Good Financial Practices

House of Delegates - Chartered Affiliates Committee

Developed August 2019

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Contents

Disclosure

The following document is provided only for informational purposes and does not provide specific financial or legal advice for any individual situation. Some or all of this document may not be appropriate for the organization. Only a certified public accountant, certified auditor, or attorney with knowledge of the specific situation or question can provide the financial or legal assistance necessary.

Any products, services or business identified in the document are suggestions and not endorsements of those products. Each board should investigate the product, service or business and determine the best product, service or business that fits the needs of the organization.

Financial Statements and Disbursement Controls

A certified public accountant (CPA) will prepare your financial statements and can do so in any frequency that is most useful for the organization. Typically, this service is performed in conjunction with bookkeeping or transaction processing services and can be monthly, quarterly or annually. The financial statements are prepared in accordance with an acceptable financial reporting framework. If you are not sure which reporting framework to use, your CPA can explain the pros and cons of each and the best fit for the organization.

CPA will prepare your financial statements directly from the records you provide, the CPA will not verify the accuracy or completeness of the information and is not required to issue a formal report on the financial statements.

Board Responsibility for Reviewing Financial Statements

Directors are stewards of a not-for-profit organization's financial and other resources. The board should ensure that financial resources are used to further charitable purposes and that the organization's funds are appropriately accounted for by regularly receiving and reviewing up-to-date financial statements and any auditor's letters or finance and audit committee reports.

Suggestions for Disbursement Controls

- The board should authorize all check signers. All checks should be signed (electronically verified) by two persons.
- Signing blank checks must not be permitted.
- An officer or executive director should receive the unopened bank statement before turning it over to the treasurer for reconciliation. This officer should review the bank reconciliation, then date and initial it. The reconciliation should be retained for the audit team.
- Incoming mail should be opened and listed by persons other than those with access to cash receipts journals and accounts receivable records.
- A person with no access to cash should compare cash receipts records and authenticate deposit slips.
- Checks should be stamped "For Deposit Only" by the person opening the mail.
- Receipts of checks and cash should be deposited each day intact.
- Verify the passwords for bank or investment accounts are not easily obtained. Use password manager application and digital vault such as Keeper or LastPass to securely store and share passwords among board-approved users. Routinely change the password and audit for strength.

Budgeting Process

Create a Realistic Operating Budget

First, is to make time for budgeting. Invest the time in creating a comprehensive budget. Involve the right people including committee chairs that require financing for activities.

Second, list three to five goals that you hope to achieve during the period for which you are budgeting. Make sure those goals line up with the organization's strategic priorities. Next, figure out how you'll achieve them.

Third, look at the previous year's budget. How do the expected revenues match actual income during the year? Does revenue need to increase, or expenses decrease? Make adjustments during the budget planning session.

Approval by the Board

Once a budget is agreed it needs to be forwarded to the board. During a board or finance meeting, questions should be asked about line items that are not aligned with the organization's goals or show variance from prior budgets. It is recommended that these discussions are during an executive session and with a supermajority of the board members present. Questioning and approving a budget with public members present may lead to questions going unanswered or briefly reviewing the budget.

Use a budget calendar

1st Quarter

- Schedule budget checkpoints for the year with board and program managers.
- Evaluate current budget estimates for accuracy.

2nd Quarter

- Review for unbudgeted revenue or expenses. Example is any unexpected expense such as a new program or service.
- End of Q2, revisit budget and determine if adjustments are needed, based on Q1 actuals

3rd Quarter

- Review financial performance (prior year and forecasted year-end).
- Assemble a budget team and assign responsibilities.
- Estimate and draft your budget timeline and goals:
    - Set deadlines to review in Q4.
    - Define organizational and program goals.
    - Determine expenses, project income, forecast cash flow.
    - Draft initial budget.

4th Quarter

- Review annual report.
- Compare actuals versus budget estimates.

- Revisit budget assumptions; determine if prior assumptions are no longer valid or are proved to be untrue.
- Review expense and revenue modeling.
- Formulate a new budget, prepare proposal, and acquire approval before the beginning of the next fiscal year.

Annual Report

An annual report should be made available to all either on request or posted on your website. The organization's mission statement, a summary of the past year's program service accomplishments, a roster of the officers and members of the board of directors, and financial information such as 990's.

