



TOOLS FOR TOP-NOTCH CAAs:
A PRACTICAL APPROACH TO GOVERNANCE
AND FINANCIAL EXCELLENCE

CAPLAW
Community Action Program Legal Services, Inc.

Dear Colleagues:

CAPLAW is pleased to make available to you a six-section toolkit intended to assist boards and management in their collaborative efforts to build well-governed and effective Community Action Agencies (CAAs). The toolkit addresses how to:

- conduct and maintain minutes for board meetings;
- build financial capacity through hiring of effective financial staff and audits;
- prepare organization-wide budgets;
- get the most out of financial statements;
- address conflicts of interest; and
- draft and implement effective whistleblower policies.

The toolkit includes case scenarios and examples revolving around the factitious Community Action Agency, Blue Community Action (BCA), to help you understand and apply the principles discussed. And, many of the sections provide sample documents that CAAs can use as a starting point for developing their own policies.

The toolkit does not cover every governance and management topic of importance to CAAs, but the topics chosen are often critical to the success or failure of the organization and are frequently stressed today by funding sources, nonprofit regulators, the Internal Revenue Service, and experts in the nonprofit field. Because of CAPLAW's focus on legal issues, we have included the legal background for many of the issues addressed. But that is just the beginning. The toolkit sections take those legal fundamentals, combine them with financial basics and the realities of running a government-funded nonprofit organization, and offer suggestions for implementing those legal and financial requirements in ways that enhance the effectiveness of the CAA. We hope that the toolkit will serve both as a conversation-starter in your CAA and as a resource for taking the steps that your organization decides are needed to best fulfill its anti-poverty mission. But don't get so caught up in the trees that you can't see the forest. Governance is not about papering the file with forms, but about developing values and a culture of integrity and accountability that ensure that the organization is achieving its mission.

Although the toolkit addresses legal issues, it does not provide legal advice and is not a substitute for a lawyer. The reason is simple: there are too many factors specific to any situation that must be taken into account when giving legal advice. For example: What does state corporate law require? Is there a state law protecting whistleblowers? Has the state imposed unique provisions in connection with the federally-funded grants? Here's one best practice: every CAA should have access to one or more lawyer(s), licensed to practice in that state, who are familiar with requirements for tax-exempt nonprofit corporations, employment law, and other areas of the law that affect CAAs and the CAA should regularly seek advice from that lawyer.

Some of the sections contain discussions of relevant tax law. Under IRS regulations, we are required to make the following disclaimer on behalf of CAPLAW and those who aided in the preparation of the toolkit:

As provided for in Treasury regulations, any advice (but none is intended) relating to federal taxes that is contained in the toolkit is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code or (2) promoting, marketing or recommending to another party any plan or arrangement addressed in the toolkit.

We would like to thank the U.S. Department of Health and Human Services' Office of Community Services for its funding of this toolkit under the American Recovery and Reinvestment Act of 2009. We also express our thanks to Kay Sohl, an expert in the fields of nonprofit management and finance and licensed public accountant, for writing a number of the sections and reviewing all of them. Thanks also go to our two CAA reviewers: Jack Burch, Executive Director for Community Action Council for Lexington-Fayette, Bourbon, Harrison and Nicholas Counties (Kentucky) and Karen Lueck, Executive Director of Community Action Partnership of Mid-Nebraska. Their comments and suggestions were invaluable. This project would not have been completed without the tireless work of the CAPLAW staff, including Communications Manager Cara Loffredo and Deputy Director Eleanor Evans. And last but not least, thanks to the support of the CAPLAW board of directors, led by President Winston Ross.

We hope you use the toolkit as part of an ongoing effort to improve board oversight and management's efforts. We are all involved in Community Action to help people in our communities. Organizations that are well-governed are much more likely to meet the needs of their communities. Let the discussion begin.

Sincerely,
CAPLAW

This publication is part of the National T/TA Strategy for Promoting Exemplary Practices and Risk Mitigation for the CSBG program and is presented by Community Action Program Legal Services, Inc. (CAPLAW) in the performance of the U.S. Department of Health and Human Services, Administration of Children and Families, Office of Community Services Cooperative Agreement Number 90SQ0047. Any opinion, findings, and conclusions, or recommendations expressed by this publication do not necessarily reflect the views of the U.S. Department of Health and Human Services, Administration of Children and Families.

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SECTION 1: MAKING BOARD MEETINGS MATTER

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Meetings of the board of directors and its committees are at the heart of governing any nonprofit organization. They are the means to carry out the philosophy of collective decisionmaking that underlies the board of director form of governance. For Community Action Agencies, the meeting is even more important because of the tripartite board structure that requires wide community participation. In order to have truly effective governance, though, board members need to understand their roles and responsibilities and ensure that the appropriate structures and procedures are adopted and implemented to carry them out. This section addresses those issues in four parts: Board role and responsibilities; board meeting basics, board meeting structure, and meeting minutes.

Part I: Board Role and Responsibilities

The role and core responsibilities of nonprofit boards and board members are similar for all types of organizations regardless of mission, budget size, funding source, or the organization's unique history and culture. Like all nonprofit boards, a nonprofit Community Action Agency's tripartite board of directors is charged with oversight of the CAA mission and overall management of the CAA's assets. At a minimum, the CAA board's oversight role vests the board with five core responsibilities:

1. Defining mission and programs and monitoring activities to ensure that they are furthering that mission
2. Setting organization-wide policy
3. Monitoring finances to ensure the CAA has adequate resources and is managing them appropriately and in compliance with legal and funder requirements
4. Managing risk and safeguarding assets
5. Selecting, determining compensation, and evaluating performance of the chief executive

In addition to these core responsibilities, of course, nonprofit CAA boards have other unique responsibilities, based on the federal Community Services Block Grant (CSBG) Act, state nonprofit and CSBG laws and regulations, and the CAA's own articles of incorporation, bylaws and resolutions. The CSBG Act requires all CAA boards to administer the CSBG program and to "fully participate in the development, planning, implementation, and evaluation of the [CSBG] program."¹ The board will also likely incorporate in some way the purposes of the CSBG Act, as well as the historical mission of the CSBG program (i.e. reducing poverty, revitalizing low-income communities, and empowering low-income families and individuals)² in defining the mission of the CAA and its own role in ensuring that the CAA's activities focus on furthering that mission.³ Finally, each board will determine for itself other responsibilities that it will take on, such as fundraising, and advocacy for the poor.

The role, responsibilities, and authority of some public CAA tripartite boards may, however, be narrower than that of nonprofit CAAs. Although, like all CAAs, public CAAs, are required by the federal Community Services Block Grant Act to administer the CSBG program and to participate in the development, planning, implementation, and evaluation of the CSBG program, their specific duties and powers are determined by the governing body of the public entity, such as the county board of commissioners. For example, many public CAA tripartite boards may not be as involved as nonprofit CAAs in setting agency-wide policy or in managing risks and safeguarding assets. For a fuller explanation of the role of boards in public CAAs, please refer to CAPLAW's online training module for public CAAs, available at www.capl原因.org.

Fiduciary Duties

Under state law, every member of a nonprofit CAA tripartite board owes a duty of care and a duty of loyalty to that CAA.⁴ Although the obligation to fulfill these legal or fiduciary duties extends beyond the board meeting, the board meeting is where the rubber meets the road.

- The *duty of care* requires that board decisions be based on a deliberative process, with an emphasis on fact gathering and the subsequent assessment of those facts. Was a decision based on facts that were developed through an orderly process, or did the board just do what felt right at time of the decision? The board has discharged its duty of care in making a decision despite the fact that the decision turns out to be a bad one if the decision was the result of a deliberative process and that process involved a weighing of facts and alternatives. Boards that rely heavily on committees to examine facts and weigh options are more likely to satisfy their duty of care when the committee synthesizes information to help the full board make an informed decision.
- The *duty of loyalty* requires each board member to act in the best interests of the CAA and its mission. The duty of loyalty becomes an issue whenever the board or one of its members faces a conflict of interest which is not disclosed or remains unquestioned in a board meeting.

Common Mistakes Boards Make

In discharging these oversight responsibilities, board members, either alone or acting as a group, often go awry. They make common mistakes, such as:

- **Micro-management.** Thorough oversight should never be confused with board involvement in day-to-day management decisions. As a general rule, boards do not directly interact with frontline staff or operations. That is senior management's role. The board member who decides to attend weatherization staff performance evaluations or the board member who offers classroom management suggestions to a Head Start teacher has crossed the line into micro-management. Boards should actively engage with senior management. For example, the board finance committee should meet with the CFO to provide input into the preparation of the annual budget. The focus of this meeting should be on refining assumptions and discussing the resource allocation among programs. Members of the finance committee would be entering the realm of micro-management if they began to build their own budget spreadsheets.

■ **Too Much Deference to the Executive Director.** Some boards view their role as cheerleaders, with the board deferring to the executive director in all matters. While this often happens when the executive director has significant input into the selection of board members, some boards simply don't understand their oversight role. The board should be supportive of the executive director, sharing board's insights and expertise, but there also needs to be some institutional tension between the board and the executive director. The board's primary function is to evaluate senior management's performance and progress in accomplishing the mission. A board that becomes too deferential to the executive director inevitably will be deficient when it comes to discharging the specific functions assigned the board, namely assessing the adequacy and utilization of the CAA's financial and other resources, setting broad policy, and ensuring an adequate system of internal controls is in place. It is therefore incumbent upon the board and the executive director who is faced with this situation to act intentionally to devise and implement strategies and processes to empower the board. This may be done, for example, through changes in bylaws, board size, committee structures, or review and approval procedures for policies and financial matters. What may be most important, however, is setting the right tone and meeting structure to encourage questions and comments from board members.

■ **Too Ceremonial.** Some boards don't even recognize that there should be some relationship between the executive director and the board or that the board is supposed to be working with the executive director. They view themselves as having a purely ceremonial function. The board is there to attend events, occasionally tour a facility, and listen to stories when CAA clients appear before the board. This board is unlikely to engage in a deliberative process in reaching decisions. It more likely acts as a rubber stamp, approving whatever is put before it without much discussion.

■ **Too Much Grand Policy.** As stated above, the CSBG Act requires a CAA's board to participate in the development, planning, implementation, and evaluation of the CSBG program to serve the low-income community. This focus on program and mission is an important one, but the board's efforts should not become a focus on the "big picture" to the exclusion of all else. Boards have some specific tasks, including evaluating the executive director's performance and setting his compensation; reviewing the financial statements and budgets; working with the external auditor; developing governance policies; addressing conflicts of interest; approving major projects, expenditures, and new programs; and ensuring adequate resources. Boards shortchange their oversight responsibilities if they devote all their efforts to thinking about mission and policy. There is other work to be done.

The CAA board's task is to find the middle ground—not too much involvement in day-to-day management, but a willingness to ask questions about specific issues and concerns, to gather facts and data to support decisions, and to interact with senior management as needed. Along the way, the board must keep its focus on the overall mission and what policies and programs will support it. The primary—although not exclusive—venue for effective board oversight is the board meeting.

CASE SCENARIO:

WHEN DEFERENCE LEADS TO DERELICTION OF DUTIES

When BCA's longstanding executive director, Leslie Warren, retired, the board hired Gloria Watson to replace Warren. During the interview process, Watson made clear to the board that she wanted more autonomy than the board had allowed Warren. Because Watson came so highly recommended, the board agreed to Watson's terms. Since that fateful decision, Watson has taken control of board meetings. The board now listens to short presentations and then rubber stamps Watson's proposals. Little time is devoted to reviewing the financial statements anymore. Despite the change in the board's relationship to the executive director, Albert Matson, a banker, still makes a point to talk to the independent auditors in his role as head of the audit committee.

Following completion of the audit, the auditor alerts him to a secret slush fund that Watson has been using for late night dinners at expensive restaurants, to purchase professional sports tickets for her family, and to pay her speeding tickets. Overall, Watson has spent \$75,000 on inappropriate expenditures.

Matson calls an emergency board meeting. After hearing the evidence, the board decides to fire Watson. Some board members want to contact the authorities, but the board decides a quiet exit is in the BCA's best interests.

LESSON: Overly deferential boards often give executive directors enough rope to hang themselves, but it often comes at a cost to the organization.

Part II: Board Meeting Basics

The board meeting is the organizing force that facilitates the board's discharge of its fiduciary or legal duties. Like all events on the calendar, a meeting serves to concentrate everyone's attention and efforts. While board members are expected to do some work outside of the regular board meeting—often within the context of standing and ad hoc committees—the regularly scheduled meeting of the full board is where most important discussions and decisions should occur.

The board meeting belongs to the board, not management. Certainly, the executive director, CAA staff, or others may help facilitate meeting logistics, offer administrative assistance, and provide accurate and timely information to help guide board discussion, but CAA executives should not attempt to drive or control board meetings and boards should never cede control.

CASE SCENARIO:

NOT EVERY DECISION HAS TO BE PERFECT, JUST TAKEN WITH CARE

BCA's board is considering whether to begin an afterschool college prep program for students in the community. Its board chair asks board members, Larry Hartford, Marsha Harris, and Devon McDuff to review the staff's preliminary research and make a recommendation to the full board on the potential impact and financial viability of the program. The three committee members examine proposed budgets, a needs assessment, staffing and training requirements, and survey data from other CAAs with similar programs. As part of its review, the committee also questions BCA staff. The committee prepares a 10-page report for the

full board, together with a recommendation that BCA start an afterschool college prep program. At its next meeting, following a 90-minute discussion, the board unanimously votes to fund the program. Unfortunately, after a year, the program turns out to be much more expensive than the initial projections showed and youth participation lower than expected. The board has no choice; it must end the program.

LESSON: Even though the board's decision turned out to be a bad one in hindsight, the board satisfied its duty of care. It based its decision on an informed and thoughtful process.

Meeting topics

Board meetings should give precedence to topics and discussions that relate to the board's five core responsibilities. While the board may not discuss each of these matters at every meeting, these topics should often appear on the agenda.

Topic 1: Mission and Programs

The nonprofit board generally acts in a representative capacity for members of the community. For CAA boards, its representative capacity is even more explicit as each board member is required by the federal CSBG Act to be selected as a representative of one of three sectors of the community: public officials; low-income individuals; and major community groups and interests, such as business, labor, and education.⁵ It serves as a connection between the community and the mission. The board is in the best position to demand adjustments if the CAA provides subpar services or if the CAA's programs are failing to fulfill the stated mission. For this reason, mission-related matters should be a regular agenda items. In addition to the general responsibilities of a nonprofit board to ensure fulfillment of the organization's mission, the CSBG Act requires CAA boards to participate in the development, planning, implementation, and evaluation of the CSBG program. This would require, for example, paying particular attention to:

- **Community Needs Assessment.** The board should regularly assess whether there are services that the CAA should be offering because there is a need in the community that is not being met. Such an assessment, called a community action plan, is required by the federal CSBG Act for all CAAs.⁶
- **Ongoing Program Evaluation.** The board should periodically evaluate each program to assess whether the program is achieving its objectives. This may require the board to meet with service recipients, but measurement of effectiveness should not stop there. The board should work with staff to develop standards and benchmarks for each program so that board members can review data collected by staff—and draw upon their own experience in making sense of data—to objectively measure program effectiveness rather than rely on anecdotal reports. The board should also look at how the CAA is implementing the performance standards required by the state CSBG office, such as the Results Oriented Management and Accountability (ROMA)⁷ standards and other programs and using those standards to lead the goal-setting, planning, and assessment processes.

CAA boards should also be aware of matters that must be addressed pursuant to laws or requirements governing other programs. For example, in 2007 Congress amended the Head Start Act to include a plethora of specific responsibilities for the grantees' board of directors, including, for example: establishing procedures for recruitment of children; reviewing and approving all major policies; approval of all major financial transactions and the annual budget; and reviewing all funding applications.⁸

Topic 2: CAA Governance Policies

Nonprofit governance has been the topic du jour for the better part of the last decade. The consensus view is that boards are at least partly responsible for putting in place conflict-of-interest, whistleblower, record retention, and other policies that assure that the nonprofit's operates ethically, in furtherance of mission, and in ways that minimize organizational risk. Boards may approach governance policies in different ways. Some will look to the staff to draft the policies, while others will take a hands-on approach, working with a lawyer or a committee to design, draft and implement the policy. Even if the staff drafts the language of the policy, it is recommended that the board be involved in setting the objectives of the policy and the procedures set forth in it, be familiar with any legal requirements in connection with it, take the time to carefully review the policy with staff and/or lawyers or other experts, and edit and revise the policy as necessary. This detailed review is often done first in a committee to allow for more time. If an organization has not yet adopted one or more of these policies, the board should place these matters on the agenda. Once the board has put these policies in place, it should, on an annual basis, review and assess whether adjustments are required or necessary. More important, the board must set aside meeting time to respond to conflicts of interest when they arise and address concerns raised by whistleblowers. This may require five minutes of meeting time, or in the case of complaints that have employment practice implications (e.g. sexual harassment, discrimination), the board may have to devote considerable time to the matter. For more information on these policies, please see the *Conflicts of Interest* and *Whistleblower Policy* sections.

Topic 3: Financial Matters

One of the board's primary responsibilities is monitoring financial resources to determine that there are safeguards in place to protect those resources, to assess whether those resources are adequate for the CAA's sound operation, and to determine whether the resources are being used optimally to achieve the mission. Time should be set aside at each board meeting to review the current financial statements; the CAA's financial position, liquidity, budget variances, and other key financial metrics; and, when available, the annual audited financial statements. Ideally, the board discussion should be led by a qualified board member—often the finance committee chair—rather than the CFO or other staff member, but the CFO or other financial or senior management staff should participate in the discussion, as necessary. If a board lacks members with financial expertise—a void that should be addressed—a staff member with the expertise should lead the discussion. Many of the matters described below should be reviewed first by a finance or audit committee that includes members with a range of finance-related expertise. At minimum, board must pay attention to:

- **Financial Statements.** The financial statements reviewed should include, at a minimum, a statement of actual revenue and expenses compared to budget and a balance sheet. The board should also consider reviewing cash flow statements and a report on the age of accounts payable (bills to be paid), which is a good indicator of the availability of cash to pay current obligations. For more information on this topic, please see the Reading Financial Statements section.
- **Annual Budget.** The board should actively engage in the annual budget process. The board should understand the underlying assumptions that guide budget development, offer input, and, ultimately, review and approve the final organization-wide budget,⁹ in addition to budgets for individual programs and central administration. The board should review budgetary performance data at every meeting. For more information on this topic, please see the *Annual Operating Budget* section.
- **Major Transactions.** Any organization will engage in major transactions during its lifetime, including buying or leasing major facilities, borrowing funds, entering new areas of activity, settling lawsuits, and making major investments. Many of these transactions will originate and be developed by management, which is appropriate. The board, however, should retain final authority over approving these actions. As a consequence, the board must set aside time during board meetings for presentations and discussion of these matters.
- **Review IRS Form 990.** This form, which is an informational return required to be filed annually by 501(c)(3) tax-exempt organizations with the Internal Revenue Service asks in Part VI whether the board of directors has received and/or reviewed a copy of the Form 990 prior to submission to the IRS. Although review is not legally required, since the form contains so much information about both the activities and the finances of the organization, and is available to the public online at www.guidestar.org, we recommend that boards do review it before submission.

■ **Audit and Internal Control Matters.** The board (or with larger boards, an audit committee) should review the annual audit report and management letter from the CAA's independent auditor and meet with the auditor. It should also review the CAA's relationship with the auditor, including whether the contract for services should be renewed, and/or selects a new auditor. Finally, the board should have periodic discussions regarding internal controls, fraud prevention measures, and other risk management issues. The board, or an audit committee, may also be tasked with reviewing whistleblower complaints and conflicts of interest. Each board will need to find the right mix. The board should focus particular attention on whether management is responding adequately to comments from the CAA's outside auditors. The board should look to the chair of the audit committee or a designated member of that committee to lead these discussions. For more information, please see the *Improving a CAA's Financial Capacity* section.

Topic 4: Risk Management

In recent years, both for-profit and nonprofit boards have taken a more proactive approach regarding organizational risk. This is reflected by the emphasis on governance policies and financial review and management. Some boards have chosen to go further, reviewing employment practices, identifying risks to stakeholders that could lead to lawsuits, assessing compliance with laws and grant requirements, and identifying vulnerabilities that could lead to fraud, waste, and mismanagement. At this time, there is no agreed upon approach to risk management by a board or the extent to which a board should engage in this sort of review. The trend, however, is clearly moving toward more board involvement. Whatever approach the board adopts, it should be a considered one. Most importantly, the board should recognize that management still is primarily responsible for risk management. Even if a board decides to rely heavily on management, it should ask for periodic reports from management.

Topic 5: Executive Hiring, Compensation, and Performance

The board is responsible for hiring and evaluating the CAA's chief executive officer, often referred to as the executive director. Most CAA boards delegate hiring decisions regarding other employees to the executive director, however, some CAAs may involve the board in hiring other members of the senior management team, such as the CFO. Hopefully, the decision to hire a new executive director does not need to be revisited annually, but the board should evaluate the existing executive director's performance annually, including how the board and the executive director interact.

The board also sets the executive director's compensation. Although the board should not set specific salaries for staff members below the executive team, and often does not set those either, it should review the overall levels of compensation throughout the CAA. It should also review the overall cost and structure of fringe benefit and retirement plans.

Federal tax law requires that the compensation paid to officers and key executives be reasonable. If it is not, the IRS can invoke what are called "intermediate sanctions," thereby forcing the executive who received unreasonable compensation to return the unreasonable portion to the CAA and possibly pay a 25 percent penalty, as well as require the managers that approved the compensation to pay a penalty.¹⁰ The law presumes that compensation is reasonable if the board can demonstrate that it: 1) used comparables in setting the compensation; 2) those on the board who approved the compensation were independent; and 3) the board documents the compensation package and decision process in writing. The IRS has the right to challenge this presumption. The board should make sure that the CAA and the executive have the benefit of the presumption, which means incorporating the three requirements into decision process.

Tip

TALK TO AN ATTORNEY TO UNDERSTAND BOARD REQUIREMENTS

Many state laws affect the operation of nonprofits and their boards. Board members are not expected to be experts on these laws' specific provisions, but they should consult with local attorneys to understand the impact of state law on board procedures. Any provision of the nonprofit's articles of incorporation (or similar documents) or bylaws that is inconsistent with the state law is void and has no legal effect. For example, if the state nonprofit law provides that board members may not vote by proxy, and an organization's bylaws allow a board member to appoint someone else to vote for him or her at a board meeting that he or she cannot attend, the provision allowing this delegation of voting authority is illegal, and can be challenged.

Board Committees

The board is responsible for much more than just passively listening to reports from the executive director. It must develop and synthesize a wide range of information and then make judgments and decisions based on that information. The board will not function effectively if this synthesis becomes a group activity that takes place during regular board meetings. The board will quickly become bogged down in details. For this reason, the board should rely heavily on committees to divide the work, build on the expertise of individual board members, and develop recommendations and solutions to problems. Some boards may decide to delegate decision-making authority to committees (assuming state law permits such a delegation), but the better practice is to have the committees report to the full board with background information and to make recommendations for board action. Most CAA boards will have both standing committees and ad hoc or special committees to handle short term special projects. Board committees should operate pursuant to a written charter, maintain minutes for committee meetings, and regularly report to the board on their activities.

CAA boards should consider having the following permanent—or standing—committees.

- **Executive Compensation or Personnel Committee.** The executive compensation committee, the personnel committee, or if neither exists, then the executive committee, should be charged with spearheading the search process for the executive director. A committee is needed to handle the heavy lifting that comes with hiring decisions and performance evaluations. The board needs a mechanism for developing position descriptions, working with head hunters, reviewing resumes, setting performance standards, and measuring performance. The full board simply does not have enough time to perform all of these tasks during regular board meetings. Nor is such an approach practical.

The committee should also develop the executive director's compensation package. This may include working with compensation consultants and/or using other resources, such as IRS Form 990s (available on www.guidestar.org) and compensation surveys to develop comparables. This committee should also be charged with developing performance benchmarks for the executive director and developing performance reviews. Finally, this committee can be charged with review of employment practices and assessment of fringe benefits and retirement plans. The committee should make recommendations to the full board, particularly on hiring, evaluation, termination, and compensation of the executive director, with final decisions remaining with the full board.

- **Audit Committee.** The audit committee should conduct the search for the CAA's independent auditor and make a recommendation to the board based on its search. The committee should then manage the relationship with the auditor by discussing plans for the audit, receiving periodic reports from the auditor during the audit, and meeting with the auditor following the completion of the audit. The committee should carefully review the management letter provided by the auditor and then work with management to see that appropriate action is taken with regard to the auditor's recommendations and observations. The committee should also be engaged in an ongoing review of the CAA's system of internal controls. Finally, the audit committee should be focused on compliance with government contracting and grant requirements.

The skills of those available to serve on the audit committee will vary from CAA to CAA, but should include at least some with financial expertise, such as a banker, accountant, or CFO at a business or nonprofit. The committee's independence from management will increase as the financial acumen of its members increase. In many instances, however, the committee may need to rely on management for assistance. In these cases, the committee members must be willing to ask questions and probe management's responses rather than accepting whatever management tells the committee.

- **Finance Committee.** The finance committee performs an entirely different function from that of the audit committee. Although CAPLAW recognizes that currently many CAAs have a combined finance/audit committee, we recommend, at least for medium to large boards, that it be a freestanding committee rather than combined as part of the audit committee. The finance committee's focus should be on assessing the adequacy of the CAA's financial resources. It should review the financial statements and prepare reports to the full board regarding the CAA's financial performance, liquidity, and financial condition. It should also be looking at long-range financial issues, such as how best to finance the CAA's operations. The finance committee should also be working with management on budgeting. The actual construction of the budget is best left to management, but the finance committee should focus on the assumptions underlying the budget and program priorities and resource allocation.

- **Governance Committee.** The governance committee should develop and periodically review key organizational governance policies, including the conflicts of interest and whistleblower policies. CAAs should consider including an attorney on the committee to assist in identifying needed policies and developing and reviewing them. Some committees will be quite active in developing these policies, while others will look to management to undertake the actual drafting. The governance committee should also periodically review the CAA's bylaws and other governing documents. It should also be involved in setting and implementing the selection process for, and recruiting, new board members, consistent with the CSBG Act tripartite board selection requirements.¹¹

Attendance

Nonprofits that experience governance-related scandals often report poor attendance on the part of some board members. People should not seek a position on a CAA board unless they are prepared to attend the meetings on a regular basis. Those board members who do not regularly attend board meetings deny the CAA their insights, or at least the insights of someone else who would otherwise occupy that seat. Those who are regularly absent also increase the level of work required of other board members.

The board should track attendance. The meeting minutes should identify board members who are in attendance and who are absent. If someone is consistently absent, the board chair or other designated person should have a discussion with that individual about their commitment to the CAA.

CAAs should add a provision to their bylaws that provides the board with the ability to remove a board member when there is a certain level of absences. A CAA's bylaws should be as specific as possible in defining acts that can lead to the removal of a board member; although a general catchall standard should be retained. This is particularly important where members of the public participate in the election process. Any provision making continued board membership contingent on some level of attendance should provide the board with some discretion. For example, the board may not want to be forced to remove a longstanding board member who is undergoing chemotherapy over a six-month period.

Part III: Board Meeting Structure

In most cases, a CAA's bylaws will govern many aspects of board meetings, such as frequency, location, quorum size, voting procedures, notice and attendance requirements, and use of parliamentary rules.¹² When making changes to board meeting procedures, CAA leaders should consult their bylaws to ensure changes do not conflict with the bylaws, and if they do, to update the bylaws to reflect the CAA's current practices. When updating bylaws, it is best to work with an attorney who is familiar with nonprofit law.

Board Meeting Logistics

Most board meetings should be held on regular basis on predetermined days and at times that accommodate work schedules and family obligations of board members. Key considerations are:

- **Frequency and Regularity.** The full board should meet at least several times a year at regular intervals. For many CAAs, this means monthly; which is generally preferable, for others particularly those covering large geographic areas, it may be every other month. The state CSBG law may dictate a minimum frequency. A board that meets less frequently (e.g., quarterly) faces increased risk of failing in its fiduciary responsibility. Whenever possible, the regular board meeting should be held on the same day of the week and at the same time. People should be able to block out time for meetings on their calendars for the upcoming year. Attending the meeting should become a habit. Some boards may find that they are simply unable to accommodate everyone's schedule by fixing one recurring day and time for the meeting. In those instances, consideration should be given to two recurring times that alternate. If consistent with state law and the bylaws, the CAA may also call special meetings when necessary.
- **Open Meeting Law Requirements.** Open meeting laws vary by state but generally require that board meetings and other official proceedings of government agencies, and sometimes some nonprofits, be open to the general public. All public CAAs would be subject to their state open meetings laws. Some nonprofit CAAs are subject to open meeting requirements of their state laws because the CAA receives government funds or the CSBG regulations require open meetings. Other CAAs are not required by law, but the CAA's governing documents require open meetings. Each CAA's board must determine, in consultation with its attorney, whether it must comply with open meeting requirements and what compliance requires (for example, whether board committee meetings must be open to the public).
- **Executive Sessions.** Open meeting laws recognize that certain sensitive matters are best discussed in a private forum. With that in mind, the laws often permit boards to adjourn to an executive session, which simply means the public is excluded from that portion of the meeting. The list of items that can be discussed in an executive session vary from state to state, but often include pending litigation and employment-related matters. In many instances, if the board makes a decision regarding the matter, it must take the formal action in the public portion of the meeting. Because boards are comprised of human beings, they have a tendency to like secrecy, which means that other sensitive topics—topics that are not on the permitted list of matters reserved for executive sessions—often seep into the discussions during executive sessions. As in, “As long as the door is closed, I’ve been meaning to raise this topic that I don’t want the press to know about.” Everyone present during an executive session should be sensitive to what is a permissible topic and what is not. When someone strays beyond the bounds of permissible topics, the group should immediately cut off the discussion. There may be criminal liability for violating open meeting laws or actions taken based on those discussions may be invalid.

- **Notice.** A notice informs all board members—and the general public if the CAA is subject to open meeting laws—of the date, time, location, and specific topics under consideration. Boards should make compliance with notice requirements a part of the routine and clearly assign the task to a specific role or individual (e.g., board secretary, member of the CAA staff). Without proper notice, all actions taken at a board meeting could be deemed invalid.
- **Agenda.** The board should always rely on an agenda to organize and conduct the meeting. The agenda should be sent to board members in advance of the meeting. Where a CAA is subject to a state open meetings law, it may also be required to make the agenda available to the public and be limited to discussing only agenda items at the meeting.
- **Meeting Length.** There is no set rule as to how long a board meeting should last. As a matter of discipline, the board should set a time for adjournment, but there is nothing wrong if the meeting runs several minutes beyond the allotted time. Given the many tasks that are assigned to a CAA board, meetings are likely to last at least two hours, particularly if there is robust discussion. On occasion, a meeting may go beyond four hours, but at this point, fatigue will set in, with the result that board members may not be as attentive or effective. If meetings regularly exceed three or four hours—or what the board finds tolerable—this may be a sign that the board is not effectively using committees to filter and organize information and proposals.
- **Chairperson.** The board chairperson, or if there is no chairperson, then the board president, typically leads the board meeting. That isn't required, but there should be a meeting leader who follows a schedule, indicates who has the floor to speak, and keeps an eye on the clock so that all business is accomplished within the allotted time.
- **Quorums.** Under state corporate law and the CAA's bylaws, a CAA's board cannot take action unless a certain percentage of the board members are present—a quorum exists. All board members have an affirmative duty to notify the board chair, secretary, or other designated person if they are unable to attend. There is nothing more annoying or dispiriting than arriving at a meeting to discover that a quorum does not exist, with the meeting then being rescheduled. E-mail, text messages, and cellphones eliminate most excuses for failing to provide timely notice.

Tip

SEEK LEGAL COUNSEL IF SUBJECT TO OPEN MEETING LAW

Often the requirement that meetings be open to the public looks to and references the open meeting laws that apply to governmental bodies. These rules tend to be complex, with the state attorney general supplementing statutory requirements with legal opinions interpreting the requirements. Any CAA subject to open meeting requirements should obtain a compliance checklist from a lawyer who is familiar with the applicable requirements. The CAA should check with that lawyer before deviating from the compliance checklist. In many states, the attorney general, secretary of state, or other state agency publish compliance handbooks that are often quite helpful. CAAs should focus on the laws applicable to them. The laws differ from state to state.

Meeting Agenda

Meeting agendas should be drafted with care by the board chair (or executive committee) in consultation with the executive director, with an eye to involving the board in decision-making on critical issues and providing information the board needs to make informed decisions. Some items – such as the date, time and location of the meeting; roll call/quorum determination; review and approval of the prior meeting's minutes; and a report on the CAA's financial condition – will generally be on every regular meeting agenda. If the CAA is subject to its state's open meeting law, it may be required to include certain items on its board meeting agendas. However, this does not mean that the agenda for every meeting must be the same. Instead, the agenda should emphasize issues facing the organization that are particularly essential for the board to be aware of or to decide – such as whether to purchase a new facility rather than lease, how to respond to Head Start monitoring findings, or what action to take in light of the President's proposal to cut CSBG funding by half. In each of these cases, staff should provide the board with a short, concise memo with sufficient information to enable board members to ask questions, have an informed discussion, request additional information, and, where necessary, make a decision that will help the CAA fulfill its mission. (In fact, some boards include the CAA's mission statement on the agenda to help the board evaluate the impact of its decisions on the mission.)

Rather than having program directors or other members of the management team present detailed reports on CAA programs and activities at every meeting, whether or not board discussion or action is needed, CAPLAW recommends having them prepare concise written reports that highlight recent developments. These reports should be included in the board meeting packet sent to board members prior to the meeting. At the meeting, the executive director can summarize the developments and issues outlined in the reports and board members can ask questions about the reports. However, unless a board member has a question or an issue has been flagged for discussion and/or decision-making, the focus of the meeting should turn to other matters.

Board Meeting Packet

In addition to the agenda, the CAA should send each board member a packet of information so that the board member can prepare for the meeting. The typical CAA board has many issues to deal with during a board meeting. Efficiency and economy warrant asking board members to come to the meeting with knowledge of the issues to be addressed. Ideally, board members should receive the packet at least one week in advance of the meeting. The packet should include:

- The minutes for the prior meeting that the board will be asked to approve
- The financial statements/budgets that will be reviewed at the meeting
- The terms of any major contracts or other decisions that the board will be asked to consider, including background information and, when possible, actual copies of the original documents
- Any studies or reports (e.g. from committees) that will be discussed at the meeting
- Other relevant information that will eliminate wasted time during the board meeting

Although each board member may not be under a legal duty to read this material in advance of the meeting, board members should review the material in advance as a common courtesy to their fellow board members.

Tip

CONSIDER PAPERLESS PACKETS

Many nonprofits now distribute board materials electronically. Options include e-mail distribution; document sharing tools, such as Google Docs; or commercial online board packet providers. Some nonprofits have gone as far as giving each board member an e-reader that can handle PDF documents. The documents are then e-mailed to the board member before the meeting, who then transfers them to the e-reader. It is conceivable that the full cost of the electronic readers may be recovered in the form of saved copying and postage/delivery service charges within a year. CAAs that are interested in this approach should weigh potential security issues, tax considerations, and potential public relations issues. They should also give board members the option of receiving hard copies through regular mail.

Rules of Order

Many people assume board meetings must be conducted in accordance with Roberts Rules of Order. This is not necessarily true. In fact, most CAA boards should avoid Roberts Rules of Order since they are designed for parliamentary bodies such as city councils and state legislatures. The rules are overly long and complex, and if followed, result in a very formal proceeding. A CAA's board should take a more working group approach when permissible.

- **State corporate laws do not mandate that boards follow Roberts Rules of Order.** Some lawyers will insert a provision in corporate bylaws that require an organization to use Roberts Rules of Order, or a board early in the history of an organization may adopt a resolution requiring the use of Roberts Rules. If this is the case, the CAA should work with an attorney to eliminate this requirement, especially since there is a good chance that the board has not followed it.

While Roberts Rules of Order may be out, there is nothing wrong with having an agreed upon set of rules designed to keep the conversation flowing in an orderly manner. There are no fixed rules, and there is nothing wrong with the board making up its own procedures, or adopting the “modern” rules of order published by the American Bar Association.¹³ CAAs should consider designating a board parliamentarian who is familiar with whatever rules the board chooses to follow.

Motions

Unless state law or the CAA's bylaws or other governing documents require otherwise, formal motions and seconds do not need to precede board decisions. They are, however, important. They tell the person taking the minutes that a decision is being made that most likely should be reflected in the minutes. A motion also informs the board that it needs to pay close attention to the proceedings and focus on the upcoming vote. The person making a motion should word it simply, avoiding trills and flourishes. It is a good practice, although generally not legally required, to require a second of a motion to keep events moving forward.

If no one is willing to second, it reflects lack of support for the proposition and, if no further action is taken on it, will avoid wasting time on the matter. In addition to motions to accept or decline proposals under consideration, some boards may also use formal motions to:

- **Refer a matter to the appropriate committee.** When a board lacks sufficient information to consider a matter, a formal motion to assign the matter to a committee documents the status and vests the committee with responsibility to investigate and return to the full board at a later date.
- **End debate.** Sometimes the vote begins and then someone has a second or third thought that they want to add to the mix. This often leads to confusion over what exactly is being considered for a decision. Is the original proposal still on the table or has it now been modified? By formally ending debate, the group now has permission to tell someone that they are out of order if the vote has begun. Before the vote, the chair or the secretary should restate the proposal.
- **Withdraw a motion under consideration.** When a subsequent discussion leaks into the voting process, the person making the original motion may withdraw the original motion to force the board to restate the proposal being considered.



BE COURTEOUS AND ATTENTIVE

Board members should come prepared to engage fully in deliberations. They should not multi-task during the board meeting. That means no e-mailing, text messaging, Gameboy gaming, telephone conversations, web surfing, checkbook balancing, or side conversations about weekend plans or rotisserie baseball standings.

Board members should also refrain from rude, domineering, or close-minded behavior, or participating in board cliques or gossip. They should also recognize that too much silence is not golden. The tripartite structure reflects the belief that input from different constituencies is valuable. Board members should not be reluctant to share their views.

Proxies

Many states do not permit board members to act through proxies, i.e. permit a non-board member to vote on behalf of a board member at a board meeting or to permit a board member to send a written proxy notifying the board of his intended vote. Nevertheless, people will on occasion send proxies to board meeting. Unless the CAA is absolutely certain that a board member can legally send a substitute to act on his behalf, the board should not permit a proxy to vote or count the proxy toward the quorum determination. Organizations should address this with counsel when it becomes an issue.

Once again, unless the board is absolutely certain that proxies are permitted, it should exclude the proxy from any discussions with the CAA's legal counsel when those discussions may be protected by attorney-client privilege. The proxy's presence could jeopardize the claim to privilege.

If the board member, who is regularly absent, is with an institution that has traditionally been represented on the board, the CAA should consider replacing the absent board member with the person he routinely sends as a proxy by following the procedures outlined in the CAA's bylaws. This may require some diplomacy.

Decisions Without In-Person Meetings

State corporate law traditionally required that to participate in a meeting, a board member had to be physically present. With the widespread availability of telephone and video conferencing, many state legislatures have modified corporate statutes to permit boards to hold meetings by telephone or video conference. Many state statutes, in authorizing electronic meetings, do require that each participant be able to communicate synchronously with the group. This means that the technology must permit each participant to interrupt someone speaking or interject a thought without any delay. If state law permits telephone or video conferencing, boards should not hesitate to avail themselves of these technologies when there simply is no way for someone to attend the meeting—the person is on vacation or is out of town on business. Most state laws will not allow actions to be taken via either phone surveys or emails. The only exception may be instances where every board member votes in favor of an action via e-mail. The unanimous affirmative vote could take the place of a similar vote at an in-person meeting. This is called a “written consent in lieu of a meeting” and is described below.

The best practice is for board and committee members to be physically present for board meetings. There is a context and interaction that comes with face-to-face communications; body language offers important cues. Those in attendance also are able to view PowerPoint and flip chart presentations, as well as viewing paper that is distributed at the meeting. Moreover, there is no opportunity to push the mute button or do other work while the meeting is in progress. Because of the advantages that come with face-to-face meetings, boards should not make a habit of relying on this technology when board members can be physically present. Any CAA that is subject to an open meeting law must consider the open meeting requirements before holding a meeting through otherwise permissible electronic means.

■ **Written Consent Resolutions May Be Helpful.** Most state corporate laws permit boards to take action through a written consent resolution without a formal board meeting. Typically these laws require unanimous written consent, meaning that all board members must be in agreement. Written consent resolutions are particularly useful when the board is faced with an unexpected decision that cannot await the next regularly scheduled board meeting. However, CAAs subject to open meeting laws are unlikely to be able to use written consent resolutions.

■ **The question has arisen whether a written consent resolution can take the form of an e-mail.** The answer can be tricky if the statute requires each board member's signature. Unless state corporate law statutes specifically address the question, conservative boards will want to obtain an opinion of counsel if the resolution takes the form of e-mails. Others may be comfortable without a legal opinion if the statute leaves some room for interpretation. In all cases where reliance is placed on e-mail, the e-mails (with full e-mail headers) should be printed out and retained in the minute book. It may be good practice to ratify the consent resolution at the next regular board meeting. Before utilizing a written consent resolution, the board should determine whether open meeting laws pose any obstacles.

CASE SCENARIO:

ABSENT MEMBERS MAY REQUIRE ACCOMMODATION

Several BCA board members want to remove Maureen Whipple and Loretta Chapman from the board. Both have missed the last six regular meetings, which are held at 7 p.m. on the first Thursday of the month. Anita Nilsson, the board chair, is reluctant to ask them to resign. Both Whipple and Chapman volunteer for one of BCA's clinics every other Saturday morning. Nilsson decides to ask both whether there is a scheduling problem. She finds out that both work for restaurants and that Thursday night is considered a weekend night in the restaurant business.

At the next board meeting, Nilsson asks whether the board would consider rescheduling the regular board meeting to Wednesday nights. Whipple and Chapman told Nilsson that there would be no

scheduling conflict if the meetings were held on Wednesday. A number of board members are thrilled because they like starting the weekend early with their families.

LESSON: Never assume a board member's absence indicates disinterest or disengagement. If several people are consistently absent, this may be a sign that the board should reconsider the day and time for regular meetings. The board should be polled regarding their preferred times. Depending on work schedules, evening meetings may be necessary, but early morning meetings or meetings on a Saturday morning should not be ruled out if those times accommodate people's schedules.

Part IV: Board Meeting Minutes

Simply defined, meeting minutes are a contemporaneous written record describing what transpired at a board or committee meeting. A minute book is a chronological compilation of all meeting minutes.

MINUTES AND THE IRS FORM 990

The IRS asks on the Form 990 whether the organization "contemporaneously document[s] the meetings held or written actions undertaken during the year by the following: (1) the governing body; and (2) each committee with authority to act on behalf of the governing body." Moreover, the tax rules governing executive compensation and financial transactions between a charity and insiders provide the organization and insiders special protections if the decisions are contemporaneously documented and certain other requirements are satisfied. The meeting minutes are the logical place for recording those decisions and transactions—and one of the first places external parties will look for documentation.

Importance of Good Minutes

Maintaining good meeting minutes for all board and committee meetings is important for four reasons:

- **Sound Board Functioning.** Memories are surprisingly short, particularly in the case of volunteer directors and committee members who may not have contact with the CAA every day. Meeting minutes permit the board to review the history of how it addressed a matter, better assuring consistency in its decisions.

Meeting minutes create and preserve institutional memory. A board can review actions that an earlier board took and understand what those actions were and why they were taken. When a board decision is a controversial one, the board may be required to revisit and fine tune it. If the board does not have a clear written statement of what was decided and why, those who opposed it may try to “re-litigate” the decision when the board needs to refer back to the decision. This can result in inconsistencies and wasted meeting time; “What did we decide?” Detailed minutes describing each decision will minimize this possibility.

- **Regulatory Compliance and Oversight.** All CAAs are subject to scrutiny from federal and state funders, the IRS, and the agencies that oversee health and safety, employment, and the myriad of other matters that governments regulate. Most are also subject to an annual A-133 audit (Single Audit) conducted by an independent auditor. Outside monitors and independent auditors often ask to review the CAA’s meeting minutes, and some funding sources, such as state CSBG offices, often request minutes to be sent to them after each meeting. Up-to-date and thorough meeting minutes create the perception that the CAA is well-governed. Minutes may also quell more extensive inquiries if they answer more questions than they raise.

Government monitors and independent auditors may take an unfavorable view of the organization if there are no meeting minutes, the minutes are haphazard, or the minute book is in disarray. The additional work on the monitor or auditor’s part may lead to findings and/or additional fees.

- **State Statutory Requirements.** Many state statutes require nonprofits to maintain meeting minutes for board and committee meetings, so doing so is a legal requirement. These same statutes rarely specify the level of required detail. Sketchy minutes may satisfy the letter of the law, but if board actions are ever questioned, highly abbreviated minutes may pose a problem for officers and board members.

State charity officials generally don’t engage in the regular review of meeting minutes or conduct audits of charities. Regulators tend to be reactive, opening investigations when they have reason to believe that charitable assets are being misused or the board or management have been derelict. Once on the scene, however, charity regulators sometimes review corporate records, including meeting minutes. Several state charity regulators have commented on the quality of meeting minutes and have imposed requirements regarding the maintenance of meeting minutes as part of settlement agreements with officers and board members.

- **Risk Mitigation.** Meeting minutes are not only of interest to regulators and auditors, but they also can protect board members and officers in the event of lawsuits or media scrutiny. When called upon to examine the board’s diligence, some courts have examined the meeting business to assess whether the board exercised business judgment and discharged its legal duties. Sketchy minutes may suggest that one or more board members have been derelict in discharging their fiduciary duties.

CASE SCENARIO:

ESTABLISHING EXERCISE OF BUSINESS JUDGMENT

The Blue Community Action (BCA) board is considering whether to borrow \$5 million to finance the construction of a low-income housing project. A number of members of the community oppose the project because they believe single-family units are preferable to the proposed 20-unit building. Larry Jones, a mayoral aide and BCA board member, agrees with the low-income members of the board who object to the proposal. Several board members have expressed concern that BCA should not proceed with the project because of poor economic conditions and BCA’s already high level of indebtedness.

After a lengthy discussion and presentations by experts, the board voted to approve the borrowing. An expert on low-income housing made a 45-minute presentation outlining the reasons the project would be self-sustaining. A special committee of the board, which included a banker and accountant, also reported on the viability of the proposal. They had run a series of projections, including ones based on low levels of occupancy. The stress tests demonstrated

that the project would be self-sustaining at even a 50 percent occupancy rate. Market studies reviewed by the board indicated that there would be significant demand for the units.

LESSON: Given the controversy and the concern of several board members over the propriety of incurring additional debt, whoever prepares the minutes should describe: (1) the concerns expressed at the meeting; (2) the presentation by the expert; (3) the special committee’s study; and (4) the data on demand. The minutes should also describe why those in favor of incurring the debt prevailed. Finally, appropriate studies reviewed by the board or presented by experts should be attached to the minutes. While this may be more detail than some believe is appropriate, the detail and exhibits demonstrate that the board’s decision was a considered one. This will help the board mount a defense based on the exercise of business judgment should a regulator, outside group, or media question the board’s judgment.

Special Considerations for Community Action Agencies

Community Action Agencies, whether private nonprofits receiving large amounts of government funding, or public agencies that are part of a local government, should carefully consider how their minutes comply with explicit laws concerning access to and retention of records, or may serve as key evidence of compliance with financial, governance, administrative, and programmatic requirements.

Community Services Block Grant Act

The Community Services Block Grant Act requires a CAA's board to participate in the development, planning, implementation, and evaluation of the CAA's program to serve the low-income community.¹⁴ The board's meeting minutes provide an opportunity to build a record demonstrating that the board is fulfilling this obligation.

Office of Head Start

The *Office of Head Start Monitoring Protocol and Guides: Program Design and Management* instructs reviewers to examine meeting minutes for evidence that the governing board:

- Approved the annual self-assessment and financial audit
- Approved personnel policies regarding hiring, evaluation, termination, and compensation
- Reviewed applications for funding and related amendments
- Received and reviewed audit reports

Monitors must also review the minutes for evidence of financial conflicts of interest, such as transactions between the CAA and business owned by board members, and related-party leases. Those CAAs operating Head Start programs should therefore expect program reviewers to request minutes for board meetings.

Open Record Laws¹⁵

Public CAAs are generally required to make their meeting minutes available to the public, so their meeting minutes should be prepared with the expectation that they will be reviewed by members of the public, including the media. Generally, there is an exception for those portions of the minutes that pertain to certain sensitive matters reserved for executive sessions. Under some state statutes, the minutes of nonprofit CAAs may be considered public records, opening them up to public review. Each CAA, whether public or private, should consult with counsel to ensure that it complies with all public records requirements.

Tip

USE MINUTES AS BOARD ORIENTATION TOOL

CAAs can use meeting minutes to orient new board members. A new board member can gain insight and context for future decisions by reading two or three years of meeting minutes. Perspective board members may ask to review meeting minutes to help them decide whether they want to join the board. Unless the CAA is subject to an open records requirement, there is nothing that requires a CAA to make those minutes available to an outsider, but doing so may help in recruiting new board members.

The Minute-Taker

CAAs have some discretion in who prepares the meeting minutes. The most common minute takers are:

- **Corporate Secretary:** By tradition, the corporate officer charged with preparing board meeting minutes is the corporate secretary. Regardless of who prepares the minutes, the secretary is ultimately responsible for ensuring the accuracy of the minutes, and for safeguarding the minute book.
- **Lawyers:** If the CAA has a lawyer as a member of its board or has a general counsel, the organization should consider having that lawyer either draft the minutes or review a draft of them before the minutes are circulated. A lawyer's legal training sensitizes him to the ramifications of word choice and tone.
- **Administrative Staff:** Some boards and members view the task of taking notes during meetings as a distraction, often assigning it to an administrative assistant. First, and foremost, the administrative assistant should receive concrete direction as to what is expected and what should be included in the notes. Until the assistant "gets the hang of it," the assistant should be given feedback. Even when an administrative assistant prepares the minutes from the notes, the assistant's work should be treated as a first draft. A designated board member, officer, or a lawyer should review and finalize the draft.

Some CAAs may adopt a process involving more than one person. Whatever the process, the CAA should ensure that it is in conformity with state law and the organization's bylaws.

When Minutes Should be Written

Ideally, minutes for board meetings should be drafted within 48 hours of the meeting. In drafting the minutes, even someone who is an excellent note taker will recall points that should be memorialized in the minutes, but that did not find their way into the notes from the meeting. The sooner drafting commences, the more likely those points will be recalled. Under no circumstances should preparation be put off until the week or day before the next regular board meeting.

Tips

EXERCISE CAUTION WHEN RECORDING

Some organizations record their meetings using audio or video tape. While this may appeal because of the verbatim nature of a recording, it is unnecessary. Despite the potential for accuracy that comes with a recording, the minutes should never adopt a "He said, She said" format as this will lead to overly long minutes and increase the likelihood that potentially inflammatory or indiscreet statements will be included. There are at least two disadvantages to recording a meeting: first and foremost, a mike and tape recorder can chill open discussion. There are some people who simply will not be as candid as they would otherwise be. Second, while fear of lawsuits should not drive the decision, a recording is open to discovery in the event of litigation. Routine destruction of tapes shouldn't carry adverse legal consequences if the destruction is routine and litigation is unforeseeable at the time the recording is destroyed. Courts can and will, however, sanction a CAA for destruction of evidence if the evidence (tapes in this case) are destroyed in anticipation of pending or foreseeable litigation in an effort to hide something that was on the tape. Before adopting any document destruction policy, a CAA should seek legal counsel.

USE A STANDARD TEMPLATE

Standard fonts, margins, headings, sequence of headings and overall consistency in content and narrative structure make the task of preparing the minutes more efficient. Moreover, someone reading minutes for 10 or 20 prior meetings in an effort to find one piece of information will appreciate standard headings and consistency in content and format.

INCLUDE KEY EXHIBITS

Any policy or other written document that was approved at a meeting should be included with the minutes. In addition, although the practice will vary from CAA to CAA, serious consideration should be given to attaching financial statements, reports, studies, or other items that were distributed at the meeting and informed board deliberation on matters of importance and provide support for final decisions reached.

MAKE SURE YOU CATCH EVERY WORD

The person charged with drafting the minutes should arrive at the meeting several minutes early with a copy of the meeting agenda in hand. Because rooms have dead spaces, echoes, and sound bleed from adjacent rooms, the person drafting the minutes should assess where the sound quality will be best and position themselves accordingly.

Contents of Minutes

At minimum, minutes must include:

- **Date, Time, and Location:** The date, commencement time, and location of the meeting.
- **Regular or Special Meeting:** Whether the meeting is a regularly scheduled meeting or a special one.
- **Attendees:** A list of the board members who were present and a list of those who were not. If board members have differing voting rights, those should be noted. As an example, those with full voting rights might be identified separately from honorary or advisory board members.
- **Quorum:** Whether there is a quorum present to conduct business. The act of documenting that a quorum was present serves one critical purpose: It forces someone to ask the question.
- **Guests:** The names and affiliation of any guests who were present at the meeting. This information is particularly important in the case of professionals, contractors, or others who advise the board or submit proposals. Listing the names of members of the public who attend if meetings are open is less important, but may be useful if members of the public are allowed to speak at meetings. Moreover, the list can be used to recruit new board members: Those who regularly show up at board meetings certainly are interested in the CAA.
- **Action on Minutes:** An indication whether minutes from the prior meeting were approved or modified by the board.

- **Major Proposals and the Actions Taken:** Each major proposal placed before the board and the action taken. The person drafting the minutes should not hesitate to ask for a clear statement of the motion under consideration. By asking, this person forces the person placing the decision before the board to clearly state the proposal that the board is being asked to consider. This signals to other board members “Something important is about to happen, so pay attention.”
- **Treasurer’s Report:** A summary of the financial report made by the treasurer, CFO, head of the finance committee, or other person responsible for reporting on financial matters. Unless there is a specific requirement under state law, the CAA’s bylaws, or a grant, the board need not separately approve the treasurer’s report, but there certainly is nothing wrong with doing so, particularly given the importance of finances.
- **Major Discussions:** Not all board business requires a decision. For example, the board may receive a quarterly report about a program or review a consultant’s report about a program’s efficacy. To meet the requirements of the Community Services Block Grant Act, the board should have these discussions and others that pertain planning, implementation, and development of programs. These discussions should be evidenced in the minutes.
- **Committee Reports:** In addition to describing what each committee reported at the meeting, the minutes should identify any standing committees that did not make a report. This will help the board chair identify any committees that have ceased functioning.
- **Compensation Decisions:** Government grant making agencies, state charity officials, and the IRS focus on whether executive compensation is excessive. If the board has a compensation committee, the minutes should thoroughly document the process that the committee (and the board) used to assure that executive compensation packages provide for reasonable rather than excessive levels of compensation. At a minimum, the minutes should:
 - Include the compensation comparables that were used to set executive compensation, including a discussion of why the comparables are for similar organizations and/or similar positions.
 - Establish that those approving executive compensation were independent of those receiving the compensation.
 - Document each material component of the compensation package (including base compensation, retirement benefits, health, disability, and life insurance benefits, expense account allowances, and other perks).

Tip

PAY ATTENTION TO TONE

Tone does matter. While each organization should find its own voice, certain practical considerations should apply.

- Take the Sergeant Joe Friday approach. Minutes should stick to the facts and avoid colorful, inflammatory, or indiscreet language.
- Avoid “He Said, She Said.” More detail does not mean that discussion and debate must or should provide a verbatim recitation of what was said at the meeting. That should be avoided. On occasion, if someone made a particularly persuasive argument, it might be noted with a reference to that person.
- Avoid Noting Personal Attacks. Despite the best of intentions, on occasion, debate can become personal and heated. Such incidents should not be reflected in the minutes.

**CASE SCENARIO:
SEEKING CLARITY**

BCA’s board has been asked to consider whether to allocate \$50,000 to an emergency program designed to help people who have been out of work for more than 99 weeks. Rita Newman is charged with preparing the meeting minutes for BCA’s board. Aki Taan has just put the following motion before the board, “I move that we approve the emergency program.” Prior to the motion, board members questioned whether BCA could afford to allocate \$50,000 to the program. A consensus was developing that \$40,000 might be the more appropriate amount.

LESSON: Minute taker Newman should ask Taan to clarify his motion by indicating the amount to be allocated to the program and over what time period. By doing so, Newman not only makes sure that the minutes will correctly reflect the board’s decision, but she assures that everyone who votes understands exactly what they are voting for or against.

CASE SCENARIO:

WHEN DEBATE BECOMES EMOTIONAL OR HEATED

At its last monthly meeting, the BCA board had to decide whether to close its Head Start program. Several parents who are board members were adamant that the program should not be closed. Mary Litwin, a banker who sits on the board, attempted to demonstrate why BCA simply could not afford to retain the program. Martha Jones, one of the parents, started screaming at Litwin, getting into her face and poking her in the arm. Someone finally had to restrain Jones. Board chair Anita Nilsson excused Jones, hoping some time away from the proceedings would permit her to regain her composure.

LESSON: The meeting minutes should indicate that several board members were opposed to the closing. They should also briefly describe the pertinent financial information that Litwin presented. There is no need to indicate that Jones lost her temper or was asked to leave the meeting so that she could regain her composure—although if the minutes do track people who leave the meeting early or step away for more than a quick personal break, the minutes should note that Jones stepped outside.

- This same information and any specific recommendations by the compensation committee to the full board should be included as part of the full board’s meeting minutes, particularly if the full board is the body that approves the compensation packages.
- **New Business:** A summary of each item of new business that was discussed.
- **Appointments and Resignations:** Any appointments or resignations from committees or the board that were announced at the meeting. In the case of new board members, their classification within the tripartite structure should be indicated.
- **Next Meeting:** The date, time, and location of the next meeting. In most cases, this will not serve as a timely notice of the next meeting because the minutes will be finalized at that meeting, but it will assist when reading minutes in the future.

Level of Detail

CAAs should adopt a more informative style that offers more detail than traditional minutes. For decades, corporate lawyers have prepared meeting minutes for large corporations, establishing the style that others use when preparing minutes. The historic preference of corporate lawyers has been to say as little as possible, viewing minutes as a formality, but one that could lead to litigation and trouble if too much is said. Many lawyers and others continue to hold this view. There are several reasons why the traditional view is counter-productive and has become outdated.

- **It Creates a False Sense of Security.** The historic view assumes that by putting nothing in writing, no evidence exists that could support future litigation against the organization or its officers and board members. The absence of details in the minutes is unlikely to dissuade someone from filing a lawsuit, but a detailed account of thoughtful deliberations may. Equally, if not more noteworthy, the historic view reflects the misguided belief that no other evidence exists that could support a lawsuit. People may be emailing or blogging descriptions of what they believe transpired at the meeting. When there is litigation, people who were in attendance will be asked to give depositions or court testimony. A CAA has no control over that testimony. By detailing what transpired at the meeting in formal minutes, the CAA creates a contemporaneous record that can be used to refute claims by others.
- **It Doesn’t Create Institutional Memory.** Details create institutional memory. Decisions are rarely discrete events. Boards revisit, modify, and base other decisions on previous decisions. Future boards can make better decisions if they know what decisions and why those decisions were made by prior boards.
- **It Results in Unnecessary Reviews of Past Decisions.** Sometimes the losing faction does not give up the fight. A divided board will make a decision, and then six months later, a question involving the original decision comes up. If the minutes are less than clear about what the board originally decided, the losing faction may try to force a reconsideration of the original decision. Clear and detailed statements of what was decided and why can eliminate “re-litigation” of what people believed were final decisions.

CASE SCENARIO:**REGISTERING OBJECTIONS IN THE MEETING MINUTES**

Delaney Clayton is a member of BCA's board of directors. At the last meeting, Clayton staunchly opposed and voted against a proposal to lease office space from a company wholly-owned by Lydia Staves, the sister of BCA executive director Gloria Watson. The board approved the lease over Clayton's objections. In reviewing the minutes that were circulated for that meeting, Clayton noticed that the minutes didn't note of his strong objections or vote against the lease.

LESSON: At the next board meeting, Clayton should request that his vote against approving the lease be explicitly noted in the

meeting minutes. If the person preparing the minutes refuses to note Clayton's opposing vote, Clayton should send a brief letter to BCA's secretary (or the other person maintaining the minutes if that person is not secretary) indicating that he voted against the lease. Clayton should request that the letter be included in the minute book. The exact procedure required of Clayton may vary from state to state, but many statutes provide Clayton with protection from liability stemming from the board action if his opposition is noted in the minutes or through a written communication. Clayton should check with a lawyer about the proper procedure to follow.

Informative Minutes:

- **Avoid abbreviations.** Those at the meeting may understand the abbreviations, but people serving on the board five years hence may not.
- **Record Last Names.** Mr. or Mrs. are optional, but last names are essential. There are a lot more Robs, Justins, and Jennifers than Blagojevichs, Biebers, and Hudsons.
- **Follow the Thread of the Debate.** The minutes should briefly summarize the threads of the debate or discussion. When appropriate, the minutes should describe the decisive factor that drove the decision.
- **Identify Documents and Experts.** The minutes should list the critical studies and other documents that the board reviewed and the experts that were consulted.
- **State the Vote.** Unless the vote is unanimous, the minutes should identify by name those who voted for and against the matter. If someone abstained, their name and abstention should be noted.
- **Note Objections.** The minutes should identify who voted against the matter even if the minutes don't identify who voted for it. Under some state laws, those who vote against a matter have the right to have their opposition vote noted in the minutes. This absolves them of liability with regard to the particular vote. If the person keeping the minutes refuses to note the objection in the minutes, the person objecting should note their objection in a letter to the board.

Board Review

The person charged with maintaining the CAA's meeting minutes should circulate the proposed version well in advance of the next regularly scheduled board meeting. In many cases the proposed minutes will be approved as is, but the use of the word "proposed" here signifies that the board has not formally approved the minutes. The proposed meeting minutes should always be labeled as "Draft" or as "For Review and Approval" when circulated to board members for review.

The exact process will vary from CAA to CAA. In some cases, the proposed minutes will be circulated as part of an information packet for the upcoming meeting, which might include an agenda, financial information, and special reports. Other CAAs will distribute the proposed minutes separately. However distributed, the proposed minutes should be in the hands of board members at least one week in advance of the board meeting. Board members should not be forced to waste valuable meeting time by reading the proposed minutes during the meeting.

Destruction of Draft Copies

After the minutes are finalized and approved, all paper drafts should be collected and destroyed and electronic copies deleted. No organization should assume that circulating and then destroying paper copies eliminates the proposed version. Somebody will inevitably make a copy or "forget" to turn in their copy, particularly if there is something controversial in the draft. For this reason, great care should be taken in preparing proposed minutes.

CASE SCENARIO:

SENSITIVE TOPICS DISCUSSED IN EXECUTIVE SESSION

BCA's board convened an executive session when the board considered whether it should dismiss Coleman Hall, a counselor who works in BCA's family counseling program. Liz Larson claimed that Hall had been sending her sexually provocative text messages and making inappropriate physical advances. Hall denied Larson's allegations, but Larson had copies of the text messages and the messages were also stored on Hall's company-issued cell phone. In response to the allegations, the HR Department opened an investigation. It learned more disturbing information about Hall from other employees. The board decided to terminate Hall for cause. As sometimes happens in these situations, a number of board members (of both sexes) made catty comments about Hall and Larson during the discussions despite being asked by the board chair Anita Nilsson to avoid irrelevant and inappropriate comments. Nilsson is particularly concerned in this case because Hall has threatened to sue BCA if he is terminated.

LESSON: Rita Newman, the board secretary, should exercise care in drafting the minutes, paying particular attention to word choice. Under no circumstances should she refer to the catty comments. She should note the allegations as such, the evidence that was taken into account by the board, and the board's decision. The discussion should be brief, neutral, and judgment free. If at all possible, it should be reviewed by the organization's attorney before the minutes are circulated for review. Because this discussion occurred during executive session, the portion of the minutes relating to the Hall matter should be segregated from the minute book regularly used for housing meeting minutes so that this discussion in the minutes is secure.

Executive Session Minutes

While minutes should be maintained for executive sessions, they should be stored in a separate minute book from the minutes of the regular board meetings. Many CAAs must comply with open meeting laws, or have bylaws that require meetings to be open to the public. These laws and requirements often permit a board to consider sensitive matters in closed or executive session. These matters often include personnel, sensitive contract negotiations, and pending or threatened litigation—each board must review the specific law or requirements for executive sessions to determine what can be considered during these sessions.

- **Establish Basis for Executive Session.** If statutes or bylaws restrict what can be discussed in executive session, the minutes should state the legal basis for the executive session.
- **Watch Tone.** Whoever drafts meeting minutes should always do so with an eye toward avoiding controversy or creating potentially damaging language should the minutes become public or the subject of a discovery request from the opposing side during litigation. This is particularly true in the case of minutes for executive session meetings given the sensitive nature of the matters typically reserved for those sessions. When appropriate, the drafter should have the CAA's lawyer review drafts before circulating or finalizing them. In sum, the tone and substance of executive session minutes should be more in keeping with the corporate lawyer's traditional view of how minutes should be maintained.
- **Take Precautions When Storing.** Executive session minutes should be stored in a special minute book physically separated from the minutes for regular sessions. In at least one known instance, an organization was asked to turn over its minute books for review in connection with potential litigation. While portions of the executive session minute books were subject to attorney-client privilege, nobody drew that distinction. The adversary was given access to the minutes books that contained those privileged minutes right alongside minutes for the regular meeting.

