Financial Risk Management:

A Guide for Nonprofit Executives

by Melanie Lockwood Herman

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About the Nonprofit Risk Management Center

The Nonprofit Risk Management Center is dedicated to helping community-serving nonprofits prevent harm, conserve resources, preserve assets, and free up resources for mission-critical activities. The Center provides technical assistance on risk management, liability, and insurance matters; publishes easy-to-use written materials; designs and delivers workshops and conferences; and offers consulting help in the areas of policy development, risk assessment, and risk management program design.

The Center is an independent nonprofit organization that doesn't sell insurance or endorse specific insurance providers. For more information on the products and services available from the Center, call (202) 785-3891 or visit our principal Web site at **www.nonprofitrisk.org**. Additional Center Web sites are available at: www.QualitySelect.org, www.MyRiskManagementPlan.org, www.RiskManagementClassroom.org and www.NonprofitCARES.org.

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Public Entity Risk Institute

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CHAPTER 6

Special Topics in Financial Risk Management

Topic #1: An Overview of SAS 112

In mid-2006, the AICPA Auditing Standards Board (also known as the ASB), released a new set of standards intended to guide CPAs on the issue of "communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements." (See Understanding SAS No. 112 and Evaluating Control Deficiencies, **www.aicpa.org**). The standard, referred to informally as SAS 112, is formally known as the Statement on Accounting Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit.* The adoption of the standard caused bells of alarm to ring in the accounting and finance offices of many nonprofits. A closer look at SAS 112 is instructive to understanding how it is likely to affect the independent financial statement audits of nonprofit organizations.

The passage of The Sarbanes-Oxley Act of 2002 led to intense focus on the responsibility that managers of an organization have for internal controls as well as the role and responsibility of an independent auditor in alerting the management of an organization about weaknesses in the entity's internal control system. With SAS 112 came the explicit recognition that it was no longer appropriate for auditors to provide oral reports of continuing *significant deficiencies* and *material weaknesses*.

The requirements of the standard provide as follows:

- The auditor must evaluate identified control deficiencies and determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses.
- The auditor must communicate, in writing, significant deficiencies and material weaknesses to management and those charged with

governance. This communication must include deficiencies and weaknesses that were communicated in prior audits by have not been remedied by the organization.

SOURCE: **www.aicpa.org**

Nonprofit leaders should recognize that:

- Under SAS 112, an auditor cannot be part of a nonprofit's system of internal control, and only the nonprofit, never the auditor, can correct or adjust control deficiencies. This does not mean that a nonprofit can't retain the services of a separate CPA firm to assist with establishing or improving the organization's system of internal control.
- The promulgation of new standards has caused auditors to be very reluctant to provide advice to their nonprofit clients. This has been an understandably frustrating development for nonprofit CEOs and CFOs who saw, in the past, their auditors and insightful experts willing to help the nonprofit's leaders improve financial operations.
- A related result of the development described above is the perception that today's audits cost more but provide less. This may lead some nonprofit leaders to reconsider the value of an audit to the organization. This is perhaps a dangerous trend, as obtaining an independent financial statement audit is quickly becoming a "best practice" for well-managed nonprofit organizations.

Topic #2: Functional Expense Accounting: The Debate About "Overhead" Expense

For more than a decade, nonprofit executives have faced the gauntlet of public scrutiny over the percentage of charitable donations spent on overhead, fundraising and administrative matters. Nonprofits with large overhead figures have been subject to harsh criticism and labeled as ineffective. In their book *Forces for Good: The Six Practices of High-Impact Nonprofits*, authors Leslie Crutchfield and Heather McLeod Grant profile twelve nonprofit organizations. The authors discuss various shared characteristics of the high impact nonprofits selected for the study, and acknowledge that

> "When we looked at traditional measures of nonprofit efficiency, such as ratings on *Charity Navigator,* many of these small groups didn't score so well. A few garnered only one or two stars out of a total of 5. These ratings web sites can tell you which groups have the lowest overhead rates, but they can't tell you which have had the most impact."

Did You Know?

- … that a nonprofit's independent auditor is not required to perform any procedures aimed at *identifying control deficiencies.* The auditor is only required to take action with respect to notifying management in writing when they become aware of deficiencies during the regular course of the audit.
- … that the term *reportable condition* is no longer used by independent audit firms. It has been replaced by the terms *significant deficiency* and *material weakness* to refer to matters of substance that must be communicated to management (e.g. the CEO, CFO) and the governing body of the nonprofit (e.g. the board of directors and audit committee).
    - **Significant Deficiency**: a control deficiency, or combination of control deficiencies, that adversely affects the entities ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles (GAAP) such that there is *more than a remote likelihood* (emphasis added) that a misstatement of the entity's financial statements *that is more than inconsequential* (emphasis added) will not be prevented or detected.

