities
- Accountability
Differences from Commercial Entities

- Ownership
- Fiduciary Responsibilities
- Legal Definitions Affecting Income
- Fund Accounting
- Tax deductibility of Contribution for Nonprofits
- Donated time and Resources for Nonprofits
Starting a Nonprofit

- Is there a real need to be addressed?
- Is there an existing agency to address need?
- Does a support base exist?
- Incorporation process is detailed and cumbersome.
- Does organizing group have business knowledge, compassion and energy?
- Are societal interests being considered and not self-interests?
Application for Tax-Exemption

- IRS Form 1023 – asks what is/are
  - Funding sources
  - Plan for fund raising
  - Planned activities next 3-5 years
  - Board members
  - Affiliation of board members
  - Financial affiliation with other organizations
Application for Tax-Exemption

- IRS Form 1023 – asks what is/are
  - Assets owned
  - Plans for owning facilities
  - Pricing method
  - Position on lobbying
  - Financial condition
  - Date of incorporation
Governance of Nonprofit Organizations

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Chapter 3
Form of Organization

- Corporation
- Association
- Trust
- Hospital
- University
- Etc.
Articles of Incorporation

- Name
- Mission/Purpose
- A nonprofit organization
- Benefit Members or Clients, not lobbying
- Dissolution – Assets to other nonprofit
- Initial Registered Office
Articles of Incorporation

- Initial Registered Agent
- Initial Directors
- Indemnification Provision
- No Personal Liability for Directors
Bylaws

- Membership
- Board Operations
- Board Meetings
- Committees
- Special Funds
- Conflict of Interest
Bylaws

- Officers
- Indemnification
- Executive Director and other Officers
- Financial Matters
- Amendment Process
Life Cycle of Governance

- Start-up Stage
- Entrepreneurial Stage
- Management Stage
  - Business Like
  - Expanded Staff
  - Larger Budgets
Board Responsibilities

- Hire, Supervise and Evaluate Executive Director
- Approve Policies and Procedures
  - Fiscal Responsibility and Timely and Accurate Reporting
  - Resource Uses for Entity Mission and Donor Restrictions
  - Other
- Participate in Planning Processes
- Actively engage in Fundraising
Board Responsibilities

- Approve Budgets, Monitor Activities and Evaluate Results
- Have Active Committees as needed
- Ensure Continuity of Governing Members
- Endowment Management
  - Establish Investment Policies
  - Investment Committee
Administrative Staff

- Implement Policies and Procedures
- Conduct Day to Day Activities
  - Program Management
  - Fiscal Management
  - Budgeting
  - Evaluation
Administrative Staff

- Coordinate Planning
  - Gather Historical Data
  - Gather Environmental Data
  - Develop Strategic Goals
- Support Board Committees
Budgeting

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Budgeting

Planning for the use of an Organization’s financial resources
Budgeting

- Key step in overall management process
- Used to make decisions about how resources will be allocated to accomplish
  - Mission
  - Goals
  - Objectives
Budgeting

- It is an estimate of the money the organization will earn and spend
  - Usually during a specific period
  - 12 month period used for financial purposes is called a fiscal year
- It is today’s plan for tomorrow’s operations
- It represents the allocation of resources based on the planning process
  - Normally a nonprofit would aim to budget for at least a small surplus
The budget process begins when the annual strategic planning starts.

- The budget is the tool for accomplishing the plan.

- Planning steps include:
  - Board Vision
  - Mission Statement
  - Goals
  - Objectives

- Planning steps feed the long and short range planning cycles.
Budget Steps

- Identify expected revenues before expenses
- Diversify revenue sources
- Match the costs to the revenue budget
- Build the budget on accurate estimates
Budget Steps

- Develop an ongoing budget narrative
- Relate the budget to the strategic plan
- Establish fiscal controls to ensure budget compliance
- Review fiscal performance at specified times and develop new budgets based on gained experience
Budget Preparation Phase