Executive session minutes should be stored in a special minute book physically separated from the minutes for regular sessions.

Committee Minutes

State law sometimes requires that minutes be maintained for board committee meetings. Regardless of whether required by state law, minutes should be maintained for board committee meetings.

- **Follow the Same Format and Content Rules.** There is no reason why those preparing and maintaining minutes for committee meetings shouldn't follow the guidelines outlined above.
- **Store Committee Meeting Minutes Separately.** The meeting minutes for each committee should be stored separately rather than being collated in one minute book containing all board and committee meeting minutes. This approach should make finding information easier, particularly if there are multiple committees, but CAAs should feel free to ignore this suggestion in favor of any system that they develop to make the minutes easily accessible, including electronic minute books.

Tip

CREATE AN ELECTRONIC MINUTE BOOK

Given the ease with which Word files can be converted to PDF files, there is no excuse for not creating an electronic minute book using Adobe Acrobat, CutePDF, or comparable software.

Benefits include:

- **Ease of creating, updating, and storing back-up copies:** An electronic file may be stored and updated on a flash drive in a fire safe box or an offsite computer or on a web-based service.
- **Search function:** If the CAA needs to reconsider a matter that came up five or ten years ago, an electronic search will prove to be much more efficient and effective than a search through binders holding paper minutes.
- **Portability:** If someone needs to review the minute books, such as an auditor or regulator, it is easier to provide the minutes in electronic rather than paper form.

Retaining minutes

Traditionally, minutes are kept in a formal minute book or a less formal binder. CAAs should adopt whatever packaging works best for their circumstances, but consider the following:

- **Number the Pages.** Each page of the minutes should be numbered (Page X of Y) and dated. This will make efforts to tamper with the minutes more difficult and will help others in future reviews involving more than one meeting.
- **Keep At Least Two Copies.** At least two copies of the minute book should be created and maintained. One should reside in a safe place in the CAA's offices. The other should be stored in a different location to provide backup in the event of fire, theft, flood, or other acts of God.
- **Avoid Using a Board Member as the Repository.** There will be instances where the CAA does not have a physical or a secure facility, meaning that a board member or officer will store the minutes at his home or place of business. This should be viewed as a last resort and should be avoided. If the keeper of the records dies, is away on business, or has a falling out with the CAA, the CAA may lose access to its minute book.
- **View Meeting Minutes as Core Organizational Documents.** There is no one right answer as to how long corporate meeting minutes should be retained. At least one state sets the minimum period at three years. Clearly CAAs subject to that state's jurisdiction want to retain meeting minutes for at least three years. However, like all record retention issues, the answer should turn on how long the CAA needs the information contained in the minutes. Consider the following two examples:
 - BCA borrows \$1 million from the bank to finance the acquisition of a new office building. The loan is for a 15-year term. At a minimum, BCA should retain the minutes from the meeting authorizing the loan for at least 15 years from the date of the loan, or if a shorter period, until the loan is retired.
 - BCA is organized under the laws of State X. Under State X's laws, an action can be brought against a board member for breach of his fiduciary duties within six years of the breach. At a minimum, BCA should retain the minutes for at least six years from the date the minutes were approved. However, determining how long statutes of limitation remain open is tricky, so BCA and its board would be well advised to retain the meeting minutes for each meeting much longer.

Given their importance and minimal demand for space, particularly if maintained in electronic form, there is no reason why any CAA should ever discard its meeting minutes. In other words, in an effort to maintain institutional memory, the meeting minutes should be retained permanently.

Endnotes

1. 42 U.S.C. 9910
2. 42 U.S.C. 9901(1).
3. For more information on this topic, see CSBG Information Memorandum No. 82, published by the Office of Community Services within the Department of Health and Human Services' Administration for Children and Families: <http://www.acf.hhs.gov/programs/ocs/csbg/guidance/informemoranda.htm>. Also see the Community Action Partnership's Standards of Excellence at www.communityactionpartnership.com.
4. Some nonprofit literature also mentions a third separate duty—the duty of obedience—which requires a board member to act in furtherance of the organization's mission and to ensure compliance with applicable laws. However, other nonprofit experts and the model acts do not include it as a separate duty and/or believe it is more appropriate to incorporate it into one of the other two recognized fiduciary duties. Whether it is considered a separate duty or subsumed within the other duties, boards should consider furtherance of the mission and compliance with applicable laws to be an important part of its role. As always, CAAs should check with their attorney on their state's laws with respect to board members' duties.
5. 42 U.S.C. 9910.
6. 42 U.S.C. 9908(b)(11).
7. See OCS Information Memorandum No 49: <http://www.acf.hhs.gov/programs/ocs/csbg/guidance/informemoranda.htm>.
8. 42 U.S.C. 9837(c)(1)(E).
9. An organization-wide budget allows for a comprehensive financial snapshot of the organization, and is required for Head Start grantees. See 42. 9837(c)(1)(E)(iv)(VII)(bb).
10. 26 U.S.C. 4958.
11. 42 U.S.C. 9910.
12. To learn more about bylaws, see The CAPLAW Bylaws Toolkit 2009 Edition. Available for purchase at: <http://www.capl原因.org/publications.html>
13. See Tortorice, Donald A, (2007). *The Modern Rules of Order, Third Edition: A Guide for Conducting Business Meetings*. Chicago, IL: American Bar Association.
14. 42 U.S.C. 9910.
15. See The Reporters Committee for Freedom of the Press Open Government Guide for a state-by-state summary: <http://www.rcfp.org/ogg/>

SECTION 2: IMPROVING A CAA'S FINANCIAL CAPACITY

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A Community Action Agency's purpose is to provide services and advocacy to move people from poverty to self-sufficiency, rather than to make profits, but like for-profit entities, CAAs cannot expect to be viable unless they are well-managed. This means that a CAA must have financial capacity. This toolkit examines the management and the board's role in financial management, board audit and finance committees, and the role of the independent auditor. It is aimed at the CAA's financial team, including those in management with day-to-day finance and accounting responsibilities, as well as members of the board who are interested in financial issues or who are members of the audit or finance committees. Other members of the executive team, such as the executive director, as well as other board members, will also benefit from reviewing portions of the toolkit.

Financial management is a complex and involved process. This toolkit does not address every aspect of financial capacity. It focuses on personnel—the CAA's internal financial staff, with a focus on the CFO, the independent auditor, and the board's audit committee.

An Overview

One of a board's primary functions is to oversee a CAA's finances, deciding how limited resources are utilized and protecting those resources from misuse and misappropriation. The board is not required to conduct audits or design accounting or control systems. Those tasks belong to management. The board must, however, make sure that management is properly carrying out those tasks and fully and continuously engaged in detailed financial management. To discharge its oversight function, the board should:

Financial Statement Review

Review both interim and annual financial statements, a task that is covered by the toolkit section *Getting the Most Out of Your Financial Statements*.

Budget Oversight

Approve and monitor an annual organization-wide budget, as well as individual grant and contract budgets, another task addressed by a separate toolkit. The extent to which the board does the latter may depend on the size of the organization, the number of grants and contracts, and funding source requirements. Some boards may delegate the detailed review of individual program budgets to committees. Some CAAs may separately list individual program budgets within their organization-wide budgets. At a minimum, with respect to individual program budgets, management should bring to the attention of the board any significant deviations between a program's budgeted and actual revenue and expenses. However, this detailed review should not come at the expense of a review of the larger financial picture of the CAA as a whole.

CFO Oversight

Provide input to the CAA's executive director on hiring and evaluating someone to manage the CAA's finances, which is the subject of Part I of this toolkit. This person preferably has skills typically associated with a chief financial officer (CFO), but due to size, resources, and sophistication, some CAAs will start with a bookkeeper. Hopefully over time, the CAA would increase its resources so as to enable the executive director to hire an additional person who is qualified to be a CFO or, if the CAA is not able to do so, the bookkeeper would obtain the formal training and skills necessary for the CFO role. Because the CFO (or person with comparable responsibilities) is considered an insider (or "disqualified person") under the Internal Revenue Code's "intermediate sanctions" rules, the board should consider following the process outlined in those rules in setting the CFO's compensation. For more information on this process, see the Conflicts of Interest toolkit section on the intermediate sanctions.

Select the Auditor

Retain an outside auditor, a task that is often mistakenly delegated to management. This subject is addressed in Part II of this toolkit.

Review the Auditor's Conclusions

Review the outside auditor's progress, reports, and mandatory communications with the board, an effort that is covered in Part V of this toolkit.

Using Committees

The board should rely on committees to address financial and accounting issues because committees conserve valuable board meeting time and concentrate expertise.

- **Two Committees** From the standpoint of best practices, the board should have separate finance and audit committees.

- **The Audit Committee.** Part IV of this toolkit addresses the role of the audit committee in detail. To summarize, the audit committee is charged with: (1) overseeing the board's relationship and interaction with the outside auditors; (2) monitoring the CAA's system of internal controls; (3) identifying and monitoring financial and related risks; and (4) conducting an in-depth review (with the auditor present) of the A-133 (compliance) audit and prepare a report to the board. The audit committee also is an appropriate recipient for whistleblower reports involving financial improprieties and other concerns.

- **The Finance Committee.** The finance committee is typically charged with addressing the following matters on behalf of the board: (1) assessing financial performance; (2) preparing and monitoring the operational budget(s); (3) preparing and monitoring capital budgets; (4) assessing lease-buy decisions (e.g., automobiles, equipment, and facilities); (5) planning long-term finances and allocation of resources; and (6) selecting lenders and developing the CAA's capital structure. Management is responsible for this work on a day-to-day basis, but the finance committee is the board committee charged with those efforts.

Many organizations place the tasks typically assigned to audit and finance committees to a combined audit and finance committee. This is not the preferred practice. The better practice is to utilize two separate committees, because the tasks traditionally assigned to each require distinct focuses. Overstating a bit, the finance committee plans while the audit committee monitors.

Management's Ongoing Role

The board's role is one of oversight while management's is operational. No two CAAs will set the dividing line between oversight and operations in the same place. That line will depend to some extent on the skills, expertise, interest, and personalities of the

Example

THE CALIFORNIA APPROACH

Section 12586(e)(2) of the California Government Code requires "charitable corporations" that are required to file reports with the California Attorney General to have an audit committee when the corporation accrues \$2 million of more in gross revenue in any fiscal year.¹ The audit committee must be appointed by the organization's governing board. It cannot include the organization's staff members, the president, the CEO, the treasurer, or the CFO. If the organization has a finance committee, members of that committee can serve on the audit committee, but cannot comprise 50 percent or more of the audit committee's membership, nor may the chairman of the audit committee be a member of the finance committee. For additional details, CAAs subject to California law should consult with a lawyer.

individuals involved, on both the board and management side, as well as the requirements of the funding sources (for example, the Head Start rules require board involvement in some very detailed levels of operations). But, as described in this toolkit and as seen in the trends at all levels in the nonprofit world, including governance questions asked on the IRS Form 990, the needle has shifted towards more, rather than less, board oversight of financial matters, including review of certain basic financial topics that all nonprofit boards should oversee and some financial expertise of the board as a whole. However, even very sophisticated boards look to management to perform some of the more ministerial tasks involved in selecting an auditor and managing the audit. In all instances, the board should look to the management to prepare the CAA for the audit. Preparation is an operational task. Part III of this toolkit addresses how management should prepare for the audit.

Concluding Thoughts

As is true in all matters of governance, the board and management should function as a team. Do not be misled, however. There should be some constructive tension in the relationship. After all, the board acts as a watchdog. But the board is also responsible for shaping the CAA's mission and long-range planning. To be effective, the board must work in a cooperative manner with management to fulfill those aspects of its duties.

Part I: Defining, Hiring, and Evaluating the Financial Personnel, with a Focus on Hiring the CFO

Titles Shouldn't Be the Focus

What's in a name? CAAs assign any number of titles to their top financial officer, including CFO, treasurer, controller, accountant, fiscal officer, and bookkeeper. In some instances, people with the same title have widely differing levels of authority and responsibility. In others, those holding different titles perform similar tasks. The board should not be concerned with titles, but rather, on ensuring that vital financial management functions are being carried out by people with the appropriate training and experience.

Common Patterns

A CAA's size is probably the single most important determinant of what title is assigned to the person with chief responsibility for the CAA's finances.

- **Large CAAs.** A CAA with a \$100 million of revenue should have more than one employee managing the CAA's accounting and finances. The senior person will most likely be referred to as the CFO, director of accounting and finance, or head of fiscal administration. This section will refer to this person as the top fiscal official.
- **Small CAAs.** A CAA with \$1 or \$2 million of revenue may rely on just one person to perform all accounting and finance tasks, including entering data into the CAA's accounting system, preparing checks, sending bills out, assembling financial reports, making bank deposits, and managing grants. This person is often referred to as the bookkeeper or the "numbers guy." This "jack-of-all-trades" approach may be dictated by practical reality, but it is far from optimal because it does not permit the segregation of incompatible duties. The board of a CAA with just one or two people handling the accounting and finance function should make building additional financial capacity a priority. Because of the lack of segregation of duties on the management side, more board involvement on the financial side, such as review of the bank statements, will likely be required.

What Comes With the Title: Duties

These are the duties that typically come with a given title:

- **Chief Financial Officer.** The person designated CFO is typically one of a CAA's top three executives. The title connotes authority and responsibility for overall financial planning, management, and reporting, as well as a variety of finance related functions. The CFO manages a team of professionals, often including both accounting professionals (controller, fiscal manager, chief accountant) and, in some instances, other business professionals such as the managers of information technology, human resources, and facilities.
- **Director of Finance and Administration.** The director of finance and administration often has duties similar to those typically associated with someone holding the title CFO. This person, however, may have slightly less authority than someone designated "CFO" and may be more directly involved in the supervision of staff accountants, bookkeepers, and administrative assistants than a CFO might be.
- **Fiscal Manager.** In large CAAs, the fiscal manager often functions as the head of all accounting functions, reporting to the CFO or director of finance and administration. In mid-sized and smaller organizations, the fiscal manager is often the top financial position, serving as a member of upper-level management. He may be the only financial professional in the organization, charged with managing a team of staff accountants, bookkeeper and administrative assistants.
- **Controller/Comptroller.** The controller/comptroller is often equivalent to the director of finance and administration or fiscal manager. The person holding this position is generally focused on accounting and financial reporting. His responsibilities generally will not include management of other business functions such as human resources, information technology, or facilities. In larger CAAs, this person is typically the top accounting professional, working under the direction of the CFO or the director of finance and administration.
- **Accountant.** Unlike someone designated CPA, in most states, anyone may refer to themselves as an "accountant" regardless of preparation or experience. The term typically refers to an individual with responsibilities for processing/recording financial transactions. In some organizations, the "accountant" is also responsible for preparation and presentation of financial statements and supporting managers in preparation of budgets. In general, the term "accountant" refers to a staff position rather than a managerial one.
- **Full Charge Bookkeeper.** Someone referred to as a "bookkeeper" has responsibility for posting financial transactions and closing the books or performing other ministerial tasks involved in the accounting function. There is wide variation in the skill levels of persons who identify themselves as bookkeepers. In larger CAAs, the term full-charge bookkeeper typically refers to a position requiring greater knowledge of the entire accounting process and more responsibility than is assigned to accounting clerks.
- **Accounting Clerk.** Those designated as accounting clerks generally perform routine tasks under the direction of a financial professional, such as processing receivables or payables. These individuals perform their duties by adhering to detailed procedures. They have little or no authority for independent decisionmaking.

Budget Size and Complexity Are Key Drivers Underlying the Need for Financial Personnel

While the size of the annual budget is often a good predictor of the sophistication required in the top fiscal position, complex funding requirements or the use of multiple entities to carry out the CAA's mission sometimes requires the skills of a high level financial professional even in smaller organizations. Let there be no doubt: Effective internal controls require that every CAA, no matter how small, have at least two persons on staff who are responsible for accounting and financial management tasks.

The Progression

The breadth of responsibilities assigned to the top fiscal officer is correlated with organizational size.

- **Small CAAs.** In CAAs with budgets below \$2 million, the top fiscal officer frequently concentrates almost exclusively on budgeting, accounting, and financial reporting, with the executive director and other staff members handling other management functions.
- **Mid-Size CAAs.** As a CAA's budget begins to exceed somewhere between \$1 million to \$2 million, the CAA often assigns a broader spectrum of responsibilities to its top fiscal officer, including grant management and compliance, human resources, information technology, and facilities management.
- **Large CAAs.** As a CAA's budget begins to approach \$10 million, CAAs will begin to hire professionals to head individual functions such as human resources, information technology, and facilities management. As the CAA begins to incorporate these individuals into its organizational structure, the person holding the duties assigned to the top fiscal position will become more conceptual and integrated with the other management functions spread throughout the organization. This person will focus on the more complex aspects of financial management, including managing relationships with bankers and structuring debt, overseeing investment management, developing internal audit capacity, and undertaking long-term financial planning.

The Fallacy Inherent in this Analysis

The foregoing analysis is useful because it explains how a CAA's financial function expands from one person to many. The analysis, however, is deeply flawed. It implies that all the other functions that show up on a large CAA's organizational chart are not taking place in a small CAA because the functions do not appear on the smaller agency's organizational chart. Every CAA, no matter its size, has the same administrative needs. Smaller CAAs may be addressing those needs less formally or totally ignoring them, but the need is still there. With the luxury of size comes the opportunity to systematically address organizational needs. Smaller CAAs that are successful have figured out how to address all these needs, but with fewer people. The boards overseeing these CAAs may have a more important role to play than the boards overseeing larger CAAs: a small CAA's board may need to engage in the sort of reflective and long-term planning that time-challenged managers are unable to engage in.

Core CFO Responsibilities

The top fiscal officer in most CAAs has ultimate responsibility for the core financial functions, which include:

- **Accounting.** The accounting function, which includes processing accounts payable and receivable, handling the payroll, and maintaining the general ledger and accounting journals.
- **Financial Reporting.** The financial reporting function, which includes preparing and assuring the accuracy of the monthly and annual financial statements. These statements include the statement of financial position (balance sheet), the statement of activities (income statement or profit and loss statement), and the statement of cash flows, together with footnotes and the statement of functional expenses. Included in this function is development of proper accruals, allowance for bad debt, and depreciation methodologies.
- **Budgeting.** The board may direct and should approve the CAA's annual budget, but the top fiscal officer and those who report to him should be the ones who prepare the annual budget. Equally important, the top fiscal officer and his staff should monitor adherence to the budget, providing the board with regular reports explaining how key income and expense categories vary from budget. Budgeting should include linking the budget to the CAA's long-term strategic planning. As just one example, those developing budgets should be prepared to show how expanding an existing program or adding a new one impacts the budget.
- **Grant Compliance.** The top fiscal officer and his staff should monitor compliance with grant terms, develop defensible overhead allocation methodologies, and prepare reports to the board for each grant.
- **Audit Preparation.** Management, not the auditors, is responsible for the financial statements and putting in place an accounting system that is self-correcting when information is initially input incorrectly. The auditors are looking for schedules, internal documentation, and responses to questions. The top fiscal officer is responsible for making sure that the auditors have what they need when they need it.
- **Fiscal Compliance.** The top fiscal officer bears ultimate responsibility for compliance with the CAA's funding agreements, IRS requirements, and any state nonprofit fiscal requirements. For organizations receiving federal funds, this includes responsibility for developing/implementing a cost allocation plan that complies with OMB Circular A-122 or negotiating and implementing a federally negotiated indirect cost rate.²
- **Communication.** Financial information does not exist in a vacuum or for its own sake. It is meant to be used by decisionmakers throughout the CAA. The top fiscal officer is responsible for ensuring that the board, its finance committee, members of management, and other stakeholders have the financial information necessary for good decisionmaking.

CFO Responsibilities Beyond Just Accounting and Finance

In many organizations, the top fiscal position has a broader scope of responsibilities, including:

Procurement

Some top fiscal officers have responsibility for development and implementation of procurement policies and procedures that protect the CAA from fraud, waste, and abuse in the purchase of goods and services, and that meet the requirements of federal and state funding requirements.

Grants Management and Compliance

Beyond ensuring compliance with fiscal management requirements, some top fiscal officers are assigned responsibility for ensuring overall compliance with administrative, governance, and program requirements. The broad scope of these responsibilities generally requires employment of a skilled compliance officer or other quality assurance professional.



Some organizations choose to have the compliance officer report directly to the CEO or the board as part of a system of internal control.

Internal Audit

The internal audit function examines whether personnel are complying with policies and procedures and whether systems are working as specified. Responsibility for the internal audit function is frequently assigned to the top fiscal position. Internal auditors nevertheless should always have access to the CEO and the board in the event that an internal audit reveals potential compliance problems that involve the CEO or the top fiscal officer.

Technology

In small and mid-sized CAAs, the top fiscal officer is responsible for procurement and management of information technology (e.g., hardware, networking, software, and database management), probably because accounting is now driven by technology. In larger organizations—particularly in those that refer to top fiscal position as the director of finance and administration—an information technology manager frequently reports to the top fiscal officer. Larger organizations generally utilize technology in virtually every aspect of their operations. Consequently, successful management of the information technology function by the top financial official requires strong communication skills and continuing collaboration with all CAA managers.

Human Resources

In smaller CAAs, the human resources function is often limited to administrative and compliance activities pertaining to both employment practices and fringe benefits. In larger CAAs, the human resources function includes oversight over legal compliance, benefits negotiation and administration, but also a variety of staff and organizational development activities including training, supporting effective performance reviews, employee assistance programs, and team building. While the top fiscal official may have the expertise required to manage the administrative and compliance aspects of HR, relatively few fiscal officials are prepared to manage the developmental aspects of human resources at the granular level.

Facilities Management

The top fiscal official is often given overall responsibility for facilities management because skills in financial analysis are required to make lease-buy decisions. Moreover, the top financial official is best positioned to assess decisions that carry wide-ranging implications for the CAA. For example, the decision whether to lease or buy the building that houses the CAA's headquarters raises insurance, property tax, overhead allocation and reimbursement, and balance sheet issues. The top financial official probably has negotiation experience because of his continuous involvement in the procurement process.

Risk Management

Nonprofits have long realized the importance of risk management, a set of concerns that involves more than procuring insurance. Risk management is the systematic analysis and control of a wide variety of risks within an organization, including assessing and developing systems to manage workplace safety, assure compliance with employment laws, train and manage volunteers, protect children and other dependent people, anticipate and respond to disasters such as fires and floods, and respond to conditions that could result in litigation. Many of these issues have a financial component, making the top financial official the perfect person to oversee a CAA's risk management program.



CAAs that do not have comprehensive risk management programs may want to attend seminars or obtain material from the Nonprofit Risk Management Center (www.nonprofitrisk.org).

Progression into Strategic Leadership Role

In smaller CAAs, the top fiscal official is often asked to function primarily as a technician, completing technical accounting and reporting tasks. As the CAA's size grows, the top fiscal official must become an effective manager, delegating, supervising, synthesizing, and communicating the work of others. In larger CAAs, the top fiscal official must function as a strategic leader, identifying and testing strategic options, and facilitating effective board and executive decisionmaking.

One Viewpoint

This progression is reflected in one executive director's reflection on the ideal CFO for her mid-sized nonprofit organization:

"My dream CFO has strong strategic business planning expertise and is really interested in the strategic side of the position but also has a good technical accounting background, intellectual curiosity, and hands-on involvement."

"My dream CFO has strong strategic business planning expertise and is really interested in the strategic side of the position but also has a good technical accounting background, intellectual curiosity, and hands-on involvement."

Barriers

A CAA's top fiscal official may be unable to fulfill his strategic leadership function for any number of reasons, including:

- **Inadequate Investment in Key Management Functions.** Fiscal officials without professional level subordinates frequently lack time to engage in strategic thinking, planning, or effective communication with top managers.
- **Difficulty Managing or Delegating.** Many fiscal officials have never been trained to manage or supervise others. Some professionals attracted to fiscal roles exhibit a strong preference for hands-on activity and have trouble dealing with imperfections in the work of subordinates.
- **Lack of Authority.** Some CEOs don't look to the top fiscal official for strategic input even though the top fiscal official has important insights that could and should be shared. When the receiving end for input doesn't expect it, input often is not forthcoming.
- **Reluctance to Move Outside of Comfort Zones.** Some fiscal officials are more comfortable performing functions in which it is possible to achieve certainty and perfection. Planning, budget modeling, and other strategic skills often involve uncertainty, with the result that some fiscal officials assign low priority to these tasks.

Required Expertise and Skills

To be an effective fiscal official, an individual requires technical expertise, as well as management and communication skills. The following are among the required knowledge and skills:

- **Accounting Skills.** Technical accounting and reporting expertise, including knowledge of:
 - Generally Accepted Accounting Principles (GAAP), particularly as they apply to nonprofits.³
 - Bookkeeping.
 - Financial system design.
 - Cost accounting.
- **Regulatory Knowledge.** Regulatory knowledge, including a basic understanding of:
 - The OMB Circulars, the Single Audit Act, and federal funding requirements such as limitations on lobbying and political activity.
 - Tax requirements for Section 501(c)(3) organizations.
- **Risk Management.** Risk management, including how to develop and implement effective internal controls and how to design internal audit and monitoring procedures.
- **Financial Management.** Finance and treasury management, including cash management, use of debt, and oversight of investment management.
- **Quantitative Skills.** Quantitative analysis, including regression and Monte Carol simulation, facility with spreadsheets, and databases.
- **Management Skills.** Management, supervisory, communication, and customer service skills.

Formal Education and Professional Certification Requirements

There are number of alternative pathways that individuals can take to prepare themselves to serve as a CAA's top fiscal official. One obvious educational pathway is study of business administration at the undergraduate and graduate levels, but there are many CFOs and other successful financial professionals who studied the humanities, social sciences, math, or science rather than business and finance during their undergraduate years. Financial professionals without business-related education have frequently completed mid-career professional development programs in finance and accounting. Many individuals take advantage of executive MBA programs offered by top universities.

Professional certifications such as CPA (certified public accountant), CMA (certified management accountant) or CIA (certified internal auditor) are often an excellent indicator of strong preparation for the role as top fiscal official.

Many CPAs, CMAs, and CIAs lack work experience in a nonprofit environment and the specialized knowledge that comes with that experience. Those charged with assessing candidates therefore should assess each candidate's willingness and demonstrated ability to adapt to new situations.

Compensation

The person holding the top fiscal position at most CAAs is usually one of the three highest-compensated individuals, reflecting the strategic importance of and responsibility associated with the position.

Obtaining Comparability Data

The demand for candidates is high, meaning that a CAA must review comparables to ensure it is offering a competitive and attractive package. Some large CAAs may enlist a consulting firm to assist in the search, but most CAAs will not have this luxury due to budgetary constraints. The majority of CAAs will need to develop their own comparables. The following are potential sources of information:

- **IRS Data.** Develop lists of comparable CAAs from state trade association directories. Then review the IRS Form 990,⁴ which can be obtained through GuideStar.⁵ CAAs should not rely on this data without a thorough review because organizations do not report information consistently.
- **Data from Non-CAAs.** A CAA looking for comparability data can consider the compensation paid to those holding comparable positions at non-CAAs. If the organization provides social services or relies heavily on government grants for funding, its top financial official may have the necessary skills. In assessing whether the position is comparable, the CAA should consider the organization's location (e.g. urban versus rural), budget size, and number of employees.
- **Salary Surveys.** Trade associations and consultants publish salary surveys that may be useful. Once again, the numbers should not be accepted at face value. A CAA must screen for comparability, both in terms of the organization and the position.
- **Fee-Based Services.** Both GuideStar and ERI⁶ charge relatively minor fees to access their nonprofit compensation databases. CAAs should consider taking advantage of one or both of these services.

The person holding the top fiscal position at most CAAs is usually one of the three highest-compensated individuals, reflecting the strategic importance of and responsibility associated with the position.

Tip

Unless a CAA receives contrary advice from an antitrust lawyer, it should not ask other CAAs for salary data or discuss compensation levels at conferences or through other informal channels that result in an interaction between employers. Such discussions may violate federal and state antitrust laws. A salary survey based on public information (such as IRS Form 990s) is generally not a problem, provided that it has a legitimate purpose (e.g., regulatory compliance) and that every CAA involved makes all decisions on salaries independently and not in coordination with other CAAs. However, CAA associations considering developing salary surveys should consult an attorney experienced in antitrust law if the survey uses nonpublic information, as such surveys could raise antitrust concerns.

Finding the Right CFO for Your CAA

Plan First, Then Act

Before announcing the opening or initiating the search for the top financial official, a CAA should:

- **Step 1.** Review its current management structure and identify future needs relating to growth and program evolution.
- **Step 2.** Refine its management structure and the position's scope based on the information developed through Step 1.
- **Step 3.** Identify the necessary skills and expertise that the successful candidate must possess.
- **Step 4.** Using comparables, determine the appropriate compensation range for the position. Organizations often think in terms of placing an individual within ranges relative to industry-wide compensation. Many organizations, for example, want to pay their senior executives at a rate that places the executive in the top quartile of industry-wide compensation. This may be an acceptable consideration, but organizational pride sometimes results in the board failing to place a less experienced candidate in the bottom two quartiles, with the understanding that the new employee's compensation levels will be adjusted as the employee demonstrates his capacity to perform above average.
- **Step 5.** If the CAA has existing employees who might be qualified, it should consider the organizational politics and morale implications of whatever decision it makes with regard to seeking outside candidates.

■ **Step 6.** The CAA should develop a position description. A sample that will require customization is included in Appendix A. Qualified candidates know that the title CFO or director of finance and administrative does not encompass a uniform set of duties. The job description accompanying the title should therefore include a high degree of specificity. To avoid wasting everybody's time, the description should describe:

- The CAA's size, employee and volunteer numbers, major funding, and number and types of programs.
- How the position fits within the CAA's organizational hierarchy, including a description of the direct reports (number, type, and qualification).
- The scope and responsibilities that come with the position

Qualifications

In addition to specifying formal educational requirements, the CAA should determine whether prior experience in the nonprofit sector is a requirement. The pros and cons of requiring nonprofit experience and the challenges and benefits of selecting CFOs with business or other relevant experience can be found in Appendix B.

Search Strategies

In addition to the CAA's standard approach to search, it should consider the following strategies, which are tailored to finding a top financial official:

- Make informal inquiries to CPA firms that perform A-133 audits.⁷
- Notify state CPA societies of the position so that they can feature it in newsletters, on job boards, and on websites.
- Advise state nonprofit associations or nonprofit training and technical assistance providers of the opening so that they can notify appropriate candidates.
- List the position with the CAPLAW Financial Network e-Forum.⁸
- Notify CAA trade associations operating at the national, regional, and state levels.
- Contact Bridgespan/Bridgestar, a national consulting firm focusing on nonprofit issues, including extensive study of CFO positions.⁹
- Contact the ASAE (American Society of Association Executives).¹⁰
- Place an add in the *Chronicle of Philanthropy* or *The NonProfit Times*.
- Contact *Idealists.org*.¹¹
- Contact *Independent Sector*.¹²
- Contact *Opportunity NOCS*.¹³

Using a Headhunter

Some CAAs may decide to retain a headhunter to help them organize their search and evaluate candidates. Many headhunters specialize, focusing on particular industries or positions, so CAAs considering a headhunter should ask about focus and expertise. A CAA should also make sure it understands the arrangement. In particular:

- What is the headhunter's fee?
- What happens if the new employee doesn't work out or quits shortly after starting work? Does the headhunter conduct a new search for free or refund any of its fee?
- Can the CAA exclude certain candidates (e.g. existing employees) from the fee arrangement?
- How involved will the headhunter be in checking background and references?

Screening and Selection

A CAA should undertake due diligence on likely hires before making a final decision. This can be time consuming and expensive, but it is necessary.

- **Step 1.** Both the CEO and the board chair or other designated representative from the board should interview the finalists. If the board has a finance or audit committee, committee representatives should be part of the interview process.
- **Step 2.** Someone with technical expertise should review credentials and interview the finalists. This person may be a board member with expertise in financial matters, a paid consultant, or a CFO with another organization who is willing

to provide assistance. If the latter, be careful. The other organization may try to hire the exceptional candidate.

■ **Step 3.** The CAA should check the references for all finalists, but only after obtaining written permission to do so. Many former employers will be reluctant to provide a candid assessment out of fear of a lawsuit. Organizations can take several steps to help cut through the gloss.

- **Read Between the Lines.** Don't automatically reject the candidate, but if the employer gives a less than glowing report ("Oh, he was OK"), read between the lines. An employer may be sorry to see someone move on, but if the employee outgrew the position and did a superlative job, many employers will not want to impede the employee's advancement.

- **Ask for Audit and Management Letters.** The CAA should ask former employers for the opportunity to review past management letters from the former employer's auditors, but this may be wishful thinking. The CAA should not be surprised if former employers refuse to make this information available and should draw no adverse implications if that is the case. The management letter often contains what the employer considers to be sensitive information.

- **Ask Audit Firms for Reviews.** The CAA should ask the candidate for references from audit firms that have direct knowledge of the candidate's work, but be cautious. Auditors obtain new work through referrals, which could make them reluctant to reveal unfavorable facts. If a CAA has a CPA on its board or finance committee who knows one of the auditors identified by the candidate, the CAA may want to ask that person to make an informal inquiry.

- **Ask Board Members for Reviews.** A former employer may be unwilling to provide a meaningful reference, but if someone knows a member of that employer's board or its finance committee, the CAA might ask its board member to informally contact the board member serving on the former employer's board.

■ **Step 4.** The CAA should perform a criminal background check and a credit check (taking care to comply with the requirements of the federal Fair Credit Reporting Act) on each finalist because the winning candidate will have access to organizational assets and will be supervising others who handle accounting and finance matters. There have been well-documented instances of nonprofits unsuspectfully hiring criminals to work in their accounting and finance departments. Nobody looks good when the media covers the subsequent theft or embezzlement. Moreover, tax-exempt organizations filing IRS Form 990 must now disclose significant thefts and embezzlements.¹⁴ Some state charity regulators also require similar information to be disclosed in annual filings.

The Board's Role

In a properly functioning CAA, the top financial official should regularly interact with the CAA's board. For this reason alone, the CAA may want to consider some board involvement in the determination of the job requirements for the position. But the board may also become involved because the top financial official plays such an important strategic and leadership role in the CAA's organizational structure. Even if the board is not involved ahead of time, it is a good idea for the executive director to report to the board on the selection process and the qualifications of the candidate hired.

CFO Performance Evaluations

Like all professionals, the top financial official can benefit enormously from thoughtful performance evaluations, particularly ones that: (1) candidly examine whether clearly articulated performance goals have been satisfied; (2) discuss the official's strengths and weaknesses; (3) set concrete goals for professional development; and (4) identify priorities for the future. The

CAA may want to look to board members and others with financial expertise to provide input regarding the official's technical skills and accomplishments. The CAA's outside auditors may be cautious about providing input into this process. Their independence may be compromised if they either are or are perceived to be playing an active role in the management of the organization, including participating in the selection or termination of a CFO. Recognizing these limits, the board and CEO should consider seeking the auditor's views on the strengths and limitations of the CFO as part of the closing interviews at the conclusion of the audit engagement.

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Professional Development Strategies

Continuing professional education is essential if the top financial official is to remain current on accounting, reporting, tax, and compliance issues. This official should be encouraged to participate in professional associations, conferences, and training. The following are just a few of the outside opportunities for professional development that are available:

- CAPLAW's financial forum, webinars, trainings, and conferences.¹⁵
- Conferences sponsored by community action trade associations and state officials.
- The American Institute of CPAs (AICPA) annual Not-for-Profit Industry Conference (June in Washington D.C.) and its Not-for-Profit Financial Executives Forum (November in San Francisco).¹⁶
- State Society of CPAs Not-for-Profit Conferences.
- WIPFLI Trainings for managers of federal funds.¹⁷

Part II: Understanding the Role of an Audit and How to Get the Most Out of It

Three Types of Audits

The External Financial Statement Audit

People are most familiar with an outside auditor's annual audit of the financial statements. This audit is performed to assure the board, grantmakers, and other stakeholders that the CAA's financial statements fairly present the organization's financial conditions and operating results in all material respects.

- **Independent CPA.** This audit must be performed by a certified public accountant who is independent.
- **Performed According to Prescribed Standards.** The auditor must adhere to generally accepted auditing standards (GAAS) in undertaking his work.
- **Performed on a Test Basis.** The auditor rarely examines every transaction. Typically the auditor develops a workplan that includes interviewing people throughout the CAA, evaluating and documenting the CAA's system of internal controls, performing tests on the data captured by the system, and making inquiries of certain third parties, including banks, other creditors, outside counsel, customers, and lenders.
- **The Output.** The auditor issues an opinion letter at the end of the audit. In the vast majority of the cases, the audit opinion—in and by itself—is a worthless piece of paper comprised of three or four standard-form paragraphs. Unless the auditor concludes that it can no longer assume the entity is a going concern (e.g., the entity is headed toward bankruptcy, insolvency, or liquidation) the opinion says nothing about the organization's financial capacity or performance. It provides no financial analysis or recommendations. In the past, many auditors also issued a management letter that contained observations about the CAA's accounting system. That letter is now mandatory and must be provided to the board.

The Internal Audit

Larger CAAs may have an internal auditor or an internal audit department. Internal auditors are usually CAA employees, although sometimes that function is outsourced to a firm other than the auditing firm. Their work is used by multiple persons and entities, including the CFO, the CEO, the board, and the external auditors. The internal auditors continuously review the CAA's accounting and internal control systems. They may also take on special projects, particularly ones that respond to problems that have arisen. Ideally every CAA will develop an internal audit function, but budgetary limitations place this option beyond the reach of many CAAs.

The Forensic Audit

Auditors are often retained following an embezzlement or other financial fraud to determine the extent of the damage and identify the failure in internal controls that allowed the fraud to occur. A forensic audit can be performed by either an external or internal auditor. Many organizations look to external auditors to perform forensic audits when the fraud is both material and highly visible. Forensic audits are complex and expensive.

The remaining discussion will be limited to the annual financial audit performed by an independent CPA.

Common Fallacies and Misconceptions about Audits

There are a number of common fallacies or misconceptions about audits that are worth dispelling from the outset.

Fallacy 1: Auditors Prepare the Financial Statements

The financial statements are management's responsibility. The auditors do not and are prohibited by professional standards from preparing the financial statements. During the course of an audit, the auditors may demand that the financial statements be adjusted because an accounting principle was incorrectly applied or because errors have been uncovered, but by and large, this is (and should be) the extent of the auditor's involvement in the preparation of the financial statements.

Fallacy 2: An Audit's Primary Purpose Is Detecting Fraud

The primary purpose of a financial statement audit is to certify the fairness of the financial statements. The professional standards applicable to financial statement audits require an auditor to consider the possibility of fraud to the extent it bears on the fairness of the financial statements, but detection of fraud is not the audit's primary objective.

- **Management's Responsibility.** Management is responsible for detecting and preventing fraud. Management discharges this responsibility by putting in place and continuously improving the CAA's system of internal controls.
- **The Audit Cycle.** Depending on the CAA's size, the auditors conduct an audit over a several week or month period following the close of the CAA's fiscal year. Even if the auditor shared responsibility for detecting fraud, the fraudster has ten or eleven months following the close of an audit to embezzle, steal, or otherwise defraud a CAA. That is more than enough time to do inflict significant harm.

Fallacy 3: An Audit Is Primarily For Management's Benefit

Let there be no doubt, management does benefit from an audit. The mere act of preparing for an audit requires the accounting staff to tie up loose ends and engage in a self-assessment. However, the board is the intended and primary beneficiary of an audit. The audit is an integral part of the good internal control and oversight. The board relies on the financial statements to allocate financial resources, evaluate management, and shape mission. The board looks to the auditor for assurance that it is prudent to rely on management's financial statements.

Example

IMPEDING ANY EFFORTS BY MANAGEMENT TO GAME THE SYSTEM

The board of Blue CAA (BCA) has set growth of the agency as its primary objective. It bases annual bonuses to top management on the year-over-year increase in grant revenue. Given its compensation package, management has an incentive to inflate grant revenue or report it in the incorrect accounting period. The annual audit of BCA's financial statements provides the board with assurance that management is not gaming the system or inflating grant revenue to increase its bonuses.

Fallacy 4: A High-Quality Audit is a Waste of Money That Could Be Better Spent on Mission.

There are two fallacies embedded in this statement.

- **Mission and Administration Are Inextricably Linked.** Any effort to distinguish between money spent on mission and money spent on administration is artificial. No entity can deliver goods or services without an administrative infrastructure. Administration is every bit as important to mission as teachers, hot meals, and housing. Without solid administration, money that is spent on mission will go to waste. The challenge is to strike the right balance between direct (e.g., teacher salaries) and indirect (e.g., accountant salaries) expenditures on mission.
- **An Audit Provides Concrete Benefits.** The culminating step in the audit is the issuance of an audit opinion, also referred to as an audit report. Although that piece of paper may provide little or no insight into the audit or the CAA's finances, a well-done audit nevertheless has great value to the CAA. As we will see, management and the board must be willing to work and communicate with the auditor to extract that value.

Example

AUDIT PROVIDES DISCIPLINE AND STRUCTURE

BCA's outside auditors have been on site for the last three weeks. Management must provide the audited financial statements to BCA's bank before next Wednesday in order to avoid violating loan covenants. The auditors have completed their on-site work, but are refusing to issue an audit opinion until management puts the financial statements in an acceptable format. Management is beginning to re-think its recalcitrance given the deadline with the bank.

Benefits to be Derived from an Audit

The following are among the benefits to be derived from an audit:

Satisfies Certain External Requirements

The board and management may not always see the value in a good audit, but external stakeholders certainly do. Many grantmakers and donors, including the federal government, make an audit a condition to funding. Many lenders also require a CAA to agree to annual audits before agreeing to extend credit. This is particularly true in the case of tax-exempt bonds. Depending on state law, a CAA may be prohibited from soliciting charitable contributions unless it obtains an audit or a review by a certified public accountant and annually reports the results to a regulator.

Offers an Independent Review of Internal Controls

The audit opinion says virtually nothing about the adequacy of a CAA's internal controls. The auditor, however, spends considerable time evaluating and testing a CAA's internal controls. If the CAA is subject to OMB Circular A-133,¹⁸ as most are, the auditor is required to include a report on the CAA's internal controls. Most auditors are more than willing to share their observations with the board and management, and in certain instances, are required to report internal control deficiencies to the board. In Part V of this toolkit, we will examine the letter to the board that is now required by GAAS.

Improved Interim Financial Statements and Reports

Both management and the board must rely on interim financial statements throughout the year when making decisions. A poorly designed accounting system will produce interim financial statements that are riddled with errors, which can undercut decisions that are based on faulty information. By identifying deficiencies in a CAA's system of internal controls, the auditor offers the CAA an opportunity to strengthen the accounting system's ability to spot and correct errors at the time they occur, resulting in more accurate interim financial statements.

Example

CREATING A SELF-CORRECTING ACCOUNTING SYSTEM

BCA's board is reviewing the year-to-date financial statements at its March board meeting. The board is concerned that grant revenue is down 20 percent, causing it to consider whether it must lay off two employees to balance the budget. In actuality, revenue is up 10 percent, but the person entering the reimbursements in the system transposed an eight and a two, entering \$280,000 rather than \$820,000. If the board waits until next February for the outside auditors to discover the error, assuming that they do discover it, BCA may unnecessarily lay off two employees when BCA should have hired an additional person.

Assures Conformity to GAAP and Comparable Data

An auditor cannot issue an unqualified opinion unless the financial statements comply in all material respects with GAAP. By assuring that a CAA's financial statements satisfy this requirement, the audit assures that the board can compare the CAA's financial metrics with the metrics from comparable organizations that have undergone audits. This permits management and the board to undertake benchmarking studies with confidence.

Example

PERMITTING COMPARISONS

BCA's board has asked management to obtain publicly available financial data for 10 similarly-situated CAAs so that the board can better understand whether BCA's finances and approach to financial issues conforms with industry practice. On occasion the board has discovered that BCA's practices deviate significantly from the practices of other CAAs. For example, BCA had higher levels of payables relative to current assets than other CAAs. The board initially was concerned, but realized that it was negotiating more favorable payment terms than the other CAAs.

Recently the board became concerned when it saw that BCA's annual allowance for depreciation was larger on a relative basis than that of the benchmark group's. Following an investigation, the accounting department had to admit that it had been improperly expensing the cost of all assets at the time of acquisition.

Sends a Message to Stakeholders

A financial statement audit provides something akin to the "Good Housekeeping Seal of Approval." It imbues the CAA with credibility, something which is important when dealing with the IRS, the media, and funders.

The Audit as a Process

An audit is a multi-step process. Its objective is to assess whether the financial statements prepared by management present an accurate and fair portrayal of the nonprofit's financial condition, cash flows, and operating results. To do that, the auditor must test the assertions implicit in the financial statements.

Example

THE ASSERTIONS UNDERLYING REVENUE RECEIVABLE

BCA's balance sheet reports a \$4.4 million balance for revenue receivable. The following are among the assertions embedded in the \$4.4 million amount: (1) the receivables exist; (2) the CAA holds legal title to the receivables; (3) the conditions for payment have been satisfied; (4) the amount recorded for each receivable is the appropriate amount; (5) the balance includes only collectible receivables; and (6) the reported \$4.4 million amount conforms to GAAP. The AICPA's Audit and Accounting Guide for Not-for-Profit Organizations summarizes the assertions that underlie other financial statements items.¹⁹

The audit is a systematic process designed to confirm that the assertions underlying the financial statement balances are correct. Given the complexity of the financial statements and practical limitations, the auditor cannot review every entry or event recorded in the accounting ledgers. This requires the auditor to make an assessment based on analysis, testing, and interviews rather than through brute force (i.e., examining every transaction). The auditor performs the following steps in conducting the audit:

Assessing the Environment

The auditor first must assess the environment and the entity. This entails becoming familiar with the CAA's mission, activities, and personnel. The auditor conducts interviews with key individuals, reviews tax returns, reads board meeting minutes, reviews promotional and marketing material, compares the organization's financial data with data from similar organizations, and considers other relevant information.

Example

MAKING INQUIRIES CONCERNING FRAUD

BCA is undergoing its annual audit. The auditors arrive on Monday, asking to speak to Mary, the receptionist, Joe, the janitor, and Larry, a Head Start teacher. The auditors ask each of these individuals what they do, who they interact with on a regular basis, whether they are aware of any fraud or wrongdoing, and whether they know of anything else that might be of interest to the auditors. When Mary sees Gloria Watson, BCA's executive director, she mentions the interview. Watson is at first surprised that the auditors asked to speak to these individuals because none of them work in the accounting department. She decides to ask Marsha Helmsley, the partner in charge of BCA's audit about the need for these interviews.

The auditors were smart to speak to employees who work outside of the accounting department. Joe told the auditors that his supplies have been disappearing lately and that he always receives more supplies than he requests. An investigation reveals that a clerk in the accounting department has been running a scam by selling the excess to outsiders. In addition to uncovering a fraud, the auditors concluded that management was not very interested in strong internal controls.

Assessing Risks of Misstatement

The auditor then must assess the potential risks of financial statement misstatements and their relative magnitude. If, for example, the CAA is highly dependent on grants to fund expenses, it likely will report large account receivable balances for grant reimbursements. One risk inherent with the reported balance is that the underlying expenditures may be ineligible for reimbursement. If the balance is high, the auditor will focus greater attention on receivables than on an immaterial account such as a \$1,000 charitable pledge receivable balance.

Reviewing the System of Internal Controls

After the auditor has assessed the risks of financial statement misstatement, he will review the CAA's system of internal controls to gain an understanding of the steps that the CAA has taken to minimize those risks.

Example**INTERNAL CONTROLS OVER REIMBURSEMENTS RECEIVABLE**

In the case of reimbursement receivables, the CAA's controls might require: (1) contemporaneous entry of the receivables data into the accounting system at the time the reimbursement request is made; (2) classification of reimbursable and unreimbursable expenses according to a schedule; (3) calculation and application of an overhead allocation formula; (4) tracking and aging outstanding reimbursement requests; (5) adjustments to the schedule distinguishing between reimbursable and unreimbursable expenses following a rejection of a request for reimbursement; and (6) use of supportable discount and disallowance factors. Each requirement furthers a business objective—ultimately collecting the receivable—but each one also (7) reduces the risk of misstatement in the financial statements and (8) supports the assertions underlying the financial statement balance. An auditor who encounters these controls will face far less audit risk than one who discovers that the CAA's personnel submit every expense for reimbursement and then toss the requests in a file cabinet without any further action.

Documenting and Testing Internal Controls

After reviewing the CAA's existing controls, the auditor will document and determine whether the controls are being applied consistently. Even if the controls are exemplary, the auditor will undertake substantive testing and gather evidence.

Example**SAMPLING AND TESTING TRANSACTIONS**

Returning once again to BCA's reimbursement receivables, the auditor might: (1) examine several of the requests to determine that each one follows the prescribed form; (2) assess whether the individual expense items fall within the categories of reimbursable expenses; (3) contact one or more payers to confirm the amount of reimbursements that have been submitted, but remain unpaid; (4) compare several receivables with the corresponding journal entries; and (5) examine how several overdue receivables are valued. The extent of the testing and confirmation will correspond to the depth of the controls, the relative size of the account balance to the overall gross assets shown on the balance sheet, and any number of other considerations.

Evaluating Audit Evidence

Once testing is complete, the auditor will evaluate his findings and decide whether an unqualified opinion can be issued. The auditor will make that determination based on whether his assessment of the controls and audit evidence permits him to conclude that the assertions in the financial statements are supportable.

For pedagogical purposes, this overview treats the audit as a linear series of events. While there should be a separate planning phase and the auditor should review internal controls before beginning any substantive testing, the other steps can occur simultaneously. For example, the auditor may discover through testing that personnel routinely ignore or override certain controls. Following that discovery, the auditor must adjust his risk assessments and audit plan. Additional testing may be required.

A Closer Look at Fraud

Just before Enron, WorldCom, and Tyco hit the headlines in the early years of the last decade, the AICPA began development of an audit standard directed at the auditor's responsibility to detect fraud. Its timing couldn't have been better. Both Congress and the public were asking how corporate fraud on such a massive scale could go undetected by independent auditors who had been issuing unqualified audit opinions and receiving millions of dollars in fees for doing so. Some attributed the audit failures to management conspiracies: An auditor cannot be expected to uncover fraud when members of senior management collude to override what appear to be otherwise adequate internal controls. The audit community also reiterated its longstanding and self-serving assertion that the purpose of an audit is to certify financial statements, not to detect fraud. The profession learned that technical distinctions and carefully crafted opinion language doesn't carry much weight with the Congress, the public, and sometimes even the courts.

Although the resulting pronouncement on financial statement audits and fraud still maintain that the purpose of an audit is not to detect fraud unless the fraud has a material impact on the financial statements, this pronouncement nevertheless attempts to heighten the auditor's sensitivities to fraud as he undertakes a financial statement audit. To accomplish its goal, this pronouncement describes and implores auditors to exercise professional skepticism. It also requires audit engagement personnel to: (1) discuss the risks of material misstatements due to fraud; (2) obtain information needed to identify risks of material misstatements due to fraud; (3) identify risks that may result in material misstatement due to fraud; (4) assess those risks in view of the entity's system of internal control; and (5) respond to those risks by designing an audit that adequately addresses those risks. The standard also requires auditors to communicate with management and those charged with governance. As is true throughout the AICPA's auditing standards, many of the actions required by the pronouncement are directed toward detecting "material

misstatements” in the financial statements, revealing a continuing ambivalence about the auditor’s role. This pronouncement has several important implications for CAA boards and management.

The board and management should expect the auditor to be focused on fraud during the course of the audit. This is likely to result in requests to interview both accounting and non-accounting personnel. No one should be surprised if an auditor asks them point blank, “Are you aware of any fraud?”

Nevertheless, the board and management must recognize that fraud can exist within a CAA even though an auditor provides an unqualified opinion regarding the financial statements. As noted, but worth repeating, management continues to be primarily responsible for the detection and prevention of fraud, not the auditors.

The Audit Opinion

The culminating step in the audit is the issuance of the audit report, which is often referred to as an opinion. The outside auditor can issue one of four types of opinions.

The Unqualified Audit Opinion

The first is referred to as the auditor’s standard report or, in the vernacular, an unqualified opinion. It is usually two or three paragraphs in length. See an example of an opinion as part of the toolkit section *Getting the Most Out of Your Financial Statements*. The typical opinion states that the financial statements present fairly, in all material respects, the entity’s financial position, results of operations, and cash flows in conformity with GAAP. There is a statement preceding this paragraph indicating that the auditor reached this conclusion after performing the audit in accordance with GAAS. Although the issuance of a clean opinion is significant, the opinion’s three or four paragraphs offer no financial analysis or specific insights or ideas for improving controls. Both management and the board should be pleased that the CAA received an unqualified opinion, but they still must be diligent.

The Qualified Audit Opinion

On occasion, the auditor will issue a qualified opinion, which is similar to an unqualified opinion, but contains an exception “for the effects of the matter to which the qualification relates.” An auditor must qualify his opinion if there is lack of competent audit evidence or the scope of the audit has been restricted and the auditor is unable to express an unqualified opinion. The auditor must also express a qualified opinion when there is a departure from GAAP which is material, but which doesn’t require an adverse opinion. As part of a qualified opinion, the auditor must explain the qualification. A qualified opinion provides the board with more information than an unqualified opinion, but not much more.

Example

SAMPLE LANGUAGE

The following are examples of how an auditor qualifies his opinion:

- **Qualification Because of Scope Limitation.** The following language contains a qualification based upon geographic limitations:

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America...

We were unable to review financial records related to the organization’s activities related to one of its delegate agencies due to a fire in that agency, which are reported as accounting for 10 percent of its revenues and 9 percent of its expenses for the year ended 20X1 as described in Note X to the financial statements.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the delegate agency’s activities, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position....

- **Qualification Because of Departure from GAAP.** The following language contains a qualification based on a departure from GAAP in the financial statements:

As discussed in Note X to the financial statements, the Foundation reports its investment in Big Festival Inc., a majority-owned subsidiary, on the equity method of accounting. In our opinion accounting principles generally accepted in the United States of America require that all majority-owned subsidiaries be accounted for as consolidated subsidiaries. As of June 30, 20X1, Big Festival Inc. was dissolved and its remaining cash and operating assets and liabilities were distributed to the Foundation, which are included in the accompanying financial statements. If the financial statements of the Big Festival Inc had been consolidated with those of the Foundation, total assets and total liabilities would be unchanged as of June 30, 20X1 and would be increased by \$XX,XXX as of June 30, 20X0; and revenues and expenses would be increased by \$XXX,XXX and \$XXX,XXX for the years ended June 30, 20X1 and 20X0.

In our opinion, except for the effects of not consolidating all majority-owned subsidiaries, as discussed in the preceding paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects,....

Both the board and management must understand the qualification and its implications, but there is no need for alarm. The board (most likely its audit committee) should meet with the auditor without any members of management present. The board should ask the auditor how seriously he views the qualification, whether this is the tip of a much larger iceberg—evidence of a contentious relationship between management and the auditor—and what action the auditor recommends that the board take.

The Adverse Audit Opinion

When the circumstances warrant, the auditor will issue an adverse opinion concluding that the financial statements do not present fairly the financial position, results of operations, or cash flows in accordance with GAAP. The auditor must explain all the substantive reasons for the adverse opinion. An adverse opinion is undesirable and should cause serious reflection and a calculated response from the board.

Example

SAMPLE LANGUAGE

The following is language from an adverse opinion resulting from departures from GAAP:

[Same first and second paragraphs as the standard report]

As discussed in Note X to the financial statements, the College does not recognize pledges from donors as revenue. Accounting principles generally accepted in the United States of America require that pledges be recognized as revenue in the year made. Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X1 and 20X0, net assets have been understated by \$XX,XXX,XXX and \$X,XXX,XXX respectively, and revenue for the years ending December 31, 20X1 and 20X0 have been understated by \$X,XXX,XXX and \$X,XXX,XXX, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the College as of December 31, 20X1 and 20X0, or the results of its operations or its cash flows for the years then ended.

The board should consider the following response:

- **Meet with the Auditor.** It should meet with the auditor without members of management present. It should ask about the seriousness of the problem, alternative ways to address it, and whether the auditor has other unstated concerns about the statements or its relationship with management.
- **Meet with Management.** It should meet with management to hear management's side of the story.
- **Audit Committee.** If the qualification took the board and audit committee by surprise, they should reevaluate their role in the audit process.
- **Change.** The board should ask whether there needs to be a change in management or the auditor.

Disclaimer of Opinion

An auditor can refuse to express an opinion on the financial statements, which is referred to "disclaiming an opinion."²⁰ This is appropriate if the auditor has not performed an audit sufficient in scope to permit an opinion to be rendered. The auditor must provide the substantive reasons for the disclaimer. Auditors often are asked to audit just a subsidiary or an internal operation of a larger entity. The auditor will disclaim an opinion with respect to the larger entity as part of the opinion covering the smaller one.

Example

SAMPLE LANGUAGE FROM A DISQUALIFIED AUDIT OPINION

The following is sample language disclaiming an opinion regarding the larger organization:

As discussed in Note 1 to the financial statements, the financial statements of Public Radio Station XXXX are intended to present the financial position of the station as of June 30, 20X3 and 20X2 and their changes in net assets and their cash flows of only that portion of the funds and account groups of Large University, that is attributable to the transactions of the Public Radio Station XXXX. They do not purport to, and do not, present fully the financial position of Large University as of June 30, 20X3 and 20X2, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with the accounting principles generally accepted in the United States of America.

Withdrawal

On occasion, an auditor will withdraw from an engagement. The board should always be interested in understanding the circumstances surrounding the withdrawal. It may be that management is impeding the audit, which has obvious and serious implications. Surprisingly, neither GAAS nor the AICPA's Code of Professional Conduct requires that an auditor issue an opinion or disclaimer once the auditor has been engaged to perform an audit. Many stakeholders and regulators will want to know what circumstances caused an auditor to withdraw from an engagement, but the AICPA's code precludes the auditor from disclosing the circumstances surrounding withdrawal to anyone but the party engaging the auditor or persons contractually obligated to be notified under the terms of the engagement letter. The board should always specify in the engagement letter that the auditor must notify the board in the event the auditor withdraws from the engagement or decides not to issue an opinion, and provide the reasons and a discussion of the surrounding circumstances.

Retaining an Auditor

The board, not management, should retain the auditor. This is a practice that has been adopted as a legal requirement by the Securities and Exchange Commission for publicly traded companies.²¹ As noted, the primary purpose of an audit is to provide the board with comfort that management has produced financial statements that present the CAA's financial results and position accurately in all material respects in accordance with GAAP. As the primary and intended beneficiary of the audit, the board should emphasize to both the auditor and management that it views the audit as an integral part of the board's oversight function. Taking charge of the selection process reinforces that message to all involved.

The board, not management, should retain the auditor.

Practical Considerations

CAA boards are comprised of volunteers who often face time constraints due to family and jobs. Moreover, many volunteers will lack the background needed to make an informed selection. For these reasons, management is often involved in the selection process. It may assemble the list of candidates and conduct the initial interviews. This approach is acceptable if:

- **A Report.** Management prepares a report discussing the results of the selection process.
- **A Discussion.** The board or its audit committee discusses the report and management's recommendations with management.
- **A Meeting.** The board or its audit committee meets with the finalists to conduct an interview and listen to presentations.
- **The Selection.** The board makes the final decision and the engagement letter indicates that auditor's duties run to the board.

Requirements Under OMB Circular A-133 Regarding Procurement

A CAA that receives federal funding is required to follow specific procurement procedures when retaining an outside auditor. For example, OMB Circular A-133, which applies to audits of both nonprofit and public CAAs, requires that the CAA adhere to the procurement standards prescribed by the Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations, found at 2 C.F.R. Part 215 (also known as OMB Circular A-110) or other applicable requirements.²² Whenever possible, CAAs receiving federal funds should "make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated." In selecting an auditor, the CAA should take into account the "responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price."²³ State and local governments and foundations may impose other requirements.

Requests for Proposals

Whoever undertakes responsibility for the search process should prepare a request for proposal (RFP), which is then sent to perspective auditors. The RFP should be divided into three parts. One should describe the CAA and its accounting staff. The second should describe the requested services. The third should indicate what information the CAA wants the prospective auditor to include with its proposal. A checklist for preparing an RFP is included as Appendix C. Additional RFP resources are available at no cost from the American Institute of Certified Professional Accountants.²⁴

Review References

Many regulators maintain online databases that can be used to confirm whether a CPA is in good standing and licensed. Some of these sites also permit access to or refer to disciplinary proceedings.

Tips

AS A MATTER OF ROUTINE, THE BOARD OR MANAGEMENT SHOULD REVIEW THESE DATABASES BEFORE ENGAGING AN AUDITOR.

The CAA should also request and then verify references provided by each firm that is under serious consideration. Unless counsel advises otherwise, the audit committee should refrain from discussing fees with references—the concern being potential violations of antitrust (e.g., price fixing or division of territories) laws. In lieu of such discussions, the committee should review published surveys.

EXAMINE PEER REVIEWS

The AICPA makes peer reviews available through its Peer Review Public File web page.²⁵ As part of the selection process, the appropriate member of management or the board should review the peer reviews for firms that are in contention for selection as the CAA's outside auditor. CAAs should also check the websites of state CPA societies, many of which address peer reviews.

The Engagement Letter

Engagement letters for audits are often based on templates developed by industry trade associations or by other audit firms or services that specialize in providing documents and audit plans to auditing firms. At one time the letters may have focused on price and been relatively short. Those days are long gone.

Engagement letters have become lengthy legal documents. Although the letters may be for the services of an auditing firm, lawyers often play a significant role in preparing the letters. This makes careful review of the letter imperative. CAAs and their audit committees should not hesitate to have a knowledgeable lawyer review the letter, particularly if the CAA is retaining the audit firm for the first time or there have been significant changes in the letter (e.g., it expands from two pages to 10 pages). Nor should CAAs hesitate to question or negotiate modifications to specific terms. Although engagement letters are often presented as contracts of adhesion (“take it or leave it”), they should not be viewed that way.

An engagement letter is a contract for services. As such, it should contain the basic terms of the agreement between the CAA and the auditor. A checklist of the basic provisions found in engagements is included as Appendix E.

In an effort to protect themselves, auditors are now adding a number of provisions to the engagement letter that are designed to protect the auditor from liability. A complete discussion of these provisions is beyond the scope of these materials. For the present purposes, CAAs should understand that some of these provisions, such as indemnification provisions, have the potential to invalidate the CAA's own insurance policies, like directors and officers coverage. This makes a review of the engagement letter by a knowledgeable lawyer especially prudent.

Management Representations

An auditor is required to verify certain facts or make an affirmative determination that those facts cannot be verified. The AICPA's auditing standards require the auditor to obtain written representations from management when facts cannot be verified by the auditor. The stated purpose of these representations is: “[to] ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.”²⁶

Forcing Disclosure and Shifting Risk

Management's representations serve two important purposes. First, these representations correct information asymmetries by forcing management to disclose information that the auditor is unable to verify because either there is no system that assures that the information is captured by the accounting system or the cost of verifying the information is prohibitive. Second, these disclosures shift the risk of non-detection or non-verification back to management and the financial statement users.

Implications

Given those purposes, management's representations have important implications for the board, management and other financial statement users.

■ **Undercutting the Audit.** The representations effectively create exceptions that are unstated in the standard auditor's opinion. The representations degrade the opinion's value. This may be necessary and justifiable, but it is nevertheless degradation. For this reason, the board and other financial statement users should demand to review the representation letter. As a practical matter, the board can make such demands and should, but other financial statement users may lack the power to force management to disclose the representations.

■ **Reviewing the Representations.** Because the representations are drafted by the auditor for management to sign, both management and the board should carefully review the representations. Management must recognize that a false, incomplete, or inaccurate representation could preclude the CAA from suing the auditor if a failed audit results in damages to the CAA. In at least one case, a false representation prevented the organization from shifting the loss to the auditor. The court, in justifying the result it reached, offered a cautionary note to all organizations, including CAAs, when it wrote:

The [client] dismisses the representation letter as mere boilerplate, drafted by the auditor in terms most favorable to it. The letter, however, basically memorializes the verbal representations made by Luhmann and Wagner in the meeting with [the] auditors on October 9, 1993. Moreover, Gary Seidleman, [the audit] engagement partner, testified that he delivered the audit report on October 16, 1993 only because [the auditor] had received a signed representation letter. Similar representations were made verbally by Wagner and Luhmann in a meeting with [the] auditors on October 9, 1993. This is the type of contributory fault described in National Surety. Thus, as a matter of law, we conclude that the [client] could properly be found comparatively negligent based on the evidence submitted to the jury.

The question of whether the false representations contributed to [the auditor's] failure to identify and disclose violations of the Board's investment policies is a factual question for the jury to decide. [Citation omitted.] The evidence was sufficient for the jury to conclude that [the auditor] relied on the truth of the representations as a condition precedent to releasing its audit report.²⁷

Standard Representations

Appendix E contains many of the representations that auditor's require management to make before the auditors will issue an opinion regarding the financial statements.

