Financial Risk Red Flags

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Resource Type: Risk eNews

Topic: Fraud and Financial Oversight

The article below is excerpted from the Nonprofit Risk Management Center's brand-new book, "Financial Risk Management: A Guide for Nonprofit Executives." To read more about the book and order a copy for your desk or copies for your entire leadership team, click here:

The finance-related risks facing nonprofits are far from inconsequential. From a community-serving mission getting off track to financial ruin and insolvency, these risks require the care and attention of every nonprofit's leaders. While it is impossible to predict every wrong turn a nonprofit might take in its institutional lifetime, or even accurately predict those with finance-related components, skillful risk managers learn to look for warning signs that something is amiss or the organization is headed down a dangerous path.

In the section that follows we identify and discuss a number of known red flags with which nonprofit leaders should be aware.

1. **Failure to report or inaccurate financial reporting** — This category of risk is one with which most nonprofit leaders can readily appreciate. Providing inaccurate monthly financial statements to the board could lead to faulty decision making based on inaccurate reports of revenue pledged or expenses for a particular activity. Astute CEOs and CFOs recognize that evidence of intentional financial misreporting could have more dire consequences, from criminal charges of fraud (Could a smaller-scale Enron happen in your nonprofit?) to loss of employment.*The danger associated with this risk includes:*
    - Crippling the nonprofit's decision-making process by providing inaccurate data on which to base decisions about the future;
    - Reducing the nonprofit's reputation and credibility among key stakeholders—including the board—whose frustration at the lack of timely or accurate financial statements could lead to disinterest in board service or the mission of the organization itself;
    - Reduced credibility among large funders, whose impressions of the effectiveness of a nonprofit are inextricably tied to the reports the funder receives on how its grants and other contributions of support were used by the nonprofit.
    - Wasteful consumption of valuable personnel time needed to correct inaccurate statements.

2. **Failure to meet minimum legal and regulatory requirements** — The Form 990, the informational tax return that charities must file with the IRS on an annual basis has become the "poster child" of efforts to improve accountability. The federal government requires charities with annual receipts over $25,000 to file the form and make it available to members of the public who request it. According to Mark Hagar of The Urban Institute,

> "…Form 990 is the only document that's legally required to be publicly available, and as a consequence, this form bears the brunt of accountability discussions."

In August 2008 the Internal Revenue Service completed its revision of the 2008 Form 990 instructions and posted them on the IRS Web site along with three new background documents explaining the new form and instructions. The 2008 Form 990, released by the Internal Revenue Service in December 2007, is effective for 2008 tax years (for returns filed in 2009). The IRS Form 990 consists of an 11-page, 11-part core form that is required to be completed by all organizations that file the form, and schedules to be completed by those organizations that satisfy the applicable requirements for each schedule. Small tax-exempt organizations (those normally with annual gross receipts up to $25,000) must file the Form 990-N, Electronic Notice (e-Postcard) for Tax-Exempt Organizations Not Required to File Form 990 or 990-EZ.

3. **Failure to budget responsibly** — Accurate budgeting is a cornerstone to good financial health in a nonprofit organization. Ideally, a nonprofit's budget should provide an accurate forecast of anticipated revenues and roadmap for appropriate spending. When budgets are developed without care and planning the nonprofit reduces its opportunities for long-term success. Similarly, when approved expense limits are routinely ignored by the nonprofit's leaders, this lack of discipline can lead to disaster in the near and long term.
4. **Failing to track income and expenses on a timely basis and make adjustments as needed** — Revenue projections outline how the nonprofit's leaders expect to finance the mission of the organization—how the nonprofit will pay for the delivery of core programs and services. The mission of a mission-driven organization is akin to the eye of a powerful hurricane: it draws the attention and focus of stakeholders who believe in the "cause" or work of the organization. However, focus on this centerpiece can lead those in leadership roles to overlook the details of managing the organization to support its mission long term. Mission-focused leaders may prefer to spend their time on designing programs to meet client needs rather than the details of tracking the myriad costs associated with service delivery. A long-standing debate in the nonprofit sector concerns the measurement of outcomes in social services delivery. What is the most important measure? Number of clients served? Benefit to individual clients? Harm avoided? What is a reasonable return on investments in vulnerable clients—children, persons with disabilities and the elderly?When a nonprofit fails to generate the income it has projected the leaders of the organization must act promptly to replace the lost income stream or cut expenses accordingly. In some cases, projected net income in a particular fiscal year will provide a sufficient cushion for small fluctuations in revenue. However, many nonprofits project net income as a strategy for building financial reserves, and failing to make adjustments in the budget to reflect changed circumstances may jeopardize the planned growth of financial reserves.

The Nonprofit Risk Management Center welcomes questions and comments at 703.777.3504 or info@nonprofitrisk.org.