Nonprofit Risk Management Center

Financial Risk Management
A Primer for Nonprofits

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Financial Risk Management Overview

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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

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Financial Management Aspirations

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

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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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Financial Management
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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Financial Management
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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Financial Management What are the Risks?

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

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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:

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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 thus the cost of capital, 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.

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?

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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

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Who is Responsible?

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

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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

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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

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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

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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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Financial Risk Management 10 Lessons to Live By

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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Financial Risk Management 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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Financial Risk Management
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

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10 Lessons to Live By

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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Financial Risk Management 10 Lessons to Live By

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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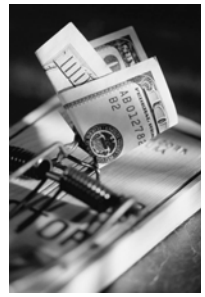
Financial Risk Management
10 Lessons to Live By

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



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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

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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

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Fraud Facts

- Two-thirds of victim organizations routinely conducted background checks on new employees
- Less than 8% of perpetrators had prior convictions

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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

Financial Risk Management
10 Lessons to Live By

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

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- 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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Financial Risk Management 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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Financial Risk Management 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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- 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)

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Next Web Seminar

- **Business Continuity Planning for Your Nonprofit**
- March 7, 2007
- 2:00 pm Eastern

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