Examples

MINUTES REFLECT SIGNIFICANT ACTIONS

The auditors typically require management to make the following representation: "The board minutes reflect all significant board and committee actions." The auditors look to the minutes to identify significant decisions that could affect financial statements, such as the incurrence of debt, acquisitions of property, and decisions to enter into partnerships. Without this representation, the auditors would be forced to prove or verify a negative: there wasn't anything else significant. Management and the board were at the board meetings, not the auditors, so the representation is a fair one.

NO VIOLATIONS OF LAW

The auditors also typically require management to make the following representation: "There are no violations of laws or regulations." Once again, the auditor has no way to prove a negative. Yet, if the financial statements (including the footnotes) do not appropriately reflect the appropriate liability for a violation of the law, the statements are most likely misleading.

If a CAA cannot make a representation, it should state so. It may be necessary to add language that clarifies the representation or that recognizes an exception. Before addressing the issue with the auditor or modifying or clarifying language, the CAA should confer with its legal counsel so as to avoid inarticulate admissions that could create legal liability where none exists or create other problems.

Special Representations

Depending on the circumstances, the auditor may require other representations.

Part III: Management's Role In Preparing for the Audit—A Step-by-Step Process

Overview

Part II focused on the board's role in the audit process and some of the legal issues that an audit poses. As indicated, management will be involved in those aspects of the audit either because the tasks requires collaboration or the CAA's board lacks the necessary knowledge. Despite Part II's emphasis on board involvement, management has a clear role in the audit that does not involve the board's active participation: preparing the CAA and its financial statements for the audit. This part provides guidance to management on its preparation, including the additional steps required to prepare for an A-133 audit. It assumes the reader is generally familiar with terminology and the requirements under federal law.

preparing the CAA and its financial statements for the audit... Management has a clear role in the audit that does not involve the board's active participation:

Pre-Audit Planning With the Auditor

In planning for the audit:

- **Timing.** Management should ask the auditor for a timeline covering all phases of management's work on the audit. Management should work with the audit manager to achieve any timeline revisions needed to be certain that management can fulfill its responsibilities while leaving the auditor sufficient time to complete all portions of the audit on deadline. Management and the auditor should recognize that OMB A-133 audits must be submitted to the federal clearinghouse within nine months after the end of the audit period unless an extended deadline has been agreed to by the CAA's federal cognizant or oversight agency. Management and the auditors should also be aware of any programs that require shorter deadlines, such as Head Start, which requires submission within four months of the end of the prior budget period.²⁸ While the auditor should be familiar with the requirements of specific programs, management is ultimately responsible for submission of the audit within specified time limits.
- **Understand Preferences for Electronic or Paper-based Versions of Information.** Management should discuss the auditor's preferences for information in electronic or paper form. Management and the auditor should agree on the documents that the auditor is prepared to accept and manage electronically, and those that must be provided as hard copies, either to review or to place in audit files.
- **Auditor Workpaper Format Preferences.** Management will prepare a variety of schedules and reconciliations for auditor review. The person responsible for these schedules should ask the auditor to provide samples of the workpaper format. If management prefers an alternative approach, management should discuss it with the auditor in advance to avoid demands to revise or reformat management's schedules.
- **Confirmation Procedure.** Management should review the list of confirmations which were sent to funders, depositories, and other outside sources as part of the prior year's audit, and then develop a proposed revised list for confirmation inquiries. Management should reach a clear agreement with the auditor about management's responsibility for preparing and sending the confirmation requests.
- **Standard Management Representations.** Management should review last year's "management representation" letter, and then ask the auditor to identify any items that it believes are likely to be added to this year's management representation letter. This preliminary planning conversation cannot be conclusive since the auditor may identify additional issues and concerns during the course of the audit.

Financial Statement Preparation

The financial statements reflect management's presentation of financial activity, results, and position and also serve as management's assertion that it has complied with law, regulation, and contractual requirements.

Given the requirements for obtaining an unqualified audit opinion, most CAAs prepare their year-end financial statements in a format which complies with GAAP, and therefore includes notes to the financial statements providing all GAAP required disclosure, as well as the statement of financial position (balance sheet), statement of activities (income statement), statement of cash flows, and statement of functional expenses. This may require the year-end statements to be prepared in formats which differ from those used for monthly reporting to the board or other purposes during the fiscal year.

The prior year's audited financial statements are the starting point for preparation of this year's statements, but management must consider whether there have been changes in GAAP requirements and/or changes in the nature of the CAA's activities, transactions, or other factors which require additional disclosures or possible changes in the format.

Some CAAs choose to work with a qualified outside accounting consultant to assist with the preparation of the year-end statements to be certain that they are complete and comply with GAAP requirements. However, the CAA must retain responsibility for the accuracy and completeness of the financial statements even when the statements are prepared with outside assistance.

In the past, some auditors were willing to assist with the preparation of the financial statements, most commonly with the notes or with the GAAP format of the financial information, but changes in auditing standards dealing with auditor independence have made many auditors extremely reluctant to become involved in preparing the statements. Those who are willing to provide such assistance will do so only when they have complete confidence that the organization has the capacity to form its own independent judgment about the financial statements after the auditor has provided such assistance.

Preliminary Financial Analysis

Before closing the books, management should compare: (1) all year-end balances with the prior year-end trial balances; and (2) year-end income and expense accounts to the annual annual budget. This review will help identify potential errors. The review is also useful for identifying the accounts that will require supporting schedules or work papers.

Trial Balance Account Schedules and Reconciliations

The trial balance produced by the accounting system following the closing of the book for the fiscal year provides balances for each asset, liability, net asset, support and revenue, and expense account.

As part of the audit planning process, management should discuss with the auditor the supporting schedules that the auditor would like for specified balances. Management should then use that information to prepare the schedules. Examples of such schedules include:

- **Bank Accounts.** The supporting schedule for each bank account takes the form of a standard bank reconciliation explaining the difference between the year-end general ledger balance and the balance reported by the bank.
- **Investment Accounts/Mutual Funds.** The financial statements must include the investment accounts, to the extent the accounts include readily marketable securities, at the fair market value of those securities as of year-end. The supporting schedule should therefore reconcile the year-end trial balance with the values reflected by brokerage firm accounts.
- **Accounts Receivable.** When multiple categories of receivables have been aggregated into one account balance, there should be a schedule that reflect the amounts receivable from each source. The schedule of accounts receivable will typically include aging schedules that report the time that each receivable has been outstanding.
- **Pledges or Grants Receivable.** When there are multi-year grants or pledges, there should be a supporting reporting the name of the entity making the commitment, the full amount of each commitment, the date each commitment was made, the payment schedule agreed upon, and the discount used to value the net present value of each commitment.
- **Prepaid Expenses.** The balance for prepaid expenses should be supported by a schedule detailing each prepayment, the time period covered, and the portion the prepaid expenses that are attributable to the fiscal year under audit.
- **Wages Payable.** There should be a schedule supporting the wages payable balance that lists each employee and the amount owed at the year-end date. During the planning phase of the audit, management should discuss its payroll processing software and the auditor's preferences for schedule format.

The work papers for the unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets are typically not prepared until management has completed its analysis of the support, revenue, and expense accounts. These work papers will reconcile the impact of releases from the temporarily restricted net assets into the unrestricted net assets, as well as the impact of additions to the temporarily restricted and permanently restricted net assets.

Management should prepare work papers to support all material revenue, support, and expense accounts. For most CAAs, work papers will be required for all grants and contracts, personnel-related expense items, professional services, sub-contracts, sub-recipient agreements, facilities and equipment lease accounts, and for depreciation or use allowance expense accounts.

Internal Controls

Management is responsible for ensuring the development and implementation of effective approaches to enterprise risk management, including analysis, systems, policies, and procedures to identify and control the risks inherent in operating a legal entity serving the public, employing staff, and entering into contracts.

The auditor is required to gain an understanding of the CAA's business, the risks inherent in its operations, and the controls it has put in place to control those risks.



In order to demonstrate to auditors that the policies are actually used and followed, these policies should be readily accessible. One method of doing so is posting them on the CAA's website, either the public portion or an internal page.

Auditor Risk Management/Internal Control Questionnaire

Many auditors provide a questionnaire or assessment tool for CAAs to complete that identifies risks and the controls that have been put in place to address risks. Other auditors prefer to gather this information by interviewing employees with specific responsibilities for risk assessment, and development and monitoring of controls. Most auditors find that a combination of written questionnaires and in-depth interviews yields the best results.

The auditor's review of internal controls is an important element of the audit. During this review, the auditor will ask senior management and other employees to identify weaknesses as well as strengths in the CAA's system of controls. By identifying weaknesses and implementing change in advance of the audit, management demonstrates that it understands the importance of controls to the integrity of the financial reporting process.

Risk Assessment Documentation

Management can demonstrate its commitment to internal controls by collecting reports and memos that reflect the CAA's effort to identify, evaluate, and control risks. As part of the audit planning process, management should ask the auditor to define the level of detail required.

Fiscal Policies and Procedures

Management should assemble written fiscal policies and procedures for review by the auditor. As part of the regular maintenance of these manuals, management should systematically date pages to assist the auditor in assessing whether the practice is in compliance with current policies and procedures.

The CAA's auditors will review the CAA's fiscal policies and procedures manual as part of their assessment of the overall system of controls. They will also use the manual as a guide for design of tests of compliance during the audit process. The compliance tests focus on determining whether personnel are following the CAA's fiscal policies and procedures. Failures to follow the CAA's fiscal policies and procedures may ultimately result in audit findings.

Other Policy Documents

The CAA's auditors may ask to review other policy documents including investment, whistleblower, conflict-of-interest, record retention, and other key policies.

Organization Chart

Management can save the auditor time by providing a detailed organization chart that includes all positions within the organization and illustrates the lines of authority within the organization. Management should also provide the auditor with a contact list for managers and others likely to be helpful during the audit, including names, titles, e-mail and phone contacts.

Accounting System Structure

Management should provide the audit team with a concise description or graphic depiction of the accounting system. The graphic should illustrate the structure incorporated into the general ledger to define cost centers and sub-cost centers. Management should describe any segmentation that is used in account coding. Typical segmentation includes line item, cost center, and sub-cost center. The description might also include designation of funding source in the expense line item codes as well as in revenue account codes. Explanations should be provided for each of the segments. For account segments relating to funding sources, management should provide the complete name of the source as well as explanation of how awards from multiple fiscal years or multiple awards from the same source are differentiated.

Data Security

Management should review any existing data security policy and procedures documents to be certain that they reflect current practice. Even if the CAA does not have a formal data security policy, management should assemble all data security related memos and instructions into a readily accessible location for review by the auditors. It should also identify the individuals who can best articulate data security practices. In larger CAAs this may be the director of information technology. In small CAAs, responsibility for data security may fall within the scope of the top fiscal officer position. Those responsible for security should be prepared to describe the major elements that ensure the security of financial, program, participant, and donor data.

Prior Audit and Monitoring Findings

Management should review any prior audit findings as well as any findings or issues for follow-up raised by funding source monitors. It should prepare a brief description of the strategies that have been undertaken to address the concerns raised in the findings or monitoring issues, and then describe the extent to which the CAA has implemented the strategies.

If some of the findings from the previous audit or from monitoring have not yet been addressed, management should prepare a concise explanation of the reasons for delay and/or rationale for declining to address them.

Grant Funding Schedules for Governmental Sources

A key element in every A-133 audit report is the Schedule of Expenditures of Federal Awards (SEFA). Management should review each funding agreement to determine whether some or all of the funds have received are federal in origin. If an agreement does not clearly state the federal source but management believe the funds are federal in origin, management should ask the funder for clarification including the Catalog of Federal Domestic Assistance (CFDA) number for the source.

Management can save the auditors time and identify areas that may require additional audit prep work by preparing a draft of the schedule identifying:

- Each source of federal funds, including the name of the federal agency, the name of the program, CFDA numbers, and fiscal years of each award;
- The amount of each award;
- The accrued or deferred revenue at the beginning of the fiscal year;
- The receipts or revenues recognized for each award during the fiscal year;
- Federal disbursements/expenditures during the fiscal year; and
- Accrued or deferred revenue at the end of the fiscal year.

Each item on the schedule must be supported by financial records. Management should develop a clear map for the auditors to follow to verify the information on the schedule. Furthermore, management should compare the information on the schedule to documentation from each funding source and to any reports that have been submitted to the funding source. Finally, management should reconcile any discrepancies between what is reported on the schedule and agreements and reports.

Grant Funding Schedule for Foundation Grants

Management should prepare a schedule of each foundation award received during the fiscal year, identifying:

- Name and contact information for each foundation;
- Public charity or private foundation status of each source. This information is generally included in the award letter. If it is not, management should contact the foundation or check IRS Publication 78, which is an electronic database located on the IRS website that provides information about the tax status of charities;
- Amount of the total award;
- Unrestricted or restricted character of the award, including what purpose, time, or other restrictions have been applied by the funder;
- Time period in which the funds may be used;
- Payment schedule;
- Amount received during your fiscal year;
- Qualifying expenditures of the award during your fiscal year;
- Any amount still receivable from the award; and
- Amounts received but not yet expended that are included in temporarily restricted net assets.

Management should be prepared to provide the auditors with copies of the applications submitted for each award and other correspondence with each foundation. It should make sure the financial records used to prepare the schedule agree with the records maintained and any reports submitted to the foundations by the CAA's fund development and/or program managers relating to each award.

Understanding the Auditor's Approach to A-133 Audits

The hallmark of the A-133 audit is the auditor's opinion regarding compliance with myriad requirements for the management of federal dollars. In planning an A-133 audit, the auditors must include procedures and analysis that will enable them to express an opinion on the CAA's compliance in addition to expressing their overall opinion regarding whether the financial statements fairly present the CAA's financial condition and results of activities.

The auditor's work on an A-133 audit is guided by principles and procedures described in OMB Circular A-133, which addresses the auditor's responsibilities and reporting requirements. In addition to the core standards and approaches described in A-133, the Office of Management and Budget has issued an A-133 Compliance Supplement which is updated at least annually. It is not feasible for the auditor to test compliance with each regulation. Instead the auditor is trained to identify and examine issues with the greatest potential impact on the CAA's major programs. The A-133 Compliance Supplement and its updates identify key compliance issues in various programs and suggest effective methods to test and evaluate compliance with those requirements. Management's audit preparation should include review of A-133, and the A-133 Compliance Supplement and updates.

A-122 Compliance

OMB Circular A-122 (now included in the Code of Federal Regulations at 2 C.F.R. Part 230) establishes principles for determining costs of grants, contracts, and other agreements with nonprofit organizations. It requires that costs charged to federal sources must be reasonable, allowable and allocable. A substantial portion of preparation for the A-133 audit will be helping the auditor understand what systems have been put in place to ensure compliance with A-122. A first step in this process is demonstrating that management has reviewed A-122 and incorporated its principles into all aspects of its grants management and internal control systems. In addition to A-122 itself, management should review the CAPLAW publication *Right on the Money: An Annotated Guide to the Federal Cost Principles for Nonprofit Grantees*.

Cost Allocation Plans

Management should begin audit preparation by reviewing the CAA's cost allocation plan and testing the cost allocation approaches used in the CAA's accounting system for compliance with the plan.

Federally Negotiated Indirect Cost Rates

If the CAA has obtained a federally negotiated indirect cost rate, the auditor will review both the proposal the CAA submitted to its cognizant agency and the letter approving the rate which the CAA received. As part of the audit preparation, management should enter year-end financial information into the same format it used to submit its proposed rate to calculate the actual indirect rate. If there is a significant variance between the CAA's indirect cost rate and the actual indirect costs incurred, management should determine how it plans to resolve the differences.

Allocation of Personnel Costs

Auditors are encouraged to pay close attention to the methods the organization utilizes to ensure that personnel costs are properly allocated to the appropriate cost centers. A-122 requires that personnel cost allocations for those employees whose time is charged directly to grants in whole or in part (as opposed to all of the time being included in the indirect cost rate) be supported by contemporaneously maintained records of employee effort.

Most auditors interpret this standard to require, for non-exempt employees, the use of timesheets, time cards, or other records (paper or electronic) that record the hours worked each day. For both exempt and non-exempt employees, an after-the-fact record of the proportion of the total time worked on each grant, called a personnel activity report, is also required.

Management's audit prep should include review of the time records maintained by both exempt and non-exempt employees and some testing to determine whether the allocations of salary and related payroll costs in the accounting records are consistent with the underlying detail on the time records.

Allocation of Other Costs

Management should identify other significant non-personnel cost line items that involve shared costs that are allocated utilizing the methods described in the CAA's cost allocation plan. For many CAAs, these line items will include facilities costs. Management should review year-end balances by cost center for each of these accounts to determine whether the allocation methods described in the cost allocation plan have been applied consistently.

A-110 Compliance

OMB Circular A-110, Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations, (now included in the Code of Federal Regulations at 2 CFR Part 215), provides the overall framework for management of federal funds.

A key element in every A-133 audit is determining whether the CAA has established and maintained the fiscal systems, policies and procedures required in A-110. Management should be prepared to explain its procurement policies, cash management requirements, accounting for and use of program income, handling of in-kind contributions, cost sharing and matching fund methodologies, and management of property acquired with federal funds. As part of that process, management should collect and organize its policies and supporting documentation pertaining to these matters.

Governance Issues in A-133 Audits

Standard audits of financial statements include the auditor's review of key governance issues, including review of board minutes, bylaws, policies, and other key documents. The auditor's goal in reviewing these documents is ensuring board authorization for the annual budget, borrowing, investment of funds, and other key organizational decisions.

In A-133 audits of CAAs, the auditor must also determine whether the organization has complied with the specific governance requirements for recipients of CSBG funding, including board composition, and the board's full participation in the development, planning, implementation, and evaluation of the program to serve low-income communities. For CAAs receiving Head Start funding, the auditor must also find evidence of adoption and implementation of policies which comply with Head Start specific conflict of interest requirements and ensure that Policy Councils are functioning within the parameters required for organizations receiving Head Start funding. With this in mind, management should prepare schedules or discussions that demonstrate that management has complied with applicable requirements.

Conclusion

As should be apparent, preparing for a financial statement audit is an involved process. In order to efficiently provide the auditor with what the auditor needs, management should place a premium on thorough pre-audit planning and meetings with the auditor. From a longer-term perspective, management should be focused on putting in place a solid system of internal controls and supporting documentation, together with effective record retention policies. A CAA with poor systems is going to struggle as it attempts to meet the demands that the auditor places on it. CAAs that have placed a premium on good systems will have far less trouble preparing for the audit. Those systems will reduce the burden on both the CAA and its auditor.

Part IV: The Audit Committee Generally

The function of the audit committee is to act on behalf of the board in connection with the audit. The audit committee must work closely with management, because both have a role in the process. How required tasks are allocated between management and the board depends in part on the depth of the audit committee's knowledge and experience, the time its members are willing to commit to what can be an involved process, and appropriateness of the division. For example, the audit committee should review the management representations, but management must sign the letter, placing primary responsibility for this aspect of the audit on management.

In order to efficiently provide the auditor with what the auditor needs, management should place a premium on thorough pre-audit planning and meetings with the auditor.

Overview

A CAA's financial statements guide and influence the board's decisions regarding program size and scope, operating and capital budgeting, compensation, fundraising, and financing. The CAA's system of internal controls directly affects the quality of interim information that the board relies on. Internal controls also serve to protect against fraud and financial mismanagement. As is true of all organizations, CAAs face an array of regulatory and financial risks, which the board must oversee.

A CAA's board requires a formal means for: (1) addressing the accuracy of the financial information that the board relies on; (2) assuring that management has adopted necessary internal controls; (3) monitoring financial and other risks; and (4) managing the board's relationship with auditors. For an organization such as CAA, that obtains audits of its financial statements, an audit committee provides that structure, as the following clause from the American Red Cross' audit committee charter demonstrates:

The Audit and Risk Management Committee (the "Committee") is appointed by the Board of Governors (the "Board") of The American National Red Cross (the "Corporation"). The purpose of the Committee is to assist the Board in oversight of (1) the integrity of the financial statements of the Corporation, (2) the qualifications and independence of the Corporation's independent auditors, (3) the performance of the Corporation's independent auditors and internal audit function, (4) the processes by which the Corporation's management assesses and manages risk, and (5) the Corporation's compliance with legal and regulatory requirements.²⁹

Committee Duties

Audit committees perform a number of important tasks, including:

- **Retaining the Independent Auditor.** As previously noted, the audit committee should make recommendations to the full board on or bear primary responsibility for selecting, retaining, managing the services of, and, when necessary, terminating the relationship with the outside auditor.

■ **Assuring Auditor Independence.** In adhering to professional codes of conduct, the outside auditor should be continuously evaluating its independence, particularly when the auditor also will be providing non-attest services to the CAA.

Notwithstanding those efforts, the audit committee should also assess the auditor's independence. The committee may decide to impose a higher standard for independence than required under applicable professional codes of conduct. Some audit committees may require that all non-attest services (e.g., consulting services) be pre-approved by the committee, particularly if the CAA's management will contract for and direct the non-attest services. There is a natural conflict once an auditor is providing both attest and non-attest services. Can an auditor remain objective when the cumulative fees received from the non-attest services exceed audit fees? Even though the full board audit or the audit committee may control the audit engagement, the fees generated by non-attest services provide the auditor with an incentive to protect those fees by keeping management happy.

■ **Communicating with the Auditor.** Statement of Auditing Standards (SAS) No. 114, *The Auditor's Communication with Those Charged with Governance*,³⁰ addresses communications between the auditor and the board or the audit committee. As is true of most audit standards, it is written from the perspective of the auditor. In this particular case, the focus on the auditor is a bit surprising given the recurring reference to the importance of two-way communications to the process. The auditor is required to communicate: (1) the auditor's responsibilities under GAAS; (2) an overview of the planned scope and timing of the audit; and (3) significant findings from the audit. The auditing standards contemplate a formal communication process, specifying which communication must be written or oral. SAS No. 115 requires the auditor to communicate significant control deficiencies and material weaknesses in the system of internal controls, something we will consider in Part V.

The audit committee should have members who are capable of upholding the committee's end of the two-way discussions. These members must understand the implications of the communications and be in a position to demand that management respond appropriately.

The central question: How much is enough? A Grant Thornton 2009 Nonprofit Governance survey found that 52 percent of the nonprofit audit committees met with the outside auditors two or three times a year.³¹ According to commentary accompanying the survey, the audit committees should meet with the organization's auditors at least twice a year: once to discuss the auditor's work plan and once to review the audit findings before they are presented to the board. In fact, it is not unusual for the auditor to meet with the audit committee four times or more per year, particularly among larger organizations.

■ **Overseeing the Integrity of Internal Controls.** Management, not the audit committee, is charged with designing and implementing the CAA's system of internal controls. The audit committee, however, should "periodically consider the integrity and effectiveness of the [organization's] internal controls, including any significant deficiencies or changes in internal controls."³² At a minimum, this oversight function requires the committee to review the outside auditor's written communication regarding control deficiencies. The review should be followed first by discussion with management about the deficiencies and the need to make changes in systems and then with periodic progress reports from management.

Example

RESPONDING TO THE AUDITOR'S COMMENTS

In a letter to the board following its audit engagement, BCA's outside auditors advise the board that BCA does not have sufficient controls in place to monitor the executive director's discretionary spending on travel, meals, and other reimbursable items. The board or its audit committee should discuss this matter with the executive director and other members of management, asking that appropriate controls be put in place. The board or its audit committee should ask BCA's auditors whether they have any suggestions or are aware of any inappropriate behavior on the part of the executive director. The board or its audit committee should then follow up with management to ensure that the deficiency is addressed.

■ **Supervising the Internal Audit Function.** Large publicly traded corporations have internal audit staffs that continually monitor, test, and improve controls. Although large nonprofit hospitals and educational institutions often rely on internal audit staffs, far too many nonprofits have chosen to rely on their outside auditors and luck, often viewing internal auditors as administrative overhead that drain resources from mission.

If a CAA does have an in-house internal audit function, the audit committee should periodically review the independence and professional qualifications of internal auditor(s). The committee should also be involved in hiring the internal auditor, or the head of the internal audit team if there is more than one internal auditor, (most appropriately, making a recommendation to the full board after a thorough search process). Finally, it should review reports annually from the in-house auditor(s) regarding the state of the existing system of internal controls and suggestions for improving it.

■ **Assessing Risk.** The board's role in organizational risk management could be the topic of an entire toolkit. The following are among the areas that the audit committee should be reviewing or monitoring:

- Maintaining and protecting the CAA's tax-exempt status.
- Assuring proper treatment of taxable (unrelated business taxable income) income streams, if any.
- Monitoring the timely payment of payroll taxes (employee income tax withholding, FICA and Medicare taxes).
- Assuring that the CAA is claiming and protecting appropriate property tax exemptions.
- Assuring that the CAA qualifies for all claimed exemptions from sales and use tax.
- Monitoring compliance with bond and debt covenants.
- Addressing other appropriate risks.
- The audit committee need not address each of these issues at every committee meeting. Depending on a board's structure, some of these issues might better be assigned to other committees (e.g., the fundraising or finance committees), or the board might ask that management make direct reports to the board. Each of these issues ultimately is management's responsibility, but the board and its committees have an oversight role.

■ **Responding to Whistleblowers.** Another section of this toolkit focuses on whistleblower policies. A critical issue under any whistleblower policy is identifying whom the whistleblower should notify about concerns. The policy need not designate the same recipient for all notifications. The audit committee is a logical choice in the case of whistleblower concerns regarding financial matters. Those matters include suspected fraud or embezzlement, financial statement inaccuracies, inadequate or improper administration of grants, and potential tax law violations.

Committee Composition

Audit committees and financial expertise go hand in hand, or at least that is the conventional wisdom. CAAs are not subject to the SEC's rules applicable to public companies, but consideration of those rules is useful. This is particularly true for CAAs that are Head Start grantees since the Head Start Act generally requires their boards to have a member with financial expertise.³³ The SEC doesn't require that a certain number of audit committee members possess financial expertise, but it does require public companies to identify an expert on the committee, or explain why there are no such experts. The SEC does offer an elaborate definition for the term "audit committee financial expert." A qualifying expert includes someone who has: (1) an understanding of GAAP; (2) experience preparing, auditing, analyzing, or evaluating financial statements; (3) an understanding of internal controls; and (4) an understanding of the audit committee's role.³⁴ Each of these attributes is a relevant one. Although CAAs will find this definition useful, they need not formally adopt it.

Difficulty Finding Qualified Committee Members

Many CAAs will have difficulty finding more than one or two committee members who satisfy the SEC's definition. This is not a problem because most CAA financial statements will not be nearly as complex as the statements for publicly traded corporations. Most CAA audit committees should be able to discharge their duties if they have a banker, accountant, or other person familiar with financial statements and internal controls as a member.

Non-Board Members

Some CAAs will not have any board members with financial expertise. If state law permits, the board should consider appointing a non-CAA member to the committee. California, for example, permits non-board members to serve on the audit committee,³⁵ but California prohibits staff members and key officers from serving on the committee, which makes perfect sense given the committee's oversight function. CAAs operating Head Start programs should be mindful of the prohibition in the Head Start Act that precludes staff members from serving on a CAA's governing board, which could be interpreted to include committees.³⁶

CAAs seeking volunteers with financial expertise should contact local or state CPA societies.

Other Ways to Obtain Expertise

CAAs seeking volunteers with financial expertise should contact local or state CPA societies.³⁷ Nonprofit audit committees governed by laws that prohibit non-board members from serving on committees might consider utilizing someone in an advisory capacity, but who is not a formal committee member. This could be a volunteer or a paid consultant. Some caution is warranted if the committee has otherwise privileged discussions with an attorney, because the presence of an outsider might jeopardize attorney-client privilege depending on the circumstances and the laws of the applicable jurisdiction.

Audit Committee Charter

As is true of all standing board committees, the audit committee should operate pursuant to a written charter.³⁸ At a minimum, the charter should contain a purposes clause, define the committee's responsibilities and duties, and address the following issues:

Authority to Act for the Board

The charter should address whether the committee is an advisory committee, or whether the committee has decisionmaking authority to act for the full board. If the committee has such authority, the charter should clearly specify the areas where the committee is free to act and the areas where the board reserves decisionmaking authority. It might, for example, be appropriate for the committee, without prior consultation with the board, to make decisions in conjunction with management to implement the outside auditor's recommendations in its SAS No. 115 letter (discussed in Part V). On the other hand, if the committee were to become aware of fraud involving the CFO, the committee might be charged with conducting the investigation, but the board might retain authority over any resulting disciplinary action.

Reports to the Board

The charter should specify when and how the committee should inform the board about its activities, findings, and concerns. Given the audit committee's importance, the agenda for each board meeting should call for a report from the audit committee chair on developments that merit the board's attention. Boards should consider requiring the audit committee to make an annual written report discussing the outside auditor's findings, changes that have been made to the CAA's internal controls, and an assessment of risks that the committee monitors. Alternatively, in addition to exigent matters, the committee might report on one or two routine issues at each board meeting, thereby permitting it to spread out its tasks and perform its work more efficiently.

Authority to Retain Legal Counsel and Expend Funds

The audit committee may learn of fraud or be required to conduct investigations. As a consequence, the charter should address whether the committee has authority in such circumstances to expend funds and retain legal counsel. The board should decide whether to place dollar caps on the authority of the committee to spend money without first obtaining board approval. If the committee's annual expenditures are foreseeable or recurring, the board and the committee should consider an annual budget.

Number of Meetings

The charter should specify the regular committee meetings each year, the procedure for noticing meetings, and the circumstances that require special meetings. At a minimum, the audit committee should meet twice a year. Preferably, the committee will meet at least quarterly.

Meetings, Quorums, and Minutes

Like the CAA's bylaws, the committee's charter should define quorums and procedures, and require that meeting minutes be maintained. Committee meetings should be conducted pursuant to an agenda distributed in advance of each meeting. If possible, meetings should be conducted in person, but if state law permits, meetings can be conducted by telephone or video conference.³⁹ It would be best if meetings conducted through technology were limited to interim or emergency ones.

- **Quorum Requirements.** Meetings should only be convened if a specified quorum is obtained. At a minimum, the charter should set the quorum at a majority of committee members.
- **Meeting Minutes.** Someone should be appointed to record and maintain meeting minutes. Minutes serve at least three important functions: first, minutes provide evidence that the committee exercised business judgment during its deliberations and in its decisions. This can be important evidence in the event someone alleges that the board or committee members breached their fiduciary duties. Second, minutes provide the committee and the board with a permanent record of the committee's past decisions and actions. This record provides the committee with institutional memory, avoiding reconsideration of issues simply because the committee doesn't recall precisely what it decided. Third, new committee members can review minutes for the last several years to speed their understanding of the type of issues that the committee considers. For a relevant discussion of meeting minutes, see the toolkit section, *Making*

Board Meetings Matter.

If at all possible, several members should be financially literate and familiar with financial statement basics or able and willing to become so, but members need not be CPAs.

- **Member Qualifications.** The charter should specify member qualifications, if any. If at all possible, several members should be financially literate and familiar with financial statement basics or able and willing to become so, but members need not be CPAs.
- **Chairperson.** The charter should provide for a committee chair and define his role. Every committee needs a leader to provide structure and direction.

- **Member Terms.** Subject to applicable corporate law statutes and the CAA's bylaws, the charter should address membership terms and whether a committee member may serve successive terms. Some boards favor term limits, but given the difficulty in finding individuals qualified to serve on the audit committee, term limits may not be practical. More important, terms limits deny boards and committees talented people who still may be enthusiastic. There is no need for artificial limits if the board retains the decision over whether an individual should be re-appointed and the board is attentive. The charter might provide for staggered terms so that only one or two committee members rotate off the committee in any given year.
- **Committee Size.** The committee should have at least three members and probably no more than five. This is a working group that needs to roll up its sleeves. The cohesiveness that often comes with smaller groups warrants limiting the number of members. As a practical matter, most CAAs are more likely to have trouble finding people to serve on the audit committee rather than to find themselves overwhelmed by the number of people volunteering for service.

Part V: Management Letters

Context

Audit clients and auditors have long recognized the limitations of the standard audit opinion. To justify their fees, some auditors historically provided the board and management with what is customarily referred to as a management letter.

Mandatory Nature of the Communications

This letter, or at least a portion of the communications that might have appeared in this letter, are now governed by two auditing standards: SAS No. 114, *The Auditor's Communication with Those Charged with Governance*⁴⁰ and SAS No. 115, *Communicating Internal Related Matters Identified in an Audit*.⁴¹ These standards require the auditor to communicate certain information to management and the board.⁴² It does not necessarily need to be communicated in the same letter.

A Desirable and Valuable Communication

Given the deep understanding of systems and controls that the auditor develops during the course of an audit, a CAA's management and board can derive significant value from auditor communications, but only if the board and management take the time to review the communications and the auditor treats the exercise as an opportunity rather than a pro forma necessity.

SAS No. 115, Communicating Control Deficiencies

SAS No. 115, *Communicating Internal Control Related Matters in an Audit*, requires the auditor to communicate to management and the board⁴³ all control deficiencies identified during the audit that are significant or that represent material weaknesses, but only if the deficiencies could result in a material misstatement to the financial statements.

The Focus

SAS No. 115 focuses on whether the deficiency has the potential to lead to a misstatement, not on whether the failure could lead to fraud. The bulk of the statement is devoted to defining control deficiencies, material weaknesses, and significant deficiencies.

Examples

For present purposes, the definitions are largely irrelevant, and are best left to the auditors, but here are some examples of control deficiencies:

Examples

PERFORMING INCOMPATIBLE DUTIES

BCA's bookkeeper writes checks and reviews the bank statement each month. No one else reviews the bank statement. This is a control deficiency. Incompatible duties are not adequately segregated: The bookkeeper has authority to disburse funds, but he also records the corresponding disbursements. These two functions should be performed by different people. Whether this deficiency is classified as a significant deficiency or a material weakness is a question of materiality.

PERFORMING INCOMPATIBLE DUTIES

An afterschool teacher collects fees from parents, counts the money, and then deposits the receipts in BCA's bank account. This is a control deficiency. Incompatible duties are not adequately segregated. The teacher has recordkeeping and custody over the funds. Those two functions should be performed by different people. (examples continued on next page)

Examples

(Control deficiency examples, continued)

FAILURE TO TAKE PHYSICAL INVENTORY

BCA's thrift shops tracks its inventory by computer, but BCA never takes a physical inventory. The failure to take a physical inventory, particularly in a retail operation, is a deficiency. Accounting records should be periodically reconciled with physical reality.

FAILURE TO CODE RESTRICTED ACCOUNTS

BCA receives both temporarily and permanently restricted grants. It does not distinguish in its accounting records between temporarily restricted and permanently restricted assets. This is a control deficiency. The failure to code accounts could adversely affect the preparation of BCA's financial statements.

BOARD MEMBER PRE-SIGNS CHECKS

BCA's board imposed a two-signature requirement on BCA's checking account. BCA's CFO and a designated board member must sign each check that exceeds \$1,000. After a few months, the board-designated co-signer concludes that the process is cumbersome. He decides to pre-sign ten checks and gives them to the CFO. This is a deficiency in how the two-signature

The Board's Concerns

The board should take notice of any reported significant deficiencies or material weaknesses in control. These items indicate weaknesses in the system of internal controls that could lead to incorrect financial reports and statements. Of equal importance to the board, these deficiencies could also lead to loss due to theft or fraud, violations of the law, or noncompliance with board directives and policy, but those concerns are not the auditor's primary focus when examining the system of internal controls.

The board should be aware that items characterized by the auditor as "material weaknesses" are considered to pose more significant problems than those characterized as "significant deficiencies" but the board should expect management to present carefully thought out responses to both types of findings, and most importantly, hold management accountable for implementing the changes needed to resolve the finding.

The Communication

The auditor must communicate the significant deficiencies and material weaknesses in a writing to the board within 60 days of the issuance of the auditor's report.

- **Prior Knowledge is Irrelevant.** The auditor is encouraged to communicate significant deficiencies and material weaknesses during the audit if warranted. For example, the auditor should communicate a fraud and the related control deficiencies immediately following discovery. Despite these more informal communications, the auditor still must communicate these deficiencies in the SAS No. 115 letter even if remediated during the audit.
- **Content.** To satisfy SAS No. 115's requirements, the written communication must: (1) state that the audit's purpose was to express an opinion on the financial statements; (2) define a significant deficiency and, if applicable, a material weakness; (3) identify each significant control deficiency and material weakness; and (4) indicate that the communication is solely for the benefit of management, the board, and others within the CAA. If the CAA is required to provide the SAS No. 115 letter to a regulator, then the letter should refer to the regulator as a permitted recipient.
- **The CAA May Make a Request.** An auditor, if requested, can provide the CAA with a letter indicating that the auditor identified no material weaknesses during the audit if a regulator or other government agency so requires. The auditor, however, is prohibited from issuing a letter indicating that no significant deficiencies were identified during the audit because such a statement is open to misinterpretation.
- **The Board Should Be on the Lookout for Recurring Deficiencies.** The auditor must discuss each material weakness or significant deficiency in the current communication even though the auditor flagged the problem in the prior year's letter. If there are recurrences, the board should ask management why it is ignoring what are in effect recommendations from the auditors.
- **Appendix G.** Several examples of deficiencies identified in SAS No. 115 communications are included in Appendix G.

Communicating Other Information

A second auditing standard, SAS No. 114, *The Auditor's Communication with Those Charged with Governance*, requires the auditor to communicate a number of other matters to the board.

Matters to Be Communicated

The following are among the subjects that must be communicated to the board:

- **Significant Difficulties Encountered During the Audit.** Any significant difficulties that the auditor encountered during the audit. These could include management's failure to timely respond to the auditor's request for information, limited time to complete the audit, missing information, the need to expend more effort than expected to perform audit, any restrictions imposed by management on the auditor's efforts, and management's unwillingness to provide information.
- **Consultation with Other Accountants.** Whether the auditor is aware of any consultations between management and another accounting firm regarding auditing and accounting issues. Such communications may be sign of a disagreement between management and the current auditors.
- **Management's Representations.** The auditor should provide the board with a copy of the representations that the auditor is requesting from management. Although the language in SAS No. 114 does not require this, the auditor also should provide the board with the representations actually made by management, particularly when there are significant deviations between what was requested and what was represented.
- **Uncorrected Misstatements.** The auditor should address uncorrected misstatements in the financial statements with the board.
- **Independence.** The auditor should consider whether the circumstances warrant communicating with the board about the auditor's independence. SAS No. 114 suggests that such communications may be appropriate when the auditor provides nonaudit services to a nonprofit that is subject to the Single Audit Act.

Example

AUDITOR INDEPENDENCE

BCA's auditor prepares BCA's annual tax return for \$5,000 and also undertakes information technology work for \$15,000. The auditor receives a \$30,000 annual fee for its BCA audit. The auditor might include a discussion of how the fees for non-audit services affect its independence.

Form of Communications

The auditor must report significant findings to the board in writing if oral communication would prove inadequate. In addition to written communications from the auditor, SAS No. 114 envisions formal presentations and discussions. In certain instances, written communications will be insufficient. The auditor, for example, may find himself in a dispute with management over a material adjustment. Informing the board of the disagreement in writing has its allure: It avoids a potentially uncomfortable confrontation with management. Yet, the seriousness of the dispute may be best communicated during a meeting with the board. A meeting gives the board the opportunity to ask questions, assess the auditor's demeanor, and resolve the dispute if management is present.

In addition to written communications from the auditor, SAS No. 114 envisions formal presentations and discussions.

Timing

Auditors often send what is best described as a SAS No. 114 letter to audited organizations at the conclusion of the audit. This practice makes sense for many of the required written communications. Many matters will require earlier communication so that the board can take timely action. Moreover, some of the matters discussed in SAS No. 114 are best communicated during the planning stage. In sum, the communications contemplated by SAS No. 114 are ongoing and interactive ones.

A Pragmatic Examination of Required Communications Between the Auditor and Those Charged with Governance

SAS Nos. 114 and 115 lend themselves to boilerplate communications. SAS No. 115 encourages that practice, as do many other auditing standards, by providing suggested language for the required written communications. Auditors take comfort in this language, but all too frequently to the detriment of effective communication. The standard form language does not account for each recipient's circumstances or knowledge.

What the Board and the CAA Should Demand

Even though the auditor may not be required to communicate certain matters, the board should demand much more information than is necessarily required by SAS Nos. 114 and 115. What is disturbing is the discretion that these standards provide to the auditor. The board should use the engagement letter as a tool to force complete and candid disclosure from the auditor. The following two examples illustrate the problem with SAS No. 115:

Examples

CONTROL DEFICIENCIES LEADING TO FRAUD

BCA's treasurer has wire transfer authority over BCA's checking account. He can wire any amount without a second person notifying the bank. The treasurer's authority over the checking account is a deficiency in BCA's internal controls, but if there are compensating controls, the auditor need not report this deficiency as a significant one or a material weakness. In this case, the auditor decides a second control requiring a board member to review the monthly bank statements is a compensating control that protects the integrity of the financial statements.

The auditor delivers its audit opinion and the SAS No. 115 letter within 60 days following the close of the audit. The auditor's letter does not make reference to the control deficiency because of the compensating controls. Moreover, the auditor received a confirmation of the year-end checking account balance from the bank. On the same day that the auditor issues his opinion, the treasurer wires \$5 million to a foreign bank account and leaves the country.

DEFICIENCY AFFECTING INTERIM FINANCIAL STATEMENTS

BCA's board meets monthly to review interim financial statements. The accounting system is unable to process accruals until year-end. As a consequence, the interim financial statements consistently underreport expenses. At year-end, the accounting staff makes all the adjustments to properly accrue all expenses. The auditor has reviewed the accrual process and found it to be 100 percent accurate over the years.

Arguably there is no potential for misstatement in the audited financial statements given the year-end procedures that are employed before the auditor commences the audit. The board nevertheless is reviewing inaccurate financial information when it reviews the interim financial statements, which could lead to bad decisions. Despite that fact, BCA's inability to accrue certain expenses before the close of the year arguably is not a reportable control deficiency because it has no impact on the audited financial statements.

If for no other reason than to justify the cost of the audit, auditors should be communicating all relevant observations for improving the CAA's accounting system and internal controls. What is puzzling about SAS No. 115 is why auditors need to be told to do this. The board should want to know more rather less, but SAS No. 115 provides a framework for reporting less than the board might like to know.

The board should demand more from its auditor than the minimum required communications., including:

- **A List of All Control Deficiencies.** A list of all control deficiencies that the auditor observed during the audit, regardless of whether the deficiencies represent significant ones or material weaknesses. Trivial deficiencies can be excluded. The engagement letter should prohibit the auditor from merely copying descriptions from audit workpapers. Too many SAS No. 115 letters are jargon-laden and filled with what often are incomplete thoughts copied from workpapers.
- **A List of Recommended Audit Adjustments.** A list of all recommended audit adjustments, divided between those that management made and those that it did not make. The auditor also should offer his understanding of why management chose not to make any recommended adjustments.

If for no other reason than to justify the cost of the audit, auditors should be communicating all relevant observations for improving the CAA's accounting system and internal controls.

- **A List of Management Representations.** A copy of the initially requested management representations and the representations as made.
- **A Description of the Materiality Standard.** A description of the materiality threshold that guided the auditor's work and an explanation why that standard is the appropriate one.
- **An Initial Meeting.** An initial meeting between the full board and the auditor prior to the commencement of the audit. This can occur as part of the regular board meeting.
- **Periodic Reports.** Periodic reports by the auditor to the audit committee or other designated board members during the audit.
- **Notification of Disagreements.** Immediate verbal notification of any disagreements between the auditor and management or significant difficulties encountered during the audit.
- **Debriefing.** A debriefing conducted for the audit committee at the conclusion of the audit.
- **Presentation.** A presentation by the auditor to the full board when the auditor delivers its opinion and related written communications. This can occur as part of a regular board meeting. During part of this meeting, the auditor should meet with the board without management or other members of the CAA's staff present.
- **Plain Language Communications.** Plain language descriptions, discussions, and analysis in all written communications whenever possible rather than reliance on boilerplate language or language that simply repeats language from the auditing standards.

Some auditors may argue that some of these recommendations are outside of industry practice, causing them to resist the request. As a practical matter, the board may be required compromise some of its requests, but the overarching point is critical: the auditor is performing a service for a fee. The board should be proactive in assuring that the CAA derives maximum benefit for the fees it is paying for the auditor.

Endnotes:

1. http://ag.ca.gov/charities/publications/nonprofit_integrity_act_novo4.pdf.
2. CAAs have two choices in how the federal government reimburses them for overhead. Broadly speaking, they can develop an appropriate allocation methodology for allocating overhead costs across each grant, or they can obtain approval of one overhead rate that is used to calculate the reimbursable overhead under each grant.
3. Generally Accepted Accounting Principles, or GAAP, govern how financial information is categorized, summarized, and presented in audited financial statements. GAAP is promulgated by a number of rulemaking bodies, including the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA).
4. Part VII of the Core Form 990 and Schedule J.
5. <http://www.guidestar.org>.
6. <http://www.eri-nonprofit-salaries.com>.
7. The Single Audit Act requires CAAs expending more than \$500,000 or more in Federal awards during a year to undergo an audit that meets certain requirements. The one audit can be used satisfy the audit requirements imposed by all the federal agencies providing funds to the CAA. Many states and local governments permit a CAA to satisfy any audit requirements with an audit under the SAA.
8. <http://www.capl原因.org/financialnetwork.html>.
9. <http://www.bridgestar.org/MyCareerCenter.aspx>.
10. <http://asi.careerhq.org>.
11. <http://www.idealists.org>.
12. <http://www.independentsector.org/jobs>.
13. <http://www.opportunityknocks.org>.
14. See Question 5 in Section A of Part VI to the IRS Form 990, referring to significant diversions of assets.
15. <http://www.capl原因.org>.
16. <http://www.aicpaconferencematerials.com/notforprofit>.
17. http://www.wipfli.com/Industry_NonProfitandGovernment.aspx.
18. See OMB, Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations (June 2003), available at <http://www.whitehouse.gov/omb/circulars/a133/a133.pdf>
19. This guide is described in detail at <http://www.aicpa.org/Publications/AccountingAuditing/KeyTopics/Pages/NotForProfitEntities.aspx>, where it is available for purchase.
20. Id. at AU §508.61.
21. See Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18788 (2003)
22. OMB Circular A-133 § .305. Public CAAs must follow the procurement requirements for state and local governments found in OMB Circular A-102.
23. OMB Circular A-133 § ____305.
24. <http://www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/Resources/NotForProfitResourceCenter/Pages/AICPANot-for-ProfitAuditCommitteeToolkit.aspx>.
25. <http://peerreview.aicpa.org/publicfile/DocDefault.aspx>.

26. AICPA, Management Representations, as codified at AU §333.02
27. The Board of Trustees of Community College District No. 508, County Of Cook, v. Coopers & Lybrand, 803 N.E.2d 460 (Illinois 2003).
28. 45 C.F.R. 1301.12
29. American Red Cross, Audit Committee Charter (undated) available at <http://www.redcross.org/images/pdfs/AuditandRisk.pdf>
30. AICPA, The Auditor's Communication, codified as AU §380.
31. Grant Thornton, The 2009 Grant Thornton Survey, available at <http://www.grantthornton.com/staticfiles/GTCom/Not-for-profit%20organizations/NFP%20Board%20Governance%20Survey%202009.pdf>
32. Smithsonian Institution, Charter of the Audit and Review Committee, 5 (Jan. 2008), available at <http://www.si.edu/about/regents/documents/Audit-and-Review-Committee-Charter.pdf>.
33. 42 U.S.C. 9837(c)(1)(B)(i).
34. SEC, Form 20-F.
35. Calif. Gov. Code 12586(e)(2). See also California Registry of Charitable Trusts, Nonprofit Integrity Act of 2004: Summary of Key Provisions, available at http://ag.ca.gov/charities/publications/nonprofit_integrity_act_novo4.pdf.
36. 42 U.S.C. 9837(c)(1)(C)(iii).
37. As an example, the New York State Society of CPA has a web page (<http://www.nysscpa.org/cpasonboards/main.htm>) that assists CPAs who are interested in volunteering for nonprofit board or other service.
38. AICPA's Not-for Profit Audit Committee Toolkit is an excellent resource for a sample charter and a variety of checklists: <http://www.aicpa.org/interestareas/businessindustryandgovernment/resources/notforprofitresourcecenter/pages/aicpanot-for-profitauditcommitteetoolkitdownloads.aspx>.
39. See for example, Cal. Corp. Code §521(a)(6); Minn. Stats., §317A.239; and N.Y. Consol. L., Chapter 35, §708.
40. AICPA, SAS No. 114, The Auditor's Communication With Those Charged With Governance, codified at AU §380.
41. AICPA, SAS No. 115, Communicating Internal Control Related Matters in an Audit, codified at AU §325.
42. SAS Nos. 114 and 115 provide that the outlined procedures should be undertaken, which suggests a strong recommendation rather than a requirement. The auditing standards indicate that when an SAS uses the word should, the enumerated action, procedure, or communication is presumptively mandatory.
43. As noted in the prior section, SAS No. 114 defines the phrase those charged with governance for purposes of SAS Nos. 114 and 115. For purposes of this toolkit, these individuals are referred to as the board of directors.

SECTION 3: CREATING THE ANNUAL OPERATING BUDGET

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This section is designed solely to illustrate concepts and practices. Each CAA's mix of funding and requirements imposed on it by specific laws and funding source agreements will be different. A key element in preparing the budget will always be gaining an understanding of all requirements of your funding sources and of how those requirements are interpreted by your local, state and federal funder representatives before making decisions regarding your cost center structure, and particularly treatment of management costs.

The annual operating budget is a comprehensive financial plan that projects all income and all expenses that are expected to be received or incurred within the CAA's fiscal year. It fulfills two key functions: planning and authorization. As a planning tool initiated by management, the budget functions as a comprehensive plan to obtain and use resources to fulfill the CAA's mission and meet all contractual and legal obligations. Board approval of the annual operating budget authorizes management to proceed with implementation of the plan. Board approval of the budget also provides evidence that board members are fulfilling their legal responsibilities to direct the use of resources to fulfill the CAA's mission and ensure compliance with legal obligations. In addition to the key planning and authorization functions, the annual operating budget functions as an important internal control when it is used as a point of comparison with actual financial results achieved, facilitating identification of errors or irregularities and needed corrections.

Part I: Building the Budget

Overall Budget Goals

Each board must determine its overall financial goals for the year covered by the annual operating budget. CAAs are encouraged to work toward long-term sustainability, which requires building both cash reserves and net assets (the nonprofit term for equity or net worth). In order to achieve these sustainability goals, the CAA must budget to have overall income exceed overall expenses in the annual budget. Unfortunately, many governmental funding agreements are structured on a “use it or lose it” cost reimbursement basis. Budgeting to generate income that is greater than expenses requires the CAA to develop additional strategies to overcome the limitations of cost reimbursement contracts.

Common strategies include seeking unrestricted contributions, developing fee for service programs, and negotiating performance based contracts that pay service providers for achievement of performance targets rather than reimbursing expenses incurred. Performance based contracts permit CAAs to potentially make and retain a profit on services provided if the payments exceed their costs. Of course, they also involve risks since failure to achieve targets will result the CAA not receiving the maximum contract amount and no additional payment will be made if actual costs exceed the negotiated price for delivery of services.

Tip

EXERCISE CAUTION WITH DEFICIT BUDGETS

Under certain circumstances, the board may decide to adopt a deficit budget in which projected expenses exceed projected income. For such a decision to be reasonable, the organization must be in a strong financial position, having sufficient operating reserves to withstand the anticipated loss. Typical reasons for accepting a deficit budget include commitment to invest in development of additional fundraising capacity, development of new programs with potential to generate earned income, or in some cases, the desire to maintain continuity of services while additional funding resources are sought. Whatever the reason, caution is warranted.

Timeframe

The annual operating budget includes all expenses expected to be incurred in the operation of the CAA during its fiscal year and identifies all sources of income expected to be available to meet those costs. Many CAAs receive funding through multiple governmental grants and contracts, many of which cover periods that do not correspond to the organization’s fiscal year. In order to prepare a comprehensive annual operating budget, the CAA must determine which portion of the expenses to be met through each of its funding agreements will be incurred during the fiscal year for which the annual budget is being developed. Similarly, the CAA must determine which portion of the funds awarded in each agreement will be available during the fiscal year to meet the costs associated with the agreement.

Example

Blue CAA (BCA) will receive Award 1 for the award period October 1, 2011 through September 30, 2012. BCA utilizes a July through June fiscal year for its accounting, financial reporting, and annual budget. When preparing the annual budget for the fiscal year beginning July 1, 2011, BCA will include only the portion of Award 1 expenses that will be incurred during the CAA fiscal year (July 1, 2011 through June 30, 2012). BCA will include an amount equal to the project Award 1 expenses for the fiscal year 2011/2012 as Award 1 income for the fiscal year.

Award #1	Total Award	FY 11/12 portion	FY 12/13 portion
	10/1/2011 9/30/2012	10/1/2011 6/30/2012	7/1/2012 9/30/2012
Personnel	\$100,000	\$70,000	\$30,000
Occupancy	\$30,000	\$22,500	\$7,500
Supplies	\$5,000	\$3,000	\$2,000

Documenting Budget Assumptions

The annual operating budget represents the CAA's best estimate or projection of income and expenses for the upcoming fiscal year. Sound budgeting requires systematic recording of the assumptions that are the basis of the projections. Documenting assumptions is most important for income and expense items of the greatest magnitude. Clear documentation of assumptions will make it much easier to calculate the impact on the overall budget that will occur when assumptions change.

Example

BCA documents its assumptions about the cost of employee health insurance for the fiscal year 2011/2012 by estimating the number of employees that will be covered by the plan for the months July through December, 2011, under the terms of the current contract with the health insurance plan. BCA documents its estimate of the monthly premium charge for the new insurance plan year beginning January, 2012, including estimating the number of employees to be covered in the first six months of 2012.

Contract period	# of covered employees	Cost per employee per month	Estimated cost for 6 months
7/1/11 - 12/31/11	40	\$450	\$108,000
1/1/12- 6/30/12	38	\$480	\$109,440
Estimated Total Cost			\$217,440

Past experience with both income and expense items is helpful but not definitive. Projections for the most significant income and expense items must be based on detailed schedules of plans for the upcoming budget year. For example, a detailed schedule listing all positions, and all components of compensation for the budget year is essential to accurately project personnel costs. Similarly, projections of income from contributions should be based on specific assumptions regarding the anticipated number of donors, average contribution size, estimated donor retention rate, and the results that are anticipated from each campaign and solicitation strategy.

Example

BCA plans to send out a year-end appeal to donors who have contributed over the past three years and new prospects identified by board members. The development director documents her assumptions regarding the total contributions that are expected to be received from the year-end appeal. This estimate is added to her other detailed projections of contributions to be received from the board's person-to-person campaign with major donors to estimate the total gifts from individuals to be included in the fiscal year budget.

Year End Appeal	# Donors	Average Gift Size	Est. % Response	Est. 11/12 Gifts
FY 10/11	300	\$50	80%	\$12,000
FY 09/10	250	\$45	70%	\$7,875
FY 08/09	275	\$60	60%	\$9,900
New Prospects	100	\$25	25%	\$625
Total				\$30,400

Part II: Identifying the Costs

Cost Center Structure

CAAs frequently operate multiple programs and in many instances, each program is supported through the use of resources from multiple sources. The use of a cost center budget structure facilitates describing how various programs will be supported and how various funding sources will be utilized in accord with the requirements of specific funders.

Clear identification of cost centers is the first step in preparing the comprehensive annual budget on a cost center basis. Once cost centers are determined, the CAA projects the income and expenses that are logically related to each cost center. Budgets for all cost centers must be integrated into the comprehensive annual budget document. For example, a CAA with a Head Start, weatherization, and energy assistance programs should develop budgets for each program. It should also develop cost centers for general administration and fundraising.

The cost center budget is best visualized as a matrix (like a spreadsheet) in which the rows are used to list income and expense categories (line items) such as contributions, program fees, salaries, telephone, and the columns are used to identify the distinct program, management, and fundraising purposes that the CAA will undertake. The matrix is completed by determining the portion of each income or expense line item that will be associated with each cost center.

	Total	Admin	Fund Raising	Program A	Program B	Program C
Income						
Grants						
Contracts						
Prog Fees						
Contributions						
Total Income						
Expenses						
Personnel						
Occupancy						
Total Expenses						

Treating each program, together with the management and fundraising functions, as separate cost centers, mirrors the distinctions that are required for CAA financial reporting on the Statement of Functional Expenses and on IRS Form 990. While IRS and GAAP accounting requirements focus on distinguishing the functional purpose of expense line items, the annual operating budget will be most useful if the cost center structure is also used to classify income line items by cost center as well. The cost center-based budget should reflect the purposes for which contributions and grants are received and/or relationship between the earned income and the programmatic efforts which result in its generation. Unrestricted gifts are attributed to the fund raising cost center, facilitating calculating the net unrestricted income (after subtraction of the fund raising expenses) that is available to underwrite program and management costs or flow into reserves.

Using cost centers is also an important internal control, ensuring compliance with federal funds management requirements. Virtually all governmental funding agreements distinguish management costs from program costs. Many governmental agreements treat fundraising expenses as unallowable. The cost center based budget allows the CAA to demonstrate its plans for compliance with restrictions on the use of funds for administration and/or fundraising. It also allows the CAA to describe its plan to use resources for the specific purposes for which they are provided.

Management Costs

CAAs should use the same definition of “management” costs to prepare the annual operating budget as they use in their accounting systems, and usually, reporting systems. In general, management costs include costs associated with executive management and financial management, audits, high level IT and HR management, general legal services, public relations, and the board of directors.

One important note here: while both GAAP and the IRS Form 990 instructions include public relations costs in the management function, OMB Circular A-122 deems public relations costs unallowable (while allowing costs for communicating information about programs to potential participants). In federal indirect cost rate proposals, unallowable costs are presented in a separate cost center. Many CAAs use this approach in their budgeting and accounting systems and then analyze the unallowable costs at year-end to put them in the appropriate cost centers for the 990 and GAAP presentation.

In addition to the salaries, taxes, and benefits of individual staff performing those functions, management costs include the supplies, facilities, and other expense line items that are required for satisfactory performance of management functions.

Fundraising Costs

In general, CAAs use the same definitions to identify the costs that should be attributed to the fundraising cost center in the annual budget as they will use in their audited financial statements and on the IRS Form 990. Both standard accounting and the IRS define fundraising costs as including expenses incurred to prepare, make, and process unsolicited requests for contributions from the general public, as well as expenses incurred to prepare proposals for foundation grants and for government grants that provide services to the general public. Costs in the fundraising cost center include the cost of the portion of staff positions which are devoted to fundraising activities, the facilities and other operating expenses necessary for them to perform the fundraising functions, as well as the direct cost of fundraising events or fund raising materials.

GAAP and the IRS generally treat the cost of soliciting and negotiating exchange transaction agreements as management rather than fund raising costs. Some federal grant programs, such as CSBG, instruct grantees and subgrantees that the definition of management costs for CSBG reporting purposes may be different than for financial accounting purposes.¹ In addition, unlike costs incurred for general fundraising from the public, capital campaigns, and the like, federal grant management requirements and cost principles generally do not prohibit the use of grant funds to prepare proposals for government or private foundation grants.²

While the distinctions between management and fundraising costs can be complex, the guiding principle for budget preparation should be making certain that your budget format will be consistent with the structure used in your accounting system which should also be consistent with the structure used in your financial reporting.

Program Costs

Typically CAAs utilize multiple program cost centers and in many cases establish structures involving sub-and sub-sub-cost centers to further distinguish elements of major programs. For example, a CAA may have a major cost center for Head Start and utilize sub-cost centers for costs associated with Head Start activities at a specific location.

Many programs are supported by multiple funding sources. The sub-cost center structure is used by some CAAs to distinguish the portion of costs of a program that are met through specific funding agreements. Other CAAs structure their cost center budget to place the costs associated with each funding agreement into a distinct cost center.

Example

Green CAA uses a separate cost center for each of its major programs. Green uses sub-cost centers for each of the major funding sources for each program.

Homeless Services Cost Center	City Contract Sub-Cost Center	State Contract Sub-Cost	CSBG (portion for homeless services) Cost Center
Personnel			
Occupancy			

Orange CAA uses a separate cost center for each funding agreement. When a single funding agreement provides funding for more than one program function, Orange uses sub-cost centers for each distinct program function.

CSBG Award Cost Center	CSBG Homeless Sub-Cost Center	CSBG Nutrition Sub-Cost Center	CSBG Youth Sub-Cost Center
Personnel			
Occupancy			

Direct Costs

Preparation of a cost center-based budget requires analyzing each expense line item to determine which elements of the total cost anticipated in the line item should be attributed to each cost center. The term “direct cost” is used to describe the situation in which it is easy to make a direct association between a specific cost and the cost center (which can also be referred to as the program or grant) that benefits most from the expenditure.

For example, in the budget of a CAA operating a homeless shelter, the cost of the night staff person who runs the shelter obviously should be attributed to the homeless shelter cost center

Shared Costs

Some line items will include costs that are incurred to provide benefit to multiple cost centers. For example, the line item for rent expense in a CAA which leases one facility to conduct all of its program, management, and fund raising activities provides benefit to all of the cost centers. When expense line items include costs that provide benefit to multiple cost centers, it is often very difficult to determine exactly which portion of the cost should be attributed to each of the benefitting cost centers. Such costs are described as “indirect costs” or “shared costs” because the benefit they provide cannot be directly determined.

There are several distinct approaches to handling shared costs in the annual operating budget. Some CAAs assign the portion of each expense line item that benefits multiple cost centers to one or more indirect cost centers. Other CAAs use specific methods to estimate the benefit that items such as rent will provide to each cost center. These methods are referred to as cost allocation methods. A detailed discussion of the issues raised by cost allocation is beyond the scope of this toolkit.

Example

Example 1:

Some CAAs allocate each cost item that benefits multiple functions by applying a formula that estimates the benefit that each distinct cost item provides to each function. In this example, for costs such as rent and telephone, Blue CAA (BCA) decided to create a formula based on the percentage of full-time equivalent positions (FTEs) whose work effort is attributed to each cost center. Fifteen percent of all BCA FTEs are devoted to Management, five percent of FTEs are devoted to Fund Raising, and 40 percent, 30 percent and 10 percent of FTEs are devoted to Programs A, B, and C respectively. BCA uses this formula to allocate the total cost of the rent and telephone line items to each cost center.

Shared Cost Line Item	Total Cost	Management	Fund Raising	Program A	Program B	Program C
Rent	\$1000	\$150	\$50	\$400	\$300	\$100
Telephone	\$200	\$30	\$10	\$80	\$60	\$20
Total	\$1200	\$180	\$60	\$480	\$360	\$120

Example 2:

Other CAAs place all costs that provide benefits to multiple functions into a shared or indirect cost pool. They then allocate the total costs in the shared/indirect pool to each of the various functions with a single allocating line, on the basis of the percentage that total indirect costs bear to total direct costs. In this example, BCA has created a cost pool for shared costs that will be allocated based on the percentage of FTE positions devoted to each cost center. Rather than apply the allocation formula to each line item separately as shown in Example 1, BCA collects all of these costs in the shared cost pool, and applies the allocation formula to the total costs in the pool. But, as these examples illustrate, the total costs assigned to each cost center in both methods remain the same.

Shared Cost Line Item	Shared of Cost Pool	Management	Fund Raising	Program A	Program B	Program C
Rent	\$1000					
Telephone	\$200					
Total	\$1200					
Allocated Shared Costs	-\$1200	\$180	\$60	\$480	\$360	\$120

The challenge of allocating indirect costs is compounded by the fact that funding sources vary in their views on how grantees should allocate indirect costs – especially management costs. Therefore, CAAs, particularly those without federally negotiated indirect cost rates, should check whether their cost allocation methodology – especially as it relates to management costs – is acceptable to their funding sources.

Of course, the costs that are assigned to the management cost center also benefit all of the other cost centers and meet the definition of indirect costs. Most CAAs find that it works best to use a separate cost center for management costs rather than combining them with other indirect cost centers. This approach facilitates developing an annual budget plan that will meet all funding source requirements related to management costs.

One of the most confusing aspects of the “terms direct” and “indirect” or shared is that while some cost items can be directly attributed to the management function, the management cost center provides indirect benefit to all other cost centers. For example, the cost of an accounting clerk position is readily attributed to the management cost center because there is a direct relationship between the work performed by that position and the management function. But the costs collected in the management cost center function are indirect costs, providing indirect benefit to all of the program and fundraising cost centers.

Terms with Multiple Definitions

One common challenge in developing a cost center-based annual operating budget is variations in how different CAAs and funders define terms, income and expense items, and cost centers.

Some CAAs use the term “indirect” cost to describe all of the costs that benefit multiple cost centers, including management costs and other shared costs such as facility costs. Other CAAs use the term “indirect” to mean only management costs. Within the world of federally negotiated indirect cost rates, nonprofit organizations are free to choose whether they want to define indirect costs as only management costs or whether they want to use the term indirect costs or shared costs to include management and other shared costs.