- Usually takes place in the last quarter of a fiscal year
- Includes a written plan of action on how you are going to achieve your goals and objectives
- The revenue side of the work plan may be called the financial development plan
  - It specifies how and why you are seeking the revenue sources
Budget Comparisons

- Budget estimates should be compared to actual expenditures at least monthly.
- Variances to budget are normal:
  - Emergencies do happen
  - Positively approach lessons learned
  - Adjust accordingly
- A flexible budget should be flexible in both revenue and expenditures.
- A fixed budget may result in major adjustments if the comparison shows expenses outpacing income.
Kinds of Budgets

- Revenue Budget – basis for expense budget
- Expense Budget – consumption of resources
- Operating Budget – revenue & expense
- Capital Budget – high cost, long term items
- Line-item Budget – from chart of accounts
- Program Budget – focus is program costs
- Zero Based Budget – starting from scratch
- Cash Flow Budget – cash availability
Financial Statements

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Chapter 5
Purposes of Financial Statements for Nonprofits

- Summary of the organizations financial transactions and financial position
- Used to determine the financial health of the organization
- Used to identify the organizations principal programs and costs
- Used to evaluate the organizations financial ability to carry out its objectives
Characteristics of Financial Statements for Nonprofits

Four variables to consider when dealing with financial statements:

- Format should be easily readable and standardized (in columns and rows, showing cumulative totals).
- The content or level of detail and scope should make it meaningful and useful.
- The frequency – most important that it be prepared using fiscal budget year.
- Distribution – who should receive it, possibly different versions for different audiences.
Comparison of Financial Statements to Budget

- Financial statements can be used to compare actual operations with budget forecasts.
- Budgets are an “estimated financial statement”.
- Budgets report planning forecasts while financial statements report results of actual operations.
Basic Financial Statements

- Balance Sheet
  - Reports the organization's financial position at a point in time
    - Assets – the resources of the organization, what the organization owns.
    - Liabilities – debts of the organization such as accounts payable, mortgages, loans, etc.
    - Net Assets – Fund balance or owners equity
Basic Financial Statements

- Statement of Activity or Income Statement
  - Reports the activity that takes place over time
    - Revenue – the act of earning resources from the delivery of goods or services - for nonprofits the revenue does not have to come directly or indirectly from those receiving the goods or services.
    - Expense – reflect the act of using the resources of the organization while pursuing its purpose.
    - Net income or loss on the income statement results in an identical change in fund balance on the balance sheet from the beginning to the end of the period.
Manager may use income statement to do the following:

- Determine agency’s sources of revenue – percentage earned compared to given or granted.
- Examine how money is spent – percentage used on salaries, fees, rent, consultants, etc.
- Compare previous year to current – have salaries gone up as a percentage of all expenses, etc.
Complete set of financial statements

- Balance sheet
- Income statement
- Statement of functional expenses
- Statement of cash flows
- Footnotes to the financial statements.
Additional Items in a Complete Set of Financial Statements

- **Statement of Functional Expenses** – lists only expenses by functional areas
  - Program – expenses to carry out charitable purpose e.g. salaries
  - Fundraising – all expenses needed to raise funds
  - General Administrative – expenses of necessary administrative functions such as office supplies
- Managers use this information to identify the ratio between these categories and if dollars are being spent on the organization’s mission
Additional Items in a Complete Set of Financial Statements

- Statement of Cash Flows – Cash is an organization’s most critical asset. Statement helps organization assess ability to generate cash to pay its obligations.

- Notes to the Financial Statements – provides supplementary information in greater detail and may include organization, summary of accounting policies and separate explanation of important factors.
Basic Accounting Principles

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Chapter 6
Accounting Standards

- Generally accepted accounting principles (GAAP) are a uniform system for measurement and accounting
  - Controlled by the AICPA and FASB
  - Non-profit Accounting
    - FASB 116
    - FASB 117
CPA Firms

- Set up Systems
- Perform Bookkeeping Function
- Assemble Financial Statements
- Compilation and Review
- Independent Audit
- Prepare Tax Returns
Fund Accounting

- Unrestricted
- Temporarily Restricted
- Permanently Restricted
- Restrictions
  - Established by Donors
Capitalization

- Assets
  - Prepaid Expenses
  - Equipment
  - Fixed Assets
- Cost Basis
- Improvements
Conservatism

- Assets, at cost or value, if lower
- Donations, at fair market value on date received
- Matching of revenues and costs
- Restrictions determine income recognition
Donations

- Pledges, if enforceable are recorded.
- Grants are recorded in full when a contract is signed, unless significant conditions are present.

