Financial Risk Management – November 2, 2011

WELCOME!

To participate in today's webinar, you must:

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2. DIAL-IN to HEAR the audio portion.

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"We are Unique"

- Every organization views itself as unique.
- Look for general, "best practice" principles and remember to adapt.

What is Financial Risk Management?

- Risk management…
- Applied to the financial systems, assets and revenue streams of the agency

Financial Management Risks

- **Include…**
  - A **loss of confidence** in the nonprofit by its stakeholders, funders, clients, staff, and the public at large. This loss of confidence could lead to the actual dissolution of the nonprofit.
  - A **catastrophic financial loss** to the organization because inadequate attention had been paid to impending financial trends or other foreseeable factors.
  - **Personal financial liability** for the leaders of the nonprofit because of inadequate *duty of care*.

Financial Risk Management Frameworks

- There is no single model that is optimal for all organizations.
- *Fiscal oversight practices are strikingly similar across sectors*: business, public and nonprofit
- Your board and leadership team must determine "what works" and "what works best" given your:
  - Mission, culture, environment, resources, ambition, vision of the future, etc.

Financial Risk Red Flags

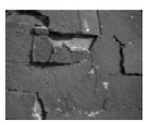
1. Poor financial reporting
2. Inadequate operating reserves
3. Poor budgeting
4. Failure to track income and expenses

Financial Risk Red Flags

5. Ineffective tracking of restricted funds
6. Unanticipated Income Loss
7. Ineffective forecasting
8. Ineffective fraud prevention and internal controls

Why Focus on Financial Risk Management?

- *Financial* management and *risk* management are components of organizational infrastructure
- Investments in infrastructure: payoff = capacity to focus on mission and enhance performance



Challenges:

- Board sophistication and comfort with fiscal oversight role
- Committee structure (e.g., separation of audit and finance roles)
- Division of labor (within board and between board and staff)
- Number of staff dedicated to finance functions
- Authority of staff with financial responsibility

Ten Lessons Framework

- How do finance-related risks come to life in my organization?
- What lessons have we learned from past experience?
- Who steps are in order to apply the lessons of the past and prepare for an uncertain future?

Finance Risks & Lessons

#1 – Adopt intentional Financial Management practices

- Structure is intentional, practical—not accidental;
  - Are roles clearly defined? Who provides oversight? It is adequate? Can we follow the rules we have created? Is the role of each committee clear?
- Structure helps position the organization to cope more effectively with changing circumstances,
  - For example, leveraging new opportunities and meeting challenges

Finance Risks & Lessons

#2 – Overcome Board naiveté; empower the board to provide oversight

- "I'm here for the mission….programs…"
- "Do I really need to understand this stuff?!"
- Isn't that what our Finance Committee is for?!

Board members must:

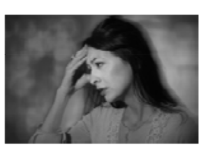
- Have a keen interest in the fiscal affairs of the nonprofit, including its overall, current financial position, the reliability of the reports the board receives, and the effectiveness of the nonprofit's management of incoming and outgoing funds.

Boards and Fiduciary Responsibility

- A fiduciary is a person legally appointed and authorized to "hold assets in trust" for another person or organization. **They manage the assets for the benefit of the organization rather than for their own benefit or profit.** It is the Board's duty to exercise reasonable care with the organization's assets and take only appropriate, thoughtful risks. The Board is responsible for the **financial well-being** of the organization.

Fiscal Oversight: *Why is it so hard?*

- **Mission**—not fiscal oversight—*attracts dedicated leaders to nonprofit board service*
- There is no single set of benchmarks or standards by which to measure financial health or success



Typical Board Fiscal Roles

- Reviewing the IRS Form 990 prior to submission
- Ensuring that assets are handled properly and funder requirements are met
- Working with the chief staff officer (e.g., Executive Director, CEO) to establish appropriate fiscal policies, such as the creation of an operating reserves policy and development of a risk management plan.
- Supporting the nonprofit's resource development activities.
- Participating in the process and later the adoption of the annual budget.

What is Fiscal Oversight?

- **Ensuring that early warning signs are visible and acted upon**
- **Determining measures of good health**
  - Relationship to short-term and long-term goals
  - What's "normal" and appropriate for this organization?
  - *Financial Ratios*: e.g., cash reserves, functional spending, fundraising efficiency, working capital, current ratio

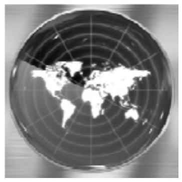
What is Fiscal Oversight?

- **Fiscal stewardship** – board members as "stand ins" for other stakeholders:
  - "…the risks of a nonprofit are borne by the people it serves (its clients), who have neither a voice in selecting the organization's leadership nor ability to manage the risks. <u>Nonprofit board members and managers do not experience the negative consequences of bad decisions as their clients do</u>. Ethics dictates they adhere to a higher standard of stewardship." – Woods Bowman, *Finance Fundamentals for Nonprofits*

Finance Risks & Lessons

#3 - Address untimely, ineffective or nonexistent forecasting…

- Remember the Titanic
- *The Perception Trap* – Randy Park



Financial Risk Management

Predicting vs. Anticipating the Future

- "**Predicting the future** is about creating and presenting one view of how the future will unfold." Sound familiar?
- "**Anticipating and preparing for the future** is about looking at multiple views of how the future might unfold." …a glimpse at inspired financial management…
  - Randy Park, *The Prediction Trap*

Forecasting: Looking Ahead

Forecasting tools may include:

- Capital requirements plan
- Cash flow projections
- Expenditure forecast/commitments
- Revenue source forecast/secured
- Donor trends