Whatever definition of indirect costs a CAA chooses, the CAA should still distinguish management costs from other indirect costs that benefit multiple cost centers. This distinction will allow the CAA’s budget to identify the management costs that must be reported on the IRS Form 990 and presented in audited financial statements.³

Part III: Allocating the Costs

Federally Negotiated Indirect Cost Rates

CAAs that have direct funding relationship with a federal agency (for example, Head Start grantees) may be required to or may choose to obtain a federally negotiated indirect cost rate. CAAs that have no direct federal awards are not able to obtain a federally negotiated indirect cost rate.

Preparing annual budget information in the cost center based format described earlier is essential for negotiating a federally indirect cost rate. Appendix C part II provides guidelines and samples of the formats which are used by nonprofit organizations to submit proposals for indirect cost rates to their federal cognizant agency.⁴ As described in the Appendix, there are multiple permissible approaches to negotiating the indirect rate and there are also multiple time periods during which different types of rates remain effective.

CAAs with federally negotiated indirect cost rates should continue to use the cost center-based format to prepare each annual budget in order to check whether their approved indirect cost rate is accurate. The addition or elimination of programs or substantial expansion or contraction of program costs, fundraising costs, or management costs could make it hard to support the approved indirect cost rate. Close attention is required.

The basic format for submitting an indirect cost rate proposal involves presenting all direct costs in appropriate cost centers, including each program, and fundraising. Management costs are placed in a management cost center. Other indirect costs (such as the cost of shared facilities) may be placed in one or more indirect cost centers. Any costs that are considered unallowable for the use of federal funds, for example lobbying costs, must be excluded from both the direct and indirect cost centers and placed into a separate cost center for unallowable costs.

Once all costs have been categorized as direct, indirect or unallowable, the indirect cost rate is calculated through division of the indirect costs by the direct costs. It is helpful to visualize this calculation as a fraction:

$$\frac{\text{Allowable indirect costs}}{\text{Allowable direct costs}}$$

As described in the Appendix, indirect cost rates can be based on use of either total direct costs or total direct personnel costs in the denominator. The Appendix also includes discussion of major choices CAAs must resolve in developing indirect cost rate proposals.⁵

Cost Allocation Plans

CAAs that do not have direct federal funding awards, as well as those that do, but that choose not to obtain a federal indirect cost rate, must develop and implement a written cost allocation plan. These plans must include the organization’s definitions of direct and indirect or shared costs and describe the methods that will be used to estimate the benefit of each type of shared or indirect cost to each cost center.

The methods for estimating the share of the benefit received by each cost center are described as cost allocation methods. Some CAAs will utilize cost allocation methods identical to those used in the negotiation of federal indirect cost rates. Others will use methods that base allocations on the percentages of full time equivalent (FTE) positions assigned to each cost center, the percentage of personnel dollars attributed to each cost center, the percentage of square feet of shared facilities used for the functions of each cost center, and a variety of other methods. The cost allocation plan serves as the basis for allocating indirect costs to the various cost centers in the annual operating budget.

Tip

SEEK PRIOR APPROVAL OF COST ALLOCATION METHOD

To avoid questions from funders later on, it is advisable to seek prior approval of your organization's cost allocation methods.

Fully Loaded Program Costs

Once management and indirect costs have been identified and placed in appropriate cost centers, the total for each cost center is allocated to the direct cost centers, including all the program cost centers and the fundraising cost center. Expenses in each cost center should include all direct costs by line item and line items for allocated shares of management and other indirect costs. The fully loaded cost of each program and the fundraising function is computed by adding the allocated share of indirect costs to the direct costs assigned to the cost center. Calculation of the fully loaded cost for each program allows the organization to justify understand the true cost of operating the program and to the use of funds for the program; it also provides important information that should be considered in contract negotiations.

Example

In this example, if the direct costs of Program A are \$2,000, the fully loaded costs for Program A (after the addition of allocated costs) would be \$2,480.

Shared Cost Line Item	Shared Cost Pool	Management	Fund Raising	Program A	Program B	Program C
Rent	\$1000					
Telephone	\$200					
SubTotal	\$1200					
Allocated Shared Costs	-\$1200	\$180	\$60	\$480	\$360	\$120

Cost Centers and Income Line Items

The cost center-based annual operating budget presents all the income line items, as well as the expense line items on a cost center basis. When funding agreements limit the use of funds to costs associated with specific programs, it is easy to assign those funds to the appropriate program cost centers. Similarly, when activities within specific programs result in the generation of fees or other earned income, it is logical to attribute that income to the cost center with which they are associated.

Some funding agreements contain specific provisions regarding the use of the funds for a share of the CAA's management costs or to cover the federally approved indirect cost rate. The full amount of such awards should be attributed to the appropriate program cost center so that the allocation of management and other shared costs will result in the grant or contract income being correctly matched to the full cost of running the program.

Some funding agreements impose limitations on the percentage of total award/contract dollars that may be used for management purposes. These limits reflect the maximum management costs the funding source will cover. However, the existence of such a limitation does not define the fair share of management or indirect costs that should be allocated to the program cost center. The fair share according to the organization's allocation plan should be assigned to the cost center. The income section for that cost center should reflect both the primary grant (the one imposing limitations) and the other sources of funds that will be used to cover the portion of the management or indirect costs legitimately allocated to the cost center that exceed the limitations of the primary funding source.

Example

	Management	Fund Raising	Program A	Program B	Program C	Total
Direct Expenses	\$100,000	\$25,000	\$400,000	\$200,000	\$75,000	\$800,000
Allocated Admin Expenses	-\$100,000	\$3,571	\$57,143	\$28,571	\$10,714	\$0
Total Expenses		\$28,571	\$457,143	\$228,571	\$85,714	\$800,000
Grant Y 5% Management limit			\$21,000			
Charges to Grant Y			\$420,000			
Paid by Other Sources			\$36,143			

In this example, the Management expenses allocated to Program A total \$57,143. The total funding for Program A from Grant Y is \$420,000 and Grant Y has a cap on Management expenses of five percent of the total grant. Therefore, Grant Y will only cover \$21,000 of Program A's Management expenses; the remainder must be covered by other sources of funds. The income section of the sample budget below shows that \$21,000 of Program A's Management expenses will be paid by Grant Y and that \$36,143 will be paid by other sources.

Some sources of income are not so easily attributed to specific cost centers. CAAs actively seek unrestricted contributions to the organization as a whole through fundraising events, mail solicitations, and personal appeals. Unrestricted contributions should be assigned to the fundraising cost center. Unrestricted contributions will be used to meet the cost of fundraising (usually an unallowable cost for governmental funding). The net fundraising income, after covering fundraising expenses, will then become available to subsidize any program cost centers that would otherwise have insufficient income to cover the full cost of the program, including allocated costs for management and other indirect costs.

Some CAAs' budgets will display the allocation of the net fundraising income to subsidize specific cost centers that have expenses in excess of cost center income. Other CAAs will display the net fundraising income in the fundraising cost center to facilitate comparison to actual results from fundraising activities.

Part IV: Complying with Government Grant Requirements

Government Awards and Contracts

Budgeting for income from government awards and contracts and for the expenses associated with fulfilling the requirements of multiple layers of government poses particular challenges in the context of the annual operating budget. While in the past, many CAAs approached budgeting for governmental funding on an award-by-award or contract by contract basis, it is now clear that developing an integrated organization-wide annual operating budget is an essential element in meeting the requirements for managing government funds, especially federal funds.

OMB Circular A-122 (2 C.F.R. Part 230) requires an organization-wide approach to cost allocation and/or indirect cost rate determination. Even after successfully negotiating a federal indirect cost rate, CAAs must continue to prepare their annual operating budgets on a comprehensive, all sources and all uses basis in order to ensure that the cost allocation approaches incorporated into the approved indirect rate will not be distorted by rapid growth or contraction of programs or in funding levels. The Head Start Act also requires the board to approve an organization-wide budget. See 42 U.S.C. 9837(c)(1)(E)(iv)(VII)(aa).

In order to build a useful annual operating budget, the CAA should analyze each government award or contract budget to determine what portion of the expenses covered by the agreement will have already been incurred at the beginning of the CAA's new fiscal year. For awards or contracts that will continue beyond the new fiscal year, the analysis should focus on the portion of the total budget that must remain available for expenditure after the close of the organization's fiscal year.

Beyond the challenge of the timing of expenditures, the CAA must examine the basis for payment incorporated into each governmental funding agreement. In agreements that are structured entirely as expense reimbursement, the projected income to be included in the annual budget will be equal to the expenses included in the budget. Agreements that require achievement of service targets or percentage of completion of projects, as well as contracts that are structured as purchase of units of service, will require analysis to determine the appropriate amount of income to include in the annual operating budget. For example, in some unit of service agreements, the unit price is based on the cost over the life of the contract but the start-up period is considerably more costly and may result in delivery of fewer units of service than subsequent months.

The CAA should document its assumptions regarding the number of units of service projected to be delivered within the fiscal year and compare the projections to the actual units of service delivered as part of its analysis of financial performance.

Governmental agreements frequently include caps on management or other specific cost items that may be inconsistent with either a negotiated indirect cost rate or the results of fair application of a cost allocation plan. In such situations, the annual budget must display the other sources of funds that will be available to cover the portion of the capped costs that cannot be covered through the governmental agreement.

Management and board members must determine the extent to which their CAA is willing and able to raise private dollars to cover the fair share of management and other indirect costs in programs which are supported by funding sources utilizing arbitrary limits on covering such costs.

Governmental agreements may also have match requirements and provisions for in-kind contributions (discussed below) that will require attention in the annual operating budget.

Matching Funds

Many governmental funding agreements require CAAs to obtain matching support from other sources. In some instances, the matching funds can be represented by in-kind contributions. (discussed below). Federal funding regulations (2 C.F.R. Part 230, Appendix A, paragraph A.2.f.) generally prohibit a CAA from satisfying the matching requirement with other federal funds (including CSBG) or with in-kind contributions from entities that are covering the cost of the in-kind contributions with federal dollars. Almost all matching funds agreements require that the recipient not count the same funding source twice.

The annual operating budget provides a great opportunity to test the CAA's plans to meet matching requirements and comply with the myriad requirements on matching. The cost center structure should be designed to facilitate identification of the program in which each source of match will be utilized. Distribution of all the sources of match into the various cost centers will demonstrate that no match is being double-counted.

In-Kind Contributions and Expenses

The term "in-kind" describes contributed goods or services used by the CAA to carry out its work. Volunteer labor is one example. The contribution of supplies, use of space, transportation or any number of other items of value is also characterized as in kind.

Two questions must be resolved before including in-kind contributions in the annual operating budget. First, the CAA must decide which in-kind contributions it will include in the annual budget. A starting point will be to include any in-kind that has been included in various funding agreements that will be in force during the fiscal year. Beyond the items that are referenced in funding agreements, most nonprofits structure their budgets to parallel their accounting policies which are in turn structured to comply with GAAP (Generally Accepted Accounting Principles, the standards which guide recording and reporting financial information by professional accountants). GAAP generally requires that the value of in-kind contributions be included in the financial statements if the goods or services being donated are essential to operation of the organization and the value can be estimated with reasonable accuracy.

For example, a CAA operating an emergency shelter services for homeless families through the volunteer efforts of churches that provide volunteer overnight staff, space, and volunteer prepared meals would otherwise have to purchase those items in order to provide shelter for homeless families. Consequently, the value of these contributions would be included in the financial statements. In contrast, the value of the contribution of a volunteer who contributed a beautiful floral arrangement to the homeless shelter every week would probably not be included in the financial statements because the shelter could operate without elaborate floral arrangements. Only services or goods that would be allowable as a reimbursable cost if the CAA had paid for them can be counted towards a match requirement.

Once the nonprofit has determined which in-kind contributions to include in the budget, the next challenge will be determining how to value the contributions. Again, most CAAs turn to the requirements of GAAP accounting, using methods in the budget that are consistent with those that will be used in accounting and financial reporting. Under GAAP, in-kind contributions are recorded at the fair market value of the goods or services received. Fair market value is defined as the price at which an item would change hands between a willing buyer and a willing seller. For in-kind labor contributions, the general practice is to identify the compensation level that would be typical for a similarly qualified person to perform similar work. CAAs with substantial in-kind labor contributions should discuss the valuation issue with a CPA so that all nuances are addressed.

In almost all cases in which a CAA decides to include in-kind contributions in the income section of the annual operating budget, an equal amount of in-kind expense must be recorded in the expense section. This approach avoids creating the misleading perception that in-kind contributions would be available to meet non-in-kind expenses.

The only exception to this general rule occurs when the in-kind contribution involves donation of an asset of material value such as a vehicle, land, or a building. In most cases, CAAs record vehicles, land, and buildings as assets on the balance sheet rather than treat them as expenses in the current period. To achieve consistency between the annual budget and the financial reports, the CAA budget will need to include the in-kind contribution of such assets in the income section and note that fair market value of the contribution will be reflected on the balance sheet.

Example

Orange CAA expects to receive an in-kind contribution of a school bus with a fair market value of \$30,000 that is expected to have a useful life of at least 3 years. Orange CAA's capitalization policy requires "capitalizing" or recording as an asset, the purchase or acquisition of equipment with a fair market value greater than \$5,000 which has a useful life of more than one year. Consequently, Orange plans to treat the donated bus as an asset.

In its budget, Orange will show an in-kind contribution line item of \$30,000 to represent the value of the bus it will receive. Orange must decide which method to use to offset the in-kind contribution. It can:

- Show a "placeholder" line item for donated equipment in the expense section of the budget with a footnote explaining that at the end of the year, an accounting adjustment will reduce this expense item to zero and record the value of the in-kind donation of the bus as an asset; or
- Not use a donated equipment line item in the expense section of the budget and allow the inclusion of the \$30,000 in-kind contribution in the income section to create the appearance of a surplus (profit) of income greater than expense. In the budget, Orange will attach a note explaining that this "surplus" is not available to meet any costs but a result of the accounting treatment of the in-kind contribution.

Part V: Accounting for Other Selected Costs and Issues

Depreciation and Use Allowances

Most CAAs use the same approach on the issue of including depreciation or use allowance expenses in the annual operating budget as they use in their accounting and financial reporting in order to facilitate comparison of the budget to the actual income and expenses reports throughout the year. CAAs that have included depreciation or use allowance expenses in their grant/contract budgets must include them in the annual operating budget in order to integrate grant and contract budgets into the annual budget.

Budgeting for Purchase of Capital Items

CAAs purchasing or rehabilitating facilities frequently prepare a separate capital budget in addition to the annual operating budget. A capital budget usually treats loans as a source of funds when the loans finance major capital investments (as opposed to working capital needs). Loan proceeds are ignored for purposes of the annual operating budget because they constitute debt rather than revenue. Similarly, funds used to repay the principal of a loan are not typically included in the annual operating budget because they are used to repay debt rather than pay expenses. However, interest paid on a loan would be included as an expense in the budget.

In contrast, it is not unusual to see planned equipment purchases included in the annual operating budget, especially if the purchases are to be made through governmental funding agreements and are included in both the income and expense portion of those agreements. Even when equipment purchases will be made without a specific funding source, many nonprofits will include the purchases in the expense section of the budget to reflect their plan to use current year income to cover the cost of the purchase. Some organizations will actually record equipment purchases as expense line items in the accounting systems during the year, and utilize a year-end accounting adjustment to reclassify the equipment to the balance sheet.

Temporarily and Permanently Restricted Contributions

CAAs should design their budget format to facilitate comparisons between the budgetary projections and the actual results reported in both interim and audited financial statements. One of the greatest challenges in this effort is developing a budget format takes into account the unrestricted, temporarily restricted, and permanently restricted categories used in GAAP-compliant financial statements.

GAAP requires that nonprofit organizations analyze all contributed income to determine whether the donor has made the gift without restriction or with either a temporary or permanent restriction. Permanent restrictions are typical of endowment gifts in which the donor intends for the organization to invest the gift in order to generate income which will then be available to the organization for either unrestricted or temporarily restricted purposes. Relatively few CAAs deal regularly with endowment gifts.

Donors or grantors making gifts with temporary restrictions intend that the gift will be used, but want to limit its use to expenditures on specific purposes or within specific time periods. GAAP-compliant financial statements characterize all contributions as either unrestricted, temporarily restricted or permanently restricted. In contrast, income other than contributions – for example income earned through performance of services or sale of products – is always considered unrestricted for the purposes of the GAAP classification system.

GAAP treatment of foundation grants typically differs from the treatment of government awards. Foundation grants, like gifts from individual donors, are classified as either restricted or unrestricted depending upon the direction provided by the grantor.

The challenges, therefore, are in developing a budget format that addresses restricted gifts and grants from foundations and individuals as well as unrestricted (for GAAP purposes) governmental grants. GAAP requires not only that temporarily restricted contributions be distinguished from unrestricted contributions, but that the entire amount of the temporarily restricted contribution be recorded in the period in which the donor's commitment to contribute is received. This means that the award of a three-year foundation grant must be recorded in its entirety in the month the award letter is received, even if the payment of the award will be spread over three years. Similarly, a pledge from an individual to make a gift of \$1000 in each of the following three years must be recorded as a \$3000 temporarily restricted contribution in the month in which the pledge is received.

GAAP also requires that when a nonprofit incurs expenses for the purposes for which a temporarily restricted gift has been made, the total of these expenses be recorded as a "release from temporary restriction" which results in increasing the unrestricted income.

Although most government funding agreements contain numerous restrictions regarding the use of the funds, the most common payment mechanisms for government agreements generally result in income being recorded in the unrestricted classification within GAAP accounting systems. Both the cost reimbursement payment mechanism and the federal cash drawdown systems are based on the concept that the CAA will either have incurred expenses already or will incur them shortly after receiving the federal cash. This makes the cumbersome process used for handling multi-year foundation grants and pledges unnecessary.

In these governmental agreements, the nonprofit is required to track and report the exacted use of the funds. In terms of the annual operating budget, this need to identify and track the specific uses of funds provided by governmental awards and contracts is addressed through the cost centers which parallel the use of cost centers in the accounting system. The accounting system should be designed to produce reports on each of these cost centers which document the organization's compliance with the restrictions and limitations incorporated in the award agreement/contract.

A more complete explanation of GAAP requirements for dealing with temporarily restricted contributions is beyond the scope of this toolkit. However, CAAs dealing with either multi-year foundation grants or multi-year donor pledges should adapt their budget format to facilitate comparison of the budget to the GAAP-based financial statements. Specifically, the annual operating budget should distinguish the plans for obtaining and expending temporarily restricted contributions from the plans for obtaining and using unrestricted income, remembering that the term "unrestricted" for this purpose would include all or almost all governmental awards and contracts.

Part VI: Working with the Budget Through the Grant Period

Funds in the Annual Budget

Governmental funders may sometimes, upon request, give the CAA permission to expend funds after the official close of either the annual budget period or the multiyear grant term, i.e. to carry over the funds. In some cases, these are funds that have already been disbursed to the CAA but have not yet been expended or obligated by the CAA. In other instances, the original award amount was not fully disbursed, to the CAA.. In most cases, the grantee will not have treated these unused amounts as income in the year in which they were originally intended to be used. Instead, it would only have recorded those expenses actually incurred in that grant year and recorded an equal amount as grant/contract income. In such situations, the budget for the subsequent grant year should include the "unused" funds that the organization will expend in that year with the funder's permission.

Example

Orange CAA has received permission to use \$50,000 in funds awarded as part of its FY 10/11 State Grant to meet expenses which will be incurred in FY 11/12. In the 11/12 annual budget, Orange will use two distinct income line items to present its income from the State Grant:

- State Grant FY10/11
- State Grant FY 11/12

Orange will use separate cost centers to track the use of each of the State Grant amounts.

The best way to present the organization's plan to use past profits to support activities in the current year is to add a budget item titled "planned use of net assets" which is positioned below the Total Expenses line in the budget. Using this technique permits comparison of what actually happens during the year to what the plan the board has adopted for the year.

For example, if the CAA planned to use \$80,000 in funds accumulated in prior years to cover current year costs, they would expect to see a net loss of \$80,000 on the financial statements, if all went according to plan. If the financial statements reported a net loss of \$50,000 it would be clear that things had gone better than planned and if the financials reported a net loss of \$100,000 it would be clear that things were going much worse than planned.

CAAs should avoid the use of the term carryover to depict plans to use profits from prior years to meet current year expenses. Instead, the budget document should present clearly the plan to incur an operating loss (expenses in excess of income). Then the board can determine the extent to which it is prudent to plan to reduce the net worth (net assets) of the CAA to meet expenses which cannot be met through current year income.

Example

BCA reported revenues which exceeded expenses by \$100,000 in FY 10/11. In the FY 11/12 budget, BCA represents its plan to use \$50,000 of the surplus it generated in FY 10/11 to sustain an essential service for which funding has been reduced. This plan is illustrated below

FY 11/12 Budget	
Income	\$4,950,000
Expenses	\$5,000,000
Net Loss	(\$50,000)
Planned Use of Net Assets	\$50,000

Using the Budget

Both the board of directors and management should use the annual budget as a reference point for evaluating progress toward agreed upon goals. The budget represents the integration of complex funding and program strategies into a unified plan for operation and for building financial health. Comparing the actual revenues and expenses to the budget plan facilitates identification of potential problem areas.

Tip

SYNCHRONIZE YOUR BUDGET AND FINANCIAL STATEMENTS

To facilitate the comparison of actual revenue and expenses with budgeted revenue and expenses by the board and staff, design the budget format to align with the financial reports.

Board members need to be able to rely upon management to monitor actual results in comparison to the budget on a detailed grant-by-grant, program-by-program, line-item-by-line level. The board's role in reviewing actual results in comparison to the budget should be focused on trend analysis and evaluating management's recommendations for achieving overall financial goals. Management should provide the finance committee and the board with its analysis of the financial performance of the organization including calling attention to areas of great success as well as potential problem areas in which either income targets are not being met or actual expenses are significantly greater than anticipated in the budget. Management's analysis should note the strategies which management has put in place to address problem areas.

The annual budget plays a key role in the CAAs overall system of internal controls. Each manager within the CAA should be clear about the extent to which they have been given authority and responsibility for achieving budget targets in both income and expense line items. Fulfilling responsibilities relating to achieving budget targets should be a key element in the performance reviews of managers assigned financially related responsibilities.

Budget Revisions

Budgets are projections. The annual budget should reflect agreement between the board and management about priorities for the use of resources and strategies for obtaining the income needed both to meet current expenses and to ensure sustainability.

The role of the budget in a nonprofit organization differs significantly from that of a budget in a governmental entity. Most governmental entities are legally prohibited from expending funds in excess of the authorization level provided by the adopted budget. In nonprofit organizations, there is not a similar legal prohibition. The extent to which management may shift resources among line items or among programs in a nonprofit is generally determined by board policy.

When CAAs experience significant changes in funding, programming, or major cost items during the year, the comparison of the adopted budget to the actual revenues and expenses may become confusing. Some CAAs address this potential problem through a system of preparing a mid-year budget revision proposal for board discussion and approval. The mid-year revised budget incorporates the new information that has become available to the CAA in the first portion of the year and reflects the actual plan for moving forward. Typically, the revised budget is then substituted in comparison of actual revenues and expenses to the budget.

For this approach to work well, the CAA must determine whether the proposed budget revisions will impact the expenditure of grant and contract funds and meet funder requirements for budget amendments when necessary. Revising the annual budget without obtaining funder approval for award budget revisions will create significant confusion and may lead to audit findings.

Another approach to dealing with significant changes during the fiscal year is the use year-end projections as a meaningful point of comparison with both actual revenues and expenses and with the approved budget. To prepare year-end projections, management combines the year-to-date financial information with its understanding of the impact that various changes will have to predict the year-end balances of each account within each cost center.

Year-end projections provide a powerful tool for board oversight. The projections reflect the strategies management has identified to cope with changes in both income and expenses and to ensure the overall financial health of the CAA. Presenting the projections on the financial statements avoids the need for management to continuously review changes that have already been discussed and facilitates board understanding of the overall impact of changes.

Next Steps

Budgeting for CAAs is challenging and requires the integration of multiple specific grant budgets and development of realistic strategies to allocate shared costs fairly. While the underlying budget work papers are complex, documenting hundreds of assumptions and the interplay among them, the final budget document must be understandable to the board of directors, which will include individuals with widely varying levels of experience with financial information.

Fortunately, time invested in developing effective budget formats and spreadsheets will often pay off over multiple years, allowing the CAA to update assumptions as information becomes available, and add or remove programs as they emerge or conclude. Even with a great budget format and spreadsheet template, developing the annual budget will require tremendous team effort.

Given the complexity of the issues, and constant time pressures, it is easy for the person in charge of developing the budget to become swamped by detailed technical issues and have difficulty presenting the final proposed budget document in a way that facilitates meaningful discussion by the top management team, finance committee, and board of directors. This challenge requires allowing enough time for reflection after the technical budget development work is completed. The final step of preparing the budget for discussion by the CAA's leadership will be highlighting the key financial choices the CAA confronts and expressing concisely the assumptions about those choices that have been included in the proposed budget.

In fact, beginning with the end in mind may be the best guiding principle for undertaking the budget process. What are the key choices that the budget document must address? Funding cutbacks, funding overhead costs during a period of contraction, benefit cost increases, major shifts in program emphasis, compensation expectations? Whatever the major choices and challenges your CAA will confront, early identification will facilitate targeting your budgeting efforts to address the most important challenges, and provide a strong foundation for communicating the key assumptions and underlying choices to staff and board.

Endnotes:

1. See Office of Community Services Information Memorandum No. 37.
<http://www.acf.hhs.gov/programs/ocs/csbg/guidance/im37.html>.
2. See 2 C.F.R. Part 230, App. B, ____ .17 and 45 C.F.R. § 74.27(b)(1).
3. See Financial Accounting Standards Board (FASB) ASC 958-720-45, which discusses requirements for presentation of expenses by function. The FASB Accounting Standards Codification (ASC) Glossary provides definitions for the Supporting Services and the terms “management and general activities,” “fund raising activities,” and “membership development activities, which together comprise “Supporting Services.” See also 2 C.F.R. Part 230, App. A, § C.3., which addresses management costs, and App. B, § 17(a) and (c). See also 45 C.F.R 74.27 (b)(1) the version of OMB Circular A-110 adopted by the U.S. Department of Health and Human Services, which states that the immediate cost of preparing bids, proposals, and applications for federal and non-federal awards, contracts and other agreements are allowable as indirect costs.
4. The cognizant federal agency is the federal agency that, on behalf of all federal agencies, is responsible for establishing final indirect cost and administering cost accounting standards for a CAA’s federal grants and contracts. By assigning one agency to oversee these matters, the federal government ensures that a CAA is not subject to the conflicting or duplicative requirements that could result if two or more agencies imposed separate requirements.
5. See *<http://www.dol.gov/oasam/programs/boc/costdeterminationguide/main.htm>* for a guide to indirect cost rates published by the U.S. Department of Labor.

SECTION 4: GETTING THE MOST OUT OF YOUR FINANCIAL STATEMENTS

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Financial statements report the CAA's operating results and its financial condition. The CAA's management is responsible for preparing the statements. The CAA's board of directors should discuss the financial statements at each board meeting. This toolkit will help both CAA boards and managements derive the maximum benefit from the CAA's financial statements. It is divided into two parts:

■ **Part I: How to Use Financial Statements**

Part I focuses on what the board and management should do with the financial statements. The detailed process presented here is the ideal. It is, however, aspirational; few if any CAAs will undertake each recommended step. That is not a problem. Each board must decide what is important, what is best left to management, and what is best left to its finance committee. The bottom line: most boards should be doing more financial review than they are inclined to do.

■ **Part II: What's in the Financials**

Part II focuses on the information included in the financial statements. It examines each of the five component parts of a set of basic financial statements.

Part I: How to Use Financial Statements—The Process

What Is GAAP and Who Is FASB?

Over time, a body of rules and conventions has developed for financial statement presentation. This body is referred to as generally accepted accounting principles (GAAP). The Financial Accounting Standards Board (FASB) has taken on primary responsibility for formulating GAAP and now offers a free comprehensive online tool (available at <http://asc.fasbg.org/>) that allows nonprofits to determine the GAAP accounting and reporting requirements in any situation. The discussion in this toolkit does not focus on the intricacies of GAAP, but it reflects that body of rules. No law requires financial statements to be prepared in accordance with GAAP. However, if an organization that does not follow GAAP seeks an outside audit of its financial statements, the auditor's opinion letter most often will include a qualification that the statements do not conform to GAAP. If the CAA has an OMB Circular A-133 audit (required if the CAA expends at least \$500,000 in federal funds in that year), the auditor is required to determine and note in the auditor's report whether the financial statements comply with GAAP. Given that some funding sources may not accept an audit report with a non-GAAP qualification, CAPLAW advises CAAs to adopt GAAP-compliant financial statements.

CAPLAW advises CAAs to adopt GAAP-compliant financial statements.

Requirements for Federal Grantees

Organizations that receive federal grants or subgrants must comply with federal rules concerning financial systems intended to safeguard the use of those funds and ensure the funds are used for their intended purposes. The key requirements are contained in the Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education Hospitals and Other Non-Profit Organizations, found at 2 C.F.R. Part 215 (OMB Circular A-110) and 2 C.F.R. Part 230 (OMB Circular A-122) or the version of those rules issued by the specific federal granting agency and in cost principles for Non-Profit Organizations 2 C.F.R Part 230 (OMB Circular A-122). A-110 requirements include,¹ among other things, that:

- Grantees' "financial management systems provide for accurate, current and complete disclosure of the financial results of each federally-sponsored project or program."
- Grantees have "[r]ecords that identify adequately the source and application of funds for federally-sponsored activities."
- Grantee records "contain information pertaining to federal awards, authorizations, obligations, unobligated balances, assets, outlays, income and interest."
- Grantees ensure that funds are used solely for authorized purposes.
- A comparison of outlays with budget amounts for each award is made.

A-122 requirements focus on the identification of which costs may be charged to federal awards, whether they are received directly or through sub-recipient agreements.

Tip

CHECK YOUR AWARD DOCUMENTS

Check your notice of award (if a federal grant or cooperative agreement) or grant agreement terms and conditions (for a state grant or contract) to confirm which federal rules govern your grants. In some cases, states may incorporate other rules relating to program eligibility, allowable costs, and financial systems and statements as well. Check all references to state statutes and administrative rules to be sure you are aware of the requirements you must meet to comply with each agreement.

Common Myths About Nonprofit Financial Statements

Myth 1: "Only a CPA Can Read Financial Statements"

Financial statements often are intimidating to those who are unfamiliar with them—all those numbers and columns. Nonetheless, with minimal effort, anyone can gain insights into a CAA's finances by reviewing its financial statements. The rules governing how information is presented in a CAA's financial statements are designed to make that information understandable to a lay audience.

Even board members who regularly review financial statements produced by businesses find nonprofit statements somewhat perplexing. There are at least two reasons for this. First, the CAA often prepares interim financial statements for review at its regularly scheduled board meetings in non-standard formats or without notes. The lack of explanation and conformity with established norms in the corporate world is troubling to many who otherwise are comfortable with financial statements. Second, as will be discussed, nonprofit financial statements divide net assets and income into three categories designed to reflect the degree to which the assets and income are subject to legal restrictions. This additional information does not appear in financial statements for business entities. Fortunately, any confusion can be addressed through education.

Myth 2: “Financial Statements are Only of Interest to Management, Not the Board”

Understanding the financial condition of the organization and guiding the use of resources are core legal responsibilities for boards. Financial statements are an important board tool for assessing management’s performance and stewardship of the organization and its resources.

CASE SCENARIO:

INCORPORATING A THOROUGH DISCUSSION OF ORGANIZATION FINANCES INTO THE MEETING

Blue CAA (BCA) has a board meeting scheduled for next Wednesday night. The packet for the board meeting went out last week. The meeting agenda accompanying the packet includes reports from the heads of the Head Start and weatherization programs, a discussion of whether BCA should hire an assistant vice president for human resources, a report from the head of HR on a new employee evaluation form, and routine matters. At the time the agenda was drawn up, BCA’s executive director was unsure whether BCA’s CFO, Howard Castle, would be able to attend the meeting because Castle’s son has a Little League game the night of the meeting. Nobody was all that concerned whether Castle would attend because the discussion of finances usually takes no more than five minutes. Most board members believe that the Gloria Watson, BCA’s executive director, can report the amount of cash on hand just as well as the CFO, particularly because nobody worries about financial issues so long as there is enough cash to cover 3 months of expenses.

At the board meeting, the reports on Head Start led to a very lengthy discussion of changes in the menu and the difficulty some children were experiencing in getting used to eating so many vegetables. This led to a variety of comments about the possibility of cultural bias in concerns about childhood obesity. In the last five minutes of the meeting, the chair asked Gloria to report on the finances. She pointed out that the cash balance had slipped slightly below the desired 3 months of operating expense level but noted that she understood that a payment had arrived the day after the financial statements were prepared. A board member

asked why the accounts payable and salaries payable line items were so much higher than the previous month but the chair noted that it was time to adjourn and commented that he was confident that BCA always paid its bills on time.

LESSON: BCA’s board is being remiss when it comes to financial issues. The board should thoroughly discuss BCA’s finances at each board meeting. To facilitate that discussion, the packet sent to board members should include a complete set of financial statements, including the balance sheet, together with a schedule or summary reporting on how expense and income items deviated from budget and basic analysis of the adequacy of the cash position and BCA’s progress towards its goals for operating reserves. In a perfect world, BCA’s board would have a finance committee, and that committee would include key financial metrics and a summary of BCA’s finances in the board packet. At the meeting, the board should be discussing the results of operations and key asset and liability balances. It should be assessing the adequacy of BCA’s financial resources and whether those resources will permit BCA to pay its bills and liabilities in an orderly and timely fashion.

Too often, boards want these discussions to be quick. This is a mistake. No organization can survive on reports about program accomplishments and ideas for new programs alone. At the end of the day, everything comes back to financing programs and new ideas. In fact, as part of their reports to the board, the heads of the Head Start and weatherization programs should be asked to discuss the adequacy of program finances and budgetary expectations in addition to offering examples of program accomplishments.

Myth 3: “The CAA’s Outside Auditors Prepare Its Financial Statements and Monitor its Finances”

The professional standards governing auditors couldn’t be clearer: management is responsible for the preparation and the content of the CAA’s financial statements. If management is unable to prepare financial statements without significant assistance from the outside auditors, both the board and management are most likely making decisions based on faulty information.

Myth 4: “Only the Financially Savvy Board Members Need to Pay Attention to the CAA’s Finances”

This is the biggest and most dangerous myth of them all. Too often, the non-financially oriented members of a board delegate the discussion of finances to the financially literate members of the board. Many board members think this review is best relegated to a finance committee so that valuable board time isn’t wasted. This approach treats finance as separate and distinct from mission. Nothing could be further from the truth. Some managers share this myopia. These individuals are mission people, who erroneously believe finance and accounting are a nuisance, best left to the technicians.

CAAs operate as nonprofits, but CAAs are nevertheless businesses. Like Exxon/Mobil, Apple, Boeing, and other business corporations, CAAs employ people, pay utility bills, rent property, and borrow money from banks. A CAA will face bankruptcy if revenue doesn’t exceed expenses or cash flow does not permit the CAA to timely pay its bills. A CAA that ceases to exist has no mission.

Nonprofit is a misnomer. A nonprofit can earn a profit, but it can’t distribute that profit to insiders as a “dividend.” There is nothing wrong with earning a surplus, as profit is referred to in the nonprofit world. A surplus can further mission by providing a CAA with assets that can be used to weather a recession or when a government grant maker has failed to pay the CAA under grants or contracts for six months. A surplus also permits the CAA to expand its programs and mission, and to pay off long-term debt.

Mission is constrained by finances. Those who refuse to acknowledge the link between mission and finances are setting themselves up to be “rolled” on issues of policy by those who are comfortable with finances. Rather than debate a decision on the merits, the financially literate sometimes focus on financial aspects of the debate, causing those who believe there is only one way to look at numbers to concede policy calls.

CASE SCENARIO:

FINANCES AFFECT MISSION

Assume that BCA is considering a new program to combat gang activity in a neighborhood. Some on the board oppose the proposed approach. Rather than arguing the merits, they may look to the numbers if the proposal's proponents are afraid or intimidated by finance and accounting. The opponents may ask an accountant to prepare a financial forecast that assumes a two percent growth in a base grant for the program, and expenses that grow at ten percent per year. Under those assumptions, the program is not financially viable. Those assumptions, however, are open to question. The city has expressed great interest in this program and shown a willingness to fund it to the max. Moreover, the forecast does not take into account that adding this program would allow BCA to spread its overhead costs over a larger base, reducing the burden each other program must bear and freeing some unrestricted funds that are currently used to subsidize programs

with inadequate grant funding to cover their share of overhead costs. Unless the program's proponents are willing to challenge a dubious financial assumption, they may yield to the claim that the program will produce a large and unacceptable deficit. But to mount that challenge, the program's proponents must be willing to examine the numbers and underlying assumptions, including the impact on the overall budget, recognizing that the financial facts and figures can be viewed through different prisms.

LESSON: No board member should ever blindly accept financial data placed in front of him. There are different ways to interpret numbers and budget proposals always are based on assumptions. Unless a board member recognizes that numbers are open to debate, that board member will cede the policy battle to those who are willing to wage the battle based on the numbers.

Board Review of Financial Statements

Every regular board meeting should include a review of the CAA's financial statements, be they the year-end audited statements or interim statements. Typically the interim statements are less formal than the audited ones, but if the CAA's accounting system is a good one, these statements should be relatively accurate. CAPLAW recommends a five-step approach to the periodic review:

Step 1: Preliminary Review by the Finance Committee

The CAA should have a finance committee. One of the committee's tasks should be to review the financial statements in advance of the board meeting and to then have a committee member report on the statements at the board meeting. If the CAA does not have a finance committee, someone should be designated to review the statements in advance of the meeting and lead the discussion. This person could be a board member or the CAA's CFO or treasurer, depending on the CAA's resources and circumstances. Even if a non-board member leads the discussion, CAPLAW recommends that the staff member review the statements ahead of time with a board member, such as the treasurer, so that at least one board member will have a more detailed understanding of the statements.

Step 2: Review by Every Board Member

Every board member should receive a packet of financial information at least one week in advance of the scheduled board meeting. The packet should include a complete set of financial statements, and if possible, an analysis of the statements from the board's finance committee or the CAA's CFO or treasurer. Each board member—no matter how financially illiterate—should review the financial statements before the meeting.

Step 3: Regular Discussion of the Financial Statements

The meeting agenda should set aside sufficient time to permit a thorough discussion of the financial statements. The discussion should include a review of:

- Variances from budget—comparing what actually happened with the annual plan
- Liquidity—the CAA's ability to meet its obligations as they become due
- Unrestricted net assets available for operations
- Program-by-program analysis of revenue and expenses
- Key financial metrics
- Stability of the CAA's grants and other revenue sources
- Any other matters involving finances warranting discussion

CASE SCENARIO:**A COMPLETE SET OF STATEMENTS**

BCA's CFO, Howard Castle, has decided that providing the board with a complete set of financial statements is a mistake. In Castle's view, the board should review a detailed schedule showing each program, the revenue associated with the program, and the related expenses. He does not provide a balance sheet presenting assets, liabilities, and net assets, and also does not provide a comprehensive statement of activities that presents income and expenses from all activities and the resulting changes in net assets. Castle believes CAAs are unique because of their reliance on multiple revenue streams that must be used for specified purposes. In his view, entity-level financial statements make no sense because grant revenue from one program (e.g., weatherization) cannot be used to finance another program (e.g. Head Start).

Castle is providing the board with useful information, but he is ignoring the value of entity-level financial statements. BCA has a revolving line of credit to finance its working capital. In administering the loan, the bank looks to the entity as a whole, which means the board needs to also look at the entity as a whole to make sure that there is sufficient liquidity to satisfy BCA's bank. Similarly, BCA's trade creditors (e.g., the electric utility, suppliers, communications company) also focus on BCA as an entity rather than on particular streams of revenue. The board should be looking at BCA through the eyes of those creditors. Moreover, not all assets are restricted to a particular program. Most organizations have unrestricted cash, receivables, and fixed assets (equipment and buildings). The board should be monitoring these on an ongoing basis. Finally, if the board wants to expand into new areas, it needs to understand the resources available for expansion.

The accounting profession shifted two decades ago from the approach advocated by Castle to one that favors entity-level financial statements for nonprofits. This in part reflects the desire to make financial information more accessible to board members who are familiar with standard financial statements. Although Castle may have legitimate reasons for disagreeing with the current approach to nonprofit financial report, he should keep one fact squarely in mind: providing the board with a complete set of financial statements does not preclude him from supplementing the financial statements with schedules that show operations on a program-by-program basis. In fact, that is to be encouraged. One effective approach is to use a columnar approach to the income statement, including both the totals for each category across the organization, and a breakdown across the columns by grant or program. An example of this approach is found in the Statement of Functional Income and Expenses in Appendix C. Moreover, CAAs are not the only nonprofits that must deal with revenue streams and assets that are subject to restrictions. Any organization with an endowment faces restrictions on how it can use the endowment and the income generated by it.

LESSON: A board member who does not receive a complete set of financial statements, including the balance sheet, should demand them. Examples of these statements, including a balance sheet, a statement of activities (income statement) and a cash flow statement, can be found in the appendices to this section. Those who think board members won't understand them or will be hopelessly confused are doing everyone a disservice, including themselves.

Step 4: Once-a-Year Discussions

At least once a year, the board should discuss the following matters in detail:

- The auditor's annual report and management letter
- The CAA's annual organization-wide budget
- The CAA's system of internal controls
- The CAA's overall financial health, including its liquidity and unrestricted net assets
- The CAA's long-term financial plans and needs

The board need not address all of these topics at the same meeting.

Step 5: Questions and Answers

Time should be set aside during each discussion of the CAA's finances for a robust Q & A session. Questions should be encouraged.

Examining Budget Variances

CAAs and their boards should routinely review variances from budget. This review involves comparing key income and expense accounts and resulting net income against budgeted amounts.

Budget variances can provide an early warning, protecting the CAA from unexpected outflows of financial resources and shortfalls in expected revenues. Both management's and the board's responses will be far more meaningful if the responses occur two months into the year problem rather than when the board examines the audited financial statements 12 months later, learning that the CAA has an insurmountable problem rather than just a growing, but correctable one. In addition to protecting the CAA's fiscal integrity, a careful examination of variances from budget can provide programmatic and operational insights. Assume, for example, that labor expense is running twenty percent above budget. Management should identify the underlying problem and its plan to resolve it. For example, the CEO might report:

- One program has incurred substantial overtime due to increased demand and management plans to add several positions which will result in overall labor savings through reduced overtime.
- Income from the energy program is based on volume of services provided and is below projections because staff have been unable to process the anticipated volume of paperwork. Management plans to retrain staff to streamline processing.
- Management has identified an opportunity to reduce labor costs by increasing the number of families assigned to Head Start family case managers.
- Several employees are submitting time sheets with fictitious hours. Those employees have been fired and all employees are being re-trained on this issue.
- The demand for mortgage counseling services is much higher than anyone anticipated. Several proposals have been written to explore additional funding.
- The CAA is looking at holding group sessions on early fatherhood rather than relying so heavily on one-on-one counseling.

In sum, budget variances and the entire discussion of finances provides an opportunity for a systematic examination of programs.

In all CAAs, management should systematically be reviewing the details of variances from budget. The board has some latitude in how it approaches the review of variances. It may want management to provide a detailed schedule, or it might ask management to prepare a short report that highlights significant and potentially problematic variances. If the board opts for a robust and complete schedule, the report should show the variances for the current period (month or quarter) and the year-to-date variance. It should show both the dollar and percentage variation.

In all CAAs, management should systematically be reviewing the details of variances from budget. The board has some latitude in how it approaches the review of variances.

Some boards might agree to examine all variances above a certain percentage, but the better approach is to target the examination variances that are both material and meaningful. Materiality will often turn on the particular income or expense category. As an example, assume the budget shows that \$10,000 of charitable contributions will be received each month. In the past, all contributions have come from a fundraising event held in August. As a consequence, there is not much point in focusing on a \$10,000 variance from the budgeted January amount, but if there is a large cumulative variance in September, the board should determine why the August event failed to produce the expected revenue. The board may also request that staff break the annual budget into monthly segments that reflect the seasonal nature of key revenue and expense items. In this approach, comparison of actual year-to-date income to the year-to-date budget for the fundraising event would have made it clear that the event was not planned to occur in the earlier months and avoided needless anxiety.

Tip

DEMAND SPECIFIC SOLUTIONS TO BUDGET VARIANCES

Management should prepare complete explanations of all material budget variances and management recommendations for addressing them for presentation to the board at its regular meetings. At the next board meeting, management should report to the board on the actions it has taken to address the unfavorable variances discussed at the prior meeting.

Actually addressing a problem is more difficult than simply adjusting numbers on paper. Management should identify the root cause behind each material variance and tell the board the steps it will undertake to resolve the underlying problem and deal with the consequences of revenue shortfalls and/or cost overruns. Simply adjusting the budget numbers, reducing the budgeted income item or increasing the budgeted expense item is rarely a solution.

Most CAAs operate a number of programs. At a minimum, the CAA's management and the board's finance committee should be reviewing budget variances for each program. The organization-wide budget may be meeting expectations, but individual programs may be "busting" their budgets. Problems with one program may be camouflaged when they are aggregated with the other programs. The finance committee should highlight any material program variances during its presentation to the board. The best practice is for management to provide the board with a program-by-program analysis of variances.

If a CAA uses or "borrows" grant funds received for one program, such as Head Start, to pay for expenses, including payroll, for another program, the transaction often violates the first program's terms and conditions, and may cause serious problems, including cost disallowances and potential program termination. If one grant program's budget is overspent, or funds are not being received in a timely fashion, the board should ask management how the costs are being paid to ensure that inappropriate funding sources are not being used. Unrestricted funds or working capital loans are the most likely appropriate source of funds.

CASE SCENARIO:

EXAMINING BUDGET VARIANCES

BCA maintains its books and records using the calendar year. At its March meeting, BCA's board is reviewing a schedule of budget variances for the period ending February 2011, which is included in Appendix A. This schedule was assembled by BCA's management and was reviewed by BCA's finance committee before the board meeting. Caesar Cruz, the head of BCA's finance committee, is leading the discussion.

Before Cruz can get one word out, board member Marsha Harris asks why income for the year-to-date from the commercial bakery, which provides whole wheat bread to child care centers around the state and is staffed by previously unemployed individuals, is 53 percent below budget. Cruz assures Harris that the finance committee asked the same question, particularly because those revenues declined in both January and February. Gloria Watson, BCA's executive director, jumps into the conversation. She notes that another organization began selling similar products in December and charges twenty percent less than BCA. She said that she and the manager of the bakery have been reviewing the situation, asking whether BCA can find a less expensive space, or whether it needs to drop the program.

Watson turns the discussion back to Cruz, who then notes the increase in salary and wage expenses. Cruz notes these expenses are running twenty percent over budget, but that there is no way that BCA's grants will cover the overage.

The problem, according to Cruz, is the mortgage counseling program. Because of increased foreclosure activity, BCA has had to hire a number of temporary employees and pay overtime to existing staff. Loretta Champion, a new board member, objects to any suggestion that people be turned away from counseling. Cruz tells her that BCA has no choice. He notes that management reran

the annual budget projections, concluding at the current pace, BCA would expend its cash balances by July and would be forced to exceed its working capital credit limits.

LESSONS: Watson and Cruz probably weren't looking forward to this discussion. But imagine if there had been no budget, review of variances, or discussion of finances. The board would have first learned of the problems facing BCA a year later, when the annual financial statements were distributed. By then, it might be too late to address problems that had a year to fester.

Take particular note of how the variances were reviewed. Management first reviewed them. It then discussed the variances with the board's finance committee. That is as it should be. The examination of budget variances is often viewed as a task for the board. It is, but management is also charged with reviewing variances. Management should be constantly analyzing the financial data produced by the accounting system. After all, management is charged with running the agency. The board is performing an oversight function, making sure that management is asking the right questions and operating within the constraints imposed by the organization's financial resources. If there is a problem, management should identify and resolve it.

Management can approach the presentation of budget variances to the board in one of several ways. It can provide the board a complete schedule, a schedule showing just the material variations, or a written summary. Less information may be more in this case; presenting just the material variations lessens the chance that the board may get distracted by unimportant issues. In any event, the board should devote meeting time to discussing the variances that are material and problematic.

Assessing Liquidity

Liquidity determines the CAA's ability to pay its staff and bills on time. The CAA simply must have cash available when it is needed to meet immediate obligations. A CAA's balance sheet may include far more assets than liabilities, but that does not necessarily mean that the CAA can meet its obligations as they become due. As an example, the income statement may show grant revenue earned and the balance sheet may have a corresponding line item for grant revenue receivable, but neither of those numbers represents cash that can be used to pay employees, the CAA's landlord, or the power company. At the end of the day, CAAs must look to cash flow rather than accounting income for their survival. With the assistance of management, the board should therefore take the following steps to assess whether or not the CAA has sufficient liquidity:

Step 1: Ask the Fundamental Question

The board should begin by identifying all liabilities that are due within the next 12 months. It should then ask what assets the CAA will use to pay those liabilities. The board should first look to the cash balance. It should then turn to marketable securities and accounts receivable. Marketable securities can be quickly converted to cash, and accounts receivable usually become cash within a relatively short period of time. At the same time, it should note any temporary or permanent restrictions on the use of cash and other assets. These might be imposed by grantmakers.

Step 2: Review the Statement of Cash Flows

The board should review the statement of cash flows to gain a better understanding of where cash is coming from and where it is going. The statement of cash flows is discussed in Part II.

Step 3: Review a Projection of Cash Flows

The statement of cash flows focuses on the past. Management should regularly develop and review projections of cash flow. It should consider sharing summarized projections with the finance committee and with the full board if significant cash flow problems are identified. A detailed discussion is best left to the finance committee, but when there are significant short falls in projected cash flow, the board should have sufficient information to discuss the shortfall. When the projections show more cash flow than was projected, the board should take the opportunity to discuss how the excess should be invested (or at least set a guiding policy).

Management should regularly develop and review projections of cash flow.

Step 4: Review Aging Schedule

Management should prepare and the board should receive an aging schedule for receivables, showing the amounts due within 30, 60, 90, and 120 days, or other appropriate timeframes. The schedule should also identify receivables that are unlikely to be collectible.

Step 5: Review Key Metrics

Management should prepare and the board should review key liquidity metrics. These include the debt/net assets, the current assets/current liabilities, the defensive interval ratios, and trends in daily cash balances relative to daily expenses, among others. A management representative should work with the board's finance committee in parsing the numbers and explaining the reasons for any material changes.

Step 6: Review Lines of Credit and Other Loans

The board should periodically review major loan agreements including lines of credit. Although the types of loans will differ from CAA to CAA, typical ones include mortgages and revolving lines of credit which require "resting" (paying any outstanding balances off fully and not drawing down any additional cash) for specified periods. The focus should be on compliance with covenants and restrictions and on the CAA's ability to retire the loans. Management should be working with both the internal staff and when necessary, outside counsel, to monitor compliance with loan covenants. In addition, the board, or at least the finance committee, should consider reviewing advances and repayments in the line of credit on a monthly basis. This would be presented along with the receivables report so that board members may compare cash flows, receivables and use of the line of credit.

CASE SCENARIO:**CURRENT ASSETS WENT UP SO WHY WORRY?**

BCA's financial statements are attached at the end of Appendix A. Its cash balance has remained relatively constant (\$253,007 in 2009 versus \$258,390 in 2010). However BCA's current assets have jumped by \$959,955 over the last year, a 16 percent increase. Board member Susan Gallagher, has little knowledge or interest in finances. When Hank Simpson, a member of BCA's finance committee, and the city's treasurer, goes beyond the five minutes allotted to his finance report, Gallagher is quick to point out that Simpson's time is up and it is now time to proceed with more important matters. She points out that they haven't hired anyone new and that current assets are up by almost a million dollars. "So why do we need to discuss this boring stuff?"

Simpson looks at Gallagher slightly irritated, and points out that current liabilities have jumped from \$3,878,796 to \$5,169,447, or 33.27 percent. Maureen Whipple, another board member, backs Simpson up, pointing to a \$1,107,068 cash overdraft. Whipple says, "I am mighty concerned that our checking account is overdrawn by over a million dollars, particularly when the president is talking about cutting appropriations for CSBG in half."

LESSON: Simpson and Whipple are absolutely right to look beyond cash balances and other current assets. The asset side of the balance sheet represents only half of the story. Moreover, there is a reason balance sheets distinguish between current- and long-term assets and liabilities. Current assets and liabilities generally are closely tied to operating cash flow. Organization's like BCA are constantly incurring current liabilities and then using proceeds from accounts receivables to pay those liabilities off. If the relationship between current assets and current liabilities changes unexpectedly, BCA may be unable to pay employees, the phone company, the utility company, or its landlord.

In this case, there has been a significant increase in what is referred to as a bank overdraft. Whipple should be concerned about this, as should the entire board.

BCA may have a revolving line of credit with its banks and the increase in the cash overdraft may be covered by that credit line, or the overdraft may refer to the fact that the bank has extended credit to BCA beyond the limit on its line of credit. The overdraft may have been expected and, planned for, and BCA may have receivables due that will permit it to reduce the overdraft.

On the other hand, a government grantmaker might be reviewing BCA's request for reimbursement more closely, with the expectation of denying a significant portion of the requested reimbursement. Alternatively, BCA may have a good relationship with the grantmaker, but the government may be a slow pay.

Whatever the reason for the overdraft, the board's task is to understand what is happening and what actions need to be taken. For example, if BCA's board learns that the government has fallen behind in processing submissions for reimbursement, the board should direct management to discuss the matter with the relevant government officials. Or, if the government is unable to timely reimburse BCA because of the government's own budgetary crisis (as has been the case in Illinois), BCA's board and management must discuss how BCA will respond to this new reality. Will programs need to be cut, or can BCA find private funding?

THERE ARE TWO LESSONS: First, boards shouldn't focus exclusively on cash and other asset balances. They must look at the relationship between assets and liabilities. Comparison to prior months is particularly helpful for spotting disturbing trends.

Second, there is always a "story" behind the numbers. Sometimes there isn't a problem, but sometimes there is. A board must be willing to ask questions so that it understands the story and can take action, if necessary. Because the members of management are normally full-time employees rather than volunteers, they should be even more proactive. The board, however, should never assume that management will fix the problem or has everything under control. One of the board's oversight functions is to keep management engaged and focused.

Reviewing Ratios

Financial statements are often intimidating. More importantly, they do not include analysis, but rather, are just a summary of the financial facts. The statements, for example, may tell management and the board that the CAA had \$126,342 in cash on hand as of the balance sheet date, but the statements do not state whether that amount is sufficient. It is up to the management and the board to ascertain what the facts mean and to draw conclusions. Financial analysts use a number of metrics, referred to as financial ratios, to help them get a grip on the data. CAA boards and managements should do the same.

Step 1: Identify Key Ratios

There are literally hundreds, if not thousands, of financial ratios. The board should work with management to identify several meaningful financial ratios that the board can use to monitor the CAA's financial performance and position. This is a case where less may be more, particularly if the board is relatively unsophisticated when it comes to financial matters. In some cases, the board may want to delegate this review to the finance committee, with the committee instructed to report significant concerns to the full board when appropriate. The following are several that should be considered—each may require modification:

- **Defensive Interval Ratio.** One of the best indicators of liquidity is the defensive interval ratio, which compares liquid assets to expenses.

$$\frac{\text{Cash} + \text{Marketable Securities} + \text{Receivables}}{\text{Average Monthly Expenses}}$$

The resulting number represents the theoretical number of months that the organization could cover its average expenses by utilizing what are viewed as highly liquid assets.

- **Liquidity Ratio.** The liquidity ratio is another metric for measuring whether a CAA will be able to pay its bills on time.

$$\frac{\text{Cash} + \text{Marketable Securities} + \text{Receivables} + \text{Inventories}}{\text{Liabilities}}$$

Obviously a number greater than one is better than a number less than one, but that certainly doesn't guarantee that the CAA will be able to convert its assets to cash on a timely basis. If, for example, people who owe the CAA money are unable to pay it, having a large value for receivables on the balance sheet is meaningless. As another example, businesses convert their inventories to cash through sales. Nonprofits, however, may be giving away rather than selling their inventories as part of their mission. If that is the case, the numerator should exclude inventories. As that should suggest, the formulation of any metric should take the CAA's particular circumstances and practices into account.²

- **Days of Cash Indicator.** This is an even simpler and more direct ratio.

$$\frac{\text{Cash Balance at Month End}}{\text{Annual expense budget divided by 365 days}}$$

Comparing the number of days cash on hand from month-to-month provides an easily computed and understood indicator of whether the cash position is improving or deteriorating.

- **Accounts Payable Indicator.** The accounts payable indicator may provide an early warning sign that the CAA is unable to satisfy its debts as they become due.

$$\frac{\text{Accounts Payable}}{\text{Average Monthly Expenses}}$$

Both the board and management should begin asking for explanations if the number is increasing. Another way to assess whether the CAA is falling behind in paying its bills would be for management to prepare an accounts payable aging schedule. As is true with all ratios, the absolute number tells the board and management very little. A board's initial reaction might be that if the accounts payable indicator is on the rise, the CAA is facing financial trouble. That could be the case, but if the CAA's creditors don't object, a number that is increasing could be a sign of good cash management. The questions that ratios generate are what is important, not the raw numbers.

- **Expenses to Net Assets.** Comparing total expenses to net assets often is often useful for assessing the CAA's ability to withstand adverse financial circumstances.

$$\frac{\text{Total Expenses}}{\text{Net Assets}}$$

The smaller the numerator is as compared to the net assets, the better.

- **Savings Indicator.** CAAs aren't interested in turning a profit when "profit" is thought of as money available to pay to investors. However, a surplus can be used to build organizational capacity. One way to measure the extent of surplus is referred to as the savings indicator.

$$\frac{\text{Revenue} - \text{Expenses}}{\text{Total Expenses}}$$

In a sense, this percentage could be viewed as a profit margin, but one that is calculated using expenses rather than revenue in the denominator.

This metric may make sense for organizations that are building endowments. However, the savings indicator may not be a very useful metric for CAAs that rely heavily on grants, as most currently do. That point, in and by itself, is an important one. Organizations need to develop metrics that are meaningful for their circumstances. Blindly selecting and relying on metrics is a mistake.

- **Total Debt to Total Assets.** Organizations have long compared their debt to some base. One way to do this is to examine total debt to total assets.

$$\frac{\text{Total Debt}}{\text{Total Assets}}$$

Not surprisingly, there is not one right percentage. In fact, there is a great deal of variation in this number among different industries. Utilities, for example, incur a lot of debt relative to their assets because they have very predictable streams of revenue. On the other hand, tech companies are notorious for incurring little debt relative to their assets. The reason is quite simple: tech companies have very unpredictable revenue streams, and even when a tech company has a runaway best selling product, that product may soon be obsolete. Similar variations should be expected in the nonprofit sector. Certainly, CAAs finance their operations differently than hospitals, universities, or museums do.

Even if there were a target number, there is another problem with this metric. The CAA could hit the target, but find itself in financial trouble if the terms of a loan require an immediate payment, but there is insufficient cash on hand to make the payment.

Once again, all financial ratios are useful only if they are first customized to fit the organization's particular facts and circumstances, and then used to identify trends and spark questions.

Step 2. Make the Proper Comparisons

So far, we have examined a number of financial metrics or ratios and identified a number of problems with them. Does that mean CAAs should ignore these ratios? Absolutely not. When used correctly, ratio analysis is very effective, but to do that, management and the board must not use ratio analysis as a mechanical benchmark, which brings us to Step 2. Ratio analysis is best undertaken on a comparative basis.

■ **Internal Trends.** A CAA's management and board should monitor any given ratio over time. If for example, a CAA's defensive interval ratio has hovered around four months for the last five years, management and the board should be asking lots of questions if the ratio suddenly drops to one month. In other words, the focus should be on why a number has changed, not on hitting a particular number.

■ **Other Organizations.** Management should also consider comparing the CAA's ratios to other similarly situated CAAs, and then sharing the results with the board. There are two critical steps in this process. First, management must identify appropriate organizations for inclusion in the database. Second, management must obtain the financial data. Management might begin assembling a database of comparable organizations by reviewing the directory of a state association of CAAs. As for the data, management might begin by looking to GuideStar (www.guidestar.org) and its Form 990 database. To a certain extent, this suggestion is aspirational. Many organizations simply will be unable to obtain the necessary information to produce a meaningful database of comparative entities. Even if the information is available, the analysis may only be meaningful if the mix and source of funding is similar for all the organizations included in the database.

CASE SCENARIO:

CAN WE MAKE UP A RATIO?

Assume that BCA has received criticism from grantmakers that its compensation levels are too high for the number of personnel it employs. The main discussion in this toolkit doesn't discuss a ratio that measures whether compensation is too high, but the board should be interested in monitoring employee compensation given the criticism. It is easy to create a metric to do that, as the following one demonstrates:

$$\frac{\text{Salaries \& Wages (\$14,467,420) + Payroll Taxes and Fringe Benefits (\$14,820,070)}}{\text{Employees (468)}} = \$30,493$$

As should be apparent, this number indicates that the average employee is paid \$30,493 in salary and fringe benefits for the year in question. Management and the board can monitor this

number over time to determine whether efforts to reduce average compensation are producing results. One potential problem with this number is that it fails to distinguish between management and other staff. A better approach might be perform separate calculations for each category, which leads to a larger point: metrics should be customized to measure meaningful relationships, which means some thought has to put into designing them. There are dozens of books listing hundreds of financial ratios and metrics. Those books are a good starting point, but customization is always warranted.

LESSON. A board or management can create a ratio or metric which it then uses to assess a particular financial relationship. Financial analysis should not be formulaic. It should be robust, creative, and inquisitive.

Step 3. Monitor Trends

In addition to monitoring financial ratios, management and the board should monitor specific balance sheet, revenue items, and expenses over time.

Step 4. Allocate the Work

Management should be using ratio analysis to keep the CAA on solid financial footing. For that reason, the board, including the finance committee, should look to management to prepare the ratios and the analysis. That, however, does not mean the board must be passive, taking what management gives it. The finance committee should not hesitate to suggest alternative ratios or reports.

Increasing a CAA Board's Financial Literacy

Too often, people in the social services community complain that they simply cannot find board members who know much about accounting and finance. That problem may be real, but that does not mean there isn't a solution.

A CAA should develop accounting and financial expertise by asking its own auditor, another auditor, or the CFO to provide in-house instruction for board members. One approach that can be particularly illuminating is to use the CAA's financial statements as the basis for the in-house training. People are often most receptive to new information when they see how it relates to a problem or task that they must address.

A CAA should develop accounting and financial expertise by asking its own auditor, another auditor, or the CFO to provide in-house instruction for board members.

CAPLAW recommends that CAAs send board members and financial staff to training at its own training conferences and workshops as well as those offered by the Community Action Partnership and the National Association of State Community Services Programs. In addition, CAA board members and financial staff should access online resources, including PowerPoint presentations and pre-recorded webinars and audio conferences, available at: Virtual CAP www.virtualcap.org or CAPLAW www.capl原因.org

Many higher education institutions, nonprofit capacity building organizations, and state and national nonprofit associations also offer courses, webinars, and live workshops in financial analysis targeted to nonprofit board members. Other options include hiring a board development consultant or asking a local university with an accounting, business, or nonprofit management program whether a member of its faculty might work with your organization to develop a customized training.

Increasing the financial literacy of board members is consistent with the CAA mission. While some may view using CAA funds to train board members in financial analysis as a wasteful diversion of funds from mission, consider that the overall purpose of a CAA is to strengthen low-income communities, including board members who reside in and represent the community. Once someone knows how to analyze financial statements and budgets, he can use those skills to assist other nonprofits operating in the community and in his regular occupation.

Part II: What's in the Financials

Financial statements are the traditional tool used to analyze an organization's finances as they offer a systematic way to portray financial information.

Most boards review the annual financial statements prepared by management at the end of the fiscal year in preparation for the annual independent audit. As discussed in Part I of this toolkit section, these statements should usually be GAAP-compliant. Management also should prepare interim financial statements each month as a tool to monitor the CAA's financial health. These should be prepared and reviewed by the finance committee on a monthly basis. The full board should review the interim financial statements at its regular meetings throughout the year. These statements might not contain the final adjustments for items like the allowances for depreciation that must be included in the audited financial statements, but they can and should accurately reflect revenues, major expenses, and asset and liability balances.

Tip

INVEST IN A GOOD ACCOUNTING SYSTEM

As should be apparent, the board will be relying on unaudited interim financial statements throughout the year as it makes decisions. The board cannot rely on an outside auditor to detect mistakes in these statements. Given that reality, the board should value an accounting system that produces accurate interim financial statements. If the statements are incomplete or filled with errors, management and the board may be relying on faulty financial data as they make decisions. For this reason, both management and the board should invest resources in an accounting system that assures accurate financial data and reports.

Investment in competent fiscal management staff is equally important. CAA accounting is complex and designing understandable financial reports is extremely challenging. Boards will receive the greatest return on their investment in effective financial management by investing in both highly qualified fiscal managers and regularly updated software that facilitates meeting the CAA's complex tracking and reporting needs.

