# Chapter Four

## The Invisible Yellow Line in Financial Operations

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Increasingly, donors, grantors, and regulatory bodies are scrutinizing how a nonprofit organization manages its fiscal responsibilities and the nonprofit's transparency in regard to financial operations. You want to make sure you are proactive, rather than reactive, in this respect. For example, you might post your current IRS Form 990 on your website as a demonstration of this intention of transparency.

### The Board's Role in Financial Oversight

In most nonprofit organizations, the board treasurer and the executive committee take the lead in fiscal oversight, but it is the ultimate responsibility of the full board to ensure sound financial management, including appropriate oversight, separation of duties, independent reviews and audits, and so on.

Of course, the board should review financial reports at every meeting. The executive committee or budget and finance committee or board treasurer should review the detailed report prior to presenting an overview to the full board. And the board should ensure that adequate internal procedures are in place to prevent malfeasance or fraud at any level.

Okay, I am embarrassed, but I will share an incident that happened to me as the new member of a board several years ago. I asked if an audit had been done and was told that it was just "too expensive." Red flag! Warning! Unfortunately, I remained on the board, diligently reviewing the rather superficial financial reports each month as presented by a chief executive everyone loved and trusted. You can anticipate the end of this story. Indeed, the financial reports showed that checks had been written to pay the bills but, unfortunately, were not mailed. By the time the board realized the extent of the problem, the organization was nearly $100,000 in debt!

stories from the real world

Note: this clearly emphasizes the need to recruit and retain qualified financial professionals on the board and the importance of budgeting for an annual independent audit or review.

What the full board needs to review each month is budget compared with actual figures. The board should set an amount for any variances above or below the budget that require a written explanation. If the shortfall is significant, the board should hold immediate strategic discussions about how the variance might affect programs and services and what should be done to ensure your organization's mission does not suffer as a result.

## The Staff's Role in Financial Oversight

The chief executive or chief financial officer monitors the day-to-day revenue and expenditures, noting *in advance* of the board meeting any deficit that might have a significant impact on your organization's programs and services, then alerting the board and presenting alternatives. Any significant deficit should be shared immediately with the board leadership so the potential consequences of the deficit can be averted or minimized.

In addition, the chief executive and key staff should undertake a cost/benefit analysis of every program, service, and fundraising activity for outcomes and cost effectiveness and be willing to recommend changes as a result. These analyses can be shared with appropriate board committees or the full board as part of the annual planning meeting.

Fiscal transparency and controls are more important than ever for every nonprofit. How does your organization stack up in light of today's environment and expectations?

food for thought

## Budgeting

Often, annual budgets are increased by a simple percentage to account for increased costs of doing business, but does this really afford a comprehensive review of critical expenses and revenue? Perhaps not, and this process can result in upwardly spiraling costs without a careful review of efficiencies to be found and implemented.

Perhaps a better way to ensure a feasible annual budget is to commit the organization to a zero-based budget exercise every few years. This assumes that nothing is in place and that the organization has just begun and starts each budget section at zero. This requires thorough and careful research into best and efficient practices.

The budget should support your annual strategic goals and action plans and should be understood and "owned" by both the board and staff leadership.

### *The Staff's Role in Budgeting*

Usually, the chief executive drafts the annual budget and then presents it to the board's executive committee or finance committee for detailed review before presenting it to the full board. Of course, getting input from other staff leaders is important because it strengthens their sense of ownership of the budget and goals.

It is the chief executive's responsibility to establish and ensure the staff salaries and benefits are fair and equitable.

### *The Board's Role in Budgeting*

Although the budget may be developed by the chief executive, ultimately the board has the responsibility for ensuring it is realistic, adequate, and attainable.

Far too often, board members merely rely on the projections from the staff without carefully reviewing the budget both from an expense and a revenue perspective.

A best practice for the board is ensuring the budget has a reserve of three to six months of operating funds.

The board should not be involved in setting salaries and benefits for any staff member other than the chief executive. The board approves an aggregate amount in the budget for staff salaries and benefits.