Five Good Practices

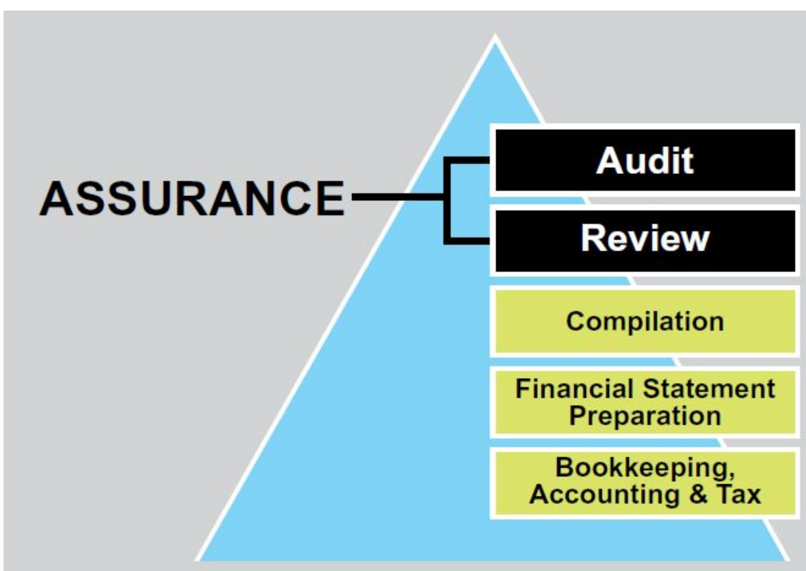
1. Include your complete audited (or reviewed or compiled) financial statements with both the notes and the audit firm's opinion letter as part of the report.
2. Post the most recent five years of annual reports on your website in a place that is easy to locate.
3. Financial position should be on a classified basis showing subtotals for both current assets and current liabilities.
4. Fully disclose all related-party and other transactions not clearly related to your organization's mission.
5. Include narrative discussion of achievements, but also show in tabular form relevant nonfinancial performance data, since your organization's whole story cannot be conveyed with just financial results.

Audit, Review, and Compilation

An *audit* is the broadest in scope, with an auditor expressing an opinion that the financial statements fairly present activities, financial position, and cash flows of the organization in accordance with GAAP. The organization may send a request for an audit proposal to several CPA firms that would seem to have the appropriate industry experience and interest. Meet with members of each firm so that they better understand your management team and organizational culture and context prior to submitting their bids. The final selection of the auditor should be done by the board or audit committee, not by management.

A *review* involves less than an audit but more than a compilation. It means that the accountant reviewed the financial statements, but all the information in those statements is the representation of management (treasurer or other members preparing statements). The accountant performing the review will not express any opinion regarding whether the financial statements are in accordance with GAAP. The accountant will state whether he or she is aware of any material modifications that should be made to the statements to bring them into conformity with GAAP. No statements will be made about internal controls since no intensive analysis of the internal control environment is performed.

A *compilation* is the most limited of engagements, and involves assembling financial statements in good form. It is not an audit and may not be called an audit, regardless of the identity of the accounting firm doing the compilation. The CPA takes financial data provided by the nonprofit and puts them in a financial statement format that complies with generally accepted accounting principles. There are no testing or analytical procedures performed during a compilation.



Audit Committee

The Audit Committee oversees the accounting and auditing practices. The committee should be composed solely of non-management directors and should be independent of the Finance Committee. Note that not-for-profit organizations that are required to file Form 990 with the IRS are required to disclose whether they have an audit committee that meets certain requirements.

Composition of the Audit Committee

A well-managed audit committee, which some argue should not be a board committee at all in order to ensure total independence, oversees regular audits of financial activities and adherence to laws and regulations and monitors the organization's conflict of interest policies.

SEC rules include stipulations that the audit committee

- Must have “direct responsibility for the appointment, compensation, retention, and oversight of the work of the company's independent auditor…”
- May have the company pay for any experts or advisers that it determines are necessary.
- “Is also responsible for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, as well as for establishing appropriate procedures to handle any anonymous employee complaints about questionable accounting or auditing issues.”
- Be made up of truly independent members, meaning that no member may directly or indirectly (including through any family member) accept any compensatory fee related to consulting or advisory services.