CASE SCENARIO:

THE IMPORTANCE OF INTERNAL CONTROLS

BCA and fellow CAA YCA are two Community Action Agencies that are identical in all respects except one: BCA and YCA both have the same number of employees, and similar programs, revenues, and expenses. BCA, however, has a stellar accounting system, while YCA's system is deficient in a number of respects. As a result, YCA's monthly financial statements often contain errors. Both BCA and YCA undergo a year-end audit. At the end of that process, both BCA and YCA issue financial statements in the same format and the auditor issues unqualified audit reports. Before that could

happen, the auditors asked YCA to make 54 adjustments to its financial statements. The auditors only asked BCA to make two minor adjustments to its financial statements.

LESSON: An organization's financial accounting system and internal controls make a difference. Throughout the year, BCA's board is making decisions based on accurate financial information. That is not true in the case of YCA's board. It is driving at night with its headlights at half power.

The Basic Set of Financial Statements

Financial statements for CAAs are usually comprised of the following four basic statements, plus footnotes:

- **The Statement of Financial Position**—more commonly known as the “balance sheet”—reports a CAA's financial condition as of a given date. It includes assets, liabilities, net assets—what the CAA owns; what it owes to creditors; and its net worth.
- **The Income Statement**, often titled the Statement of Activities, reports the CAA's income and expenses for a specified period of time. It is often referred to as the profit and loss statement. The income statement and the budget are two distinct statements. The income statement reports what has happened in the past, while the budget is a plan or projection of future events. While the income statement for the entire fiscal year must be included in the audited financial statements, every CAA also needs statements which report income and expenses for the current month and the fiscal year to date. The income statement explains what happened during the specified period. It connects last year's (period's) ending balance sheet with this year's (period's). It explains the changes in the CAA's net assets.
- **The Statement of Cash Flow** is the most complex and perhaps the most important of the four financial statements. The rules that govern financial accounting place heavy emphasis on measuring economic income rather than cash inflows and outflows. The experts agree that this focus is the appropriate one. Nevertheless, a CAA cannot exist on accounting income alone. Both management and the board must focus on cash inflows and outflows—cash flow. The statement of cash flows converts accounting conventions and concepts to make it clear how the organization has obtained and used cash.
- **The Statement of Functional Expenses** divides the CAA's expenses into at least three categories: program services, fundraising, and management and general expenses. The accounting rules³ specifically require nonprofits providing human services (organizations classified as “voluntary health and welfare” organizations) to provide a more detailed breakdown of their expenses in either a statement of functional expenses or a footnote to the financial statements. The

A CAA cannot exist on accounting income alone. Both management and the board must focus on cash inflows and outflows—cash flow.

statement of functional expenses uses a matrix format to show the specific line item expenses incurred for programs, fundraising, and management functions. For interim financial statements reviewed by the board and management, many CAAs go beyond the GAAP requirement to break down expenses by function (program, fundraising, and management) to present the income associated with each of these functions.

- **The Footnotes to the Financial Statements.** The financial statements contain footnotes (actually endnotes) that provide background information about the CAA and detail about how various accounting conventions were applied in assembling the statements. These are considered an integral part of the financial statements. When asked to review financial statements, most financial professionals will start with the footnotes. While all CAAs will prepare footnotes to their annual financial statements, many will not prepare complete footnotes to monthly interim financial statements.

Accrual Accounting Method

Most CAAs use the accrual basis of accounting. For some board members, financial statements prepared using the accrual basis are initially confusing. This is actually one of the main reasons that CAAs need to provide training in reading financial statements for every board member.

It is probably easiest to understand accrual accounting by thinking about it in contrast to the other common basis (or method) for accounting, the cash basis. Most of us are very familiar with cash basis accounting because it is what we do in our checkbooks every day. We record income when we receive it and we record expenses when we authorize payments to come out of our accounts by writing checks or paying our bills electronically. In the cash basis of accounting, income is recorded when the CAA actually receives payments and deposits them into its bank accounts and an expense is recorded when checks are written or electronic payments authorized. For an organization using the cash basis of accounting, the income statement will look just like the checkbook, reporting all the cash coming in and going out.

But the financial reality of a CAA is more complicated than this oversimplified picture. Why? Like most businesses, CAAs have some sources of income that require submitting a billing or request for reimbursement and waiting for the funder to send payment. Similarly, many CAAs pay employees for the work they did in one month on the first day of the following month and have a variety of other bills that are paid in the month after the goods or services are received.

In the accrual basis of accounting, these realities are described as receivables and payables and are reported on the balance sheet as assets (for the receivables) and liabilities (for the payables). The CAA has a legal right to receive what is owed and a legal obligation to pay what it owes to employees and others. To understand the financial condition of the CAA, the board must be made aware of the whole picture, including the receivables and the liabilities. The accrual basis of accounting presents the impact of receivables and payables clearly. The cash basis of accounting does not include recording and reporting these important items.

What many find most confusing in accrual basis financial statements is that the recording of these amounts that the CAA is owed or owes to others impacts the income statement as well as the balance sheet. This is because recording the fact that the CAA has incurred expenses to fulfill the requirements of a grant and is now owed reimbursement from the funder increases the grant income as well as increasing the amount reported as grants receivable. Similarly, recording the fact that the CAA owes a consultant \$1,000 for a training provided to staff during the month increases both the professional services expenses for the month and the liability account for vendors payable.

Consequently, the revenues, expenses and net income reported on the accrual basis of accounting will be different from that reported using the simpler cash basis. The accrual basis net income presents a more accurate picture of the true economic outcome of the CAA's activities. Accrual basis accounting is extremely important for understanding the financial health of the CAA. But boards must take care when reviewing accrual basis statements to also pay attention to the CAA's actual cash position. Despite having a legal right to receive the amounts shown as receivable from funders, the CAA will confront serious problems if it does not have sufficient cash available to pay its bills on time.

Cash vs. Accounting Income

Financial accounting and the resulting statements can be confusing to many people because they rely on a series of conventions that attempt to measure something approximating economic income rather than the CAA's net cash intake.

The following are a just a few examples where those developing the principles underlying financial statements choose to use the accrual basis of accounting to focus on economic income and wealth rather than cash inflows and outflows.

- **Borrowed Money.** When a CAA borrows money, it clearly has more cash on hand. On first impression, the loan proceeds might be viewed as revenue. However, the CAA also has an obligation to repay the loan. As a consequence, the borrowed funds are not treated as additional revenue and the repayment of the loan is not treated as an expense.
- **Prepaid Income.** Assume a CAA receives fees for services, and it asks people to pay in advance for next year's services. Looking at the cash inflow, many people would reasonably conclude that the CAA has income when it receives the cash. However, under the accounting rules, the CAA must recognize the income next year when it actually delivers the services rather than this year. The accounting rules assume that there will be expenses next year associated with delivering those services as the services are provided. By deferring recognition of the income until next year, the CAA better matches the income with the expenses of generating it.
- **Depreciation.** When a CAA purchases a new car or a building, it is not permitted to expense the entire purchase price in the year that it acquires the car or building. Permitting the CAA to fully expense the car at the time it acquires the car would provide a measure of cash flow. However, the new car or building will benefit multiple periods. The accounting rules require a portion of the purchase price to be charged or expensed in those periods, thereby better matching the expenditure with the periods benefited. The annual expense is referred to as depreciation.
- **Vacation Pay Liabilities.** Many CAAs agree to pay employees for unused vacation when they leave (and some states require it), but don't set aside funds ahead of time. If the focus were on cash, the CAA would reduce its income by the amount it paid to departing employees when paid. There are two problems with that approach. By failing to treat a portion of the future payments as an expense in the year the employee provides services to the CAA, the CAA would fail to match the revenue it receives with the expense of generating that revenue. Equally, if not more important, the CAA would not be recognizing a future obligation that could be very large. If the board doesn't adequately keep track of that promise, the CAA may discover that it lacks the resources to meet its obligations when they become due in twenty years.

The accounting conventions applied to a CAA's operations don't create expenses and income, but rather shift income and expenses among accounting periods to better measure annual economic income. If the normal accounting period were 25 years, net cash flow would more closely approximate accounting income. What creates the difference is the fact that accounting statements are prepared on an annual basis—a relatively short period of time.

The Balance Sheet

The balance sheet—or Statement of Financial Position—provides a snapshot of a CAA's assets and liabilities at any given point in time. Unlike the balance sheet for a for-profit business, the balance sheet for a CAA will draw distinctions between net assets that are subject to legal restrictions and unrestricted net assets. This classification scheme will be discussed later in the section under the heading “One Other Issue of Note - Restrictions.”

There is a fundamental problem with any balance sheet. By the time the board reviews it, the balance sheet is out of date. For example, a year-end balance sheet will report the CAA's assets and liabilities as of December 31. Assets and liabilities will have changed by the time the board reviews that balance sheet in February or March when the outside auditors sign off on the statements. This is another reason why both management and the board should be focused on trends.

As a general rule, the financial statements reflect historical cost rather than fair market value. For example, assume a Texas CAA purchased a parcel of real estate for its headquarters for \$100,000. Several years later, a large deposit of oil is discovered on the land. The market now values the parcel at \$50 million. Nevertheless, the CAA must continue to carry the land on its books at \$100,000.

Those new to accounting will find this focus on historical cost confusing, asking why the increase in value is not reflected in the CAA's balance sheet and income statement. The reason is simple: there is another principle at work, which is equally as important. Historic value is objective, but current value is not, which is why the accounting rules do not permit the use of market value accounting except under certain circumstances: while fixed assets (land, buildings, and equipment) are reported at their historic cost, marketable securities (e.g., stocks and bonds) must be reflected on the balance sheet at their current market value, and declines in inventory value (but not increases in value) must be reflected in the carrying value of the inventory. In recent years, accounting principles have begun to reject their traditional focus on historic value. Anyone who wants to understand when the balance sheet is valuing a category of assets at other than historical value should review the footnotes.

A CAA's financial statements omit several important assets, including the value of the CAA's workforce, know-how, and reputation. These assets may not be readily convertible to cash, but they are nevertheless important. Management and the board should never overlook these intangibles.

The balance sheet is divided into three sections. The first section lists assets, the second lists liabilities, and the third lists accumulated surplus, which equals the excess of assets over liabilities.

Assets

By tradition, assets are listed in the order or ease with which they can be converted to cash. This means that cash, marketable securities, accounts receivable, and inventories are listed first. Sometimes these are referred to as current assets. If your CAA holds certain funds in trusts, such as for self-funded employee health insurance plans, vacation pay, or unemployment insurance reimbursement, these may be listed separately in the asset category. Then equipment, land and buildings, and intellectual property are listed.

Liabilities

The liability side of the balance sheet is divided into two sections. The first section reports current liabilities, which are liabilities (or the portion thereof) that will become due within the next 12 months. Obviously the board should be concerned about these because they will require cash payment. The second section reports long-term liabilities, which are liabilities that are due more than one year from the balance sheet date. Although the day of reckoning is farther in the distance, the board must focus on accumulating the cash necessary to retire this debt.

Contractual Obligations

The liabilities section of the balance sheet generally does not reflect contractual liabilities like a long-term lease for the CAA's headquarters, although liabilities for capitalized leases must be reflected.

Contingent Liabilities

The accounting rules require that contingent liabilities must be reflected in the financial statements when the liability can be valued and is relatively certain to become a fixed liability. When a CAA is sued, it must determine whether the potential judgment against it must either be reflected as a liability on the balance sheet or disclosed in the footnotes. The rules reflect a bias against including these liabilities in the balance sheet, except when it is highly likely that the contingency liability will become fixed. Because of this bias, liabilities that could result from a pending lawsuit are typically reflected in the footnotes, but not the balance sheet.

Net Assets

Net assets simply is the number that equals the difference between assets and liabilities: $\text{assets} - \text{liabilities} = \text{net assets}$. In the case of a business corporation, the difference between assets and liabilities is referred to as equity and includes both the shareholders, investment in the company and the accumulated profits which may either be retained in the company or may be made available for distribution to shareholders. In the nonprofit context, this number could be viewed as the organization's equity in its mission. Net assets at the end of the year is equal to net assets at the beginning of the year, plus net income, which is referred to as the increase in net assets. As previously noted, the income statement connects last year's balance sheet with this year's.

The Income Statement

Of the four statements that make up a complete set of financial statements, the income statement is probably the most straightforward. The first part of the income statement includes revenues. This may include grant revenue, contributions, income from the sales of goods and services, and investment income. The second part of the statement lists categories of expenses. Some organizations choose to classify expenses as program, fundraising, and general administration rather than or in addition to providing line-items for more familiar notions of expense, such as salaries, rent, utilities, and supplies. The final section of the income statement reports the difference between the total revenues and the total expenses, which is expressed as the net increase or net decrease in net assets. It is this net increase or net decrease in net assets that connects the income statement to the balance sheet by explaining how the net assets increased or decreased over the period being reported.

Volunteer Labor

Many board members will be surprised to learn that the value of volunteer labor is reflected as income in the income statement if the volunteer services are provided by an individual with specialized expertise such as a lawyer or CPA or a skill that requires licensure such as a plumber or electrician. A corresponding expense "in-kind labor expense" is recorded as well, resulting in no increase in net income. If volunteer labor results in the creation of an asset (think Habitat for Humanity) the value of the in-kind contribution is determined by the increase in value of the asset as a result of the volunteer labor. The CAA must also record this increase in value of the assets on the balance sheet. This admittedly unusual rule forces both management and the board to focus on the value of volunteers.

Disbursement Agent vs. Provider of Services

Normally when a CAA provides services under a grant, it includes the grant revenue in its income statement. However, on occasion, the CAA may simply be acting in a pass-through capacity, acting as a disbursement agent for a government agency. This is different from acting as a fiscal sponsor or utilizing sub-recipients to carry out certain projects.

There are complex accounting rules that distinguish between fiscal sponsorship and pass-through (disbursing agent) relationships. In the case of the true pass-through or disbursing agent role, neither grant revenue nor offsetting expenses is included in the income statement. Instead the funds received are recorded on the balance sheet as a liability, which is reduced as the funds are disbursed for the purposes specified by the government agency. This is the right result, but management and the board should not simply ignore this activity. The activity should be a part of the CAA's mission, meaning that the board and management should be monitoring it and assessing performance. These arrangements generally should be described in the footnotes when material. The board should be certain that both it and management understand each funding relationship clearly, including understanding the extent of the responsibility that the CAA holds for proper management of any funds which are transferred to other entities to carry out specific projects.

Depreciation

Depreciation is an expense. It is an allocation of a portion of the cost of a capital asset (e.g. a building, a truck, or a piece of equipment) to each year benefited by the equipment. The accounting rules prescribe depreciation schedules for different asset categories. Depreciation is an attempt to match income with the costs of generating it. The financial statement reader should keep one critical point in mind: the annual allowance for depreciation bears absolutely no relationship to the economic decline in the value of any given asset. The balance sheet may show a large balance for any particular asset, but the CAA may need to replace that asset next year.

One additional challenge to understanding the CAA income statement may arise from accounting requirements for recording contributions that have been restricted by the donor or grantor. Accounting requirements and options for presenting the information about restricted contributions clearly will be discussed later on in this section.

The Statement of Cash Flows

This is the most complex of the four basic CAA financial statements. The uninitiated will initially be put off by the seemingly indecipherable lines. Even seasoned accountants have trouble fully comprehending this statement, but it does contain valuable information that is accessible to even the financial neophyte.

Keeping the following two points in mind makes the statement of cash flows something that is both useful and understandable:

- The first part of the statement is obtuse, or at least looks obtuse. This section converts the increase in net assets for the year into net cash from operations. The focus of every adjustment is on operating cash flow.
- Part two focuses on a basic tautology. Cash is either used in or provided by the following activities: operations, investment, and financing activities. For this purpose, investment is broader than stocks, bonds, and options. It involves the purchase or sale of any asset that is capital in nature. That means investment assets exclude cash, accounts receivable, and inventories. The tautology is expressed in equation form as follows:

The change in the cash balance = Cash provided from or (used by) operations + Cash provided from or (used by) investment activities + Cash provided from or (used by) financing activities

Appendix B includes an example that provides board members with a step-by-step approach to analyzing the statement of cash flows.

The Statement of Functional Expenses

As previously noted, the statement of functional expenses is relatively straightforward. It provides additional details about a CAA's expenses by displaying which portion of each line item expense was incurred for the purpose of management, fundraising, or program services

Location

The statement of functional expenses can be presented as either a separate statement or as part of the footnotes. Anecdotal evidence indicates that most organizations choose to use a separate statement.

The Detail

The statement of functional expenses divides expenses into three categories: program, management, and fundraising. The statement then lists the portion of each line item expense (e.g. rent, wages, and utilities) attributable to each of the three functional categories.

Some organizations choose to break down program expenses further by individual programs. For example, a CAA with Head Start, weatherization, counseling, and housing programs would show the program expenses for each of these programs, providing management and the board with a far better understanding of what resources each of these programs consumes.

Allocations

Some line item expenses will need to be distributed among the three functional categories through allocation formulas, which can introduce some discretion into the process. CAAs must establish clear, consistent methods for allocating costs among functions in a cost allocation plan. CAAs with direct federal funding relationships such as Head Start, may use their cost allocation plan to negotiate a federal indirect cost rate. CAAs without direct federal funding relationships may be required to submit their written cost allocation plan to their state or other funders for approval. In either case, the board should have a basic understanding of the cost allocation methods the CAA is using. The allocations in the statement of functional expenses should be based on these plans or rates.

What About Income?

What is missing from the statement of functional expenses is the income side of the equation. Although "profits" are not a driving force for a CAA—at least in the Fortune 500 sense of the word—management and the board should be assessing whether each program covers its expenses. This is particularly important in the case of CAA—most of which are highly reliant on grant revenue, because grant agreements may not permit the CAA to use grant revenue to cross-subsidize other programs.

The statement of functional expenses may not be the appropriate place for this analysis, but both management and the board should be looking at the income side of the equation on a program-by-program basis.

Grant Funding Periods

Management and the board should also be monitoring revenue on a grant-by-grant basis so that they know the amount of each grant and its expiration date. Such a schedule will help management and the board assess the extent to which individual grants can be counted on for future revenue.

The Footnotes to the Financial Statements

As noted, the footnotes to the financial statements contain important information that should be reviewed by all financial statement users. Many of the footnotes are mandatory for the presentation of GAAP-compliant formal financial statements. Many CAAs prepare detailed GAAP-compliant footnotes only at year-end and use a more informal bullet point narrative to highlight issues in monthly financial statements. CAAs using this more informal approach for monthly statements should be sure that every board member has a copy of the most recent audited statements that includes the complete footnotes.

GAAP accounting rules specifically dictate that certain information be disclosed in footnotes for GAAP-compliant statements. The rules often go so far as to prescribe the format for numerical disclosures. The footnotes will generally include the following information, but the level of detail differs significantly from organization to organization:

- **The Organization.** A brief discussion of the organization's legal form, purposes, and tax-exempt status.
- **Estimates.** A discussion of the methodology used in making estimates.
- **Depreciation Methods.** The methods used to calculate depreciation expense.
- **Donated Services.** The treatment and valuation of donated services.
- **Grants and Receivables.** A listing of material contracts and accounts receivable and a discussion of any allowance for doubtful accounts.
- **Contingent Liabilities.** A listing of all material contingent liabilities that are not otherwise reflected in the financial statements. Every reader should be reviewing this footnote for a listing of threatened or pending lawsuits.
- **Lease Commitments.** A listing of material leases and their terms.
- **Pension and Retirement Plans.** A listing of pension and retirement plans, their funding status, and valuation. This or another footnote will also contain a discussion of accrued vacation pay, if applicable, and there may be a discussion of other employee benefits.
- **Long-Term Debt.** A listing of material long-term debt, with payment and maturity terms.
- **Consolidation.** If the financial statements include other entities (such as subsidiaries—i.e. organizations that the CAA controls through membership, board of director appointments, or ownership arrangements), a listing of entities that have been included in the financial statements and principles used to produce the consolidated financial statements.

Tip

UNDERSTANDING CONSOLIDATED FINANCIAL STATEMENTS

Most boards will need specific training to understand consolidated financial statements. The training should emphasize the legal relationships between the entities with emphasis on any risks that the CAA confronts as a result of the operations of its related entities.

CASE SCENARIO:

THE FOOTNOTES CONTAIN VITAL INFORMATION

Albert Matson is a new member of the BCA's board. Being a banker, Matson asked for a copy of BCA's year-end audited financial statements at the time he joined the board. When he looked at the balance sheet, he was puzzled by the \$245,890 reserve for unemployment compensation. After reading footnote 8 to the financial statements he has a better understanding of the liability represented by that number. He recognizes that by self-insuring to cover unemployment insurance benefits, BCA may be reducing the annual payments it would otherwise have to make to the state unemployment compensation insurance fund. Matson, however, is worried that if BCA is forced to lay off employees, its obligation to pay benefits could exceed the reserve. At the board meeting, Matson asks whether BCA has explored obtaining secondary insurance to protect itself.

LESSON: The footnotes to the financial statements are an integral part of those statements. Matson did what all experienced bankers and others who regularly work with financial statements do: he read the footnotes to the financial statements to gain a better understanding of the assumptions and conventions underlying the numbers. In this instance, Matson recognized that BCA might be exposing itself to greater risk than the board realized. He also saw a possible way to reduce that risk while retaining some of the savings from self-insuring BCA's obligation to fund unemployment compensation. Matson should have also noticed the pending litigation revealed by the footnotes. Management should be regularly updating the board on that litigation.

One Other Issue of Note — Restrictions

GAAP accounting rules require that nonprofits distinguish whether or not gifts received carry donor-imposed restrictions, which are further distinguished as either temporary or permanent.⁴ As the word implies, the restrictions on permanently restricted gifts will never expire. In contrast, donors making temporarily restricted gifts or grants intend that the nonprofit will use the gift for specified purposes or in specified time periods.

The impact of receiving donor-restricted gifts is reflected on both the balance sheet and the income statement. When a temporarily restricted gift is received, it increases the temporarily restricted net assets. When the restrictions are fulfilled, the temporarily restricted net assets are reduced. When a permanently restricted gift is received, the permanently restricted net assets are increased. Since the restriction is permanent, the permanently restricted net assets cannot be reduced by the fulfillment of restrictions.

CASE SCENARIO:

HOW RESTRICTED IS RESTRICTED?

Gifts and grants received without donor restrictions are considered unrestricted. All revenues from fees for services or product sales are classified as unrestricted under GAAP rules (although federal funds management requirements may actually impose some limitations on the use of fees that are deemed program income). GAAP accounting rules for the treatment of funds received through government grants and awards are complex and go beyond the scope of this toolkit. Although most CAAs receive a substantial portion of their total income from governmental sources, many of the funding agreements are structured on a cost reimbursement basis in which the CAA must first incur allowable expenses and then request reimbursement. The nature of these reimbursement agreements generally results in these governmental funds being classified in the “unrestricted” category for GAAP purposes, despite the reality that many restrictions are included as part of the governmental agreement.

The technical nature of the GAAP rules for classifying income as unrestricted, temporarily restricted or permanently restricted requires that CAAs have highly competent fiscal managers with expertise in nonprofit accounting. Most board members rely on the auditor’s opinion for assurance that their organization is correctly recording restricted grants and gifts. It is not necessary for board members to become expert nonprofit accountants. Instead, it is important that board understand the nature of the gifts and grants the CAA receives and the presence or absence of restrictions on the net assets. The presence of restrictions on the net assets, either permanent or temporary, represents a commitment or obligation to use resources in donor-specified ways. The absence of restrictions, represented in unrestricted net assets, represents the resources that the board can direct toward purposes which it believes are in the best interest of the CAA.

LESSON: It is important to understand the distinctions among the various types of income to ensure your financial statements are accurate and in compliance with GAAP.

Three Categories of Net Assets

The balance sheet should divide net assets into the following three categories: (1) unrestricted; (2) temporarily restricted; and (3) permanently restricted.

- **Unrestricted Net Assets.** The name says it all. These are net assets that are not subject to restrictions imposed by grant makers or donors. The CAA board can use them as it sees fit.
- **Temporarily Restricted Net Assets.** Many CAAs will encounter temporarily restricted assets, which are defined as net assets that are subject to a donor/grantor imposed restriction on either the purpose for which the gift may be used or the time period in which it may be used. For many CAAs, the temporarily restricted net assets will include funds received under a grant that have not yet been expended for allowable costs specified by the grantor. Until the expenses are incurred to fulfill the restricted purpose, the net assets will be classified as temporarily restricted. When the expenses to fulfill the restricted purpose are incurred, the financial statements will reflect the fulfillment of the restrictions as a “release from temporarily restricted net assets” which will reduce or, if all restrictions are fulfilled, eliminate the balance in the temporarily restricted net assets account.
- **Permanently Restricted Net Assets.** Net assets classified as permanently restricted typically are held as an endowment. Roughly speaking, the organization cannot spend principal, but can spend income. The actual definition is much more complex, but this one will suffice for present purposes.

Presentation

Balance Sheet

There are two common ways that CAAs present information about restrictions on the balance sheet.

Method 1

Blue Community Action Agency (BCA) Statement of Financial Position December 31, 20X2 and June 30, 20X1		
	12/31/X2	12/31/X1
Assets		
Current Assets:		
Cash	\$3,500	\$5,000
Accounts receivable	\$5,000	\$6,000
Prepaid expenses	\$500	\$500
Total Current Assets	\$9,000	\$11,500
Liabilities and Net Assets		
Liabilities:		
Accounts payable	\$2,000	\$1,500
Accrued assets	\$5,000	\$5,500
Total Current Liabilities	\$7,000	\$7,000
Net Assets:		
<i>Unrestricted net assets</i>		
Available for operations	\$200	\$1,200
Board designated reserves	\$800	\$800
Total Unrestricted Net Assets	\$1,000	\$2,000
Temporarily Restricted Net Assets	\$1,000	\$2,500

■ **Method 1.** Many CAAs provide a summary at the end of the balance sheet that analyzes the net asset balance in terms of the three categories—unrestricted, temporarily restricted, and permanently restricted—but this summary does not provide asset-by-asset detail. Note that this example does not include permanently restricted net assets because BCA does not have any such assets (i.e. it does not have an endowment).

■ **Method 2.** Some CAAs present the entire balance sheet, including assets, liabilities, and net assets, in columns titled *Unrestricted*, *Temporarily Restricted*, and *Permanently Restricted*, and include a fourth column titled *Total* to combine the three columns. The appropriate portion of each asset, liability or net asset is placed in the corresponding column, and the three columns are then summed to show the total net asset balance. If, for example, BCA, as of December 31, 20X2, had \$3,500 in cash, \$2,500 of which was temporarily restricted and the remaining amount was subject to no restrictions and none of BCA's other assets were permanently restricted, the balance sheet would show \$2,500 under the temporarily restricted column, \$1,000 under the unrestricted column, and no column for permanently restricted assets. The two columns would then be summed, and the result would be displayed in the third column as the overall cash balance. This method is more complex than the second one, and generally requires use of higher-end fund accounting software, but it shows the limitations on each category of assets, which provides great insight into the CAA's liquidity. A CAA, for example, may have a large cash balance, but if all of it is restricted, the board should not look to the cash to satisfy needs outside of the permitted uses.

Method 2

Blue Community Action Agency (BCA) Balance Sheet December 31, 20X2 and 20X1						
	20X2			20X1		
	Unrestricted	Temporarily Restricted	Total	Unrestricted	Temporarily Restricted	Total
Assets						
Assets:						
Cash	\$1,000	\$2,500	\$3,500	\$1,500	\$3,500	\$5,000
Accounts receivable	\$5,000	\$0	\$5,000	\$6,000	\$0	\$6,000
Prepaid expenses	\$500	\$0	\$500	\$500	\$0	\$500
Total Current Assets	\$6,500	\$2,500	\$9,000	\$8,000	\$3,500	\$11,500
Liabilities and Net Assets						
Liabilities:						
Accounts payable	\$1,000	\$1,000	\$2,000	\$1,000	\$500	\$1,500
Accrued expenses	\$4,500	\$500	\$5,000	\$5,000	\$500	\$5,500
Total Current Liabilities	\$5,500	\$1,500	\$7,000	\$6,000	\$1,000	\$7,000
Net Assets:						
<i>Unrestricted net assets</i>						
Available for operations	\$200		\$200	\$1,200		1,200
Board designated reserves	\$800		\$800	\$800		800
Total Unrestricted Net Assets	\$1,000		\$1,000	\$2,000		\$2,000
Temporarily Restricted Net Assets		\$1,000	\$1,000		\$2,500	\$2,500
Total Net Assets	\$1,000	\$1,000	\$2,000	\$2,000	\$2,500	\$4,500
Total Liabilities and Net Assets	\$6,500	\$2,500	\$9,000	\$8,000	\$3,500	\$11,500

The Income Statement and Restrictions

The income statement distinguishes contributions with donor restrictions from contributions received without donor restrictions. It also reflects the organization's fulfillment of donor restrictions. There are two common methods to display the receipt of restricted gifts and the fulfillment of restrictions on gifts previously received. One method uses multiple columns, one each for unrestricted, temporarily restricted, and permanently restricted. The other method is referred to as "stacked" and presents all of the unrestricted activity in the top section, then the temporarily restricted, and finally the permanently restricted activity. Both formats are designed to help readers of the statements understand whether gifts received have been restricted and whether restrictions have been fulfilled or must be fulfilled in future periods.

Not as Complex as It Sounds

Many board members will initially be intimidated by the terminology and the multiple columns. However, the overall concept is actually quite simple to understand once it becomes clear that the numbers simply mirror the restrictions in gifts and grants received by the CAA. A little effort on the part of board members will produce significant insight to the limitations on the use of certain assets.

Concluding Thoughts

Financial management is the responsibility of management and the board, not the auditors. First and foremost, the auditors conduct their audit once a year, following the close of the CAA's fiscal year. Even if the auditors were monitoring the adequacy of the CAA's financial resources, it would only be once a year, which is insufficient. Monitoring any organization's finances is an ongoing process, which must be undertaken at each board meeting and continuously by management.

Equally, or possibly even more important to recognize, the primary function of the auditors is NOT to assess the CAA's financial condition, but rather, to assess whether the financial statements present that condition fairly, whatever that condition might be. The auditor's opinion letter says nothing about the adequacy of cash balances, whether one form of bank financing is preferred over another, or whether the CAA should be leasing its space rather than own it.

A CAA's financial statements contain important information. Many board members who are unfamiliar or uncomfortable with financial matters will decide to ignore the statements. This is a mistake. Here are some basic principles to keep in mind.

- Anyone can read financial statements. It may initially take a little bit of effort, but not all that much.
- Board members have a legal duty to monitor finances, which means reading the financial statements.
- Finance and mission are integrally linked. The financial statements provide an opportunity to discuss mission in an organized and meaningful way.
- The financial statements measure financial performance and condition. They do not, however, measure whether a CAA is achieving its mission. The board should spend considerable time discussing whether the CAA's programs are effective and how to best measure effectiveness.

Endnotes:

1. 2 C.F.R. 215.21.
2. See <http://www.nonprofitsassistancefund.org/clientuploads/MNAF/ToolsTemplates/NonprofitFinancialRatios.pdf>
3. FASB 117
4. See Accounting Standards Codification (ASC) 958 605 20.

SECTION 5: DEALING WITH CONFLICTS OF INTEREST

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Conflicts of interest pose difficult issues for CAAs and other organizations. A conflict exists whenever circumstances could cause an individual to elevate his personal interests over the CAA's interests, with the result that the CAA's efforts become a secondary rather than the primary consideration. In the broadest sense, a conflict is a situation where an individual who has authority to make or influence decisions affecting the CAA, such as a board member or the head of the purchasing department, has a personal incentive, often a financial incentive, to cause the CAA to take, or not take, a particular action.

Part I: Conflicts of Interest

Everyone should be concerned about conflicts because, when poorly managed, they often lead to negative consequences. Most notably, conflicts can jeopardize a CAA's nonprofit and tax-exempt statuses and government funding and result in disallowances of costs charged to grants and contracts. State and federal governments are often concerned that conflicts of interest will lead to a nonprofit paying too much for goods or services provided by insiders or paying insiders for unneeded or inappropriate goods or services, thus diverting funding or assets intended for a public charitable or educational purpose to an insider for private benefit. They are concerned that unqualified relatives of insiders will be hired as employees or as contractors, therefore weakening the ability of the nonprofit to carry out its mission and the intended purposes of the funding. Both federal and state laws and program funding requirements have therefore imposed numerous conflict of interest restrictions. The IRS also requires most 501(c) tax-exempt organizations to disclose on the Form 990 whether they have a conflicts of interest policy and how it is implemented.

Conflicts can also adversely affect employee morale, draw unwanted media attention, and create negative public perceptions that can damage a CAA's reputation. The media often portrays conflicts as a sign of corruption and wrongdoing. When a newspaper or television reporter decides to investigate a charity, the story often will describe any conflicts that the reporter discovered even if the conflicts do not relate directly to the story's primary subject matter. The reporting will always present the conflicts in a negative light, thereby damaging the CAA's reputation.

Conflicts of interest are a fact of life. Not all conflicts are objectionable or even defined as a "conflict of interest" by relevant laws or policies. A person who faces a conflict has not necessarily done anything wrong. His or her conduct, as well as that of the CAA, will be judged by how both address the conflict. A conflict of interest policy tries to address those issues by defining conflicts, establishing a mechanism to disclose potential conflicts, outlining a process and criteria for determining whether a transaction involving a conflict is acceptable, and setting forth the consequences where a conflict is deemed unacceptable.

Every CAA should, and in many cases is required to, have a written policy that addresses conflicts of interests. With a written policy, CAA boards and senior managers will be less likely to adopt an ad hoc approach to conflicts that could result in ethically questionable and potentially illegal transactions, or reasonable and defensible transactions that lack sufficient documentation to withstand external scrutiny.

Examples of Common Conflicts

Common conflicts encountered by nonprofit organizations are:

- **Sales of Goods, Services or Property** by a nonprofit's officers, board members, employees, and other interested persons—often referred to as "insiders" — to the nonprofit or vice-versa. Examples include a CAA board member who provides legal services to a CAA for a fee; a CAA that hires the executive director's nephew to do plumbing work; or a CAA that leases its headquarters from its board chair.
- **Loans** to or from the nonprofit to a board member, officer, key employee, or related entity. Some states prohibit or severely restrict loans from a nonprofit to its board members and officers. Examples include a bank that lends money to a nonprofit when the president of the bank serves on the nonprofit's board or a nonprofit that lends money to a newly hired CEO to buy a house.
- **Joint Undertakings** between nonprofits and businesses and individuals who have valuable skills and expertise in an effort by the nonprofit to find innovative ways to deliver goods and services. In structuring a joint undertaking or other ongoing relationship, a CAA should ensure that the arrangement is structured so that the CAA's interests do not become secondary to the interests of any CAA officers, board members, or employees who are participating in the joint undertaking either directly or through ownership interests in another entity.
- **Positional Conflicts** that arise because a CAA board member simultaneously holds two positions, one as a member of the tripartite board and the other unrelated to the CAA (e.g. a full-time job, an elected office or a board member of another entity). A CAA's tripartite board is comprised of three categories of individuals who represent their respective constituencies. While board members of each category should take into account the interests of their constituency, each board member must still act in the best interests of the CAA as a whole.

Tip

BOARD ELIGIBILITY AND BYLAW REVIEW

The CAA should summarize the relevant portions of its conflicts of interest policy in the board application materials provided to prospective board members. A member of the community may want to be considered for board membership, but if his/her firm does business with the CAA and has what would be an impermissible conflict, then the community member has a choice to make—be a board member and lose the business opportunity, or refrain from board service. It is best if the impediment to membership is known up front. The bylaws should provide a process that will preclude an individual from being elected or seated as a board member if s/he has an impermissible conflict. This would require the board to have some final say in who is seated on the board, rather than give other parties the right to fill seats on the board without initial vetting by the CAA board through the application process. The bylaws should contain a similar provision for board members who find themselves faced with impermissible conflicts during their terms.

- **Corporate Opportunities** offered to a board member or an employee that might also be of interest to the CAA. For example, a real estate developer who serves on the CAA's board might be interested in acquiring a parcel of land that the CAA is also interested in acquiring. This board member owes a duty of loyalty to the CAA. That duty requires the CAA and the real estate developer to assess whether he can honor his duty of loyalty to the CAA while simultaneously competing with the CAA for the land.
- **Employment.** Hiring the relatives of board members and key employees raises questions of favoritism or nepotism. For example, a CAA that hires the board chair's daughter to head its weatherization program over a more qualified candidate potentially harms employee morale and, if the CAA runs a Head Start program, jeopardizes its Head Start funding.
- **Gifts to Board Members or Staff** from vendors may improperly influence their decisions in connection with doing business with the vendors. For example, a representative for a vendor of a financial software package may offer the CAA finance director two tickets to a baseball playoff game.

Two Categories of Conflicts

The legal system divides conflicts into two categories, those that are legally prohibited and those that are legally permissible. A conflict of interest policy creates a board and senior management mindset that allows them to recognize potential conflicts, know the difference, take appropriate actions to avoid illegal conflicts or—if the CAA wishes to—proceed with a legally permissible conflict in an objective and transparent manner.

- **Legally Prohibited Conflicts.** Federal and state laws prohibit certain categories of transactions between a CAA and specified persons. For example, the Head Start Act prohibits financial transactions between a Head Start grantee and its board members and Policy Council members. In certain states, a nonprofit corporation cannot lend money to or borrow money from certain “insiders,” usually officers, board members, and employees, or may only do so on a limited basis.
- **Legally Permissible Conflicts.** When there is not a specific prohibition, the CAA and the conflicted person may be able to enter into the arrangement notwithstanding the conflict, but certain procedures should be followed before going forward with the transaction to ensure that it is both transparent and in the CAA's best interest. State nonprofit corporate law often outlines a procedure that an entity can use to “validate” transactions with conflicts. Depending on the wording of the particular statute, following these provisions can provide some protection from liability to board members or the person with the conflict or preclude the transaction from being void or voidable. Because of the different statutory formulations and interactions with the case law defining the duty of loyalty, a CAA and its board and officers should consult with a lawyer familiar with applicable state law to better understand the procedures and their significance. Generally, the procedure to validate a conflict must include three elements: (1) notification of conflict; (2) disclosure of material facts related to conflict; and (3) an objective, good faith review prior to moving forward with the otherwise legally permissible transaction. This procedure of board validation would be followed for board members with conflicts, and, if attempting to gain protection from potential liability from federal tax law liability, for conflicts of high-level management staff as well. The CAA should develop procedures to ensure that transactions involving conflicts of other employees are either approved through appropriate procedures or avoided.

CASE SCENARIO:

THE NEED FOR A CONFLICT OF INTEREST POLICY

BCA's board of directors has yet to adopt a conflicts of interest policy. It has never had to deal with a conflict, which explains why the board saw no need for a policy. (For purposes of this example, assume BCA does not operate a Head Start program.)

Two months ago, the board directed BCA's CEO, Gloria Watson, to find larger facilities for BCA. During a subsequent lunch with Noelle Burke, a member of BCA's board, Watson learned that Burke owns a building that might meet BCA's needs for additional space. Burke and Watson negotiate a proposal under which BCA would enter into a triple net lease that requires BCA to pay a \$100,000 annual rent as well as all taxes, insurance, and maintenance expenses for the building. The initial lease term will be five years, with an option to renew for an additional five years.

Burke and Watson present the proposal to BCA's board for approval at the next board meeting. Because everyone knows and likes Burke, everyone assumes she will propose a “fair” deal. The board votes unanimously in favor the proposal.

An investigative reporter for the local newspaper learns of the deal. He contacts a local real estate broker, who reports that BCA could have obtained comparable space for a mere \$80,000 per year, with the landlord responsible for all other building costs. The newspaper story results in several investigations and criticism from the community.

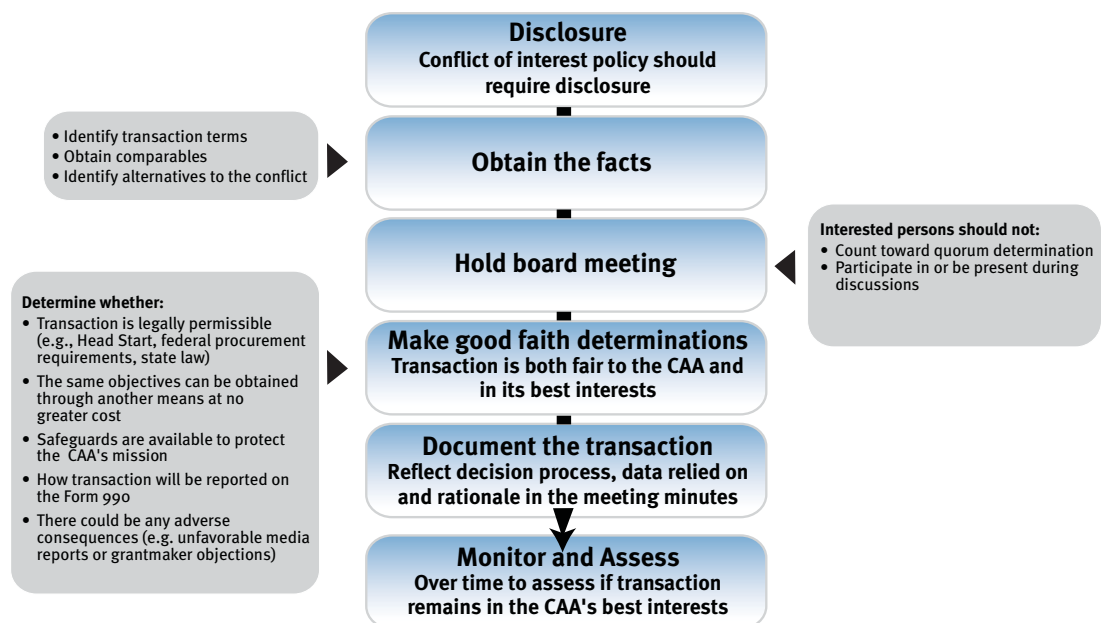
LESSON: Just because a CAA has never encountered a conflict does not obviate the need for a conflict of interest policy. By defining BCA's values in advance and encapsulating them in a policy, BCA's board can avoid the sort of ad hoc decisionmaking that often spells trouble. Had BCA adopted a policy in advance, the board would have had a blueprint to follow in evaluating the Burke-Watson proposal. Instead, the resulting decision was based largely on goodwill and emotion, which doesn't always lead to a defensible decision when the decision is viewed in hindsight.

Contents of the Conflict of Interest Policy

At a minimum, the policy should address the following:

- **Purpose.** An introductory statement identifying the policy's purposes and objectives, reflecting a philosophy that guides the board and others subject to it when the policy does not explicitly address a particular situation.
- **Covered Individuals.** Identify by category the persons who are covered by the policy. Due to different conflict of interest rules and procedures that apply, respectively, to board members, officers and employees, and Head Start Policy Council members, it is often clearer to have separate policies for each of those categories. At a minimum, persons covered by a conflict of interest policy should include board members, officers, key employees and others involved in the procurement process, and Head Start Policy Council members.
 - **Family Members.** Board members, officers, and employees sometimes face conflicts because of their relationship to someone else who does business with or receives funds, goods, or services from, the CAA. For this reason, the policy should define how transactions between the CAA and family members are treated. Policies typically define a family member as a covered person's spouse, children (including adopted and step-children), parents, in-laws, and brothers and sisters. Typically, if a transaction would be problematic or require approval if an officer, board member, or employee engaged in it, then the transaction will be viewed similarly if one of their family members engages in it. Including domestic partners in the definition of family member is recommended.
 - **Related Entities.** Define the related entities included in the policy. These typically include corporations and other entities owned by the CAA's officers, board members, or employees or controlled by or affiliated with the CAA itself, through authority to appoint at least a majority of the board members, for example. The trick is to define the ownership thresholds that bring an entity within the policy's scope. If a CAA has a particularly strong aversion to conflicts, its policy might cover any transaction between the CAA and an entity in which one or more covered persons own more than a 5 percent interest in the entity. Less risk adverse CAAs might set the threshold at more than 35 percent ownership interest. Some broadly-worded policies also include entities for which CAA insiders work or serve as officers, even if they do not have an ownership interest.
- **Conflicts Covered by the Policy.** This is best done with a general statement, accompanied by examples. At a minimum, the policy should address purchases and sales of goods, services, and property; loans; leases and use of property and resources; investments and joint ventures; and employment of family members.
 - **Enumerated Conflicts.** Some policies enumerate specific types of transactions, which often include: selling goods to the CAA; providing services to the CAA; leasing property to the CAA; and receiving gifts or loans from third parties dealing with the CAA. A more general statement, as described below, should also be used to catch situations not covered by specifically enumerated conflicts.
 - **General Statement.** Other policies use more generalized language, often providing that no officer, board member, or employee may vote or oversee any matter in which that person has a material or direct financial interest. Although a standards-based policy is often preferable, it should nevertheless specifically identify certain common transactions and circumstances.
 - **Exclusions of Certain Benefits.** The CAA may want to consider excluding from the conflicts of interest definition certain benefits provided to insiders who are eligible for CAA services. Typically, services or benefits provided by the CAA to an insider solely because the person is a member of a charitable class that the CAA intends to benefit as part of the accomplishment of its charitable purposes would not be considered a conflict of interest, provided that: (1) the insider meets all applicable eligibility criteria for the services/benefits, including funder rules on the provision of services/benefits to insiders; (2) the insider does not receive preferential treatment in receiving the services/benefits due to his or her status as an insider; (3) the services/benefits are provided on terms similar to services/benefits provided to individuals who are not insiders; and (4) neither the insider nor any of his family members are involved in the decision about whether to provide services/benefits to the insider. This exclusion is consistent with the IRS instructions for completing the related party disclosures on the Form 990.
- **Notification.** The policy should require those who are covered by it to notify the appropriate persons when they become aware of a potential conflict involving themselves, with whom they have family or business relationships and entities in which they have an ownership interest. Receiving a timely notification of potential conflicts is particularly important because early knowledge allows the CAA to prevent a potential conflict from ripening into an actual one. The policy should specifically instruct all covered persons to err on the side of disclosing more than may be necessary so that the CAA has the opportunity to review transactions and determine whether there is in fact a conflict.
- **Validation Process.** A CAA may choose to prohibit some or all conflicts outright or to allow certain legally permissible conflicts, subject to a review by the board or a board committee (for a board member, CEO or other staff as determined by the board) or by a designated staff member (for a staff member such as a purchasing manager). If the CAA allows certain legally-permissible conflicts, the policy should outline the procedures that must be followed before the CAA will enter into a transaction involving a conflict. Organizations should review applicable state laws to ensure that efforts to validate the conflict comply with statutory provisions, but six basic principles should guide the process:

- **Obtain All Facts.** Before the decision is made, obtain all material facts pertaining to the transaction and the conflict.
- **Act in Good Faith.** Act in good faith and base the decision solely on what is in the best interests of the CAA.
- **Demonstrate Fairness.** Before approving the transaction, demonstrate that it is fair to and in the best interests of the CAA.
- **Exclude Interested Parties from the Deliberations.** The individual with the conflict should not be present while the board or other party making the determination discusses the transaction, except for making an initial presentation or responding to questions. If a board member, the individual should not be present for the board vote, or counted for purposes of determining whether there is a quorum.
- **Review and Approval by Independent Board Members.** Any conflict transaction requiring board approval should be approved by independent board members who constitute a majority of all board members (unless the CAA's articles of incorporation or bylaws require a higher percentage). An independent board member is usually defined as one who is neither an employee nor is involved in any conflict of interest transactions himself or herself.
- **Satisfy Tax Law Requirements.** The board should conduct the process so as to permit reliance on the rebuttable presumption in Section 4958 of the Internal Revenue Code—this provision is referred to as the “intermediate sanctions.” The decision should be made by an independent board, be supported by appraisals or other evidence demonstrating that the transaction's pricing reflects fair market value (or a bargain to the CAA), and there should be a contemporaneous written record that lists the comparables or bidding process that the board relied on and describes the basis for the decision. (See Part II for a more detailed discussion of the intermediate sanctions).



- **Sanctions.** The policy should define the consequences if someone violates it; people are more likely to take the policy seriously if violations carry consequences.

- **Sanctions and Employees.** Any sanctions should be integrated with employee policy handbook. Terminating an employee is risky business, even when the person is an at-will employee. By providing notice of any sanctions, the CAA will support the termination and may head off litigation.
- **Sanctions and Board Members.** When a board member violates the policy, involuntary removal can be difficult, particularly if the board member has been elected or appointed by an outside group, elected official, or constituency, as is often the case with CAAs. Some state laws do not allow a board to remove such members; the entity that designated the individual must do so. Any sanctions provided for in the policy should be integrated with the relevant portions of the CAA's bylaws, articles of incorporation, and other organizational documents. This is one example of why it may be preferable to include a provision in the bylaws for removal for cause and to make all appointments to the board advisory only; subject to election by the board as a whole.

■ **Disclosure.** The policy should require each covered person to disclose actual and potential conflicts in a timely manner. An annual conflicts of interest disclosure questionnaire, which serves as a reminder to covered persons that the CAA has a conflict of interest policy and that compliance with it is both important and expected, is recommended. A questionnaire also can serve as a tax-compliance tool. Organizations (most if not all CAAs) required to file a Form 990 must disclose extensive information to the IRS, and sometimes to state regulators, pertaining to certain related-party transactions and relationships among board members. The disclosure requirements are complex, but the instructions to the Form 990 permit the organization to rely on an annual questionnaire in fulfilling the disclosure requirements. Auditors also typically require disclosure of related party transactions.

Implementing a Conflict of Interests Policy

Each CAA should integrate its conflict of interest policy into its operations. Although there is no “right” way to do this, here are a few suggestions:

- **The Form.** People often speak of a conflict of interest policy without giving much thought to its physical form. Some organizations have one written document. This is simple and convenient, but it may not be the best way to communicate the policy to different audiences.
 - **Board Members.** The CAA should distribute the master policy to all board members.
 - **Employees and Officers.** In the case of employees, the CAA should consider two versions of the policy. The first should be distributed to officers (including board members who are officers) and key employees and look similar to the one distributed to board members, but will contain the appropriate requirements and references for key employees and officers. The second should be one or two paragraphs notifying all employees of the overall policy. It should be included in the employee handbook.
 - **Head Start Policy Councils.** CAAs operating Head Start programs should distribute an appropriately modified version of the policy to members of the Policy Council.
- **Notification.** Individuals who are subject to the policy and faced with a potential conflict should be required to notify someone who is in a position to address the issue.
 - **Board Members and Officers.** Board members might be asked to notify the board chair of any potential conflicts. Or the policy might require board members to notify the board’s audit committee.
 - **Key Employees.** Key employees might be asked to notify the executive director because s/he is the intermediary between them and the board. In large CAAs, key employees who don’t have regular contact with the executive director might be asked to contact someone in the HR department.
 - **Head Start Policy Councils.** Notification could go to the chairperson of the Policy Council and the Head Start director.

Conflicts are the acid test of a board’s determination to act ethically. People on boards know and often trust each other, which means their natural inclination is to do each other favors and think the best of each other. Those tendencies often blind boards to the problems associated with conflicts, particularly problems of perception.

CASE SCENARIO: TONE AT THE TOP

Over the years, BCA has regularly done business with members of its board of directors. It has borrowed money from a board member’s bank, purchased property from a board member, and used a board member’s printing company to meet its printing needs. The board has always rationalized approving transactions with insiders on the grounds that the insiders are either volunteers or work for “nonprofit” wages even though they could earn more in the for-profit sector. Assume for purposes of this example that BCA does not operate a Head Start program.

For years, Sam Melvin, BCA’s chief bookkeeper, has taken note of these deals with insiders. He finally decides that it is time for him to “get his.” As a result, he puts in place an elaborate scheme involving phantom vendors, permitting him to steal money from BCA. When Melvin is caught, he tells the FBI:

Despite all the conflicts I noticed and how others were getting rich at the expense of BCA there still remains the question of myself. As I allude to in the last paragraph I did convert BCA

funds, goods and service to my own use. I am not sure when this began, but probably around late 2010. Like all schemes it started out discreetly and grew. I am ashamed and remorseful for these actions and offer no credible excuse for what I did. At some point I guess I began to feel that I should be getting my fair share, at least this is how I rationalized my use of BCA resources.¹

LESSON: In his letter, Sam Melvin contended that seeing everyone benefitting from their positions with the nonprofit served as the catalyst for his wrongdoing. In other words, the tone at the top, or at least perceptions regarding that tone, influenced behavior. Employee perceptions are one reason to avoid conflicts, or at least to have a policy that ensures that any conflicts don’t disadvantage the CAA and are out in the open.

¹ Quote is based on a pre-sentencing letter written by a nonprofit executive to a district court judge in a federal criminal case. The executive was subsequently sentenced to 15 years in prison for stealing somewhere around \$1.5 million from his employer, a well-known nonprofit.

A CAA's board may believe there are circumstances that justify a transaction with an insider (i.e., board member, officer, key employee, or another person or entity with a relationship with the CAA), assuming that type of insider transaction is not prohibited by a funder, such as Head Start. For example, particularly in a small town, the insider transaction may truly offer the best deal or the only provider of the service. If possible, however, the CAA's board should consider an alternative to these transactions, because conflicts can result in both foreseen and unforeseen problems. Possible alternatives include procuring goods or services from a business in another town, asking the board member to step down, or validating the transaction by the board member removing himself or herself from the discussion and vote and the board or committee making an independent determination as to whether the transaction with the board member is in the best interest of the CAA, or, conversely, if there is another business that would supply equivalent goods or services for a better price.

Conflicts are tracers. When organizations run into serious trouble due to poor governance and internal controls, the organizations are often riddled with conflicts of interest. Leaders of CAAs with existing conflicts should consider those conflicts more closely. Chances are the problems run deeper than the conflicts and warrant a fuller examination of governance and staff policies and practices.

Part II: Additional Legal and Regulatory Considerations

Federal Tax Law

Intermediate Sanctions

The intermediate sanctions are a comprehensive set of federal tax rules designed to ensure that transactions between Internal Revenue Code Section 501(c)(3) charities¹ and insiders reflect market values. The goal is to prevent "sweetheart deals." The sanctions apply to transactions between an organization and certain related parties. They also apply to compensation agreements.

The sanctions under Code Section 4958² are referred to as "intermediate" because they permit the parties to a transaction that is determined to be abusive, i.e. to reward an insider in excess of the fair market value, to reverse the abusive aspects of the transaction. Before the enactment of the intermediate sanctions, the only statutory remedy available to the IRS was to revoke the organization's tax-exempt status. That remedy is still available to the IRS, but it is generally limited to cases of clear and extensive diversion of charitable assets to private interests.

- **The Remedy.** The sanctions require the beneficiary of a transaction that is too favorable to the beneficiary to return amounts received in excess of market value to the exempt organization and to pay an excise tax potentially equal to 25 percent of the excess, if the beneficiary falls into one of the categories of designated insiders.
- **The Rebuttable Presumption.** The centerpiece of this regime is a rebuttable presumption that a transaction is reasonable if the charity adheres to certain procedures before entering into the transaction.³ Specifically, the organization must demonstrate that: (1) the transaction or arrangement was approved in advance by the board of directors (or a committee thereof); (2) such board (or committee) was comprised entirely of individuals who did not have conflicts as defined by the regulations; (3) such board (or committee) obtained in advance and relied on appropriate data as to comparability of the transaction's price with market values; and (4) such board (or committee) adequately documented the basis for its determination concurrently with the decision. The rules contemplate otherwise conflicted individuals recusing themselves from the process. The rebuttable presumption does not provide the organization or the insider with ironclad protection. The IRS can rebut the presumption; in other words the IRS

CASE SCENARIO:

DUALITIES OF INTEREST—PUBLIC SECTOR MEMBER OF THE BOARD

Director of City Grants Warren Yatzke serves as a public sector member of BCA's board; as the mayor's designee. Yatzke has never been excited about being a member of BCA's board. He finds the organization to be poorly run and inefficient. He repeatedly has tried to correct the deficiencies, but has met with continued resistance from entrenched management.

BCA recently applied for a city grant to fund one of its programs. Even though he is a member of the board, Yatzke doesn't believe he can recommend to the mayor that the city award the money to BCA. Yatzke believes that the funds would be better utilized if awarded to Yellow Community Works (YCW), an organization that offers many of the same types of programs that BCA offers.

LESSON: Yatzke faces a conflict rooted in his dual positions. As a member of BCA's board, Yatzke owes BCA a duty of loyalty. He should be doing everything possible to further BCA's mission, which arguably means that Yatzke should advise the mayor to award the grant to BCA. However, Yatzke, as a city employee, also has a duty to the city to recommend that the grant be awarded to the most worthy organization, which clearly is not BCA. It is unlikely that BCA or the state attorney general would successfully win a lawsuit against Yatzke were he to recommend that the grant be awarded to YCW, but BCA's board and management are likely to be less than pleased with Yatzke, reducing his effectiveness. In situations like the one in this example, everyone should agree in advance about the protocol for dealing with this sort of conflict and adjust their expectations accordingly.

can challenge the transaction and attempt to prove that it was not fair to the organization by proving, for example, that the comparables relied on by the organization were not reasonable or appropriate in the circumstances that existed at the time of the board's decision.

If the organization does not follow these steps, the transaction is not automatically unreasonable or considered an "excess benefit transaction," but the nonprofit will have the burden of proving the reasonableness of it if the IRS challenges it.

■ **Disqualified Persons.** The intermediate sanctions only apply to transactions between the organization and individuals who are referred to as "disqualified persons." A disqualified person is anyone who was in a position to exercise substantial influence over the organization during the five-year period before the transaction in question. Examples of disqualified persons include voting members of the board, the president, chief executive officer, chief operating officer, the treasurer, the chief financial officer, and other persons who have substantial influence over the affairs of the organization. An employee who receives less than \$110,000 in total compensation during the 2011 tax year (this number is indexed for inflation and adjusted annually) generally will not be considered a disqualified person if the employee is not a voting member of the board or one of the officers named earlier. There are related-party rules which can cause someone otherwise not considered to be a disqualified person to be treated as one because of family membership or beneficial ownership interests.

This is only a brief summary of the intermediate sanctions. These rules are quite complex. For a more detailed discussion, the IRS has published a guide available on its website.⁴ Consultation with an attorney and/or accountant is also advised.

Form 990 Required Disclosures

The IRS requires tax-exempt organizations to make numerous disclosures on Form 990 concerning transactions with insiders and related organizations.⁵ The definitions, contained in the instructions to Form 990, are often quite complicated and therefore require careful reading. Even if an accountant prepares the Form 990, the persons reviewing and signing the form should speak to the accountant to ensure an understanding of the required disclosures.

Form 990 also requires responses to questions concerning whether the tax-exempt organization has a written conflict of interest policy, whether it requires annual disclosures of conflicts, and whether it monitors and enforces compliance with the policy.⁶

Federal Grant Requirements

Procurement Regulations

The rules governing the use of federal grant funds to buy goods and services look unfavorably upon conflicts of interest. The existence of a conflict could result in the denial of a reimbursement request or a claim for repayment of funds already advanced. It could also result in termination or non-renewal of the grant and audit or monitoring findings. OMB Circular A-110, the grant administration standards for nonprofit recipients of federal grant funds, requires grantees to "maintain written standards of conduct governing the performance of its employees engaged in the award and administration of contracts."⁷

Since all CAAs are subject to this regulation as recipients of federal Community Services Block Grant funds, they should ensure that these standards are followed. In essence, OMB Circular A-110:

- Prohibits employees and officers from participating in the selection, award, or administration of a procurement contract funded by federal grant funds if they have a real or apparent conflict of interest; and
- Defines "conflict of interest" to mean whenever:
 - an employee or officer;
 - a member of his or her immediate family;
 - his or her partner; or
 - An organization that employs or is about to employ any of the parties described above has a financial or other interest in the firm selected for an award.

In addition, OMB Circular A-110 prohibits gifts from vendors other than those of insignificant value. Grantees are permitted to set standards for situations in which the financial interest is not substantial or the gift is an unsolicited item of nominal value.

To ensure that these standards are followed, they should be included in a personnel policy handbook and employees, particularly those who have a role in selecting vendors and administering vendor contracts, should receive training on them. The Circular also requires the standards of conduct to provide for disciplinary actions to be applied for violations of such standards.

The standards of conduct shall provide for disciplinary actions to be applied for violations of such standards by officers, employees, or agents of the recipient.

One recommended step, in addition to having such employees complete and sign annual conflict of interest disclosure forms, is to include a question or certification on vendor bidding or selection documents and/or contracts to the effect that they do not have a prohibited conflict of interest, as defined by the definition above, and have not and will not in the future offer gifts to employees or officers.

Professional Service Providers

No federal grant funds may be used by grantees to pay for professional services provided by officers or employees of the grantee.⁸ For example, a grantee may not use federal grant funds to pay attorneys fees to its Head Start director, who happens to be a lawyer, for advice in connection with a real estate transaction. Nor may the grantee use federal grant funds to pay the volunteer president of the board of directors, also an attorney, for such advice.

The Head Start Act

The 2007 amendments to the Head Start Act imposed very stringent conflict of interest restrictions on members of the governing board and the policy council. The Act now both generally prohibits board members from having financial conflicts of interest with the grantee and bans certain specific conflicts related to employment and compensation.⁹ Unlike other laws' conflict of interest provisions, it does not permit a prohibited conflict situation with a board member to be validated through a process of disclosure and approval by other board members.¹⁰ Some people might draw the wrong conclusion: that the organization needs a one sentence conflict of interest policy prohibiting all conflicts of interest. This is an overly simplistic approach. Like other CAAs, a CAA with a Head Start program requires a comprehensive conflict of interest policy.

The Act contains the following conflict of interest provisions:

■ **Financial Conflicts.** Board members may not have “financial conflicts of interest” with the grantee or a delegate agency. There is no provision for a process to approve the transaction if it is in fact in the best interest of the grantee to engage in the transaction; it is just outright prohibited. In other words, if a grantee finds itself wanting to do business with a board member, it has only two choices: ask the board member to resign, or don't do business with him/her. The Act does not define the term “financial conflict of interest,” and the Office of Head Start has not adopted any regulations on this issue. Although the Office of Head Start has posted a Policy Clarification on the conflicts of interest provision generally, it really does not provide any clarification on the definition of financial conflicts.¹¹ Thus, the grantee needs to define the term for itself. This is not a difficult determination when the grantee is doing business directly with a board member. The phrase clearly contemplates sales and exchanges of goods, services, and property; loans and other extensions of credit, and leases.

The provision does not explicitly address, however, whether the ban applies to just direct conflicts with the board member, or also includes indirect conflicts, such as a transaction with the board member's spouse, an entity owned by a board member, or an entity that employs the board member. CAPLAW recommends that the grantee's written conflict of interest policy define the term and that the coverage and the scope of the coverage be determined by the extent of the potential influence of the financial interest on the board member.

- For example, one could reasonably assume a board member who is the sole owner of a corporation that operates a small plumbing business from whom the grantee wants to purchase services is likely to have a material financial interest in the grantee engaging in that transaction. Therefore, that type of conflict (100 percent ownership) would likely be considered a prohibited financial conflict of interest under the Head Start Act, even though the transaction is with the corporation and not the board member directly.
- But is a grantee prohibited from acquiring office supplies from a company that is one percent, five percent, or twenty percent owned by a board member? The IRS's intermediate sanctions set the threshold at 35 percent. Other standards, such as those of the Financial Accounting Standards Board, would look to the extent of control by the board member over the decision of the grantee, rather than a set percentage of ownership.¹² Other factors may be the dollar amount of the transaction or the portion it represents of the total revenue of the business. The sample conflict of interest policy for board members of CAAs with Head Start programs included in Appendix C in the online version of this toolkit (available at www.capl原因.org) sets the materiality threshold at 5 percent of ownership of the business, but also includes a catch-all statement that covers any situation where the board member has a material financial incentive to engage in the transaction, such as receiving a commission based on the sale or a bonus tied to the business with the grantee.
- Clearly, defining a “financial conflict of interest” is more of an art than a science, but a good faith effort to define the term in the policy, using reasonable criteria and common sense, should go a long way toward staying out of trouble on that issue. The Office of Head Start has said this about addressing conflicts:

OHS suggests that Head Start agencies faced with a conflict of interest situation should examine the facts, analyze the issues, and make a determination about how the situation will be handled. The agency is advised to make a record of the conflict of interest situation, how it was resolved, and why it was resolved in a particular way.¹³

- When in doubt, consult legal counsel and/or run the transaction past the Office of Head Start.

CASE SCENARIO:

DUALITIES OF INTEREST— LOW-INCOME MEMBER OF THE BOARD

Larry Hartford is a member of the BCA's board of directors. He holds one of the board positions allocated to low-income community members. Due to cutbacks in federal funding, BCA's board is considering whether to eliminate a program with high overhead costs that are ineligible for reimbursement under a federal grant. Hartford is troubled by this idea, but he recognizes the problem that BCA faces. He has heard from many members of the low-income community who have urged him to fight for the program. He has lost much sleep over this decision. As a representative of the community, he would like his vote to reflect the community's concerns and desires, but he also doesn't want to place BCA in financial jeopardy.

LESSON: The law provides little guidance to people facing Hartford's predicament. As a board member representing an important constituency, Hartford certainly should give voice to the interests of the low-income community. However, as a board member, Hartford has a duty to act in BCA's best interests. Hartford must try to reconcile what are conflicting interests or perspectives. State law probably provides him with some degree of latitude, but many corporate law experts would likely agree that Hartford should not focus just on the desires of his low-income constituency when casting his vote.

- **Receipt of Compensation.** Board members cannot receive compensation for service as members of the board or for providing services to the grantee.