> According to the current IRS Form 990, the board should carefully review extemporaneous and comparative data when establishing the chief executive's salary and benefits. To accomplish this, there are many salary and benefit surveys available. You can find them on the Internet by searching for "nonprofit salary survey."
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> ! important

## Fiscal Controls

Staff leadership and the board's financial officer should review written organizational fiscal policies and procedures every year. These policies should state who has authority to sign contracts over a certain amount, what should be reviewed by the board prior to signing, who signs checks over a particular amount, and how donations are processed. It should specify internal controls to prevent fraud, separation of receiving and recording cash and other contributions, who has signatory authority, how banking relationships are managed, and every other detail of financial management. For example, the person who reconciles bank statements should never have signatory authority. This simple practice, even in small organizations, serves to remove the temptation to defraud.

Other policies that are critical to fiscal management include a board-endorsed written investment policy and a gift acceptance policy that clarifies what tangible and intangible donations your organization will and will not accept. You can find good examples of these policies by searching the Internet.

> Nonprofits are certainly not immune to embezzlement and fraud. Be sure your organization has the internal controls in place to prevent this from happening. Both board advisors and staff leaders "own" this responsibility.
>
> ! important

Additionally, an important fiscal policy should state who has authority to sign contracts and documents for the organization and at what monetary level.

An annual independent audit or independent cash review is essential to most organizations and is often required by certain funders. Far too many organizations have been negligent in this arena because it can be an expensive item in the budget. Unsuspecting boards may then be caught off guard when a trusted employee commits fraud or embezzles funds. Although we may want to believe that the nonprofit sector is immune to fraud, in fact there are many nonprofits, both large and small, that have suffered fraud. The responsibility for ensuring adequate fiscal controls ultimately resides with the board but is usually delegated to the chief executive to manage.

### *The Board's Role in Fiscal Controls*

The board provides oversight and is ultimately responsible for assuring stakeholders and regulators that your organization has appropriate fiscal controls in place and that you are in total compliance with federal and other regulations governing nonprofits.

It is critical that the board treasurer or another key board officer has the experience and expertise to review and ensure that internal fiscal controls are adequate and in place. The board leader is ultimately responsible for ensuring that someone on the board has this professional expertise or that it has contracted with the appropriate professional.

The board should have adopted a whistle-blower policy that allows confidential

> When I was hired as the executive director of a statewide nonprofit, I was aware that the organization was close to losing its statewide charter from the national organization because so little money had been raised. I had a huge staff—composed of me and a sweet woman who answered the phones, paid the bills, and did the office work. It didn't take me long at all to uncover her scheme: changing the payee on checks to her own name. It wasn't even a sophisticated form of embezzlement, but it had been working for some time because people liked her and trusted her. The board and former chief executive had clearly not understood their ultimate Yellow Line and legal responsibilities.
>
> watch out!

reporting of any suspected or confirmed financial impropriety. The policy should prohibit retaliation and ensure adequate investigation and correction. If you don't have a whistle-blower policy, just google it and you will find lots of examples.

The annual audit or financial review should be presented to the full board by the independent auditor or reviewer, not by a staff person. The board should agree to act on any credible findings revealed in the audit. These actions should be documented in the board meeting minutes. Having the audit presented by the independent source ensures fiscal separation and transparency. This should not be construed as mistrust of the chief executive. In fact, the chief executive should welcome this opportunity to present a positive outcome that ensures good fiscal management.

***The Staff's Role in Fiscal Controls***

The internal management and administrative functions of fiscal controls are the responsibility of the chief executive and leadership staff. Appropriate internal controls must be in place and must be reviewed regularly by the appropriate staff leadership and ultimately for compliance by a qualified board member. The chief executive should ensure that appropriate employees are trained and that they understand and accept internal fiscal controls.

The chief executive is responsible for hiring and managing staff with requisite experience and training to appropriately manage the financial functions of the organization.

The chief executive oversees and manages the internal process of completing the annual audit or independent cash review and institutes whatever changes are required by the board as a result of audit findings. The board leader or qualified financial professional should regularly review progress in addressing any requirements of the annual audit or financial review.

Additionally, important internal controls must be in place for fundraising. The chief executive should ensure compliance with all applicable local, state, and federal requirements in regard to fundraising activities. For example, registration is required in many states for certain fundraising activities. Since the rules vary from state to state, check with your state attorney general's office for current regulations. You must have policies that ensure restricted contributions are *never* compromised.

