Financial Risk Management
A Primer for Nonprofits

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Financial Risk Management Overview

Generous funding for this program was provided by the Public Entity Risk Institute
Uniquely Nonprofit?

- Financing of charitable activities—increasing competition for public support
- Support is voluntary; subject to discretion of the donor
- Competition to attract donors, members
- Management must continually justify existence
- Public displease affects revenues

Financial Management Aspirations

- **Transparency** - “glass pocketbook”
- **Board leadership** - not *over the line* but never *asleep at the wheel*
  - culture of candor
  - freedom to question
Financial Management Aspirations

- **Financial accountability** - accurate, timely reporting

- **Ethical conduct** - discharging fiduciary duties in a way that meets or exceeds stakeholder expectations

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What is Risk?

- “Risk is subjective... It is a word that refers to a future that exists only in the imagination.”
  - John Adams, *University College London*

- “a balancing act involving uncertain rewards and costs”
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What are the Risks?

- Failure to report or inaccurate financial reporting
- Public Filings - meeting minimal legal and regulatory requirements
  - The Form 990
  - What else?

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What are the Risks?

- Failure to budget responsibly
- Failing to track income and expenses on a timely basis and making adjustments as needed
- Ineffective tracking of restricted funds
- Income loss
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What are the Risks?

- Tracking staff time
- Ineffective internal controls
- Proper planning for surpluses
- Investments

The Corporate World

**Objectives of Financial Risk Management**

- Financial risk management identifies, measures, and limits risk within corporate risk tolerances and maximizes investment returns and earnings for a given level of risk in the following ways:
The Corporate World, continued

- **Reduction in economic or cash flow earnings volatility.** A firm that reduces the uncertainty of its cash flows benefits from a greater flexibility in its planning and budgeting activities.

- **Management of financing costs on a risk-adjusted basis.** This is accomplished in domestic and currency derivatives markets, first by reducing interest rate and currency risks, and then by matching time-weighted, discounted, asset and liability cash flows.

- **Increases in the value of the company shares.** By reducing financial volatility, risk managers lower the rate of return required by shareholders and thereby raising company profits and value.

- **Management of raw materials costs.** A firm that responds proactively to fluctuations in raw materials costs improves control over sales price and the profit margin.

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Financial Risk Management for Nonprofits

- Identifying, measuring, and minimizing risk to financial assets while maximizing accountability to stakeholders, fiscal integrity and mission-fulfillment.
  - Protecting assets ($$, reputation) needed for...
  - Mission fulfillment
    - use of resources for mission-critical activities

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Who is Responsible?

- **The role of the board**
  - oversight
  - discharging fiduciary duties
  - what are the barriers and challenges?
  - how do you overcome these to ensure effective financial management?

Who is Responsible?

- **The role of the staff**
  - day-to-day oversight
  - keeping the board informed (via the finance committee?)
  - seeking outside help as needed
  - communicating difficult news
Who is Responsible?

- The role of outside advisors
  - knowing who and when to call
  - objective advice?
  - not risk transfer!

PHASE 1

Risk Analysis
- RISK IDENTIFICATION, EVALUATION AND MEASUREMENT

PHASE 2

Risk Response
- RISK CONTROL, FINANCING AND COMMUNICATION

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Using the Framework

- Managing financial risks as part of an overall RM program, or separate effort
- Diverse group of people involved
- Reporting to the finance committee and board
- Remember to communicate and review effectiveness

Financial Risk Management
10 Lessons to Live By

1. Commit to an enlightened budgeting process
   - Inclusive annual budgeting process
     - Essential to good organizational planning
     - Results in monitoring tool available to board
How?