Although a member of the governing board cannot receive compensation for service as a board member, OHS does permit the grantee to establish policies and procedures to reimburse board members for reasonable costs actually incurred by members, such as transportation and child care expenses, if associated with participation in board and committee meetings. Reimbursement may be limited to low-income board members.¹⁴

- **Employment-Related Conflicts.** Neither board members nor members of their immediate family may be employees of the grantee, whether in Head Start or elsewhere in the organization. A person's immediate family includes the person's "spouse, parents and grandparents, children and grandchildren, brothers and sisters, mother-in-law and father-in-law, brothers-in-law and sisters-in-law, daughters-in-law and sons-in-law, and adopted and step family members."¹⁵

- **Operating As an Independent Entity.** The board must operate as an entity independent of grantee staff.¹⁶

- **Head Start Policy Councils.** Policy Council members may not have a conflict of interest with the Head Start grantee or any delegate agency. This prohibition is broader than the one that applies to board members as it applies to all conflicts, not just financial conflicts.¹⁷ In addition, Policy Council members cannot receive compensation for serving on the Policy Council or for providing services to the grantee.

HUD Programs

Some U.S. Department of Housing and Urban Development grant programs from which CAAs may receive funding also face significant additional conflict of interest restrictions. These rules limit the ability of individuals who have a role in an entity receiving direct grant funding from HUD to also serve a role at the entity serving as a subgrantee of the HUD funding. For example, a member of the city council of the locality receiving Community Development Block Grant (CDBG) funds may not also serve on the board of a CAA receiving CDBG funds from the city, assuming she exercises any functions or responsibilities regarding CSBG activities or votes, or could vote, or could gain inside information on who receives CDBG funds from the city. The reason is that would violate the HUD rule that:

No person who is an employee, agent, consultant, officer, or elected official or appointed official of the grantee, or of any designated public agencies, or of subgrantees, who exercises or has exercised any functions or responsibilities with respect to CDBG activities, or who is in a position to participate in a decisionmaking process or gain inside information with regard to such activities, may obtain a financial interest or benefit from a CDBG-assisted activity, or have a financial interest in any ... agreement with respect to a CDBG-assisted activity, or with respect to the proceeds of the CDBG-assisted activity, either for themselves or those with whom they have business or immediate family ties, during their tenure or for one year thereafter.¹⁸

Although not every HUD office or program necessarily interprets this rule in the same way, and the extent of a local official's involvement in the HUD programs may vary, the conflict issues raised by these HUD regulations should be considered when selecting CAA board members and/or applying for certain HUD funds, such as CDBG, the HOME program and the Emergency Shelter Grant program. One possible solution for CAA public sector board members is for the public official to appoint a representative (preferably someone who is not a public employee) who serves as the CAA board member, rather than the public official himself. Another possible resolution is to seek a waiver of the provision from HUD, which the rules permit under certain circumstances.

State or Local Conflict of Interest Rules

Some states and localities have their own conflict of interest restrictions on the ability of public officials to serve on boards of entities that receive funding from them if those public officials have a role in the selection of the funding recipients or the administration of the grants or contracts. Even if such board service is not prohibited, the public official may be required to recuse himself from taking part in discussions or votes on those matters, be it in the CAA and/or in the government. Speak to the elected official and a knowledgeable attorney to avoid problems in this area.

In addition, some states and localities have their own conflict of interest rules that apply to nonprofit organizations and other entities that receive government funding. These rules may be included in state laws and/or in funding contracts. Review your contracts carefully to ensure compliance with these rules in drafting the conflict of interest policy and engaging in any transactions with insiders.

Financial Accounting Systems Board (FASB)

Auditors follow FASB standards, which require that material "related party transactions" be disclosed in financial statements.¹⁹ States and other jurisdictions may also incorporate those standards into their rules. For example, Massachusetts generally limits the amounts paid in related party transactions (as defined by FASB) that are funded through contracts with the state to the lower of cost or fair market value.²⁰ FASB's definition of a "related party transaction" focuses on the control or influence that the organization insider or family member has over the other party with whom the organization is doing business. For example, a related party transaction includes transactions by a nonprofit with:

- Family members of the nonprofit's management who might control or influence a member of management; and
- Entities in which a person whose influence over the nonprofit is so significant that one or more of the transacting parties might be prevented from fully pursuing its own separate interests, has an ownership interest.

CASE SCENARIO: LOAN FROM A BANK

Muriel Litwin is the president of the Ten Spot Community Bank and she serves on BCA's board. BCA has been looking for a bank to provide a revolving line of credit to finance its working capital needs. Litwin proposes a loan at $\frac{1}{2}$ percentage point below prevailing market rate for comparable organizations. BCA's board views this as a win-win situation because it reduces BCA's financing costs and helps Ten Spot satisfy certain community lending requirements imposed by state law. Assume BCA does not operate a Head Start program.

At the time Ten Spot and BCA put the credit facility into place, BCA was financially sound, but during the last two years, BCA's creditworthiness has significantly deteriorated. Its outside law firm and CFO have determined that bankruptcy may be the only hope of keeping BCA's doors open.

BCA's finance committee is scheduled to meet today to hear a presentation from the CFO and BCA's law firm about BCA's deteriorating financial condition and plan for bankruptcy. Litwin is a member of the finance committee and will be in attendance.

LESSON: When an organization borrows money, both the organization and the lender expect that the loan will be repaid. Given those expectations, a loan like the one from Ten Spot to BCA looks like a good deal for both sides. Circumstances sometimes change, with the result that what seemed to be a good idea ends up highlighting serious conflicts of interest for those involved.

Litwin owes both BCA and her employer duties of loyalty. What is Litwin supposed to do with what she learns during finance committee's meeting? On the one hand, she can keep her employer in the dark, respecting BCA's desire to position itself in the best position vis-à-vis Ten Spot. That means that Litwin is ignoring her duty to Ten Spot and its shareholders. Or, Litwin can inform Ten Spot of the problems and the likely bankruptcy, which could thwart BCA's efforts to place itself in the best position possible vis-à-vis its lender. That course may honor Litwin's duty to Ten Spot, but it clearly violates her duty to act in BCA's best interests.

Despite the obvious potential problems this sort of loan poses, there will be organizations and financial institutions that ignore them. In such cases, everyone should agree upfront about how the banker/board member will act should problems arise.

Endnotes

1. The intermediate sanctions also apply to Section(c)(4) organizations (social welfare).
2. 26 U.S.C. 4958.
3. 26 C.F.R. 53.4958.
4. <http://www.irs.gov/pub/irs-tege/eotopicho2.pdf>
5. Form 990, Part IV, and Schedules L and R.
6. Form 990, Part VI.
7. 2 C.F.R. 215.42
8. 2 C.F.R. Part 230, App. B __.37. (nonprofit grantees) and 2 C.F.R. Part 225, App. B __.32.
9. 42 U.S.C. 9837(c)(1)(C).
10. However, in Policy Clarification OHS-PC-E-029, which is only guidance and not binding authority, the Office of Head Start (OHS) said that in situations where there is a potential personal conflict of interest (as opposed to a financial conflict of interest of the board member) that is not otherwise expressly prohibited by the language in the Act, the conflict may be resolved through the exclusion of the board member from discussion and voting on the matter.
11. OHS PC-09-E-029. OHS Policy Clarifications are available on the Early Childhood Learning and Knowledge Center (ECLKC) website (<http://eclkc.ohs.acf.hhs.gov/hslc>).
12. FASB Accounting Standards Codification 850.
13. OHS-PC-E-029. Policy Clarifications are not binding law and are subject to change. They are useful for providing insight into OHS's thinking at the time the clarification is issued. As they are sometimes revised on or deleted from the website, CAPLAW recommends printing them out if a grantee intends to rely on them inc case a question is raised at a later point.
14. OHS-PC-E-030.
15. OHS-PC-E-029.
16. 42 U.S.C. 9837(c)(1)(C)(iv).
17. 42 U.S.C. 9837(c)(2)(C).
18. 24 C.F.R. 570.611.
19. FASB Accounting Standards Certification 850.
20. 808 C.M.R. 1.05.

SECTION 6: ADOPTING A WHISTLEBLOWER POLICY

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A whistleblower policy is a governance policy that encourages an organization’s employees, volunteers, and other stakeholders to notify designated persons within the organization when they have concerns and suspicions regarding fraud, illegal activity, and other wrongdoing and that protects the “whistleblower” from retaliation. It is a policy adopted with increasing frequency by for-profits and nonprofits alike, particularly since the Internal Revenue Service has begun asking about it on the annual information return and auditors have begun asking about it in annual audits. But in order to be effective, the policy needs to be more than a piece of paper. The policy should be just one component of internal controls and communications strategies that inform decisions through open communications channels and a philosophy of rewarding, rather than punishing, those who come forward with information concerning problems in the organizations. This toolkit section addresses how to write and implement an effective policy, who should be covered by the policy, the legal background, tracking and reporting, and the role of legal counsel.

Part I: Reasons to Have a Whistleblower Policy

The board of directors of a Community Action Agency (CAA) is charged with organizational oversight. Its management is responsible for the CAA's day-to-day operations. Both the board and management rely on formal communication channels and reports to obtain the information necessary for decision-making. As everyone knows, there also are informal networks within organizations. Information that should be of interest to the board and management often resides in those networks, but the organization's formal systems aren't designed to capture it.

A whistleblower policy is one tool that both a CAA's board and senior management can use to surface critical information that might otherwise remain hidden until a problem arises or a crisis unfolds. In fact, there is convincing evidence that information received from whistleblowers is one of the most effective tools to do so. Surveys and studies conducted by several well-respected organizations, including the Association of Certified Fraud Examiners, the National Bureau of Economic Research, and PricewaterhouseCoopers, have shown that hotlines and employee and whistleblower reports lead the list of methods that have successfully detected fraud. Although no whistleblower policy can eliminate all risk or surface all information, the following are areas where an effective policy may permit a CAA to take the necessary steps to avert a crisis that would otherwise result in damage to the CAA and its mission:

Problematic Employment Practices

Despite management's best efforts, a supervisor or other employee may be engaging in illegal employment practices. An employee who is subject to discrimination or harassment may not know anyone in upper level management. A whistleblower policy and a culture that supports whistleblowers may result in that employee contacting someone within the organization rather than retaining a lawyer or contacting the Department of Labor.

Neglect of Children

Allegations of child neglect plague a Head Start program over a two year period. State officials threaten to revoke the licenses to operate the program's childcare centers. Ultimately, the federal Office of Head Start defunds the offending program. Given the severe consequences that can follow in the wake of allegations that children have been neglected or abused, every organization that serves children should make sure that those who might know or have inklings about abuse or neglect know how to report it and are encouraged to do so. In addition to inclusion in a whistleblower policy, every CAA with child care or Head Start programs should have a separate well-developed policy and procedure on reporting suspected occurrences of child abuse or neglect that conforms with its state statute(s) related to mandatory reporters of child abuse and neglect.

Financial and Contracting Fraud

Many CAAs rely on government grants and contracts for the vast majority of their funding. Embezzlement, reimbursement irregularities, and other types of financial fraud jeopardize contracts and grants. All too often, members of the accounting staff or other employees know about the wrongdoing or irregularities, but are afraid to voice their concerns. By encouraging individuals to communicate their suspicions, a CAA may be able to address a problem before its auditors or outside reviewers uncover it. By adopting a whistleblower policy, the CAA sets the right "tone at the top," as the auditors refer to it. When a CAA discovers and then addresses financial misconduct, auditors and reviewers are likely to view the organization as well-managed. Auditors and outside reviewers draw just the opposite conclusion when they are the ones who first bring the problems to management's attention.

All too often, members of the accounting staff or other employees know about the wrongdoing or irregularities, but are afraid to voice their concerns.

Poorly Run Programs

Service recipients may be dissatisfied with programs or employees and volunteers may know that government-funded programs are not in compliance with regulatory requirements. Comments from dissatisfied service recipients and disgruntled employees can prove embarrassing when made to federal and state monitors. More significantly, such comments can result in reduced funding or the non-renewal of grants. Once again, a CAA's best defense will be surfacing concerns before they come up during an audit, review, or in the press.

The recent interest of the Internal Revenue Service in whistleblower policies of tax-exempt organizations is likely another reason for an uptick in the adoption of such policies. Form 990, an informational return that is required to be submitted to the IRS by most, if not all, nonprofit CAAs, now asks whether an organization has adopted a whistleblower policy. The IRS has been clear that a whistleblower policy is not required for tax-exempt organizations; what is unclear is how the IRS plans to use the data collected. The IRS is currently analyzing data to determine how it should use the responses to this and other governance-related questions in determining which organizations it will select for audit. IRS officials have repeatedly said that a "well-governed organization is a tax-compliant organization." That sentiment suggests that the answers to the governance questions could play a significant role in determining whether a CAA is selected for audit. All the more reason a prudent CAA should adopt a whistleblower policy.

CASE SCENARIO:**THE NEED FOR A WHISTLEBLOWER POLICY**

Blue CAA (BCA) has a 28-member board of directors that has yet to adopt a whistleblower policy. Gloria Watson is BCA's hard-charging executive director. Her administrative assistant, Lance Richards suspects that Watson has been diverting funds from a grant to provide HIV/AIDS screening in the community through a reimbursement scheme. Richards, who was released from prison four years ago following completion of a sentence for armed robbery, has four children. He earns \$25,000 a year. With unemployment at 9.6 percent, Richards is very reluctant to "rock the boat" at work, but he is deeply troubled by Watson's scheme. He would like to let someone know about what he has observed,

but he doesn't know whom to contact and isn't sure how any report would be received given Watson's status and power. After months of considering what to do, Richards decides to remain silent, but to look for a new job. Several months later, monitors from HHS conduct a review of the program. During the course of the review, they discover that Watson has stolen \$59,000 in grant funds. They advise their superiors that HHS should not renew the grant.

LESSON: Although implementing a whistleblower policy can be time consuming, short-sighted organizations often pay a heavy price by failing to adopt one.

Part II: Legal Background

Many Laws Protect Whistleblowers

Whistleblower statutes generally do not mandate a policy or its contents. Instead, these statutes focus on whistleblower protections. Several well-known federal laws include provisions providing specific protections to individuals who report violations under those acts. These include the Americans with Disabilities Act, Comprehensive Environmental Response, Compensation and Liability Act, Fair Labor Standards Act, the Family Medical Leave Act, and the Occupational Safety and Health Act. Of particular note is Section 1513(c) of Title 18 to the United States Code, which provides:

Whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense, shall be fined under this title or imprisoned not more than 10 years, or both.

This provision, which was part of the Sarbanes-Oxley Act Of 2002, applies to "whomever," which includes nonprofits and their board members, officers, and employees. It outlines the element of a crime. It can lead to a prison sentence.

In August 2005, the National Conference of State Legislatures released a survey of state whistleblower laws. It reported that 32 states provided statutory protections to whistleblowers. Many of these states limit the protection to public employees, but some states also protect private-sector employees. California is such a state. Its labor code provides that is unlawful for an employer to retaliate against an employee who discloses information to a government or law enforcement agency, when the employee reasonably believes that the employer has violated a state or federal statute or regulation, or with reference to employee safety or health, unsafe working conditions or work practices in the employee's employment or place of employment. The employer may be required to reinstate the employee's employment and work benefits, and pay lost wages. Connecticut, Florida, Michigan, New Jersey, New York, and Ohio have similar laws. Many state laws also protect employees against firing if it would violate "public policy," which could include, for example, terminating an employee because she reported an employer's illegal actions.

Tip

CONSULT LEGAL COUNSEL BEFORE DRAFTING POLICY

No whistleblower policy should be drafted without thoroughly reviewing applicable federal and state statutes in consultation with legal counsel. Of particular concern, is the need to understand the state laws pertaining to whistleblower protections.

The scope of the federal law and state law applicable to a particular CAA may impact the scope of the CAA's whistleblower policy. When examining these statutes, CAAs and their attorneys should keep the following questions in mind:

- Does the statute protect just governmental employees, or are private sector employees also protected?
- Even if the statute's protection is limited to just governmental employees, how does it define members of that group? Might employees of an organization subject to open meeting or record laws be granted statutory protection?
- Does the statute only provide protection in the case of external reports to governmental agencies, or does it also protect those making internal reports to people employed by the CAA?
- Is the protection limited to reports of only certain types of activity, or does the statute protect all reports?
- If the report turns out to be false, are there limitations on what actions the CAA can take to sanction the employee for making a false report?

Some Laws and Government Agencies Encourage Reporting and Reward Whistleblowers

Many government entities maintain hotlines to encourage reporting of waste, fraud, and abuse of government funds and resources, including grants and contracts awarded to nonprofits. For example, programs funded by the American Recovery and Reinvestment Act are required to post a whistleblower notice that includes a phone number to contact the Recovery Board Fraud Hotline. Many federal agencies' inspector generals' offices also have fraud hotlines.

In addition, some statutes reward whistleblowers. Legislatures and governmental officials recognize that determining whether governmental funds have been misused is not an easy task. To minimize the effort, many governmental entities deputize employees, volunteers, and others to blow the whistle. Under what are termed "false claims" acts, whistleblowers share a percentage of recoveries of misused government funds. The best known of these statutes is the Federal False Claims Act, but there are state and local analogues.

Most employees do not know about the Federal False Claims Act, but if they have a concern about illegal activity, they might do a web search on the term "whistleblower," or the phrase "report illegal activity." Search results will reveal dozens of law firms willing to assist employees in their efforts to report fraud and abuse involving government contracts and grants. These law firms are not acting out of benevolence. They agree to provide legal assistance in exchange for a percentage of any reward paid to the whistleblower.

An employee, volunteer, or other person who believes that a false claim has been filed with the federal government can bring a legal action as a *qui tam* (as someone who acts on behalf of the king). In other words, the government is not necessarily the only entity that can bring legal action if a CAA knowingly makes a false claim under a governmental contract or grant. Of course, the employee or volunteer is unlikely to act alone when filing a suit. This is where the law firms that specialize in false claims litigation enter the picture. Under the statute, the employee or volunteer is entitled to receive at least 15 percent, but not more than 25 percent of the amount recovered. The lawyer looks to this reward for his fee.

An entire body of law has developed around false claims and *qui tam*. A complete discussion of that law is beyond the scope of these materials. What CAAs must understand is that by providing an internal path for reporting wrongdoing, the CAA may be able to avoid a fight with an adversary who is equipped and has the incentive to pursue a lawsuit on behalf of the government.

Many government entities maintain hotlines to encourage reporting of waste, fraud, and abuse of government funds and resources, including grants and contracts awarded to nonprofits.

Part III: Writing a Good Whistleblower Policy

A well-drafted whistleblower policy should encapsulate the CAA's needs, as well as its culture and internal structures. Those designing the policy should adopt the mindset of an employee who is reluctant to make a report, developing a procedure designed to mitigate that reluctance, which will generally require that the policy elevate "nuts and bolts" over generalities. At minimum, the policy should address the following issues:

Purposes

A well-designed whistleblower policy often requires several pages to communicate its details. Many stakeholders will not take the time to read the entire policy. Consequently, the policy should begin with a provision that outlines its purposes. This should be written so as to encourage someone who knows about a problem to keep reading. Here is illustrative language:

The Organization has implemented various policies and controls to ensure that its resources are used to further its nonprofit mission. While no set of policies or controls can eliminate all unethical or illegal behavior or prevent theft or misuse of organizational resources, the Organization's board of directors recognizes the vital role that employees and volunteers can play in bringing inappropriate or illegal behavior to the attention of the board and others who are in a position to respond. In recognizing the role you play, the board has adopted this whistleblower policy to encourage you to report your concerns to the appropriate individuals without fear of retaliation or harassment. The board asks for your assistance in protecting the Organization's assets, activities, and mission. We appreciate and recognize the importance of your role.

Intended Audience(s)

The policy should identify to whom it is directed. Employees are the obvious audience. The drafter should also consider addressing volunteers, vendors, and those served by the CAA. Because an effective whistleblower policy is directed to various audiences, the organization should consider adopting separate policies for each audience. More importantly, the relevant portions of the overall policy should be made available in ways that will be visible to and readily accessible to each audience.

- **Employees.** The whistleblower policy should be included in the employee handbook.
- **Volunteers.** The whistleblower policy should be incorporated into the volunteer handbook.
- **Vendors.** The organization's standard form purchasing contract should include language asking vendors to report wrongdoing and fraud.
- **Service Recipients.** Any information packet provided to service recipients should include a discussion of the whistleblower policy. This is particularly important for CAAs with Head Start programs and programs assisting other vulnerable groups. Head Start parents need to know how to report concerns over child neglect or abuse. School-age youth, the elderly and the disabled also can be subject to neglect and abuse, so their children and guardians should be aware of how to report concerns.

CASE SCENARIO:

NEED TO DISCLOSE WHISTLEBLOWER POLICY

Sarah Douglas runs a diaper distribution business. Max Sussman, BCA's purchasing agent, has been placing orders for an extraordinary number of diapers that he claims will be used in BCA's Head Start program. Douglas suspects that Sussman is selling some of the cartons of diapers to other programs and pocketing the money. Five years ago, BCA's board adopted a whistleblower policy. It attached the policy to the board meeting minutes and distributed it to employees. Other organizations that Douglas does business with usually include a statement on their

purchase orders about whom to contact if the vendor thinks there might be fraud. Although BCA's policy covers vendors, nobody has ever informed Douglas that the policy exists. She isn't sure whom to contact and decides to go about her business: "Why rock the boat if nobody seems to care?"

LESSON: CAAs must make sure that everyone who might have important information about fraud and other potential problems is aware of the policy.

Types of Concerns Covered by the Policy

The policy should identify the subject matter of allegations or types of concerns covered by the policy, which in most cases should include:

- Financial fraud
- Violations of the law
- Violations of federal procurement and contracting law
- Violations of conflict of interest policies
- Waste and/or mismanagement of organizational resources
- Workplace safety
- Workplace violence
- Employment practices (e.g., discrimination, harassment, and collective bargaining rights)
- Privacy violations
- Environmental concerns
- Substance abuse
- Service quality

The policy should list each subject matter covered by the policy as part of a laundry list, together with a general catch-all statement covering any illegal or unethical behavior.

CASE SCENARIO: TROUBLE WITH OPEN DOOR POLICIES

BCA's board desired to portray itself as very democratic and accessible. It adopted a whistleblower policy instructing employees to contact any board member with any problem. Several of the board members are lawyers, but most members have no legal or managerial experience, nor have most ever dealt with a whistleblower, when two separate whistleblower reports are made.

Situation 1: Harvey Mapplethorpe believes he was unjustly passed over for promotion. He contacts Celia Williams, his neighbor who serves on BCA's board, to complain about this perceived wrong. Mapplethorpe tells Williams that he thinks he was passed over because of his age. Williams is quite sympathetic, telling him that she sees how he was treated unfairly and that she will get the problem fixed. When Williams raises the issue with the executive director, she learns that Mapplethorpe has been chronically late for work and is unreliable in other ways. Wanting to avoid an embarrassing situation, Williams lets the matter slide into oblivion. Unfortunately, it doesn't. Mapplethorpe contacts a lawyer, informing him that even a board member told him he was treated unfairly. The lawyer files an age-discrimination suit on Mapplethorpe's behalf.

Situation 2: April Golden's daughter, Lilly, is in BCA's Head Start program. Lilly comes home from school upset. On questioning, Golden learns that Lilly believes Jenny Smart, a teacher, touched Lilly inappropriately. April immediately contacts Harold Wiley, a member of BCA's board. Wiley asks Golden to bring Lilly to one of his restaurants for questioning. He asks whether Lilly was fully

dressed when this happened, where Smart touched her below the waist, and whether others saw the incident. Lilly tells Wiley that her pants were down, that Smart touched her buttocks, and that other students were present. Wiley immediately sends a memo to the entire board, informing them that Jenny Smart sexually molested a student and there are witnesses. Following a thorough investigation, the staff learns from other students that Lilly was coming out of the bathroom with her pants drooping around her knees. Some boys were laughing and Lilly began to cry. Smart saw what was happening, rushed to her aid, and pulled up her pants and buckled Lilly's belt. Prior to the investigation, the local newspaper obtained a copy of Wiley's memo and published a story suggesting that Smart had molested a child. Smart has sued BCA for defamation.

LESSON: Unless a CAA is willing to provide training to the persons named as the recipients for whistleblower reports, it is asking for trouble. Moreover, not everyone has the temperament or experience to deal appropriately with reports. In most cases, an organization will be better off naming a few people as report recipients rather than a large number. Fewer candidates for reports provide the CAA with greater control over the process. The two situations demonstrate what can happen when people who don't regularly receive reports and have not undergone training respond to a report.

Reporting Concerns

The policy should specify whom the whistleblower should contact about the whistleblower's concerns. A whistleblower policy must recognize that the person designated to receive reports might be the subject of a report and should avoid designating just one person as the recipient for all reports from whistleblowers. Alternatives should always be offered. Conversely, CAAs should avoid open door policies that advise employees, volunteers and others to contact any member of the board of directors with their concerns. Unless each board member has undergone special training, this open-door policy is a mistake. As volunteers, most board members do not have day-to-day contact with the CAA. This makes it more likely that they don't fully know the CAA's inner workings. Moreover, without training, their natural response may not be the proper one. CAAs should provide potential whistleblowers options and ensure that anyone who is designated as a contact for whistleblowers should have some training in what is and what is not a proper response.

- **Immediate Supervisor.** Many whistleblower policies are written based on the assumption that a whistleblower wants to report his concerns to someone other than the whistleblower's immediate supervisor. This is a faulty and potentially damaging assumption. The policy could contain a statement encouraging whistleblowers to bring concerns to an immediate supervisor. This suggestion demonstrates why governance policies involve much more than just a piece of paper. Encouraging employees to approach their immediate supervisor first only makes sense if everyone is comfortable with this approach—a culture of collaboration. Fostering this sort of cooperation is in the employee's and the CAA's long-term interest because the supervisor-employee relationship is at risk if the employee "goes around or over" the supervisor.
- **Around or Over Supervisor.** In many instances, the whistleblower will be uncomfortable reporting his concerns to an immediate supervisor, particularly if the supervisor is the source of those concerns. A whistleblower policy should always provide the whistleblower with the option to report around or over his immediate supervisor. It should therefore designate the appropriate recipients. Each recipient should be identified by name and position, together with the preferred method of contact, including e-mail addresses or phone numbers.
- **Designated Subject Matter Contacts.** A CAA should consider designating different people as recipients of reports, with the designation determined by subject matter. For example, the policy might designate the CFO or the board's audit committee as the recipient of reports involving financial fraud and related matters. If the CAA has a lawyer on staff, the policy might designate the lawyer as the one who receives reports involving illegal activity and federal procurement law. Employment-related matters might be referred to the head of HR or the board committee that handles personnel matters.
- **Site-based Contacts.** Some CAAs have operations at more than one location. When that is the case, the policy should take the different locations into account. If, for example, a policy directs people to contact the head of HR regarding workplace discrimination, the policy should recognize that those at a satellite location may not have direct or easy access to the head of HR. The policy must provide these individuals with a reporting mechanism that takes that into account.
- **Fail Safe Contact.** The whistleblower policy should designate an alternative recipient for reports in cases where the matter involves the executive director or someone who is a designated report recipient. If the concern involves the executive director, the board's chair is the logical candidate. When the concern involves an employee other than the executive director, then the executive director is a logical choice as the alternative.
- **Alternative Contacts.** As noted, the policy should list report recipients by name. The CAA should consider alternative recipients in cases when the primary contact is out of the office on sick leave, vacation, or business. Some organizations advise potential whistleblowers to wait for the primary contact to return. This is a mistake. The precipitating event might be the first in a series of events that could quickly escalate. Equally important, whistleblowers are often reluctant to make a report. The first time the whistleblower picks up a telephone may be the last.

CASE SCENARIO: PROMISES OF ANONYMITY

Patrice Jones works in BCA's Head Start program and observes the head of the program engaging in discriminatory hiring practices. Wanting to see those practices put to an end, Jones reviews BCA's whistleblower policy. The policy states that BCA will use its best efforts to protect a whistleblower's identity from disclosure. She reports her concerns as instructed by the policy. BCA investigates and confirms that 15 men were denied employment because of their gender. BCA decides to make changes to its employment practices on a going-forward basis. Despite this corrective action, the men file a class action lawsuit against BCA. They allege that

many BCA employees were aware of the illegal practices. To prove their case, they ask the court to require BCA to turn over any reports from employees about those practices. The court grants their motion, and BCA reveals Jones' identity, as ordered by the court.

LESSON: The written policy should address anonymity, but should not promise to use best efforts to protect the whistleblower's identity, or otherwise suggest that it can prevent disclosure in all cases.

Confidentiality/Anonymity

A whistleblower policy should never contain an outright promise of confidentiality or anonymity because no organization can absolute guarantee such a promise. There will be instances when addressing the problem, no matter how delicately handled, will result in the whistleblower's identity becoming apparent to others even if the whistleblower's name is never explicitly revealed. Moreover, if the matter results in litigation or a government investigation, the CAA simply cannot guarantee that it will not be legally required to reveal the whistleblower's identity. The policy should address confidentiality as a means of encouraging whistleblower's to file reports, but make no guarantees. The policy certainly can indicate that the CAA will try to protect the whistleblower's identity. It should avoid using the phrase "best efforts" because some courts have interpreted such language in other contexts to require an organization to employ extraordinary means. Here is illustrative language:

The Organization's interest in being thorough in its investigation means that it cannot promise complete confidentiality, but it will act as discretely as reasonably possible. However, the whistleblower's identity may be disclosed in order to conduct a thorough investigation or to comply with applicable legal requirements.

Retaliation

To encourage whistleblowers, the policy should state that retaliation (i.e., harassment, punitive actions, termination) against those making reports will not be tolerated. It should also specify the consequences should someone retaliate against a whistleblower. If dismissal of the retaliating offender is warranted, stating that dismissal is a sanction provides the CAA with a possible defense against a wrongful termination suit. The CAA employee handbook and, if applicable, employee contracts should incorporate the consequences of retaliation, namely making it a basis for termination.

Threats of Violence

Unfortunately, there have been serious incidents involving workplace violence in recent years. The policy should advise potential whistleblowers to contact a supervisor, the executive director, or the authorities immediately following threats that could involve bodily injury or other catastrophic consequences.

Misuse of Policy

The policy should explicitly state that reports are encouraged, but that reports should not be filed regarding petty or trivial matters. It should also state that the CAA will not tolerate reports that are filed to gain an advantage in a personal dispute between two equals. The policy should require that reports be made in good faith.

Report's Content

The policy should ask the whistleblower to be as specific as possible in outlining his concerns. It should ask for names, dates, and a description of the incidents precipitating the report. It should also ask the whistleblower to describe any steps that he has taken to address the problem. The policy should advise the whistleblower to be as objective as possible and to avoid inflammatory or emotional language.

No Internal Investigations

The policy should state that the whistleblower should not undertake an internal investigation to obtain additional information before making the report.

Mandatory Reporting

Some organizations include a provision in their policies mandating that employees report wrongdoing as soon as they observe or learn of it. Failure to report can result in sanction. This mandate makes perfect sense; employees owe a duty of loyalty to their employers. However, CAAs should proceed with caution if they decide to impose any requirement that comes close to a mandate. Those charged with drafting such a provision should ask themselves: Should or can we expect a clerical worker who makes just above minimum wage to file a report implicating the executive director in wrongdoing, particularly when the circumstances may be ambiguous? To emphasize the dilemma confronting the clerk, assume he has three children under the age of 10 and unemployment in the community is at 20 percent. Some people may still be in favor of such a provision after considering those facts. They are not wrong, but they should then ask themselves two more question: When circumstances suggest that an employee may have known something, how are we going to distinguish between hunches, glimmering suspicions, and certitude? Will an inability to draw such lines result in inconsistent (or perceptions of inconsistent) enforcement that could lead to employment practices litigation? If the drafters still believe such a provision is warranted, they should take all of these questions into account in finalizing what should be a carefully worded mandate. An alternative might be devoting additional resources to increasing the level of pride that employees already have in mission, with employees then being more likely to voluntarily report wrongdoing. Being a matter of organizational culture, this approach will only work if the channels of communication are open and supportive.

Report Investigation and Resolution Process

To the extent possible, the policy should describe how the CAA will respond once it receives the report. For many individuals, filing a whistleblower report is a stressful experience. Everyone who has ever interviewed for a job or been on a date knows all too well about the speculation that follows the event: “I wonder why they haven’t contacted me yet, or whether I should call him.” The same is true for whistleblowers. Because each report will involve somewhat unique circumstances, the CAA will be unable to describe each detail, but the policy should describe the general process for handling reports and offer an estimate of the likely response time.

CASE SCENARIO: SAFEGUARDING REPORTS

Brian McLaughlin has long believed that Maxine Gold, his supervisor, has had it in for him. She openly criticizes him in front of other employees, makes him work overtime without permitting him to receive payment for the extra hours worked, has passed him over for promotion on countless occasions, speaks to him using vulgar language, and has even slapped him several times. McLaughlin decides that he has had enough when Gold suspends him without pay for three days for no apparent reason. Without that additional pay, he won’t be able to pay his mortgage this month. McLaughlin reviews the whistleblower policy in the employee handbook. It instructs him to report his concerns by e-mail to Jason Jones, BCA’s VP of Administration, which he does. Jones is out of the office, but he has left instructions with his administrative

assistant, Marcia Newhart, to review all of his emails. Newhart is good friends with Gold both inside and outside of the office. Upon reading McLaughlin’s e-mail, Newhart immediately informs Gold. She also destroys the e-mail. Gold responds by suspending McLaughlin for another six days. With all avenues closed, McLaughlin hires a lawyer, who files suit over the failure to pay overtime.

LESSON: The organization cannot rely on whistleblowers to secure their reports. It must put in place systems that secure those reports. In this case, BCA might have created a password-protected e-mail address and instructed Jones not to grant his administrative assistant access to the mailbox linked to that address.

Part IV: Internal Process

Adopting a written policy is insufficient without supporting it through internal systems. The process includes both the system for reporting the whistleblower’s complaint and the response to it.

Reporting systems should engender confidence in the whistleblower. CAAs should consider special e-mail addresses and phone numbers that are password protected. That security should be evident to the whistleblower through web disclosure (in the case of e-mail) or outgoing phone messages when the whistleblower is asked to leave his name and number. If anonymous reporting is envisioned, the policy should advise the whistleblower that a caller ID system is in use. This sort of warning adds credibility.

A better option might be an external, third-party hotline. Following the enactment of the Sarbanes-Oxley Act of 2002, publicly-traded corporations have increasingly looked to third-party service providers to maintain whistleblower hotlines for them and many nonprofits have followed suit. External hotlines have several advantages. Most importantly, they can accept reports on a 24/7 basis. As already noted, whistleblowers are often ambivalent about making a report, which means that a whistleblower may only make one attempt. Equally important, whistleblowers may perceive an external hotline as providing greater anonymity, which can be an important factor in the whistleblower’s decision whether to make a report. Whistleblower hotlines also offer computerized tracking, multi-lingual capabilities, and specially trained operators.

Tip

THIRD PARTY HOTLINES MAY BE MORE ECONOMICAL THAN YOU THOUGHT

CAAs may be reluctant to consider an external hotline because of incorrect perceptions about cost. Each CAA will need to obtain bids, but the annual cost can be surprisingly low, often in the \$1,000 to \$2,000 range. There is often an initial start-up fee. Several providers of external hotline services offer both call center and web-based reporting as part of one package. These services use a template for web-based reporting, but the template can be customized to meet the CAA’s specific needs and concerns.

CASE SCENARIO: INVESTIGATION FOLLOW-UP

Sidney Hurwitz heads up BCA's Responsible Fathers program. Sally Mann, who is an instructor in the program, files a complaint with HR, as the BCA whistleblower policy instructs, alleging sexual harassment from Hurwitz. HR conducts an investigation, determining that Hurwitz made several off-color jokes, but that nothing else had transpired. BCA requires Hurwitz to take a course designed to help him better understand boundaries and what is and what is not appropriate workplace behavior.

Several months later, BCA receives a notice that Mann's lawyer has filed a lawsuit alleging sexual harassment by Hurwitz and a hostile work environment. An investigation reveals that the course

had no impact on Hurwitz's behavior. In fact, Hurwitz began to verbally abuse Mann.

LESSON: BCA's initial response to Mann's complaint was a logical and appropriate one. It gave Hurwitz a second chance, but required him to undergo training that was designed to sensitize him to proper workplace behavior. BCA made one critical mistake. It failed to follow-up with Mann. Had there been proper follow-up, Mann might have informed BCA of the ongoing and escalating incidents. Instead, she sought recourse outside of BCA, which could cost BCA hundreds of thousands of dollars in defense and settlement costs.

How a CAA responds to a report from a whistleblower will depend on the specific circumstances, but a basic procedure should be established. In all instances, the whistleblower's report should be acknowledged soon as possible and the whistleblower should be given as much information about the resolution process and timeline as possible.

The next step is to determine the seriousness of the allegation and the depth and scope of the investigation necessary. Not all reports merit the same level of investigation; some may need just a quick meeting with the whistleblower to check on facts, while others may need multiple interviews with many parties, review of CAA records, or even involvement of an outside lawyer. A decision also needs to be made about who will make that determination.

Before beginning the investigation, a CAA should consider how it will conduct interviews with whistleblowers who have revealed their identity and with others who may have knowledge relevant to the investigation. The following are among the issues that the CAA should address:

- **Who will Conduct the Interview.** The CAA should assign two individuals to conduct the interview. The individuals should be objective parties and at least one should be a subject matter expert (e.g., an HR person for employment related concerns, a finance person for financial concerns).
- **Where the Interview Will be Conducted.** It might be possible to conduct the interview in the office, but the CAA should recognize that other employees who see the whistleblower or other interviewee entering a particular person's office may begin to speculate. Because of that possibility, potential whistleblowers might not be willing to come forward. A better option is to conduct the interview before or after hours, and/or in a location away from the interviewee's office and his colleagues.
- **Union Presence.** Whether a union representative must be present or contacted under the terms of any collective bargaining agreement.
- **Documentation.** How the interview will be documented. Unless the circumstances are unusual, a simple pen and notepad is probably sufficient, but there may be instances where a stenographer or audio recording is warranted.

Tip

TRUST BUT VERIFY

The individuals charged with investigating a whistleblower's concerns have a duty to look at all parties objectively and honestly. They must recognize any bias they might hold toward the whistleblower or the target of the report. The best approach to questioning is to keep the tone neutral and ask open ended questions that mirror the chronology of the events under investigation (When did you learn X? How do you know that? What documents do you have?). Investigators should collect, examine, and organize any and all documents, including emails or other electronic records, related to the whistleblower's concern and have the documents in-hand during interviews. Often, a chronological sequence of documents will provide a useful guide to discovering the true story.

Part V: The Role of Legal Counsel

Not every response to a report made by a whistleblower need be reviewed by a lawyer, but the importance of legal counsel should not be overlooked or ignored. CAAs should have a lawyer review any proposed whistleblower policy. This should not be a lawyer who is a member of the board and practices in the area of family, bankruptcy, real estate law, or personal injury law, as just four examples. It should be a lawyer who is knowledgeable about corporate governance and employment law.

A whistleblower report may be the result of an honest misunderstanding. In those instances, the CAA should be able to clear up the misunderstanding and smooth any ruffled feathers. In other instances, the accusations may be more serious. The CAA may discover that the accusations are totally unfounded, or it may learn that the denial is patently false. The CAA may even learn that there has been a cover-up or conspiracy. In these instances, someone is likely to be terminated. Given the cost of employment practices litigation, a CAA that tries to handle the matter without the benefit of legal counsel has engaged in false economy. Get competent legal counsel involved early.

On occasion the executive director or another senior manager is accused of wrongdoing. There may be allegations involving reimbursement practices, kickbacks, conflicts of interest, excessive compensation, or sexual harassment. Ascertaining the facts

A log permits management and the board to systematically review complaints, potentially revealing recurring problems that the board or management should address through changes in policy, personnel, or procedures.

may require an investigation. This sort of investigation is often best carried out by special legal counsel. Although an organization cannot hide the unfavorable facts from a legal adversary by using legal counsel, lawyers generally believe that a good portion of legal counsel's efforts are protected as attorney-client communications and attorney work-product. Often of greater importance, outside legal counsel brings objectivity that an internal investigator may lack. There are lawyers around the country who specialize in internal investigations. By retaining one of these individuals, the CAA gains the specialized knowledge of someone who is experienced with investigation and responding to a crisis.

Part VI: Documenting and Tracking Whistleblower Reports

CAAs should maintain a dedicated log where every whistleblower report is recorded and then tracked. This helps ensure that a report isn't lost, overlooked, or forgotten. Logging has the added advantage of facilitating efforts to audit the whistleblower policy as a log permits management and the board to systematically review complaints, potentially revealing recurring problems that the board or management should address through changes in policy, personnel, or procedures.

A log should identify the whistleblower, the person who received the report, the time and date of the report, each person who was involved in the response, the steps taken to resolve the matter, the date when the CAA responded to the whistleblower with the final outcome of the investigation, a description of the outcome, and an assessment of whether the whistleblower was satisfied with the response.

- **Security.** Procedures must exist to secure and limit access to the log. If the log is in paper form, it should be in a locked safe or other secure place. If digital, the log should be encrypted and password protected.
- **Follow-up.** The process should include appropriate follow-up after the whistleblower's concerns have been addressed. For example, a student in a class offered by a CAA might make a report alleging sexual harassment. The ensuing investigation might determine that there was an honest misunderstanding. Nevertheless, at appropriate intervals after the matter was resolved, someone should contact the student to make sure that he continues to feel comfortable with the outcome and that there have been no further incidents.
- **System Audits.** At least once a year, someone should audit the process by reviewing all or a representative sample of reports to make sure that the CAA has been complying with the policy and related procedures when responding to reports.
- **Review.** At least once a year, the board and management should review all reports made under the policy. They should be looking for commonalties, with an eye toward recurring problems.

Part VII: Tone at the Top

Culture plays a significant role in all matters of governance. Any organization can put words on paper. Those words can inspire people in the organization to do the right thing. Alternatively, they can serve as cover for an organization that is fundamentally corrupt. No one will make a report if the CAA's culture is repressive or retaliatory. People simply won't believe the words written on the paper, no matter how eloquently stated. Potential whistleblowers have often had years to observe upper management's behavior and office politics. Whistleblowers will come forward if the board and management have set the right tone, but setting that tone requires more than words.

CASE SCENARIO:

ANNUAL REVIEW OF REPORTS MAY REVEAL PATTERN

BCA manages a number of affordable housing projects. Several staff members are charged with reviewing rental applications. During the last several years, five Asian-American applicants have written letters to BCA's executive director, Gloria Watson, complaining that despite meeting all of the income thresholds and other requirements, their applications were turned down. Watson always responds promptly. She has never received any follow-up communications from any of the applicants after she sends a response.

The truth is that Watson perceives Asian-Americans as difficult tenants, so Watson is happy that the staff is turning them down. Under BCA's whistleblower policy, Watson is named as a recipient for reports under the policy. Larry Wiggins, an employee who works in the affordable housing program, has received a lot of pushback from the Asian-American community about Watson's responses. Wiggins is afraid to report that pushback because the whistleblower policy states that all concerns should be made to known to Watson.

Out of nowhere, Watson receives notice that she and BCA have been named in a class-action lawsuit for housing discrimination. Ten Asian-Americans are the lead plaintiffs. The board is shocked to learn of the allegations.

LESSON: Had BCA's whistleblower policy specified that the board chair be notified when concerns involve Gloria Watson, the board might have seen the same discriminatory pattern that caused the lawyer to file a lawsuit. Both the board and management can derive important benefits from a whistleblower policy. The policy can place management in a position to respond to issues before they blow up in management's face. The board gains a tool to assist it with its oversight responsibilities. If the policy does not designate the appropriate persons for notice, the policy does the CAA no good.



APPENDICES



178 Tremont Street, 10th Floor, Boston, MA 02111 | Phone 617-357-6915 FAX 617-350-7899

SECTION 1

Making Board Meetings Matter

Appendix A






Sample Meeting Minutes

SAMPLE MEETING MINUTES

The following examples of board meeting minutes are based on those of an actual Community Action Agency. The specific location, state, all names, and some details have been changed. CAPLAW annotations highlight points made in *Why Board Meetings Matter and How to Get the Most Out of Them*.

Overall, these minutes evidence a board that is involved in the development, planning, implementation, and evaluation of the CAA's program, and that engages in regular discussion of financial issues. Anyone reviewing these meeting minutes will recognize that this particular CAA takes its mission and governance seriously.

These minutes reflect the traditional view that the minutes should only record topics of discussion with related motions and actions, rather than recording the "thread of debate." Minutes that include a brief summary of points raised in the discussion would provide further support to the board's engagement in these issues.

CAPLAW COMMENTS	
BLUE COMMUNITY ACTION BOARD OF DIRECTORS MEETING MINUTES ~ APRIL 15, 2009	 Date
<p>The meeting was called to order by the Chair, Ms. Nilsson, at approximately 7:43 p.m. The meeting was held at Blue Community Action's Central City Center, 555 Commongood Street, Big City, Red/BlueState in the Conference/Training Room. The roll was called and it was determined that a quorum was present.</p> <p><u>INTRODUCTION OF NEW BOARD MEMBERS</u></p> <p>The Chairman, Ms. Nilsson, introduced new Private Sector Board Members: Mr. Mark Rodman, representing Ivy League University and Mr. Lou Espinosa, representing the Big City Bar Association.</p> <p><u>ADOPTION OF THE AGENDA</u></p> <p>Motion by Ms. Livingston that the proposed agenda for the April 15, 2009 Board of Directors meeting be adopted with the deferment to the June board of agenda item #4.a.(11) – Migrant Head Start Selection and Enrollment Criteria-Year 2009-2010 (Blue Sheet). Second by Mr. McDuff. Motion carried.</p> <p><u>APPROVAL OF MINUTES OF MARCH 19, 2009</u></p> <p>The Secretary, Mr. Clayton, made a motion that the minutes of the March 19, 2009 Board of Directors meeting be approved as submitted. Second by Mr. Simpson. Motion carried.</p>	<p> Location, presiding officer, and roll call/quorum determination.</p> <p> Records new appointments and notes classification within the tripartite structure.</p> <p> Notation of change from proposed agenda included in board packet.</p> <p> Prior meeting minutes approved without amendment.</p>

ANNOUNCEMENTS

★★A Poverty Forum session will be held on Wednesday, April 29th at the Clyde Center from 5:30 – 7:30 p.m. ★★A meeting of the Turning Leaf Place, Inc. and Mustard Seed Energy Fund, Inc. Boards will be held following the regular Board of Directors meeting.

COMMITTEE REPORTS


• Planning and Evaluation Committee


In the absence of the Committee Chairman, Mr. Hartford, the Program Development Manager, Mr. Sam Jones reviewed the committee reports. Mr. Jones reviewed the following reports that required Board action: ♦♦♦2009-2010 Annual Plan. Motion by Mr. McDuff that the Board adopt the 2009-2010 Annual Plan. Second by Ms. Livingston. (Brief discussion ensued.) Motion carried. ♦♦♦2009 Head Start Community Assessment. Motion by Ms. Livingston that the Board approve the 2009 Head Start Community Assessment. Second by Mr. McDuff. Motion carried. ♦♦♦2009 Migrant Head Start Community Assessment Update. Motion by Mr. McDuff that the Board approve the 2009 Migrant Head Start Community Assessment Update. Second by Ms. Livingston. (Brief discussion ensued.) Motion carried. ♦♦♦Head Start/Early Head Start 2009-2010 Grant Application. Motion by Dr. Litwin that the Board approve the Head Start/Early Head Start Grant Application for Program Year 2009-2010. Second by Ms. Livingston. Motion carried. ♦♦♦Head Start/Early Head Start 2009-2010 Training and Technical Assistance Plan. Motion by Ms. Livingston that the Board approve the 2009-2010 Head Start/Early Head Start Training and Technical Assistant Plan. Second by Dr. Varney. Motion carried. ♦♦♦Head Start/Early Head Start 2009-2010 Self-Assessment. Motion by Ms. Livingston that the Board approve the 2009-2010 Head Start/Early Head Start Self-Assessment. Second by Mr. McDuff. Motion carried.


Mr. Jones reviewed the Community Services Block Grant (CSBG) and Weatherization Site Visit Monitoring Report; the J.J. Browne Child Development Center Licensing and Regulations Plan of Correction Letter; the East BigCity Child Development Center Licensing and Regulations Plan of Correction Letter; the West End BigCity Child Development Center Licensing and Regulations Report and Response; the 2009-2010 Results Oriented Management and Accountability (ROMA) Outcomes Report; the 2009-2010 Annual Monitoring Report for the Marsha County God's Pantry Food Bank; and, the Monitoring Report and Response for the Child and Adult Care Food Program.


• Audit Committee

Committee Member, Ms. Nilsson, reviewed the Audit Committee Report and the recommendation that the Board ratify the committee's decision to award Big Accounting Firm CAPs and Consultants the June 30, 2009 – One Year Fixed Price contract in the amount of \$42,500.00 with options for two (2) additional one-year periods. All documentation will be retained on file in the Fiscal Office supporting issuance of an official purchase order. Motion by Ms. Livingston that the Board approve the recommendation. Second by Mr. Rodman. (Lengthy discussion ensued.) Motion carried.

 *BCA minutes detail the committee reports.*

 *In compliance with the Community Services Block Grant Act (42 USC 9910), BCA's board is engaged in planning, implementation, and development of programs; the minutes reflect the BCA board's attention to these matters.*

 *The notation of "brief discussion" of BCA's 2009-2010 Annual Plan" and the "2009 Migrant Head Start Community Assessment Update" suggest board members raised issues or had questions. A one or two sentence summary of the discussion would provide further evidence of the board's active engagement in planning and evaluation.*

 *The board and board minutes evidence attention to BCA's procurement policy and compliance requirements under OMB Circular A-110. However, BCA minutes might be strengthened with a summary of the key issues raised in the "lengthy*

FINANCIAL REPORTS

The Treasurer, Mr. Cruz, reviewed the Consolidated Balance Sheet and the Financial Statement for the period ending March 31, 2009 and made a motion on behalf of the Finance Committee that both reports be accepted for filing with one (1) vote. Second by Mr. Clayton. Motion carried. Mr. Cruz reviewed the following reports for the period ending March 31, 2009: Accounts Receivable; Line-of-Credit; Health Plan Financial Statement; and, the Unemployment Insurance Report for the quarter ending March 31, 2009

BUDGET AMENDMENTS

The Treasurer, Mr. Cruz, reviewed the Family Self-Sufficiency Coordinator Program 2009 Budget Amendment #1 and made a motion on behalf of the Finance Committee that the amendment be approved. Second by Mr. McDuff. Motion carried. Mr. Cruz reviewed the Management and Support Services 2009-10 Budget Amendment #2 and made a motion on behalf of the Finance Committee that the amendment be approved. Second by Ms. Livingston. Motion carried. Mr. Cruz reviewed the Sojourner CARE 2009-2010 Budget Amendment #1 and made a motion on behalf of the Finance Committee that the amendment be approved. Second by Ms. Fraser. Motion carried.

NEW BUDGETS

The Treasurer, Mr. Cruz, reviewed the **❶ Information Technology (ITS) 2009-2010 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Livingston. Motion carried. Mr. Cruz reviewed the **❷ Communications 2009-2010 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Livingston. Motion carried. Mr. Cruz reviewed the **❸ Human Resources 2009-2010 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Livingston. Motion carried. Mr. Cruz reviewed the **❹ YouthTech Program Planning 2009-2010 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Livingston. (Brief discussion ensued.) Motion carried. Mr. Cruz reviewed the **❺ Magpie County Pre-Kindergarten (Pre-K) 2009-2010 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Vernon. (Brief discussion ensued.) Motion carried.

EQUAL OPPORTUNITY QUARTERLY REPORT – (PERIOD ENDING 03/31/09)

Ms. Crouch, Manager, Administrative Services, reviewed the Equal Opportunity Quarterly Report for the period ending March 31, 2009.

OPERATIONS REPORTS – MARCH 2009

Ms. Watson, Executive Director, reviewed the Operations Reports for March 2009.

♦♦♦**Customer Survey Quarterly Update (Cumulative from April 2007-March 2009):**

discussion “ and reference to board packet Item 6 Audit Committee -- Designation Of Auditor, which can be found following these minutes.

☪ *A CAA board must engage in regular review of the CAA’s financial statements and CAA-wide and/or program budgets. BCA’s board fulfills this responsibility but the minutes would be strengthened by recording whether or not the board engaged in discussion of the information reviewed.*

☪ *BCA is moving toward paperless board packets; the minutes evidence a well-*

Ms. Watson reviewed. ♦♦♦**Board Communications:** Ms. Watson reviewed the report submitted by the Ad hoc Committee. The Committee recommended that the Board approve the following resolution:

- All official communications with the Board of Directors shall be available in both paper and electronic versions.
- Members and Representatives of the Board of Directors shall have the option to receive official communications in either paper or electronic version.
- Members of the Board of Directors who do not select an option for the format and delivery of official communications shall receive a paper version via the United States Postal Service or another comparable delivery service.
- The effective date of full implementation of the above decisions shall be June 16, 2009.

Motion by Mr. McDuff that the Board approve the resolution. Second by Dr. Litwin. (Lengthy discussion ensued.) Motion carried. (Board members will be sent a revised "Board Member Information Sheet" requesting email addresses and asking how they wish to receive the board packet. A deadline for the return of the responses will be set, if no response is received, from a board member, it will be presumed the board member wishes to receive paper copies of the board packet.)

Re: Board Meeting Days and Times ~ An ad hoc committee was appointed to discuss meeting days, times and other questions in the survey. Members will be Tiana Litwin, Leslie Chou, Caesar Cruz, Cindy Quense and Anita Nilsson.

NEXT MEETING

The next meeting of the BCA Board of Directors will be May 14, 2009 at 7:30PM

ADJOURNMENT

Motion by Ms. Livingston that the meeting be adjourned. Motion second and carried. The meeting was adjourned at approximately 9:28 p.m.

Cindy Quense	<u>MEMBERS PRESENT</u>	Marsha Harris*
Devon McDuff	Leslie Chou*	Mark Rodman
Anita Nilsson*	Ann Varney	Susan Gallagher
Hank Simpson*	Caesar Cruz*	Warren Yatzke
Delaney Clayton*	Mary Bissel	Albert Mason
Rita Newman	Mary Little	Tiana Litwin*
Lillian Vernon*	Melody Livingston	Alex Donovan
Gloria LeGrande	Lou Espinosa	Harold Wiley
	Sandra Fraser	

	<u>EXCUSED ABSENCE</u>	
Mag Davis	Larry Hartford*	Maureen Whipple

considered process and timeline and allow board members to opt out.

☉ *BCA minutes record follow up actions that emerged from lengthy discussion.*

☉ *Since a change in meeting schedule may negatively or positively affect board attendance and engagement, BCA will carefully study the matter.*

☉ *BCA is paying close attention to board attendance, including distinguishing between board members who notify BCA in advance and those who simply do not show up.*

Loretta Chapman*

Celia Williams

Kathy Johnson

ABSENCES

Noel Burke

Max Weingard

Pete Janko

Aki Taan

Ginny McNeal

Mickey Shay


Respectfully submitted,

Delany Clayton, Secretary

Date Signed

cc: Members, Board of Directors
Cabinet for Health and Family Services

*DENOTES EXECUTIVE COMMITTEE MEMBERS AS REQUIRED AT THE AUGUST 26,
2002 BOARD MEETING

 *BCA is monitoring
Executive Committee member
attendance more closely.*

ISSUE: AUDIT COMMITTEE REPORT -- DESIGNATION OF AUDITOR

DISCUSSION: A Request for Proposal for Audit Services (RFP) for the Period Ending June 30, 2009, with the option for two additional one-year periods, was prepared by Fiscal Operations and approved by the Audit Committee. The proposals were evaluated based on the following criteria.

A. Prior Experience	45 Points
B. Organization, Size, Structure	25 Points
C. Staff Qualifications	10 Points
D. Price	20 Points
Total Points Possible	100 Points

Audit RFPs were mailed to a list of auditors on February 26, 2009 who perform audits of other Community Action Agencies in the Red/Blue State and other firms that requested an RFP. Twenty-six (26) Audit RFPs were mailed to audit firms. The Audit RFP was advertised in the Big City News on Wednesday March 3rd, 2009. The deadline for all Audit RFPs to be submitted to Blue Community Action, Inc. was Tuesday, March 23, 2009, by 5:00 p.m.

The Audit Committee met on Wednesday, March 24, 2009 at 11:00 a.m. to open the sealed bids, assess points and select an audit firm. Those present were Kathy Johnson and Anita Nilsson. Absent were Max Weingard and Leslie Chou. Blue Community Action staff that attended were Howard Castle, Chief Financial Officer, and Sam Melvin, Staff Accountant.

Six (6) firms submitted a response to the Audit RFP. The following is a schedule of the firms, price and points awarded.

	Blue	Turning Leaf	Mustard Seed	5500s 990s	Total Price	Total Points
Moss & Stone	\$24,570	\$ 9,660	\$4,581	Included	\$38,811	73
Big Accounting Firm	\$27,500	\$ 5,000	\$4,500	\$ 5,500	\$42,500	95
Capra & Company	\$38,000	\$ 5,750	\$3,000	\$11,300	\$58,050	75
Hound & Co	\$47,660	\$12,018	\$6,815	Included	\$66,493	80
Steinway & Associates*	\$25,340	\$ 5,240	\$2,190	\$ 4,740	\$37,510	95
Golf, Base, & Bow **	\$31,500	\$ 4,800	\$3,500	\$ 5,300	\$45,100	59

* Steinway & Associates included \$2,000 per year increase for years 2 & 3

** Golf, Base, & Bow included \$1,600 increase for year 2 and another \$1,100 for year 3

Big Accounting Firm and Steinway & Associates both received 95 initial points. The audit committee looked more in depth at each firms qualifications and determined that Big Accounting Firm has experience auditing over 45 Community Action Agencies and Baldwin and Associates only had audit experience with 1 Community Action Agency.

Big Accounting Firm has been our auditor for the past 3 years and the agency has been very pleased with the working relationship and the results. The process led the Audit Committee to select Big Accounting Firm as our auditor for the fiscal year ending June 30, 2009 with the option of 2 additional years.

RECOMMENDATION: The Audit Committee recommends that the board ratify the committee's decision to award Big Accounting Firm the June 30, 2010 - One Year Fixed Price contract in the amount of \$42.500, with options for two additional one-year periods. All documentation will be retained on file in the Fiscal Office supporting issuance of an official purchase order

Drafted by:
Howard Castle
Chief Financial Officer

Approved by:
Leslie Chou
Chair, Audit Committee

Approved by:
Gloria Watson
Executive Director

Approved By:
Board of Directors on _____

**Blue Community Action BOARD OF DIRECTORS
MEETING MINUTES ~ NOVEMBER 16, 2010**

The meeting was called to order by the Chair, Ms. Nilsson, at approximately 6:30 p.m. The meeting was held at Blue Community Action's Central City Center, 555 Commongood Street, Big City, Red/BlueState in the Conference/Training Room. The roll was called and it was determined that a quorum was present.

ANNOUNCEMENTS

Meetings of the Turning Leaf Place and Mustard Seed Boards will be held following the "regular" Board of Directors meeting.

ADOPTION OF THE AGENDA

Motion by Mr. Clayton that the agenda for the November 16, 2010 Board of Directors meeting be adopted as presented. Second by Ms. Livingston. Motion carried.

APPROVAL OF MINUTES OF OCTOBER 19, 2010

The Secretary, Mr. Clayton, reviewed the minutes of the October 19, 2010 Board of Directors meeting and made a motion that the minutes be approved as submitted. Second by Ms. Livingston. Motion carried.

NEW COMMITTEE APPOINTMENTS FOR 2010-2011

The Chair, Ms. Nilsson, reviewed the proposed New Committee Appointments for 2010-2011 and made a motion that they be approved as submitted. Second by Mr. Hartford. (Brief discussion ensued regarding the make-up of the Consumer Sector.) Motion carried.

Board Members were advised to pay particular attention to the committee appointments to make sure they are aware of their assignment(s).

COMMITTEE REPORTS

• **Planning and Evaluation Committee**

Mr. Hartford, Committee Chair, reviewed the following reports: ♦♦♦Big City Urban County Government Tenant Based Rental Assistance (TBRA) Sub-Recipient Review (Letter dated: 9/20/10; Review Conducted: 3/23/10); ♦♦♦Sweet Child Development Center Licensing and Regulations Report and Response (Letter dated: 10/19/10; Survey Conducted: 9/21/10) and Letter – Accepting Corrective Action Plan (Dated: 11/9/10 for Review Conducted: 9/21/10); ♦♦♦America Park Child Development Center Licensing and Regulations Report (Letter dated: 10/20/10; Survey Conducted: 10/5/10); ♦♦♦Letter – "No Regulatory Violations Found" – Woodlawn Child Development Center (Letter dated: 10/27/10; Investigation Conducted: 10/25/10); ♦♦♦Letter – "No Regulatory Violations Found" – North End Community and Technical College (NETC) Child Development Center (Letter dated: 10/28/10; Investigation Conducted: 10/6/10); ♦♦♦Letter – "No Regulatory Violations Found" – North End Community and Technical College (NETC) Child Development Center (Letter dated: 10/28/10; Investigation Conducted: 10/22/10); ♦♦♦Woodlawn Child Development Center Licensing and Regulations Report (Letter dated: 10/25/10; Licensure Inspection Conducted: 10/21/10); ♦♦♦Letter – "No Regulatory Violations

☞ Date

☞ Location, presiding officer, and roll call/quorum determination.

☞ Evidence that BCA board is attentive to the tripartite composition of the community action board.

☞ In compliance with the Community Services Block Grant Act, 42 USC 9910, BCAs board is engaged in planning, implementation, and development of programs; the minutes reflect the BCA board's attention to these matters.

Found” – Smithfield Child Development Center (Letter dated: 11/1/10; Investigation Conducted: 10/21/10); ♦♦♦Letter – “Corrective Action Plan Accepted” – Weatherization Program Monitoring Review (Letter dated: 10/26/10; Review Conducted: Feb. 24-25, 2010); ♦♦♦Kiwaniis Child Development Center Licensing and Regulations Report (Letter dated: 10/25/10; Inspection Conducted: 10/7/10); ♦♦♦Terrapin Park Child Development Center Licensing and Regulations Report (Letter dated: 11/2/10; Inspection Conducted: 10/28/10).

- **Program Development Committee**

The Committee did not meet during the month of November. Mr. Jones, Manager, Program Development, reviewed the Committee’s report for October. ♦♦♦**Artists Stand Against Poverty (A.S.A.P.)** Silent Art Auction held on November 13th went very well; an estimated \$3,000 was made.


- **Audit Committee**


Mr. Castle, Chief Financial Officer, reviewed the “draft” Audit for the Fiscal Year Ending June 30, 2010. Motion by Mr. Hartford that the Board of Directors accept the Community Action Council’s “Draft” Audit for the Fiscal Year Ending June 30, 2010. Second by Ms. Livingston. (Brief discussion ensued regarding fundraising.) Motion carried. (Note: A breakdown of fundraising activities is to be included in the January 2011 board packet.)


FINANCIAL REPORTS

The Assistant Treasurer, Ms. Chou, reviewed the Unaudited Balance Sheet for the period ending October 31, 2010 and made a motion on behalf of the Finance Committee that it be accepted for filing. Second by Mr. Hartford. Motion carried. Ms. Chou reviewed the Financial Statement for the period ending October 31, 2010 and made a motion on behalf of the Finance Committee that it be accepted for filing. Second by Ms. Livingston. (Brief discussion ensued.) Motion carried. Ms. Chou reviewed the following reports for the period ending October 31, 2010: Accounts Receivable; Line-of-Credit; Health Plan Financial Statement, the Unemployment Insurance Report for the quarter ending September 30, 2010 and the Big Sky Community Foundation Reports for the period ending September 30, 2010.

Ms. Chou reviewed the **Banking and Financial Transactions Authority** to designate Central Bank as BCA’s primary financial services provider. On behalf of the Finance Committee, Ms. Chou made a motion that the Board of Directors:

 *BCA board is paying attention to financial health and will zero in on fundraising revenue at the next meeting.*

 *BCA Board monitors cash inflows and outflows by reviewing four key reports.*

 *BCA’s Finance Committee performed the due diligence*

1. designate Central Bank as BCA's primary financial services provider;
2. authorize Howard Castle, Chief Financial Officer, to arrange for the transfer of the accounts listed in Item 1 - under DISCUSSION from Bank of America to Central Bank;
3. authorize the signers identified in Item 2 – under DISCUSSION to sign checks, authorize transfers between accounts and authorize ACH and wire transfers on behalf of BCA; and
4. ~~affirms~~ authorize the Executive Director and Chief Financial Officer, acting jointly, to execute loan documents and other credit instruments upon approval by the Board of Directors of budgets that expressly identify the related activity and the relevant financial costs. (Wording added to this item is underlined and *italicized*.)

necessary for a major financial decision. The committee members brought their recommendation to the full board for discussion and a vote. BCA board minutes carefully record the details of the board decision and evidence attention to internal controls.

Motion second by Mr. Hartford. (Brief discussion ensued.) Motion carried with the amendment to #4.