Significant Conditions -
- Matching Fund Requirement
- Subject to Approval of a Future Development Plan
In-kind Services

Recorded if two conditions are met:

- Services must create or enhance non-financial assets.
- Services must require specialized skills and are performed by persons having such skills and would have typically been purchased.

- Identical amount is expensed
Accrual Accounting

- Record Income when Earned
- Record Expenses when Incurred
- Record Assets and Liabilities when firm commitments are made.
- Matching of Income and Expenses
- Required for GAAP Purposes
Cash Accounting

- Record Income when Received
- Record Expenses when Paid
- Record Assets when Purchased
- Not in accordance with GAAP
Consistency

- Same accounting principles and procedures to be used each accounting period
- No apples-to-oranges
- Disclose accounting changes in financial statements
System Basics

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Chart Of Accounts

- List all of the organizations accounts
- Contains five basic accounts: assets, liabilities, net assets, revenue and expense
- Should do the following:
  - Show present structure and activities
  - Provide flexibility for future changes
  - Enable easy data collection
  - Describe the accounts
  - Facilitate the analysis of financial activities
Double-Entry Bookkeeping

- Traditional System in which each financial transaction affects two accounts
- There must be an equal **debit** for each **credit** and vice versa
  - Common misconception is that credits are always positive and debits are negative
**T Accounts**

- Balances in “T” accounts are normally found in this way:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$XXX</td>
</tr>
<tr>
<td>Liabilities</td>
<td>$XXX</td>
</tr>
<tr>
<td>Net Assets</td>
<td>$XXX</td>
</tr>
<tr>
<td>Revenue</td>
<td>$XXX</td>
</tr>
<tr>
<td>Expense</td>
<td>$XXX</td>
</tr>
</tbody>
</table>
The Process Flow

- Record transactions in journals
  - Journals are Books that record financial transactions, including cash receipts and cash disbursements in chronological order

- Posting journals to ledgers
  - Consolidates similar transactions
  - Summarize all entries from journals to the general ledger

- Make adjustments to fix errors or to note non-cash adjustments
The Process Flow

- **Prepare the Trial Balance**
  - A list of the accounts and the balance as of a given moment of time

- **Prepare the Financial Statements**
  - A statement that shows the net income or loss
  - A balance sheet
  - The profit or loss must be added to or subtracted from the trial balance

- **Closing Process**
  - Brings Income statement balances to zero to start capturing the activity in the next time period
Subsidiary Ledgers

Ledgers that provide information that goes beyond the classic organization of information

Example: keeping an accounts receivable information by client
Managing the Process

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Internal Controls

- Internal Control is a System of Checks and Balances
- Objectives of Internal Controls
  - Provide Reliable Financial Data
  - Safeguard Assets
  - Promote Operational Efficiency
  - Encourage Adherence to Policy
Internal Controls

- Elements of Good Internal Control
  - A defined organizational structure
  - Definitions of Responsibility (job descriptions)
  - Segregation of Duties
  - Reconciliation of Records
  - Budget/Actual Comparisons
  - Periodic Outside Review by Independent Auditors
Managerial Accounting

The process of collecting and analyzing financial data for use internally

- Helps management identify, collect, and interpret costs, and thus, provides information for:
  - Resource allocation: most bang for the buck
  - Decision making: what program to expand or eliminate
  - Performance goal setting: plan vs. reality
  - Planning, budgeting and forecasting: determining future costs
  - Pricing: determining the best prices
Identifying Costs

- A “cost” is the value of resources used to carry out an agency’s objectives
- Does not have to require a new cash outlay, for example depreciation
Collecting Costs

- Cost accounting should provide a method for collecting (classifying) cost into “cost pools”
- Cost pools are a grouping of homogeneous costs
- Varies by the sophistication of the accounting system and the needs of the management
- At a minimum organizations need to classify costs as either direct or indirect
Collecting Costs (Continued)

Direct Cost is an expense that can be identified directly with a cost objective in relation to the benefit received.