The external auditor should report to the board through the audit committee. The external auditor is not the accountant or individual that prepares tax returns. The President and Vice President(s) shall be ex-officio members of all special committees (except the Audit Committee). For most effective operation, the audit committee should be composed of three to five trustees, none of whom are employees of the organization.

Sarbanes-Oxley requires mandatory rotation of audit partners after five years, with a five-year timeout period during which the former audit partners can have no decision-making authority with respect to the audit.

Internal Controls

Internal control is defined as "a process effected by [a nonprofit's] board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."

In developing the procedures followed by the audit team, or the audit program, internal controls are essential:

- To prevent loss through errors, misappropriation of funds or theft.
- To document the responsibility of the board as it safeguards the assets of the NPO.
- To assure that all transactions are properly authorized and recorded.

All internal controls should be documented in a procedure's manual. Common sense must be applied in considering internal controls as well as the other areas being reviewed by the audit team. Frequently, there are not enough volunteers to perform all the desired internal controls. The organization is then challenged to write procedures that will best protect its assets, present its financial situation fairly and be reviewable by the audit team. Whatever the situation, internal control must be examined and improved if found lacking.

Three Areas of Emphasis to Include in an Audit Program

1. The proper authorization of activities and expenditures
    a. Budget and the board of directors' minutes are the usual source of verification.
    b. Generally, committee chairs are required to authorize any expenses from their budget funds.
    c. Corporate charter and bylaws should be reviewed to determine that all activities comply.
2. Determination of the physical existence of assets
    a. Verification of bank balances and current bank signatures, an actual count of securities owned.
    b. Records such as monthly bank statements, brokerage statements, deeds and donation forms should be available to the audit team.
3. Ascertaining that returns and reports are filed in a timely fashion
    a. A nonprofit has the obligation to file tax returns and corporate report.
    b. Failure to comply with these requirements will expose the nonprofit to possible fines or penalties.
    c. Be aware of the Form 990 filing dates.

Sarbanes-Oxley (SOX) Good Practices for the Board

- Nominating committee rigorously screens prospective members and submits nominations to full board for a vote.
- Board members receive extensive orientation, including job description, performance expectations, bylaws, complete financial documentation, strategic plan, and other relevant documents.
- Board members are expected to review all materials in advance of the board meeting and come fully prepared to analyze, deliberate, and debate, if necessary, the issues at

hand. Board members know how to read and analyze financial reports and spot important trends.

- Board culture reflects the reality that the nonprofit is a financially viable business enterprise governed by competent directors and their leaders whose primary allegiance is to the mission of the organization.
- Board members are required to sign a conflict-of-interest statement on an annual basis for the purpose of identifying any existing, or possible, conflicts of interest. Board members are prohibited from having contracts of any kind with the nonprofit or other types of self-dealing.
- The board orientation clearly articulates that the board's only employee is the executive director (ED) and stipulates that all board members will conduct themselves in a professional manner at all times.
- All boards are indemnified through the purchase of D&O insurance.
- An audit or financial review is required on an annual basis. An audit may be stipulated depending on the organization's budget and relevant state legislation. However, smaller nonprofits should arrange for a review of their financial statements.

Conflict of Interest

A conflict of interest may exist when a decision is made that may personally benefit a board member, an employee, or a volunteer. A conflict of interest exists in any situation in which a person has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties as an employee or administrator. An example is allowing the association's name or logo to be placed on another company's product packaging which may lead to the appearance of endorsing this company's product.

A potential conflict of interest does not mean that the organization cannot do business with friends or family of the board or volunteers but full disclosure of the connection to this individual is necessary. The committee member with the conflict of interest may "recuse" themselves from the deliberations and vote involving purchasing, borrowing, or placement of funds.

There are many examples of a conflict of interest policy online, and it is suggested to invest time reviewing and modifying to best fit the needs of the organization.

Example of the AARC Conflict of Interest Disclosure form

Pursuant to the purposes and intent of the resolution adopted by the Board of Directors of the American Association for Respiratory Care, requiring disclosure of certain interests, a copy of which has been furnished to me, I hereby state that I or members of my immediate family have the following affiliations or interests or have taken part in the following transactions that, when considered in conjunction with my position with, or relation to, the Association, might possibly constitute a conflict of interest. (Check "none" where applicable.)