Ms. Chou reviewed the **Ratification of the Approval by the Chair of the Board of Directors of the Head Start/Early Head Start Request to Carry Over the FY 2009-10 Quality Improvement Fund Balance into FY 2010-11** and made a motion on behalf of the Finance Committee that the Board of Directors approve the recommendation. Second by Mr. Hartford. Motion carried.

BUDGET AMENDMENT

The Assistant Treasurer, Ms. Chou, reviewed the **Gridline Gas Energy Assistance Program 2010-2011 Budget Amendment #1** and made a motion on behalf of the Finance Committee that the amendment be approved. Second by Mr. Hartford. Motion carried.

NEW BUDGETS

The Assistant Treasurer, Ms. Chou, reviewed the **❶ Foster Grandparents (FGP) 2011 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Mr. Hartford. Motion carried. Ms. Chou reviewed the **❷ Retired and Senior Volunteer Program (RSVP) 2011 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Mr. Hartford. (Brief discussion ensued.) Motion carried. Ms. Chou reviewed the **❸ Family Self-Sufficiency Program 2011 Budget** and made a motion on behalf of the Finance Committee that the budget be approved contingent upon final contract agreement. Second by Mr. Hartford. Motion carried. Ms. Chou reviewed the **❹ HOME-GAP Rehabilitation 2010-2011 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Mr. Hartford. Motion carried. Ms. Chou reviewed the **❺ Big City Clinic Foundation Health Assessment 2010-2011 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Livingston. Motion carried. Ms. Chou reviewed the **❻ Senior Medicare Patrol 2010-2011 Budget** and made a motion on behalf of the Finance Committee that the budget be approved. Second by Ms. Livingston. Motion carried. Ms. Chou reviewed the **❼ State Housing Corporation-Tenant Based Rental Assistance 2011-2012 Budget** and made a motion on behalf of the Finance Committee that the Board of Directors approve the budget contingent upon receipt of the award document.

Second by Mr. Hartford. Motion carried. ♦♦♦♦*The Chair, Ms. Nilsson, stated this would be Ms. Chou' last board meeting and asked board members to "give her a big hand" for a job well done!*

2011 AGENCY HOLIDAY AND BOARD MEETING SCHEDULE

The Executive Director, Ms. Watson, reviewed the 2011 Agency Holiday and Board Meeting Schedule. Motion by Mr. Hartford that the Board of Directors approve the proposed schedule of holidays and board meeting dates. Second by Ms. Livingston. (Brief discussion ensued.) Motion carried.

PROGRAM UPDATE: PEACE TREE COUNTY CENTER (HIGHLIGHTS OF RECENT ACCOMPLISHMENTS.)

Ms. Sissy James, Interim Manager, Peach Tree County Center, presented an informative PowerPoint presentation featuring highlights of the center's recent accomplishments.

OPERATIONS REPORTS

The Executive Director, Ms. Watson, reviewed the Operations Reports for October 2010. She also reviewed her November 1, 2010 memo on the Status of the 2010 Employee Compensation Plan.

☞ *BCA board members are paying attention to the overall cost and structure of BCA employee compensation and fringe benefit plan. The November 1, 2010 memo is a key exhibit in BCA's minute book.*

EVALUATION OF THE NEW BOARD MEETING STARTING TIME – EFFECTIVE JANUARY 2010

Effective as of the January 2010 Board of Directors' meeting, the starting time of the meeting was changed from 7:30 p.m. to 6:30 p.m. This change was to be evaluated at the November 2010 board meeting. A review of board attendance for 2010 was compared with attendance during 2009 and as a result, it was decided to continue the starting time of 6:30 p.m.

☞ *BCA minutes record the final outcome of the "Board Meeting Days and Times" review launched with the formation of an ad hoc committee in April 2009.*

NEXT MEETING

The next meeting of the BCA Board of Directors will be January 13, 2011 at 6:30PM. The BCA Board will not meet in December 2010.

ADJOURNMENT

Motion by Mr. Hartford that the meeting be adjourned. Second by Ms. Harris. Motion carried. The meeting was adjourned at approximately 8:12 p.m.

MEMBERS PRESENT

Larry Hartford*	Mag Davis	Leslie Chou*
Delaney Clayton*	Devon McDuff	Anita Nilsson*
Cindy Quense	Tiana Litwin*	Loretta Chapman*
Larry Jones	Mary Little	Mark Rodman
Marsha Harris*	Mary Bissell	Lou Espinosa
Melody Livingston	Lillian Vernon*	Noel Burke

Rita Newman	Maureen Whipple	Aki Taan	
<u>EXCUSED ABSENCES</u>			
Gloria LeGrande	Caesar Cruz	Albert Mason	
Hank Simpson*	Ann Varney	Harold Wiley	
Celia Williams	Ginny McNeal		
<u>ABSENCES</u>			
Warren Yatzke	Susan Gallagher	Kathy Johnson	
Pete Janko	Mickey Shay	Alex Donovan	
Max Weingard	Sandra Fraser		
Respectfully submitted,			
_____		_____	
Delaney Clayton, Secretary		Date Signed	
cc: Members, Board of Directors Cabinet for Health and Family Services			
*DENOTES EXECUTIVE COMMITTEE MEMBERS AS REQUIRED AT THE AUGUST 25, 2002 BOARD MEETING, BOARD MINUTES 11 22 2010			

SECTION 2

Improving a CAA's
Financial Capacity

Appendix A

Sample CFO Job Description

Sample CFO Job Description

Blue Community Action
Position Opening (City, State)
(Posted: April 15, 201X)

POSITION: Chief Financial Officer (CFO).

SALARY AND BENEFITS: The salary for this position ranges from between \$70,000 and \$90,000 per annum, depending on education and experience. BCA offers all full-time employees health and dental insurance (under the existing plan, the employee pays 20% of the annual premium, plus deductibles), participation in a 403(b) plan (with a BCA match), group term life-insurance (150% of annual salary), long-term disability insurance, 3-weeks annual paid vacation, 10 personal days, and continuing education opportunities.

RESPONSIBILITIES AND DUTIES: The CFO will manage BCA's finance and accounting operations and a staff of five. The CFO (and the staff that the CFO supervises) will be responsible for the following: (i) entry of all financial data; (ii) the accounts receivable, payable, payroll, grant management, and purchasing functions; (iii) preparation of interim (monthly) and annual financial statements; (iv) preparation of capital and operating budgets; (v) maintenance of BCA's relationship with its lenders; (vi) maintenance of BCA's relationship with its external auditors; (vii) tax compliance, including federal and state income tax, state and local property tax, and sales and use tax; (viii) risk management, including evaluation and procurement of all insurance; (ix) continuous improvement to BCA's system of internal controls; and (x) strategic planning. The CFO will attend regular meetings of the board and its audit and finance committees, responding to their requests for information. The CFO will also work with program heads, assisting them with program budgeting, submission of grant proposals, and compliance with grant and contract terms.

REPORTS: The CFO will work with and report primarily to BCA's executive director. The CFO will regularly work with BCA's board, including its finance and audit committees. In certain matters, the CFO will have a direct report to the board chairperson, or a designee.

QUALIFICATIONS: Qualified candidates must have a BS degree in finance or accounting (or equivalent) and a minimum of seven years experience in fiscal management and financial reporting, preferably with a nonprofit providing social services. Preference will be given to candidates who have experience working with federal grant, contracting, and procurement requirements, including OMB Circulars A-110, A-121, and A-133. Candidates should also be familiar the federal tax rules governing Section 501(c)(3) organizations, wage and hour reporting, workers'

compensation insurance, state unemployment insurance, and employee benefits. Candidates should also have information technology skills, including knowledge of Excel, PowerPoint, and extensive knowledge of and comfort working with computerized accounting systems. As noted under responsibilities and duties, the CFO is expected to interact with all levels of the BCA, including the board of directors, which means the successful candidate will need demonstrated oral and written communication skills.

REFERENCES: Finalists for the position will be requested to provide a list of references and to sign a statement granting BCA permission to contact the references. Finalists will also be required to undergo a criminal background check.

ABOUT BCA: BCA is a community action agency that provides social services to members of the City community. It currently operates Head Start, child care services, family shelter, job training, energy assistance, low-income housing, senior recreation, and formula distribution programs. Last year, it received \$22 million in federal and state grants and an additional \$7 million in other revenue.

BCA currently employs 100 full-time equivalent employees. It also relies on about 200 volunteers. Its operations are located in one building that houses the bulk of its staff and programs. However, BCA also rents three store-front locations for its child care and job training programs.

BCA uses a customized accounting system. The system was developed to provide social services agencies that are highly reliant on government funding with the accounting infrastructure to facilitate grant compliance. It has outsourced its payroll processing to a national vendor of such services, thereby freeing up staff for more strategic work.

BCA currently employs three bookkeepers, a grant-management specialist, and a CPA, all of whom report to the CFO.

APPLICATION DEADLINE: Resumes will be accepted prior to May 15, 20X1, with a decision expected to be made before July 15, 20X1. Interested persons should submit their resumes to Larry Garcia, Blue Community Action, 1234 West Elm Street, City, State 555-555-5555. Alternatively, resumes may be submitted by email: Subject Line: 20X1 CFO Opening; Address: lgarcia@bca.orX

EQUAL OPPORTUNITY EMPLOYER: BCA is an equal opportunity employer. Qualified applicants are considered for employment without regard to age, race, color, religion, sex, national origin, sexual orientation, disability, or veteran status. If you need assistance or an accommodation during the application process because of a disability, it is available upon request. BCA is pleased to provide such assistance, and no applicant will be penalized as a result of such a request.

Appendix B

FAQ: CFO/Fiscal Director Positions

FAQ: CFO/Fiscal Director Positions

1. Is the CFO/Fiscal Director an “officer” for 990 reporting purposes?

In most cases, the CFO will meet the 990 definition for an “officer.” The 2010 instructions for IRS Form 990 define an “officer” for reporting purposes as the “top financial official.” That is the official who has ultimate responsibility for managing the organization’s finances.

2. Do CFOs with CPA licenses confront any special challenges?

CPAs must comply with the standards and requirements for professional conduct established under state law. In general, these requirements prohibit the CPA from associating himself with false or misleading financial reports or knowingly participating in inaccurate or deceptive reporting to the IRS or any other regulatory body. Consequently, in addition to the usual ethical considerations of any responsible employee, the CFO who is a CPA must consider the degree to which his conduct complies with applicable professional and ethical standards.

3. How much involvement should the top financial official have in the selection of the outside audit firm?

The CFO generally organizes the process through which auditor selection will occur, working closely with the person in charge of procurement for the CAA. The selection, however, is the board's responsibility because the audit is for its benefit rather than management's. The board should look to its audit committee to make a recommendation to the board.

The CFO or other fiscal staff frequently assist the procurement officer develop a list of firms interested in responding to a RFP for audit services by obtaining information about CPA firms that have performed A-133 audits for similar organizations. The CFO often prepares a draft RFP which provides background information about the CAA and describes the constraints on or deadlines for the audit. The board, or its audit committee, should review the RFP and the list of potential candidates before the RFP is distributed, taking the review as an opportunity to amend the RFP or add other candidates to the list.

The board, or its audit committee, should review all responses to the RFP. It should also interview each finalist. Although the presence of staff during interviews will prove helpful, at some point during the interview, the board should excuse the staff so that the board can discuss its role and expectations regarding the audit.

4. What should we do if our current CFO unexpectedly departs?

Selection of a CFO is critical to a CAA's success. Rushing to fill an unexpected vacancy frequently creates more problems than it solves. Sometimes someone who had worked for the CFO can serve as an interim CFO. Before tapping this person, the CAA should decide whether this person will be considered during the search for a permanent replacement. The CAA should then communicate that information to the person so that there are no misunderstandings. In some instances, the interim CFO will require assistance. In these instances, the CAA should consider contacting a temp agency that can supply the appropriate finance and accounting personnel. Even when the interim CFO is eager to demonstrate a commitment to cost savings, the CAA should be cautious: Understaffing the department for more than a limited period can result in other staff members burning out.

The CAA has several options if there is no staff member capable of serving as the interim CFO. The CAA may be able to look to other staff members to assume the more technical aspects of the CFO's position on a short-term basis, but this should not delay the search for a permanent CFO. Although current staff may be able to handle these aspects, the critical strategic aspects of the CFO's job are likely to suffer.

The CAA should not hesitate in seeking the assistance of and recommendations from the CAA's auditor and other CPAs who have worked with the CAA--although there may be limitations on the assistance that the auditor can provide and still be able to perform the audit. Board members may also be able to use their professional networks to identify potential interims. Recently retired CFOs from other nonprofits may provide the best pool of individuals who are both prepared to step in and available for short term assignments. The CAA should also contact state nonprofit associations and organizations specializing in developing nonprofit capacity. These organizations may have people available to assist on an interim basis and they may be able to help with the search. For-profit temporary employment services may also be able to provide interim CFOs, but be cautious: Due to lack of familiarity with CAAs, some of these agencies may underestimate the skills necessary to properly handle the restrictions and reporting requirements that come with government grants and contracts.

5. Should we consider CFO candidates with limited or no experience in nonprofit organizations?

In many regions, CAAs are among the largest and most complex providers of social services. While nonprofit hospitals and universities, as well as governmental entities, have well established professional development pipelines that continuously replenish the supply of

candidates, this is not always the case for social service agencies. CAAs may therefore be unable to find a replacement who has a deep knowledge of the requirements that come with the types of government contracts and grants that CAA's typically seek. Nevertheless, so-called "cross-overs" from other industries frequently bring strong leadership skills and innovative approaches to systems and workflow. The CAA's task will be to identify the candidates who are quick learners and who have demonstrated experience addressing new challenges.

Before hiring a cross-over, the CAA should make sure that the candidate understands what will be a new environment. There may be fewer resources available than the candidate is accustomed to. Moreover, the CAAs internal workings and dynamics may be confusing and cumbersome. While many find great satisfaction in being part of a team dedicated to improving their community and "giving back," others find the focus on mission rather than financial outcomes makes measuring progress difficult. Additionally, the CFO who is new to the nonprofit sector may need to build additional skills in communicating financial information to fellow managers and in some cases board members who lack formal financial training and confidence in their own understanding of finances.

CAAs that select a CFO without nonprofit financial leadership experience should be prepared to work with their new leader to develop explicit expectations for mastery of both the technical aspects of the job and the cultural and communication challenges that come with working with people who may not be as focused on a financial bottom line.

6. What types of tax/IRS issues should our CFO be prepared to handle?

The CFO should play a leadership role in ensuring that the CAA maintains its tax exempt status and avoids unnecessary tax liabilities and penalties. Although many CAAs rely on outside professionals to prepare key tax reports (e.g., Form 990, Form 990-T, Form W-3, Form 5500), the CFO remains responsible for ensuring compliance with the underlying regulations and maintaining the records required for completion and substantiation of reports to the IRS.

The CFO should focus on a number of tax compliance issues. At the federal level, these include excess benefits transactions, automatic excess benefits, executive compensation, deferred compensation, unrelated business income, lobbying and political activity, fiscal sponsorships, employee-independent contractor classification, trust fund taxes, and the tax implications from joint ventures and partnerships. At the state and local level, these include sales and use taxes, property taxes, and trust fund taxes.

Appendix C

RFP From Auditors: A Suggested Checklist

RFP From Auditors: A Suggested Checklist

Describing the CAA

With respect to the CAA, the RFP should:

1. Briefly describe the CAA's mission, programs, primary sources of revenue, relative size (e.g., revenues, expenses, gross and net assets), and principle grants and contracts.
2. Briefly describe the the CAA's accounting and finance staff and their backgrounds and experience.
3. Indicate whether the CAA has an audit committee and briefly describe who the auditor's primary contact will be.
4. Describe the CAA's relationship with its current or prior auditor (optional).
5. Describe the CAA's accounting system and accounting software.
6. Identify the CAA's location(s) and any possible need for fieldwork.
7. Either include or offer to make available the CAA's financial statements and IRS Form 990.

Enumerating the Requested Services

With respect to the requested services, the RFP should:

1. Specify the timeframe for the services.
2. Indicate whether the audit is limited to a standard financial statement audit, or will be used to satisfy Single Audit Act (SAA) and OMB A-133 requirements. The latter requires additional reports, usually addressing internal controls and compliance with grant requirements and related laws.
3. Identify any required non-attest services and then specify whether those are to be addressed in the proposal or are subject to a separate RFP. Those might include preparation of the Form 990 or preparation of state charitable solicitation filings.
4. Identify any limitations on the engagement or the auditor's work.
5. If the audit is a SAA or similar audit, identify the type of grants, the grantors, and any special requirements.
6. Describe requirements for progress reports and notifications in the event fraud is uncovered.
7. Specify required deliverables, including the physical number of reports to be provided by the auditor; and what sort of management letter is expected.

8. Describe expectations regarding exit interviews with the audit committee and/or management and meetings with the audit committee.
9. Specify the number of years covered by the RFP (e.g., just one audit or annual audits for the next five years).
10. Specify the selection criteria (optional).
11. Specify the deadline by which the proposal must be received and, if relevant, the means of delivery (e.g., by post, delivery service, or email).
12. Identify required representations regarding the applicant's experience, qualification, independence, and licensing.

Requesting Information

The RFP should ask the auditor to:

1. Briefly describe the auditor's approach to the audit process.
2. Provide the qualifications and experience of the persons who will staff the audit.
3. Describe the auditor's relevant experience, including names of similar clients and references.
4. Include a proposed budget, which identifies hourly rates and the experience mix of audit team members that will staff the audit.
5. Identify the person to be contacted if the applicant has questions; and
6. Include a copy of the auditor's standard form engagement letter.

CAAs should exercise some discretion when referring to this list of suggested items to be included in the RFP, particularly if the audit or the universe of potential auditors is small. The CAA may have to reduce the amount of requested information in order to attract any proposals. Nevertheless, before any CAA signs an engagement letter, it should have all the suggested information. As should be evident, the CAA should not make price its sole determinant in selecting an auditor.

Appendix D

Engagement Letters: Common Terms

Engagement Letters: Common Terms

The CPA's Perspective

If the CPA firm has had a lawyer draft its standard form engagement letter, the CAA should not be surprised to find a letter that:

1. Identifies the name of the CAA and each affiliated entity to be audited, the financial statements to be audited, and the statement “as of” and “for the period ended” dates.
2. Incorporates relevant terms from the RFP and the winning proposal. This might best be accomplished by incorporating the RFP by reference and attaching it to the letter.
3. If the audit is a SAA audit, indicates that the audited statements will include the Schedule of Expenditures of Federal Awards and refer to the additional reports and opinions that will be required.
4. States the auditing standards that will govern the conduct of the audit.
5. Identifies the audit’s objectives and any limitations.
6. Addresses the circumstances that could give rise to a qualified or adverse opinion or a disclaimer of opinion.
7. Identifies management’s responsibilities. These typically include: (a) establishing and maintaining internal controls; (b) designing and implementing all programs and controls necessary to identify and prevent fraud; (c) selecting and applying accounting principles; (d) preparing the financial statements and the accompanying schedules in conformity with GAAP; (e) making all management decisions and performing all management functions; (f) making all financial records and relevant information available to the auditor; (g) making all necessary adjusting entries necessary to avoid material misstatements in the financial statements; and (h) complying with all applicable laws and grant requirements.
8. States that management will be required to make a number of representations, including ones pertaining to disclosure of any fraud, absence of management overrides of internal control, and condition of internal controls.
9. Acknowledges that management will bring all known fraud to the auditor’s attention.
10. States that management will disclose previous audits and corrective actions taken by management in response to those audits.
11. Describes how the auditor will communicate information to management and the board.

12. Describes audit procedures, including the procedures for examining internal controls.
13. Describes the auditor's commitment to protect the CAA's confidential information.
14. Describe the possibility that the audit and the CAA's information may be subject to a peer review process.
15. States that the auditor may use third-party service providers during the course of the audit, which may involve sharing confidential information with those providers.¹
16. If the audit is conducted pursuant to the SAA, states that management is responsible for submitting the Data Collection Form to the FAC.
17. States that the audit documentation (workpapers) are the auditor's property and are confidential information, but will be released as required by law and to the cognizant or oversight agency or its designees if requested.
18. States the CAA's minimum retention period for the audit documentation.
19. Addresses the auditor's right to withdrawal from the engagement and the circumstances that could give rise such a withdrawal.
20. States the fee or an estimate and describe the circumstances that will result in upward adjustment to the fee (e.g., uncooperative client personnel or unexpected circumstances).
21. States what out-of-pocket (e.g., travel, copying, courier services) disbursements will be billed to the CAA and at what rate.
22. Describes billing procedures (e.g., monthly) and payment terms.
23. Requires the CAA to sign the letter agreement.

The CAA's Perspective

Many of the provisions in the auditor's engagement letter are perfectly appropriate, setting forth the financial terms of the arrangement and the scope of the work. CAAs, however, should make no mistake about many of the other provisions. They are designed to protect the CPA firm from liability in the event of a failed audit--the financial statements turn out to have been materially mistated or major fraud is subsequently uncovered. This is particularly true with respect to provisions that require the CAA to make certain representations, undertake certain actions, or acknowledge certain responsibilities. CAAs should not hesitate to ask that terms of the letter be modified, particularly if the CAA knows that it will not be able to comply with the requirements. There is nothing wrong with pushing back. CAAs should have their lawyers review the engagement letter.

¹ This is required by AICPA, Rules of Professional Conduct ET-191.224-25 and 291.023-.024.

Engagement letters will only grow longer with the passage of time. CAAs should read them carefully and make sure that their representations are accurate and that the duties they agree to undertake can be fulfilled.

Although CAAs may welcome a short engagement letter, this may be a telltale sign that the auditor lacks sophistication, which may call into question their skill level.

Appendix E
Standard Representations Required
As Part of An Audit

Standard Representations Required As Part of An Audit

Under the AICPA's auditing standards, management will be required to make, among others, representations to the auditor as to whether:

1. The financial statements comply with GAAP.
2. Management believes the financial statements fairly present the organization's financial position, results of operations, and cash flows.
3. Management has made all financial records available to the auditor.
4. Management has made available all board and committee meeting minutes to the auditor.
5. Those minutes reflect all significant board and committee actions.
6. There are no written or oral communications from regulatory or others indicating possible deficiencies in financial reporting practices.
7. All material transactions are properly recorded in the accounting records.
8. All transactions have been recorded.
9. Management acknowledges that the design and control of internal controls are its responsibility.
10. Management has no knowledge of any fraud or suspected fraud.
11. Management has no knowledge of any allegations of fraud or suspected fraud.
12. Management has no plans or intentions that materially affect the carrying value of assets or liabilities.
13. Related-party transactions have been properly reflected or disclosed in the organization's financial statements.
14. The organization has not entered into any guarantees.
15. There are no significant estimates or material concentrations that must be disclosed in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.
16. There are no violations of laws or regulations.
17. Counsel hasn't advised management of any unasserted claims or assessments if assertion of such claims or assessments is probable.
18. The organization has title to all owned assets.
19. All owned assets are free from liens and encumbrances.
20. Any owned assets have been pledged as collateral.
21. The organization is in compliance with all other contractual obligations.

Appendix F

Sample Audit Committee

Sample Audit Committee

The Blue Community Action's (BCA) board of directors has chartered the audit committee to assist the board in fulfilling the board's general oversight responsibilities. In discharging its duties, the audit committee should consider the two primary aspects of the audit function: (i) assuring that BCA's accounting system produces both interim and annual financial statements that accurately reflect BCA's financial position and operating results in all material respects; and (ii) assuring that internal systems are in place to protect BCA's financial resources from fraud, misappropriation, waste, or other improprieties. Although the audit committee is not charged with actually designing BCA's accounting and reporting system, implementing controls, producing financial statements, or conducting audits, the committee is charged with overseeing those who are responsible for such activities.

SECTION 1. MEMBERSHIP. The audit committee shall be comprised of at least three board members, each of whom is independent.

- 1.1 **QUALIFICATIONS.** Each member of the audit committee shall have the ability to read and understand financial statements. If at least one member is not an audit committee financial expert, the committee shall retain a professional who qualifies as an audit committee financial expert to advise the committee on an ongoing basis.
- 1.2 **VACANCIES.** When a position on the audit committee becomes vacant, the audit committee shall notify the board, which shall then appoint a replacement member. The audit committee may provide the board with a recommendation for a replacement member at the time it notifies the board of a vacancy.
- 1.3 **CHAIRPERSON.** If the board does not name a chairperson, the committee shall select a chairperson.

SECTION 2. MEETINGS. At a minimum, the audit committee shall meet quarterly, but it can meet more often and at such times as needed.

- 2.1 **QUORUM.** The committee must have a majority of its members present to conduct business. When a quorum is present, the committee may take action and make decisions based on a majority of those present.
- 2.2 **MINUTES.** The committee shall maintain written minutes detailing its proceedings and decisions.
- 2.3 **LIMIT ON THE PRESENCE OF OTHERS.** Subject to applicable open meeting laws, the committee's meetings shall be open only to members of the committee. At the invitation of the committee, BCA's employees and professional advisors may attend meetings to answer questions, provide information, or otherwise assist the committee.

SECTION 3. DUTIES. The audit committee shall:

- 3.1 **SELECTING THE AUDITOR.** The board shall select the auditor and enter into an engagement letter after receiving a recommendation from the committee. To facilitate the board's decision, the committee shall conduct the search process, including identifying appropriate candidates, interviewing those candidates, and examining peer reviews. The committee is charged with negotiating the terms of the engagement and discussing with the auditors how the audit will be conducted. In formulating its recommendation to the board, the committee should consider the following, among other relevant, factors: peer reviews, cost, experience with comparable organizations, and general reputation. Although cost is always a consideration when retaining outside professionals to render services, cost should not necessarily be the determinative factor. The committee may seek the assistance and recommendations of management as it proceeds with the selection process and develops a recommendation for the board's consideration.
- 3.2 **COMMUNICATING WITH THE AUDITOR.** The committee shall engage in regular communications with the auditor. These discussion shall occur during the planning, execution, and concluding phases of the audit. The committee shall discuss with the auditor its conclusions, findings, and recommendations. As part of that discussion, the committee should review BCA's audited financial statements with the auditor. It shall also review with the auditor any communications required under SAS Nos. 114 and 115, and discuss with the auditor any recommendations to improve BCA's system of internal controls and financial reporting. The committee shall also: (i) resolve any disputes between the auditors and BCA's management; and (ii) meet with the BCA's chief financial officer and appropriate staff to determine how to implement the auditor's suggestions.
- 3.3 **APPROVING NON-AUDIT SERVICES.** Management must obtain board approval before engaging the auditors to perform non-attest services. The audit committee shall be management's initial contact in this process. The committee shall evaluate the proposal, particularly its potential impact on the auditor's independence, and then make a recommendation to the board.
- 3.4 **ADDRESSING CONCERNS OF STAKEHOLDERS REGARDING FRAUD.** The audit committee shall serve as the recipient of whistleblower reports under BCA's whistleblower policy to the extent those reports pertain to BCA's financial affairs and resources, including fraud and other financial crimes. The committee has the authority to investigate and respond to such reports, but it shall keep the board fully apprised of any reports and the resulting investigation. The committee shall maintain records which track incidents or concerns reported to the committee. At a minimum, those records shall include the name of the person reporting the incident

or concern, the date the person first contacted the committee, the nature of the incident or concern, the actions taken to address the reported incident or concern, and the manner in which the committee followed up with the person reporting the incident or concern. If a report from a whistleblower involves a matter beyond the scope of the audit committee's duties, the audit committee shall refer that person to the appropriate recipient for the report, as designated in BCA's whistleblower policy.

- 3.5 **MONITORING FEDERAL GRANT REQUIREMENTS.** The audit committee shall assess the need for and review any audits that may be required under the Single Audit Act, federal or state regulations pertaining to grants, or any other requirements. It shall also conduct an annual discussion and interview with the staff regarding BCA's compliance with federal, state, and local grant and procurement requirements. The audit committee shall provide the board with an annual report summarizing such communications.

SECTION 4. ANNUAL BUDGET. The audit committee shall submit an annual budget for its operations to the board for approval.

SECTION 5. TRAINING AND ORIENTATION. The audit committee shall develop materials to be used by new committee members for orientation. In connection with that orientation, the committee may send new committee members to appropriate seminars or courses. The committee may also arrange or provide continuing educational opportunities to existing committee members.

SECTION 6. RETENTION OF OUTSIDE LEGAL COUNSEL. The audit committee shall have the authority to retain independent legal counsel to advise the committee as needed. The committee is authorized to retain such counsel despite the fact that no allowance for such counsel is made for in the committee's audit annual budget, provided that if it will not impede the work of the committee, the committee shall notify the appropriate officers of the need to retain counsel so that the availability of financial resources to pay the independent counsel can be assessed and arranged. In such event, the committee need only provide the appropriate officers with an estimate of the cost of retaining such independent counsel.

SECTION 7. REPORTS TO THE BOARD. In addition to the communications from the audit committee to the board provided for herein, at least once a year, the committee shall provide the board with a written report describing its activities during the preceding year in sufficient detail so as to permit the board to determine whether the committee is properly discharging its duties.

SECTION 8. DEFINITION. For purposes of this charter, an audit committee financial expert is a person who has either through education or experience as a public accountant, auditor, financial officer, accountant, business executive, or director of other organizations, gained: (i) an understanding of generally accepted accounting principles and financial statements; (ii) experience with internal controls and

procedures for financial reporting; (iii) and an understanding of audit committee functions.

Appendix G
Examples of Significant Control Deficiencies and
Material Weaknesses Taken From Actual SAS
No. 115 Letters

Examples of Significant Control Deficiencies and Material Weaknesses Taken From Actual SAS No. 115 Letters

Example 1: Significant Deficiency

OBSERVATION: The Organization does not have adequate procedures in place to ensure accurate closing and review process to determine that the financial statements are accurately presented. There were ten entries proposed during fieldwork.

RECOMMENDATION: The books are the responsibility of the Organization and as such, management should review the closing process to ensure that the general ledger reflects the actual activity and balances at year end. The Organization should pay close attention to closing of books to ensure that financial statements are fairly stated. A list of these entries has been provided to management.

Example 2: Material Weaknesses

FINANCIAL STATEMENT PREPARATION AND ACCOUNTING ASSISTANCE: We assisted in the preparation of the Organization's year end financial statements. The Organization has not hired personnel trained to, and assigned responsibility for, preparation of annual financial statements including related footnote disclosures. Therefore, the Organization does not have qualified resources to perform these functions and relies on its external auditors to assist in the preparation and drafting of annual financial statements and financial disclosures. Under the provisions of American Institute of Certified Public Accountants Statement of Auditing Standards No. 112, the lack of the skills and knowledge necessary to apply generally accepted accounting principles in preparing financial statements are defined as areas of material weakness in internal control.

The Organization should periodically consider its alternatives to either obtain this required expertise, whether on a full time or as needed basis, or continue to outsource these functions. However, outsourcing of these functions requires oversight of these processes by a member of the Organization's management who has the appropriate skill, knowledge and/or experience and will also accept responsibility for the results.

Example 3: Significant Deficiency

ACCOUNTS PAYABLE. During our search for unrecorded liabilities, we noted one exception in which an invoice relating to services performed prior to year-end were not recorded as payables in the proper period. Proper cutoffs are critical for the accuracy of the accrual basis of accounting. We suggest that the Controller prepare written instructions to be included as a part of the Company accounting policies and

a procedures' manual that indicates basic concepts of proper cutoffs and the individuals responsible for accruing payables at the accounting period end.

Example 4: Significant Deficiency

FAILURE TO PROPERLY APPLY GAAP. During our audit, we became aware that several of the Council's operating leases contain clauses that require scheduled rent increases. The Council currently records rent expense as the rent becomes payable. SFAS, Accounting for Leases, requires rental expense to be recognized on a straight-line basis, even if the rental payments are not made on this basis. We recommend that the Council record their rent expense on a straight-line basis to be in accordance with accounting principles generally accepted in the United States.

Appendix H

Useful Web Sites

Useful Web Sites

American Institute of CPAs – Not-for-Profit Conferences and Resource Materials:

- www.aicpaconferencematerials.com/notforprofit
- www.aicpa.org/Publications/AccountingAuditing/KeyTopics/Pages/NotForProfitEntities.aspx

Bridgespan/Bridgestar:

The Nonprofit Chief Financial Officer-

- <http://www.bridgestar.org/Library/NonprofitCFO.aspx>

Bridgespan Sample Nonprofit CFO Job Description-

- web.bridgespan.com/LearningCenter/ResourceDetail.aspx?id=500

CAPLAW Financial Forum, Webinars, and Trainings

- www@caplaw.org

Government Accountability Office Report to Congress on Treatment of Indirect Costs

- www.gao.gov/products/GAO-10-477

The Nonprofit Finance Fund:

- <http://nonprofitfinancefund.org/knowledge-advocacy>

The Nonprofit Quarterly:

- <http://www.nonprofitquarterly.org>

Stanford Social Innovation Review:

- www.ssireview.org/topics/category/nonprofit_management/

WIPLI Trainings for Managers of Federal Funds

- www.wipfli.com/Industry_NonProfitandGovernment.aspx

Office of Head Start Early Childhood .Knowledge and Learning Center:

- <http://eclkc.ohs.acf.hhs.gov/hslc/tta-system/operations/Fiscal/Narrative%20Discussions/TestAuditRequir.htm>

SECTION 3

**Creating the Annual
Operating Budget**

Appendix A

Sample Cost Allocation Plan

XYZ COMPANY

Model Cost Allocation Plan

Use the following model Cost Allocation Plan (CAP) as guidance for Non-profit organizations. The CAP should be tailored to fit the specific policies of each organization. If your organization's policies are different in any of the categories, please specifically identify the methodology used. Although there are different methodologies available for allocating costs, the methodology used should result in an equitable distribution of costs to programs. Recipients must have a system in place to equitably charge costs. Additionally, as required by Office of Management and Budget Circular A-122, time distribution records must reflect an after-the-fact determination of the actual activity of each employee. Considerations in determining an appropriate base for allocating costs include the relative benefits received, the materiality of the cost, and the amount of time and cost to perform the allocation.

XYZ COMPANY

COST ALLOCATION PLAN

Purpose/General Statements

The purpose of this cost allocation plan is to summarize, in writing, the methods and procedures that this organization will use to allocate costs to various programs, grants, contracts and agreements.

OMB Circular A-122, "Cost Principles for Non-Profit Organizations," establishes the principles for determining costs of grants, contracts and other agreements with the Federal Government. *XYZ Organization's* Cost Allocation Plan is based on the Direct Allocation method described in OMB Circular A-122. The Direct Allocation Method treats all costs as direct costs except general administration and general expenses.

Direct costs are those that can be identified specifically with a particular final cost objective. Indirect costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective.

Only costs that are allowable, in accordance with the cost principles, will be allocated to benefiting programs by *XYZ Organization*.

General Approach

The general approach of *XYZ Organization* in allocating costs to particular grants and contracts is as follows:

- A. All allowable direct costs are charged directly to programs, grants, activity, etc.
- B. Allowable direct costs that can be identified to more than one program are prorated individually as direct costs using a base most appropriate to the particular cost being prorated.
- C. All other allowable general and administrative costs (costs that benefit all programs and cannot be identified to a specific program) are allocated to programs, grants, etc. using a base that results in an equitable distribution.

ALLOCATION OF COSTS

The following information summarizes the procedures that will be used by *XYZ Organization* beginning *Month/Day/Year*:

- A. Compensation for Personal Services - Documented with timesheets showing time distribution for all employees and allocated based on time spent on each program or grant. Salaries and wages are charged directly to the program for which work has been done. Costs that benefit more than one program will be allocated to those programs based on the ratio of each program's salaries to the total of such salaries (see Example 1). Costs that benefit all programs will be allocated based on the ratio of each program's salaries to total salaries (see example 2).
 - 1. Fringe benefits (FICA, UC, and Worker's Compensation) are allocated in the same manner as salaries and wages. Health insurance, dental insurance, life & disability and other fringe benefits are also allocated in the same manner as salaries and wages.
 - 2. Vacation, holiday, and sick pay are allocated in the same manner as salaries and wages.
- B. Travel Costs - Allocated based on purpose of travel. All travel costs (local and out-of-town) are charged directly to the program for which the travel was incurred. Travel costs that benefit more than one program will be allocated to those programs based on the ratio of each program's salaries to the total of such salaries (see Example 1). Travel costs that benefit all programs will be allocated based on the ratio of each program's salaries to total salaries (see Example 2).
- C. Professional Services Costs (such as consultants, accounting and auditing services) - Allocated to the program benefiting from the service. All professional service costs are charged directly to the program for which the service was incurred. Costs that benefit more than one program will be allocated to those programs based on the ratio of each program's expenses to the total of such expenses (see Example 3). Costs that benefit all programs will be allocated based on the ratio of each program's expenses to total expenses (see Example 4).
- D. Office Expense and Supplies (including office supplies and postage) - Allocated based on usage. Expenses used for a specific program will be charged directly to that program. Postage expenses are charged directly to programs to the extent possible. Costs that benefit more than one program will be allocated to those programs based on the ratio of each program's expenses to the total of such expenses (see Example 3). Costs that benefit all programs will be allocated based on the ratio of each program's expenses to total expenses (see Example 4).
- E. Equipment - *XYZ Organization* depreciates equipment when the initial acquisition cost exceeds \$x,xxx. Items below \$x,xxx are reflected in the supplies category and expensed in the current year. Unless allowed by the awarding agency, equipment purchases are recovered through depreciation. Depreciation costs for allowable

equipment used solely by one program are charged directly to the program using the equipment. If more than one program uses the equipment, then an allocation of the depreciation costs will be based on the ratio of each program's expenses to the total of such expenses (see example 3). Costs that benefit all programs will be allocated based on the ratio of each program's expenses to total expenses (see example 4).

- F. Printing (including supplies, maintenance and repair) - Expenses are charged directly to programs that benefit from the service. Expenses that benefit more than one program are allocated based the ratio of the costs to total expenses. Costs that benefit more than one program will be allocated to those programs based on the ratio of each program's expenses to the total of such expenses (see example 3). Costs that benefit all programs will be allocated based on the ratio of each program's expenses to total expenses (see example 4).
- G. Insurance - Insurance needed for a particular program is charged directly to the program requiring the coverage. Other insurance coverage that benefits all programs is allocated based on the ratio of each program's expenses to total expenses (see example 4).
- H. Telephone/Communications - Long distance and local calls are charged to programs if readily identifiable. Other telephone or communications expenses that benefit more than one program will be allocated to those programs based on the ratio of each program's expenses to the total of such expenses (see example 3). Costs that benefit all programs will be allocated based on the ratio of each program's expenses to total expenses (see example 4).
- I. Facilities Expenses - Allocated based upon usable square footage. The ratio of total square footage used by all personnel to total square footage is calculated. Facilities costs related to general and administrative activities are allocated to program based on the ratio of program square footage to total square footage (see example 5).
- J. Training/Conferences/Seminars – Allocated to the program benefiting from the training, conferences or seminars. Costs that benefit more than one program will be allocated to those programs based on the ratio of each program's salaries to the total of such salaries (see Example 1). Costs that benefit all programs will be allocated based on the ratio of each program's salaries to total salaries (see Example 2).
- K. Other Costs (including dues, licenses, fees, etc.) - Other joint costs will be allocated on a basis determined to be appropriate to the particular costs. (*Grantee should describe methodology for applicable costs*).
- L. Unallowable Costs – Costs that are unallowable in accordance with OMB Circular A-122, including alcoholic beverages, bad debts, advertising (other than help-wanted ads), contributions, entertainment, fines and penalties. Lobbying and fundraising costs are unallowable, however, are treated as direct costs and allocated their share of general and administrative expenses.

Examples of Allocation Methodology

Example 1

Expense Amount = \$5,000

Costs that benefit two or more specific programs, but not all programs, are allocated to those programs based on the ratio of each program's personnel costs (salaries & applicable benefits) to the total of such personnel costs, as follows:

Grant	Personnel Costs	%	Amount Allocated
A	\$ 20,000	20%	\$1,000
C	\$ 30,000	30%	\$1,500
E	\$ 50,000	50%	\$2,500
Total	\$100,000	100%	\$5,000

Example 2

Expense Amount = \$10,000

Costs that benefit **all** programs are allocated based on a ratio of each program's personnel costs (salaries & applicable benefits) to total personnel costs as follows:

Grant	Personnel Costs	%	Amount Allocated
A	\$ 20,000	13%	\$1,300
B	\$ 10,000	7%	\$ 700
C	\$ 30,000	20%	\$2,000
D	\$ 40,000	27%	\$2,700
E	\$ 50,000	33%	\$3,300
Total	\$150,000	100%	\$10,000

Example 3

Expense Amount = \$4,000

Costs that benefit two or more specific programs, but not all programs, are allocated to those programs based on the ratio of each program's expenses (direct costs other than salaries & benefits) to the total of such expenses, as follows:

Grant	Program Expenses	%	Amount Allocated
A	\$ 120,000	30%	\$1,200
C	\$ 130,000	33%	\$1,320
E	\$ 150,000	37%	\$1,480
Total	\$ 400,000	100%	\$4,000

Example 4

Expense Amount = \$8,000

Costs that benefit **all** programs will be allocated based on a ratio of each program's salaries to total salaries as follows:

Grant	Program Expenses	%	Amount Allocated
A	\$ 120,000	18%	\$1,440
B	\$ 110,000	17%	\$1,360
C	\$ 130,000	20%	\$1,600
D	\$ 140,000	22%	\$1,760
E	\$ 150,000	23%	\$1,840
Total	\$650,000	100%	\$8,000

Example 5

Facilities Expense Amount = \$10,000

Facilities costs are allocated based on square footage. Square footage for each program and general and administrative activity is considered in the analysis. General and administrative facilities costs are further allocated to each program based on the square footage of each grant program to the total square footage of all grant programs. The calculation is as follows:

Grant	Square Footage	%	Amount Allocated	G&A Allocated	Total Amount Allocated
A	300	30%	\$ 3,000	\$ 340	\$ 3,340
B	100	10%	\$ 1,000	\$ 110	\$ 1,110
C	200	20%	\$ 2,000	\$ 220	\$ 2,220
D	200	20%	\$ 2,000	\$ 220	\$ 2,220
E	100	10%	\$ 1,000	\$ 110	\$ 1,110
G&A	100	10%	\$ 1,000	0	0
Total	1,000	100%	\$10,000	\$1,000	\$10,000

Appendix B

Sample Indirect Cost Proposal

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

A. INTRODUCTION

Name of Organization (nonprofit) is a nonprofit located in Anytown, USA. The nonprofit administers a variety of programs funded by Federal, State, and Local agencies. These programs include Community Service programs, Head Start programs, State Weatherization, and Food Service programs. This example assumes a June 30 year end. Nonprofits can have different year ends and should use the year end of their nonprofit when preparing indirect cost proposals.

B. COST ALLOCATION METHODOLOGY

This proposal is for an indirect cost rate based on the nonprofits actual costs for its fiscal year beginning July 1, 200X and ending June 30, 200X. The proposal is based on the nonprofit organization's audit report (Statement of Functional Expense Statement) for the year ended June 30, 200X.

This proposal addresses all elements of cost incurred by "Name of Organization" and identifies shared costs that require allocation.

The nonprofit treats all costs as direct costs except general administration and general expenses. Joint costs are prorated individually as direct costs to each category and to each award using a base most appropriate to the particular cost being prorated. Therefore, the direct allocation method has been used in allocating indirect costs.

C. DIRECT COSTS

Direct costs are costs that can be identified specifically with a project and therefore are charged to that project. The accounting system records these costs as they are incurred within the series of accounts assigned for that purpose and further distribution is not required.

D. INDIRECT COSTS

Indirect costs are costs incurred for common or joint objectives and therefore cannot be readily and specifically identified with a particular project or activity. These costs are grouped into common pool(s) and distributed to benefiting activities by a cost allocation process.

E. COST POOL AND BASE FOR DISTRIBUTION

The nonprofit has created an Administrative Services Pool consisting of salaries, fringe benefits, and non-salary costs. The Administrative Services Pool is charged with all the indirect costs as defined above. The pool is distributed to the various program activities on the basis of direct salaries, including vacation, holiday, and sick pay but excluding other fringe benefits expended on those activities. Volunteers for the Head Start program are included in the direct salaries total.

The total direct salaries and wages on which this proposal is based is \$1,111,343 which includes \$99,230 of volunteer salaries and wages for the Head Start program.

Volunteers involved in any direct activity of the organization should be included in the direct salaries base assuming they meet the requirements outlined in Circular A-122.

Circular A-122 can be found at: www.whitehouse.gov/omb/circulars/index.html

F. SUPPORTING FINANCIAL STATEMENTS

The Schedule of Total Expenditures (Schedule C) contained in this proposal is assumed to agree to the nonprofits audit report Statement of Functional Expenses.

- Audit report, Statement of Functional Expenses: \$2,632,449
- Indirect Cost Proposal: \$2,632,449

NOTE: Nonprofit must include a complete copy of the audited financial statements with their proposal submission.

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

G. SALARIES

Listed below are the positions, functions, and budgeted annual salaries for the people who comprise the Administrative Services Pool. These positions are charged 100% to Administrative Services.

<u>Position</u>	<u>Function</u>	<u>Salary</u>
Executive Director	General Management	\$48,754
Deputy Director	General Management	\$30,664
Administrative Assistant to Executive Director	General Management	\$21,566
Administrative Secretary / Personnel Officer	Clerical support to the Executive Director and Administrative Assistant Responsible for personnel information	\$17,087
Finance Officer	Accounting and related activities	\$26,484
Bookkeeper	Accounting	\$20,797
Bookkeeper	Accounting	\$17,215
Bookkeeper / Payroll Clerk	Payroll accounting and general disbursements	\$16,560
Custodian	Cleaning	\$2,936
Receptionist	Switchboard / Clerical	\$14,232
Total Administrative Services Pool Salaries:		=====
		\$216,295

H. **FRINGE BENEFITS**

Fringe benefits associated with the positions within the Administrative Services Pool are as follows:

Payroll taxes:	
FICA (actual paid)	\$16,546
State Unemployment (actual paid)	<u>\$1,145</u> \$17,691
Health and Life Insurance (actual paid)	\$22,474
Retirement Plan (actual paid)	\$3,050

TOTAL	\$43,215
	=====

The nonprofits fringe benefit policies should be included with proposal submission.

I. **NON-SALARY COSTS**

Each category on non-salary expenditures has been analyzed based on the facts, and Schedule B shows the allocation between the Direct and Administrative Services Pool. Total non-salary direct costs excluding indirect cost reimbursements are \$984,656 of which direct is \$861,966 and indirect is \$122,690.

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

J. COMPUTATION OF BASE AND POOL COSTS

Schedule A (attached) shows the computation of the indirect cost rate for the year ended June 30, 200X. A summary of the rate calculation follows:

Direct Costs (Base - Salaries and Wages):	
Community Service	\$140,831
Head Start	\$950,615
Weatherization	\$18,305
Memberships and Fundraising	\$1,592

Total Direct Salaries:	\$1,111,343
	=====
Indirect Costs (Pool):	
Administrative Services Salaries	\$216,295
Administrative Services Fringe Benefits	\$43,215
Administrative Services Non-salary costs	\$122,690

Total Administrative Services:	\$382,200
	=====

K. RATE

Adjusted indirect costs (above - pool):	\$382,200	
	-----	34.4%
Total direct salaries (above - base):	\$1,111,343	

L. FUNDING OF RATE

When the above rate is applied to the direct salaries paid from the State Department of Human Resource funds (Community Services Block Grant) and funds from the U.S. Department of Health and Human Services (Head Start Grant), the eligible reimbursement is \$374,365 ($\$140,831 + \$950,615 = \$1,091,446 \times 34.4\% = \$374,365$). However, the allowable budgeted funding for indirect costs was significantly less than the eligible reimbursement. The Department of Energy programs and other local funds will have to absorb their fair share of the difference, within their funding limitations. The nonprofit can apply to outside sources to absorb any difference in indirect costs paid by other programs.

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

SCHEDULE A

Functional Groupings:

Direct Costs (Base - Salaries and Wages):		<u>Total Salaries</u>
Community Services		\$140,831
Head Start	Salaries	\$851,385
	Volunteers	<u>\$99,230</u>
Weatherization		\$18,305
Memberships and Fundraising		\$1,592
Total Direct Salaries:		<u>\$1,111,343</u>
Indirect Costs (Pool):		=====
Labor Costs		\$259,510
	Non-Labor Costs	\$122,690
Adjusted Administrative Services Pool:		<u>\$382,200</u>
		=====

RATE

Adjusted indirect costs (above - pool):	\$382,200	
Total direct salaries (above - base):	<u>\$1,111,343</u>	34.4%

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

SCHEDULE B

<u>Elements of Cost</u>	<u>Methodology of Allocation</u>
Contractual Services	Actual usage.
Depreciation / Use Allowance	Indirect cost.
Emergency assistance payments	Direct cost.
Equipment rental and maintenance	Rental and maintenance on equipment used in central office finance office.
Equipment / Capital	Purchasing of office furniture for use in performing administrative services.
Equipment / Minor	Actual usage.
Food costs	Direct cost.
Insurance	Actual usage.
Occupancy	Central office repairs and utilities on basis of square footage used for administrative services.
Office supplies	Office and janitorial supplies for administrative and program services.
Other expenses	Based on administrative services actual use.

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

SCHEDULE B (continued)

<u>Elements of Cost</u>	<u>Methodology of Allocation</u>
Postage	Actual usage.
Professional fees	Accounting and audit services, payroll processing services, charged on work performed for administrative services.
Program supplies	Programs are charged to project as costs are incurred. Costs are direct costs.
Printing	Actual usage.
Renovations and improvements	Direct cost.
Telephone	Basic services allocated on number of instruments, toll calls charged on basis of logs of such calls for administrative services.
Travel	Charged based on actual administrative and program use of vehicles. Costs include mileage, transportation, per diem, gas, oil, repairs, and insurance on vehicles.

The methodologies used in this example are not recommended methodologies. They are used for purposes of example only. Allocation of costs should be accomplished on a cost benefit basis. This cost benefit can be different from one nonprofit to the next.

Sample Indirect Cost Proposal Format for Nonprofit Organizations
Total Expenditures for the year ended June 30, 200X

Schedule C

(A)			DIRECT PROGRAMS and ACTIVITIES					(H)		(I)
ELEMENTS OF COSTS			(B)	(C)	(D)	(E)	(F)	(G)	(D)+(E)+(F)+(G)	
			FINANCIAL STATEMENT	ADJUSTMENTS	COMMUNITY SERVICE	HEAD START	WEATHERIZATION	MEMBERSHIP & FUND RAISING	TOTAL DIRECT COSTS	INDIRECT COSTS
Salaries and wages		a	\$1,327,638	\$0	\$140,831	\$950,615	\$18,305	\$1,592	\$1,111,343	\$216,295
Fringe benefits			\$245,434	\$0	\$28,138	\$170,107	\$3,657	\$317	\$202,219	\$43,215
Subtotal labor			\$1,573,072	\$0	\$168,969	\$1,120,722	\$21,962	\$1,909	\$1,313,562	\$259,510
Contractual Services			\$245,420	\$0	\$3,493	\$207,770	\$34,157	\$0	\$245,420	\$0
Depreciation/Use allowance			\$41,582	\$0	\$0	\$0	\$0	\$0	\$0	\$41,582
Emergency asst. payments			\$72,859	\$0	\$52,809	\$0	\$20,050	\$0	\$72,859	\$0
Equipment rental and maint.			\$11,448	\$0	\$592	\$5,197	\$0	\$281	\$6,070	\$5,378
Equipment / Capital			\$58,215	(\$58,215)	\$0	\$0	\$0	\$0	\$0	\$0
Equipment / Minor			\$546	\$0	\$0	\$0	\$546	\$0	\$546	\$0
Food costs			\$124,616	\$0	\$0	\$124,616	\$85	\$0	\$124,616	\$0
Insurance			\$12,554	\$0	\$92	\$8,209	\$85	\$373	\$8,759	\$3,795
Occupancy			\$129,314	\$0	\$24,637	\$100,956	\$459	\$233	\$126,285	\$3,029
Office supplies			\$32,540	\$0	\$1,794	\$13,317	\$3,649	\$842	\$19,602	\$12,938
Other expenses			\$36	(\$36)	\$0	\$0	\$0	\$0	\$0	\$0
Postage			\$3,901	\$0	\$476	\$301	\$125	\$2,467	\$3,369	\$532
Professional fees			\$34,211	\$0	\$0	\$0	\$0	\$0	\$0	\$34,211
Program supplies			\$109,663	\$0	\$7,603	\$55,241	\$40,659	\$6,160	\$109,663	\$0
Printing			\$65,697	\$0	\$5,140	\$7,022	\$1,345	\$44,838	\$58,345	\$7,352
Renovations and improv.			\$16,470	(\$16,470)	\$0	\$0	\$0	\$0	\$0	\$0
Telephone			\$29,013	\$0	\$5,788	\$13,331	\$349	\$600	\$20,068	\$8,945
Travel			\$71,292	\$0	\$7,298	\$56,553	\$2,513	\$0	\$66,364	\$4,928
Subtotal non-labor			\$1,059,377	(\$74,721)	\$109,722	\$592,513	\$103,937	\$55,794	\$861,966	\$122,690
TOTAL			\$2,632,449	(\$74,721)	\$278,691	\$1,713,235	\$125,899	\$57,703	\$2,175,528	\$382,200

Calculation of the Rate

(1) If the nonprofit organization uses Direct Salaries & Wages excluding fringe benefits as their Base their rate would calculate as follows:

Indirect costs = \$382,200
Base (Direct S&W) = \$1,111,343 = 34.4%

(2) If the nonprofit organization uses Direct Salaries & Wages including fringe benefits as their Base their rate would calculate as follows:

Indirect costs = \$382,200
Base (Direct S&W + FB) = \$1,313,562 = 29.1%

(3) If the nonprofit organization uses Modified Total Direct Costs (MTDC) as their Base their rate would calculate as follows:

Indirect costs = \$382,200
Base (MTDC) = \$2,175,528 = 17.6%

Explanation of Adjustments

- a) Includes salaries and wages of \$99,230 for volunteers of the Head Start program.
- b) Excludes capital equipment purchases.
- c) Remove unallowable costs - \$22 Interest + \$14 Bad Debt = \$36.
- d) Excludes capital renovations and improvements.

General Notes

- This is a sample proposal only. It is not intended to prescribe a particular method for allocating costs. An organization should choose the Base that they feel will most accurately reflect the true allocation of their indirect costs to each program.
- An organization can use any ONE of the three bases shown. Regardless of what Base (1,2 or 3) is chosen the total indirect costs (\$382,200) do not change. The only thing that changes is the distribution Base.

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

1. The Indirect Cost Proposal is supported by: (Include a copy of this document with proposal.)

☐ Audited financial statements. If not available include one of the following documents:

☐ Federal Form 990

☐ Internal Financial Statements

☐ Other _____

☐ 2. A reconciliation of item 1. (above) to the Indirect Cost proposal has been made and is included in this proposal.

☐ 3. Unallowable expenses have been eliminated from the indirect cost pool (e.g., donated or contributed salaries and services, bad debts, fund raising, advertising, independent research and development (IR&D), depreciation of Federally funded assets and lobbying costs, etc.).

☐ 4. The direct cost base is complete (i.e., it includes all activities that benefit from the indirect cost pool). For example, fund raising, IR&D, project cost sharing, voluntary (e.g., donated or contributed labor and services are included where applicable).

☐ 5. A functional analysis of salaries and wages included in the indirect cost pool. If any function is less than 100% show the percent.

☐ 6. Treatment of Paid Absences and Fringe Benefits statements have not changed since the last indirect cost rate agreement.

☐ 7. We have not made any significant changes, during the proposal fiscal year, (i) to our accounting system, or (ii) to the definition or to the accounting treatment of any expense category (e.g., a change in building/equipment costing methodology, a change in charging an expense from direct to indirect or visa versa).

☐ 8. We have not changed the equipment capitalization threshold during the proposal fiscal year. The capitalization level is \$ _____. If there is a change made during the proposal fiscal year, indicate the effective date of the change and the new capitalization level.

☐ 9. The required "Lobbying Cost Certificate" is attached.

Please explain any boxes not checked on a separate sheet.

Signature _____ Date _____

Title _____

Organization _____

SAMPLE INDIRECT COST PROPOSAL FORMAT FOR NONPROFIT ORGANIZATIONS

LOBBYING COST CERTIFICATE

I hereby certify that the _____
(name of organization)
has complied with the requirements and standards on lobbying costs in OMB Circular
A-122 for the fiscal year ended _____
(fiscal year covered by indirect cost proposal)

Signature

Name

Title

Date

(Signed by the official having the authority to negotiate
indirect cost rates for the organization or by a higher
level official)

**Note: The above certification is a requirement of OMB Circular A-122.
We will not be able to process your indirect cost proposal without this certification.**

Appendix C, Part I
Illustrations of the Cost Allocation
Approaches

Appendix C, Part I

Annual Operating Budget

Illustrations of the Cost Allocation Approaches

Overview of the Exhibits:

This Appendix illustrates some of the many approaches to cost allocation used by CAAs. They are not intended to take the place of the standard format for submitting a proposal for a federally negotiated indirect cost rate which is included in Appendix C, Part II. Instead, these samples illustrate key concepts about the use of indirect cost pools and strategies for deal with arbitrary limitations on indirect and/or administrative costs that may be imposed by various funding agreements.

In these Exhibits the term “indirect” cost is used to describe costs which provide benefits to multiple cost centers including both program and administrative cost centers. For purposes of clearer illustration, the Exhibits use a separate cost center for administrative costs. The Exhibits illustrate the impact of either combining the administrative and other indirect cost centers or using separate cost centers to collect them.

The Exhibits illustrate the calculation of the “effective indirect cost rate” which represents the relationship between the “indirect” but not “administrative” costs and all other costs (both program and administrative). The Exhibits also include calculation of the “administrative rate” which presents the administrative costs as a percentage of all costs. There are other methods to compute both the effective indirect cost rate and the administrative cost rate. To conserve space, the Exhibits do not include a fund raising cost center which will be used by most CAAs in their actual cost allocation structures.

The Exhibits are designed to illustrate the impact of different approaches to defining and dealing with indirect or common costs, including strategies to deal with funder limitations on indirect costs and distribution of indirect costs among multiple funding sources supporting one program.

Exhibits 1, 2, and 3:

Exhibits 1, 2 and 3 illustrate three distinct organizations – A, B, and C. While each of the three organizations has 3 distinct programs and an administrative cost center, there approach to treatment of indirect costs other than administration is different. Organizations A and B (Exhibits 1 and 2), use a separate cost center to display non-administrative indirect costs by line item and then allocate a share of the total indirect costs to each of the programs and to the administrative cost center. In contrast,

Organization C (Exhibit 3) does not display indirect costs in a separate indirect cost center. Instead, organization C allocates its indirect costs on a line item by line item basis, increasing the costs shown in all three programs and the administrative cost center while avoiding displaying any line item for allocated indirect costs. The approach used by Organization C would be typical of an organization that chose to allocate shared/indirect costs on a transaction by transaction basis rather than collecting them into an indirect cost pool or cost center.

Note that the indirect cost rates shown at the top of the three Exhibits are dramatically different. Organization A computes an indirect cost rate of 6.6%, while Organization B computes an indirect rate of 65.8% and Organization C reports an indirect rate of 0%. The contrasts in indirect cost rate result from different methodologies (the transaction by transaction allocation of indirect costs used by Organization C in contrast to the allocation of an indirect pool by Organizations A and B) and by different fact patterns or interpretations of fact patterns regarding costs which are considered indirect (Organizations A and B). In fact, allow A and B may operate with very similar realities, B may have chosen to treat more costs as shared or indirect than A. For Exhibit, B may have installed an electronic utilization program on its copiers so that costs of copying can be directly attributed to specific program and administrative cost centers while A may have chosen not to do cost center tracking of copies and to include copier costs in the indirect pool. Presumably all of these choices have been made to facilitate cost effective operation and none are evidence of either waste/extravagance or exemplary thrift.

Exhibits 1, 2, and 3 ultimately illustrate the need to think carefully about both the most efficient way to track and allocate costs in your system and the impact that your choices will have on the resulting indirect cost rate.

Exhibit 4:

Exhibit 4 illustrates the consequence of yet another choice. In Exhibit 4, Organization A chooses to combine the information shown in the Admin and Indirect columns in Exhibit 1 into a single column which is labeled "Indirect/Admin". While the computed indirect cost rate remains 6.6%, the visual impact is striking. Most casual readers will conclude erroneously that Organization A has administrative costs equaling \$47,436. In fact, the combined total of the admin and indirect cost centers would be described as "indirect" costs in a proposal for a federal indirect cost rate prepared under the Simplified Allocation method (see Exhibit 9). The confusing use of the terms indirect and administrative is discussed in the *Annual Operating Budget* section of the Toolkit and represents yet another challenge to be addressed in designing your cost allocation model.

Exhibit 5:

Exhibit 5 illustrates the impact of computing the fully loaded cost of each of Organization A's programs. In this approach, A allocates both the indirect cost pool and the total of the admin cost center to the three programs. The fully loaded cost model approach allows Organization A to determine and present the full cost of delivering each of its three services. It is a particularly useful tool for negotiating fee for service contracts and evaluating pricing decisions.

The fully loaded cost model may also provide valuable insight for the preparation of program specific funding proposals. Unless Organization A has unlimited unrestricted resources to meet its admin and indirect costs, it will need to communicate the full cost of delivering each of service to its funders, including a fair share of the admin and indirect costs which are necessary to ensure the sound management of the program and the availability of basic tools such as heat and light which are required to provide any service.

Exhibit 6:

Not all organizations would agree with the premise that underlies the analysis presented in Exhibit 5, the fully loaded cost model. Some would argue that not all administrative costs are incurred in order to provide the administrative support required to operate programs. Proponents of this view

believe that some administrative costs are incurred in order to sustain the organization as a viable entity and would be incurred whether any programs were in place. From this point of view, only a portion of the administrative costs can be legitimately allocated to the programs.

Exhibit 7:

Exhibit 7 illustrates the impact of a funder imposing a cap on the indirect cost rate, refusing to allow its funds to be used for indirect costs that exceed 5% of the direct costs associated with the program the award supports. While the example illustrates a cap on indirect costs, the issues involved would be the same for a cap on admin costs.

OMB A-122 cost allocation principles require that all shared or common costs be allocated fairly among cost objectives or cost centers. Organization A has used program cost centers as its cost objectives. Consequently, each program must be allocated its fair share of allocated costs. In Exhibit 7, A is allocating its indirect costs by applying its indirect cost rate of 6.6% (illustrated earlier in Exhibit 1) to the direct costs of each of its 3 programs. The result of that fair allocation, as shown on Exhibit 1, is that Program A would be allocated \$2112 in indirect costs, and Programs B and C would be allocated \$2667 and 3084 respectively.

However, in Exhibit 7, Organization A is dealing with the reality that the funder of Program A has established a 5 % cap on indirect costs which will limit the amount of indirect costs which may be charged to the funder's award to \$1593 ($\$31,869 \times .05$). Consequently, the amount which may be charged to the funder of Program A will total \$33464, the total of the direct costs (\$31,869) and the allowable portion of the fair indirect cost allocation (\$1,593).

Exhibit 7 illustrates that despite this funder cap on indirect costs, Organization A must allocate the fair share of indirect cost to Program A and demonstrate that it has other funds available to pay the \$519 in indirect costs which the funder has refused to pay. OMB A-122 explicitly prohibits Organization A from using the availability of funds as a basis for cost allocation. Consequently, A cannot limit the share of indirect costs allocated to Program A to an unfair share simply because of a funder limitation.

Exhibit 8:

Exhibit 8 illustrates the use of multiple indirect cost pools, generally in larger, more complex CAAs. Multiple pools are utilized when different types of indirect cost can be most fairly allocated through the use of different methodologies. For example, in Exhibit 8, the costs in Indirect Cost Pool 1 are allocated by the percentage of direct salaries and wages in each cost center. Cost Pool 2 is allocated based upon the distribution of FTE (full time equivalent positions) among the cost centers. Cost Pool 3 is allocated based upon the percentage of square footage utilized by each cost center. The rationale for each of these allocation methods, as well as the definition of costs to be included in each cost pool, must be included in the organization's cost allocation plan.

Exhibit 9:

Exhibit 9 takes a deeper look at the sub-components of Organization A's Program A which has been illustrated in the earlier exhibits. The total column in Exhibit 9 is identical to the line item costs of Program A presented in Exhibit 1, including the line item for Allocation of Indirect Cost which represents the fair share of indirect costs allocated to Program A by applying the indirect cost rate of 6.6% to the direct costs of each of the three program cost centers and the admin cost center.

Three distinct sources of funds are supporting Program A – a government grant, a private grant, and unrestricted general operating funding. As noted in the footnotes, both the government grant and the private grant have imposed limits on the types and amounts of costs that will be allowed. Consequently, Organization A has determined that it must cover a large portion of the indirect costs allocated to Program A (see Exhibit 1) with unrestricted general operating funds. The \$1763 in allocated indirect costs (1,763) assigned to the general operating funds column comprises nearly 8% of the direct costs (22,149) assigned to the general operating funds column. In contrast, portion of the allocated indirect costs assigned to the private grant (106) comprises less than 7% of the direct costs assigned to the private grant (1605), and the share of allocated indirect costs assigned to the government grant (203) comprises less than 3 % of the direct costs assigned to the government grant.