- Program
- Fund raising
- Management
- General

Indirect Cost is a cost that is incurred for the general welfare of the organization (ex: accounting and legal costs). Some large organizations split into overhead, and general administrative
Behavior of Costs

Important clue in determining which pool to collect cost in. It can be broken down into three basic patterns: variable, semi-variable, or fixed.

- **Fixed Costs** – do not vary with changes in volume; usually indirect costs
- **Variable Costs** – increase or decrease proportionately with change in volume; usually direct costs
- **Semi-variable** – Change with the volume or activity level, but not proportionately with volume (ex.: phone bill); can be direct or indirect
Allocating Costs

- Critical, but often problematic for most organizations
  - Most direct costs benefit one functional area and direct allocation is the simplest way of recording
  - Organizations with multiple programs may want to collect and allocate costs separately to each program
  - Indirect costs should also be allocated in like fashion
  - Many organizations struggle with fairly allocating costs across multiple programs
**Allocation base**

The result of dividing costs among particular cost objectives in a reasonable, rational manner that reflects the relative benefit received

- It is the most important component of developing a cost allocation system

- Examples of common allocation bases are:
  - Total salary dollars (most common)
  - Total program expense
  - Total square footage
  - Total available working hours
Allocation base (continued)

- Direct and Indirect costs should be spread using an allocation base that:
  - Makes sense
  - Facilitates monthly bookkeeping
  - Is consistent and dependable
  - Provides meaningful data for decisions
  - Is in compliance with rules and regulations
Statement of Functional Expense

Financial report that shows all costs by functional category and the relative percentage of each category to total cost

- It traces expenses and revenue to management and fundraising areas as well as program areas
- Helps determine the actual cost of services
- Allows the board to determine priorities between functional areas
- When allocating and analyzing costs agencies and boards must keep in mind that not all agencies are self-supporting
Salary Allocation

- Particularly important because for most nonprofits, this expense amounts to 60 to 80% of the budget

- It is helpful to ask:
  - How much time is spent by each employee in each program, and in management or fund raising?
  - How does this time relate to salary expense that should be allocated to each functional area?
Salary Allocation (Continued)

- Most common way to track use of time are timesheets designed to track activities and program
- Allocate by type of employee
  - Exempt – total gross wages/hour worked in period
  - Non-exempt – hourly cost x hours spent in each program
- Alternate methods include
  - Percentage of hours
  - Percentage of time
  - Time studies
Unit Cost

- Cost per unit of service = Total program costs / Total number of service units
  - Unit of service could be hours of client service, number of beds, etc. It should be based on what you want to know
  - Total Program Cost is from functional expense statement
Unit Cost (Continued)

- Unit Recovery = Total income for program area / Total units of service for that program
- Unit Support Needed = Unit Cost – Unit Recovery
  - Tells you how much fundraising you need to do
- Decisions can be made with unit cost information because it allows for cost/benefit analysis
Pricing Strategies

- The selling price of a product should be high enough to:
  - Recover its direct costs
  - Recover a fair share of indirect costs
  - Yield a satisfactory profit
Pricing Strategies (Continued)

- **Specific considerations:**
  - Should price be set to break even, make money, or only recover part of cost?
  - Should cost be a barrier to service?
  - Should price take into account such factors as elasticity of demand and consumer’s disposable income?
  - Should pricing of “competitors” be considered?
Pricing Strategies (Continued)

- Break even analysis analyzes if costs = revenue
  - Total cost = Fixed costs + (number of units*variable cost per unit)
  - Revenue = (volume*price) + philanthropic support
  - Break even equation: $X(VC) + FC = X(unit price) + G$
Performance Evaluation