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As indicated on the Web site of the *National Center for Charitable Statistics* (see **http://nccsdataweb.urban.org/FAQ/index.php?category=40**), "For better or worse, the percentage of total expenses going to program costs is the most common measure of nonprofit organizational efficiency. Focus group research has found that donors expect worthy organizations to have low fundraising and administrative costs. Consequently, nonprofits frequently tout their low overhead ratios in their mailings to the donors. Most striking, the federal government's Combined Federal Campaign, which raised nearly $250 million for nonprofits in 2003, requires that participating organizations certify that their combined fundraising and administrative costs constitute no more than 25 percent of the organizations' total revenues."

In February 2005, The Urban Institute hosted a panel discussion titled "Nonprofit Disclosure: The Answer to Nonprofit Accountability?" The participants in the panel offered provocative views about existing benchmarks for nonprofit effectiveness. These views capably express some of the key points in the ongoing debate about the use of a single benchmark — the percent of revenues a nonprofit spends on programs versus overhead — as the primary measure of effectiveness. To read the full text of the panel discussion, visit **www.urban.org/publications/900780.html**.

- **Material weakness**: a significant deficiency, or combination of significant deficiencies, that results in *more than a remote likelihood* (emphasis added) that a material misstatement of the financial statements will not be prevented or detected.

❏ …that it is possible to receive a "clean opinion" that cites material weaknesses? The reason is twofold. First, the purpose of the audit is to express an opinion (and thereby provide reasonable assurance) that the financial statements of the organization are free from material misstatements. Second, although the auditor performs procedures in order to make the above assurance, these procedures do not correct deficiencies which might result in misstatements in the future.

During the panel discussion, Mark Hagar of The Urban Institute noted:

> "And that brings me to my third point. A third reason why functional expense accounting is scrutinized is that all too generally, nonprofit organizations don't track and report these expenses very well. Consequently — and I'm getting to my conclusion here — there is widespread misreporting of the very figures that we rely on most to monitor charities. Before we began the overhead cost study, we already knew that many of the functional expense allocations reported on Forms 990 defied plausibility.
>
> What we learned in the course of this study is that this reporting is real. Sometimes it comes from mistakes, sometimes from misunderstandings of rules, sometimes in miscommunications between charities and their CPAs, and sometimes — and I think we all know this happens — from the strategic decisions of managers to make those popular financial ratios look as good as possible.
>
> My conclusion is to note the irony of the relationship between disclosure and accountability. As disclosure increases — greater

> access to Forms 990 through these various outlets, and without simultaneous increases in oversight and regulation — charities have more incentive to misreport than they do to report accurately.
>
> This has implications for all parties who rely on information provided on the form or similar information provided and audited as financial statements; that is managers, watchdogs, regulators, donors, institutional funders, researchers — six parties I think that are all represented in the room today and many of which are represented on the panel with me today. Each gets a misshapen view of the world when they rely on self-reported functional expense allocations."

A second panelist at the program, Julie Floch of Eisner, LLP added her views on the topic of benchmarks for nonprofit accountability and effectiveness by addressing the variations in judgment that lead to differences in allocation methods for what are viewed as overhead costs:

> "And you can start to get a flavor that, first of all, those are judgment calls and those are imprecise at best. Second of all, they are very fluid because I might pick a particular day or a particular time, or a particular year and go by that kind of allocation method, but come next week, next month, next year, things change. My program person now suddenly is helping to do development because my development person has left. My person who is the executive director in point of fact is crossing over and doing all of those allocations or all of those different functions — so on and so forth.
>
> So essentially what I'm really trying to say or try to give you a flavor for is it is such an imprecise measure — assuming you are really, truly trying to report in a way that's to the best of your ability accurate, right — although I hate to use the word "accurate" — but fair to the best of your ability. You've got to go and try to figure out through the course of the year all of those expenses that the organization has. How should they be allocated?"

The debate about what percentage of a nonprofit's resources may be reasonably spent on overhead, administrative and fundraising expenses will likely continue in the years to come. A growing number of organizations, including charity watchdog groups, associations of nonprofits and umbrella organizations, have chosen to drawn a line in the sand. Given the variety of acceptable approaches for allocating overhead costs, this litmus test may be inherently flawed. What we have learned from the debate, however, is that the public's interest in and scrutiny of the fundraising and financial management practices of nonprofit organizations is unlikely to wane. Brewing scandals in the nonprofit world will add to this ongoing discussion, and at some distant point a more effective means of measuring the benefit of nonprofit service delivery may be at hand.