This distribution is compliant with A-122 because Organization A has chosen to use Programs as cost objectives and has demonstrated in Exhibit 1 that it has fairly allocated the indirect costs to all of its cost objectives (cost centers). So, Organization A is free to distribute the costs assigned to Program A among the various sub-cost centers of Program A in a manner that works with funder limitations.

Appendix C, Part II

Illustrations of the Cost Allocation Approaches

*These exhibits were reprinted with permission from Gary McGee, CPA, managing partner at Gary McGee & Co. LLP, Certified Public Accountants
808 S.W. Third Avenue, Suite 700, Portland, Oregon 97204*

Exhibit 1

Organization A - Indirect cost rate of 6.6%

TOTAL EXPENSES						
	Programs					Total
	A	B	C	Admin	Indirect	
Expenses:						
Salaries & wages	\$ 18,613	19,500	23,347	18,557	5,150	85,167
Employee benefits	2,792	2,925	3,502	2,784	772	12,775
Materials & supplies	5,200	8,900	3,581	1,124	0	18,805
Postage & shipping	605	987	4,251	895	2,088	8,826
Printing & publications	1,000	1,355	756	201	50	3,362
Telephone	756	1,222	1,336	2,285	2,263	7,862
Occupancy	2,219	4,590	9,675	11,116	0	27,600
Depreciation	684	758	95	151	0	1,688
Total direct expenses	31,869	40,237	46,543	37,113	10,323	166,085
Allocation of indirect costs	2,112	2,667	3,084	2,460	(10,323)	0
	\$ 33,981	42,904	49,627	39,573	0	166,085

- 1. The effective indirect cost rate = 6.6% [\$10,323/(\$166,085 - \$10,323)]
- 2. The administrative rate = 23.8% [\$39,573/\$166,085]
- 3. Indirect costs are allocated by applying indirect cost rate (6.6%) to each cost center's total direct expenses
[e.g., Program A: 6.6% X \$31,869 = \$2,112]

Exhibit 2

Organization B - Indirect cost rate of 65.8%

	TOTAL EXPENSES					
	Programs					Total
	A	B	C	Admin	Indirect	
Expenses:						
Salaries & wages	\$ 12,500	14,950	19,635	15,400	22,682	85,167
Employee benefits	1,875	2,243	2,945	2,310	3,402	12,775
Materials & supplies	3,300	6,000	895	1,400	7,210	18,805
Postage & shipping	500	1,035	3,675	1,682	1,934	8,826
Printing & publications	950	1,184	642	120	466	3,362
Telephone	1,672	1,724	1,126	2,418	922	7,862
Occupancy	0	0	0	0	27,600	27,600
Depreciation	0	0	0	0	1,688	1,688
Total direct expenses	20,797	27,136	28,918	23,330	65,904	166,085
Allocation of indirect costs	13,184	15,768	20,709	16,243	(65,904)	0
	\$ 33,981	42,904	49,627	39,573	0	166,085

1. The effective indirect cost rate = 65.8% [\$65,904/(\$166,085 - \$65,904)]
2. The administrative rate = 23.8% [\$39,573/\$166,085]
3. Indirect costs are allocated based on each cost center's direct salaries & wages as a percentage of total direct salaries and wages

Exhibit 3

Organization C - Indirect cost rate of 0%

	TOTAL EXPENSES				
	Programs				Total
	A	B	C	Admin	
Expenses:					
Salaries & wages	\$ 19,255	21,621	25,388	18,903	-- 85,167
Employee benefits	2,881	3,050	3,727	3,117	-- 12,775
Materials & supplies	5,200	8,900	3,581	1,124	-- 18,805
Postage & shipping	923	1,612	4,541	1,750	-- 8,826
Printing & publications	1,025	1,380	800	157	-- 3,362
Telephone	1,290	1,417	2,244	2,911	-- 7,862
Occupancy	3,219	4,590	8,675	11,116	-- 27,600
Depreciation	188	334	671	495	-- 1,688
Total direct expenses	33,981	42,904	49,627	39,573	-- 166,085
Allocation of indirect costs	--	--	--	--	-- --
	\$ 33,981	42,904	49,627	39,573	-- 166,085

- 1. The indirect cost rate = 0%. No indirect allocation mechanism is used; all expenses are charged directly
- 2. The administrative rate = 23.8% [\$39,573/\$166,085]

Exhibit 4

Organization A - Indirect cost rate of 6.6%; administrative and indirect costs combined

	TOTAL EXPENSES				
	Direct		Indirect		
	Programs		Admin		Total
	A	B	C	Admin	Total
Expenses:					
Salaries & wages	\$ 18,613	19,500	23,347	23,707	85,167
Employee benefits	2,792	2,925	3,502	3,556	12,775
Materials & supplies	5,200	8,900	3,581	1,124	18,805
Postage & shipping	605	987	4,251	2,983	8,826
Printing & publications	1,000	1,355	756	251	3,362
Telephone	756	1,222	1,336	4,548	7,862
Occupancy	2,219	4,590	9,675	11,116	27,600
Depreciation	684	758	95	151	1,688
Total direct expenses	31,869	40,237	46,543	47,436	166,085
Allocation of indirect costs	2,112	2,667	3,084	(7,863)	0
	\$ 33,981	42,904	49,627	39,573	166,085

1. The effective indirect cost rate = 6.6% [$\$10,323/(\$166,085 - \$10,323)$]
2. The administrative rate = 23.8% [$\$39,573/\$166,085$]
3. Indirect costs are allocated by applying indirect cost rate (6.6%) to each cost center's total direct expenses

Exhibit 5

Organization A - "Fully loaded" cost model

TOTAL EXPENSES						
	Direct			Admin	Indirect	Total
	Programs					
	A	B	C			
Expenses:						
Salaries & wages	\$	18,613	19,500	23,347	18,557	5,150
Employee benefits		2,792	2,925	3,502	2,784	772
Materials & supplies		5,200	8,900	3,581	1,124	0
Postage & shipping		605	987	4,251	895	2,088
Printing & publications		1,000	1,355	756	201	50
Telephone		756	1,222	1,336	2,285	2,263
Occupancy		2,219	4,590	9,675	11,116	0
Depreciation		684	758	95	151	0
Total direct expenses		31,869	40,237	46,543	37,113	10,323
						166,085
Allocation of indirect costs		2,112	2,667	3,084	2,460	(10,323)
						0
Total direct & indirect costs		33,981	42,904	49,627	39,573	0
						166,085
Allocation of admin costs		10,629	13,420	15,524	(39,573)	0
						0
	\$	44,610	56,324	65,151	0	0
						166,085

1. The effective indirect cost rate = 6.6% [$\$10,323/(\$166,085 - \$10,323)$]
2. The administrative rate = 23.8% [$\$39,573/\$166,085$]
3. Indirect costs are allocated by applying rate (6.6%) to each cost center's total direct expenses
[e.g., Program A: $6.6\% \times \$31,869 = \$2,112$]
4. Administrative costs are allocated based on pro rata distribution of total direct & indirect costs of each program
[e.g., Program A: $\$33,981 \times (\$39,573/(\$166,085 - \$39,573)) = \$10,629$]

Exhibit 6

Organization A - Adjustment of fully loaded model for GAAP purposes

TOTAL EXPENSES						
	Programs					Total
	A	B	C	Admin	Indirect	
Expenses:						
Salaries & wages	\$ 18,613	19,500	23,347	18,557	5,150	85,167
Employee benefits	2,792	2,925	3,502	2,784	772	12,775
Materials & supplies	5,200	8,900	3,581	1,124	0	18,805
Postage & shipping	605	987	4,251	895	2,088	8,826
Printing & publications	1,000	1,355	756	201	50	3,362
Telephone	756	1,222	1,336	2,285	2,263	7,862
Occupancy	2,219	4,590	9,675	11,116	0	27,600
Depreciation	684	758	95	151	0	1,688
Total direct expenses	31,869	40,237	46,543	37,113	10,323	166,085
Allocation of certain administrative costs	3,223	4,070	4,707	(12,000)	0	0
Allocation of indirect costs	35,092	44,307	51,250	25,113	10,323	166,085
	2,326	2,936	3,397	1,664	-10,323	0
	\$ 37,418	47,243	54,647	26,777	0	166,085

1. The effective indirect cost rate = 6.6% [$\$10,323/(\$166,085 - \$10,323)$]
2. \$12,000 of administrative costs are allocated to programs based on total direct expenses [e.g., $\$31,869 \times (\$12,000/(\$31,869 + \$46,543)) = \$3,223$]
3. Indirect costs are allocated by applying rate (6.6%) to each cost center's total direct expenses after the allocation of selected administrative costs [e.g., Program A: $6.6\% \times \$35,092 = \$2,326$]

Exhibit 7

Organization A - 5% cap on indirect costs that can be charged to Program A

	TOTAL EXPENSES					
	Programs			Admin	Indirect	Total
	A	B	C			
Expenses:						
Salaries & wages	\$ 18,613	19,500	23,347	18,557	5,150	85,167
Employee benefits	2,792	2,925	3,502	2,784	772	12,775
Materials & supplies	5,200	8,900	3,581	1,124	0	18,805
Postage & shipping	605	987	4,251	895	2,088	8,826
Printing & publications	1,000	1,355	756	201	50	3,362
Telephone	756	1,222	1,336	2,285	2,263	7,862
Occupancy	2,219	4,590	9,675	11,116	0	27,600
Depreciation	684	758	95	151	0	1,688
Total direct expenses	31,869	40,237	46,543	37,113	10,323	166,085
Allocation of 5% approved indirect cost cap	1,593	0	0	0	(1,593)	0
Total expenses of Program A reportable to contractor	33,462					
Allocation of Program A's 1.6% excess	519	0	0	0	(519)	0
Allocation of remaining indirect costs	0	2,667	3,084	2,460	(8,211)	0
	\$ 33,981	42,904	49,627	39,573	0	166,085

1. $\$31,869 \times 5\% = \$1,593$ = maximum indirect costs chargeable to Program A

2. Total indirect cost rate remains 6.6% [$\$10,323/(\$166,085 - \$10,323)$]

Exhibit 8

Organization B - Multiple cost pools

	TOTAL EXPENSES							
	Programs				Indirect cost pools			
	A	B	C	Admin	1	2	3	Total
Expenses:								
Salaries & wages	\$ 12,500	14,950	19,635	15,400	22,682	0	0	85,167
Employee benefits	1,875	2,243	2,945	2,310	3,402	0	0	12,775
Materials & supplies	3,300	6,000	895	1,400	7,210	0	0	18,805
Postage & shipping	500	1,035	3,675	1,682	0	1,934	0	8,826
Printing & publications	950	1,184	642	120	466	0	0	3,362
Telephone	1,672	1,724	1,126	2,418	0	922	0	7,862
Occupancy	0	0	0	0	12,589	15,011	0	27,600
Depreciation	0	0	0	0	0	0	1,688	1,688
Total direct expenses	20,797	27,136	28,918	23,330	46,349	17,867	1,688	166,085
Allocation of indirect costs	9,272	11,089	14,565	11,423	(46,349)	0	0	0
Allocation of indirect costs	6,497	3,249	4,872	3,249	0	(17,867)	0	0
Allocation of indirect costs	359	467	718	144	0	0	(1,688)	0
	\$ 36,925	41,941	49,073	38,146	0	0	0	166,085
FTEs	2.0	1.0	1.5	1.0	0.0	0.0	0.0	5.5
square footage utilized	500	650	1000	200	0	0	0	2350

1. Indirect cost pool 1: costs allocated to programs based on direct salaries and wages

2. Indirect cost pool 2: costs allocated to programs based on FTE

3. Indirect cost pool 3: costs allocated to programs based on squared footage

Exhibit 9

Organization A - Program A by funding source with multiple caps and limitations

	PROGRAM A			
	Gov't grant	Private grant	General ops.	Total
Expenses:				
Salaries & wages	\$ 5,000	0	13,613	18,613
Employee benefits	0	0	2,792	2,792
Materials & supplies	2,600	0	2,600	5,200
Postage & shipping	0	605	0	605
Printing & publications	0	1,000	0	1,000
Telephone	115	0	641	756
Occupancy	400	0	1,819	2,219
Depreciation	0	0	684	684
Total direct expenses	8,115	1,605	22,149	31,869
Allocation of indirect costs	243	106	1,763	2,112
	\$ 8,358	1,711	23,912	33,981

1. Government grant caps salaries at \$5,000, benefits and depreciation at 0, and indirect costs at 3%
2. Private grants pays only postage and shipping, and printing and publications, but accepts the 6.6% indirect cost rate

Appendix D

Template for Budget Preparation in Multi-Program/Multi-Source CAAs

Note:

Visit <http://www.terrymiller.biz/Downs.html> to download an Excel Spreadsheet template for a multi-program, multi-funding source comprehensive annual budget. To find the template, slide down the page until you see Budget Template in the right hand navigation column.

The template includes linked worksheets that allow users to build an annual budget from the ground up, beginning with identification and naming of cost centers, moving on to establishing cost allocation formulae for allocating shared costs, identifying direct costs of each program, and associating all income sources with the cost centers they will support.

The printed versions of the some of the template tabs are included to illustrate some of the key concepts in cost center based budgeting. However, the actual Excel template file will be more useful since it can be easily modified to address your specific needs.

The Budget Template is designed for organizations that do not have a federally negotiated indirect cost rate. With modifications, it could be used as the basis for submitting an indirect cost rate proposal. Please see Appendices B and C for more detailed formats for preparation of indirect cost rate proposals.

The Budget Template is maintained by Terry Miller, a nonprofit financial management consultant on his website www.terrymiller.biz where you will also find extremely useful information about other financial management issues of interest to nonprofit organizations.

COST CENTERS									
LINE ITEMS							Fund		
	Prog A	Prog B	Prog C	Prog D	Prog E	Prog F	Prof G	(& GenSupt Income)	Admin (& Gen)
Income									
Foundation grants									
Individual contributions									
Corporate contributions									
Government grants & contracts									
Funds released from restriction									
Events									
Program Service Revenue									
Investment Income									
Total Income									
Expense									
Personnel Expenses									
Payroll									
Payroll tax & work comp									
Benefits									
Personnel Expenses									
Program-specific Expenses									
Travel & meetings									
Dues, subs & pubs									
Website devp & maint									
Policy research									
Legal analysis									
Financial analysis									
Market analysis									
Communication counsel									
Publications & media									
Events									
Board expenses									
Fundraising services									
Project-specific Expenses									
Shared Operating Expenses									
Occupancy									
Office expenses									
Postage & delivery									
Phone & internet									
Copying & printing									
Equipment lease & rent									
Repairs & maintenance									
Insurance									
Professional/outside services									
Staff devp & training									
Taxes & licenses									
Bank charges									
Miscellaneous expense									
Capital purchases-furn & equip									
Shared Operating Expenses									
Total Expenses by Function									
Net Income									

This is the schedule where we change names, version numbers, etc.

Please DO NOT change names without communicating closely with whoever is doing the accounting - important to talk it through from various perspectives and make sure the two use the same words.

Sample Organization			Draft 4.2c		printed		03/08/11		9:49 AM		
Fiscal Year 2003 (7/1-6/30)											
Shared Operating Expense Detail											
G/L Acct #	Line Item Definition / Planning	FY 2002 thru 4/30									

Sample Organization																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																								
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SCHEDULE A: PAYROLL PLANNING

[illegible]

	A	B	C	D	E	F	G	H	I	J	K
column:							(D x B) x 1.5				
calculation:						A + (CxB) + E + D x E) x 1.5	F * G				1 + J

1.00	President / Principal / Project Director 1	Boss Person	\$ 75,000		\$ 75,000	\$ 75,000	\$ 1,875	5% mid yr	\$ 76,875
1.00	VP / Principal / Project Director 3	Senior Specialist - Incoming	\$ 60,000		\$ 65,000	\$ 65,000	1,625	5% mid yr	\$ 66,625
-	VP / Principal / Project Director 2	Senior Specialist - outgoing	\$ 50,000			\$ -			\$ -
1.00	Business Manager	Biz Mgr			\$ 50,000	\$ 50,000	1,250	5% mid yr	\$ 51,250
1.00	Office Assistant	Genl Office	\$ 12.00	2,080	\$ 24,960	\$ 27,120	27,988	5% mid yr	\$ 27,988
0.25	Fundraiser	Fundraising Staffer	\$ 16.00	520	\$ 8,320	\$ 9,040	226	5% mid yr	\$ 9,266
								Innmt \$15	
0.25	Research Assistant	Junior Specialist	\$ 13.00	520	\$ 6,760	\$ 6,985	1,244	+5%mid yr	\$ 8,199
0.75	Project Assistant	Occasional Specialist		10	\$ 23,400	\$ 1,360	619	5% mid yr	\$ 25,369
0.25	Temp hourly	open name		1,560	\$ 5,200	\$ 5,200	130	5% mid yr	\$ 5,330
-	open salaried position	open name		520	\$ -	\$ -			\$ -

Totals

use these lines here and carefully add lines to all other staff lists here and on PRAlloc tab if additional staff positions are created

	new staffer name	2,080	\$	\$	\$	\$	\$	\$
New Position - waged			\$	\$	\$	\$	\$	\$
New Position - salaried & bonused	new staffer name		\$	\$	\$	\$	\$	\$

SCHEDULE B: PAYROLL TAX & BENEFITS PLANNING

	FY03 Payroll Budget	Employer Soc Sec rate	Employer Medicare 1.45%	Employer SUI 3.00%	Workers Comp 0.51%	WBF Assess estimate	Transit Tax (exempt)	FUTA (exempt)	Total Payroll Taxes	TXBL Disability 204.20	Health Insurance currently 1,500.26 / mo	Retire 3%	Total Benefits
President / Principal / Project Director 1	66,875	4,786	1,115	750	352	80			7,103	2,450	7,600	2,306	12,357
VP / Principal / Project Director 3	66,625	4,131	966	750	340	80			6,267	-	6,120	1,999	8,119
VP / Principal / Project Director 2	-	-	-	-	-	80			80	-	-	-	-
Business Manager	51,250	3,178	743	750	261	80			5,012	-	5,080	1,538	6,618
Office Assistant	27,798	1,723	403	750	142	80			3,098	-	-	834	834
Fundraiser	9,266	574	134	278	47	80			1,174	-	-	278	278
Research Assistant	8,199	508	119	246	42	80			995	-	-	246	246
Project Assistant	25,369	1,573	368	750	129	80			2,900	-	5,080	761	5,841
temp hourly	5,330	330	77	160	27	80			675	-	-	-	-
open salaried position	-	-	-	-	-	-			-	-	-	-	-

(Workers Comp is booked slightly higher than actual experience in FY 02, because Sr. Specialist Incoming will be at a higher rate. This year was rate .458%.)

** Health Insurance figures are 8 months at current rates + 4 months of increase similar to last year.

SECTION 4

**Getting the Most Out of Your
Financial Statements**

APPENDIX A

Supplemental Examples

PREFACE

Most of the examples in this toolkit are based on the sample financial statements included at the end of this appendix. Those statements are based on the financial statement layout of an existing CAA, but the numbers have been changed, the statement layouts have been simplified, and some account detail has been aggregated, thereby reducing the number of accounts. Our purpose is not to show you complete financial statements--there are plenty of those available on the web--but to show what the data reveals. That objective is furthered by using simplified statements. Because of the absence of financial statements for 2008, the statement of cash flows does not contain a statement of cash flows for 2009. Like the statements of financial position and results of operation, the statement of cash flows would normally present two years of data. The financial statements also do not present information on restricted and unrestricted assets, except for a note in the footnote. This information was omitted to keep the statements simple, so that key points could be made.

Throughout the discussion of these examples, we will offer explanations of what the numbers *might* mean. Those explanations are meant to illustrate some of the issues and information that a board can discover through a systematic examination of the financial statements. But those discussions are speculative. Only a discussion with BCA's management can reveal the story behind the numbers. That is why financial oversight requires discussion rather than just distribution of the financial statements.

To illustrate the type of analysis that a CAA's management and board might undertake, some of the examples will involve comparisons to certain benchmarks. Your CAA should not use the benchmark numbers used in the examples because they were pulled out of thin air rather than developed through an analysis of CAA financial data.

Supplemental Examples, A Closer Look at BCA's Financial Statements

A. EXAMPLE 1: HOW TO ASSESS LIQUIDITY

The facts are the same as Example 5 in the main discussion toolkit. If BCA were following best practices, its management would have alerted the board's finance committee to the changed circumstances and developed a proposal for dealing with the overdraft, if necessary. The board member or other person charged with leading the discussion on finances should have anticipated the obvious question about the overdraft and been prepared to discuss it regardless of whether somebody asked about it.

One useful way to assess liquidity is to compare the cash balance (\$258,390) to the current liabilities (\$5,169,447), and then ask: "How are we going to make up the shortfall (\$4,911,057)?"

The board should begin by reviewing revenue receivable (\$4,406,070). For many CAAs, a large portion of this number represents amounts that the CAA is entitled to be reimbursed under government grants. Both management and the board should examine a schedule aging the reimbursements (e.g., amounts due and expected to be received in 30, 60, 90, and 120 days). Management should indicate whether circumstances exist that might turn routine reimbursements into ones that are denied. Management should also provide the board with aging schedules for other receivables. In all likelihood, the funds collected as these receivables are paid by grantmakers will be the primary source for repaying the current liabilities.

BCA's balance sheet shows \$725,000 in investment assets. BCA may be able to sell these investments to help pay the current liabilities. However, before management and the board decided to take that approach, they first need to determine whether there are any legal restrictions on how those investment assets can be used. Those funds might represent endowment provided by a donor, with the restriction that only income from the investments can be spent. Or, the funds might be funds advanced under a grant that can only be used to cover expenses from that grant. Management should know the limitations. Board members should be able to look to the footnotes to the financial statements to determine whether there are any restrictions.

Next on the balance sheet is inventory (\$594,234). If this were a manufacturing or retail business, the board would be interested in how quickly the inventory will be converted into cash. With a nonprofit, the inventory may be of goods that the nonprofit gives away (e.g. food) or sells at a substantial discount. Consequently, the inventory is may not be a source of cash. In fact, it might be viewed as just the opposite—something that requires more cash to replace as it is depleted. Whatever the case, the board should discuss how the inventory affects BCA's cash flow.

Getting the Most Out of the Financials Examples

Finally, there are prepaid expenses (\$634,342). These typically are amounts that have been paid in advance, like rent or insurance. Although these amounts don't represent cash that BCA will eventually receive, they do represent goods and services that do not require further cash expenditure. As part of the discussion, management and the board should consider whether prepaying expenses makes sense or whether the cash could be better used for other purposes (e.g. paying down bank debt). One factor that will play heavily into that discussion is the discount that BCA is receiving for prepayment. The details of this particular discussion are probably best assigned to management and the finance committee, which should report back to the board when it has recommendations.

B. EXAMPLE 2: WHAT ABOUT LOOKING AT LAND, BUILDING, AND EQUIPMENT?

The facts are the same as as Example 5 in the main discussion toolkit, but Gallagher now asks about how the land, building, and equipment affect liquidity.

By and large, the portion of the balance sheet reporting balances for fixed/physical assets is the least interesting aspect of the balance sheet. First, and foremost, the balances reflect historical cost (with an allowance for depreciation), which means that they may bear no relationship to current value. But of greater practical importance, BCA could sell its building or mortgage its land to raise cash to meet its current liabilities, but each of those actions is a major and involved one. Although selling its headquarters is one way to pay employee salaries, organizations don't routinely sell operating assets to pay recurring operating expenses. This does not mean that a discussion of long-term borrowing or asset sales is off limits, but that discussion is best undertaken as part of longer term planning efforts. It probably should start as a discussion between the finance committee and management until there are firm proposals.

C. EXAMPLE 3: IS THERE ANOTHER WAY TO MEASURE LIQUIDITY?

The facts are the same as Example 5 in the main discussion toolkit. Gallagher is still skeptical about devoting more meeting time to the financial statements, but she did notice that BCA lost \$366,781 last year, at least according to its income statement. Gallagher says, "I know I may be a financial neophyte, but we can't keep losing money like this forever.

In the long run, Gallagher is absolutely correct. The problem is that Gallagher is basing her conclusion on the income statement. She should focus her attention on the cash flow rather than accounting income. That means reviewing the statement of cash flows, which focuses on the nitty-gritty of cash in and out rather than abstract accounting income.

Unfortunately the statement of cash flows is complex and a seemingly indecipherable document when first examined. The average board member can easily cut through the complexity by examining just four numbers-- Net Cash Provided/Used by Operations (\$377,094); Net Cash Provided By/Used in Investment Activity -\$410,123); Net Cash Provided/Used)By Financing Activities

Getting the Most Out of the Financials Examples

+\$38,412); and the Net Increase in Cash(+ \$5,383). These four numbers will always sum to zero, which is evidence of a simple equation or relationship among them. The change in the cash balance can be explained (equals) as the sum of the cash provided/used by operations, financing activities, and investment activities. In BCA's case, the operations are producing cash (\$377,094.). Those funds are being used to finance the purchase of assets other than current ones (\$410,123). However, BCA had to borrow money to complete the purchases (\$38,412), but that was \$5,383 more than was necessary. That excess explains the \$5,383 increase in the cash balance that occurred this year.

All of the additional lines on the statement of cash flows explain the detail behind those four numbers. The board should be focused on at least three numbers. The first should be on the -\$447,594 adjustment for receivables. This number represents income that was reported in the income statement, but which has yet to be converted to cash. If those receivables are collected as expected, then they shouldn't pose a cash flow problem.

The second number worth noting is the \$599,103 entry for accounts payables owed to vendors. The statement of cash flows treats this number as an increase in cash flow, which at first is counter-intuitive. The statement of cash flows starts with net income and makes adjustments to convert it to cash flow. The \$599,103 is added back because it represents expenses that were not paid, but which were deducted from revenue in arriving at net income. However, this isn't magic. In the current period, the \$599,103 represents additional cash flow, but in a subsequent period, these payables will be paid with cash, and at that time will represent cash outflow. Both management and the board must ensure that there is cash available when the day of reckoning (i.e., payment of the payables) arrives.

One observation is in order before moving onto the third number: Notice the relationship between receivables and payables. BCA had a \$447,594 increase in receivables that was treated as a reduction when arriving at cash flow. At the same time, BCA had an increase of \$599,103 in payables that was treated as an increase when arriving at cash flow. This reflects a common cycle. Expenses are incurred and paid for on credit. When the receivables (for many CAAs, receivables equal amounts owed by the government for reimbursement requests) that were generated by the expenses are collected, the funds are used to repay the payables. Although it may be a coincidence, the fact that the increases in receivables and payable are almost equal is not surprising.

Management and the board should turn next to the section in reporting cash flow from financing activities. They should pay particular attention to the \$982,501 adjustment labeled cash overdraft. This raise at least two concerns: First, why is this entry referred to an overdraft? That suggests that this was not planned for and raises the possibility that BCA exceeded its available bank line of credit. Second, if BCA has to rely on bank credit to pay its bills as they became due, this may be an indication that it is not collecting its receivables on a timely basis or that its unreimbursed overhead is too high. There may be other explanations, but whatever

Getting the Most Out of the Financials Examples

the reason, both management and the board must understand exactly what is happening.

The statement of cash flows contains lots of other information, but this discussion illustrates how the board should use the statement. Management and the finance committee should be reviewing the other entries in greater detail.

D. EXAMPLE 4: IS THERE ANYTHING ELSE THE BOARD CAN USE TO MAKE THIS PROCESS EASIER?

The facts are the same as Example 5 in the main discussion toolkit. Whipple has grown tired with the BCA board's reluctance to meaningfully discuss BCA's finances. With that in mind, she asked Simpson to prepare some metrics that might make it easier for the board to understand BCA's finances. Seeing her opportunity, she passes out a piece of paper with the following numbers on it:

DEFENSIVE INTERVAL RATIO

$$\frac{\text{Cash } (\$258,390) + \text{Revenue Receivable } (\$4,406,070) + \text{Inventories } (\$594,234) + \text{Prepaid Expenses } (\$634,342)}{\text{Total Average Monthly Expenses } (\$29,499,681)/12}$$

The Defensive Interval ratio shows that if BCA received no other revenue, it could cover its average annual expenses for about 2.397 months or 72 days. Gallagher immediately asks Simpson what this number should be. There really isn't a "right" answer. For the prior year, the number was 2.44 months. Although there has been a slight increase, it represents about 1.3 days, which is not a very material change. Ideally, Simpson compiled this data for the last five or ten years. If the ten-year data shows that BCA's Defensive Interval ratio has remained relatively constant over time in terms of what goods and services BCA provides, that suggests that BCA's current operating model is functioning properly—but nobody should blindly accept that supposition as fact. On the other hand, if YCA's Defensive Interval Ratio has dropped to .2 or 6 days, management and the board should be concerned about a liquidity crisis.

Management and the board should not be too quick to congratulate themselves had the number jumped to 5 months. This might be a sign of inefficient cash management. The overarching point: Any material change in the number should lead to a thorough investigation.

If management is thorough, it will have built a database of financial data from similar CAAs, and that database will be used to develop baseline ratios for comparison. Assume, for example, that management has identified 25 similar agencies and that their weighted average Defensive Interval ratio is 5 months. Although the board need not necessarily discuss the reasons for the vast difference between BCA and the group, at some point the management and the finance committee should develop an understanding of why the difference exists and prepare a presentation to the board, with recommendations.

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Finally, a couple of notes about the calculations. The investment assets were not included because it was assumed that those assets were restricted. Inventories, however, were included because it was assumed that those assets could be sold. The calculation of expenses probably overstates expenses. It included depreciation, which is a bookkeeping entry rather than a cash expenditure. A good case can be made that depreciation should therefore not be included in total expenses for purposes of calculating this ratio.

LIQUIDITY RATIO

Cash (\$258,390) + Receivables (\$4,406,070) + Inventories (\$594,234)

Current Liabilities (\$5,169,447)

The liquidity ratio shows that BCA has 1.07 cents in current assets for every dollar of current liabilities. When long-term liabilities are taken into account, that number drops to 71.03 cents. There is nothing magic or inherently good about either of these numbers. For the prior year, BCA's liquidity ratio yielded 1.09 cents of current assets for every dollar of current liabilities. The relatively small change is probably not reason for concern, particularly if the results for the two years are consistent with the results for the last five or ten years.

Management and the board need to be particularly careful if they decide to calculate the ratio by also including long-term liabilities in the denominator. The ratio will be identical regardless of whether the long-term liabilities are due in two years or ten years, but a ten-year period certainly provides BCA with more time to raise the funds to repay the liabilities.

Accounts Payable Indicator

Accounts Payable (\$2,800,000)

Total Average Monthly Expenses (\$29,499,681)/12

The accounts payable indicator is at 1.14, which means slightly over one dollar of BCA's average monthly expenses are represented by accounts payable. The indicator was at 1.09 for the prior year, suggesting that BCA has not changed its reliance on vendors for financing. Once again, there is not a right or wrong number. The numbers only become meaningful when compared against long-term trends.

The question that both the board and management should be asking is whether the overdraft should be included in the calculation. A good case can be made that it should if the bank expects BCA to reduce its borrowing under its line of credit to the maximum level permitted under the agreement. The very fact that there is a cash overdraft and that it has grown by eight times last year's overdraft is a sign that BCA may be facing liquidity problems.

Efficiency Ratio

Program Expenses

Total Expenses

Assume that program or mission related expenses are 90% of total expenses. Gallagher is particularly pleased when she sees this number, proclaiming, "I am glad we waste so little money on needless overhead. I like seeing our money go to help people in need."

Many organizations and donors draw the same conclusions that Gallagher drew. The problem: This use of what are referred to as efficiency ratios results in largely meaningless conclusions. Spending 90% of every dollar of expense on mission guarantees nothing. BCA may be very inefficient in delivering its services, or its services may not be helping people. Spending 90% of every dollar of expense on teachers doesn't guarantee that the children are learning. Spending 90% of every dollar of expense on meals for the poor doesn't guarantee that the meals are nutritious. Spending 90% of every dollar of expense on housing doesn't guarantee that the housing is up to code, habitable, or crime-free.

Gallagher's view also mischaracterizes overhead, such as that incurred to run a human resources department or maintain an accounting system. An organization with high employee turnover or embezzlement is not one that is using its resources effectively. Overhead incurred by the CAA is just as much mission-related as providing food or housing. Organizational overhead directly affects whether expenses that carry a more obvious link to mission are being effectively deployed.

E.

F. **EXAMPLE 5: BUDGET VARIANCES CAN SHOW MORE THAN JUST SHORTFALLS**

The facts are the same as Example 4 in the main discussion toolkit. As the discussion of the after school child care and overtime problems are coming to an end, Max Weingard, another board member, pipes up, "What is going on with the insurance premiums? The budget variances show that we haven't paid any premiums this year. That could be a big problem if we have a fire or a theft." Weingard is absolutely right to raise this point. Cruz offers the following explanation: BCA pays its premium twice a year. The budgeted amount is 1/12 of the expected total premiums, but the actual column only reflects cash payments. For June, there will be a \$152,229 entry in the column for actual payments. Weingard objects, pointing out that the analysis is not only misleading, but will constantly show large variances from budget. He suggests that if this practice continues, there should at least be a footnote explaining the premium payment schedule.

LESSON: Weingard makes an excellent point. Anyone reviewing any financial schedule must understand the assumptions and conventions used in assembling and presenting the data. This is one reason the board should be reviewing financial data at each board meeting. It takes time and familiarity with the reporting system to understand the data produced by the system. That requires regular discussions.

Getting the Most Out of the Financials

Examples

Even financial professionals who earn their livings working with financial data will misunderstand schedules and data if they only work with them once a year.

Once Weingard understands the methodology in assembling the variance schedule, he is better equipped to ask the right question. In this case, Weingard might ask whether there is any indication that insurance premiums might head higher.

BCA STATEMENT OF FINANCIAL POSITION [BALANCE SHEET]¹

Assets	2009	2010
Current Assets		
Cash	\$253,007	\$258,390
Investments	\$725,000	\$725,000
Revenue Receivable	\$3,958,475	\$4,406,070
Inventories	\$245,709	\$594,234
Prepaid Expenses	<u>\$475,890</u>	<u>\$634,342</u>
Total Current Assets	\$5,658,081	\$6,618,036
Long-Term Assets		
Furniture	\$24,345	\$34,468
Land	\$102,345	\$102,345
Building	\$1,450,000	\$1,850,000
Grant-Funded Assets	\$3,245,469	\$3,245,469
Less Accumulated Depreciation	<u>(\$1,899,270)</u>	<u>(\$2,307,066)</u>
Total Long-Term Assets	\$2,922,889	\$2,925,216
Total Assets	\$8,580,970	\$9,543,252
Liabilities		
Current Liabilities		
Cash Overdraft	\$124,567	\$1,107,068

¹ For purposes of simplification, this financial statement does not classify assets as temporarily or permanently restricted, or unrestricted. However, many CAA statements will include such a classification system.

Getting the Most Out of the Financials Examples

Accounts Payable--Vendors	\$2,200,897	\$2,800,000
Accounts Payable-Others	\$42,100	102,034
Current Portion of LT Debt	\$25,000	\$25,000
Line of Credit	\$1,240,342	\$1,000,345
Unemployment Compensation Reserve	<u>\$245,890</u>	<u>\$135,000</u>
Total Current Liabilities	\$3,878,796	\$5,169,447
Long-Term Liabilities		
Notes Payable	\$256,789	\$356,900
Mortgage Payable (Less Current Portion)	<u>\$1,938,495</u>	<u>\$1,876,796</u>
Total Long-Term Liabilities	\$2,195,284	\$2,233,696
Total Liabilities	\$6,074,080	\$7,403,143
Net Assets	\$2,506,890	\$2,140,109

Getting the Most Out of the Financials Examples

BCA Statement of Activities [Income Statement]²

	Current Month	Year to Date	Annual Budget	% of Budget Realized	Prior Year Actual
Revenue					
Grant Revenue	\$1,800,000	\$22,405,222	\$23,500,000	95%	\$20,100,300
Program Service Fees	\$125,000	\$890,000	\$950,000	94%	\$1,234,897
Product Sales	\$250,000	\$4,200,000	\$4,000,000	105%	\$4,000,890
Interest Income	\$1,900	\$23,000	\$28,000	82%	\$22,890
Rental Income	\$31,000	\$375,000	\$375,000	100%	\$350,000
Contributions	\$150,000	\$450,678	\$500,000	90%	\$234,000
In-Kind	<u>\$80,000</u>	<u>\$789,000</u>	<u>\$725,000</u>	<u>109%</u>	<u>\$567,000</u>
Total Revenue	\$2,437,900	\$29,132,900	\$30,078,000	97%	\$26,509,977
Expenses					
Salaries and Wages	\$1,250,000	\$14,987,536	\$15,000,000	100%	\$10,345,673
Payroll Taxes and Fringe Benefits	\$250,000	\$2,956,789	\$3,600,000	82%	\$2,508,740
Interest Expense	\$20,000	\$243,630	\$238,000	102%	\$236,931
Legal and Professional	\$5,000	\$225,698	\$15,000	1505%	\$12,000
Cost of Goods Sold	\$200,000	\$3,700,891	\$3,200,000	116%	\$3,489,456
Depreciation	\$34,000	\$407,796	\$408,000	100%	\$390,768
Weatherization	\$100,000	\$650,000	\$650,000	100%	\$345,000

² For purposes of simplification, this income statement does not show comparison of actual expenses to budgeted expenses. However, a sample excerpt of this approach, which is recommended, is included in the next financial statement in this Appendix B.

Getting the Most Out of the Financials Examples

Materials					
Equipment Lease	\$8,250	\$98,976	\$50,000	198%	\$24,679
Property Taxes	\$3,630	\$43,567	\$42,000	104%	\$34,543
Office Supplies	\$7,500	\$76,578	\$75,000	102%	\$65,786
Communications	\$1,600	\$45,986	\$40,000	115%	\$21,567
Fundraising	\$5,000	\$8,658	\$7,500	115%	\$4,000
In-Kind Expenses	\$80,000	\$789,000	\$725,000	109%	\$567,000
Miscellaneous	<u>\$450,000</u>	<u>\$5,264,576</u>	<u>\$6,000,000</u>	<u>88%</u>	<u>\$6,167,567</u>
Total Expenses	\$2,414,980	\$29,499,681	\$30,050,500	98%	\$24,213,710
Net Income/Increase in Net Assets	\$22,920	(\$366,781)	\$27,500	-1334%	\$2,296,267

Getting the Most Out of the Financials

Examples

Getting the Most Out of the Financials Examples

2010

STATEMENT OF CASH FLOWS

Change in Net Assets

-\$366,781

ADJUSTMENTS TO RECONCILE CHANGE IN NET ASSETS TO NET CASH FROM OPERATIONS

Depreciation

\$407,796

(Increase) Decrease in:

Investments

\$0

Revenue Receivable

-\$447,595

Inventories

-\$348,525

Prepaid Expenses

-\$158,452

Increase (Decrease) in

Cash Overdraft

\$982,501

Accounts Payable--Vendors

\$599,103

Accounts Payable--Others

\$59,934

Current Portion of LT Debt

\$0

Line of Credit

-\$239,997

Unemployment Compensation Reserve

-\$110,890

NET CASH (USED) PROVIDED BY OPERATIONS

\$377,094

Getting the Most Out of the Financials
Examples

CASH (USED) PROVIDED FROM INVESTING ACTIVITIES

Purchase of Furniture	-\$10,123
Purchase of Land	0
Purchase of Building	-\$400,000
Purchase of Grant Funded Assets	0
CASH (USED) PROVIDED BY INVESTING ACTIVITIES	-\$410,123

CASH (USED) PROVIDED BY FINANCING

Increase in Notes Payable	\$100,111
Decrease in Mortgage Payable	<u>-\$61,699</u>
CASH (USED) PROVIDED BY FINANCING ACTIVITIES	\$38,412
Increase in Cash	\$5,383

Beginning Cash Balance	\$253,007
Ending Cash Balance	\$258,390
INCREASE IN CASH	\$5,383

Getting the Most Out of the Financials Examples

NOTE 1

The Organization is a nonprofit corporation that provides assistance to low-to-moderate income individuals and families in Blue County of the State of Apple. The Organization operates a variety of programs including, but not limited to, Head Start, child care services, family shelter, job training, energy assistance, low-income housing, senior recreation, and formula distribution programs. The Organization's programs are funded by various federal, state, and local grants, allocations, and private donations.

The Organization accounts for contract and grant revenue, which are exchange transactions, in the statement of activities to the extent that expenses have been incurred for the purpose specified by the grantor during the period. In accounting for such revenue, the legal requirements of each individual program are used as guidance. All funds not expended in accordance with the grant or contract are recorded as a liability to the grantor as the Organization does not maintain any equity in the grant or contract. Additionally, grant and contract funds received in advance of their proper usage are accounted for as deferred revenue in the statement of financial position.

NOTE 2

The Organization and Maple Dale Academy are in dispute over their services contract. On March 5, 2009, the Organization filed a lawsuit in the district court against Maple Dale Academy for breach of contract. The amount in dispute as of December 31, 2011 included in grant revenue and revenue receivable totals \$881,960. As of December 31, 2010, a settlement had not been reached, and the Organization's counsel has advised they expect this case to proceed to trial in Spring 2012. In April 2009, Maple Dale Academy counter-sued by expanding the dispute to include a total of \$2,995,828 in billings dating back to 1999. The Organization's counsel has advised their evaluation of the outcome is that it is probable that the Organization will prevail. Accordingly, no provision for losses from this lawsuit has been made in these financial statements

Getting the Most Out of the Financials
Examples

NOTE 4

Inventories as of December 31, 2009 and December 31, 2010 consist of the following:

Description	December 31, 2009		June 30, 2010	
Weatherization Materials	\$ 55,192		\$ 35,482	
WIC Formula Warehouse	530,860		301,348	
Total Inventories	\$ 586,062		\$ 336,830	

NOTE 8 - UNEMPLOYMENT COMPENSATION RESERVE

Effective January, 2004 the Organization elected to reimburse the State of Apple Unemployment Compensation Fund for actual unemployment compensation claims paid. For the years ended December 31, 2009 and December 31, 2010, contributions were made to the reserve at the statutory rate. When employees receive unemployment compensation, the Unemployment Compensation Fund is reimbursed for the amount of the payment and the Organization's unemployment compensation reserve is reduced accordingly. To obtain this method of providing for unemployment compensation, the Organization was required by the state to put up as collateral a passbook savings account which has been pledged to the state. The balance in the savings account at June 30, 2009 and 2010 is \$36,343 and \$36,343 respectively. The balance of the Organization's unemployment compensation reserve at June 30, 2009 and 2010 is \$245,890 and \$135,000, respectively. [NOTE TO TOOLKIT READER--These numbers may not reflect what an organization with this size payroll would be required to pay into the fund. The larger point, however, is an important one: The footnotes reveal important information.]

NOTE 9 - LONG TERM DEBT

.....Maturities of long-term debt for each of the next five years are as follows:

Year Ended	
June 30, 2011	\$ 15,347
June 30, 2012	\$16,828
June 30, 2013	\$18,453
June 30, 2014	\$20,233

**Getting the Most Out of the Financials
Examples**

June 30, 2015	\$22,107
Thereafter	\$2,140,728

NOTE 13 - PERMANENTLY RESTRICTED ASSETS

Permanently restricted net assets represent \$334,128 in funding received from the the State of Apple Department of Human Services to purchase the initial WIC formula inventory. These funds are permanently restricted for inventory.

NOTE 18 - LINE OF CREDIT

The Organization has available an unsecured line of credit of \$1,833,333 at the Ten Spot Bank, which is tied to LIBOR. The rate at December 31, 2010 was 7.79%. The balance as of December 31, 2009 and December 31, 2011 was \$1,240,342 and \$1,000,345 respectively. The Organization also had overdrafts on the line of credit of \$124,567 and \$1,107,068 as of December 31, 2009 and December 31, 2011, respectively. The Ten Spot Bank is working with the Organization to restructure its existing line of credit to address the overdraft.

INDEPENDENT AUDITOR'S UNQUALIFIED OPINION

TO: THE BOARD OF DIRECTORS

We have audited the accompanying statements of financial position of Blue Community Action Agency (BCA) as of December 31, 2009 and December 31, 2010 and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of BCA's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of BCA as of December 31, 2009 and December 2010, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued a report dated January 25, 2001 on our consideration of BCA's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of this report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

Our audit was performed for the purpose of forming an opinion on the basic financial statements of BCA taken as a

Getting the Most Out of the Financials Examples

whole. The accompanying schedule of expenditures of federal awards on pages 32 to 39 [NOTE TO TOOLKIT READER: This is not included in this appendix] is presented for purposes of additional analysis as required by the U.S. Office of Management and Budget Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

Signed Auditor

APPENDIX A Exhibit Supplemental Examples

Sample Excerpt from BCA Statement of Activities Showing Budget Variances

Category	Actual Feb.	Budget Feb.	Variance	%	Actual	Budget YTD	Variance	Percentage
Grant Revenue	\$2,700,000	\$3,200,000	-\$500,000	-15.63%	\$6,100,000	\$6,000,000	\$100,000	1.67%
Program Serv. Fees	\$15,000	\$25,000	-\$10,000	-40.00%	\$30,000	\$50,000	-\$20,000	-40.00%
Product Sales	\$200,000	\$400,000	-\$200,000	-50.00%	\$375,000	\$800,000	-\$425,000	-53.13%
Contributions	\$10,000	\$8,000	\$2,000	25.00%	\$20,000	\$12,000	\$8,000	66.67%
Salaries and Wages	\$1,643,222	\$1,100,250	\$542,972	49.35%	\$3,200,435	\$2,300,035	\$900,400	39.15%
Payroll + Fringe Ben.	\$425,007	\$300,000	\$125,007	41.67%	\$957,453	\$600,000	\$357,453	59.58%
Rent	\$105,000	\$100,000	\$5,000	5.00%	\$210,000	\$200,000	\$10,000	5.00%
Weatheriz. Materials	\$150,000	\$100,000	\$50,000	50.00%	\$250,000	\$200,000	\$50,000	25.00%
Insurance Premiums	\$0	\$25,383	-\$25,383	-100.00%	\$0	\$50,766	-\$50,766	-100.00%

APPENDIX B

Statement of Cash Flows

PREFACE

This example is based on the sample statement of cash flows included at the end of this appendix.

Throughout the discussion, we will offer explanations of what the numbers *might* mean. Those explanations are meant to illustrate some of the issues and information that a board can discover through a systematic examination of the statement of cash flows. We don't, however, know the underlying facts that gave rise to the numbers. At best, we can identify possible inferences and speculate. To do more would require much more knowledge and an opportunity to discuss matters with the CAA's management.

The Statement of Cash Flows, An Example

At the end of this exhibit is a Statement of Cash Flows for a Community Action Agency (CAA) that we will refer to as YCA. This is a fictional agency. Financial managers will understand how to use this statement, but many board members will be puzzled by it. Here is how the board should approach the statement.

STEP 1: START WITH PART I. Ignore every line except Line 16, which indicates that the YCA's operations consumed (net outflow) \$166,879 in cash. Obviously this cannot go on forever. The question that the board should be asking is a simple and obvious one: How did YCA cover or fund its cash loss from operations?

STEP 2: GO TO PART II. One answer to the first question might be that YCA sold assets to fund its operating cash flow deficit. That looks like a possibility. After all, YCA generated cash by selling investments (\$2,315), land (\$112,500) and a building (\$356,138). However, YCA also purchased or constructed leasehold improvements (\$1,250,000) and purchased vehicles (\$86,760). We have no knowledge regarding YCA other than the numbers presented in the statement of cash flows. However, just by looking at that statement, we suspect that YCA probably sold its headquarters this year and leased a new facility to meet its space needs. Overall, YCA spent more on new investment assets than it raised by selling the old ones, which means YCA did not cover its operating cash flow deficit through sales of assets it held for investment. Remember, investment assets are not limited to stocks and bonds, but also include equipment, land, real estate, and any other assets that are not current assets.

STEP 3: GO TO PART III. YCA has to be coming up with the money to finance its operations and purchase of investments assets either through its internal cash balances or by borrowing from third parties. We know this because the statement of cash flow is nothing more than an equation where equality must be maintained. Part III demonstrates that fact. YCA increased its net borrowings by \$577,842, which represents cash that could be used to finance its operating cash flow deficit (-\$166,879) and investment activity (-\$865,807). What should be obvious is that the \$577,842 in new funds from borrowing doesn't fully cover the operating deficit and the net expenditures on investment assets. There is a \$454,844 shortfall. If we turn to Part IV, we see that the YCA's cash balance decreased by \$454,844 as a result of taking in less cash (from all sources- operations, investing, and financing) than it paid out.

STEP 4: ASSESSING THE STATEMENT. The fact that the change in the four balances sums to zero is not a coincidence. The changes in Parts I, II, and III must always equal the change in Part IV. If YCA's operations had generated cash, its statement of cash flow would explain what YCA did with that cash. In the aggregate, it would have either used that cash to pay down debt, buy investment assets, or increase its internal cash holdings.

STEP 5: ASKING THE RIGHT QUESTION. The financial neophyte who is a member of the board may be puzzled how the statement of cash flow is assembled, but YCA's statement of cash flow raises an important and obvious question if the board member simply takes the time to examine the four numbers that we have already examined: Was YCA's operating deficit a one-time event or is there a structural problem that will cause YCA to continue to have operating deficits? At this point, the board need do no further heavy lifting in terms of reading this statement. It can turn to management and ask for a complete explanation.

STEP 6. PUSHING THE ENVELOPE. If the board is willing to examine the details in Part I, it may be able to better understand the potential problem that YCA faces. Line 15 in the statement jumps out--deferred revenue. The meaning of the term "deferred" revenue isn't exactly clear from the face of the statement. In all likelihood, the deferred revenue represents the excess of funds advanced, but that have not yet been earned. The number in the statement of cash flows is not the balance for deferred revenue, but the change in the balance from last year to this year. In this case, the number is a negative number, which means that YCA is viewed as having used cash to reduce these advances. Looked at differently, YCA recognized \$873,178 of revenue this year, but there was not a corresponding receipt of cash this year. The cash was received last year. The change in its accounts payable was negative, which means YCA used cash to reduce its accounts payable.

APPENDIX B Exhibit

Statement of Cash Flows

		LINE NUMBER
	CASH FLOW FROM OPERATIONS	
	Change in Net Assets	\$257,743 1
	Depreciation Expense	\$498,385 2
		3
	(Increase)/Decrease In:	4
	Grants/Contracts Receivable	\$6,545 5
	Accounts Receivable	\$170 6
	Prepaid	\$51,338 7
PART I	Inventory	\$58,593 8
	Deposits, reserves and custodial	(\$49,763) 9
		10
	Increase/(Decrease) In:	11
	Accounts Payable	(\$151,435) 12
	Accrued Expenses	\$23,168 13
	Wages Payable	\$11,555 14
	Deferred Revenue	(\$873,178) 15
	Net Cash Used by Operations	(\$166,879) 16
		17
	CASH FLOWS FROM INVESTING ACTIVITIES	18
	Investments	\$2,315 19
	Land	\$112,500 20
PART II	Building	\$356,138 21
	Leasehold Improvement	(\$1,250,000) 22
	Vehicles	(\$86,760) 23
	Net Cash Used by Investing Activities	(\$865,807) 24
		25
	CASH FLOWS FROM FINANCING ACTIVITIES	26
PART III	Increase in Long-Term Debt	\$1,625,000 27
	Paydowns on Long-Term Debt	(\$1,047,158) 28
	Net Cash Provided by Financing Activities	\$577,842 29
		30
	NET DECREASE IN CASH	(\$454,844) 31
		32
		33
		34
	Beginning Cash Balance	\$1,201,035 35
PART IV	Ending Cash Balance	\$746,191 36
	Net Change in Cash Balance	\$454,844 37

APPENDIX C

Sample Statements of Activities

All Good Things

Statement of Activities

Quarter Ending 9-30-10

	1st Quarter	Annual Budget	% Budget Realized	Projected Year End
Unrestricted Support & Revenues				
Foundation and corporate grants	\$ 5,000	\$ 30,000	0.17	20,000
Governmental grants & contracts	140,000	630,000	0.22	620,000
Contributions from individuals	15,000	60,000	0.25	50,000
Events net of expenses	5,000	50,000	0.10	50,000
Investment income	1,300	5,000	0.26	3,000
	<u>166,300</u>	<u>775,000</u>	<u>1.00</u>	<u>743,000</u>
Net assets released from restrictions	140,000	225,000	0.62	225,000
Total support and revenue	<u>306,300</u>	<u>1,000,000</u>	<u>0.31</u>	<u>968,000</u>
Unrestricted Expenses				
Personnel	200,000	720,000	0.28	700,000
Prof Services	35,000	40,000	0.88	40,000
Occupancy	11,300	45,000	0.25	45,000
Other expenses	50,000	170,000	0.29	165,000
Total Unrestricted Expenses	<u>296,300</u>	<u>975,000</u>	<u>0.30</u>	<u>950,000</u>
Increase in Unrestricted Net Assets	<u>10,000</u>	<u>25,000</u>	<u>0.40</u>	<u>18,000</u>
Temporarily Restricted Support				
New TR Grants Received	290,000	360,000	0.81	325,000
Released from Temp Restrict	(140,000)	(225,000)	0.62	-225,000
Increase in TR Net Assets	<u>150,000</u>	<u>135,000</u>	<u>1.11</u>	<u>100,000</u>
Increase in Total Net Assets	<u>160,000</u>	<u>160,000</u>	<u>1.00</u>	<u>118,000</u>

Sample Nonprofit
Statement of Activities by Function
for the period 7-1-10 - 9-30-10

	7/1/08 thru 9/30/08	Admin	Fund Raising	Prog X	Prog Y	Prog Z
Unrestricted Support and Revenues						
Foundation grants	5,000		5,000			
Government contracts	140,000				60,000	80,000
Individual gifts	15,000		15,000			
Events net of expenses	5,000		5,000			
Investment Income	1,300		1,300			
Released from Temp Restrictions	140,000		40,000	28,000	40,000	32,000
Total Unrestricted Support and Revenue	306,300	0	61,300	33,000	100,000	112,000
Direct Expenses		0.20	0.10	0.10	0.25	0.35
Personnel	200,000	40,000	20,000	20,000	50,000	70,000
Prof Services	35,000	15,000			10,000	10,000
Supplies	5,000	500	1,000	500	2,000	1,000
Other expense	15,000	2,000	3,000	1,000	3,000	6,000
Sub-total Direct Expenses	255,000	57,500	24,000	21,500	65,000	87,000
Excess Support & Revenue over Direct Expenses	51,300	-57,500	37,300	11,500	35,000	25,000
Allocated Expenses						
Occupancy	11,300	2,260	1,130	1,130	2,825	3,955
Depreciation	30,000	6,000	3,000	3,000	7,500	10,500
Sub- total Allocated Expenses	41,300	8,260	4,130	4,130	10,325	14,455
Direct and Allocated Expenses	296,300	65,760	28,130	25,630	75,325	101,455
Allocation of Admin Expenses	0	-65,760	8,024	7,311	21,486	28,939
Expenses after Allocation of Administrative Expense	296,300	0	36,154	32,941	96,811	130,394
Excess (deficit) of Support & Rev over Total Expenses	10,000	0	25,146	59	3,189	-18,394

SECTION 5

Dealing with Conflicts of Interest

APPENDIX A

Sample Conflict of Interest Policies

Appendix A: Sample Conflict of Interest Policies

The following are links to conflicts of interest [and procurement] policies that nonprofits have posted to the web. CAAs will benefit most by examining these policies to see the ways that organizations approach the different issues posed in designing and implementing any conflicts of interest policy.

CAPLAW Model Conflicts of Interest Policies

<http://www.caplaw.org/modelpolicies.html>

Board Source Managing Conflicts of Interest: A Primer for Nonprofit Boards (for purchase)

By: Daniel L. Kurtz, Sarah E. Paul

<http://www.boardsource.org/Bookstore.asp?Item=182>

Board Source Downloadable Policy Samplers (for purchase)

<http://www.boardsource.org/Bookstore.asp?Type=epolicy>

Blue Avocado Nonprofit Conflict of Interest: A 3-Dimensional View/Samples

<http://www.blueavocado.org/node/545>

Independent Sector Panel on the Nonprofit Sector and

<http://www.nonprofitpanel.org>

Independent Sector Resource Center for Good Governance and Ethical Practice

http://www.independentsector.org/governance_ethics_resource_center

Internal Revenue Service Sample Conflict of Interest Policy

<http://www.irs.gov/instructions/i1023/ar03.html>

National Council of Nonprofits Conflict of Interest Policies/Samples

<http://www.councilofnonprofits.org/conflict-of-interest>

APPENDIX B
Sample Annual Disclosure
Questionnaire

Sample Annual Disclosure Questionnaire

ANNUAL CONFLICTS-OF-INTEREST DISCLOSURES FOR COMMUNITY ACTION AGENCIES

NOTE TO USERS: This document was designed to be a comprehensive questionnaire—even then several possible areas of inquiry were omitted. If you believe a question is too intrusive or the coverage is too detailed, your organization should modify the questionnaire.

NAME: (Please Print your Name) _____

REASON FOR POLICY. Conflicts of interest raise governance, tax, and regulatory issues for community action agencies. They also raise concerns in the mind of public and members of the media, potentially undermining the Organization’s reputation and good standing. For these reasons, the Organization’s officers, directors, and key employees should avoid conflicts of interest, disclose ethical, legal, financial, and other such conflicts, and remove themselves from a position of decision-making authority if they would otherwise be called on to act on a conflict involving themselves.

REASON FOR THE QUESTIONNAIRE. The Organization’s board of directors is committed to the highest ethical standards in how the Organization conducts its business and operations. An annual questionnaire helps the board and management identify and evaluate situations and relationships that could be problematic to the Organization, including ones that could jeopardize its tax-exempt status or ability to obtain grants or other funding.

WE ASK FOR YOUR COOPERATION. The questionnaire should take no more than five to ten minutes for most people to complete. It asks intentionally broad questions, with the hope of identifying all relevant transactions. Please do not view it as intrusive or invasive. The information will be shared with others only on a “need-to-know” basis. If you do have privacy concerns, please speak with your immediate supervisor, the Head of Human Resources, or the Executive Director.

IDENTIFYING A CONFLICT OR RELATIONSHIP DOES NOT NECESSARILY MEAN THERE IS A PROBLEM. In some instances, you may need to reveal a conflict or a relationship when responding to a question. This does not necessarily mean that you have done something improper or violated the Organization’s conflicts-of-interest policy. As just one example, if your spouse works as a repairperson for a utility that provides electrical services to the Organization you should indicate so, but that sort of relationship should not be a problem.

By identifying all relationships, you permit the board and management to make an informed judgment, further permitting them to address the issues through appropriate action or safeguards. Being forthright now is the best approach.

COMPLETING THE QUESTIONNAIRE. Each director, officer, and key employee (a covered person) is required to complete and sign this questionnaire annually. **[CAAs with Head Start programs should include members of the policy council].** You should base your answers on facts that either exist now, or that have arisen since you last completed the annual questionnaire. All answers should be to the best of your knowledge. If you need additional space when responding, please attach additional sheets of paper with the question numbers and your responses.

Immediate family members include the following persons: a spouse, parents and grandparents, children and grandchildren, brothers and sisters, in-laws, brothers- and sisters-in-law, daughters- and sons-in-law, and adopted and step family members.

1. **RELATIONSHIP WITH OTHER COVERED PERSONS.** Are any members of your *immediate family* members of Organization's board of directors, or officers or employees of the Organization?

☐ Yes ☐ No

If yes, then identify the immediate family member and his or her position with the Organization.

2. **DOING BUSINESS WITH THE ORGANIZATION.** Do you or any members of your *immediate family* do any business with the Organization? Doing business includes, but is not limited to, selling goods and services to, renting property, or lending money to the Organization.

☐ Yes ☐ No

If yes, then identify the immediate family member and the nature of the business.

3. **OWNERSHIP OR EMPLOYMENT WITH ORGANIZATION'S DOING BUSINESS WITH THE ORGANIZATION.** Do you or an *immediate family* member have a financial interest in or employment relationship with a business organization that does business with the Organization?

☐ Yes ☐ No

If yes, then identify the other organization and the financial interest or employment relationship and who has it.

4. **OTHER.** Are there any other relationships or facts that could cause you to act in a matter that is adverse to or not in the best interests of the Organization or its mission?

___Yes ___No

If yes, then describe the nature of those relationships or facts and why they pose a potential conflict or problem.

5. **CERTIFICATIONS.** I have received a copy of the Organization's conflicts-of-interest policy; I have read and understand it; and I agree to abide by it.

___Yes ___No

If no, explain.

To the best of my knowledge, my responses to this questionnaire are true, complete, and accurate.

Date: _____

Signature: _____

SECTION 6

Adopting a Whistleblower Policy

APPENDIX A

Sample Whistleblower Policies

Sample Whistleblower Policies

The following are links to whistleblower policies that nonprofits have posted to the web. CAA's will benefit most by examining these policies to see the ways that organizations approach the different issues posed in designing and implementing any whistleblower policy.

CAPLAW Model Combined Complaint Resolution/Whistleblower Policy for CAAs/Head Start Grantees

<http://www.caplaw.org/documents/ComplaintPolicy-2008.doc>

American Institute of CPAS (AICPA) Sample Whistleblower Policy and Tracking Tool in AICPA Not-for-Profit Audit Committee Toolkit Downloads Part III: Audit Committee- Internal Control and Internal Audit

<http://www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/Resources/NotForProfitResourceCenter/Pages/AICPANot-for-ProfitAuditCommitteeToolkit.aspx>

Blue Avocado Model Whistleblower Policy for Nonprofits

<http://www.blueavocado.org/content/model-whistleblower-policy-nonprofits>

Cumberland Community Action Program Anti-Fraud Policy and Procedure

<http://www.ccap-inc.org/anti-fraudpolicy09.pdf>

Epilepsy Foundation Whistleblower Policy /Policy on Reporting and Investigating Allegations of Suspected Improper Activities

<http://www.epilepsyfoundation.org/aboutus/whistleblower.cfm>

Inland Regional Center Whistleblower Policy

<http://inlandrc.org/wp-content/uploads/2011/05/whistleblowerletter.pdf>

Kimmel Housing Development Foundation Whistleblower and Protected Disclosure Policy

http://kimmelhousing.org/resources/KHDF_Whistleblowing_Policy.pdf

Missouri Ozarks Community Action Personnel Policy, See Section V. Standards of Conduct

<http://www.mocaonline.org/PDF/PERSONNEL%20POLICY%20MANUAL%202009.pdf>

National Council of Nonprofits Whistleblower Protection Policies/Samples

www.councilofnonprofits.org/resources/resources-topic/boards-governance/whistleblower-protection-policies

Nonprofit Risk Management Association Whistleblower Protections in the Nonprofit Sector/Sample

www.nonprofitrisk.org/library/articles/employment091005.shtml

SIEDA Community Action Whistleblower Policy

<http://www.sieda.org/Complaints-Fraud.htm>

St. Bede's School Pupil Safeguarding and Welfare (Child Protection) Policy

<http://www.stbedesschool.org/assets/3--pupil-safeguarding-and-welfare-policy-oct-2010.pdf>

West Central Community Action Agency Whistleblower Policy

<http://www.westcentralca.org/Whistleblower.html>

APPENDIX B

Whistleblower Online Resources

Whistleblower Online Resources

The following are websites that users of this toolkit may find helpful. CAPLAW offers these websites as resources that might be of interest, but does not warrant the accuracy of the information presented, nor does it endorse the sample policies or any products or services offered by these organizations.

Association of Certified Fraud Examiners (ACFE)

ACFE's biennial surveys of fraud examiners that demonstrate the importance of whistleblower policies in any program designed to curb fraud. <http://www.acfe.com>

Government Accountability Project (GAP)

GAP is a nonprofit organization that promotes corporate and government accountability. It receives funding from the Carnegie Foundation, the Ford Foundation, and the Rockefeller Family Fund, among other donors. This site addresses issues that go far beyond the ones that are of concern to nonprofits, but much of the material should be of interest to CAAs. <http://www.whistleblower.org>

Independent Sector Panel on the Nonprofit Sector

Independent Sector convened a panel of national nonprofit leaders to develop recommendations to improve the governance of nonprofit entities. The Panel's final report, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundation* and supplemental materials address the importance of whistleblower policies. <http://www.nonprofitpanel.org>

Internal Revenue Service Whistleblower Office

The IRS allows anyone to file a report alleging violations of federal tax laws. This website explains program details and how to file a claim. <http://www.irs.gov/irs/article/0,,id=179207,00.html>

National Conference of State Legislatures (NCSL)

NCSL maintains a website listing whistleblower laws on a state-by-state basis. The listing includes a citation, coverage, and a brief summary of the provisions. The list was compiled in 2005 and was updated in November 2009. In several cases, the citations are out of date, but the list is a good starting point for identifying whistleblower laws for a particular state. <http://www.ncsl.org/?tabid=13390>

Taxpayers Against Fraud

Taxpayers Against Fraud is a nonprofit organization that maintains a website providing information about Federal False Claim Act and *qui tam* litigation. <http://www.taf.org>

United States Department of Labor

This site includes compliance materials prepared by the DOL and other agencies and a list of applicable federal laws and regulations pertaining to whistleblowers. <http://www.dol.gov/compliance/laws/comp-whistleblower.htm>