- Using Cost accounting individual cost centers can be evaluated based on service vs. cost
- Board can find out if resources are getting quality service and the most for the dollar
Performance Evaluation

When using data for performance evaluation decisions, watch out for the following games:

- Spend it or lose it
- The shell game
- What’s yours is mine
- Count only what counts
- Creative accounting leads to inadequate data and unethical practice
Other Costs

- Opportunity Cost – Cost of choosing the next best alternative
- Sunk Cost – Cost incurred prior to a decision
- Incremental Cost – Cost incurred for something new or different
- Managerial Accounting is all about knowing your costs intimately and making decisions about them carefully.
Cash-Flow Management

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Chapter 10
Cash Flow Management

Managing the flow of cash into, and out of, an organization
Why is managing Cash Flow so critical for Nonprofits?

- Government payments may be late
- Foundation grants are usually paid in one lump sum
- Many nonprofits experience a "seasonal" demand for program services
- Accounting for time between providing service and receiving payment for service
Cash Flow Analysis

- Should be performed at least once a month
- Analysis should answer:
  - How much do we need?
  - Where is it coming from?
  - When does the money come in from each income source and go out for each resource?
Cash Flow Projection

- A tool that is used to facilitate cash flow analysis
- It is a forecast of all cash received and expended over some future period, ideally 12 months
  - A “roll forward” 12 months (e.g. June to May then July to June, etc.)
- Based on Agency’s Annual Operating and Capital Budgets
- Takes into account Agency’s cash reserves
  - Funds invested in short-term securities, savings, and money market accounts
Cash Flow Projection

- Is dynamic – constantly changing
- Essential tool in the financial decision making process of the Board of Directors and Finance Committee
- Should provide timely information for Agency Leadership to proactively make decisions and provide guidance
Managing Cash Deficits

- Increase or speed up cash inflows
- Decrease and/or slow down cash outflows
- Access additional cash through financing
  - Line of credit
  - Bridge loan
Managing Cash Surpluses

- Cash balances that are not needed in the immediate future should be put to work earning interest

- Factors to consider:
  - The degree of liquidity desired (ability to convert the investment to cash)
  - The return provided by the interest
  - The degree of risk
Analyzing Financial Statements

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Chapter 11
Elements of a Complete Set of Financial Statements

- **Opinion** – The results of the auditor’s examination reported in a letter.

- **1st paragraph** – Statement that auditors have examined balance sheet and related documents but also stating that statements are the responsibility of the audited organization.

- **2nd paragraph** – Notes that audit conducted in accordance to accepted practices on a test basis and also assesses accounting standards used by the agency. Omissions of certain tests are mentioned in this section.
Elements of a Complete Set of Financial Statements

- **3rd paragraph** states that management has made an acceptable choice in the presentation of its financial position, following principles consistent with the Financial Accounting Standards Board or FASB (not necessarily supports the accuracy of all content).

- A **final paragraph** may note additional information accompanying the audited statements.
Elements of a Complete Set of Financial Statements

The outcome of an audit may be:

- **Unqualified opinion**-when financial statements meet all criteria
- **Qualified opinion**-state reasons and concerns for not making an unqualified statement such as “subject to” (what prevents the qualified opinion or “except for” (when principle is not adhered to)
- **No opinion**-usually means the auditors did not do an extensive analysis
- **Adverse opinion**-indicates serious exceptions making the report misleading. Indicates a red flag but very rare.
Balance Sheet: Statement of Position in Time

- Comparison of assets to liabilities
- The selling and buying of assets and price
- Loans taken and paid off
- Reserves available – increasing or decreasing
- Liquidity of assets
- Effectiveness of accounts receivables collection
Income Statement: Statement of Activity Over Time

- Did agency make a surplus?
- Comparison of expenses and revenues to previous years
- Changes in source of revenue
- Comparison of fundraising expenses to operations
- Cost per unit and comparison to previous years
Statement of Cash Flows

- Changes in cash and what added to cash?
Statement of Functional Expense

- Categorizes expenses by function:
  - Administration
  - Fundraising
  - Program