Forecasting

- **Effective Nonprofit Leaders**…

  #6 - …"predict how their organization will end the year financially, on January 1. They also know what the **levers** are that will make their prediction more or less likely. They will continue to update predictions with "actuals" and new projections to year-end and beyond as the year proceeds. They share these routine numbers with the board, and make **course corrections** accordingly."

http://nonprofitfinancefund.org/files/Top_Tens.pdf

Finance Risks & Lessons

#4 – Revisit Your Policy on Reserves

- See the terrific article and sample from the **Nonprofits Assistance Fund**
- **What is an operating reserve?** "An unrestricted fund balance set aside to stabilize a nonprofit's finances by providing a cushion against unexpected events, losses of income, and large unbudgeted expenses"
- Most likely trigger: <u>income side</u>
- **Prudent use?** "to solve temporary problems, not structural financial problems"
- **How much?** It depends….low end: one payroll; high end: two years' budget. Critical issues: stability of cash receipts
- **POLICY:** purpose and use; allow for flexibility and ease of access, but guard against erosion of reserve fund.

Finance Risks & Lessons

#5 – Increase Fraud Awareness

What is Fraud? "Gain through misrepresentation"

- Leslie Kim, *The John Cooke Fraud Reports*

- **Occupational Fraud:** "The use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets."
  - Association of Certified Fraud Examiners

Fraud Findings

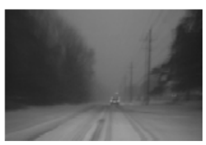
Fraud Study

- Median duration of fraud for nonprofits – 24 months
- Only 7% of perpetrators had prior convictions; 12% had been terminated by a former employer for fraud-related conduct
- Occupational fraud is fare more likely to be detected by a tip than by audits, ICs or any other method!
- Fraud was most often committed by accounting staff or upper management
- *Note: 14% of cases examined for report took place in nonprofits (134 cases)*

The Perfect Storm for Fraud

Dollars & Cents, January 2009
By *David L. Cotton, CPA, CFE, CGFM*

"During the current economic environment, it is important to remind already busy organizations that this is also the time they become more vulnerable to fraud. Fraud risk is often discussed in terms of the "fraud triangle" – incentives/pressures, opportunities and rationalization. When all three are present without adequate mitigating internal controls, the result is the "perfect storm".



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

False Assumptions about Fraud

- Long-time, trusted employees do not commit fraud
- Most frauds are perpetrated by bookkeepers
- A criminal history background check will enable a nonprofit to avoid hiring an embezzler
- An independent audit is the best way to detect fraud

Finance Risks & Lessons

#6 – Strive for an appropriate division of labor

- "Constructive partnership"
- Recognition of Board / Staff interdependency
- Lack of clarity may result in duplication of effort, frustration, inability to realize important goals (performance falls under target), etc.
- Finance Committees and Audit Committees: what's the difference?

Clarity is Key

- Effective corporate governance requires **a clear understanding of the respective roles of the board and senior management** and of their relationships with others in the corporate structure. The relationships of the board and management with shareholders should be characterized by <u>candor</u>; their relationships with employees should be characterized by <u>fairness</u>; their relationships with the communities in which they operate should be characterized by good citizenship; and their relationships with government should be characterized by a commitment to compliance.

Source: *Principles of Corporate Governance 2005, Business Roundtable, www.businessroundtable.org*

Separate Responsibilities

Assets are for boards: Activities are for managers

BOARDS INVEST, MANAGERS SPEND

Boards	Managers
Assets	Activities
Long term	Short term
Concepts	Details
Safeguard and grow	Produce and control

Big decisions of the kind boards must make have their own life cycles.

CONCEPTS VS. DETAILS

BOARDS 'OWN' THE CONTROLS, MANAGERS IMPLEMENT THEM

Finance Risks & Lessons

#8 – Cultivate candor

- "Duty of dissent"
- Institutionalizing a **culture of inquiry**:
  - Constructive debate leading to sound and shared decision making
  - The Board seeks more information, questions assumptions, and challenges conclusions – in an environment of mutual respect

Finance Risks & Lessons

#9 – Inspire an "Ethos of Transparency"

- The degree to which an organization:
  - Provides public access to information,
  - Accepts responsibility for its actions, and
  - Makes decisions more openly

Source: Ball, C. (2009) What is Transparency? *Public Integrity*, 11(2), 293-307

- Practical steps?
  - Operating as if the policies and policy-making process of the organization were on display
  - Erring on the side of open, versus closed deliberations
  - Code of conduct

Finance Risks & Lessons

#10 - Commit to continuous improvement -

- **Actively seeking ways to improve,** rather than lying in wait to fix things that break
- **Continuous learning** (example: improving the presentation of financial information and quality of forecasting over time)

Final Thoughts on Financial Risk Management

- Be fearless
- Listen to the "small voice" telling you to speak up
- Keep in mind that it's ok to change your answer (and keep an open mind)
- Remember that the mark of a leader is the courage to ask tough questions, not boasting that you have all the answers
- Remember your duty to advance the mission of the organization; measure your decisions and actions by their impact on mission fulfillment

My Reading List…

- ***The Flaw of Averages***, by Sam Savage
- ***Why We Make Mistakes:*** *How We Look Without Seeing, Forget Things in Seconds, and Are All Pretty Sure We Are Way Above Average*, by Joseph T. Hallinan
- *Predictably Irrational*, by Dan Ariely

Resources

- www.nonprofitsassistancefund.org
- “Separate Responsibilities” by Tom McLaughlin

Thank you

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