1. Outside Interests: Identify any purchases or sales or property or property rights, interests or services by yourself or your immediate family that might be deemed to have been in competition with the Association.

2. Outside Activities: Identify any instances in which you or any member of your immediate family have rendered directive, managerial or consultant services to any outside concern that does business with, or competes with, the services of the Association or have rendered any other services in competition with the Association.

3. Gifts, Gratuities and Entertainment: Neither I nor any member of my immediate family have accepted gifts, gratuities or entertainment from any outside concern that does, or is seeking to do, business with, or is a competitor of the Association except as listed.

4. Inside Information: Neither I nor any member of my immediate family have disclosed or used information relating to the Association's business for the personal profit or advantage of myself or my immediate family, except as listed.

5. Other: List any other activities in which you or your immediate family are engaged in what might be regarded as constituting a conflict of interest.

Insurance

Insurance does not mitigate all risk management issues in your organization. Some of the reasons are:

1. Insurance does not cover every risk.
2. Coverage may be limited.
3. Claims today may raise premiums tomorrow.
4. Claims may be rejected if negligence is discovered by the insurance company.

Risks to an organization can be reduced, but they cannot be eliminated. This is a checklist of factors to consider when choosing insurance.

- What does the policy cover?
    - Property or liability risks
    - Risks from all causes
    - Named perils such as earthquake, flood, lightning
- What are you covered for?
    - Theft by employees or others
    - Legal negligence
    - Personal injury
    - Sexual misconduct
    - Negligence of member, employee, or any other person associated with the organization
    - Volunteer activities
    - Inventory
- What do you know about your policy?
    - Are there exclusions?
    - How much coverage do you carry and based on what? Are these amounts up-to-date?
    - Is actual cost or replacement cost covered?
    - Is replacement cost at 100 percent vs. other percentages?
    - How is depreciation handled?
    - Are the contents or inventory of buildings accurate and up-to-date?
    - Are rare or other especially valuable items covered, such as art or other precious objects?
    - Is your policy contingent upon construction codes in your area? If so, do you comply and have proof of compliance?
    - Do you have a physical inventory, pictures, and other documentation that could be used as proof of loss?

Directors & Officers Liability Insurance

Directors & Officers (D&O) Liability insurance helps cover defense costs and damages (awards and settlements) arising out of wrongful act allegations and lawsuits brought against an organization's board of directors or officers. These types of claims have become increasingly common and directors and officers themselves could be held personally liable.

D&O liability insurance protects the personal assets of corporate directors and officers, and their spouses, in the event they are personally sued by employees, vendors, competitors, investors, customers, or other parties, for actual or alleged wrongful acts in managing a company.

The insurance, which usually protects the company as well, covers legal fees, settlements, and other costs. D&O insurance is the financial backing for a standard indemnification provision, which holds officers harmless for losses due to their role in the company. Many officers and directors will want a company to provide both indemnification and D&O insurance.

Directors and officers are sued for a variety of reasons related to their company roles, including:

- Breach of fiduciary duty resulting in financial losses or bankruptcy
- Misrepresentation of company assets
- Misuse of company funds
- Fraud
- Failure to comply with workplace laws
- Theft of intellectual property and poaching of competitor's customers
- Lack of corporate governance
- Illegal acts or illegal profits are generally not covered under D&O insurance.

Bonding

Bonding buys insurance on those handling money for the organization and ensures to its constituency that the finances are being handled properly. There is a wide variety of bonding patterns. In some instances the individual is bonded; in others the position is bonded, so that a change in personnel does not affect coverage. Group bonds cover everyone who handles the money. Costs of bonding vary widely, depending on the number of individuals involved and the amount of money handled. The insurance carrier for the organization is the best source to begin the process of determining how to meet its bonding needs.

General Liability

The purpose of the general liability insurance is to pay for damages that the organization is liable for and to cover legal costs for its defense. These policies cover negligent acts that result in property damage or personal or bodily injury. Harm resulting from executive decision making or related allegations of wrongful employment practices is not covered by the general liability policy.

Insurance Providers

The Hartford - www.thehartford.com/management-liability-insurance/d-o-liability-insurance

The CIMA Companies, Inc - www.cimaworld.com

Nonprofits Insurance Alliance - www.insurancefornonprofits.org

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