- Helpful to examine ratios and ensure programs are receiving adequate ratio of funds.
Notes to Financial Statements

Provides important explanations of statements and includes information such as:

- Terms of loans listed
- Who owns the agency
- Allowances for bad debts
- How cost of assets are listed
- Lawsuits pending
- Other important information
Letter to Management

- Summary of observations auditors make to management
Tools for Analysis

- Horizontal and Vertical Analysis – comparing year to year and line item to line item
- Ratio Analysis – variations of either horizontal or vertical analysis
- Ratios for Current Viability – current assets/current liabilities – In trouble if less than 1:1 ratio. Higher ratio = safer financial position.
Tools for Analysis

- Ratios for Long-term Financial Health
  - Debt Ratio – total liabilities / total assets
  - Equity Ratio – total liabilities / net assets
Tools for Analysis

- **Efficiency Ratios** – A/R receivables / A/R revenue
- **Support Services Ratios** – admin expenses / total expenses
- **Other** – Cost per client served, contribution ratio, program demand ratio
Investments

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Most nonprofits don’t have investment decisions to make and should not be in the business of investing in stocks.

- Surplus revenue should be placed in certificates of deposit or other forms of fixed income.
- Stocks received as donations should be liquidated immediately.
Investments and the Nonprofit (cont’d)

However:

- Endowments might be an option for some nonprofits
  - Under $1 million—invest in combined funds created for nonprofits
  - Over $1 million—seek investment fund manager
  - With Endowment, establish a percentage of income that will be used for operations—leaving the remainder to continue earning
Investments Options

- Goal: Earn highest rate while protecting hard-earned dollars.
- Short term option: cash
- Long term option: stocks
- *Remember: Identify investments.
Cash on hand is necessary for:

- Transactions: To conduct daily business
- Immediate uncertainties: to cover unexpected circumstances
- Shows the organization is a “safe investment”
  - between 3-6 months of reserves to cover expenses.
Types of Cash

- Checking: Flexible deposit and withdrawals; Protected to a certain limit.
- Money Markets: Minimum deposit required; Limitations on withdrawals.
- Certificates of deposits: Restricted early withdrawals; Higher rates for longer investments.
- Treasury Bills: In $100,000 units; Remain invested for a specific time; High security.
Cash Tools

- Discounts: can be received when paying in cash by some vendors.
- Float: time between payment by check and processing by bank; Has shrunk some.
- Compensating balances: Minimum balance in checking account can result in waiving of bank fees
Fixed Income

- Lending money as opposed to borrowing
- Includes mortgages, corporate and government bonds
- Characterized by:
  - Fixed rate of return
  - Promise to pay the principal (loaned amount)
  - Get paid before owners or shareholders but no management control
Cash vs. Fixed Income

- Cash: can get your deposited back at any time
- Fixed income: must wait until the investment matures
  - Must be sold on the open market
  - May be subject to interest rate fluctuations
Elements of Fixed Income

- Indenture: Agreement of provisions of loan
- Maturity: Date when principal is paid
- Security: Assets pledged in case of default
- Par value: Original stated value
Elements of Fixed Income (cont’d)

- Coupon rate or face rate: interest rate paid by debtor
- Yield or yield to maturity: actual percentage return
- Call provisions: payment before maturity. Allows borrower to borrow at a lower rate to pay existing note.
Elements of Fixed Income (cont’d)

- Tax status: taxable or nontaxable
- Sinking Fund: Allows borrower to set aside funds to pay off the principal
- Convertibility: conversions of bonds into stocks
Types of Bonds

- Corporate debenture-unsecured:
  - Typically:
    - 20 year note
    - Call provision after 10 years
    - Taxable
    - Face rate of 9%
    - Sell at 105 of par value
Types of Bonds

- Government bonds
- Usually nontaxable
- Lower return
- Lower risk
Types of Bonds

Zero-coupon bonds:
- Does not pay interest
- Sells at a deep discount
Types of Bonds