Often, donors, funders, underwriters, or others will restrict a gift or designate a specific use for the gift. Appropriate internal controls on these types of gifts will not allow them to be used for anything other than the donor's intended purpose. If that intent is betrayed, the donor or your state's attorney general could rescind the gift and even seek legal action against your nonprofit. Ultimately, it is the responsibility of the board to ensure these controls are adequate and in place, while the day-to-day management of fundraising is delegated to the chief executive to manage.

Many organizations institute an internal control requiring that any employee who handles cash or other donations must be bonded. While not a requirement, this is a sound fiscal practice you and your board should consider.

A chief executive learned the importance of having a crystal-clear gift-acceptance policy the hard way. A board member and her husband made a significant cash gift to the agency with a rather vague restriction on its use. The chief executive determined what she believed was an appropriate use of the donation. When the donors learned how their contribution was put to use, they disagreed strongly and demanded the gift be returned. Ultimately, this disagreement involved attorneys and lawsuits and was not settled to anyone's satisfaction. This situation could have avoided if the agency had clear gift-acceptance policies and these policies had been discussed with the donor in advance of the gift.

**watch out!**

Finally, the IRS Form 990 asks if the board has reviewed the document before it is filed, and that is certainly a good practice. After all, this is a public document, so it is important that all board members and leadership staff have reviewed the document in advance and that they are familiar and comply with the rules governing access to the document.

## Review and Clarify the Invisible Yellow Line in Your Financial Management

This worksheet will help you clarify the Invisible Yellow Line in your organization's financial management. You might complete it individually and then share the results to start a conversation about how you will define the Invisible Yellow Line to operate most effectively and efficiently. Just open the lines of communication using this worksheet to avoid assumptions and confusion.

Discuss the key activity and decide for your organization who has primary responsibility at this time: board, board leader, chief executive, or other staff member. Or is it a shared responsibility?

### The Invisible Yellow Line in Financial Management

| Key Activity | Responsibility |
|---|---|
| Who has ultimate responsibility for fiscal and financial oversight? | |
| Who requires adequate accounting and financial reporting to support the organization's governance and management functions? | |
| Who ensures financial transparency to stakeholders and regulatory bodies? | |
| Who reviews the budget and regularly compares it with the actual figures? | |
| Who explains variances from budget over or under a specified amount? | |
| Who monitors day-to-day revenue and expenditures? | |

| Key Activity | Responsibility |
|---|---|
| Who performs an annual cost/benefit analysis of all programs and services? | |
| Who ensures the budget is realistic and adequate to achieve the long-term vision for the organization? | |
| Who participates in the annual budgeting process? | |
| Who reviews and sets staff salaries and benefits? | |
| Who sets the chief executive's salary and benefits? | |
| Who uses contemporaneous information to determine the CEO's salary and benefits? | |
| Who sets policies regarding the authority to sign contracts and documents for the organization? | |
| Who authorizes an annual audit or independent cash review? | |
| Who manages the audit or independent review process? | |
| Who reviews and accepts the annual audit or financial review and acts appropriately on recommendations? | |
| Who ensures that adequate financial reserves are in place? | |
| Who ensures that written fiscal policies and procedures are current and are followed consistently? | |
| Who develops an investment policy? | |
| Who ensures that a whistle-blower policy is in place? | |
| Who is responsible for ensuring that restricted funds are never used for purposes other than for the purposes the donor has designated? | |
| Who ensures that a gift-acceptance policy for tangible and intangible donations is in place? | |
| Who ensures that bank statements are reconciled by someone without signature authority? | |
| Who has appropriate qualifications to assess internal controls and provide regular financial statements to the board? | |
| Who ensures timely compliance with all local, state, and federal reporting requirements? | |
| Who ensures that internal controls for fundraising are current and compliant with all regulations? | |

| Key Activity | Responsibility |
|---|---|
| Who reviews the annual IRS Form 990 before it is filed? | |
| Who is responsible for ensuring that all employees who handle checks are cash bonded? | |
| Who follows the rules governing access to the IRS Form 990? | |

## To Recap

- The board has ultimate responsibility for financial oversight.
- The board has ultimate responsibility for adequate and appropriate fiscal planning, review, controls, and reporting.
- The chief executive and staff manage the day-to-day financial operations, develop internal controls, and regularly update internal policies and controls to ensure compliance with regulatory bodies.