- Draw a wide circle – who should be involved?
- Begin at least three months prior to target for adopting the budget
- Explore ways to forecast income, e.g. discounting funding source totals based on predictions of success
- Help the board understand relationship between core programs and major funding sources – show how much each program will draw from unrestricted support

Financial Risk Management
10 Lessons to Live By

2. Take a closer, realistic look at income risks

- “diversified revenue base” - is this enough?
- forecasting trends and changes
  - what's changed?
  - what's changing?
- looking ahead - weighing opportunities and risks
  - entrepreneurial efforts
  - stakeholder perspective
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3. Establish an Audit Committee
   × audit committee versus finance committee (see fact sheet)
   × audit committee charter
     ➤ See sample from the Nonprofit Risk Management Center

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10 Lessons to Live By

4. Commit to Effective Due Diligence (management)
   × asking the right questions
   × legal compliance component
   × accountability component
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10 Lessons to Live By

5. Ensure Accountable Vendor Relationships
   - relationship-building; but not “who you know”
   - accountable for deliverables
   - putting contracts out to bid

6. Scrutinize Fundraising
   - Methods, strategies
   - Who solicits?
   - What promises?
   - Tracking commitments, promises
     - written agreements?
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7. Pay More than Lip Service to Your Investment Policy
   - Does it suit your nonprofit? “Is it working for you?”
   - What changes are required?
   - How effective is the investment advice your nonprofit is receiving

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8. Manage Restricted Contributions with Care
   - What triggers are in place to avoid missteps with restricted funds?
   - Are accounts set-up to ensure that board gets the information it needs, or simply to satisfy funders?
   - Does the board understand the conditions, requirements and implications of restricted funding?
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10 Lessons to Live By

9. Commit to understanding the true nature of fraud risk
   ✗ Don’t believe everything you read!
   The headlines don’t tell the whole story

Three Fraud Classifications
(source: Gerald Zack, CPA, CFE)

■ Fraud committed against the nonprofit
   ✗ Phony vendors, expense report fraud, cash receipt schemes

■ Fraud committed by the nonprofit
   ✗ Falsification of grant reporting documents,
     noncompliance with grant/contract requirements

■ Fraud committed through the nonprofit
   ✗ e.g., identity theft of donor
Understanding Fraud Risk

- For Nonprofits
  - × 29.3% – Corruption (bribes, conflict of interest)
  - × 28.6% – Billing frauds
  - × 28.6% – Expense Reimbursements
  - × 24.5% – Check tampering

- Source: ACFE

Fraud Facts

- Two-thirds of victim organizations routinely conducted background checks on new employees

- Less than 8% of perpetrators had prior convictions
Sources for Fraud Detection in Nonprofits

Source: ACFE 2006 Report to the Nation on Occupational Fraud and Abuse

- Tip (34.4%)
  - 44% of million-dollar frauds detected by tips
- Accident (28.7%)
- Internal controls (19.7%)
- Internal audit (16.4%)
- External audit (14.8%)
- Notified by police (4.9%)

Creating an environment hostile to fraud

- Screening
  - Would have any hesitation placing the employee in a position of trust with respect to financial assets?
- Fraud is unacceptable at any level
  - Fraud policy
  - Ethics policy / Code of Conduct
  - Fraud prevention/detection measures are in place
- Perpetrators will be prosecuted
- Everyone’s help is needed to protect the mission—and the assets needed for the mission
  - Policy dissemination
  - Accountability
  - Hotline
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10. Adopt internal controls that reflect the three “Fs”

- Customized to reflect the resources and meet the needs of your nonprofit
- Practical?!
- Three Fs: Feasible, Focused, Followed

Don’t forget:
- practical/feasible for your nonprofit
- perfect controls are probably not feasible—design a control framework that works for your organization
  - re-examine over time—circumstances change
- policies:
  - follow them
  - change them, or
  - abandon them

Post-incident review—
- what happened?
- did controls/detection measures work as we hoped?
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BONUS LESSON #1

Remember that communication is the cornerstone to accountability and effective financial risk management

- communicate losses promptly
- provide details
- have a plan
- communicate directly

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BONUS LESSON #2

Examine your governance and decision-making culture

- Is a culture of candor alive and well at your nonprofit?
- Do leaders and managers have permission to make you uncomfortable?
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Nonprofit Risk Management Center

- Free technical assistance by email or telephone through www.nonprofitrisk.org

- **Nonprofit CARES** - nine modules, including one on Internal Controls – (www.nonprofitcares.org)

- **My Risk Management Plan** (www.myriskmanagementplan.org)

- **Risk Management Classroom** (www.riskmanagementclassroom.org)

Next Web Seminar

**Business Continuity Planning for Your Nonprofit**

- March 7, 2007

- 2:00 pm Eastern