**Treasury notes**
- Government bonds
- Tax-exempt
- Secured by U.S. government
- Low interest payments
Factors to Consider about Bonds

- Risk of default:
  - weak balance sheet = higher risk = high interest

- Bond ratings
  - Defines degree of risk
  - AAA, AA, A, BBB
  - Lower rating = higher interest rate
Junk Bonds

- Rated lower than investment quality
- Yield higher interest rates
- However, generally inappropriate for nonprofit investing
Yield Curve

- Illustrates interest rate and life of bonds
- Steep curve shows concern for the future
- Flat curve shows concern for short-term
- Positive curve is good: long-term rates higher than short-term rates
Equity

- Business Ownership
- Entitlement to share of profits—dividends
- Have a say in management
- Ownership interest can fluctuate
Other Types of Investments

- Real Estate
  - Can serve as inflation hedge
  - Adds diversity to portfolio
  - Can generate income and appreciate in value
Other Types of Investments

- Investments in foreign companies
  - Offers diversity in investments
  - U.S. is only a small part of the world market

However:

- Dollar rate can impact return on investment
- Japanese market has great influence on other markets
Other Types of Investments

- Venture Capital
  - High risk capital to start-up companies
  - Success of companies are difficult to predict
Managing Investments

- Establish board investment committee
- Decide investment policy
  - Defines purpose and goals of investing
- Specify asset allocation
  - How much in cash, fixed income, equity, etc.
- Specify diversification plan
- Select investment manager
  - Consider performance, style, etc.
- Consider timing
Sources of Capital

- **Equity**
  - Share of profit or losses
  - Transferability of ownership
  - Decision making responsibility
  - Nonprofits—not funded by equity.
  
  However:
  - Grants/contributions—investments in a sense
  - Stakeholders instead of shareholders
Sources of Capital

- **Debt**
  - Liability to pay
  - Return principal along with interest
  - Term of loan is detailed
  - Collateral is listed
  - Recourse for default
  - Amortization to pay principal along with interest to liquidate debt
Types of Debt

- **Short-term debt**
  - Letter of credit—credit line
  - Ready reserve
  - Short term, cash-flow loan
Types of Debt

- Long-term debt
  - Notes
  - Mortgages
  - Discounted notes: purchased below par value
  - Tax-exempt bonds—large organizations like municipalities
Types of Debt

- **Leases**
  - Sale/lease back: sell asset, then lease back from lender
  - Service lease: lessor keeps and services equipment
  - Financial lease: lessee keeps and maintains equipment
Leases

Specific techniques for leasing:

- Capital lease
  - Ownership is transferred at the end of term
  - Option to purchase below expected market price
  - Term equal or greater 75% of expected life
  - Value greater than 90% of price for new asset
  - Recorded as loan on financial statement
Specific techniques for leasing (cont’d):

- Operating Lease
  - Rental or service lease
  - Payments recorded as an expense
  - Future commitments disclosed in footnotes
Financial Concepts

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Return

- Gains from original investment
- Can be simple interest:
  - \((\text{principal}) \times (\text{rate}) \times (\text{time}) = \text{SI}\)
- Or compound interest:
  - \(\text{SI} + [(\text{principal}) \times (\text{rate}) \times (\text{compound period})]\)
    - \(= \text{CI}\)
Risk

- Probability that returns will be lower than expected
- Can be Business Risk: Uncertainty of returns
- Or Financial Risk: Risk introduced by borrowing
  - Measured in terms of Beta:
    - high risk: \( \beta = < 1 \); Low risk: \( \beta = > 1 \)
Risk (cont’d)

- Levels of Risk
  - Risks with Cash: little
  - Risks with Fixed Income: some, over period of time
  - Risks with Stock: high, returns vary daily
Leverage

- Borrow for an investment
- Adds risk to an investment
- Done with hopes that returns of investment are higher than interest of loan
Time Value of Money

Principle: Value of money today is greater than value in the future

- Money invested today can earn more money
- Long investment period = greater risk
- Inflation decrease future value of a dollar
Time Value of Money (cont’d)

- Present Value
  - Future values are known
  - A need to determine amount needed to be invested today.
  - Calculated at:
    - \((\text{Future value}) \times \left(\frac{1}{1 + \text{interest}}\right) \text{time}\)
Time Value of Money (cont’d)

- **Future Value**
  - Calculation of compound interest
  - (future value) x (time) x (given interest rate)

- **Annuities**
  - Variation of both present and future value
  - Examples: mortgage; endowment; retirement
Time Value of Money (cont’d)

- **Net present value**
  - To determine viability of an investment

- **Internal rate of return**
  - Used to compare investments with varying initial amount
Basic Economics

Study of how limited resources are allocated to meet unlimited wants

- **Opportunity Cost**
  - Cost of deciding to take a particular path
  - Cost of decision compared to Benefits of outcomes
Basic Economics (cont’d)

- **Demand**
  - What the buyer wants
  - Consumers purchase more when opportunity cost is low; and vice versa
  - Demand curve: relationship between selling price and quantity sold
Factors that affect demand:
- Tastes and preferences
- Income—what can be afforded
- Price of relative goods
- Future expectations of price and income
- Number of buyers—can affect costs
Supply

- Amount of product on the market
- Higher prices induce more items on the market
- Supply curve: total cost in relation to the changes in demand
Basic Economics (cont’d)

Factors that affect supply

- Costs of resources
- Production technology
- Prices of other producible commodities—does it cost less to produce something else
- Expectations of the future
- Number of seller in the market
Basic Economics (cont’d)

- Supply and demand together determine quantity and price of a good or service
- Affects price you may want to charge for services
- Consider marginal cost: what does it cost to increase production?
Capital Budgeting

- Process of planning expenditures whose returns are expected to go beyond one year
- Resources and expenses to cover large, one-time purchases
- Optimal: investment maximizes present value of the nonprofit
- Marginal revenue = marginal costs
IRS Issues

- Local Taxes
  - Sales Tax Exemption
  - Property Tax Exemption

- State Taxes
  - Payroll Taxes – No Exemption

- Federal Taxes
  - Income Taxes on Unrelated Business Income
IRS Issues

- Unrelated Business Income
  - Three Characteristics
    - Trade or Business Activity – Carried to generate a net profit
    - Regular Activity
    - Not related to exempt purposes
  - Income is Taxable at Corporate Rates
  - UBI reporting has been lax by Nonprofits
IRS Issues

- Federal Income Tax Exemption
  - 501(c)3 Application Form 1023
  - Determination Letter
    - Usually an Initial 5-year period
    - Filing required to become Permanent
    - Donors Rely on it for Deductibility of Contributions
    - KCF Requires for all proposals
IRS Issues

Federal Income Tax Exemption

- Public Charity Rules
  - Requirements vary based on nature of exemption
  - 1/3 of revenue from public sources
  - Actively seeking public support
  - Some flexibility to as low as 10%
  - KCF should not cause noncompliance by Nonprofit
IRS Issues

Reporting by Nonprofits

- Annual Filing of Form 990
  - Revenue in excess of $25,000
  - Copies must be made available to public upon request

- Normal Payroll Reporting
  - Failure to pay payroll taxes-Board is Liable
IRS Issues

- Lobbying (Attempting to influence Legislation)
  - Grass Roots Lobbying-attempting to influence general public
  - Direct Lobbying-attempting to influence legislators, their staffs, government employees
  - Applies to Local, State and Federal legislation
**IRS Issues**

- **Lobbying Restrictions**
  - 501(h) Election permits 20% of expenditures to be spent on Lobbying with limitations. Penalty is a tax on excess expenditures.
  - Otherwise cannot be substantial (vague) amount with loss of tax-exempt status as penalty.
  - Definition of what is lobbying is restrictive so detailed understanding is critical. Legal assistance is recommended.
Payroll

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Payroll Basics

- Exempt vs. Nonexempt
- Payroll Taxes/Deductions
  - Unemployment tax
  - Workers’ Compensation
  - Retirement Benefits
- Employer/Employee Deductions
- Employee Paid